Introduction

In 1975 the economy began to recover from the longest and deepest recession of the post-World-War-II period. The precise timing of the turnaround in general business activity has yet to be designated, but an upturn clearly was under way by late spring. The level of employment reached its cyclical trough in March and then began to rise; for new housing starts the low point occurred a month earlier and for industrial production a month later. During the second quarter the gross national product (GNP) in constant dollars registered its first increase since the final quarter of 1973.

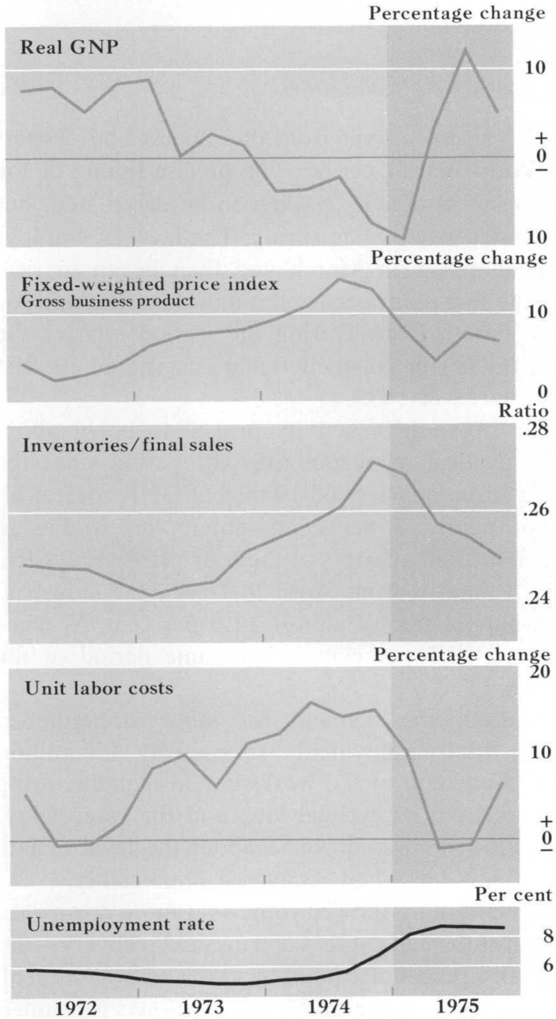
Once under way, the upswing in activity proved to be of about average dimensions for cyclical recoveries over the period since the Korean war. In the last three quarters of 1975 real GNP rose at an average annual rate of nearly 7 per cent—about comparable to the average rise in the first three quarters of the four previous cyclical recoveries. And in the 8 months from April to December industrial output advanced at an annual rate of almost 11.5 per cent, as compared with an average of 12.5 per cent in the same period of the earlier recoveries.

As production advanced, the demand for labor strengthened materially. By year-end, total employment had risen by 1.3 million from its March trough; the length of the workweek in manufacturing had moved up 1½ hours from its cyclical low; and the rate of layoffs in manufacturing industries was down to about the level of late 1973, while the rate of new hires had recovered appreciably.

The unemployment rate initially showed somewhat more downward resistance than is typical for the early stages of a cyclical recovery—declining only about one-half a percentage point by year-end from its peak in the second quarter. Growth in the civilian labor force continued to be fairly rapid in the latter half of 1975, as it had been throughout the recession. With real incomes and savings significantly eroded by the effects of inflation, family efforts to maintain and improve their living standards contributed to the sustained growth in the number of persons seeking jobs.

A substantial factor in the turnaround of business activity from steep recession to vigorous recovery was the pattern of interaction

Indicators of economic performance



Change (from previous quarter) in real GNP (1972 dollars), Dept. of Commerce data at seasonally adjusted annual rates.

Change (from previous quarter) in gross domestic business product fixed-weighted price index, Dept. of Commerce data at seasonally adjusted annual rates.

Ratio of real nonfarm business inventories to final sales, Dept. of Commerce data, seasonally adjusted. End of period stocks/sales at annual rates.

Change (from previous quarter) in private nonfarm unit labor costs. Dept. of Labor data at seasonally adjusted annual rates.

Unemployment rate, Dept. of Labor data.

between inventory investment and final sales. Consumer spending began to strengthen early in 1975—partly in response to price concessions and manufacturers' rebates—and it was further bolstered in the late spring by tax rebate checks and special social insurance disbursements. As a consequence, efforts of business firms to clear their shelves of excess stocks were remarkably successful. In the second quarter the pace of inventory liquidation was the deepest, relative to GNP, of any quarter in the postwar period, and inventory/sales ratios declined rapidly—setting the stage for a strong rebound in production in the third quarter.

The strengthening of final sales that had begun to develop early in 1975 was not confined to consumer markets, however. In real terms, purchases of goods and services by State and local governments, although growing at a slower rate than in earlier years, continued to advance throughout 1975. Housing starts began to rise appreciably after April and continued to increase during the remainder of the year. By December the physical volume of residential construction activity was up one-fourth from its spring trough. As is typical of the early stages of a cyclical upswing, the recovery of business fixed investment outlays lagged behind the turnaround of spending in other sectors. By the fourth quarter, however, even this sector had registered some modest improvement in real terms.

A factor tending to cushion the severity of the recession was the strong U.S. performance in foreign trade. Even though the 1975 setback in economic activity was worldwide, the yearly volume of U. S. exports declined only 3 per cent, and exports of capital goods held up well. On the other hand, the volume of imports dropped sharply—by 12.5 per cent—as demand in the United States weakened and inventories were liquidated. As a result, the U.S. trade balance rebounded from a deficit of $5 billion in 1974 to a surplus of $9 billion in 1975. Net transactions on services, including income on foreign investments, were down somewhat from the record total in 1974, but they also remained high by historical standards.

Full recovery from a recession as deep as that of 1974–75 is bound to take some time. Substantial further gains in real output will be needed in 1976 and beyond to provide employment not only for the large number of unemployed persons who are still looking for jobs but also for an expanding labor force, and to restore utilization of the Nation's industrial plant to a satisfactory rate. Public policy in 1976 will need to keep this objective clearly in mind. Yet the strength of the recovery in 1976 may well depend more on the dynamics of the business cycle than on any important new stimulus to be provided by public policy.

It was heartening therefore to note that as 1975 drew to a close conditions in the economy appeared very favorable to continued expansion. Inventory/sales ratios in many lines were at or near historic lows, and final sales remained strong following an unusually big upsurge in consumer buying over the Christmas season. Conditions in financial markets remained supportive of expansion. Thus, by early 1976, interest rates had moved down to their lowest levels in about 3 years; savings inflows to the specialized mortgage lenders remained strong; and stock prices staged a spirited recovery. Most importantly, these and other signs indicated a rebuilding of confidence among consumers and business firms in the prospects for a sustained economic expansion.

Bolstering that confidence must be another important objective of public policy during 1976. This will require continued progress in the Nation's struggle to free itself from the grip of inflation. Substantial headway has been made toward that objective since the end of 1974. In 1975 the rise of consumer prices moderated to 7 per cent—from 12 per cent in the prior year. For wholesale prices the improvement was even more dramatic; these prices increased on the average by only 4 per cent in 1975, compared with 21 per cent in 1974. The statistics on consumer and wholesale prices, however, reflect in part the relative absence in 1975 of the influence of several factors that had boosted prices in the prior year—such as the ending of price controls, the unprecedented upsurge in energy prices, and the sharp rise in prices of food. Hence they tend to exaggerate the degree of improvement that was made in reducing the underlying rate of inflation.

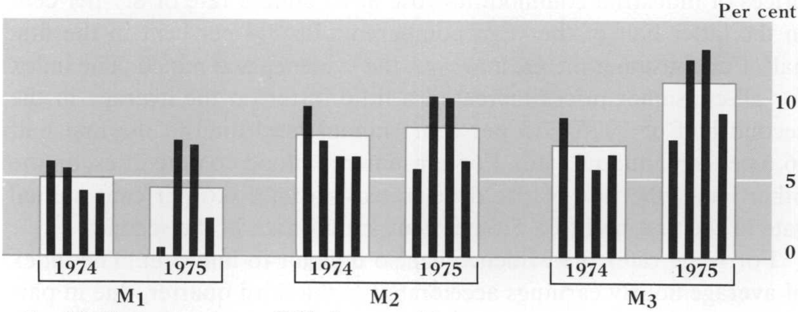
Further significant progress during 1976 in winding down the rate of price increase may be difficult to achieve if economic activity continues to expand substantially, as is widely expected. The substantial improvement in price performance in late 1975 and the early months of 1976—which was paced by declines in prices of foods and fuels—may prove to be temporary. In fact, during the latter half of 1975, there was some worsening in the inflation picture. For example, wholesale prices of industrial commodities rose at an annual rate of 8.7 per cent in the latter half of the year, compared with 3.4 per cent in the first half. For consumer prices, however, the evidence was mixed. The index for all consumer prices increased a little faster on the average in the second half of 1975 (7.5 per cent, annual rate) than in the first half (6.6 per cent, annual rate). For consumer nonfood commodities, on the other hand, the rate of rise decelerated—from a 6.6 per cent annual rate in the first half to a 5.6 per cent annual rate in the second.

