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Monthly Review

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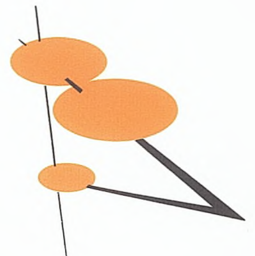

September 1971

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The First Ninety Days: Implications

. . . The new economic policy will produce major changes in the climate in which business operates at home and abroad.

The First Ninety Days: Precedents

. . . The history books record significant precedents for each of the major portions of the President's program.

Housing: Can It Last?

. . . Although the West's housing market is very strong just now, population and financing trends pose questions about the future.

Editor: **William Burke**

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The First Ninety Days

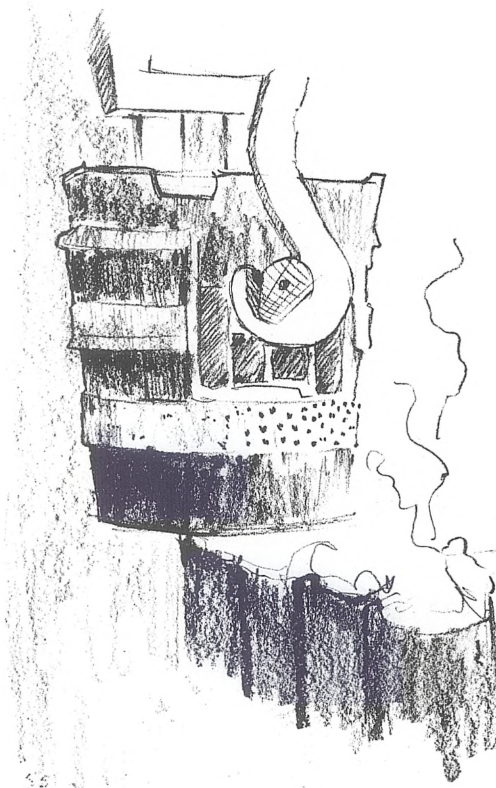
I. Implications

The nation has embarked on a totally new course of economic policy—one that should produce major changes in the climate in which business operates at home and abroad. In his history-making announcement, the President said, "The range of actions I have taken and proposed tonight—on the job front, on the inflation front, on the monetary front—is the most comprehensive new economic policy to be undertaken by this nation in four decades." To date, few economists (if any) have seen fit to quarrel with that assessment.

Most business forecasters, either of the econometric or the garden variety, now look forward to a significant improvement in the economy because of this breathtaking policy shift. A few experts, such as Nobel laureate Paul Samuelson, foresee little net stimulus because of the way the Administration has offset its tax-relief measures with expenditure reductions, such as the cutback in Federal employment and the postponement of a scheduled Federal pay raise. Other experts see things differently, however, because of the strategic nature of the fiscal stimulus to the auto and machinery industries, as well as the possible over-statement of the expenditure cuts that will finally come out of the budget-making mill.

The stimulus from the Administration's program should be substantial over the next year or so. According to Brookings Institution estimates, the net stimulus may reach $4.8 billion in the second half of 1971 and $4.5 billion in the first half of 1972, at annual rates. (However, those estimates may be on the high side.) During the current period the investment-tax credit and the auto-excise tax removal should both exert a significant impact. During the first half of 1972, those same factors, plus the personal income-tax speed-up, should again stimulate the economy, although their effect will be partly offset by the various Federal expenditure reductions.

Several major econometric forecasters, who had previously been looking for gains of 4-to-5 percent in real GNP in 1972, are now thinking in terms of a 6-to-7 percent increase. They now see no more than a 2-to-3 percent rise in the



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general price index (the GNP deflator), instead of a price rise of 4 percent or more—and perhaps also a drop in the unemployment rate of ½ percentage point or more below earlier estimates. Still, there is much ground to be made up; the gap between potential and actual GNP (in 1970 prices) was on the order of $70 billion or so at midyear.

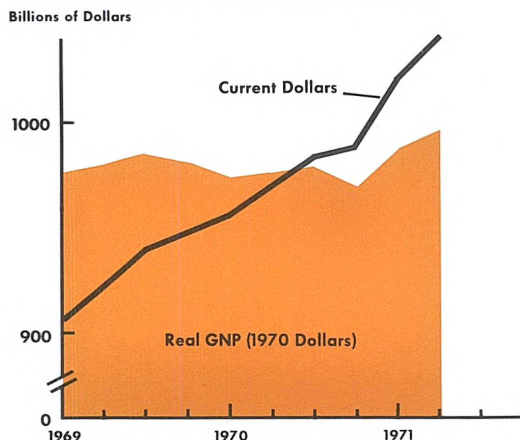
Scenario, with numbers

Most scenarios now being constructed would suggest substantial expenditure increases over the next year in consumer durable goods, business fixed investment, and net exports. Allowing a certain number of months for the tax credit to stimulate investment and for the dollar depreciation to stimulate the export sector, the previously sluggish recovery should gain momentum in the fourth quarter of 1971 and lead to a stronger year in 1972.

All sectors of the economy can expect to see more acceptable numbers arising from this optimistic scenario, but they should also expect to see a different kind of numbers developing because of the workings of the wage-price freeze. If the freeze is successful in slowing wage and price increases to a creep from the now all-too-familiar gallop, the dollar increases in GNP should be smaller—but much more real—than those recorded in the last several years. To put this situation in context, the moderate advance in GNP posted during the second quarter amounted to $9 billion in real terms but to $20 billion in current-dollar terms.

Somewhat ironically, to the extent that the Administration's anti-inflation stance is successful, government tax collectors will lose part of the inflationary windfall generated because of the graduated nature of the personal-income tax. (The persistent inflation has helped push many taxpayers into higher income brackets, where they are subject to higher tax rates.) But at the same time, the government sector will benefit from the freeze because of its holddown on inflationary purchases. In 1970, the price deflator

Freeze may bring current-dollar GNP more into line with real GNP



rose over 10 percent for Federal spending and over 7 percent for state-and-local government spending, so any improvement in that area will help government budgets substantially. Meanwhile, military sales abroad should be stimulated by the depreciation of the dollar—but for the self-same reason U.S. defense costs abroad should rise (perhaps by $200 million in fiscal 1972), unless the military burden is taken over more fully by the countries concerned.

