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January/February 1978

ECONOMIC PERSPECTIVES

Review and Outlook: 1977-78

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ECONOMIC PERSPECTIVES

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Review and outlook: 1977-78

Last year, after surmounting the winter fuel crisis, the economy scored above-average gains in output, employment, and income. The star performer was residential building, especially single-family homes. Price inflation continued at a rapid pace. In contrast to the general prosperity, farm income declined as record harvests depressed commodity prices. Heavy oil imports were associated with a record deficit in the balance of foreign trade. Another large deficit was recorded in the federal budget. Interest rates moved higher as all classes of credit rose. Early in 1978 the expansion retained substantial momentum. Nevertheless, a reduction in federal taxes was widely urged to provide additional stimulus.

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Review and outlook: 1977-78

Business: upswing retains momentum

As 1978 gets under way, prospects appear favorable that the expansion that began in the spring of 1975 will continue through another year. Developments in the states of the Seventh Federal Reserve District—Illinois, Indiana, Iowa, Michigan, and Wisconsin—have paralleled national trends, allowing for differences related to their mix of industries.

In 1977, for the second straight year, large gains occurred in output, employment, personal income, and profits. Total agricultural output was at a record level. Consumers again increased spending substantially, especially on durable goods, using instalment credit extensively. Construction activity was led by residential construction, with single-family home starts at a record level. Businesses increased investments in inventories and capital goods, but at a cautious pace. Government spending on goods and services at the federal and state/local levels combined rose somewhat less than the gross national product (GNP). All classes of credit expanded substantially and interest rates rose, particularly short-term rates.

There are significant flaws in the generally favorable economic picture. Most glaring is the huge deficit in the nation's international trade balance, reflecting heavy dependence on imported oil. Incomes of most farmers are sharply depressed, paradoxically because of bountiful harvests of major crops. Many observers are concerned over the failure of business capital spending to rise more rapidly. Some bankers are disturbed that large corporations are not using credit lines more intensively. Rising market interest rates are tending to reduce the supply of funds available to thrift institutions, the dominant suppliers of residential mortgages. Some car models have not been selling well recently, and output schedules have been reduced. Finally, there is a deep uneasiness over continued price inflation at a seemingly "imbedded" rate of 6 percent annually, and an unending string of large deficits in the federal budget.

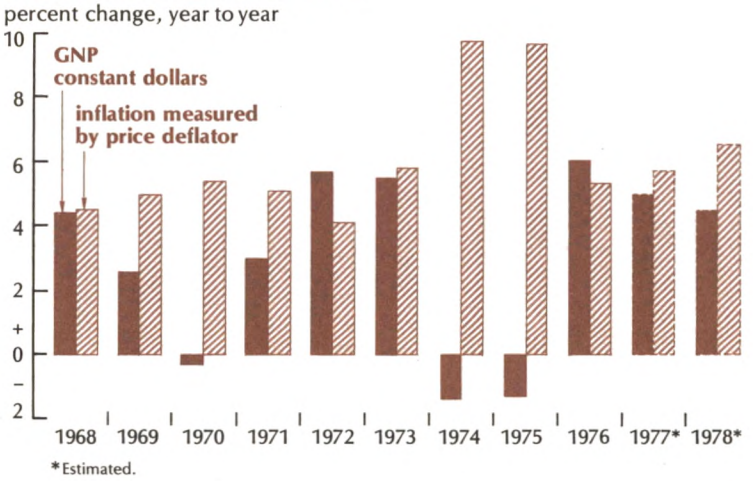
A fairly good year—but

Despite a bad start associated with severe winter weather and natural gas shortages, the performance of the economy in 1977, in broad outline, was remarkably close to the typical forecast made at the start of the year. The gross national product totaled almost $1.9 trillion, 11 percent larger than in 1976. Adjusted for inflation of 6 percent, "real" GNP was up 5 percent.

The rise in real GNP last year followed a gain of 6 percent in 1976, the first full year of expansion. Both years exceeded the long-term growth trend of about 3.5 percent, but this improvement did not fully make up the shortfall caused by year-to-year declines of more than 1 percent in both 1974 and 1975.

In mid-January of 1977 the nation was suddenly confronted with an unprecedented energy crisis. Except in the West, the winter had been abnormally cold starting in October. January was the worst month, with temperatures averaging 10 degrees or more below normal in many major cities. Requirements for natural gas to heat homes and

Output and prices are expected to increase again in 1978



other structures seriously depleted reserves in a number of areas. Utilities were forced to sharply reduce gas deliveries to many industrial customers. Many schools were closed, and hundreds of thousands of workers were laid off temporarily. For a time it was feared that sufficient gas would not be available to heat residences in certain areas. The situation was exacerbated by high winds, heavy snows, and frozen waterways that impeded deliveries of oil and coal. The President was granted special powers to deal with the emergency.

The winter fuel crisis subsided after mid-February. Conservation measures, relaxation of some restrictions on the use and pricing of fuel, adjustments in production processes to use alternative fuels, and a favorable turn in the weather all played a part. Recovery in most sectors hit by fuel shortages and transportation problems was very rapid in late February and March. Surprisingly, data subsequently available showed economic growth in the first quarter to be at the fastest pace for any quarter of the year!

The challenges of the severe winter were met successfully and the worst consequences feared did not occur. Nevertheless, the experience left an indelible impact. The rapid rise in fuel costs, under way for years, accelerated sharply. Businesses and households took steps, often involving expensive capital outlays, to reduce needs for fuel in general and natural gas in particular. Congress began deliberations on far-reaching legislation to encourage fuel users to conserve and, when possible, to switch to coal, and to stimulate development of new fuel supplies. A Department of Energy was established.

In the past the spectacular growth of the American economy has been based on abundant supplies of energy at relatively cheap prices. The general public is now more receptive to the warnings of experts who had been proclaiming for years that the day of cheap energy was over. Intelligent policies relating to the production and use of energy will provide the key to the nation's future growth and prosperity.

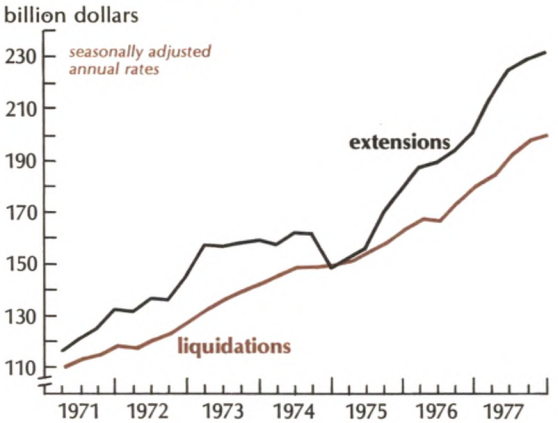
Consumers spend freely

Consumer spending on goods and services accounts for about 65 percent of GNP. Total consumer spending is closely related to disposable personal income (DPI)—current income from all sources less taxes. In the past decade consumer outlays of all types have ranged from 92 to 95 percent of DPI. The residual amount, 8 to 5 percent, is called "personal savings." This residual is influenced by the extent to which households supplement current income by incurring instalment debt.

Consumer spending remained relatively strong through the 1974-75 recession, when business firms cut back sharply on investments in inventories and capital goods. For 1975 as a whole consumer spending rose 10.2 percent in current dollars, while GNP rose 8.2 percent. In both 1976 and 1977 consumer spending increased at almost precisely the same rate as GNP.

Last year consumer spending rose more

Consumers increased instalment debt sharply last year



than 10.5 percent, while DPI rose 9.5 percent. As a result, the savings rate dropped to 5 percent, down from 5.6 percent in 1976, and well below the 7.5 percent average for the years 1973-75. In part, the drop in the savings rate last year reflected heavy purchases of autos, appliances, and other durable goods, often with the aid of instalment credit extended by banks, sales finance companies, and credit unions. Spending on durable goods rose 13 percent last year, while nondurables rose 8 percent and services, including rent, increased 12 percent.

Extensions of consumer instalment credit totaled about $225 billion in 1977, a record by a wide margin. Liquidations of these debts totaled about $195 billion. Outstandings, therefore, rose $30 billion, compared to $21 billion in 1976. Liquidations of instalment debt have been at a high rate relative to DPI on the basis of past experience. Nevertheless, most lenders report that delinquencies are at a low rate, far below the levels of the recession. The continued willingness of consumers to incur instalment debt freely will provide a major clue to the nation's economic performance in 1978.

Early in 1977 the Administration had advocated a $50 per capita tax rebate, and a similar payment to nontaxpayers, to provide consumers with additional purchasing power. As fuel bills skyrocketed in January and February, it was widely argued that an even larger income supplement was required. As the economy showed adequate improvement in the spring, however, these proposals were withdrawn.

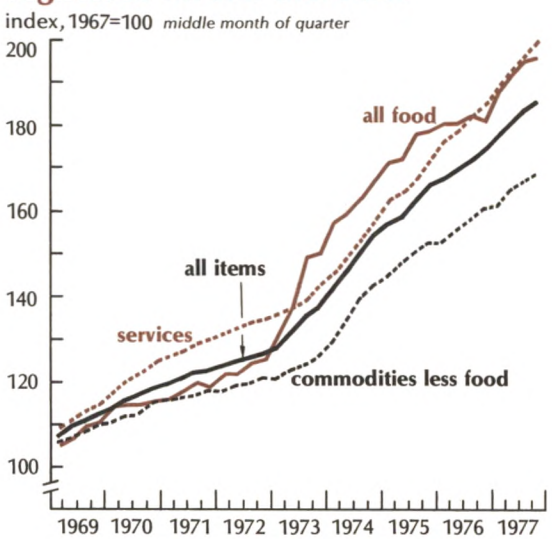
Large retailers reported sales during the Christmas season to be excellent, above budgeted expectations in many cases. Many of these companies reported a continuance of strong sales after Christmas as well. Some described their inventory positions as below desired levels, indicating a need for increasing orders to suppliers.

Consumer price rise accelerates

The government's consumer price index (CPI) averaged 181.5 in 1977 (1967=100) up 6.5 percent from 1976. In 1976 the CPI had increased 5.8 percent, down from 9 percent in 1975, and 11 percent in 1974. It had been hoped that inflation would moderate again in 1977. However, prices shot up at a 10 percent annual rate in the first quarter, partly because of weather-induced increases for fuels and foods. Prices of certain imported foods, including coffee and cocoa, soared to record highs.

The rate of inflation slowed after midyear. Nevertheless, in December the CPI

The consumer price index registered further increases



was 6.8 percent above the year-ago level. Food was up 8 percent, medical care 9 percent, and fuels and utilities 12 percent.

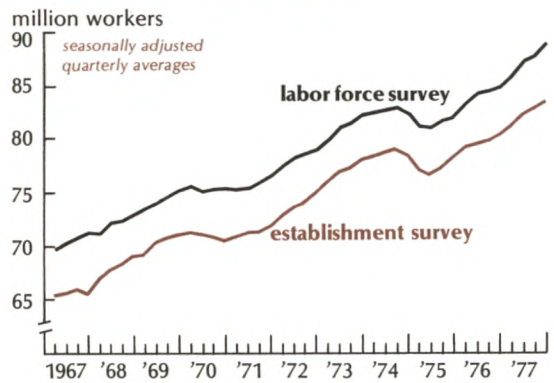
The performance of the CPI is of vital importance. For millions of individuals wages, salaries, pensions, and welfare benefits are automatically "escalated" in line with increases in this index. Thus past inflation helps to perpetuate itself. Although some of the forces that pushed up prices last year were temporary, most forecasters believe that the CPI will rise at least as fast in 1978 as in 1977.

