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ECONOMIC PERSPECTIVES

Review and outlook: 1979-80

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ECONOMIC PERSPECTIVES

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Review and outlook: 1979-80

The start of a new decade traditionally provides a convenient point for assessments of the economic outlook for the longer-term future. After the long period of economic expansion in the second half of the 1970s, most observers believe that a recession has now begun, although they expect it to be short and shallow. Concern with inflation is worldwide, and the primary constraint on supply is the availability of energy essential for virtually any human activity. The inflation and energy questions are closely related to the widening crisis in the Middle East, which has led the President to call for substantial increases in military outlays.

Review and outlook: 1979-80

Business: the expansion slows

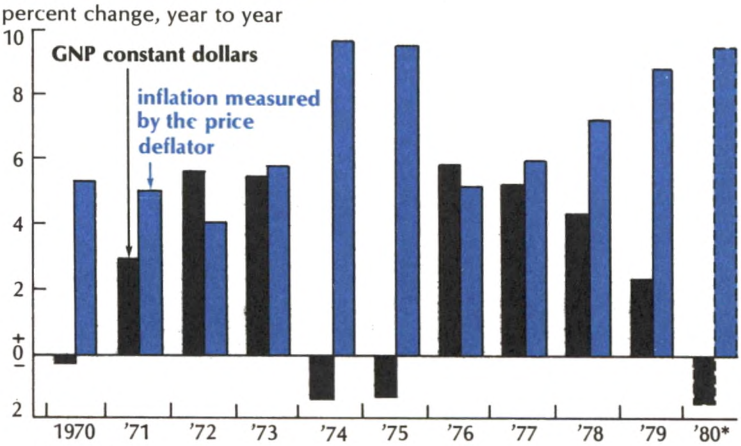
Despite sharp cutbacks in the auto and housing industries, the economy finished 1979 surprisingly strong. Employment continued to rise. Industrial production remained on a high plateau. Business capital spending remained vigorous. And consumers continued to spend freely on most items.

Early in 1980, however, evidence began to accumulate that a cyclical downturn was, at long last, under way. Manufacturers' order backlogs had begun shrinking in the fourth quarter. Surveys of consumer and business attitudes showed widespread foreboding for the new year.

The Midwest did not fare generally as well as the nation in 1979. The difference reflected, in the main, concentration of motor vehicle production in Michigan and Indiana. Centers specializing in vehicles and components had recessions starting in the spring. Activity continued high in most centers specializing in producer goods, Milwaukee, for example. But the picture was marred by labor disputes in the farm and construction equipment industries. Lengthy strikes depressed incomes in affected areas. Also contributing to the relatively poor performance of the Midwest was the greater decline in housing construction, partly a result of three successive severe winters.

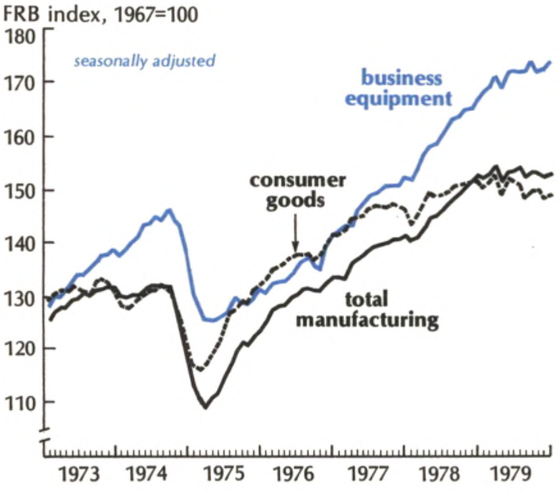
While employment and production were better last year than most observers expected, price inflation exceeded the highest rates expected even by pessimists. The turmoil in Iran touched off a rapid escalation of world oil prices that played a large role in boosting U.S. price indexes. But oil stringencies were only part of the problem. Other factors were government deficits, spreading government regulation of business, excessive growth in private credit, large increases in worker compensation in the face of declining worker productivity, and restrictions on the use of natural resources.

Inflation has accelerated while real growth has slowed



*Projected.

Industrial production has been on a high plateau



Caution pays off

Forecasts of an impending recession were heard frequently in late 1978. Some analysts believed the decline would start early in the new year. As 1979 unfolded, the economic picture was confused by severe winter weather, oil stringencies, and a series of unsettling developments abroad. Recession-minded forecasters responded by pushing the date further and further ahead.

Memories of the sudden decline in demand that hit business in the fourth quarter of 1974 are still fresh. Inventories that seemed reasonable as long as sales were rising suddenly became burdensome in late 1974. Order backlogs that had appeared firm melted away in a rash of cancellations. Capital goods producers, particularly, were caught in this predicament. Market gluts quickly replaced the shortages of the spring and summer.

Managers kept a tight rein on inventories all through 1979. High carrying costs, reflecting record interest rates, provided an additional incentive to avoid excess accumulations. Most manufacturers chose not to boost production if use of high-cost marginal resources was required. Both buyers and sellers were more careful than in 1974 in placing and accepting orders for items with long lead times.

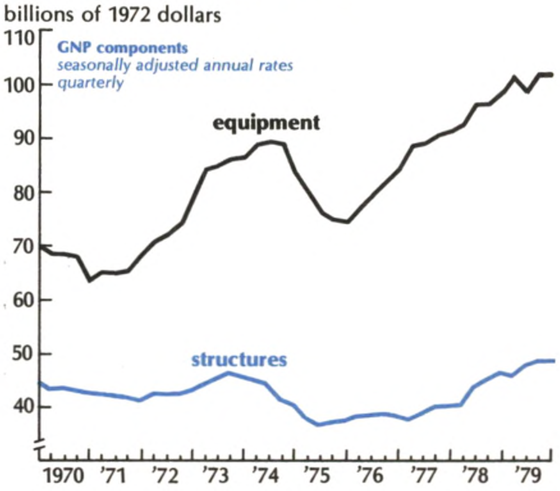
Lean inventories and order backlogs free of duplications help explain why the economy did not skid downward in 1979, despite severe strains in some sectors. Conservative mananagment policies will also tend to moderate the adjustment that seems to be under way now.

Output and prices

The gross national product, spending on goods and services plus additions to inventories, totaled almost $2.4 trillion in 1979, 11.5 percent more than in 1978. But with prices averaging 9 percent higher, the increase in physical volume was only about 2.5 percent. Increases in real GNP have been less every year since 1976, the first full year of recovery after the 1974-75 recession. While growth in output has slowed since the 6 percent gain in 1976, price inflation has accelerated every year. Last year's 9 percent price rise was the largest since 9.5 percent in 1974 and 1975.

Transportation, manufacturing, and construction were hampered in the first quarter last year by extreme cold and winter storms that afflicted most of the northern states, es-

Business investment rise continued through 1979



pecially the great industrial areas of the Midwest and Northeast. Nevertheless, measured by real GNP, activity increased slightly during that period.

As the weather improved, the economy faced a new problem—shortages of gasoline and diesel fuel associated with the cutoff of oil shipments from Iran. Long lines of vehicles formed at gas stations, especially on the East and West coasts. Motor transport was slowed by the reduced availability of diesel fuel, and the slowdown was reinforced by strikes of independent truckers protesting high fuel prices and private rationing.

Fuel prices rose sharply, with gasoline up more than 40 percent in the first half of the year. In June, per-gallon prices passed the $1 a gallon mark for the first time. Higher prices for fuel and, even more, concern over ability to obtain fuel had a dramatic effect on some sectors. Sales of large cars, light trucks, and recreational vehicles plummeted. Tourism was hard hit. Housing sales were also affected, especially in areas far from urban centers.

The upshot was a one-quarter recession. Real GNP declined in the second quarter at an annual rate of about 2 percent.

The third quarter saw a modest revival. Fuel supplies improved, mainly because of conservation. Construction crews made up most of the time lost during the winter. But businessmen and consumers were still cautious in making new commitments.

Improvement in activity in the third quarter appeared at first to be mainly a reaction to problems encountered earlier in the year, with the underlying trend still down. But further growth was apparently achieved in the fourth quarter. Final sales were buoyed by business spending on plant and equipment and consumer spending on nondurable goods and services.

In retrospect, the economy stood up well to the weather and fuel problems of 1979. But the effects are far from over. Nearly all doubters are now convinced that energy stringencies are real and likely to become more pressing in years to come. The impact on patterns of consumption and business investment will be profound.

Consumer price rise accelerates

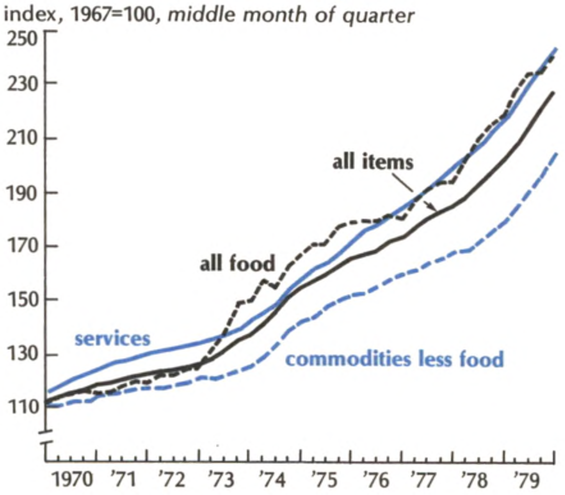
The Consumer Price Index (CPI) for all urban consumers averaged 11.3 percent higher than in 1978, a substantially faster rate of rise than for the general price level measured by the GNP deflator. Mainly reflected in the difference are the fixed weights for the CPI, which do not vary as consumers adjust to changes in relative prices. The deflator is weighted every quarter. Also, the CPI assigns more importance to costs of fuel and homeownership, both up sharply last year.

Trends in the CPI are crucially important, because the index is used in automatically escalating wages and other payments covered by cost-of-living adjustments (COLAs), often in addition to other agreements to increase compensation. Even without a contractual obligation, employers may look to the CPI as a guide when raising wages or pensions. COLA adjustments, becoming steadily more common, have the effect of building in past inflation and fueling future inflation.

Up from 7.7 percent in 1978, the 11.3 percent rise in the CPI last year was almost twice the rise in 1976. It slightly exceeded the rise of 1974, then by far the largest for any year since

The rise in the Consumer Price Index accelerated last year

index, 1967=100, *middle month of quarter*



World War II price controls were removed in 1946.

In November, the CPI was 12.6 percent higher than a year earlier. Unlike some years, the main culprits were not costs of food and medical care, both rising less than 10 percent. Apparel rose less than 4 percent. The main culprits were energy, up 36 percent, and homeownership, up 18 percent. For many families, these costs rose much more, particularly if they heated with oil or negotiated a new home mortgage.

Unlike a year ago, few analysts expect consumer price inflation to moderate this year. Higher oil and natural gas costs are only partially reflected in retail prices so far, and further increases in basic fuels are inevitable. Housing is in short supply, with costs rising rapidly. Advancing incomes enable many consumers, however, to maintain their buying patterns without difficulty.

Employment and spending

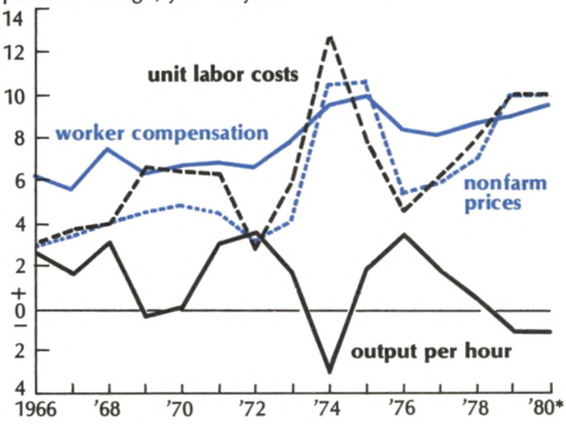
Despite sizable layoffs in the motor vehicle industry, jobs remained plentiful throughout 1979, except for depressed inner-city areas. Take-home pay of most autoworkers was maintained, temporarily at least, by public and private unemployment benefits.

