

Transition to Reduced Inflation

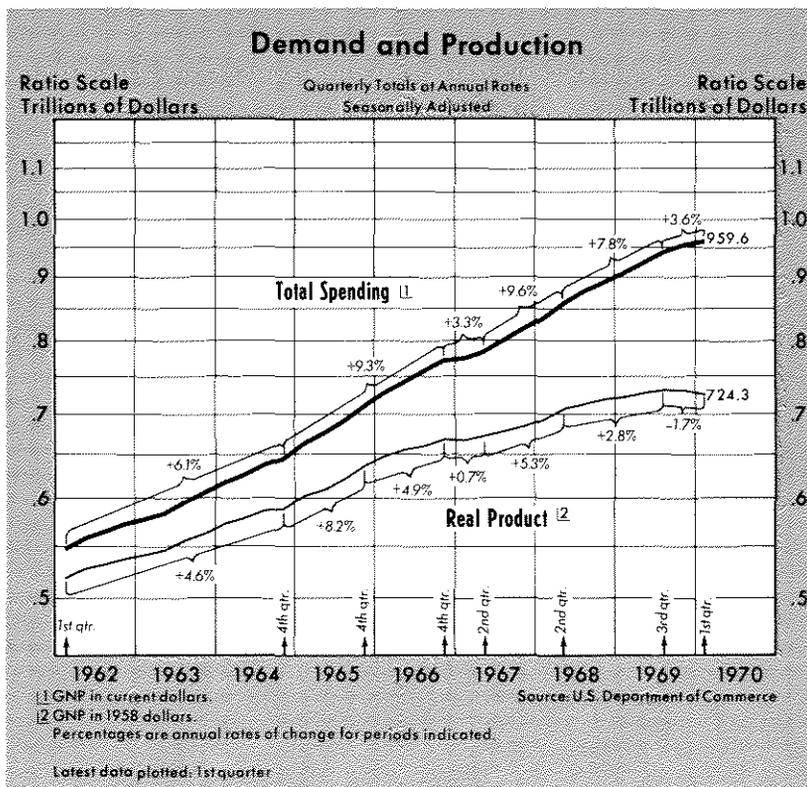
GROWTH OF TOTAL SPENDING slowed further in the first quarter of this year, following a significant moderation late last year. This reduced expansion of total spending has been accompanied by a substantial decline in real economic activity with little change in the upward trend of prices. The goal of a reduction in the rate of increase of prices remains to be achieved.

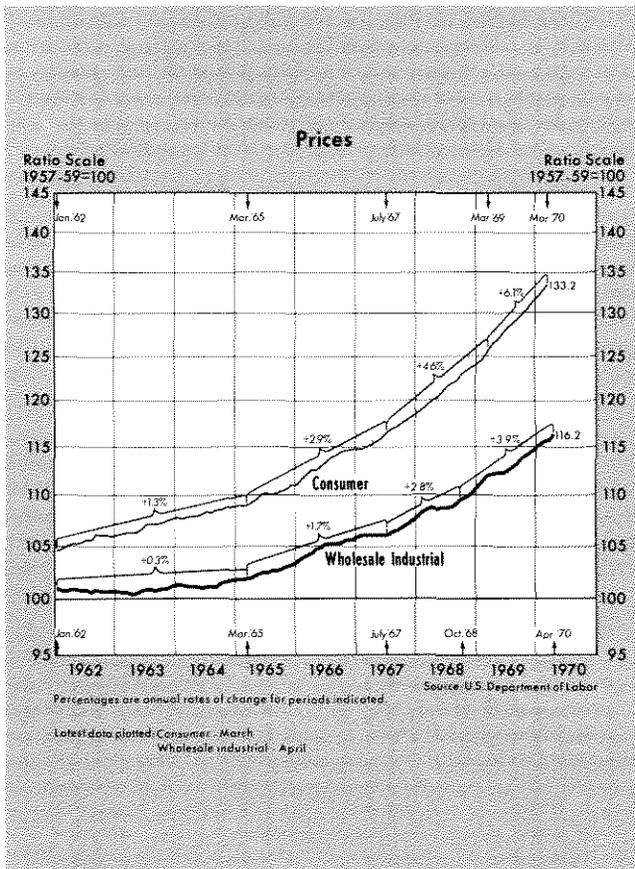
Reduction in the rate of inflation typically follows a slowdown in the growth of total spending with a substantial lag. It took several years to significantly reduce each of the other postwar inflations, and the current inflation is the strongest we have experienced in the last twenty-five years. As a result, the rate of increase of prices can be expected to come down slowly in response to a moderated expansion of total spending. Real product will probably continue for some time to bear most of the impact of the reduced rate of growth of spending, but further reduction in real economic activity seems likely to be more mild.

