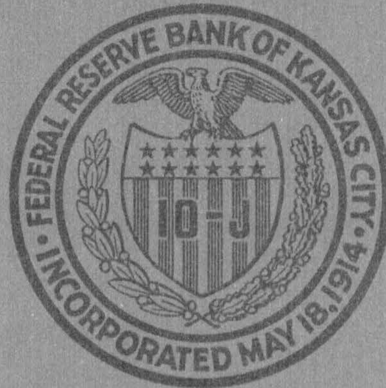

monthly review

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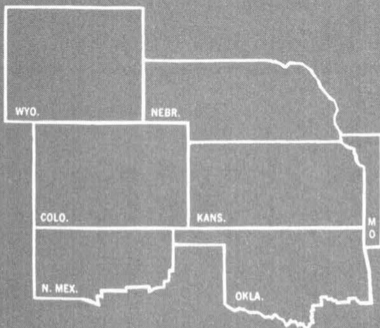

FEDERAL RESERVE BANK OF KANSAS CITY

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Outlook '70—
The Pause That Refreshes?

By Sheldon W. Stahl

In February of this year the U.S. economy quite likely will mark its ninth consecutive year of economic advance. The immensity of such a performance may be appreciated by noting that the four previous expansions in the post-World War II period ranged from only 25 to 45 months—averaging roughly 36 months in length. Even the prior record 80-month advance from mid-1938 through February 1945 has long since been eclipsed. Yet, despite this remarkable achievement, public attention is more likely to be focused on the economy's nonachievements. Concern and dissatisfaction rather than elation are quite likely to be the prevailing sentiments because the record that the economy carries into 1970 bears the deep scars of inflation—an inflation which has demonstrated a stubborn resistance to determined fiscal and monetary restraints designed to bring it to heel.

The seeming unresponsiveness of the economy to anti-inflationary ministrations has raised serious questions as to what lies ahead. Will 1970 bring the long-awaited easing of demand and supply pressures on prices as the economy slows its forward momentum? Can such a deep-rooted inflation be dampened merely by slowing the economy's rate of advance, or does it require an actual decline in real growth to accomplish the task? Is public policy capable of bringing about a desirable slowing down in the economy without the danger of precipitating a recession and excessive unemployment? If so, how soon might the price indexes be expected to reflect the beneficial effects of such moderation in the rate of economic activity? These questions seem to be representative of those being asked by persons who are very much concerned about the future course of the economy.

To approach the answers to these questions, and to better understand the concern which prompted them, this article will review the recent economic record — with particular emphasis on developments in 1969 — and its implications for the outlook in the months ahead. Because future events and policy actions loom so large in shaping the outlook, some of the major elements likely to affect economic activity in 1970 and some of the issues confronting policymakers will be examined.

A REVIEW OF THE RECORD

The Pre-Surtax Period

In mid-1965, the trough of the 1960-61 recession was more than four years behind us. Growth in the major demand sectors of the economy had been essentially balanced and orderly. From January 1961 through the first

quarter of 1965, the annual rate of increase in consumer prices was only 1.2 per cent; industrial prices at wholesale rose at an annual rate of only 0.2 per cent. For all practical purposes, this was a period of essentially stable prices. At the same time, the overall unemployment rate declined from near 7 per cent at the beginning of 1961 to 4.5 per cent in mid-1965.

It seems clear that the availability of considerable idle resources—both labor and manufacturing plant capacity—was a key element in permitting the economy to expand as smoothly as it did. In addition, stimulative fiscal policy and accommodative ease in monetary policy throughout this period proved to be appropriate for sustaining the forward movement of the economy. Yet, it is also clear that the economy in mid-1965, although still capable of accommodating further demands, no longer had the same real productive capabilities as earlier. For the continuing expansion of output to have remained noninflationary, the scale of demand would have had to more closely approximate the growth in the resource base from sources such as new entrants into the labor force, additions to manufacturing capacity, and increased productivity from improved technology. But this was not the case. It was at this juncture that the dimensions of the U. S. commitment to Vietnam and the consequent demands to be made on the economy changed dramatically.

That the decision made in mid-1965, to heighten significantly the degree of U. S. involvement in Vietnam, would have profound consequences for the economy was not long in being demonstrated. Real gross national product (GNP) gains in the latter half of 1965 through the first quarter of 1966 were at an annual rate of more than 7 per cent, or well in excess of the economy's longer-run or more normal real productive capacity. Price stability, both for consumers and at wholesale, gave way in the face of overall excess demand. After mid-1965, the need for restraint in monetary and fiscal policy became increasingly apparent.

The response of the monetary authorities to this shift in the economic climate began late in 1965 and their restrictive actions extended into the latter part of 1966. Federal Reserve actions during that period and the details of the credit crunch which finally ensued late in 1966 are well known and need not be repeated here. Despite the costs in terms of the credit crunch and the severe impact on homebuilding, monetary restraint was successful in moderating the rate of economic activity and in dampening price inflation for a time.

However, late in 1966, the monetary authorities were confronted with not only a severely depressed homebuilding sector, but with a pronounced softening in consumer expenditures as well. Involuntary inventory accumulation was added to an already rapid pace of accumulation occasioned by strong defense and capital outlays. The stage was set for a sharp inventory adjustment in the first and second quarters of 1967, when the lagged effects of earlier monetary restraint would fall on the economy with full force. Thus, late in 1966, with inflation moderately repressed rather than eliminated, the monetary authorities anticipating the danger of a pronounced weakening in the economy, shifted the direction of policy toward ease.

By early 1967, the shift in monetary policy had accomplished a reversal of the fourth quarter decline in bank credit, bank reserves, and the money supply. Throughout 1967, growth in these monetary aggregates was substantial and the economy, after faltering in the first half of the year, recovered its momentum. For the year as a whole, current dollar GNP rose by $44 billion.

