Stabilization Policy and Inflation

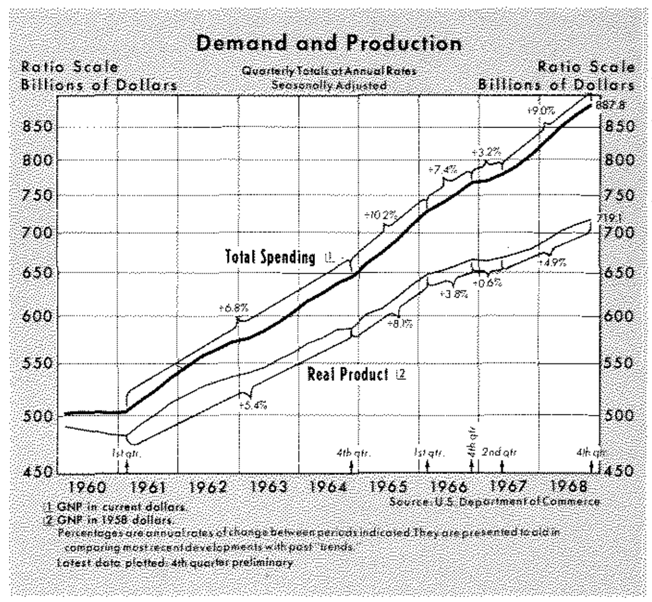
THE PROJECTED COURSE of economic activity for this year is discussed in the 1969 Economic Report of the President, which was presented to Congress on January 16. The appended report of the outgoing Council of Economic Advisers projected total spending in the fourth quarter of 1969 to be 6 per cent above fourth quarter 1968. Though their estimate is labeled a forecast, it may be considered, more appropriately, a target or plan in the spirit of the Employment Act of 1946. To achieve this 6 per cent target growth in total demand, the outgoing Administration proposed a budget consisting of a 5.5 per cent increase in Federal spending in the year ending fourth quarter 1969, and continuation of the 10 per cent tax surcharge to mid-1970.[1] Enactment of these proposals, in conjunction with the Council's projections of economic activity, would yield a small surplus in the Federal budget for calendar 1969. No specific recommendations were offered for the course of monetary actions, other than that such actions should be "appropriate."

Projections of total spending are supplemented by estimates of growth in real product and of the advance in the price level. The Council's report demonstrates clearly the necessity for slowing the growth of total spending as a means of reducing inflationary pressures. According to the Council, reduction in the growth of total spending from 9.5 per cent in the year ending fourth quarter 1968 to 6 per cent in the same period in 1969 would probably be manifested in about 3 per cent growth in real product and about 3 per cent increase in prices. Real product advanced 5.5 per cent from fourth quarter 1967 to fourth quarter 1968, while prices rose 3.9 per cent.

Recent Economic Developments: Background for Forthcoming Policy

The rate of growth of total spending slowed only slightly in the fourth quarter, continuing far in excess of growth in the economy's productive potential. As a result, upward pressure on prices persisted and prices rose at a 4 per cent annual rate in the fourth quarter, the same as in the previous year. By comparison, prices increased at a 2.5 per cent average rate from 1964 to 1967 and 1.3 per cent annually from 1961 to 1964.

Both monetary and fiscal actions provided substantial stimulus to total spending in the year ending last June. The pace of economic activity, through December, continued to reflect these expansionary

