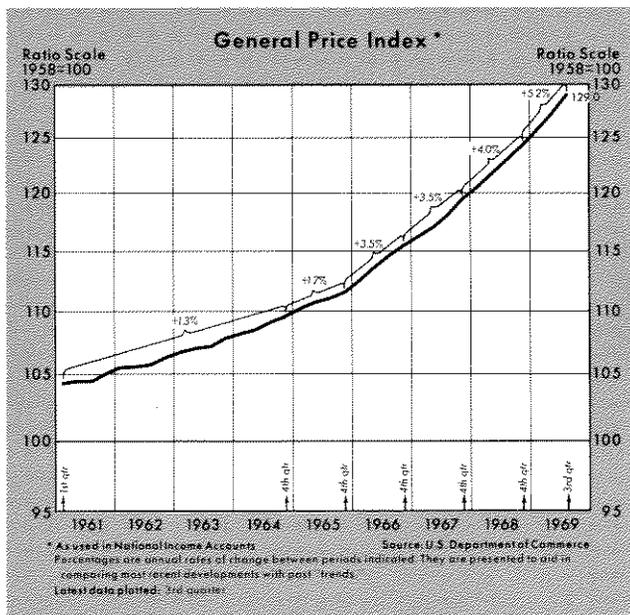


1969—Battle Against Inflation

by NORMAN N. BOWSER

NINETEEN SIXTY-NINE has been the fifth year of intensifying inflation. Overall prices, after remaining fairly stable in the early Sixties, rose 1.7 per cent during 1965, 3.5 per cent a year in 1966 and 1967, 4.0 per cent during 1968, and an estimated 5 per cent in 1969. Not since World War II has the American economy experienced such a sustained price upsurge.



Inflation has been the nation's most serious domestic economic problem in recent years. The extent of concern over this problem has been evident from the numerous tough decisions the public authorities have made in an attempt to moderate it. Tax rates were raised, growth in Government spending was reduced, and monetary growth was restrained. Despite these actions there is as yet no firm evidence that the rise in prices has decelerated, or that inflationary expectations have moderated.

Some believe that inflation has now become inevitable, and that the country should learn to live with it. They feel that inflation has some desirable features, and that even if undesirable on balance, the nation apparently cannot stop it, or the costs of doing so are likely to exceed the benefits. At the other extreme, some feel that inflation is intolerable, and that it must be stopped even though the necessary cost is likely to be a severe and prolonged recession. The majority

of experts are neither complacent about inflation, nor so pessimistic about its cure. Although stopping inflation is generally believed to involve hardships, it is felt that the necessary transition costs of following proper public policies would not be great compared with the inequities and inefficiencies resulting from continued reductions in the purchasing power of the dollar.

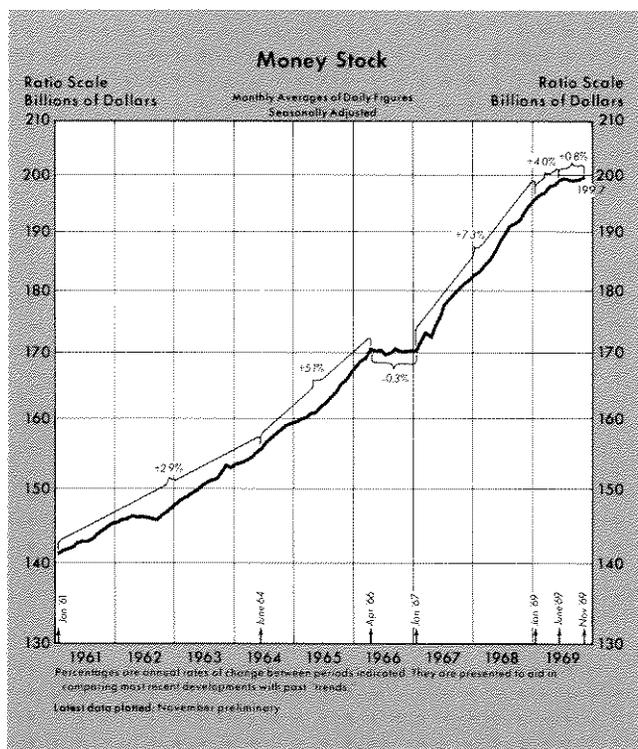
This article traces the course of the inflation of the past five years. It sets forth some of the chief causes and effects, reviews the actions taken to resist inflation, presents an analysis of economic developments during 1969, and provides some observations on the outlook.

Balanced Economic Expansion — 1961 through 1964

Following the recession of 1960, the country experienced four years of pronounced economic expansion with little inflationary pressure. Real output of goods and services increased at a 5.4 per cent annual rate from early 1961 to late 1964. Except for a pause in late 1962, this was a period of steady economic expansion.

In the early Sixties real growth was faster than the estimated 4 per cent rate of growth in productive potential. As a result, unemployment was reduced from about 7 per cent of the labor force in early 1961 to less than 5 per cent in late 1964, and manufacturing plant utilization rose from 75 per cent to 86 per cent of normal capacity. These gains were accomplished in an orderly fashion without great frictions, shortages, or imbalances, while average prices remained relatively steady. Overall prices, measured by the GNP deflator, rose at a 1.3 per cent annual rate. However, because of the difficulty of fully taking account of changes in discounts granted and quality improvements, the index probably overstated the actual price increase.

The economy demonstrated a great resiliency and ability to expand in the 1961 to 1964 period. Fiscal and monetary management caused no great shocks to the economy, and the free enterprise system responded admirably. The nation's money stock grew at a 2.7 per cent annual rate from mid-1960 to mid-



1964, faster than the average 2 per cent rate of the previous decade, but slower than the estimated 4 per cent rate of growth in productive capacity. During the early Sixties policymakers faced two major economic problems which apparently called for opposite courses, probably accounting for a compromise between moderate and relatively steady growth in money. Unused resources were a signal for monetary expansion while an adverse balance of payments and gold outflows called for restraint. Since the demand for money to hold was probably increasing less rapidly than either real production or productive potential, it was appropriate that money expand less rapidly than either of these magnitudes in order to avoid inordinate inflation.

