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ECONOMIC PERSPECTIVES

Review and outlook: 1978-79

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In late 1978, predictions of a recession were common. Increases in employment, retail sales, and output seemed to be slowing down. But with the accumulation of more data, the picture looks brighter. So far, the economy has withstood extremely high interest rates and rapid price inflation. Under such conditions, true economic stability is impossible, so the nation is girding to reverse this trend.

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ECONOMIC PERSPECTIVES

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Review and outlook: 1978-79

Business: a time of test ahead

Large gains were made in 1978 for the third consecutive year in employment, output, income, and retail sales. Momentum was so strong at year-end that some forecasters were modifying their predictions that a recession was imminent. Again, the economy had shown unexpected staying power in the face of adversity.

If activity continues to increase through March, as most observers expect, the expansion will have passed its fourth anniversary—remarkable longevity compared with past expansions. But a critical period of testing is certain in the coming months. Signs of strain can be seen in several areas.

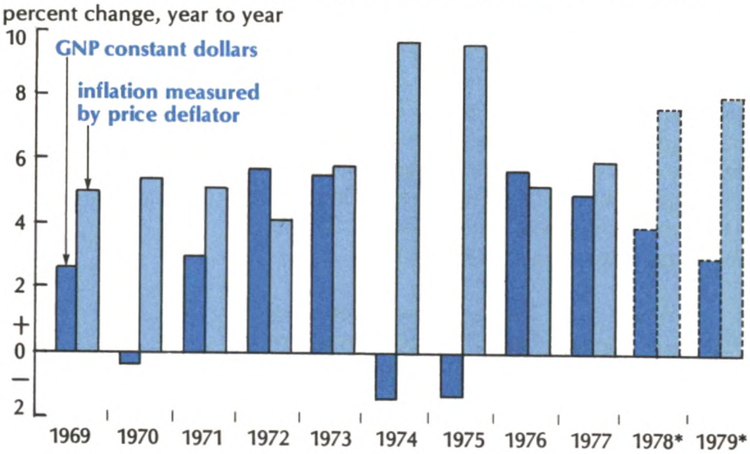
- Interest rates are at (or near) historical highs and credit markets are taut.
- Consumer debt burdens have climbed to an unprecedented level.
- Pressures have mounted to restrict government taxing and spending.
- A huge deficit persists in the balance of trade.
- The adequacy of oil supplies is again in question.
- Efforts to curb inflation through guidelines and budget stringency suggest disruptive conflicts among powerful sectors.

All of these problems arise from the fact that effective demand exceeds the nation's resources. The excessiveness of demand is reflected in continued inflation, the international trade deficit, and pressures on available facilities, materials, and labor. A start toward resolution of the problem of excess demand requires moderation of competing, and therefore conflicting, demands.

A broad perspective

The gross national product reached $2.1 trillion in 1978. That was an increase of almost 12 percent, compared with 11 percent in both 1976 and 1977. Forecasts made early in the

More inflation and less growth expected for 1979



*Estimated.

year proved optimistic. Price inflation was significantly underestimated, and real growth was overestimated. Inflation at about 7.5 percent was well above price increases of 5 percent in 1976 and 6 percent in 1977. Probably less than 4 percent, the real gain in output was well below the 6 percent reached in 1976 and 5 percent in 1977.

Two developments early in the year helped account for the year's performance being poorer than expected. One was the severe cold, high winds, and heavy snows that hampered transportation and production. The other was a 111-day strike by Eastern coal miners that sharply reduced coal supplies, forcing some utilities and steel mills to curtail output.

As in early 1977, when severe weather and natural gas shortages slowed activity, the economy snapped back as soon as normal conditions returned. Lack of growth in real GNP in the first quarter, nevertheless, interrupted a procession of 11 consecutive quarterly increases. The rate of price increase accelerated sharply in the second quarter but moderated after midyear.

Consumer outlays rose 11 percent, about in line with the rise in after-tax income and somewhat less than the rise in nominal GNP. Construction and spending on business equipment increased significantly faster than GNP. Government expenditures increased less than GNP, mainly because federal outlays fell short of the spending budgeted.

A recession is usually defined as a significant decline in real GNP for at least two consecutive quarters. The declines usually center in plant and equipment, inventory investment, housing, and consumer durable goods. Government spending and consumer purchases of nondurables and services usually rise even in a general slump.

Plant and equipment spending seems headed for a good year. Inventories are generally well balanced but could be vulnerable if final sales falter. Housing, which was still strong in 1978, is almost certain to decline in 1979. Consumer purchases of durables, which were at a high level in 1977 and 1978, are generally expected to soften.

Consumer spending remains strong

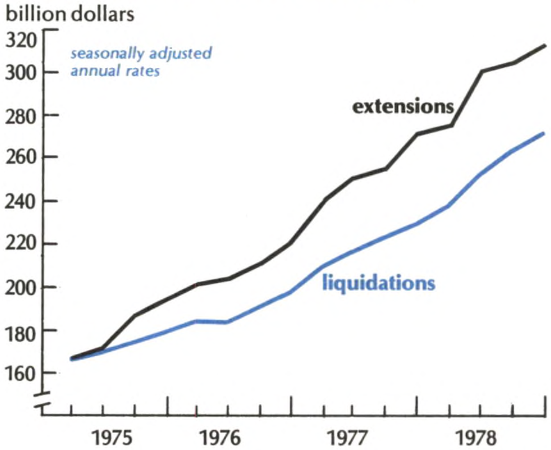
Despite surveys suggesting widespread apprehension, consumers continue to spend at a high rate. Total consumption spending rose about 11 percent last year. That was the same rate of increase as in 1976 and 1977.

Outlays on goods—both durables and nondurables—rose 10 percent. Outlays for services—including medical care, rent, and recreation—rose about 12 percent, marking continuation of a trend for services to account for a growing share of consumption. In 1978, 15 percent of consumption spending went for durables, 39 percent for nondurables, and 46 percent for services. Ten years before, less was spent on services than on nondurables.

Disposable personal income (DPI), income from all sources less taxes, rose more than 11 percent last year. That was the biggest rise since 1973. Savings (DPI less consumption) advanced in step, but as a proportion of DPI, held at about 5 percent. Though roughly the same as in 1977, that was down from almost 6 percent in 1976 and an average of 7.6 percent for 1972-75.

Reflected in the comparatively low rate of savings was continued heavy use of instalment credit. Gross extensions of instalment credit totaled $300 billion last year, 18 percent more than in 1977, when extensions increased

Consumers borrowed heavily



20 percent. Credit outstanding at year-end totaled $273 billion, $42 billion more than a year before and only slightly less than the rate of rise in 1977.

For the past two years, the rise in outstanding instalment credit has been more than half as much as personal savings. That has been unprecedented since World War II. Consumers have also been using mortgage credit increasingly to finance consumption spending.

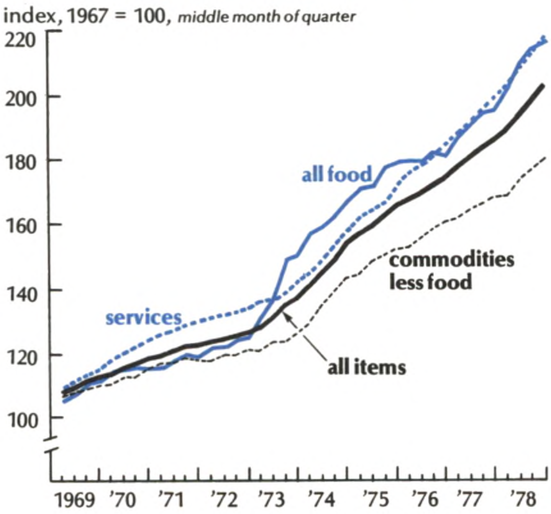
Total car sales of 11.3 million, including 2 million imports, were only slightly below the 1973 record. Including trucks, vehicle purchases reached a new high. About 70 percent of all sales were financed. More than half of the new car loans last year were for more than 36 months. They were mostly for 42 or 48 months, but some carried even longer maturities. Car loans for more than 36 months were rare as recently as 1974.

Of the various types of instalment credit, use of bank cards, a handy substitute for cash, has increased fastest. About $40 billion was extended on bank card credit last year, 30 percent more than in 1977. Outstandings at year-end approached $18 billion, again an increase of about 30 percent.

New debt instruments, changes in consumer attitudes, and the structure of household income cast doubt on assertions of some analysts that consumers generally are over-extended. The Survey Research Center at Ann Arbor has stated that analysis of consumer opinions reveals that fears of inflation, which once caused consumers to hold back on nonessentials, now seem to be stimulating spending.

More couples now have two incomes and no children or old folks to provide for. Most people expect their income to rise year-by-year, often through automatic indexation, and retirement income to be provided. They are often well protected against the contingencies of sickness and disability. Under these circumstances, the concept of discretionary income takes on new dimensions.

Consumer prices accelerated



Consumer prices

The Consumer Price Index (CPI) averaged 7.7 percent higher in 1978, following increases of 5.8 percent in 1976 and 6.5 percent in 1977. After the record 11 percent rise in 1974, the rate of increase slowed in 1975 and 1976, giving unfounded hope that inflation was on the wane.

Monthly trends show an even darker inflation picture. In December, the CPI was up 9 percent from a year before. That was for all types of consumer purchases. But prices of food for use at home were up 12 percent, home ownership up 12 percent, medical care up 9 percent, fuel up 8 percent, and transportation up 8 percent. Apparel prices, which have been held down by a heavy influx of foreign clothes, were up 3 percent.

Part of the record rise in the CPI in 1974 could be attributed to special factors—the sharp increase in energy prices after OPEC boosted oil prices, poor crops, and the end of price controls. No special factors can be blamed for the acceleration of prices in 1978. A multitude of forces are working either to increase money income, reduce supply, or both. These include, for example, automatic cost-of-living adjustments (COLA), more liberal unemployment compensation policies, environmental regulations, government farm programs, restrictions on imports, the higher minimum wage, higher Social Security taxes, the depreciating value of the dollar abroad, and subsidies for rent, food, medical care, and transportation.

Wage and price guidelines

The Administration has insisted it does not favor mandatory wage and price controls. The program in effect from August 1971 to April 1974 is generally believed to have done more harm than good. Many observers have pointed out that interference with the functioning of the market system leads to misallocation of resources, shortages, black markets, and over the long run, more inflation than if controls had not been imposed.

On October 24, the President announced a program of **voluntary** guidelines to slow inflation. He urged that increases in compensation, including fringe benefits, be held to 7 percent, not for every individual, but on average for groups of workers. He also urged that price increases—here, too, the average for all products of a company—be held to half a percent less than the average annual increase for 1976-77. The guidelines do not apply to farm products or imports. A profit margin test will be applied, however, to food processors and retailers and others with special problems.

Under this program, the Council on Wage and Price Stability will require reports from large corporations, especially the 500 largest with annual sales of more than $500 million, for use in determining whether the companies are complying with the guidelines. Companies believed not to be complying will be barred from government contracts if the goods or services they provide can be obtained elsewhere. This holds even if the companies are potentially low bidders.

