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Monetary Policy Report (1979) 9



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Board of Governors of the Federal Reserve System



Monetary Policy Report to Congress
Pursuant to the
Full Employment and Balanced Growth Act of 1978

February 20, 1979



Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 20, 1979

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its first Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
G. William Miller, *Chairman*

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Letter of Transmittal

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CHAPTER 1

"a review and analysis of recent developments
affecting economic trends in the nation"

Section 108(a) Full Employment and
Balanced Growth Act of 1978

Section 1. Overview

The current economic expansion is about to enter its fifth year. It thus outranks in longevity every prior cyclical upswing of the postwar era with the exception of that in the 1960s. Yet it has maintained considerable vigor, with real gross national product rising more than 4 percent during the past year. The attendant increases in employment and industrial capacity utilization have reduced considerably the margin of unutilized productive resources in the economy.

The narrowing of the gap between actual and potential output implies that a tighter hold on the Nation's aggregate demand for goods and services is necessary if inflationary forces are to be contained. The urgency of such restraint is reinforced by the fact that there has already been an acceleration in the rise of wages and prices. Aggregate measures of unit labor costs and prices advanced around 9 percent in 1978, appreciably more than in the preceding years of this economic expansion.

Apart from the hardship that this large and generally unanticipated surge in inflation created for many families and business enterprises, the behavior of prices deepened concerns around the world regarding the stability of the U.S. economy and the soundness of the dollar. The value of the dollar on foreign exchange markets declined through most of 1978, exacerbating domestic inflationary pressures in the process. To prevent a serious disruption of the international financial system, a broad program of corrective actions was initiated last November. The dollar has since strengthened, but remains vulnerable to shifts in sentiment among exchange market participants.

The longer-range strength of the U.S. economy and of the dollar depends greatly on our success in retarding inflation. This was recognized during the past year in actions taken to reduce the size of the Federal budget deficit, in the establishment of voluntary wage-price standards, and in efforts to curtail the inflationary impact of Federal regulation. In the monetary sphere, too, there was movement toward moderation of aggregate demand growth and restraint of inflation as the Federal Reserve acted to prevent excessive growth of money and credit.

Section 2. Aggregate Economic Activity

The current economic upswing, which began in the spring of 1975, ranks among the most durable in this Nation's history. In the period since World War II, only the expansion of the 1960s was longer, and it was marked by massive increases in military outlays associated with the Vietnam War.

The past four years have seen sizable gains in production and employment. Between the first quarter of 1975 and the fourth quarter of 1978, real gross national product rose more than 20 percent. By last month, industrial production had increased about 35 percent and nonfarm payroll employment more than 14 percent from their levels at the cyclical trough in March 1975.

The momentum of expansion, furthermore, has been well maintained. Real GNP increased 4.3 percent from the fourth quarter of 1977 to the fourth quarter of 1978--a bit slower than the average pace over the earlier part of the expansion, but still well above the trend growth of potential output in the economy. The persistent strength of aggregate demand was demonstrated by the surge in activity during the final quarter of last year, when GNP grew at an annual rate in excess of 6 percent. Available indicators suggest that the economy has remained generally strong in the opening months of 1979.

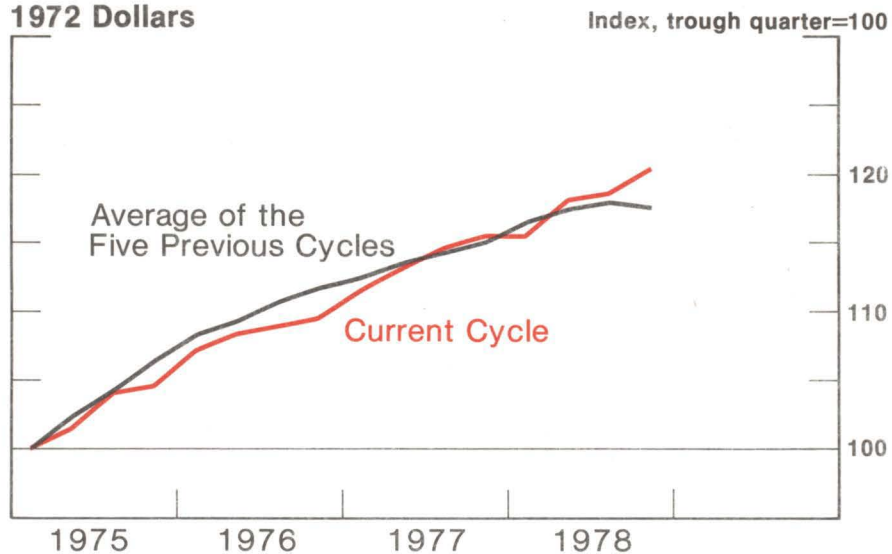
Residential construction, which provided a good deal of impetus to the early recovery, stayed on a high plateau last year in the face of rising interest rates and a continued rapid escalation in building costs. Household demands for shelter have been bolstered by demographic trends as well as by an inflation-hedging

motive. The sustained advance in economic activity also has been fostered in good part by strength in consumer spending. A marked turnaround in the willingness of consumers to spend--reflected in a sharp drop in the personal savings rate--provided much of the impetus to over-all expansion in the early stages of the economic recovery, and consumption expenditures have remained unusually robust throughout the upswing.

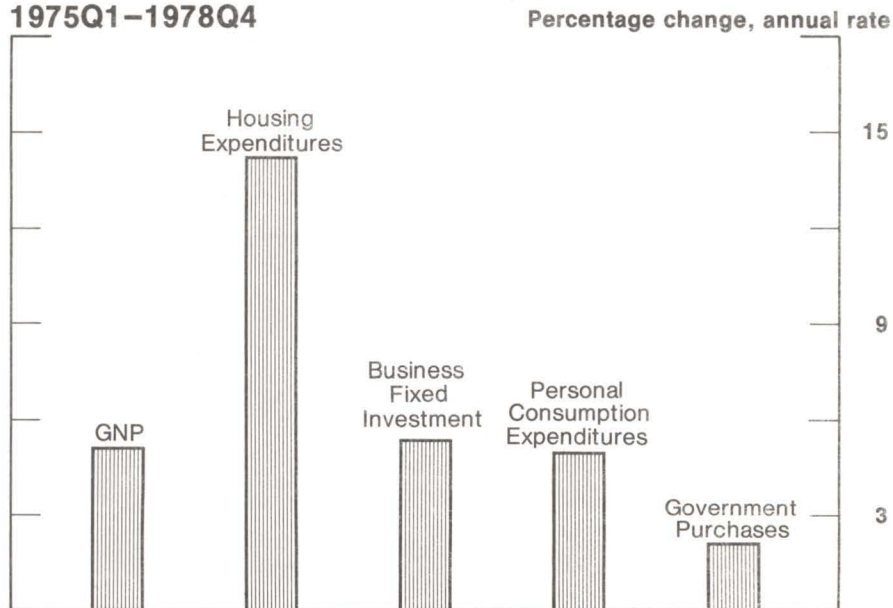
In the business sector, spending on new plant and equipment has continued to rise, but there have not as yet been the large increases seen in some earlier cycles. Business fixed investment actually declined during the initial quarters of the economic expansion, as firms concentrated on the repair of strained financial positions in an environment of low capacity utilization. Capital spending policies have continued to be characterized by considerable caution, and it was not until mid-1978 that the previous peak level of real outlays was reattained. Firms also have exercised caution in managing their inventory positions, and stocks generally have remained lean relative to sales.

Government purchases of goods and services rose briskly at both the Federal and State and local levels during the second half of 1978, but have been a moderating influence on over-all activity during most of the cyclical upswing. The over-all budgetary position of the Government sector, including transfer payments and revenues, has remained stimulative throughout the expansion, albeit in diminishing degree. An improving net export position contributed to the expansion of GNP during the early recovery phase, but deterioration in the

REAL GNP 1972 Dollars



REAL GNP AND MAJOR SECTORS 1975Q1-1978Q4

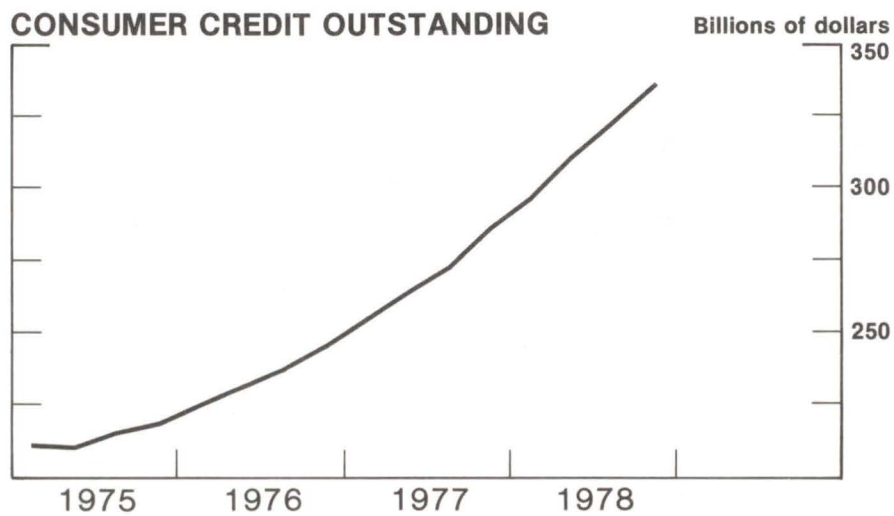
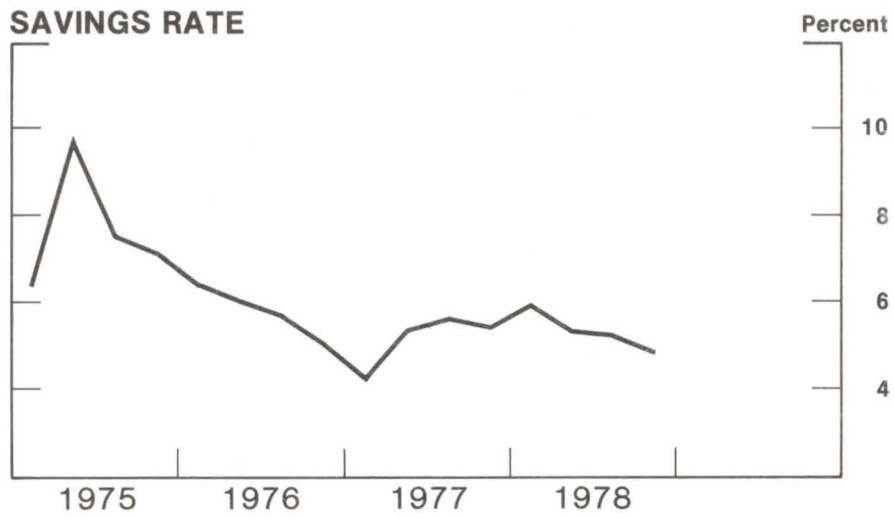
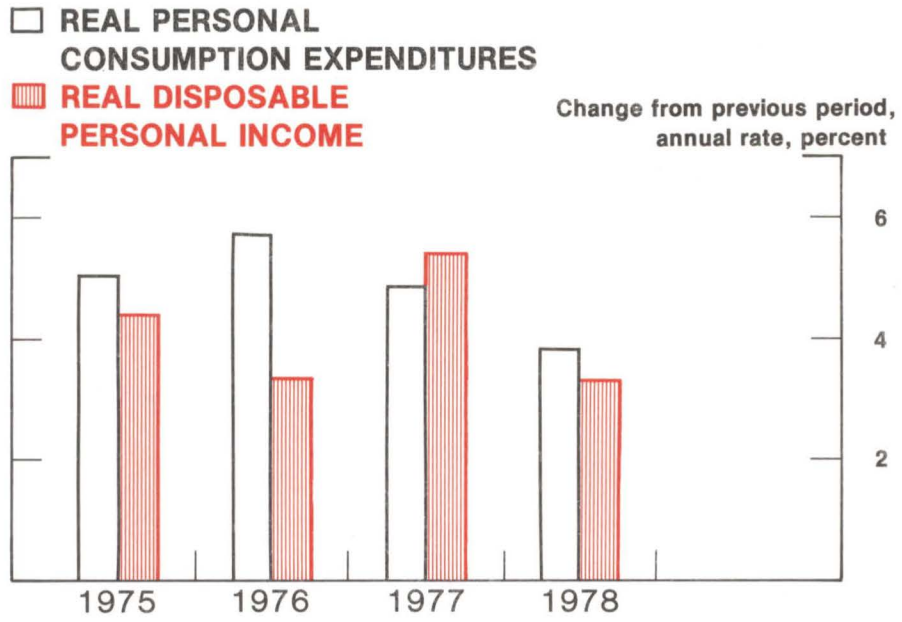


trade balance was a decidedly negative factor from 1976 to early 1978. The U.S. trade deficit did narrow over the course of 1978, however, owing in part to the strengthening of economic expansion in other major industrial countries.

Personal Consumption Expenditures

Consumer outlays grew 3.8 percent over 1978 after averaging 5-1/2 percent, at an annual rate, earlier in the economic recovery and expansion. The slower growth of spending reflected relatively smaller recent gains in real disposable income; increases in real personal income were eroded by larger tax burdens related to higher contributions for social security and the interaction of inflation and a progressive tax system.

The proportion of consumption in gross national product has held at a high level over the course of this upswing. In prior cycles this share typically fell as the expansion matured. In particular, household spending for durable goods has hovered at around 10 percent of GNP throughout the past three years, while during other economic expansions it accounted, on average, for about 7-1/2 percent. This exceptional strength in consumption and the associated rapid increase in instalment credit and low savings rates can be attributed, in part, to the higher relative number of younger households. But it also appears to be in some degree a reaction of households to persistently high inflation rates. For example, opinion surveys suggest that many consumers have been buying durable goods in anticipation of price increases.



Business Fixed Investment

Real business fixed investment rose 8-1/4 percent over 1978. This was nearly the same pace of advance as in the two previous years and almost twice the rate of expansion in aggregate activity. Recently, nonresidential construction activity has become an important source of business investment growth. In 1978, real spending for such structures increased 12-3/4 percent as outlays for commercial and industrial buildings showed particularly impressive gains. On the other hand, investment in producers' durable equipment grew about 6-1/2 percent in real terms during 1978 compared with increases of more than 10 percent in each of the previous two years. Demands for motor vehicles, which were exceptionally strong earlier in the expansion, began to tail off in 1978, while machinery outlays continued to advance at about the same moderate pace experienced since early 1976.

Inventory Investment

Investment in business inventories was characterized by caution in 1978, as it generally was in the three previous years. As a result, aggregate inventory-sales ratios remained at or below historical averages. This caution, which can be traced back to the severe inventory cycle of 1974-75, appears to have been responsible for the avoidance of the types of overhangs that preceded several prior cyclical downturns. Incipient build-ups of stocks have been met with prompt increases in sales promotion or curtailments of orders and production. Most recently, overhangs that developed at general merchandise retail outlets in the fall apparently were corrected by the sharp rise in



sales during the holiday season and a slowing of production of durable home goods.

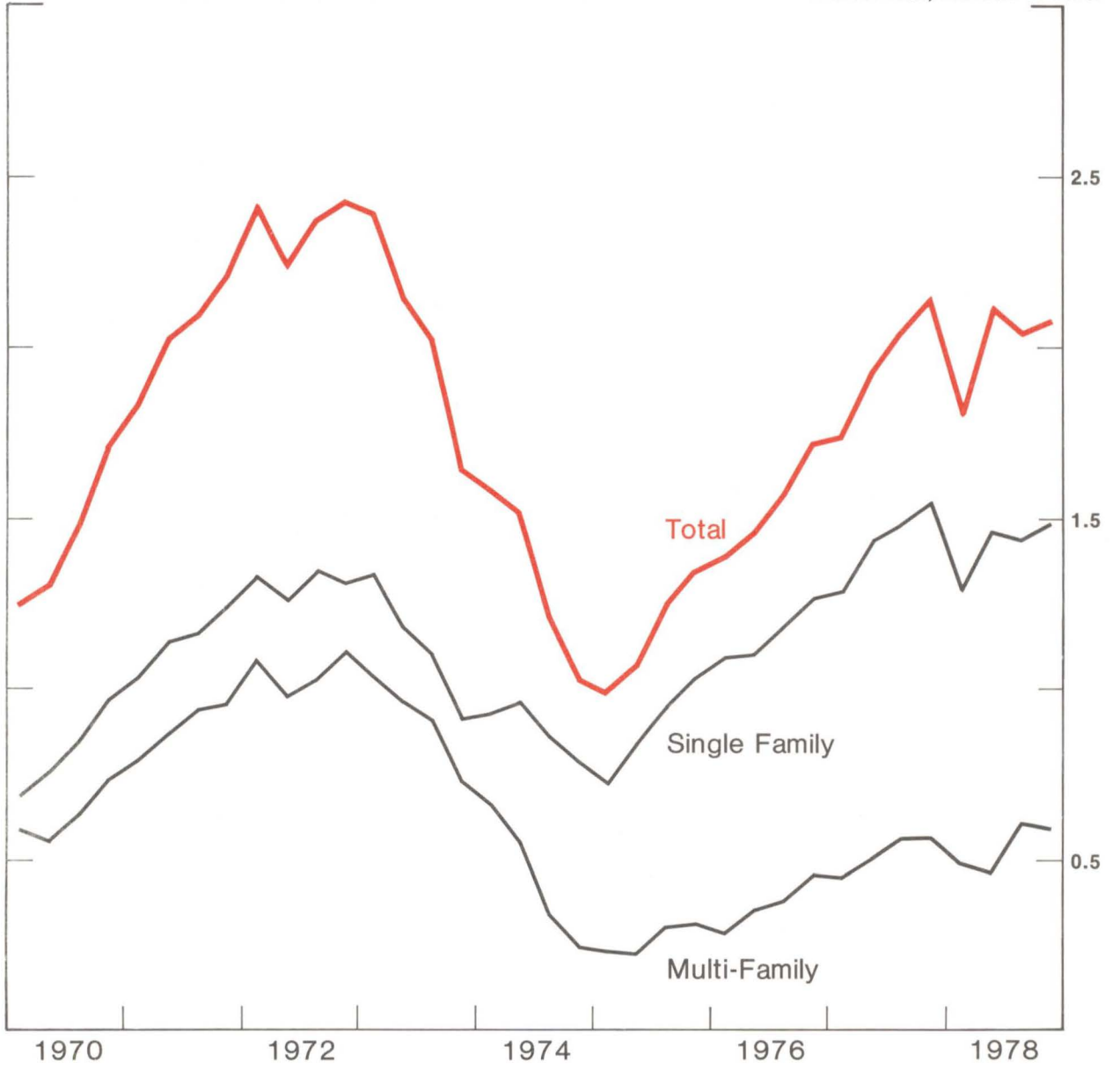
Residential Construction

The rate of private housing starts advanced briskly during the 1975-77 period and in 1978 they were sustained at the high annual rate of 2 million units. Spending for residential construction in real terms increased at an average annual rate of 21 percent from the 1975 trough before leveling off in 1978. In addition to production capacity constraints, the recent developments in housing activity reflect the tightening in financial markets. Interest rates on both construction loans and long-term mortgages rose appreciably in 1978 and by year-end they had reached usury ceilings in a number of states and record postwar highs in many other areas. Even so, the variable-ceiling six-month time accounts introduced in June of last year buoyed deposit growth at key mortgage lenders and helped maintain the high rate of housing construction.