Experience of recent years has tended to reduce the public's threshold of concern over rapid price inflation, particularly for individuals who believe they are "protected" through income adjustments. But a 6 percent rate of inflation means that the price level doubles in 12 years. At a 7 percent rate doubling occurs in 10 years; at 10 percent in seven years. For a large proportion of the population price increases of such magnitudes may cause severe hardship. Moreover, experience in many countries suggests that rapid inflation feeds on itself, thereby causing an accelerating spiral with far-reaching social and political consequences.

Employment and unemployment

In December total employment, measured by the government's survey of households, reached 92.6 million, up 4.2 million or 4.7 percent from the year-ago level.

Employment growth very rapid since the spring of 1975



Since the recession low of March 1975, employment has increased 8.4 million or 10 percent. Payroll employment, reported by employers, has traced a roughly similar pattern. Gains in employment have been fairly steady throughout the expansion, but have been concentrated in trade, service, and government rather than in manufacturing. Overall, the performance of the economy in creating jobs for a growing labor force compares favorably with earlier expansions.

Press accounts of labor market developments tend to emphasize unemployment rather than employment. The number of unemployed, defined as those without jobs who are seeking work, has remained disappointingly high despite the rapid rise in employment.

Unemployment averaged 7 percent of the total labor force in 1977, but was 6.4 percent in December. At the worst of the 1974-75 recession the rate was 9 percent. Unemployment averaged 5 percent in 1973, and less than 4 percent in the late 1960s. Unemployment has been particularly high among minorities and the young generally.

Continued high unemployment is related to the unexpectedly rapid growth of the labor force in recent years. In late 1977, 63 percent of people 16 and over were in the labor force. This was a record high, up from 62 percent a year earlier and 61 percent in 1973. The rapid rise in the labor force largely reflects an acceleration in the number of married women who have taken jobs in a job market that is increasingly receptive to them.

Labor costs and prices

In the long run inflation can be contained only if labor costs per unit of output are reasonably stable, as was the case in the early 1960s. Stability in unit labor costs, in turn, can be achieved only if increases in compensation per hour, including employer contributions for social insurance, do not exceed increases in output per hour (productivity). This has not been the case in recent years.

By Department of Labor calculations productivity grew at an annual rate of 3.3 per-

cent in the period 1947-66. In the 1966-73 period productivity gains averaged only 2.1 percent. In 1974, partly because of the oil embargo and the recession, there was a *decline* of almost 3 percent in 1974 followed by increases of less than 2 percent in 1975 and 4 percent in 1976. Last year the rate of gain fell back to about 2 percent.

While productivity gains have slowed, increases in compensation have been maintained at a rapid pace. From an average rate of rise of almost 7 percent in the 1971-73 period, the increase in compensation jumped to 9 percent in the years 1974-77. Some contracts negotiated by unions brought increases well in excess of this average.

Largely because of the disparity between increases in compensation and increases in productivity since 1972, unit labor costs have been rising at a rate of over 6 percent, closely approximating the rate of price inflation. With compensation gains expected to approach 9 percent again in 1978, and with little hope for a substantial spurt in productivity, it is widely accepted that inflation will again approach or exceed the 6 percent level.

Manufacturing output rises

After declining more than 13 percent from September 1974 to March 1975—one of the sharpest drops since World War II—manufacturing output began a gradual recovery. In December 1976 the 1974 peak was regained. Severe weather caused a decline in January 1977, but, surprisingly, of less than 1 percent.

Manufacturing's recovery from the disruptions of January was swift. Output snapped back to the December level in February. Each month in the February-December period saw at least a slight rise in total manufacturing output, although some industries cut production at times, notably steel and autos, in response to softening demand.

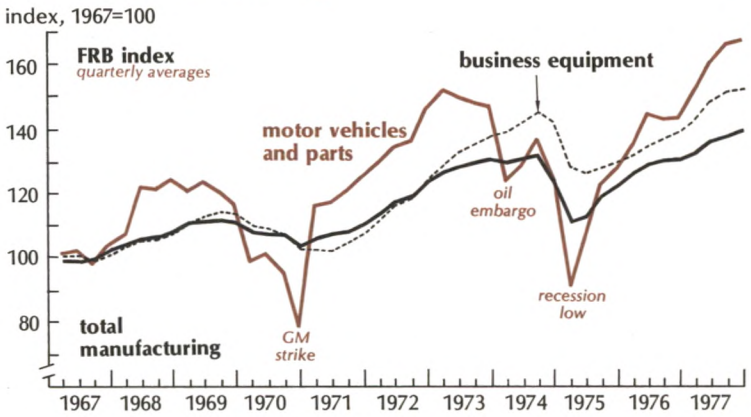
In December total manufacturing output, measured in physical units by the Federal Reserve's Index of Industrial Production, stood at 140 (1967=100). For 1977 as a whole output was up 6 percent, following a rise of 10 percent in 1976.

Durable goods manufacturing, in the aggregate, has lagged nondurables in recent years. Within these broad categories, however, there have been wide variations. Among the nondurables, chemicals have been very strong, while apparel, beset by imports, has been weak. Among the durables, the rise in business equipment and motor vehicles has exceeded total manufacturing, but activity in steel, aerospace, and ordnance has remained well below earlier peaks.

Steel plagued by imports

Shipments from U.S. steel mills rose only 2 percent in 1977 to about 91.5 million tons, instead of the 5 to 10 percent rise some analysts had anticipated at the start of the year. Last year's volume contrasted with the industry's peak years of 1973 and 1974, when shipments were at record levels of 111 and 110 million tons, respectively. Some steel-using industries bought less steel than had been expected, particularly producers of heavy capital goods, but the main reason for the

Auto industry has led expansion of total manufacturing



shortfall was rising imports.

Steel imports totaled a record 19 million tons in 1977, while exports were only 2 million tons. Since 1967, the lowest year for steel imports was the recession year 1975, with 12 million tons. Imports accounted for about 18 percent of total domestic supplies last year, approximately the same as in 1971 when users were hedging against a possible domestic steel strike. Twenty years ago imports were less than 2 percent of domestic supplies. Western European producers accounted for most of the rise in steel imports last year. A large share came into the Great Lakes region via the Seaway.

In August a number of major steel producers started a series of closings of their less efficient facilities with resulting layoffs of workers. The Administration pledged support of moves to halt "dumping" of foreign steel in U.S. markets at prices that do not cover full costs of production. A court decision also pursued the same end. In the fourth quarter there were signs that some foreign producers were easing efforts to sell in the United States. The fall in the dollar may have been partly responsible. In any case, U.S. mills reported increases in orders in December, and a rise in output was projected for the first quarter.

Motor vehicles

Cars and trucks were prime movers of the business expansion in both 1976 and 1977. Some producers are confident that last year's levels of output and sales can be equaled or even exceeded in 1978.

Passenger car sales totaled 11.2 million in 1977, up 11 percent from 1976 and second only to 11.4 million in 1973. A record total of over 2 million of the cars sold last year were imports, mainly from Japan. The share of the market going to imports at 18.5 percent also set a new high. Truck sales at about 3.5 million, including 300,000 small imports, set a record by a wide margin. Well over a half million of the trucks sold last year were vans and other light trucks purchased by households for personal and recreational use.

U.S. factories assembled 9.2 million passenger cars last year, up 8 percent from 1976, but short of the 9.7 million built in 1973. Truck output of almost 3.5 million far surpassed earlier years.

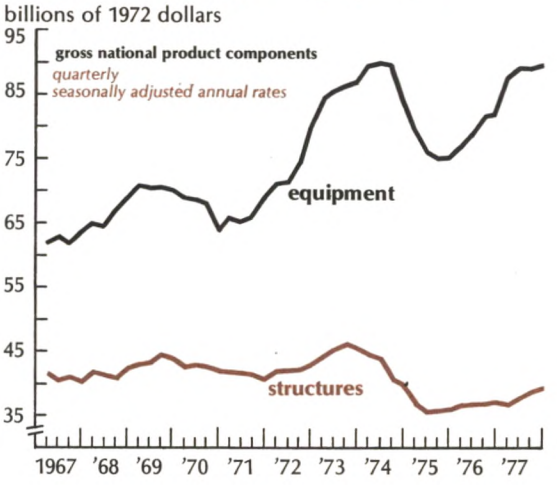
The auto industry is engaged in a massive program to provide a mix of cars that will meet government standards for improved fuel economy. In December and January some of the new intermediate-sized models were selling below expected levels, and production schedules were reduced.

Auto and truck prices have increased sharply in recent years, partly because of changes required to satisfy government rules on economy, safety, and emission control. The impact of higher prices has been softened for some purchasers by longer maturities on instalment loans with monthly payments stretching out 42 to 48 months as opposed to the 36-month maximum generally in effect until three or four years ago.

Plant and equipment

Business outlays on new plant and equipment located in the United States rose 14 percent in 1977, somewhat faster than GNP, to a total of $137 billion. After adjustment for inflation the rise was about 8 percent. Spending plans were increased slightly during the year,

Nonresidential construction has lagged spending in equipment



as indicated by the quarterly survey of the Department of Commerce.

Most industries boosted capital outlays significantly last year. Far in the lead were the motor vehicle producers, who increased spending 64 percent, mainly for new facilities to produce down-sized autos to improve gas mileage. Larger-than-average increases also were reported by the machinery, oil, and airline industries and by gas and electric utilities. Outlays by the steel and water transportation industries declined even before adjustment for inflation. Farmers also reduced spending on machinery and other facilities.

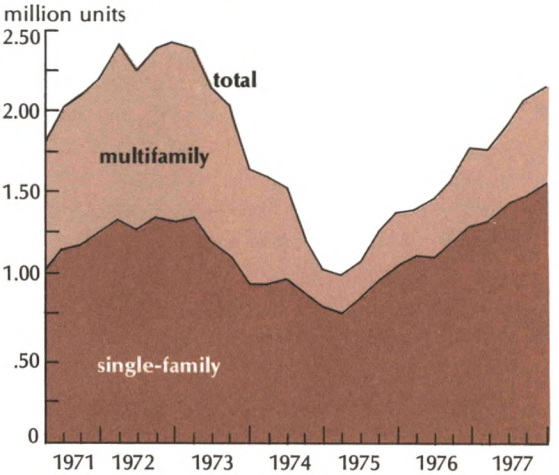
Total spending on equipment has been much more vigorous than spending on new construction. The physical volume of output of business equipment measured by the Federal Reserve's index reached 153 (1967=100) in the fourth quarter, surpassing by 5 percent the rate reached in the third quarter of 1974 at the peak of the boom. Despite a modest pickup in 1977, nonresidential private construction adjusted for inflation remained well below the level of 1974 and earlier years.

The government's preliminary survey of 1978 plant and equipment spending plans issued in January indicated an increase of only 10 percent—4.5 percent after inflation. In past expansions capital spending usually was outpacing GNP at this stage. Various economists and business executives are strongly urging reductions in corporate taxes or other measures to stimulate fixed investments.

Housing and construction

Late in 1977 construction activity was at an annual rate of $178 billion, about 18 percent above the level of a year earlier. After adjustment for 10 percent inflation, activity was up 8 percent. The residential sector again led the rise in private construction, but commercial building also was reviving. Public construction was about 3 percent below the level of a year earlier, despite an increase in outlays for water supplies and sewers.

Single-family homes lead recovery in housing starts



Construction was started on 2 million housing units in 1977, up from 1.5 million in 1976, but still well below the 1972 peak of 2.4 million. Single-family starts set a new record in 1977 of over 1.45 million, up 25 percent. The market was booming in most parts of the country. Sales of existing homes totaled 3.6 million, up 20 percent from the record set in 1976. Prices increased 10 to 12 percent on average and substantially more in some areas. Multifamily starts totaled 535,000 in 1977, up 42 percent but still 40 percent below the rate of the early 1970s.

