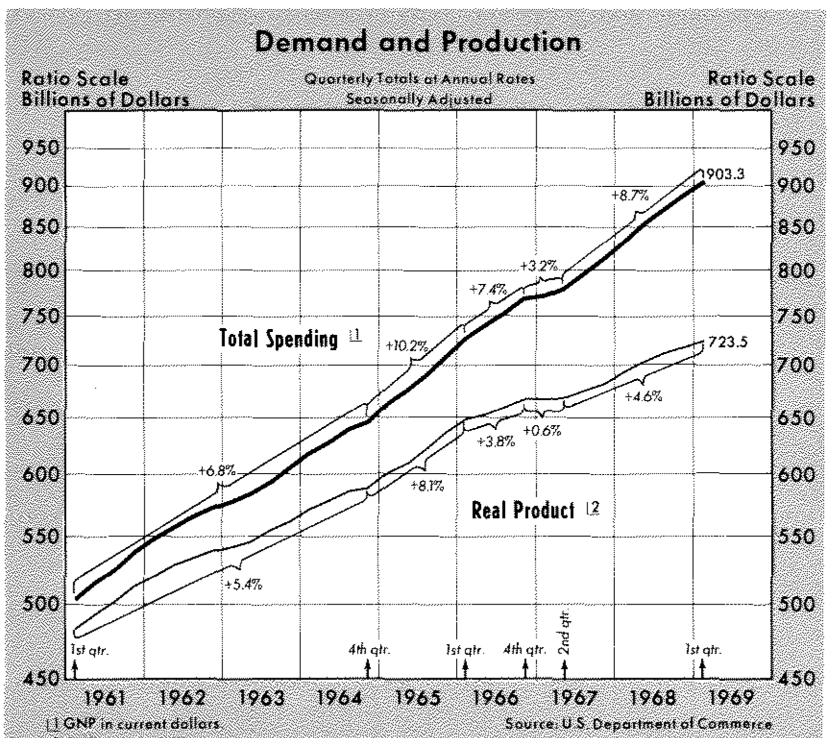
Real Growth and Prices

THE GROWTH of total spending continues excessive compared to the growth of the nation's long-run output potential, but recent monetary developments give reason to expect slowing in the growth of total spending in coming months. The growth of the money supply has been substantially slower in the last five months than in 1967 and 1968. Some recent studies indicate that most of the effects on total spending of changes in the rate of monetary growth tend to be distributed over about four quarters. The growth of total spending may therefore slow to a less inflationary pace in the second half of 1969, if the recent slower rate of monetary expansion is maintained.



1 GNP in current dollars.
2 GNP in 1958 dollars.
Source: U.S. Department of Commerce
Percentages are annual rates of change between periods indicated. They are presented to aid in comparing most recent developments with past "trends."
Latest data plotted: 1st quarter

Total Spending

Total spending (that is, GNP in current dollars) increased $16 billion, or at a 7.4 per cent annual rate, from the fourth quarter of 1968 to the first quarter of 1969, slower than the 8.3 per cent rate in the second half of 1968 and the 9.3 per cent rise in the preceding year. Even though spending growth has moderated somewhat, it remains well in excess of growth in the economy's ability to produce, generally estimated to be about 4 per cent a year.[1] Final sales, which is total spending less changes in inventories, grew at a 9.2 per cent rate in the first quarter, the same rate as in the previous year.