Total employment rose 300,000 in December to reach 98 million. The 12-month rise was 2 million, after increases of 3 million in 1978 and 4 million in 1977. Since 1975, employment has risen an unprecedented 13 million. Unemployment, people without jobs and seeking work, was estimated at 5.9 percent of the labor force in December, about the average for the year, and well below the 8.5 percent average for 1975.

Personal consumption expenditures rose almost 12 percent in 1979, slightly more than in each of the three previous years. In real terms, the rise was only about 2.5 percent, however, the smallest increase since 1975. Higher consumption expenditures mainly reflected higher disposable (after-tax) income, up almost 11.5 percent last year. But a drop in the savings rate also helped. Savings is defined as disposable income not spent on consumption. Savings dropped to 4.5 percent of disposable income last year, down from 5 percent in 1977 and 1978 and over 7 percent in the early 1970s, to the lowest rate since 1949.

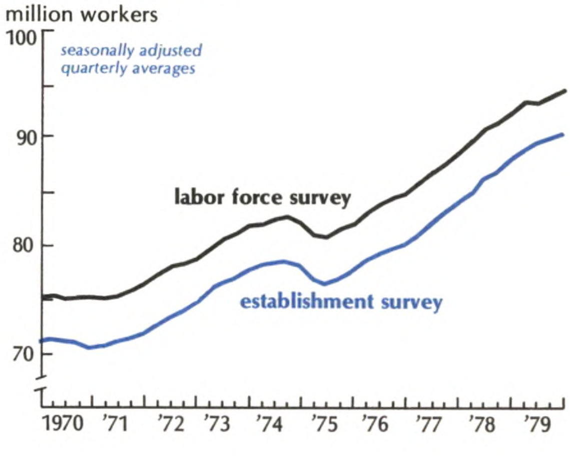
The low savings rate of recent years partly reflects heavy use of instalment credit, and sometimes mortgage credit, to finance consumer purchases. Willingness to incur debt, in turn, reflects both confidence in future income and the belief that inflation will continue to erode the buying power of money.

Large wage gains and poor productivity boost costs and prices



*Projected.

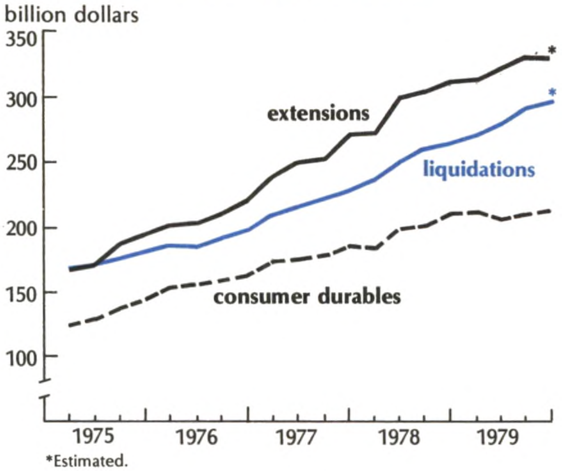
Nonfarm employment shows vigorous growth



Most households are protected, more or less, against the risks of sickness, old age, and unemployment. Many also benefit from government subsidies for food, housing, heating, transportation, and education. The preference for spending over saving fuels inflation both by adding to total spending and by reducing the volume of funds available for investment.

Because employment is expected to decline in 1980, at least in the first half, growth in consumption spending is likely to moderate. Individual incomes, however, are likely to grow faster. Total compensation per hour in the private economy, including nonwage income, rose 9 percent last year—more than in any year since 1975. The 7 percent guideline for increases in compensation, a dampening influence on some sectors last year, is expectd to be raised. Unions are increasingly militant and successful. Pressure to meet union gains in nonunion sectors is growing. Partly because of leveling or declining output, productivity changes are likely to continue to be small or negative. As a result, increases in compensation will tend to be fully reflected in unit labor costs and, therefore, selling prices.

Instalment credit growth outpaced outlays in consumer durables



*Estimated.

Construction and housing

Outlays on new construction increased about 9 percent last year. Corrected for inflation, however, the data show construction down about 3 percent. Broad categories of construction showed remarkable differences. Nonresidential private construction was up about 8 percent in real terms. Residential construction was down 6 percent, and public construction was down 10 percent.

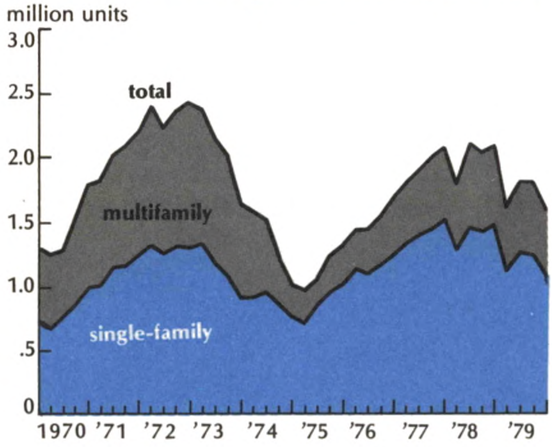
Within the nonresidential private sector, construction of office buildings soared 25 percent in real terms. Stores and other commercial structures were up 14 percent. The boom in office buildings, a revival after the sharp drop of the mid-1970s, was concentrated in the downtown areas of major cities, with Chicago a leading example.

As in past periods of higher interest rates, housing was affected more than other types of construction. New housing construction had held up surprisingly well in 1978 despite tightening credit markets as thrift institutions tapped new sources of funds through sales of money market certificates and "jumbo" CDs. Also, a large volume of securities collateralized by home mortgages were sold in the capital markets.

About 1.7 million new residential units were started in 1979, down 16 percent from 1978 and well below the 1972 peak of 2.4 million. Starts were down more than 40 percent in the Chicago area and about 28 percent in the North Central region. The larger decline in this region reflects relatively slower growth, less speculative building, more conservative lending practices, and the bad weather of recent years.

The construction outlook for 1980 is for continued strength in nonresidential building, at least for the first half. Contracts have already been awarded for most of this work and firm financial commitments are outstanding. New mortgage loan commitments, however, were hard to obtain for any kind of construction project in late 1979 as record-high interest rates attracted funds to the short-term money markets. As a result, nonresidential construction may slow later this year, despite a scarcity of high-quality, well-

Housing starts begin downward trend



located commercial and industrial buildings.

Public construction will be sluggish again this year, depending in part on the release of funds for federally sponsored programs. Most municipalities have a long list of needed projects that they have been unable to finance. Arresting the deterioration of roads and bridges throughout the country will require billions of dollars, but funds are lacking now, partly because of reduced collections of fuel taxes.

Residential construction was dropping sharply in late 1979, even with the allowances for seasonal trends. Most analysts are forecasting starts on 1.4 million units this year, with the annual rate maybe as low as 1.2 million in the first or second quarters. Even so, that will be better than the 1972-75 period, when starts dropped more than 50 percent.

Federal subsidies will directly aid starts of 200,000 units in 1980, mainly apartments. Any easing of credit will help the private market. No large volume of unsold single and multifamily units overhangs the market as in 1973-74. An accelerating rate of household formations requires a high level of residential construction to prevent a serious housing shortage in the years ahead.

Government: federal government focuses on inflation and energy

Fiscal policy of the federal government was aimed all year at attacking inflation. The Economic Report of the President and the administration's budget message for fiscal 1980, both presented to Congress in January, showed the attack was to be carried out along two related lines.

- The federal deficit was to be progressively reduced, reaching a balanced budget in fiscal 1981.
- Budget outlays were to be reduced as a proportion of GNP from 22.1 percent in 1978 to 21.2 percent in 1980 and 20.3 percent in 1982.

When these plans were laid a year ago, the administration expected unemployment to average 6.2 percent for 1979 and inflation, as measured by the consumer price index, to run about 7.5 percent. On the basis of these expectations, the administration had forecast outlays of $493.4 billion for fiscal 1979 and a deficit of $37.4 billion, about $11 billion less than the fiscal 1978 deficit.

Fiscal 1979—the outcome

For the first time in several years, federal spending was close to the estimate made in January. When the fiscal year ended in September, actual outlays were $493.6 billion, only $200 million less than expected nine months earlier. It seems likely, however, that had it not been for rapid inflation and higher interest rates, the shortfall of expenditures from the levels projected (a regular event for the past several years) would have occurred again in fiscal 1979. As late as July, the Office of Management and Budget was estimating outlays $3 billion higher than they turned out.

The combined impacts of lower unemployment and higher inflation raised revenues over the expected $456 billion to an actual $465.9 billion, leaving a deficit of $27.7 billion, nearly $10 billion less than the January forecast. When the budget for fiscal 1979 was first presented in January 1978, the proposed deficit was $61 billion. The difference between the deficit originally proposed and the actual deficit represents a significant change in the administration's view of how fiscal policy should be used to affect the general economy.

Increased revenue sources

Major tax changes reducing income tax rates for individuals and corporations but increasing payroll taxes became effective January 1, 1979. Because of the way income taxes are paid, the full impact of the changes did not show up completely in fiscal 1979 or even calendar 1979. Final settlement of 1979 personal income taxes will not be made until April 1980. Corporations will not settle until June 1980. It is estimated, however, that total receipts for fiscal 1979 were $11-$12 billion less than if the rates had not been reduced.

With the differences in timing taken into account, the increase in personal income tax receipts was over 20 percent more than in fiscal 1978. Withheld income taxes, which make up about three-fourths of all income tax receipts and are closely related to wage and salary payments, rose 18.2 percent. During that time, wage and salary payments rose just under 12 percent.

Thus, despite the tax cut, which lowered the withholding payments at any given salary level, the progressiveness of the taxes with income combined with higher salary and employment levels to raise personal income taxes substantially. Some analysts suggest that the tax withholding levels understated the effect of the tax reduction so that refunds this spring may be higher than usual.

Similar increases were made in receipts from Social Security taxes. The basic tax rate was increased only slightly, from 6.05 percent in calendar 1978 to 6.13 percent in 1979. The maximum income on which the tax was due increased, however, from $17,700 to $22,900, with the result that revenues went up to 15.5 percent.

Corporate income tax payments did not go up as much. They rose a little over 9 percent, about the same as in fiscal 1978, and less than they would have without the tax cut.

Personal income and payroll taxes provide the main receipts. Corporate income taxes are the third largest source. Together, these three tax sources provided over 86 percent of the tax revenue in fiscal 1979, up steadily each year from just under 84 percent in 1976.

Where the federal money went

Income maintenance programs still make up the largest single classification of federal spending, as they have since they first exceeded defense spending in fiscal 1974. Close to a third of net federal spending went for income maintenance in fiscal 1979. That was nearly $45 billion more than went for national defense. Of the $160.5 billion spent on income maintenance, payments generally thought of as Social Security (federal old age and survivor benefits and federal disability payments) accounted for the largest share. Up more than over 11 percent from fiscal 1978, they exceeded $100 billion for the first time.

The third largest outlay was $52.6 billion paid for interest expenses, up 19.5 percent from 1978. Next was expenditures on health, at $49.6 billion, up 13.6 percent. Except for spending on education, training, employment, and social services, no other category of spending was as large as 5 percent of net total outlays.

In a few categories, spending was less than in fiscal 1978. Agriculture outlays, for example, were down about 16 percent to $6.4 billion. Spending on commerce and housing credit was also down, as were outlays for community and regional development.

The outlook—fiscal 1980 and beyond

The objectives of progressively lower deficits leading toward balanced budgets and lower government spending as a share of GNP remain in the forefront of the administration's fiscal plan. It now appears unlikely, however, that the budget can be balanced before fiscal 1982. When fiscal 1980 began, both the administration's projections and the second congressional budget resolution suggested a deficit in the neighborhood of $30 billion. Recent estimates indicate the deficit is more likely to approach the $40 billion level.

Expectations vary slightly, depending on assumptions about the general economy. Receipts will also depend on the final version of the "windfall profits" tax on the oil industry. Outlays will be effected by how fast receipts from the tax are appropriated to new spending.

The dependence of both receipts and outlays on general economic conditions combined with the cost of the Soviet grain embargo and the impact of the problems in Iran and Afghanistan suggest that the deficit will be larger than either Congress or the administration originally expected.

