monthly review

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SOLVING THE FARM INCOME DILEMMA: THE NEW FARM PROGRAM AND THE OUTLOOK FOR 1978

By C. Edward Harshbarger and Marvin Duncan

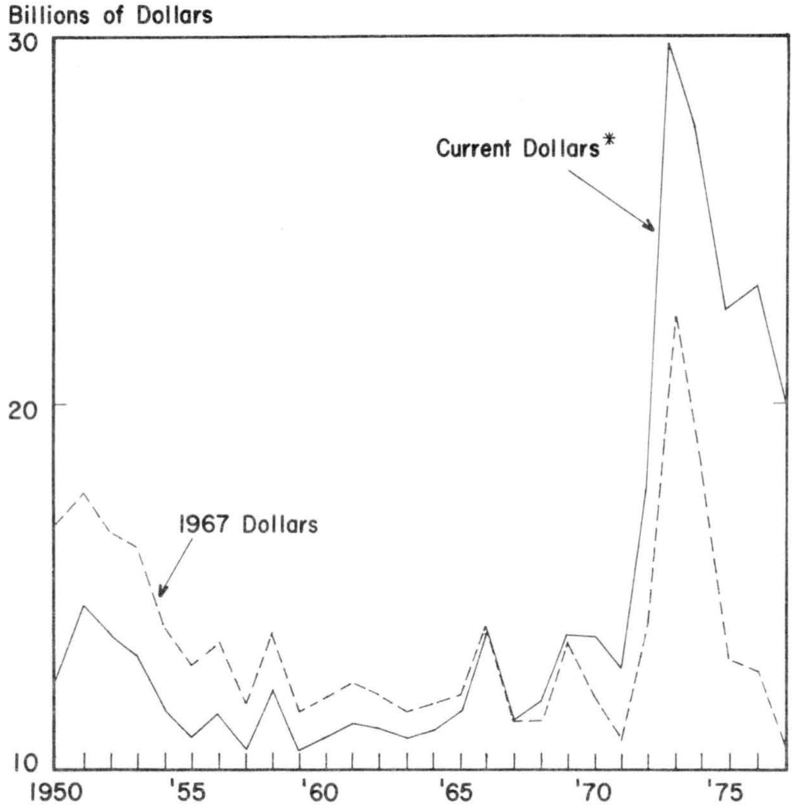
Compared with recent years, when farm prices behaved erratically and made farm income prospects uncertain, the outlook for 1978 is reasonably clear. In short, farm prices—even after allowing for a few surprises—are not likely to show unusual strength in the year ahead because supplies of most farm commodities are ample. Thus, net farm income is likely to remain at a relatively low level in 1978.

Although gross farm income normally rises each year, realized net farm income often varies widely from one year to the next. Using current dollar figures, net farm income has slipped from a high of almost $30 billion in 1973 to approximately $20 billion in 1977 (Chart 1). Most of this decline is attributable to sharply rising production costs, which underscores agriculture's vulnerability to the ravages of inflation. When these figures are adjusted for inflation and expressed in real terms, the recent results for net farm income are quite sobering. For example, the $20 billion earned by farmers in 1977 amounts to only $11 billion when measured in constant 1967 dollars, representing the lowest net return to agriculture since the Depression, and compares with $22 billion in constant dollars for 1973.

Most agricultural analysts agree that the prospects for farm prices and incomes in the near future are not bright. Given the recent diminution in net farm income and the attendant problems with financial liquidity, many farmers are increasingly looking to the U.S. Government for assistance. In large measure, the Government has responded. The Food and Agriculture Act of 1977—signed into law by President Carter in late September—significantly increases the level of Government aid to farmers. In fact, many of the benefits of the new program were made retroactive to cover the 1977 crop year. Thus, after a brief period of little intervention in agriculture, the U.S. Government is once again stepping in to exercise closer control over the production and marketing decisions of farmers as part of an income support program.

Although it is widely agreed that a fundamental goal of farm policy is to foster the growth and development of a prosperous and productive agriculture, differences arise as to how much direct involvement the Government should have. For example, should farmers expect to obtain their incomes solely from the marketplace, however capricious it may be, or should they expect some support from governmental assistance? Were it not for problems of excess production in agriculture, the answer to this question would be clear. Direct involvement from the Government should be minimized. But because of the enormous capacity of the American farmer to produce food, low prices frequently prevail in the marketplace, causing financial distress for many farmers and creating a need for outside assistance.

Chart 1
REALIZED NET FARM INCOME



*Current Dollars are deflated using the "items used for family living" component of the Index of Prices Paid by Farmers. Government payments are included in the data.
SOURCE: U.S. Department of Agriculture.