Various large companies have announced they will cooperate with the guidelines. In most cases, they say the proposed regulations are flexible enough for them to comply without undue interference with their operations.

Some labor leaders have said their unions will cooperate. Others have denounced the proposals as unfair. Major tests will come in the months ahead. The trucking industry pacts expiring in March are deemed particularly significant.

Labor negotiations ahead

In the first five months last year, first-year wage increases negotiated in major labor contracts averaged 7.7 percent, about the same as in 1977. First-year increases in total compensation, including pensions, health insurance, and other supplements, averaged 8.8 percent, somewhat less than in 1977 but clearly well above the guideline.

Some labor unions, those representing coal miners, railroad workers, and machinists, for example, have recently negotiated contracts for increases of 30 percent or more over a three-year period. Administration spokesmen say no effort will be made to challenge contracts already negotiated for fixed future increases. Moreover, new contracts will not be opposed if they match increases in other contracts, provided there is a traditionally "tandem" relationship between the workers.

The labor bargaining calendar was light in 1978, both in terms of the number of workers covered (1.8 million) and the types of unions involved. This year, the "heavy hitters" will come up to bat. Altogether, over 3.7 million workers are involved, including those in the oil industry (January), trucking (March), rubber (April), electrical equipment (June), and autos, farm and construction equipment (September). Most of these groups had increases in compensation in 1976 in excess of the average in contracts negotiated in that year.

Labor costs and productivity

Hourly compensation per worker in the private economy, including employer contributions for Social Security, rose over 9 percent last year, somewhat above the average for the previous five years. In the late 1960s and early 1970s, increases had averaged about 6.5 percent, up from 4 percent in the early 1960s.

Improved efficiency reflected in increased productivity (output per worker hour) helps hold down prices. If increases in productivity matched increases in worker compensation, unit labor costs—the main element in total costs—would be stable. Pressures on prices would be minimized.

In the 25 years 1947 through 1972, productivity for the entire private economy rose an average of 3 percent a year. Since 1972, increases have averaged only about 1 percent. Last year, there was little or no rise in productivity.

With compensation rising 9 percent a year for the past five years and productivity increasing only 1 percent, labor costs per unit of output have increased about 8 percent a year. Prices in the nonfarm economy increased about the same pace.

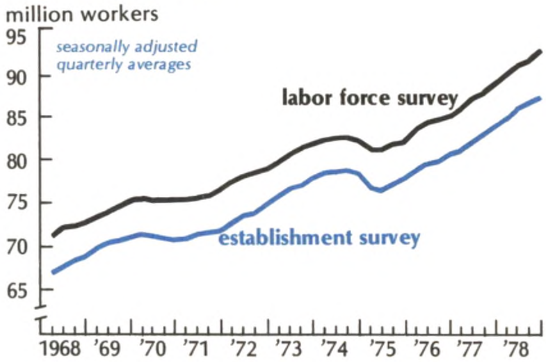
The reasons for the sluggish trend in productivity are not entirely clear. The 1974-75 recession, increased government regulation, unusually severe weather, an inadequate level of investment in modern labor-saving equipment, inadequate training of younger workers, and a rise in the proportion of total output originating in the service industries (where productivity is lower than in the goods-producing industries)—all these have played a part. But one thing is certain. The gap between increases in compensation and increases in productivity will have to narrow before progress can be made against inflation.

Employment and unemployment

One of the salient features of the business expansion that began in the spring of 1975 has been the rapid rise in employment. Employment totaled almost 96 million in December, up 3.3 million from a year earlier and 10 million from the cyclical peak of 1974. The rise has been unprecedented.

Except for agriculture, where the trend is still downward, all major types of employment have increased substantially in the past three and a half years. Proportionately, the biggest gains have been in the trade and service industries. All five states of the Seventh

Employment rise has been unprecedented



Federal Reserve District report large gains in employment, though only in Wisconsin has the pace matched the national surge in employment led by the fast-growing states of the South and West.

Unemployment remained at the 6 million mark last year. That was slightly less than 6 percent of the civilian labor force, which was almost 102 million in December. Unemployment tends to be concentrated among young workers and minority workers.

Over 59 percent of the population over 16 years old held jobs in December. That was a record proportion, up from 58 percent in December 1977 and 56 percent in December 1976. Reflected mainly in the higher job-to-population ratio was the increase in the number of women workers. Women now make up 41 percent of the labor force, compared with 36 percent a decade ago.

Manufacturing leads GNP

While real GNP rose 4 percent last year, manufacturing output increased about 6 percent, the same as in 1977. After a drop in January associated with bad weather, manufacturing output rose steadily throughout the rest of the year. Large order backlogs for durable goods suggest that the uptrend could continue well into 1979.

In December, the Federal Reserve's index of manufacturing output, measured in physical units, passed 151 (1967=100), rising to a level 8 percent higher than a year earlier. Nearly all types of manufacturing participated in the rise, but business equipment was the star performer. Output of business equipment was 10 percent higher than in December 1977, compared with an increase of 3 percent for the production of consumer goods.

The motor vehicle industry turned in another strong performance. It produced 9.2 million passenger cars, about the same number as in 1977. The record was set in 1973, when 9.7 million cars were produced. The industry produced 3.7 million trucks. That was a new record, 7 percent more than the previous high set in 1977. Many of the smaller trucks were bought for personal use. Plants producing trucks operated close to capacity all year. Demand for four-wheel drive vehicles and heavy-duty trucks was especially strong.

Demand for farm equipment was weak early in the year, when farm prices were low and farm income depressed. But sales began improving rapidly in the spring, and production schedules were stepped up. Inventories of farm equipment were low in December, compared with a year earlier.

Steel shipments from domestic mills totaled 98 million tons last year, up from 91 million a year earlier but still well below the record 111 million tons shipped in 1973.

With the government moving to discourage below-cost sales of foreign steel here, imports had been expected to decline from the 19.3 million ton record set in 1977. Instead, they rose to a new high of 21.6 million tons. That was 18.4 percent of domestic supplies last year, another new high.

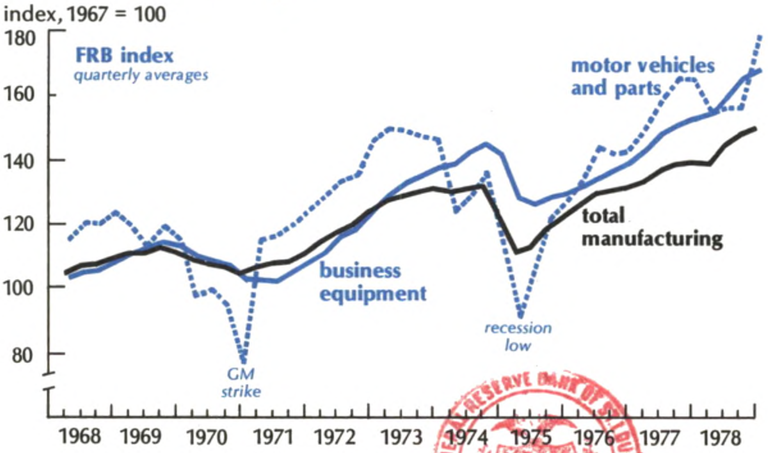
Housing surprisingly strong

Because of high interest rates and a projected reduction in the availability of mortgage funds, housing starts had been generally expected to decline in 1978, dropping probably 10 percent or more. But about 2 million units were started, the same as in 1977 and a total substantially exceeded only in 1972, when there were 2.4 million starts. Sales of existing homes rose 9 percent from the previous record set in 1977 to a new high of 3.9 million. Prices rose 12 to 14 percent.

Starts and sales stayed high because mortgage credit remained available. Savings and loans, the main lenders on residential property, continued to receive large net inflows of funds. In previous periods of tight money, such as 1973-74, interest rate ceilings imposed by regulatory authorities prevented savings institutions from competing effectively for funds. The result was *disintermediation,* meaning investors turned to higher-yielding money-market instruments, such as Treasury bills.

Several factors helped support the flow of mortgage funds in 1978. Beginning in June, S&Ls were allowed to offer six-month certificates of deposit in amounts of $10,000 or more at yields as high as ¼ percent above the latest auction yield on six-month Treasury bills. Sales of these money-market certificates enabled S&Ls to maintain a large volume of funds to meet loan demand. Another factor was the sale

Business equipment production outgained total manufacturing



of bonds secured by mortgages, mostly under federal guarantees. Still another was an easing up on usury ceilings. Various states, including Illinois and Iowa, had raised ceilings or made them more flexible in recent years.

At 1.4 million, single-family starts last year approached the 1.45 million record set in 1977. Construction of apartments was much more volatile, as it has been in recent years. About 600,000 multifamily units were started in 1978, 12 percent more than in 1977. But while the rate of multifamily starts was twice the depressed rate in 1975, it was still 40 percent less than in the boom from 1971 to 1973.

A major factor in the undertaking of multifamily projects has been the availability of federal subsidies. Subsidized multifamily starts reached about 200,000 in 1978, more than four times the starts in 1975. Despite low vacancy rates, unsubsidized apartment construction has been held back by rents that while rising, have not kept up with costs of construction and operation. Starts on condominiums and conversions of existing apartments to condominiums have picked up in the past two years. This has been mainly because of tax advantages to both buyers and sellers.

After holding near 9 percent from 1975 through 1977, interest rates on new mortgages averaged about 10 percent by late 1978. Buyers were willing to pay these rates because real estate has proven to be the best hedge against inflation available to most households. To acquire an equity interest in their house or apartment, people have been willing to devote more of their income to mortgage payments. The trend has been encouraged by the growing number of families with two incomes and often no children.

High rates on mortgate and construction loans, combined with slower growth in family income, are likely to dampen residential construction this year. But with the continued availability of credit and a strong rate of household formation, the decline can probably be held to no more than 10 to 20 percent this year, which is not nearly so steep as in past housing cycles.

Capital expenditures and capacity

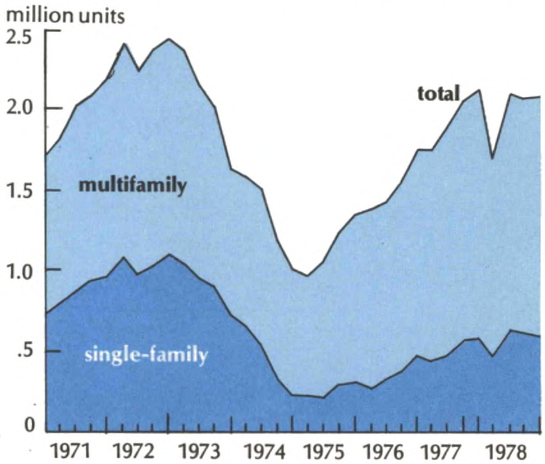
Business outlays on new plant and equipment have increased rapidly for three years. Spending increased 16 percent last year. After adjustment for inflation, the increase was about 8 percent. Capital outlays were 10.6 percent of GNP last year, a ratio surpassed only in 1966 and 1974 and then only slightly.