For wage rates the evidence is also difficult to interpret. The index of average hourly earnings accelerated in the third quarter, due in part to some relatively large contract settlements in that period. Even so, the rate of rise in average wages was not appreciably higher in the second half of 1975 than in the first half—and was well below the peak rates of advance recorded in 1974. In any event, the rise in average wages in 1975—around 8 per cent—exceeds by a wide margin the long-term trend rate of improvement in productivity, which is in the neighborhood of 2.5 per cent per year. The long-term trend in production costs and prices is thus still strongly upward, and it remains a serious problem for economic stabilization policy.

The course of monetary policy in 1975 had to take account of the urgent need to make further progress in dampening inflation, but it also had to ensure that conditions in money and credit markets would contribute to a good recovery in economic activity, and to the rebuilding of liquidity needed to sustain economic expansion. The middle ground sought by the monetary authorities led over the course of the year to generally easier credit market conditions, lower interest rates, and a substantial rebuilding of liquidity positions.

While the narrowly defined money stock, M_1 (currency and demand deposits), expanded at a relatively moderate 4.5 per cent rate from the fourth quarter of 1974 to the fourth quarter of 1975, the broader measures of money showed more substantial growth. M_2—which includes time and savings deposits other than large-denomination certificates of deposit (CD's) at commercial banks, in addition to currency and demand deposits—rose by 8 per cent, and M_3—which also includes deposits at thrift institutions—rose by 11 per cent.

On the basis of historical relationships, one might have expected that the moderate 4.5 per cent rate of growth in M_1 during 1975, Growth in monetary aggregates

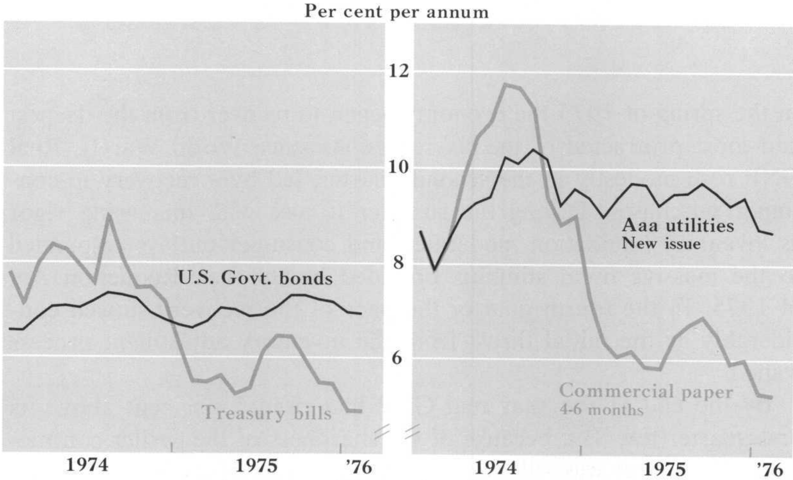


For definitions and notes, see Table 6 on page 53.

occurring in the context of a 9 per cent increase in nominal GNP, would have been accompanied by sharp increases in interest rates, particularly short-term interest rates. Yet in the latter half of the year, when nominal GNP increased at an annual rate of 15 per cent and the narrow money stock at only 5 per cent, interest rates did not rise at all. On the contrary, interest rates declined on balance over the second half of 1975, and by early 1976 both long- and short-term interest rates were below their levels of late 1974. Thus, even with large increases in aggregate spending, relatively moderate monetary growth was associated with an easing of credit conditions.

This changed relationship between money and GNP appears to reflect an important structural shift under way since mid-1974 that affects the amount of cash balances needed to support any given level of economic activity. These changes have probably resulted, in part, from public responses to the record levels of interest rates that prevailed in the spring and summer of 1974, and in part from recent financial innovations—including the spread of overdraft privileges extended by banks to demand deposit customers, the growth of NOW accounts (negotiable orders of withdrawal), telephonic transfers of funds from savings accounts to demand deposits, arrangements for making payments to third parties from savings accounts, and shifts of funds from demand deposits to savings accounts by governmental units (beginning in late 1974) and by business firms (authorized for the first time in the fall of 1975).

Interest rates



Monthly averages. U.S. Treasury bills, market yields on 3-month issues; U.S. Govt. bonds, market yields adjusted to a 20-year constant maturity by U.S. Treasury; Aaa utility bonds, weighted averages of new publicly offered bonds rated Aaa, Aa, and A by Moody's Investors Service and adjusted to an Aaa basis; prime commercial paper, dealer offering rates.

How long this shift in the public's demand for cash balances will continue remains to be seen. Clearly, increases in the income velocity of money as large as those that occurred in the latter half of 1975 cannot be counted on as a long-run matter. Nevertheless, there is little reason to expect that the innovational process that has been set in motion in recent years will end abruptly. As in 1975, monetary policy in 1976 will therefore need to be especially alert to signs of change in the rate of change in the relationship between the growth of money balances and the growth of aggregate demand. This would seem to mean, among other things, that greater emphasis will need to be placed on encouraging growth rates in the broader monetary aggregates that appear consistent with sustainable expansion in the Nation's economy.

Introduction

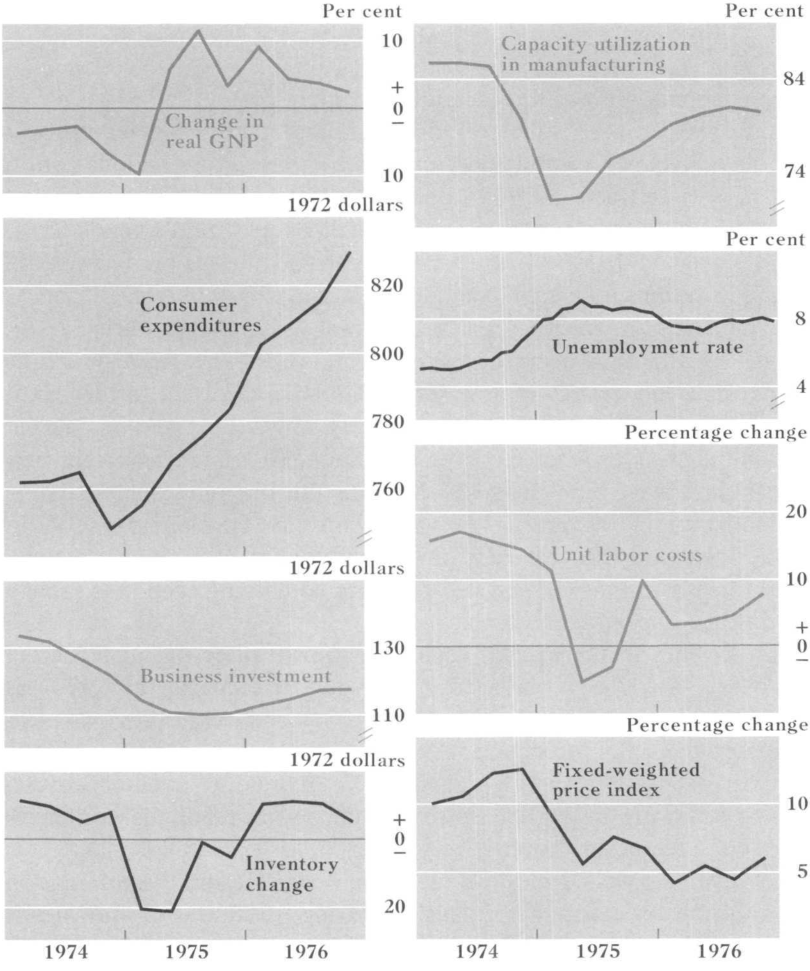
The economy grew at a reasonably favorable pace in 1976—at a rate about comparable to that at corresponding stages of other postwar recoveries. However, the 5 per cent gain in real gross national product (GNP) between late 1975 and late 1976 occurred in an economy that had only begun to recover from the steepest and longest recession since the 1930's. Thus, at the year-end the economy was still faced with unusually high unemployment and excess physical capacity.

