Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

# What's Ahead for Prices?

Most economists attribute inflation trends to past changes in money growth, but "shocks" of one type or another have also contributed recently to the price upsurge. Last year's near-doubling of OPEC oil prices and this year's drought-caused food shortages have created bulges in the price indexes atop a high underlying rate of inflation. Any analysis of the future direction of prices thus should consider the possibility of new shocks from such factors, as well as the underlying productivity and money-growth trends.

**First-half upsurge**

Volatility has marked price patterns in each of the first several quarters of 1980. In the first quarter, the consumer price index (CPI) soared at almost a 17-percent annual rate, reflecting sharp increases in both energy and homeownership components. During that period, retail energy prices surged at a 53-percent annual rate—more than double the preceding quarter's pace—as the huge crude-oil price increases posted by the OPEC cartel in late 1979 and early 1980 filtered through to the prices of energy purchased by U.S. consumers. The homeownership component also rose at an accelerated pace, under the influence of rising mortgage-interest rates. On the other hand, the increase in retail food prices decelerated during this period, reflecting declining producer prices for livestock, fruit, vegetables, poultry and eggs.

The inflation rate—as measured by the CPI—improved only modestly in the second quarter, as the index registered a 14-percent annual rate of increase. Most of the improvement emanated from the energy component, which rose at about the high fourth-quarter rate rather than the stratospheric first-quarter pace. The homeownership component again increased sharply, but food prices continued to rise moderately, in line with the first quarter's performance. Apparel and medical prices also contributed to the slight second-quarter deceleration.

**After the summer lull**

The early-summer period was quite different, with only a 5½-percent annual rate of CPI increase over the June-August period. But this deceleration, marked by July's overall stability and August's single-digit inflation number, turned out to be something of a fluke. The major reason was a decline in mortgage rates, which partly offset a sharp acceleration in food prices. But the reported interest-rate declines of July and August actually represented commitments made during the late-spring downturn in interest rates. In view of the mid-summer turnaround in rates on new mortgage commitments, the housing component will aggravate rather than cushion the upward movement in the overall index this fall.

Moreover, the recent upsurge in food prices may be just the beginning of a major rise in that key component of the average household budget. Over the June-August period, the food component of the CPI rose at a 21-percent annual rate—more than three times the increase of the second quarter. That upsurge reflected drought-induced losses of livestock and poultry, as well as even sharper price increases for sugar, fruits and vegetables. More ominously, the CPI's future movement will be affected by July and August's explosive 62-percent annual increase in producer prices of finished foods, and equally huge food-price increases at the crude and intermediate levels. The food component has a weight of nearly 18 percent in the overall consumer-price index. Assuming it rises at a 21-percent annual rate over the third quarter as a whole, the acceleration in food prices between the second and third quarters could add as much as two percentage points to the rate of increase in the overall consumer price index.

Energy was an important contributor (along with interest rates) to the recent price deceleration, but it poses a major question mark over the near-term future. The energy component

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of the CPI rose at only a 3-percent annual rate over the June-August period, compared with a 33-percent rate of increase in the preceding six-month period—reflecting a recession-caused falloff in demand and consequently a massive buildup of oil inventories throughout the world. The Iran-Iraq conflict raises a dark cloud over the energy outlook, but no one yet knows when (or if) the effects of that conflict will outweigh the effects of a worldwide oil glut.

The energy situation requires a closer look. Some analysts believe the Middle East conflict will contribute to only a brief spurt in energy prices, with the resumption of a moderate price pace later this year. They maintain that spot prices for crude oil and refined products will rise briefly, in such key markets as Rotterdam, due to the initial fear of possible shortages. That movement will provide support for the current structure of OPEC contract prices, including the recent $2-per-barrel increase posted by Saudi Arabia. But spot prices should stabilize thereafter as basic supply-demand factors come into play.

This analysis reflects the fact that worldwide crude-oil inventories reached a monumental 6 billion barrels before the conflict. At that level, it would take a prolonged cutoff of the 4 million barrels/day of Iranian-Iraqi exports to make a dent in the inventory. Moreover, that impact could be mitigated by the decision of other OPEC members to rescind a planned 10-percent production cutback decided upon before the outbreak of the war.

But this scenario is based on the assumption that the Middle East conflict doesn't spread beyond the Iranian-Iraqi borders. A far more serious situation could arise if the Strait of Hormuz were closed. More than one-third of the non-Communist world's crude-oil supply moves through that 24-mile-wide waterway.

During the fourth quarter, meanwhile, the rate of increase in food prices should moderate somewhat as the effects of the drought subside. Prices of all items other than food and energy could be expected to decelerate if the recession continues, reflecting a low rate of capacity utilization in manufacturing. Yet during the fourth quarter, the consumer-inflation rate appears likely to move into double-digit territory again after the recent softness, due to the present accelerated rate of increase in food prices and homeownership costs. It may even approach the 14-percent rate of the spring quarter.

