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RECENT INFLATION AND ITS IMPLICATIONS FOR THE ECONOMIC STABILIZATION PROGRAM

by

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Relates inflationary pressures on wages and prices to the implications of these for economic stabilization purposes.

Before one can assess the efficacy of current wage and price controls, it is necessary to examine the nature of the present inflationary forces. This paper looks first at general economic conditions and then focuses on inflation from the wage side (cost push) followed by an analysis of recent behavior on the price side. Attention is then turned to the causes of the recent surge-in of prices and the implications of these for economic stabilization purposes.

The most notable feature of the economy in the first half of 1973 was the strong economic up-turn. Employment increased by almost three million persons during the past year with unemployment moving down to 4.5 percent. Although this latter figure is still high when judged against a four percent "full employment" target, it is much less unacceptable when viewed against a back-drop of huge increases in the labor force over the past year. In addition, the "spread" between employment rates and various categories is wide, thereby indicating particularly tight labor supply conditions in some occupations and sectors.

Capacity utilization measures point to even greater tightness in product markets than in labor markets. During

the first half of 1973, capacity utilization stood at around 90 percent versus approximately 70 percent in August, 1971, when the first price freeze was imposed. Also, the spread among different sectors in utilization rates is greater than during comparable periods in the past with some sectors such as autos, steel, rubber, paper, and oil refining displaying extremely high capacity utilization rates. All of this is reflected in very high production levels coupled with an extremely rapid growth in real GNP during the first half of 1973. The economy, then, is in the midst of a strong boom although many economists have dubbed this one of the unhappiest booms in recent history.

Wages

The inflationary pressures in the first half of 1973 are strikingly different from those which existed in 1971 when the New Economic Policy was implemented. At that time the inflation was rightly considered to be a wage-push problem while the current inflation is almost entirely devoid of cost-push characteristics from the labor side. Major (first year) collective bargaining settlements in 1971 (contracts covering over 5,000 workers) averaged 12.4 percent; the comparable figure for the first nine months of 1973 was 7.6 percent (and 8.5 percent for 1972). Average hourly earnings increases have similarly moved down, albeit not so dramatically, from 7.1 percent in 1971 to 6.3 percent during the first half of 1973.

Inflation from the wage side, then, has subsided substantially from what it was when the President first imposed wage-price controls in the autumn of 1971. It would, however, be a mistake to believe that we are out of the woods on the wage side. Two factors are important in assessing the degree of inflationary pressures from the wage side: (1) the increase in hourly earnings, i.e. wages; and (2) the level of productivity improvements. Both of these factors have been behaving favorably from an anti-inflationary standpoint during the first half of 1973. However, this behavior is not likely to continue during the latter part of 1973 and into 1974. Both variables are likely to become less favorable: hourly earnings can be expected to increase as a result of continuing pressures from Cost of Living increases and productivity improvements can be expected to decline. This latter factor is especially important as the economy approaches full capacity utilization and full employment of its labor resources. As full capacity is reached, unit costs will no longer recede because of declines in fixed costs. At the same time, less efficient labor resources must be utilized, thereby increasing per unit labor costs. Given the likelihood of both of these factors, let us examine a possible scenario. If hourly earnings move up by only one to one and one-half percent--a very likely occurrence--they will be in the neighborhood of 7.5 percent. At the same time, it is quite likely that productivity improvements will recede to the two to two and one-half percent neighborhood. The result of this would be an inflationary bias from labor cost side of five to five and one-half percent. That is, because of labor cost pressures alone, prices would move upward at an annual rate of five to five and one-half percent, far from a national goal of two and one-half to three percent. This, of course, is a level of inflation above what most persons consider tolerable and would take place even in the absence of

any price pressures on the product market side. Unfortunately, it is highly unlikely that such price pressures from the product side will be anywhere near the zero level.