From the point of view of diagnosing a possible turning point and avoiding an incipient recession, the monetary authorities were quite correct in their choice of policy actions. Although the unemployment rate did move above

the 4 per cent level in October 1967, it averaged less than 4 per cent for the year as a whole. But the hoped-for fiscal relief in the form of a surtax failed to materialize, and the cost to the economy in terms of renewed upward price pressures proved to be high. As 1968 opened, both the economy and price inflation were on a strongly rising path.

The monetary authorities were not oblivious to the resurgence of price increases during 1967. Poor first-half performance of the economy and expectations of fiscal restraint had stayed the Federal Reserve from moving toward restraint throughout most of the year. As the year waned, however, with the economy's strength becoming more clearly discernible, and with price increases accelerating, the Federal Reserve in the fourth quarter increased reserve requirements and raised the discount rate. Nonetheless, growth in the monetary variables remained substantial through first quarter 1968, and early in 1968 the discount rate was raised twice. During the second quarter, growth in bank reserves fell close to zero, and only negligible growth occurred in bank credit.

In the first half year, the increase in current dollar GNP was nearly $43 billion, or about the equivalent of the entire GNP gain in 1967. However, well over half of this gain was attributable to increased prices. Despite the shift in monetary policy, the lagged impact of earlier ease and the continued absence of a tax increase in the face of growing excess demands and rising cost pressures were making their inflationary impact felt. Finally, in June 1968, the cumulative pressures on the domestic front along with a growing loss of confidence in the dollar internationally provided the necessary impetus for passage of the Revenue and Expenditures Control Act of 1968. After more than a year and a half of debate, fiscal restraint had been legislated. At midyear 1968, the surtax was law, spending limits had been imposed on the budget, and growth in bank credit and bank reserves had been dramatically curtailed.

The Post-Surtax Period

In the first half of calendar 1968, the Federal budget on a National Income Accounts (NIA) basis was in deficit at an annual average rate of $9 billion. This dropped to a rate of less than $3 billion in the third quarter, and was close to zero in the final quarter of 1968. In terms of the unified budget, the shift for the fiscal years 1968 and 1969 was even more dramatic. From a deficit of $25.2 billion in fiscal 1968, the budget moved to a $3.1 billion surplus in fiscal 1969—a shift of $28.3 billion. These data give clear indication of the anti-inflationary stance assumed by the budget position within a relatively short time after passage of the fiscal restraint package.

At the same time, recognition of the deflationary implications of the surtax and associated expenditures constraints soon appeared in financial markets. Expectations of a decline in the level of interest rates were based on several considerations. These included the likelihood of slower growth in the economy, as well as the possibility of a more accommodative monetary policy given the strong element of restraint introduced on the fiscal side. During the early summer months, both longer-term rates and Treasury bill rates did fall. Monetary policy eased and, through open market operations, provided a large volume of reserves. To buttress the emerging pattern of lower rates, the discount rate was lowered from 5½ to 5¼ per cent in August.

Nonetheless, despite growth in bank reserves at close to 9 per cent during the second half of 1968, the decline in interest rates was short-lived and the whole spectrum of interest rates was on a sharply rising trend in the closing months of the year. The reason for the emergence of high and rising interest rates was an intense growth in the demand for funds

—a growth traceable to the failure of the economy to respond either as quickly or as fully to fiscal restraint as many observers had expected. In particular, consumer spending, abetted by a sharp drop in the saving rate, rose substantially in the third quarter. Then, in the fourth quarter, when the pace of consumer spending waned as the surtax bit into the growth of disposable personal income, the level of overall demand in the economy was sustained by a surge in gross private domestic investment. Residential and nonresidential construction, plant and equipment spending, and inventory investment all contributed to strength in investment outlays. And, strong state and local government spending blunted somewhat the tapering off in the growth of Federal expenditures occasioned by tighter spending controls.

During the first half of 1968, the economy had shown how sorely strained its real productive capacity was, and the strength of demand served to maintain pressure on prices during the second half of the year. Inflationary expectations grew in both real and financial markets. Plant and equipment spending plans were revised upward. Credit demands kept apace in anticipation of still higher interest rates, and as potential borrowers discounted price increases at an annual rate of more than 4 per cent from the then high nominal costs of credit. In retrospect, the inherent strength of the economy had been underestimated and the short-term deflationary effects of the surtax on aggregate spending had been overestimated. Monetary ease, which prevailed for most of the last half of 1968, proved to be a mistake. Thus, in mid-December, the Federal Reserve discount rate was raised from 5¼ per cent to 5½ per cent. This move, in conjunction with open market operations on the side of firming, reinforced the upward movement of interest rates and brought further pressure to bear on financial markets from the supply side. At the close of 1968, and for the first time in the current expansion, the thrust of both monetary and fiscal policy was restrictive. But the economy in 1968 had recorded a 9 per cent rise in current dollar GNP—more than half accounted for by price increases. Consumer prices advanced 4.2 per cent, an increase half again as large as in 1967, and wholesale prices for the year rose by 2.5 per cent—also well ahead of the year-earlier pace. As 1969 approached, the task of fighting inflation continued to challenge public policymakers.

1969—What Happened?

Given restrictive monetary and fiscal policy from the very beginning of 1969, and with monetary restraint increasing in intensity throughout the year, a quick reading of the economic record into late 1969 proves very disappointing. Current dollar GNP gains in the first three quarters averaged about 7½ per cent at an annual rate—only slightly below the 8 per cent average rate for the last half of 1968. In the third quarter, 1969, the rate of increase had accelerated to almost 8 per cent and was above the rate of gain for the preceding three quarters. Similarly, the rate of advance both for consumer prices and for industrial commodities at wholesale had accelerated vis-a-vis 1968. Late in 1969, consumer prices were advancing at an annual rate of 6 per cent, while industrial prices were rising at more than a 4 per cent annual rate.

