

BARRY BOSWORTH

Brookings Institution

WITH THE ASSISTANCE OF

JOHN FARMER

Brookings Institution

The Current Inflation: Malign Neglect?

THE UNITED STATES IS CURRENTLY EXPERIENCING its worst inflation since the outbreak of the Korean war in 1950. In the first four months of 1973, consumer prices have risen at an annual rate of 8.5 percent and wholesale prices have increased at a phenomenal 19 percent rate. The acceleration of the inflation has resulted in sharp criticism of the administration's anti-inflationary policy. But the critics have not rallied around a single policy alternative. Many have advocated a return to more stringent controls from the relaxed controls of Phase III, which started in January 1973. Proposals vary from modified versions of Phase II to a general freeze on all wages and prices. In its two most notable actions since the start of Phase III, the administration froze retail prices of most meats in April, and in May instituted prenotification requirements for price increases by the largest firms—firms with earned sales over \$250 million—if such increases raise the average price of all products sold by the firm by more than 1.5 percent over the authorized levels prevailing at the end of Phase II. At the other extreme, some critics have attempted to blame all of the nation's problems on the controls themselves. They have advocated an end to all direct attempts to restrain prices and wages. As an alternative they propose a more restrictive monetary and fiscal policy, controlling inflation by maintaining a larger margin of unemployed workers and idle capacity.

This note examines several characteristics of the current inflation that differentiate it from the inflation that existed prior to the freeze of August

1971. The inflation of early 1973 reflects several forces: supply shortages in agriculture and a few other basic material industries; the effects of the second U.S. devaluation; a bubble of price increases in some industries, such as lumber, which had been held down by Phase II controls; and what appears to be some speculative increases in industrial prices in anticipation of renewed, stronger, controls.

Many of the problems faced during Phase III would have been problems under a Phase II system. Phase II had no solution to rising food costs, and its response to industries where shortages existed (such as lumber, food, cement, fuels) did risk distortions. But the widespread interpretation of Phase III as a signal of an end to controls multiplied price increases in early 1973. The major task faced by current policy is to find a way to prevent the spread of rising food prices into wages and prices in the industrial sector and thus to avoid a return to the institutionalized upward spiral of wages and prices that operated during 1969–71.

A Review of Recent Price and Wage Patterns

In^F the latter months of 1972, it appeared that the Phase II program had been quite successful. As Table 1 shows, the administration's target of reducing the inflation to a 2½ percent annual rate by year-end was basically realized in the nonfood sectors. In the fourth quarter the nonfood items of the consumer price index (CPI) increased at a 2½ percent annual rate, the industrials component of the wholesale price index (WPI) rose at a 2 percent rate, and the private nonfarm deflator (fixed weights) increased at a 2.6 percent rate.

Food prices rose far more rapidly over the latter months of Phase II, so that the overall target was not realized. But the problems in this area reflected errors in other policy decisions and were not of the type toward which controls should be directed. The forces behind the rising food prices will be discussed in a later section.

Wage rate increases slowed significantly in Phase II, from a 7½ percent rate prior to controls to a rate slightly above 5 percent in the middle of Phase II, as shown in Table 2. The fourth-quarter data showed some signs of acceleration but many of the effects appeared to be transitory. A new year for the pay controls began in November and resulted in the concentration of a large number of nonunion increases in December. In the union

Table 1. Rates of Change in Selected Price Series, Various Periods, 1969–73
Seasonally adjusted annual rate in percent

Index or deflator	1969–70	December	March	September	December
		1970– August 1971	1972– December 1972	1972– December 1972	1972– March 1973
<i>Consumer price index</i>					
All items	5.9	3.8	3.4	3.2	8.8
Food	5.5	5.0	3.5	5.2	29.8
Nonfood items ^{a,b}	5.9	5.0	3.4	2.5	3.2
Commodities ^a	4.2	3.1	3.4	1.0	3.4
All services ^{b,c}	7.9	7.2	3.1	3.9	3.6
Rent ^c	4.1	4.3	3.2	3.7	5.4
Medical care	7.1	7.1	2.8	7.1	2.9
<i>Wholesale price index</i>					
All items	3.7	5.2	5.8	9.6	21.5
Farm products, processed foods, and feeds	3.4	6.5	10.9	30.1	53.1
Industrial commodities	3.8	4.7	4.1	2.0	10.3
Consumer finished goods	3.0	2.2	3.0	−0.4	7.2
Producer finished goods	4.7	3.6	2.5	−1.6	5.4
Intermediate materials ^d	3.6	6.5	4.7	3.7	14.6
Crude materials ^e	7.4	3.3	7.5	14.6	11.8
<i>Private nonfarm deflator^f</i> (fixed weights)					
	4.9	4.8	2.1	2.6	5.6

Sources: Price indexes—consumer and wholesale price index series of the U.S. Bureau of Labor Statistics. Nonfarm deflator data are based on authors' estimates and on fixed-weight deflators published in *Survey of Current Business*, Vols. 51 and 52 (August 1971 and August 1972), p. 25 and pp. 34–35, respectively.

a. Adjusted for repeal of auto excise tax.

b. Excludes mortgage interest.

c. No significant seasonal variation present.

d. Excludes manufactured foods and feedstuffs.

e. Excludes crude foodstuffs and feedstuffs.

f. Calculated from quarterly data for the quarters in which the months listed in the column headings fall.

sector several large deferred wage increases took effect during the quarter and the rise in food prices triggered many cost-of-living escalator clauses. Newly negotiated union increases declined steadily throughout the year to a 6.2 percent first-year increase for contracts concluded in the fourth quarter. This was far below the 10 to 12 percent range of first-year increases negotiated in 1970 and 1971.