The quiescent behavior on the wage side, while unexpected by most observers, has been even more remarkable when one compares hourly earnings with price movements. During the past year real spendable earnings--which take into account the length of the work week, the amount of earnings, the increase in prices, and taxes for a family of four--have actually gone down by 0.6 percent. This is an ominous sign. It means, among other things, that while corporate profits have increased at a record pace and the economy is in the midst of a boom, workers are, in fact, worse off than they were a year ago. Since real gross national product is moving up at a very rapid rate, this means that there is a sizable redistribution of income occurring which is taking earnings from the wage side and transplanting them into corporate profits. Of course, some redistribution in this direction is expected during an upswing; however, the absolute decline in real income for a working family of four is distressing.

Prices

While it is true that the outlook is none too bright on the wage side, the real inflationary impact during 1973 has come from the price side. Price movements during the first six months of the year display a remarkable surge, which was unforeseen by almost all observers. Looking first at the consumer price index, all items have moved up by 7.4 percent (first half of 1973, seasonally adjusted annual rate). All items with the exclusion of food moved up at an annual rate of 4.6 percent while food moved up at an annual rate of 17.8 percent. These price movements are even more dramatic when one views the wholesale price index. Here all commodities moved up at an

annual rate of 26.5 percent during the first half of 1973. Industrial prices moved up at a somewhat slower, but still high, rate of 10.9 percent while farm and farm products jumped at an alarming 66.8 percent rate.

For analytical purposes, it is useful to look at price increases by the stage of production. Invariably, prices have increased faster at the early stage of production than at the consumer end. Wholesale prices of crude materials (the first stage of input) moved upward at an annual rate of 17.7 percent during the first six months of 1973. Wholesale prices of intermediate goods (the next stage of production) moved upward at a rate of 8.3 percent, omitting food. Wholesale prices of consumer finished goods moved up at an annual rate of seven percent while consumer prices less food moved up at an annual rate of 4.6 percent. Thus, we move from an increase of 17.7 percent on the input end to an increase of 4.6 percent on the final consumer output end. What this means is that there is a good deal of pressure left in the pipeline. Thus, even if the upward surge in wholesale prices moderates over the coming months, the impact of this is not likely to be felt at the consumer end for some time. Indeed, consumer prices could well accelerate at a time of slackening wholesale price increases.

These basic economic forces on the wage and price side must, of necessity, constitute the parameters in which any public policy can operate. Before moving to the policy alternatives, however, it will be useful to review and explore some of the major reasons for the remarkable surge during 1973.

Inflationary Forces

As usual, the explanations for the current price increases can be found in the interaction of supply and demand--coupled with some large doses of policy miscalculations and mistakes.

In the first instance, we are under the influence of a very significant, world-wide economic boom which means a high world-wide demand for many products and raw materials. This pressure is severely felt in some basic industries and commodities and is leading to very severe cost pressures on the industrial side. For example, the steel industry is operating at extremely high capacity utilization levels in this country as well as throughout the Western World. This has put an extraordinarily high level of demand on inputs, including ferrous scrap. The same is true of copper, zinc, aluminum, and other basic industries with the result being unprecedented world-wide price pressure on these commodities.

This world-wide demand has also led to wide-spread capacity shortages in these basic industries. Over the past decade or so, there has been relative over-capacity in most basic industries. This has led to quite stable prices along with relatively low profits. Now, however, along with rising demand there are rising costs resulting from new pollution control efforts, labor cost increases, lack of quality ores, etc., which have led to a further squeeze on profits. Therefore, there has been little incentive for capacity expansion in these industries. With demands now at unprecedented levels, existing capacity is simply not sufficient enough to allow rapid increases in output. The result is sharp increases in prices in these areas.

Food prices have been subject to similar international pressures. Bad weather and resulting crop failures in large areas of the world have led to shortages in food supplies. The United States has been one of the few countries able to respond by increasing agricultural exports. This, again, has led to severe domestic price pressures on these vital foodstuffs.

