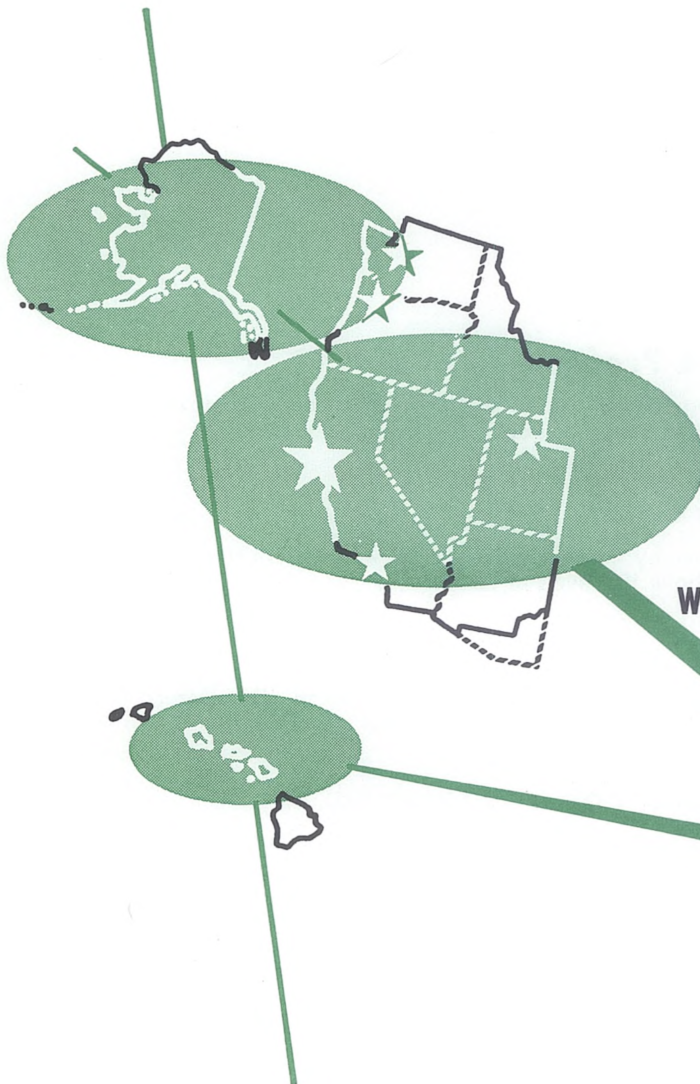
FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



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APRIL
1968

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Wages, Prices, Positive Thinking

. . . Guideposts still have a role to play, although monetary and fiscal policy share top billing in the '68 labor-relations drama.

Editor: William Burke

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Record Bank Profits

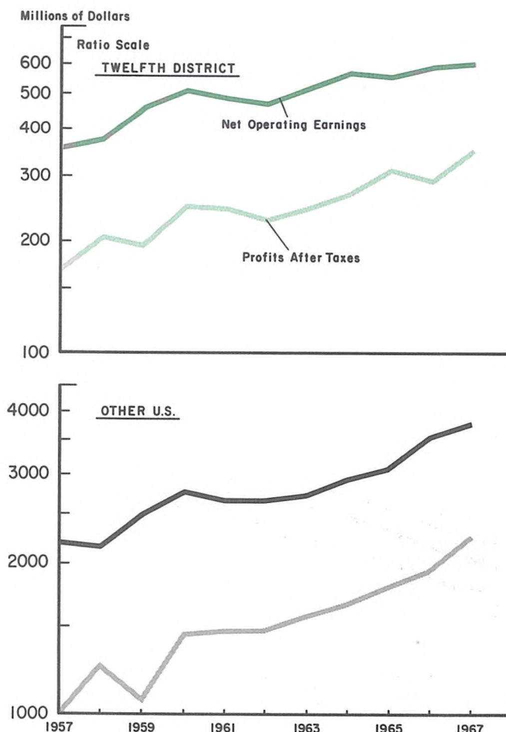
The commercial banking system operated in a much more favorable environment in 1967 than in 1966. Monetary policy was relatively easy, and banks were able to expand their total credit and to recover from the deterioration in liquidity experienced in 1966. Even in the face of near-record rates in the money and capital markets, particularly in the long-term sector, banks recorded increased deposit inflows both in demand and time categories. Under these generally favorable circumstances, Federal Reserve member banks nationwide increased their net current operating earnings by 5 percent and their net income after taxes by 18 percent.

Twelfth District member banks, however, departed somewhat from the national pattern. Their net current operating earnings reached a record $604 million, but this represented only a 1½-percent gain over the 1966 figure. The effects of the favorable financial atmosphere were offset for many major Western banks by sharp increases in costs, related to the introduction of credit-card programs, the installation of second- or third-generation computers, and expanded building programs. On the other hand, District banks' security losses were sharply reduced over the year, and net income after taxes thus soared to $351 million — 20 percent above the 1966 figure and 12 percent above the previous (1965) peak.

Loan portfolios, security portfolios, and all other sources of revenue contributed to the 1967 increase in District banks' operating revenues. Even so, this gain exceeded the rise in current expenses by only a small margin. The largest item of bank expense — interest on time deposits — continued its upward trend, but at a decelerated rate. However, wage costs and other miscellaneous costs increased rapidly.

Paradoxically, 1966's poor profit experience was a major contributor to 1967's large net profit, since the heavy capital losses on securities taken by District banks in 1966 (some of which represented shifts in holdings for tax purposes) placed them in a much better position to hold down security losses in the following year. Furthermore, the reinvestment of funds from these earlier sales into higher-yielding issues contributed substantially to 1967's 25-percent increase in security revenues.

Banks post record profits along with record current earnings



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Higher loan income

Current operating revenues of District member banks totaled $2.8 billion in 1967, for a 10-percent increase over the previous (1966) record. Reflecting changes in the financial climate, the revenue "mix" differed markedly from that in the preceding year. Loan income accounted for less than one-half of the gain last year, compared with 80 percent in 1966. But interest from securities made up over one-third of the 1967 revenue increase — in contrast to a mere 7 percent in 1966, when banks reduced their security holdings to obtain funds to meet loan demand.

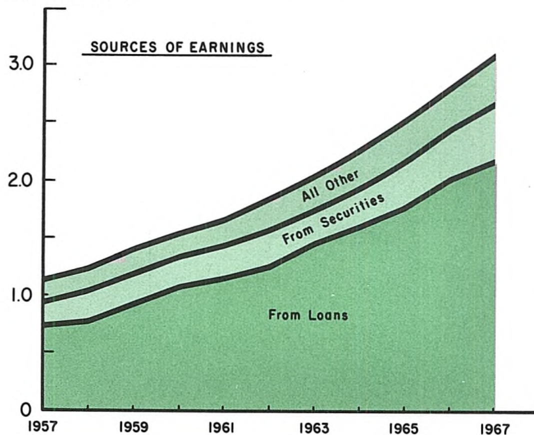
Last year's rise in loan income was due to a combination of expanded loan portfolios and an increase in the average rate of return. However, the 5-percent expansion in loan volume fell one percent short of the 1966 gain, and the average rate of return on loans rose only 14 basis points — far less than the dramatic 32-basis point increase of the previous year.

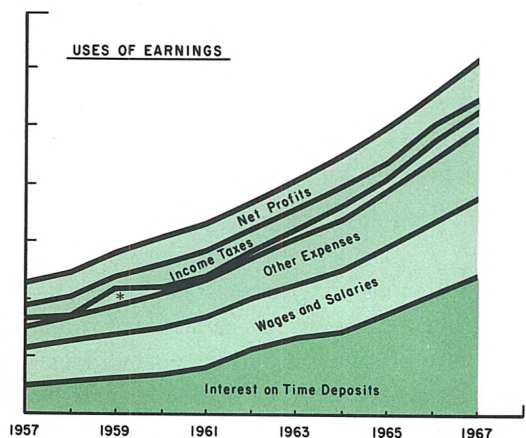
The 1967 rise in the average rate of return, to 6.87 percent, developed in the face of two reductions in the prime loan rate. (This rate, offered to key business customers, dropped from 6 to 5¾ percent in late January and to 5½ percent in late March, but then returned again to 6 percent on November 20.) However, banks benefitted from the carryover of loans made in 1966, which bore sharply higher rates than loans made in other recent years.

Soaring security revenue

District member banks added over $2 billion to their security portfolios in 1967 as a result of easing monetary policy and slackened loan demand in the first half of the year. Obviously, this 20-percent increase in holdings was a major cause of the sharply higher earnings from securities. It also was a factor contributing to the increase in net profits, since about three-fourths of the increase in security revenues came from bank portfolios of tax-exempt municipal obligations, which expanded 30 percent last year.

