Carter seems to know the program will not work, but he signs on anyway

THE PRESIDENT HAS SEEN.

cc Schultze

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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

January 7, 1977

MEMORANDUM FOR THE PRESIDENT

From: Charlie Schultze CLS.

Subject: An Approach to Reducing Inflation

Your economic advisers have put together a program aimed at getting a gradual reduction in the rate of inflation over the next two years. The basic approach was conceived by Barry Bosworth, the Executive Director of COWPS. All of your economic advisers believe we should pursue it. It will require a commitment of Administration energy and time next year.

The attached memorandum is a brief outline of the approach. We are sending it to George Meany, Doug Fraser, Reg Jones, Irv Shapiro and John DeButts. After they read it, we will meet with them (business and labor separately) to get reactions and suggestions. Bosworth has discussed it extensively with John Dunlop who thinks it is a workable approach.

The Vice President, Stu Eizenstat, and I would like to meet with you briefly on Monday to discuss its substance and implications. I will try to get a time from Tim Kraft.

Welcome back!

Attachment

Charlie - The program seems (inevitably, I guess) very general in nature & mostly wishful thinking. However, I'll do all I can to help make it successful. JC

A Program for Reducing Inflation

The rate of inflation has stabilized over the last two and one-half years within the range of 6-7 percent. There have been short-term deviations from this pattern. But, they have been due almost exclusively to volatile movements in food and fuel prices, with no indication of any longer term trending toward either higher or lower inflation rates. A similar pattern of a generally constant inflation rate is evident on the wage side where 8-9 percent increases in hourly compensation have become the norm. With a standard growth in productivity of about two percent -- down from the near three percent rate of the 1960s -- these increases in employment costs are consistent with the trend in prices and constant profit margins.

There is nothing on the economic horizon to suggest that there will be any substantial departure from the current trend. For the present there are few reasons to expect an acceleration of inflation. At the same time, however, the opportunities for any additional slowing of price and wage increases in an expanding recovery are painfully limited. In the absence of specific government action, the most reasonable expectation would be for inflation to continue in the range of 6-7 percent over the next several years. This said, an important caveat must be kept constantly in mind:

Note: This memo corresponds almost exactly with the beginning of the ~~re~~ wave of accelerating inflation.

this is that the risks of a higher future rate are greater than the probabilities of moderation, since forecasts assume the absence of any major shocks which unquestionably would add fuel to the inflation.

It is true that we do not face the threat of a sudden explosion of prices such as occurred in 1973-74. Several events have combined during the last two years to reduce the threat of a sharp upward surge in the inflation rate from its current plateau. Grain reserves have been replenished. A current surplus of petroleum and diplomatic negotiations have improved the outlook for stability in energy prices. Capacity shortages continue to be a significant longer term threat, but the tax program will provide incentives for adding to capacity and the acute near term problems are limited to a few industries.

But, we cannot point to similar positive developments which would make possible a significant moderation downward of the inflation rate from its current high plateau, or prevent a gradual move to higher inflation rates as the economy approaches higher levels of employment and capacity utilization.

It is abundantly clear that substantial deceleration will not be forthcoming from any single major market. Agricultural prices have reversed the sharp rise of earlier years and any further declines at the farm level will only create conditions that will lead to major price increases in the future. Similarly, raw material prices have receded from the high levels of 1974 and currently seem close to or below the costs of production.

A potential moderation of food price increases from the rapid pace of 1977 will be more than offset in employer payroll taxes and the higher minimum wage

If we are unable to slow inflation during a period in which economic slack still remains, then we are almost certain to face higher inflation rates by 1980 or 1981 as the economy approaches higher levels of employment and capacity utilization. Because of both public attitudes and economic reality, an accelerating inflation would almost surely bring economic expansion to a halt, reverse progress towards lower unemployment rates, and depress investment spending.

To combine an economic expansion with decelerating inflation is a major challenge, particularly in the third and later years of a business cycle recovery. Such a combination has never been previously achieved. It is unlikely to happen simply by letting events pursue their normal course.

