Research Department
Federal Reserve
Bank of
San Francisco

September 29, 1978

FRBSF Weekly Letter

Happy New Year?

The business community and the forecasting fraternity usually think of Labor Day as the beginning of their new year, because that's when most of the action starts in their activities. But since they still do their record-keeping on a calendar-year basis, everyone's attention is now turning to what will happen after next January 1. This year, the interest will be greater than usual, because of the uncertainty over the continued viability of a prolonged business expansion which first got underway in the dismal days of early 1975.

The consensus view is that 1979 will be a rather mediocre year, whatever euphemistic or pejorative term is used to describe the situation – soft landing, rolling readjustment, profitless prosperity, growth recession, or whatever. The ugly word "stagflation" may do as well as any other, because most observers see the 1979 performance as a combination of inflation and relatively stagnant business activity, with the plus and minus signs in the marketplace generally offsetting one another. Most expect real GNP to grow at less than the approximate 4-percent trend line generated by a continually expanding workforce and technological improvements, but relatively few expect an actual recession, with real GNP declining for a half-year or more.

Plus and minus

Consumer spending, which accounts for roughly two-thirds of total GNP, represents one of the major question marks in the outlook. This sector has dominated most of the expansion to date, aided by a vast increase in consumer instalment and mortgage credit. (New funds raised by households have been roughly half again as large in the 1977-78 period as in 1976, and roughly double the amount raised in any earlier year.) But spending in this sector should now decelerate, at least in part because of a reduction in credit use. In addition, spending on new home construction may actually decline, although from a very high level, because of the reduced inflow of funds available to mortgage-lending institutions.

Business capital spending also is a major question mark. This sector has consistently performed better than the headlines have suggested – spending has increased 27 percent (in real terms) since the recession trough – but much of the spending has been mandated by energy and environmental purposes rather than by economic-expansion needs. Again, the business sector has emphasized purchases of short-lived equipment rather than long-lived assets such as new structures – the type required for major expansions of capacity. This attitude of caution probably reflects an increase in the projected rate of return needed to justify new investment, undoubtedly as a result of the uncertainties created by prolonged inflation.

In contrast, spending could rise significantly in several other sectors of the economy. The export sector is likely to be stimulated by the expected upturn in the economies of our major trading partners, and primarily by the

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bargain-basement price-tags on American goods resulting from the past year's 10-percent drop in the average trade-weighted value of the dollar. Also, military spending is scheduled to rise as a result of Congress' commitment to an expanded defense establishment, following the prolonged post-Vietnam decline.

These mixed trends suggest a record of modest growth in 1979, following the path of gradual deceleration evident over the past several years. (Real GNP increased almost 6 percent in 1976 and 5 percent in 1977, and could rise perhaps 4 percent this year and 3 percent in 1979.) Over the longer term, however, a more important question will be how well the economy copes with some of its structural problems, beginning with energy.

Energy problem

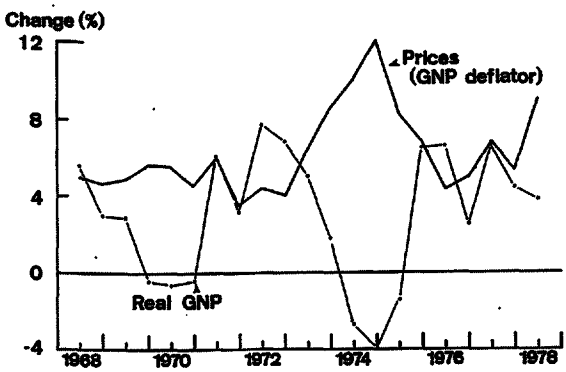
The nation for several generations based its growth on ample supplies of cheap energy, but in this decade, the U.S. can no longer call itself a cheap-energy country. Around 1970 a "quiet revolution" occurred (in Alan Greenspan's phrase), as the U.S. Gulf Coast states were supplanted in the role of marginal supplier in the world petroleum market by the Persian (Arabian) Gulf Coast states. The magnitude of the shift can be measured by the eight-fold increase since 1970 in the price of Saudi Arabian crude. The oft-quoted quadrupling of Arab oil prices in the 1973-74 period obviously understates this shift.

OPEC actions have levied a severe tax on the entire industrial world. (The impact on the U.S. economy can be measured by a sharp rise, from $5 billion to $45 billion, in net oil imports between 1972 and 1977.) Again, this shift has disrupted production functions in the world economy, making obsolete many hitherto-productive industrial processes. Over time, but with some difficulty, the price mechanism will enforce conservation practices and will generate the development of new energy sources. In the meantime, the nation's present energy policy is creating bewilderment among economists, apoplexy among *Wall Street Journal* editorial writers, and rising living standards among the hordes of lawyers, accountants and Energy Department employees dealing with the problem.