Within the housing sector, the rise in single-family starts led activity early in the recovery. More recently, multi-family starts--supported by an increase in Federally subsidized rental units--have increased while single-family starts have remained above their 1972-73 peak levels. Indeed, in the fourth quarter of 1978, total housing starts averaged an annual rate of 2.1 million units, the same as a year earlier.

PRIVATE HOUSING STARTS

Annual rate, millions of units



International Trade

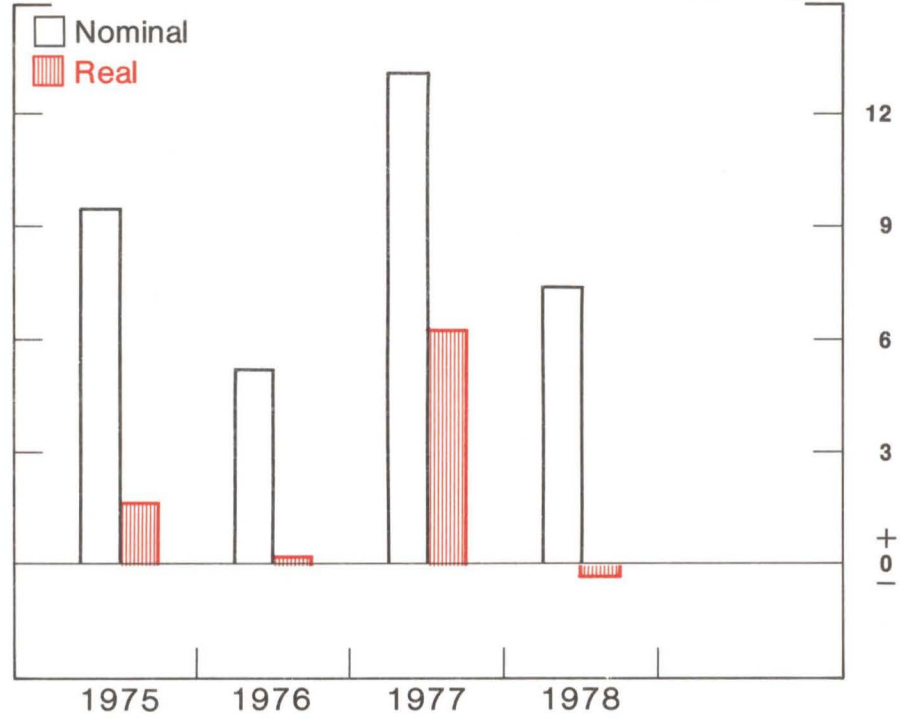
After providing some initial stimulus to economic growth during the early recovery period in 1975, the U.S. balance of trade began deteriorating. In large part this reflected the relatively stronger rate of economic expansion in the United States compared with our major trading partners. The deficit in net exports narrowed during 1978, however, as activity abroad picked up in contrast to the moderation in the U.S. expansion. In addition, the more favorable trade balance reflected a 20 percent rise in agricultural exports last year, associated with unusually poor harvests of wheat and soybeans in the Southern Hemisphere.

Government

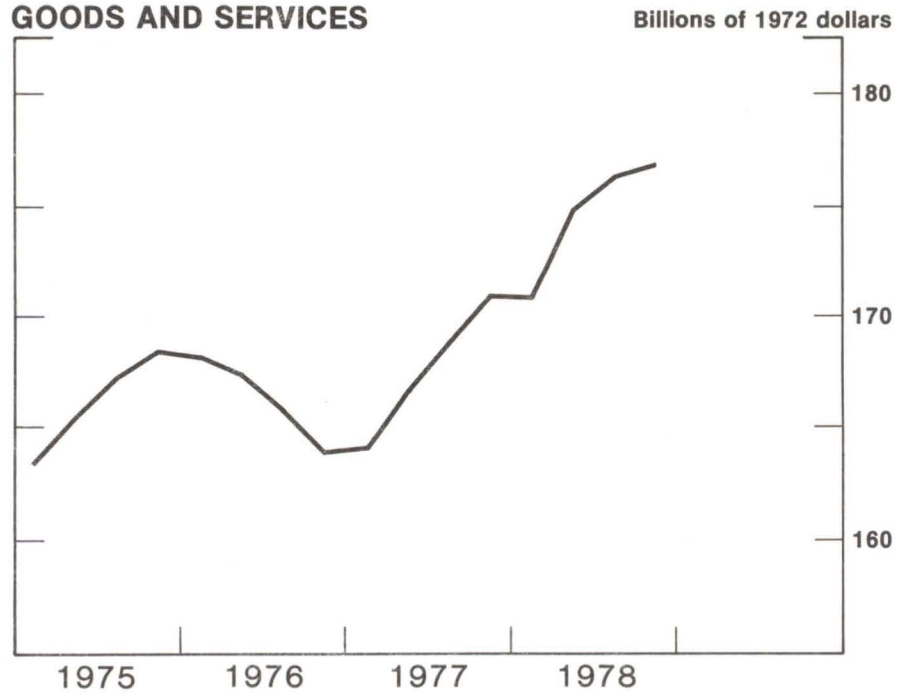
Growth of purchases by the Federal Government has been uneven in this expansion. In real terms, such purchases increased little during 1975 and 1976, rose substantially in 1977, and then--despite a surge in the second half of the year--declined slightly in 1978. Total expenditures, however, have risen consistently, reflecting increased grants to State and local governments and transfers to individuals for Social Security, food stamps, and retirement benefits. Revenues have increased even more than outlays over the past several years, so that the Federal budget deficit has declined from \$66.4 billion in fiscal year 1976 to a projected \$37 billion for the current fiscal that ends next September.

State and local government purchases also have grown irregularly over the past four years. In real terms, outlays by this sector for goods and services expanded at a 2-1/4 percent annual rate during the second half of 1978, matching the average pace over the expansion as a whole. This is well below the trend rate of increase experienced during the 1960s and early 1970s. The slowing of growth reflects changing requirements for services, associated with demographic developments, and a degree of fiscal conservatism prompted partly by the financial difficulties encountered by some communities in recent years. In 1978, however, a tendency toward tax relief--occasioned in part by voter preferences expressed in California's Proposition 13 and like measures elsewhere--outweighed the impact of spending economies on budgets. As a result, although the aggregate operating surplus of State and local governments totaled \$6 billion for the year, this was only half the size of the 1977 surplus.

GROWTH OF FEDERAL GOVERNMENT PURCHASES OF GOODS AND SERVICES



STATE AND LOCAL GOVERNMENT PURCHASES OF GOODS AND SERVICES



Section 3. Labor Markets

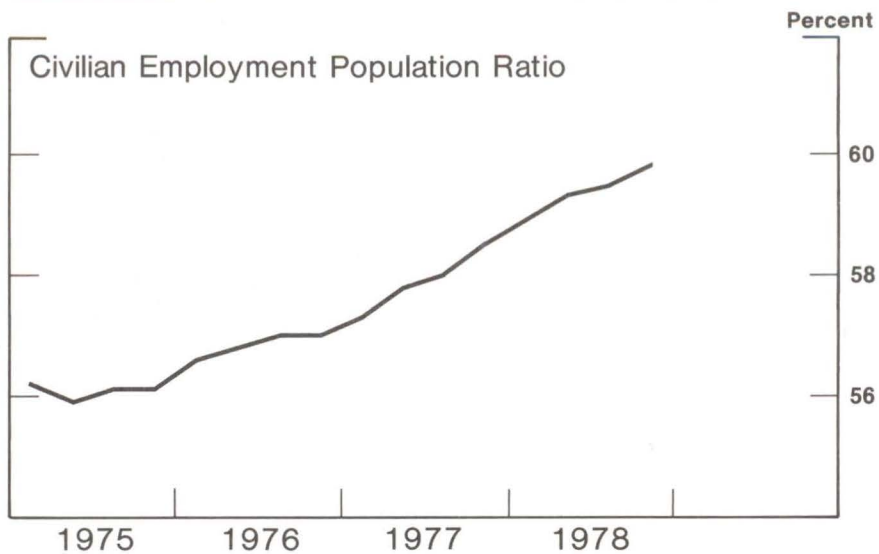
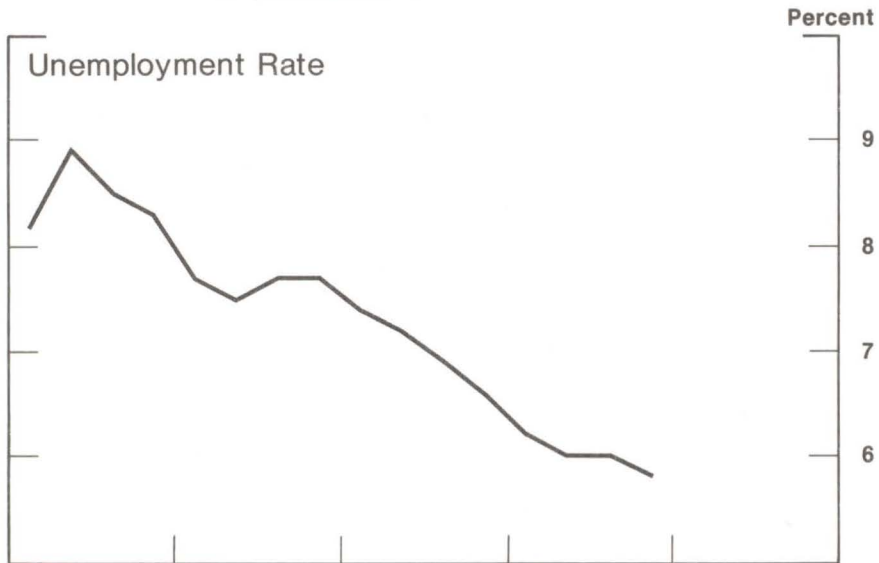
Labor demand has been strong throughout the current economic expansion. During the three years following the cyclical trough in early 1975, nonfarm payroll employment advanced at an average annual rate of 3.7 percent--compared with a 2.8 percent median rate of gain during the five previous postwar expansions. During the past year--at a stage when in earlier cycles employment levels had begun to level off or even fall--payroll employment has continued to advance at a 4.2 percent annual rate. Over the almost four years of expansion, employment has increased by 12 million, and today the ratio of employment to total civilian population aged 16 and over stands at the highest level on record.

Employment in the goods-producing sector of the economy rose rather slowly early in this recovery, reflecting in part the sluggish behavior of business fixed investment. It was not until late 1978--as a result of large hiring increases in the hard goods industries--that factory employment reached its pre-recession peak. Similarly, construction hiring showed only small increases for nearly three years after the trough. During 1978, however, employment in contract construction surged ahead to record levels.

In the private service-producing sector, employment dipped only briefly in early 1975 and has been on a steady uptrend since then--far exceeding the gains of previous expansions. The trade and service industries have continued to grow faster than other sectors, and by the end of 1978 they accounted for more than 4 of every 10

LABOR MARKET

Change from previous period,
annual rate, millions



jobs in nonfarm establishments. In contrast to the private sector, Government hiring has been modest. Federal Government civilian employment has been fairly stable at around 2-3/4 million over the past 4 years, about the same level that has prevailed since the late 1960s. State and local government employment has risen, but growth has slowed substantially in recent years as a consequence of reduced needs for education personnel and fiscal retrenchment by many units.

The reduction in educational labor demand reflects the shift in the age structure of the population that has been affecting not only school enrollments, but also the size of the work force. Growth of the teenage population (ages 16 to 19) in the late 1960s and early 1970s was exceedingly large, reflecting the attainment of working age by the postwar baby boom cohort. At the same time, labor force participation rates for teens rose sharply. In the mid-1970s, growth of the 16 to 19 age group slowed, and in 1978 the teenage population actually began to contract. Nonetheless, with participation rates still rising rapidly, the teenage labor force continued to grow at a rapid pace (up 3.2 percent in 1978 compared to 1.6 percent on average in the preceding four years).

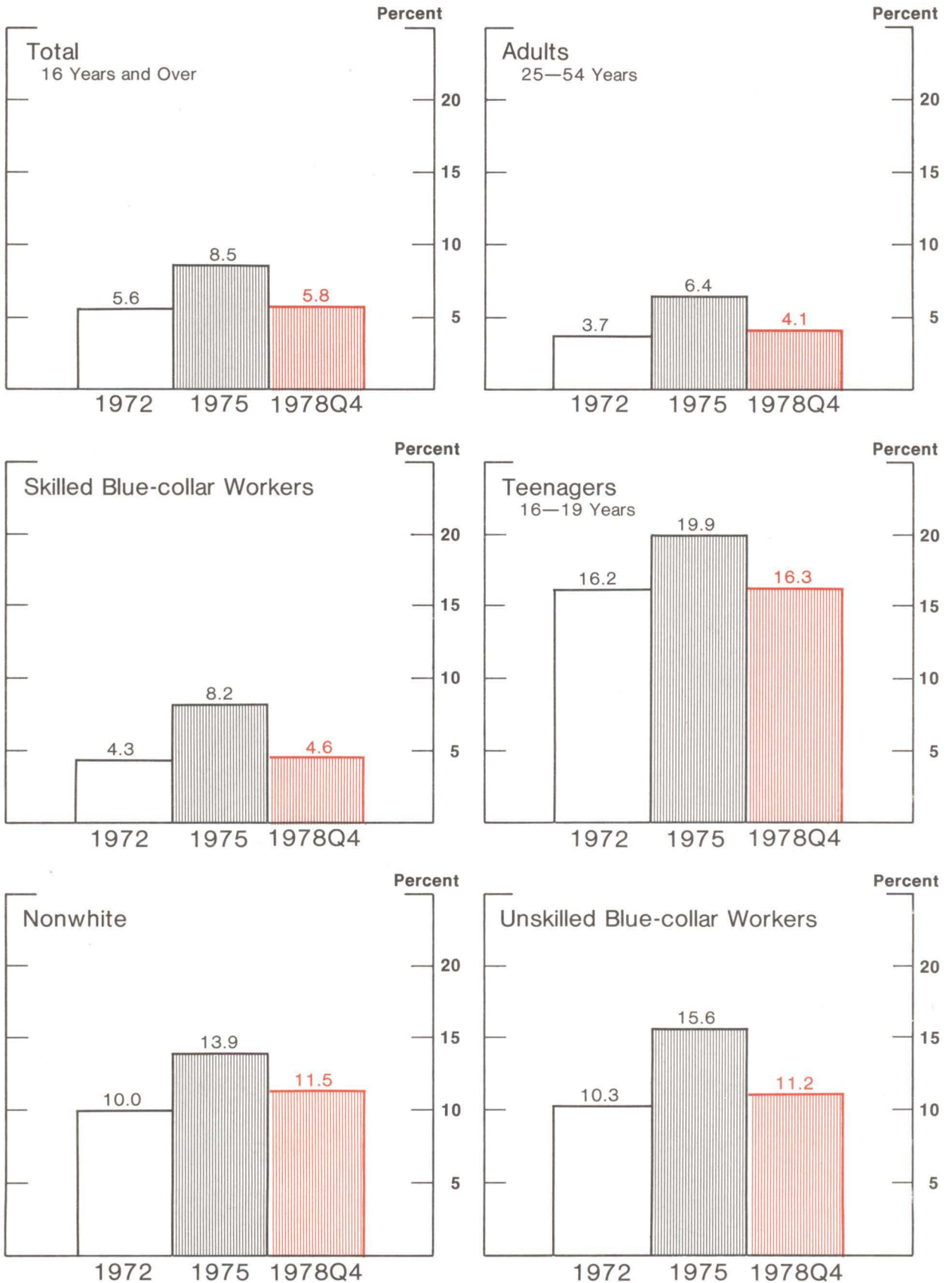
An even more significant factor in the expansion of the work force has been the continued rise in the participation rates of adult women. The longer-run trend, which reflected low birth rates as well as changing attitudes and social trends, apparently was augmented in the 1970s by a desire of families to maintain their material living standards in the face of rapid inflation. As a

result of these participation rate patterns, the total civilian labor force grew 3 percent during 1978--about the same as in 1977, but up considerably from the 2-1/4 percent annual rate during preceding years of the decade.

With the growth of employment outstripping even the large increase in the size of the labor force, the unemployment rate fell one-half percentage point over the course of 1978 to just under 6 percent. Labor market conditions improved significantly for most groups of skilled and experienced workers. For example, unemployment rates for workers 25 to 54 years old, skilled blue collar workers, and workers seeking full-time employment all were at or near the levels reached in 1972 when labor and product markets were beginning to tighten noticeably. While there was as yet no general shortage of skilled workers during 1978, many firms reportedly were finding it increasingly difficult to fill certain job vacancies at prevailing wage rates.

The improvement in employment conditions during the current expansion has not been uniform. Despite the gains made by many groups, unemployment rates for younger workers, minorities, and the unskilled were still very high at the end of 1978. For example, the unemployment rate for teenagers at the end of 1978 was 16-1/4 percent, more than four times the rate for workers 25 to 54 years old; for minority youth the rate was over 35 percent. Younger workers between 16 and 24 years of age accounted for about one-half of all joblessness in the fourth quarter of 1978.

UNEMPLOYMENT RATES



The enlarged proportion of the labor force accounted for by teenagers and women means that the over-all unemployment rate does not imply the same degree of labor force pressure that it would have in past years. These groups tend to have relatively high rates of joblessness for a number of reasons, including generally more limited training and work experience. As a rough adjustment for such structural influences, the average unemployment rate can be recomputed using the age-sex composition of the labor force in the mid-1950s. The result of such a calculation is an unemployment rate about one percentage point below its current level, which vividly illustrates that the level of labor utilization consistent with price stability may change considerably over time. To enhance the possibility of simultaneously achieving low unemployment and price stability, it may be necessary to augment monetary and fiscal policies with carefully focused programs to facilitate job placement and to provide skill-training.