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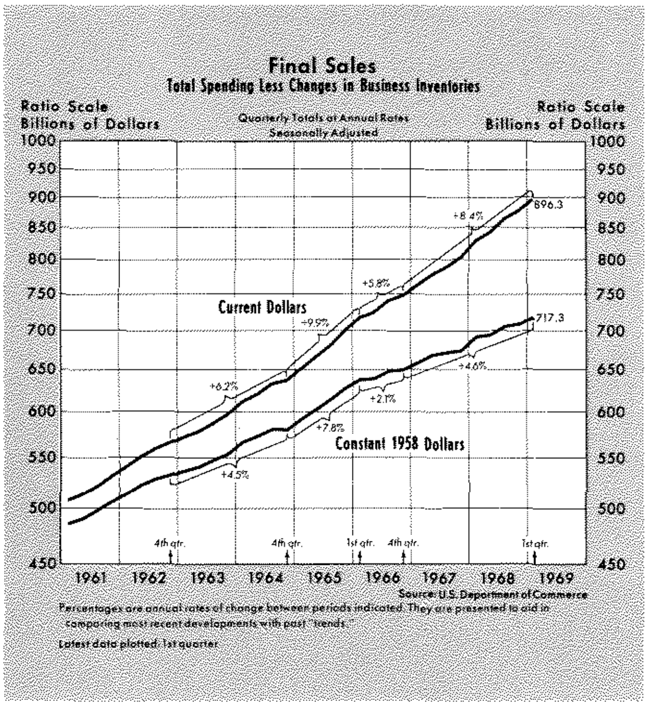
[1]According to the Council of Economic Advisers, production potential grew at a 3½ per cent rate from mid-1955 to the fourth quarter of 1962, at a 3¾ per cent rate from IV/1962 to IV/1965, and at a 4 per cent rate from IV/1965 to IV/1968. See pages 64 and 65 of the 1969 *Economic Report of the President,* United States Government Printing Office, (Washington, 1968).



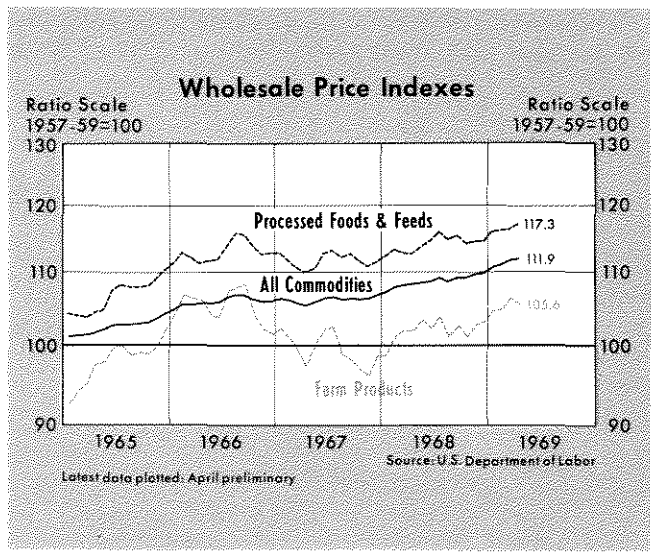
When total spending in the economy expands at rates greater than the expansion of production potential, the difference is largely manifested in rising prices. From the beginning of the recovery in 1961 to the initial phases of the Vietnam War buildup, the increase in total spending was at a 7 per cent rate, and prices increased on average 1.5 per cent a year. From 1965 to 1968 the average annual increase in total spending was 8 per cent, and since a very high level of employment of resources had been achieved, the rate of increase in real product fell somewhat and the average growth of prices rose to over 3 per cent a year. In order to maintain sustainable economic growth with high employment and a generally stable price level, the growth rate of spending should be slower in periods of high capacity utilization than in periods of recovery from a recession or underutilization of resources.

Real Product and Prices

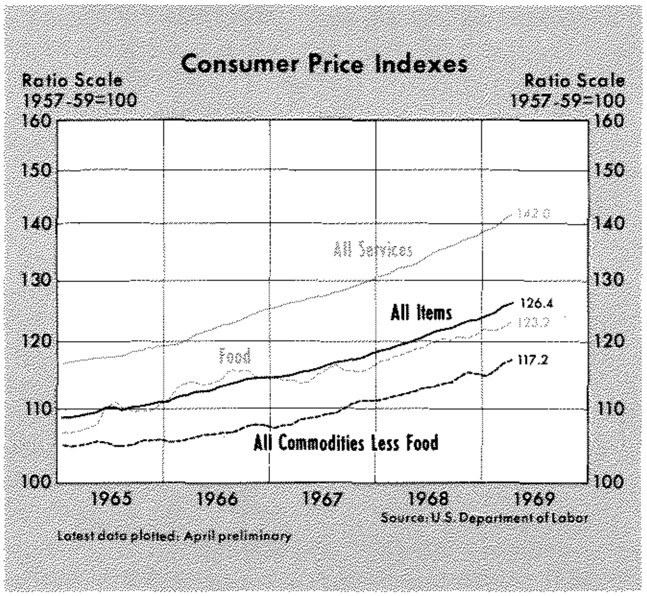
The moderate slowing in the growth of total spending, which has occurred since the middle of last year, has been accompanied by deceleration in the growth of real product. Actual output of goods and services increased at a 6 per cent annual rate in the first three quarters of 1968, then slowed to a 3.5 per cent rate in the fourth quarter, and to less than a 3 per cent rate in the first quarter of 1969.