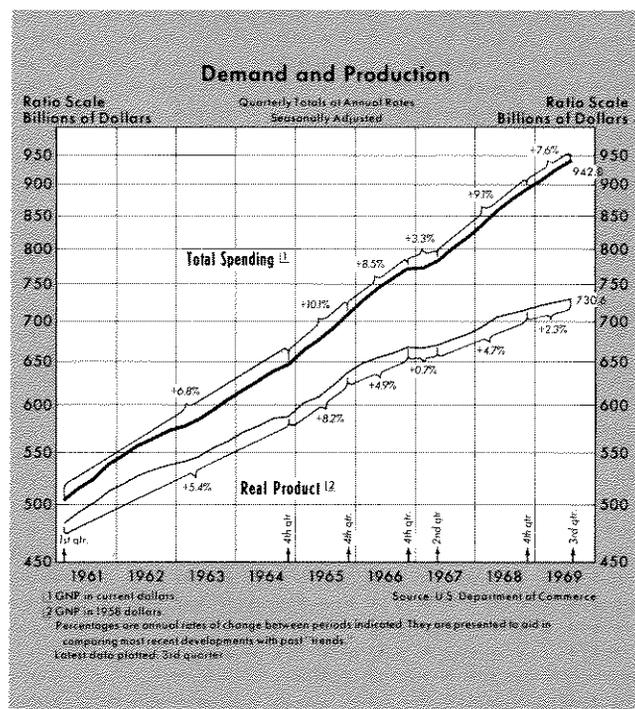
The influence of the Federal budget on total spending, as commonly measured, was moderate from 1960 to early 1964. The growth rate of Government spending and the net surplus or deficit of both the high employment and the national income accounts budgets remained in fairly narrow ranges. Despite the strong and balanced economic expansion without excesses during the early Sixties, some policy advisers held theories which indicated that the state of the budget was highly depressing to total spending, production, and employment. After a substantial delay, taxes were cut in early 1964, with the objective of keeping the country moving by eliminating the alleged actual or potential "fiscal drag."

Excessive Spending and Inflation — 1965 through 1969

Since 1964 total spending for goods and services has risen much faster than the country's potential to supply them. Total outlays rose at an average 8 per cent annual rate from late 1964 to late 1969. With little excess capacity, increases in real output were constrained by the growth in the nation's capacity to produce. The rise in spending was roughly double the estimated rate of expansion in potential output, given the growth in the labor force, capital equipment and technology.

Most sectors of the economy have participated in the rapid increase in spending which began in late 1964. Government purchases of military goods have expanded at an 11 per cent annual rate since 1964, compared with a trend rate of 2 per cent from 1957 to 1964. Other Federal Government expenditures have also increased at an 11 per cent rate since late 1964. Business investment has risen at an 8 per cent rate since late 1964, after increasing at a 5 per cent rate from 1957 to 1964. Personal consumption expenditures have increased at a 7.6 per cent rate since late 1964, following a 5 per cent rate of increase from 1957 to 1964.

With spending on goods and services rising faster than their production, prices were bid up. The rate of inflation appeared mild at first, reflecting inflexibility of some prices in the short run, the moderate amount



of excessive demand, and fuller use of resources. Overall prices went up 1.7 per cent from late 1964 to late 1965. About one-sixth of the rise in total spending was reflected in higher prices while five-sixths went for additional goods and services.

As time passed, demand-pull intensified, and price increases accelerated. During both 1966 and 1967 prices rose 3.5 per cent, and in 1968 they rose 4 per cent. Only about half the total growth in spending during the 1966 through 1968 period went for additional real output; the other half was taken in higher prices. Effective prices may have risen even more than these figures indicate, for when demand becomes excessive, discounts and rebates are eliminated, surcharges abound, and there is a tendency to reduce quality standards. In the preparation of price indexes, some of these developments may have been missed, since producers are not likely to disclose their complete discount policies or a deterioration in product quality.

The inflation has been even more severe during 1969. The continued rise in total spending in excess of production, prompted in part by deterioration of the illusion that money has a relatively constant value, has contributed to the greater price increases. Overall prices have gone up about 5 per cent in the past year, even though there has been a little moderation of growth in total spending. As a result, nearly three-fourths of the rise in outlays has been used to pay higher prices. Growth in real production declined to about 2 per cent in 1969, or to about half the trend rate. In recent months the rise in prices probably has been at about the same pace as the rise in spending, with little net change in total real output.

Causes of Excessive Spending and Inflation

In our free enterprise system each spending unit — household, business firm, or governmental unit — determines whether to spend or save the funds available to it. Hence, one might conclude that the excessive total spending resulted from an unfortunate bunching of expansive individual decisions. Such a conclusion is only a half-truth, providing little insight into the basic forces determining total spending.

Consumer spending is closely related to income, and business outlays are generally related to expected profits. Although these sectors account for a major portion of total spending, and changes in them do have considerable effects on total spending, they alone have seldom been the prime motivating forces in bringing about cyclical movements in total spending

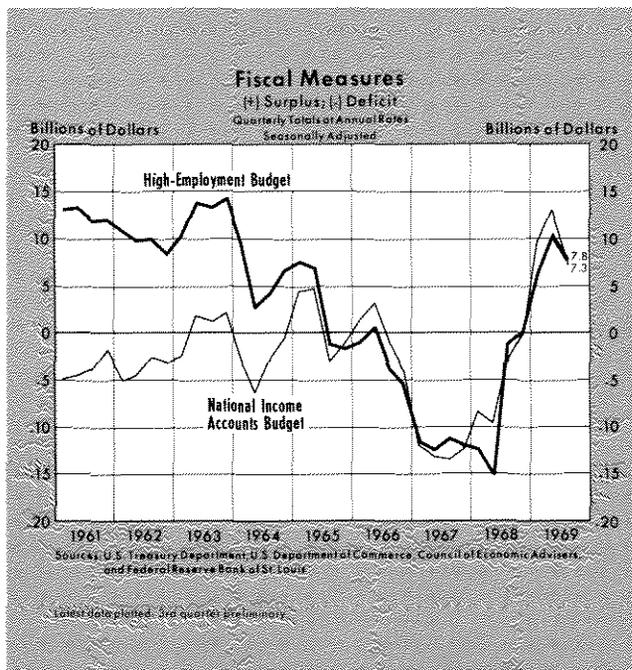
Two forces in the economy which are under the control of public policy and which are believed to have a great influence on private spending decisions are fiscal policy and monetary management. Most studies of economic stabilization have focused on them.