Some private political observers suggest that, as 1980 is an election year, there may be a tax cut of as much as $30 billion. The administration has consistently taken the view, however, that a tax cut would be a severe setback in the fight against inflation, and there has been no significant work on legislation to enact such a cut.

Barring far worse performance of the economy than expected in the next few quarters, it seems unlikely that a tax cut could be enacted in time to have any significant effect on fiscal 1980. Even a tax reduction bill passed before the November elections with retroactive provisions would have most of its effect in fiscal 1981.

Maybe more significant than receipts, outlays, and the deficit expected for fiscal 1980 is the shift in priorities for 1980 and the years beyond. Almost every year since the Viet Nam War, the proportion of the budget allocated to defense has declined. Adjusted for inflation, defense spending has stayed relatively flat since 1973.

Beginning in 1980, it is planned for defense outlays to increase 3 percent a year, after adjustment for inflation. Spending could increase even faster in later years. Plans call for budget authority (allocation of funds for spending in future years) to increase 4.5 percent in fiscal 1981. Increases in defense spending combined with pressure to lower total government spending relative to GNP means spending on categories other than defense must increase significantly slower than growth of the total economy. Since many programs, particularly Social Security, have legislated ties to the inflation rate, there will be severe pressure to reduce programs funded year to year.

With the emphasis on defense and the pressure for a balanced budget coming together in an election year, establishing a program for fiscal 1981 could entail a difficult struggle. The President's budget message in late January is expected to call for a deficit of about $15 billion, few new spending programs, and rather tight limits on existing programs other than defense.

The energy program

Shortly after midyear, the President outlined a modified and extended energy program. The program still stressed conservation as a major means of reducing demand for energy. It also stressed accelerated development of a subsidized synthetic fuel program, however, added funds for public transportation, solar and other unconventional energy sources, a stepped-up shift to coal, financial assistance to low-income families, and a board to expedite the various review and environmental procedures to speed construction of energy facilities. The program was to be financed entirely by the "windfall" oil profits tax, actually an excise tax on domestic oil production, the tax being tied to the cost of imported oil and graduated according to when the oil was discovered.

Introduction of the program came when the Three Mile Island incident, long gasoline lines, and the rapid runup (and instability) in imported oil prices made the need for putting together a complete energy plan generally accepted.

The year ended with three major bills essential to implementation of the program in Senate-House conference committees: the Windfall Tax Bill, which in its final form may implement other aspects of the program as well; the Energy Mobilization Board Bill, which would create a board with power to expedite major energy installations; and the Energy Security Corporation Bill, which would set up the means of financing and controlling synthetic fuel production.

Although none of these elements of the administration's program are likely to take quite the form proposed in the President's energy message, they will represent a major move along the lines he proposed. It could be well into the second session of Congress, however, before full details of the energy program are complete.

State and local government

Measured on the national income account basis, state and local governments generally operated at near-balance in 1979, though not as comfortably near as in 1977 or 1978. Their overall surplus in 1979 has been estimated at about $24 billion, down about $3 billion from 1978. As this surplus was less than the surplus expected in their social insurance funds, they had an operating deficit of possibly $2-$3 billion, instead of the operating surpluses of the previous two years.

Total receipts increased about 7 percent. Outlays increased about 8.5 percent. As this rate of increase in spending was about the same as the inflation rate applicable to state and local government, there was almost no growth in spending measured in constant dollars.

Some other state and local governments followed up on California's Proposition 13 movement to limit tax or spending increases. The tax revolt, however, did not become the national movement some observers were forecasting a year ago.

California took another step toward fiscal austerity by passing a second proposition restricting spending. Local governments in California can no longer increase spending faster than the combined rise in inflation and the population served, without approval by referendum.

Some local governments continued to have financial problems. The most serious was in Chicago, where the public school system was unable to sell short-term notes in November after a close examination of its prospectus caused the Board of Education's credit rating to be lowered. While the problem in Chicago is not of the magnitude of New York City's problems, the procedures that led to it were much the same—persistent use of funds assigned to capital costs and previously incurred debts to meet operating expenses.

The school system was unable to meet its payroll for the second half of December. Estimates suggest the system will need between $350-$400 million to pay outstanding debt and operate the rest of the school year. Meanwhile, some combination of higher income and lower outlays is needed to put the system in sound financial condition. The most likely source of the income needed is an increase in the property tax rate, already at the legal ceiling.

Agriculture: embargo undermines strong world demand for agriculture

Last year marked the fifth consecutive year of record domestic crop production. Huge crops of grains and oilseeds—in light of the embargo on shipments to the Soviet Union—are more than enough to meet prospective utilization. As a result, carryover stocks will increase substantially, possibly weighing heavily on crop prices in the year ahead.

Livestock production was nominally larger than in 1978, and a further increase is likely this year. Beef production dropped sharply to a six-year low and may be slightly lower again this year. But large increases in pork and poulty production more than offset the decline in beef production, and further increases this year are expected to bring higher production of all meats. Small increases in milk and egg production are expected again this year.

The financial perspective

Developments in agricultural finance were highlighted last year by high earnings and continued sharp increases in farmland values and farm debt. The composite of prices received by farmers averaged about 240 (1967=100), up 14 percent from 1978. Larger marketings complemented the higher prices, boosting cash receipts from marketings 17 percent. Earnings for crop farmers rose the most, but livestock producers also saw a significant rise in receipts.

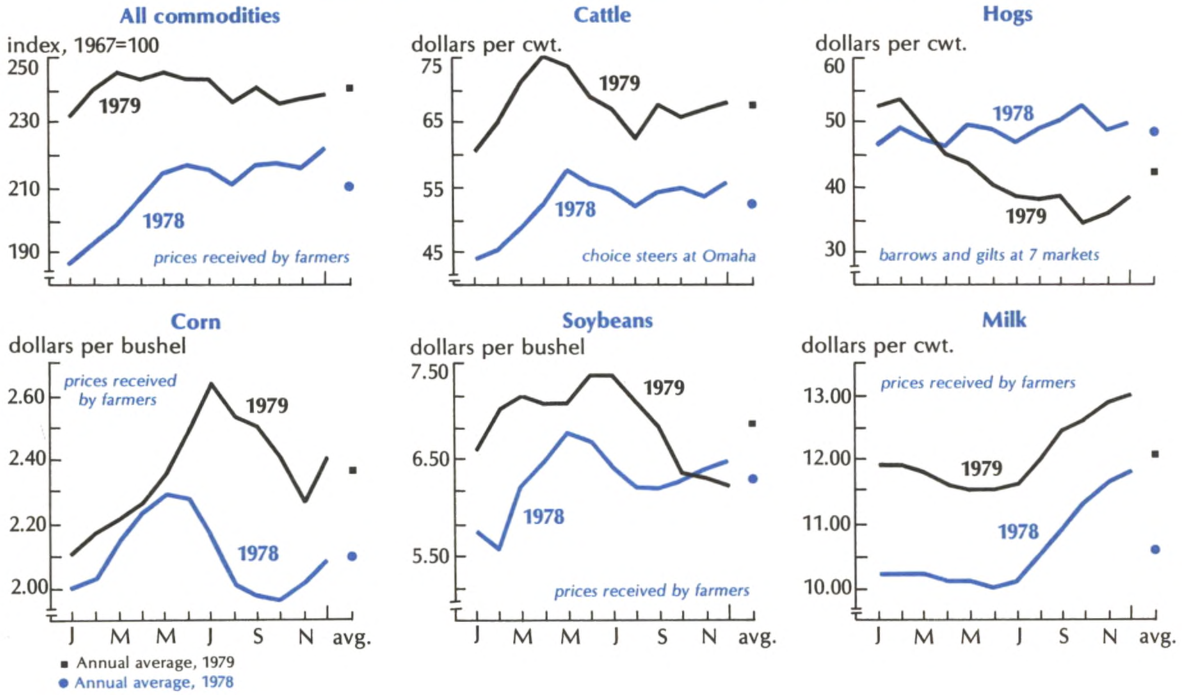
Preliminary estimates show net farm income rose from $28 billion in 1978 to $32 billion last year. Nearly all the increase, however, traced to non-money sources, such as the increased value of inventories, the higher rental value of farm dwellings, and the value of farm products consumed directly in farm households. Current estimates suggest that nearly all the increase in marketing receipts was offset by a $2 billion decline in government payments to farmers and a rise in production expenses from $98 billion in 1978 to $114 billion in 1979. Fuel and interest costs, which together account for a sixth of expenses, led the rise in production costs.

Earnings of farmers in states of the Seventh District were mixed. Except for fuel and interest, the rise in the costs of producing crops was fairly modest. Earnings from crops were supported by higher corn and soybean prices and by the larger marketings made possible by bountiful harvests in 1978 and 1979. Livestock producers were affected by higher feed costs throughout the district. With milk prices up 14 percent, dairymen had another year of favorable earnings. Budgets prepared by Iowa State University indicate, however, that earnings of hog producers and cattle feeders turned sharply lower in the latter part of the year. Net returns for hog producers were negative during most of the second half because of sharply lower hog prices. For cattle feeders, the earnings squeeze was due mostly to the high prices paid for feeder cattle during the first half of the year.

Farmland values made big increases again last year, continuing a trend that highlighted agricultural developments of the 1970s. Estimates by the USDA show a 16 percent increase nationwide last year. If that is right, the year capped a decade in which per-acre values rose at a phenomenal compound annual rate of nearly 13.5 percent. Quarterly surveys by the Federal Reserve Bank of Chicago suggest values in the district parallelled the rise in farmland values nationwide. Year-to-year gains ranged from 7 percent in the district portion of Illinois to 18 percent in Iowa.

Farm debt rose substantially again last year, topping out a threefold increase for the decade. Government estimates show farm

1979 farm commodity prices in perspective



debt reached $158 billion, up 15 percent from the year before. Higher input prices, expanded production, strong capital expenditures, and higher land values all contributed to the rise.

There was wide variation in the contribution of major lenders to the rise in farm debt. Rural banks struggled to meet the strong farm loan demand. The liquidity pressures that had been building at rural banks in recent years intensified last year as deposit growth slowed and soaring interest rates compounded bankers' problems of liquidating securities to fund new loans. Evidence suggests that with loan-to-deposit ratios well above the levels of a few years ago, farm debt held by banks at the end of the third quarter was up less than a tenth from a year before. By contrast, the debt held by the cooperative farm credit system was up nearly a fifth. That held by life insurance companies was up a sixth. Government lending continued strong last year, fueled by the availability of funds through various disaster and emergency lending programs and more liberal ceilings on traditional farm lending programs. Overall, farm debt held by government agencies rose a third. This was despite a marked decline in farm loans held by the Commodity Credit Corporation.

The inflationary perspective

Food was one of the main factors boosting consumer prices. Although pressures eased substantially in the second half, the index of retail food prices averaged about 11 percent higher than in 1978. That made 1979 the fourth year of double-digit increases in food prices in the 1970s. Retail beef and veal prices led the rise last year with average increases of a fourth.

Raw food commodity prices trended lower during the second half. But retail food prices continued to edge higher because of the escalating costs of processing and distributing food. The third-quarter index of utility costs (fuel, power, and lights) to food marketing companies was up a fourth from the year before. Food container and packaging costs were up 11 percent and rising. Rail freight charges for food products were up 22 percent in October from a year earlier. Labor costs for processing and distributing food were up 12 percent last year. Together, labor, transportation, utilities, and packaging account for more than 70 percent of the costs of marketing domestically produced food. Nearly half of the retail spending on domestic food goes for these four items.

Overall, consumer demand for food was fairly strong last year, due to continued growth in employment, large nominal gains in disposable income, and huge increases in food-stamp benefits. One area of consumer food demand showed considerable softness, however. That was for food eaten away from home. Sales at eating and drinking places averaged 12 percent higher than a year earlier in the first quarter. But that gain was cut in half during the late spring and summer as concern over gasoline supplies and prices forced changes in vacation plans. The gain widened some in the fall. Nevertheless, the increase in sales was still less than the rise in prices of food eaten away from home, indicating a significant decline in the amount of food eaten out.

