Inflation remained mild again during 1985

Consumer prices rose by less than 4 percent, about the same as during 1982–84; the rate of increase for producer prices of finished goods was less than 2 percent, as inflation continued to be moderate for the fourth consecutive year

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The rate of inflation in the American economy continued to be moderate for the fourth consecutive year. For the 12 months ended in December 1985, the Consumer Price Index for All Urban Consumers (CPI–U) advanced 3.8 percent, about the same as during 1982–84. Once again, the rate of increase in the Producer Price Index (PPI) for Finished Goods was even lower than the CPI's, moving up only 1.8 percent over the same 12 months. (See table 1.)

As in 1984, small increases in prices for food, energy, and other consumer goods kept the all items CPI advance moderate. Although 1985 energy prices rose more than in 1984, the increase was still under 2 percent. The indexes both for food and for commodities other than food and energy slowed noticeably, to increases of less than 3 percent. However, several categories of consumer services, such as shelter, medical care, and education, continued to register above-average increases. The CPI for services other than energy rose 5.7 percent, approximately the same as in 1984.

In 1985, the PPI for Finished Goods rose less than 2 percent for the third consecutive year, having increased 1.7 percent in 1984 and 0.6 percent in 1983. Producer prices for intermediate and crude goods actually decreased in 1985. After moving up less than 2 percent in both 1983 and 1984, the intermediate materials, supplies, and components index fell 0.3 percent, the first calendar year drop in this series since 1962. The index for crude materials for further processing fell rapidly through the first 9 months of 1985, before recovering somewhat in the fourth quarter to finish the year 5.5 percent below its December 1984 level. This was not only more than the 1.6-percent decrease recorded between December 1983 and December 1984, it was also the largest annual decline in crude material prices in a third of a century.

Much of the moderation in 1985 price movements was related to competition from imported goods. The price index for All Imports published by the Bureau of Labor Statistics fell 1.1 percent in 1985, following a 1.6-percent decline the year before. (See the article on import and export prices in this issue of the *Review*.) Whereas declines in 1984 were widespread among end-use categories of imported goods, in 1985 the downward impulse was concentrated in the categories of petroleum—down 4.9 percent—and other raw materials—down 7.1 percent. In contrast, prices for imported automobiles and parts jumped 5.9 percent over the year, partly reflecting the decline of the dollar vis-a-vis the

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Japanese yen, and the continued informal Japanese export restrictions.

The enormous volume of imported goods absorbed a substantial portion of growth in aggregate demand, so that most domestic industries continued to operate well below their potential levels of output. Total industry capacity utilization in the United States hovered around 80 percent throughout 1985; historically, this rate has approached or exceeded 90 percent once the economy is 3 years into a business cycle expansion. (The current expansion began at the end of 1982.)

Having slowed sharply in mid-1984, the general expansion of the American economy regained some vigor after mid-1985, aided by less restrictive monetary policies and a considerable drop in interest rates. Consumer spending continued to climb, undeterred by mounting consumer debts and low rates of personal saving. However, after several years of unusually strong growth, investment spending increased more slowly. Uncertainties generated by possible changes in tax laws affecting capital expenditures may have contributed to business caution on long-range commitments. The residential housing market was no stronger than it had been in 1983 and 1984, in spite of a substantial drop in interest rates over the 1983–85 span. Tighter credit eligibility restrictions by mortgage lenders effectively limited housing demand by disqualifying many potential home buyers without sufficient resources for a substantial downpayment. At year's end, there were few labor or material shortages or capacity constraints threatening to reignite inflation.

The sustained record of low inflation from 1982 to 1985 in the midst of strong aggregate economic growth has not been matched in the United States for nearly two decades. Accordingly, this article will take a different slant than those of previous years. Before focusing on the causes of 1985 price changes for particular goods and services, we will employ a long-term perspective to identify major recent trends.