At the same time, pressure on prices from wage demands had further intensified even as employment growth had slowed. This wage-push was particularly severe in the construction trades and served only to exacerbate the problems of the residential construction sector. Housing starts dropped sharply as monetary restraint severely restricted the availability of funds to the mortgage market—as was the case during 1966. In the face of strong and growing anti-inflationary medicine, many wage earners and consumers had found that their real in-

comes were barely keeping pace with price increases, while businessmen saw their profit positions deteriorating as the year progressed. It would not be surprising that the ninth year of economic advance might well be greeted by concern on the part of many observers, collectively wondering why moderation in the economy had seemingly failed to take hold.

A Digression

To understand the answer to this question, it is helpful to understand the way monetary and fiscal policy operates. The immediate object of anti-inflationary public policy is to reduce the rate of growth of aggregate spending. Simply stated, spending creates income. When this income is spent, it accrues to others in the form of wages and salaries, interest, rents, or profits which are then respent in employing economic resources to produce goods and services. By reducing the rate of aggregate spending, both income growth and the derived demand for economic resources would be reduced and pressure on prices would be eased.

Fiscal policy may be defined simply as the Government's taxing and spending decisions. By spending less, or by taxing more to deprive the private sector of the economy of funds which might be spent, or by some combination of the two, the Federal Government may inhibit total spending. The shift in the Federal budget position after the surtax had been passed has already been described. It resulted both from lower Federal spending and higher tax revenues. But the immediate response of consumers, it may be recalled, was to reduce their saving rates rather than the level of their spending. By so doing, the impact of fiscal restraint was blunted for a time, and total spending remained higher than would otherwise have been the case.

The major instruments of monetary policy consist of decisions made or actions taken by the Federal Reserve with regard to the level of, or changes in, the volume of money and credit and its cost. Like fiscal policy, anti-inflationary monetary policy aims to reduce the rate of growth in total spending. To accomplish this, credit policy operates primarily through slowing down lending activities of the banking system. Ultimately, expansion of bank credit depends upon the reserve base at the disposal of the banking system. Since the Federal Reserve is the source of additional reserves, the link between bank lending and monetary policy should be clear. Nonetheless, despite restrictive measures by the monetary authorities, banks can, for a time, continue to expand their lending activities by making adjustments in their assets and liabilities.

Perhaps the simplest adjustment banks can make to expand their lending in the face of pressure on reserves is either to limit or to reduce their investments. This policy was strongly pursued by banks throughout 1969. At the same time, banks in need of reserves may borrow them from a variety of sources such as the Federal funds market, the discount window of the Federal Reserve, the Eurodollar market, and through competition for time deposits. More recently, banks also have made heavy use of the commercial paper market to raise funds. The fact that these sources carry either no reserve requirements, or lower reserve requirements than for demand deposits, would suggest their continued attractiveness as a source of funds even when monetary restraint diminishes. However, as the Federal Reserve adhered to a tight credit policy, a number of these avenues were effectively restricted and the cost of borrowing these funds became progressively higher. While the inventiveness of the banking system can forestall the impact of a tight credit policy on its lending activities, banks cannot expand lending without limits if the Federal Reserve does not expand the reserve base on which the ultimate creation of bank credit is dependent. And, throughout most of 1969, the reserve base was not expanded.

Despite the intense pursuit of monetary restraint in 1969, the quantity of funds raised for lending was high. Businesses and households responded to monetary tightening—first by reducing their liquidity, then by economizing in the use of their cash balances. Both of these devices were resorted to during 1969 and they served to soften the impact of monetary restraint on the growth of aggregate spending. But, perhaps, one of the most important factors which sustained relatively high levels of spending in 1969 in the face of restrictive monetary policy, was the very liberal provision of reserves by the Federal Reserve to the banking system during the second half of 1968 as noted earlier. All of these factors clearly helped to temper the effects of tight credit policy on the level of economic activity and, thereby, on price behavior.

A Closer Look at 1969

The previous quick reading of the 1969 economic record does give cause for questioning the efficacy of stabilization policy. Yet, in an economy characterized by workable—if not perfect—competition, the basic premise that, by slowing down spending, the rate of price increases might be reduced, remains valid. And, a closer inspection of economic events last year strongly suggests that, although the rate of price increases was not markedly slowed, the first step in the process—the reduction of the rate of aggregate spending—was being attained.

It was noted earlier that the rate of advance in current dollar GNP in the first three quarters of 1969 was not much below that of the last half of 1968. If, however, one focuses on the rates of increase in real GNP—current dollar GNP deflated for price increases—there is persuasive evidence that real spending slowed markedly not only in 1969, but since mid-1968. In the second quarter of 1968, real GNP increased at a 7.4 per cent annual rate. This rate of advance had declined to 4 per cent and then to 3.2 per cent in the third and fourth quarters of 1968, respectively. During the first three quarters of 1969, the rate of real GNP gain steadily declined still further to an average of 2.2 per cent.

Toward the latter part of 1969, the reduction in the growth of real spending or output was confirmed by a slowing down, and then by a decline, in the forward movement of the industrial production index. Because a slowdown in real spending and real output implies a lesser demand for productive resources, the reduced rate of growth in nonfarm employment, and the further fall in the capacity utilization rate in manufacturing also corroborate the slowdown in real spending and output. In this connection, preliminary third quarter GNP data were distorted by a very large Federal pay increase and a stepped-up pace of inventory accumulation—presumably including some involuntary accumulation as consumer spending remained quite sluggish. Retail sales, in real terms, had been essentially flat since the latter months of 1968. Thus, third quarter data, although outwardly reflecting simply higher dollar spending, are subject to a quite different interpretation on closer inspection. On balance, the signs of moderation in the rate of economic activity seemed to be outweighing those to the contrary in the closing months of 1969.