The rate of advance in real activity was quite uneven during 1976. Much of the gain occurred early in the year. The strength of the expansion moderated in the spring and then slowed further until autumn, raising fears that the recovery might be "running out of steam" at low levels of resource utilization. In this environment new fiscal initiatives were proposed by both the outgoing and incoming administrations to provide tax reductions for consumers and businesses. Toward the year-end, however, the pace of economic activity again began to quicken and prospects for continuing economic growth during 1977 appeared favorable.

A slowing in the rate of economic growth after the first year of recovery—such as occurred following the first quarter of 1976—is not unusual in the course of cyclical expansions. As in previous postwar upswings, the proximate source of the slower growth of economic activity during 1976 was a leveling off in the rate of inventory investment, following an earlier sharp rebound; such rebounds are necessarily of a temporary nature.

No two business cycles are identical, however, and the retardation in the rate of economic expansion during 1976 was by no means predetermined. In 1976 factors other than the sluggish growth of inventory were also contributing to the slowing in economic activity. One of the most important of these was that real capital spending by businesses failed to expand at rates typical of most cyclical expansions. These outlays continued to decline during the first two quarters of the economic recovery—an unprecedented event in recent cyclical experience—and as of the end of 1976 they had not yet regained pre-recession levels when measured in real terms.

Indicators of economic performance



Change from previous quarter in GNP, 1972 dollars, U.S. Dept. of Commerce data at seasonally adjusted annual rates.

Consumer expenditures, business investment, and change in business inventories, U.S. Dept. of Commerce data.

Capacity utilization in manufacturing, Federal Reserve.

Unemployment rate, seasonally adjusted monthly data from U.S. Dept. of Labor.

Unit labor costs (private nonfarm), change from previous quarter, U.S. Dept. of Labor data at seasonally adjusted annual rates.

Fixed-weighted price index (1972 weights) for gross domestic business product, change from previous quarter, U.S. Dept. of Commerce data at seasonally adjusted annual rates.

This weak performance of business capital spending occurred despite a substantial recovery in corporate profit margins and a considerable improvement in the financial liquidity of businesses. Business confidence appears to have been severely shaken by the turbulent economic environment of recent years—especially by fears of a resurgence of inflationary pressures and by the trauma of the adjustments required during the steep decline in economic activity beginning in late 1974. Moreover, in many lines the pressure to invest has been diminished by the existence of large amounts of excess capacity. During the first quarter of 1975 the rate of capacity utilization had fallen to 71 per cent in the manufacturing sector, the lowest quarterly figure in the postwar history of this statistical series. Although the rate had recovered to an average of a little more than 80 per cent by the end of 1976, business firms remained very cautious about adding to capacity.

A second factor that contributed to the slowing in the U.S. expansion was the sharp deterioration in net exports of goods and services—from $20½ billion in 1975 to $6½ billion in 1976. Exports increased only a little, as foreign agricultural demands were limited by the excellent harvests outside Europe, and as demands for nonagricultural exports were held down by the sluggish recovery of most foreign economies. Merchandise imports, on the other hand, increased more than 25 per cent in 1976. In particular, fuel imports rose sharply, reflecting not only sizable increases in over-all U.S. consumption but also a continued, gradual decline in the domestic production of petroleum.

A third source of the slowing in the pace of expansion in 1976 was the slackening in the growth of Federal spending. During the first three quarters of the year Federal expenditures—as measured in the national income and product accounts—rose at an annual rate of 5½ per cent in current dollars, and very little in real dollars. This weak pace of Federal spending was spread among a number of budget functions and was not limited to income-support programs, which typically slow as the economy improves. Coming at a time when business inventory investment had leveled off and capital spending was lagging, the slower growth in Federal spending contributed to the retardation of the expansion in consumers' real incomes. As a result, the sluggishness of consumer spending that had begun in the second quarter was extended into the summer, and inventories began to appear excessive.

In fact, throughout much of 1976 businesses appear to have wrestled with problems of excess inventory accumulation. Production of nondurable goods rebounded at what was clearly an unsustainable pace in the latter half of 1975 and in early 1976. When growth in final demand began to slow, inventories of these goods rose rapidly—necessitating adjustments in current production. As a result, production of nondurable goods remained essentially flat from the spring into the fall. By midsummer, production adjustments had spread to the durable goods industries, as inventories in these lines also threatened to become undesirably large. The weaker-than-expected pace of business fixed capital outlays was responsible to some extent for this back-up of durable goods stocks; but so, too, was the much slower growth in consumer spending for durable goods, which in real terms, rose at an annual rate of only 3 per cent in the second and third quarters compared with 17 per cent in the first year of the recovery.

During the fourth quarter of 1976 businesses made substantial progress in eliminating excessive inventories. Retail sales began to pick up in October—apparently due in part to price concessions given by business firms—and during the Christmas buying season they advanced strongly. This strengthening of consumer demands, together with the earlier adjustments in production, quickly led to a working-down of excessive stocks of both durable and nondurable goods.

The performance of prices during 1976 was more favorable than in other recent years, but this may have been due in part to special factors. Consumer prices rose by about 5 per cent over the four quarters of 1976, compared with 7 per cent during the preceding year. Moderation in the pace of consumer price increases was attributable mainly to a marked slowing in price increases for foods and to declines in prices of petroleum products early in the year. Wholesale prices of industrial commodities moved up moderately during most of the first half and then accelerated later in the year. While some of this deterioration in price performance reflected unfavorable developments in the energy sector, upward adjustments in prices were fairly widespread among other sectors. Despite underutilization of industrial capacity in many industries, upward pressures on industrial prices continued in early 1977. In short, the underlying rate of inflation remained high by any standard except that of the past 3 years.

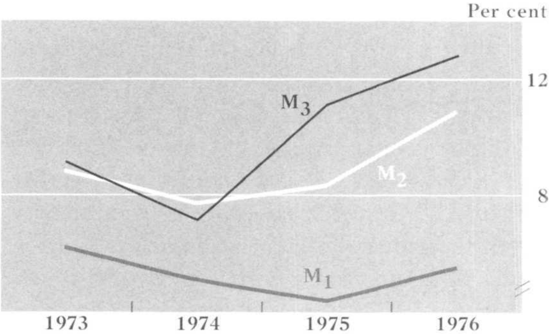
Increases in wage rates slowed in 1976 from the unusually rapid pace of the preceding 2 years, despite a heavy collective bargaining schedule. However, when fringe benefits and employer contributions to social security are taken into account, the rise in compensation was little different from that of 1975—averaging just under 8 per cent for all private nonfarm businesses. Meanwhile, growth in productivity slackened—reflecting in part the reduced pace of economic expansion in the latter half of the year. Thus, unit labor costs rose by about 4¾ per cent from the fourth quarter of 1975 to the fourth quarter of 1976. Such a marked rate of increase in production costs at a time of widespread underutilization of resources indicates the difficulty of curbing inflationary pressures in our society, and it underscores the need to design public policy measures that can bring about further progress in this critically important area.

During 1976 monetary policy sought to foster an expansion of money and credit that would sustain the economic recovery but that would not lend support to any resurgence of inflationary pressures. The financial environment that evolved was one of moderately declining interest rates and considerably more accommodative credit conditions in which business and financial institutions were able to bolster their liquidity positions.

Growth in the monetary aggregates was a little more rapid in 1976 than in the preceding 2 years. M_1—the money stock defined narrowly to include only currency and demand deposits—expanded 5.7 per cent between the fourth quarter of 1975 and the fourth quarter of 1976. M_2—which, in addition to M_1, includes time and savings deposits at commercial banks other than large-denomination negotiable certificates of deposit (CD's)—rose 10.8 per cent. M_3—which also includes the deposits at nonbank thrift institutions—increased 12.7 per cent.