This world-wide increase in demand, especially for industrial commodities, is unprecedented. During most world business cycles, the U.S. economy leads the economies of other nations. While we are on the upturn, they are still on the downturn or in the trough. Then, when the U.S. economy begins moving downward other economies begin the upward movement. This time, however--most probably because of greatly increased communication networks--the business cycles of the major western industrial nations have tended to coincide. This, of course, exacerbated the already severe domestic inflationary pressures.

Combined with the world-wide expansion has been the effect of the recent devaluations in the dollar. Formal devaluations beginning in August of 1971, and again January of 1973, combined with an unofficial devaluation resulting from floating exchange rates, have had two sharp domestic effects: (1) an increase in the price of imports which is directly reflected in the domestic consumer price index, and (2) more attractive exports which have furthered the shortages of U.S. commodities already in short supply. Examples here include copper, steel scrap, copper scrap, aluminum, lumber, pulp, and food. This had, among other things, led to a rising demand for export controls which the Administration has wisely resisted.

Finally, in response to the above pressures, there has been widespread speculation in several basic commodities, including copper, cotton, and even soybeans. Because of world-wide doubt concerning the value of the dollar, persons holding large amounts of these commodities have felt increasingly uneasy and have attempted to get rid of their dollars by buying basic commodities. This, in turn, has led to even more world-wide and domestic price pressures.

The Impact of Public Policy

Nor can Administration policies be completely excused from the present inflationary situation. First of all, there was the infamous Russian wheat deal. While the Administration is correct in asserting that it did not directly sell the wheat to the Soviet Union, it did approve of the sales and, in fact, did underwrite them with loan guarantees. The point here is not that the export of American agricultural products is bad; quite the opposite is the case. However, severe domestic price fluctuations should not be the price of increased exports. The export of American agricultural products could be carried on in a more orderly and systematic fashion so as to preclude the violent gyrations on the price American consumers are forced to pay. Furthermore, the huge sale of Russian wheat--which amounted to nearly two-thirds of one year's domestic production--had unforeseen consequences. It meant, among other things, a virtual tie up of railroad cars in an attempt to get the wheat to the ports. This led to rail car shortages in critical areas such as pulp, paper products, and steel scrap which further increased the price pressures in these seemingly unrelated areas.

In another related matter, Administration policy is even less susceptible to favorable interpretation. The dimensions of the Russian wheat deal were well known as early as August, 1972. However, it was not until January of 1973, that the Administration belatedly released 50 million acres of idle agricultural land for increased production. While this was a laudable move, it was, of course, too late to affect the winter wheat crop of 1972 and so led to even greater shortages in 1973. Perhaps political desires for high farm prices by election day overrode anti-inflationary considerations for lower consumer

prices. In any case, the result was as predictable as it was dramatic: Farm prices shot upward at an unprecedented rate.

During this same period--in particular, January of 1973-- the Administration scrapped its fairly effective Phase II price and wage controls in return for a "self-administered" or "voluntary" Phase III. The results were disastrous. Prices moved upward at a rate much faster than could be termed simply pent-up prices from earlier months. A large reason for this is that it was clear that inflationary pressures had not subsided. Businessmen as well as most other persons assumed that the government would again have to take strong anti-inflationary actions. The result was a series of anticipatory price increases in the hopes of each individual firm not being caught "with its prices down" in the event of another price freeze. This, of course, is precisely what happened as the anticipatory price increases of Phase III coincided with the remarkable surge in international prices.

The above considerations would, of course, have been enough to produce a considerable inflation by themselves. However, the administration also coupled these forces with a tremendous amount of pre-election spending in the early parts of 1972. This hurry-up spending, undertaken in an effort to speedily pull the economy up out of its planned recession of 1971, further fueled the already raging fires of inflation.

As a result of all of these above pressures, we are now in Phase IV of the Administration's "New Economic Policy" with only the most optimistic observers assessing the immediate future as bright.

