THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
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MEMORANDUM FOR THE PRESIDENT

Where Next in Price-Wage Control?

In our opinion, the economic and political background against which decisions about anti-inflation controls must now be made is as follows:

The recent and current rates of price increase -- say 10% in the CPI and more in the WPI -- will not continue, no matter what is done about controls. These high rates of increase result from a combination of temporary phenomena. With a moderate fiscal and monetary policy there is no way for the average level of prices to continue rising at any such rates. Most forecasts would put the rate of increase of the CPI later this year and in 1974 in the 3 to 5 percent range.

Even though the average rate of price increases will probably be in this "moderate" range, there will be numerous cases where, in a free market, individual prices would rise much more, and should. There will be more cases where demand is outrunning supply, either at home or world-wide, and where price increases are needed to increase or allocate the supply -- energy being a leading example. Moreover, productivity will be rising less rapidly than in 1972 and there will be more cases where the rise of labor costs will cause a serious profit squeeze unless prices also rise.

The upward momentum of the economy is now very strong. However, we expect that the rise of the economy will be slowed down sufficiently in late 1973 and early 1974 so that any additional depressant force would create the danger of a recession.

Schultz: Box 5 ~~[illegible]~~

The present situation differs economically in important respects from that of August 1971:

a) There are or will be many more domestic and international shortages at existing prices.

b) We do not have so rapid a rise of productivity ahead of us, to help hold down unit labor costs.

c) Despite the recent sharp rise of food prices the prospect for reasonable wage behavior is better than in 1971 because wages are in better balance with each other and with the cost of living.

d) We do not have so rapid a rise of employment and hours ahead of us, to yield workers higher incomes apart from higher wages.

e) There would be less confidence that any move towards more vigorous controls would be temporary, and this would seriously affect the reaction of the private sector, especially with respect to compliance and to investment.

f) We start with higher profit margins.

Except for the last of these points, all of these factors make rigid price and wage controls more difficult or less justifiable than at the beginning of Phase I.

On the political side, there is clearly great anxiety in the country about inflation, a common belief that controls are the remedy, and a decline of confidence in the Administration because the inflation is so sharp and the Administration apparently refuses to take the remedy. The Congress is preparing to confront the President with the option of accepting the popular remedy or rejecting it, which is a no-win situation even if the remedy works for a while. The Administration's failure to exercise what the people regard as leadership may weaken the Administration's ability to govern in other fields. If the feeling persists the Republicans could be hurt in the 1974 elections.

Against this background, several possibilities may be considered:

1. A roll-back of prices, etc. This is the most ,magogic proposition, but we really regard it as out of the question. No law can restore the relative supply situations as they existed on January 11, or some such date. The cattle that died in the mud in February cannot be revived for sale in April. A roll-back would cause general shortages and chaos.

2. A comprehensive, temporary freeze at present levels.

This seems to be where Congress is headed. It is also the move that would be most accepted by the public as decisive leadership. It would purchase a period of calm in the political sphere, but it would raise very difficult economic questions.

a) Would the freeze apply to wages? The Congressional proposals leave that question up to the President. It would not be easy for labor to swallow a wage freeze after the CPI increases we have had and not be easy for business to live with a price freeze without a wage freeze. Even with a wage freeze business would be pretty worried about retroactive increases when the freeze ended. The whole thing might be seriously adverse to business activity.

b) Would the freeze apply to raw agricultural products, interest rates, imports, exports? They didn't last time, but none of those items was so dynamic then as now.

c) Since demand is more active now, and people have a pretty good idea of what follows the freeze, would we get more withholding of supplies to await the higher post-freeze prices?

In terms of the 1974 elections the freeze seems irrelevant. Obviously, the freeze cannot be held in being until next year. What will count next year is the system in effect then and the behavior of the economy. The faint praise we will get for allowing ourselves to be pushed into a freeze now -- since we can no longer invent the freeze -- will not survive into the next election period. In that case, we might as well by-pass the freeze and go to whatever would follow it. In August 1971 we needed the freeze to have time to plan the successor. We don't need that now -- or not much.

3. Return to Phase II. This is the essence of the Congressional Republican proposal. It has the advantage of being something we could live with better than a freeze, and of going directly to what would probably be the successor to the freeze. It has the disadvantage of looking gray -- of lacking pizzazz compared to the freeze.

The basic argument against returning to Phase II is the argument for leaving it in the first place, an argument which has not been seriously contradicted by the events. The argument had several parts:

a) The cooperation of labor in a year of difficult labor negotiations would be better obtained without the Pay Board and prenotifications.

b) Phase II was irrelevant to the basic problem of food prices.

c) Bureaucratic lags and the nature of the Phase II rules made the system incapable of dealing with shortage situations.

d) Some of the rules interfered with investment and productivity.

e) If our goal was to get back to free markets, it was desirable to make a significant step before the economy reached a cyclical high of inflationary pressure.

As far as the average level of prices over a period of, say, a year is concerned, there probably is little difference between Phase II and Phase III. A return to Phase II would have the temporary effect of slowing down price increases when it was first done because business and unions would have to get advance approval for increases. But it would mean larger increases later on when this requirement was relaxed. It might give us another price bulge in 1974 closer to elections, unless we are prepared to stick with it for 20 months.

4. Defend Phase III. Phase III can be defended as a [illegible] of getting back to free markets via a gradual but not [illegible]erminable process. It then rests on the solid ground of [illegible]e case for free markets but maintains a certain lifebelt for those who are not yet sure of their ability to swim in free markets. A very substantial argument can be made that the American people are well off in real terms, that they will be better off if they are permitted to pay for what they want -- food, fuel, gasoline, houses, etc. -- than if they are prevented from doing so, and that their prosperity would be endangered by inflexible price controls.

By now some support may be found for this argument from people who are beginning to worry over the pervasiveness of the political fondness for controls. This would include some business people. But their education may have come too late. Therefore, we may be confronted with a choice among a freeze, a return to Phase II, and nothing.

5. Return to an uncontrolled situation. While we do not see any reason to do this now on our own initiative, it seems to us a real alternative if we cannot get legislation permitting retention of Phase III. In this case a voluntary system might be set up -- on the model of the Wage-Price Review Board we used to talk about in 1970. Certain other steps might be taken on the supply side and on the fiscal side to bolster the anti-inflation program. There would be a period of uncertainty, and possibly rising prices, when the controls ended, but this would probably be brief. The rate of inflation in 1974 would not be predictably higher than with any of the other alternatives and the recovery might be better sustained.