On the other hand, price increases have accelerated in 1969, accounting for about 60 per cent of the increase in total spending in the first quarter. The general level of prices rose at a 4.6 per cent annual rate in the first quarter this year, the most rapid quarterly increase of the recent inflationary years. Prices rose at a 1.9 per cent rate in the 1964-65 period, at a 3 per cent rate to mid-1967, and have risen more than 4 per cent rate since mid-1967.

Wholesale prices rose at a 5.9 per cent annual rate from December to April 1969, much more rapidly than at any time in the previous year. Wholesale prices of industrial commodities rose at a 5.3 per cent annual rate in the December to April period, compared to the 4 per cent rate in the corresponding period a year earlier, and a 2.6 per cent increase in 1968. Wholesale prices of farm products and processed foods and feeds increased at a 7.1 per cent rate from last December to April, compared with a 5.8 per cent rate in the December to April period last year and a 3.4 per cent increase in 1968.

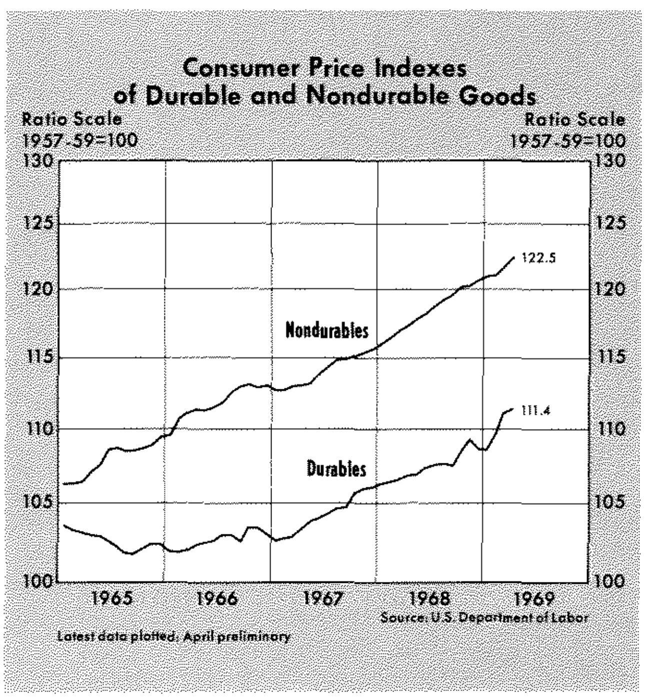


Consumer prices have increased recently with exceptional rapidity, rising at a 6.7 per cent annual rate from December to April compared with a 4.7 per cent rate in the preceding year. During 1968 food prices went up 4.3 per cent, and since last December have risen at a 5 per cent rate. Food prices fluctuate more sharply than prices of other consumer goods because supplies are more strongly influenced by unanticipated factors such as weather and strikes. Prices of consumer commodities other than food increased at an average rate of 1.3 per cent from 1958 to 1968, with prices of nondurable goods rising about twice as fast on average for the whole period as prices of durable goods. In 1968 the prices of nondurable goods went up 4.4 per cent, while durable good prices rose 2.5 per cent. In contrast, so far in 1969 prices of



durable goods have risen at a much more rapid 7.6 per cent rate, while prices of nondurable goods have continued to rise at about the same rate as in 1968.