Consumer receipts

Consumers generally should benefit from the new policy, partly because of the real and psychological benefits resulting from the general price freeze, and partly because of the overall stimulus created by the personal income-tax reduction and other elements of the Administration's fiscal package. Much now depends upon the general nature of the post-freeze controls, as well as the results of the Congressional debate over the Administration's fiscal package. In this connection, Congress may be tempted to offset, in some way, the deflationary increase in social security taxes now scheduled to take effect on January 1. That increase in total would amount to a $7-billion tax hike in 1972, according to the present House bill; specifically, for a $10,000 worker with a family of four, the $175 social security

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increase would more than offset the $80 he would gain from the income-tax speedup.

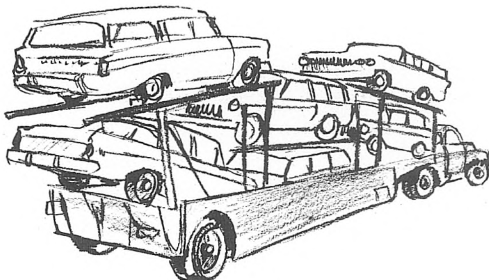
Aside from this general impact, some consumers will gain more than others from the workings of the new policy. The strongest beneficiaries include those who received substantial wage increases prior to August 15, social security recipients (with their retroactive benefit increase), workers in the export trades, and workers in the auto and associated industries. (Administration statistics suggest that 25,000 jobs are created for every increase of 100,000 in new car sales.)

Not so lucky are those who expected to gain substantial wage increases after August 15. Nonetheless, inequities of this sort would be bound to arise, no matter what date was chosen for the wage freeze.

Consumer purchases

Consumers may encounter rising prices for some raw agricultural products that are not covered by the price freeze. Also, for imported goods, the combined effect of the depreciation and the import surcharge should raise the sales price of such goods, depending on the amount of revaluation and on the amount absorbed by foreign suppliers or U.S. importers. But some reports indicate a boomlet for imports that were on hand before August 15—especially imported cars, with their eligibility for the auto-excise refund.

Consumers may be expected to look more favorably on Detroit's products now than they have for some time. The excise-tax removal could mean an average cut in new car prices of around $200 per car, and proportional reductions in the cost of used cars. And, since new and used cars are an important part of the consumer price index, a reduction in auto prices should help hold down the index.



Consumers who purchase foreign products on the basis of snob appeal rather than price competition may not be discouraged by the double-barreled increase in import costs. (Still, foreign cars will benefit from the elimination of the auto excise.) But conversely, low-income buyers who buy foreign products because they represent the best available at the bottom of the price line may be hurt by the rising prices of such goods.

Record-breaking boost

The Administration's program means a significant boost to U.S. corporations. The investment tax credit, plus the recent ADR (asset-depreciation range) measure, should mean a reduction of $8 billion or more in business taxes during the next year alone—the largest reduction of this type in history. Even so, many businesses may wait to see a boost in consumer demand—and a reduction in idle capacity—before they take advantage of these tax incentives.

With over one-fourth of the nation's manufacturing capacity now unused, most industries do not need new plant investment just for the sake of expanding production facilities. But with the 10-percent tax credit available for only one year, most would be tempted to replace their older equipment sooner than they otherwise would. Also, more of that increased investment should now take place here rather than abroad, in view of the dollar depreciation, the import surcharge, and the availability of the tax credit only on U.S.-produced equipment.

The Administration hopes to encourage the widest possible use of modern machinery and equipment, to stimulate both the long-term growth of productivity in manufacturing and the competitiveness of U.S. producers in both do-

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mestic and foreign markets. Modern production techniques are, of course, available to all industrial countries. If the U.S. is to maintain its competitive position, its prices must remain low relative to those of foreign competitors, and thus it must generate increases in productivity at least sufficient to match its wage increases. But to accomplish this, U.S. manufacturers should promptly apply the most modern and efficient production methods. Indeed, a high-income economy must remain innovative, as was seen by the President when he announced the beginning of work on new tax proposals to stimulate increased research and development.

The Administration's package of international actions means more orders for U.S. exporters, as well as fewer domestic sales for U.S. importers, including travel agents. The favorable impact of these actions should be greatest for manufacturers of products, such as chemicals and steel, that are mose sensitive to international price differentials.

The package of domestic actions should bolster consumer confidence and, by persuading consumers to rechannel their savings into the spending stream, should give an extra boost to retail sales. Reordering by retailers means a filling up of manufacturers' order books and thus an increase in the factory operating rate. The higher operating rate, plus the relative stability of wage costs, should then boost profit margins above their present sickly state and encourage businessmen to set aside more funds for new investment.

Detroit's boost

The auto industry will be a major beneficiary of the Administration's new policy, and Detroit's triumphs will be shared with its suppliers—steel, rubber, glass, copper, leather, and textiles. The auto industry could probably use such stimulus, since it had a record 1.7-million end-of-the-run models on hand August 1, and may soon have a large number of price-frozen '72 models coming off the assembly line early. With a smooth launching of new-model production, there may be 1.2 million '72 models available by the end of September, or double the number ready by that date in any earlier year.

The petroleum industry may obtain a mild boost from the expected prosperity of the auto industry, but at the same time, it faces a threat from the Organization of Petroleum Exporting Countries to raise the price of oil by whatever amount their currencies appreciate relative to the dollars in which they are paid. Steel industry prospects, formerly dismal, are now brighter because of the improved outlook not only for autos, but also for freight cars, farm equipment and other types of equipment. Yet the short-term steel outlook remains clouded by the overhang of 12 million tons of strike-hedge inventories built up before the new labor contract was negotiated on August 1.

The more efficient of the nation's export industries undoubtedly will be helped by the depreciation of the dollar. Producers of computers, jet planes, heavy machinery, and farm goods should be able to expand their already large bridgeheads abroad as their products become relatively cheaper in those markets. In addition, certain industries which can help modernize the nation's productive plant—machine tools and computers, in particular—should benefit from the expansion of orders resulting from the investment-tax credit.

Foreign exchange rates

The implications of floating currencies will become clearer as the nations gain more experience in freer foreign-exchange markets. Nevertheless, such experience will not serve as a reliable guide to the longer-run equilibrium levels of exchange rates so long as controls remain on movements of goods and investments. The free-market forces in foreign-exchange markets will not reveal the proper exchange relationships until the U.S. removes both the import surcharge and direct controls over foreign investment, and until other countries remove similar and related impediments to international economic activity.