Fiscal Actions — The results of decisions by the Federal Government which change its spending and taxing programs are fiscal actions. It has commonly been believed that such changes expand or contract total public and private spending by some multiple. However, the aggregate influence of the Government on total spending is greatly diminished if the resulting deficits or surpluses are financed by the public out of planned saving rather than accompanied by changes in the money stock.¹ Changes in Government activities tend to be offset by opposite movements in private spending when the Government finances its deficits with debt paid for by the public out of current planned saving.

Among the commonly used measures of Government fiscal actions are the national income accounts budget, the expenditure component of this budget, and the high-employment variation of it. The national income accounts budget summarizes the receipts and expenditures of the Federal Government sector as an integral part of the national income accounts. The high-employment budget is an estimate of the expenditures and revenues in the Federal sector of the national income accounts at an assumed constant rate of growth of real economic activity (conventionally about 4 per cent unemployment). It attempts to abstract from the impact of actual economic activity on the realized surplus or deficit.

It is widely believed that the inflation since 1964 has been caused by Government fiscal mismanagement. Forthcoming defense spending was greatly underestimated, there was lack of restraint on non-defense outlays, and there was delay in raising taxes. As a result, from 1963 to mid-1968 the Government cut tax rates and increased growth rates in both defense and nondefense outlays. The high-employment budget, which was at a \$13 billion surplus in 1963, declined to about a \$14 billion annual rate of deficit in the first half of 1968. The national income accounts budget shifted from a small surplus in 1963 to a \$9 billion deficit in the first half of 1968. From 1963 to

¹Leonall Andersen and Jerry Jordan, "Monetary and Fiscal Actions: A Test of Their Relative Importance in Economic Stabilization," this *Review*, November 1968, pp. 11-24; and Michael Keran, "Monetary and Fiscal Influences on Economic Activity — The Historical Evidence," this *Review*, November 1969, pp. 5-24.



early 1968 national income accounts expenditures rose at a 10 per cent annual rate, after increasing at a 6 per cent rate from 1957 to 1963.

Monetary Actions — Another force under the control of public policymakers, which is believed to have a vital influence on private spending decisions, is monetary actions. The Federal Reserve, by determining the volume of Federal Reserve credit outstanding and thereby the amount of the monetary base and the reserves of the member banks, can manage the supply of money (demand deposits and currency) in the economy. By supplying more money than the public desires to hold, given current levels of income, wealth, and interest rates, the public's demand for other financial assets and for real goods and services is stimulated. Businesses and households undertake to exchange excess money balances for assets which will provide more satisfaction. Conversely, by providing less money than the public wishes to hold, the central bank can place downward pressure on the rate of spending, since businesses and individuals will reduce outlays in an attempt to build up cash balances in relation to other assets.

Monetary actions share responsibility for the overheating of the economy. From the end of 1964 to the end of 1968 the stock of money rose at an average 5 per cent annual rate. By comparison, money grew at about a 2 per cent rate from 1957 to 1964. By sub-periods, from late 1964 to the spring of 1966 money rose at a rapid 6 per cent rate, remained on a plateau during the summer, fall and winter of 1966, and then

rose at a 7.3 per cent rate until January 1969. The course of money reflected roughly parallel courses of Federal Reserve credit, the monetary base and member bank reserves.

Effects of Inflation

Inflation is a rise in the general level of prices or, otherwise stated, a decline in the purchasing power of the dollar, and tends to cause a redistribution of wealth and income.² It affects holders of money adversely, reduces the relative value of bonds, savings accounts, and other dollar-denominated assets, and gives a windfall to debtors. For a savings account drawing 5 per cent per year interest, while prices increase at a 6 per cent annual rate, the saver receives a net yield before taxes of minus one per cent, since when the saver receives his principal plus interest, the funds will buy less than his principal alone would have bought at the time the deposit was made. After-tax income is a yet greater net loss.

Inflation has different effects on various individuals and businesses, depending on types of assets and liabilities held and sources of income, which, in turn, may have been affected by the extent to which inflation has been anticipated. When inflation can be anticipated and provided for, types of asset and liability holdings may be adjusted and the rate of price increase built into contracts by cost-of-living or other escalators. If both borrower and lender expect a 5 per cent inflation, and funds are worth a real 4 per cent, the interest rate stated in the contract would be 9 per cent. Then, with the 5 per cent rate of inflation, neither party gains nor loses.³ Hence, with greater inflationary expectations market interest rates are driven up to progressively higher levels.

Since there is much uncertainty about the future course of prices and all people are not capable of making contracts against contingencies, inflation causes a redistribution of wealth and income. Money is noninterest bearing, and so adjustments cannot be made for reduced purchasing power of money holdings. Many mortgages, pensions, bonds, and other long-term contracts cannot be changed until they mature. Persons with small savings have been especially disadvantaged by inflation.

²See Albert E. Burger, "The Effects of Inflation (1960-68)," this *Review*, November 1969, pp. 25-36.

³Income tax considerations would make the stated rate even higher, since the borrower is able to deduct from his income the amount of interest paid, and the lender must include as income the greater amount of interest received.

Inflation has a tendency to cause inefficiencies and reduce output. For example, many find it advantageous to devote more effort to holding cash balances to a minimum. Because some prices are not completely flexible, shortages develop, causing inefficiencies in production. Uncertainties regarding the rate of inflation tend to encourage speculation.