In the first quarter of 1973, retail food prices exploded to a 30 percent annual rate of increase and wholesale prices of farm products and processed foods and feeds rose at a 53 percent annual rate. But the problems went beyond food as increases in the nonfood items of the CPI rose from a 2.5

percent rate in the fourth quarter to a 3.2 percent rate. Industrials rose at a 10.3 percent rate from the very low 2.0 percent rate of the fourth quarter. Nearly all of the major categories of the CPI and WPI accelerated sharply.

Several transitory factors contributed to the first-quarter results. First, the second U.S. dollar devaluation had a substantial impact on several major components of the price indexes. The effective average devaluation against other major currencies is estimated to be between 6 and 7 percent, bringing the total devaluation since August 1971 to about 17 percent. The impact of the second round is a partial explanation of the 9.3 percent rise in the price index for nonferrous metals that occurred between December 1972 and March 1973. These increases are concentrated in metals, other than aluminum, of which the United States imports a substantial portion of its consumption. In addition to the pure effects of devaluation, prices of many imported goods have been driven up by commodity speculation by the Japanese and others in anticipation of a U.S. devaluation and a Jap-

Table 2. Rates of Change in Selected Wage and Productivity Series, Various Periods, 1969-73

Seasonally adjusted annual rate in percent

<i>Sector and series</i>	1969-70	1970:4- 1971:2	1972:1- 1972:3	1972:3- 1972:4	1972:4- 1973:1
<i>Private nonfarm sector^a</i>					
Employee compensation per manhour	7.1	7.4	5.3	7.2	10.7
Excluding payroll tax increase	7.3
Output per manhour	0.6	4.8	5.5	3.0	3.8
Unit labor cost	6.5	2.5	-0.2	4.1	6.5
Average hourly earnings ^a	6.7	7.7	5.1	7.5	4.8
<i>Negotiated wage changes^b</i>					
Total benefits over life of contract	9.1	8.4	7.3	6.3	5.5
First-year adjustments, all industries	11.9	10.1	6.8	6.2	5.3
Manufacturing	8.1	8.7	6.8	6.4	6.5
Contract construction	17.6	13.4	6.2	4.7	4.5

Sources: U.S. Bureau of Labor Statistics, *Current Wage Developments*, Vol. 25 (February 1973), Tables 1, 7, and 8; BLS, News Release, "The Employment Situation: March 1973" (April 6, 1973), Table B-4; BLS, "Major Collective Bargaining Settlements, First Quarter 1973" (April 27, 1973; processed), Table 1, and unpublished BLS data.

a. Data are for nonsupervisory employees and are adjusted for interindustry shifts and for overtime in manufacturing.

b. Average during the period; 1972:1-1972:3 uses an average of data for 1972:2 and 1972:3. Data on life of contract refer to units of more than 5,000 employees. First-year adjustments are for units of more than 1,000 employees.

anese appreciation. Such activity was concentrated in the futures markets for commodities, including wool, cotton, rubber, and nonferrous metals.

The impact of devaluation on the domestic market is heavier in 1973 than it was in 1971 for several reasons. In 1971 many of the major industrial countries were experiencing mild recessions and consequent reductions in demand and prices for the raw materials that the United States imports. But in 1973 world prices of these commodities were generally stable or rising. Importers of more finished products absorbed a major portion of the devaluation effect in 1971, but passed it forward in 1973. Also, domestic competitors of imported goods were free to raise their prices in 1973 unlike 1971, which may have permitted some sympathetic adjustment of domestic prices. Over the coming year continued substantial price increases for imported raw materials (other than petroleum) appear to be unlikely. In most cases world supply appears adequate for near-term needs. In addition, the release of U.S. stockpiles of some basic materials will help contain price pressures.

A second influence on the price indexes was the Price Commission's postponement of the increase for automobiles into the beginning of 1973. This action lowered the reported fourth-quarter index and raised that for the first quarter—particularly for the seasonally adjusted data. Third, lumber prices, which had been held down by Phase II, rose at an annual rate of 59 percent for the quarter ending in March. This rate will not continue in future months. A final transitory influence resulted from the spurt in rents following the removal of national controls.

However, issues of more lasting concern are raised by price increases in manufacturing industries that have not been seriously affected by rising raw material prices and that cannot be accounted for by the special factors just cited. Examples of such industries are metal containers, machinery and equipment, products involving man-made textiles, and paper products. It is the broad range of the price increases in recent months that raises the major questions with respect to the effectiveness of the Phase III controls.

Data on wage increases in the first quarter of 1973 trace a mixed pattern. The fixed-weight wage index for private nonfarm workers rose at only a 4.8 percent annual rate. New union contract settlements continued the downward trend begun under Phase II. But the first-quarter data are dominated by the settlement in the rail industry. This was a second step of the 1971 contract, with a focus on nonwage benefits, and thus may not be representative of future agreements.

However, preliminary first-quarter data on compensation per manhour

in the private nonfarm sector show an annual rate of increase above 10½ percent. This rate is strongly influenced by the January 1 increase in payroll taxes; but, even after adjustment for this element, compensation per man-hour was up at a 7 to 7½ percent rate. The first-quarter discrepancy between the two major wage series (compensation per manhour adjusted for the tax increase and the fixed-weight earnings index) is an unusually large 2½ percent. Part of this discrepancy may reflect increased overtime and an employment shift toward high-wage industries, effects that are removed from the fixed-weight index, but it is not possible to reconcile them from available data. Splitting the difference between the two measures, as a best guess, implies that wage rates are currently rising at about 6 percent per year.