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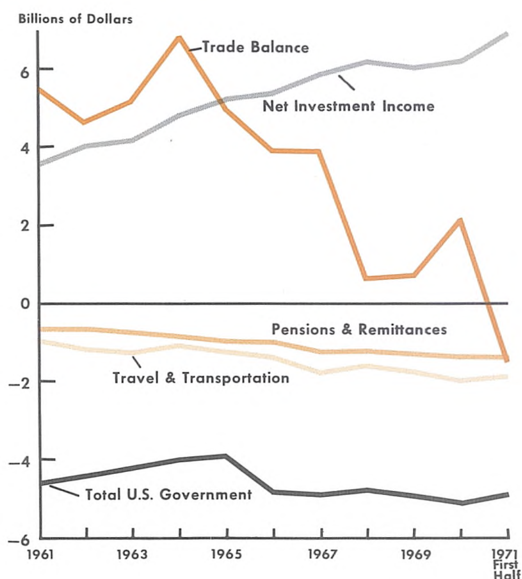
Prolonged decline in trade balance helps explain dollar crisis



The President's message suggested that basic changes are necessary in the international monetary system. The major trading nations must reach agreements about exchange-rate flexibility, the convertibility of the dollar, and the future role of gold and other reserve assets.

In the ongoing discussion, Pierre-Paul Schweitzer, managing director of the International Monetary Fund, proposed a three-step program of monetary reform. First, major nations would realign their currencies, define the role of gold, and return to fixed currency parities with wider bands, while the U.S. would remove its 10-percent import surcharge. Second, creditor nations would help correct the U.S. balance-of-payments deficit through more burden sharing and more effective capital controls. Third, the IMF would increase the available supply of liquid assets for world trade, perhaps through some new instrument resembling Special Drawing Rights. In reply to this plan, U.S. negotiators noted that the import surcharge would not be removed until creditor nations revalued their currencies in relation to the dollar and assumed a larger share of the U.S. military and aid burdens.

Domestic interest rates

In the monetary field, the new economic policy has relieved much of the heavy pressure which had borne down upon the Federal Reserve during the last several years. The burden has now been distributed more equitably among all the policy-making agencies.

In a major expectational switch, market participants are no longer disposed to believe that interest rates will inevitably move higher. Psychological factors earlier had helped push rates upward, despite the sluggishness of economic activity and the modest level of credit demands. But then, with the announcement of the President's program, 90-day Treasury bill rates dropped from 5.40 percent to 4.90 percent within a month's time, while in the long-term market, Treasury bond rates dropped from 5.85 percent to 5.52 percent, and corporate bond rates from 7.71 percent to 7.42 percent.

The slide in rates reflected a general confidence in the braking effect of the wage-price freeze, capable of reducing the inflation premium that lenders otherwise would tack on to their interest-rate demands. The dramatic drop in bill yields, which went as low as 4.45 percent at one point, also reflected an upsurge in foreign buying of bills and a tight supply condition of dealers. As foreign purchases have begun to taper off, the bill rate has moved upward again, although it still remains far below the pre-crisis level.

Heavy foreign buying of Government securities—close to $20 billion so far this year—has acted as an indicator of the accumulation of excess dollars in the hands of monetary authorities abroad. This new development introduces a volatile factor into the Government-securities market, since it could lead to heavy market pressures if substantial amounts of foreign-held Treasuries were to be liquidated.

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The money supply, after a large jump in early July, has since remained relatively flat. The stimulus arising from the President's program should require an accommodative growth of the money supply. Yet, to the extent that the freeze brakes the price rise, current-dollar GNP will rise more slowly, and there will be a smaller need for money to underwrite normal business transactions.

II. Precedents

Never before in the nation's history has such a multi-faceted economic program been unveiled at any one time. Even so, the history books record significant precedents for each of the major portions of the President's program.

The present attempt to stimulate growth through fiscal actions is reminiscent of the policy of the early 1960's. The policy of freeing the dollar and encouraging realignment of foreign exchange rates is reminiscent of the actions of the 1930's. Moreover, the attempt to curb the wage-price spiral through direct controls is related to a constant policy theme of the past generation. (Kremlinologists might note also that Lenin used the term New Economic Policy to describe his attempt to stimulate the Soviet economy in the early 1920's.)

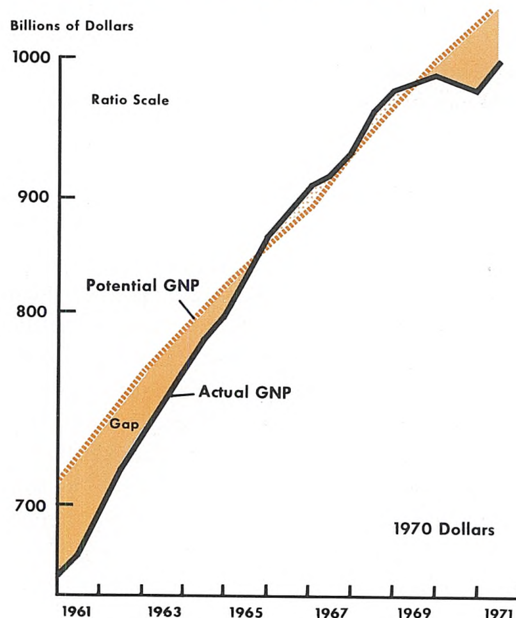
The various policy precedents differ somewhat in detail from their present-day counterparts. Nonetheless, they are worth examining to see what light they throw upon the likely direction of policy in the 1970's.

Gap of the '60's

One of the major elements in the present program is the 1960-style attempt to use fiscal policy to eliminate the large gap between the nation's potential output and aggregate demand. The main policy challenge a decade ago was to stimulate the growth of total demand, sufficient to catch up with the growth of productive capacity. Fiscal policy met this challenge by generating an increase of $21 billion in Federal expenditures and a reduction of $16 billion in tax liabilities (from 1960 rates) over the course of the 1961-64 period.

The budget at the beginning of that period would have generated a $13-billion surplus if the economy had been operating at full employment. This was quite inappropriate to an economy with a substantial amount of unutilized human and material resources. Heavy expenditures for defense, space, and civilian programs helped reduce that surplus, however, and two tax-reduction measures adopted in 1962 provided a needed long-run stimulus to lagging private investment. The net effect of new depreciation guidelines (announced July 1962) and the investment tax credit (enacted in the Reve-

Fiscal policy designed to close gap between actual and potential GNP



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nue Act of 1962) was a $2½-billion increase in the annual cash flow of corporations, plus an appreciable increase in the after-tax rate of return on new investment projects.

