
FRBSF WEEKLY LETTER

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Inflation: Retreating or Reheating?

Actual inflation continues at a relatively low rate compared to its double-digit pace of a few years ago. Both the consumer price index and the price index for total output—the GNP deflator, have measured inflation in the neighborhood of four percent over the last two years. Given that over the same period the unemployment rate fell more than three percentage points and real output grew more than ten percent, the failure of inflation to rise is particularly noteworthy. In fact, many forecasters have been surprised by its continuing low rate and have accordingly revised their inflation forecasts downward for this year and next.

One signal that overall inflation may remain low for the next few quarters is given by prices at the wholesale level. Producer price changes often foretell consumer price changes since cost increases at the wholesale level tend to get passed onto the retail level. The inflation rate in producer prices has been even lower than that in retail prices. And recently it has fallen even further. Producer prices have only risen three percent in the two years since the current recovery began, in contrast to their ten percent total rise in the first two years of the 1975-1980 recovery. From July to October, producer prices actually fell. Few expect deflation at the retail level, but the low rates of increase in producer prices have played a significant role in expectations of continued low inflation for the next few quarters.

The current relatively low rates of inflation are due in part to transitory factors. These factors have depressed the observed, or actual, rate of inflation below its underlying, longer term component which is determined primarily by fundamentals such as the basic direction of monetary policy and the trend in labor productivity. This *Letter* discusses these temporary factors and the contributions they have made to reducing both the observed and the underlying rates of inflation and to keeping current inflation low.

Importance of imports

Because expenditures for imported goods and services currently exceed \$450 billion per year—about one-eighth of GNP—changes in import prices directly affect the overall domestic inflation

rate. They also exert indirect pressures that are perhaps more important. Chart 1 shows the recent inflation rates of the Consumer Price Index and of a price index for imports. In 1979 and 1980, the prices of imported goods rose much more rapidly than other prices. The doubling of OPEC oil prices was responsible for virtually all of this increase in the relative price of imports. Since then, import prices have risen very much less than other prices, and for the last three years, have actually fallen.

The fall in import prices relative to the prices of domestically produced goods and services has been due to the recent strength of the U.S. dollar in relation to other major currencies. The trade-weighted real value of the dollar has risen about 40 percent since 1980. As a result, foreign suppliers have been able to charge lower dollar prices while maintaining the profitability of their exports to the United States. The lower dollar prices of imported goods show up in the price indexes for goods purchased by Americans, and thereby hold down the overall rate of increase of those indexes.

Indirectly, the lower American price of imports has led competing domestic producers to hold down their prices. Almost everything we import has a close counterpart, or substitute, produced in the U.S. Autos, steel, petroleum, and clothing are large domestic industries that must compete with foreign producers of the same goods. Roughly half of total domestic production consists of goods with substitutes that are or could be imported. This competition from foreign goods, whose dollar prices have remained relatively low because of the strong dollar, has kept a lid on both domestic producers' and workers' ability to raise prices.

The price of one major imported commodity, petroleum, is not directly affected by changes in the value of the dollar because its price is set primarily in dollars. But even the price of petroleum has fallen. Since the early 1980s, the dollar price of a barrel of OPEC crude has fallen by about one-third because the worldwide demand for oil has softened markedly compared to demand in the late 1970s. Among the reasons for weaker oil demand are the continuing increases in energy efficiency and the very low real growth rates of the

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world economy. The strong dollar also has helped reduce the price of oil by making the cost of oil higher for countries other than the United States. It thereby saps those countries' demand for oil and puts downward pressure on oil prices.

The 14-percent increase in the real value of the dollar over the past two quarters gives us every reason to expect inflation to remain quiescent over the next year and perhaps to fall further. However, should the real value of the dollar fall significantly, short-term direct and indirect upward pressures on inflation, perfectly analogous to those we experienced throughout much of the decade of the 1970s, will re-emerge.

Once again, inflation and unemployment

Since labor costs constitute approximately three fourths of costs for the economy as a whole, changes in the growth rate of labor costs also play a significant role in determining short-run changes in the inflation rate of domestically produced goods and services. How fast wages rise depends on the amount of slack in the labor market. The unemployment rate is a good signal of this slack and, to a large degree, of the general level of demand for domestically produced output. Its level, then, is likely to be an important factor in determining how fast wages rise.

Chart 2 plots the course over the last half dozen years of the level of the unemployment rate and the change in the growth rate of labor compensation per hour. During the late 1970s, the unemployment rate fell to relatively low levels and the growth rate of compensation per hour rose. With the higher unemployment rates of recent years, labor costs have grown slower and slower. This year, for example, compensation per hour is growing about half as fast as it grew during 1980. As long as the amount of slack in labor markets remains substantial, such slowing is to be expected. When the economy returns to more normal levels of unemployment, this downward pressure on wage and price inflation will disappear.

Deregulation and disinflation

The last few years have also seen some changes in government budget and regulatory policies that

have helped reduce inflation in the short-run. Compensation costs, for example, will not be pushed up nearly as much by payroll tax hikes between 1982 and 1985 as they were in the period 1978 through 1981, when payroll taxes increased substantially. These increased costs apparently were passed on by employers as price increases that temporarily raised the inflation rate. Once this pass-through was completed, the upward pressure on short-term inflation would have evaporated even without the help of other anti-inflation government policies.