Major trends

Although energy prices were a major source of inflationary pressures from 1979 to 1981, they have been the principal moderating influence during the last 4 years. In the earlier years, retailer profit margins were squeezed as consumer resistance prevented the full passthrough of increased producer prices of gasoline and fuel oil. In general, consumer prices have not reflected the volatility seen in the producer market in the subsequent period. Retail price declines have been moderated by increased State, local, and Federal excise taxes over the 1982–85 period, while dealers have been reluctant to reduce their recovered margins over the last few years. Declines in producer prices for refined products have reflected fundamental changes in the structure of the world petroleum market. During the early 1980's, consumers and businesses throughout the industrial world dramatically curtailed energy consumption in response to skyrocketing prices. At the same time, increased production of crude oil by such non-OPEC nations as Britain and Mexico

Table 1. Annual percentage changes for major categories of the Consumer Price Index and Producer Price Index, 1978–85[1]

Consumer Price Index	1978	1979	1980	1981	1982	1983	1984	1985[2]
All items	9.0	13.3	12.4	8.9	3.9	3.8	4.0	3.8
Food	11.8	10.2	10.2	4.3	3.1	2.6	3.8	2.7
Energy	8.0	37.4	18.1	11.9	1.3	-.5	.2	1.8
Commodities excluding food and energy	7.6	8.8	9.9	5.9	5.8	5.0	3.1	2.1
Services excluding energy	9.4	13.6	14.1	12.9	3.4	4.8	5.6	5.7
Food and beverages	11.6	10.0	10.1	4.3	3.2	2.7	3.7	2.8
Housing	9.9	15.2	13.7	10.2	3.6	3.5	4.2	4.3
Apparel and upkeep	3.2	5.5	6.8	3.6	1.6	2.9	2.0	2.9
Transportation	7.7	18.2	14.7	11.0	1.7	3.9	3.1	2.6
Medical care	8.8	10.1	10.0	12.5	11.0	6.4	6.1	6.7
Entertainment	5.8	6.9	9.6	7.2	5.6	3.9	4.2	3.2
Other	6.4	7.9	10.1	9.8	12.1	8.0	6.1	6.3
Commodities	8.9	13.0	11.1	6.0	3.6	2.9	2.6	2.5
Services	9.3	13.7	14.2	13.0	4.3	4.8	5.4	5.1
Producer Price Index								
Finished goods	9.2	12.8	11.8	7.1	3.7	.6	1.7	1.8
Consumer foods	11.7	7.4	7.5	1.4	2.1	2.3	3.5	.3
Energy	8.5	58.0	27.8	14.1	-.1	-9.2	-4.1	0
Consumer goods excluding food and energy	8.5	9.7	10.4	7.1	5.3	1.9	2.2	2.7
Capital equipment	7.9	8.8	11.4	9.2	3.9	1.9	1.8	2.7
Intermediate goods	8.8	16.1	12.6	6.0	.2	1.8	1.3	-.3
Foods and feeds	14.5	8.2	16.1	-12.9	0	9.3	-5.4	-4.7
Energy	4.8	44.7	25.4	11.1	-.7	-5.5	-.1	-.8
Intermediate goods excluding food and energy	8.9	12.8	10.1	6.6	.6	3.0	2.1	-.2
Crude materials	17.2	16.4	12.8	-3.7	.4	4.7	-1.6	-5.5
Foodstuffs and feedstuffs	18.3	10.6	8.6	-14.0	1.5	8.0	-1.2	-6.4
Energy	11.1	34.9	26.9	22.8	2.6	-4.6	-1.3	-4.3
Crude nonfood materials excluding energy	21.3	15.1	7.5	-11.4	-7.6	15.5	-3.3	-4.5

[1] Calculated on a December-to-December basis; Consumer Price Index for All Urban Consumers.

[2] Producer Price Index data for December 1985 are subject to revision.

introduced a new element of competition that eventually led to sharply falling prices.