The expenditure increases and the tax reductions just about halved the original full-employment surplus by late 1962. In 1963, however, the aggregate demand generated by consumers, businesses, and governments was not adequate to move the economy sufficiently close to the full-employment target, and the full-employment budget surplus widened sharply again. Consequently, Congress passed the Revenue Act of 1964 and reduced tax liabilities by $11 billion on individuals and $3 billion on corporations. This legislation helped generate a 4½-percent rise in real GNP in 1964, whereas the increase without those tax cuts probably would have been below 3 percent.

Fiscal policy provided a further stimulus in 1965 with a reduction in excise taxes, mostly affecting consumer durable goods. These reductions amounted to about $3½ billion in the 1965-66 period. The excises were wartime emergency taxes, so they were considered long due for termination. Appropriately, then, when the Vietnam war flared up, further reductions scheduled for auto and telephone excises were shelved, and tax rates remained unchanged throughout the late stages of that conflict.

Turmoil of the '30's

In analyzing the current negotiations to alter international financial arrangements, it may be instructive to review the turbulent period which preceded the Bretton Woods arrangements. In the dark days of the early 1930's the world scene was marred by a number of competitive tariff increases and exchange devaluations. Against this backdrop, an activist new Administration came to power in Washington.

The Emergency Banking Act of 1933 (March) empowered the President to regulate or prohibit transactions in gold or foreign exchange. Under that authority, President Roosevelt embargoed all exports of gold and required banks and other holders to exchange their gold and gold certificates for other cash. In breaking the old ties with gold, the President—who had become determined to raise the level of domestic prices—was influenced by the arguments of a prominent farm economist, George Warren. In the latter's view, the price of gold controlled the general price level, and thus the only way to inflate was by raising the price of gold.

Accordingly, the President persuaded Congress to accept the Thomas Amendment to the Agricultural Adjustment Act, which authorized him "to fix the weight of the gold dollar . . . at such amounts as he finds necessary . . . to stabilize domestic prices or to protect the foreign commerce against the adverse effect of depreciated foreign currencies." (When informed of the abandonment of the old parity price, Budget Director Lewis Douglas intoned, "This is the end of Western civilization," and Bernard Baruch added, "Respect for law and order is gone.")

The London conference that spring became a center of the struggle between the American economic nationalists and the European gold bloc. The French and other European central banks tried to push through a plan for stabilizing exchange rates by adhering to the gold standard, but the President (to the applause of John Maynard Keynes) denounced this plan and called upon the conference instead "to cure the fundamental economic ills" of the world economy. The conference broke up at that point, but it was doomed anyway, because of the essential difference between those for whom the domestic price level was important and those for whom the traditional ties with gold were crucial.

Reaching $35 an ounce

Acting under the authorization of the Thomas Amendment, the President initiated a gold purchase program in late 1933, usually setting the price at some arbitrary figure, in a generally fruitless attempt to push up the domestic price level. In early 1934, however, a new arrangement was

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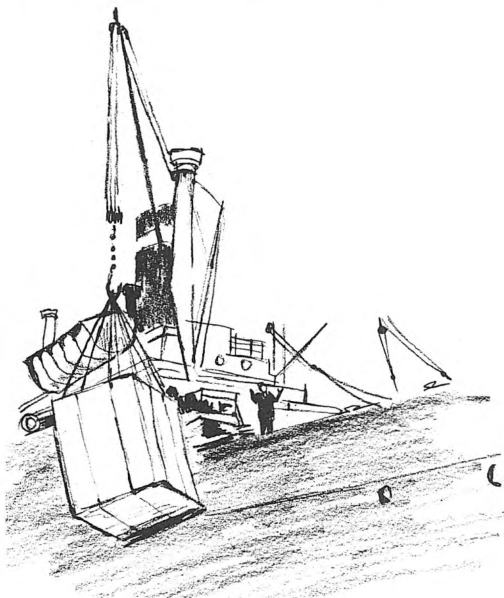
established with the passage of the Gold Reserve Act of 1934. This legislation permitted the President to set the price of gold at 50 to 60 percent of the old parity—that is, between $41.34 and $34.45 an ounce—and he thus set it, "temporarily," at $35.00 an ounce.

With the U.S. gold price settled in this manner, other currencies gradually aligned themselves with the dollar. In particular, the French devaluation of 1936 provided the occasion for a tripartite (American-British-French) agreement over the foreign-exchange situation. No definite parities were set, but each nation agreed to consult on future moves so as to avoid competitive depreciations, and also agreed to use stabilization funds to smooth the course of exchange rates. This arrangement lasted until World War II.



During the early stages of the war, the Treasury initiated plans to prevent monetary chaos in the postwar world. Treasury planner Harry Dexter White conceived of a United Nations stabilization fund that would stabilize exchange rates and promote liberal trade policies, and would act to halt the spread of restrictive exchange controls and bilateral currency arrangements. British economist John Maynard Keynes developed a far bolder plan for a Clearing Union that would have no assets of gold or securities but would consist of an extensive system of clearing credits to settle international imbalances. The final plan, which was somewhat an amalgam of the White and Keynes plans, was hammered out at the Bretton Woods Conference in the summer of 1944.

To discharge its obligations to maintain the value of the dollar under the Articles of Agreement of the IMF, the U.S. undertook to buy and sell gold freely at $35 an ounce with foreign central banks in exchange for dollars. The par values for other currencies were then established in terms of relative gold content and in terms of the dollar. (The U.S., with its reserve currency, did not have the same flexibility that other countries did to alter its declared parity.) The initial subscription of the Fund was less than $9 billion—substantially below the $35 billion that Keynes had in mind.

Spiral of many decades

Comparisons with the present attempt to halt the wage-price spiral through direct controls are scattered throughout the history of the past half-century. Since Bernard Baruch's War Industries Board in 1918, wage-price controls have had quite a checkered career, but their heyday came during World War II and the Korean conflict.

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, without express 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

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line by June 1946, as an economy fueled by a massive accumulation of liquid funds sought to make up for a four-year-long repressed demand for consumer goods. The 1945-48 period thus was dominated by an upsurge of demand-pull inflationary pressures, significantly different from the recent type of cost-push pressures; during that period, consumer prices jumped by one-third and wholesale prices even more.

