

Research Department
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No Double Digits?

Some pessimistic analysts argue that inflation will approach double-digit figures again in 1977, as underlying cost and capacity pressures in manufacturing industries push upward against the price indexes. In contrast, the consensus forecast is that inflation rates will remain in the neighborhood of 5-6 percent during the year. According to this line of thought, strong cost-push and capacity pressures may arise in a number of industries—especially the basic materials industries—but these conditions will not be pervasive enough throughout the economy to push the overall inflation rate to the double-digit level.

Prices rose at a slower pace in the first half of 1976 than at any time since 1972, when wage and price controls hid the actual cost pressures underlying the economy. The GNP deflator, the broadest measure of price change, rose at a 3.2-percent annual rate during the January-March quarter and at a 4.7-percent rate during the April-June period—quite moderate rates in the context of the past several years. The unexpectedly low first-quarter figure reflected declines in food and energy prices, and the second-quarter rise came about as food prices rose again and energy prices leveled off.

The wholesale price index obviously decelerated during the first half of this year. Industrial commodities, which account for more than three-fourths of the total index, rose at a 3.0-percent annual rate during the recessionary first half of 1975 and at

a 9.4-percent rate during the early-recovery period of second-half 1975, but the rate then decelerated to 3.4 percent as the recovery continued over the first half of 1976. At wholesale, consumer food prices actually declined at a 3.6-percent rate over the past half-year, and finished non-food consumer goods prices rose at only a 1.4-percent rate—thereby indicating considerably reduced pressures on retail consumer prices. And despite highly publicized price increases in certain industries, such as steel and nonferrous metals, countervailing forces in other industries have acted to moderate the overall rate of inflation in industrial prices.

Moderate labor pressures

Reductions in labor cost pressures help account for these favorable developments. Unit labor costs in manufacturing, which rose sharply during the recession, have declined at a 2.6-percent annual rate since the early-1975 trough in business activity. By now the trend is upward again, but even so, the annual rate of increase in the second quarter of this year amounted to only 3.2 percent—just a fraction of the increases recorded in 1974 and early 1975.

This improvement can be traced to solid growth in productivity, with hourly manufacturing output per worker rising at a 10.3-percent annual rate since the spring 1975 recession low. Although productivity growth has recently slowed, output per hour still rose at an annual rate of 7.8 percent during the second

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quarter—far higher than both the strong first-quarter pace and the long-term trend of productivity growth.

Labor-settlement increases during the recovery meanwhile have decelerated, holding down the rate of increase in hourly compensation. When 1976 opened, large settlements seemed in prospect as organized labor sought to compensate for the prior decline in its real wages attributable to sharply rising living costs. Moreover, the likelihood of strong cost-push pressures seemed particularly great, in that major contracts covering 4.4 million workers were up for renegotiation, compared with the 2.5 million involved in 1975 contracts.

As it turned out, contracts negotiated in the second quarter called for first-year wage increases averaging 8.2 percent, somewhat less than the settlements reached during the first quarter and far less than the 10.2-percent first-year rise granted in contracts negotiated during 1975. Despite the “uncapped” cost-of-living escalator in the new Teamsters contract, that settlement and the equally important electrical-workers settlement set a relatively moderate pattern, which may be copied in the autoworker and other important upcoming contract negotiations. Apparently, with inflation decelerating, fewer pressures have arisen for big wage settlements and—another aspect of this beneficent spiral—fewer automatic wage increases have resulted from slowly rising price indexes.

Moderate capacity pressures

Capacity restraints still represent little threat to the overall price level. By the second quarter of this year, the rate of capacity utilization in the manufacturing sector had risen to 73 percent—substantially above the cyclical low of 67 percent but still more than 10 percentage points below the peak reached in 1973, when shortages and production delays generated intense upward price pressures. In the materials industries, the operating rate was somewhat higher on average—81 percent—with some industries such as paper and steel producing at around 90 percent of effective capacity. But the overall operating rate for this group of industries was also well below the prior peak of 93 percent reached in 1973, and several industries—such as copper—were known to be operating well below the group average.