Late in the summer home builders were hampered by shortages of materials, especially insulation and gypsum board. With needs for alterations also strong, material shortages may be a problem again in 1978. Also, many areas report a limited supply of developed lots, partly because of stricter local building regulations.

Demand for housing remains strong, but various analysts predict a decline in starts in 1978 of perhaps 10 percent. Usually, these views are predicated on the belief that rising market interest rates will significantly reduce the availability of mortgage funds.

Agriculture: issues of the past resurface

The past year marked a return to conditions in the agricultural sector that closely parallel those prior to 1973. Agricultural production rose to a record high, boosting "reserves" to levels comparable to the "surpluses" experienced in the late sixties and early seventies. Increased output dropped net income per farm—adjusted for inflation—to levels more typical a decade ago. Lower earnings coupled with record-high production expenses and debt-servicing obligations rekindled concerns about farmers' "tight cash flows" similar to past concerns about the "cost-price squeeze." A "farm strike" late in the year enhanced public awareness of the deterioration in farm income but probably will have no more impact on prices than past "withholding" efforts. New legislation in 1977 propelled the federal government back into a major role in supporting farm earnings at potential costs likely to surpass previous highs. The return of government has brought a number of programs—such as "set-aside acreage" and "extended Commodity Credit Corporation (CCC) loans"—that embody features similar to programs of a few years ago. These parallels may ultimately be judged as the bridging of a time span during which the farm sector experienced a major debt-financed boom in capital expenditures and land values that may result in particularly difficult adjustments in the years ahead.

Expanded government role

A sagging farm economy, a new Administration, and expiring legislation covering such diverse areas as the Food Stamp Program, the Food for Peace Program, and the various farm commodity programs made 1977 a bellwether year for agricultural policy developments. The Administration undertook several measures—many of which were ultimately incorporated into new legislation—to prop up the farm economy. Congressional deliberations also indicated an overwhelming desire for an increased government role in supporting the farm sector. Although the debate was wide-ranging, the compromise was struck in the omnibus four-year Food and Agricultural Act of 1977, which was signed in late September.

The new act retained the basic provisions for supporting agricultural commodity prices but mandated substantially higher levels of support. Loan rates—which establish effective floor prices—for 1977 and 1978 crops of corn were boosted to $2 per bushel, up from the 1976 rate of $1.50 per bushel. Direct government payments to wheat producers in 1977 were 17 percent higher than would have been the case had the new legislation not amended the expiring act.

A major feature of the new act was the authorization for a long-term wheat and feed grain reserve program. The program is currently designed to accumulate 25 million metric tons of grain in farmer-controlled storage facilities. Farmers who participate in the program receive three-year CCC loans on the stored grain plus a payment to cover storage costs. Overall, these and other provisions of the new act materially expose the federal budget to increased costs if the farm economy continues to be saddled by huge stocks. Although projections vary, the U.S. Department of Agriculture has estimated that the various farm programs covered by the new act will cost $6.4 billion annually.

Farm earnings decline despite increased government support

Farm earnings from commercial market sources declined markedly in 1977, particularly for grain farmers. Although the composite of farm commodity prices averaged only 2 percent lower, prices of feed grains and food grains declined 20 percent. Prices received by farmers for oil-bearing crops—primarily soybeans—provided a partial counterbalance, averaging about one-fifth higher in

1977. Prices of meat animals—mostly cattle and hogs—averaged 1 percent lower in 1977.

A larger volume of marketings and a marked increase in government support operations cushioned the overall decline in net farm earnings despite the lower prices. Cash receipts from farm marketings in 1977 were virtually unchanged from the year-earlier level of $94 billion, even though net proceeds from crops placed under loan with the Commodity Credit Corporation—which are counted as market receipts—were up $3.5 billion. Total gross farm income, at an estimated $106 billion, was up about $2 billion from the year-earlier level, with about one-half of the gain due to the rise in direct government payments to farmers. Since the increase in gross farm earnings offset only one-half of the estimated $4 billion rise in production expenses, net realized farm income fell to about $20 billion last year, down nearly $2 billion from 1976.

Last year's marked decline in grain prices sharply lowered returns to most District grain farmers but improved operating margins of livestock producers. Returns to dairy farmers were high throughout 1977, buoyed by lower feed costs and increased production. Earnings of hog producers remained at a relatively high level for the third consecutive year despite somewhat lower hog prices. In contrast, the prolonged financial squeeze on cattle feeders continued throughout most of 1977, although losses narrowed appreciably late in the year.

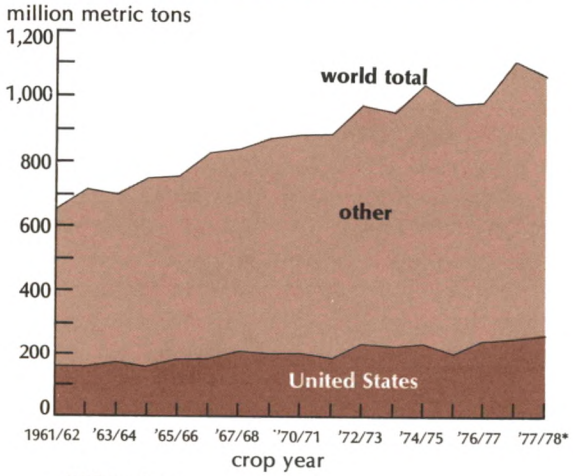
Earnings of District crop farmers were sharply reduced by last year's drop in grain prices. The extent of the reduced margins, however, hinged largely on the crop mix of individual farmers, the extent of weather-related crop losses, and farmers' land costs. Soybean prices were exceptionally high during the first half of 1977, offering excellent returns to farmers who had stored their 1976 crop. On the other hand, drought conditions over the past two years reduced the quantity of crop marketings during 1977 for a number of District farmers. Returns to corn farmers in 1977 were generally sufficient to cover all non-land costs of production. But returns to those whose production came largely from acreage purchased during the height of the land boom, or those who cash-rented most of their land, were severely squeezed.

Last year's sag in farm earnings was evident in a number of related developments. Although purchases of grain storage facilities were strong, overall capital expenditures by farmers slowed appreciably. Most evident was the decline in farm machinery and equipment purchases. Unit retail sales of farm tractors declined 6 percent last year, while combine sales dropped 11 percent. The reduced farm earnings in 1977 also ended the boom that had led to a near-tripling in District farmland values during the four and one-half years that ended in mid-1977. Surveys conducted by the Federal Reserve Bank of Chicago found that District farmland values, on average, stabilized during the latter half of 1977. Nevertheless, large increases during the first half were sufficient to hold year-ending 1977 farmland values more than one-tenth above the ending 1976 level.

Among all the various developments related to last year's decline in farm earnings, perhaps the most evident was the deterioration in credit conditions. Farmers' cash flows tightened substantially in 1977—particularly during the third quarter—reflecting lower grain prices, continuing losses to cattle feeders, and the increased operating expenses that were associated with the record agricultural output in 1977. Repayment rates on farm loans slowed considerably as a result. Renewals and extensions of existing farm loans rose sharply, as did refinancings of short-term debt with longer maturities. Simultaneously, the demand for new loans remained at a very high level. Among District agricultural banks, the strong farm loan demand outstripped reasonably large increases in deposits and resulted in substantially tighter liquidity positions. Loan-to-deposit ratios at District agricultural banks, for example, averaged more than 62 percent at the end of last year, nearly 4 percentage points above the high year-earlier level.

The deteriorating credit situation was also reflected in the national increase in farm debt. Preliminary estimates indicate total farm

Consecutive bumper grain harvests offset earlier calamities . . .



*USDA estimates.

debt rose to nearly $120 billion by the end of last year, marking a huge increase that in a historical perspective was uncharacteristic for a year of declining farm earnings. In dollar terms last year's increase of $16 billion in farm debt was almost double the average for the preceding five years, while in percentage terms the increase marked a level exceeded in only two other years since World War II.

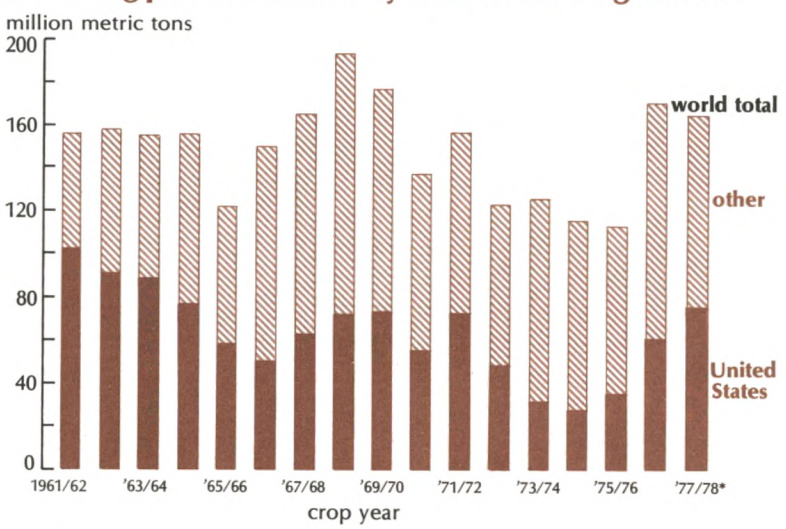
Last year's increase in farm debt culminated a five-year period during which farm debt rose more than four-fifths. In comparison, cash receipts from farming rose by only a half, while net realized farm income in 1977 was only slightly more than one-tenth above the 1972 level. These disproportionate growth rates coupled with the rebuilding of grain stocks and prospects that grain prices will closely parallel government support prices over the near term suggest the financial health of the farm sector will likely be a continuing concern this year.

Food and commodity review

Retail food prices increased more than originally expected last year, in spite of lower farm commodity prices. The upward pressures were largely concentrated within the first half, when escalating prices of imported foods were joined by fruits and vegetables reflecting the winter freeze in Florida. Overall, food prices in grocery stores averaged 6 percent higher last year, with more than half of the rise due to higher prices for fish, coffee, and other imported foods. Retail prices of domestically produced farm foods averaged about 2 percent higher as increased costs of processing and distribution more than offset the drop in raw material prices.

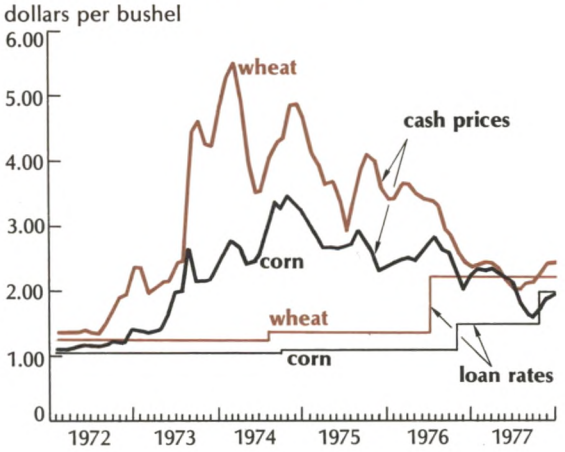
Upward pressures on retail food prices are expected to continue in the current year. The bulk of the pressures will likely be evident in processing and distribution costs, which account for two-thirds of the $180 billion spent by consumers for U.S. farm foods in 1977. Labor alone accounts for one-half of the processing and distribution costs, and in 1977—for the first time—labor surpassed raw food material costs to become the largest component of the consumer food dollar. This year's increases in the minimum wage and social security withholdings may accelerate

. . . easing pressures on carryover stocks of grain . . .



* USDA estimates.

. . . and driving U.S. grain prices down to CCC loan rates



labor costs, while increases in energy prices will have an impact on most other processing and distribution costs.