Some facets of inflation

Our other major structural problem, of course, is inflation. The U.S. can no longer call itself a low-inflation country; indeed, the 1970's now threaten to be the most inflationary decade in the nation's peacetime history. Early in the year, Administration economists argued that the nation was faced with an "imbedded" 6-percent rate of inflation, and following the second quarter's double-digit upsurge, they now claim to see an imbedded rate in the 7-to-8 percent range. Whatever the causes — demand pull, cost push, or imported — the acceleration in prices has been as severe as it has been unexpected.

This year's decline in the value of the dollar threatens to aggravate 1979's inflation problem. U.S. consumers will now pay considerably more for Japanese, German and other countries' products. U.S. business firms will now pay considerably more for foreign ma-



terials, and will pass these higher prices on to consumers. Again, U.S. producers will find themselves protected by the price umbrella raised by foreign firms, and accordingly will be able to raise their own prices with greater impunity. The process won't be reversed without a stronger dollar, which to a large extent will depend upon the fate of the overall attack on inflation.

The inflation problem also involves the leapfrogging of prices and wages, which make up the vast bulk of industry's costs. In 1977, labor compensation increased about 9 percent while labor productivity rose about 3 percent, and the resultant boost in unit labor costs became translated into increased inflation. In 1978, the increase in compensation is likely to be larger and the increase in productivity considerably smaller, with worsening consequences on the price front.

The Administration is now planning to promulgate some guidelines, in an attempt to curb the growth of labor compensation, and hence the rise in business costs. Over the long run, however, the more promising avenue is to boost productivity, which in the past decade has risen only about half as fast as in the several preceding decades. Actually, the passage of time may help bring about a more productive labor force. The postwar baby-boom generation, much to their parents' amazement, is now producing a reasonably mature and productive cadre of workers. But those workers can't live up to their potential without new tools, and those tools won't be available without new investment-stimulating tax measures, such as those Congress is now considering.

Basic inflation problem

Basically, however, the inflation problem involves the continued stimulus generated by a series of large budget deficits in the midst of a strong business expansion—which deficits in turn have pushed monetary policy off course in an expansionary direction. Both the M_1 and M_2 measures of the money supply have increased more than 8 percent over the past year—close to or even above the upper limits of their target ranges. The Federal Reserve is committed to reducing money growth over time, to a level consistent with relative price stability, but that goal will be difficult to achieve as long as Treasury deficit financing continues at its recent pace. The U.S. Government and its agencies raised a total of $96 billion (annual rate) in the nation's credit markets in the first half of 1978—roughly triple the Treasury's financing demand in any year prior to 1975.

The nation's energy and inflation problems, being structural in nature, seem to require long-run structural solutions. Meanwhile, in 1979, perhaps the optimum outcome is the most likely outcome—a year of modest growth amidst reduced stimulus from monetary and fiscal policy. After all, substantial pressures have built up in the past 3½ years, as the economy recorded its strongest and longest peacetime expansion of the past generation. In 1979, with reduced pressure in the boiler of the U.S. economy, this key "locomotive" of the industrial world may avoid jumping the tracks as it approaches the long stretch of the 1980's.

William Burke

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/13/78	Change from 9/6/78	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	117,228	− 146	+ 16,362	+ 16.22
Loans (gross, adjusted) − total	94,029	− 341	+ 16,125	+ 20.70
Security loans	1,735	− 423	− 172	− 9.02
Commercial and industrial	27,668	− 14	+ 3,835	+ 16.09
Real estate	32,681	+ 100	+ 6,926	+ 26.89
Consumer instalment	17,487	+ 12	+ 3,966	+ 29.33
U.S. Treasury securities	9,265	+ 365	+ 835	+ 9.91
Other securities	13,934	− 170	− 598	− 4.12
Deposits (less cash items) − total*	114,655	+ 1,986	+ 15,377	+ 15.49
Demand deposits (adjusted)	31,992	+ 1,383	+ 3,265	+ 11.37
U.S. Government deposits	476	− 154	− 19	− 3.84
Time deposits − total*	80,180	+ 1,035	+ 12,162	+ 17.88
States and political subdivisions	6,528	− 21	+ 1,279	+ 24.37
Savings deposits	31,580	− 48	− 67	− 0.21
Other time deposits‡	38,489	+ 897	+ 9,443	+ 32.51
Large negotiable CD's	19,446	+ 1,028	+ 8,060	+ 70.79

Weekly Averages of Daily Figures	Week ended 9/13/78	Week ended 9/6/78	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves(+)/Deficiency (−)	+ 51	+ 19	+ 51
Borrowings	11	50	10
Net free(+)/Net borrowed (−)	+ 40	− 31	+ 41
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions Net purchases (+)/Net sales(−)	+ 1,932	+ 818	+ 686
Transactions with U.S. security dealers Net loans (+)/Net borrowings (−)	+ 697	− 12	+ 358

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .

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