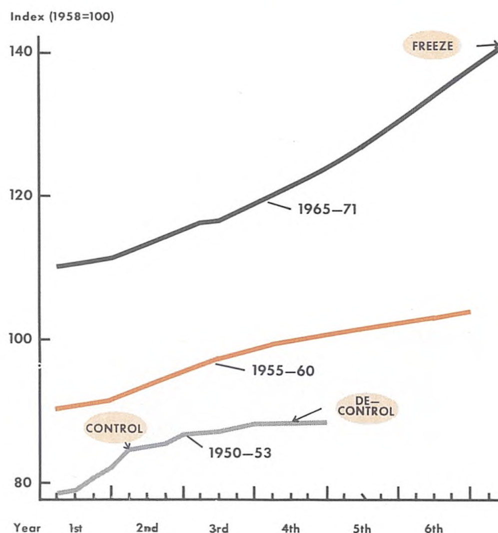
Case study: Korea

The Korean War inflation ran its course within a fairly brief period, being confined mostly to the period mid-1950 to early-1951. Sharp price pressures in this interval were attributable only partially to expanded demand or to supply shortages, but instead largely reflected expectational factors. Increases in raw-material prices anticipated future shortages and price controls, while increases in consumer buying anticipated future scarcity of consumer durables.

The initial policy response was the quick enactment of the Defense Production Act of 1950 and of tax increases on individuals and corporations. (Corporate excess-profits taxes were levied during the Korean War, as during both of the two World Wars.) The Federal Reserve also imposed controls on mortgage credit and consumer durable goods purchased at that time. Selective wage-price controls were instituted in late 1950, and these were followed by a general price freeze (January 1951) and by wage restrictions under the Wage Stabilization Board.

A fairly rapid restoration of price stability was achieved even in the face of the continuing war effort, which reduced the unemployment rate to a very low 2.5 percent. Substantial producer supplies of many types of commodities, plus retailer overstocking in anticipation of continued scare buying by consumers, helped to stabilize prices during the war period. Altogether, consumer prices jumped at a 14-percent annual rate in the first six months of the war, increased about 4½ percent more during 1951 (after the imposition of the General Ceiling Price Regulation), and then leveled off.

Three inflationary periods occur within past two decades



The principal price-control mechanism used by the Office of Price Stabilization (after the initial freeze) was to set fixed percentage markups for each commodity. The objective was to remove the principal distortions of the freeze by restoring the original relation between each manufacturer's cost for labor and materials and the price existing in the pre-Korea base period.

As a longer-run solution, the Economic Stabilization Administrator directed OPS (April 1951) not to permit any general increase in ceiling prices for any industry unless its pre-tax profits were below 85 percent of its profits in the three best years of the 1946-49 period. This policy ensured the absorption of cost increases so that they would not form the basis for future price increases.

Wages were controlled by the Wage Stabilization Board, which set to work in January 1951 by freezing wages, salaries, and other compensation at existing levels. Thereafter, the Board refused to permit payments of any raises without prior WSB approval. However, some 2 million workers had obtained raises under major wage contracts just prior to the freeze, probably be-

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cause of the Administration's discussion of forthcoming controls, and some attention had to be paid to smoothing out the resulting inequities. Thus, in February 1951, the WSB permitted 10-percent raises for those who had not obtained them at the first of the year, and on top of that, allowed previously negotiated cost-of-living raises in excess of 10 percent. (The then-Council of Economic Advisers suggested that productivity allowances, on the order of 2-to-3 percent annually, should be included as part of the stabilization program.)

Case study: new inflation

As price stability returned in 1952, OPS began to reduce controls on certain commodities (such as consumer items) where market conditions permitted, and the incoming Eisenhower Administration dropped the whole panoply of controls in February 1953. But then, around the middle of the decade, a new type of inflation began to develop. Its causes were a major investment boom, sharp rises in food prices because of supply difficulties, and in particular, a sharp rise in unit labor costs as factory worker costs exceeded productivity gains.

During this period, labor and other costs apparently produced inflationary price increases even under conditions of less-than-full employment and a lack of excess demand. More and more observers came to stress the monopoly power of big corporations and big unions as the real forces behind the inflation. They also noted that the inflationary bias imbedded in the economy through the existence of rigidities of this type could not easily be overcome by standard monetary and fiscal policies. Thus, a new type of problem confronted the Kennedy Administration when it took office in the midst of recession in 1961.

The guideposts

The new Administration 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 production 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 dominated a number of the Council's reports after 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 complications which eventually led to the discarding of the guidepost approach. The 5-year average in 1966 actually would have yielded a 3.6-percent guidepost, but even that figure would have provided little gain in real wages because of sharp price increases in food and services—two areas not reached effectively by guideposts because not governed by

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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 a 1968 restatement, admitted 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 argued 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."

How effective?

How effective were the guideposts during the relatively short period in which they were tried? Experts disagree about both their validity and their effectiveness, and statistical tests of wage and price behavior have not actually proven that they were 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 relative wage-price stability of the early 1960's.

The Brookings Institution's George Perry, writing in the *American Economic Review* (September 1967), argued that wage and price changes were smaller with guideposts than they would have been without guideposts. Moreover, according to Perry, smaller-than-anticipated wage increases occurred more 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 comparing wage movements during the periods 1954-57 and 1963-66, Perry found that the average wage increase in "invisible" industries declined from 4.3 percent in the first period to 3.8 percent in the guidepost period—but that the increase in "visible" industries dropped from 5.0 to 2.9 percent. 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.

The overall record shows that, at one time or another over the past several decades, Americans have gained a great deal of experience stimulating inadequate demand, confronting turmoil in the foreign-exchange markets, and overcoming inflations of the cost-push variety. No doubt, as 1971 comes to an end, they will gain greater familiarity with problems of this type, and hopefully with their cures as well.

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Western Digest

Bank Credit Expands

Total credit at large District banks rose 0.9 percent on a seasonally adjusted basis in August, but this offset only part of the 1.4-percent decline registered in July. . . . Loans expanded at a brisk 3.1-percent pace in August, more than offsetting the previous month's modest decline, and far outpacing lending activity elsewhere in the nation. August's strength primarily reflected heavy borrowings related to the foreign-exchange crisis. . . . District banks' security holdings fell sharply—6.6 percent for Government securities and 3.1 percent for other securities. (These reductions were considerably greater than those recorded nationally.) District banks now hold fewer Government securities than they did at the beginning of the year (seasonally adjusted basis).

Lockheed Financing Signed

A $750-million financing program to rescue financially troubled Lockheed Aircraft Corporation has been formally approved by the Federal Government and representatives of a 24-bank lending consortium. The Government will guarantee $250 million in new bank loans to support the L1011 TriStar program. The loan will cost Lockheed an 8-percent interest rate, with the Government getting 2.3 percent of that amount and the banks getting the rest. Of the 9,200 employees laid off during the company's financing crisis, the company has rehired 4,400 since June 1 to work on the TriStar. The first deliveries of the planes are scheduled for next April.