Dairy producers continued to expand production last year, encouraged by comparatively low feed prices and an increase in the support price of manufacturing grade milk from $8.26 to $9 per hundredweight last spring. Preliminary estimates indicate total milk production exceeded 123 billion pounds, up 2.5 percent from the year-earlier level and the highest annual output since 1965. The output was well in excess of the lackluster consumer demand, forcing large government purchases of manufactured dairy products in order to maintain the higher support prices. Net CCC purchases of manufactured dairy products in 1977 exceeded 6 billion pounds (milk equivalent)—a fivefold increase from the previous year and a level exceeded in only two other years since 1965.

Prospects for dairy producers look favorable again for 1978. High milk/feed price ratios are expected to lead to another increase in production. Support prices, by mandate of the 1977 act, will likely be raised again in April of this year, which would assure higher milk prices to dairy farmers. Although there has been some evidence of a pickup in commercial sales, the gain is not likely to offset the gain in production. Hence, government support purchases of manufactured dairy products will remain at exceptionally high levels during the current year.

Total meat production in 1977—including red meat and poultry—slightly exceeded the 1976 record. Beef production declined nearly 3 percent, even though fed cattle slaughter rose 3 percent last year. The overall decline in beef production permitted choice steer prices to average about $1 above the $39 per hundredweight registered in 1976. Slaughter of cows and nonfed steers and heifers declined, but remained at a relatively high level because of drought and prolonged losses to cow/calf operators. In conjunction with the high level of cow and nonfed steer and heifer slaughter in recent years, the 1977 calf crop fell to the lowest level since 1970, and the year-end inventory of all cattle and calves declined to an estimated 118 million head, down from 123 million a year earlier and the 1974 peak of 132 million head.

Hog slaughter in 1977 fell short of expectations, but nevertheless exceeded the year-earlier level by 5 percent. The increased pork production pushed average annual hog prices in 1977 about $2 per hundredweight below the 1976 level of $43. Despite the decline, favorable operating margins encouraged a buildup in the inventory of hogs held for breeding purposes, portending further increases in pork production for the current year.

Meat production trends in 1978 are expected to parallel the 1977 experience. Beef production, despite prospects for increased fed cattle marketings, might decline roughly 5 percent if the reduction in nonfed slaughter reaches current expectations. At present, the vastly improved moisture situation, increased feed supplies, and prospects for higher feeder cattle prices all support expectations for a marked decline in nonfed slaughter. Despite lower beef output, pork production is expected to be up about one-tenth, which coupled with larger poultry production portends total 1978 per capita meat supplies about equal to the highs of the past two years. Within this scenario cattle prices are expected to average somewhat higher during the current year, while hog and poultry prices will

likely average considerably lower.

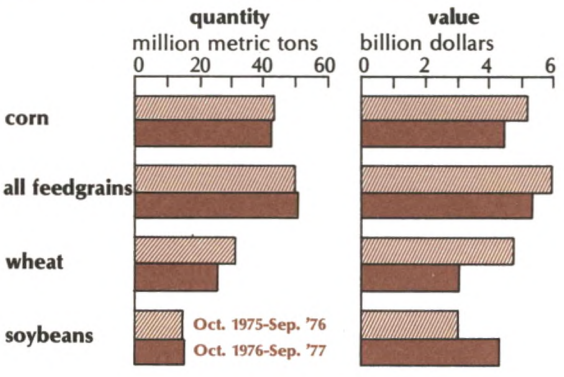
Grain supplies were in general abundance last year, due largely to record domestic and worldwide harvests in 1976. Nevertheless, adverse weather conditions provided ominous indications that the large harvests might not be repeated in 1977. Internationally, harvests in the Soviet Union, China, and the Southern Hemisphere were hampered by drought and other weather problems. Domestically, weather concerns were so widespread in 1977 that approximately three-fourths of the agricultural counties in the United States were declared a disaster area—and, hence, eligible for government and assistance loans—at some point during the past year. Winter fruit and vegetable production was reduced by a killing frost in Florida. A summer drought sharply lowered crop production in the Southeast. Drought in the West raised dire predictions of a crop failure in California. Critically low moisture supplies were a major concern in the Midwest and Plains States from the fall of 1976 until widespread showers began to alleviate the situation late last summer.

Despite the widespread weather concerns, increased use of irrigation coupled with timely rains during the growing season contributed to a record domestic harvest. Preliminary estimates indicate the index of all crop production rose to 129 (1967=100) in 1977, up from the previous high of 122 in 1976. Among individual crops, new record highs were established for corn and soybeans. Wheat production, on the other hand, declined about 5 percent from the 1976 high, but was still sufficient to meet projected needs.

The large 1977 crop harvest will be a major influence on crop prices through most of the year ahead. Exports and domestic utilization of grains and soybeans are expected to rise during their respective 1977/78 marketing years. Nevertheless, total utilization is not expected to match last year's record harvests, portending further accumulation of domestic carryover stocks. In general, carryover stocks of wheat and corn are expected to reach the highest levels since the mid-sixties, while soybean stocks may again approximate the relatively burdensome level experienced in late 1976. Barring another round of adverse weather patterns, these large stocks will likely hold 1978 corn prices close to the loan support rate of $2.00 per bushel and push soybean prices well below the 1977 average of nearly $7 per bushel.

Crop plantings in 1978 are again expected to be very large, despite the reintroduction of "set-aside" programs, which will remove some acreage from production. There will be some shift in acreage devoted to major crops due to changed price relationships. Current prospects point to reduced wheat and cotton acreage and increased soybean plantings. Corn acreage may decline slightly if set-aside provisions—as tentatively announced—remain in force. Overall prospects for large plantings, coupled with the vast improvement in moisture conditions, provide an initial foundation for assuming 1978 crop harvests may again be large. As usual, however, weather conditions both here and abroad will play an important role in determining final output and pricing patterns.

Soybeans partially offset lackluster year for grain exports in fiscal 1977



International: new strains emerge

The recovery of the world economy from the 1974-75 recession slowed down considerably in 1977. Economic growth (as measured by changes in real gross national product) in the industrial countries comprising the membership of the Organization for Economic Cooperation and Development (OECD),[1] declined from a 4 percent annual rate in the first half to 3¼ percent in the second half. This brought the growth for the year to about 3½ percent, compared to the approximately 5¼ percent recorded in 1976. The slowdown in the aggregate rate of growth between 1976 and 1977 was the result of a leveling off of growth in Japan and the United States, and a considerable reduction in the rate of growth in virtually all of Europe.

With economic growth generally below the 4½ percent rate necessary to absorb new additions to the labor force, total unemployment in the OECD countries rose to 16.3 million (about 5.4 percent of the civilian labor force) at the end of 1977, some half million higher than the low point of the recession in 1975. The rise in unemployment was particularly marked in the European member countries where, unlike in the United States, unemployment has been rising steadily, from 4.7 million at the beginning of 1975 to over 7 million today.

The slow rate of growth was one of the contributing factors to the easing of inflationary pressures in the OECD countries during the year. The rate of increase in consumer prices declined from an 11 percent annual rate during the first four months of the year to about 6 percent in the four months ending October. But, for the year as a whole, the rate of inflation—averaging about 8 percent for the industrial countries—was about the same as in 1976.

The slow and divergent rates of economic growth in the major industrial countries accentuated some existing problems in the world economy and contributed to the emergence of new ones during the year. The slow rate of growth in the industrial countries depressed their demand for primary commodities produced largely in the developing countries. As a result, balance-of-payment deficits experienced by many of the developing countries (particularly since the sharp increase in energy prices) persisted and led to further increases in their already large international indebtedness as they attempted to finance the deficits by borrowing abroad. Commercial banks in the industrial countries continued to be the main source of financing. The growth of indebtedness of the developing countries, and of some smaller industrial countries of the OECD group, to these banks perpetuated concern of the regulatory authorities both here and abroad about the possible adverse consequences of the growing foreign "exposure" and raised questions about future financing.

The dollar declines in value

The relatively rapid rate of economic growth in the United States as compared to the rest of the industrial world was the major contributing cause to the emergence of large trade and current account deficits in the U.S. international accounts (for details see below). The excess supply of dollars on the foreign exchange markets associated with such deficits was not being fully absorbed by demand for dollars for private investment purposes. As a result, by midyear the U.S. dollar began to weaken against the currencies of certain ma-

[1]The United States, Japan, Germany, France, the United Kingdom, Canada, Italy, Australia, New Zealand, Austria, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and Turkey.

Economic events in 1977—a chronology

Jan 3 Dow industrial stock average closes at 1,000, high for the year.

Jan 4 President Ford proposes tax cut, $10 billion for individuals and $2.5 billion for business.

Jan 10 Prolonged cold requires sharp emergency curtailments of natural gas to industrial users.

Jan 16 Chicago has its coldest day of the century, low of minus 19 and high of minus 7.

Jan 20 Dow Chemical drops plans for large complex in California because of environmental restrictions.

Jan 20 Freeze damages Florida's citrus and vegetable crops.

Jan 31 President Carter proposes economic stimulus, including $50 per person tax rebate.

Feb 2 Carter addresses nation on energy problems after signing emergency law to allocate natural gas.

Feb 3 Federal Open Market Committee (FOMC) announces retention of M-1 growth targets, but reduces lower end of range for M-2 and M-3.

Feb 9 Chicago ends record string of 43 subfreezing days.

Feb 14 Electronic banking sytem begins operation in Iowa, nation's first statewide system.

Feb 22 Illinois Waterway reopens after being closed for five weeks because of heavy ice.

— Carter proposes fiscal 1977 budget changes raising deficit from $57 billion to $68 billion.

— Federal Reserve Board rules that bank holding companies cannot acquire savings and loan associations.

Mar 1 U.S. reserves 200-mile fishing zone for domestic vessels.

Mar 15 Detroit's Renaissance Center opens 73-story hotel.

Mar 23 Revised Regulation B to implement 1976 Amendments to Equal Credit Opportunity Act becomes effective.

— Carter proposes boost in federal grants and loans to victims of widespread drought.

Mar 27 Two B-747s crash in Canary Islands with 600 dead.

Apr 1 Boost in price supports for milk becomes effective and stimulates output.

Apr 2 Drought forces San Francisco to impose water rationing.

Apr 4 Carter terminates natural gas emergency.

Apr 6 Federal Home Loan Bank Board lifts ban on S&Ls having savings accounts at banks.

Apr 11 United Steelworkers agree to pact raising compensation more than 30 percent in three years.

Apr 14 Carter withdraws his $50 per capita tax rebate because the economy seems stronger.

— Chicago area butchers union ends ban on meat sales after 6 P.M.

Apr 19 Act gives federal credit unions broader lending powers, including authority to make 30-year mortgage loans.

Apr 29 Carter unveils detailed proposed National Energy Plan.

May 3 FOMC announces retention of M-1 growth target but reduces upper limit for M-2 and M-3.

May 7 Officials of major industrialized nations meet in London to discuss mutual problems—sluggish growth and high unemployment.

May 13 Major bank raises prime rate from 6.25 to 6.5 percent.

May 27 Major bank raises prime rate from 6.5 to 6.75 percent.

May 31 Ceiling on FHA home mortgages is raised from 8 to 8.5 percent.

Jun 15 Spain holds first free elections since 1936.

Jun 20 Oil starts flowing into the Alaskan pipeline, completed after four years at cost of $7.7 billion.

Jun 30 Carter announces decision not to develop the B-1 bomber.

— Britain nationalizes its shipbuilding industry.

Jul 1 Social Security and welfare payments are increased 5.9 percent, based on escalation formula.

Jul 13, 14 Power failure blanks out New York City.

Jul 15 Commonwealth Edison reports record load of 13.9 million kilowatts as temperature hits 99 degrees in Chicago.