Surveys show business capital outlays are expected to rise again in 1979. Though the increase is apt to be somewhat less than in 1978, prospects for continued expansion in control spending are supported by large backlogs of orders reported by producers of capital equipment and by the heavy volume of contracts for nonresidential construction.

Orders have been particularly strong for machine tools, construction equipment, heavy trucks and trailers, railroad equipment, and commercial aircraft. F.W. Dodge reported that contracts for commercial buildings last year were 50 percent higher than in 1977. Contracts for manufacturing buildings were up 60 percent. Similar increases were reported for the Midwestern region. Much of this work will be put in place in 1979.

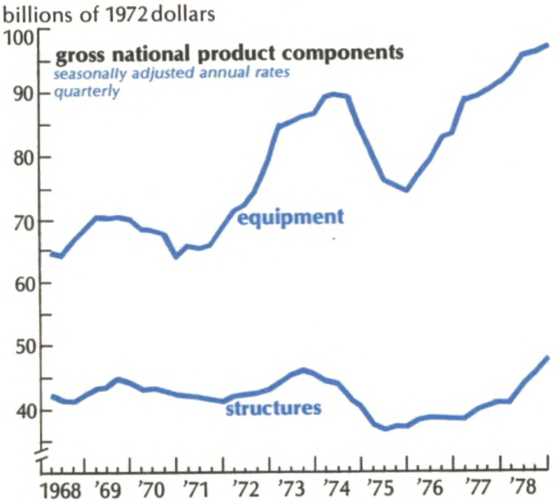
If the nation is to have a comfortable, prosperous future, capital outlays will have to

Housing maintained high plateau



rise further. A large part of business outlays is going to alleviate pollution, promote health and safety, and comply with other state and federal regulations, rather than to improve efficiency or add to the capacity to produce goods and services. Large additional outlays are also going to ensure adequate supplies of increasingly expensive energy and to conserve use of energy.

Spending on business structures and equipment surged



Demands on productive facilities, raw materials, and the experienced people in the workforce kept the nation's economy operating close to its effective capacity in 1978. Margins of unused resources are uncomfortably narrow in such important sectors as energy, transportation, steel, nonferrous metals, and building materials, including cement, brick, sheetrock, and insulation. Demand for technical and scientific skills substantially exceeds the number of trained people available for work.

Until the capital stock and pool of trained workers are raised appreciably, additional buying power created by higher incomes and expanding credit will not raise total output. Rather, it will be dissipated in higher prices. A healthy atmosphere for private capital formation is an essential ingredient for material progress.

Agriculture: farm income recovers

Farm earnings rose substantially last year, breaking a four-year slide. The index of prices received by farmers averaged a record 209 (1967=100). That was 14 percent over the previous year and 9 percent over the previous high in 1974.

Livestock led the upturn as smaller supplies of meat and milk and decidedly stronger demand pushed prices of livestock 23 percent higher than in 1977.

Crop prices contributed to the rise, but with increases that averaged only 6 percent. Crop production surpassed the record 1977 harvest, providing abundant grain supplies throughout last year. But with record foreign purchases and the new grain reserve programs, grain and soybean stocks were not as burdensome as expected.

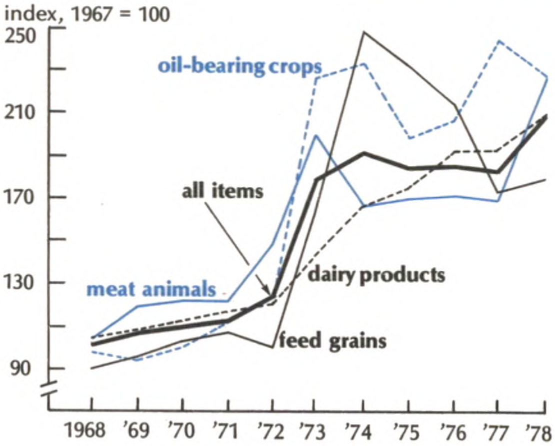
Higher prices and higher government payments boosted gross farm income to about $125 billion. Despite another substantial rise in production expenses, gross returns were enough to boost net farm income about two-fifths higher than the depressed $20 billion in 1977.

This strong performance contrasted sharply with initial forecasts of another year of low earnings. It also belied much of the concern that had prompted the American Agricultural Movement to mount one of the strongest farm lobbying efforts ever seen.

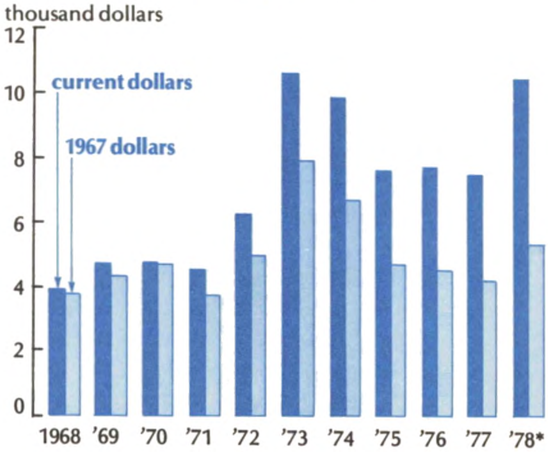
Land values and capital spending rose

Improved farm earnings led to a strong recovery in capital spending and aggressive bidding for farmland. It is estimated that farmland values rose a tenth last year, marking a threefold increase since the beginning of the 1970s. Even bigger increases were seen in the Midwest, where surveys by the Federal Reserve Bank of Chicago showed farmland values rose about 17 percent. For many farmers that own their land, the unrealized gain from appreciation in land values again surpassed the net operating returns to land.

Strong livestock markets boosted farm prices to a new high in 1978 . . .



. . . ending the 4-year slide in net farm income per farm



*Preliminary.

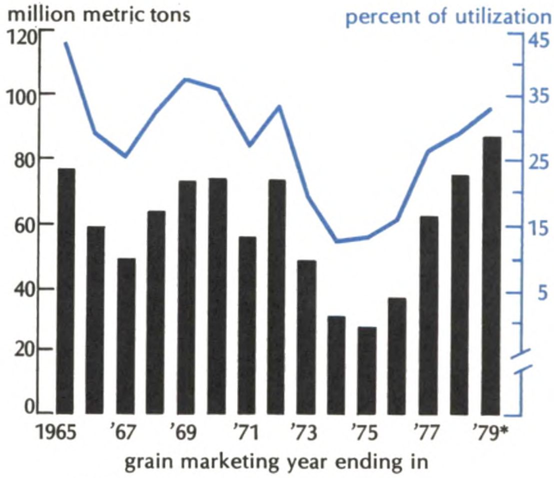
With the remarkable appreciation in land values has come concern that nonfarmer investors may be a stronger component in the demand for land. Concern focused last year on foreign investors, partly because of the bidding advantages that accrued to some foreign buyers from the decline in the value of the dollar. Although it is generally believed that foreign ownership of land is at most nominal, the facts are not known. To provide information for an objective assessment of the situation, Congress passed the Agricultural Foreign Investment Disclosure Act late last year. The act set up a nationwide system for keeping track of the amount of land foreigners own and the amount they buy in the future.

The recovery in capital expenditures showed up particularly in purchases of machinery and equipment and construction of grain storage facilities. In the first 11 months of the year, unit retail sales of farm tractors were 6 percent higher than in the corresponding period a year earlier. Sales of combines were up 9 percent. These increases were in sharp contrast to the sluggish sales forecast in early 1978 that led to layoffs and caused some manufacturers to shut down plants for a while.

Information on expenditures for new grain storage facilities is sketchy. It is clear, however, that substantially more was spent than in other recent years. A liberalized government loan program helped finance over 750 million bushels in new on-farm storage capacity in fiscal 1978. That was equivalent to nearly a third of the storage facilities built under the loan program during the previous 29 years it had been in existence. Other facilities were built, no doubt, with private financing. Overall, farmers probably expanded their storage capacity about a tenth last year.

The reason for the surge in construction of on-farm storage facilities was the new grain reserve program authorized in late 1977. The program is designed to withhold grain from the market for three years or until prices at the farm rise up to established trigger levels. By late December, 33 million metric tons of grain had been accumulated under the program, including 410 million bushels of wheat and 720 million bushels of corn. That represents about half of the projected carryover stocks of grain.

The buildup in carryover stocks of grain is expected to continue into next year



*USDA projection.

Agriculture and the rest of the economy

Improved farm earnings reflected strength in both domestic and foreign markets but left divergent implications for two measures of the economy overall. The value of agricultural exports rose to a new high in fiscal 1978, helping offset the ballooning deficit in nonagricultural trade. But there was also an ominous development in agriculture's contribution to the rekindling of inflationary pressures.

Nearly 122 million metric tons of farm commodities were shipped abroad in the fiscal year that ended in September. That was nearly a fifth more than the shipments in fiscal 1977 and a seventh more than the previous high in fiscal 1976. The increase was made despite transportation snarls during the winter and shortages of rail cars during the spring and summer, when grain and soybean shipments were exceptionally high.

With feed grain and soybean prices down

from the year before, not all the increase in shipments was reflected in the value of exports. The value of farm exports, nevertheless, rose to $27.3 billion in fiscal 1978—14 percent more than the previous year. Imports of agricultural products, on the other hand, were up only nominally, leaving an agricultural trade surplus of $13.4 billion.

Despite the declining value of the dollar, exports to such strong currency countries as Japan and those in Western Europe increased little in fiscal 1978. At a combined $13 billion, farm exports to Japan and Western Europe were up only 4 percent.

By contrast, exports to the Soviet Union increased about three-fourths, nearly equaling the $2 billion in 1976. Mainland China, after three years of virtual absence from American farm markets, imported over $350 million in agricultural products from here last year. Agricultural exports to Latin America increased nearly a third, to $2.8 billion. Exports to African countries were up about a fifth, and exports to Asian countries—excluding Japan and mainland China—were up a sixth.

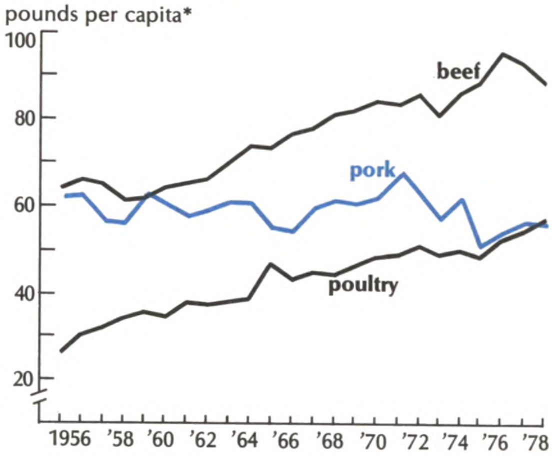
Food prices soared

Retail food prices soared at an annual rate of 18 percent in the first half but slowed to an annual rate of 5 percent in the second half. For the whole year, food prices averaged a tenth higher, twice the increase forecast a year ago. Higher prices for raw food materials accounted for about half of the rise. Higher costs for processing and distribution accounted for two-fifths.