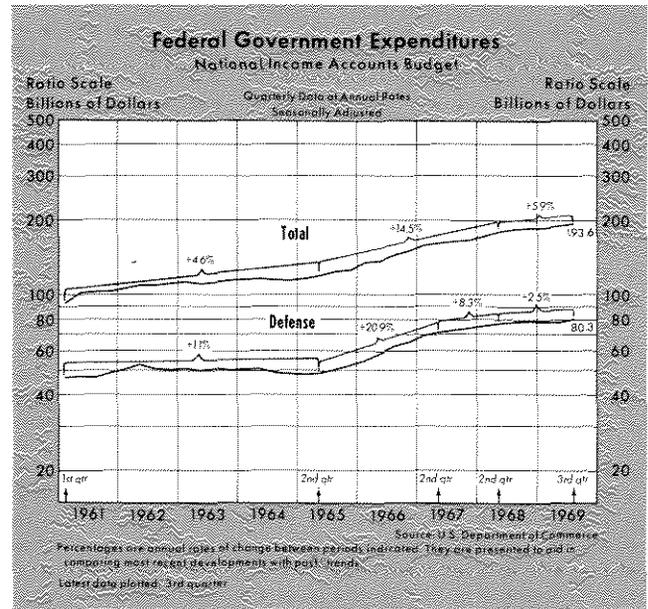
The presumed benefits of inflation are dependent upon its continued acceleration and upon the losses of some to the benefit of others. Only if the rate of inflation were stabilized, with all the public fully anticipating it and acting upon the anticipations intelligently and costlessly, would the rate of inflation be immaterial. But, under present conditions of uncertainty, nonuniform expectations, and lack of flexibility, inflation is unjust, inefficient, and undesirable, and it is the stated policy of the Government to eliminate it.

Actions Taken to Resist Inflation

Because inflation is such a serious problem, the Government has regretted the policy errors which produced it, and taken a number of actions designed to resist or eliminate it. Unfortunately, many of these actions have been based on poor economic analysis, and they have proven to be largely ineffective, at least until very recently. Chief actions presumed and intended to be anti-inflationary have been raising tax rates, reducing the rate of increase of planned Government spending, regulating credit, permitting high interest rates, using moral suasion, and slowing the growth in money. Some have suggested that since these measures as yet have been largely ineffective in stopping price acceleration, the country should resort to a broad set of wage and price controls in order to govern prices.

Fiscal Actions — Because the rapid increase in the demand for goods and services and the resulting acceleration of price increases were thought to stem from expansionary fiscal actions, a serious step in resisting inflation was to reverse these actions. In fact, it was widely felt that the best, and perhaps only, way to reduce inflation was to raise taxes and reduce Government spending.

After long deliberations filled with assurances of potency of fiscal actions, the Revenue and Expenditure Control Act was passed and signed into law on June 28, 1968. The Act represented a significant move in fiscal policy for the express purpose of moderating



growth of total demand, and thereby reducing inflation. The major features of the Act were reductions in some proposed spending and a 10 per cent surcharge on corporate and individual income taxes.

Reflecting the provisions of the Act and a few subsequent decisions made in the same spirit, growth in total Federal expenditures slowed sharply. In the last half of 1968 outlays in the national income accounts budget rose at an 8 per cent annual rate, and in the first three quarters of 1969 at only a 4 per cent rate, compared with a rapid 13 per cent per year pace from late 1964 to mid-1968.

The larger tax receipts, flowing from the surtax and the higher levels of the public's income, and the slower growth in Government spending led to an abrupt reversal in the Federal budgets. The national income accounts budget went from a \$9 billion annual rate deficit in the first half of 1968 to a \$10 billion rate surplus in the first three quarters of 1969. On a high-employment budget basis, the shift was from a rate of \$14 billion deficit to an \$8 billion surplus.

Despite the predominant feeling that a tax increase and some expenditure controls were necessary, many analysts in the late summer and fall of 1968 felt that the steps actually taken were too vigorous, and expressed a fear of overkill. Most econometric models of the economy indicated a quick and drastic slowdown in spending and inflation as a result of the fiscal actions. Arthur Okun, then the Chairman of the Council of Economic Advisers, summed up this opinion by stating, "I know of no one who would say now that our worries are still those of expanding too fast. If any-

thing, the balance has shifted a bit in the other direction."⁴

Responding to the marked shift in sentiment and expectations after the tax increase and the cut of planned Government spending, monetary policy was ostensibly relaxed. The directive to the System's operating manager on July 16, 1968, stated in part, "The new fiscal restraint measures are expected to contribute to a considerable moderation of the rate of advance in aggregate demands," and he was instructed to accommodate "... the tendency toward somewhat less firm conditions in the money market . . ."⁵

Not all early evaluations of the impact of the fiscal action agreed that the inflation would be stemmed by this action alone. For example, this bank's study of the effects of the fiscal program published in the August 1968 issue of this *Review* (pp. 3-6) concluded:

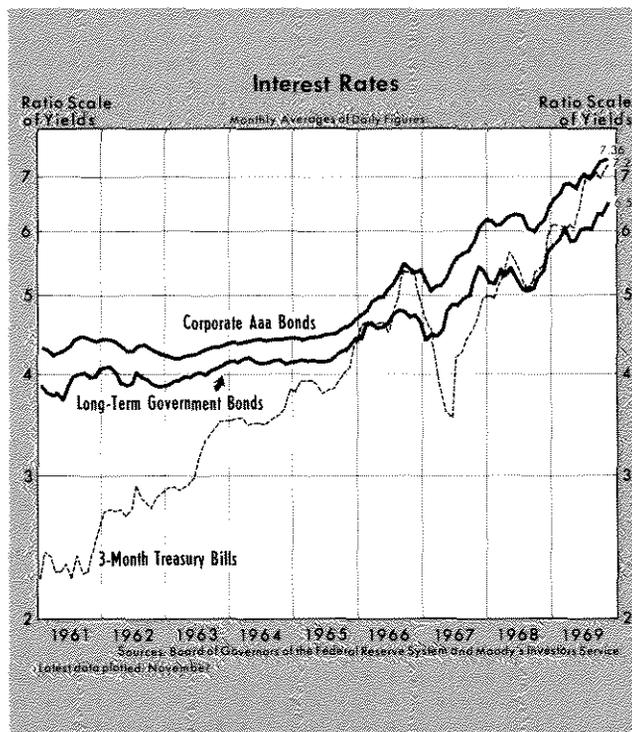
Fiscal authorities have adopted a program of Federal budget restraint in an effort to combat excessive total demand. It is hoped that this action will moderate inflationary pressures while only slightly affecting output and employment. However, an inflationary psychology has become entrenched in the economy, as evidenced by large wage settlements and the rising costs of credit. If the Administration and Congress have finally assigned high priority to the task of reducing inflationary pressures, monetary actions to complement the fiscal program are needed.