THE OUTLOOK

The achievements cited to suggest that the goals of moderating spending and the rate of economic activity are being realized would seem more credible to many if they had succeeded in reducing the rate of price increases. The fact that the pace of consumer price increases during the third quarter of 1969 was slightly below that of earlier quarters was of little solace, since it remained unacceptably high. It must be understood, however, that the sheer length of the current inflation and the distortions that it engendered have lengthened the period of adjustment as well. It is not easy to overcome

inflationary expectations generated and validated during several years of rising prices. Pricing decisions made, and wage demands granted, on the presumption that inflation would continue, affect the price indexes for some time after real demands have abated. However, in the absence of strong and rising demands, inflation inevitably will give ground —even where imperfections exist both in product and resource markets. To be sure, such imperfections will further extend the period of adjustment to relative price stability and make the job of policy that much harder. Nonetheless, the key to dampening inflation in the months ahead would seem to rest most strongly on the economic and expectational climate in which price and wage decisions will be made in 1970. For this reason, a look at some of the factors which may shape this climate is in order.

The Outlook for Economic Activity

Late in 1969, the Chairman of the President's Council of Economic Advisers suggested that business conditions in 1970 were likely to be "rather uncomfortable." The basis for such a projection rested upon several factors. Perhaps first and foremost was the tenacious nature of inflationary forces and the need for public policy to continue to build "back pressures" against wage and price increases. The impact of such policy would serve to extend the economy's slow real growth. And, in conjunction with expectations of heightened resistance by management to wage demands which could have short-run disruptive effects on the economy, these factors might be expected to further add to the slowing down in real growth evident in the economy late in 1969.

It should be recalled that housing activity was being seriously hampered by the squeeze on mortgage lending. Excluding the midyear pay hike, Federal expenditures were rising little. State and local government outlays in the third quarter lost some of their earlier buoyancy as those governmental units found it increasingly difficult to obtain funds in already tight capital markets. Consumer spending was sluggish and inventory developments seemed to suggest a downward adjustment was in the making in this sector. Business spending on plant and equipment still showed strength, however, although capital outlays for all of 1969 did fall somewhat short of earlier anticipations. Preliminary surveys of plant and equipment spending plans for 1970 suggest a further rise in outlays in the order of 7 to 9 per cent. In December, an SEC-Commerce survey reported expectations of a 6 per cent increase for the first half of 1970 alone. Although these projections do not augur well for the battle against inflation, coming in the face of deteriorating profits and with a growing risk of excess capacity, the realization of these projections remains open to question.

Looking ahead further for the next several quarters, the demand picture in the economy as a whole would not appear to be conducive to a resurgence of more rapid economic growth. More than likely, the rate of real growth may well decline further in the early months of 1970. Given the likelihood of continued tightness in availability of mortgage funds, residential construction would not seem to be an especially stimulative sector. The current tightness in municipal capital markets and the lagged response of spending to availability of financing suggest that the outlook for state and local government spending would involve more modest increases than in recent years. In the Federal sector, defense spending is expected to decline further. The extent of such a decline, though, remains a matter of question, given the recent passage of a sizable military appropriations bill and the uncertain dimensions attached to further reductions in U. S. involvement in Vietnam. With declining growth in production expected, personal income gains will likely be more moderate as

the weakening trend in employment observed throughout 1969 continues. Thus, consumer spending might well be lackluster in the months ahead, with gains largely accounted for by higher prices for goods and services. To be sure, the reduction in the surtax, and the likelihood of increased social security benefits as well, would make the consumer sector capable of further expansion. However, consumer behavior in 1969 was not ebullient and in the face of an expected further slowing in the economy, a surge in consumer optimism and in the rate of spending would not appear likely.

On the resource side, the outlook suggests a further easing in resource utilization. During 1969, labor markets, although generally tight, did exhibit tendencies toward easing — especially in the latter months when the rate of growth in employment slowed markedly. Expectations of further declines in industrial production in the months ahead, if realized, would make the employment picture ease still more. With additional capacity coming on stream from earlier capital outlays, capacity utilization rates in manufacturing are likely to edge down further.

Despite any tendencies for labor markets to loosen somewhat more in the months ahead, wage pressures are likely to be intense in 1970. In 1969, labor unions won median wage and fringe benefit increases of more than 8 per cent, on average, for the first three quarters of the year—in contrast with a 6.6 per cent increase for all of 1968—and wage costs in nonunion sectors have advanced sharply as well. In 1970, the collective bargaining calendar will be far heavier than last year, with more than 5 million workers involved in major contract negotiations. Wage demands will undoubtedly be very high, reflecting the attempt by labor to make up for the erosion of real income gains from a combination of smaller settlements in previous contracts and price inflation. However, reduced demands for labor as overall demand pressures further abate in the economy, along with increased employer resistance to large wage settlements in the face of weakening profit positions, would point toward both a less generous pattern of wage packages and an intensification of labor strife in 1970. Given the number of key industries involved in bargaining, the depressant effect on the economy of labor strikes cannot be overlooked. In the final analysis, though, the extent to which cost-push pressures will be reflected in the behavior of prices may well be determined largely by the success of public policy actions in generating a more temperate economic climate in 1970.

Some Policy Considerations

The first point of departure for examining the possible future role of public policy in bringing inflation to heel is the fundamental recognition that, at the close of 1969, both monetary and fiscal restraints were more strongly disinflationary than in recent years. Earlier adjustments of businesses and households to mitigate the impact of this restraint on their total spending have largely passed. Increasingly, restrictive policy was biting harder on the real economy. Yet, price increases had remained uncomfortably high, indicating a clear need for continued restraint. Under these circumstances, the future course of public policy becomes extremely important in assessing both the outlook and the degree of success which might be achieved in slowing down the rate of price inflation.

On the fiscal side, there are clear indications that the restraint which has prevailed since mid-1968 will be much reduced in 1970. An examination of the Federal budget position would, indeed, suggest that maximum restraint took place in the first half of 1969 and that policy has become progressively less restrictive since then. The surtax, in all likelihood, will be reduced to 5 per cent, effective through June 30, 1970, with the loss in revenue to be

compensated for by cancellation of the 7 per cent investment tax credit—to be effective retroactive to April 18, 1969. If extended at 5 per cent, the restrictive effect of the surtax will decline from a 10 per cent annual rate in 1969 to one-half of that in the first half of 1970 and to zero in the last half of 1970. To this must be added the possibility of some tax revenue loss in calendar 1970 inherent in tax reform proposals—which include tax relief as well—now before the Congress. Even without considering the likelihood of unavoidable increases in Federal spending in 1970, it is reasonably clear that the near-term battle against inflation can count on little fiscal help relative to that which had prevailed earlier. It should be pointed out, however, that the net effect of fiscal stimulus on the economy depends upon the stance of monetary policy.