The Effects of Restraint

Total spending is estimated to have increased at only a 3.6 per cent annual rate from the third quarter of 1969 to the first quarter of this year, markedly slower than the 8.5 per cent rate during the previous two years. The reduced growth of total spending since last fall includes moderation of spending for consumer durables and for inventories. Spending for consumer durables, normally one of the first activities to feel the pinch of public policy restraint on total spending, fell slightly from the third quarter, after increasing at a 10.7 per cent rate in the previous two years. Inventory accumulation slowed sharply in the first quarter of this year in response to sluggish sales. Total non-farm inventories increased at a \$0.4 billion annual rate following an increase of \$7.8 billion in 1969.

Prices — The GNP deflator, often used to measure changes in general prices, showed a 6.3 per cent annual rate of increase in the first quarter of this year, but is not an accurate indicator of price trends in this instance. The accounting procedure used to measure total spending treats Government pay raises as increases in the prices paid by the Government sector. Thus the recent Government pay increase, retroactive to January, was entered into the first quarter data as an increase in the GNP deflator. Therefore, the general price index for the quarter must be received cautiously. Without the pay increase, the index rose at a 5.3 per cent annual rate in the first quarter, about the same rate as in the previous year. The distortion of the price data caused by the handling of the Government pay increase is indicated by the behavior of the other price measures in the same period. Consumer prices, for example, rose at a 6.3 per cent annual rate from late fall to late winter, compared with a 5.8 per cent rate in the preceding year. Prices of wholesale industrial commodities rose at a 4.3 per





cent rate from late fall to late winter, compared with a 4 per cent rate in the previous year. It seems reasonable to conclude, therefore, that the rate of increase of general prices did increase from the fourth quarter to the first quarter, but not by as much as the general price index indicated.

While care must be taken in analyzing the apparent acceleration of inflation in the first quarter, one must also remain aware that the pace of inflation has not yet moderated. Furthermore, there is little evidence that the rate of increase of prices will decline sharply in the near future. Instead, the rate of inflation will more likely decline slowly, in response to moderated growth of total spending.

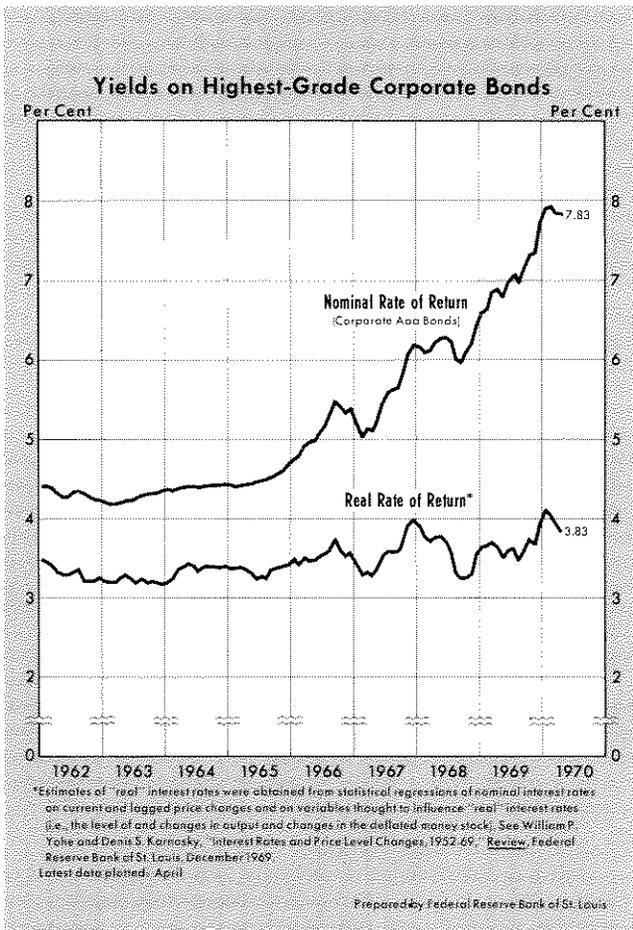
Output — Real product fell at a 1.7 per cent annual rate from the third quarter of 1969 to the first quarter of this year. Industrial production declined at a 3.2 per cent annual rate from July to April. Paralleling the decline in the growth of total spending, the demand for labor, especially in manufacturing, has weakened. Total employment was about unchanged from January to April, compared with a 2.7 per cent rate of increase during the previous two years. Payroll employment has increased at about a 1 per cent annual rate since last fall, compared with about a 3 per