Section 4. Productivity

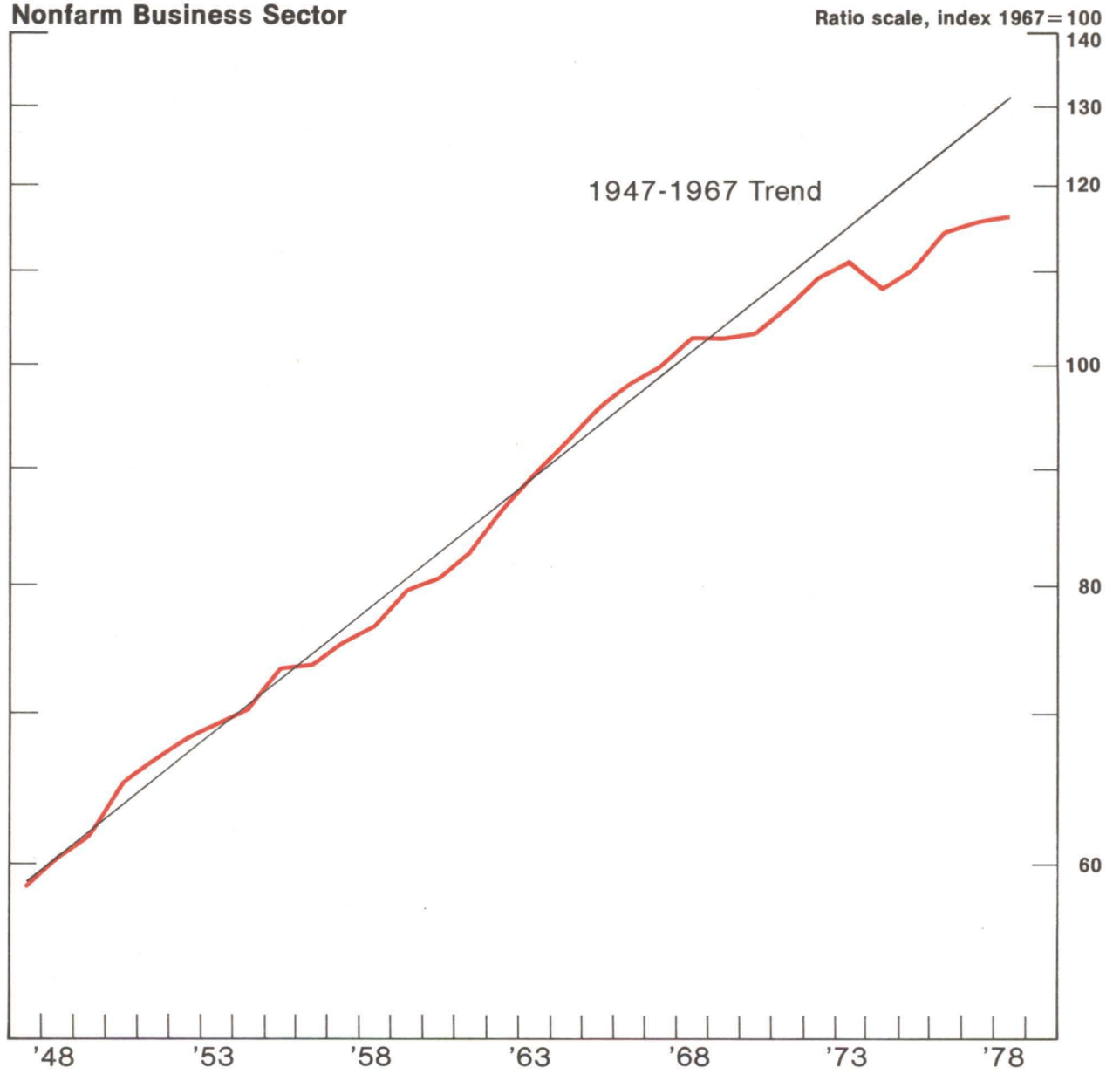
The 3.5 million increase in payroll employment during 1978 was much larger than would have been expected on the basis of the historical relationships between output changes and labor demand. Although real GNP growth decelerated from 5-1/2 percent in 1977 to 4-1/4 percent in 1978, businesses added to their payrolls at almost the same rate. Output per hour of work rose only slightly over the four quarters of 1978.

Much of the slowdown in productivity growth last year occurred outside the manufacturing sector; output per hour in manufacturing increased 3-1/2 percent during 1978. Normally productivity growth slows as labor markets tighten and capacity constraints are approached, but the fall-off in productivity gains in the past two years has been particularly sharp.

This poor performance of labor productivity continues a trend toward slower growth evident since the late 1960s. During the period from 1947 to 1967, productivity in the nonfarm business sector rose on average by 2-2/3 percent per annum, and accounted for almost 70 percent of the gain in output for this sector. Since 1967, the rise in output per hour has slowed, with average annual gains of only 1.2 percent recorded since 1973. As a result, less than 50 percent of output growth over the last five years can be attributed to gains in efficiency.

The deterioration of productivity performance in recent years is a complex phenomenon that is not completely understood. It

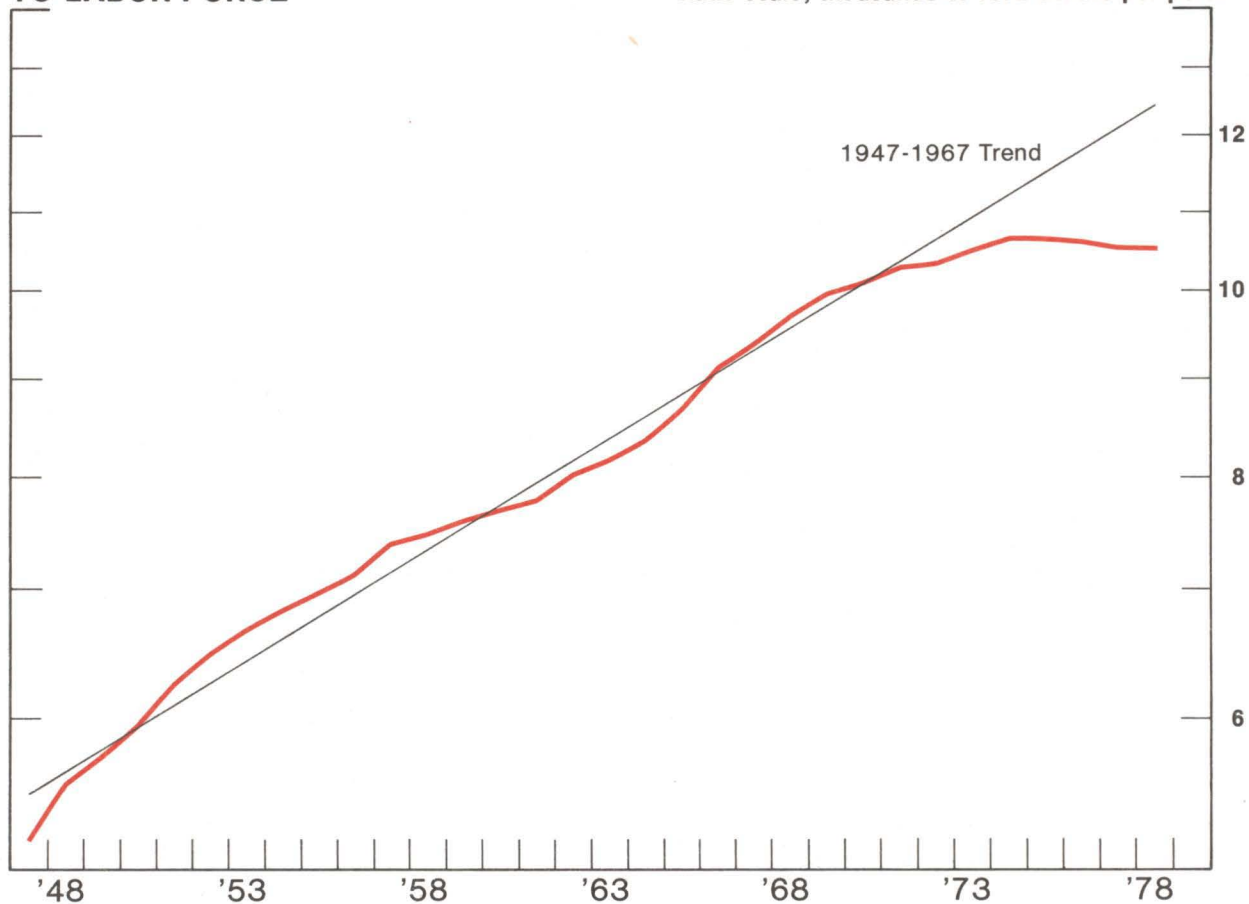
OUTPUT PER HOUR Nonfarm Business Sector



appears, however, that a crucial factor has been the failure to maintain an adequate rate of capital formation. Indeed, the Nation's stock of capital has shown little growth relative to the size of the labor force over the past decade; in contrast, the capital-labor ratio trended upward rapidly in the preceding 20 years. Other factors that may have contributed to reduced productivity growth in recent years are the influence of environmental and safety regulations that divert resources to uses not measured in the National Income and Product Accounts, and the increase in the proportion of young and inexperienced workers in the labor force.

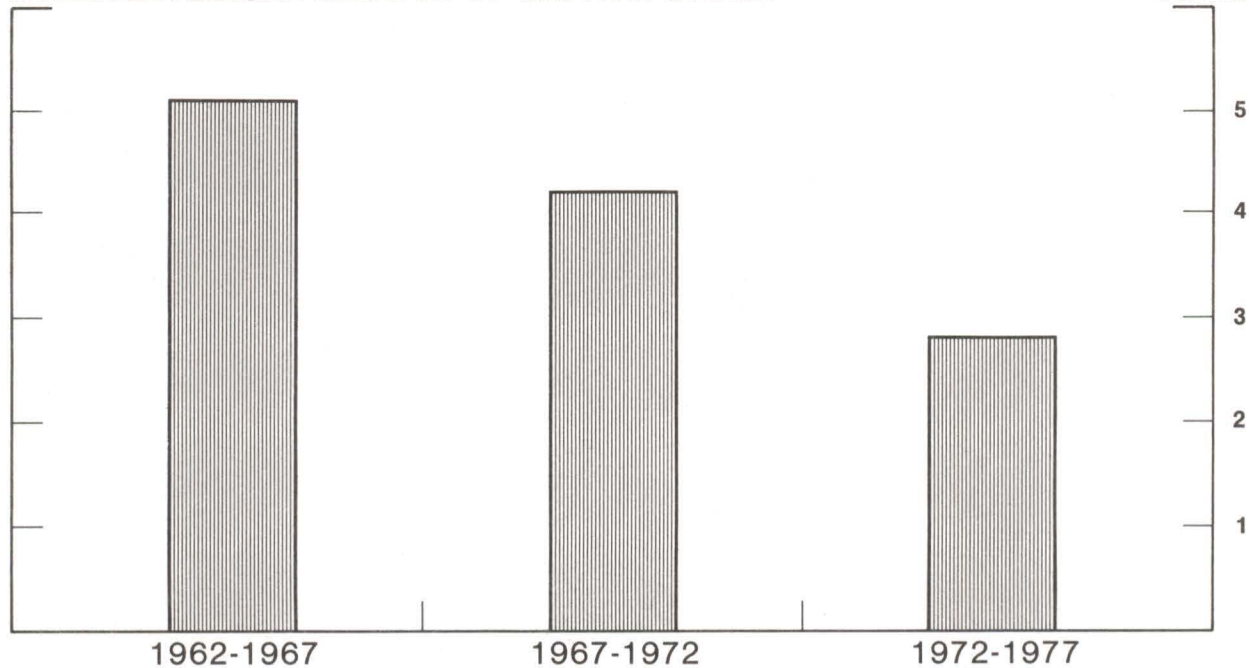
RATIO OF CAPITAL STOCK TO LABOR FORCE

Ratio scale, thousands of 1972 dollars per person



AVERAGE ANNUAL GROWTH OF CAPITAL STOCK*

Percent



*Private nonresidential net capital stock measured in constant dollars

Section 5. Investment

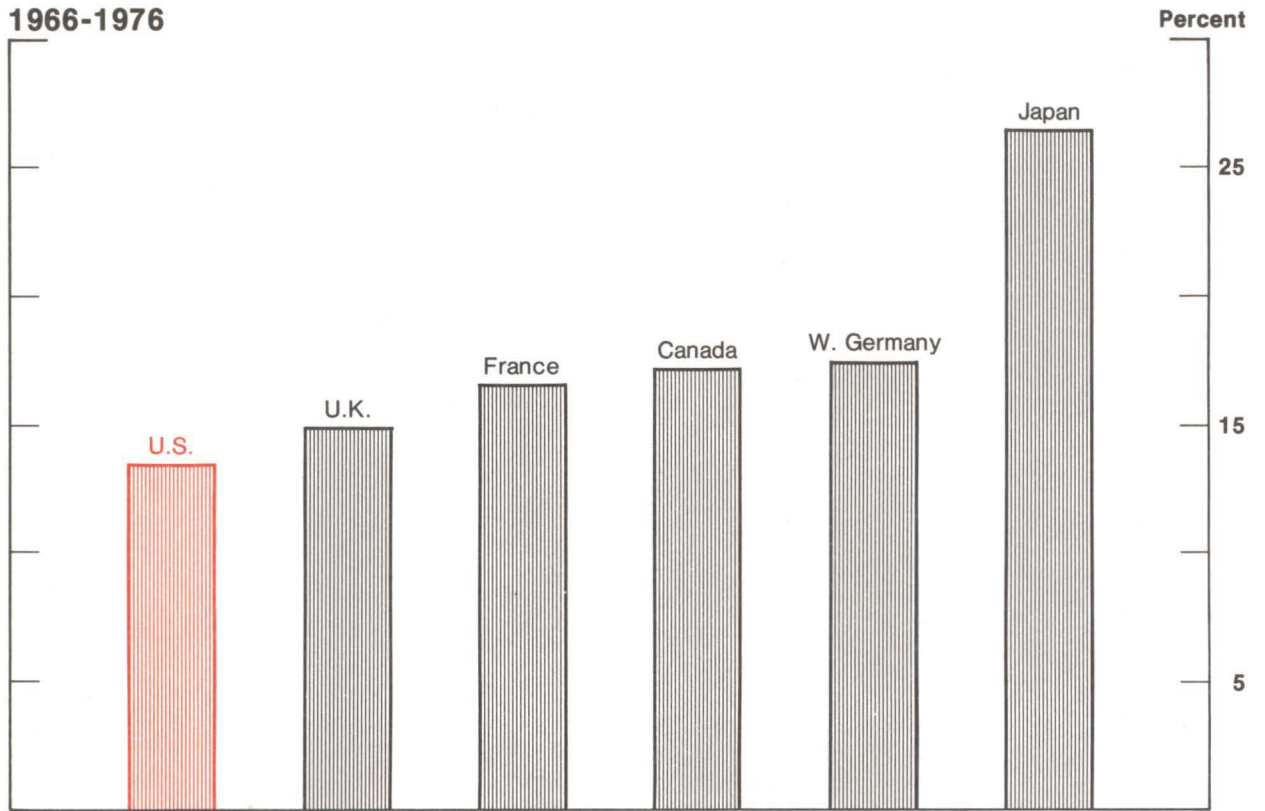
Since the early 1960s, there has been a marked trend toward slower growth of the stock of business capital in the United States. Although real gross business fixed investment last year surpassed the 1973 record, still stronger investment activity will be needed if there is to be a sustained reversal of this trend. In part this merely reflects the arithmetic truth that unchanged absolute amounts of investment translate into declining percentage increases in a growing stock of plant and equipment. Also important, however, is the fact that it is net investment--that is, gross investment less the depreciation of existing capital goods--that adds to the capital stock, and real net investment has yet to reach its previous peak level. Because the fraction of the capital stock in the form of relatively short-lived equipment has been increasing in recent years, a higher level of gross investment is now needed simply to maintain the existing capital stock.

It also must be noted that even the figures for net investment probably overstate the contribution that capital outlays have been making recently to the expansion of productive capacity. A significant share of plant and equipment spending has been undertaken to meet Government pollution, health, and safety regulations. During the past several years roughly 5 percent of total capital spending has been for the purpose of pollution abatement, and some estimates suggest that perhaps an additional 2 percent of investment has been for improvements in health and safety conditions. Although

these outlays may well yield important benefits to society, they do not directly enhance productive capacity.

When an economy is near full employment, the commitment of additional resources to capital formation will require some near-term sacrifice of consumption by individuals or Government. However, there is ample evidence that higher levels of investment effort can enhance long-range economic growth and raise living standards. The increase in U.S. capital spending last year raised the ratio of real gross business fixed investment to GNP to 10.2 percent--the first time since 1974 that it reached the 10 percent level, but still somewhat below the average of the late 1960s and early 1970s. Although international comparisons must be made with caution, owing to differences in accounting and other technical problems, it is clear that other major industrial nations have allocated greater shares of GNP to investment and, as a result, have enjoyed substantially faster increases in productivity and output. While this does not lead to the conclusion that the United States should attempt to achieve the same investment-to-GNP ratios as prevail elsewhere, it tends to confirm the proposition that this Nation would benefit from higher proportions of capital spending to GNP than have been experienced in recent years.

INTERNATIONAL COMPARISON OF INVESTMENT SHARES* 1966-1976



* Real nonresidential fixed investment as percent of real gross domestic product; OECD data.
Includes Government purchases of capital goods.
Data for France cover the period 1970-75.

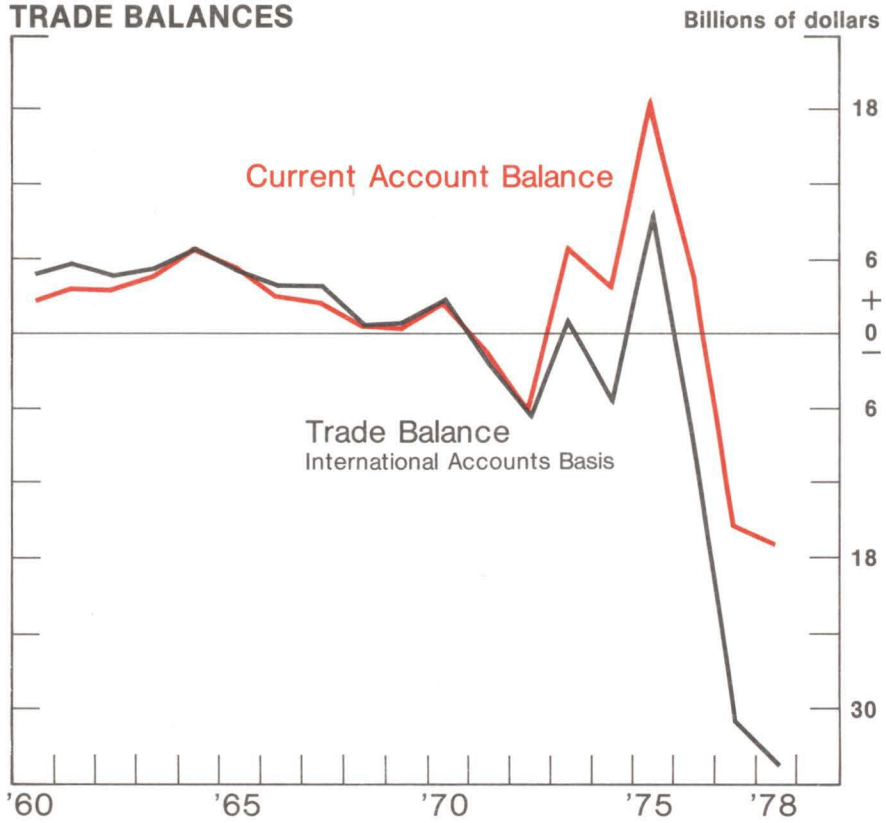
Section 6. International Trade and Payments

From the mid-1960s through the early 1970s, the U.S. merchandise trade balance moved gradually from surplus to deficit. Then, during the 1974-75 worldwide economic slowdown the United States a suffered disproportionately sharp contraction, so that-- despite an enormous increase in our outlays for imported oil--the U.S. trade balance swung into surplus in 1975. The surplus proved temporary, however; the subsequent economic recovery was stronger here than abroad, and this played a major role in the steep increase of our trade deficit from 1976 through early 1978.