Food prices have behaved more moderately than the All Items CPI–U in every year since 1979, having a favorable cumulative effect on the overall inflation rate. Consumer prices for food rose 2.7 percent in 1985, following 4 years of similarly moderate advances. It is interesting to note that producer prices for consumer foods (up only 0.3 percent in 1985) have risen at a slower rate than prices at the retail level in each year since 1978. The persistent gap in trends between the CPI and the PPI for foods would seem to imply a rise in the share of the food dollar going for marketing, packaging, and distribution. A further salient aspect is that prices received by farmers have *declined* in most recent years. The PPI for crude foodstuffs and feedstuffs was 5.3 percent lower at the end of 1985 than it had been 6 years earlier. Reduced foreign demand for foodstuffs, partly reflecting greater production abroad, as well as the unusual strength of the U.S. dollar during most of the 1980's, contributed to already substantial domestic stocks and kept food prices in check.

While prices have slowed substantially in most sectors of the economy in recent years, charges for consumer services have not slowed nearly so much as prices for consumer commodities have. Among the various explanations offered for this trend, an important one is that prices for goods have responded to competitive pressures from the foreign sector. Between late 1980 and early 1985, the exchange value of the U.S. dollar staged a massive advance because of high real interest rates and a surge (at least since the end of the 1981–82 recession) in investor confidence. The stronger dollar made it cheaper for Americans to buy foreign goods, while prices of U.S. exports rose because of the relative fall of other nations' currencies. As a result, domestic manufacturers were often forced to hold their prices to relatively low levels to avoid losing too much of their market share to imports. Although the dollar began to decline in the spring of 1985, the price effects will take some time to materialize. Consequently, there was little perceptible influence on prices during the latter part of the year.

A clear trend observed in table 1 is the steady deceleration in consumer inflation rates for commodities other than food and energy since the peak year in 1980. Furthermore, it is apparent that inflation has virtually ceased or even reversed among intermediate and crude materials in recent years. As already noted, the strength of the U.S. dollar has made an important direct and indirect contribution to these developments. Another important factor has been the modest increase in labor compensation. The Employment Cost Index for compensation of private industry workers in goods-producing industries has slowed in each successive year since 1981, from an annual increase of 10.0 percent in 1981 to only 3.2 percent in 1985.

Although price increases for most consumer services have moderated considerably since 1981, they have generally continued to rise more rapidly than commodity prices. A variety of institutional factors have contributed to this difference. In general, service industries do not have to contend with the same type of foreign competition faced by goods-producing industries. Although price advances for tuition and other school fees have slowed somewhat in the last few years, they have shown more resistance to moderation than other items—rising 8.4 percent in 1985.

Having reviewed the general course of inflation in recent years, we will now take a closer look at producer price changes during 1985.

Finished goods

Prices received by producers of finished goods rose 1.8 percent, about the same as in 1984; however, price movements of the individual components were somewhat different. Consumer food prices rose much less than a year earlier; energy prices showed no net change after falling during 1984; and the index for finished goods other than foods and energy moved up somewhat more than in the previous year.[1]

The index for finished consumer foods inched up 0.3 percent in 1985, following a 3.5-percent rise in the preceding year. Prices for pork, beef, and veal, processed poultry, and fish fell significantly for much of the year, largely because of plentiful supplies, but turned up by year-end; only beef and veal ended the year in the minus column. Consumer demand continued to drift away from red meats toward poultry and fish. Egg prices rose nearly 7 percent in 1985, after falling the previous year when egg farmers over-expanded flocks. In contrast, shortening and cooking oils were 15 percent lower than a year earlier, as both animal- and vegetable-based products showed declines. Prices also dropped over the year for dairy products and soft drinks.

Among finished energy goods, the index for natural gas moved down 6.2 percent, after rising 1.0 percent in 1984. This decline reflected lower prices for interstate gas following the lifting of controls in January 1985 on most U.S. wellhead natural gas under the 1978 Natural Gas Policy Act. However, indexes for gasoline and home heating oil turned up after falling a year earlier. Gasoline prices were poised for sharp declines in 1985, amid strong expectations of falling crude oil prices because of disarray within OPEC and general worldwide overproduction. While gasoline prices did post a net decline for the second half of the year, this was insufficient to offset the unusually strong advances that occurred in the spring when the glut of gasoline on the market eased. After drastic declines in the first half, fuel oil prices rose sharply in the second half when inventories of heating oil were unusually low. Hoping that crude oil prices would fall, refiners sometimes preferred to buy fuel oil from other refiners instead of buying crude oil on the spot market. The resulting surge in purchases of heating oil in some areas led to higher prices.