Rapidly rising prices of services have been a large factor in the increase in average consumer prices in the past decade, and especially since 1966. Currently about 41¢ out of every dollar spent by consumers is for services. Prices of services have risen at a 3 per cent average rate in the last 10 years and at a 4.8 per cent rate since 1966. In 1968 prices of services increased 6.1 per cent, and in early 1969 the rise has accelerated to an 8.7 per cent annual rate.

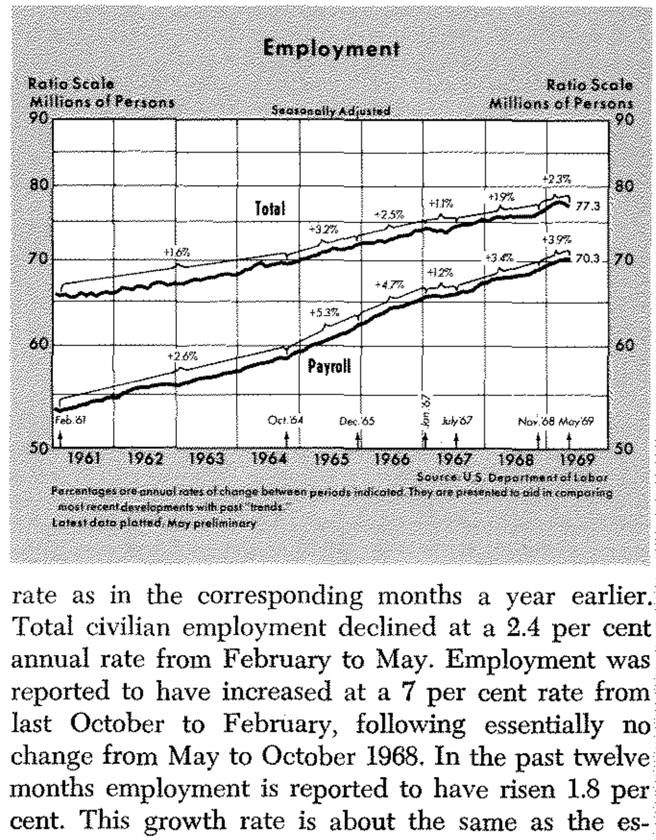


Other Business Indicators

Recent movements in most economic indicators do not show a distinct pattern of acceleration or deceleration of the economy, but do provide some basis for optimism that slowing is gradually being achieved. Personal income has risen at a 7.3 per cent rate since last December, compared with 9.3 per cent in the previous year. Due to higher taxes and larger social security payments, growth of aftertax disposable income has slowed even more. Industrial production has risen at a 5 per cent annual rate since last December, not significantly different from the increase in the previous year.

Retail sales have increased at about a 5 per cent rate in the past six months, considerably less than the rate of increase in the corresponding period a year ago, and about the same as the average annual increase in the past ten years.

Payroll employment grew at about a 1.7 per cent annual rate from February to May, about the same



rate as in the corresponding months a year earlier. Total civilian employment declined at a 2.4 per cent annual rate from February to May. Employment was reported to have increased at a 7 per cent rate from last October to February, following essentially no change from May to October 1968. In the past twelve months employment is reported to have risen 1.8 per cent. This growth rate is about the same as the estimated 1.7 per cent growth of working-age population in 1968.

Unemployment has ranged between 3.3 per cent and 3.5 per cent of the labor force since last October. Unemployment of married men has been below 1.6

ECONOMIC INDICATORS

	Compounded Annual Rates of Change	
	1968*	early 1969†
Total Spending[1]	9.4 %	7.4 %
Final Sales	9.2	9.2
Real Product[2]	5.4	2.9
Prices:		
Overall Price Index[3]	3.9	4.6
Consumer[4]	4.7	6.7
Services	6.2	8.7
Food	4.3	5.0
All Commodities less food	3.7	5.3
Durables	2.5	7.6
Nondurables	4.4	4.5
Wholesale — All Commodities	2.8	5.9
Farm Products	4.5	6.8
Processed Foods and Feeds	2.9	7.0
Industrial Products	2.6	5.3
Other Indicators:		
Industrial Production	4.1	5.1
Personal Income	9.3	7.3
Retail Sales	6.8	11.2
Payroll Employment	3.4	3.9
Total Civilian Employment	1.7	3.3

*For Total Spending, Final Sales, Real Product, and Overall Prices, rates of change are from fourth quarter of 1967 to fourth quarter of 1968. For all other indicators rates are from December 1967 to December 1968.