The tax increase and the controls placed on Federal spending did not produce the results expected by their sponsors. Excessive growth in total demand continued at only a slightly reduced rate. Slower growth in spending by the Federal Government was largely offset by greater outlays by those who were able to attract the funds formerly flowing to the Government to finance its deficits. To some, fiscal action as a tool of economic stabilization became largely discredited by this experience, while the more devoted followers of this approach believe that the inflation would have been much worse without the higher tax rates and spending cuts, that the actions were not large relative to the size of either the economy or the inflation, and yet total spending growth stopped accelerating and slowed moderately after the action.

Interest Rates — Market interest rates have risen greatly since the early 1960's, but the increasing rates,

⁴"What's Ahead for Business," *U. S. News and World Report*, August 5, 1968, pp. 52-55.

⁵Federal Reserve *Bulletin*, October 1968, p. 866.



rather than limiting inflation, have been the result of excessive total spending and resulting inflation. Yields on highest grade seasoned corporate bonds, which averaged less than 4½ per cent in the first half of the 1960's, rose to 5.13 per cent in 1966, 5.51 per cent in 1967, 6.18 per cent in 1968 and over 7.30 per cent in the fall of 1969. Interest rates on other marketable securities also increased sharply.

Greater costs of credit, it was argued, should moderate inflation since higher rates make expansion of spending more difficult and are a stimulus to increased saving. The high interest rates have made it more costly for businessmen to purchase plant, equipment, and inventories. Higher rates have made it more expensive for consumers to buy homes, purchase automobiles, and obtain other durable goods. Yet, the excessive growth in aggregate spending has continued, placing more and more upward pressure on prices.

The higher interest rates have not stopped the inflation, but rather the inflation itself has been largely responsible for the rise in rates. Interest rates are a price for the use of funds, and as a price, they are affected by inflation. Price expectations, as indicated by recent actual price behavior, have been a major factor in the rise of market interest rates.⁶ With expected inflation, saving is discouraged unless inter-

⁶"Interest Rates and Price Level Changes, 1952-1969," by William P. Yohe and Denis S. Karnosky on pp. 18-38 of this *Review*.

est rates paid are high enough so that expected future real purchasing power of funds is protected, while borrowers offer higher rates since they expect that the prices of investment goods will increase.

The higher market rates in 1969 may have had no more stimulative effect on savers or restraining influence on investors than the lower market rates did in the early 1960's. In fact, recent rates paid on savings accounts have not even equalled the attrition in the purchasing power of the dollar, and many borrowers have anticipated that equipment and building costs would rise faster than the interest rate charged to finance purchases. Income tax considerations have also dulled the effectiveness of interest rates, since lenders must pay taxes on interest "earnings" and borrowers receive deductions for interest "expense."

Controlling Bank Credit — During 1969, the rate of growth of commercial bank loans and investments has been sharply reduced. In the first six months of the year outstanding bank credit rose at a 3.5 per cent annual rate, and since June has declined at about a 2 per cent rate. By comparison, this credit increased at an average 7 per cent rate from 1959 to 1966, and at an 11 per cent rate in 1967 and 1968. The reduction in the growth of bank credit has been brought about largely by regulating the maximum interest rate banks are allowed to pay on savings and other time deposits (Regulation Q). The marked slowing in time deposits and corresponding bank credit growth seems unlikely to have exercised any restraint on excessive total spending and inflation.

Regulation Q was instituted following bank failures of the early Thirties, primarily as a device to keep maverick banks from establishing rates clearly out of line with market conditions. However, in recent years as market rates have risen above Regulation Q ceilings, and most banks have found it increasingly difficult to compete for time deposit funds. Regulation Q apparently has been considered a tool for influencing total spending, on the grounds that a lower growth in time deposits causes a reduced growth in bank credit.

Largely because of limitations on interest rates they can pay on time deposits, banks have been drained of a substantial amount of time funds and have been unable to attract a normal flow. Large certificate of deposit obligations of commercial banks have fallen by more than half in the past year, from about \$24 billion to about \$11 billion. Growth in other time and savings deposits slowed from an 11 per cent

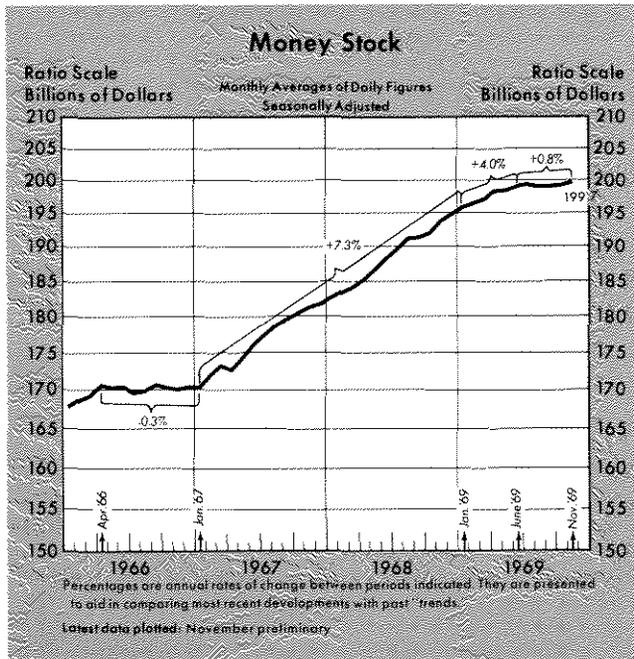
annual rate from 1957 to 1968 to a 4.9 per cent rate in the first half of 1969 and to a 1.8 per cent rate of decline from June to November. With fewer funds flowing to them, banks have had less to lend or invest.

Regulation Q limitations, however, have had no demonstrable effect on the total amount of credit extended in the economy. Funds have failed to flow through commercial banks because they have been attracted to users through other channels, such as direct loans, commercial paper, and the Eurodollar market. By diverting loan funds through a second best route, the financial system has become less efficient. Other financial intermediaries subject to similar regulations have also been severely affected. Interest rate limitations have made it more difficult for home buyers and smaller businesses who must rely on local institutions to obtain credit. Larger businesses which can obtain funds in the central money markets have probably obtained funds cheaper and more readily than in the absence of disintermediation. Small savers have been penalized by the low rates received, while larger lenders who have more alternatives have received higher returns. Despite these inequities and disruptions to the financial system, it appears that growth in total credit granted (bank plus nonbank) was largely unaffected by the limitations placed on interest rates paid by financial intermediaries.