cent rate during the previous two years. Population of labor force age has been increasing at a 1.6 per cent rate.

The recent slowdown of real economic activity was inevitable if the inflation rate of the past four years is to be reduced. Over the past few years production increased at unsustainable rates under the pressure of excessive growth of total spending. Real product increased at a 5 per cent rate from mid-1967 to late 1968, compared with an estimated 4 per cent rate of increase in capacity. During that period the rate of unemployment fell to 3.4 per cent of the labor force, and shortages of skilled labor became widespread. Employment of progressively less efficient workers contributed to a marked reduction in growth of labor productivity. Output per man-hour, after increasing at a 3.6 per cent rate from 1961 to 1965 and a 2.8 per cent rate from 1965 to 1968, decreased slightly during 1969.

The economic slowdown since last summer has been quite mild, however, compared to other periods of slowdown in the last twenty-five years. The recent 1.7 per cent rate of decrease of real product compares with a 4.7 per cent average rate of decline during the first two quarters of other contractions. On average, the unemployment rate increased from 4 per cent to 6 per cent in the first two quarters of other postwar slowdowns, yet the average quarterly rate increased from 3.6 per cent of the labor force to 4.2 per cent in the first two quarters of this slowdown. Corporate profits after taxes have declined at about a 14 per cent annual rate since the third quarter of last year, markedly less than the average 30 per cent annual rate of decline experienced in the first two quarters of previous contractions. Most other measures of economic activity have also moderated much less than in similar periods in the past.

Interest Rates — Short-term interest rates declined rather sharply early this year, probably reflecting a shift in market expectations as it became apparent that economic activity was slowing. The yield on 4- to 6-month commercial paper fell from an average of 9.00 per cent in early January to 8.03 per cent in late March. The rate on Treasury bills declined from 8.02 per cent in January to 6.16 per cent in late March. Subsequently, short-term rates have risen somewhat. The rate on commercial paper averaged 8.33 per cent in early May and the rate on Treasury bills averaged 6.80 per cent. Long-term interest rates have changed little on balance since early in the year.



The yield on seasoned corporate Aaa bonds averaged 8.04 per cent in early May, up slightly from a 7.90 per cent yield in early January. Failure of long-term interest rates to decline as economic activity has weakened suggests continued strong demand for long-term funds, probably bolstered by expectations of continuing inflation.¹