District banks show slightly larger gain in income than in expenses —but their profits soar as security losses decline





*Net losses on securities and loans, including transfers to and from valuation reserves

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PERCENT CHANGES IN SELECTED EARNINGS AND EXPENSE ITEMS OF TWELFTH DISTRICT MEMBER BANKS

	All		13 Largest[1]		Other	
	1966-1967	1965-1966	1966-1967	1965-1966	1966-1967	1965-1966
Earnings on loans	+ 6.4	+14.4	+ 6.1	+14.3	+ 8.2	+14.4
Interest and dividends on securities	+25.3	+ 5.6	+28.8	+ 4.0	+12.7	+12.1
U. S. Government	+16.1	− 7.0	+18.7	−10.3	+ 8.1	+ 4.4
Other	+35.7	+24.6	+38.9	+23.8	+19.0	+28.8
Service charges on deposit accounts	+ 5.7	+ 6.9	+ 4.8	+ 5.9	+ 9.4	+11.0
Trust Department earnings	+ 8.5	+ 8.6	+ 8.5	+ 7.5	+ 8.0	+15.5
Other earnings	+32.3	+24.2	+33.3	+27.6	+21.1	+ 7.6
Total earnings	+10.0	+12.6	+10.1	+12.3	+ 9.4	+13.7
Salaries and wages	+ 9.2	+ 7.8	+ 9.3	+ 7.8	+ 8.9	+ 8.0
Interest on time deposits	+14.7	+17.9	+14.7	+17.6	+14.6	+19.7
Other expenses	+11.2	+14.8	+11.6	+15.1	+ 9.4	+14.0
Total expenses	+12.2	+14.0	+12.5	+13.9	+11.3	+14.6
Net current earnings	+ 1.6	+ 7.5	+ 1.3	+ 6.9	+ 2.9	+10.0
Net profits before income taxes	+11.1	− 7.0	+12.4	− 7.8	+ 5.9	− 3.52
Taxes on net income	− 7.9	− 9.7	− 9.4	− 9.3	− 2.8	− 9.5
Net profit after taxes	+19.8	− 6.0	+22.5	− 7.2	+ 9.9	− .4
Cash dividends declared	+10.3	+ .5	+11.0	− 0.2	+ 6.9	+ 3.9

[1] Includes all District member banks with total deposits of $500 million and over as of December 30, 1967.
Source: Federal Reserve Bank of San Francisco

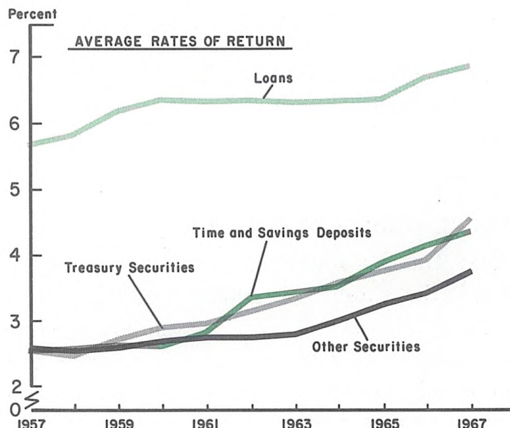
District banks also reaped benefits from the higher yields borne by their 1967 acquisitions and from the earlier restructuring of their portfolios. Banks realized an average yield of 4.56 percent on U.S. Government securities in 1967 — 64 basis points above their 1966 rate of return — and an average (before-tax) yield on other securities of 3.77 percent — up 35 basis points. In view of these rate developments, it is not surprising that income from securities last year represented a much larger share of total operating earnings of Western banks.

All other itemized sources of income, including earnings from service charges on deposits and trust functions, also rose in 1967. The fastest growing item was "other current revenue," which increased by one-third over the 1966 figure. Profits from foreign branches are included in this category, so the expanded participation of District banks in foreign operations accounts, at least in part, for the large increases reported under this revenue item in recent years.

Rapid time-deposit growth

District bank expenses reached a record $2.5 billion in 1967, for a 12-percent year-to-year increase. Interest expense on time deposits again was the major cost item, as could be expected from the 10-percent increase in the inflow of time-and-savings deposits. But the cost increase could have been

Yield on Treasury issues exceeds average time-deposit rate



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SELECTED RESOURCE AND LIABILITY ITEMS OF ALL MEMBER BANKS TWELFTH DISTRICT, DECEMBER 30, 1967

(MILLIONS OF DOLLARS)

	As of Dec. 30, 1967p	As of Dec. 31, 1966	Changes from December 31, 1966	
			Dollars	Percent
Net loans and investments[1]	46,073	42,284	+3,789	+ 8.96
Loans and discounts, net[1]	32,476	30,931	+1,545	+ 4.99
Commercial and industrial loans	12,307	11,282	+1,025	+ 9.09
Agricultural loans	1,326	1,271	+ 55	+ 4.33
Real estate loans	9,831	9,535	+ 296	+ 3.10
Loans to individuals	6,388	6,074	+ 314	+ 5.17
U. S. Government obligations	6.038	5.545	+ 493	+ 8.89
Other securities	7,559	5,808	+1,751	+30.15
Total assets	57,246	52,392	+4,854	+ 9.26
Total deposits	50,778	46,111	+4,667	+10.12
Demand deposits	22,293	20,298	+1,995	+ 9.83
Total time and savings deposits	28,485	25,813	+2,672	+10.35
Savings	16,260	15,727	+ 533	+ 3.39
Other time, IPC	8,022	6,407	+1,615	+25.21
Capital accounts	3,789	3,665	+ 124	+ 3.38

p—Preliminary

[1]Total loans (including Federal Funds sold) minus valuation reserves. Selected loan items which follow are reported gross.

Note: Details may not add to totals due to rounding.

Source: Federal Reserve Bank of San Francisco

even greater; a large share of the inflows went into savings deposits, which earn lower rates than other time deposits, while a slowdown developed in the struggle for deposits through higher-paying certificates which had dominated the two preceding years.

In 1967, the average rate of interest paid by Western banks on their time-and-savings deposits was 4.39 percent — a 21-basis-point increase over the previous year's rate. But this increase fell well below the increases of 26 and 37 basis points, respectively, recorded in the two preceding years. Besides, banks last year benefitted from the fact that the average yield realized on bank holdings of U.S. Government securities exceeded by 17 basis points the average interest paid on deposits.

Rising wages and borrowing costs

The District recorded a small net reduction in the number of member banks in 1967 because of mergers and consolidations, but the number of new branch offices exceeded the number established in 1966. Staffing requirements of these new offices and of new or expanded credit-card programs helped account for a 5-percent expansion in the number of bank employees and for a 10-percent increase in wages and salaries (including non-wage benefits). Western banks in 1967 allocated a significantly larger amount of funds for officer and employee benefits, such as pension-fund contributions. This expenditure item (nearly $100 million) represented a 14-percent increase over allocations for this purpose in the preceding year.

In contrast to the 1966 experience, the number of wage-and-salary employees rose at a faster rate than the number of officers. Furthermore, their average wage increased nearly 5 percent, as against a 4-percent gain for employees of officer rank.

Despite 1967's easier monetary policy, District banks paid $40 million for borrowed funds — $5 million more than they paid in 1966, when their borrowing costs climbed 58 percent. Actually, banks borrowed somewhat less at the discount window in 1967 than in 1966, and their average cost for this

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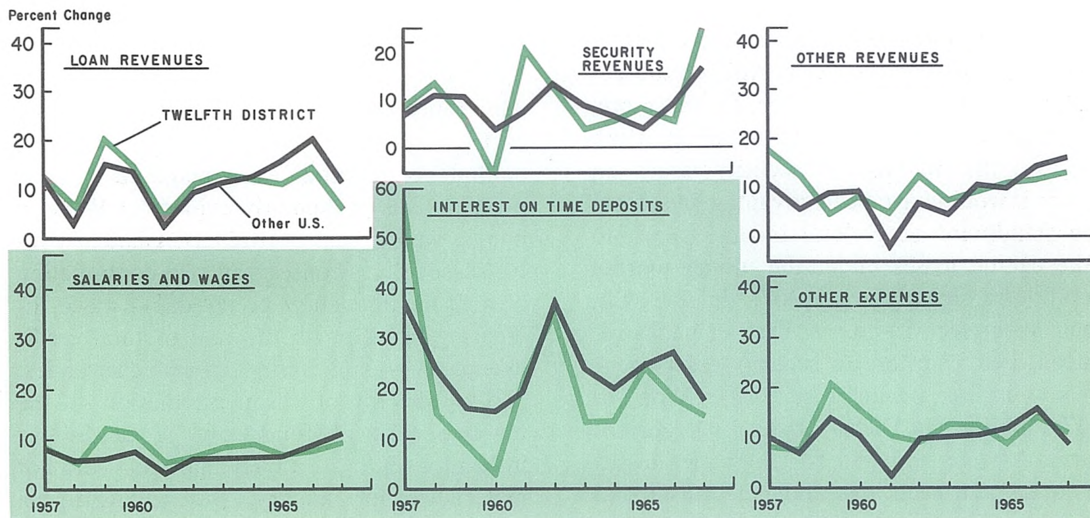
District banks outpace other banks in growth of security revenue but not loan revenue . . . also lag in growth of wage, interest expenses



type of borrowed funds was lower because of the reduced (4-percent) discount rate between April and November. At the same time, banks substantially increased their borrowings through inter-bank purchases of Federal funds, or idle balances of other banks on deposit with the Federal Reserve. Banks used some of these borrowed funds to meet their reserve requirements, but they also relent large amounts to dealers in U.S. Government securities. On these funds the arbitrage between the "buy" and "sell" rate was reflected in loan income, and was more than an offset to the expense item involved.

Loan and security losses

Net loan losses rose slightly to $76 million in 1967. Thus, for the second consecutive year, Western banks exhibited relatively high loan-loss ratios. In recognition of their increasing write-offs and their expanded loan portfolios, District banks made net transfers of $115 million to their reserves for bad debts in 1967.