Although M_1 did grow somewhat more than in 1975, its expansion continued to be less than might have been expected on the basis of historical relationships among the money stock, interest rates, and income. The income velocity of M_1—that is, GNP divided by M_1—increased about 4 per cent during the year. As a result, the cumulative growth of velocity since the first quarter of 1975 remained higher than in past business cycle expansions. Moreover, whereas

Growth rates of monetary aggregates



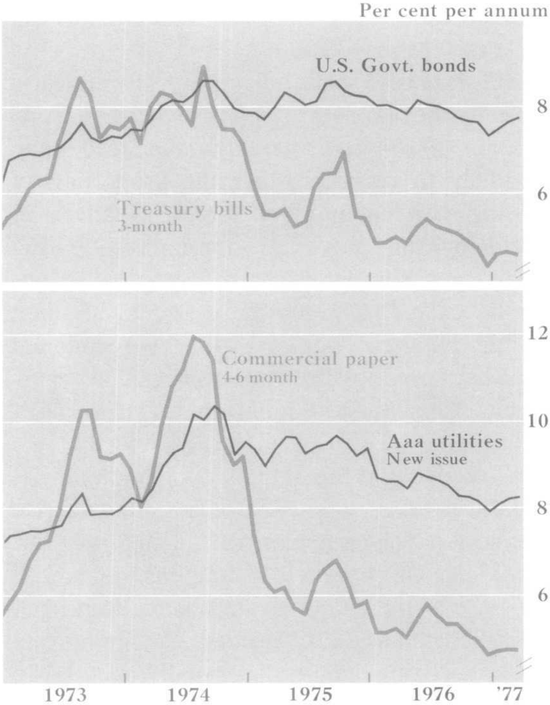
For definitions of these aggregates, see p. 46.

such periods typically have been characterized by significant increases in interest rates, during 1976 interest rates declined—in many instances reaching their lowest levels in several years.

The major factor behind this exceptional behavior of M_1 appears to have been the continuing competition for transactions balances from money substitutes, which tended to reduce the public's desired holdings of demand deposits. Consumers, businesses, and State and local governments increasingly economized on non-interest-bearing checking-account balances by availing themselves of relatively new financial instruments and money-management techniques. Of particular importance were various types of interest-bearing deposits recently authorized by regulatory bodies—most notably, those subject to negotiable orders of withdrawal (NOW) accounts and commercial bank savings accounts for businesses and State and local governments. Shifts of funds from demand deposits to such accounts are estimated to have reduced the growth of M_1 in 1976 by around 1½ percentage points.

The availability of the new savings deposits may also have prompted some shifting of funds out of large CD's and other money market instruments, thereby explaining to some degree the rapid growth of M_2 and M_3 and the extraordinarily wide spread between the growth rates of these broader aggregates and that of M_1. The large increases in M_2 and M_3, however, were attributable primarily to the relative levels of deposit rates and yields on market securities.

Interest rates



For notes see chart on p. 41.

Because banks and other institutions moved slowly to adjust their offering rates on savings and small-denomination time deposits, these rates exceeded those available on high-quality market instruments of like maturity throughout much of the year.

The liquidity of the economy, viewed broadly, continued to improve gradually during 1976. The supply of funds was ample—especially from financial intermediaries—and the total volume of funds raised by the nonfinancial sectors of the economy increased relative to GNP. Many business firms and financial institutions were able to achieve a significant further strengthening of their balance sheets by funding short-term debt in the bond markets or by adding to equity positions through the sale of new stock. Interest rates on most short- and long-term market securities showed declines of a percentage point or more over the course of 1976, while stock prices for the most part rose sharply early in the year and fluctuated narrowly thereafter at the higher level.

With unemployment still extensive and inflation persisting at a troublesome pace, the objective for monetary policy in 1977 remains broadly the same as that in 1976—to foster continued economic financial technology are likely to reduce further the proportion of expansion without releasing new inflationary forces. Changes in transactions balances held by the public in non-interest-bearing form—especially as demand deposits. However, a great deal of uncertainty remains about the extent to which these structural shifts may affect the relationship between money and other economic variables during 1977. Furthermore, possible regulatory actions bearing on the payments mechanism cast additional doubt on the reliability of historical relationships.

In order to operate constructively in this rapidly evolving financial system, therefore, the Federal Reserve will need to maintain a flexible approach to monetary policy, paying attention to the full range of indicators of financial conditions. On the whole, conditions in financial markets improved during 1976 as the inflation rate was reduced from the 1975 level, as economic expansion proceeded at a relatively moderate pace, and as business firms remained unusually cautious in their financial planning. Whether these or other factors will persist in holding back pressures on the cost and availability of credit during 1977 remains to be seen. The Federal Reserve, for its part, fully intends to encourage expansion in supplies of money and credit at rates commensurate with the underlying needs of a strong and expanding U.S. economy.

Introduction

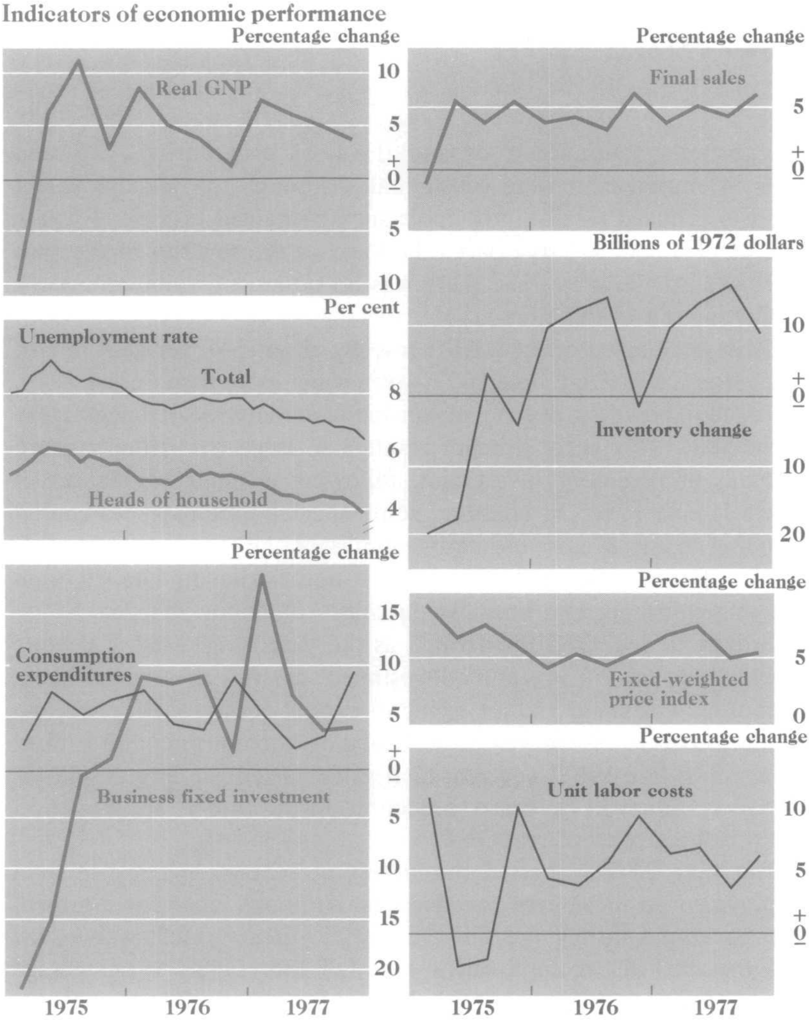
The economy continued to expand at a brisk pace during 1977, and gains in employment were substantial. Although the unemployment rate was reduced significantly, joblessness remained historically quite high at year-end, in large part a heritage of the severity of the past recession. At the same time there was no progress in moderating the underlying rate of inflation.

Gross national product (GNP) rose by about 5¾ per cent in real terms from late 1976 to late 1977—somewhat more than during 1976. As in 1976, however, over-all expansion of activity was strongest early in the year. This early strength resulted in large part from a sharp rebound of inventory investment, following a small liquidation of stocks late in 1976. In addition, some special circumstances caused spending to increase in the early months of the year; the most important of these was the effect of the auto strike in late 1976 in delaying consumer and business purchases of motor vehicles.

Growth of real GNP moderated as the year progressed, reflecting smaller increases in inventory investment, as well as a sluggishness of consumer demand and an easing of capital outlays during the two middle quarters of the year. But spending for consumption picked up again in late 1977, and real final sales posted the largest gain of the year, although a sharp reduction in inventory accumulation damped the growth of real GNP.

The year 1977 witnessed the largest percentage increase in total employment in more than two decades. Although labor force growth was also rapid throughout the year, employment growth was faster, and the over-all unemployment rate fell more than 1 percentage point to less than 6½ per cent at the year-end. The improvement was concentrated among workers who had lost their last job rather than among new entrants or re-entrants to the labor force. Unemployment rates remained extremely high for young and inexperienced workers, minority groups, and those disadvantaged by lack of skills or training.

In general the expansion in 1977 was quite widely based, with most of the major sectors contributing to over-all growth. The rise in real consumption spending, while slower than it had been earlier in



All figures for "percentage changes" are from previous quarter and are seasonally adjusted at annual rates.