Moral Suasion — Another popular suggestion for resisting inflation, which is usually considered to be largely ineffective, is to ask the public to forego raising wages and prices. A set of guideposts was proposed by the President's Council of Economic Advisers in mid-January 1969: wages were to be raised no faster than average productivity growth (estimated at about 3 per cent a year), and prices were to be established so as not to raise profit margins.

However, the guideposts and other appeals to the public to use restraint in setting prices and wages have never been effective. Workers and businessmen cannot be expected to forego returns which are available to them. If they did, the economy would become less efficient; incentives would be dulled; shortages would quickly develop; and resources would not be attracted into areas of greatest demand.

Some have suggested that prices and wages should be rigidly controlled by law, with severe penalties for violations. Yet, attempts to control prices in the past indicate that such controls have been largely ineffective, because blackmarkets develop, quality deteriorates, and in other ways effective prices are raised.



Controls are costly to administer, impinge on freedom, create shortages, and misallocate resources.⁷ Controls interfere with the continuous price adjustments which are essential for equating supply and demand in the myriad sectors of the economy and attracting resources to the uses where they are most needed. Inflation may be "bad," but an inflation temporarily repressed by a broad set of arbitrary wage and price controls is worse. Unless controls are accompanied by policies which will reduce the excessive demand for goods and services, they provide no solution to inflation. If total spending is restrained, the controls are unnecessary.

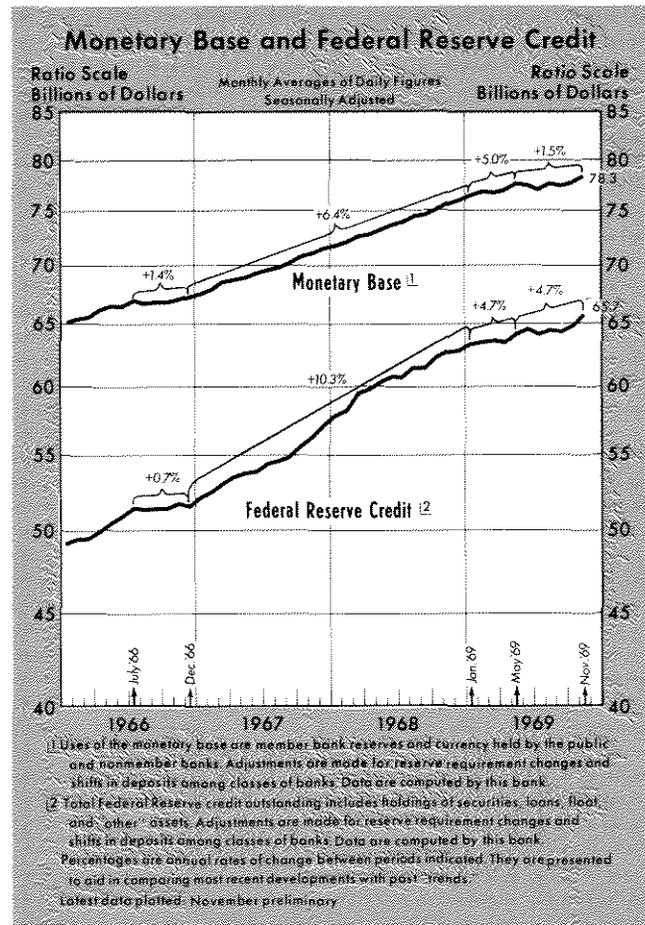
Monetary Actions – Growth in the nation's money stock has slowed markedly in the past year. This action has already limited total spending, and studies of past lags of the effect of monetary restraint indicate that this action will be effective in further reducing demand for goods and services. Reducing the stock of money relative to the demand for it causes consumers and business to spend less than their incomes in an attempt to build up actual cash balances to desired levels.

During 1967 and 1968, the money stock rose at a very rapid 7 per cent annual rate. In the first half of 1969, growth in money slowed to a 4 per cent rate, and since June money has risen only slightly. By comparison, money rose at a 2 per cent trend rate

from 1957 to 1964 when total spending was restrained. Most of the recent slowing of the money supply occurred in the demand deposit component. The currency component, which responds more to trends in spending than to current changes in member bank reserves, continued to rise rapidly in 1969.

The reduced rate of money stock growth during 1969 reflected a marked reduction in the rate of expansion in other monetary aggregates. Federal Reserve credit outstanding, which had risen at a 10 per cent rate during 1967 and 1968, slowed to about 5.5 per cent rate in the first five months of 1969 and to a 4.7 per cent rate after May. The monetary base after rising 6.5 per cent in both 1967 and 1968, increased at a 5.3 per cent rate in the first five months of this year, and has slowed to a 1.5 per cent rate since then. The deceleration in total member bank reserves growth was even sharper.

Continued growth in spending at an excessive rate during most of 1969 was consistent with the monetary actions of the past two years. Growth of the money stock was very rapid until early 1969, and the expansionary effects of such growth have usually been



⁷See "Controlling Inflation," a speech by Darryl R. Francis, President, Federal Reserve Bank of St. Louis, printed in the September 1969 issue of this Review, pp. 8-12.

**SELECTED MONETARY AGGREGATES
(Annual Rates of Change)**

	Dec. 67 to Dec. 68	Dec. 68 to June 69	June 69 to Nov. 69 p.
Money Stock	7.2	4.4	0.8
Demand Deposits	7.1	3.7	-0.5
Currency	7.4	6.6	5.4
Money Plus Time Deposits	9.4	0.1	-4.0
Federal Reserve Credit	10.2	5.9	4.2
Monetary Base	6.5	4.0	2.3
Total Reserves	7.8	0.7	-5.9