On the other hand, District banks effec-

EARNINGS AND EXPENSES OF TWELFTH DISTRICT MEMBER BANKS
(MILLIONS OF DOLLARS)

	1967p	1966
Earnings on loans	2,155.5	2,025.6
Interest and dividends on		
U. S. Government securities	254.9	219.5
Other securities	266.5	196.5
Service charges on deposit accounts	198.8	188.0
Trust Department earnings	86.4	79.6
Other earnings	132.7	104.8
Total earnings	3,094.8	2,813.9
Salaries and wages	684.0	626.4
Interest on time deposits	1,197.8	1,044.0
Other expenses	609.2	549.0
Total expenses	2,491.0	2,219.4
Net current earnings	603.8	594.5
Net recoveries and profits (— losses)[1]		
On securities	— 4.8	— 46.4
On loans	— 115.4	— 106.0
Other	— 9.8	— 16.0
Total net recoveries and profits (— losses)[1]	— 130.0	— 168.4
Net profits before income taxes	473.6	426.3
Taxes on net income	122.9	133.4
Net profits after taxes	350.7	292.8
Cash dividends declared	193.1	175.1

p—Preliminary
[1]Includes transfers to (—) and from (+) valuation reserves
Note: Details may not add due to rounding.
Source: Federal Reserve Bank of San Francisco

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tively limited their security losses to less than $6 million in 1967, compared with a $47-million loss in 1966. The strong increase in deposits, reflecting the relative ease in monetary policy, permitted banks to expand their loans by 5 percent last year without the necessity of liquidating securities. Furthermore, the extensive capital losses taken in 1966 reduced the holdings of security issues on which it would have been advantageous, from the standpoint of Federal income taxes, to take capital losses under the money-market conditions prevailing in 1967. In line with their lower security losses, District banks reduced their transfers to security reserves.

Net pre-tax profits rose $47 million, to $474 million, as District banks' net current earnings were adjusted for these net losses on loans and securities and net transfers to reserves. Total taxes paid by member banks declined by 8 percent in 1967. Federal taxes were lower for the second consecutive year, and the increase in state taxes, although 10 percent, was not large enough to offset the Federal reduction. As a consequence, banks realized net income after taxes of $351 million — $58 million higher than in 1966. Stockholders benefitted from high profits by receiving $193 million in cash dividends — a 10-percent increase over the preceding year. Although capital accounts increased last year, the ratio of cash dividends to capital accounts was higher.

New factors in 1968

As the new year started, bankers faced a wide range of economic uncertainties. In the early months of 1968, monetary conditions continued to firm, and increased reserve pressure was particularly evident at Western banks, where loan portfolios expanded contra-seasonally. Consequently, a continuation of a firmer monetary policy could place increasing restraint on the rate of total credit expansion — and thus on operating revenues.

The spectre of disintermediation — the massive shift of funds out of depository institutions into the money market — did not materialize in January. But in April, as money rates continued to rise, substantial time-deposit outflows occurred and thereby created pressures that led the Federal Reserve to increase the rate ceilings on large-denomination time certificates of deposit. Some of the pressure on market interest rates that gave rise to this disintermediation would be removed if the proposed tax increase is enacted — for it would not only improve our financial position in the eyes of the world, but would also reduce the Federal deficit and

SELECTED OPERATING RATIOS OF TWELFTH DISTRICT MEMBER BANKS
(PERCENT RATIOS)

	1967p	1966	Increase or Decrease
Earnings ratios:			
Return on loans	6.87	6.73	+ .14
Return on U. S. Government securities	4.56	3.92	+ .64
Return on other securities	3.77	3.42	+ .35
Current earnings to capital accounts	16.24	16.49	— .25
Net profits after taxes to capital accounts	9.44	8.10	+1.34
Cash dividends to capital accounts	5.19	4.85	+ .34
Other ratios:			
Interest paid on time deposits to time deposits	4.39	4.18	+ .21
Time deposits to total deposits	56.74	55.65	+1.09

p—Preliminary

Note: These ratios are computed from aggregate dollar amounts of earnings and expense items of Twelfth District member banks. Capital accounts, deposits, loans, and securities items on which these ratios are based are averages of Call Report data as of December 31, 1965, June 30, 1966, and December 31, 1966; and as of December 31, 1966, June 30, 1967, and December 30, 1967.

Source: Federal Reserve Bank of San Francisco

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thus Federal borrowing requirements.

Of course, any reduction in time-deposit growth that does take place strengthens counter-inflationary monetary policy by reducing relatively the excess reserves of commercial banks, leaving them with fewer funds for investment. Nevertheless, the improvement in banks' liquidity positions achieved last year gives bankers somewhat more flexibility in adjusting to adverse changes in the financial environment.

Banks in the West, as elsewhere in the nation, started the new year with a 6-percent prime rate on business loans—and they then boosted this key loan rate to 6½ percent in April on the heels of the discount-rate increase. Moreover, they experienced a relatively strong demand for business and real-estate loans during the early months of the year. Meanwhile, yields on U.S. Government securities and municipals continued at or near the high late-1967 levels under the pressure of expanded Federal and state financing needs. Thus, in the near future at least, bank revenues from loans and securities can be expected to exceed earnings for the comparable period of 1967.

On the cost side, District banks are faced with still further increases in time-deposit interest expense, even though the growth in time deposits so far this year has fallen short of the gain in the early months of 1967. Employment costs also can be expected to follow an upward secular trend. But on the plus side, many District banks should experience some leveling-off in the wide variety of costs which in 1967 were associated with the start-up of credit-card programs.

—*Ruth Wilson*

Boost in Money Rates

The Federal Reserve Bank of San Francisco raised its discount rate from 5 to 5½ percent on April 19, on the heels of a similar move by the New York, Philadelphia, and Minneapolis Reserve Banks the preceding day. This increase, the third in the last five months, boosted the discount rate to the highest level since the 1929 stock-market crisis.

In addition, the Federal Reserve Board adopted a new schedule of maximum interest rates payable by member banks on large-denomination negotiable certificates of deposit. The Board left unchanged the rate ceilings for time-and-savings deposits of less than $100,000, but for the large CD's it substituted a graduated rate schedule for the previous 5½-percent maximum. The new maximum rate was set at 5½ percent for maturities of 30-59 days, 5¾ percent for 60-89 days, 6 percent for 90-179 days, and 6¼ percent for maturities of 180 days and over.

In the wake of these measures — "actions to restrain intensifying inflationary pressures and to strengthen the position of the dollar at home and abroad" — the financial community acted quite promptly to raise rates on business and mortgage loans. Banks nationwide boosted the prime rate on business loans from 6 to 6½ percent, a record unmatched since this industry standard came into use in the early 1930's, and a major Southern California savings-and-loan association raised its prime rate on home mortgages from 6¾ to 7 percent or more.

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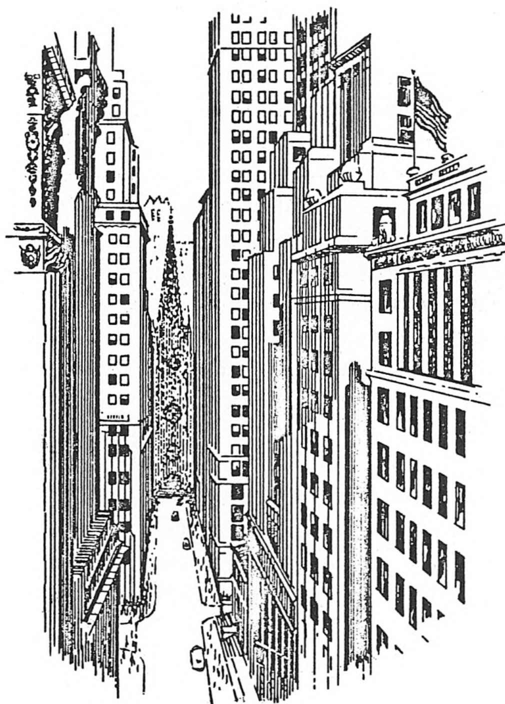
Rising Loan Rates



Businessmen who borrowed from Twelfth District metropolitan banks in the first half of February found their borrowing costs rising substantially above last November's levels. These results showed up in the latest Federal Reserve business-loan survey, covering all business loans made during the first 15 days of February by 25 banking offices located in four major District cities. The higher borrowing costs reflected the November 20 increase (from 5½ percent to 6 percent) in the prime rate — the rate charged business borrowers with the highest credit rating. The prime-rate increase followed in the wake of the British devaluation of the pound and the ½ percentage-point increase in the Federal Reserve discount rate.

The weighted-average interest rate on regular short-term loans (excluding loans made under formal revolving-credit agreements) rose to 6.31 percent in the February survey period — 28 basis points above last November's average rate. (It was also above the 6.26-percent rate reported in February 1967, shortly after a prime-rate reduction from 6 percent to 5¾ percent.) Despite this increase, the difference between the average loan rate and the prime rate was substantially smaller this February than it was in any of the four preceding quarterly surveys. Furthermore, 45 percent of the dollar volume of regular short-term loans was made at, or below, the prime rate — a higher proportion than in November 1967.

Several factors may have contributed to the narrowing of this margin. There was probably some time lag in adjusting to a higher prime rate, because of prior commitments to borrowers based on the previously existing prime rate. There was also little evidence of the sharp expansion in business-loan demand which normally precedes a rise in the prime rate. The November increase was the result of international pressures on the money market rather than domestic credit demands. However, later increases (to 5 and then to 5½ percent) in the discount rate — and the related rise in the prime rate to 6½ percent — will lead to further upward revisions in the schedule of business-loan rates.