Food Prices¹

Grocery store prices have dominated public discussions of the inflation problem for the last six months. As shown in Table 3, consumer prices began to accelerate in the last half of 1972 and reached a 36 percent annual rate of increase in the first three months of 1973. Wholesale food prices rose at a 53 percent rate during the same period. These sharp rises reflect the coincidence in one year of several factors, each of which reduced food supplies available to U.S. consumers.

In the area of grains the single dominant factor was the pronounced 3½ percent decline in world grain production in 1972 compared with an average annual increase of 3½ percent since 1961. The crop failures in the USSR were of greatest significance for the United States since wheat purchases by the USSR raised projected U.S. exports above 1,100 million bushels in 1973 compared with 632 million bushels in 1972. This amount represents a major portion of the estimated 1973 crop of 1,500 million bushels. Current exports together with domestic consumption will reduce carryover stocks to very low levels by midyear.

1. The material of this section relies heavily on "Summary: The 1972-73 Food Price Spiral," A Joint Economic Committee Staff Study prepared in consultation with Schnittker Associates (April 3, 1973; processed); William C. Helming, "Statement on Why Farm and Food Prices Have Increased During 1972-1973 and Price Outlook for Farm Commodities and Food During the Balance of 1973," before the Joint Economic Committee on Consumer Economics (April 4, 1973; processed); "Food Prices," A Report prepared by the Cost of Living Council Committee on Food (March 20, 1973; processed).

Table 3. Rates of Change in Selected Consumer and Wholesale Food Price Indexes, Various Periods, 1970-73

Seasonally adjusted annual rate in percent

<i>Index</i>	<i>December 1970- December 1971</i>	<i>December 1971- June 1972</i>	<i>June 1972- December 1972</i>	<i>December 1972- March 1973</i>
<i>Consumer price index</i>				
Food at home	4.2	2.9	7.1	35.8
Cereals and bakery products	2.0	1.1	2.5	10.8
Meats, poultry, and fish	4.6	9.7	11.1	74.8
Dairy products	2.2	1.6	2.2	12.4
Fruits and vegetables	12.5	-6.1	11.4	24.5
Other	0.5	2.8	4.2	16.0
<i>Wholesale price index</i>				
Farm products, processed foods, and feeds	6.0	5.9	23.6	53.1
Fruits and vegetables	13.5	-17.8	37.5	58.8
Grains	-11.6	-4.7	119.4	-33.1
Plant and animal fibers	18.2	45.5	-5.0	143.3
Soybeans ^a	5.0	30.1	49.7	376.6
Meats, poultry, and fish (processed)	15.4	9.4	16.2	98.2

Sources: U.S. Bureau of Labor Statistics, *The Consumer Price Index*, and BLS, *Wholesale Prices and Price Indexes*, monthly issues for March 1973 and earlier months.

a. Not seasonally adjusted.

The most dramatic price increases have been in the area of feed grains, particularly soybeans. These prices reflect a long-run inadequacy of protein sources which has kept prices at a high level in recent years. The situation became critical when the Peruvian fish harvest plummeted in 1972, for fishmeal is the world's richest source of protein feed. Then, in 1973, Peru suspended all fishing for anchovies until at least late summer. The harvest of other world sources of protein was also depressed during 1972.

Production of soybeans in the United States has failed to match consumption since 1968 and carryover stocks are practically nonexistent. This development has resulted in part from the acreage set-aside provision of the Agricultural Act of 1970. Farmers who raised both corn and soybeans could set aside land for the corn program, but could use land previously allocated to soybeans for corn production. Under this legislation the farmer can plant whatever he wants on the remaining land. Since yields per acre have risen far more rapidly for corn than for soybeans, the planting of corn is favored unless soybean prices continually rise more rapidly than corn prices.

Unlike grain prices, the rising domestic price for meat products results only indirectly from world market conditions. Meat prices have shown a general upward trend that has been accentuated by current supply problems. Many government spokesmen have stressed the role of rising demand during the current period. While of long-run significance, demand factors have been of relatively minor importance in early 1973. Wholesale meat prices, which rose at an annual rate of 3.8 percent between 1965 and 1970, have accelerated sharply in the last year. As shown in Table 4, total meat

Table 4. Selected Statistics on Production of Various Agricultural Products, Various Periods, 1960-73

<i>Product and status</i>	<i>Period</i>				
<i>Meats and poultry</i> (inspected slaughterings; average annual rate of change in percent ^a)				<i>Second half 1971-second half 1972</i>	
	<i>1960-70</i>	<i>1970-71</i>	<i>1971- 2</i>		
Meats, total	3.4	4.7	-1.6	-1.4	
Beef and veal	4.9	1.1	4.1	5.5	
Pork	1.9	9.7	-8.8	-10.0	
Poultry	5.2	1.1	6.2	3.8	
<i>Wheat</i> (millions of bushels, annual average)	<i>1965-69^b</i>	<i>1969-70^c</i>	<i>1970-71^c</i>	<i>1971-72^{c,d}</i>	<i>1972-73^{c,e}</i>
Beginning carryover	626	817	885	731	863
Production	1,426	1,443	1,351	1,618	1,545
Total supply ^f	2,054	2,263	2,237	2,350	2,409
Domestic disappearance	709	772	768	855	818
Exports	705	606	738	632	1,150
Ending carryover	640	885	731	863	441
<i>Feed grains^g</i> (millions of tons, marketing years)	<i>1970</i>	<i>1971</i>	<i>1972^d</i>	<i>1973^d</i>	
Beginning carryover	48.6	33.2	48.4	35.0	
Production	160.1	207.7	199.8	...	
Total supply ^f	209.1	241.4	248.5	...	
Domestic disappearance	155.2	165.7	180.1	...	
Exports	20.7	27.3	33.4	...	
Ending carryover	33.2	48.4	35.0	...	