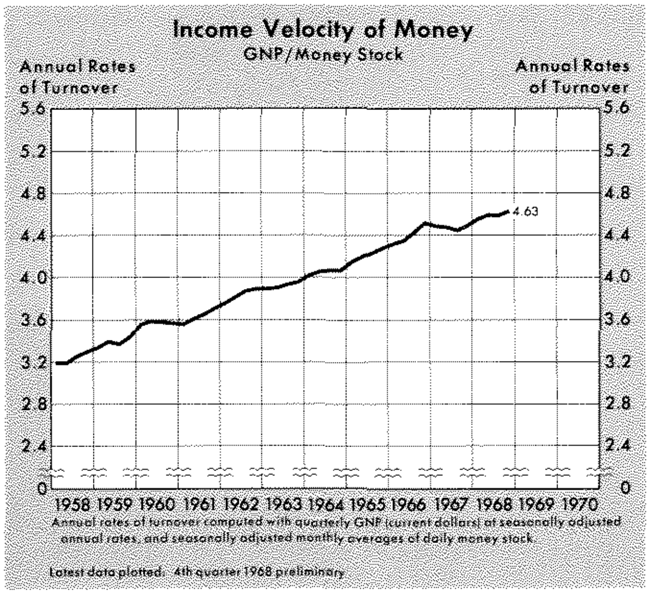


policy developments. After mid-year, the Federal budget deficit declined as tax receipts increased and the growth of Federal spending slowed. However, the rate of monetary expansion continued well above the growth rate of productive potential and velocity of money continued to rise.

Fiscal Actions

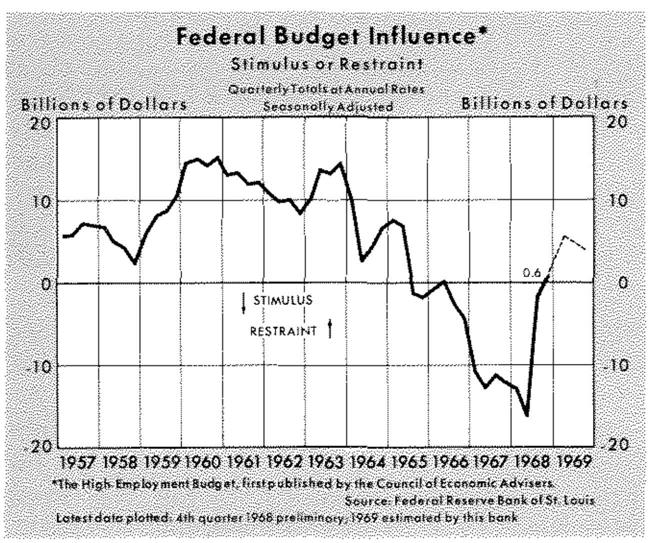
Federal budget actions have been less stimulative since mid-year; revenues have increased very rapidly since July, while expenditure growth has slowed. The moderation of expenditure growth reflects the restraints included in the Revenue and Expenditure Control Act of 1968. Growth of revenues reflects the combined effects of the tax surcharge provision of the Act and large advances in nominal incomes.

[1]All references to the government budget projections for 1969 are on a seasonally adjusted national income accounts basis.



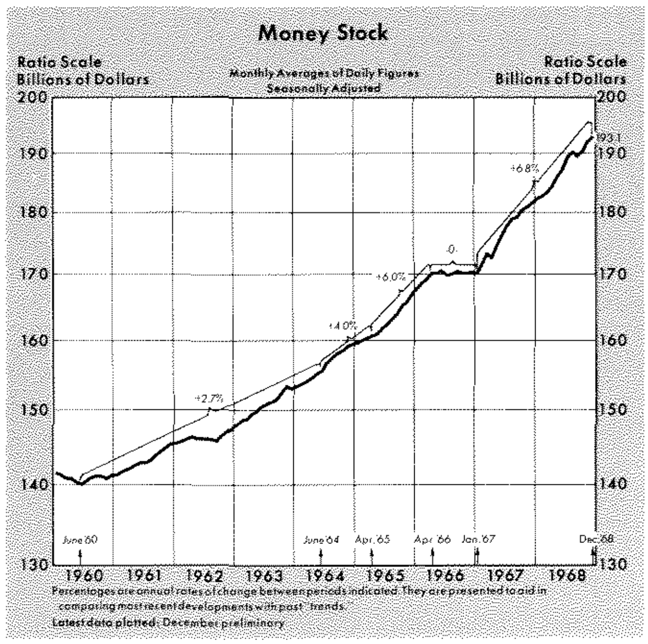
The high-employment budget, a measure of fiscal influence, shifted from a $14.5 billion annual rate of deficit in the first half of calendar 1968 to a slight deficit in the second half. While all measures of fiscal actions indicate that the expansionary influence of the Federal budget has been reduced substantially, total spending in the economy has continued to expand at a rapid rate.