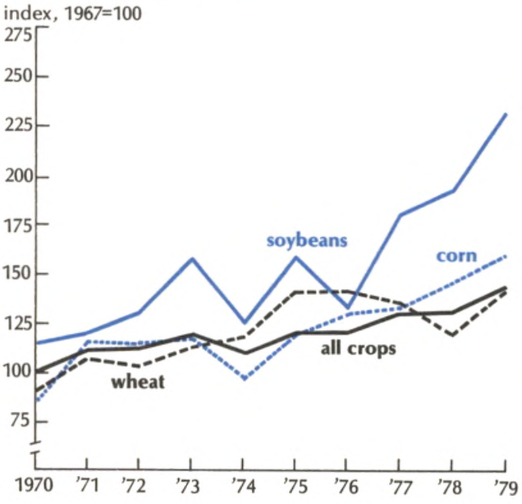
Commodity highlights

The cropping season was characterized by rain-delayed plantings, late developing crops, and a late harvest. The outcome was, nevertheless, phenomenal. Current estimates show crop production up a tenth nationwide—and that from the previous year's peak. Feed grain production (corn, sorghum, oats, and barley) was up 8 percent to a new all-time high. Food grain production (wheat, rye, and rice) was up 16 percent and above the previous high in 1975. Oilseed production (soybeans, cottonseed, peanuts, flaxseed, and sunflowers) was up 20 percent from the peak in 1978.

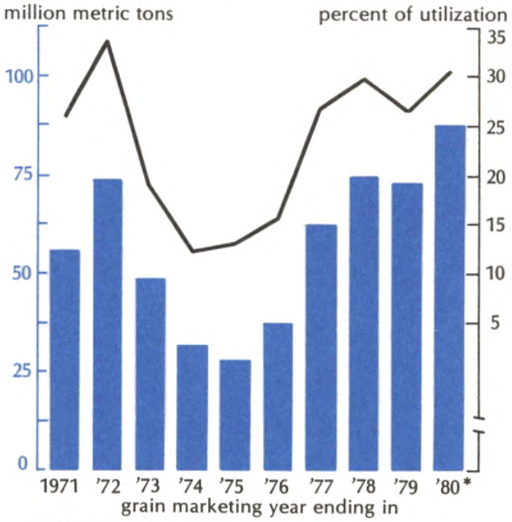
The bumper harvest was equally apparent in district states, which account for more than half the nation's corn and two-fifths of its soybeans. Per-acre corn yields reached new highs in all district states, except Wisconsin. For the five states, corn yields averaged 120 bushels, nearly 22 bushels per acre more than the average for all other corn-growing states. Soybean yields for the five district states averaged 37 bushels per acre, over a fourth more than the average for other soybean producing states.

Last year's record domestic grain and

Another banner year for crop production . . .



. . . promises to boost carryover stocks of grain substantially



*USDA projection.

oilseed harvest was particularly fortunate, considering the situation worldwide. Wheat production in the Southern Hemisphere set new records last winter, but bottlenecks in transportation kept producing countries from sharing proportionately in the burgeoning world market. Production of coarse grain was no better in the Southern Hemisphere last spring than the year before. It was even lower in the top exporting countries. Contrary to expectations, Brazil's soybean harvest was only marginally better than the weather-devasted crop of the year before.

Except in the United States, grain production in the Northern Hemisphere was off appreciably last summer. The most evident downturn was in the Soviet Union, where production fell from the record 237 million metric tons in 1978 to an estimated four-year low of 179 million tons. Although wheat production reached a new high in India, production of coarse grains and rice (by far the dominant crop) fell nearly a fifth. In Canada, the grain harvest fell 14 percent to a five-year low. Western Europe had a bumper grain crop, but the harvest was still 4 percent less than in 1978. In Eastern Europe, a sharp decline in wheat reduced the total grain harvest 5 percent.

World demand and prices for U.S. grains and soybeans proved stronger than expected because of the adverse crop developments throughout much of the world. The value of U.S. agricultural exports rose 17 percent to $32 billion in fiscal 1979 boosting the agricultural trade surplus to nearly $16 billion. That closed a decade that had seen agricultural exports increase nearly sixfold and the agricultural trade surplus nearly 18-fold. Grains and oilseeds accounted for over two-thirds of the exports last year.

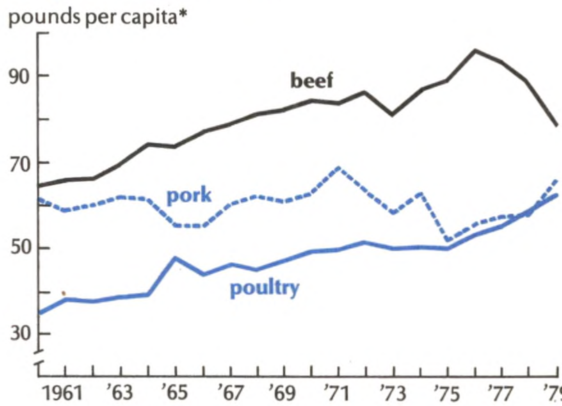
Strong world demand—and significantly greater domestic utilization—led to higher crop prices, despite record domestic supplies. Monthly corn prices received by farmers averaged $2.37 a bushel, compared with $2.10 in 1978. Soybean prices averaged $6.86 a bushel, against $6.28 in 1978. Prices varied between regions more than in 1978, however. A 12-week strike at the Duluth/Superior port facilities and bankruptcies and strikes on major rail lines contributed to smaller price gains in western and northern areas of the Midwest.

For livestock producers, last year ended the downturn in the cattle cycle and brought forces that could end the upswing in the hog cycle this year. Improved prospects for cow-calf operators led to a one-third decline in cow and calf slaughter. As a result, cattle numbers are up slightly from the very low level a year before. A similar increase is expected in this year's calf crop, following the 16-year low set last year. These developments provide the base for an increase in beef supplies in another year or two.

Commercial feedlot activity turned lower last year, resulting in an 8 percent decline in fed cattle marketings. That, plus the decline in cow slaughter, pulled beef production to a six-year low, 11 percent less than a year before. Per capita beef consumption, as a result, fell to a 12-year low.

Even with the downturn in beef, increases in pork and poultry production raised per capita consumption of meat 1 percent back to the 1977 record. Broiler and turkey production increased a tenth. Pork production, paced by year-to-year gains of more than a fifth in the second half, rose 16 percent. These large increases sharply lowered prices,

Lower production pulled per capita beef consumption to a 12-year low in 1979



*Retail weight basis.

Economic events in 1979—a chronology

Jan 1 Minimum wage rises from $2.65 to $2.90. (On January 1, 1980, minimum wage rises to $3.10.)

Jan 1 Social Security tax rate rises from 6.05 to 6.13 percent, and taxable income rises from $17,700 to $22,900. (On January 1, 1980, tax base rises to $25,900.)

Jan 1 Mandatory private retirement age rises to 70 .

Jan 3 Secretary Schlesinger urges energy conservation because of the cutoff of oil from Iran.

Jan 15 Chicago temperature falls to a record low of minus 19 degrees; heavy snows in Midwest snarl transportation.

Jan 16 The Shah leaves Iran.

Jan 24 Department of Energy (DOE) urges states to encourage natural gas hookups to save oil.

Jan 30 Chinese Vice Premier Teng begins official visit to U. S.

Jan 31 Religious leader Khomeini returns to Iran.

Feb 5 Farmers in Washington, protest low farm prices.

Feb 5 Gold jumps to a record $246.50.

Feb 13 Iranians attack U.S. embassy in Tehran.

Feb 18 China invades Vietnam border area.

Feb 19 Heavy snows impede traffic on East Coast.

Feb 20 Federal Reserve's report to Congress projects monetary growth for 1979 at 1½ to 4½ percent for M-1, 5 to 8 percent for M-2, and 6 to 9 percent for M-3.

Feb 22 DOE predicts serious gasoline shortage.

Feb 26 Airlines reduce flights because of fuel shortages.

Feb 28 Major oil companies curtail fuel allocations.

Mar 13 Nuclear Regulatory Commission orders five large East Coast nuclear power plants closed.

Mar 13 European Monetary System goes into effect.

Mar 21 Rail transport of fresh foods deregulated.

Mar 21 Supreme Court rules, 6-3, that states can pay unemployment compensation to strikers.

Mar 22 Iran cancels $700 million in contracts with U.S.

Mar 26 Egypt and Israel sign peace treaty in Washington.

Mar 27 OPEC votes 9 percent rise in base price for crude oil.

Mar 28 Accident closes nuclear plant at Three Mile Island.

Apr 5 Carter proposes phase out of oil price controls, along with a "windfall" profits tax.

Apr 11 Teamsters end 11-day strike.

Apr 12 Moody's reduces rating on Chrysler bonds.

Apr 16 Jane Byrne takes office as mayor of Chicago.

Apr 17 UAW official denounces price-wage guidelines.

Apr 20 Federal court declares bank ATS accounts illegal and sets January 1, 1980, deadline for Congressional action.

Apr 30 Israeli ship passes through Suez Canal, first since Israel was founded in 1948.

May 4 Margaret Thatcher becomes Britain's Prime Minister.

May 4 Long lines develop at California gas stations.

May 23 Crude oil sells in spot markets abroad at over $30.

May 24 Strike ends at United Airlines after 55 days.

May 24 Diesel fuel shortages slow truck traffic.

May 25 DC-10 crashes after takeoff at O'Hare—274 die in worst air disaster in U.S. history.

Jun 1 Long lines reported at gas stations on the East Coast.

Jun 4 Independent truck drivers halt traffic, protesting price and availability of diesel fuel.

Jun 6 FAA grounds all DC-10s operated by U.S. airlines. (Ban lifted July 13.)

Jun 7 Carter again rules out wage and price controls.

Jun 15 United States and Russia sign SALT pact in Vienna.

Jun 17 United Nations projects world population at 4.3 billion in 1980 and 6 billion in 2000.

Jun 20 Emmett J. Rice joins Federal Reserve Board, succeeding Stephen S. Gardner.

Jun 27 OPEC raises basic oil price to $18, plus surcharges.

Jun 27 In Weber case, Supreme Court rejects a "reverse discrimination" plea.

Jul 1 Social Security and welfare payments rise 9.9 percent.

Jul 1 Passbook savings rate ceiling raised to 5.5 percent at thrifts and 5.25 percent at banks, four-year floating rate certificate authorized, and other regulations are eased.

Jul 2 Circulation of Susan B. Anthony dollar coins begins.

Jul 11 Skylab falls into Australian desert.

Jul 16 Thermostats in nonresidential buildings ordered set at 78 in summer, 65 in winter.

Jul 17 Carter announces receipt of resignations of his entire cabinet and senior staff. (Most are retained.)

Jul 17 Treasury auctions gold at a record $296.

Jul 17 Federal Reserve's report to Congress retains 1979 monetary growth ranges announced February 20 and sets similar ranges for 1980.

Jul 18 Frederick H. Schultz confirmed as Vice Chairman of the Federal Reserve Board, succeeding Philip C. Jackson, Jr. as Governor and Stephen S. Gardner as Vice Chairman.

Jul 19 G. William Miller, Federal Reserve Board Chairman, named to replace Blumenthal as Secretary of the Treasury.

Jul 19 Federal Reserve announces increase in discount rate from 9.5 to 10 percent.

Jul 25 Paul Volcker named to succeed Miller as Chairman of Federal Reserve Board.

Jul 26 Legislation implements Multilateral Trade Negotiations.

Aug 1 Chrysler reports large operating losses and asks federal financial aid.

Aug 1 RPs of less than $100,000, maturing in 90 days or more, made subject to Regulation Q interest rate ceilings.

Aug 15 Andrew Young resigns as ambassador to the U.N.

Aug 16 Federal Reserve announces increase in discount rate to a record 10.5 percent.

Aug 17 Price controls end for "heavy" crude oil.

Sep 1 California lettuce growers sign pacts with United Farm Workers, raising wages by about two-thirds over three years.

Sep 12 Major bank raises prime rate to 13 percent.