Sources: *Survey of Current Business*, Vol. 53 (March 1973), pp. S27-28, and prior issues; John A. Schnitker, "Changes Needed in Farm Legislation," in *The Economics of Federal Subsidy Programs*, A Compendium of Papers Submitted to the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 93 Cong. 1 sess. (1973), Pt. 7, pp. 869-70.

a. Calculated from production data, by weight.

b. Average for the twelve months, July through June, in these years.

c. Twelve-month marketing year, spanning the years indicated.

d. Preliminary.

e. Forecast.

f. Includes imports.

g. Includes corn, oats, barley, and grain sorghum.

production actually declined 1.6 percent in 1972 compared with an annual growth of 3.4 percent from 1960 to 1970. Production in the first quarter of 1973 is estimated to have been 8 to 10 percent below the fourth-quarter level.

The supply shortages can be traced to an interaction between high feed costs and cyclical lows in cattle and hog marketings. Since early 1970 cattlemen have been holding back on marketings in order to build up their herds. Hog production has only recently begun to recover from the cutback in output in early 1972, which followed low prices of the previous year. Supplies of both cattle and hogs were adversely affected by fears of an extensive corn blight in 1970, which encouraged marketings designed to beat higher feed prices. Facing high costs for feed grains, farmers have had little incentive to bring animals into the feedlots. High feed costs also limit the time spent in the lots and reduce the amount of weight per animal slaughtered.

Because of its shorter cycle, production of poultry is far more sensitive to feed prices than that of other meats. Poultry prices have tended to follow the upward trend of feed costs in recent months. Increases in other farm commodities primarily reflect the vagaries of weather. Cotton prices have been driven up by heavy foreign bidding for the current crop; but, unless the weather is very poor in the South, these prices should return to more normal levels over the next year.

Until very recently, agricultural policy served to aggravate the problem of short supply that characterizes today's food price problem. The 1973 wheat program called for maximum acreage set-aside. Despite the massive wheat sale to the USSR, this decision was not reversed until January, well after the fall planting period. As late as December, Agriculture Department policy called for a restrictive feed grain program to hold corn production to 1972 levels. This policy was revised in January and March so that perhaps the U.S. feed grain carryover will not be further reduced during the coming crop year. The meat shortage has been evident for several years; but policy changes to expand grazing land were delayed until January, when the administration permitted the use of set-aside acreage for grazing and hog production.

The outlook for farm prices over the next year remains very uncertain. Most major grain-producing countries have scheduled substantially higher goals for farm production. However, weather conditions have remained poor in many parts of the world. U.S. grain reserves have been reduced to

minimal levels; stocks held by the Commodity Credit Corporation were sold and federal grain loans were recalled. The elimination of reserve stocks means that any repetition of serious crop failures would be disastrous. However, it is too early for agricultural experts to form any confident forecasts of this year's grain production.

The Cost of Living Council (CLC) forecasts some improvement in food supplies late in 1973. The annual survey of planting intentions by the U.S. Department of Agriculture showed a 6 percent increase in acreage devoted to feed grains and wheat. The current outlook for the wheat crop is very good, with expectations for a 10 to 15 percent increase in wheat production over 1972; but a world shortage of rice implies continued high demand for wheat. Moreover, the weather is beginning to reduce seriously the estimates of the corn crop. Spring plowing completed in the Midwest was significantly behind rates of previous years. While this land may still be planted to soybeans, relief for the feed grains market will be delayed. In addition, Peru recently suspended all fishing for anchovies until August or September.

In the first part of 1973 the number of cattle on feed was 8 percent above levels of early 1972 and the pig crop for the December-to-May period was 7 percent larger than in 1972. Even so, overall meat supplies for current consumption are forecast to rise only 2 percent during 1973 as farmers rebuild their stocks. High costs of feed grains could begin to hold hog supplies below the forecasts. Cattle cannot be easily held back from the market in the short run; but, given the freeze on meat prices, high feed grain prices will be passed back to cattle producers, and may reduce planned expansion of herds. Poultry and egg production is also certain to be curtailed.

It appears that 1973 will be a very high risk year for farm production. Since carryover stocks are so very low, poor weather could send grain prices above present levels, though good growing weather could bring them back down toward historically more normal levels. Meat supplies will remain very tight throughout the year, and substantial increases in supply will not be forthcoming until 1974. Fruit and vegetable prices, currently at high levels, are extremely dependent on future weather conditions. Consumer food prices rose sharply during the spring months, and will continue upward throughout the year.

Lumber Prices

The problem of rising lumber prices did not originate with Phase III. It was one of the dominant concerns during Phase II. The rise began with the

recovery of homebuilding in 1970: Lumber and wood prices advanced 21 percent during the eight months of 1971 prior to controls, 11 percent between August 1971 and the end of 1972, and a further 21 percent in the first four months of 1973.