If we are to make progress to moderate inflation it will require strong efforts by both the government and the private sector. The following is an outline of that effort.

NO mention of monetary policy

I. Government contributions towards moderating inflation

The government will undertake a number of steps itself

- incentives for capital formation to promote growth of capacity and productivity
- a responsible long-run budgetary policy
- improved programs to deal with structural unemployment

- substantially improved review, control and simplification of the government regulatory process
- hospital cost containment
- modest but positive steps to reduce costs and prices directly, by repeal of the telephone excise tax and reduction of the Federal unemployment insurance tax rate
- building farmer-owned reserves of grain against future short supplies
- the objective of deceleration in the rate of inflation will be applied in the determination of federal pay increases in a fashion similar to that suggested below for the private sector.

II. The private sector

The actions listed above will not alone be sufficient. Slowing inflation while business activity expands will require an effort to decelerate price and wage increases across a broad front of individual markets.

The general characteristics of a deceleration program and its rationale are outlined below. Some of the qualifications to the general concept which would have to be recognized in applying the principle to specific situations are discussed and methods for consultation between the private sector and the government are suggested.

A. Rationale for a Deceleration Concept

There is a need to recognize that the inflation problem cannot be quickly solved in a dramatic fashion. It will be necessary instead to demonstrate sustained, steady progress toward achieving a lower rate over the next several years. In addition, the momentum of the current inflation does not result from unrestrained self-interest or the large price and wage increases of a few. Rather, it reflects the momentum of general price and wage increases that are based on catching up with past inflation, keeping up with others, or on general expectations of continued inflation at the current or higher rate.

Thus, policy would focus on a <u>deceleration of the overall inflation rate with the explicit recognition that such overall deceleration will have to result from deceleration in the vast majority of individual markets. It would begin with the initial proposition that deceleration should and could be achieved in every market</u>. Individual industries should aim to achieve a smaller price increase and individual wage increases should be less than in prior years. However, it is important to emphasize that the amount of deceleration in wages and prices that can be achieved may vary from situation to situation. In other words, we should not expect an equal amount of deceleration in every labor market or industry because of different circumstances that include such factors as profit margins, labor productivity, import competition, and past wage performance. Thus, the basic proposition would need to recognize several qualifications:

Wages. A focus on deceleration of individual increases is especially difficult on the wage side, because of wide variations in past wage settlements.

-- Deceleration cannot be the same for all. Those who have received the largest increases in recent years should decelerate more, and vice-versa. There will also be very special cases where recent gains have been so small as to permit no deceleration.

-- There should be a recognition of the need for variations in relative wages from historical trends in response to newly emerging tendencies (such as skill changes, locational shifts, employment growth, changes in productivity trends, the competitive position of a specific industry, etc.).

-- Thus, individual situations will vary within an overall pattern of deceleration.

-- Also, changes in work rules or practices that significantly affect productivity would be recognized as an integral part of any wage settlement.

-- The 1978 increases in employment taxes and the minimum wage will add to employment costs. The deceleration of costs will have to be large enough to offset these increases if any effective price deceleration is to be achieved.

Prices. Similar qualifications will be required with respect to prices:

-- Depressed price-cost margins relative to the historical record will have to rise toward the average. Certainly, there should be no criticism of firms that lowered their price-cost margins during the recession and are now restoring those margins as demand strengthens. However, the improvement in profit-margins, as the expansion continues, should come primarily from higher volume rather than increased prices relative to standard costs.

-- Uncontrollable cost acceleration may result from mandated programs (such as regulatory programs, employment taxes increases, and minimum wage changes), tax changes, or imported and other forms of raw materials and some flexibility should apply in those situations. Prior labor contracts may result in cost acceleration which is traceable to decisions made prior to initiation of the deceleration objectives.

-- <u>Falling raw materials prices, increased productivity gains, or reduced second and third year wage increases under multi-year contracts</u> should result in greater than average deceleration.

