

Research Department
Federal Reserve
Bank of
San Francisco

January 20, 1978

Real Wages

Part of our current malaise can be traced to the fact that workers in recent years have recorded much smaller wage gains — after paying for inflation — than they did in the first half of the post-World War II period. Between 1947 and 1962, the real hourly earnings of nonsupervisory workers in the private nonfarm economy (adjusted for overtime and interindustry-employment shifts) increased at a 2.5-percent average annual rate. Between 1962 and 1976, in contrast, the advance averaged only 1.2 percent annually — and the 1977 figure seemed to be about the same.

Over the long term, American workers have experienced numerous periods of slow growth in real wages. Moreover, according to H.M. Douty, the long-run trend was below 2 percent a year prior to World War I (August 1977 *Monthly Labor Review*). Yet in good times and bad, the historical trend has fostered expectations of continued gains in real wages, and hence in living standards, among the working population.

Expected: higher wages

The difference between this and earlier generations, however, is the increasing institutionalization of such expectations. Workers eventually began to perceive real wage gains as accruing regularly, with a close relationship to a measurable trend in national productivity. This expectation was formalized in the path-breaking 1948 contract between General Motors and the United Automobile Workers. The agreement provided for an

annual wage increase of about 2 percent, together with a cost-of-living escalator clause, to assure the GM worker "that the buying power of his hour of work will increase as the nation's industrial efficiency improves."

The highly favorable real-wage experience during the first half of the postwar period created expectations that these gains would continue, institutionalized as they were under GM-type agreements throughout the economy. But these expectations could not be realized in the past decade and a half, at least for workers generally, because underlying gains in productivity gradually lessened in size. At the same time, the upward movement of consumer prices after 1966 threatened to erase further gains in real wages or even to lower living standards. Thus, union leaders increasingly began to push for cost-of-living factors to accompany those annual money-wage adjustments which, given a weakening trend in productivity, were not fully sustainable in real terms.

Needed: more productivity

Because rising real wages depend so closely on continued improvements in productivity, a return to the strong real-wage trend of 1947-62 evidently requires a return to the high trend rate of hourly output attained during that same period. Output per hour increased at a 3.1-percent average annual rate in the private business sector over the 1947-62 period, but at only a 2.1-percent annual rate over the 1962-76 period. (Last year's gain apparently fell in the same low range.) The sluggish

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F R B S F Weekly Letter

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growth of the past decade and a half reflected (in particular) the slowdown in the shift of workers from low-productivity agriculture to high-productivity nonfarm industries, and it also reflected the changing composition of the labor force, notably the influx into the workforce of unskilled young people and adult women.

Douty lists other intangible forces which may help account for the recent productivity slowdown, such as factors of worker motivation and morale. Among some segments of the labor force, the 1960's at least witnessed shifts in attitudes towards jobs and work that apparently contributed to low levels of performance. "These shifts might have reflected the increasing affluence of the population; the fact that jobs were, in general, more readily available than in the past; the relaxation of higher standards in response to both labor-market and governmental pressures; the spread of government transfer payments, so that, to some extent, alternatives to work were created; and social discontent, particularly in regard to our involvement in Vietnam."

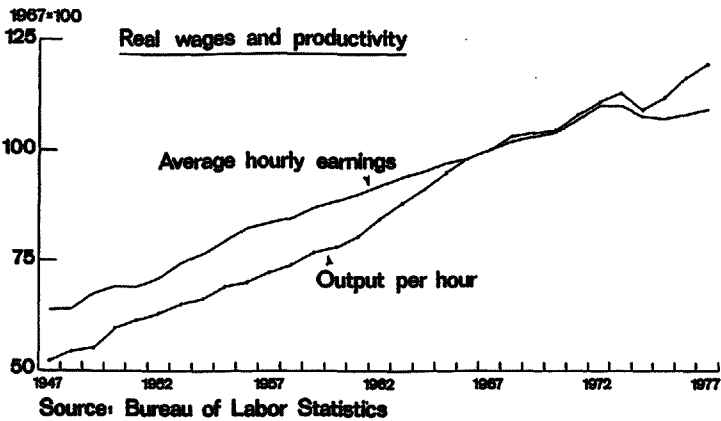
The persistent inflation of the past decade also helped contribute to the slowdown in productivity, because of the way that inflation adds to the uncertainties inherent in business planning and inhibits capital formation and equity investment. Again, some productivity loss undoubtedly was entailed in the recent rising share of capital investment required to meet pollution-control and health-and-safety standards. Yet another factor was the slowdown in technological inno-

vation, at least in contrast to the immensely innovative period of a generation ago.

Needed: more investment

The ability of American workers to obtain higher living standards through faster-rising real wages thus depends on their ability to return to higher levels of productivity growth. One hopeful sign is a new shift in labor-force composition — in particular, the maturing of the "baby boom" generation, as the millions of inexperienced workers who poured into the labor force during the past decade become more productive after increased job experience. Productivity should benefit also from the dying out of those social attitudes which Douty blamed for many of the problems of a decade ago. The largest question mark, however, centers around the prospects for productivity-enhancing investment. As Treasury Secretary Blumenthal and other officials have argued in many recent speeches, productivity has been lagging because we have not provided the growing labor force with enough tools.