The Available Options

What, then are the policy choices? Basically, we face three possible alternatives. First, we could "let 'er go".

The administration could abandon its already unpopular wage and price control mechanism and return to the more conventional tools of fiscal and monetary policy. There are two major difficulties with this policy. First it is very dangerous. Inflation is an extremely serious problem not only from the perspective of the business community, but, more importantly, from the perspective of the consumer. Rampant inflation leads inexorably to social instability which in turn can induce a weary populace to accept almost any alternative. The political and social implications of this course of action are ominous at best. Second, such a policy would inevitably lead to a serious outbreak of wage-push inflation next year as labor unions along with everyone else fought to regain their lost purchasing power. Thus, there would be little likelihood of the inflation "burning itself out".

A second course of action would be another planned recession such as that of 1971 in order to squelch the inflationary fires. Again, there are two major objections to such a policy: First, such a policy is very expensive. At the present time, every one percent increase in unemployment leads to over 800,000 persons being thrown out of work. The difference, then, between 4 percent and 6 percent unemployment implies approximately 1,600,000 additional persons on the unemployment roles. At the same time, given the current level of gross national product, every one percent of unemployment implies approximately \$35 billion in foregone output. The output difference between a four percent and six percent unemployment rate is around \$70 billion of which approximately \$24 billion would be federal, state, and local tax revenues. At the very least, then, one advocating a recessionary policy should be extremely well aware of the costly consequences.

These consequences would perhaps be more palatable should the outcome on the

inflationary front be more certain. Unfortunately, it is not. There is no assurance whatsoever that plunging the economy into another recession would diminish significantly the inflationary pressures. Indeed, given the costs already in the pipeline along with the experience of 1970 to 1971, it is extremely unlikely that this would be the case. Therefore, the economy may be forced to incur the costs of recession without reaping any of its supposed benefits.

A third alternative is Phase IV. This, in essence, means trying to keep the lid on prices and wages, and, while cooling the economy somewhat, relying upon wage and price controls to help keep smooth the transition to a sustainable economic growth rate. This is a reasonable policy alternative. In fact, given the likely scenarios of the other alternatives, it is almost attractive. Unfortunately, given the Administration's extreme distaste for direct intervention in the market place, the likelihood of this policy being effective is questionable at best.

In addition, at the very time that the task of wage and price controls is becoming more complex, consumer business and labor opposition is becoming more vocal. In part, this is true because controls are now pinching more than before. In part, however, it is true because the Administration repeatedly makes its own disdain for such policies so obvious. In addition, controls have, of late, been asked to do many things that most economists would say they could not accomplish even under the best of circumstances. The most obvious example is the placing of the most stringent controls over the most competitive sector of the economy; namely agriculture.

What, then, is the outlook? In my judgment, the food industry, which is under quite tight price controls at this

time, will continue to be so in the foreseeable future. This is not because price controls intrinsically make more sense in this industry; indeed, they make little sense. Nor is it because the "middlemen" have been "greedy" and deserve to be punished accordingly. Instead, the problem is almost entirely political. The price movement in this industry, which has been the result of (foreseeable) supply and demand forces, have produced extremely severe political pressures to "do something". As a result, until the distortions become even more pronounced than they are now, this pressure will probably continue to dictate public policy.

At the same time, the increased supplies of agricultural products that almost surely will come about next year will greatly reduce the pressures, both political and economic, for continued controls. As this happens, it can be expected that the Administration's economists--who dislike controls in any case--will move swiftly to remove them from the competitive sectors of the economy.

In the long run, it is unlikely that this or any other Administration will again be able to completely give up any responsibility over wage and price decisions in the industrial economy. At the same time, it can be hoped that efforts in this area will be increasingly turned toward those areas of the economy where controls can do some good. This does not include, at this time, the food distribution sectors of the economy.