Sep 14 General Motors agrees to boost compensation 34 percent over three years, assuming 8 percent annual inflation.

Sep 18 Gold rises to $382 and silver rises to $16.

Sep 18 Federal Reserve announces increase in discount rate to 11 percent.

Sep 25 HUD raises ceiling on government-backed residential mortgages to 10.5 percent.

Sep 26 Duluth grain elevator strike ends after 12 weeks.

Sep 27 Auto manufacturers again reduce assembly schedules to cut inventories.

Oct 1 Federal workers receive general pay boost of 7 percent, in addition to annual step increases.

Oct 1 Panama's sovereignty extended over the Canal.

Oct 1 Gold jumps to $416, double year-earlier price.

Oct 5 Dow industrial stock index closes at 898, high for the year. (Low of 797 reached on November 7.)

Oct 6 Federal Reserve takes strong actions to slow inflation: discount rate rises to 12 percent, marginal reserve requirements are established on increases in "managed liabilities," and monetary policy emphasis is shifted to control of member bank reserves.

Oct 15 Libya raises oil price to $26.27, exceeding OPEC's $23.50 ceiling.

Oct 17 1,800 Marines reinforce Guantanamo Naval Base, following reports of Russian troops in Cuba.

Oct 18 John Deere strike ends after 18 days.

Oct 22 Treasury 90-day bills hit record 12.93 percent.

Oct 23 Major banks raise prime rate to 15 percent.

Oct 23 Britain terminates long-standing exchange controls.

Nov 1 Britain's Conservative government announces sharp cuts in welfare outlays.

Nov 1 Company-wide strikes start at Caterpillar and International Harvester.

Nov 4 Iranian "students" invade U.S. embassy in Tehran and seize.hostages.

Nov 5 Iranian Premier Bazargan resigns.

Nov 7 Prime rate rises to 15.5 percent.

Nov 8 Big Three auto makers announce further layoffs.

Nov 8 Illinois law suspends mortgage usury rate.

Nov 12 Carter bans oil imports from Iran; Iran halts shipments to U.S.

Nov 14 Chicago school financial crisis begins.

Nov 14 U.S. freezes Iranian financial assets.

Nov 16 Prime rate rises to 15.75 percent.

Nov 19 Lane Kirkland is elected president of the AFL/CIO, succeeding George Meany.

Nov 21 Mob burns U.S. embassy in Islamabad, Pakistan, acting on an unfounded rumor.

Nov 26 FNMA auctions conventional mortgage funds at a record 13.35 percent.

Nov 26 Major bank cuts prime rate to 15.5 percent.

Dec 5 IMF auctions gold at $426.

Dec 9 Brazil devalues cruzeiro by 30 percent.

Dec 13 Venezuela and Saudi Arabia raise basic oil price from $18 to $24. (Spot price is $40.)

Dec 13 Canada's Conservative government falls on vote over austere budget.

Dec 14 Financial authorities authorize banks and S&Ls to issue 2½-year certificates with rates tied to yields on Treasury bonds, and no minimum balance, effective January 1.

Dec 14 Major bank cuts prime rate to 15 percent.

Dec 19 Caterpillar strike ends after 79 days; strike continues at International Harvester.

Dec 20 Congress passes bill providing for a $1.5 billion loan guarantee for Chrysler, conditional on other steps.

Dec 20 OPEC nations adjourn meeting at Caracas without agreement on a price for crude oil.

Dec 21 Chicago transit strike ends after four days, with disputed cost-of-living adjustment to be arbitrated.

Dec 21 Chicago school employees are not paid.

Dec 26 Gold closes in New York at $506, first time over $500.

Dec 28 Legislation temporarily overrides court decision banning ATS accounts at banks, and suspends state mortgage usury ceilings, etc.

Dec 30 Soviet troops invade Afghanistan.

Dec 31 Silver hits $35, up from $6 a year earlier.

triggering income losses late in the year among hog and broiler producers.

Monthly choice steer prices at Omaha averaged about $67.65 per hundredweight, compared with $52.34 in 1978. By contrast, hog prices fell from $48.50 per hundredweight in 1978 to an average of $42.50 in 1979.

Milk production increased about 1 percent last year, spurred by a favorable milk/feed price ratio. Milk prices received by farmers averaged more than $12 per hundredweight, 14 percent higher than in 1978. The higher prices resulted mostly from strong commercial demand, but they also reflected higher government support prices.

What lies ahead?

Trends that could develop in the year ahead suggest the need for caution. Consumer demand for food could ease if the economy turns down as expected. Consumers' food budgets would be strained by rising unemployment and continued price increases for energy and other essentials. Although food demand usually weathers recessions fairly well, partly because of food-stamp and other government aid programs, downturns sometimes impact on demand for more preferred foods, such as beef and fresh fruits.

World demands for agricultural commodities will continue strong this year. Much of the strength was undermined, however, by the unexpected embargo on shipments to the Soviet Union imposed in early January. The embargo applies to all agricultural commodities except the unshipped portion of the 8 million metric tons of corn and wheat authorized in the five-year U.S.-USSR grain agreement. The loss in shipments to the Soviet Union will amount to 17 million tons of grain, plus a small amount of soybeans and related products.

Until the embargo, grain and oilseed exports were projected to rise 17 percent in fiscal 1980. The projected increase has been cut in half as a result of the embargo.

The Soviet Union has accounted for a large part of the world market for U.S. grains. For the past two years, corn shipments to the Soviet Union have accounted for more than a fourth of all corn exports and more than 6 percent of corn production. The impact of the embargo on such a large customer is not yet certain. For the short run, it appears the government intends to isolate from free market supplies a large part of the lost Soviet sales. Such actions would reduce the downward pressure on grain prices. For the longer term, production adjustments will likely be necessary if the embargo is not lifted.

Underlying inflationary pressures will continue to swell farmers' operating expenses and may limit the hoped-for easing in retail food prices. With the cost pressures facing food processing and distribution companies, it is doubtful that this year's rise in retail food prices can be held much below the double-digit level. Farmers will find the inflationary pressures most evident in fuel, fertilizer, and interest costs.

The USDA has projected a one-fifth decline in net farm income this year. That projection assumes small gains in marketing receipts and an increase of more than a tenth in production expenses. Few analysts argue about the direction of the change of income, and—in light of recent events—more are beginning to accept the magnitude of the change. Although world events regarding crop production or political developments may alter subsequent projections, it now appears that the agricultural sector will start the 1980s under less favorable conditions.

International: inflation and slowing growth plague the world economy

Inflation cast a deep shadow over the world economy in 1979. Rapidly rising prices of goods and services in nearly every country in the world eroded the purchasing power of consumers everywhere, disrupted business investment decisions, left deep marks on the balance of payments and external values of currencies of individual countries, and, together with the rising political tension in the world, contributed to the skyrocketing price of gold. A growing concern of governments in industrial countries over the pernicious impact of inflation on their economies led, in many instances, to the adoption of increasingly stringent monetary and fiscal policies. These policies tended to impede the industrial countries' economic growth, and—given the high degree of economic interdependence in today's world—stymied economic progress worldwide. In the meantime, a sharp increase in oil prices by OPEC during the year gave a new boost to inflationary pressure everywhere and severely disrupted progress toward regional equilibrium in the world's balance of payments. And so, the world economy entered 1980 with the gloomy prospects of declining economic activity, rising unemployment, high inflation, and major disequilibria in balance of payments.

Rising inflation . . .

In the closing months of 1979, the average rate of inflation in the 24 major countries comprising the Organization for Economic Cooperation and Development was a two-digit figure for the first time since 1974-75 when a fourfold increase in the price of oil and sharply rising commodity prices boosted the rate of increase in consumer prices to those levels. Rising prices of commodities in general, and oil in particular, again played a significant role in last year's resurgent inflationary pressures in the industrial countries.

From January to October, the food commodities index increased about 23 percent and exceeded the previous high in April 1977 by nearly 15 percent. Short supplies of grains in the Soviet Union, coupled with continued strong demand for grain elsewhere, pushed corn and wheat prices upward throughout most of the year. Beef prices worldwide increased dramatically, continuing an upward trend that began in 1977. Coffee prices soared again after declining from the record levels of early 1977 as an early frost in Brazil raised expectations of short supplies.

The industrial commodities price index had increased about 25 percent by early October. Large price increases in copper, lead, rubber, and tin were primarily responsible for the upward movement in the index. Upward pressures on prices came in response to fairly strong industrial demand for metals and tight supplies resulting from extended strikes and political unrest in some producing countries.

OPEC's formal action at midyear, raising the price of oil some 60 percent, combined with the disruption of supplies from Iran and with the continued strength of world demand, led to a steep runup in prices of energy around the world, giving a further boost to inflation.

Also contributing to the upward thrust in prices in the industrial countries were sharply increasing labor costs as lagging productivity gains were outrun by rising wage demands.

. . . leads to slower growth . . .

Efforts to restrain the emerging inflationary pressures by applying restrictive monetary and fiscal policies led to a slowdown in real economic growth in the industrial world. In the second half of 1979, the combined GNP of the 24 industrial countries comprising the OECD was growing at an annual rate of around 3 percent, compared with 4.3 percent in the second half of 1978. A further significant slowdown to less than 1 percent growth is projected for the industrial countries in 1980.

The slowdown in growth was and is expected to be particularly pronounced in the United States and in the United Kingdom, where growing labor problems contributed to the sluggishness of the economy. The combined weight of these two countries significantly influenced the aggregates for the area as a whole, both in 1979 and the projections for 1980. Other countries that fared fairly well in 1979, however, are expected to share in the decline in economic activities in 1980 and to experience rising unemployment.

. . . and balance-of-payments disequilibria

Rising prices of oil and other commodities sharply boosted the import bill of the industrial countries. This, combined with a substantial decline in their exports to OPEC, caused their aggregate trade balance to swing from a $5 billion surplus in 1978 to a $34 billion deficit in 1979. A broader measure, the current account balance (which includes not only trade in goods but also trade in services, aid, and unilateral transfers) reflected this deterioration. It moved from a $9 billion surplus to a $30 billion deficit. The current account deficit of the nonoil-developing countries also deepened, from $36 billion in 1978 to $47 billion in 1979.

A direct counterpart of the deterioration in the international accounts of industrial and developing countries was the increase in the current account surplus of OPEC countries. It rose from $7 billion in 1978 to $65 billion in 1979. Further substantial increases in the OPEC surplus—and accompanying deficits for the rest of the world—are projected for 1980.

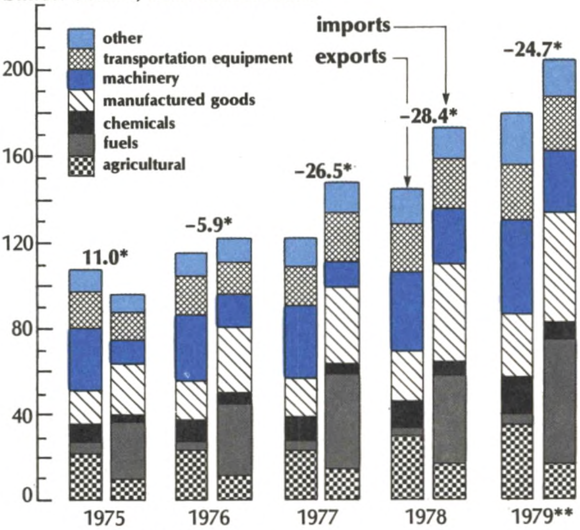
These trends have led to renewed concern over the financing of the deficits, particularly for developing countries already strapped with heavy external debt. For the past several years, developing countries have financed their largely oil-related balance-of-payments deficits by loans from banks in industrial countries. As a result, their combined debt to these banks rose from around $33 billion in 1974 to an estimated $150 billion at the end of 1979. In 1980, the combined deficit of the nonoil-developing countries has been estimated to run well in excess of $60 billion. Some of this deficit will no doubt be financed from foreign exchange reserves that are, in the aggregate, much higher than they were only a few years ago. But a good portion must be financed by borrowing. In light of the apparently growing reluctance of commercial banks around the world to continue lending to these countries, new sources of financing must be found if the developing world is to avoid severe economic problems in the coming year.