p—Preliminary

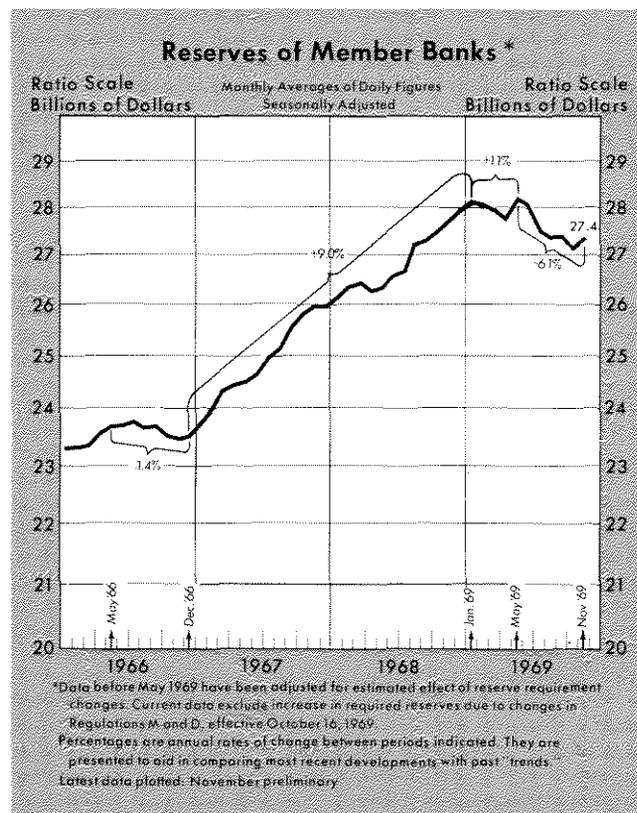
strongest after a lag of about two quarters. Hence, spending in the first half of 1969 was being affected primarily by earlier expansionary monetary developments. Then in the first half of 1969, money expansion, although dampened, continued at a rate in excess of the trend since 1957. As a result, one might have expected only a gradual moderation in the growth rate of spending during the summer and early fall. Since mid-year monetary restraint has intensified, and the initial major effects of this action would normally be expected to occur in late 1969 or early 1970.

Economic Developments in 1969

Despite the many actions taken in the battle against inflation, price increases accelerated in 1969. The greater inflation has been caused by both a continued strong demand-pull effect from excessive spending and a cost-push effect from previous excessive demands for goods and services. As the year progressed, however, there were increasing signs that the demand excesses were waning.

First Half — In the first half of 1969, growth in total spending continued to be excessive and moderated only slightly from a year earlier. Total spending on goods and services rose at a 7.4 per cent annual rate, down from the 9 per cent rate in the previous six quarters, but only a slightly less than the average 8 per cent rate that had prevailed since late 1964. Final sales (that is, total sales less changes in business inventories) rose at an 8.3 per cent rate in the first half of 1969, virtually the same as in the previous year and a half, and in the entire period since late 1964.

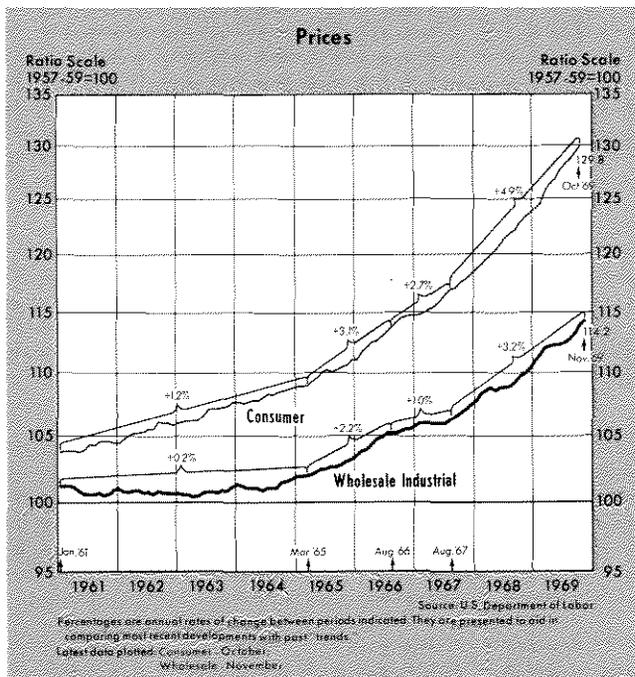
Growth in production, however, slowed in early 1969. Real output of goods and services rose at a 2.3



per cent annual rate during the first six months of 1969, about half the rate of the period from late 1964 to late 1968. Despite cutbacks in total output, both industrial production and employment continued to rise at rapid rates, and the level of unemployment remained unusually low. The upward trend in total production was probably restrained as the economy approached capacity and could not physically maintain the earlier growth pace. Growth of productivity slowed reflecting inefficiencies resulting from the inflation.

With spending continuing to rise rapidly and with production expanding at slower rate, the pace of inflation accelerated in early 1969. Overall prices went up at a 5 per cent annual rate in the first half of the year after rising 4 per cent in 1968 and 3.5 per cent in 1967. Consumer prices rose at a 6.4 per cent rate in the first half of 1969 compared with 4.7 per cent in 1968 and 3.1 per cent in 1967. Wholesale prices increased at a 6.3 per cent rate in the first half of 1969 following a 2.8 per cent rise in 1968 and a 0.8 per cent increase in 1967.

Second Half — Evidence of some real progress in combatting the economic ebullience was provided by a number of sensitive data series during the third quarter of 1969. Although the overall measure of



Prices have risen since June at about the same pace as during the first half. The overall measure increased at a 5.4 per cent annual rate from the second to third quarter, up from a 5.1 per cent rate earlier in the year. Consumer prices rose at a 5.1 per cent annual rate from July to October, compared with a 5.9 per cent rate in the first seven months of the year. Wholesale prices increased at a slower pace from June to November, but the improvement provided little encouragement to those seeking to control inflation since it reflected a decline in farm prices resulting primarily from a jump in supplies.