Nonetheless, the potential does exist for significant price increases in those industries where market conditions will be strong enough to support higher prices, and where a higher rate of return is required to finance necessary expansion in plant and equipment. Many firms are still trying to overcome financial problems generated by the recession. The basic materials industries, especially the metals, were among the hardest hit during the recession, because the demand for their products was adversely affected not only by a slowdown in consumption but also by a huge wave of inventory liquidation. For example, steel-mill product shipments

dropped 28 percent during 1975, and nonferrous metals experienced similar declines.

Despite an appreciable deceleration in cost increases during 1975, these industries were still unable to improve their profit margins or rates of return on investment, and the slippage for some continued into 1976. During the first quarter of 1976, profits per dollar of sales in primary-metals industries were only 3.5 cents, while their return on stockholders' equity was only 7.1 percent—in both cases, less than one-half the levels reached in mid-1974. The recent series of price increases in steel and nonferrous metals thus can be understood in terms of their attempt to recover from a severe profit squeeze.

More action in '77?

Looking towards 1977, industry observers visualize a rise in the cost of some basic materials such as steel, and consequently a rise in the price of many manufactured goods in which those materials are utilized. This does not mean, however, that the overall inflation rate will accelerate significantly next year. To date, supply conditions in only a few manufacturing industries seem tight enough to generate bottleneck pressures over the next year or so, while the outlook is also favorable for significant labor productivity growth, ample food supplies and relatively stable energy prices.

Private nonfarm productivity should continue rising at a good

pace—especially if capital-goods production begins to pick up, forestalling incipient capacity pressures and boosting the rate of real economic growth. In fact, the behavior recorded during comparable stages of previous recoveries suggests that the growth of private nonfarm productivity should continue to exceed the long-term trend value of 2-3 percent for several more quarters. Eventually, as the recovery matures, productivity growth could moderate, but with labor compensation rising slowly as it has this year, increases in unit labor costs should not rise much beyond recent bounds.

Increases in farm-product prices also may be held to a relatively low rate. Despite drought conditions in certain parts of the nation, total supplies of grain and other crops should be ample to meet demand, even if exports remain strong. Similarly, large supplies of livestock could help hold prices down in that commodity group. In view of the OPEC cartel's recent decision to hold prices stable throughout 1976, energy prices also may increase at a relatively slow pace.

In summary, given the present lack of bottlenecks and the moderate pace of activity in the U.S. economy, cost pressures may continue to remain relatively weak. Thus, it seems difficult to make a case for a resurgence in 1977 of the double-digit inflation rates witnessed during the 1973-74 period—unless pressures are generated in the rest of the world through the higher cost of internationally traded goods.

Yvonne Levy

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/21/76	Change from 7/14/76	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	88,577	- 264	+ 2,959	+ 3.46
Loans (gross, adjusted)—total	66,685	- 207	+ 2,491	+ 3.88
Security loans	1,411	- 48	+ 728	+106.59
Commercial and industrial	21,984	- 194	- 1,132	- 4.90
Real estate	20,211	+ 45	+ 606	+ 3.09
Consumer instalment	11,266	+ 48	+ 1,243	+ 12.40
U.S. Treasury securities	9,607	- 41	+ 1,268	+ 15.21
Other securities	12,285	- 16	- 800	- 6.11
Deposits (less cash items)—total*	89,520	- 484	+ 4,807	+ 5.67
Demand deposits (adjusted)	24,945	- 852	+ 1,880	+ 8.15
U.S. Government deposits	574	+ 314	+ 318	+124.22
Time deposits—total*	62,289	- 256	+ 2,243	+ 3.74
States and political subdivisions	6,012	- 103	- 486	- 7.48
Savings deposits	26,450	+ 96	+ 5,682	+ 27.36
Other time deposits‡	27,237	- 168	- 1,770	- 6.10
Large negotiable CD's	12,070	- 343	- 3,333	- 21.64
Weekly Averages of Daily Figures	Week ended 7/21/76	Week ended 7/14/76	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves	- 18	46	-	1
Borrowings	1	3		6
Net free(+)/Net borrowed (-)	- 19	+ 43	-	7
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales (-)	+ 92	+ 845		+ 1,462
Transactions of U.S. security dealers				
Net loans (+)/Net borrowings (-)	+ 259	+ 679		+ 223

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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