U.S. balance of payments improves . . .

Developments in the United States both influenced and were influenced by developments in the world economy. Somewhat faster economic activity abroad

U.S. trade deficit declines

billion dollars, f.a.s. census basis



*Annual trade balances.
**Category data are based on January-November at an annual rate.

contributed to a reduction in the U.S. trade deficit from $34 billion in 1978 to around $28 billion in 1979. This improvement came as U.S. exports to industrial countries and nonoil-exporting developing countries increased nearly a third while imports from these areas increased less than half that fast. Much of the improvement in the U.S. trade balance recorded elsewhere was blunted, however, by declining exports to the oil-exporting countries and an increase of about a third in the value of oil imports.

Petroleum imports still dominated U.S. import trade. The nearly one-third increase in the value of petroleum imports last year was due primarily to increases in the price. The amount of oil imported increased only about 2 percent. But by November, the per-barrel price of imported oil had been boosted more than 70 percent.

Although oil prices were still being raised by individual OPEC members when the year ended, the slowdown in the world's economies and expanding inventory accumulations in consuming countries appeared to have had some moderating effect on oil spot prices, if not on the official prices set by OPEC members.

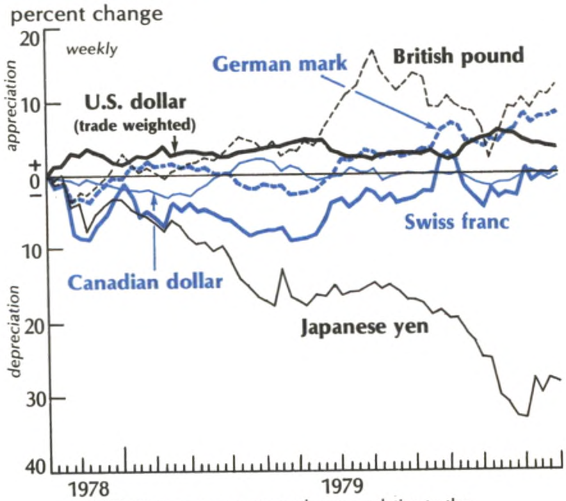
A continued increase in the surplus in trade in services contributed substantially to the reduction in the current account deficit. In the first nine months of the year, the services surplus totaled more than $25 billion—$7 billion more than in the same period a year earlier. The dramatic increase in the services surplus came mainly from a more than 50 percent increase in receipts of income of U.S. assets abroad over payments to foreigners of income from foreign assets in the United States.

. . . and the dollar steadies

Improvement in the U.S. international accounts was partly responsible for the marked improvement in the trends in the value of the dollar relative to other major currencies in the first half of 1979. The stage for the improvement was actually set in late 1978 when, after a precipitous drop in the international value of the dollar between June and October, the U.S. government announced, on November 1, 1978, a series of measures signaling its determination to defend the external value of the dollar. Through the last two months of 1978, the dollar was rising steadily from its October 31 low, and the momentum carried it well into 1979, as the initial, largely psychological impact of the November package was reinforced by rising U.S. interest rates and by the improving U.S. balance-of-payments position. By the end of May, the value of the dollar had increased by 8 percent over its October low, relative to the German mark, 13 percent relative to the Swiss franc, and almost 19 percent relative to the Japanese yen. On the trade-weighted basis (which takes into account the dollar value relative to currencies of 14 major U.S. trading partners, weighted by the respective volumes of trade) the dollar improved more than 6 percent. By the end of May, its value stood only 1.6 percent below the point at the inception of the general floating of major currencies in February 1973.

The dollar began weakening in early June, however, as the gap in interest rates between the United States and major foreign money markets narrowed. The change came with the increasingly tight monetary policy

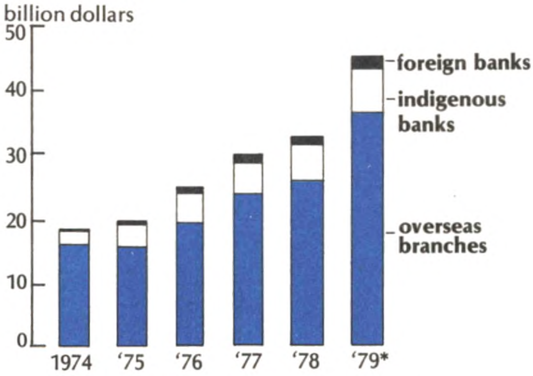
Dollar volatile—ends 1979 above year earlier



NOTE: Data are percentage changes, relative to the dollar, from November 1, 1978 base.

abroad that caused net capital outflows from the United States and rising U.S. inflation that reduced confidence in the dollar. The weakening continued through the summer but was sharply reversed in early October when the Federal Reserve announced a package of credit-tightening measures to dampen inflation in the United States. Some post-October gains in the value of the dollar were partially offset in the final weeks of the year as tension between the United States and Iran deepened. Nevertheless, the dollar ended the year at roughly the same value (on the trade-weighted basis) as at the beginning—some 2.5 percent below its value in February 1973.

Foreign claims of district banks continue to rise



*As of October 1979.

Banking in the district

International banking activity picked up in the Seventh District last year, continuing the expansion that began in the early 1960s. Foreign assets of banks in the district increased more than twofold in the past four years, totaling $45.1 billion in September, compared with $31.8 billion a year earlier. Domestic offices of district banks held claims on foreigners totaling $6.2 billion, up from $5.2 billion a year earlier. Liabilities to foreigners totaled $4.7 billion, an increase of $2.8 billion over the previous 12-month period.

The past decade saw a rapid increase in foreign lending through overseas branches. Banks in the district operated six overseas branches in 1967. By 1979, there were over 70 branches operated by 20 district banks. Assets of these district maintained branches totaled $36.8 billion in September, compared with $25.6 billion a year earlier.

Chicago has expanded steadily as an international financial center since 1973, when Illinois passed legislation allowing foreign banks to establish offices in Chicago. Since then, 34 offices of foreign banks have opened in Chicago. At year-end these offices had assets of over $5 billion.

Finance: restraint versus inflation

Inflation was a dominating force in financial markets in 1979. Despite a slowing economy, credit flows were only slightly less than the record growth reached in 1978. Against the Federal Reserve's intensified efforts to fight inflation by monetary restraint, credit demands pushed interest rates far higher than the country had seen in this century. But inflation itself, combined with the public's sinking hopes that it would diminish much in the foreseeable future, was an important element contributing to high interest rates.

Although expensive, credit remained generally available in most sectors of the financial markets—even for residential mortgages, which had been severely affected in earlier periods of tight money. As usual in the late expansion phase of the business cycle, business increased its share of the total demands on credit markets, and commercial banks became more important as suppliers of funds, financing their own growth mainly by increased reliance on money market sources and the six-month money market certificates. Reflecting the combination of high interest rates and regulatory ceilings on savings and small time deposits, many consumer funds were recycled to lending institutions through money market mutual funds. The funds were heavy buyers of large CDs, which are not subject to rate ceilings.

Actions to restrain rapid expansion in money and bank credit—to combat inflation, speculative activities, and a weakening dollar—intensified in early October. At that time the Federal Reserve announced that all its restrictive policy tools were being brought to bear in an effort to reduce credit growth and keep monetary aggregates from exceeding the target ranges set in February for the year as a whole. Money and credit growth moderated significantly in the fourth quarter.

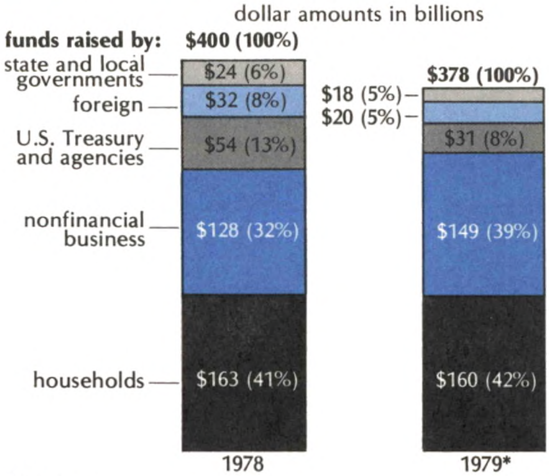
Credit market financing down

Aggregate credit flows were down last year for the first time since 1974, largely because of weakness in the fourth quarter when conditions were tighter. Despite higher inflation, net funds raised in the debt and equity markets by nonfinancial sectors were an estimated 5 percent lower than in 1978. This financing amounted to 16 percent of nominal GNP, down from 19 percent in 1978.

Of the major nonfinancial sectors, only business increased its effective credit demands. Combined net business borrowing and equity sales totaled about $150 billion, more than in 1978. As their external financing needs increased, firms relied more on short and intermediate-term borrowing both in the commercial paper market and from banks. Commercial bank loans accounted for about a third of the net new business financing, the dollar increase exceeding the earlier record set in 1973. Commercial mortgage financing also rose sharply. The pace of bond financing, on the other hand, remained moderate as corporations avoided increasing their long-term debt at prevailing high interest rates.

Households, with borrowings at $160 billion, remained the biggest credit users. This debt rose about 2 percent less than in 1978, however, mainly because of the slower

Less funds raised by all sectors but business



*Preliminary.
NOTE: Totals may not add due to rounding.

growth in auto loans. Despite record-high nominal mortgage interest rates, home mortgage lending remained close to the historically high 1978 gain.

As record-high short-term interest rates constrained mortgage lending at savings and loan associations—the single most important source of funds to the home mortgage market—thrift institutions' share of this market declined. Many savers switched from S&L deposits to such higher yielding investments as Treasury securities and money market mutual fund shares. Exacerbating S&Ls' problems was the elimination of their rate advantage over commercial banks in selling money market certificates. In mid-March, the rules were changed to eliminate the quarter-point differential when the ceiling rate is 9 percent or more. At the same time, both banks and savings institutions were prohibited from compounding interest on money market certificates. At times during the year, some S&Ls chose to limit their mortgage lending while directing more funds to money market instruments. This was a response to the pressure on earnings as the marginal cost of funds exceeded the then-current mortgage loan rates, a problem made worse in some areas by state usury ceilings. Moreover, as mortgage rates accelerated sharply late in the year, demand for mortgage credit declined. The rapid increase in mortgage pools ($28 billion in 1979 against $18 billion in 1978) played a major part in maintaining the flow of funds into home mortgages.[1]

Credit demands of government were drastically lower last year. Combined federal, state, and local government net borrowing was nearly 40 percent less than in 1978. Total government borrowing accounted for 13 percent of the funds raised by all nonfinancial sectors. That was the lowest percentage of the total since 1973.

Commercial banks supplied about one-third of total credit market financing—slightly more than in 1978 despite a reduced share in the final quarter. An increased portion of household savings was channeled into credit markets through money market mutual funds. Assets of these funds increased more than $30 billion. Direct investments by households in credit market instruments and equities increased about $50 billion, only slightly less than in 1978.

In contrast to 1978, when foreign sources supplied credit markets $40 billion, foreigners liquidated investment in credit market instruments last year by more than $5 billion. Strength of the dollar relative to foreign currencies, especially during the first half of the year, greatly reduced foreign exchange market intervention by central banks, thereby reducing their demand for U.S. government securities.

Interest rates to record highs

Both short and long-term interest rates ended the year sharply higher than at the beginning. Most interest rates passed the peaks reached the previous interest rate cycle. Movements responded to comparatively strong credit demands, increased inflationary expectations, and action taken by the Federal Reserve to curb monetary and credit growth. By year-end, the Federal Reserve's discount rate stood at a record 12 percent, up 250 basis points during the year.

The inverted yield curve that emerged in the fall of 1978 continued through the end of 1979, reflecting investor expectations that rates would soon decline. In the previous cycle, a similar yield curve pattern lasted from mid-1973 through late 1974.