Loans made under formal revolving-credit agreements usually bear a somewhat lower average interest rate than regular short-term

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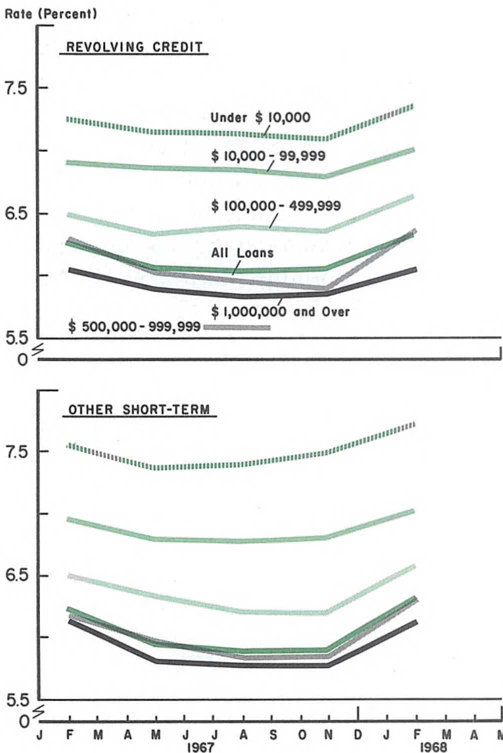
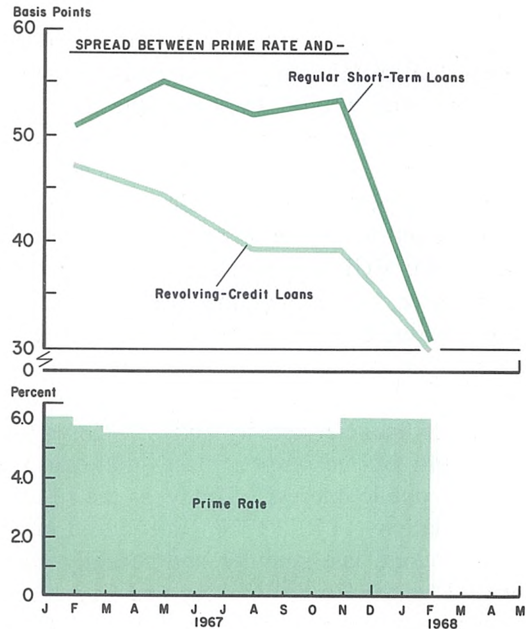
loans, because of the relatively greater proportion of large loans made to business firms which have formal loan agreements. But between November and February the average rate on revolving-credit loans jumped 41 basis points to 6.30 percent — only one basis point below the average cost on regular short-term loans.

As in the case of regular short-term loans, the margin between the average rate on revolving-credit loans and the prime rate was

Interest rates jump sharply for all business-loan categories



Spread narrows between prime rate and average short-term rates



smaller than in any of the preceding four surveys. One-half of the dollar volume of these loans made in the February survey period carried the prime rate — a smaller proportion than three months earlier.

The 25 metropolitan banking offices included in the February survey reported 2,213 regular short-term loans, totaling $225 million; 1,249 loans made under revolving-credit agreements, totaling $508 million; and 58 long-term loans, totaling $22 million. The dollar volume and number of both short-term and long-term loans was less than reported in November.

—Dee Dee Robertson

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H. R. 13718

Three years ago, the former Chairman of the Federal Home Loan Bank Board stated that the Housing Act of 1964 was but the "opening wedge" by which the nation's savings-and-loan associations would secure a "greater participation in the consumer-credit field and in other medium- and long-term credit fields." The specific provisions which the FHLB spokesman had in mind were those authorizing the S&L's to make college-education loans and to invest in state-local government obligations — provisions which would place the S&L's "nearer to the center of financial activity and . . . closer to that multi-faceted range of needs that constitute the public interest." Today, as the result of legislation (H.R. 13718) introduced into the Congress last summer and recently approved by the House Banking and Currency Committee, the nation's S&L's and mutual savings banks have moved a step closer to "the center of financial activity."

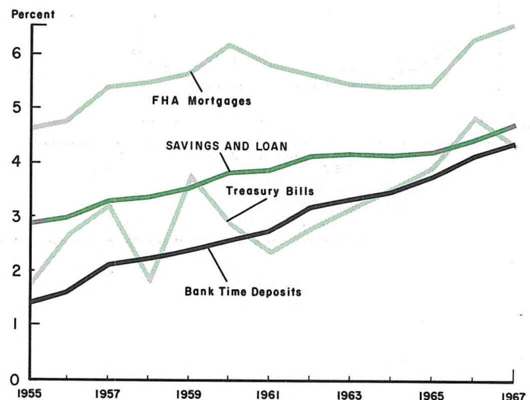
"New banking system"

If passed by the Congress in its present form, the "Federal Savings Institutions Act" would make possible a substantial alteration in the structure of the savings industry and a considerable broadening of the S&L's lending and investment powers. In fact, the proposed legislation envisions the eventual possibility of "a new banking system" resulting from a fusion of existing S&L's and mutual savings banks into new institutions which would eventually be called "Federal Savings Banks."

The mutual savings banks, which are located primarily in the northeast section of the country — the Twelfth District contains only five banks of this type — support the legislation on the grounds that a dual-chartering system would be conducive to a more favorable regulatory climate. However, in view of the fact that the mutuals already enjoy a much broader range of lending and investing powers than the S&L's, the number of conversions from state to Federal charters may not be very great.

The S&L's, on the other hand, may have a very strong inducement to convert to the new-type institution under Federal charter, while the new charter may also act as inducement for new institutions to be organized. Much will depend, of course, upon the extent to which existing state-chartered institutions are able to receive from their respective state governments additional lending powers obtainable under the new Federal charter. The possible impact varies by state; California state-chartered associations account for somewhat over two-thirds of all S&L assets in the state — a considerably higher proportion than the two-fifths share held by state-chartered associations in the rest of the nation.

Rate spread between mortgages and savings narrows—then widens



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New elbowroom

If the proposed legislation is adopted, a number of new *lending* powers would become available to all Federal S&L's and to state S&L's in many states where lending and investing powers are now limited. With their expanded lending, S&L's would be able to make home-improvement loans, furniture-appliance loans, mobile-home loans, loans to purchase unimproved property, loans for educational purposes (other than for college educations), loans secured by deposits or life-insurance policies, and unsecured ("personal") loans up to $1,000. (The figure in the original bill was $5,000.) *Investing* powers also would be substantially broadened to include the investment of funds in corporate bonds and (through mutual-fund sales) equity issues, as well as bankers acceptances, state-local government obligations, and the entire range of U.S. Government and Agency issues.

These provisions would thus enable the S&L's to accommodate a much wider range of borrowers in both the public and private sectors of the economy, although they would still be required to hold at least 60 percent of their "non-liquid" assets in mortgages. (Mortgages now account for over 80 percent of S&L total assets, in both the Twelfth District and the rest of the nation.) This provision is designed to assure that the bulk of their assets would be devoted to their primary function, housing finance. They would also be required to maintain liquidity reserves in the form of cash, bank deposits and Government securities, within the range of 4 to 10 percent of their deposits plus borrowings from the Federal Home Loan Bank.

On the supply side of the ledger, changes also would be substantial. In fact, some supporters of the measure argue that its main purpose is to provide the S&L industry "with greater ability to compete for savings," and not simply to provide it with broader lending and investing powers.

The new institutions would be authorized to raise funds through the issuance of longer-term obligations, so that they would become less vulnerable to shifts in depositor funds induced by fluctuations in market rates of interest. Similarly, they would be empowered to issue a broader range of certificates of deposit promising a fixed rate of return. (The rate would be subject to the then-effective rate ceiling on certificates as prescribed by the Bank Board, but not subject to any *change* in the ceiling during the life of the certificate.) They also would be empowered to accept so-called "Keogh-Smathers money"—the retirement funds of self-employed persons. Finally, the savings institutions could—like commercial banks and savings banks—call savings "deposits" rather than "shares," and designate the return on such savings as "interest" rather than "dividends." After January 1, 1973, any institution converting to a new charter also could use the name "bank" in its title in lieu of "association."

The pros . . .

The S&L's and the mutual savings banks have mustered a number of arguments in support of the legislation, including several advanced by the Council of Economic Advisers and by such earlier bodies as the Commission on Money and Credit and the President's Committee on Financial Institutions. One argument is that broadened lending and investing powers will result in greater inter-industry competition, to the advantage of the public at large. Another point is that diversification would reduce the dependence of certain types of borrowers upon specific sources of funds, thereby easing the transfer of funds from one financial sub-market to another when there are shifts in demand, and thus avoiding the contraction or expansion of a single industry such as occurred in 1966.

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The ability to make consumer loans, or to invest in corporate bonds or state-local government obligations, for example, would have the effect of "providing an alternative to mortgage investments during periods when there is too much money seeking the same thing." This added flexibility, it is argued, not only would make the institutions much less prone to a 1966-style squeeze, but also less prone to a 1963-style temptation to make risky mortgage loans on overly liberal terms.

By their increased ability to make consumer loans, it is also argued, S&L's would be strengthened from an earnings standpoint, thus strengthening their ability to pay higher rates (within the limits imposed by rate ceilings) and to retain depositors' savings. But perhaps the most controversial argument is that diversification on the part of the S&L's will strengthen their capacity, at least in the long run, to help finance the nation's housing needs.