The index for consumer goods other than foods and energy advanced 2.7 percent in 1985, after rising 2.2 percent a year earlier. Increases were widespread and generally moderate. However, passenger cars rose 4.5 percent and light motor trucks increased 8.0 percent, the largest annual advances in 3 years. Demand for cars and trucks boomed over the year, peaking at periods when low-interest financing and other incentives were in effect, then slumping when they were discontinued. Light trucks became increasingly popular as the second family car; 1985 sales of light trucks exceeded the previous record of 4.3 million sold in 1978. Domestic manufacturers sold about 8.2 million passenger cars in 1985, compared with 7.9 million in 1984.

From December 1984 to December 1985, the capital equipment index advanced 2.7 percent. Inflation for most domestically produced capital goods was restrained by continued fierce competition from imported machinery. Although capital spending rose in 1985, the rise was smaller than in other recent years. Unlike a year before when there was widespread optimism, several developments caused business to become more cautious about investment spending in 1985. For example, uncertainty over the possible cancellation of the investment tax credit increased, and speculation persisted on whether there would be a change in the period over which companies could recover their investment in machinery through depreciation allowances.

Intermediate goods

The Producer Price Index for Intermediate Goods edged down 0.3 percent from December 1984 to December 1985, following a 1.3-percent rise during 1984. Moderate declines were widespread among products within this category, while annual increases of more than 3 percent were rare.

Despite the improvement in the economy after midyear, metal markets were generally sluggish in 1985. For example, demand for domestic steel was limited. Restrictions on steel imports reduced the market share won by foreign steel producers only marginally. Some producers who were in financial straits lowered their prices to maintain or increase their market share and to generate needed cash. The continuing trend towards substitution of plastics and aluminum for steel in many major products also kept steel manufacturers from boosting output.

Prices for many nonferrous metals were considerably lower at the end of 1985 than they had been a year earlier. Tin, lead, and zinc all fell more than 20 percent. After fluctuating indecisively during most of 1985, tin prices plummeted nearly 30 percent in November and December. The financial collapse of the International Tin Council, which had been maintaining a massive buffer stock in order to support tin prices, precipitated the abrupt price drop. Lead and zinc prices fell because of a surplus in world markets that persisted despite production cutbacks in North America. (Because these two "sister metals" are generally mined together, their respective production levels are interrelated.) Aluminum prices continued to fall moderately in 1985, as demand did not improve enough to pare worldwide inventory levels sufficiently. In contrast, copper prices rose 7.5 percent, the first yearly increase since 1979. Recent increases in copper prices have been attributed in part to the falling value of the U.S. dollar. Gold prices were much less volatile than in recent times, finishing the year 2.9 percent lower than in December 1984. Silver was down more sharply (14.6 percent), partly as a result of large sales of private holdings.

Prices were weak throughout the textile industry during 1985. In recent years (particularly since 1983), competition from foreign producers has intensified in textile material markets, above and beyond the longstanding foreign penetration of apparel markets. For example, domestic production of manmade fabrics was down nearly 10 percent during the first three quarters of 1985, compared with the same period in 1984. Decreased domestic production of these textile fabrics had a direct impact on American producers of synthetic fibers, the index for which fell 4.8 percent over the year. This was the fourth consecutive annual decrease and the largest such drop on record.

The domestic electronics industry suffered an unusually sharp slump during the year because of a slowdown in personal computer sales and intensified competition from foreign (mainly Japanese) component suppliers. The PPI for electronic components and accessories edged up only 0.7 percent in 1985, the smallest rise in 10 years. Sharp price declines were particularly evident in the semiconductor industry, where prices for some advanced integrated circuits plunged more than 40 percent.