Fiscal restraint is expected to intensify in the first half of calendar 1969, and moderate slightly in the second half. The high-employment budget is scheduled to move to a $5.6 billion annual rate of surplus in the first half, and a $4.0 billion rate of surplus in the second half. The government's budget proposes expenditure increases of 5.5 per cent in the year ending fourth quarter 1969, and continuation of the 10 per cent surcharge for all of 1969. The effect on total demand of the movement from a budget deficit to a surplus is contingent on the rate of monetary expansion.



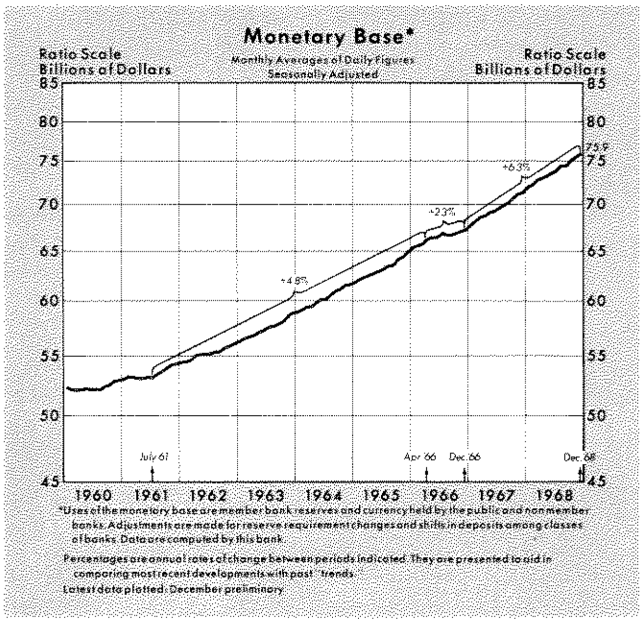
Monetary Actions

Monetary aggregates have continued to grow rapidly since June. The money stock has grown at a 5.2 per cent annual rate in the past six months, less rapidly than the 8 per cent rate of increase in the previous six months. However, in the most recent three months, money has increased at an 8.6 per cent rate. In comparison money grew at a 4.1 per cent trend rate from 1964 to 1967 and a 2.6 per cent rate from 1960 to 1964.



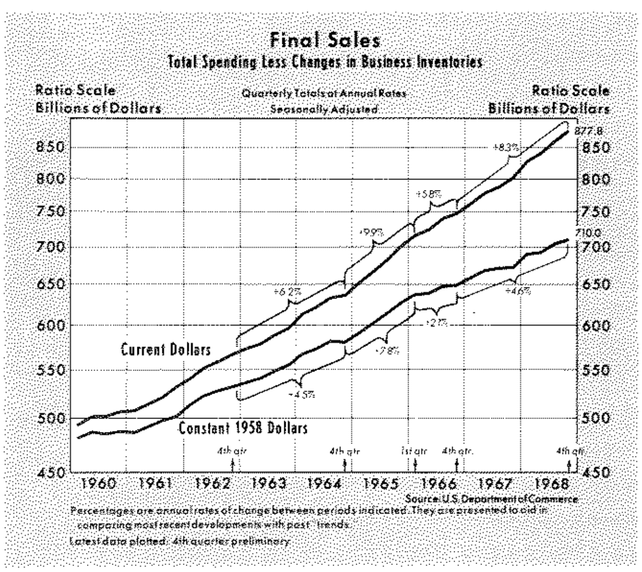
The monetary base, which largely determines the trend growth of money, has risen at an 8.1 per cent rate during the last six months, greater than the 5 per cent increase in the previous six months. Over the past year, the monetary base has increased more steadily than either the money stock or bank credit. Fluctuations in the money stock and bank credit during short periods are caused by many factors, including changes in the growth rate of time deposits as market interest rates change relative to the ceiling rates that banks can pay on time deposits, and, in the case of money, by abnormal shifts in Treasury deposits.