The cons . . .

Commercial bankers and other opponents of the proposed legislation question whether legislation empowering the S&L's to place their funds in loans and investments other than mortgages will, in fact, mean "more money for housing." These observers quote the Council of Economic Advisers (which supports the legislation) that "to the extent that thrift institutions shift to more diversified portfolios, the amount of funds available to the mortgage market will be initially reduced." They note, moreover, that institutions which enjoy much broader lending and investing powers than the S&L's—that is, the mutual savings banks — allocated less than one-half of their increased savings to mortgages last year, because of the high yields which were available on corporate bonds and other investments, and also because of the statutory ceilings on mortgage rates in some areas. (Admittedly, mutuals in 1966 allocated 108 percent of their savings inflow to mortgages, as against an 89-percent figure for the S&L's, but they accomplished this by liquidating some non-mortgage assets initially acquired through savings inflows which otherwise would have been channeled into mortgages.)

But even if the S&L's had enjoyed broader lending powers in, say, 1963 and 1964, when the supply of loanable funds was growing very rapidly, they would not necessarily have placed more funds in investments other than mortgages. After all, the yield spread between mortgages and other investments in that period was even greater than it was in 1966 and 1967 — for example, about 115 basis points between FHA mortgages (at 5.45 percent) and corporate Aaa bonds (at 4.30 percent). During that earlier period, in fact, a number of marketable instruments offered lower yields than those which the S&L's were paying on their own passbook savings (especially in the West), so that earnings-conscious associations were under a strong inducement to place their funds in higher yielding (if riskier) mortgages.

To the extent that interest-rate ceilings on deposits restrict competition for funds, the ability of the S&L's and mutuals to increase their share of savings flows simply because of their broadened lending powers may be less than generally supposed. However, the actual rates which institutions can pay on their deposits will depend in the longer run on the earnings on their assets, and differences in the net earning ability of different institutions may provide various competitive advantages. Thus, to the extent that asset portfolios vary because of differential reserve, liquidity, and tax requirements, the potential for shifts of deposit funds in response to interest-rate differentials will remain.

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Depending on the point of view, then, the proposed legislation may (or may not) enhance the S&L's ability and willingness to allocate more funds to the housing sector. More definite answers may be provided by the forthcoming Wharton School report on the industry, for which Congress appropriated $500,000 two years ago.

H.R. 13718, in any case, seeks to broaden S&L lending and investing activities so that they can accommodate a much wider spectrum of borrowers—including borrowers whose supply of and demand for loanable funds may be cyclically more volatile than that of homeowners. In this way, the bill has again focussed attention on a number of matters of vital importance to commercial banks and S&L's alike, including the questions of liquidity, of "equity" as between banks and other institutions, and of the applicability of traditional techniques of monetary control.

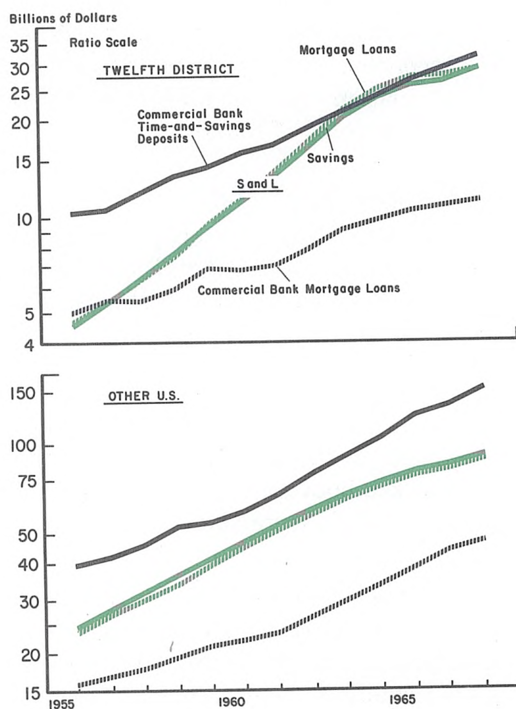
—*Verle Johnston*

Savings and Mortgages

Western commercial banks tripled their time-and-savings deposits between 1955 and 1967, while Western savings-and-loan associations — despite the slowdown of recent years — recorded a six-fold increase over the same period. At year-end 1967, S&L savings accounts in Twelfth District states totaled $29.1 billion, against a $31.4-billion figure for District-bank time deposits.

In the rest of the nation, the rate of savings inflow at both banks and S&L's exceeded the pace at District banks during the 1955-67 period — but lagged far behind the pace at Western S&L's. At year-end 1967, bank time-and-savings deposits totaled $151.2 billion while S&L savings accounts totaled $91.1 billion.

Mortgage trends naturally followed the direction of savings inflow: District S&L's scored a very sharp gain, while other S&L's and banks (both East and West) recorded smaller yet still substantial gains. District S&L's held a much larger mortgage portfolio than District banks at the end of 1967 — $29.1 billion vs. $11.1 billion. Elsewhere, associations held $88.8 billion in mortgages while banks held $46.7 billion.



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Western Digest

Loans Rise, Total Credit Declines

In March, bank credit declined sharply ($429 million) at large District banks — but primarily because of a $434-million decrease in loans to securities dealers and a $183-million reduction in bank holdings of U.S. Government securities. . . . Commercial-industrial loans meanwhile rose sharply ($139 million) as businessmen sought financing to meet their mid-March corporate income-tax payments. Tax-related borrowing by Western business firms rose at double the year-ago pace, but this increase was still smaller than the gain recorded by weekly reporting banks elsewhere. . . . Large banks, in the West as elsewhere, continued to expand their real-estate loans, in contrast to their year-ago experience.

Bank Deposits Increase

Large District banks ended March with a $578-million increase in demand deposits adjusted — representing over one-half of the national gain for weekly reporting banks. Moreover, their $79-million rise in total time-and-savings deposits accounted for nearly one-half of the national gain in that category. Pre-crediting of quarterly interest on savings deposits boosted the March increase in passbook savings to $204 million.

Copper Strike Ends

The 8½-month copper strike ended in late March, as the striking workers won a record-sized package of wage and fringe-benefit increases, but lost their attempt to get common contract-expiration dates at all company facilities and uniform economic terms for all workers. The settlement called for a $1.13-an-hour raise in wages and fringes over a 40-month period for Western mine and smelter workers, along with smaller increases for workers at Eastern fabricating plants. . . . In the aftermath of the strike, producers posted an increase, from 38 to 42 cents a pound, in the domestic price of copper. But the Council of Economic Advisers attacked both the wage settlement and the subsequent price increase as contributing to inflationary pressures.

Airbus Orders Zoom

The largest single commercial-aircraft sale ever made was recorded in late March, when one British and two American firms placed a $2.2-billion order with a California manufacturer for the new Model L-1011 airbus. The order was for 144 of these tri-jets, including options. . . . The L-1011 airbus, a 250-300 passenger medium-range plane, is due to enter service in late 1971. Because of the influx of orders, the workforce producing the plane will rise from 1,200 today to 11,000 by the end of 1969.

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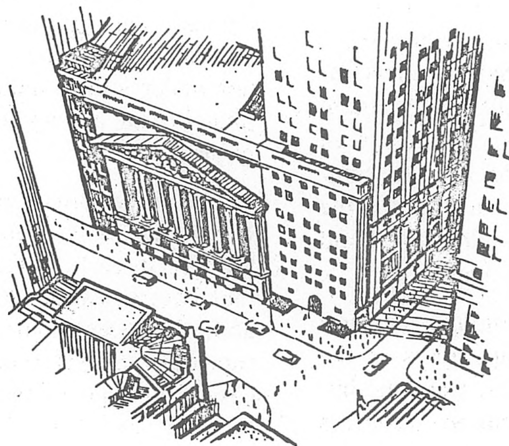

Wages, Prices, Positive Thinking

"Guideposts," the name of an inspirational pamphlet published by the author of *The Power of Positive Thinking,* is also appropriately the name of the approach designed by the Council of Economic Advisers to inject some positive thinking into the nation's wage- and price-setting mechanisms. This approach of course has played a secondary role to monetary and fiscal policy in countering the inflationary pressures that have developed in the last several years. Yet although secondary in importance, it has on occasion been first in dramatic interest, providing opportunities for many industrial statesmen—from the steel moguls of 1962 to the copper barons of 1968—to bask (sometimes unwillingly) in the national spotlight.

Guidepost pressure on industrial prices has garnered many headlines, but an important element in the CEA's approach to inflationary price increases is its attempt to curb the wage-price spiral by holding industrial wage increases within the bounds of industry's productivity gains. In the past two years or so, however, rapidly rising consumer prices have eaten into otherwise bulging paychecks and have thereby prompted union rank-and-filers to demand that their leadership get "more" in confrontations with management. In this atmosphere, guidepost pressure has been less successful than heretofore. Yet, all this has only led the CEA, in its 1968 report, to reiterate the close connection between labor costs and prices.

In each of the several segments of the postwar period, price movements have generally conformed closely to movements of unit labor costs in all the major sectors of the economy. Both prices and unit costs rose annually by about 3 percent in the 1947-53 period; the rate lessened to 2 percent in the 1953-59 period, and declined further to 1 percent annually in the 1959-66 period. Thus, an analysis of the present outlook for price stability should include an examination of the status of 1968's wage negotiations and of the record of the 1962-67 guidepost pressure on wage settlements. But first, the price record.