Prices for red meats, poultry, fish, and eggs averaged 15 percent higher last year, largely because of the pronounced recovery in demand. Per capita supplies of all meat, although less than expected, were down only 1 percent from the 1977 record. The mix in meat production shifted, however, resulting in more poultry and less beef. Pork production was virtually unchanged.

Retail prices of fruits and vegetables averaged 11 percent higher last year. Much of the rise was related to weather. For the second winter in a row, produce in Florida was trimmed by a freeze. And in California, an unusually warm winter coupled with high winds and excessive rain in the spring and summer reduced the production of several different fruits and vegetables.

Consumers ate more poultry than pork in 1978



*Retail weight basis.

Government programs also put pressure on food prices last year. The ratcheting up in dairy supports, for instance, contributed to an average rise of 7 percent in retail dairy product prices. Likewise, changes in government programs that boosted wheat prices helped push average retail prices of cereals and bakery products 9 percent higher. And government actions to support domestic sugar producers led to a 12 percent average rise in retail prices of sugars and sweets. This was despite the most burdensome world sugar surplus in years.

Review and outlook by commodities

One of the surprises in 1978 was the lack of an increase in pork production. The consensus a year ago was that pork production would increase at least a tenth, causing hog prices to plunge. Instead, pork production was virtually unchanged. And hog prices, reflecting smaller supplies of beef and a pronounced recovery in demand, rose nearly a fifth to average $48.50 per hundredweight.

The failure of pork production to respond to the strongest incentives for expansion in decades is not fully understood. The harsh winter was a contributing factor, however. And many analysts believe the shift in recent years to more capital-intensive production facilities may have lengthened the production-response cycle.

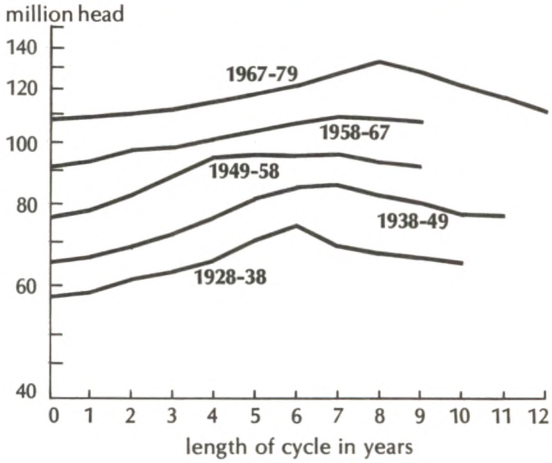
Whatever the reason for the performance last year, conditions still point to a substantial rise in pork production. A December survey of recent and prospective actions by hog farmers showed that pork production could rise a tenth in 1979. An increase of that size would push hog prices lower and offset much of the expected decline in beef production. With the further likelihood of substantially larger poultry production, per capita consumption of all meats could increase slightly this year.

The mix in cattle slaughter last year moved closer to the norm of the early 1970s as the liquidation phase of the cattle cycle wound down. The movement of cattle through feedlots rose to a near-record level, boosting fed cattle slaughter 7 percent. But nonfed steer and heifer slaughter was cut in half and cow slaughter was reduced 13 percent, resulting in a 4 percent decline in total beef production. The decline, buttressed by strong demand, pushed choice steer prices to a record average of $52.25 per hundredweight, nearly 30 percent higher than the year before.

Factors underlying the past two years of decline in beef production are tied to the cattle cycle. The huge financial losses that staggered cattlemen from 1974 to 1977 triggered a massive liquidation of the breeding herd, temporarily swelling beef supplies. The liquidation, however, has reduced the inventory of beef cows (net of additions through replacement heifers) nearly a fifth over the past four years. With fewer cows, calf crops have gotten smaller. Estimates show the 1978 calf crop was the smallest in 11 years. And the crop could be smaller in 1979.

Implications of the sharp reduction in the cow herd are not encouraging for near-term beef supplies. Calf crops are not large enough to maintain past levels of beef production and accommodate the herd rebuilding that is needed for future growth in consumption.

The downturn in the cattle cycle is the most pronounced since the 1920s

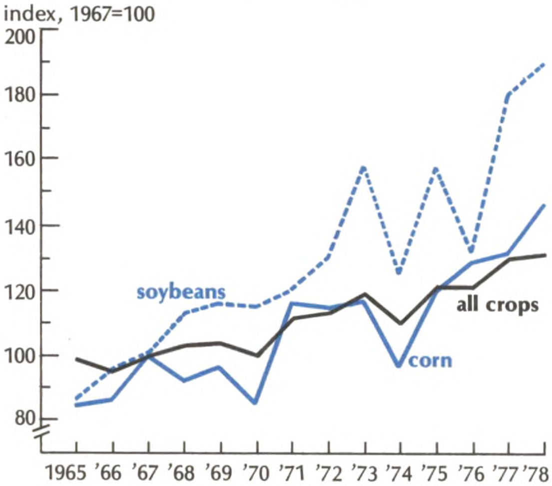


If market forces encourage herd rebuilding, beef production will trend lower for the next two or three years. Per capita beef consumption could drop to the levels of the late 1960s. And cattle prices could rise to new heights. The extent of the rise in prices will depend mostly on the availability of pork and poultry and the willingness of consumers to switch to these other meats while beef supplies are tight.

Dairy farmers received higher prices and earned more in 1978, and their prospects seem equally bright for 1979. Prices farmers received for milk averaged 9 percent higher than in 1977. The increase came largely as a result of the statutory semiannual increases in dairy support prices. Milk production declined nominally but still exceeded the record amount utilized commercially. The better balance between production and utilization allowed government purchases of manufactured dairy products (the mechanism for supporting prices) to decline more than a half from the high level a year earlier.

Higher support prices will contribute to another rise in earnings of dairy farmers this year. Milk production may edge up a little,

Corn and soybeans pulled all crop production to a new high in 1978



but high cow prices will probably encourage further culling of the dairy herd. Barring a downturn in the general economy, demand is expected to remain strong, fueled in part by a rebuilding in the low commercial stocks of dairy products.

Grain and soybean prices were supported throughout much of last year by the drouth-reduced harvests in the Southern Hemisphere. The combined Australian and Argentinian wheat harvest was cut a third last winter. In Brazil, the soybean harvest last spring was a fourth less than expected. These reductions in competing supplies overseas—and transportation problems in Canada—gave U.S. exporters a decided edge in meeting the strong world demand for grains and oilseeds.

Prices drifted slightly lower in the second half as it became apparent that grain crops in the Northern Hemisphere would be very large. Final estimates show the United States, Western Europe, and the Soviet Union all brought in record harvests.

In the United States, reduced plantings cut wheat production 12 percent. But corn production rose a tenth, to a record 7.1 billion bushels. Per-acre corn yields exceeded 101 bushels, ten bushels above the previous year and four bushels above the previous high in 1972. The soybean harvest, at a record 1.8 billion bushels, was up 5 percent. These levels were reached despite late plantings and the first use of voluntary acreage controls since 1973.

Large crop harvests the past two years have provided more than adequate supplies of grain. Domestic carryover stocks rose to 74 million metric tons in 1978, up a fifth from the year before. Projections show the carryover rising to a 15-year high of 86 million metric tons in 1979. Equal to a third of the expected utilization, that will be the largest stock relative to utilization since early in the decade. Corn accounts for all of the projected increase in carryover stocks of grain.

The relative accumulation of soybean carryover has been far more modest. Projections are the soybean carryover this year will still be less than a tenth of utilization.

Prices of grains and soybeans will be strongly influenced this year by foreign demand and growing conditions around the world. Mainland China will import large amounts of grain from the United States. But exports to other countries may be somewhat eroded by the large world supplies, particularly if wheat and soybean production in the Southern Hemisphere returns to the record levels expected this winter and spring.

Domestic crop production in 1979 will likely reflect larger plantings. Wheat acreage will be up substantially. In the Midwest, farmers will likely substitute soybeans for some corn acreage. Final production prospects, of course, will hinge largely on the vagaries of weather.

Economic events in 1978—a chronology

Jan 1 Minimum wage rises from $2.30 to $2.65. (On January 1, 1979, it rises to $2.90.)

Jan 1 Pay base for Social Security rises from $16,500 to $17,700, and tax rate rises from 5.85 to 6.05 percent. (On January 1, 1979, base rises to $22,900 and rate rises to 6.13 percent.)

Jan 4 Treasury and Federal Reserve intervene in foreign exchange markets to moderate fluctuations in the dollar.

Jan 6 Prime rate rises from 7.75 to 8 percent.

Jan 9 Discount rate rises from 6 to 6.5 percent.

Jan 13 Arthur Burns resigns from Federal Reserve Board, effective March 31.

Jan 23 President Carter proposes $34 billion tax cut.

Jan 27 Blizzard hampers industry and trade in Midwest.

Feb 6 Major blizzard hits Midwest and East.

Feb 14 President approves sale of advanced fighters to Egypt, Israel, and Saudi Arabia.

Feb 20 Indiana orders cutback in electricity usage to conserve coal supplies depleted by strike in eastern mines.

Feb 22 Supreme Court rules employees can demand jury trial in age discrimination cases.

Feb 27 ICC orders railroads to allocate freight cars to speed grain shipments.

Feb 28 Dow stock average closes at 742, low for the year.

Mar 4 Chicago Daily News ceases publication after 102 years.

Mar 8 G. William Miller (named December 28) is sworn in as chairman of Federal Reserve Board.

Mar 9 Federal Open Market Committee (FOMC) announces retention of M-1 and M-2 growth ranges, but reduces limits of M-3 range.

Mar 13 Treasury and Federal Reserve announce commitment of additional resources to stabilize the dollar.

Mar 27 Coal strike ends after 111 days with three-year pact boosting compensation 39 percent.

Apr 1 Majority of member nations ratify changes in the articles of agreement of the IMF.

Apr 6 Amendment to Age Discrimination Act ends mandatory retirement age in federal jobs and raises age from 65 to 70 for private companies.

Apr 11 President urges 5.5 percent ceiling for price and wage hikes.

Apr 11 Volkswagen produces its first U.S.-built car at New Station, Pennsylvania.

Apr 12 House rejects Emergency Farm Aid Bill.

Apr 14 Federal Home Loan Bank Board (FHLBB) reduces liquidity requirement for S&Ls from 7 to 6.5 percent.

Apr 18 Senate approves treaty transferring Panama Canal to Panama by year 2000.

Apr 20 Treasury announces additional sale of gold to stabilize the dollar.

Apr 25 FOMC announces retention of growth ranges for M-1, M-2, and M-3.

May 1 Federal Reserve Board approves plan to allow automatic transfers from savings to checking accounts (ATS), starting November 1.

May 5 Prime rate rises to 8.25 percent.

May 7 Saudi Arabia and Iran overrule other OPEC nations that want to boost oil prices.

May 11 Federal Reserve discount rate rises to 7 percent.

May 25 Prime rate rises to 8.5 percent.

Jun 1 Change in Regulation Q permits banks and S&Ls to tie rates paid on CDs to Treasury Bill rates.