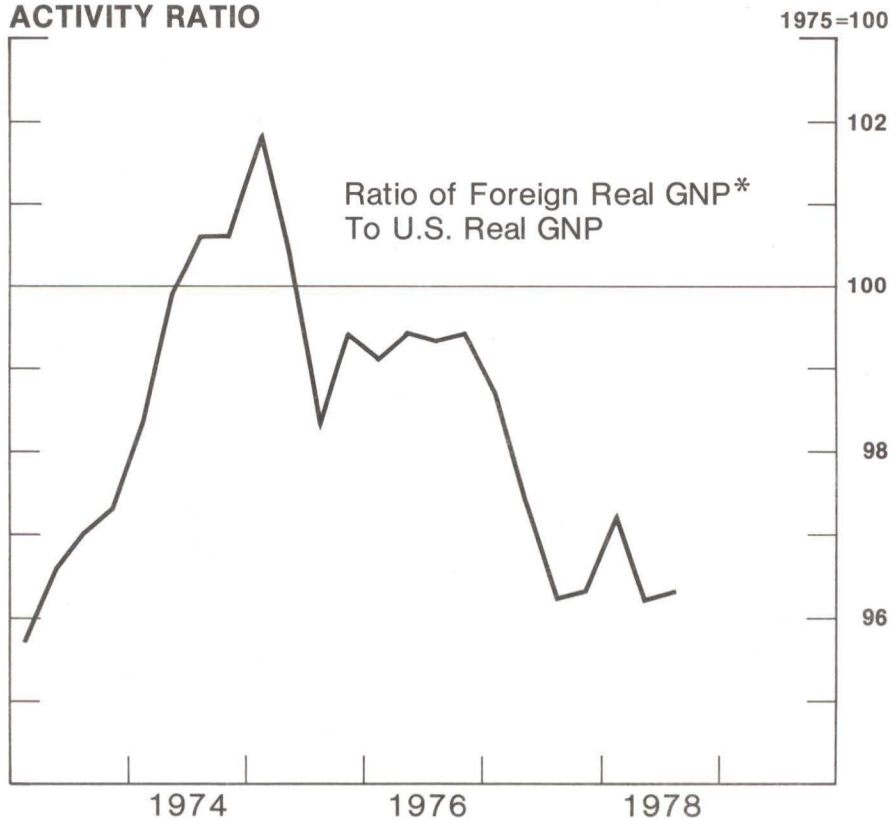
The trade deficit in 1978 was \$34 billion, slightly larger than in 1977. But the deficit peaked at an annual rate of \$45 billion in the first quarter of 1978, and developments in both exports and imports contributed to a narrowing of the imbalance to a rate of about \$30 billion in each of the subsequent quarters.

The growth of exports accelerated in the second quarter. The step-up was partly attributable to temporary causes--for example, demand for U.S. agricultural commodities was stimulated by poor Southern Hemisphere harvests. More important, however, was a strengthening of economic activity abroad and the improved competitiveness of U.S. goods resulting from the substantial depreciation of the U.S. dollar that began in the fall of 1977. The real volume of non-agricultural exports increased 6 percent in 1978, and growth picked up strongly in the second half of the year. Prices of exports increased in line with the general pace of domestic inflation,

U.S. CURRENT ACCOUNT AND TRADE BALANCES



ACTIVITY RATIO



*Weighted average of G-10 countries plus Switzerland using total 1972-1976 average trade of these countries

and the total value of merchandise exports rose 17 percent from 1977.

The relatively moderate rise in the volume of imports in 1978, following two years of very large increases, resulted primarily from a slower increase in nonoil imports, but it was reinforced by some decline in petroleum imports. Although total U.S. petroleum consumption is estimated to have increased 3 percent, the higher demand was more than met by increased Alaskan production and by a drawing down of inventories from unusually high levels. The total value of imports increased 16 percent in 1978 with the gain spread over most major commodity categories. Almost half of this increase was in volume terms as imports responded to the continuing strength in U.S. economic activity. Prices of nonoil imports were boosted by the decline in the international value of the dollar.

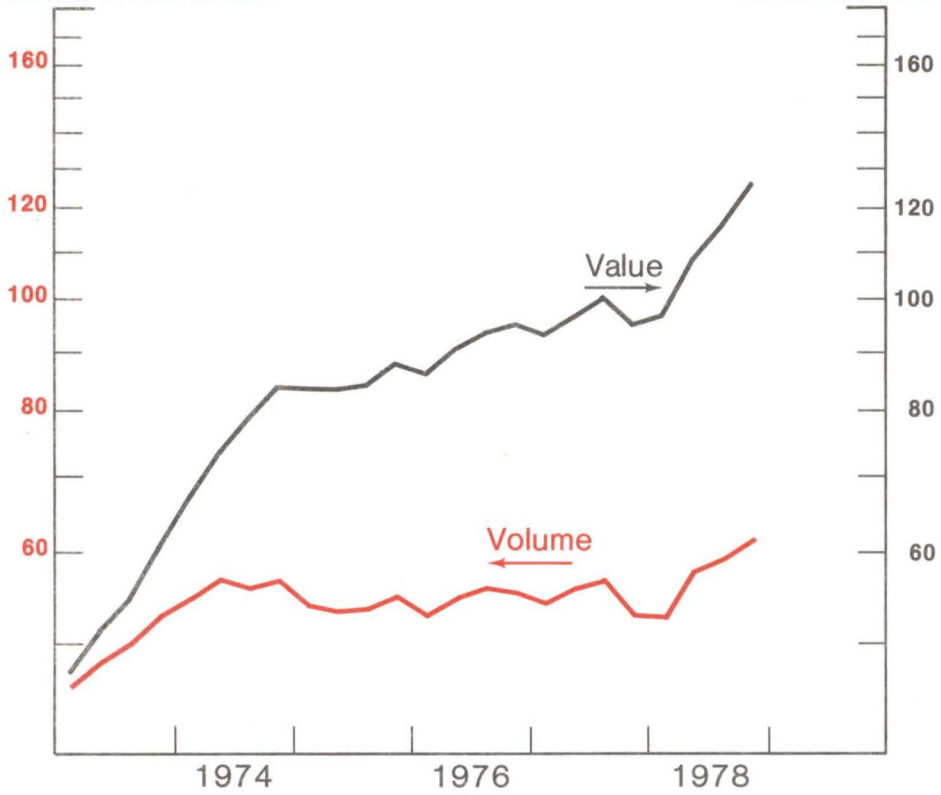
The current account deficit in 1978, estimated at \$17 billion, was slightly larger than in 1977. As in other recent years, net receipts from service transactions provided a substantial offset to the merchandise trade deficit. Earnings, fees, and royalties from foreign direct investments have shown a strong uptrend during the 1970s.

In the period between the onset of generalized floating of currencies in March 1973 and September 1977, the exchange value of the dollar went through several phases of appreciation and depreciation. The average value of the dollar increased sharply (nearly 15 percent) from October 1973 to January 1974, despite large sales of dollars by foreign central banks. Continued large sales of dollars

NON-AGRICULTURAL EXPORTS

Ratio scale, annual rate
Billions of 1972 dollars

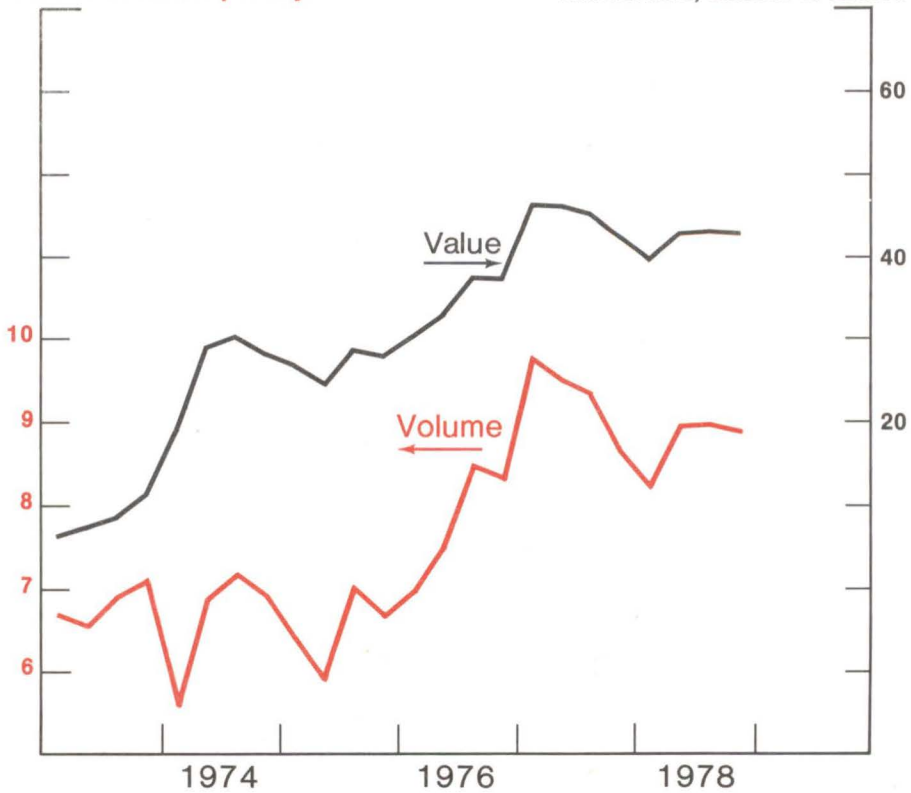
Ratio scale, annual rate,
billions of dollars



OIL IMPORTS

Millions of barrels per day

Annual rate, billions of dollars

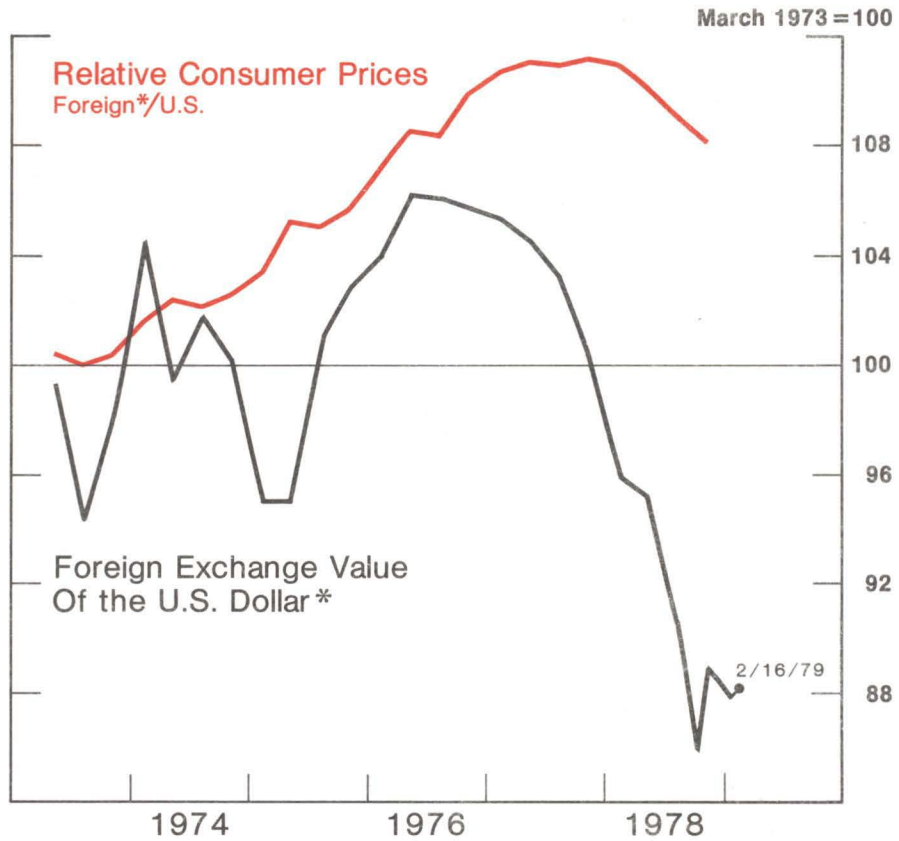


by foreign central banks in 1974, later reinforced by the easing of domestic interest rates associated with the U.S. recession, contributed to a decline in the dollar that began in the first quarter of 1974 and did not end until the spring of 1975. Thereafter, the emergence of a large current-account surplus and a relative firming of U.S. interest rates led to a substantial appreciation of the dollar until the spring of 1976. The dollar subsequently held relatively steady until the fall of 1977.

The dollar began to depreciate markedly against most major foreign currencies in late September 1977 as forecasts for 1978 suggested that the U.S. trade deficit would be no smaller than in 1977. The decline continued through the end of 1977, despite large intervention purchases of dollars by foreign central banks. An announcement in January 1978 that the U.S. Treasury would join the Federal Reserve in exchange market intervention in German marks, followed by an increase in the discount rate, improved market sentiment only temporarily, and by early April the dollar had declined about 10 percent on a weighted-average basis. Between early April and mid-May, a relative firming of U.S. interest rates contributed to a recovery, but the dollar declined fairly steadily thereafter in response to continuing concerns about the size of the U.S. trade deficit and increasing fears that U.S. price performance was deteriorating.

Although some depreciation of the dollar was justified by the need to restore external balance in the face of differential growth rates in the United States and major foreign economies and

U.S. INTERNATIONAL PRICE COMPETITIVENESS



* Weighted average against other G-10 countries plus Switzerland using total 1972—1976 average trade of these countries

a relative worsening of U.S. inflation, by midsummer it was clear that the dollar's decline was becoming excessive in trading that was increasingly disorderly. Consequently, in August the Federal Reserve announced a 1/2 percentage point increase in the discount rate and reduced to zero reserve requirements on borrowings by member banks from the Eurodollar market. The Treasury subsequently announced that it would increase the size of its regular monthly gold auctions. These measures produced a brief rally and then a few weeks of stability for the dollar. However, the dollar's slide soon resumed. After the President announced his wage-price program on October 24, the decline steepened alarmingly, threatening to undercut the anti-inflation effort at home and to lead to further erosion of confidence abroad. By late October, the dollar had fallen 21 percent from its September 1977 level.

Under these circumstances, more forceful action was required. On November 1, the Federal Reserve increased the discount rate by 1 percentage point and imposed a 2 percentage point supplementary reserve requirement on large time deposits. To increase the availability of foreign currencies for exchange market intervention, enlarged swap lines were arranged with the central banks of Germany, Japan, and Switzerland. The U.S. Treasury simultaneously announced its intention to draw on its reserve position in the IMF, to sell SDRs, and to issue foreign currency denominated securities. In addition, the Treasury announced a doubling in its rate of gold sales.

The aim of these measures was to correct the excessive depreciation of the dollar and thereby to counter upward pressures on the domestic price level. When viewed in its entirety, the policy initiative of the Administration and the Federal Reserve System indicated that the United States recognized the need for an integrated approach in addressing domestic and international economic concerns. The announcement of these measures on November 1 produced a dramatic jump in the dollar's exchange value. On that day alone the dollar advanced by 5 percent on a weighted-average basis. Heavy cooperative central bank intervention over the following few weeks provided support for the dollar as market participants tested the authorities' resolve, but the need for such intervention abated in January. As of mid-February of this year, the dollar was more than 7 percent above its October low on a weighted-average basis.

Section 7. Prices

Inflation typically has accelerated over the course of cyclical expansions in economic activity, and this upswing has proven no exception. However, the marked increase in the pace of price advance during the past year was in large measure a consequence of forces not directly related to an intensification of general demand pressures on available productive resources. Government-mandated increases in costs and special developments in the agricultural and international sectors contributed substantially to the pick-up in inflation during 1978.

Inflation moderated during the first stages of the cyclical recovery in 1975 and 1976. The earlier extraordinary pressures associated with the rise in oil prices, the sharp escalation in food prices, a worldwide boom in other commodities, and domestic price decontrol subsided, and the considerable slack in labor and product markets restrained wages and prices. Inflation began to speed up again in 1977, however, and prices then surged in 1978. The Consumer Price Index, the Producer Price Index, and the fixed-weight price index for gross business product all registered increases of around 9 percent during 1978, about 2 percentage points more than in the preceding year.

The acceleration of inflation last year reflected importantly the pressure of rising labor costs. Wage rates in the private nonfarm sector increased 8-1/4 percent, compared with about 7-1/2 percent in each of the preceding two years. A boost in the Federal

minimum wage contributed appreciably to the accelerated rise of wages; the impact was especially noticeable in the trade sector, which has the largest concentration of lower-wage workers and saw average wage increases of more than 9 percent last year.

Hourly compensation, which includes, in addition to wages, the costs to employers of social insurance contributions and of privately negotiated fringe benefits, rose 9-3/4 percent--about 2 percentage points faster than in 1977. About one-quarter of the acceleration resulted from increased Social Security taxes and unemployment insurance contributions. In addition, private fringe benefits continued to rise faster than wages.

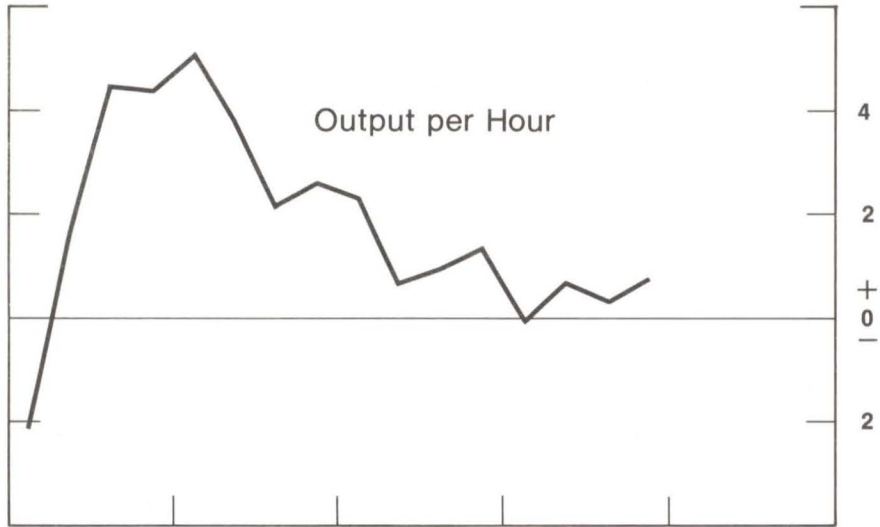
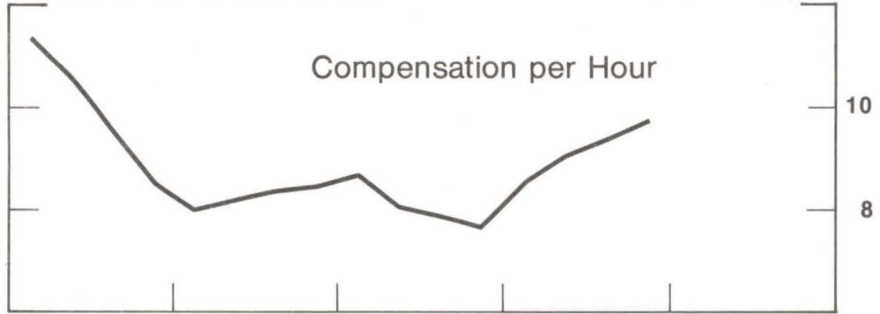
Given the weak performance of labor productivity, the larger compensation gains were translated into rapid increases in unit labor costs. Unit labor costs in the nonfarm business sector rose 9 percent during 1978 versus 6-1/3 percent in 1977. As 1979 began, labor costs again were given an upward jolt by further increases in the minimum wage and Social Security taxes.