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Threat of spiral

In the decade to date, four separate periods of price movement can be discerned. Wholesale prices of industrial products remained relatively stable until the Vietnam conflict escalated in mid-1965; prices then accelerated between mid-1965 and late summer of 1966, eased somewhat during the economic slowdown until mid-1967, and lately have accelerated once again.

During the business expansion of the early 1960's, price stability was not upset by the period's sharp economic gains, since the initially large margin of unutilized resources was gradually absorbed into production. Yet, in early 1965, farm prices jumped because of lower domestic supply and heavy export demand, and the price trend accelerated soon thereafter when the Vietnam escalation created a heavy demand for industrial products.

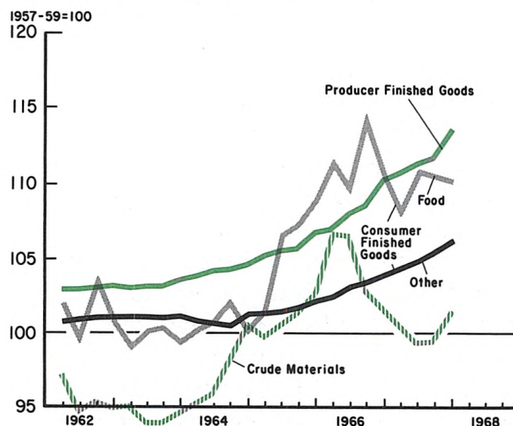
A spiral developed as rising living costs and tight labor markets led to sharp increases in wage demands — with the dollar cost of settlements rising faster than productivity, and with the resulting bulge in unit labor costs, along with stronger product markets, generating higher prices. Rising prices in turn served as the basis for further wage advances — and wage advances as the basis for further price increases.

Nonetheless, final demand slowed in late 1966, under the restraint of a restrictive monetary and fiscal policy, and a period of marked decline in inventory investment and sluggish economic growth followed in the first half of 1967. This slowdown, along with an improved supply situation, caused declines in farm and crude material prices and a pronounced slowing of the rise in industrial-product prices. Yet some prices continued to rise on the heels of rising costs attributable to the earlier period of heavy demand.

In more recent months, the threat of a renewed spiral has again developed. Aggregate demand has increased sharply during this period, and, although resources generally are not under strain, industrial costs have continued rising as they did in the earlier period of slack.

Wholesale prices of industrial products, which were only 1 percent above the 1957-59 base in early 1962 and 2 percent above that base in early 1965, have since jumped about 6 percent higher. Within that over-all category, mixed trends have developed. Crude material prices jumped 7 percent in the first year of the Vietnam expansion but then declined from spring '66 to mid '67 before turning up again. Wholesale prices of consumer food products have remained rather high even after a 10-percent jump in the early Vietnam period, and prices of other consumer finished goods have moved up about 5 percent since early 1965. More important, prices of producer finished goods have recently accelerated and have thereby created further worries about the competitive status of American goods in world markets. In each of the last two years, prices in this category have risen roughly 3 percent.

Worrisome uptrend develops in finished-goods prices



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Inflationary bias?

Rapidly rising prices of this type reflect pressure on productive capacity from excess demand, but they also indicate the possible presence of an inflationary bias in the economy — a tendency for prices to rise even when overall demand does not exceed productive capacity. An inflationary bias can develop in various ways; for example, from concentrations of market power or from inefficiencies and bottlenecks.

Competitive pressures which limit the ability of industrial firms and unions to raise prices and wages are weaker when manpower and capital resources are rather fully employed than when resource utilization slackens. In a strong economy, industrial firms use their market power to widen profit margins and workers attempt to raise their wages relative to others, while they resist symmetrical reductions when costs decline and demand slackens. At high levels of resource use, firms can raise prices without fear of losing business, since their competitors have sufficient business themselves as well as sufficient profits from other lines. Moreover, union workers can obtain wage increases and not fear the loss of employment, because their employers understandably are not anxious to lose production during boom periods. But in any case, price increases may also occur because of bottlenecks generated by stagnant technology, restrictive labor practices, or costly distribution systems.

Wages and prices can reinforce each other in either a balancing or an unbalancing direction. Rising living costs can support demands for wage increases greater than productivity gains, and price and wage increases can reinforce each other long after the initial source of price momentum has ceased operating. On the other hand, a circular relationship can support stability, as it did in the earlier years of this decade. With prices stable, demands for wage increases are not swollen to cover rising living costs; with wage increases moderate, costs and prices also remain stable. But, if the stable relationship is broken, as in the recent past, government policies must be called upon to break the spiral. In particular, fiscal and monetary policy must work to prevent an expansion of demand in monetary terms that would otherwise validate expected price increases.

The wage record

The problems of wage-price stability can be gauged from a review of recent changes in labor costs, productivity, and earnings. Gains in *hourly* earnings have of course increased sharply. In manufacturing, the average annual increase rose from 3.0 percent in the 1960-65 period to 4.1 percent in the 1965-67 period, and in construction the increases were even greater — 3.8 percent annually in the early part of this decade and 5.2 percent annually in the last several years.

Gains in *gross weekly* earnings have also remained strong. But after adjustments for taxes and prices, a different picture emerges: *spendable weekly* earnings of a factory worker with three dependents increased in real terms by 2.5 percent annually in the 1960-65 period, but then declined by 0.5 percent annually in the 1965-67 period.

The difference in these statistics highlights the vastly different appearance of wage-price relationships from the opposing sides of the bargaining table. Workers see that their annual gains in compensation have continued in the same 4-percent range established in the earlier years of this decade, but that their livings costs have recently jumped by about 3 percent annually as against the 1-percent increases they had become accustomed to in earlier years. Sharp gains in real earnings, based upon the stable prices and tax reductions of yesteryear, thus have now disappeared. Employers meanwhile watch the

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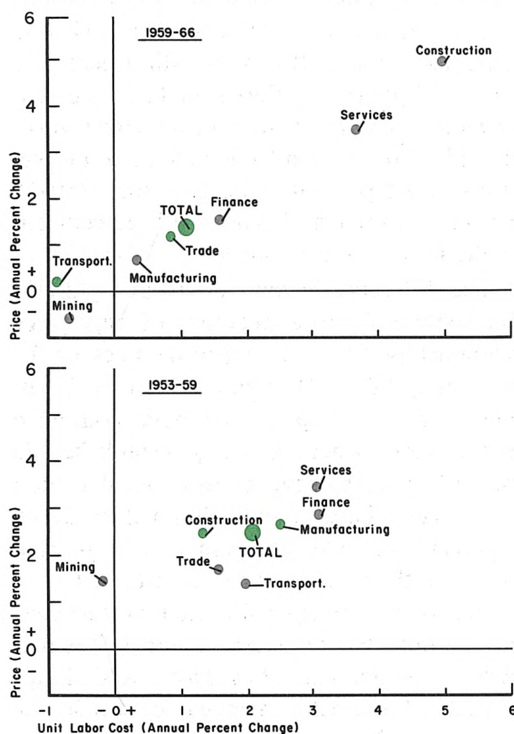
sharp gains in labor compensation overtake diminishing gains in labor productivity. The earlier stability in unit labor costs thus has now disappeared — in fact, this index has risen over 5 percent in the last year alone — and profit margins, aided by whatever price increases may be achieved, have been forced to absorb increased labor costs as well as the costs of reduced capacity utilization.

The 1968 calendar

The pressures arising from this dichotomy will be felt in major 1968 contract negotiations. Although the total number of workers covered by contracts which expire or can be reopened for wage negotiations is lower this year than last — 4.0 million as against 4.6 million — several major pace-setting industries are involved in negotiations this year. Contract expirations alone involve 2.8 million workers nationally and over 600,000 workers in the West. In this region, major negotiations are scheduled (mostly around midyear) in construction, aerospace, steel, and food products.

In Western manufacturing, contracts will expire for 176,000 aerospace and shipyard workers — roughly half the national total in the transport-equipment field. Also in the manufacturing sector, 34,000 Western food workers will account for 31 percent of the national total, while 27,500 Western steel and aluminum workers will account for 5 percent of the total involved in nationwide contract negotiations. Outside manufacturing, 193,000 Western construction workers will account for roughly half of the national total involved in new construction negotiations, with four carpenters' and laborers' agreements making up the bulk of the regional total.

Each major industry exhibits close correlation of prices and labor costs



Major contracts

The steelworkers union, following a grueling nine-months' struggle with the copper industry, now faces contract terminations on June 1 for aluminum and on August 1 for steel. In its 1965 steel industry bargaining, the union gave way to Administration pressure and signed a contract providing for a package increase of 3.5 percent annually. In 1968, however, the union is determined to match the contract gains recorded recently by the auto workers, by the rubber workers — and by the steelworkers union itself in the can industry, where it obtained a 6-percent annual average gain in wages and fringe benefits.