Jul 29 FOMC announces reduction of lower end of growth range for M-1 but retains existing range for M-2 and M-3.

Aug 3 Strip mining law requiring restoration of excavations approved.

Aug 4 Act establishes Department of Energy.

Aug 15 King Tut exhibit closes in Chicago after four months and 1,350,000 visitors.

Aug 19 Major steel companies announce layoffs and plant shutdowns.

— Major bank increases prime rate from 6.75 to 7 percent.

Aug 29 Administration announces 20 percent set-aside of wheat acreage for 1978.

— Despite drought, total California farm output in 1977 is expected to approximate 1976 level.

— Sweden withdraws from the "snake" (international arrangement for maintaining currency values) because of its growing payments deficit.

Aug 30 Federal Reserve raises discount rate from 5.25 to 5.75 percent.

Sep 13 Major bank raises prime rate from 7 to 7.25 percent.

Sep 14 Congress approves revised fiscal 1978 budget targets with spending at $458 billion and deficit at $61 billion.

Sep 21 Bert Lance resigns as director of Office of Management and Budget.

Sep 26 Trading in 90-day commercial paper futures begins on the Chicago Board of Trade.

Sep 27 Zenith announces decision to halt color TV set output in U.S., citing foreign competition.

Sep 29 Food and Agricultural Act of 1977 approved, boosting commodity support prices.

Oct 1 General Pay Increase boosts pay of federal civilian and military personnel by 7.05 percent.

Oct 4 Prime rate raised from 7.25 to 7.5 percent.

Oct 12 Housing and Community Development Act approved to stimulate residential construction.

Oct 13 Carter pledges federal action to curb "dumping" of foreign steel.

Oct 21 Major bank raises prime rate from 7.5 to 7.75 percent.

Oct 24 Department of Energy expects no natural gas shortage if winter is no more than 10 percent colder than normal.

Oct 25 Canadian dollar sinks to .898 U.S. dollars, lowest rate in over 40 years.

Oct 26 Federal Reserve raises discount rate from 5.75 to 6 percent.

Oct 27 Treasury reports fiscal 1977 spending at $402 billion and deficit of $45 billion, down from $61 billion in fiscal 1976.

Oct 28 National Commission on Electronic Funds Transfer issues final report recommending implementation with user safeguards.

Nov 1 Law approved raising minimum wage from $2.30 to $2.65 on Jan 1, 1978, and to $3.35 by 1981.

Nov 2 Soviet Union announces 1977 grain harvest at 194 million metric tons, well below earlier estimates.

— Dow industrial stock average closes at 801, low for the year.

Nov 7 Carter uses first veto to reject funds for continuing work on Clinch River Breeder Reactor.

Nov 9 FOMC retains existing range for M-1 growth, but reduces both upper and lower limits for M-2 and M-3.

Nov 11 Government reports record corn and soybean crops.

Nov 16 Single-family home starts reported at 1.6 million rate for October, highest on record.

Nov 17 Boeing workers end strike that began October 4, for a 7 percent wage boost and large gains in benefits.

Nov 19 Egyptian president Sadat becomes first head of an Arab state to visit Israel.

— Major auto producers announce reduction in output schedules as sales lag.

Nov 22 Two supersonic Concordes land at New York to begin regular service after long delay.

Nov 29 East and Gulf Coast dockworkers end two-month strike against container ships.

Dec 1 Conservative party gains in South African elections.

Dec 6 Soft coal strike begins idling 130,000 miners, mainly in Eastern underground mines.

Dec 14 Various farmer groups proclaim "strike" to protest low crop prices.

Dec 15 Most iron ore miners end strike that began Aug 1.

Dec 19 Milwaukee Road files for bankruptcy under Section 77.

Dec 20 Act approved raising Social Security tax sharply starting in 1979. (Under existing law base rose to $17,700 and tax rate to 6.05 percent on Jan 1, 1978.)

Dec 21 Consumer Price Index reported up 0.5 percent in Nov, 6.7 percent above year ago.

— OPEC semiannual meeting adjourns without changing oil price.

Dec 26 Last ship traverses St. Lawrence Seaway 11 days after scheduled winter closing.

Dec 27 Carter names acting director James McIntyre to be director of OMB.

Dec 28 Carter names G. William Miller, industrialist, to succeed Arthur Burns as chairman of the Federal Reserve Board.

Dec 29 U.S. dollar hits historic low relative to mark, yen, and other major foreign currencies.

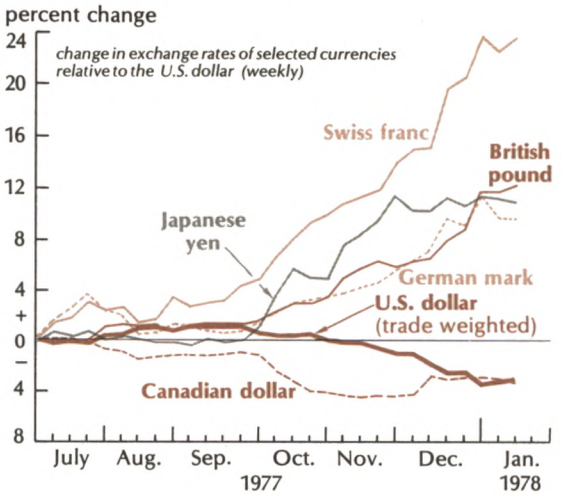
Dec 31 U.S. ends year with trade deficit estimated at $25 billion, a record by far.

jor countries, particularly those experiencing large surpluses in their international accounts. Initially, unlike the foreign central banks, whose currencies were being affected, the U.S. authorities refrained from actively moderating the decline of the dollar. This relative "inaction" reflected the U.S. policy of intervening only to counter disorderly market conditions; and the dollar's decline up until the fourth quarter was not generally disorderly. However, in the closing weeks of the year, increasing doubts about the ability and willingness of the United States to reduce the deficit led to the emergence of a strong speculative undercurrent in the foreign exchange markets that resulted in wide gyrations and rapid movements of the exchange rates. To deal with the unsettlements the U.S. Treasury and the Federal Reserve in the early days of 1978 announced their intention to actively intervene in the markets. Their action, together with forceful support provided by the European central banks, stabilized the markets. At the time of the writing of this report, the international monetary system appeared to have weathered the strains created by the disequilibrium in the world payments situation.

U.S. balance of payments position deteriorates

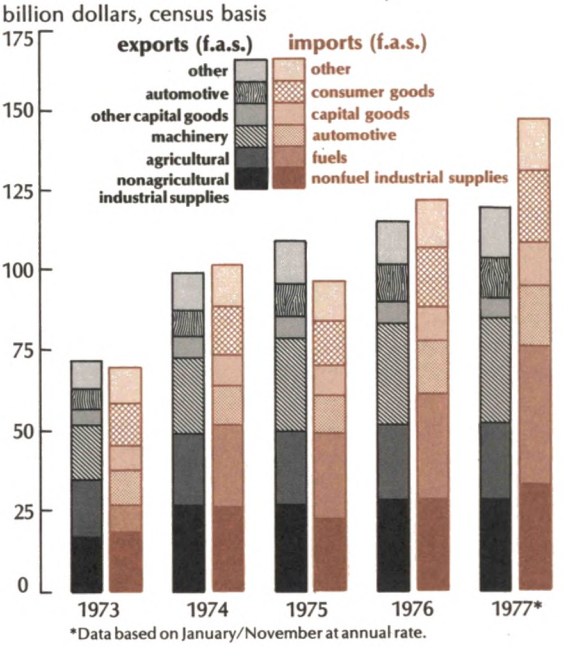
The strong economic growth in the United States, accompanied by an increasing reliance on foreign oil, led to rapid growth in imports during 1977. This, combined with the sluggish economic growth abroad that hampered U.S. exports, served to extend the deterioration in the U.S. balance of payments observed in 1976 through 1977. The merchandise trade balance (census basis), which had shifted from an $11 billion surplus in 1975 to a $5.9 billion deficit in 1976, plunged further in deficit during 1977 with a shortfall of exports to imports of $26.7 billion. A strong U.S. demand for foreign goods, both petroleum and nonpetroleum products, resulted in a surge in imports by nearly 22 percent during the year. Among nonfuel imports, the categories of manufactured goods, machinery, and foods

U.S. dollar declines relative to most major currencies



showed especially strong gains of 20 percent or more, while fuel imports were up nearly 33 percent over the year-earlier period. Exports were up 4.5 percent from 1976, but second-half shipments were only marginally greater than those in the first half.

U.S. trade deficit surges



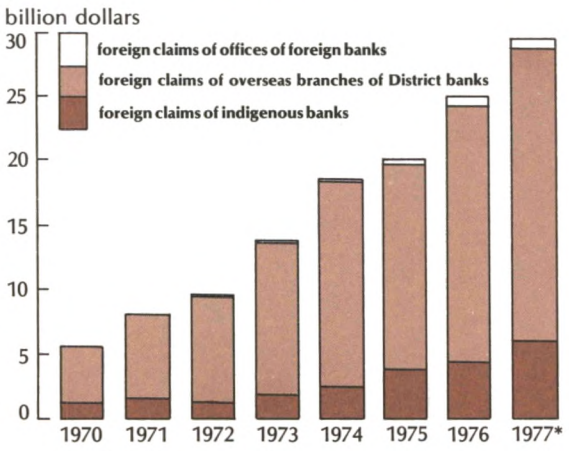
*Data based on January/November at annual rate.

Trade flows, especially of exports, were severely disrupted in the second half of the year by an East and Gulf coast longshoremen's strike against containerized shipping operations which lasted from October 1 through November.

The deterioration in the U.S. trade balance was reflected in trade patterns between all major trading regions. While the United States continues to run a trade surplus with the European Economic Community, by the end of October that surplus was $2.4 billion less than over the same period in 1976. The United States recorded a trade deficit with the developed countries of $2.9 billion for January/October, a deterioration of $6.1 billion from a year ago. The U.S. trade deficit with the Organization of Petroleum Exporting Countries (OPEC) amounted to $16.5 billion (an increase of some $6.4 billion) while the deficit in trade with other developing countries reached $4.5 billion (an increase of some $5.3 billion).

The excess of payments to foreigners over the receipts from abroad implied by the current account deficit has been more than offset by financial flows recorded in the U.S. capital account. During the third quarter of 1977 net acquisition of U.S. assets by foreigners amounted to $12.9 billion, while holdings of foreign assets by U.S. residents increased $3.4 billion, leaving a net capital inflow of $9.5 billion during the quarter. This followed net capital inflows of $2.8 billion in the first quarter and $3.5 billion in the second quarter. A major factor influencing the net capital inflow was the purchase of U.S. Government securities by foreign official institutions with dollars acquired by them through intervention in foreign exchange markets in an effort to moderate the rise of their currencies relative to the dollar. A net reduction in loans to foreigners by U.S. banks as a result of improved lending opportunities in the United States vis-a-vis foreign countries also played a significant role.

Foreign claims of the District banks continue to rise



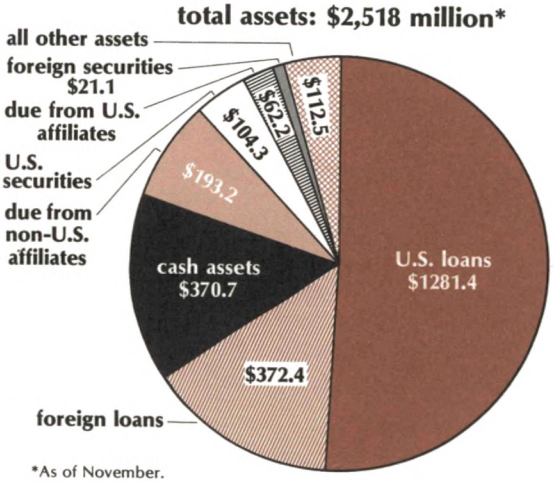
*As of November.