Aerospace . . . Improvement?

After many months of declining payrolls, aerospace employment in California showed a 2,700 increase in August, as workers were rehired to work on the TriStar program. In contrast to the strengthening in California, aerospace payrolls continued to slip in the Seattle area. As a result, the unemployment rate for that area remained above 14 percent.

Dock Strike Continues

President Nixon may intervene to stop the West Coast's three-month-long dock strike if it isn't settled soon, according to Administration officials. Contracts for East and Gulf Coast longshoremen meanwhile expire September 30; should the strike become nation-wide the President could order striking employees back to work under the "national emergency" provisions of the Taft-Hartley law. Hawaii and Alaska are both feeling the effects of the West Coast strike, combined with the current price freeze, as they make other and often more costly arrangements to procure necessary supplies.

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Housing: Can It Last?

The recovery in homebuilding which began in mid-1970 has gained considerable momentum — aided by a record flow of savings into mortgage-lending institutions, by a sharp decline in the cost of mortgage credit, and by an expansion of various government programs designed to "help housing." In the West, the recovery has been particularly impressive. On the heels of a modest decline from 324,000 units in 1969 to 310,000 units in 1970, housing starts in this region soared to a 478,000-unit annual rate in January-July 1971, and far outpaced the previous (1963) record in doing so. Twelfth District states accounted for about 90 percent of the regional total.

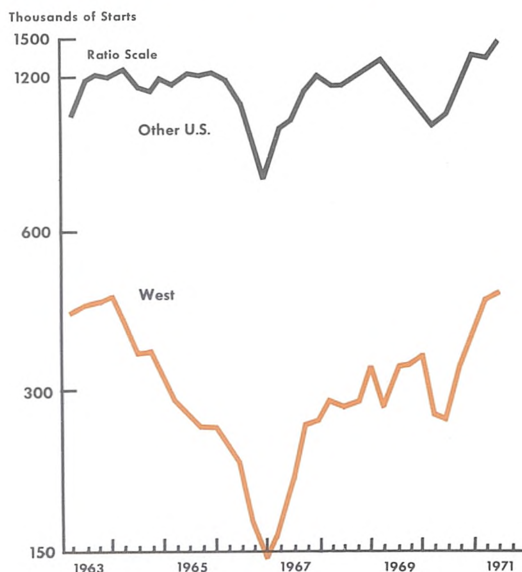
Now, however, increasing numbers of observers are asking just how long the current pace of Western homebuilding can be maintained. The population trend is one major factor; the recent housing boom has taken place in the face of a sharp reduction in population growth, to a level only about half that of the early 1960's. (Despite a huge population inflow and ample supplies of mortgage credit, builders got so far ahead of the market in 1963 that the boom collapsed fully 2½ years before money became tight in 1966.)

High unemployment is another question mark; serious structural problems in the regional economy, mainly tied in with the fortunes of the aerospace industry, have caused jobless rates in the West to rise more than one full percentage point above the national average, and thus have limited demand for the products of the regional building industry. The credit market is a third factor; continued availability of record levels of mortgage funds cannot be guaranteed as the national economy begins to expand. For several reasons, therefore, questions are now being asked about the sustainability of the boom into 1972.

Stronger in the West

The recent housing boom, like its 1961-63 counterpart, has been stronger in the West than in the rest of the nation. Through July of this year, the housing pace in the West as a whole was about 50 percent above the 1970 average, while elsewhere in the nation, activity through July was running 30 percent above the 1970 average. Not included in the Western statistics were record numbers of new mobile homes — shipments reached a 70,000 annual rate during the January-July period, considerably above last year and more than double the pace of the 1963 period.

Recent housing boom stronger in West than in rest of nation



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Housing activity has increased substantially this year in almost every District state. Alaska, Nevada and Idaho have been running about 20 percent above the 1970 pace, while California and Utah have scored 40-percent gains, and Arizona and Oregon, 55 percent or more.

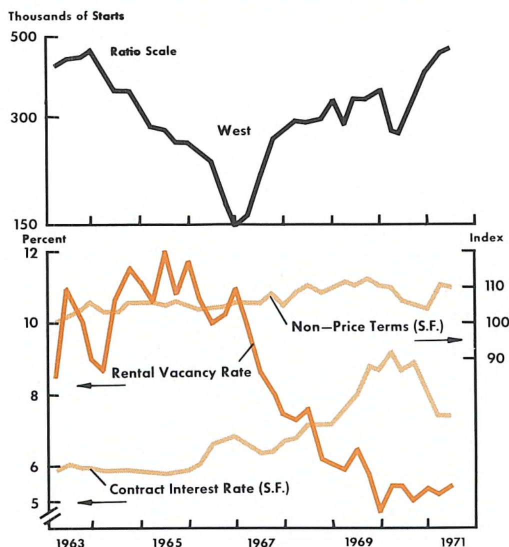
Hawaii alone has recorded a decline, largely because of an adjustment from last year's high level of condominium construction. Even Washington has scored a slight gain — despite a substantial decline in homebuilding in the Seattle area caused by the present high rate of unemployment and the significant overbuilding in Seattle's 1964-68 upsurge. Notwithstanding the substantial (35 percent) declines this year in both Seattle and Honolulu, the regional housing boom has continued to be an urban phenomenon; some 13 metropolitan areas account for three-fourths of all the new homes built in the District.

Los Angeles-Long Beach, with 50,000 starts (annual rate) during the first half of 1971, retains its position as the nation's first-ranking metropolitan housing market. Its performance nonetheless lags far behind earlier levels; in 1963, for example, L.A. builders put 140,000 units on the market. As a consequence, Southern California now accounts for only about 40 percent of all the starts in the District, whereas it recorded over half of all homes built in the District in the lush days of the early 1960's.

In the West's 1971 boom, the construction of multiple units (apartments, duplexes, and the like) has continued to expand, although this sector has not dominated the market as much as it did in 1970 or, for that matter, in 1963. (In the earlier boom, all of the net gain in homebuilding occurred in multiples.) To a considerable extent, however, the 1971 statistics have been distorted by California, which has been having a boom in single-family construction.