The major source of this spectacular rise in prices is obvious in the 73 percent expansion in homebuilding between the second quarter of 1970 and the fourth quarter of 1972. This single area of construction accounts for about one-half of total lumber consumption. The industry was unable to meet this heavy demand and the result was a classic case of excess demand bidding up prices. Because of the rapidity of these developments, neither expansion of productive capacity nor substitution of other products by lumber consumers could be mobilized to moderate the effects on prices.

In understanding the current supply shortage it is important to distinguish between the short-run and long-run problems that the industry faces. At present the major limit to production is sawmill capacity rather than a physical shortage of logs. This problem has been accentuated by the roller coaster nature of monetary policy over the last half decade. The collapse of homebuilding associated with the severe monetary restraint of 1966 and 1969 sharply reduced lumber prices, driving the smaller independent sawmills out of the industry and restricting the expansion of the larger firms. As a result the industry's capacity today is only slightly above the levels of 1966.

Foreign trade has on balance provided a strong stabilizing influence on domestic prices. As shown in Table 5, imports of 9.4 billion board feet in 1972 were of substantial importance in terms of both their absolute levels and their sensitivity to domestic prices. Given the reliance on imports, it is not feasible to shut the United States off from world lumber markets by export controls in an attempt to restrain prices, since lower U.S. prices would redirect Canadian exports toward other countries. Exports of logs to Japan are a relatively unimportant factor in the current lumber shortage. Even if they were terminated, the sawmills in the Northwest, already operating at capacity, would be unable to increase production significantly. However, the entrance of Japanese buyers into the U.S. market for logs does have greater long-run significance. It has permanently increased the price of logs and thus put the future costs to sawmill operators on a higher plateau.

The declining level of lumber sales from federal lands has frequently been cited as a source of rising lumber prices. As Table 5 indicates, the harvest from these lands represents about one-fourth of current production.

Table 5. Selected Statistics on the Lumber Industry, 1969-73

<i>Statistic</i>	<i>1969</i>	<i>1970</i>	<i>1971</i>	<i>1972</i>	<i>1973</i>
Wholesale price index for lumber and wood products (1967 = 100)	131.5	113.7	127.0	144.3	182.0 ^a
<i>Billions of board feet</i>					
Production, all types of lumber	35.8	34.5	36.7	38.7	...
Exports, total sawmill products	1.2	1.3	1.1	1.4	...
Imports, total sawmill products	6.3	6.1	7.6	9.4	...
Change in inventory stocks, end of period, total	0.4	1.0	-1.0	-1.2	...
Domestic consumption ^b	40.5	38.3	44.2	47.9	...
Log exports	2.1	2.5	2.0	3.1	...
<i>Billions of board feet</i>					
<i>National Forest timber sale program^c</i>					
Allowable cut	11.5	11.5	11.5	11.6	11.5 ^d
Sale of cutting rights	8.9	11.7	9.2	8.8	8.8 ^d
Actual cut	10.4	9.8	8.8	10.2	11.0 ^d

Sources: U.S. Bureau of Labor Statistics, *Wholesale Prices and Price Indexes* (March 1973), and prior issues; *Survey of Current Business*, Vol. 53 (March 1973) and prior issues, p. S31; National Forest Products Association tabulation, "National Forest Timber Sale Program: Allowable Harvest, Sell, and Harvest, Fiscal Years, 1965-1974" (April 1973; processed); and unpublished data from U.S. Forest Service.

a. April.

b. Domestic consumption equals production less exports plus imports less change in stocks.

c. Sawtimber only, fiscal year data.

d. Estimate.

The reduction in timber sales is a joint result of increased concern with environmental issues and a cutback in previous years of the budget of the U.S. Forest Service. This is not a major problem for the short term: Sawmills are already operating at very high levels. However, in some areas of the country, excess sawmill capacity does exist and the log shortage has had some immediate impact. Efforts of the CLC to expand future timber sales may have some effect by encouraging holders of cutting rights on federal land to increase their current rates of harvesting.

Other government policies have contributed to the current lumber problem. The large wheat sale to the USSR in 1972 diverted railroad cars from delivering lumber to domestic users, and thus caused lumber production to be curtailed in some areas as local storage facilities filled up. Second, the company-by-company approach to price decisions utilized by the Price

Commission during Phase II, together with the control of profit margins, threw the structure of market prices into chaos, and led some firms, constrained by the profit ceiling, to cut production and hoard their logs on the stump until controls ended.

The flexibility of lumber prices in previous cycles, together with the low degree of concentration in the industry, implies that lumber is basically a competitive industry. The current price increases reflect real underlying supply shortages with little hope of immediate relief. In such a situation direct price controls probably do more harm than good. With housing starts expected to decline during the rest of 1973, inflation of lumber prices is probably behind us; but in the absence of a drastic recession in homebuilding, any significant downward trend in prices during 1973 appears highly unlikely.

Capacity Pressures

The rapid inflation of recent months together with a strong expansion of real demand has raised questions about how much industrial capacity is being strained and to what extent excess demand pressures are appearing in the economy. Some of the evidence on capacity utilization is briefly reviewed in this section.

The aggregate index of the Federal Reserve Board gives little indication of serious pressure on capacity. Capacity utilization in manufacturing averaged 80.5 percent in the first quarter of 1973, substantially above the 75 percent rate for 1971 but far below the peaks of 91.9 and 87.7 percent reported for 1966 and 1968. Clearer evidence of capacity pressures can be found in the index for primary process industries, which rose from a low of 78 percent in the third quarter of 1971 to 87.5 percent in the first quarter of 1973; this compares with peaks of 92.1 percent in 1966 and 88.5 percent in 1968 and 1969. The utilization rate for advanced processing industries is a very low 76.8 percent compared with 92 percent in 1966.