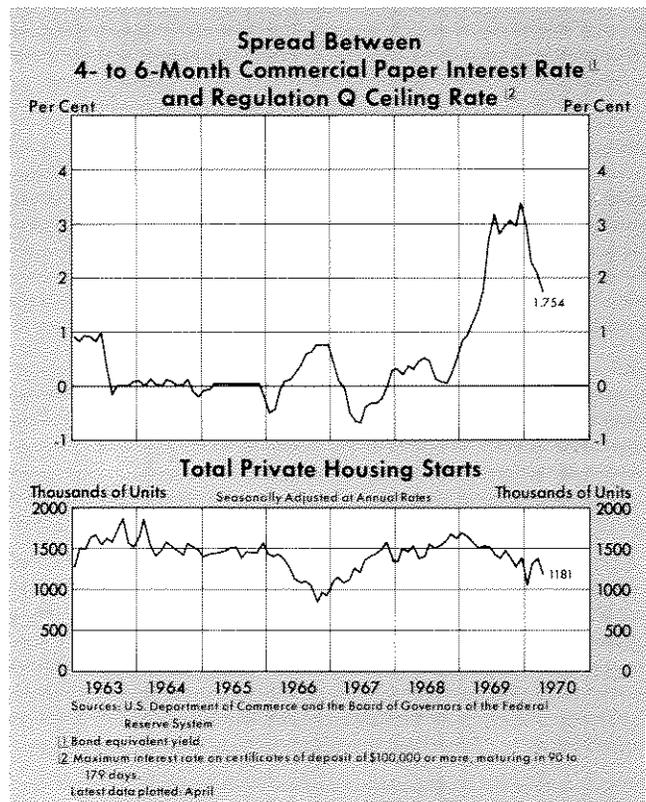
In the past, interest rates have generally declined along with economic activity, and were apparently expected to fall with moderation of spending this year. Never before in the postwar period, however, have interest rates been so influenced by inflation as since 1966. Expectations of inflation have accounted for most of the rise in interest rates since 1966, and if rates are to fall significantly, these expectations must first be reduced. There is little prospect of reducing expectations, however, until the actual rate of inflation begins to slow.

Trends in housing are influenced considerably by Government regulations which set the maximum interest rates savings institutions can pay on deposits.²

¹See this *Review* (December 1969), pp. 18-38.
²See this *Review* (June 1968), pp. 5-12.

When the rate of growth of total spending increases and demand for credit pushes market interest rates above the rates savings institutions can pay on deposits, the supply of residential mortgage funds is restricted. Similarly, when moderation of demand for credit pushes interest rates down toward the level paid on time deposits, the flow of funds into time deposits increases, and expands the supply of residential mortgages.

Since there are only limited amounts of saving and loan funds available in the economy at any one time, shifts in the demand for funds for nonresidential construction have caused changes in the amount of credit supplied for housing. The accompanying chart compares residential housing starts with the spread between market interest rates and the ceiling rates on time deposits under Regulation Q.³ There is a very close correspondence between periods of weakness in residential construction and periods when market interest rates were significantly above the Regulation Q ceiling rates, such as in 1966 and 1969. This sug-



gests that with current Regulation Q ceilings, interest rates in 1970 would have to be significantly lower

³Under the provisions of Regulation Q, the Federal Reserve sets the maximum interest rates commercial banks can pay on time and savings deposits. Similar regulations on savings institutions are administered by the Federal Home Loan Bank Board and Federal Deposit Insurance Corporation.

than they were last year if residential construction is to increase significantly.

The Government has recently been attempting to induce large institutional investors to place more funds in the housing market in order to encourage residential construction. Such a program would have little effect on total credit available in the economy. While it could lead to more housing construction, this plan would tend to reduce the flow of funds into other credit markets.

Monetary and Fiscal Actions in 1970

The rate of inflation probably cannot be reduced rapidly, but a gradual decline is possible. Should spending continue to grow at a reduced pace, the rate of resource utilization will continue to fall and contribute to slowing in the rate of inflation. If the growth of total spending were to accelerate, however, the pressure to cut back on production would ease significantly. This would mean that the pressure to hold back on price increases would also be reduced.

The strength of total spending through the rest of this year depends in large part on the past and future course of monetary and fiscal actions. The effect of last year's restrictive policies continues to be a strong force in the economy, while recent and future actions will have progressively more influence as the year proceeds.