With the economy showing signs of weakening and only a modest uptick in the federal funds rate (then the key operating target of Federal Reserve open market policy), other short-term interest rates were quite stable in the first half of 1979. Later, as the Federal Reserve responded to rapid

[1]These are mortgage pools against which marketable securities have been issued. Timely payment of interest and principal is guaranteed by either the Government National Mortgage Association or the Federal Home Loan Mortgage Corporation. The mortgage pools are made up predominately of single-family home mortgages. Some, however, are composed of multifamily or farm mortgages.

monetary growth accompanied by continued high inflation and a stronger-than-expected economy with a more restrictive monetary policy, short-term interest rates increased. Increases ranged from 250 basis points on six-month Treasury bills to 400 basis points on the bank prime loan rate. Late in the year, these rates eased down slightly as credit demands subsided.

Bond yields, as measured by standard rate series, rose by as little as 80 basis points on long-term municipals to more than 200 basis points on new high-grade utility issues. As with short-term yields, most of the increases were late in the year. Except in the municipals market, long-term yields exceeded historical highs by more than 100 basis points. The tax-exempt market benefited from a reduction in gross offerings. The amount offered would have been still less, except for the continued issuance of mortgage revenue bonds. Demand for municipal securities was especially strong from property and casualty insurance companies.

Yield spreads between long-term Treasury and corporate issues widened, partly reflecting the reduction in Treasury financing as the deficit narrowed. Quality spreads also widened but far less than when interest rates approached their peaks in 1974.

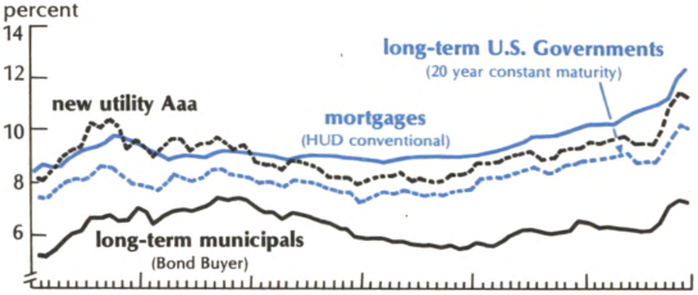
Mortgage interest rates, already at record highs when the year began, rose another 250 basis points before it ended. By year-end, rates on standard new mortgages averaged around 13 percent, plus points. Mortgage demand remained strong as consumers continued to view housing purchases as an inflation hedge. Many state usury ceilings were lifted or suspended to sustain the supply of mortgage funds. Further, as the cost of funds increased for mortgage lenders, mortgage rates were raised to maintain profit margins. In addition to the increases in contract rates, nonprice forms of mortgage credit rationing, such as larger downpayments and shorter maturities, became widespread.

Monetary aggregates and policy actions

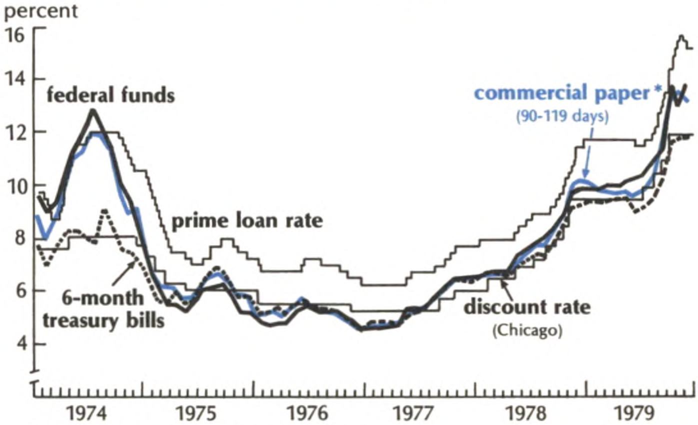
Last year was the first year that monetary policy decisions were reviewed within the framework of the Full Employment and Balanced Growth Act of 1978. This act (Humphrey-Hawkins) provides for a more formal coordination between monetary and fiscal policy.

In February, the Federal Open Market Committee set target monetary and credit aggregate growth ranges for the period from the fourth quarter of 1978 to the fourth quarter of 1979. In the judgment of the com-

Most long-term interest rates and . . .

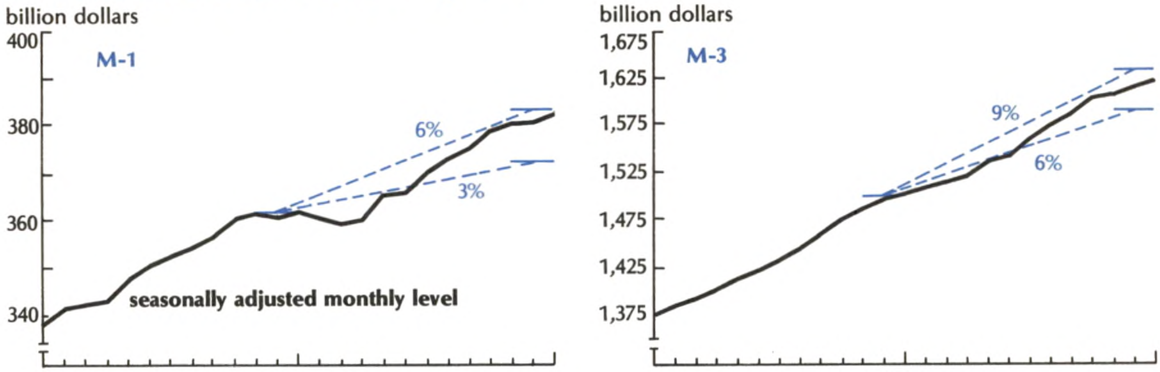


. . .short-term interest rates surpass previous cyclical highs

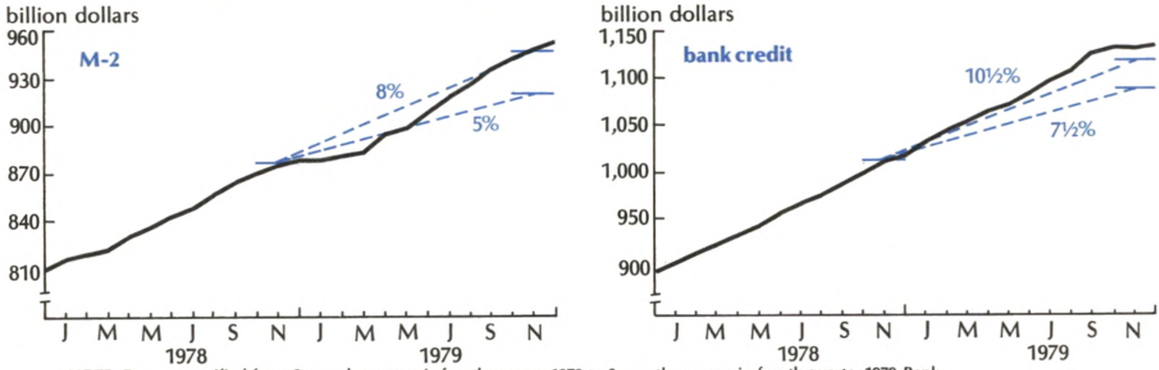


*Beginning November 1979, 90-day maturity.

M-1 and M-3 within 1979 ranges . . .



. . . but M-2 and bank credit above



NOTE: Ranges specified from 3-month average in fourth quarter 1978 to 3-month average in fourth quarter 1979. Bank credit data adjusted for breaks in series due to reclassifications.

mittee, monetary expansion within these ranges would be consistent with achieving the broader economic objectives that were also stated goals of fiscal policy—the gradual unwinding of inflationary pressures, the maintenance of a stronger position for the dollar in foreign exchange markets, and the encouragement of moderate economic growth. The following ranges were specified:

M-1[2]	1½-4½ percent (3-6, adjusted)
M-2	5-8 percent
M-3	6-9 percent
Bank credit	7½-10½ percent

The M-1 range specified in February assumed that shifts from demand deposits to automatic transfer from savings (ATS) accounts and New York negotiable orders of withdrawal (NOW) accounts, first authorized in November 1978, would reduce M-1 growth in 1979 by 3 percentage points.[3] Such shifts were later estimated to have reduced M-1 growth in 1979 by only 1½ percentage points. The equivalent longer-term M-1 growth range, therefore, is 3 to 6 percent.

The actual increases over the policy period were about 5½ percent for M-1, 8¼ percent for M-2, and 8 percent for M-3, compared with 7.2, 8.7, and 9.5 percent, respectively, in 1978. Bank credit rose about 12¼

[2]M-1 includes currency and commercial bank demand deposits held by the public. M-2 includes M-1, plus commercial bank savings and time deposits other than large negotiable CDs. M-3 includes M-2, plus deposits of mutual savings banks and shares at savings and loan associations and credit unions.

[3]A federal court ruled in April that ATS accounts, credit union share drafts, and S&L point-of-sale terminals would be illegal after 1979. In late December, Congress extended the deadline to March 31, 1980.

percent in 1979. Although credit also slowed from the pace of the previous year, it exceeded the upper end of the range specified.

While monetary expansion was generally within the targets over the year as a whole, there was considerable variation in growth rates during the year. Because of the volatility of money demand over short periods, the Federal Reserve responded gradually, its actions tempered by incoming evidence regarding the strength of the economy and associated inflationary pressures.

Monetary growth slowed significantly in the first quarter. M-1 declined at a 1.3 percent annual rate, while M-2 expanded at only 2.8 percent and M-3 only 5.3 percent. With inflation accelerating, however, the Federal Reserve took no stimulative action. Throughout the first quarter, reserves were supplied to the banking system at around a 10 percent federal funds rate.

As monetary growth accelerated sharply in the second quarter, the Federal Reserve became less accommodative. Reserves were supplied at a federal funds rate of 10¼ percent from late April through most of June. Not only were there indications of a weakening economy, but further restraint in the second quarter was not called for under the long-term growth targets. Because of the first-quarter slowdown, monetary aggregates at midyear were still near the lower limits of their long-term growth ranges.

Growth in money continued to accelerate in the third quarter. Inflation, moreover, continued at a torrid pace and incoming economic information suggested some bounce-back in production and income. Over the third quarter, the Federal Reserve took several restrictive steps. Every month of the quarter, the discount rate was increased 50 basis points, pushing the rate to a record 11 percent. In addition, reserves were supplied at a progressively higher federal funds rate. By the end of September, the rate was around 11½ percent, up 1¼ percentage points over the quarter.

Despite these actions, inflationary forces in the economy remained strong; the dollar came under additional pressure in the foreign exchange markets; and speculative excesses associated with deeply entrenched inflationary expectations appeared in the financial and commodity markets. In light of these developments—and to give public notice of its determination to take a firm stand against inflation—the Federal Reserve announced a three-part program on October 6 designed to ensure better control of monetary and credit growth.

First, the discount rate was raised a full percentage point to a record 12 percent. Second, a marginal reserve requirement of 8 percent was imposed on increases (above the larger of $100 million or the base period level) in the total managed liabilities of member banks, Edge corporations, and U.S. agencies and branches of foreign banks.[4] Finally, the FOMC approved a change in the target used in determining day-to-day open market transactions. Instead of focusing on the estimated price of reserves (the federal funds rate) consistent with a desired path for money, the new method focuses on the estimated quantity of reserves consistent with that path.

Interest rates increased sharply after October 6 and fluctuated over broader ranges than before. The federal funds rate, now free to reflect demand relative to the volume of reserves provided, rose to a high of 15.61 percent (on a weekly average basis) in late October and ended the year trading around 13½ percent. A significant reduction in the rate of expansion in the monetary and credit aggregates in the fourth quarter attested to the initial success of the program.

Despite the improved performance of the aggregates relative to predetermined goals, concern remained over whether those aggregative measures (as currently defined) adequately represent the funds actually available to the public for spending. Financial innovations and regulatory changes over the past decade have tended to blur the distinc-

[4]Managed liabilities include large denomination time deposits with maturities of less than a year, Eurodollar borrowings, repurchase agreements against U.S. government and federal agency securities and borrowings of federal funds from institutions other than members of the Federal Reserve System.

tions between different types of deposits, deposits at different types of institutions, and between deposits and other liquid assets. Early last year, the staff of the Board of Governors proposed new definitions for the monetary aggregates. That proposal has since been under study, and new definitions are expected to be adopted early this year.

