Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

Cost-Push

According to one view, the nation's persistent inflation reflects the tendency for money growth at times to be pushed above its target range by the pressures generated by the financing of large Federal deficits. Thus, the prescription for reducing the inflation rate involves gradual reductions in the amount of deficit financing and in associated money growth. According to another view, however, the various rigidities present in the economy make it difficult for a firmer monetary policy to stabilize prices without also bringing on a recession. Further, restrictive policies would require a lengthy effort with costly side effects in terms of lost output. Estimates prepared by the Council of Economic Advisers suggest that a gradual attack on inflation could entail a six-years' delay in reducing the jobless rate from 6 to 3 percent, at a total loss to the economy of $600 billion. Thus, a constant search goes on for other approaches which can curb inflation at a smaller overall cost.

In the CEA's view, the failure of wages and prices to decelerate over the past several years illustrates the strength of the forces which support a basic 6- to 6½-percent inflation rate in the face of substantial slack in the economy. The results can be seen in a smaller and smaller deceleration of wages and prices with each successive cyclical contraction. Indeed, in the last cycle, wages and prices rose sharply in the year preceding the peak, but then rose even more sharply in the late recession and early recovery period.

One major cause of inflexible wage-price behavior is the attempt by workers to obtain constant increases in real wages, even where productivity gains do not permit such increases. Again, a widespread belief in continued inflation leads business firms to agree to cost increases in the expectation that they will be able to pass those increases forward in the form of higher prices. In recent years, new rigidities have developed in the form of government-mandated cost increases, such as regulations designed to meet environmental, health and safety objectives.

Wages and productivity

The persistence of wage inflation reflects continued high increases in unit labor costs, which in turn reflect a continued wide spread between compensation and productivity increases. Hourly compensation increased 8.7 percent in 1977—slightly below the 1976 figure—but productivity growth slowed to 2.4 percent, as is typical in a mature expansion. Productivity growth generally is greatest in an early-recovery period—witness the 4.2-percent growth of 1976—because overhead labor then becomes more fully utilized while cyclically-sensitive and high-productivity industries recover faster than the rest of the economy.

Serious problems have been caused by a slowdown in productivity growth over the past decade and a half, compared to the first half of the post-World War II period. This long-term productivity slowdown reflects the virtual end of the massive shift of farm workers to more productive non-farm pursuits. The slowdown also reflects

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the gradual adjustment of the economy to higher energy prices, as more costly resources are substituted for previously cheap energy inputs. A slower relative growth in the nation's capital stock is an important factor, as is also (to a lesser extent) the rise in the proportion of inexperienced women and younger workers in the economy. Environmental regulations are also important, as seen in increased limitations on choices of raw materials and plant sites, delays in construction, and constraints on production processes. Increases in sales and payroll taxes are an extra cost consideration, as is also the continued rise in minimum wages.

Cost and price pressures should intensify as the labor force becomes more fully employed. The unemployment rate, although declining sharply in recent months to 6.3 percent in January 1978, is still considered to reflect a substantial amount of slack in the economy. However, that rate would be close to 5 percent if today's labor force had the same demographic make-up as the labor force of two decades ago. Stronger labor-market pressures are also indicated by the sharp rise in the index of help-wanted advertising, and by the rise in total employment to a record 58 percent of the total population.

CPI influence

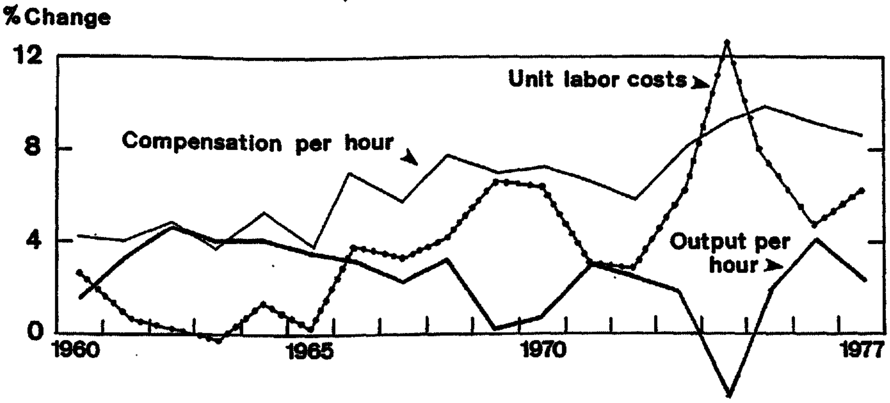
Negotiated wage increases are heavily influenced by movements in the consumer-price index, which affects both the size of cost-of-living allowances and other elements in the wage package. The rate of increase in consumer prices moderated over the 1975–76 period, but then worsened again in 1977. These fluctuations were related principally to erratic variations in food and energy prices. But prices of other categories, which account for two-thirds of the total market basket, rose at almost the same 6 to 6½-percent rate in each year of this recovery period.