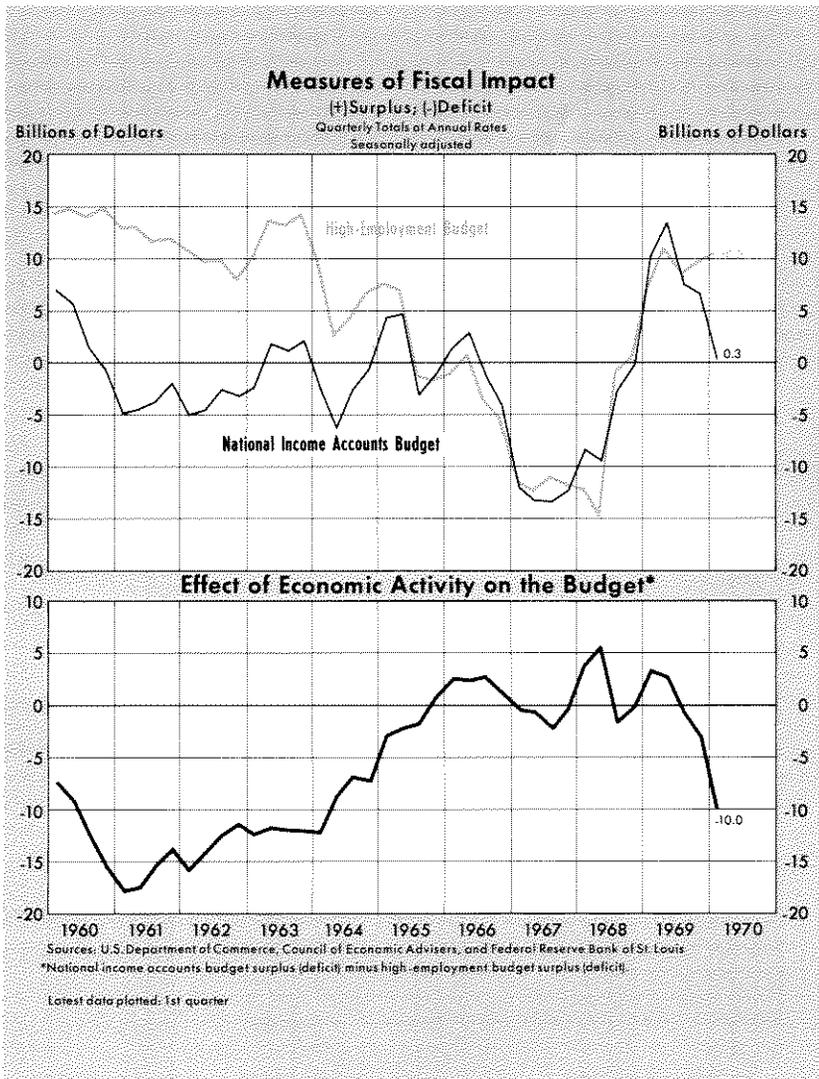
Monetary Actions — The trend of monetary actions has apparently shifted in the first quarter of this year. The money stock rose markedly in March and April and has increased at a 5.7 per cent rate since December, following a six-month period of no growth.

Resumption of monetary expansion should not be expected, however, to produce sharp and sustained declines in interest rates. An increase in the rate of monetary expansion can restrain interest rates for a short period by increasing liquidity and the supply of credit, but the effect is not long lasting. Increased monetary expansion also stimulates total spending with a brief lag, which in turn results in higher prices, stronger expectations of inflation, and in upward pres-

sure on interest rates from increased demand for credit.

Reduction of money growth tends to have the opposite effect on interest rates. In the short run, interest rates may rise in response to monetary restraint. After a few months, however, the slower growth of money causes growth of total spending to slow and the demand for credit to moderate. The net result is downward pressure on interest rates.

Fiscal Actions — In January the Federal Government proposed a budget for fiscal 1971 which suggested that fiscal actions would remain restrictive. A budget surplus of \$1.3 billion was planned, about the same as was expected for the current fiscal year. Since January there have been several fiscal actions which threaten to shift the budget for both fiscal 1970 and fiscal 1971 from surplus into deficit. The recently enacted 6 per cent pay increase for all Federal em-



ployees seems likely to increase budget expenditures above the January estimates by \$1.2 billion in the fiscal year ending June 30 and by \$2.6 billion in fiscal 1971.