Jun 7 California voters overwhelmingly approve Proposition 13, sharply limiting property taxes.

Jun 16 Prime rate rises to 8.75 percent.

Jun 28 Supreme Court issues Bakke decision, apparently limiting use of racial quotas for "affirmative action."

Jun 30 Prime rate rises to 9 percent.

Jul 3 Federal Reserve discount rate rises to 7.25.

Jul 7 Federal Reserve Board sends Congress proposed changes in rules for membership in the System.

Jul 16 Economic summit meeting convenes in Bonn to discuss measures for dealing with world economic problems.

Jul 28 FOMC announces retention of growth ranges for M-1, M-2, and M-3.

Aug 4 Agricultural Credit Act permits Farmer's Home Administration to aid farmers facing foreclosure.

Aug 21 Federal Reserve discount rate rises to 7.75 percent.

Aug 24 Treasury announces increased gold sales.

Aug 28 Federal Reserve Board eliminates reserve requirements on foreign borrowings.

Aug 30 Prime rate rises to 9.25 percent.

Sep 7 House upholds President's veto of $37 billion arms bill.

Sep 8 Dow industrial average closes at 908, high for year. (Identical peak is reached again on September 11.)

Sep 15 Prime rate rises to 9.5 percent.

Sep 15 International Machine Tool show closes in Chicago, with reports of booming business.

Sep 17 International Banking Act provides for federal regulation and supervision of foreign banks in the United States.

Sep 18 Nancy Teeters sworn in as first woman on Federal Reserve Board.

Sep 20 Energy Department officials report adequate natural gas supplies for winter.

Sep 20 Congress adopts Second Budget Resolution setting fiscal 1979 outlays at $487.5 billion and deficit at $38.8 billion.

Sep 22 Federal Reserve discount rate rises to 8 percent.

Sept 28 Prime rate rises to 9.75 percent.

Sep 29 Nationwide rail strike ends by court order after four days.

Oct 1 General pay increase boosts pay of federal workers by 5.5 percent in addition to usual "step" increases.

Oct 4 Council on Wage and Price Stability (CWPS) says underlying inflation rate is 7 percent, against 6 percent in 1977.

Oct 12 Prime rate rises to 10 percent.

Oct 15 Congress passes $18.7 billion tax-cut bill.

Oct 15 Congress passes major energy legislation.

Oct 16 Discount rate rises to 8.5 percent, all-time high.

Oct 17 Agricultural Foreign Investment Disclosure Act creates system to monitor foreign purchases of farmland.

Oct 18 Philip Jackson resigns from Federal Reserve Board, effective November 17.

Oct 23 Prime rate rises to 10.25 percent.

Oct 24 OSHA drops 928 job-safety rules.

Oct 24 President announces voluntary guidelines for wage and price boosts.

Oct 27 Full Employment and Balanced Growth Act ("Humphrey-Hawkins") calls for achievement of 4 percent employment and 3 percent inflation by 1983.

Oct 30 Treasury sells notes yielding a record 9.25 percent.

Oct 31 Amendment to Civil Rights Act of 1964 requires employers to treat pregnancy as an illness.

Nov 1 Commercial banks begin offering ATS accounts.

Nov 1 President announces plan to support sagging dollar. Plan includes larger gold sales and increased market intervention through acquisition of foreign currencies. In coordinating actions, Federal Reserve raises discount rate from 8.5 to 9.5 percent and increases reserve requirements on large CDs.

Nov 1 Prime rate rises to 10.5 percent.

Nov 2 Under Treasury tax and loan investment program banks pay interest on Treasury note balances and receive fees for services.

Nov 3 Prime rate rises to 10.75 percent.

Nov 5 Iranian prime minister resigns as riots and strikes disrupt economy and reduce oil output.

Nov 6 New York newspapers resume publication after 88-day strike.

Nov 6 Community Reinvestment Act regulations become effective, requiring financial institutions to meet neighborhood credit needs.

Nov 7 Elections somewhat reduce large Democratic majorities in Congress.

Nov 9 Department of Agriculture reports record corn and soybean harvests.

Nov 10 Financial Institutions Regulatory Act increases supervisory power over financial institutions.

Nov 13 Prime rate rises to 11 percent.

Nov 16 FOMC announces retention of growth ranges for M-2, M-3 but reduces limits for M-1 range.

Nov 17 Federal Reserve Board issues tentative schedule for pricing check collection, clearing, and settlement services.

Nov 19 Death of Vice Chairman Stephen Gardner creates second vacancy on Federal Reserve Board.

Nov 24 Prime rate rises to 11.5 percent.

Dec 1 Shell announces plan to ration gasoline to dealers.

Dec 11 Supreme Court affirms Federal Reserve Board's power to set capital requirements for bank subsidiaries of bank holding companies.

Dec 12 FHLBB reduces liquidity requirement for S&Ls from 6.5 to 6 percent.

Dec 13 Production of Susan B. Anthony dollar begins.

Dec 15 President announces formal recognition of China, effective January 1, 1979.

Dec 16 Cleveland defaults on bank loans.

Dec 17 OPEC announces three-stage 14.5 percent boost in crude oil prices for 1979.

Dec 20 Prime rate rises to 11.75 percent.

Dec 22 Consumer price index for November reported 9 percent above year-earlier level.

Dec 27 FNMA auctions commitments to buy government-backed mortgages at record 10.6 percent.

Dec 31 Heavy snows hit Midwest, followed by severe cold.

Dec 31 Year ends with widespread forecasts of a recession, but with employment, output, and retail trade still vigorous.

Government: the federal government shifts gears

This time a year ago, the government was expecting a deficit for fiscal 1978 (October 1, 1977, to September 30, 1978) of $62 billion. The Administration presented Congress with a budget proposal for fiscal 1979 that implied essentially no change in the deficit that year.

Nowhere in the President's Budget Message last January was the word *inflation* used. The focus was on the need for a fiscal policy that provided continuing economic recovery. Over the course of the year, however, the Administration shifted its attention from stimulating further growth of the economy to reducing inflation.

The change had little effect on fiscal 1978. But it was largely responsible for differences in the planning for fiscal 1979 and 1980.

Fiscal 1978—the outcome

Federal outlays totaled $450.8 billion in fiscal 1978. With receipts at $402 billion, the deficit was $48.8 billion. The final figure for receipts is remarkably close to the January estimate of $400.4 billion, particularly as that figure would have been about $800 million higher if it had been estimated by the bookkeeping procedures used now. Outlays were almost $11 billion less than expected in January and $2 billion less than the forecast in July—mainly for a reason that has plagued budget authorities for years.

Government departments consistently overestimate their needs, during both preparation of the budget and later quarterly reviews. This year a substantial portion of the shortfall came from lower-than-expected defense spending and slowness in building the petroleum reserve. The Office of Management and Budget has tried to improve estimates of spending, but considering the large proportion of spending going to entitlement programs, errors in estimates of total outlays are apt to recur.

The tax cut—smaller, later, restyled

The budget proposal presented last January for fiscal 1979 included a tax cut over and above those previously passed but scheduled to expire at the end of calendar 1978. The cut, about two-thirds for individuals and a third for businesses, was planned to take effect October 1.

As proposed, the cut in personal income taxes was skewed toward low incomes. A tax credit would replace the personal exemption. Some deductions taken by individuals that itemize deductions would be eliminated or reduced, and use of other deductions would be restricted. Treatment of capital gains and some other tax preferences under the minimum tax would be tightened.

A similar approach was taken toward corporate income taxes. Rates would be reduced, but so would the allowable deductions. The investment tax credit would be made permanent and even liberalized. But the liberal treatment of domestic international sales corporations, income of foreign subsidiaries, and deductions for business meals, entertainment, and first-class air travel were items scheduled to be phased out, limited, or eliminated immediately.

About three and a half months after the President made his tax proposal, however, the Administration and Congress agreed that with inflation worsening, the tax cut would have to be smaller than originally proposed. The change was made primarily by shifting the effective date for most provisions forward to January 1979.

In addition to reducing the size of the tax cut, moreover, Congress drastically changed its form. Two concepts seem to have been underlying the thinking in Congress. One was that the combined effects of inflation and the progressiveness of the tax structure required that more relief be given to middle-income groups than to low-income groups. The other was that taxes on capital gains, which had been raised in several recent tax bills, were discouraging the investment now needed to increase the potential growth of the economy.

The bill that finally passed raises personal exemptions from $750 to $1,000. It reduces the progressiveness of the personal income tax by reducing the rates and widening the tax brackets. Tax rates on capital gains are generally reduced, the maximum effective rate dropping from 49 percent to 28 percent. Taxpayers that itemize lose their deductions for state and local gasoline taxes.

Corporations get less reduction in income taxes than originally proposed. Broader use can be made of the investment tax credit, however, and like individuals, corporations pay lower taxes on capital gains. Some deductions for entertainment expenses are no longer allowed.

The bill, identified as the Revenue Act of 1978 (PL 95-600), is long and complicated. It changes the treatment of partnerships, some tax shelters, deferred income, and unemployment compensation. These are special changes, however, and while they may impact heavily on some taxpayers, they will have little effect on the size or shape of the tax reductions in the bill overall.

Fiscal 1979—the outlook

The budget picture for fiscal 1979 is now completely different from the way it was originally proposed last January, particularly for revenues. Expenditure estimates have been reduced from $501 billion to about $492 billion, but this lower estimate comes almost entirely from the lower-than-expected spending in fiscal 1978. Increases in spending in fiscal 1979 over those of 1978 are expected to be about the same as originally forecast. Revenues are now estimated at about $453 billion, up sharply from the original estimate of $441 billion, primarily because of the smaller tax cut.

As a result, instead of a deficit in excess of $60 billion, as was originally forecast, the estimate is now down to $39 billion. Receipts and expenditures during the first quarter of the fiscal year (last quarter of calendar 1978) were consistent with these forecasts.

This shift is a major change from the fiscal policy underlying the budget presented a year ago. There is clearly less fiscal stimulus. Moreover, the most recent budget statement for fiscal 1980, with a proposed deficit of $29 billion, suggests that a policy of progressively lowered deficits is to continue at least another year. The deficit for fiscal 1980 could, however, grow substantially if the economy weakens as much as some private forecasters are suggesting. Lower incomes than the administration has estimated would reduce receipts, and higher unemployment would increase spending.

Holding the deficit to this figure, without raising taxes, will take a tight rein on spending. Social Security pensions, government retirement pay, veterans' pensions, and payments covered by similar programs go up automatically with the inflation rate. For budget objectives for 1980 to be met, spending on other programs—those legislated every year—will have to be constrained or even reduced from the levels of fiscal 1979.

A partial energy program

A year and a half after the President presented his proposals for a comprehensive energy program, Congress passed a bill that dealt primarily with the pricing and use of natural gas. Problems with the oil aspects of the energy program were left to the new Congress. Unless Congress acts, existing controls on oil will expire in May.

Legislation as passed has two main features: the gradual phasing out of price controls on new natural gas by 1985 (with some standby authority through 1988) and the imposing of controls on intrastate gas, which has been free of federal controls.