Because of developments in the California market, single-family building District-wide has increased about twice as fast as multiple construction over the past year. Nevertheless, in some local markets — such as Portland, Phoenix,

Boom reflects earlier improvement in vacancy rates, financial terms



Salt Lake City, and San Diego — construction of multiples recently has outpaced single-family housing. In other markets, where multiples have long been the major source of strength, that dominance has been maintained; in Los Angeles-Long Beach, the largest regional market, multiples still account for almost 70 percent of all new units.

Heavy demand . . .

The current housing boom in the West (as in the nation) reflects the accommodation of some pent-up demand that was held in restraint during the tight-money period of 1969 and early 1970. Even so, the level of housing activity was surprisingly high during that tight-money period, probably because of such factors as continued population growth, a tight supply of housing, and a general stability of non-price terms of mortgage lending. (In the West, average loan maturities and loan-to-price ratios exceeded the national averages by a fair margin throughout the period.)

Housing demand also received some support in 1970 from a net decline in home prices. In

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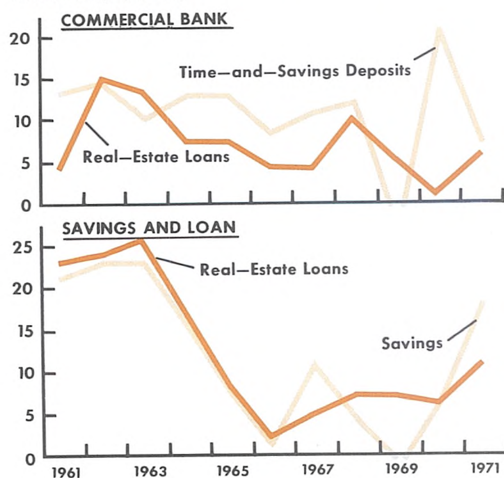
the West, the median price of new homes had jumped 36 percent between 1963 and 1969, but it then fell 5 percent in 1970, from $25,300 to $24,100. (The decline reflected a decline in average home size as well as the elimination of such "frills" as garbage disposals.) More recently, home prices have edged upward again, as have rents and homeownership costs, but these factors have been outweighed by the vastly increased availability and lower cost of mortgage credit, which have enhanced the ability of new buyers to enter the housing market and of other buyers to "move up."

The turnaround in the mortgage market over the past year has been perhaps the most spectacular on record, sustained as it was by a mammoth inflow of savings funds. District banks and savings-and-loan associations together sustained a $3.5 billion net *outflow* of time-and-savings deposits during the five quarters covering 1969 and the early months of 1970, but they then recorded a $15.5 billion net inflow during the next five quarters. In the first half of 1971 alone, District S&L's recorded a larger inflow than they did in the entire record year of 1963.

The increased inflow of funds into the thrift institutions reflects the recent sharp expansion of the pool of household savings. The personal saving rate nationwide has exceeded 8 percent throughout 1970 and 1971, while it averaged only about 6½ percent during the 1965-69 period. Moreover, these household funds have tended to move into thrift institutions rather than into other channels, because of an early-1970 shift in the structure of interest rates, specifically a decline in market rates at a time when thrift-institution ceiling rates were being raised. For example, 90-day Treasury-bill yields exceeded 8 percent in early 1970 — far above the rates payable by thrift institutions on their basic passbook accounts (4 percent by banks and 5 percent by S&L's) — but the bill rate fell considerably below thrift-institution rates by early 1971.

Massive inflow of savings funds helps sustain mortgage lending



. . . easier money

With their savings inflows rising so sharply, District banks and S&L's vigorously expanded their mortgage lending during the first seven months of 1971 — a record $970 million for banks and a record $2.6 billion for S&L's. These increases were accompanied, at least until late spring, by declining mortgage rates. The *average* rate on conventional new-home loans on Western housing, which had dropped from 9.40 percent to 8.75 percent over the course of 1970, fell further to 7.65 percent this past spring, while the *prime* mortgage rate on new single-family homes briefly reached 6.75 percent this spring.

Rates have firmed again in recent months; conventional-loan rates have risen to about 7.90 percent and the going prime rate is now 7.50 percent. This rebound reflects heavy mortgage-loan demand, a slowdown in savings (especially at the banks), and an increase in the cost of funds to the lenders themselves. So far this year, almost 90 percent of the S&L's net savings inflow, and over 50 percent of the banks' inflow, have occurred in the higher-yielding savings accounts.

. . . and government help

The homebuilding boom, regionally as well as nationally, has been bolstered by various gov-

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ernment programs designed to "help housing." The most notable of these are the FHA Section 235-236 "direct assistance" programs, which utilize direct subsidies to reduce the mortgage-borrowing costs and rental payments of low-income families. (In the San Francisco Bay Area, a four-person family cannot qualify under these programs unless its income falls somewhat under $8,000.)

The total number of Federally subsidized starts, nationwide, jumped from 160,000 units in 1968 to 430,000 units in 1970, and is likely to reach 525,000 units or more this year. Starts under these programs thus have accounted for about 25 percent of total housing starts during the 1970-71 period, and starts under other Federal programs — especially "regular" FHA and VA programs — have accounted for 10 percent more. Secondary-market operations of the Federal National Mortgage Association, the Government National Mortgage Association, and the Federal Home Loan Mortgage Corporation, although much lower now than a year or two ago, have also provided significant (albeit indirect) support to the housing market.

New economic policy

The future course of homebuilding nationwide will depend in part upon the capital market's response to the President's new economic policy. To date, the banks and the S&L's both have gone along with the Administration's request to hold the line on interest rates. The continued availability of mortgage money will depend, however, on the capital requirements of governments, businesses, and consumers, each reacting in its own way to the various provisions of the President's program.

Treasury borrowing requirements will be very heavy in coming months, because of the continued record gap between Federal receipts and expenditures. Corporate financing requirements may be somewhat lighter than heretofore, since most large firms have now improved their liquidity condition through their record borrowings of early 1971. On the other hand, many corporations are likely to re-enter the capital market, and not simply rely upon their improved cash flow, to finance the increased machinery-equipment purchases expected as a consequence of the renewed investment-tax credit. In the improved psychological atmosphere, consumers too may borrow more and save less. Should they do this, they could seriously affect thrift-institution funds, since they allocated a whopping 85 percent of their financial saving to time-and-savings deposits during the first half of 1971.