Bank credit has expanded at a 14 per cent rate in the past six months and 11 per cent in the past year. Total loans at commercial banks have risen at a 15 per cent annual rate in the past six months and 12 per cent in the past year.



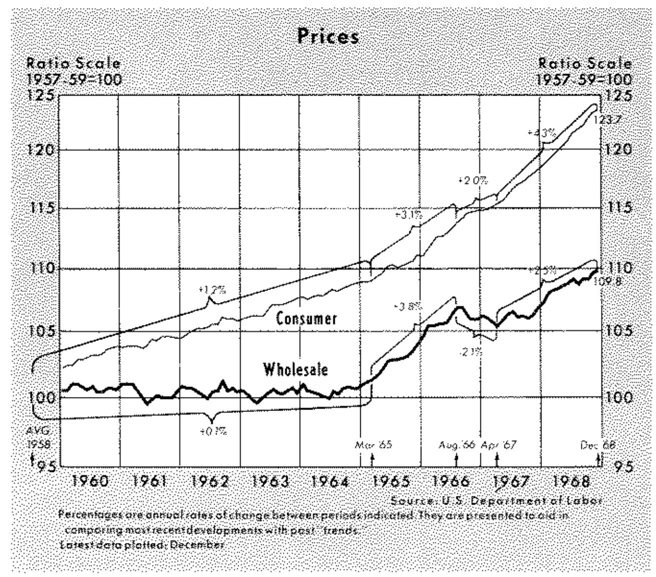
Total Spending, Final Sales and Production

Despite the movement of the Federal budget toward surplus, total public and private spending has continued to advance rapidly as rapid monetary expansion has continued unabated in the last half of 1968 and in early 1969. Total spending increased at a 7.9 per cent annual rate from the third to the fourth quarter, slightly slower than earlier in the year, but about the same as the 8.1 per cent average rate from mid-1965 to late 1968. The composition of total spending changed from the third to the fourth quarter as the advance in final sales moderated and the rate of inventory accumulation increased. Final sales grew at a 6.8 per cent rate from the third quarter, compared with an 8 per cent average rate since 1964.



Similar quarter-to-quarter slowdowns in final sales have frequently taken place in the inflationary period since 1964, however, so that the fourth quarter slowdown in growth of final sales is not necessarily indicative of a change in trend. For example, final sales slowed from first to second quarter 1968, only to resume a rapid advance in the third quarter.

Real product rose at a 3.9 per cent annual rate in the fourth quarter, slower than in the previous three quarters but at about the same rate as in the previous two years. A slowdown in real product growth may not indicate a moderation of inflationary pressure, but may reflect the restraints of labor force growth and of limited advances in productivity. In an economy operating at essentially full employment, an increase in total demand is manifested by more rapid



increases in prices than otherwise. Total or final demand, not real product, reflects the overall influence of monetary and fiscal actions.

Industrial production has risen 5 per cent from late 1967, about the same growth rate as from 1965 to 1967, but less than the 7 per cent rate from 1961 to 1965. Recent growth in industrial output has been less than in the 1961 to 1965 period, probably because of high levels of resource utilization. At these high levels, productivity gains tend to decline as less efficient labor and equipment are utilized.

Prices and Employment

Prices began to accelerate in late 1965 in response to the pressures of excessive demand relative to productive capacity. The annual rate of increase of prices has been at about 4 per cent since mid-1967.

up from a 3 per cent rate from late 1965 to mid-1967, and from a 1.5 per cent average rate in the 1961 to 1965 period.

Wholesale prices of industrial commodities rose at a 2.7 per cent rate from late 1967 to late 1968 and at a 1.7 per cent rate from 1964 to 1967, after being essentially unchanged from 1961 to 1964. Consumer prices increased 4.7 per cent from late 1967 to late 1968, at a 2.9 per cent average rate from 1965 to 1967, and at a 1.3 per cent rate from 1961 to 1965.