Figures for the unemployment rate (seasonally adjusted monthly data) and for the change in unit labor costs are from U.S. Dept. of Labor. All other data are from U.S. Dept. of Commerce.

Fixed-weighted price index (1972 weights) is for gross domestic business product. Series designated as "real" are based on 1972 dollars.

Scales for changes in GNP, consumption expenditures, and business fixed investment are smaller than those for changes in final sales, fixed-weighted price index, and unit labor costs.

the expansion, was still substantial by historical standards. Spearheaded by a further strong rise in purchases of durable goods, consumer purchases rose 4¾ per cent in real terms over the four quarters of 1977.

Although growth of business fixed investment moderated after the first quarter, such outlays provided support for economic expansion in 1977. Capital expenditures increased by 8.3 per cent in real terms, as compared with a rise of 7 per cent during 1976. Spending early in 1977 was concentrated on light machinery, particularly on vehicles. Outlays for commercial and industrial construction began to pick up in the spring, however, and during the remainder of the year they rose at a healthy rate. Nevertheless, business capital spending continued to lag behind its typical cyclical performance; at the year-end, after nearly 3 years of economic expansion, real business outlays were still below the pre-recession peak.

Residential construction remained a strong expansive force in 1977. A vigorous sales pace in housing markets stimulated a further, major increase in homebuilding activity during the year. Private housing starts were at an annual rate of 2.1 million units in the final quarter, and for the year as a whole they totaled nearly 2 million, the most since 1973. Including additions and alterations as well as new building, residential investment rose 15 per cent in real terms during 1977. Strength in this sector was reflected in gains in other areas such as employment in contract construction, production of construction supplies, and sales of furniture and appliances.

Growth of final demands for goods and services in 1977 also reflected larger government outlays. Federal Government purchases in real terms rose proportionately faster than total output of the economy. At the same time, outlays of States and localities were buoyed by Federal grants-in-aid for countercyclical revenue sharing, local public works, and public employment programs. These grants, together with a substantial improvement in fiscal positions of State and local governments, helped to generate a 3 per cent increase in real purchases of these governments during 1977; by contrast, such purchases had declined marginally during 1976. In another fiscal action supportive of over-all growth, personal income taxes were reduced; this helped to sustain consumption spending and to build savings flows after the unusual expansion of consumer spending during the winter.

Higher costs of energy continued to have a strong influence on economic developments in 1977. For some time consumption of fuel had been constrained, reflecting both the reaction to the earlier quadrupling of the price of imported oil and the curtailment of economic activity during the recession. During the unusually cold winter of 1976–77, however, fuel imports rose strongly along with consumption, and as the economy expanded, they continued high. The result was a sharply increased bill for imported oil. This, in combination with rising imports of other goods and little change in demand for our exports, shifted the U.S. net balance on goods and services into a deficit (national-income-accounts basis), which persisted throughout the year. The deficit totaled $11 billion for the year as a whole—a shift of $19 billion from the 1976 surplus.

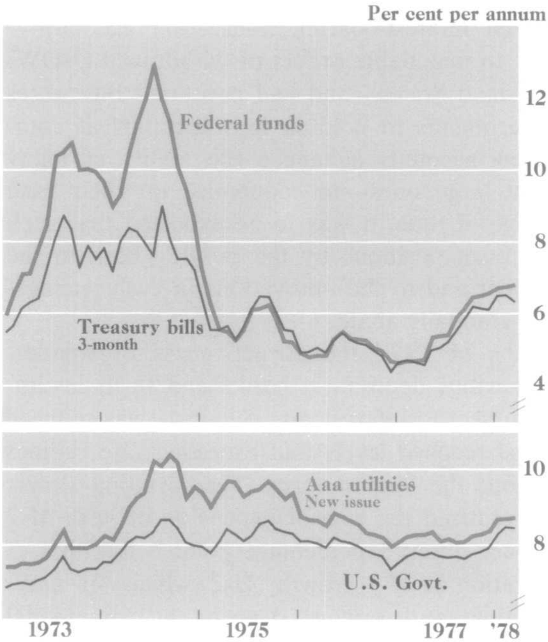
In part reflecting this deficit, the value of the dollar declined relative to the currencies of a number of our major trading partners. The initial effect was to raise the price of a wide range of imported goods, and thus add to inflation. While U.S. exports should be stimulated over the longer term by increased competitiveness, the impact to date appears to have been quite small.

Inflation continued rapid during 1977. Consumer prices rose about 6¾ per cent; during 1976 they had risen somewhat less, almost entirely because of a very small increase in food prices. Exclusive of foods, the rise in consumer prices was about 6¼ per cent during both 1976 and 1977. Wholesale prices exhibited a similar pattern; the average rise for industrial commodities remained in the neighborhood of 6½ per cent, whereas farm product and food prices, which had declined in 1976, rose during 1977, reflecting in large measure the effects of the unusually hard winter.

A variety of forces were operating to sustain price increases in 1977 in the face of continued sizable unemployment and ample productive capacity. The inflation of recent years continued to play an important role. Formal and informal indexation of wages, pensions, and welfare benefits to past price increases has mounted in the last decade, and the presence of such escalators lengthens the period necessary to unwind inflationary developments once under way. In addition, substantial cost increases arise from various government regulatory and payroll tax programs. Reflecting these and large increases in wage rates, hourly compensation in the private nonfarm business sector rose about 8½ per cent during 1977. At the same time, growth in productivity slowed from the cyclically advanced rate of 1976. As a result unit labor costs rose about 5.9 per cent; this was almost the same as in 1976, and much above the historical trend for this vital determinant of average price change. In addition, the deterioration of dollar exchange rates provided an upward bias to prices of imports and permitted larger price increases for domestically produced competitive goods.

Monetary policy in 1977 continued to be directed toward sustaining growth in the U.S. economy, while seeking to avoid additional inflationary pressures. Federal Reserve policy actions were designed to moderate the expansion in the monetary aggregates and to establish the basis for a slowing in inflation over the longer term. With demands for credit and money rising, short-term interest rates rose 1 to 2 percentage points over the year, and long-term market yields generally rose about ½ of a percentage point.

Interest rates



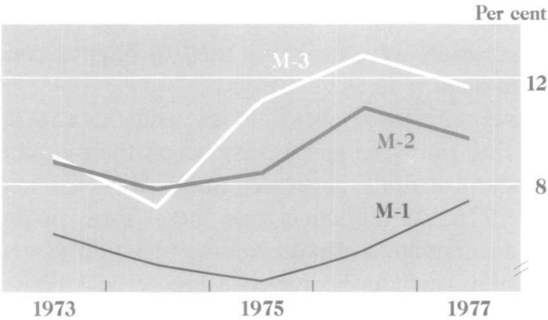
For notes see chart on p. 40.

In the two previous years *M*-1, the narrow measure of the money stock (currency and demand deposits), had grown considerably less than would have been expected on the basis of the historical relationships among money, income, and interest rates. The counterpart of this comparatively limited growth had been a larger increase in the income velocity of *M*-1—GNP divided by *M*-1—than at similar stages in previous business expansions. Since the spring of 1977, however, *M*-1 has grown about in line with earlier traditional relationships and from the fourth quarter of 1976 to the fourth quarter of 1977 the rate of growth in *M*-1 exceeded 7¾ per cent, well above the upper end of the Federal Open Market Committee's longer-run range of 4½ to 6½ per cent for this aggregate for that period.

The more rapid growth of *M*-1 appeared to reflect in part a reduction in the impact of previous financial innovations and of regulatory changes on money growth. Several years earlier, in 1974, the high levels of interest rates had induced the public, especially businesses, to use a growing number of cash-management techniques and devices that tend to minimize holdings of demand balances on which no explicit interest is paid. Moreover, regulatory and legislative changes after 1974 had authorized interest-bearing transaction accounts—particularly those subject to negotiable orders of withdrawal (NOW) accounts in the New England States—and had permitted businesses and State and local governments to hold savings accounts at commercial banks. These new accounts enhanced the ability of many economic units—not just large ones—to economize on their cash balances. With the passage of time, it was to be expected that such adjustments of financial asset positions by the public—both to the new regulatory environment and to the innovations in cash-management techniques—would gradually abate.