Bank portfolio shifts

As in 1978, loans accounted for most of the expansion in total bank credit. Despite heavy credit demands from businesses and increased monetary restraint, the commercial banking system did not, on balance, liquidate securities. Total loans, in fact, did not rise as fast as in 1978 and investments grew faster.

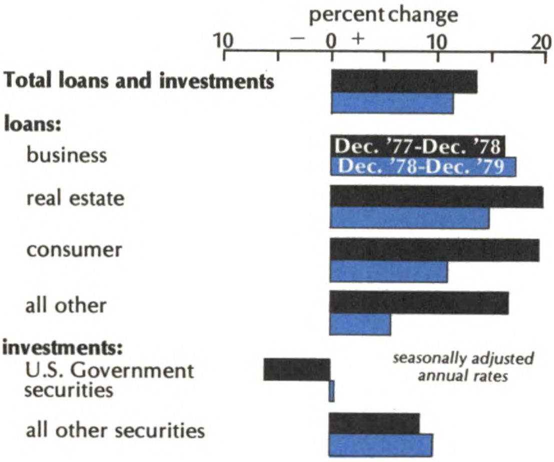
More than two-fifths of the 13 percent increase in loans last year was business loans, compared with a third in 1978. Commercial and industrial loans expanded at a 20 percent annual rate during the first three quarters before leveling off in the fourth quarter. Business loans were up about 17 percent for the year, compared with 16 percent in 1978.

Corporate borrowing strengthened at money center banks and accelerated further at U.S. branches and agencies of foreign banks. These institutions were generally aggressive in seeking to increase their loan business. Until October 6, many domestic banks were offering certain credits at less than the prime loan rate to meet competition from foreign-related banking institutions. Some term loans were made at fixed rather than floating rates.

Most large banks were able to pass on the rising cost of funds, thus maintaining their earnings margins. By mid-November, the prime rate reached 15¾ percent, 375 basis points above its mid-1974 peak, before easing down to 15¼ percent at year-end. After October 6, many banks tightened their terms of lending (price and nonprice) because of their higher cost of funds. Some borrowers were effectively priced out of the loan market, but competition continued to temper restrictive policies. Credit was still widely available for normal business needs, and there was evidence that special arrangements were being worked out for weaker customers that would have been severely hurt by money market interest costs.

While bank loans to businesses increased in 1979, loans to other borrowers slowed. Real estate loans at commercial banks, nevertheless, rose 15 percent over the year and consumer loans rose 11 percent.

Total bank credit expansion slows despite faster pace in business loans and investments



Sources of loanable funds

Growth in demand deposits was modest last year, but as market interest rates rose, outflows of savings deposits picked up. Some of the outflow went into small denomination time deposits, which provided an estimated $60 billion of loanable funds, compared with $20 billion in 1978. All the net growth in small CDs could be attributed to increases in six-month money market certificates, which rose about $80 billion at commercial banks nationwide.

Large CDs were allowed to run off in the first half of the year, as the 2 percent marginal reserve requirements imposed in late 1978 increased the cost of funds from this source. Late in the year, however, issuance of CDs resumed. The faster growth in CDs in the second half resulted from several factors, including strong third-quarter loan demands, weakness in other time and savings deposits, and the rising cost of funds from other sources. To a considerable degree, the savings funds flowed back to large banks through CD purchases by money market mutual funds.

Other "managed liabilities" were tapped extensively. These nondeposit sources—which include federal funds and security repurchase agreements with nonbanks, net Eurodollar borrowings, and sales of loans to nonbank affiliates—rose over $45 billion in the first three quarters, financing more than 40 percent of the increase in bank credit over that time. The new marginal reserve requirements were intended to slow the credit expansion financed by these sources. Given the basic weakness of "core" demand and savings deposits in a high interest-rate environment, however, financing any resurgence in loan demand is likely to require further additions to managed liabilities.

District bank asset and deposit changes reflect area differences in credit demands

	Loans[1]	Securities	Demand deposits	Time and savings deposits	Loans as percent of deposits	
	(percent change, Nov. 29, 1978 to Nov. 28, 1979)				11/78	11/79
Large banks[2]						
Chicago	16.7	3.3	5.6	−1.1	95.7	110.3
Detroit	6.2	22.6	2.5	3.5	71.7	73.8
Indianapolis	14.9	− 7.0	−4.1	8.5	72.8	80.6
Other cities	6.2	9.4	0.6	3.7	83.3	86.1
Other member banks						
Illinois	2.0	−1.0	−2.6	4.7	65.8	65.5
Michigan	5.7	−2.3	−1.9	4.5	71.2	73.1
Indiana	6.1	5.5	1.7	9.1	67.3	66.8
Wisconsin	11.2	6.6	--	4.4	68.7	74.0
Iowa	4.6	−1.8	−2.4	3.4	68.6	70.7

[1]Excludes fed funds sold.

[2]Large weekly reporting member banks with domestic office assets of $750 million or more as of December 31, 1977.

Banking in the district

Credit at member banks in the Seventh District expanded less than in 1978. Excluding interbank loans but including loans sold to affiliates, total loans and investments of member banks in the district rose 7.9 percent, compared with 10.5 percent in 1978. Loans accounted for most of the rise. Unlike 1978, when there was a net reduction in total bank holdings of securities, district banks acquired securities in 1979. Total bank loans expanded 9.4 percent, compared with an expansion of 15.7 percent in 1978.

The district data illustrate the greater impact of cyclical fluctuations on large banks than small banks. Loans expanded faster at large banks than at small and medium-sized banks, where demands had been strong the three previous years. Real estate lending was still the strongest element of growth in bank loans, although business lending picked up at the largest Chicago banks.

Although ratios of loans to deposits, often used as an inverse indicator of liquidity, rose more at large banks and were considerably higher, these institutions had many sources of liquidity. Many were still below their desired loan levels. Smaller banks, close to what they considered loaned-up positions, were more constrained in their lending. Net time and savings inflows were less at large banks, as some large denomination deposit certificates were not replaced at maturity. Most of the growth in time and savings deposits at large banks was due to a $2.5 billion increase in money market certificates.

In the year ended in November, total deposits at all district member banks were up only 3 percent, leaving most of the growth in loans to be financed by nondeposit sources. At Chicago banks with assets totaling $1 billion or more, these sources provided about $5 billion of loanable funds.

District holding company activity

During 1979, 102 applications were decided on involving Seventh District holding companies. Fifty-eight one-bank formations were approved, and 27 banks became subsidiaries of multibank holding companies.

At the national level, 547 applications were decided on in 1979, up from last year's total of 523 completed cases. Holding companies nationwide currently control 52.6 percent of the 50,422 commercial banking offices in the United States.

Four holding company applications involving district banks were denied on the basis of adverse competitive factors. One, for the formation of a one-bank holding company in Iowa, involved a chain banking situation. The Board took the position that approval of the application would perpetuate a situation that was already anticompetitive, further removing the possibility that banks in the chain could compete in the future.

Two applications by multibank holding companies to acquire additional banks were denied—one in Iowa and another in Michigan—on grounds that significant existing competition would be eliminated without enough outweighing convenience and needs factors.

One merger application was denied on grounds not of existing competition but concern over the concentration of statewide banking resources and the elimination of potential competition. Proposed was the merger of the sixth and twelfth largest banking organizations in Michigan. Completion of the merger would have given the resulting organization control of 5.1 percent of the deposits in the State. The Board determined that both holding companies had the potential for expanding *de novo* into the other's markets and that several of the markets were attractive for *de novo* entry.

Eight of the applications completed in the district were the subjects of substantive protests. Five of the applications were filed by the same Michigan multibank holding company, and all were contested under the new Community Reinvestment Act (CRA) by a community group in Detroit.

The group protested the proposed acquisitions of an existing bank and four *de novo* banks on grounds the banking organization had done little lending in low and moderate-income areas in the Detroit SMSA. The protests also charged racial discrimination in the lending pattern and challenged the delineation of one subsidiary bank's lending community. These were the first CRA protests filed against a holding company in the Seventh District.[5]

The Board approved the applications in November but directed the holding company to broaden its lending and marketing efforts in low and moderate-income areas. The holding company had contended that its lending performance before November 6, 1978, when CRA became effective, should not be considered. The Board found, however, that the convenience and needs analysis had meeting the credit needs of its community. Also, stressing the importance of technical compliance with the act, the Board reprimanded the holding company for technical violations regarding, for example, failure to post CRA notices and not making CRA statements available.[6]

Other CRA protested cases outside the Seventh District are pending Board action. Resolution of these cases will provide additional insights into the regulatory parameters used in evaluating a bank's lending record under CRA.

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[5]The Board had ruled on two CRA-protested applications from other districts. See Board Order of June 16, 1978, approving the merger of Commerce Bancshares, Inc., Kansas City, Missouri, with Manchester Financial Corporation, St. Louis (64 Federal Reserve Bulletin 576). Also see Board Order of May 31, 1979, approving the merger of the Ohio Citizens Trust Company, Toledo, and The Peoples State Bank, Wauseon, Ohio (65 Federal Reserve Bulletin 517).

[6]See Board Order of November 30, 1979, approving the acquisition of the following five Michigan banks by Michigan National Corporation, Bloomfield Hills, Michigan: Litchfield State Savings Bank, Litchfield; Michigan Bank-Livingston, Brighton; Michigan Bank-Midland, Midland; Michigan Bank-Northwest, Petosky; and Michigan Bank-South Metro, Lincoln Park.

Perils of the 1980s

The start of a new decade traditionally provides a convenient point for assessments of the economic outlook for the longer-term future. Since World War II, such projections typically have been characterized by a spirit of optimism. Output usually was expected to rise steadily with accompanying increases in productivity and consumption. In early 1980, however, confident optimism is a rare commodity. Sanguine expectations of perpetual economic growth and rising living standards have given way to apprehension that the existing level of consumption cannot be maintained.

Concern with a cyclical decline bears less heavily upon consumers and businessmen than in the past. The second half of the decade of the 1970s was a period of economic expansion, one of the longest on record. Now, most observers believe that a recession has begun. Typically, they expect the decline to be short and shallow with upward forces reasserted before year-end. Income supports will help keep spending at a high level. If a more serious adjustment appears to be developing, most people believe that the federal government will move speedily to cut tax rates and accelerate outlays, and that the Federal Reserve System will ease the supply of money and credit.

Since World War II, fears of the recurrence of a 1929-33 model depression have been gradually put to rest. Along with other industrialized nations, the United States has learned that high levels of consumption can be supported by maintaining consumer buying power through stimulatory monetary and fiscal policy. Unfortunately, a satisfactory program for containing the inflationary consequences of such policies has eluded all major nations.

Concern with inflation is worldwide. Frenzied efforts of individuals to maintain the real worth of their assets are reflected in wild fluctuations in the prices of gold and silver. The number of people speculating in precious metals, however, is small, compared to the number who have purchased houses and farmland at prices that cannot be justified by the revenues currently earned by these properties. Efforts to "hedge against inflation" show a deep distrust in the ability of the nation to deal with its problems. Such efforts add to price pressures by diverting resources from productive to speculative channels.

The primary constraint on supply is the availability of the energy that is essential for agriculture, manufacturing, mining, transportation, space heating, and air conditioning—in fact, virtually any human activity. Oil provides about half of U.S. energy, and almost half of this oil is imported. Prices of imported oil have doubled in the past year, a development quite unforeseen. Oil imports are the cause of the now-chronic deficit in the U.S. balance of international trade. Downward pressures on the value of the dollar abroad complicate the situation. Attempts to lessen U.S. dependence on oil have been hampered by restrictions on the construction and operation of power plants, the mining and burning of coal, and by other environmentalist regulations. Energy will remain the basic constraint determining the level of output and consumption. Monetary and fiscal policy can do little to ameliorate this situation.

The inflation and energy questions are closely related to the widening crisis in the Middle East. The State of the Union address called for substantial increases in military outlays to meet the threat of further Russian encroachments in this vital area. Congress and the people seem to approve. Because the United States has little in the way of surplus materials, facilities, or trained workers, the military buildup may preempt resources destined for consumption or private investment, and alter economic forecasts.