Apart from the broad pressures exerted by rising unit labor costs, the general level of prices was affected considerably in 1978 by developments in the farm and food sector. Retail food prices rose 12 percent over the year--the largest increase since 1974. The increases at the retail level reflected a rise of almost 20 percent in farm prices during 1978 following little change in the preceding year. Meat price increases were particularly rapid, as beef production continued to decline.

UNIT COST INDICATORS

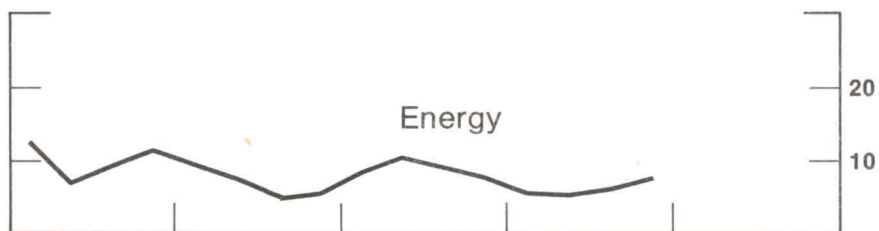
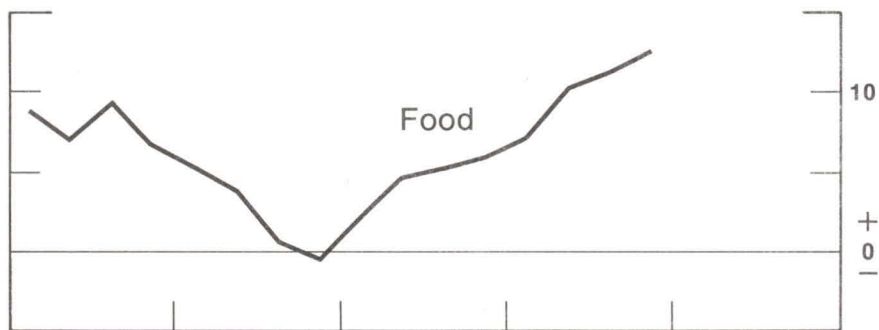
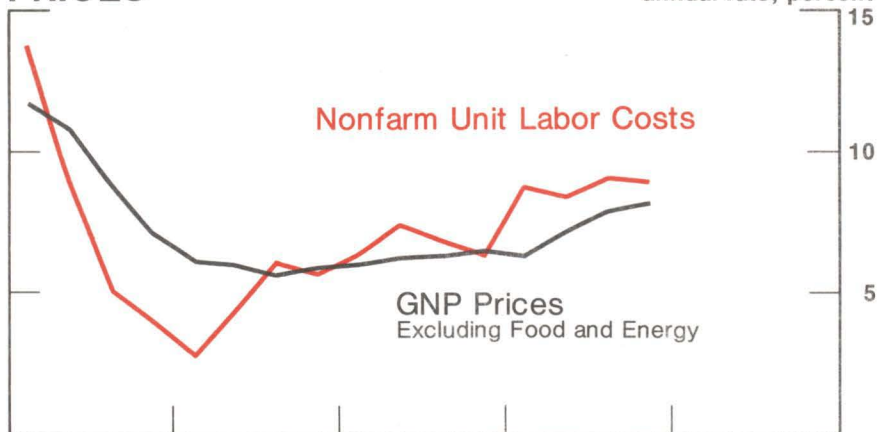
Nonfarm Business Sector

Change from year earlier,
annual rate, percent



LABOR COSTS AND PRICES

Change from year earlier,
annual rate, percent



The decline in the foreign exchange value of the dollar also aggravated inflation. Aside from the direct impact of higher prices for imported merchandise, the price-restraining pressure of foreign competition was weakened for many domestic products. Large price increases for domestically produced automobiles and other durable goods reflected both of these effects. The inflationary pressures associated with the steep depreciation of the dollar that began in September 1977 appear to have accounted for about 1 percentage point of last year's rise in the Consumer Price Index.

At the producer level, the inflation of prices of capital equipment accelerated considerably less than that for consumer finished goods. But crude materials prices, for both food and nonfood items, increased sharply, and prices for construction materials also rose rapidly. In the first month of this year the continuing strength of inflationary forces was demonstrated by a 1.3 percent jump in the Producer Price Index; although consumer foods posted an especially large increase, all of the major groupings of finished goods and materials showed accelerated advances.

Section 8. Financial Markets

Interest Rates

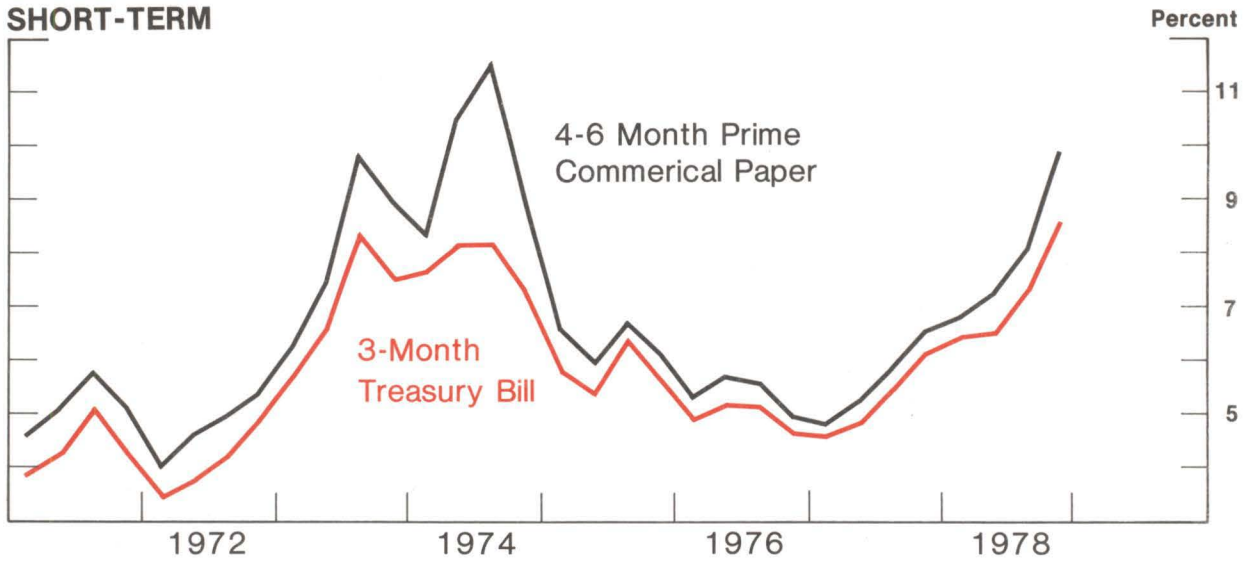
Interest rates generally declined during the early part of the current economic expansion. This departure from usual cyclical patterns probably was attributable in part to a diminution of inflation expectations associated with the observed slowing in the advance of prices and to the limited credit needs of businesses which were pursuing cautious capital spending policies. Interest rates began to move upward in the Spring of 1977, however, as the Federal Reserve acted to restrain accelerating growth in money and credit. Over the course of 1977, yields on short-term market instruments generally rose about 2 percentage points, while corporate and Treasury bond yields increased around 3/4 percentage point.

With inflation picking up, the margin of unutilized resources narrowing, and the dollar under downward pressure in foreign exchange markets, the Federal Reserve applied increasing restraint to the expansion of money and credit in 1978. This was reflected in further increases of 3 to 4 percentage points in most short-term rates over the course of the year. The combination of rising short rates and heightened inflation expectations resulted in increases of roughly 1 percentage point in bond yields. By year-end, a number of interest rates were near or above the peak levels of 1974.

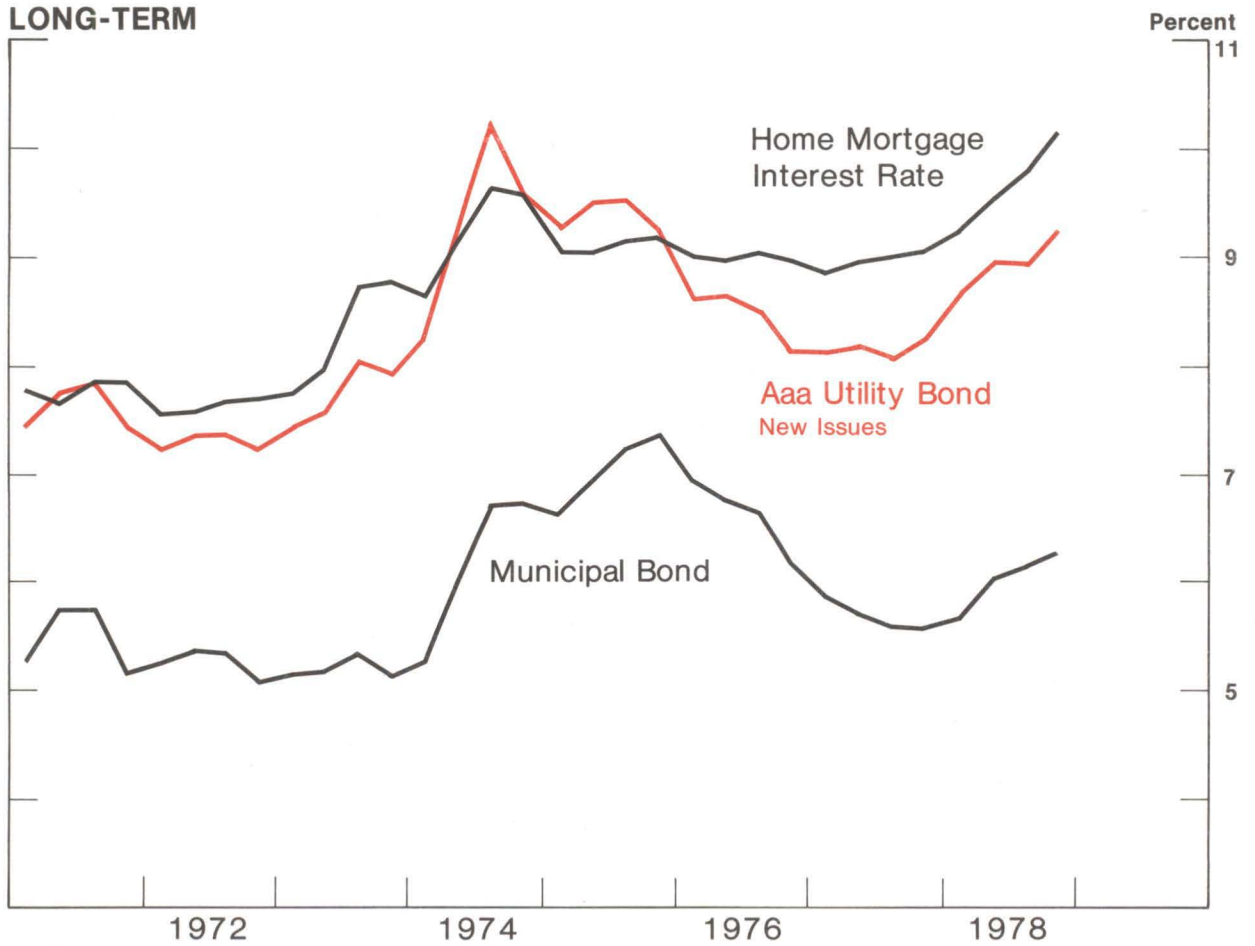
Monetary Aggregates

The monetary aggregates have exhibited some unusual patterns of behavior during the past several years. This has been especially true with respect to the narrow money stock, M-1. During

INTEREST RATES SHORT-TERM



LONG-TERM



1975 and 1976, growth in M-1 averaged just over 5 percent per annum. Given the concurrent decline in interest rates, the sizable increases in M-1 velocity--that is, the ratio of GNP to M-1--were much larger than would have been predicted on the basis of previous historical relationships among money, income, and interest rates.

The moderation of the public's demand for M-1 may have reflected to a degree an unusually strong cyclical swing in confidence and increased willingness to spend out of existing cash balances as the economy recovered from a severe recession. However, there is also considerable evidence that other factors played an important role. The unprecedentedly high level reached by interest rates in 1974 stimulated the creation and adoption of new cash management techniques that permitted individuals and businesses to economize on nonearning demand deposits. This development apparently continued to exert a significant influence even after interest rates turned downward, and it was reinforced by several important legislative and regulatory developments and innovations affecting the payments system. These included the authorization of NOW accounts in all of New England, of savings accounts for businesses and governmental units, and of preauthorized third party and telephone transfer privileges for personal savings accounts.

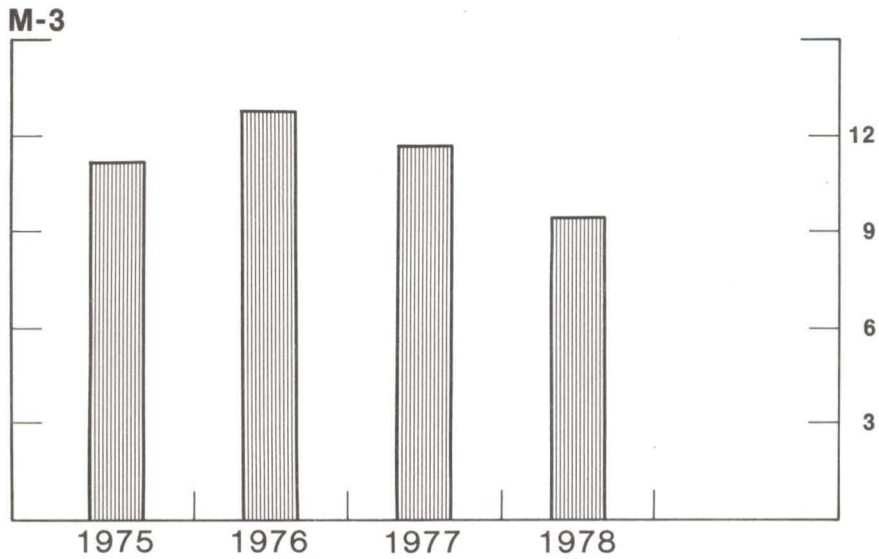
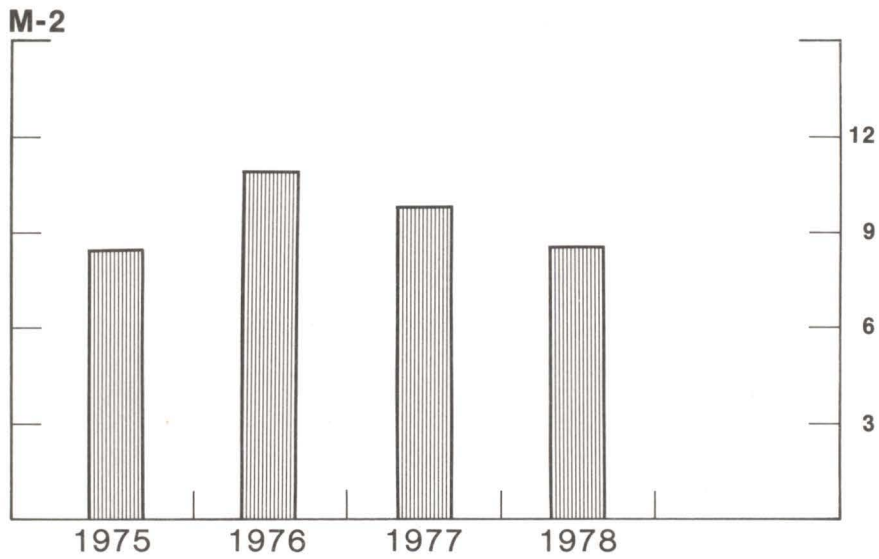
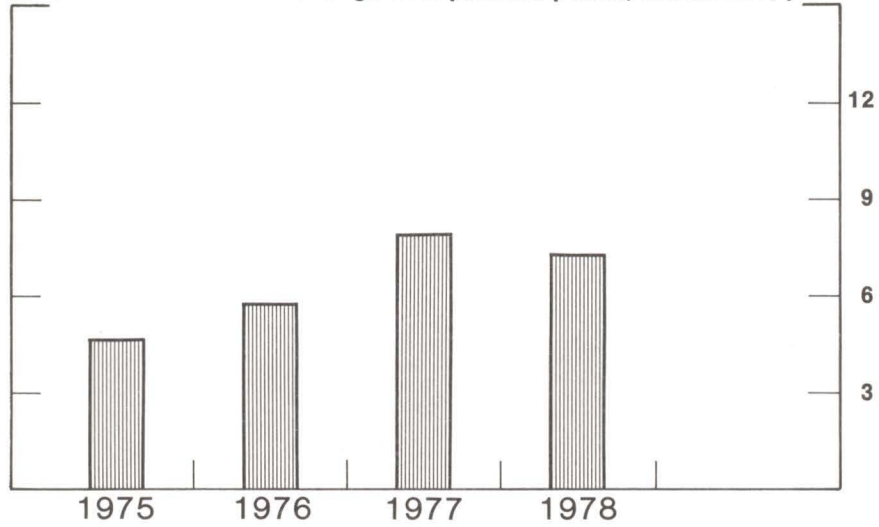
By the beginning of 1977, the level of M-1 was well below that predicted by most standard econometric models of the demand for money. This downward shift in money demand abated in early 1977, however, and growth of M-1 generally conformed to historical patterns until the final months of 1978. M-1 expanded 8 percent during

1977 and at about the same pace over the first three quarters of 1978; rising interest rates and slowing economic expansion worked to moderate M-1 growth over this span, but these influences were offset by the effect of accelerating inflation on transactions requirements.

On a quarterly average basis M-1 growth in the fourth quarter of 1978 was at a 4.4 percent annual rate, but the average level of the money stock in January was slightly below that for October. A portion of this weakness is the direct consequence of the introduction of automatic transfer services (ATS) last November 1; many individuals have shifted their transactions balances from checking accounts to savings accounts from which funds are automatically transferred to cover checks. These shifts appear to have reduced M-1 growth rates by roughly 3 percentage points per month, on average. Even after allowance for this, however, growth in M-1 has been weaker than might have been expected in light of the recent expansion of income and spending. It may be that, as in 1974, interest rates have reached a high threshold level at which households and businesses are induced to seek out and adopt cash management techniques that permit major economies in demand deposit holdings. The advent of ATS--which occasioned basic changes in the checking account pricing policies of many banks--undoubtedly has caused many individuals to assess more carefully the opportunity costs of holding noninterest-earning demand deposit balances as compared not only with ATS accounts but also with other highly liquid interest-earning assets.