The rise in food prices is likely to be considerably smaller in 1978 than in 1977, because of improved supplies of grain, pork, fruits and vegetables—but not beef. Also, with OPEC prices stabilized, consumers' energy prices should continue to reflect the gradual adjustment of domestic prices to world levels. But other cost and price pressures are evident—from the decline in the value of the dollar, from the projected first stage of the crude-oil equalization tax, and from several government actions (e.g., a $6-billion rise in employer payroll taxes and a 15-percent rise in the minimum wage).

Wages, fringes, taxes

Employer costs have increased not only because of steady increases in wages and salaries, but also because of even-sharper increases in wage supplements—largely employer contributions for social insurance and private pension funds. These fringe benefits increased from less than 8 percent of the total wage package in 1960 to 17 percent of the total in 1977. Their magnitude will rise substantially in the next several years because of sharp in-

PRODUCTIVITY, COSTS AND PRICES



creases in social-security taxes. Total (employer plus employee) contributions to social insurance funds will rise 50 percent between fiscal 1976 and fiscal 1979, to $151 billion.

In reviewing a number of proposals for reducing cost pressures through reductions in taxes – e.g., state sales taxes and Federal unemployment-insurance and social-security taxes – the CEA has found that reductions in one area will only mean higher taxes in other areas. As a better means of controlling cost-push factors, it has suggested a set of guidelines (left unquantified) which employer and employee groups would voluntarily follow in their future wage and price decisions. Otherwise, it sees little hope of bringing about the necessary deceleration in the wage-price spiral.

Investment and profits

The inflation problem could worsen if insufficient capacity is available when the economy approaches full utilization of resources. Thus, increased investment is a necessity, but this might be difficult to achieve if corporate profits are inadequate to the purpose. However, the adequacy of profits is difficult to measure because of inflation itself – and the tendency of many people to ignore the necessary costs of replacing inventories and capital goods at today's prices. Whereas total pre-tax profits equalled roughly $172 billion in 1977, adjusted profits amounted to only about $140 billion, after taking account of this inflation impact on the value of inventories, plant and equipment. Inflation thus boosted the effective tax rate, because taxes were levied on total profits before those adjustments.

For this and other reasons, business fixed investment (in real terms) has grown very slowly in recent years. In the final quarter of 1977, it was still 2 percent below the level of the preceding cyclical peak, whereas it would have been 14 percent above that figure if this expansion had conformed to the pattern of earlier expansions. Equipment investment recently has been in line with historical trends, but the investment in structures has lagged considerably below trend. The apparent reason is a rise in the perceived risk of investment in the 1970's, because of higher (and more variable) inflation, wider cyclical fluctuations in output, and the uncertainty resulting from higher energy, foreign-exchange and environmental costs.

A stable financial environment and investment-enhancing tax measures apparently are needed to stimulate growth in the nation's capital stock. To accomplish the latter purpose, the Administration has proposed a reduction in the corporate tax rate and a liberalization of the investment-tax credit, especially the extension of that credit to structures. But to accomplish the former purpose, a continued attack on inflation through traditional monetary and fiscal measures also seems necessary – since, in the long run, inflation is primarily a monetary phenomenon.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/25/78	Change from 1/18/78	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	105,920	+ 1,213	+ 13,772	+ 14.95
Loans (gross, adjusted)—total	84,000	+ 1,221	+ 14,206	+ 20.35
Security loans	3,043	+ 1,115	+ 1,770	+ 139.04
Commercial and industrial	24,967	− 201	+ 2,238	+ 9.85
Real estate	27,750	+ 109	+ 5,958	+ 27.34
Consumer instalment	14,820	+ 47	+ 2,550	+ 20.78
U.S. Treasury securities	7,541	− 30	− 1,855	− 19.74
Other securities	14,379	+ 22	+ 1,421	+ 10.97
Deposits (less cash items)—total*	102,688	− 1,206	+ 10,814	+ 11.77
Demand deposits (adjusted)	28,693	− 903	+ 2,996	+ 11.66
U.S. Government deposits	345	− 215	− 44	− 11.31
Time deposits—total*	72,043	− 162	+ 7,503	+ 11.63
States and political subdivisions	6,669	− 23	+ 733	+ 12.35
Savings deposits	31,486	− 57	+ 581	+ 1.88
Other time deposits‡	31,402	− 19	+ 5,752	+ 22.42
Large negotiable CD's	13,334	− 197	+ 3,902	+ 41.37

Weekly Averages of Daily Figures	Week ended 1/25/78	Week ended 1/18/78	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves(+)/Deficiency (−)	+ 13	+ 15	+ 64
Borrowings	12	4	8
Net free(+)/Net borrowed (−)	+ 1	+ 11	+ 56
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales(−)	+ 1,546	+ 694	+ 688
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (−)	+ 765	+ 426	+ 188

*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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