With developments such as these in mind, several agencies have attempted to sustain the housing boom by moving to ensure the continued availability of mortgage funds at moderate rates. The Federal Home Loan Bank Board reduced the liquidity requirement of member S&L's from 7.5 to 7.0 percent, and thus released up to $800 million in funds that previously were unavailable for mortgages. In addition, the Bank Board announced that it would permit S&L's to make conventional loans with only a 5-percent downpayment, considerably below the going norm of 20-30 percent. The Home Loan Mortgage Corporation meanwhile raised the price it will pay for Federally-backed mortgage loans it purchases from thrift institutions, and announced that it would purchase $300 million of FHA and VA mortgage loans and an additional $700 million of conventional mortgage loans over a six-month period.

In addition to these steps GNMA moved to purchase $2 billion in FHA and VA mortgages for resale to FNMA and other investors, in a program designed essentially to subsidize interest rates on Federally-backed non-subsidized mortgages. GNMA—in effect the Treasury—will then absorb the difference between its buying and selling prices. With this resale procedure, GNMA avoids having to borrow in the market to raise the necessary funds to make its purchases, but the ultimate investor must then go to the market to raise the funds with which it will acquire these mortgages. In fact, FNMA

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recently announced a $1-billion debenture operation, the largest in its history, to help finance its own current operations.

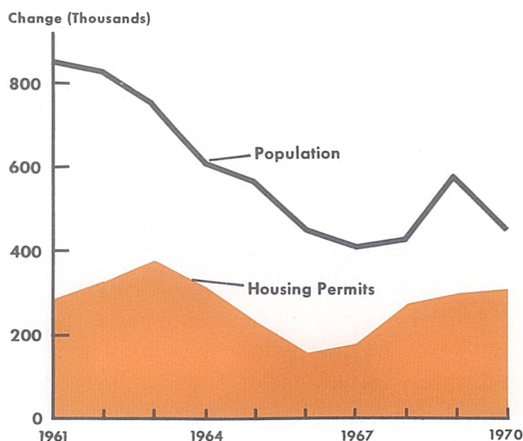
Thrift institutions meanwhile have begun to moderate their lending pace, or at least their rate of new commitments. Western S&L's actually reduced their loan commitments in June and July, after doubling their totals to a record $1.4 billion between December and May. Their action may reflect a feeling of caution about the future availability of mortgage funds, but it probably also indicates a growing concern over a potential oversupply of housing in some Western communities.

Shaky demand?

Underlying demand, and not the state of the credit markets, indeed represents the biggest question mark in the Western housing situation. The question essentially is—how long can a record housing pace be sustained, given a population growth which is only about half the amount that proved incapable of sustaining the housing boom of the early 1960's? In the 1961-63 period, one new housing unit was built for every 2.5 people added to the Western population, but in 1970 the ratio was one unit for every 1.4 new people, and in 1971 to date, the ratio has been just about one to one. (The ratio would be even more striking if mobile homes were counted.) That means one new dwelling unit for every man, woman, and child added to the regional population—and very few children buy homes.

Other factors beside basic population growth of course must enter the calculation of housing demand. Substantial demolitions and other removals from the housing stock, high rates of household formation because of the population's present age distribution, and a catching-up with the demand which could not be met during the 1969-70 tight-money period—all have contributed to the record level of construction. Even after allowing for those factors, however, the recent rate of home building may be in excess of what the regional market can absorb.

Housing activity strengthens in face of population slowdown



Indeed, effective demand could be expected to be relatively low because of the West's serious unemployment problem, caused largely by the structural problems of the aerospace industry. (In July, the Twelfth District's jobless rate, 7.5 percent, was substantially above the national average of 5.8 percent.) Net declines in employment have actually occurred over the past year in such key states as California, Washington, Oregon, and Hawaii, and unemployment rates have exceeded the national average in six of the nine District states. Yet, surprisingly, home-building activity has been most exuberant in some of those areas with the highest jobless rates—San Diego, Anaheim, Los Angeles, the San Francisco Bay Area, Portland and Salt Lake City.

Recent trends in vacancy rates provide amply evidence of a potential oversupply of housing. In Seattle, the apartment vacancy rate exceeded 13 percent at one point this year, and in Portland, Phoenix, and several California markets, rates of 6 percent or more have been reported recently. (This development prompted the San Francisco Home Loan Bank to issue a number of market "alerts" to member S & L's.) To be sure, vacancy rates, mortgage delinquencies, and foreclosure rates are still below the peak levels

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reached at the end of the 1963 boom, but the recent trend in these measures has been disturbingly reminiscent of that earlier period.

Government help?

What can policymakers do to stabilize the market in the face of this oversupply situation? One way would be to expand effective demand, and the President's new economic policy is designed to do just that. The expansionary features of that program should eventually increase the real income of Western (and other) consumers, and thereby expand the household resources that could be allocated to new housing. The anti-inflationary features of the program should help stem the soaring prices of land, labor, and materials—increases which have priced a large proportion of the potential buying public out of the market.

In the area of costs, much will depend on the success of the Administration's "Operation Breakthrough" in achieving the production of low-cost housing. (The first housing module produced under "Breakthrough" rolled off the assembly line in late May.) The original intent of the program was to accommodate buyers in the $15,000-and-under price range—a market presently dominated by mobile homes, which account for about 90 percent of all the units sold under $15,000. HUD Secretary Romney has claimed that industrialized housing of the "Breakthrough" type will provide a "substantial portion" of the nation's new housing by 1975, although production of industrialized housing units will probably not exceed 15,000 units in 1971.

Policymakers might also be tempted to support the market by easing financial conditions further, through reduced downpayments for borrowers, reduced liquidity requirements for lenders, and expanded secondary-market purchases by such agencies as GNMA, FNMA, and FHLMC. It should be remembered, however, that the generally easy conditions which prevailed in the Western mortgage market during 1964 and 1965—well after the last housing boom had weakened—exacerbated the original problem of overbuilding, so that vacancy rates, loan foreclosures, and delinquencies in some Western localities soared to levels two, three, or four times the national average. In the light of the historical record, the nation's housing authorities may decide that easy financing is not the only solution to the region's housing problems.

Besides, in view of the expected level of effective demand and the already reduced rate of population growth, everyone connected with the industry might do well to reassess the much-publicized housing goal of an average of 2.6 million new units annually during the decade of the 1970's. In addition, there might be some justification for re-examining the whole question of housing finance—deciding, for example, just which groups should qualify either for direct or indirect subsidies, and what type of asset-liability structure for thrift institutions would generate the most effective pattern of resource allocation. But while pondering these longer-range questions, Western builders and mortgage lenders would do well to keep developments in local housing markets under close scrutiny in coming months.

Verle Johnston

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