MONEY SUPPLY GROWTH

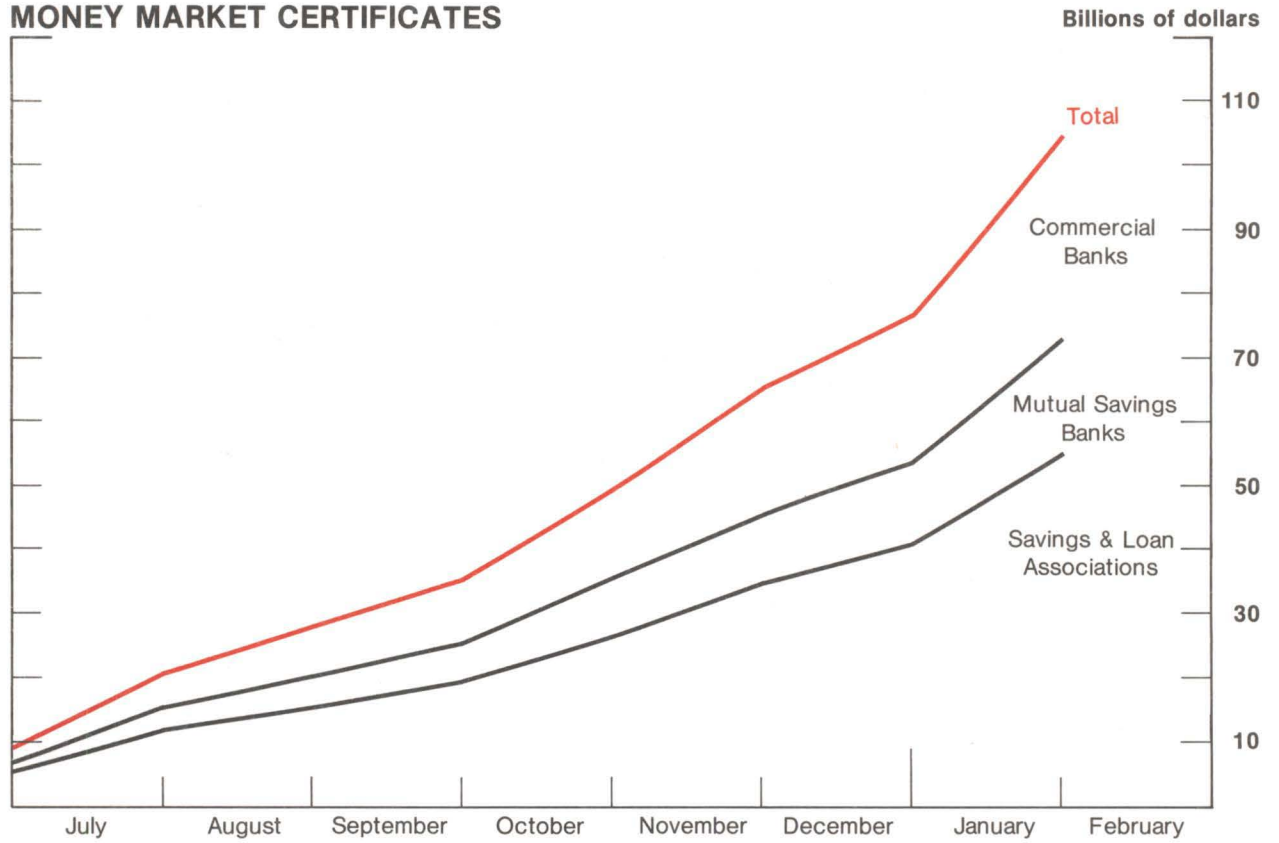
M-1 Change from previous period, annual rate, percent



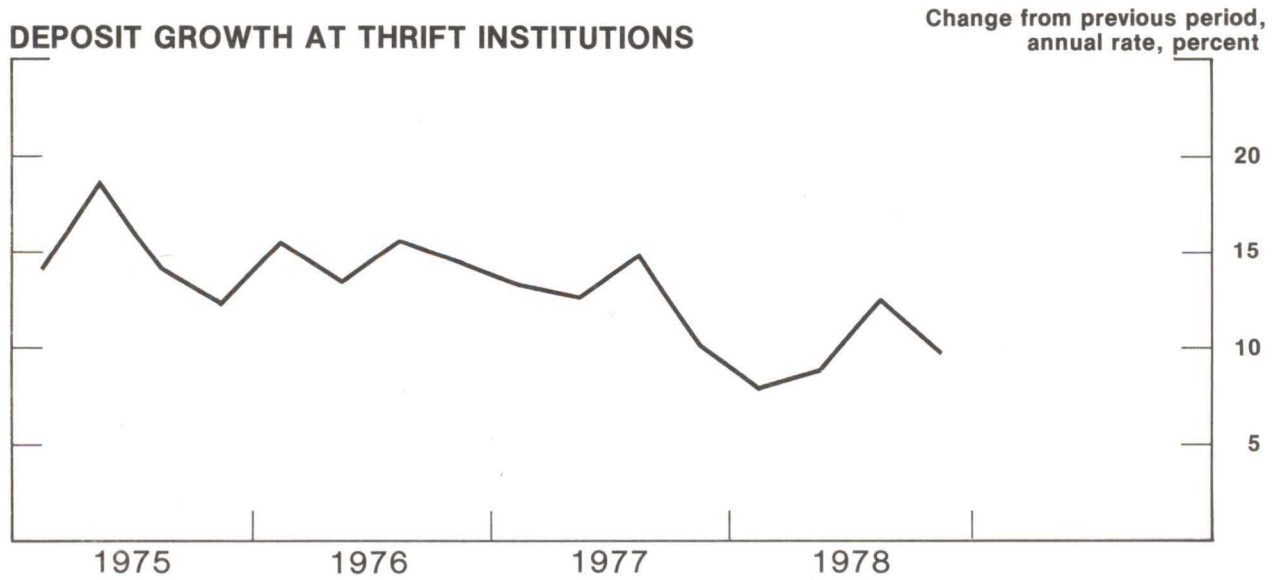
The behavior of the interest-bearing components of the broader monetary aggregates--M-2 and M-3--was generally in line with historical patterns during the first three years of the economic upswing, but there has been a marked deviation since last June. Commercial banks and thrift institutions experienced rapid growth of savings and small denomination time deposits until the latter part of 1977. At that point a gap began to develop between interest rates on short- and intermediate-term market securities and the rates permitted on insured deposits by Federal regulations. As the gap grew, inflows to savings and small time accounts gradually diminished through the spring of 1978. Commercial banks found it necessary to rely more heavily during this period on large time deposits and other managed liabilities to fund their lending activities, and savings and loan associations borrowed heavily from Federal Home Loan Banks.

To prevent a repetition of past episodes when markedly reduced deposit inflows led to an abrupt curtailment of credit to home buyers and others reliant on the depository institutions for credit, the Federal regulatory agencies authorized two new time deposit categories effective June 1. One was an 8-year account paying up to 7-3/4 percent at commercial banks and 8 percent at thrift institutions. The other was a 6-month "money market certificate" (MMC) whose maximum rate varies weekly with the average yield on newly issued 6-month Treasury bills. Given rate relationships, the 8-year certificate has not added significantly to over-all

OUTSTANDING BALANCES OF MONEY MARKET CERTIFICATES



DEPOSIT GROWTH AT THRIFT INSTITUTIONS



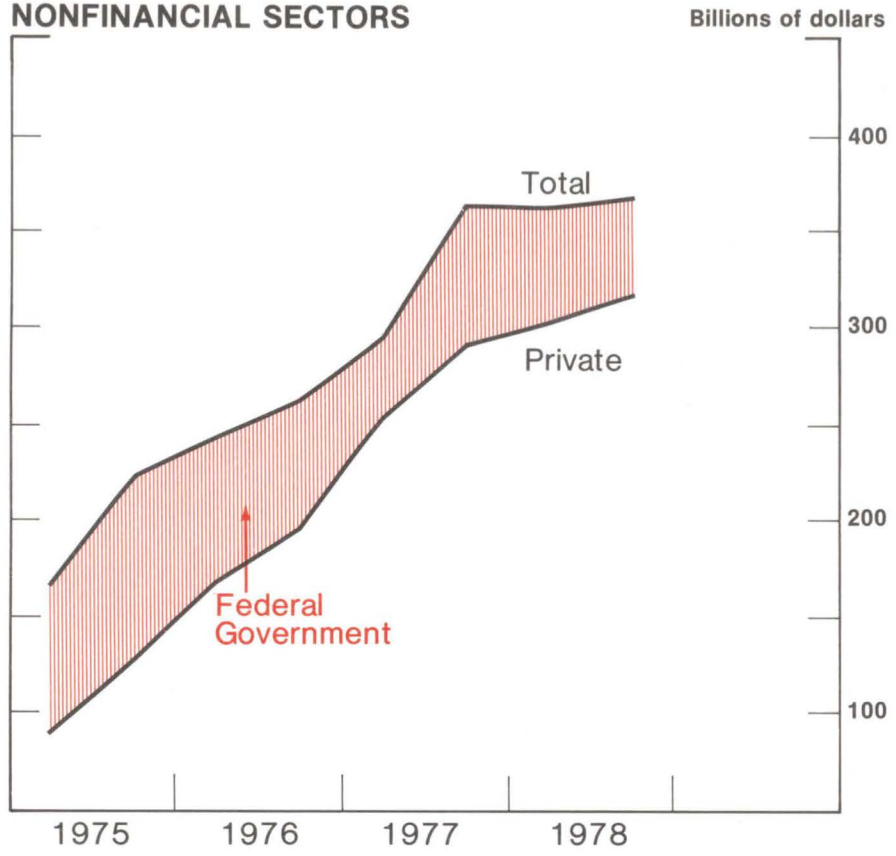
deposit flows, but quite the contrary is true of the MMCs. During the first 5 months of 1978, time and savings deposits subject to rate ceilings at commercial banks, savings and loan associations, and mutual banks grew at a 7.9 percent annual rate; since the beginning of June, these deposits have grown at a 10.3 percent rate despite substantial further increases in market interest rates. MMC balances at the end of January totaled about \$105 billion and accounted for 7-3/4 percent of savings and small time deposits at banks and almost 13 percent at thrift institutions.

The MMCs have greatly reduced the sensitivity of time and savings deposit growth to changes in market interest rates, but they have not eliminated it. Indeed, inflows have moderated during the past few months, at least partly in response to the substantial further rise in interest rates. Increased noncompetitive tenders in auctions of Treasury securities and record growth of money market mutual funds are indications that recent interest rate levels have been inducing some diversion of funds from savings and small time accounts subject to fixed rate ceilings.

Credit Flows

Although accelerating inflation has tended to dampen the impact of rising nominal interest rates on credit demands, there has been a perceptible flattening of the over-all pace of borrowing in the economy over the past year. Total funds raised in credit markets by the private domestic nonfinancial sectors have expanded only moderately

FUNDS RAISED BY DOMESTIC NONFINANCIAL SECTORS



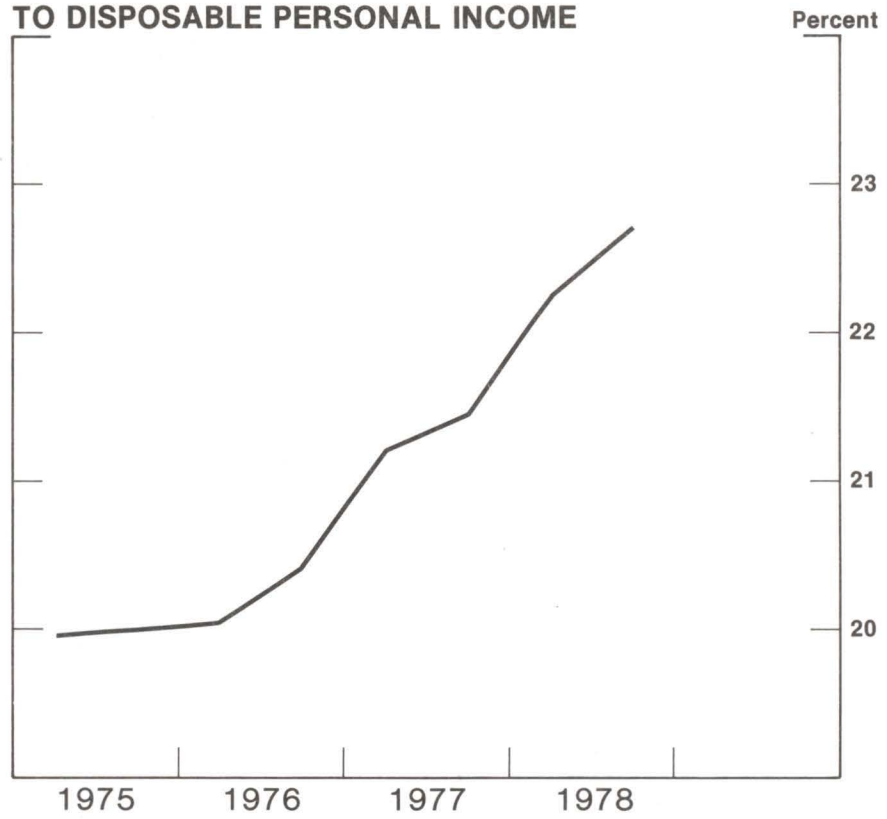
since the second half of 1977 after having risen rapidly during the earlier part of the economic expansion. Although the liquidity of depository institutions has declined over the past two years, the introduction of the MMC has prevented the disintermediation that accompanied previous interest rate cycles and permitted banks and thrift institutions to continue to account for a very large share of the funds advanced to ultimate borrowers.

Households, in particular, are heavily reliant on depository institutions for credit, and their demands for funds have remained strong. Home mortgage borrowing in 1978 was slightly larger than in 1977, and consumer instalment borrowing rose to a new record as households financed purchases of autos and other large ticket items. The aggregate flow of credit to households in 1978, at more than \$160 billion, was 15 percent greater than in 1977 and three times the volume recorded in 1975.

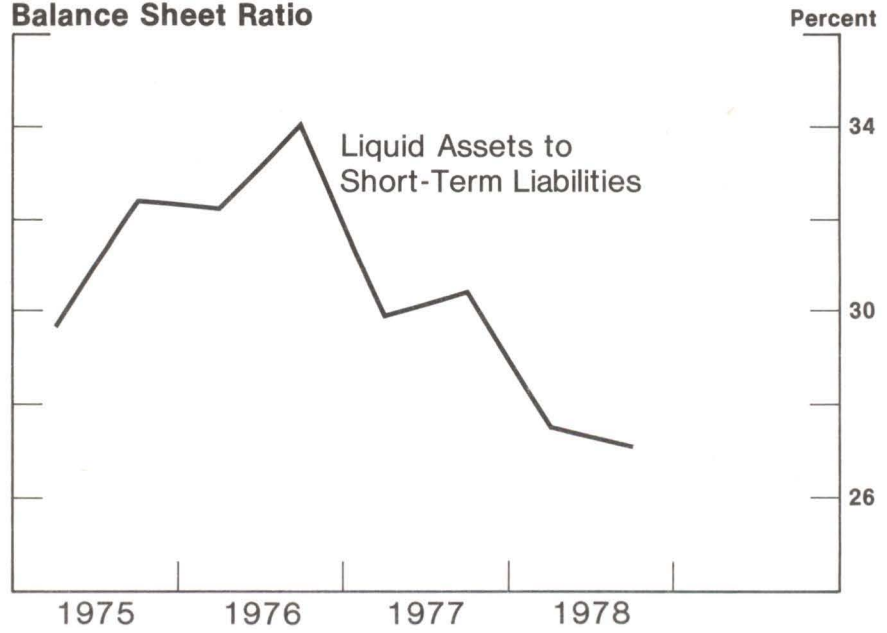
The build-up of indebtedness by households over the last three years has outstripped both the growth of this sector's financial asset holdings and of disposable income. Repayment burdens have reached record proportions. Although loan delinquency data indicate that families have not as yet encountered significant difficulty in meeting their obligations for debt service, the diminished liquidity of household financial positions suggests a greater fragility and vulnerability to any deterioration of income flows.

The nonfinancial business sector also experienced some decline in liquidity in the past year. The gap between corporate capital spending and internal cash flow widened, and firms met

HOUSEHOLD DEBT REPAYMENTS RELATIVE TO DISPOSABLE PERSONAL INCOME



NONFINANCIAL CORPORATIONS Balance Sheet Ratio



a substantial portion of their external financing needs through short-term borrowings--particularly from commercial banks. While commercial mortgage borrowing increased and private bond placements remained large, many of the big, highly rated industrial firms that have ready access to the public bond markets evidently preferred to defer long-term financings in the expectation that long-term rates would eventually decline. As a consequence, the aggregate ratio of liquid assets to short-term liabilities in the nonfinancial corporate sector declined over the course of 1978, to a level only slightly above the 1974 low.

State and local borrowing was about the same in 1978 as in 1977. Advance refundings again accounted for a sizable share of tax-exempt bond issuance, but such operations virtually ceased after August owing to the combination of restrictive IRS regulations and rising interest rates. Despite some rise in the past few months, the ratio of yields on municipal bonds to those on taxable obligations has remained relatively low by historical standards, reflecting in part the continued demand for tax-exempt securities by casualty insurance companies, commercial banks, and individuals.

Borrowing by the U.S. Treasury has declined over the past year, reflecting the diminution of the Federal budget deficit. Government borrowing from the public totaled \$59 billion in FY 1978, but is projected by the Administration at about \$40 billion in the current fiscal year. The preponderance of the increase in outstanding Treasury debt during 1978 was absorbed by State and local governments, which purchased a large volume of nonmarketable Treasury securities with

proceeds of advance refundings, and by foreign official institutions, which invested dollars obtained in exchange market intervention.

Commercial banks satisfied a substantial proportion of the credit demands of households, businesses, and State and local governments during 1978. Total bank credit expanded 10.9 percent over the course of the year, with loan portfolios increasing by 14.6 percent. To meet loan demands many banks had to liquidate holdings of Treasury securities and to borrow either from correspondents or in the open market through the issuance of large CDs or nondeposit liabilities such as Federal funds and repurchase agreements. Aggregate bank liquidity ratios declined appreciably, especially among the smaller and regional institutions that have experienced the strongest business loan growth during this expansion.

Thrift institutions experienced considerable cash flow pressure during the first half of 1978, but they have been able to rebuild their liquid asset positions since the MMCs began to bolster deposit growth. Thrift institution mortgage lending declined moderately during 1978, although there was some upturn in the final quarter in lagged reaction to the midyear pick-up in deposit inflows. Outstanding loan commitments also rose during the second half, but in December were slightly below the year-earlier level.

Life insurance companies and pension funds have continued to experience large inflows of investable funds. In 1978, as in previous years of the economic expansion, these institutions absorbed

the bulk of the net issuance of corporate bonds. The insurance companies also have supplied a large share of commercial mortgage credit.