In regard to financial-market impediments to investment, the inflation-related weakness of business confidence leads people to demand high risk premiums on private debt instruments as well as higher returns on investment to compensate for increased uncertainty. Thus we see a shortfall of spending on new plant and equipment, especially long-lived investments whose profit expectations are concentrated a decade or two in the future. Spending on short-lived assets — those with rapid rates of cash return, such as trucks and business



equipment — has advanced in real terms at an 8-percent annual rate over the course of the business expansion. On the other hand, spending on long-lived assets such as major construction projects has increased at less than a 3-percent rate over this same time-span. Underlying this growing investment risk is a general uncertainty about the shape of the future economic environment in which new facilities will be brought on line. Greater inflation risk means greater uncertainty over the real value of future returns on investment.

Profits and productivity

The weakness of business confidence reflects to some extent the uncertainties created by recent and pending legislative cost increases — energy, social security, tax reform, minimum wage, hospital and welfare reform — as well as the costs of past environmental and health legislation. Weakened confidence also reflects the sluggishness of corporate profits — a problem which is aggravated by a general misunderstanding about the actual level of profits. (Federal Reserve Chairman Arthur Burns emphasized this point in his Spokane speech last fall.) The commonly cited profits figures — the book profits reported to stockholders — have risen sharply in the last several years, to about double their level of a decade ago. However, raw profit figures have become a poor guide to corporate health because of the way that inflation distorts cost calculations.

Under historical-cost accounting, the true costs of producing goods are understated with respect to both the drawdown of materials from inventory and the consumption of capital as-

sets — which means a general overstatement of profits. Chairman Burns argues that the use of replacement-cost accounting would indicate an overstatement in 1976 of about \$30 billion in corporate profits, and thus an "overpayment" of close to \$12 billion in corporate income taxes. Similarly, the use of replacement-cost accounting for the tangible-assets portion of equity capital would indicate only about a 3¼-percent average after-tax return on stockholders' equity in the 1970's — about two percentage points below the average rate of return for the 1950's and 1960's. This would suggest continued weakness in plant-equipment spending, in view of the historically close correlation between the rate of return on stockholders' equity and the rate of real investment.

These considerations help explain the inclusion of corporate reductions in the Administration's proposed tax-cut package — such as a reduction this fall in the top corporate rate, from 48 percent to 45 percent, as well as an improvement and liberalization of the investment-tax credit. The plan recommends that the present 10-percent credit be made permanent (instead of reverting to 7 percent in 1980), that businesses be allowed to offset up to 90 percent of taxes with the credit, and that the credit itself be allowed for "structures" instead of only machinery and equipment purchases. If investment is stimulated in this fashion, the foundation should be laid for improved productivity, which in turn should stimulate greater growth of real wages and create less pressure for faster gains in nominal wages.

William Burke

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities	Amount Outstanding	Change from	Change from	
			Dollar	Percent
Large Commercial Banks	1/4/78	12/28/77		
Loans (gross, adjusted) and investments*	106,600	- 58,746	- 47,139	- 30.66
Loans (gross, adjusted) — total	83,393	- 29,253	- 17,567	- 17.40
Security loans	1,938	- 9,949	- 9,954	- 83.70
Commercial and industrial	25,508	- 2,043	+ 293	+ 1.16
Real estate	27,395	- 1,343	+ 4,433	+ 19.31
Consumer instalment	14,727	- 2,500	- 70	- 0.47
U.S. Treasury securities	8,806	- 15,505	- 17,426	- 66.43
Other securities	14,401	- 13,988	- 12,146	- 45.75
Deposits (less cash items) — total*	105,470	- 36,963	- 27,660	- 20.78
Demand deposits (adjusted)	30,240	- 11,822	- 10,114	- 25.06
U.S. Government deposits	282	- 4,437	- 4,261	- 93.79
Time deposits — total*	72,800	- 18,174	- 11,325	- 13.46
States and political subdivisions	6,559	- 2,412	- 1,643	- 20.03
Savings deposits	31,517	- 1,924	- 1,732	- 5.21
Other time deposits ‡	31,782	- 2,893	+ 2,467	+ 8.42
Large negotiable CD's	14,617	- 6,917	- 2,951	- 16.80
Weekly Averages of Daily Figures	Week ended 1/4/78	Week ended 12/28/77	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves(+)/Deficiency (-)	+ 43	+ 54	+ 67	
Borrowings	27	25	1	
Net free(+)/Net borrowed (-)	+ 16	29	+ 66	
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales(-)	- 564	414	- 175	
Transactions with U.S. security dealers				
Net loans (+)/Net borrowings (-)	+ 327	176	+ 282	

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

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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