†For Total Spending, Final Sales, Real Product, and Overall Prices, rates of change are from fourth quarter of 1968 to first quarter of 1969. For all other indicators rates are from December 1968 to April 1969.

[1]Gross National Product in current dollars.

[2]Gross National Product in 1958 dollars.

[3]Implicit Price Deflator for Gross National Product.

[4]Consumer Price Index.

per cent, and unemployment among nonwhites in the labor force also remains well below the average rate of the earlier Sixties.

Reducing the Growth of Total Spending

Experience suggests that policies designed to reduce the rate of growth of total spending are likely to have their initial lagged impact on the growth of real product, with restraint on price increases appearing after an even longer lag. The most recent experience with lags between slowing of total spending and slowing of real product growth and price increases was in 1966 and 1967. From late 1965 to late 1966 total spending increased 8.2 per cent, real product 4.8 per cent, and prices 3.3 per cent. In the first half of 1967 total spending growth dropped sharply to a 3.2 per cent annual rate, following three quarters of monetary restraint. As total spending slowed, real product fell from 4.8 per cent growth in 1966 to a 0.6 per cent annual growth rate in the first half of 1967, while price increases decelerated to a 2.5 per cent rate. This slowing of inflation from a 3.3 per cent rate in 1966 to a 2.5 per cent rate in the first half of 1967 was an unusually rapid response of prices to monetary restraint, but was accompanied by a halt in real product growth.

As spending and real product growth were decelerating sharply in early 1967, the stance of monetary influence was shifted to substantial stimulus. Subsequently, total spending resumed rapid growth in the second half of 1967, and the improvements made on the problem of inflation were short-lived.

With current growth rates of resources and technology, a sustained growth of total spending at about a 5 per cent annual rate would seem to be more desirable than rates as low as 2 per cent or as high as 8 per cent. Policies designed to achieve about a 5 per cent growth of total spending would minimize the likelihood of an abrupt halt in the growth of real product or a hasty reacceleration of price increases.

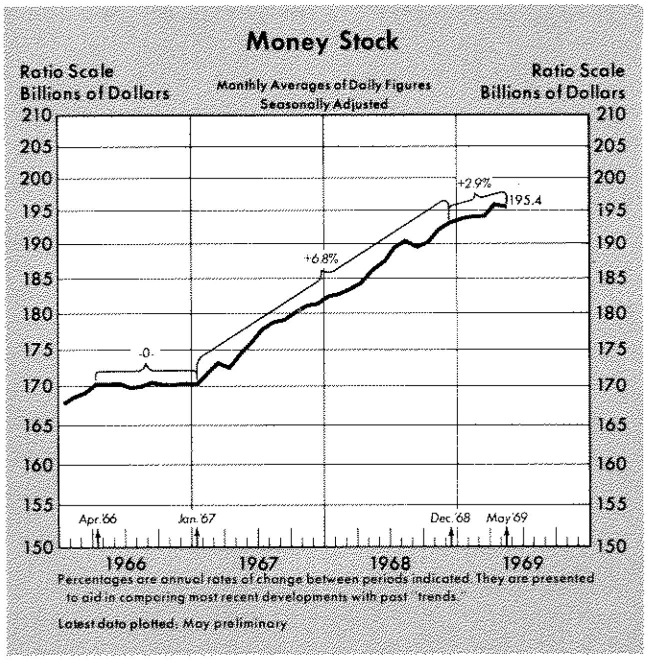
Policies and Policy Indicators

Recent statements by policymakers emphasize a firm commitment to reduce upward price pressures, but also reveal a significant concern for minimizing reductions in the growth of real production and decreases in employment. Confidence that the pace of spending will be brought under control depends upon these statements by policymakers, the fiscal situation, and the recent slower monetary growth, rather than on available evidence from business indicators. Movements of most business indicators are difficult to interpret over short periods because of vagaries in data collection and the influence of random temporary events.