CHAPTER 2

"the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or diminution of the monetary and credit aggregates for the calendar year during which the report is transmitted, taking account of past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade and payments, and prices"

Section 108(a) Full Employment and
Balanced Growth Act of 1978

Section 1. The Objective of Monetary Policy in 1979

The objective of the Federal Reserve is to foster financial conditions conducive to a continued, but more moderate, economic expansion during 1979 that should permit a gradual winding down of inflation and the maintenance of the stronger position of the dollar in international exchange markets. Given the limited margin of unutilized labor and industrial resources remaining in the economy, it is critically important to avoid strong aggregate demand pressures that would aggravate our already serious inflation problem. At the same time, the current condition of general balance in the economy suggests that it should be possible to continue restraint to relieve inflationary pressures without triggering a recession.

Section 2. Growth of Money and Credit in 1979

The Federal Open Market Committee has selected growth ranges for the monetary aggregates that it believes will bring to bear an appropriate degree of restraint in light of current outlook for fiscal policy and the underlying strength of private demand in the economy. Over the year ending with the fourth quarter of 1979, M-1 is expected to grow between 1-1/2 and 4-1/2 percent; M-2, 5 to 8 percent; and M-3, 6 to 9 percent. Commercial bank credit has been projected to increase between 7-1/2 and 10-1/2 percent during the year.

The growth range for M-1 calls for a marked deceleration from the pace of recent years. This reflects in part an expectation that the shifting of funds to savings accounts with automatic transfer facilities and to the NOW accounts recently authorized in New York State will continue to depress the growth of demand deposits throughout 1979. The Board's staff has projected that such shifting will damp growth in M-1 this year by around 3 percentage points. Because there has been only a brief period of experience upon which to base an analysis of the attractiveness of the ATS accounts, this projection carries a broad range of uncertainty.

The unexplained flatness of M-1 in recent months introduced another uncertainty in the FOMC's deliberations regarding the monetary growth ranges. At this stage it is impossible to tell whether the weakness of M-1 relative to what would have been expected on the basis of historical relationships among money, income, and interest rates is a transitory phenomenon or one that is likely to persist for some time. The range for M-1 assumes that the recent

weakness does in some degree reflect a change in the public's desired allocation of funds among various financial assets that may persist for some time ahead, though not so strongly as in recent months.

The breadth of the specified growth range for M-1 recognizes the considerable uncertainties that currently exist. As subsequent information begins to resolve those uncertainties, the range may be adjusted. In the meantime, M-1 may continue to be a somewhat ambiguous indicator of monetary policy, and it will be especially important to monitor carefully the behavior of other financial variables.

It may be noted that the Federal Reserve is studying possible redefinitions of the monetary aggregates. Among the proposals made in a staff paper published for public comment in the January Federal Reserve Bulletin is that M-1 be redefined to encompass ATS, NOW, and other similar transactional accounts. While such a redefinition would not eliminate the need to understand the behavior of the various financial assets, it might produce an aggregate that is more reflective of the public's need for transactions balances in light of ongoing institutional changes.

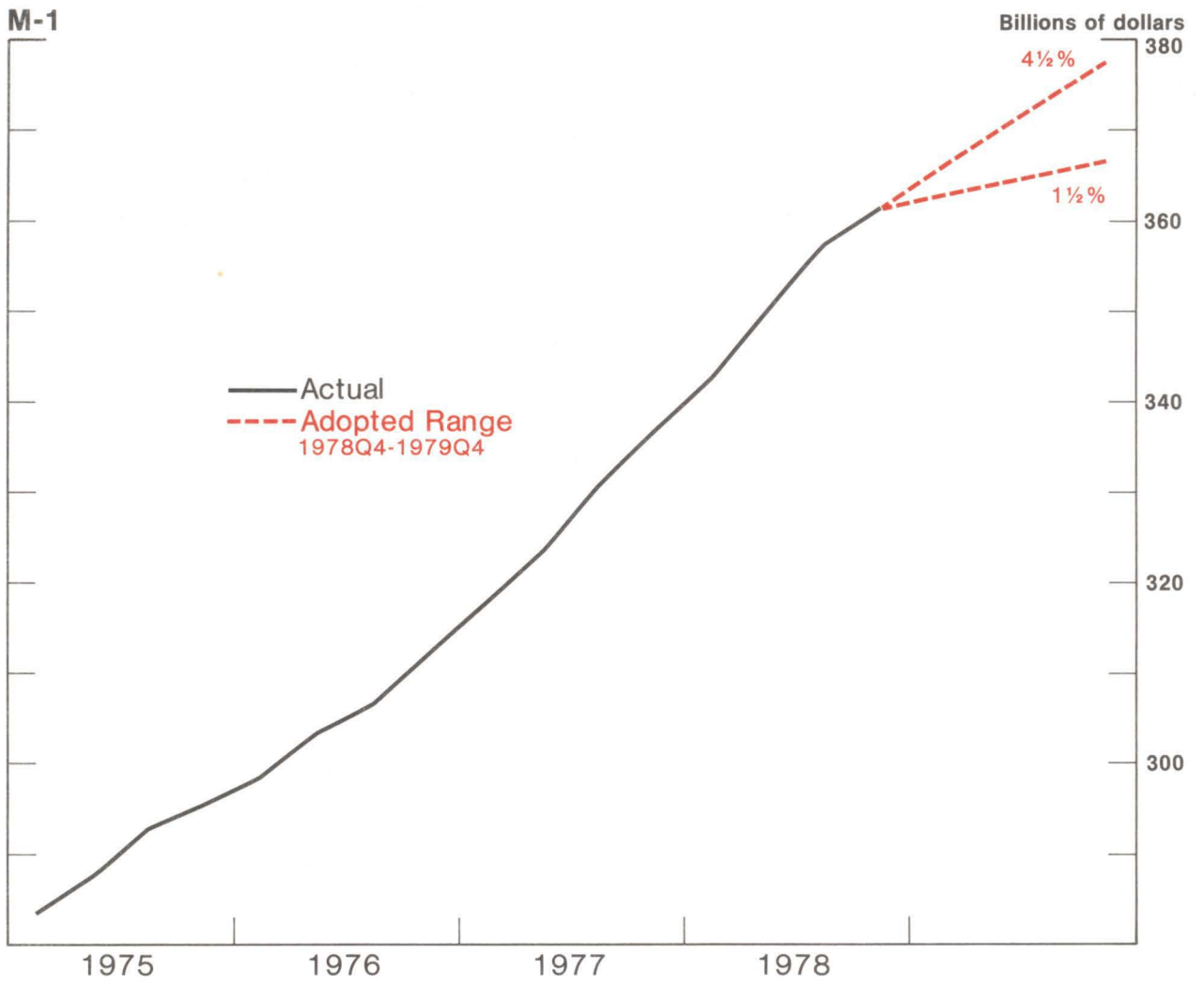
The behavior of M-1 was not the only puzzling development confronting the FOMC early this month as it considered the appropriate ranges for monetary growth during 1979. There were questions as well regarding the movements of the interest-bearing components of the broader aggregates--especially the time and savings deposits at commercial banks that, along with M-1, constitute M-2. Bank savings

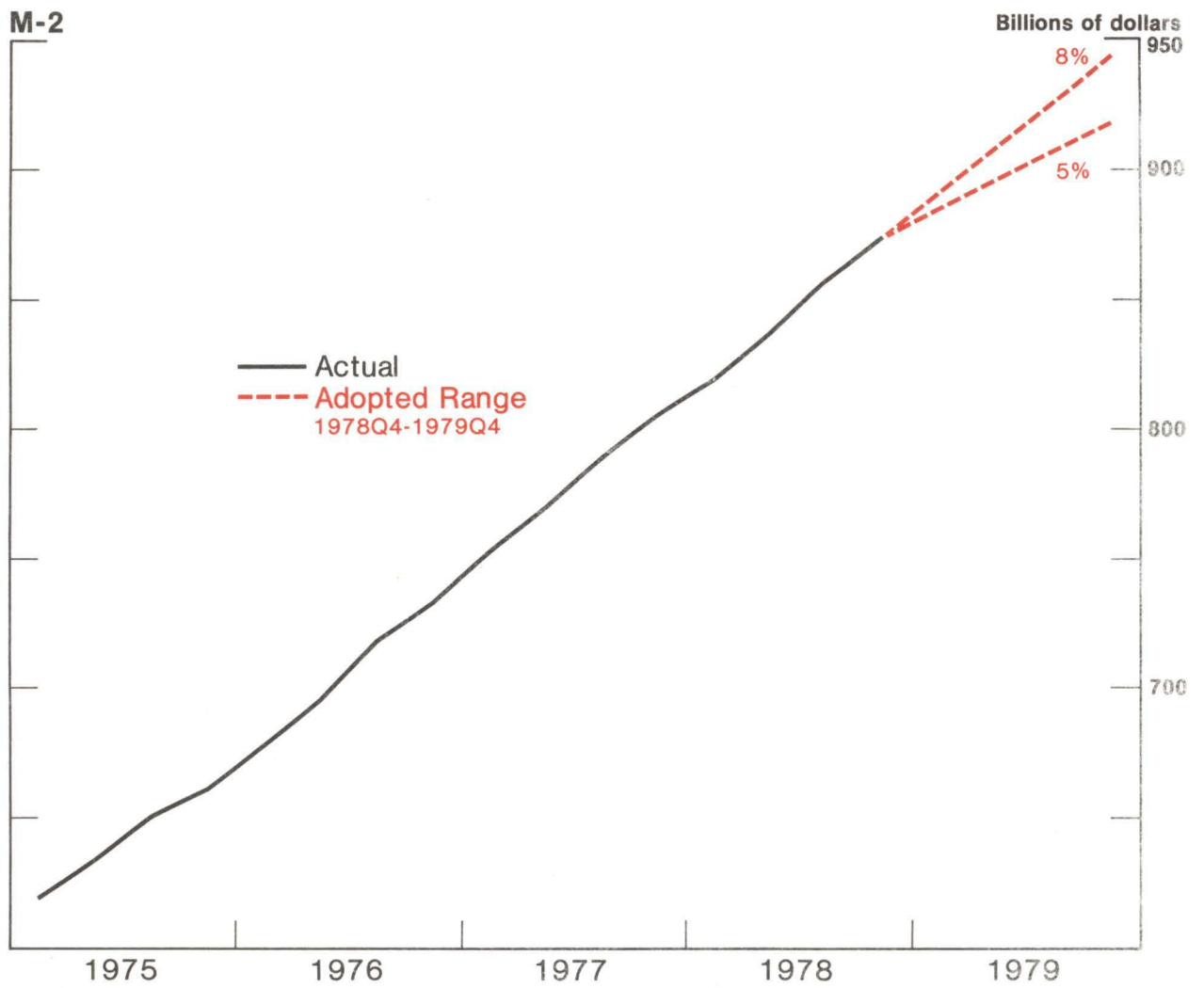
deposits have declined appreciably in the past few months, despite the influx of funds to ATS savings accounts. While savings deposit inflows might be expected to exhibit weakness when market interest rates are so far above regulatory ceilings, a large gap had existed for a considerable time and it might have been expected that most of the interest-sensitive funds had already moved into other instruments. It is possible, however, that--as perhaps with demand deposits--the recent further sharp increase in interest rates to historically high levels has prompted many people to seek out more aggressively alternative assets carrying market yields. The M-2 range adopted by the FOMC reflects an expectation that growth of the interest-bearing component will be somewhat stronger in the months ahead, buttressed by further sizable increases in the large denomination time deposits included in the total and abatement of the recent unusually large withdrawals of funds from savings deposits.

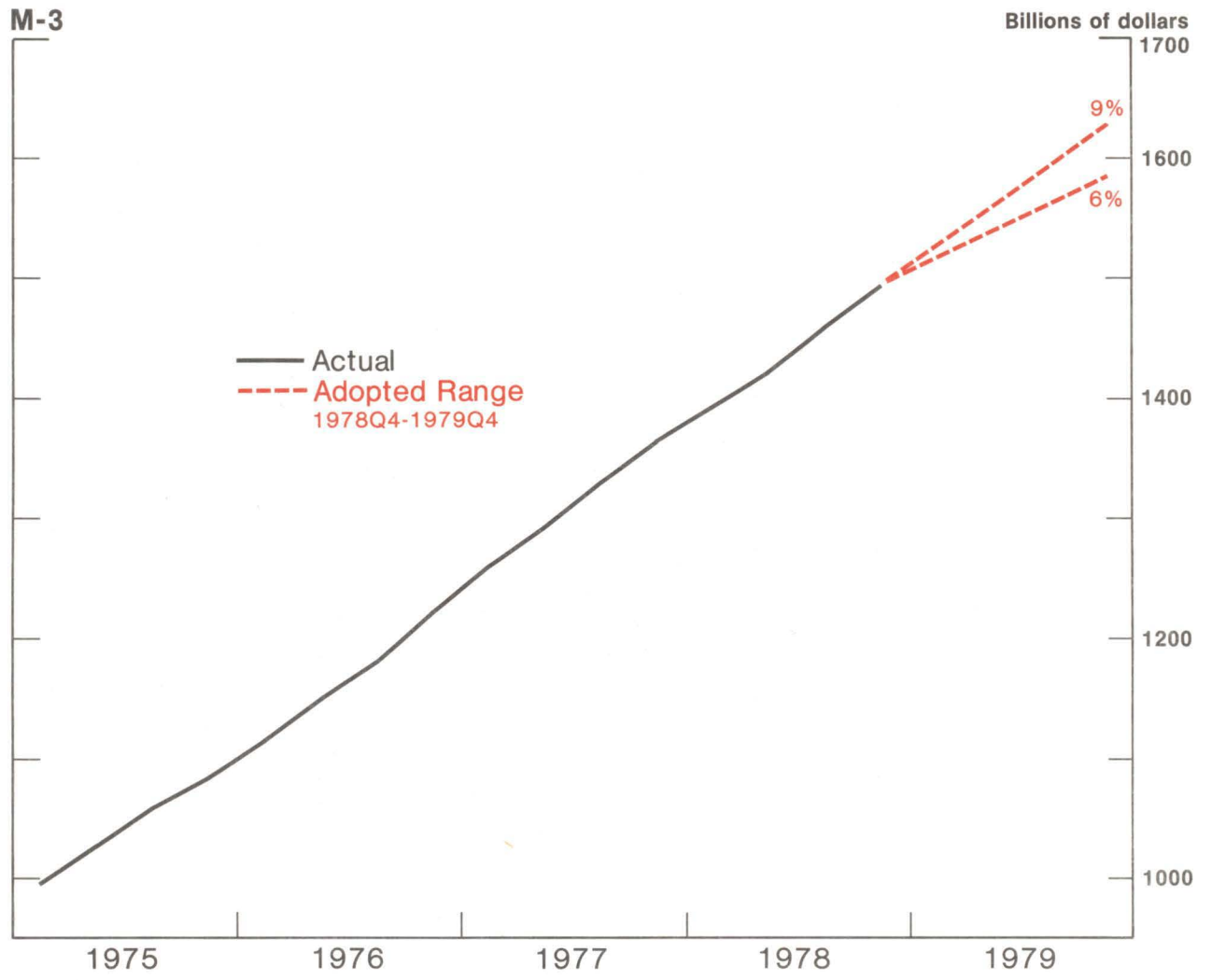
The range for M-3 implies a continued substantial growth of deposits at nonbank thrift institutions. The money market certificates have proven a reliable source of funds. While some institutions have reduced their promotion of MMCs, the certificates have continued to be widely offered at ceiling rates--although there has been some erosion of thrift institution earnings since mid-1978 as these relatively high cost deposits have taken a growing share of thrift institution liabilities.

The projected range for bank credit expansion reflects an expectation that loan demands will be less intense in 1979 than in 1978, in line with the prospective more moderate growth of economic

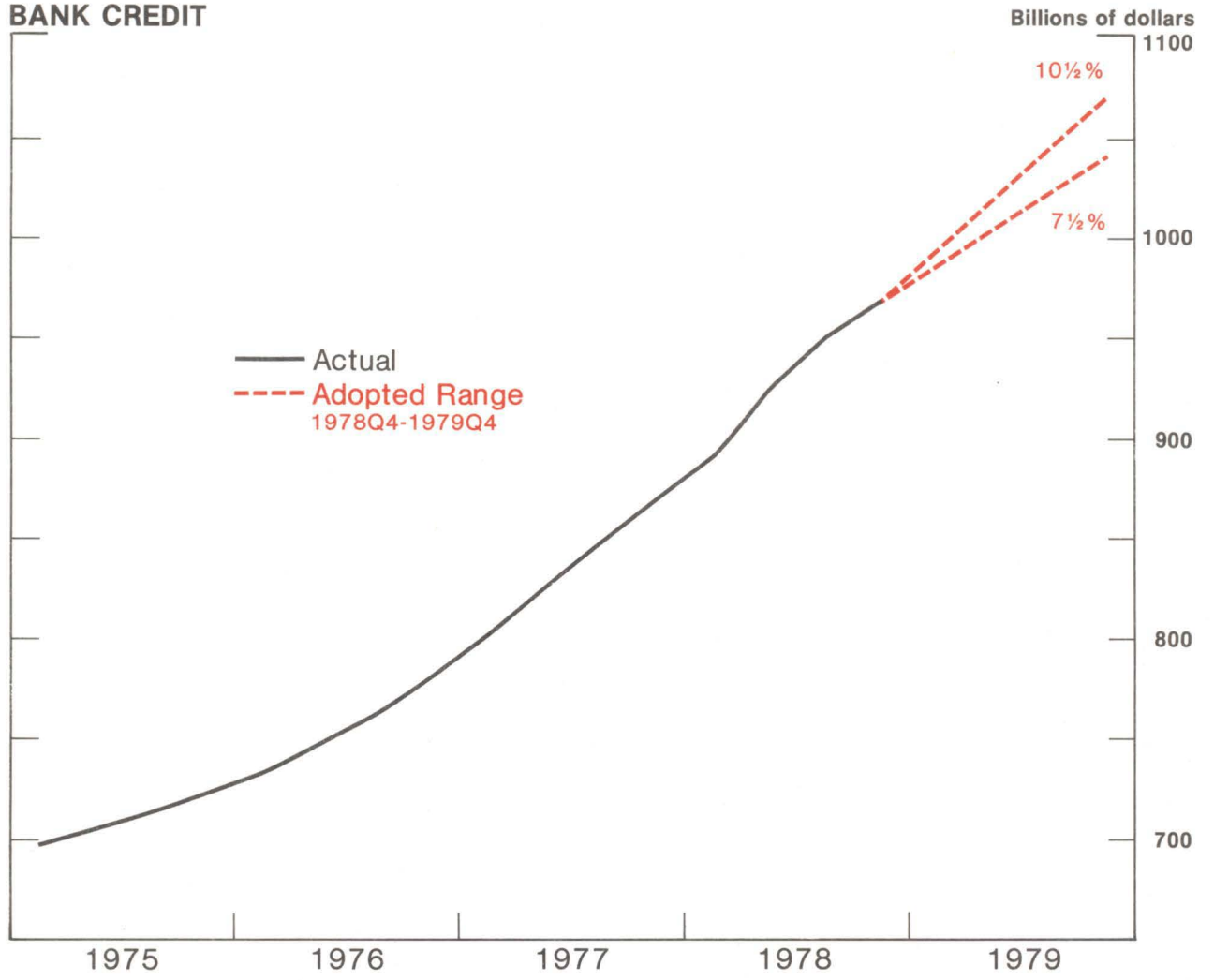
activity. Banks likely will have to continue relying heavily on large time deposits and other money market liabilities to fund asset growth, and this implies some further decline in traditional measures of institutional liquidity.