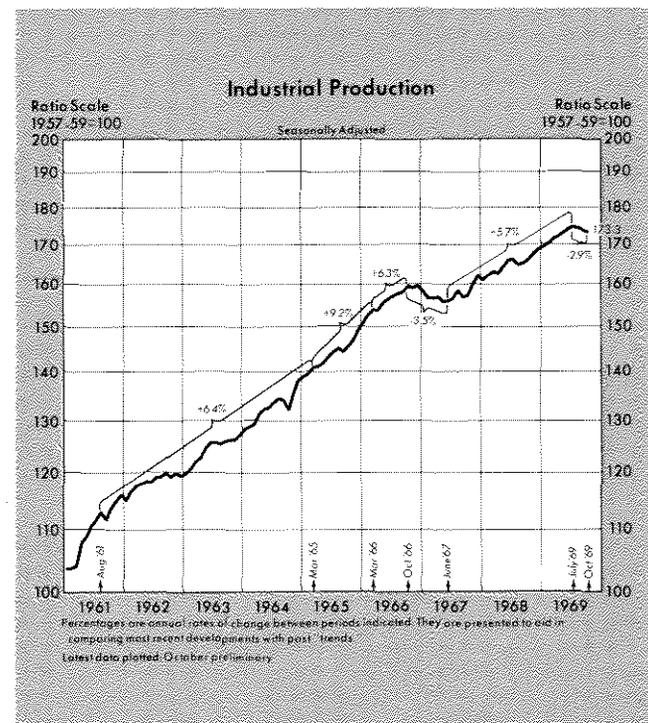
Personal income grew at a 4.5 per cent annual rate from August to October after growing at an 8.8 per cent rate in the first eight months of the year. Business spending may have been moderated by rising inventories, declining corporate profits, and less optimistic expectations. Consumers found personal income rising at a slower rate after mid-summer, a development which, according to surveys, was accompanied by deterioration of consumer confidence. State and local governments have reduced the growth rate of their outlays in response to higher interest rates, in some cases to levels above ceilings permitted, and to public discontent with ever rising tax burdens.

total spending expanded slightly faster than in the first half, analysis of spending by major categories indicated much less strength. Spending was supported by an unusually large catch-up Government pay raise in July. Nevertheless, final sales rose at only a 6.3 per cent annual rate, down from the 8.3 per cent rate in the first half. Total sales were bolstered by a substantial, probably largely unintended, buildup in inventories, as final sales apparently did not measure up to earlier expectations. An unplanned rise in business inventories while sales fall below expectations is frequently a sign of developing weakness in total demand.

Summary and Outlook

The past year has been the worst of five successive years of inflation. Overall prices have risen about 5

Real output of goods and services grew at a 2.2 per cent annual rate from the second to third quarter of 1969, about the same as in the first half. Other measures of performance, however, indicated weakness. Real final sales were about unchanged from the second to the third quarter after rising at a 3.3 per cent annual rate in the first quarter. Industrial production declined at a 5 per cent rate from July to November after rising at a 6 per cent annual rate from last December to July. Payroll employment rose at a 1.1 per cent annual rate from June to November, following a 4.2 per cent increase in the first half. Total civilian employment rose at a 1.6 per cent annual rate from August to November, after increasing at a 2.8 per cent rate in the first eight months of the year. Private nonfarm housing starts were at a 1.4 million rate from July to October, down from a 1.6 million rate in the first half.



per cent while consumer prices have increased 5.6 per cent. The inflation has caused a substantial redistribution of real wealth and income and has created inefficiencies.

The inflation has resulted from an unduly large demand for goods and services which was nurtured by expansive monetary developments in 1967 and 1968. In addition, prices have been forced up increasingly by cost-push forces resulting from the delayed effects of previous excesses. The rapid increases in spending and inflation have continued despite higher tax rates, cuts in Government spending programs, higher interest rates, a reduction in the growth of bank credit and exhortations by public officials for business and labor to use restraint in raising prices and wages.

The end of inflation is not clearly in sight. The recent record of economic advice and business forecasting has not been distinguished for its accuracy. A slowdown in activity and inflation widely predicted for the last half of 1968 and then for the first half of 1969 as a result of the restrictive policies adopted failed to materialize. This unimpressive record should engender caution, if not humility, for those who venture judgments as to current economic prospects.

Monetary actions continued very expansive through 1968, and projections based on these developments have not been misleading, except when based on short-run movements in preliminary data which were later revised. Monetary expansion was moderate in the first half of 1969, and since midyear the money stock has been virtually unchanged. Experience indicates that spending usually slows in about two quarters after a marked reduction in the growth rate of money.

After mid-1969, evidence began accumulating that the economic environment was changing, that the expansionary forces were weakening, and that a slackening in the quarter-to-quarter growth rate of spending was in prospect. It now (early December) appears that further reductions in the growth of total spending and production appear to be in prospect for early 1970 as a result of the monetary restraint in the summer and fall of 1969.

Even if growth of total spending continues to slow and is moderate in 1970, inflationary forces will probably remain serious throughout the year and perhaps for some time afterward. Expectations of rising prices are strong. Price increases usually continue for an ex-

tended period after growth in overall demand for goods and services moderates, reflecting cost-push forces generated by the earlier excessive spending. It took about seven years of restrained growth of spending in the 1950's to eliminate the inflationary pressures created during the Korean conflict. Some prices, such as negotiated wages and those set in other contracts, which have been relatively inflexible during recent periods of rapid price increase, will probably be adjusted upward later at time of renegotiation. Other prices have been held back by a money illusion, lack of knowledge of costs, public opinion, and inertia. As these wages and prices advance toward equilibrium levels, the increase in production costs will place upward pressure on other prices.

Nevertheless, the campaign against inflation seems to be yielding results in the last half of 1969, as inflationary pressures probably passed their peak in intensity. The results of great economic imbalances are likely to be felt more keenly in 1970 than they were in the late 1960's when they were generated. Assessment of economic prospects suggests that the country faces a very difficult period. Spending is likely to be sluggish, with corollaries of reduced production, rising unemployment, and a squeeze on business profits. At the same time significant deceleration of price increases may be dishearteningly slow. Success will require great perseverance which is more likely to be achieved if extreme erratic stabilization actions can be avoided.

The crucial consideration for stabilization policy-makers in the coming year will be the determination of how rapidly the excessive growth of total spending can and should be reduced. Because of past errors, the choice now is to determine the lesser of evils. If monetary and fiscal actions are followed which will slow the rise in total demand for goods and services abruptly, inflationary pressures may be extinguished sooner than otherwise. However, the costs in terms of lower production, employment and incomes would be great, and the temptation would be strong to re-stimulate the economy before the task is completed as was the case in 1967. On the other hand, if demand grows so rapidly as to permit growth in production, employment and income to continue at near their long-run maximum trends, moderation of inflationary pressures may not be achieved and we are likely to have a continuation of the inefficiencies and inequities caused by a continuous erosion of the value of the dollar. A middle course is advisable.