The capacity utilization indexes published by McGraw-Hill provide some additional industry detail and are shown in Table 6. Because of different methods of estimating capacity, the overall manufacturing index has been moderately above that of the Federal Reserve index² in recent years; but it

2. See Board of Governors of the Federal Reserve System, Statistical Release E.5, "Capacity Utilization in Manufacturing," relevant issues.

Table 6. Industrial Operating Rates, Selected Years, 1966-73

Percent

<i>Industry</i>	<i>Feb- ruary 1966</i>	<i>Feb- ruary 1968</i>	<i>Feb- ruary 1971</i>	<i>Feb- ruary 1972</i>	<i>Feb- ruary 1973</i>
Manufacturing	90.5	84.5	77.0	78.5	84.5
Metalworking industries	93.0	84.5	70.0	71.5	80.0
Machinery	93.0	82.5	68.5	70.5	79.5
Electrical machinery	93.0	83.5	64.5	67.0	74.0
Autos, trucks, and parts	94.5	84.5	98.0	99.5	115.5
Other transportation equipment	90.5	88.0	58.5	59.0	65.0
Fabricated metals	93.5	83.0	67.0	66.0	73.0
Instruments	95.5	88.0	69.0	76.0	82.5
Chemical process industries	89.5	85.0	80.5	83.5	88.0
Chemicals	84.5	82.0	73.5	78.5	82.5
Paper	93.0	88.5	92.0	93.5	96.5
Rubber	96.5	96.5	92.5	95.0	106.0
Stone, clay, and glass	84.5	76.5	72.5	76.0	76.0
Petroleum refining	93.0	95.0	92.5	88.5	95.5
Nonferrous metals	104.0	82.0	78.5	80.0	85.5
Food and beverages	83.5	80.5	86.5	84.5	82.5
Textiles	99.0	91.5	81.5	79.0	86.5
Mining ^a	n.a.	82.5	90.0	77.0	77.0
Utilities	n.a.	90.0	83.0	76.0	79.0
All industries	n.a.	85.0	77.5	78.5	84.0

Sources: McGraw-Hill Publications Company, Economics Department, tabulations, "Industrial Operating Rates," and McGraw-Hill Economics Department, News Release, "Rising Operating Rate Suggests Boom in Capital Investment Is Here" (April 20, 1973).

a. Crude oil and natural gas extraction are excluded.

n.a. Not available.

is still far below its own 1966 level of 90.5 reported in Table 6. It is quite comparable with the utilization rates of 1968 and early 1969. Signs of severe strain on capacity are restricted to automobiles and certain nondurable goods industries—paper, rubber, and petroleum refining. The high operating rate in the automobile industry is not a serious inflationary factor as it does not reflect sharply rising marginal costs or rigid supply constraints.

The Wharton index of capacity utilization for manufacturing, mining, and public utilities was at 94.2 percent in the first quarter of 1973.³ Although this index is sharply higher than the others, what matters is comparisons with previous levels of the Wharton index itself. The current index is still below the utilization rates of 96 percent and above recorded during the peak demand periods of 1966-69, but it has increased sharply from the

3. Information from Wharton Forecasting Associates, Philadelphia.

depressed levels of 1970–71. The Wharton index appears to be in greater agreement with that of McGraw-Hill than with that of the Federal Reserve.⁴

The capacity indexes are vulnerable to criticism because of problems of defining and measuring capacity. In some industries production methods imply that capacity rigidly limits supply and that more output can be forthcoming only at sharply higher costs. In industries whose production methods are more flexible, higher operating rates do not result in shortages or higher marginal costs. Therefore we have attempted to obtain further evidence about operating rates in several key industries through a survey of their trade associations.

Significant pressures on capacity are evident in industries such as lumber and cement, which have been supplying the boom in residential housing in recent years. But, as homebuilding begins to decline in 1973 in response to higher interest rates, the problems in these industries will begin to abate. The adjustment of lumber prices to demand pressures has been largely completed. The problems in cement are concentrated in the Southeast and higher imports and shipments from other parts of the country have brought some relief.

Paper, petroleum refining, and man-made fiber textiles are three non-durable industries whose operating rates, as reported by trade associations, are very high and likely to remain so in the future. The paper industry is subject to very rigid supply constraints and its operating rate of 97 percent is substantially above the 94.7 and 94.6 percent rates reached in previous cyclical peaks of 1966 and 1969. Petroleum refineries are operating above 90 percent of capacity, but pressures have been evident for several years. The problems in this area are more complex than simple excessive growth in aggregate demand. The pressures on the man-made fiber industry result more from rapid shifts in the composition of the demand for textiles than from a sudden acceleration of total demand.

Excess capacity appears to be relatively plentiful in most of the durable goods industries. Although a published utilization index is not available for

4. In part this discrepancy reflects the greater emphasis placed on the growth of the capital stock in constructing the Federal Reserve index. On this basis, estimated capacity grew more rapidly during the 1968–69 investment boom than the other measures suggest. The Wharton index is based primarily on extrapolation of output growth between cyclical peaks and thus gives less direct weight to variations in the growth of the capital stock. The McGraw-Hill index has as its benchmark an end-of-year survey of operating rates reported by major firms.

steel, the industry can hardly be under any general capacity pressures, since raw steel production in the first quarter was only 6½ percent above the 1969 level. Operating rates in aluminum have recovered from the depressed levels of 1971 but are still substantially below the peaks of 1966 and 1969. The low levels of the ratio of unfilled orders to shipments for capital goods industries supports the impression given by the McGraw-Hill index that substantial unused capacity is available. Shipments of machine tools in the first quarter of 1973 were about 75 percent of 1968–69 levels.