In the last few months of 1977 the attractiveness of smaller-denomination time and savings deposits at banks and thrift institutions—all of which are subject to interest rate ceilings—was reduced as market rates of interest reached levels that exceeded rate ceilings on time deposits of all but the longest term. The resulting slower growth of such deposits reduced the rate of expansion of both *M*-2 and *M*-3 in 1977 to a pace about 1 percentage point below that of 1976, despite the acceleration in *M*-1 growth. *M*-2, which—in addition to *M*-1—includes time and savings deposits at commercial banks other than negotiable certificates of deposit (CD's) issued by

Growth rates of monetary aggregates



For definitions of these aggregates, see Table 6, p. 38.

large banks, increased about 9¾ per cent over the year; this was close to the upper end of the longer-run range of 7–10 per cent for the aggregate for the period from the fourth quarter of 1976 to the fourth quarter of 1977.

As the growth of deposits subject to interest ceilings slowed, banks and thrift institutions turned increasingly to other sources for loanable funds. In the second half of 1977 commercial banks, for example, raised more than $20 billion through time deposits in denominations of $100,000 or more, a class of deposits not subject to regulatory interest rate ceilings. By contrast, in all of 1976 such deposits had declined by about an equal amount, and in the first half of 1977 they had contracted moderately, on average. Similarly, savings and loan associations, which had made net repayments of borrowings from the Federal home loan banks in 1976, borrowed more than $4 billion from this source in 1977 and an additional $4½ billion from other sources—mainly from commercial banks and by the issuance of mortgage-backed bonds.

Total funds raised in domestic credit markets reached record proportions in 1977. Borrowing by the Federal Government—although still large by historical standards—declined appreciably, and so did that by foreigners. However, private domestic nonfinancial sectors increased their credit demands sharply. Borrowing by households reached record levels, with the largest increases occurring in the mortgage market. The amount that consumers borrowed on mortgages exceeded their outlays on new and existing houses, suggesting withdrawals of equity built up in the increased value of the existing housing stock; such withdrawals were probably used to finance consumer expenditures and to acquire financial assets.

Nonfinancial businesses increased both long- and short-term borrowing as their financing gap—the amount by which their capital outlays exceeded the amount of funds generated internally—widened from the small total of 1976. At the same time these firms, in the aggregate, continued to accumulate a sizable volume of liquid assets. Finally, State and local governments borrowed a record $27 billion in 1977. However, as a result of advance refunding and of considerable budget surpluses, these units also accumulated substantial amounts of financial assets; they acquired, for example, more than one-fourth of the net issues of U.S. Government and Federal agency obligations.

Despite the considerable further increase in economic activity in 1977, resource utilization continued slack at the year-end, as indicated by the still high levels of unemployment and excess plant capacity. In order to sustain the pace of economic advance, the administration has proposed reductions in late 1978 in personal income taxes and in business taxes to encourage larger investment; such reductions are designed to offset mandated increases in payroll taxes and the effects of inflation in raising effective tax rates.

At the same time, the persistence of inflationary forces and the weakness of the dollar in foreign exchange markets suggest that public policies must be particularly sensitive to increasing pressures stemming from higher costs and higher prices. In this respect, the administration has initiated additional public and private efforts to address the cost-price problem more directly in 1978. The Federal Reserve, for its part, will pursue policies that encourage continued growth in economic activity and reduction in the unemployment rate, while seeking to attain further reduction in the rate of inflation over the longer run.

Introduction

U.S. economic activity remained on an upward path during 1978, making the current cyclical expansion to date the second longest of the postwar period. Employment increased substantially, and the unemployment rate declined further despite large increases in the labor force. At the same time, however, acceleration in the rate of inflation posed a threat to continued economic progress.

Inflation emerged clearly as the Nation's most urgent economic concern in 1978. The legacy of past price increases imparted a strong momentum to the inflationary process, and upward pressures on costs and prices were exacerbated by the poor performance of productivity, by adverse agricultural supply conditions, and by Government-mandated cost increases.

The deterioration in U.S. price performance added impetus to the decline in the international exchange value of the dollar that had begun in the latter part of 1977; the falling dollar in turn reinforced inflationary pressures by raising the costs of imported goods and by easing competitive constraints on the prices of domestically produced goods. By late October the decline of the dollar had become precipitous, and it imperiled the health of both the U.S. economy and the international financial system. On November 1 the Federal Reserve and the Department of the Treasury announced a package of actions intended to fight inflation and to bolster the dollar. The dollar improved markedly in subsequent weeks, but nonetheless showed a large net decline for the full year against other major currencies.

Throughout 1978 monetary policy was directed toward resisting additional inflationary pressures while providing financial conditions conducive to moderate economic expansion. Federal Reserve policy actions were designed to restrain growth of the monetary and credit aggregates and to resist further depreciation of the dollar abroad. The actions of the System, coupled with strong demands for money and credit and a heightened level of inflation, caused interest rates —especially on short-term instruments—to rise substantially.

Despite the tightening of credit conditions, the momentum of economic expansion was sustained throughout 1978 and into 1979. A liberalization of Federal regulations on deposit interest rates prevented a recurrence of disintermediation, and banks and thrift institutions were able to supply the credit necessary to finance high levels of homebuilding and other business and consumer outlays. Monetary restraint—as well as progress toward fiscal restraint—did, however, contribute to a needed moderation of economic growth from the stronger pace earlier in the expansion. A continued slowing of growth appears in prospect for 1979; and this slowing is desirable if the Nation is to avoid further inflation emanating from increased pressure on the relatively small margin of unutilized resources of capital and skilled labor.

The Economy in 1978

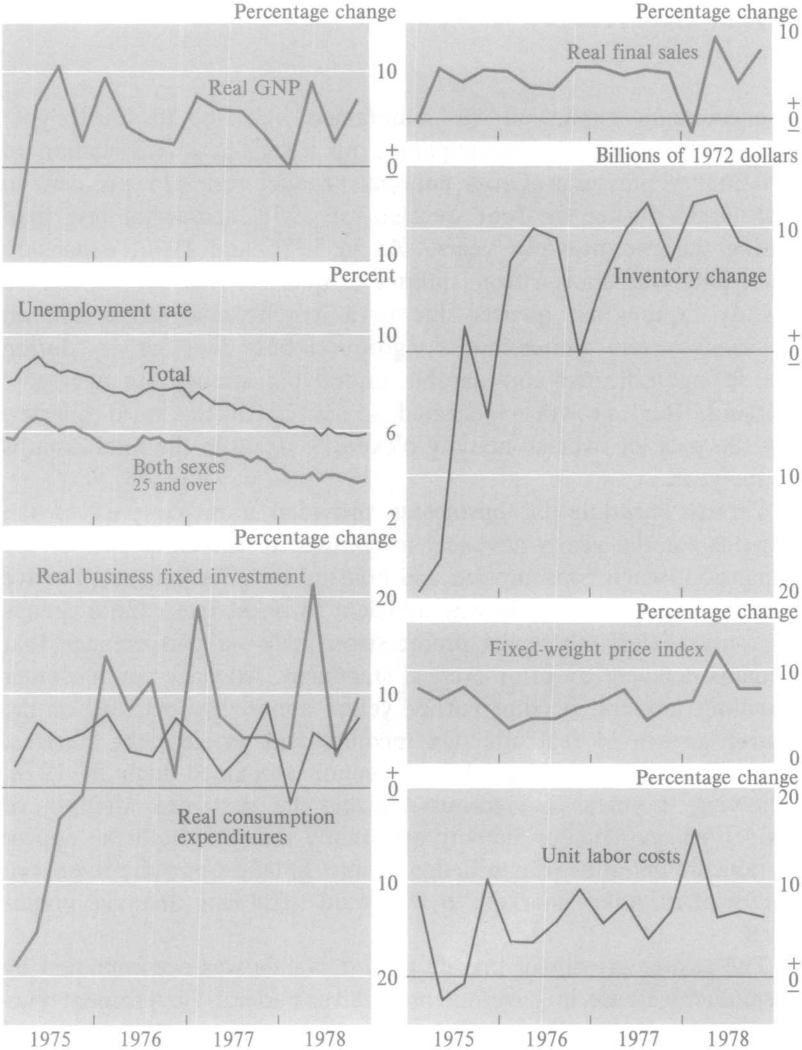
The economic expansion was maintained well into its fourth year during 1978, but was accompanied by a serious intensification of inflationary pressures. Gross national product rose 4½ per cent in real terms during the four quarters of 1978, somewhat less than during the two previous years.[1] As in 1976 and 1977, expansion of activity was uneven from quarter to quarter. Real GNP declined slightly in the first quarter due to a lengthy coal strike and an unusually severe winter, but a vigorous rebound of activity during the spring indicated considerable underlying strength in aggregate demand. Real growth moderated somewhat in the third quarter, but the pace of over-all activity picked up again in the final months of the year.

