Prices

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

EV/ FOA w/d a.m. meeting tomorrow ②

April 25, 1966

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MEMORANDUM FOR THE PRESIDENT

Subject: The Prospect for Prices

This note supplements the recent Troika review, by spelling out somewhat more fully the prospect for prices in 1966 and 1967.

A. Outlook for 1966

1. For the balance of 1966 we expect

   -- the increase in prices of industrial goods and of services to accelerate;

   -- farm and food prices to stabilize; and thus

   -- the over-all price increase to be somewhat more moderate than the disturbing rate of recent months.

2. All in all, consumer prices are likely to rise about 2-1/2% during 1966.

   - Agriculture still insists that food prices, both wholesale and retail, should decline somewhat during the balance of 1966. But retail food prices at year end will remain perhaps 2-1/2% above the level of December 1965.

   - Service prices will rise at a somewhat faster pace than in the past, as the typically low wages paid in service industries are pulled up by competition with higher wage industries. Consumer services will probably rise more than 3% during 1966 as against last year's 2.7%. Medical services will show a particularly sharp jump.

   - Prices of consumer nondurables other than food should rise 2-1/2 to 3%.

   - Consumer durables should show little average increase, assuming that the auto manufacturers will not have the gall to raise prices.

Original + [illegible] also sent to Central Files as of 8/2/66

3. In the industrial area, the pressure of demand on labor supplies and capacity should push up prices a good bit faster than last year.

   - The crucial industrials component of the wholesale price index could rise 3 to 4% during 1966, even assuming that steel and aluminum can be held to creeping increases, and that copper does not go through the roof. This contrasts with a rise of 0.4% a year during 1961-1965, and 1.4% during 1965.

   - If farm products and processed foods decline as Agriculture expects, the upward movement of the entire wholesale price index would be held to a more moderate 2-1/2 to 3%.

   - Construction costs will continue to rise rapidly.

4. Although pressures on labor markets will become much more intense, the average increase in wages and fringes will remain moderate, especially in basic manufacturing, simply because few major contracts are up for renewal, and not in industries where unions are powerful. Moreover, experience shows that it takes time for wages to reflect the pressures of tight labor markets and rising living costs.

B. Outlook for 1967

1. The price situation will be much less favorable in 1967. The main reason will be rising wage costs.

   - There will be many more large collective bargaining settlements next year, involving powerful industrial unions.

   - The largest (autos) doesn't come until September. But in the first half of 1967 alone more workers will be covered by major settlements than in all of 1966.

2. At the start of 1967, the pressure on wages will be comparable to the start of 1956 -- a year when average hourly labor costs rose 5.7%.

   - As compared with the start of 1956, our projections for the start of 1967 indicate

     -- a significantly lower level of unemployment,

-- the same high share of profits in total GNP, and

-- a much larger rise in the cost of living during the preceding year.

. All of these would suggest an even larger rise in average wages and fringes than the 5.7% of 1956.

3. With strong demand and high capacity utilization, producers will find it easy to raise prices not only to cover labor cost increases, but to raise their margins as well. This suggests the possibility of a repetition of the worst aspects of 1956's price record, when

-- wholesale prices jumped 4-1/2%,

-- consumer prices rose 3% (and continued to rise rapidly during 1957 and 1958), and

-- the GNP deflator increased 4%.

4. Some factors will be more favorable than in 1956.

. Capacity utilization will probably still be in better balance.

. We can hope not to repeat the large steel price increase which accounted for one-third of the 1956 rise in WPI.

. Farm prices were up 7% in 1956 -- we can hope for a smaller rise in 1967.

. Productivity gains were low in 1956, partly because of slow growth, but for other reasons as well.

. The guideposts, plus all our efforts to hold down raw material prices, will also help.

But these favorable factors will no more than offset the greater pressures of demand on labor and industrial capacity.

5. The above considerations imply that a considerable price inflation is already built into 1967, whatever we do. But this does not mean that what we do makes no difference. Indeed, unless

demand is restrained, the over-all price record of 1967 is not likely to be better than during the Eisenhower inflation of the mid-1950's. We have repeatedly called that rate of inflation thoroughly unacceptable. Restraint applied during 1966 could give us an acceptable price record in 1967.

6. During the course of 1966 our reserves of unemployed and under-employed manpower will be about exhausted. It is just not physically possible for output to grow faster than about 4% a year for very much longer. If demand grows faster than that it will just push up prices.

   - Action soon is necessary to get the growth of expenditures into line with the feasible growth of output. This means reducing the quarterly growth of GNP from its recent \$16-\$17 billion to about \$10 or \$12 billion a quarter.

   - Within a relatively short time tax increases would dampen the expansion of consumer expenditures.

   - It would also have a prompt effect on new orders for equipment and construction. That will dampen price pressures, even though the reduction in expenditures is delayed.

7. If we fail to act, the competition for manpower and materials will become extremely intense in 1967

   -- pulling up wages and prices in the service area (among other things, wasting medicare dollars);

   -- pushing up construction costs (thereby wasting our highway, housing, and education dollars);

   -- causing speculative investment which could bring on a major bust later on; and

   -- turning a creeping inflation into a canter, which would force us to slam on the brakes and risk bringing the Johnson prosperity to an end.

Gardner Ackley