No further restraint from additional fiscal actions is expected in 1969-70. The high-employment budget, estimated to be in surplus at an $8 billion annual rate in the second quarter of 1969, is projected to move to about a $6 billion surplus in the next four quarters, assuming extension of the surtax as currently planned. This measure of fiscal action showed a $16 billion deficit in the second quarter of 1968 and a $10 billion average surplus from 1961 to 1964.

Recent empirical studies indicate that growth of total spending at a 6 per cent annual rate in the last half of 1969 and about a 5.5 per cent rate in 1970 would require continued monetary restraint. One of these studies indicates that this moderation in the growth of total spending could most likely be attained if the money supply were to continue to increase at about a 3 per cent average annual rate.[2] Since December the money stock has risen at a 3 per cent

[2]See "Monetary and Fiscal Actions: A Test of Their Relative Importance in Economic Stabilization," in the November 1968 issue of this *Review*.



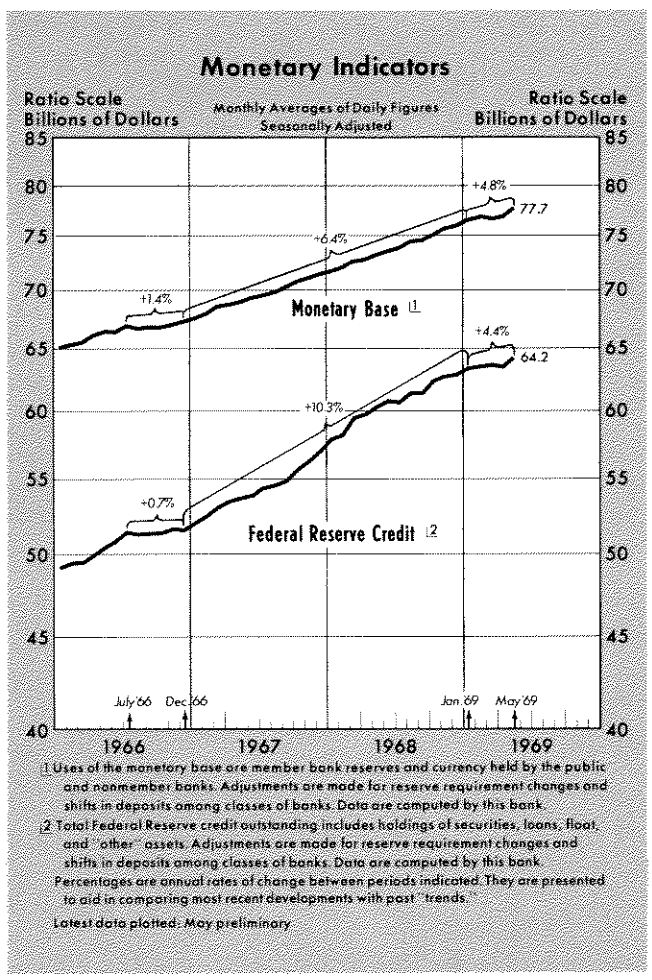
annual rate, compared with a 6.5 per cent average annual rate during the previous two years.