International banking activities in the District expand

International banking activity in the District during 1977 continued its expansion, which began in the early 1960s. Over the last five years the foreign assets of Seventh District banks increased by over 200 percent, and the total stood at $29.5 billion in November 1977. There have been three major channels through which District banks conducted their international business: (1) head offices; (2) foreign offices of District banks; and (3) District branches and subsidiaries of banks domiciled in foreign countries. The domestic offices of District banks had claims on foreigners of $6.0 billion towards the end of 1977, a sizable increase over the $4.1 billion in the same period a year ago. District banks had liabilities to foreigners of $2.5 billion—an increase of $300 million over the 12-month period. Domestic offices of Seventh District banks presently account for 10.2 percent of the total claims on foreigners held by all domestic offices of U.S. banks. This was a significant increase over the District's share in 1976.

Over the last decade the major means by which the Seventh District banks have engaged in foreign lending has been through their overseas branches. While in 1967 District banks operated only six overseas branches, by

Assets of the District's foreign banks increase in 1977



*As of November.

1977 there were 74 overseas branches maintained by 19 District banks. In November these branches had total assets of $22.7 billion, an increase of $4.0 billion over the prior 12 months.

The Seventh District's position as an international financial center was strengthened in 1973 when the Illinois General Assembly passed legislation permitting foreign banks to establish agencies, branches, and subsidiaries in Chicago. In the four years since the passage of that legislation, 30 offices of foreign banks were opened in Chicago, including seven in 1977. The offices of foreign banking institutions in the District had assets of $2.5 billion as of the end of November, an increase of $400 million in a 12-month period. Chicago is presently the third largest foreign banking center in the United States.

Government: a new administration takes command

During 1977 the operations of the federal government proceeded, to a large extent, on the momentum of programs and plans initiated in earlier years. Although a new administration took over in January, the process of preparing new program plans is far from complete. Several new programs were either announced or were promised for early 1978. However, little was done that changed the course of federal action from the direction set during the former administration.

The government's continuation along the previous course was particularly true for the first three quarters of the calendar year, which were part of fiscal 1977. The new starting date of the government's fiscal year from July 1 to October 1 may actually have increased the difficulty experienced by any new administration in altering programs' directions early in its term of office. Decisions made and embodied into legislation now cover three-quarters of the new administration's first year rather than two quarters. On the other hand, there is more time to alter the proposed budget for the next fiscal year before it is implemented. The budget for fiscal 1977 was presented to Congress by the Ford Administration in January 1976. The outgoing administration also prepared the budget for fiscal 1978, presented in January 1977, together with some proposed changes for fiscal 1977. While the Carter Administration proposed still further changes in the 1978 budget shortly after taking office, the end results for fiscal 1977 were similar to the Ford proposals. The first budget fully incorporating the Carter Administration's plans will not take effect until October 1978, some 20 months after the change of administrations.

The vanishing rebate

During the last few months of 1976 the data on the economy were increasingly negative in tone. The unemployment rate rose sharply, and many economists forecast a new recession. As the new year began, much of the nation experienced record cold weather. Shortages of fuel, particularly natural gas, caused plants to close. The incoming administration felt that a substantial increase in fiscal stimulus was necessary to avoid a general economic decline. President Carter proposed a three-pronged program to stimulate the economy: tax reduction, public works and increased public employment, and a rebate on 1976 taxes. While the program was being debated, it became evident that the fears of a new recession were unwarranted. Unemployment began a rapid drop, industrial production increased sharply, and housing starts jumped back up to above a 2 million annual rate. As a result, while Congress did pass legislation increasing public service jobs and providing funds for subsidizing hiring by state and local governments as well as a modified form of the President's proposals for tax reduction, the rebate was dropped.

Fiscal 1977—a surprising outcome

In January 1976 President Ford proposed a fiscal 1977 budget with expenditures of $394 billion and a deficit of $43 billion.

These proposals were deemed too austere by Congress, and the second Congressional budget resolution proposed spending of just over $413 billion and a $50.6 billion deficit. In January 1977 the Ford-

prepared budget proposed broadening the deficit to $57 billion, but Congress took no action until President Carter's proposals had been made. Then a third budget resolution was adopted changing proposed spending to $418 billion and allowing for a $70 billion deficit.

By late spring it was evident that spending was still running below the levels anticipated by Congress. At the same time receipts were higher in part because the rebate had been omitted from the stimulus program. The administration's spending estimate was reduced to about $408 billion with an expected $49 billion estimate for the deficit. By the time the fiscal year ended, spending turned out to be even lower, and the final figure for the deficit was $45 billion, surprisingly close to the original proposal made in January 1976.

Fiscal 1978—currently on schedule, but changes to come.

The original budget proposals for fiscal 1978 were also prepared by the Ford Administration. The Ford budget received little attention from Congress until the Carter Administration was able to present modifications. These modifications raised spending about $20 billion above the Ford proposal of $440 billion, estimated revenues at about $402 billion, and proposed a deficit of about $58 billion.

President Carter's new proposals were basically those adopted in the second Congressional budget resolution last September. Spending was projected at $458.3 billion, while revenues were expected to be $397.0 billion, giving a projected deficit of $61.3 billion. The principal difference in these Congressional estimates is that they are based on a slightly more pessimistic view of economic conditions during fiscal 1978. The Congressional estimate of revenues was several billion dollars lower than the administration's figure. Estimates of actual spending and revenue during the first quarter of the fiscal year (October-December 1977) are about what would be expected so far, but it is too early to forecast accurate final totals. Furthermore, the tax changes that will emerge from the energy program and the tax reduction program will have an unknown impact on both revenues and the deficit for the coming year.

Social Security—a half-century reprieve

Each year since 1972, when Congress incorporated automatic increases in Social Security benefits tied to the consumer price index and increases in the wage base tied to the change in average wages, it has been increasingly evident that the trust funds sustaining the system would be exhausted within a few years. The revisions of 1972 inadvertently adjusted benefits for inflation twice, since benefits were raised periodically (for new and future retirees) by both a wage and a price adjustment. In late December a new revision to the Social Security law was enacted. This change eliminated the double adjustment of benefits by tying future increases to wages only. In addition, the bill scheduled a series of increases in both the tax rate and the level of wages subject to the tax beginning in 1979 and continuing through 1987. This change will increase the tax paid by all covered workers and, in addition, will impose substantial increases on higher income workers. The maximum tax, matched by an equal tax on employers, will go from $1,071 in 1978 to $3,046 in 1987. The Congressional Conference Committee estimates that the trust fund for retirement benefits will remain in surplus for 50 years but that the disability trust fund will need further funding in about 30 years. Some committee members anticipate that the solvency of the disability fund can best be achieved by tightening eligibility requirements rather than by further funding.

Energy—still unresolved

In April 1977 President Carter presented his energy message to Congress. This program was intended to reduce total energy consumption growth to 2 percent a year or less as rapidly as possible and to shift consumption—

first from oil and gas toward coal and nuclear power, and eventually to newer, essentially inexhaustible resources such as solar energy. Heavy stress was placed on conservation. A series of taxes were proposed to increase the price of petroleum to the world price, encourage coal use over oil or gas, increase the cost of low-mileage automobiles, and increase the cost of gasoline if consumption were to rise above scheduled levels. Currently unregulated natural gas in intrastate commerce was to be brought under the same regulations as in interstate commerce, and gas pricing was to be designed to encourage home heating as its primary use. Accompanying the new taxes was a series of tax refunds and credits designed to encourage conservation measures by households and industry and to encourage industries to shift to coal.

When Congress adjourned in December, Senate-House Conference committees were attempting to develop a program implemented by two bills: one dealing with tax aspects and one dealing with non-tax aspects of the program. Several thorny problems involving pricing and regulation of both oil and natural gas and the amount and utilization of taxes to be imposed remained to be resolved at year-end.

The final form of the energy program to emerge from Congress in early 1978 is uncertain. Undoubtedly, however, the legislation will have an important impact on both businesses and personal lives in the years ahead and will differ in substantial details from the original proposals of last spring.

Federal expenditures—where the money went

Total federal government expenditures, as measured on the National Income Accounts Basis, were about $422 billion in 1977, more than 9 percent above 1976. This growth was somewhat faster than had occurred the previous year. As in the past several years, only a little over one-third of this total—about $147 billion—was spent on the purchase of goods and services. Defense purchases were about $95 billion, a smaller share of both total purchases and total expenditures than in either 1975 or 1976.

By far the largest claim on the federal purse was for transfer payments to persons. These payments totaled $170 billion, over 40 percent of all federal expenditures. About $105 billion—$10 billion more than total defense spending—was for Social Security benefits. While many other programs in this category—such as pensions to retired government employees and unemployment insurance benefits—each resulted in expenditures of $10 billion or more, even in the aggregate they totaled substantially less than Social Security expenditures.

Grants-in-aid to state and local governments was one of the fastest growing segments of federal expenditures during 1977, primarily as a result of the jobs and public works programs aimed at stimulating the economy. This grant totaled about $69 billion in 1977, up nearly 12 percent from 1976, and is scheduled to continue at a high level into 1978.

Finance: credit demands strong

As economic expansion progressed, financing in the credit markets rose, along with the demand for transactions balances. Growth in the narrow money supply (M-1) was close to 7½ percent for the year, the largest since 1972. In an effort to reduce monetary growth to a pace consistent with a lower rate of inflation, the Federal Reserve supplied the reserves that supported the deposit expansion at only a slightly higher cost to the banking system. Although short-term interest rates moved up from the cyclical lows reached late in 1976, funds were in plentiful supply as evidenced by the record amount raised in the credit market. Intermediate- and long-term interest rates ended the year at levels inside or below their range of fluctuation in 1976.

Commercial banks supplied about one-fifth of the total funds advanced—roughly the same proportion of the total as in 1976. However, there was a significant shift in the use of bank funds. Credit provided to the private nonbank sectors of the economy by the banking system more than doubled in 1977 despite continued weakness in loan demand by major national corporate customers at the big money center banks.

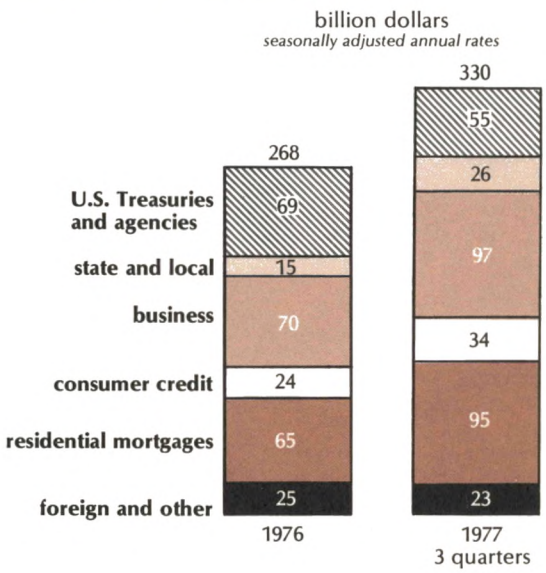
Credit flows higher

Funds were raised in the credit markets by individual businesses, nonfinancial businesses, and governmental units at an annual rate of nearly $330 billion during the first three quarters of 1977 (seasonally adjusted)—almost one-fourth higher than during 1976. All of the increase was accounted for by the private sector. Higher borrowings by state and local authorities were more than offset by lower borrowings at the federal level. Higher prices increased financing needs for all sectors.