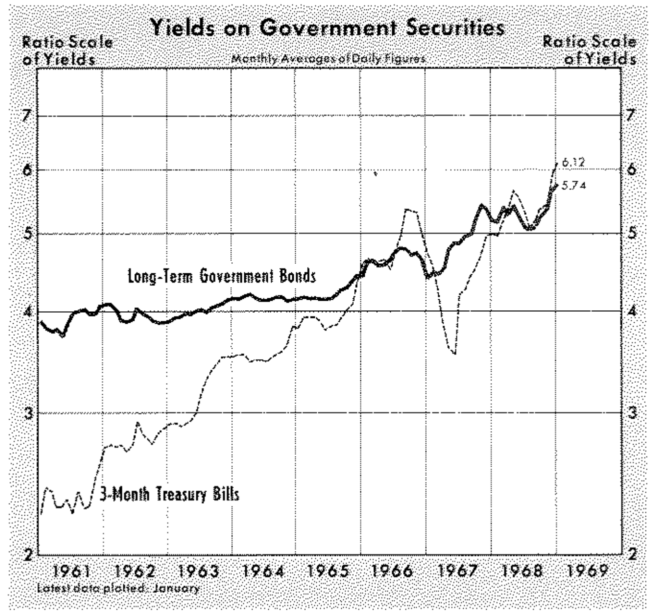
The acceleration of price increases and total demand growth have been associated with a rising rate of employment of the labor force. In January 1965, when unemployment was 4.8 per cent of the labor force, the Council of Economic Advisers stated that employment of 96 per cent of the labor force should be an interim target for stabilization actions. That target level was achieved in early 1966, while inflationary pressures intensified. Since then, employment has exceeded that level in all but two months, reaching an extremely high 96.7 per cent of the labor force in November and December of 1968. The acceleration of the rate of price increase which began at the end of 1965 has continued almost without interruption.

Interest Rates

Intensification of inflationary pressures has also affected prices for the use of loan funds. As increasing prices for the use of borrowed funds and for goods and services come to be anticipated, the public increases current purchases and borrowing in an effort to avoid higher prices and interest rates in the future. In this manner, anticipated inflation gives rise to additional demand pressures, and prices and interest rates rise further. Because of the expectation of higher prices, borrowers are willing to pay higher interest rates than otherwise. Holders of assets direct their holdings away from the loanable funds markets and into equities and real assets, unless they can obtain a return from loans sufficient to compensate them for the anticipated inflation.

Market interest rates, in response to both supply and demand forces, have risen on balance since last September. This increase was especially rapid in late November and early December. Yields on long term securities have followed the trends of prices of goods and services. Long-term Treasury bond yields averaged 4 per cent in the 1960 to 1965 period, 4.8 per cent from 1966 to 1967 and 5.3 per cent in 1968.

The Federal Reserve discount rate and the rate charged to prime borrowers by commercial banks



were raised as lagged responses or adjustments to market rate developments. On December 3 the prime rate was raised from 6¼ per cent, which it had been since September, to 6½ per cent. The Federal Reserve discount rate was increased from 5¼ per cent to 5½ per cent on December 18 in response to the increased market rates. On December 19, the prime rate was raised again to 6¾ per cent, and on January 7 to 7 per cent. This is the highest level of the prime rate since it was first defined in 1929. With prices currently rising at a 4 per cent rate, the 7 per cent prime rate may be no higher, in real terms, than the 4½ per cent prime rate prevailing in the early Sixties when prices were rising at about a 1½ per cent rate.

Regulation Q of the Federal Reserve System and similar regulations by the Federal Home Loan Bank Board limit interest rates paid on deposits and savings and loan shares. However, there is no reason to suppose that these restrictions keep the general level of market interest rates lower than it otherwise would be. Since the restrictions may limit the total supply of loan funds, the average level of interest rates paid by borrowers of loan funds is, in response to supply and demand forces, probably higher than it would be in the absence of the controls.

Stabilization Policy and the Economic Outlook for 1969

There is widespread agreement that inflation is the nation's chief economic problem in 1969. It is also agreed that inflationary pressures can be reduced by slowing the growth of total spending. Such a slowing requires a policy of monetary and fiscal restraint.