BANK CREDIT



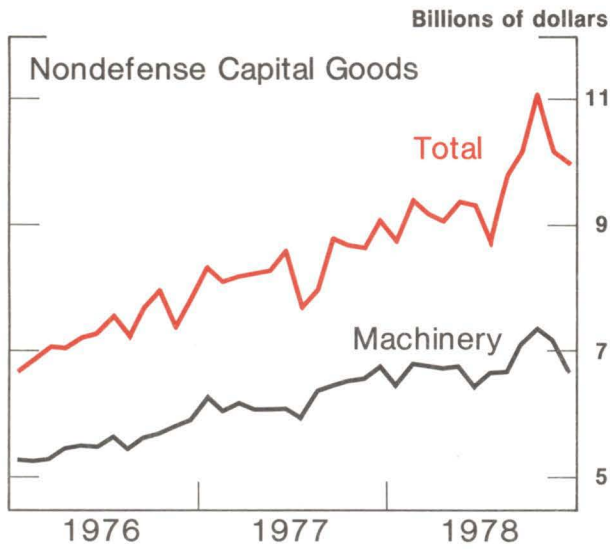
Section 3. The Economic Outlook

Despite the surge in real GNP during the fourth quarter, it appears that underlying economic and financial conditions will lead to a moderation of economic growth in the year ahead. The absence of the sorts of distortions and imbalances that have often precipitated economic downturns in the past indicates that it should be possible to slow the pace of expansion--and thereby relieve inflationary pressures--without prompting a recession. However, any further acceleration of inflation or the occurrence of severe shortages of critical commodities, such as oil, would imperil this outcome.

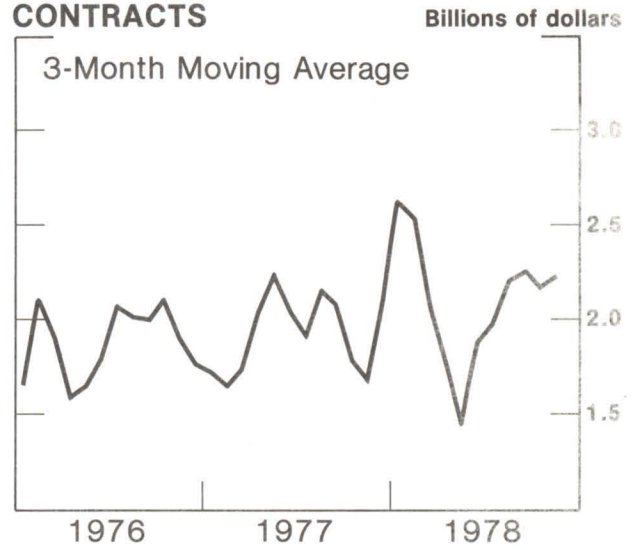
The monetary restraint applied over the past year by the Federal Reserve is expected increasingly to affect the residential construction sector. Higher costs of credit will cause land developers and builders to put aside marginally profitable projects, and the combination of higher house prices and mortgage rates will lead some families to defer home purchase. Nonetheless, owing to the MMCs and various institutional developments that have broadened the sources of mortgage funds, as well as to the strong underlying demand for shelter, the decline in housing activity should be moderate by comparison with past cycles.

Business fixed investment likely will continue to grow during 1979, but at a slower rate than in 1978. There has been some indication in the past few months of a slowing in the steep upward trend of contracts and orders for plant and equipment, and this is generally consistent with surveys of capital spending plans which

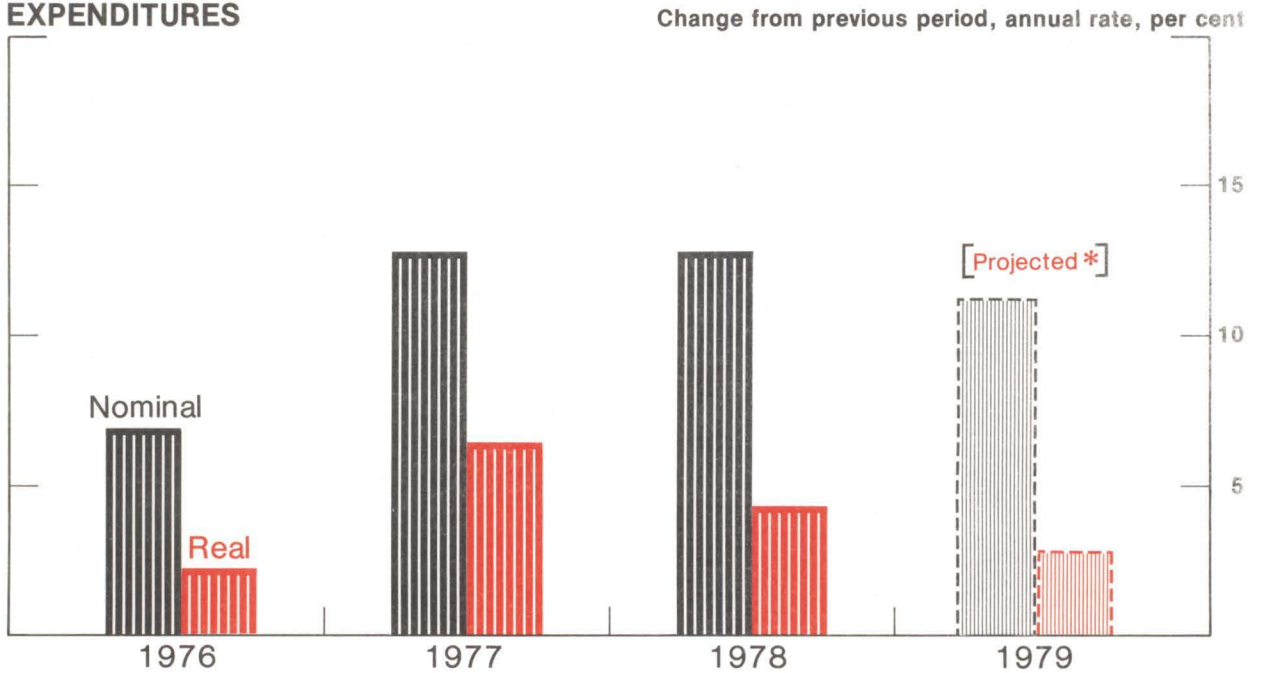
REAL NEW ORDERS



REAL CONSTRUCTION CONTRACTS



PLANT AND EQUIPMENT EXPENDITURES



* Department of Commerce Survey of Anticipated Plant and Equipment Expenditures, December, 1978.

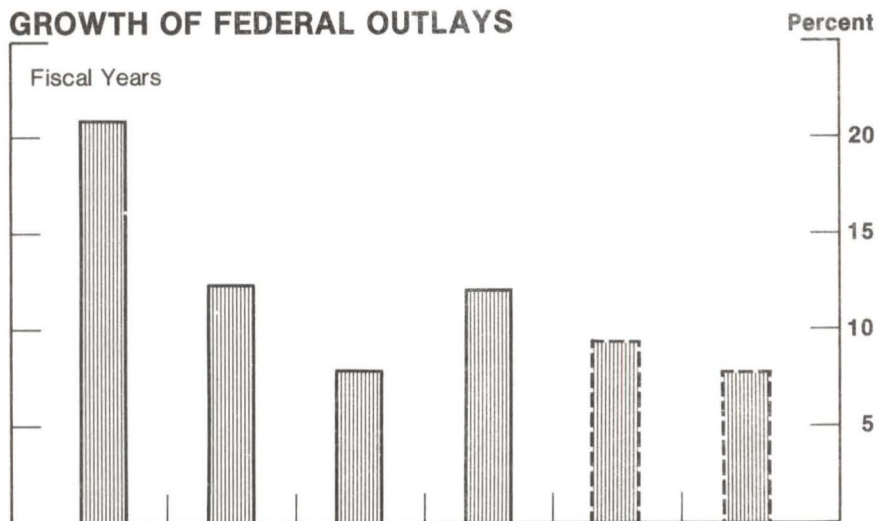
point to smaller gains in outlays this year than last. On the other hand, the climate for investment can be expected to improve as business managers begin to perceive some progress in retarding inflation and become more confident about the sustainability of expansion.

Government spending probably will post only a small increase in real terms this year. Indeed, real Federal purchases could decline during the first half due partly to expected repayments of Commodity Credit Corporation loans (which are, in effect, sales of agricultural stocks). At the State and local level, slower growth of Federal financial aid and the pressure for tax relief will tend to hold spending increases to small proportions.

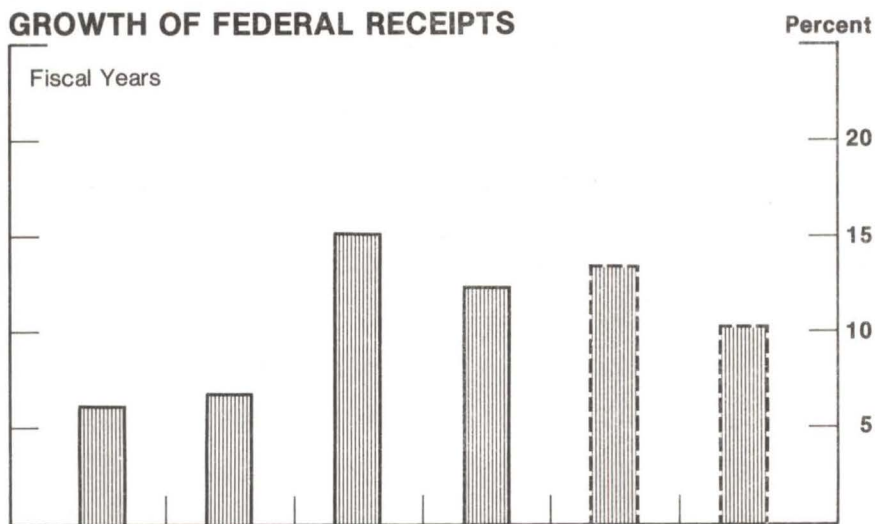
Foreign demand for U.S. exports should tend to strengthen during 1979. Economic expansion abroad is generally expected to continue at its recent more rapid pace, and the effects of the substantial depreciation of the dollar on the U.S. trade position should become more evident as the year progresses.

On balance, the aforementioned sectors are likely to provide a reduced impetus to income growth during the year ahead. As a consequence, consumer spending is likely to grow less vigorously. Moreover, the substantial debt repayment burdens faced by many households and generally reduced liquidity of the household sector could prompt households to increase their recent relatively low savings rate. The demand for imports also should moderate this year, not only because of the slower expansion of domestic income and production, but also because of the lagged effects of the 1977-1978 decline

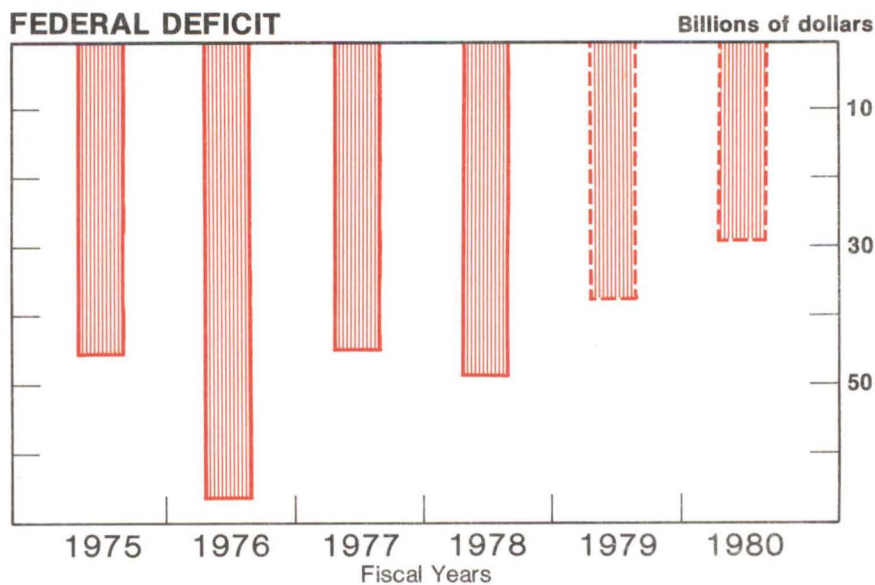
GROWTH OF FEDERAL OUTLAYS



GROWTH OF FEDERAL RECEIPTS



FEDERAL DEFICIT



Note: Projections for 1979 and 1980 are from The Budget of the U.S. Government.

in the international exchange value of the dollar. Inventory investment is likely to be relatively flat in the projected economic environment.

With a slower growth of activity, pressures on productive capacity should ease a bit. Industrial capacity utilization rates, which in the manufacturing sector are not now far below past cyclical peaks, should decline slightly. In labor markets, the growth of employment should moderate from its recent rapid pace. Labor force increases likely also will diminish, as the growth of the working age population slows slightly and as labor force participation rates--especially for youth--respond to the slackening in economic expansion. Together, the prospective changes in employment and the labor force point to a small increase in the over-all unemployment rate during 1979.

The moderation of demand pressures in labor and product markets will tend to slow the advance of wages and prices and thus to reduce the present, unacceptable rate of inflation. However, uncertainties will remain as a result of highly volatile and largely exogenous influences such as farm prices and oil prices. It now appears that food prices will increase somewhat less this year than last. Unfortunately, the price of imported oil will be boosted substantially this year as a result of the decisions taken by OPEC in December, and the unsettled situation in Iran raises the possibility of even larger price increases.

Setting aside these special factors, a key determinant of the rate of inflation this year will be the performance of unit labor

costs. Although there may well be some improvement in productivity in the next few years as the work force tends to become, on average, somewhat older and more experienced, there is little reason to expect any marked acceleration of productivity growth during 1979. Consequently, if there is to be a noticeable slowing in the rise of unit labor costs, compensation gains will have to moderate significantly.

Toward this end, the Administration's wage-price program can play an important role. By providing a standard for constructive behavior on the parts of both business and labor, the program can be a vehicle for helping to brake the wage-price spiral. Broad compliance with the Administration's standards would make a significant contribution to the slowing of inflation. Of course, the wage-price program can be successful only if there is complementary restraint in monetary and fiscal policy--to contain aggregate demand pressures and to assure the public of the Government's commitment to the restoration of price stability.

CHAPTER 3

"the relationship of the [Federal Reserve's] objectives and plans to the short-term goals set forth in the most recent Economic Report of the President"

Section 108(a) Full Employment and
Balanced Growth Act of 1978

Section 1. The Short-Term Goals in the
Economic Report of the President

As specified by the Full Employment and Balanced Growth Act, the President's Economic Report, transmitted to the Congress last month, lays out a detailed set of economic goals for 1979 and 1980. The discussion of the Act's requirements points out that the Administration's "short-term goals for [1979] and 1980 represent a forecast of how the economy will respond over the next 2 years not only to the budgetary policies proposed by the President for fiscal 1979 and 1980 but to the anti-inflation program announced on October 24."^{1/}

The Administration's goals, along with the comparable figures for 1978, are summarized in the following table:

The President's Economic Goals

Item	1978	1979	1980
	Level, fourth quarter		
Employment (millions)	95.6	97.5	99.5
Unemployment rate (percent)	5.8	6.2	6.2
	Percentage change, fourth quarter to fourth quarter		
Consumer prices	8.9	7.5	6.4
Real GNP	4.3	2.2	3.2
Real disposable income	3.3	2.8	2.3
Productivity	0.2	0.4	1.1

^{1/} Economic Report of the President, p. 108.

Section 2. The Relationship of the Federal Reserve's
Monetary Growth Ranges to the Short-Term Goals in
The Economic Report

The Full Employment and Balanced Growth Act directs the Federal Reserve to assess the relationship of its plans for monetary growth to the short-term goals in the Economic Report. This task is complicated by the fact that goals are specified for a variety of economic variables, and monetary policy does not affect each of them separately. Monetary policy has its most direct short-term impact on aggregate nominal GNP. Within the context of a particular nominal GNP outcome, the mix of real output gains and inflation, the growth of employment, and the movements in other variables are influenced importantly by conditions at the beginning of the period, by other governmental policies, by the structural and behavioral relationships in the economy, and by developments outside the domestic economy.

As required by the Full Employment and Balanced Growth Act, the Federal Reserve at this time has established ranges for monetary growth through the end of 1979. It will reassess these and report preliminary ranges for 1980 in July, unless developments in the months ahead necessitate earlier reconsideration. At this juncture, the monetary growth ranges and the Administration's 1979 economic goals appear reasonably consistent. The Administration's forecast implies an expansion in nominal GNP of around 9-3/4 percent from the fourth quarter of 1978 to the fourth quarter of 1979. The midpoint of the FOMC's growth range for M-1 is about 6 percent after adjustment for the expected impact of shifts of funds to ATS and NOW accounts.

This suggests an increase of M-1 velocity on the order of 3-1/2 percent, a figure somewhat above the longer-term trend, but reasonable in light of the lagged effects of the recent substantial increases in interest rates and the downward shift in money demand that has been occurring. The upper and lower boundaries of the M-1 range, of course, allow for the possibility of smaller or faster increases in velocity over the year.

The output-price mix in the Administration's 1979 forecast appears attainable if there is reasonable compliance with the wage-price standards and as long as there are no untoward shocks such as an unanticipated surge in food or energy prices. The employment and productivity forecasts appear consistent with the output goal, and the unemployment rate forecast seems consistent with reasonable assumptions about labor force growth in the projected economic environment.

Considerably greater uncertainties naturally are encountered with respect to the Administration's goals for 1980, a period that is still rather distant. Nothing in the monetary or economic projections for 1979 suggests to us that conditions prevailing at yearend will bar the achievement of the Administration's forecasted 9-1/2 percent growth in nominal GNP during 1980. At this time, however, the achievement of the output-price mix projected for 1980 appears to be more difficult.

The Administration has forecast a marked acceleration of real GNP growth in 1980 and a marked deceleration of inflation. Such an outcome is certainly attainable, but given the projected levels

of resource utilization--with the unemployment rate remaining around 6-1/4 percent--this result will require considerable progress in the lowering of inflation expectations. There will have to be broad conformance to the Administration's wage-price standards, and Government will have to give careful attention to the potential cost-raising impacts of its regulatory and legislative actions. Continued budgetary restraint also will be necessary, both to build confidence in the Government's commitment to avoid fiscal excesses and to minimize pressures on the capital markets.

Recognizing the risks and uncertainties that currently exist, the Administration's 1980 forecast can serve as an appropriate goal for Congress as it considers its budgetary plan for fiscal 1980. If inflationary pressures subsequently should prove stronger than the Administration has projected, then the prudent course for Government policy would be to exercise a substantial degree of restraint even if it risks less real growth in 1980 than the 3.2 percent goal. Such a policy would lay the foundation for balanced economic growth over the years to come and help to maintain the integrity of the dollar.