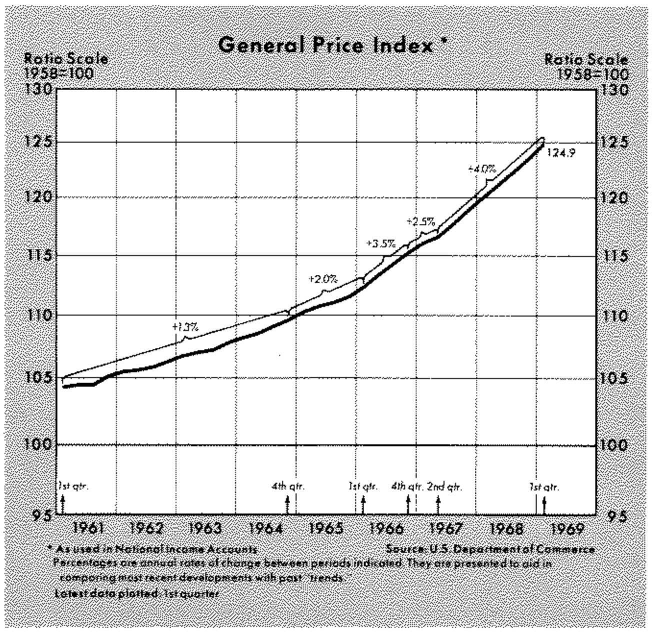
Since last December there has been considerable reference to possible monetary restraint resulting from commercial banks' loss of time deposits, especially large negotiable certificates of deposits. Banks have lost $6.4 billion in large CD's since then, and growth in other time and savings deposits has moderated. Total time and savings deposits have declined at a 5 per cent annual rate since December, in contrast with an 18 per cent rate of growth in the last half of 1968. This development has been a major factor in the slowing of bank credit growth from a 14 per cent rate in the last half of 1968 to about a 3 per cent rate from December to May. However, for several reasons this development is probably not a reliable indicator of restrictive monetary influence on total spending.

The deceleration in the growth of time deposits (and, consequently, total loans and investments at all commercial banks) has been mainly the result of market interest rates rising relative to Regulation Q ceilings. These ceilings prevent banks from offering interest rates competitive with yields on other market securities. Since the decline in the *demand* for time deposits, due to their relatively low yields, affected bank holdings of time deposits, the recent rates of growth of time deposits and bank credit are not necessarily an indication of monetary restraint.

While the impingement of Regulation Q has brought commercial banks under severe pressure, funds otherwise held in time deposits flow through other channels. Funds not available to banks are available in other money markets, and funds less readily available through banks are more readily available than otherwise in these other markets. Similarly, the 18 per cent growth of time deposits in the last half of 1968, compared with a 5 per cent rate in the first half, reflected reintermediation of time deposits as interest rates declined relative to Regulation Q ceilings, rather than a marked easing of monetary policy and influence.

Beginning with the reserve computation period ending April 23, the banking system has been required to hold about $660 million more in reserves because of a ½ percentage point increase in reserve requirements against demand deposits. The Federal Reserve, through open market operations, has provided banks with part of the increase in required reserves. At the same time banks have increased their borrowings from Federal Reserve Banks. In the eight weeks following the reserve requirement increase, member bank borrowings averaged $1309 mil-





lion compared with $876 million in the previous eight weeks. Member bank reserves (adjusted for the increase in reserve requirements in April) averaged $27.3 billion in the eight weeks after the increase in reserve requirements compared with $27.1 billion in the eight weeks prior to the change.

The Federal Reserve System can control the growth of the money stock over periods of a few months by controlling the growth of Federal Reserve credit and thereby the monetary base. Since January the monetary base has increased at a 4.8 per cent annual rate, compared with a 6.4 per cent average rate in the previous two years. The base increased only $400 million, or at a 2 per cent rate, from January to April. However, from April to May the base increased about $800 million, or at a 13 per cent rate (after adjustment for reserve requirement changes in April), largely as a result of a $1241 million increase in the total of member bank borrowings plus Federal Reserve System holdings of U.S. Government securities. If the growth of the monetary base resumes the relatively slow rate that prevailed in the first four months this year, then no sustained reacceleration in the growth of the money stock would be expected.

Summary

The small reduction in the growth of total spending since mid-1968 has been accompanied by a decline in the growth of real product; price increases have not moderated. Recent history suggests that it is not unusual for real product growth to slow earlier or more rapidly than price increases during the transition from a period of rapid inflation to a period of greater price stability. Experience suggests that a sustained slower growth of the money stock can reduce the rate of increase in total spending, and that slower price rises are likely to follow. Once the economy fully adjusts to the slower growth of spending, output and employment can resume growing at long-run potential rates.