If fiscal policy appears to be waning in its restrictive role, then what of monetary policy? It is, of course, impossible to predict the future course of monetary policy. The fact does remain, however, that it may be called upon to continue its restrictive role for some time. In 1969, it exerted increasing pressure on money and capital markets. Indeed, there are many analysts who believe that the Federal Reserve has already pursued its policy of restraint too long. These observers cite the overwhelming importance of changes in the money supply on the level of economic activity. They assert that the moderate growth in the money supply early in 1969, along with virtually no growth in the last half of the year—with allowance for a lag in its effect—virtually has insured a recession in 1970.

Without denying the importance of money, there is reason to question this restricted view of the determinants of economic activity. As the present period of restraint has demonstrated, businesses, households, and banks have shown a remarkable degree of innovativeness in economizing on the use of cash balances. Of course, the monetary authorities would agree that any program of restraint carried too far would have deleterious effects on the economy. The question which remains to be answered is "How far is too far?"

The problems confronting the monetary authorities in answering the above question are not easy. The gradual abatement of demand pressures in 1969 was the first step in the process of ultimately slowing down price inflation. Such a slowing down of demand is a necessary prerequisite to changing inflationary expectations as they affect spending decisions. That such expectations still exist is evidence that the adjustment process still has some time to run. Any policy move will have to be considered within this context.

Even with demand pressures easing, 1970 will be characterized by very strong wage pressures. In fact, it may be argued that the nature of the present inflation has changed from largely demand-pull to the cost-push variety. If cost pressures on prices are not to be validated by a permissive market atmosphere, the Federal Reserve will have to adhere to a policy consistent with moderate, rather than excessive, demand growth, despite the costs in lost production which might stem from labor strife.

The 1966-67 experience in which the fight against inflation became subordinated to avoiding recession is still fresh in the minds of many observers. So, too, is the premature easing in policy in 1968 after the surtax was passed. The Federal Reserve will be closely scrutinized in the months ahead to appraise its actions if and when the economy shows signs of faltering. The twin dangers of recession or rekindling inflation make the task of the Federal Reserve an unenviable one. Under such circumstances, the premium will be very high for a strategy which can avoid either of these pitfalls.

Some Final Observations

In the introduction to this article, several questions were posed as being perhaps representative of those concerned with the outlook

for the economy. Some tentative answers to those questions may now be in order. It does appear reasonably hopeful that the easing of excessive demand pressures observed in 1969 will continue in 1970, and that such easing also will help to temper cost or supply pressures on prices as well. Even the abortive experience of 1967 suggests that inflation can be moderated by slowing the rate of advance of the economy. However, a crucial component of success in such a venture is public awareness of the inflationary process and how it responds to public policy and to changes in economic environment which result from such policy.

It also should be understood that policy actions which may bring about a needed slowing down in the economy nearly always carry an inherent risk of precipitating recession and excessive unemployment. Stabilization policy still lacks the degree of precision to obviate such a danger, and the danger is heightened as the degree of pervasiveness or persistence of inflation becomes greater. But, as already suggested, a more universal appreciation of the issues and the tactics involved in controlling inflation may minimize this danger. Finally, though anything less than dramatic progress in the response of prices to moderation in the rate of economic activity seems unsatisfactory to many, it is reasonable to expect more progress in the future than has been observable thus far. Price developments in the third quarter of 1969 seemed to point toward such progress. It may be too early yet to know whether the high water mark in inflation has been reached, but if monetary policy can continue to exert a moderating influence on the economy in the months ahead, further progress would seem to be in prospect.

The difficulties facing the monetary authorities in 1970 are compounded by the extent to which inflation has permeated the economy, and by the fact that decreased fiscal restraint will place an even greater burden on monetary policy. The results of policy actions with respect to prices thus far have been modest, a factor which should reinforce the notion that the battle against inflation will not be short. From a longer-run perspective, however, the solution to inflation involves more than mere fiscal and monetary actions. A careful reexamination and restructuring of our institutional arrangements for wage and price determination to make them more responsive to the forces of competition is clearly part of the long-run strategy against inflation. The fruits of such an effort would be the increased responsiveness of the economy to stabilization policy with a consequent decrease in the risks of exercising such policy. But considering the more immediate future, the resolution of the question as to whether 1970 will be the pause that refreshes is still uncertain. The future course of monetary policy may have much to do with the answer.

Uncertainties Cloud 1970 Agricultural Outlook

By Gene L. Swackhamer

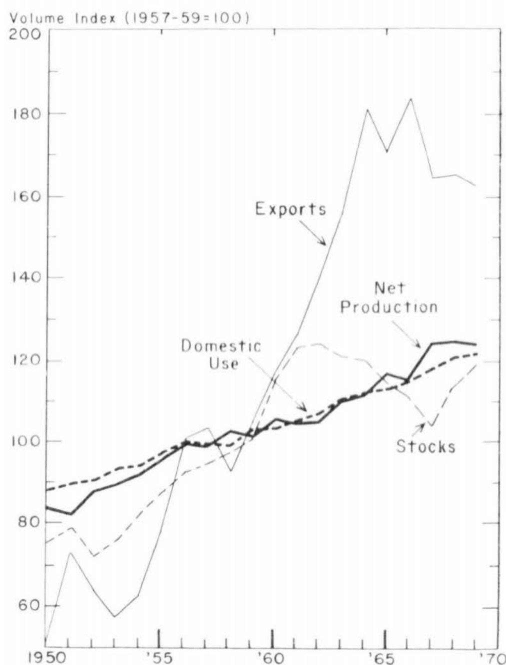
FARM INCOME improved in 1969 over the preceding year and could show further advance in 1970 if favorable conditions dominate, but many uncertainties cloud the outlook. The farm sector exhibited strength last year by generating gross income sufficient to offset a lower level of exports, lower crop income, and higher production expenses. Net farm income is estimated to have been nearly $15.8 billion—up sharply from $14.8 billion in 1968. For this performance to be equaled or exceeded in 1970, domestic demand must increase further, the downtrend in exports needs to be reversed, and production expense increases must moderate. What are the prospects for each of these developments?