Capital spending by businesses provided a major part of the impetus for the year's advance, in contrast to the early part of the expansion, when consumption and housing were the most supportive sectors. Even so, the gain was sufficient to boost real capital spending only slightly above its prerecession peak—a performance that remains deficient by prior cyclical standards. Advances in consumer spending moderated from earlier years, apparently because of the slower growth in real after-tax incomes and record debt burdens. Expenditures for residential construction remained high in 1978, following 2 years of vigorous growth; the sustained strength of residential construction activity apparently reflected both the appeal of housing investment as a hedge against inflation and the improved ability of mortgage markets to withstand tightening financial conditions.

The slower growth of private final demands was accompanied by a smaller increase in government outlays. Federal Government purchases of goods and services declined in real terms while State and local purchases rose more moderately than during the previous year. The over-all budgetary position of the government sector became less stimulative; a decline in the Federal deficit was offset only in

[1] Unless otherwise indicated, annual figures represent changes from the end of 1977 to the end of 1978.

Indicators of Economic Performance



All percentage changes are measured from the previous quarter and are seasonally adjusted at annual rates.

The unemployment rate (seasonally adjusted monthly data) and the change in unit labor costs are from U.S. Department of Labor. All other data are from U.S. Department of Commerce.

The fixed-weight price index (1972 weights) is for gross domestic business product. Series designated as "real" are based on 1972 dollars.

Scales for unemployment rate and inventory change are larger than those for the other panels.

part by a reduction of the large operating surpluses experienced by State and local governments in recent years.

Inflation worsened noticeably during 1978, with the change in most broad measures of prices about 2 percentage points larger than over the previous year. The intensification of inflation early in the year was attributable in part to rapid increases in food prices; however, homeownership costs and gasoline prices also accelerated markedly from their rates of increase in 1977. In addition, the depreciation of the dollar on international exchange markets had inflationary effects on prices of imports and many import-competing goods. Moreover, labor cost pressures intensified as sizable increases in compensation continued—in part because of a boost in the minimum wage and higher payroll taxes—and labor productivity rose relatively little over the year.

The persistence of high rates of inflation apparently influenced the pattern of economic activity in several ways. To some extent, the continued relative strength in consumer spending for durable goods reflected the desire to purchase in anticipation of price increases. The personal saving rate remained at the lower end of its postwar range and aggregate household indebtedness relative to disposable personal income reached record levels. In the business sector, accelerating inflation continued to add uncertainties that probably lessened the willingness of firms to commit funds for major capital spending projects.

The economy displayed strong momentum at the end of 1978, with sales and production registering sizable gains. Employment and personal income posted large increases, and housing starts remained strong. In the business sector, new orders for capital goods held at a high level, and inventories remained generally lean relative to sales. Even so, there were mixed signs about the longer-run economic outlook. Survey and appropriations data suggested that capital outlays by businesses would grow more slowly over 1979. Retail sales strengthened markedly during the final months of the year, and the personal saving rate edged even lower at year-end to 5 per cent—near the lower end of its postwar range. This factor, together with continuing high debt burdens and weakening consumer sentiment, could retard near-term advances in consumption. Finally, the prospects for sustained growth were clouded by the persistence of intense inflationary pressures.

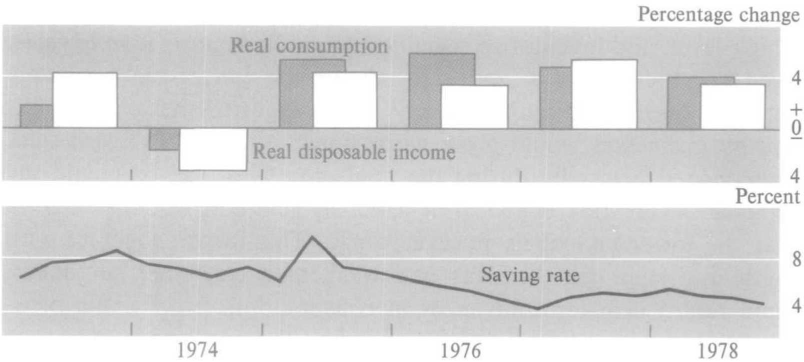
HOUSEHOLD SECTOR

Moderation of growth in real household spending accounted for much of the slowing of growth in real GNP in 1978. Consumer outlays increased 4 per cent in real terms, compared with average increases of 5¼ per cent during the three previous years. Nominal personal income rose at about the pace recorded earlier in the expansion, but inflation and higher tax burdens cut gains in real disposable income from the pace of the previous year. Wage and salary disbursements were up sharply in nominal terms, especially early in the year, and a rebound in farm income reflected higher food prices and government support programs.

Retail sales were depressed in the first quarter by severe weather, although outlays for heating increased sharply. Spending rebounded strongly in the spring, sparked by an increase in automobile sales to a near-record annual rate of 12.1 million units. In the second half of the year, growth of consumer spending was sustained at a generally rapid pace despite a slight decline in automobile sales.

In the housing sector, activity remained at a high level in 1978. Starts totaled 2 million units, up slightly from the previous year. Single-family starts edged off to 1.4 million units, while sales of new and existing homes remained at about the advanced rate of late 1977. Average prices of new units sold rose about 13 per cent during the year, in part reflecting some upgrading in quality. Starts of multifamily dwellings increased about 9 per cent to 580,000

Income, Consumption, and Saving



Based on U.S. Department of Commerce data, seasonally adjusted at annual rates. "Real" is in terms of 1972 dollars. Changes are from fourth quarter to fourth quarter.

units; nonetheless, activity in this sector remained well below the peak levels of the early 1970's. Multifamily construction in 1978 was supported by an increase in units under the Section 8 rental subsidy program of the Department of Housing and Urban Development, which is aimed at low- and moderate-income families.

At the end of the year, housing markets remained generally firm. Sales of new single-family homes, which had dipped during the summer, turned up again during the fourth quarter, and total starts remained close to the annual rate of 2 million units that had prevailed for a year and a half. High interest rates on mortgages and already large household debt burdens are, however, likely to retard housing activity in 1979.

BUSINESS SECTOR

Business fixed investment rose over 9¼ per cent in real terms during 1978, slightly more than the 1977 gain and about twice the rate of advance in over-all economic activity. A very sharp increase in real capital spending in the first half of the year was followed by a rise of 6½ per cent in the second half. Outlays for structures began to show relatively greater strength in 1978 than in 1977, paced by large increases for industrial and commercial buildings. Investment in producers' durable equipment grew somewhat more slowly, as business purchases of motor vehicles tapered off.

Investment in the manufacturing sector continued to grow moderately as utilization rates gradually increased through the year. Gains in capital outlays were strongest among producers of durable goods, particularly in the stone, clay, and glass, electrical machinery, and aircraft industries. In the nondurable goods sector, producers of rubber and food also recorded large increases. Investment by materials producers, a group that includes some manufacturers in both the durable and the nondurable goods categories, continued to advance at a relatively modest pace, reflecting an adequate margin of unused capacity. Outside the manufacturing sector, the air transportation industry posted the largest increase in spending, and strong gains were also evident in railroads, communications, and electric utilities.

Advance indicators of capital spending were mixed at year-end. Contracts and orders for plant and equipment generally moved ahead vigorously in the fall after having been nearly unchanged over most of the summer. Surveys of business intentions and capital appropriations for the manufacturing sector suggested some slowing of spending during 1979.

Inventory policies were generally cautious in 1978, continuing a trend that has characterized most of the present expansion. Inventory investment declined somewhat over the year, and inventory-sales ratios for most sectors remained low to normal on an historical basis. Most of the accumulation of stocks in the manufacturing sector was at durable goods producers, reflecting the relatively more intense demand for these products. At the trade level, wholesale stocks were swollen early in the year by rapid increases in prices of agricultural products and food; in the fall some overhang did emerge at general-merchandise retailers, but the sales surge in the final quarter appears to have absorbed a good deal of this excess.

GOVERNMENT SECTOR

As is typical during a business expansion, the government sector provided less stimulus to aggregate activity in 1978 than earlier. At the Federal level, the growth of spending slowed, and large gains in nominal incomes combined with mandated tax increases to push up receipts. As a result, the Federal deficit for the calendar year declined to about $30 billion on a national income accounts basis—roughly $18 billion less than in 1977, but still large relative to similar phases of past expansions.