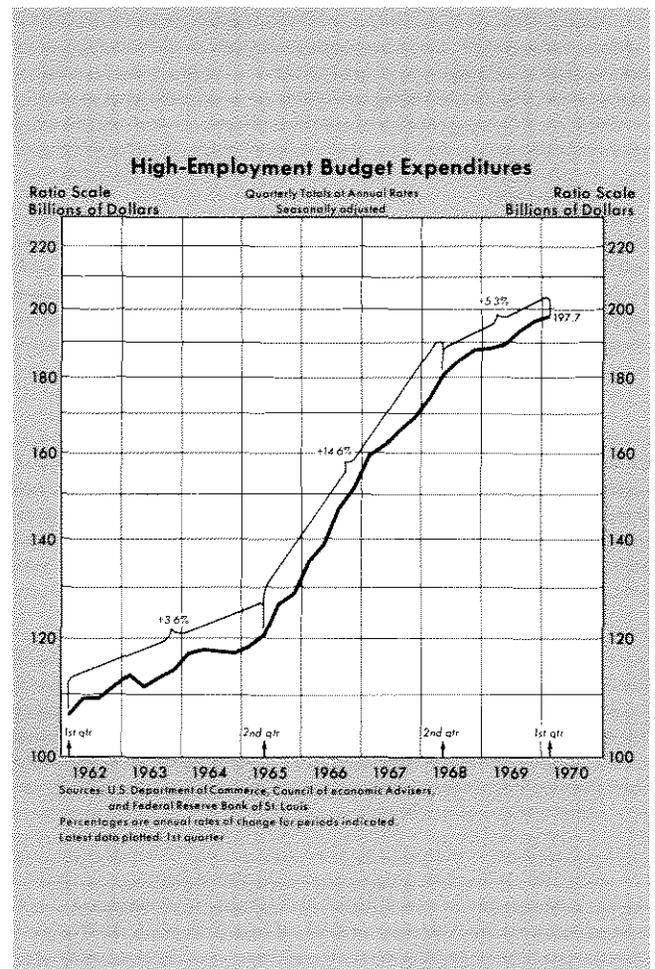
The budget picture is further clouded by the probable course of economic activity. Growth of tax revenue normally slows in periods of business slowdown, and if the economy continues on its current path or even picks up moderately, the Government can expect only slow growth in revenue. This would serve to push the budget further into deficit, unless Federal Government expenditure growth is curbed beyond current plans.

The prospect of a budget deficit suggests to some observers that the Government would be contributing to further inflation. Care must be taken, however, in attaching too much significance to budget figures in analyzing the effect of fiscal actions on economic activity. The budget tends toward deficit in periods of economic slowdown as revenue growth automatically slows in response to moderation of total spending growth in the economy. This response does not represent expansionary fiscal actions or policy but reflects the effect of slower economic expansion on the budget.

The high-employment budget was developed to eliminate some of the misleading information about fiscal actions which arises from actual budget figures, and was first popularly used in the early 1960's to argue that fiscal actions were actually restrictive despite large deficits in the actual budget. It removes most of the effect of real economic activity on the budget and attempts to indicate only the effect of the budget on economic activity.

Growth in Government spending, on a high-employment basis, has moderated considerably from the high rates of increase experienced in 1966 and 1967. Although the pay increase for Federal employees and increased Social Security benefit payments will cause a large increase in the second quarter of this year, the growth in expenditures from late 1969 to late 1970 is expected to be at about the same rate as in the previous year.

Government spending and revenue in fiscal 1971, as proposed in January, would result in a high-employment budget surplus of \$13 billion in the second half of this year. The pay increase provisions enacted since January are estimated to decrease this surplus by about \$4 billion in the second half, to about the level of fiscal 1970. Actual budget deficits



which develop in response to continued moderation of economic activity might be as large as those of the 1961-63 period. As was true then, however, they need not indicate a shift in the influence of fiscal actions on the economy toward stimulus.

Conclusions

The mild slowdown experienced since last fall has been the logical consequence of restrictive monetary and fiscal actions. Businesses have responded to moderation of total spending growth by cutting production, but only later will the effect of reduced growth of spending be reflected in a slower advance in the level of prices.

There is no reason to expect sudden improvement in the rate of inflation. Eliminating substantial inflation has never been a quick or painless process, and the current inflation is the strongest we have experienced in the postwar period. There appears to be little danger that the current slowdown will develop into a full-blown recession. It appears that the danger, if any, is in the other direction.