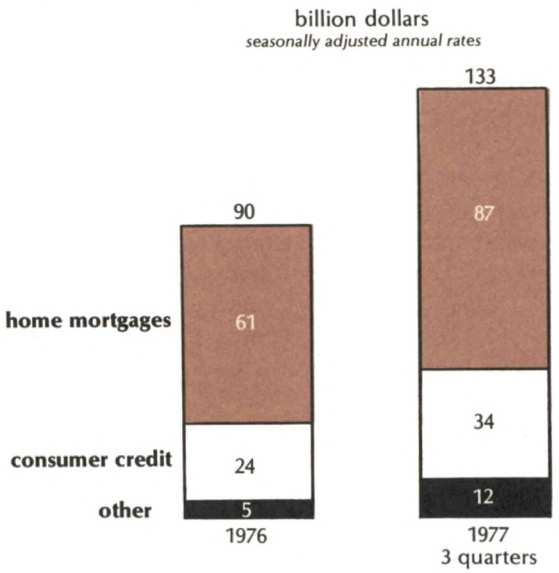
Within the private sector, consumer borrowing led the pace in the credit area, reflecting the large consumer expenditures on autos and houses. Record increases in both consumer credit and home mortgage credit accounted for two-thirds of the overall increase over 1976 in credit market financing. Businesses also borrowed almost two-fifths more than in the prior year, especially through short-term obligations.

Strong demand for single-family homes and continued inflows of savings to depository institutions, especially during the first half of the year, produced record mortgage lending activity. In the latter part of the year, thrift institutions relied heavily on advances from Federal Home Loan Banks and on borrowings from other sources. Although thrift institutions were again the major source of home mortgage financing, their share declined. The amount supplied by the commercial banking system doubled as mortgage interest rates remained relatively attractive at historically high rates. The sale of securities backed by pools of mortgages in the capital markets by the federally sponsored agencies

Funds raised up sharply . . .



. . . with household sector accounting for most of the increase



continued to be a growing source of mortgage funds.

Commercial banks dominated the provision of consumer credit to households, supplying about one-half of the total, the same as in the prior year. Credit unions and finance companies provided most of the balance.

Nonfinancial corporate businesses expanded their credit market borrowing in 1977 to almost the 1974 level. Funds were used to finance increased capital expenditures not covered by internally generated funds and larger and higher cost inventories. New equity issues declined to 9 percent of net funds raised after increasing from 5 percent in 1974 to 27 and 18 percent in 1975 and 1976, respectively. Commercial bank loans to business (excluding mortgages) represented almost three-fourths of the increase in debt financing by business, but such bank loans were still at only two-thirds of the 1973 and 1974 rates. The balance of the increase in business debt was mostly in finance company loans, primarily to finance automobile inventories, and in commercial mortgages.

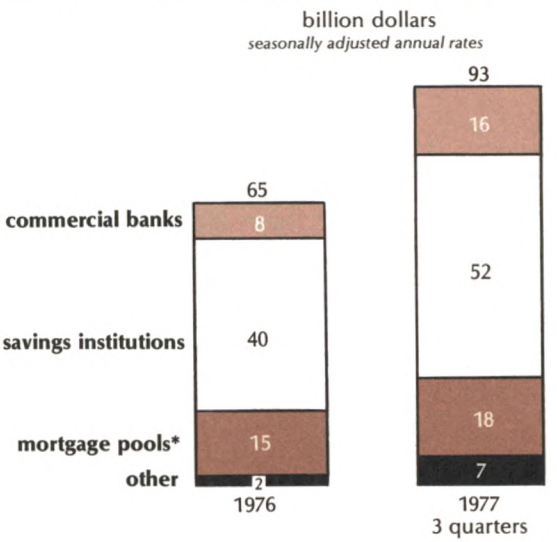
State and local governments refunded substantial amounts of securities issued at artificially high rates in 1974 and 1975. Municipal interest rates remained relatively low throughout the year as commercial banks and fire and casualty insurance companies, buoyed by increased profitability, returned to the tax-exempt market. Local governments invested the proceeds in special Treasury issues when the terms of the original issue prevented immediate refunding. Local governments raised about the same amount as they supplied to the U.S. Government market.

Reduced borrowing by the federal government and the purchase of Treasury issues by state and local governments and foreign accounts mitigated the impact of the U.S. government on the credit markets. The foreign sector was the largest purchaser of Treasury securities in 1977, doubling the amount purchased in 1976 and absorbing two-fifths of the net increase. State and local governments accounted for 29 percent.

Mixed demand at banks

Commercial bank credit rose more than 11 percent in the year ended November 30, 1977, compared with 8 percent in the previous

Savings institutions provide bulk of home mortgage financing



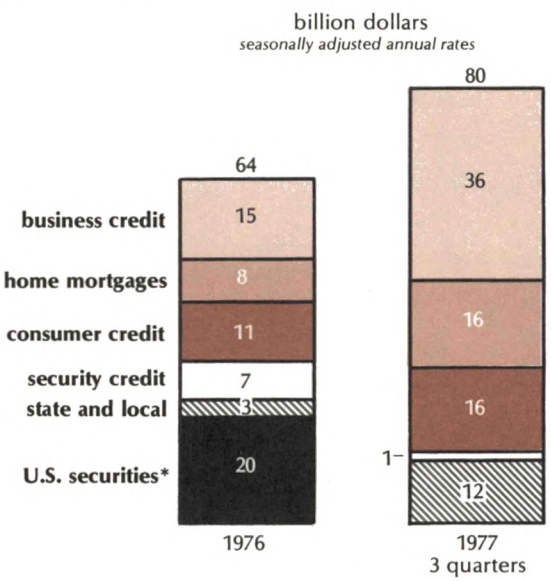
*GNMA, FHLMC, and Farmers Home Administration pools.

year. Bank loans accounted for the gain. Total loans increased about 15 percent for the year, while bank acquisition of securities was up about 4 percent. The expansion in loans was largely a reflection of the firmness in household credit demands, although business loan demands increased also. Continuing the uptrend that persisted throughout 1976, household credit demands at all commercial banks increased markedly as the year progressed and were up about 15 percent for the year as a whole compared with an 11 percent rise in 1976.

Real estate loans rose at a much faster pace than in 1973 when construction activity as reflected in starts and completions was emphatically greater. Consumer instalment loans increased faster than in any other year, although the bulk of the rise was in the last three quarters of the year.

Bank loans to business borrowers rose more than 12 percent in 1977, after rising less than 1 percent in 1976, with the rate of growth accelerating during the year. In the fourth quarter business loans were up 15 percent. Business loans expanded more rapidly at small- and medium-sized banks than at large banks. The contrast was much sharper earlier in the year, but in the fourth quarter business loan demands at large banks came on strongly. In the fourth quarter of the year business loans rose at an annual rate of about 16 percent at the large banks and only 13 percent at the smaller banks.

Commercial bank credit up moderately



*U.S. securities were –1 billion dollars for first three quarters of 1977.

Bank acquisition of U.S. Governments decreased sharply last year. Holdings of Treasuries at all commercial banks declined more than 3 percent, after rising 23 percent in 1976. By contrast, bank acquisition of other securities, mainly obligations of states and political subdivisions, rose more than 7 percent in 1977 compared with a 2 percent rise in the previous year.

While the banking industry enjoyed rapid demand deposit expansion in 1977, growth in total time and savings deposit increased sharply. Time and savings accounts, other than large certificates of deposits (CDs), rose very rapidly in the first half of the year but at a much slower rate thereafter. Large CDs rose only moderately in the first half of the year, reflecting the modest rise in business loan demands. As the year drew to a close, however, the growth in CDs was the fastest since the recession. The faster growth in CDs resulted, in part, from the expansion of business loans and a decline in consumer-type savings flows at the large banks.

The increase in the prime loan rate of the large banks, which closed the year at the highest level in two years, lagged the rise in short-term market interest rates. During the early part of the year major banks allowed a large spread to develop between their prime rate and the market rate on commercial paper—an alternate source of funds for large firms. As loan demand rose and banks competed for customers, the spread was reduced. At year-end the prime-paper rate spread had narrowed to about 100 basis points compared to 160 basis points earlier.

Although the prime rate rose about 150 basis points in 1977, competition for loan business intensified as the year progressed. Nonprice terms were reported eased somewhat, with more flexibility in compensating balance requirements and some term

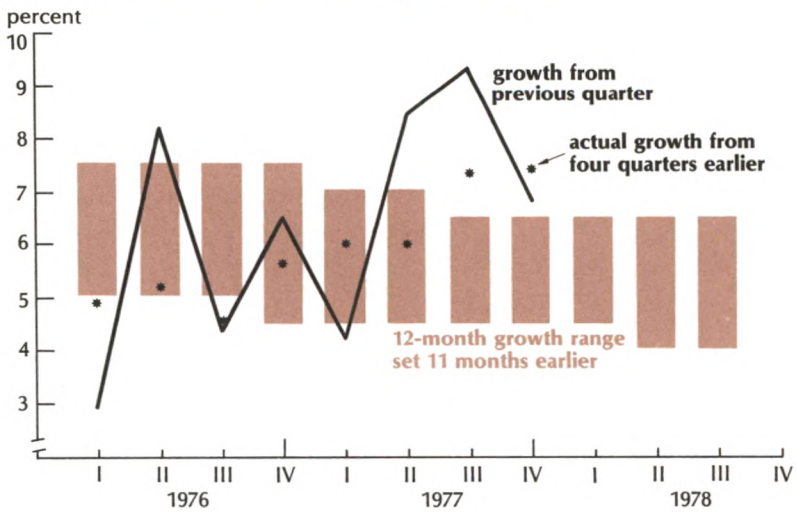
loans made at fixed rates. Before year-end some large banks were aggressively seeking loan business through below-prime commercial paper-type arrangements. While such actions will undoubtedly increase loan volume, the strength of business loan demands will have an important bearing on the flexibility of lending terms.

Growth in the broader aggregates was in line with projections . . .

	M-1		M-2		M-3	
	January projection	Actual	January projection	Actual	January projection	Actual
	(percent, seasonally adjusted annual rates)					
1972		8.4		11.2		13.6
1973		6.2		8.8		9.1
1974		5.1		7.7		7.1
1975		4.4		8.3		11.1
1976	4.5-7.5	5.6	7.5-10.5	10.9	9.0-12.0	12.8
1977	4.5-6.5	7.4	7.0-10.0	9.6	8.5-11.5	11.6
1977-1		4.2		9.9		11.3
2		8.4		9.2		10.0
3		9.3		10.3		12.4
4		6.8		7.6		10.7

NOTE: Annual data based on fourth-quarter averages.

. . . but rapid rise of M-1 in second and third quarters pushed it above lowered target ranges

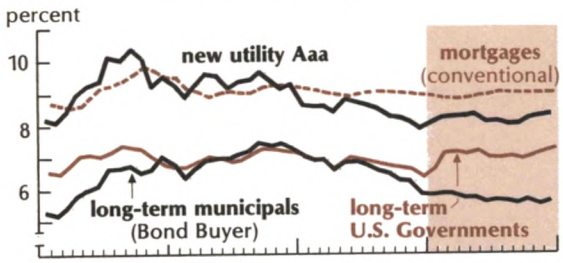


Monetary aggregates and interest rates

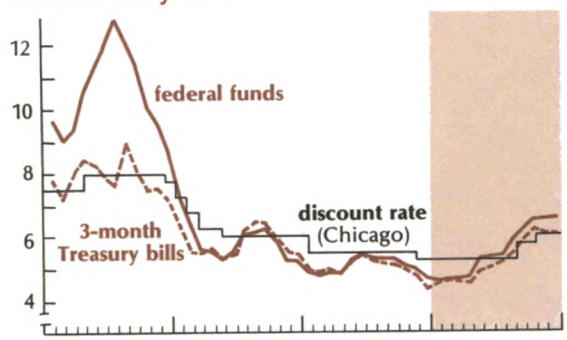
As the economy moved into its third year of economic expansion in the spring of 1977, the Federal Reserve in conducting monetary policy sought to sustain economic growth and to restore price stability. Projected annual growth ranges for the monetary aggregates were gradually reduced during the year to dampen inflationary expectations and renew public confidence both at home and abroad. With the income velocity of money increasing at a more normal rate than in the first year of recovery and credit expansion proceeding at a brisk pace, the Federal Reserve sought to restrain monetary growth to within desired ranges by supplying reserves only at a higher cost to the banking system.