Transportation is one industry in which capacity problems are severe and crucial to aggregate economic activity. The huge movements of grain to the ports has created a serious boxcar shortage, which in turn has affected a long list of industries, including domestic food production, lumber, paper, textiles, and the primary processing industries. The situation has been exacerbated by the inefficient operation of the rail industry in the East, where unused rail cars have tended to accumulate. Regulations of the Interstate Commerce Commission have maintained very low rental rates for cars so that there is little incentive for a rapid turnaround.

Most of the current concerns with capacity pressures seem to arise more from the rate at which current production is rising than from difficulties associated with its absolute level. Some industries are experiencing trouble in expanding their utilization of existing capacity at a rate that matches the inflow of new orders.

Policy

No simple set of policy changes will extricate the United States from its current inflation problem. There is a limit to the number of previous policy mistakes that can be overcome by current actions. Thus, with the benefit of hindsight, we can list some lessons learned from the last year. First, actions could and should have been taken early to meet the problems of rising food prices. Additional grazing land for beef cattle should have been made available several years ago when the beef shortage became obvious. The large one-shot sale of wheat to the USSR imposed serious domestic costs though it may have been an important element of foreign policy. Multi-year contracts for increased agricultural exports are very desirable but short-run agreements that give production no time to respond can be problematic. In any case, the size of the export demand was known in

August 1972 and production controls should have been relaxed then instead of waiting until January and March of 1973.

The problem of rising lumber prices clearly demonstrates the dangers of allowing monetary policy and thus homebuilding to suffer such gyrations. Sudden and extreme fluctuations in demand are themselves inflationary in the long run. They seriously hamper rational planning of capacity expansion in industries with long lead times.

The abandonment of Phase II for Phase III was carried out in a fashion that contributed to the failure of the controls program. Phase III was widely interpreted as a virtual end to controls, and thus spurred price increases in recent months. Nor is it evident that uncertainty concerning government actions itself contributes to price stability, as some government spokesmen maintain. Indeed, uncertainty is a powerful incentive to raise prices.

What to do about current policy is a far harder question. The economy currently faces three major risks. First, the bad weather in the Midwest could continue, with serious damage to agricultural production. The carryover of food supplies in the United States has been eliminated during the past crop year. If the United States or any other major food-supplying nation has a serious crop failure, the world food situation could become critical. Second, the sharp rise in food prices could be translated over the next two years into marked wage and price increases in the industrial sector and force a return to the type of wage-price spiral experienced in 1969–71. Third, the government could overreact to the current problem, adopt a very restrictive monetary and fiscal policy, and turn the present expansion into a recession.

Certainly, much in the first-quarter price developments argues that the current intensification of inflation is transitory. Devaluation, lumber prices, and agricultural prices explained a major part of the story. But price increases were not limited to these areas, and the peak in food prices is yet to come. The current outlook harbors many uncertainties; but, because the risks involved in assuming the worst are lower than those of hoping for the best, there are strong arguments for further government actions.

FOOD PRICES

In the area of farm production, little damage could be done by attempting to expand production to the maximum extent possible. Given the need to rebuild food inventories, prices cannot decline precipitately. In contrast to

the costs of a major world food shortage, any risks of overproduction are minor and can be corrected.

At present, federal production controls are no longer the limiting short-run factor in augmenting food supplies. The government will have to look beyond removing them for measures to correct the problem. I believe that several policy actions of increasing severity may be required.

First, the problem of transportation has become very serious. Corn currently has a premium of 60 cents per bushel for delivery, and the margin for delivered wheat is about 47 cents. Substantial immediate gains could be realized from federal control of railroad cars or improvement in the economic incentives for railcar utilization. Current government actions to relieve the transportation problem have been of little help. In addition, several farm communities have been under the threat of a fuel shortage during 1973 that the government could easily remove by guaranteeing the supply of fuel.

Furthermore, unless weather conditions improve soon, the United States may have to consider an embargo on feed grain exports. This move is certainly not desirable in view of the long-run goal of expanding agricultural exports, but there is a limit to the burden that the United States would wish to place on the domestic economy. Little benefit inures to this country if foreign countries allow imports from the United States on a one-shot basis but then reimpose quotas after the crisis has passed. Farmers and consumers in the United States should not be forced to bear the brunt of adjustment to crop fluctuations around the world. The nation has an interest in long-term trade arrangements, but not in deals that allow a one-time sale to dominate current exports. The embargo is less appropriate for food grains since the wheat crop should be large and is a close substitute for rice, which is currently in short world supply. The embargo could be effected by announcing that it will be applied if prices rise beyond a specific level. A preferable approach might be to place quotas on exports to individual countries based on their purchases over recent years, in an attempt to maintain supplies to countries that are willing to open their economies to U.S. agricultural exports over the long term.

Finally, direct controls may be required if food prices continue to rise. Current prices are high enough to ensure that farm production would not be adversely affected. The major problem with such controls is on the distribution side. They are always a last resort but they may become necessary to prevent a passing through of food prices into substantial wage and price

increases in the industrial sector, and a rapid spreading of the inflation. The nation may be forced to choose controls as the lesser evil. However, even they can work for short periods, if they are carefully and flexibly administered.