Construction material prices edged up 1.0 percent over the year. There was considerable variation in price behavior among the various kinds of construction materials. Several kinds of nonmetallic mineral products climbed moderately. Gypsum product prices turned up 8 percent, recovering from the drop that had occurred in 1984's second half. In contrast, prices for plastic plumbing products dropped nearly 12 percent, and lumber and plywood prices declined for the second consecutive year. While the residential housing construction market remained fairly good in 1985, it did not expand in response to the general drop in interest rates; this had a restraining impact on prices of lumber and other wood products heavily used in building new homes. The commercial construction market, however, had a very strong year, helping to boost prices for those materials used in erecting office buildings.

The index for intermediate energy goods moved down 0.8 percent in 1985. Residual fuel prices fell 15.6 percent, principally because of reduced world demand following the settlement of the British coal strike. Prices for jet fuels and coke also decreased. These declines were nearly balanced by increases for electric power, gasoline, and diesel fuel. The 4.7-percent fall in the index for intermediate foods and feeds was led by substantial decreases for crude vegetable oils and animal fats and oils. Price movements for other products in this category were moderate.

Among other kinds of intermediate goods, prices for woodpulp fell more than 15 percent, as a shift from seasonal to year-round production resulted in a sizable rise in supplies. Paperboard prices declined nearly 10 percent, reflecting an overexpansion of capacity in this country and Canada. Prices for paper and paper boxes and containers moved down modestly. Prices and production levels in the pulp and paper products industry had risen steadily during 1983 and most of 1984. Moderate decreases were registered for a number of other products, such as mixed fertilizers, plastic resins and materials, synthetic rubber, and medicinal and botanical chemicals.

Crude goods

The Producer Price Index for Crude Materials for Further Processing dropped 5.5 percent, following a 1.6-percent decrease in 1984 and a 4.7-percent advance in 1983. The indexes for foodstuffs and other nonenergy materials both fell more in 1985 than in the preceding year, following increases in 1983. The crude energy price decline, which had slowed in 1984, nearly matched the 1983 rate of decrease.

After moving down 1.2 percent a year earlier, the crude foodstuffs and feedstuffs index fell 6.4 percent from December 1984 to December 1985. The index declined through the first 9 months of the year before recovering somewhat in the fourth quarter. Falling prices prevailed while livestock farmers liquidated portions of their herds in order to meet the high debt service costs incurred in connection with previous loans for expanded production. Prices then turned up at the close of 1985 as this liquidation of stocks left livestock inventories low. The decline for grain and feedstuff prices reflected continued bountiful harvests both here and in many other countries. However, inclement weather in some areas and higher export demand generally pulled fourth-quarter prices up.

The crude energy materials index moved down 4.3 percent, considerably more than the 1.3-percent decline for the previous year. The bigger decrease was principally because of a 6.2-percent drop in the natural gas index, the largest yearly decline on record. Crude petroleum prices fell for the fourth consecutive year, moving down 4.0 percent. Most of the decline occurred in the first quarter as a response to the October 1984 cut in international light crude oil prices by North Sea producers; prices were relatively stable through the rest of the year. The coal index dropped 1.4 percent, the first annual decrease since 1975. Contract coal prices, which were in many cases tied to declining indexes for fuel oil and natural gas, turned down in 1985.

The index for crude nonfood materials other than energy dropped 4.5 percent, following a 3.3-percent decline in 1984. Lower prices for ferrous scrap and iron ore were prompted by slack demand from domestic steel manufacturers. Prices for aluminum base scrap fell because of an oversupply of primary aluminum, and brass scrap dropped as it followed the downward movement of primary zinc. Leaf tobacco was down a record 11.6 percent, reflecting reduced effective price supports and large supplies. Raw cotton prices were lower as a result of burdensome stocks and weak demand from domestic fabric manufacturers confronted with intense foreign competition. The 38.5-percent fall in wastepaper prices was chiefly a reaction to the sharp drop in prices for woodpulp, which competes with wastepaper as a basic material in the manufacture of certain paper products. In contrast, cattle hide prices increased in response to good demand from foreign apparel manufacturers, coupled with low supplies in the wake of a partial liquidation of cattle herds. □

——FOOTNOTE——

[1] Effective with data for July 1985, the 1-month lag in indexes for major refined petroleum products was eliminated. At the same time, the sample of refined petroleum products was reweighted.