A similar temporary reduction in short-term pressure on inflation emanated from (de-)regulation policy. The removal of a wide range of price regulations in the communications and transportation industries prompted price declines in those sectors. These price declines fed back into downward pressure on employee wages. Together, lower costs and prices in deregulated industries helped reduce the overall inflation rate temporarily. But, again, once the adjustment is completed, the underlying inflation rate will re-establish itself.

Summing up

The economy's underlying rate of inflation has been reduced substantially in the past four years. Over that time, the actual rate of inflation has been even lower than the underlying rate. The strengthening of the dollar, slack aggregate demand, and adjustment to less price regulation have each played a role in bringing down both the actual and the underlying rate of inflation. However, the actual rate will remain below the underlying rate only to the extent that factors like these continue to exert downward pressure. Once the dollar stabilizes and the adjustment to its level is complete, and once the economy finishes its adjustment to more normal levels of unemployment and capacity utilization and to deregulation, actual inflation will move toward its underlying rate. As yet, there are indications that these adjustments are not complete. Until they are complete, the underlying rate itself may recede further. These forces together may keep inflation relatively low for the near future.

James A. Wilcox

Chart 1
Import Prices
Influence Domestic Inflation
(4-Quarter Growth Rates)

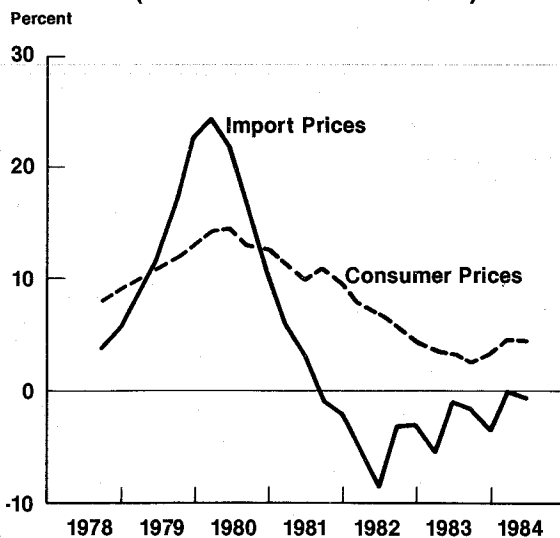
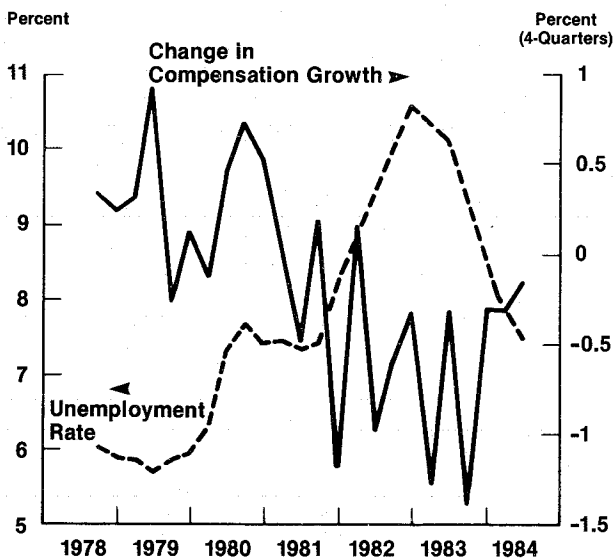


Chart 2
Higher Unemployment and
Slowing Growth in Labor Costs



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities	Amount Outstanding	Change from	Change from 12/28/83	
			Dollar	Percent ⁷
Large Commercial Banks	11/28/84	11/21/84		
Loans, Leases and Investments ^{1 2}	186,775	- 376	10,750	6.6
Loans and Leases ^{1 6}	168,039	- 319	12,684	8.8
Commercial and Industrial	51,621	157	5,658	13.3
Real estate	61,371	38	2,472	4.5
Loans to Individuals	31,030	180	4,379	17.8
Leases	5,075	1	12	0.2
U.S. Treasury and Agency Securities ²	11,631	- 58	- 876	- 7.5
Other Securities ²	7,105	0	- 1,058	- 14.0
Total Deposits	189,069	-2,103	- 1,928	- 1.0
Demand Deposits	42,805	-1,842	- 6,432	- 14.1
Demand Deposits Adjusted ³	28,892	219	- 2,439	- 8.4
Other Transaction Balances ⁴	12,200	- 198	- 575	- 4.8
Total Non-Transaction Balances ⁶	134,064	- 63	5,079	4.2
Money Market Deposit Accounts—Total	40,007	344	410	1.1
Time Deposits in Amounts of \$100,000 or more	40,427	- 261	2,262	6.4
Other Liabilities for Borrowed Money ⁵	21,902	-2,290	- 1,105	- 5.2
Two Week Averages of Daily Figures	Period ended 11/19/84	Period ended 11/05/84		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (-)	18	55		
Borrowings	21	133		
Net free reserves (+)/Net borrowed(-)	- 2	- 78		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

⁷ Annualized percent change