In quarterly reports to Congress, the Federal Reserve specifies annual monetary growth ranges expected to be consistent with achieving economic objectives. Annual growth projections are made for M-1, which includes currency and commercial bank demand deposits held by the public; for M-2, which includes—in addition to M-1—commercial bank savings and time deposits other than large CDs; and for M-3, which includes—in addition to M-2—mutual savings bank deposits and shares at savings and loan associations and credit unions. The projec-

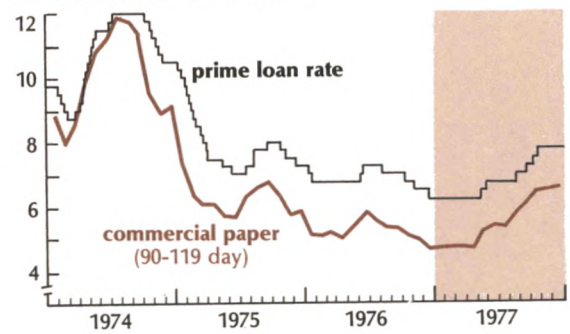
Not much change in long rates . . .



. . . as money rates moved up moderately . . .



. . . and banks kept prime above market cost of funds



tions take account of developments that may influence the expected rate at which money balances will be used.

As the third year of the current expansion progressed, the income velocity of M-1 (V-1)—a measure of the intensity with which the public uses transactions balances relative to GNP—increased at a somewhat slower rate. Over the last three quarters of 1977 V-1 increased at about 3 percent, below the 3.5 percent average annual postwar rate experienced in the second year of the current expansion and in sharp contrast to the average 8.3 percent rate of the first year.

Actual growth in the monetary aggregates over the year was near or above the upper limits of projected ranges specified in quarterly reports to Congress. The first quarterly report of 1977 specified growth ranges of 4½-6½ percent for M-1, 7-10 percent for M-2, and 8½-11 percent for M-3 over the fourth-quarter 1976 to fourth-quarter 1977 period. Actual M-1 growth over this period was 7.4 percent, up from 5.6 percent in 1976 and the fastest since 8.4 percent in 1972. In contrast, actual 1977 growth rates for M-2 and M-3 of 9.6 and 11.6 percent, respectively, were somewhat slower than in 1976.

As it had done in 1975 and 1976, the Federal Open Market Committee (FOMC) progressively lowered annual monetary growth ranges through 1977. By year-end the ranges, applying from third-quarter 1977 to third-quarter 1978, had been reduced to 4-6½ percent for M-1, 6½-9 percent for M-2, and 8-10½ percent for M-3.

After the first quarter, as public demand for transactions balances strengthened and monetary aggregate growth—especially for M-1—exceeded desired growth, the FOMC became less accommodative in supplying reserves to support the deposit expansion. Rapid monetary growth in April and July prompted the FOMC to allow the federal funds rate—the market price of reserves—to rise from the prevailing 4⅝ to 4¾ percent to around 5⅜ percent in early May, to 6 percent by mid-August, and to 6½ percent by mid-October. In addition, the discount rate—the rate charged by the Federal Reserve on loans to member banks—was increased 50 basis points to 5¾ percent at the end of August and an additional 25 basis points to 6 percent in late October.

As the year progressed, short-term interest rates moved higher mirroring the 191 basis point increase in the federal funds rate. In contrast, borrowing costs in capital markets changed little during 1977. The December 1977 new utility Aaa bond rate was but 40 basis points higher than its cyclical low reached in December 1976. The long-term municipal

bond rate continued to decline through 1977 reflecting renewed investor confidence in the tax-exempt market.

District banking

At Seventh District member banks credit expanded more during 1977 than during the previous year and kept up with the pace nationally. Total loans and investments (excluding fed funds) of all District members rose about 9 percent in the year ended November 30, 1977, compared to 6 percent in 1976. The 13 percent rise in loans accounted for most of the 1977 credit increase whereas in 1976 emphasis was on U.S. Treasury securities. Much of the growth in loans was concentrated in areas outside of the major cities. Money center banks in Chicago felt the effects of light loan demand by large business customers, while agricultural-based banks experienced heavy loan demand and very tight liquidity positions. In all District areas loan growth in 1977 was stronger than in 1976.

Consumer-type savings inflows were weak at District large weekly reporting banks in 1977 compared to 1976. This was true during the first half and even more so in the third quarter when "wild cards" (4-year time certificates issued in late 1974 without a ceiling rate) were maturing. Some of these funds left commercial banks and flowed into S&Ls primarily because of the rate differential. However, during third-quarter 1977, District banks acquired additional deposits through stepped-up sales of large CDs.

Nonbank financial institutions continued to offer more competition to commercial banks as they sought to expand services available to customers. Credit Unions in Wisconsin and Indiana aggressively expanded share draft accounts, while those in Iowa, Michigan, and Illinois were hampered by litigation. The number of Illinois S&Ls in the District offering NINOWS increased to about 60 compared to 46 the previous year.

Approximately 25,000 NINOW items were processed daily during December, representing an average volume of about $3 million. This was almost four times the daily average number and dollar amount processed during the same month in 1976. However, the impact of NINOWS on commercial bank deposits in Illinois was minimal.

The first statewide, shared electronic funds transfer system was introduced by the commercial banks in Iowa. The Iowa Transfer System (ITS), owned by about 550 of the 650 banks in Iowa, had close to 40 banks participating during the year. Because of Iowa's sharing law, small banks have the same ITS opportunities as do the larger ones. Services available through ITS include point-of-sale terminals and both on- and off-premise automated teller machines.

Loans dominate credit growth in 1977

	Loans[1]		U.S. Govt. securities		Other securities	
	Nov. 1976	Nov. 1977	Nov. 1976	Nov. 1977	Nov. 1976	Nov. 1977
	(percent change)					
Large banks[2]						
Chicago	- 2.3	8.4	40.2	-17.7	0.7	19.9
Detroit	- 1.2	11.1	- 0.6	15.0	1.8	0.3
Indianapolis	- 5.7	5.8	11.0	63.8	41.4	-22.6
Milwaukee	2.3	14.9	58.9	-19.1	-12.6	2.3
Des Moines	14.9	26.5	20.5	89.7	2.3	3.0
Other member banks						
Illinois	11.9	16.4	17.2	- 7.8	4.6	5.6
Michigan	11.0	16.7	19.9	- 0.1	6.8	7.6
Indiana	11.3	16.2	23.9	-18.3	9.7	1.2
Wisconsin	11.7	16.6	22.3	- 5.7	3.3	3.8
Iowa	18.1	18.4	8.9	-13.6	9.0	0.5

[1]Excludes fed funds.

[2]Large weekly reporting member banks.

District holding company activity

During the past year 63 of the District's commercial banks became subsidiaries of holding companies. Twenty-seven of these banks became subsidiaries of one of the District's 55 multibank holding companies operating in Iowa, Michigan, and Wisconsin, where multibank holding companies are legal. By year-end holding companies controlled 774 banks or 23 percent of all commercial banks in the Seventh District.

The Board of Governors and the Federal Reserve Bank of Chicago, acting under delegated authority, ruled upon 98 bank holding company and merger applications that involved District banks last year. Eighty-three of the applications were approved and 15 (15.3 percent) were denied. Decisions on applications stressed the financial and managerial soundness of the bank holding companies and their subsidiaries. Of the applications denied by the Board, 11 were on grounds that the proposals would have created or added to strains on the financial and managerial resources of the applicant company or a bank or nonbank company involved. Four applications were denied because the acquisitions were judged to eliminate or significantly diminish competition, without sufficient offsetting convenience and needs or public benefits. Of these, two involved chain banking relationships. The Board has stated that where a proposed acquisition involves the use of a holding company by a group of individuals to acquire control of a bank that is a competitor of another bank under the control of essentially the same individuals, consideration must be given as to whether the formation would entail significant anti-competitive effects.[1] Only one of the 11 applications to engage in permissible nonbanking activities was denied; and that denial was incidental to the denial of the formation of the one-bank holding company. The most frequently entered nonbanking fields during 1977 were insurance and consumer finance.

[1]See Board Order of May 11, 1977, denying the application by Mahaska Investment Company, Oskaloosa, Iowa, to become a bank holding company through the acquisition of 51.47 percent of the voting shares of Farmers Savings Bank, Fremont, Iowa (63 *Federal Reserve Bulletin* 579). Also see Board Order of November 18, 1977, denying the application by Citizens Bancorp., Inc., Hartford City, Indiana, to become a bank holding company through the acquistion of 80 percent or more of the voting shares of the Citizens State Bank, Hartford City, Indiana.

Bank holding company applications processed during 1977

	Holding company formations		Multibank and additional shares proposals		Merger proposals		Nonbanking activities*	
	Approval	Denial	Approval	Denial	Approval	Denial	Approval	Denial
Illinois	10	2	1	—	—	—	4	—
Indiana	2	1	2	—	—	—	—	—
Iowa	22	3	2	—	1	—	6	1
Michigan	1	—	13	1	2	1	1	—
Wisconsin	7	1	9	5	—	—	—	—
Seventh District	42	7	27	6	3	1	11	1

*Excludes 23 4(c)(8) notifications by bank holding companies to engage in permissible nonbanking activities on a de novo basis.

Maintaining the expansion

Most informed observers expect 1978 to resemble 1977 in broad outline in terms of both economic growth and price inflation. By and large the states of the Seventh Federal Reserve District can be expected to share in the nation's gains in output and employment.

The current expansion will be three years old this spring. As a result, some analysts believe that the upswing is "growing old," based on the average of past movements, and suggest that a downturn may be near. But averages are of little use in charting the future paths of business fluctuations. In retrospect, each expansion and contraction has had important unique characteristics. Longevity has varied substantially. The record expansion of 1960-69 was widely believed to be running out of steam in 1962 and in 1967.

Virtually all past business declines have followed the development of excesses and imbalances, which required painful adjustments. In early 1978 there are surprisingly few serious excesses and imbalances, at least in the domestic economy. During the past year manufacturers have moved promptly to cut production when demand failed to match expectations and inventories threatened to become burdensome. Conversely, except for certain specific items—mainly natural gas and materials for home insulation—raw materials, components, and finished goods have been available on normal time schedules. The widespread shortages of 1973-74 were associated with extremely long lead times, double ordering, and excessive inventory buildups. When goods are readily obtainable, it may appear that any rise in demand can be accommodated. Actually, margins of unused capacity in most industries are not large. Variations in demand that may cause shortages on the one hand, and market gluts on the other, are often narrow. The best assurance against such imbalances is provided by the system of free and flexible market prices.

The President has proposed a net tax reduction of $25 billion for individuals and businesses to maintain and accelerate the expansion. Many other individuals and organizations have urged tax reductions of a similar magnitude, although proposals differ greatly in detail. In part, tax reduction is urged as an offset to increases in Social Security and unemployment taxes, effective this year, and to the rise in tax receipts that occurs as individual incomes move into higher tax brackets, partly reflecting inflation.

While interest rates have increased in recent months in response to rising credit demand, all types of loans have continued to be readily available. The monetary authorities are pledged to facilitate increases in money and credit of a magnitude that will assure adequate liquidity, but not so great as to add to existing inflationary pressures.