Similarly, in their negotiations with the aerospace industry, the machinist and autoworker unions are determined to get the now-fashionable 6-percent package instead of the more modest gains they settled for in 1965. Other factors will also complicate negotiations in this industry. The unions want the

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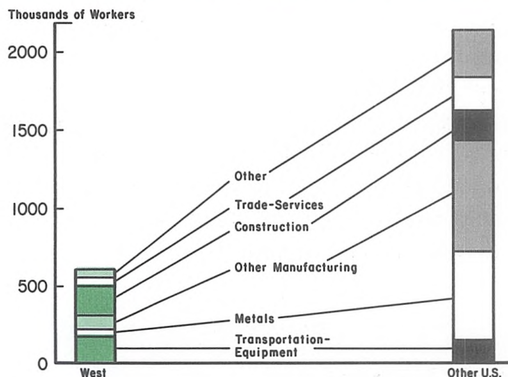
Aerospace, metals, construction dominate Western bargaining in '68



same type of additional wage adjustment for skilled workers that skilled autoworkers recently obtained — and skilled workers account for 30 percent of the aerospace work force as against less than 20 percent in the auto industry. At the same time, the aerospace firms want to keep costs under control in a period when Federal budget sensitivities are especially acute. Meanwhile, both sides to the negotiations will have the White House looking over their shoulders because of the importance of keeping production flowing in this key defense industry.

Decisions already made

Even so, the number of workers involved in newly negotiated wage agreements this year will be less than the number who will receive deferred wage increases under earlier negotiated plans. Nationwide, about 4 million workers are involved in contracts which either expire or are subject to reopening, while almost 5 million workers will automatically receive adjustments under earlier agreements. Moreover, the 3.8-percent median wage increase scheduled under deferred plans this year is the largest increase on record.

The Council of Economic Advisers, in its latest annual report, drew attention to the unhappy implications of this development for wage-price stability. In 1967, the wage-and-benefit increases negotiated under major union settlements averaged 5½ percent a year over the life of the contracts involved, while average annual compensation in the total private economy increased 6 percent. But, the CEA argued, average compensation will increase even faster in 1968 if negotiated settlements are again in the 5½-percent range, since the second- and third-year provisions of earlier contracts provide larger 1968 increases than were inherited in 1967 from the similar wage provisions of earlier contracts.

Another earlier decision, set in motion in the fall of 1966, entitles millions of additional workers to higher pay through a newly effective increase in the Federal minimum wage. The 1966 amendment to the Fair Labor Standards Act upped the hourly minimum by 20 cents this year — to $1.60 an hour — for workers already covered by the Act, and by 15 cents — to $1.15 — for those covered for the first time. Notably, the 20-cent increase effective this year exceeds the 15-cent boost effective a year ago.

Productivity principle

The increases negotiated last year and held up as a target for this year suggest major difficulties for price stability unless industrial firms act to absorb rising costs and unless productivity increases rapidly enough to reduce cost pressures. Although the Council admits that it would be unrealistic to hold to its earlier 3.2-percent guidepost for wage increases in view of the recent 3-percent increases in living costs, it still argues that new contracts could and should include less than the 5½-percent package gains negotiated last year.

To emphasize this point, the CEA repeated its 1967 message in its 1968 report: "The only valid noninflationary standard for wage

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increases is the productivity principle. If price stability is eventually to be restored and maintained in a high-employment U.S. economy, wage settlements must once again conform to that standard."

The AFL-CIO Executive Council rejected this CEA standard in its Miami Beach meeting in February. AFL-CIO economist Nat Goldfinger said: "We rejected 3.2 percent and we'll reject 5.5 percent," on the grounds that "income flows in the economy have gone out of kilter . . . with other groups gaining the major share of benefits of the economic advance of the last two years." At the same time, the AFL-CIO argued that it would support mandatory wage controls if the President determined that a national emergency warranted extraordinary stabilization measures — provided that such measures included "even-handed restraints" on all costs, prices, profits, rents, dividends, stock options, and other compensation.

Lead, Guiding Light

The new British budget calls for stiff increases in sales taxes — already among the highest in the world — along with a strengthening of guidepost policy to keep wages and prices under control. In presenting the budget to Parliament, the Chancellor of the Exchequer argued that increases in wages, salaries and dividends must conform to the productivity "guiding light" of 3.5 percent a year; otherwise the competitive advantage which Britain gained from devaluing the pound would quickly disappear.

According to the proposed Prices and Incomes Act, the Government would set a 3.5-percent ceiling (through 1969) on annual increases on all types of remuneration, including corporate dividends. The new legislation would empower the Government to require price reductions when recommended by the Prices and Incomes Board, to delay pay and price increases for 12 months (instead of 7 months, as at present), and to bring rent increases within the purview of the Board.

Thus, in line with the trend of the 1960's, the U.K. version of guidepost policy has been tightened yet another notch. (Informal attempts of this type were relatively successful during the 1948-50 austerity period but were much less so during the ensuing decade.) The U.K. took official action in early 1962 — the same time that the U.S. moved into this field — when it set up a 2 to 2½ percent "guiding light" geared to the historical trend of productivity. But when hourly wages increased at twice the proposed rate that year, the "guiding light" was raised to 3 to 3½ percent in line with the estimated *future* increase in productivity.

The 1964 balance-of-payments crisis led the Government to create the National Board on Prices and Incomes to rule on price and wage increases. The 1966 crisis brought about the enforced "standstill" — which helped keep average wages stable throughout late 1966 — and the ensuing period of "severe restraint" — which in practice was anything but that. But the response to the 1967-68 crisis suggests that "severe restraint" henceforth will be an increasingly accurate description of British guidepost policy.

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Historical record

The Council's statement and the union (and management) response raise the question of the possible role that can be played by voluntary wage-price guideposts in an inflationary high-employment economy — both as a supplement to monetary-fiscal policy measures and as an alternative to mandatory controls. Since Bernard Baruch's War Industries Board in 1918, wage-price controls have had a checkered career indeed, but their heyday came during World War II and the Korean conflict.

During World War II, a piecemeal administration of wages and prices developed in an atmosphere of underutilized resources until after the attack on Pearl Harbor. Then, in July 1942, under the National War Labor Board's Little Steel formula, wage increases were permitted up to 15 percent above January 1941 wage levels — and after October 1942, no wage increases were allowed without WLB approval. Nonetheless, wages and (especially) fringe benefits drifted upward throughout the war. Meanwhile, in the field of commodity prices, the OPA Maximum Price Regulation (April 1942) stipulated that sellers could not exceed their highest March 1942 prices for any commodity and that further price increases would not be permitted without OPA approval. These wage-price regulations continued in effect until after V-J Day, but the wage line was broken effectively by February 1946 and the price line by June 1946, and formal de-control followed soon thereafter. The result of the entire episode was a severe price rise in the three-year period following the war; between 1945 and 1948, consumer prices jumped by one-third and wholesale prices even more.

Early in the Korean War period, a spending splurge occurred as resources shifted to war production and as workers and consumers reacted to psychological fears of a repetition of a World War II situation. Congress resuscitated controls under the Defense Production Act of September 1950, but the Administration did not adopt a general freeze until the following January — long after inflationary pressures had first appeared. By late 1951, in fact, controls became unnecessary except for a few scarce materials. In this period, the sharpest increases in the general price level took place prior to — and largely in anticipation of — the establishment of controls.

How to stabilize

In its recent report, the CEA characterized mandatory controls as the most obvious and least desirable way of attempting to stabilize prices. Granted their necessity in an all-out war, the Council argued that it is folly to consider them as a normal solution to the inflationary problem. Direct controls distort the allocation of resources and require the development of arbitrary rules by a vast administrative apparatus — and they offer countless temptations for evasion or outright violation.

The Council, while emphasizing the central stabilization role of fiscal and monetary policy, thus recommended once again an incomes (guidepost) policy as an essential way of reconciling high employment and rapid growth with reasonable price stability. In a sense, they are a unique response to the unique problem of price stability over the past quarter-century.

A nagging rise in prices occurred in the late 1950s despite deflationary policies and rising unemployment, and the problem was compounded by the lagging exports of manufactured goods and the related deterioration of the nation's balance of payments. Moreover, when expansionary measures were adopted in the early 1960s, it became apparent that rising business activity could stimulate wage claims and could reduce the restraints on price increases that had previously been exerted by resource underutilization.

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The guideposts

The new Administration thus was forced to seek new measures to restrain wage and price increases, and the answer it adopted was a system of guideposts. These guides were unveiled in the CEA's 1962 report: "The general guide for noninflationary wage behavior is that the rate of increase in wage rates (including fringe benefits) in each industry be equal to the trend rate of over-all productivity increase. General acceptance of this guide would maintain stability of labor costs per unit of output for the economy as a whole — though not of course for individual industries."

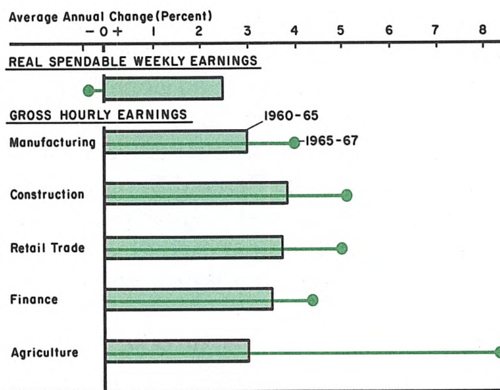
"The general guide for noninflationary price behavior calls for price reduction if the industry's rate of productivity increase exceeds the over-all rate — for this would mean declining unit labor costs; it calls for an appropriate increase in price if the opposite relationship prevails; and it calls for stable prices if the two rates of productivity increase are equal."

These guideposts were based on the assumption that the economy would work more efficiently if discretionary price and wage decisions of powerful firms and unions were brought more into line with the results expected in competitive markets. The same viewpoint has dominated each of the Council's reports since 1962, despite variations in detail. The original 1962 statement provided no precise measure of long-term productivity trend to serve as a basic guide. The 1964 statement, however, was much more specific, citing the now-famous 3.2-percent figure — the 5-year moving average of output per man-hour in the private economy — as the standard for average wage increases.