Federal expenditures rose 9 per cent during 1978. Purchases of goods and services—the component of spending that is included directly in GNP—declined slightly in real terms, following an increase of 6 per cent during 1977. The reduction in purchases was most noticeable in the nondefense area, as net loan redemptions by farmers under the agricultural price support program of the Commodity Credit Corporation (CCC) more than offset increases in other nondefense expenditures.[2] Real defense spending declined in 1978 following a 3 per cent rise in 1977.

Transfer payments to individuals grew only moderately, owing to a sizable decline in unemployment compensation. Grants to State

[2] CCC loans are treated as Federal purchases in the national income accounts because the value of farm products in inventory, which are used as collateral for the loans, is transferred from the farm to the government sector. Similarly, loan repayments are treated as negative purchases in the Federal Government accounts.

and local governments rose briskly over most of the year, with an expansion in local public works and public employment programs; however, late in the year funds for the countercyclical revenue-sharing program expired and funding for public service employment began to taper off.

At the State and local government level, purchases of goods and services grew at a 3½ per cent rate in real terms over the course of 1978, somewhat below the gain of the previous year. Construction outlays, supported by Federal grants, increased sharply in real terms, dramatically reversing the trend of recent years. State and local employment, however, grew by only 200,000 jobs—about half of the average gain since 1970—as the number of jobs in the Federally supported public service employment program reached targeted levels. The operating surplus in the State and local sector—that is, the surplus excluding net savings by social insurance funds—fell sharply in 1978. Indeed, the sector's receipts and expenditures moved into virtual balance by the third quarter, marking the end of the large operating surpluses that had prevailed since late 1976.

Fiscal conservatism at all levels of government became a prominent political and economic issue in 1978, and the passage of California's Proposition 13 in early summer stimulated action in other areas of the Nation. Budget-reduction proposals appeared on the ballots of 19 other States in November, and although voters generally chose less rigid methods of holding down tax burdens, the growth of State and local government budgets is likely to be restrained for a number of years.

LABOR MARKET DEVELOPMENTS

Demand for labor remained strong during 1978. Employment in private nonfarm establishments increased by 3½ million, exceeding the exceptionally strong rise during 1977 despite the slower growth in over-all output. Construction employment rose about 450,000 to a record level, and manufacturing employment increased by more than 700,000, with sizable gains in the machinery, transportation equipment, and metals industries.

Hiring outpaced the continued rapid growth of the labor force over the year, and the unemployment rate declined 0.8 percentage point to an average of 5.8 per cent in the fourth quarter. While labor markets for experienced and skilled groups of workers tightened, joblessness was still very high at year-end among persons aged 16 to 24 and among minorities.

A major disappointment in 1978 was the poor performance of productivity: output per hour in the nonfarm business sector showed relatively little growth. Productivity growth had bounced back in a fairly typical fashion in the first 2 years of the expansion, but after 1976, growth in output per hour resumed the slow pace that had been characteristic of over-all productivity since the late 1960's. The reason for this pattern is not entirely clear, although several factors appear to have contributed to it, including the sluggish performance of capital spending in recent years, the emergence of a less experienced labor force due to demographic changes, and environmental and safety requirements that have directed resources to uses traditionally not measured as output.

Reflecting the lackluster performance of productivity and the continuing large increases in hourly compensation, the rise in unit labor costs during 1978 accelerated to about 9 per cent, the sharpest rise since 1974. Compensation in 1978 was boosted by a pronounced speed-up in wage rate increases outside the manufacturing sector. Construction wages rose sharply for the first time since 1974, and pay rates in the relatively low-wage sectors such as trade and services were pulled up in part by the legislated rise in the minimum wage. At the same time, wages in the manufacturing sector rose 8¼ per cent, about the same pace as that during 1977 despite a light schedule of collective bargaining. In addition to more rapid wage increases, higher payroll taxes for social security and unemployment insurance added further to the acceleration in hourly compensation.

PRICES

In addition to the sizable increases in unit labor costs, special developments in the food, homeownership, and international sectors contributed to the acceleration in the rate of inflation in 1978. In part because of these special factors, price increases far exceeded most forecasts made at the beginning of the year: the consumer price index rose about 9 per cent during 1978 as did the fixed-weight price index for gross business products and the producer price index for finished goods.

Retail food prices increased about 12 per cent during 1978, the largest rise since 1974. The increases at the retail level reflected a jump of nearly 20 per cent in prices of farm products following little change in the previous year. Price increases for meat were especially rapid and those for other food items were also quite large.

In general, prices outside the food area also rose rapidly during 1978. Energy prices increased about 8 per cent at retail. Gasoline prices changed little in the first half, but a tightening of supplies led to a sharp upturn later in the year. Natural gas prices continued to surge upward during most of the year. Consumer prices of services excluding energy accelerated to an annual rate of 9½ per cent from 8 per cent in 1977, reflecting in part the 12½ per cent rise in the homeownership component; strong demand pressures on house prices and rising mortgage interest rates were mainly responsible for that rise. Also, consumer prices were boosted by the depreciation of the dollar, which had noticeable direct impacts on the prices of imported merchandise and indirect effects on prices of domestic automobiles and other goods that are competitive with imports.

At the producer level, prices of capital equipment accelerated less during 1978 than those for finished consumer goods. Prices of crude materials—both food and nonfood commodities—were up sharply, and prices for construction materials also rose rapidly.

In an effort to restrain price increases, the President in late October announced an anti-inflation program that included a commitment to Federal budgetary restraint as well as voluntary wage and price standards and regulatory reform. The general price standard calls on firms to limit their increases to 1/2 of a percentage point below their average annual price rise during the 1976–77 period. Wage increases are to be generally limited to 7 per cent a year. The program also sets an alternative profit-margin standard, provides for public monitoring of certain price and wage increases, and includes a legislative proposal for real-wage insurance.

Although the program holds out hope for a gradual unwinding of the wage–price spiral, inflationary forces appear likely to continue strong in 1979. The collective bargaining calendar is quite heavy, and no relief from food price pressures is in sight. In addition, legislated increases in the minimum wage and in social security taxes will once again add a premium to labor costs. Furthermore, the Organization of Petroleum Exporting Countries has announced an increase in the price of oil for 1979, which will have an adverse effect on prices, as will the continuing impact of the 1978 depreciation in the international exchange value of the dollar.

Introduction

The U.S. economy expanded little in 1979, in a worsening inflationary environment. In real terms the gross national product increased only about 1 percent over the year, compared with nearly 5 percent during 1978; all major domestic sectors of the economy showed reduced rates of growth. Employment also increased less than in 1978, but growth in the labor force moderated, and the unemployment rate fluctuated within a narrow range throughout the year.

Acceleration of prices during 1979 reflected to a considerable extent the sharp increase in the prices of oil and other energy-related items. Food prices also rose substantially in the early part of the year. Even excluding energy and food, however, prices increased more rapidly last year than in 1978, as a decline in productivity resulted in a marked rise in unit labor costs.

The primary goals of monetary policy in 1979 were to curb inflationary expectations at home and to maintain the value of the dollar abroad without exacerbating recessionary tendencies. The policy of progressive restraint pursued by the Federal Reserve beginning in the spring contributed to slower growth in real economic activity, but inflationary pressures remained intense. Over the second and third quarters of the year, the monetary aggregates expanded at rates well above those specified by the Federal Open Market Committee and faster than was appropriate to the containment of inflation. Moreover, highly speculative activities emerged in commodities markets and the dollar came under increased pressure in foreign exchange markets. To counter these developments, the Federal Reserve on October 6 announced a set of actions, including new operating procedures, designed to provide greater assurance of control of the aggregates.

These measures, together with the relatively sluggish pace of economic expansion, brought a marked reduction in the fourth-quarter growth of both the monetary aggregates and the volume of credit made available to the economy as a whole. Most market rates of interest increased sharply immediately after October 6, and although some had receded from their highs by the end of the year with the moderation in money and credit demands, rates generally remained at near-record levels. On the other hand, the favorable initial effect of the policy actions on the exchange value of the dollar was later eroded as foreign interest rates increased further and as financial markets reacted to the uncertainties associated with developments in the Middle East.

At year-end, the short-term outlook for inflation remained bleak. Inflationary pressures seem likely to continue intense, not only because of the further boost in oil prices but also because past increases in costs and prices will still be working their way through the economy. In these circumstances, the urgent task of policy is to make sure that inflation is not exacerbated by the development of excessive demands on the economy or by unrealistic expectations as to the future strength of markets.