Further increase in domestic demand can be expected, with considerable confidence, because of natural population increase. But annual population growth of 1.2-1.4 per cent has not been sufficient to keep utilization of farm output in balance with production. A high level of economic activity and rising personal incomes also contribute to domestic demand but, even during periods of prosperity, little more than an additional one-half to 1 per cent is added to total domestic demand. Thus, domestic use of farm output has been increasing at a stable annual rate of around 2-3 per cent.

As the companion article on the business outlook in this issue indicates, a slower rate of increase in personal income and a more moderate expansion of economic activity seem likely this year. If these conditions develop as expected, growth in demand for farm products will be moderate.

As shown in Chart 1, production of farm food commodities, increasing at a 3-4 per cent annual rate, has exceeded domestic use in recent years. Because of agriculture's technical capability, the same is also true of nonfood agricultural production. It is this tremendous technical capability that has contributed to the surplus production side of the farm problem. As long as more is produced than is used domesti-

Chart 1
SUPPLY AND UTILIZATION OF FARM FOOD COMMODITIES 1950-69



SOURCE: U. S. Department of Agriculture.

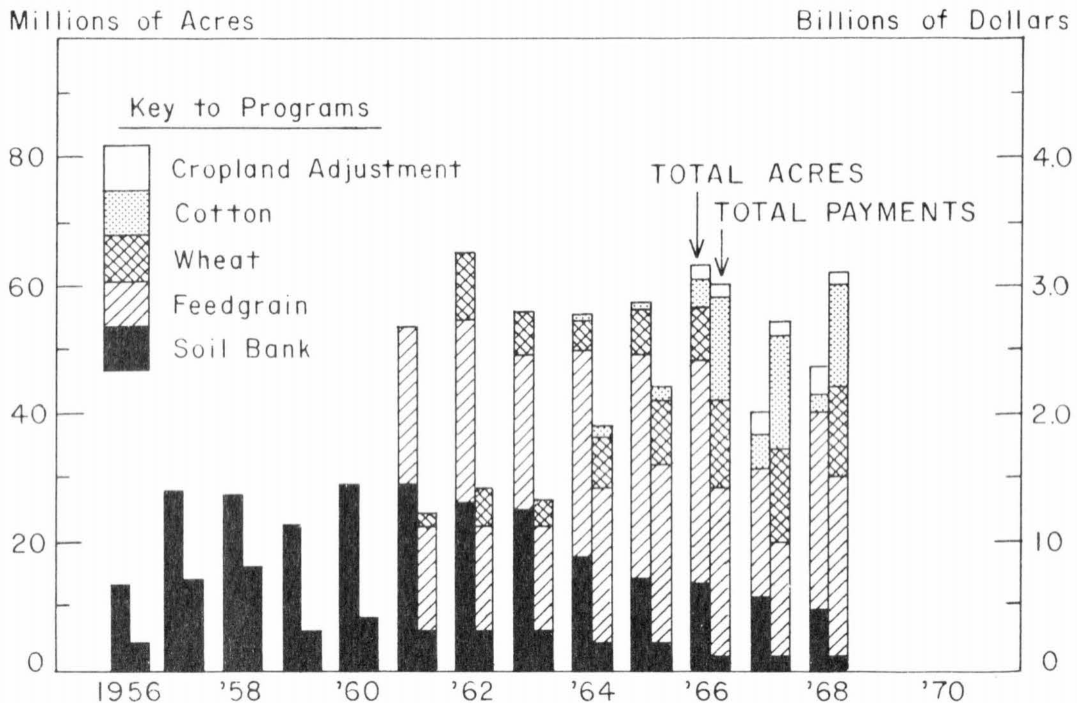
cally and in foreign trade, yearend carryovers increase inventories and exert downward pressure on farm prices.

Exports have declined from a peak level of $6.9 billion in 1965-66 to an estimated level of $5.7 billion in the 1968-69 fiscal year. Export prospects for 1969-70 are somewhat more promising than last year, and the downward slide may be arrested, but world grain supplies remain abundant and trade competition intense. Thus, with neither domestic nor foreign demand expected to be especially strong, further production adjustment may be necessary if increasing carryovers are to be moderated.

The rate of price increase of purchased farm inputs is expected to slow this year, but farm production items likely will still cost 3-4 per cent more than in 1969. The index of prices paid by farmers for commodities and services—including interest, taxes, and farm wage rates—is at a historic high after advancing more than 5 per cent last year. Higher prices for purchased livestock, supplies, and machinery—along with higher taxes and wage rates—are expected this year.

To offset the price-depressing impact of surplus production, agricultural legislation has attempted to better regulate total output and increase farm incomes. The successes and failures of these efforts are being debated by Congress as they attempt to draft a new agricultural act to replace the expiring, temporarily extended, Food and Agricultural Act of 1965. There is much speculation about what features will be included in new legislation and how they will affect agriculture. Chart 2 illustrates part of the difficulty faced by Congress and the Administration. Nearly 50 million cropland acres are currently idle at an annual cost of approximately $3 billion, and yet, as shown by the increasing stocks in the last two years in Chart 1, production continues to exceed domestic needs. Furthermore, reliable estimates indicate that more land will need to be removed from production in the 1970's just to maintain the present supply-demand relationship. The problem is how to bring this adjustment about smoothly without further increasing the cost to Government or depressing farm income. Several alternatives have been proposed, and include permanent and whole-farm retirement, a "set-aside" program of voluntary removal of cropland from production, and a domestic allotment program. It now seems likely that new farm policy legislation will not be forthcoming until well into 1970. It also seems probable that the longer it takes to write new legislation, the less likely it is to deviate much from current programs. Permanent whole-farm retirement appears destined for a pilot study role. Provisions for direct farm income support with limits on amounts to individuals are being de-