Price ceilings with escalator clauses tied to the inflation rate were established for various classifications of gas, depending on such factors as dates of discovery and terms of contract. The escalators seem generous enough for market conditions to keep prices below legal ceilings until controls end.

Under certain circumstances, the Energy Department can order industrial boilers converted to coal and require use of coal on new facilities. Use of coal, however, is still constrained by environmental requirements.

Similarly, utilities burning natural gas in existing plants are expected to convert by 1990. New power plants cannot be built to use natural gas, nor can existing plants be converted to gas.

Other provisions of the program require state regulators to hold hearings over the next two years on the feasibility of introducing rate structures designed to encourage energy conservation.

A "gas-guzzler" tax was introduced, beginning with 1980 models. The tax gets progressively higher and the mileage rating to which it applies gets progressively lower every year through 1985. For 1980, performance better than 17 mpg is not taxed. But a tax as much as $650 is imposed on cars (and light vans) getting no more than 13 mpg. By 1985, the levy begins at $400 for performance less than 23.5 mpg and rises to $3,850 for vehicles getting no more than 12.5 mpg. These penalties are, naturally, to be passed through to buyers.

State and local government

Last year has been called the year of the taxpayers' revolt. The rallying point of the revolt was California's Proposition 13, which sharply rolled back property taxes and limited the ability of the state legislature and local taxing authorities to raise other taxes. The proposition was originally thought to be another attempt at an issue that had been defeated in 1968 and 1972. This time, however, California voters surprised everybody by passing the proposition decisively. The California vote in June was a catalyst for discontent in other states. Some form of tax limitation issue was on the ballot in 16 states in November.

Issues were generally less restrictive than the proposition in California. Only Nevada passed a constitutional amendment directly modeled on Proposition 13. And the law there requires that before the amendment can take effect, it must be voted on again in 1980. Voters in 11 other states took some kind of action bearing on taxes. Outcomes ranged from Illinois's advisory referendum that said taxes and spending were too high, and should be limited, to North Dakota's direct reduction of individual income tax rates. Several states put limits on spending by tying outlays to personal income.

The limit placed on California's property tax is believed to have reduced local tax receipts there by about $7 billion. Much of that was made up by dividing the state's $5 billion surplus with local governments. It is estimated that the federal government will collect about $2 billion more in California than it would have. This is because both individuals and businesses will have smaller deductions for local taxes.

While the financial conditions of most state and local governments have improved with growth in the general economy, there are exceptions. Even with the federal government guaranteeing loans up to $1.6 billion, New York City has still not convinced some observers that it can cut spending fast enough to bring its budget into balance in the near future. Detroit has been able to recover after substantial austerity, but Newark continues to experience financial problems.

The newest addition to the list of cities with severe problems is Cleveland. When it could not pay notes due December 15, Cleveland became the first city to default since the Great Depression.

Despite these problems, state and local governments have operated, on the whole, with a surplus, as measured in National Income Accounts. In the aggregate, the surplus declined quarter by quarter over the year. And given the sharp decline in revenue in California, the sudden limitations on taxing authority in other states, and outright reduction in federal assistance that can be expected in 1979, the number of total governments with financing problems could increase this year.

Finance: restraint without imbalance

Expansion in economic activity combined with accelerated price inflation last year to sustain the strong demands for credit and money that characterized 1977. Credit flows, spurred by growth in business and household borrowings, reached a new high, although the rate of increase was sharply less than in the two previous years.

In an effort to reduce inflationary pressures from excessive expansion in money and credit and stabilize the dollar in the international exchange markets, the Federal Reserve was less accommodative in providing reserves to the banking system. Moreover, the discount rate was raised to the highest level in its history.

In this environment, money-market interest rates rose sharply but held well below the peaks reached in 1974. Rates on Treasury coupon obligations and residential mortgages, however, rose to new highs, reflecting the heavy credit demands, rising costs of funds to lenders, and investor expectations of continued inflation.

While the cost of borrowing rose sharply, those willing to pay the higher rates had little difficulty obtaining financing. Moreover, because of actions taken to sustain the supply of funds available to finance residential construction, effects of restraint were spread more evenly over the economy than in previous periods of tight money. Nevertheless, growth in the credit and money aggregates slowed late in the year. If this moderation continues, it should have a favorable effect on inflation in the months ahead.

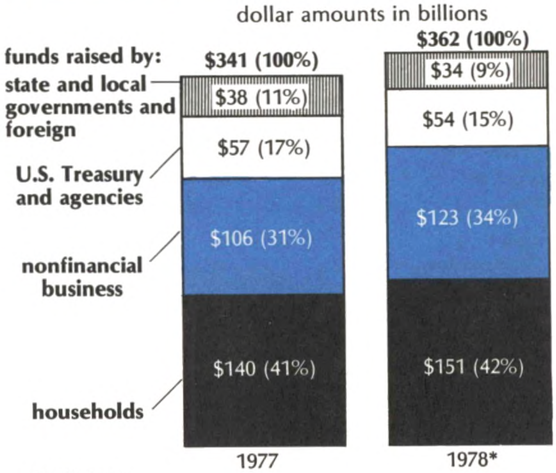
Record credit flows

Funds raised in the equity and credit markets by economic sectors other than financial institutions totaled $362 billion in 1978. While a record, this represented only a 6 percent increase over 1977. In the two previous years, increases ranged from 25 to 30 percent. More of the financing needs also reflected rising prices. Total funds raised amounted to 17 percent of nominal GNP compared with 18 percent in 1977.

All of the increase in funds raised in 1978 can be attributed to the private sector. Its combined net borrowing and equity sales increased $28 billion, to $274 billion. Treasury borrowing decreased somewhat. At $54 billion, federal borrowing accounted for 15 percent of the funds raised in credit markets. That is a historically high proportion for this stage of an economic expansion. State and local governments issued a large amount of securities during the year but invested much of the proceeds in Treasury securities.

Nonfinancial businesses raised $123 billion in 1978—16 percent more than in 1977.

Record credit flows were paced by private sector borrowing



*Preliminary.

Business mortgages, which accounted for more than 35 percent of the total funds raised by businesses, rose 27 percent more than in 1977. Demand for nonmortgage business credit rose even faster. The $30 billion increase in bank loans was one-third greater than in 1977 but slightly lower than the previous record set in 1973. Business borrowing in the commercial paper market also accelerated.

Households continued to raise more funds than any other sector, though the increase over 1977 was only about 7 percent. Home mortgages rose $94 billion, which, even with record-high mortgage interest rates, was slightly above 1977. Strong housing demand, combined with rapid appreciation in home prices, the general rate of inflation, and the tax advantages of home ownership, have largely offset the dampening effects of high nominal mortgage rates on home buying.

The supply of mortgage funds was sustained mainly by two factors. First, S&Ls, the main suppliers of household mortgage credit, increased their borrowings from the Federal Home Loan Banks by $12 billion. Second, beginning June 1, savings and loan associations were allowed to offer $10,000 minimum-denomination, six-month maturity time certificates at maximum issuing rates 25 basis points above the average weekly issuing rate on six-month Treasury bills with the same maturity. Through these money-market certificates (MMCs), S&Ls were able to compete more effectively for savings than in previous periods of high market interest rates. By late November, total outstanding MMCs at S&Ls were estimated at $37 billion.

Another factor helping sustain the availability of mortgages was the sale by some larger financing institutions of mortgages or mortgage-backed securities to supplement deposit flows.

Other household credit, led by a rapid rise in automobile loans, surged ahead by $57 billion. That was about 22 percent more than in 1977.

Lenders and investors supplied funds only at rising interest rates. Net credit advanced by commercial banks and their affiliates was $94 billion—16 percent more than the 1977 increase.

Nonbank financial institutions—S&Ls, savings banks, and credit unions—were again the biggest source of credit. Their net lending did not increase as fast as in 1977, however, reflecting a marked slowdown in deposit inflows early in 1978. Through the first half of the year, households stepped up their purchases of Treasury securities in response to rising yields on frequent offerings. Later, savings institutions' lending picked up again as MMCs attracted funds—though at comparatively high costs to the issuers. Nevertheless, the net increase in direct acquisition of credit-market instruments by households was close to twice as much as in 1977.

Funds advanced by foreign sources slowed to $31 billion from a record $42 billion in 1977. Foreign central banks purchased large amounts of U.S. government securities during the first quarter of 1978 and again in the fall. These were periods when the dollar was under extreme pressure in foreign exchange markets. Foreigners liquidated U.S. Governments in the second quarter.

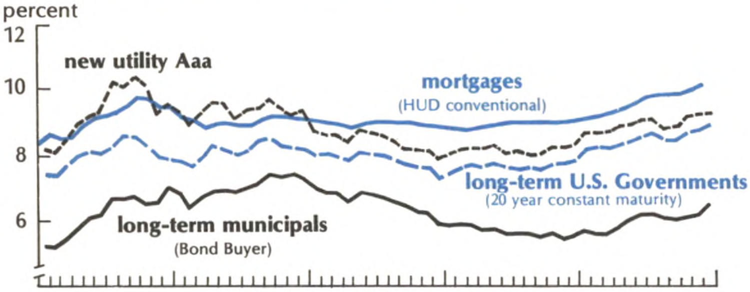
Sharply higher interest rates

As a result of record credit demands, increased inflationary expectations, and Federal Reserve policy actions designed to temper undesirably rapid growth in monetary aggregates, interest rates rose at an accelerated pace in 1978. Federal Reserve policy actions were manifested in a fed funds rate around 10 percent at the end of the year—about 350 basis points higher than at the beginning of the year—and discount rate of a record 9½ percent.

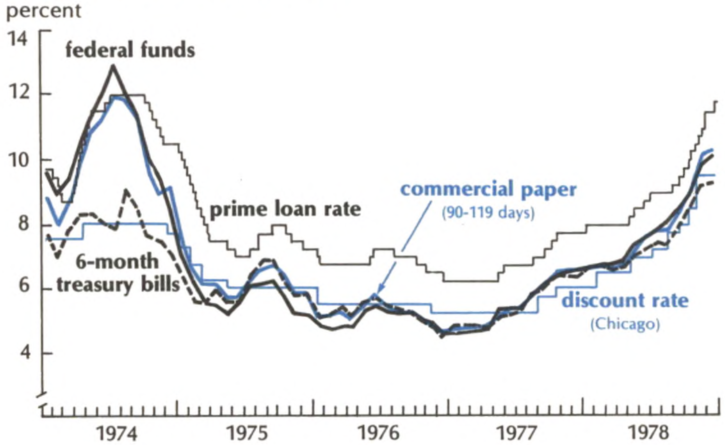
The year also saw the re-emergence of an inverted yield curve—short-term interest rates higher than long-term rates. In the past, inverted yield curves had usually come late in an interest rate cycle. In the previous cycle, yields on Treasury securities inverted in mid-1973 and remained so through late 1974.

Over the year, representative short-term

Rising long-term interest rates. . .