Properly approached, controls could be a compromise between the current interests of farmers and consumers. The government should not seek to return farm prices to former levels over the next year, the goal enunciated by some administration officials. Fears of future price declines, fueled by such statements, inhibit the expansion of farm output, particularly of meat. Farmers are legitimately concerned about a boom-bust pattern of farm prices over the next few years. It would be preferable to aim for a gradual and controlled decline in farm prices from current levels, with the government prepared to buy up excess supplies if they should develop. Farmers did not cause the current crisis and some guarantee of stability in future prices could expand current production.

The current predicament amply demonstrates the long-run need to reform the general farm program. The solution to the problem of low-income farmers lies in treating them as part of the overall problem of poverty rather than as beneficiaries of production controls and price supports. The government agricultural program should focus on maintaining commodity reserves only as a device for meeting unforeseen short-run fluctuations in supply and demand. Thus the Department of Agriculture might follow directives such as those given to the Federal Reserve Board and operate so as to maintain an orderly market for the farm products.

INDUSTRIAL PRICES AND WAGES

Unlike the inflation problems in foods, those in the industrial sector do not appear to be susceptible to simple solutions. Extreme measures do not seem appropriate, nor do I believe that a general wage-price freeze is the answer in the current situation. A freeze is useful as a prelude to some other policy: In 1971 it provided time to set up control machinery for Phase II. That machinery still exists. Nor is there a need for a shock treatment to break anything loosely defined as an inflationary psychology. The need, rather, is to act before a renewed spiral of wage-price and wage-wage inflation begins, rather than to intervene once it is under way. In addition, the economy is operating at higher levels of resource utilization and has a greater need for relative price adjustments than in 1971. A freeze of any sig-

nificant duration also is quite inequitable to labor and disrupts the collective bargaining process.

At the other extreme, I do not believe that the government can responsibly simply wash its hands of the whole mess. The recognition that some policies can be inept should not stand as a general condemnation of all policy. Government intervention in wage and price decisions is not desirable, but for the near future it is necessary. The alternative of sole reliance on fiscal and monetary policy proved ineffective and costly between 1969 and 1971 and I doubt that it could do much better today. In the longer run other policies of market reforms and reductions in the costs of inflation and unemployment are available, but they would be of little immediate benefit.

The most frequently heard recommendation is for a simple return to Phase II. But this proposal must face the difficulty of defining an equitable wage standard in view of the substantial increase in food prices. This difficulty illustrates a basic problem of controls: Food prices can drive the rest of the program because of their importance for consumer prices. As long as they continue their sharp upward trend, public support would require a significantly higher wage standard. But a wage standard of 6½ to 7 percent would itself be inconsistent with price goals in the nonfood sector.

The immediate need is to halt the rises in industrial prices that are not justified by cost increases. The reluctance of the designers of Phase III to maintain at least the prenotification requirement is difficult to understand. At the minimum there is a need to know of price increases and their justification. In place of an across-the-board requirement for prior approval, use might have been made of authority to hold up price increases for which the CLC believes the justification may be inadequate. This would reduce the bureaucratic tie-ups with trivial price increases experienced during Phase II.

The changes announced in May requiring prior approval were a step in the direction of tighter controls. But their effectiveness was severely limited by exempting price increases until those increases raise average prices on the firm's sales. At present, it is more important that the CLC learn to say "no" than that it adopt further minor changes in the regulations. A strict enforcement of the Phase II practice limiting to 5½ percent the wage increase that can be used for justifying price increases would also add some needed restraint.

Stronger enforcement of controls does risk creating some distortions and inefficiencies. But these costs must be balanced against the costs of further acceleration in the overall rate of inflation and the high unemployment that

will again result if the restraint must depend on fiscal and monetary policy alone.

At the moment, wage rates do not appear to be the primary problem. However, the current rate of wage inflation is subject to some ambiguity arising from the data. The focus should be on preventing substantial acceleration of wage settlements in response to what may prove to be temporary food price increases. But the 5.5 percent general wage standard may be difficult to enforce. It may need some modification to allow for escalator clauses or some other partial adjustment for food price increases. This allowable adjustment might be averaged over several years or limited to low-wage industries.

STABILIZATION POLICY

In an earlier section we argued that capacity pressures were of serious concern in only a few sectors of the economy. But rates of real growth in gross national product in excess of 8 percent must arouse some concern that fiscal and monetary policy is overly expansionary. The aggregate unemployment rate has declined to 5 percent and should drop further in the next few months. A gradual slowing of real output growth to the economy's long-run growth rate by year-end would certainly be desirable. The major issue will be whether currently planned shifts in policy are adequate to achieve this goal.

Monetary policy appears already to have shifted substantially in the direction of restraint. Market interest rates have risen to a level that has sharply reduced the deposit inflows of the mortgage lending institutions, a development that will lead to lower rates of homebuilding in future quarters.

If Congress holds total budget expenditures to the \$268.7 billion recommended by the President for fiscal year 1974, fiscal restraint will tighten in the rest of 1973 and early 1974. The increase in the social security tax will have some impact and expenditures are projected to rise by only \$2.5 billion in the last half of 1973, following a \$15 billion increase in the first six months. Most of the current forecasts seem to imply that these policies will be sufficient to slow the rate of growth in real gross national product to its sustainable trend rate by year-end.