Chart 2
GOVERNMENT FARM PROGRAM EXPENDITURES



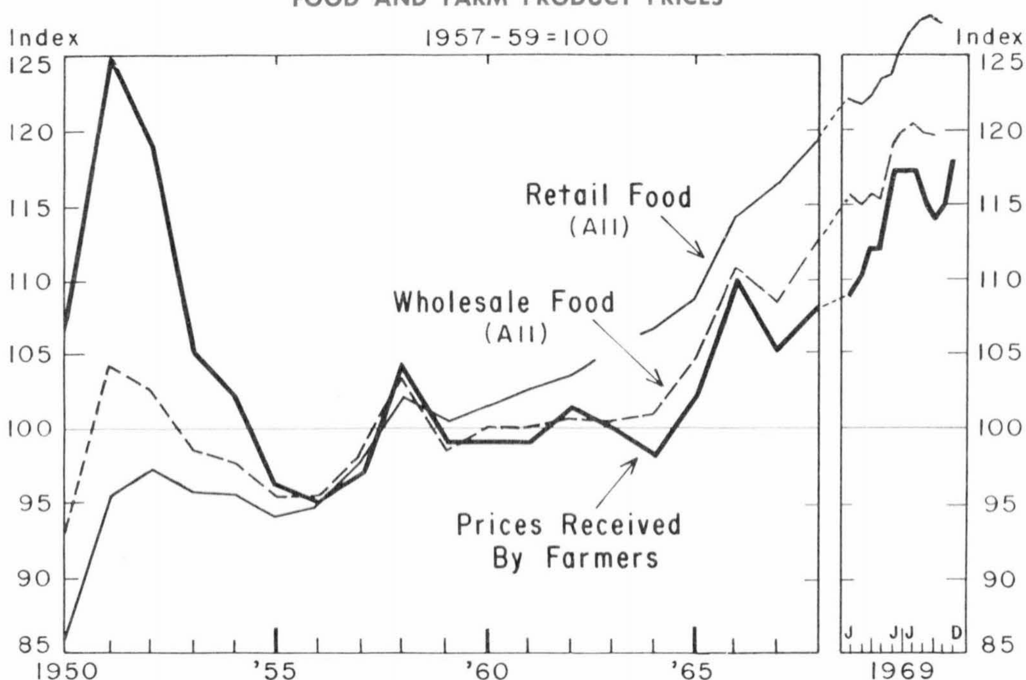
SOURCE: U. S. Department of Agriculture.

bated. Consideration also is being given to shifting commodity price support levels from a parity base to a market-clearing price level.

A MORE DETAILED LOOK AT PRICES

The index of prices received by farmers dipped to its lowest level of the past decade in 1964; since then, it has risen irregularly, but steadily. In 1969, the index fluctuated widely while rising to its highest level since 1952. Some interesting observations of food and farm prices are shown in Chart 3. Throughout the 1960's, the retail food prices component of the Consumer Price Index rose much more rapidly than either farm or wholesale prices. In fact, during the two periods when farm prices declined (1963-64 and 1967), retail food prices continued to rise. In part, this occurrence reflects the small relative share of farm products in finished food items, but, more importantly, it represents a widening marketing price spread as farm products are transported, processed, modified, and packaged to meet consumers' demands. Each of these intermediate steps adds to product value, but also increases the retail price. If the rate of increase of retail food prices slows in 1970, it will more than likely be the result of weakening consumer demand rather than of lower farm prices because of surpluses.

The livestock sector contributed most to the increase in farm income in 1969 and likely will again this year. Livestock prices strengthened last year because of unusually strong demand and only moderate supply increases. Although beef cattle prices are not expected to rise as spectacularly this year as last, they are expected to remain strong and perhaps average



NOTE: Retail food includes "meals away from home," which has a weight of 20 per cent in the index.
SOURCE: U. S. Department of Agriculture, U. S. Bureau of Labor Statistics.

near the 1969 level. If hog production declines as surveys indicated last fall, pork prices may average around the 1969 level.

Continued attempts are being made to keep both food- and feed-grain production closely in balance with demand, and grain prices could strengthen some in 1970. Total feed-grain production in 1969 was estimated to be 171 million tons—up slightly from 1968. Domestic feed use of feed grains last year rose to about 136 million tons—nearly 9 million tons above 1968. The increase in feed use resulted from a larger number of grain-consuming animal units and a higher feeding rate. Projections for the 1969-70 (October 1, 1969-September 30, 1970) feeding year indicate a further rise in the number of grain-consuming animal units and about the same feeding rate. A larger feed-grain demand against a stable supply is expected to result in higher feed-grain prices; however, supplies are expected to remain adequate.

Food-grain prices, especially wheat prices, may not change much from last year's average. A larger carryover of wheat, coupled with continued low export prospects, continues to place wheat prices under stress.

While the level of farm prices in 1970 may match the 1969 performance, the likelihood of widespread improvement appears slim. There are too many uncertainties to encourage much optimism. It is important to remember that the agricultural sector is an intricate part of the total economy and is influenced by national economic developments. A general economic slowdown would also slow demand for many farm products. In addition, export demand for farm products may not improve much this year; so, with ample supplies on hand and a likelihood of slower growth in demand, only

moderate improvement in farm prices may be forthcoming.

Outlook for Livestock

The livestock sector exhibited more price strength in 1969 than many expected. Hog production slipped, even though prices were well above average and feed prices were favorable for expansion. Fed cattle prices rose to a $35-$36 per hundredweight top in June 1969, even though fed cattle marketings were higher than comparable year-earlier periods. A reduction in the number of nonfed slaughter cattle and in average slaughter weights through the first six months of 1969 apparently was the major factor in holding beef production at year-earlier levels. This restraint on output, in the face of brisk consumer demand, resulted in substantially higher fed cattle prices. Lamb prices, likewise, averaged from $2-$3 per hundredweight higher in 1969 than in 1968 because of reduced production, and are expected to show continued strength this year.