. . . were surpassed by sharply higher short-term rates



interest rates increased between 300 basis points on six-month Treasury bills and 400 basis points on 90 to 119-day commercial paper and the bank prime loan rate. Reflected in the increases were both the surge in business demands for short-term credit and monetary policy actions which usually have their initial impact on the money market.

Rates on long-term securities other than Treasury issues rose about 100 basis points over the year. Despite a record volume of new issues of state and local government securities, average yields on municipals remained well below the peak reached in the previous cycle. Strong demand for tax-exempt securities—by individuals and by property and casualty insurance companies—attenuated yield increases on these securities. Corporate bond yields, as measured by the new issue Aaa utility bond rate of 9.28 percent at year-end, were still about 100 basis points short of 1974 highs.

By contrast, yields on intermediate and long-term Treasury securities exceeded the peaks reached in the previous cycle. Twenty-year government bonds closed out the year at 8.90 percent—30 basis points above the previous record high in 1974. These record-high Treasury bond yields reflected both the coincidence of heavy net borrowing by the federal government with record private credit demands and the Treasury's continued efforts to lengthen the maturity structure of its debt.

Individuals that obtained home mortgage loans in 1978 also paid record-high interest rates. The conventional home mortgage rate average finished the year at 10.10 percent—30 basis points above its previous high established in 1974. However, without the new six-month certificates and record Federal Home Loan Bank advances, which enabled S&Ls to maintain loanable funds, even higher mortgage rates—or some nonrate rationing of mortgage credit—would have been likely.

Monetary aggregates and monetary policy actions

Domestic monetary policy was directed to the achievement of financial conditions consistent with reduced inflationary pressures and an improved international payments position while being supportive of moderate economic expansion. Given that excessive monetary growth is likely to induce expectations of increasing inflation, the Federal Open Market Committee responded to the strong demand for money and credit by supplying reserves only at a higher cost to the banking system. The increase in the discount rate, coming in early January in the wake of growing disorders in foreign exchange markets, signaled the added emphasis the Federal Reserve would put on international considerations in 1978.

Since 1975 the Federal Reserve's quarterly reports to Congress have specified annual ranges of monetary growth expected to be consistent with economic objectives.[1] Projections are made for M-1, (currency and demand deposits held by the public), M-2 (M-1 plus commercial bank savings and time deposits other than large CDs), and M-3 (M-2 plus mutual savings bank deposits and shares at S&Ls and credit unions).

The year began with growth in M-1 running well above the range specified for 1977 and M-2 and M-3 at the top of their ranges. Growth in each of these aggregates, measured from the fourth quarter of 1977 to the fourth quarter of 1978, was slower than in 1977.

Growth in M-1 was about 7 percent, compared with nearly 8 percent in 1977—but still above the 4 to 6½ percent range specified for the period QIV-77 to QIV-78. Growth in M-2 and M-3 was near the midpoints of their specified ranges. The increase in M-2 was about 8 percent, down from 9.8 percent in 1977 and well within its 6½ to 9 percent target range. The increase in M-3 was about 9 percent, down from 11.7 percent in 1977 and also within its 7½ to 10 percent range. As usual, however, there was considerable variation in growth rates over the year, which made it difficult to discern underlying trends as the year progressed. Growth in M-1 did not slow significantly until the last quarter.

Policy actions were aimed at reducing inflation and strengthening the dollar while seeking to sustain moderate economic growth. The year began with the Board of Governors approving an increase in the discount rate from 6 to 6½ percent. The rate Federal Reserve banks charge on loans to member banks was increased because the Federal Reserve believed "the recent disorder in the foreign exchange market constitutes a threat to orderly expansion of the domestic and international economy."

In support of this action, the FOMC became less accommodating in supplying reserves to the banking system and allowed the fed funds rate (the market price of reserves) to move up from 6½ percent to 6¾ percent. Weather and strikes, however, reduced both economic activity and the need for transaction balances through the rest of the first quarter and the fed funds rate leveled off.

With the economy rebounding in the second quarter, transaction balances surged. To restrain monetary growth without choking off financing needed to sustain real activity, the FOMC moved gradually to increase the cost of deposit-supporting reserves. By mid-August, the fed funds rate was near 8 percent.

Increases in the discount rate were approved in May (to 7 percent) and July (to 7¼ percent) to bring the discount rate into closer alignment with other short-term interest rates and thus reduce the incentive for banks to borrow reserves at the discount window.

With foreign exchange markets still disorderly and domestic inflation serious, the discount rate was raised another 50 basis points in August (to 7¾ percent), and the Board of Governors announced that reserve requirements on foreign borrowings were being reduced to zero.

The persistence of inflation and problems with the dollar combined with another surge in monetary aggregates in late summer to prompt the FOMC to tighten money-market conditions further. By late October, the fed funds rate was around 9¼ percent. Another increase in the discount rate (to 8 percent) had already been approved in September, and in October it was raised to 8½ percent.

The package of policy actions announced in support of the dollar on November 1 in-

[1]From 1975 through 1977, quarterly reports to Congress were in response to House Congressional Resolution 133 passed March 24, 1975. The Federal Reserve Reform Act of 1977, approved November 16, 1977, amended the Federal Reserve Act to require such reports.

Monetary growth in 1978 slowed from previous year

	M-1		M-2		M-3	
	Projected range	Actual	Projected range	Actual	Projected range	Actual
	(percent, seasonally adjusted annual rates)					
Annual*						
1973		6.2		8.8		9.0
1974		5.1		7.7		7.1
1975		4.6		8.4		11.1
1976	4.5–7.5	5.8	7.5–10.5	10.9	9.0–12.0	12.8
1977	4.5–6.5	7.9	7.0–10.0	9.8	8.5–11.5	11.7
1978	4.0–6.5	7.2	6.5– 9.0	8.0	7.5–10.0	9.1
1979**	2.0–6.0		6.5– 9.0		7.5–10.0	
Quarterly						
1978-1		6.2		6.9		7.7
2		9.9		7.9		7.8
3		7.6		8.9		10.1
4		4.4		7.5		9.7

*Annual data based on fourth-quarter averages.

**Ranges in effect at the end of 1978 applying to the third-quarter 1978 to third- quarter 1979 period.

cluded an increase of a full percentage point in the discount rate to a record 9½ percent and a supplementary 2 percent reserve requirement on large time deposits at member banks. At the same time, open market operations were designed to supply reserves consistent with a fed funds rate between 9½ and 9¾ percent. The FOMC agreed before year-end to aim for a fed funds rate of 10 percent.

Despite the momentum of the economy, growth in both M-1 and M-2 slowed appreciably in the last two months of the year. In addition to earlier policy measures, another factor weakening M-1 in the last few weeks of the year was the introduction of automatic transfers. Effective November 1, an amendment to Federal Reserve Regulation D permitted banks, on preauthorization by customers, to cover overdrafts by transferring funds automatically from savings to checking accounts (ATS). By year-end, balances in savings accounts authorized for transfer under ATS arrangements were estimated at more than $3 billion. Of that, 50 to 60 percent was believed to have been shifted out of demand deposits.

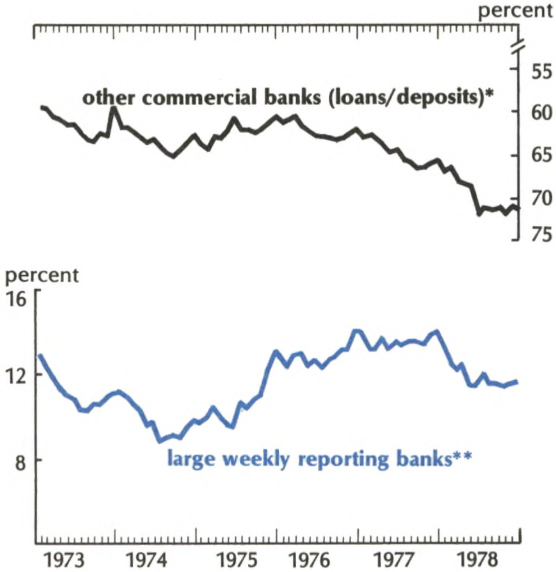
Recognizing the uncertainty of effects of ATS on M-1, the FOMC lowered and widened the M-1 target range for the year ending with the third quarter of 1979—to 2 to 6 percent—and placed more emphasis on M-2 in assessing the behavior of the aggregates. M-2 was largely unaffected by ATS-related shifts. The attractiveness of savings and small time deposits, however, including bank MMCs with maximum rates 25 basis points less than S&Ls could pay, declined relative to other outlets available for savings. Some investors, giving increased weight to the probability that interest rates were nearing their peaks, acted to extend currently high returns by lengthening maturities.

Bank loans and liquidity

Commercial banks feel pressures from restrictive monetary policy from two sides. Because of rising prices and the growing need for working capital—plus an unwillingness to issue long-term debt at current interest rates—business demand for bank credit increases. At the same time, loanable funds become less available and more expensive.

Both elements were at work in 1978. While the expansion of total funds raised in credit markets slowed, outstanding loans and investments of commercial banks rose at about the same pace as in 1977—11 percent. Loans accounted for most of the rise. Bank holdings of state and local securities continued to expand, but the expansion was largely offset by a decline in Treasury issues.

Liquidity ratios weakened at all banks in 1978



*Last Wednesday of the month except for June and December Call dates. Total loans exclude loans to banks and total deposits exclude cash items in process of collection.

**Ratio of liquid assets to liabilities. Monthly averages of Wednesday figures. Liquid assets include Treasury and other securities maturing in one year or less, loans to brokers and dealers and domestic commercial banks, holdings of bankers' acceptances and gross sales of fed funds. Liabilities are total liabilities less capital accounts, valuation reserves, and demand deposits due to banks.

Total bank loans increased 15 percent, also about the same as in 1977.

Loan growth and smaller savings inflows reduced bank liquidity significantly. This did not result in any appreciable tightening in loan policies of large banks, since many were still below desired loan levels. Nor was there any evidence of severe constraint on the availability of credit overall. By year-end, however, even large banks were screening applications more carefully, and there were signs that some potential applicants were discouraged by the high costs of borrowing.

Real estate and consumer loans were again the strongest elements of growth in bank credit last year. Both rose more than 18 percent, matching the record 1977 gains. Loans to business rose rapidly in the first half, but later slowed. For the year as a whole, commercial and industrial loans rose $27 billion. That was an increase of 13 percent, compared with 12 percent in 1977 and 20 percent in 1973. Business lending picked up at the very largest banks, however, while moderating at smaller banks where demands had been strong in 1976 and 1977.

Aggressive competition for loan business and the purchase of participations from regional banks that were loaned up helped bolster loans at large banks. There were other elements, however, holding them down. Outstanding commercial paper issued by large nonfinancial firms rose by almost a third last year. Business loans at U.S. branches and agencies of foreign banks were also up sharply. The cost of funds from these sources was generally less than charges based on the bank prime loan rate.