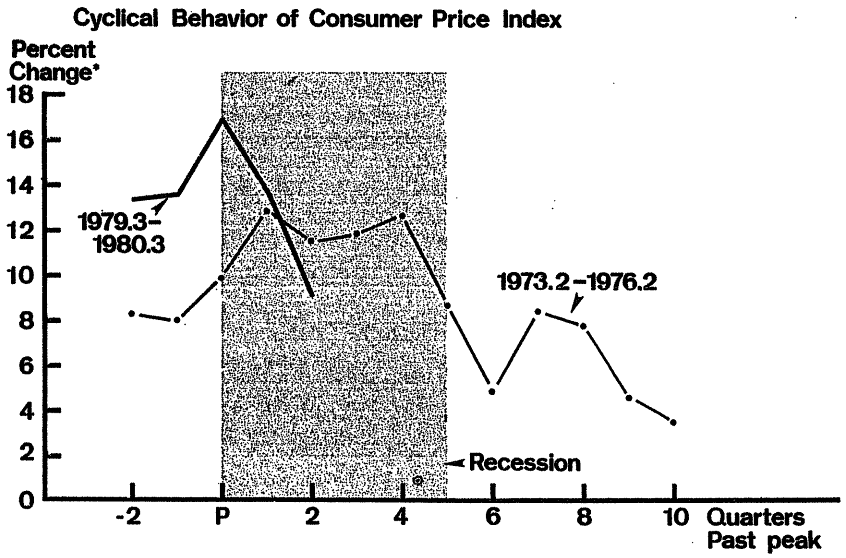
**After the recession**

Many analysts, on the basis of past cyclical productivity behavior, anticipate a weakening of price pressures when the economy moves into the recovery period. The CPI rose at more than an 8½-percent rate at the recession trough in the first quarter of 1975, but five quarters later it rose at only a 3½-percent rate (see chart). A moderation of food and energy prices accounted for some of that deceleration, but the remainder of the index showed similar moderation, reflecting a strong improvement in unit labor costs. In the first quarter of 1976, private nonfarm output per worker-hour rose at a 7-percent annual rate, and compensation per hour at a 9-percent rate. Consequently, unit labor costs rose at only a 2-percent annual rate in that period.

Productivity growth may be slower in the early stages of the forthcoming recovery than it was during the 1975-76 recovery period, in view of the widespread expectation of slow growth in business activity over the period ahead. But if productivity growth reaches an annual rate of (say) 3 percent, and compensation reaches a rate of (say) 10 percent, then labor costs should rise at about a 7-percent rate four quarters into the recovery period. A movement of that type would cut the labor-cost increase in half from the second-quarter 1980 figure—but unfortunately, it would also represent a much higher increase than was recorded in the early-recovery period of any previous business cycle.

That 7-percent projected rise in unit labor costs could represent a proxy for the underlying rate of inflation in the 1981 economy—the increase apart from food and energy "shock" pressures on the price index. But those shock effects could add several percentage points to the underlying trend next year. Retail food prices could rise as much as 14 or 15 percent during 1981—several points above even the high 1980 rate—as supplies of livestock and food-and-feed crops fall somewhat below year-earlier levels. The energy situation remains a question mark, depending upon whether the production and export cutoffs resulting from the Middle East conflict seriously erode the heavy inventories of crude existing throughout the world. If that happens, the energy component of the CPI could rise at a faster rate than in 1980. On balance, despite major shock effects, the overall price trend could improve in 1981 just as it did in the last business recovery. Still, that would leave the inflation rate at a higher level than it reached at the comparable stage of any previous recovery.

**Yvonne Levy**




*Percent change from previous quarter at annual rate.



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

| Selected Assets and Liabilities Large Commercial Banks | Amount Outstanding 9/17/80 | Change from 9/10/80 | Change from year ago Dollar | Change from year ago Percent |
|---|---|---|---|---|
| Loans (gross, adjusted) and investments* | 139,880 | 707 | 5,556 | 4.1 |
| Loans (gross, adjusted) — total# | 118,027 | 619 | 6,862 | 6.2 |
| Commercial and industrial | 34,299 | 257 | 2,291 | 7.2 |
| Real estate | 47,758 | 214 | 7,019 | 17.2 |
| Loans to individuals | 23,751 | 44 | 487 | 2.1 |
| Securities loans | 946 | − 67 | − 1,271 | − 57.3 |
| U.S. Treasury securities* | 6,465 | 57 | − 1,164 | − 15.3 |
| Other securities* | 15,388 | 31 | − 142 | − 0.9 |
| Demand deposits — total# | 46,437 | −1,738 | 1,870 | 4.2 |
| Demand deposits — adjusted | 33,466 | 51 | 2,984 | 9.8 |
| Savings deposits — total | 29,600 | 61 | − 753 | − 2.5 |
| Time deposits — total# | 63,843 | 238 | 9,543 | 17.6 |
| Individuals, part. & corp. | 55,378 | 148 | 9,433 | 20.5 |
| (Large negotiable CD's) | 24,360 | 242 | 4,022 | 19.8 |

| Weekly Averages of Daily Figures | Week ended 9/17/80 | Week ended 9/10/80 | Comparable year-ago period |
|---|---|---|---|
| **Member Bank Reserve Position** | | | |
| Excess Reserves (+)/Deficiency (−) | − 19 | − 21 | 62 |
| Borrowings | 166 | 136 | 226 |
| Net free reserves (+)/Net borrowed(−) | − 186 | − 156 | − 164 |

* Excludes trading account securities.
# Includes items not shown separately.

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