B. <u>Consultation with Individual Industries</u>

The program would involve early discussions between the government and individual industry and labor groups with respect to specific areas which constitute a significant inflation problem. On the price side, firms would be approached separately or, in those situations where legal problems can be overcome, jointly as an industry group; they would be requested to exchange information with CWPS about the outlook for cost increases and market conditions. These discussions would involve cost projections and anticipated supply and demand trends. CWPS would work with staff assigned to the project by the other agencies to develop a briefing paper on the inflation outlook for that firm or industry.

The Chairman of CWPS or other Council members would participate in more extended discussions based upon the staff review of the price-cost outlook and major problems of the industry. An effort would be made to assess the major sources of price increases and to identify specific actions that the parties could undertake to contribute to a moderation of price and cost increases. These discussions should be underway by February, and in one or two cases where CWPS has been following the industry on a regular basis, could begin informally in January.

Implicit criteria for selecting industries for such discussions would include their importance to the economy, the existence of discretion by individual firms in setting prices and the occurrence of other major developments affecting jobs, prices or costs.

The discussions of major wage negotiations should precede the beginning of bargaining. They would focus on a review of past trends in relative wages, effects of the previous settlement, productivity, and other conditions relevant to the environment of the negotiations. These discussions would provide an opportunity to emphasize the importance of deceleration, possible improvements in productivity and a review of potential barriers to achieving deceleration. By scheduling such discussion prior to the beginning of bargaining there would be no conflict with normal bargaining procedures.

The deceleration concept has several advantages:

-- It recognizes that basic rates of price increases must vary among markets because of differences in productivity growth and material cost trends. Yet, virtually all should be able to achieve some deceleration.

-- It provides an individual wage or price situation with an understandable objective far in advance of any specific decision. For example, any discussions with the government would take place before the cost increases have occurred and while some discretion with respect to prices still exists. It focuses on efforts to strengthen incentives to minimize future cost increases. It also avoids confrontation over numerous individual price actions.

-- It provides a conceptual framework for government actions that reduces the arbitrariness in the selection of specific sectors for focusing efforts to reduce inflation. In those markets where the absence of price or wage discretion rules out discussions with the private parties, it would provide a framework for evaluating and coordinating a wide range of government policies which affect prices and costs. The establishment of a joint labor-management committee, conducted with the responsible government department, may sometimes be a useful means to explore opportunities for reducing costs and improving productivity performance.

-- Within this framework specific programs can be developed to reduce inflation in those markets (such as food, housing and medical care) which are of greatest concern to consumers.

C. Elaboration of the Deceleration Scenario in the CEA Annual Report

The CEA Annual Report would outline the inflation outlook for 1978 within the confines of a deceleration scenario. Among others, the following points should be stressed:

-- Some deceleration of retail food prices seems achievable.

-- Moderation of energy price increases compared to 1976-77 is doubtful.

-- Service prices have increased at a particularly rapid rate. Some deceleration of the rate of increase will occur with passage of the hospital cost containment program, a slowing of local property tax increases, and reduced excise taxes.

-- Commodities other than food and fuel typically show a rate of price increase below the overall inflation rate as a result of high productivity growth. But, while the rate of price increase is below the average, it has shown a parallel amount of acceleration compared to earlier periods of lower inflation. Thus, a similar amount of deceleration will be sought in those markets.

-- Specific notice should be made of the slower growth of productivity during the 1970s and its impact on potential real income gains.

-- A slower rate of price increase will translate into lower wage increases through the automatic operation of cost-of-living escalators, but more than a passive response will be required.

Given the persistence of a high and continuing rate of inflation, the only strategy which holds promise for returning to reasonable price stability is a gradual and pervasive deceleration of wages and prices. The principal benefits of a deceleration strategy can best be appreciated over a multi-year time frame. In the absence of such a longer-term strategy, there can only be a further institutionalizing of the inflation momentum making eventual resolution even more difficult and traumatic in its effect on the economy. Gradual deceleration supports expectations that price increases will continue to slow, greatly increasing the likelihood that successively lower rates of inflation will be factored into wage and price decisions in future periods. Taking into account its favorable effect on sustaining economic expansion, a successful deceleration effort will improve gains in output, unemployment, and real income.