Away from 3.2

The Council clung to this 3.2-percent standard throughout the next several years despite the development of several compli-

Workers' real earnings decline despite gains in hourly pay



cations. For one thing, the 5-year average in 1966 should actually have yielded a 3.6-percent guidepost. For another, even that figure would have provided little gain in real wages; the consumer-price index rose by 2.9 percent in 1966, boosted by price increases in food and services — two areas not reached effectively by guideposts because not governed by major industry and union decisions. Thus, in 1966 and 1967, unions tried to obtain wage settlements which effectively equalled the original 3.2-percent guidepost plus the amount necessary to offset the rising trend in consumer prices.

The Council, in its recent restatement, admits that many sellers of commodities and services have no discretion over their prices, that many wages are not set by collective bargaining agreements, and that prices of imported goods and farm products are determined by other factors than the domestic wage level and the discretionary decisions of large firms. Nonetheless, it argues that "If the guideposts were essentially observed by those firms and unions that possess discretion with respect to prices and wages, the inflationary bias inherent in a high-employment economy should be largely overcome."

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Many business and union critics argue that guideposts hamper the flexibility of wages and prices and reduce their effectiveness as guides to efficient decision-making. In other words, they might not really be worth their cost, since controls of this type could seriously undermine the U.S. economy's productive capacity, its potential for growth, and its power to hold down costs.

Guideposts and bottlenecks

In his recent book, *The Wage-Price Guideposts,* Professor John Sheahan of Williams College argues that guideposts in a sense *are* controls, since they set up principles and call for actions that reduce the scope for discretion in the private sector. Although relatively mild, informal, and infrequently applied with serious pressure, they do aim to bring government pressure to bear on private decisions.

Such intervention, in Sheahan's view, would distort incentives and reduce efficiency if the economy were highly competitive in all markets. But of course the economy is not completely competitive: there are limitations through implicit and explicit business agreements, restrictions on entry into certain markets, union and professional-society controls over supply of workers, and so on. Thus, if pressure were brought to bear on a limited number of significant areas, the result should be a closer approach to competitive conditions.

Professor Sheahan does not advocate, however, that guideposts should replace other stabilization policy or even become the dominant tool in the anti-inflation kit. "Aggregative monetary and fiscal management can be used to keep the economy above total disaster and below all-out inflation. The guideposts then become part of a second line of economic policy, gaining in relative importance because of the very success of improved aggregative techniques."

There are several possible supplements (or alternatives) to the guideposts. In fact, Harvard Professor John Dunlop suggests the abandonment of guidepost restraints and the establishment instead of a bottleneck-oriented program. In his approach, the attack on bottlenecks would be worked out in each field by labor, management and government agencies, with specialized groups making detailed studies, proposing corrective policies, and coordinating private and public approaches. Dunlop believes that the most critical sectors for early action are some branches of transportation, medical and hospital services, construction, local-government services, certain professional services, and perhaps auto manufacture. (This approach thus may call for an institutionalized Ralph Nader.)

This list aims at sectors (aside from auto manufacturing) which are typified by rising costs, inadequate efficiency, and small-scale operations. A bottleneck-oriented program thus may well help to reinforce guideposts, since it is these sectors that tend to push the consumer-price index upward even when industry's unit labor costs are stable. (Nearly half of 1967's 3-percent rise in consumer prices developed in the guidepost-free field of services.)

The Federal contribution in this field, according to Wisconsin Congressman Henry Reuss, could include more support for the training of medical personnel to overcome supply problems and thereby curb the medical price spiral, along with a shift in agricultural programs from price support to income support, so as to provide consumers with cheaper food while providing farmers with adequate income. Other observers have suggested greater vigor in anti-trust enforcement, more support for productivity-enhancing research-and-development work, and countercyclical variations in Federal stockpiles of key materials.

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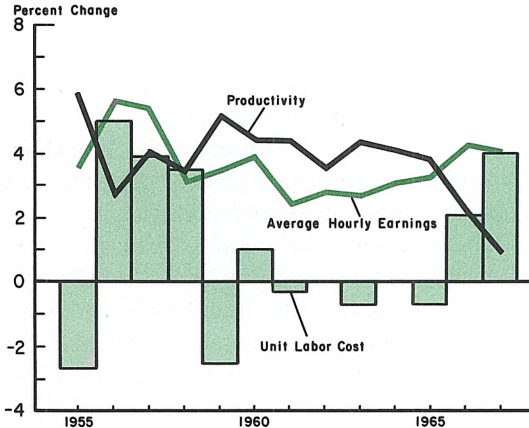
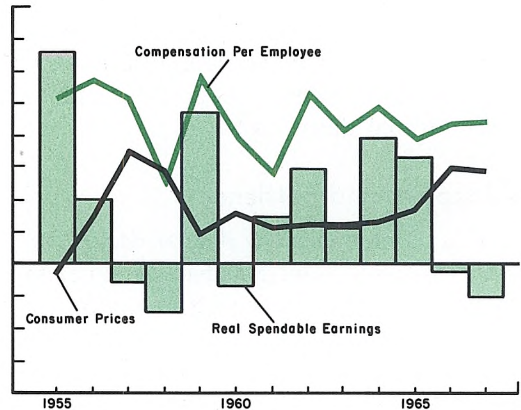
Employers' costs jump: workers' pay rises faster than productivity . . . employees' budgets suffer: prices, taxes bite into their earnings





How effective?

The question remains whether guideposts have been effective during the relatively short period in which they have been tried. The experts disagree about both their validity and their effectiveness, and statistical tests of wage and price behavior have not actually proven that they were completely effective over this period. Still, the tests are consistent with the hypothesis that guideposts contributed — along with the more intensive competition from imports — to the increased wage-price stability of the mid-1960s.

In recent Congressional testimony, the Brookings Institution's Dr. Gary Fromm presented a statistical model which showed the "substantial effect" of the guideposts' wage-price pressure over the 1962-66 period. In that timespan, guideposts are credited with reducing the annual rate of increase of manufacturers' wholesale prices by more than 1¼ percent, and exerting an even greater downward pressure on unit labor costs. But in 1967, when guidepost pressure was weaker, the results would have been less favorable.

In a study by Minnesota Professor George Perry (September 1967 *American Economic Review*) wage and price changes again were shown to be smaller with guideposts than they would have been without guideposts. Moreover, according to Perry, smaller-than-anticipated wage increases occurred most notably in "visible" industries — that is, the mass-production industries most susceptible to guidepost pressures. (The "visible" industries, which account for roughly 10 percent of total employment, include metals, machinery, electrical equipment, and transportation equipment.)

In the two otherwise comparable periods of 1954-57 and 1963-66, the average annual wage increase in "invisible" industries declined from 4.3 percent in the first period to 3.8 percent in the guidepost period — but in "visible" industries the wage increase dropped from 5.0 to 2.9 percent in these respective periods. Even after adjustment for changes in employment patterns, this test strongly indicates a much greater differential in wage behavior in those industries most susceptible to guidepost influence.

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Countering inflationary bias

The relevance of guidepost behavior is emphasized in Perry's book, *Unemployment, Money Wage Rates, and Inflation,* in which he pointed up the inflation-prone nature of the U.S. economy. The wage-determination process is such, he argued, that with low levels of unemployment and with profit rates and productivity gains typical of the postwar period, wage changes will tend to be inflationary. (The study relates the rate of price increase with given rates of unemployment and profits, assuming a 3-percent annual gain in productivity and no change in labor-force or income distribution.) For example, with unemployment at the "target" rate of 4 percent, with the profit rate at the postwar average of 11½ percent, and with productivity rising by 3 percent annually, the price index could be expected to increase by about 2 percent a year.

Perry suggests several ways of altering the equation to dampen this mild inflationary bias. For example, a slower rate of inflation could be obtained with an accelerated rate of productivity, so that wage increases could be offset through improved efficiency. Moreover, the structure behind the wage equation could be changed through guideposts policy, with pressure exerted on the wage-price nexus in the manner prescribed by the CEA.

But there are still further complications, as outlined by the Conference Board's Dr. Michael Levy in the Fall 1967 *Business Economics*. The problem is that identical target unemployment rates can have a different economic meaning over time, and hence could be a treacherous tool for the "fine tuning" favored by Administration economists. As Levy shows, price stability occurred in 1952-53 with an overall unemployment rate below 3 percent, but stability was sadly lacking in 1966-67 with unemployment higher at 3¾ percent. What is involved here, among other things, is a shift in the structure of unemployment over time, with the most recent period of high employment evidencing a much lower jobless rate for adult males and a much higher rate for teen-agers than was standard heretofore. This upward drift in the teen-ager jobless rate during successive high-employment periods reflects shifts in labor supply and other structural factors — factors which lead to inflationary complications when treated by expansionary monetary and fiscal policies.

Guideposts, then, although relatively successful in their operation, are not a cure-all for the nation's wage and price problems. Moreover, as several observers suggest, they may be far less relevant to the present period of high demand than to the more sedate period of several years ago. (Professor Perry: "I am afraid that the guideposts are least reliable when we need them most.") Yet, as Sheahan suggests: "The hope of the guidepost-type approach is not that it replace desirable aggregative restraints, but that it permit the economy to move to higher levels of employment and output before deflationary brakes need to be employed, by reducing the possibility that misleading signals of inflation may be generated by arbitrary price and wage decisions in the absence of excess demand."

—*William Burke*

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