Cattle. Further increases in fed-beef production are expected this year, whereas nonfed-cattle slaughter is likely to continue to decline. With orderly marketing of finished cattle at reasonable weights, cattle prices are expected to remain favorable—rising seasonally as the large winter supplies of fed beef begin to diminish. Because of the rapid increase in cattle feeding, the demand for feeder cattle has been strong and feeders have commanded higher prices. Profit margins this year for cattle feeders may average lower than last year's favorable returns because of the higher prices paid for replacement feeders, higher feed-grain prices, and continued costly credit. However, profit margins may remain near average in 1970 despite these factors.

Hogs. Favorable hog profits in 1968 apparently did not generate the normal production response because output in late 1969 lagged sharply below year-earlier levels. With beef at higher prices, the demand for pork was good, and hog prices in 1969 averaged strongly above 1968. If pig production develops as expected this winter, hog prices will continue higher than last year into early summer. Prices during the latter half of 1970 will depend on the strength of consumer demand, the price level of competing meats, and the amount of new production resulting from the response to favorable profits.

Lambs. A smaller lamb crop in 1969 and apparent withholding of ewe lambs from slaughter for herd rebuilding indicate that 1970 will again be a good price year for slaughter lambs.

Dairy. Milk production has declined each year since 1964, when production peaked at 127 billion pounds. Production last year was approximately 116 billion pounds, and may decline an additional 1 per cent in 1970. Little change in total use is anticipated if declining per capita consumption is about offset by population increase. Some additional price increase seems likely this year.

Broilers, Eggs, and Turkeys. Broiler supplies increased enough in 1969 to normally have caused serious price erosion. Surprisingly, however, percentage growth in both prices and supply was nearly the same. The pressure of a continuing large supply, however, may press broiler prices lower this year. Egg production is expected to expand in 1970 by possibly 2 or 3 per cent in response to higher egg prices. The current expansion phase has been slower than in prior years, and egg prices in 1969 averaged higher than in 1968—but price declines are expected as the year advances. A reduction of cold-storage stocks of turkeys last year developed as production held at a constant level of about 106 million birds. Strengthened farm prices in 1969 can be expected to encourage larger production this year.

Outlook for Grains

The index of crop output for the United States in 1969 rose one point—to 120 per cent of the 1957-59 base. Most of the increase came

from tobacco, cotton, and sugar production; while food-grain output declined a little and feed-grain and oil-seed production remained unchanged. The slightly larger volume of crops at lower price levels held cash receipts from crop marketings below prior years. With relatively little change in the volume of marketing expected this year, and with the possibility of somewhat higher crop prices, cash receipts in 1970 may average a little better than last year.

A summary for major feed and food grains is presented in Table 1, and each is discussed.

Corn. This year's corn supply is estimated to be moderately above that of last year. With increases expected for feed, export, and food and industrial utilization in the 1969-70 (October 1, 1969 to September 30, 1970) marketing year, prices are expected to remain above loan support levels and strengthen seasonally. The expectation for increased utilization is predicated on an increase in the number of grain-consuming animal units and in recovery of feed grain exports to a higher level. If these conditions develop as expected, the carryover of old corn into 1970-71 could be less than 1 billion bushels.

Grain Sorghum. Sorghum production increases in recent years have been about absorbed by larger feed utilization, so the year-to-year carryover has remained nearly stable. Increased production of fed cattle, much of which will be in the Southwest, is expected to maintain a reasonably strong demand for sorghum grain this year, and a decline in carryover next September is anticipated.

Wheat. Production in 1969 declined by more than 100 million bushels, yet further stock carryover is anticipated next July. Although acreage allotments for this year's crop were cut about 12 per cent to 45.5 million acres (the smallest ever), plentiful fall moisture and a good growing season could keep production prospects high and continue supply pressure on wheat prices. If wheat feeding continues and exports rise, total disappearance may increase by 100 million bushels this marketing year. The prospect for more than modest export gain is

Table 1
BALANCE SHEETS FOR MAJOR CROPS
United States
(In Millions of Bushels)

	Corn		Grain Sorghum		Wheat		Soybeans	
	Marketing Year Oct. 1-Sept. 30		Marketing Year Oct. 1-Sept. 30		Marketing Year July 1-June 30		Marketing Year Sept. 1-Aug. 31	
	1968-69	1969-70	1968-69	1969-70	1968-69	1969-70	1968-69	1969-70
Supply								
Beginning carryover	1,162	1,122	289	300	539	818	166	303
Production and imports	4,376	4,444	739	757	1,572	1,457	1,080	1,095
Total Supply	5,538	5,566	1,028	1,057	2,111	2,275	1,246	1,398
Utilization								
Feed	3,512	3,640	615	650	167	250	606	620
Exports	535	550	100	125	544	550	287	310
Food and industrial	370	375	......	......	520	525	......	......
Seed and residual	......	......	13	13	62	55	50	50
Total Utilization	4,417	4,565	728	788	1,293	1,380	943	980
Ending Carryover	1,122	1,001	300	269	818	895	303	418

NOTE: 1969-70 values are forecasts.
SOURCE: U. S. Department of Agriculture.

dim because of a record 2.4 billion bushel world supply—two-thirds of which is located outside this Nation.

Soybeans. Soybean carryover into this marketing year—which began last September—at an estimated 303 million bushels, nearly doubled from the preceding year. The increase was due to production expanding more rapidly than utilization, which has been the case in recent years. Even if utilization expands as expected this year, carryover next August 31 will again increase by nearly 100 million bushels. Total utilization is approaching a 1 billion bushel annual rate, but the pressure of larger supplies will likely hold the prices received by farmers to near the support rate of $2.25 per bushel for 1969 crop soybeans, compared with the $2.42 average last year.