Despite the competition by large domestic banks for loan business, the prime rate was increased 14 times last year, rising to within a quarter-point of its historic 12 percent peak reached in mid-1974. Late in the year, some banks adopted a "two-tier" prime. Under this arrangement, when the prime rate set for large borrowers rose above a specified level, the base rate for small companies was set at some margin (such as 125 basis points) below the prime. While this arrangement mitigated to some extent the heavy interest burden on small businesses, by keeping the rates on most of their lending closely aligned with the marginal cost of loanable funds, the major banks tempered loan volume and avoided the squeeze on earnings they had experienced in 1973.

Growth in demand deposits continued strong throughout most of 1978, but as market interest rates rose, savings inflows dwindled. Savings and small-denomination time deposits, which had supplied almost $32 billion of loanable funds in 1977, rose only $16 billion in 1978, with most of the gain attributable to the new MMCs. While MMCs helped stem outflows into direct market investments, because of the better return on identical obligations offered by S&Ls, they did not produce a great deal of new money for banks.

With consumer-type savings flows weak and the need for loanable funds rising, banks increased their reliance on certificates of deposit of $100,000 or more, which are exempt from rate ceilings. Altogether, large CDs increased about $47 billion last year, financing roughly half the growth in total bank credit. Negotiable CDs issued by large banks accounted for half this gain. Outstandings at year-end were at a record $100 billion.

Rates paid for these funds ranged from 10½ to 11½ percent in the last two months of the year, and their cost was increased even more by the imposition of the 2 percent marginal reserve requirement in early November.

As banks found deposits insufficient to meet credit demands, they also tapped "nondeposit" sources of funds. These sources—which include fed funds and security repurchase agreements with nonbanks, borrowings from foreign branches, and sales of loans to nonbank affiliates—rose about $15 billion.

District banking

Credit growth at banks in the Seventh Federal Reserve District kept pace with the expansion of bank credit nationwide. Total loans and investments of member banks in the district, exclusive of interbank loans, rose 10.5 percent, compared with 8.8 percent in 1977.

Nearly all the expansion was accounted for by loans, which rose more than $10 billion. That was an increase of 15.7 percent. Holdings of Treasury securities declined almost $1.2 billion, more than offsetting the dollar gain in holdings of municipals, agencies, and other securities. Portfolios of non-Treasury securities rose only 3.9 percent, compared with 7 percent in 1977.

In contrast to the two previous years, loans expanded faster at large banks than at small and medium-sized banks. Loans at large banks submitting weekly condition reports increased 16.5 percent. Gains were especially strong in Chicago. Loan growth at the large banks was broadly based. Gains in all three of the main loan categories—consumer instalment, real estate, and commercial and industrial—were more than 15 percent. Loans to nonbank financial institutions also rose, while loans on securities declined from a year earlier.

Loans at small banks—for which a breakdown by type is not yet available—rose 13 percent, down from 17 percent in 1977. While loan demand was reportedly strong, many of these banks had to tighten their lending policies because of greatly reduced liquidity.

Aggregate demand deposits for all member banks in the district were virtually unchanged over the year, leaving net growth in loans to be financed by interest-bearing funds. Total time and savings deposits at all

Strong loan demand set pattern for district banking
(Nov. 30, 1977 to Nov. 29, 1978)

			Deposits		
	Loans[1]	Securities	Demand	Negotiable CDs[2]	Other time and savings
			(percent change)		
Large banks[3]					
Chicago	19.3	−12.4	2.5	28.9	−0.8
Detroit	15.2	1.7	−6.9	64.9	1.4
Indianapolis	9.5	− 7.2	8.6	22.8	4.1
Milwaukee	16.7	21.6	1.2	8.9	0.6
Des Moines	16.6	12.6	2.8	187.5	8.6
Other member banks					
Illinois	13.7	1.5	2.9		6.5
Michigan	13.8	4.5	5.3		10.2
Indiana	15.0	3.1	4.3		6.7
Wisconsin	11.4	1.5	−2.3		5.0
Iowa	11.1	3.2	7.1		9.2

[1]Excludes fed funds sold.
[2]Data not available on negotiable CDs at smaller member banks.
[3]Large weekly reporting member banks.

member banks in the district increased 8.2 percent—11.6 percent at large banks and 7.8 percent at other banks. Excluding large negotiable CDs, time and savings deposits at large banks rose less than 1 percent.

Gains in time and savings deposits at money-center banks in Chicago and Detroit included an increase of more than $600 million in MMCs after June 1. After November 1, all banks in the district with $1 billion or more in deposits offered their customers automatic transfer service. By year-end, savings balances authorized for transfer at these banks totaled more than $170 million in about 19,000 accounts.

Bank holding company developments

Eighty-five bank holding company applications were decided on from the Seventh District last year compared with 98 in 1977. Two of the sixty one-bank holding company formations were denied, while only one of the twenty multibank acquisitions and proposals for additional shares was denied. Three applications for acquisition of existing nonbank activities were approved as were two bank holding company mergers.

Nationwide, 523 applications were completed last year, compared with 428 in 1977. The record was set in 1973, when 723 applications were completed.

The Supreme Court has found that the Board of Governors has authority under the Bank Holding Company Act of 1956 to deny the formation of a bank holding company solely on grounds of financial or managerial unsoundness. The decision, in *Board of Governors of the Federal Reserve System v. First Lincolnwood Corporation,* was delivered December 11.

The court found that the Board's authority is not limited to situations where the formation of a holding company would cause a bank to be unsound or where it would exacerbate the unsoundness of a bank. The court, therefore, affirmed authority of the Board of Governors to require that a bank's financial position meet Board standards before a bank holding company application is approved. This is regardless of the agency that is the bank's primary regulator.

Newly enacted legislation

Two fairly new pieces of legislation will have a direct effect on banks and bank holding companies. One is the Community Reinvestment Act of 1977. The other is the Financial Institutions Regulatory and Interest Rate Control Act of 1978.

The major purpose of the Community Reinvestment Act (CRA) is to encourage subject financial institutions—banks, savings and loan associations, and mutual savings banks—to meet the credit needs of their communities, including low- and moderate-income neighborhoods. This has to be done, of course, in accordance with safe and sound operations.

When applications for branches, mergers, charters, deposit insurance, and bank holding company acquisitions are filed, the regulatory agency will assess the institution's past performance to determine if the credit needs of the *entire* community are being met.

Financial institutions had to have CRA statements delineating their local lending community and the types of credit available on file by February 4, 1979. The statement and all correspondence regarding the institution's CRA compliance must be available to the public. The availability of this information had to be announced in a public notice posted in the lender's lobby by the deadline. The purpose of the information is to improve public awareness of the organization's obligation to the community, especially low- and moderate-income neighborhoods.

Several sections of the Financial Institutions Regulatory and Interest Rate Control Act (FIRA) relate specifically to banks and bank holding companies. Under this act, the Board of Governors can require a holding company to divest itself of a nonbank subsidiary or cease a nonbanking activity when there is reason to believe the financial safety of a subsidiary bank is at stake.

The act also deals with insider transactions. Aggregate total loans of more than $25,000 to an officer, director, or 10-percent shareholder require advance approval of a majority of the directors, not including the interested party. These loans have to be made on essentially the same terms as comparable loans made at the same time. Overdraft payments on the accounts of officers and directors are prohibited. The act also authorizes the Board of Governors to assess civil penalties of $1,000 a day against banks and individuals for violations of the Bank Holding Company Act. Cease and desist orders can be brought against individuals as well as banks and bank holding companies.

Regulatory agencies can remove officers, directors, or others involved with a bank for violating a final cease and desist order. Individuals that have engaged in unsafe or unsound banking practices that might cause a bank to suffer financial loss or that have gained financially as a result of personal dishonesty or willful disregard for a bank's safety and soundness can also be removed.

Banking structure will be affected by Title II of FIRA, which deals with management and director interlocks in all types of depository institutions. Interlocks between banks (or thrift institutions) in the same SMSA—or the same, contiguous, or adjacent city, town, or village—are prohibited. The SMSA test does not apply to financial institutions with assets less than $20 million. Interlocks are also prohibited, regardless of geographic limits, where one institution has assets of more than $1 billion and the other institution has assets exceeding $500 million. Existing interlocks that would otherwise be legal are grandfathered for ten years.

Title VI of FIRA, also called the Change in Bank Control Act of 1978, gives regulatory agencies authority to disapprove an individual's acquisition of control of a bank holding company or an insured bank. An individual has to give to the agency 60 days prior written notification of the proposed acquisition. The applicant must furnish personal, financial, and legal history, as well as plans for the organization to be controlled. The proposed acquisition can be denied on either competitive or managerial grounds. Under Title VI, insured banks are required to report any loans secured by as much as 25 percent of the stock of another insured bank.

Another significant change brought on by FIRA is the establishment of a new federal financial institution examination council. The council will consist of a governor of the Federal Reserve System, the Comptroller of the Currency, and chairmen of the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the National Credit Union Administration. The council will make recommendations for the development of uniform reporting and examination standards for financial institutions supervised by federal agencies.

Future uncertain

In late 1976 and in late 1977, various professional forecasters concluded an end to the business expansion was at hand. But all major sectors continued to make major gains. Dips in indicators of activity that were pointed to as heralding a general decline proved to be temporary or even illusory as statistical series were later revised upward.

Again in late 1978, predictions of a recession were common. Increases in employment, retail sales, and output seemed to be slowing down. But as more data has accumulated, the picture looks brighter. Growth in real GNP, in fact, appears to have *accelerated* in the fourth quarter. Personal income, farm income, and corporate profits were all sharply higher than a year before.

A substantial majority of the forecasters this January were still calling for a recession, saying it would begin sometime this year. Others, however, thought a decline would not occur, and a surprising number admitted that they were baffled. One of the most threatening new developments has been the long drawn-out turmoil in Iran, which has shut off that country's important contribution to world oil supplies.

So far, the economy has withstood extremely high interest rates and rapid price inflation—to an extent once thought impossible. Credit conditions tightened significantly throughout 1978, but unlike other such periods, credit remained available to those willing to pay the price. Mortgage credit grew more than in 1977. Banks continued to seek out new business. And capital markets accommodated a large volume of new issues.

The rapid rise in prices is viewed with alarm, even anger. But most incomes have been rising almost as fast, and some much faster. Consumers protest but buy anyway. So do businesses and farmers. Rising purchasing power from income and debt is one of the main factors propelling inflation.

The Administration and the Federal Reserve System are committed to slowing inflation. The Administration's wage-price guidelines were unveiled October 24. And on November 1, the Administration and the Federal Reserve jointly announced moves to support the dollar in international money markets and further restrict growth of domestic credit. Then on January 22, the President presented a "lean and austere" budget that forecasts a reduced deficit, even at the cost of restricted spending on programs interested groups consider highly desirable. By and large, all these measures have been widely supported.

Inflation of 1 to 2 percent was considered intolerable 20 years ago. By 1974, an underlying inflation rate of 5 percent was generally viewed as "imbedded." More recently, the concensus has raised the expected rate to 6 percent, then 7 percent, and now 8 percent.

True economic stability is impossible under such conditions. The nation is girding to reverse this trend. The road to faster price increases was easy. The return to slower rates of inflation will be long and hard.