Despite universal acceptance of the need to reduce the rate of growth of total spending, there is a question of how such a reduction will affect real product and prices. The outgoing Council has judged that a 6 per cent growth in total demand from fourth quarter 1968 to fourth quarter 1969 will be accompanied by about 3 per cent growth in real product and about 3 per cent advance in prices. Such a judgment requires further examination.

Demand, Production and Prices
Annual Rates of Change

Period	Total Demand	Real Product	Period	Prices
II/54 to I/57	7.3	4.5	IV/55 to I/58	3.7
I/57 to II/58	.3	−2.5	I/58 to IV/59	1.6
II/58 to I/60	8.2	6.4	IV/59 to IV/60	1.9
I/60 to I/61	.1	−1.5	IV/60 to IV/61	1.1
IV/64 to I/66	10.2	8.1	IV/65 to IV/66	3.3
I/66 to II/67	5.7	2.5	IV/66 to II/67	2.5
II/67 to IV/68	9.0	4.9	II/67 to IV/68	3.9

Stabilization Actions and Total Demand

The outgoing Council has suggested a 6 per cent growth in total demand as an optimum target for stabilization actions in 1969. This goal for GNP growth was presented in conjunction with a budget that projects a continuation of the less expansionary fiscal stance implemented in mid-1968. Whether such a goal will be achieved depends on the ultimate fiscal program that is adopted by Congress and the new Administration, and the forthcoming rate of monetary expansion. Rapid monetary expansion apparently has continued up to the present, and, due to the lagged effect of monetary actions, rapid growth of total spending might be expected well into 1969.

The rate of monetary expansion in recent years seems to have been influenced to a considerable degree by changes in the amount of outstanding Federal debt. Since late 1966, large Federal deficits have prompted rapid increases in bank reserves to facilitate absorption of new issues of Government securities, without much immediate increase in interest rates. With the Federal budget now near balance and scheduled to move into surplus, monetary authorities may be better able to combine the program of fiscal restraint with restriction of the rate of growth of monetary aggregates, such as Federal Reserve credit, total bank reserves, the monetary base and the money supply.

Real Product and Prices

An evaluation of the Council's 1969 projections for real product growth and prices can be facilitated by examining past periods when the growth of total spending decelerated. As the table indicates, on three occasions since 1954 there was a marked and sustained decline in the rate of increase of total spending: first quarter 1957 to second quarter 1958, first quarter 1960 to first quarter 1961, and first quarter 1966 to second quarter 1967. On each of these occasions, a slowdown in total spending growth was accompanied by a simultaneous deceleration of real product. The effect on prices, however, has tended to lag the deceleration of total spending by three or four quarters.

Growth in total spending slowed in the period beginning second quarter of 1957 from a 7.3 per cent rate to a 0.3 per cent rate. Real product decelerated at the same time while price increases did not slow until about a year later. When total spending decelerated beginning second quarter 1960 from an 8.2 per cent rate to a 0.1 per cent rate, real product decelerated simultaneously. Price increases did not decelerate until three quarters later. Total spending slowed beginning second quarter 1966 from a 10.2 per cent rate to a 5.7 per cent rate, and real product growth declined simultaneously. Prices first accelerated, then decelerated three quarters later.

This experience, though limited, suggests that a deceleration of growth in total spending in 1969 probably would be accompanied by a simultaneous deceleration of real product. However, a slowdown in the rate of price increase might be expected to be delayed by three quarters or a year.

Summary

Inflation is a problem that will take time to overcome. On the basis of past experience, it is doubtful that the Council's proposed economic program will be successful in reducing the rate of price increase to 3 per cent for the year ending fourth quarter 1969. Monetary expansion continues rapid, implying continued fast growth in total spending unless the rate of monetary expansion is moderated. With inflationary expectations apparently entrenched in the economy, it is more likely that significant price effects of a reduction in spending growth, once it occurs, would not appear until as much as a year later.