As farm policy has evolved over the years, several different philosophies and approaches have been used to develop a suitable support mechanism for agriculture.[1] The new farm program represents another refinement in this evolutionary process which may cause the Government to play a more active role in agricultural affairs for the next 4 years if farm prices remain depressed. After reviewing the major agricultural developments of 1977 and examining the commodity outlook for 1978, this article discusses some of the principal features of the new law, giving special attention to the likely impact on farm prices and incomes in the year ahead.

1977 HIGHLIGHTS

Although the demand for farm products has remained strong in both the foreign and domestic sectors, large increases in supplies of several major farm commodities have caused prices to tumble significantly in the past year.

[1] Marvin Duncan and C. Edward Harshbarger, "Agricultural Policy: Evolution and Goals," *Monthly Review*, Federal Reserve Bank of Kansas City, November 1977.

Most of the price declines occurred during the second and third quarters of the year when it became apparent that the 1977 crops were going to be bountiful. During this period, soybean prices fell from nearly $10 per bushel to less than $5 per bushel, while wheat and corn prices both dropped about 50 cents per bushel. As a result of the deterioration in grain prices, coupled with the seemingly inexorable rise in production costs, the prospects for improvements in net farm income during the second half of 1977 faded considerably.

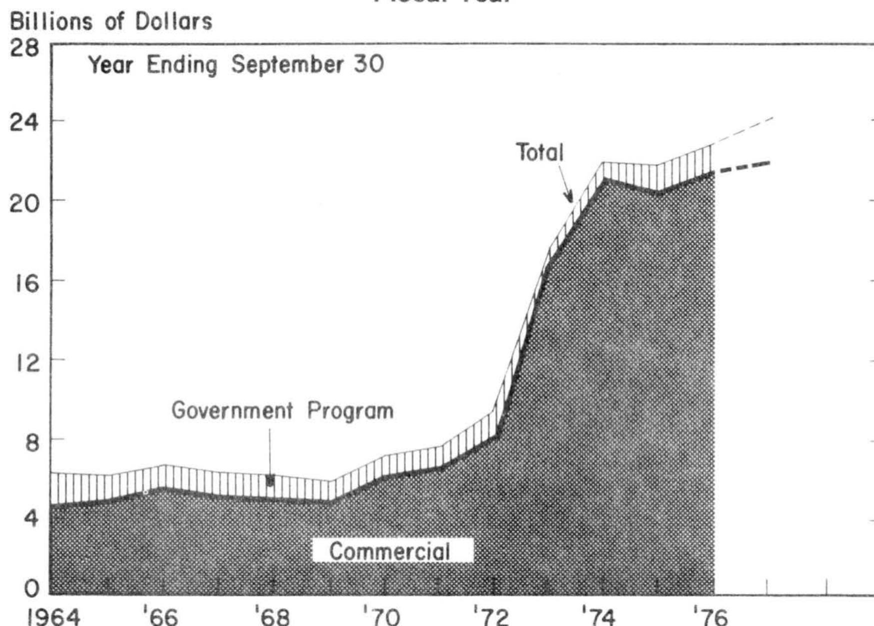
Despite some slippage in 1977 farm prices, cash receipts from farm marketings will likely match the $94 billion farmers received in 1976. Returning to a traditional situation that has not existed since 1974, livestock receipts are expected to exceed crop receipts this year, reflecting the relative strength of livestock prices. Another important change this year concerns Government payments to farmers. Although hardly new, deficiency payments are being made to wheat farmers this year because the average price for wheat during the first 5 months of the marketing year (June-October) was below the $2.90 per bushel target price specified in the new farm legislation. These payments—amounting to about $1.1 billion—are the first of this type since 1973 and have helped push total gross farm income for 1977 to an estimated $105 billion, or slightly above the $103.5 billion earned in 1976. However, higher production costs, which have more than doubled in the last 10 years, will offset this gain, nudging net farm income somewhat below the 1976 level.

The livestock sector has provided a mixture of surprises this year. A year ago, it was expected that cattle prices would probably show significant strength in 1977 as beef supplies diminished, and that hog prices would probably decline sharply given the prospects for bulging supplies. With the benefit of hindsight, it can now be seen that the markets exhibited far more stability than was expected. After choice steer prices rose from $37 to about $42 per hundredweight in the spring, prices fluctuated within a relatively narrow range that centered on $40 per hundredweight for the rest of the year. Similarly, prices for barrows and gilts tended to stay reasonably close to $40 per hundredweight as well. This unusual price stability stemmed largely from the manner in which producers marketed their livestock, although the strength in consumer demand for red meats also contributed to the performance of prices in 1977.

During the first 9 months of 1977, total red meat production was about 2 per cent more than in the comparable year-earlier period. A 2 per cent drop in beef, lamb, and mutton production was more than offset by a 12 per cent gain in pork output. Total beef slaughter included more animals from feedlots than originally anticipated as declining feed costs encouraged producers to place more cattle in feedlots in 1977. Moreover, the slaughter of grass-fed animals was somewhat above projected levels due to poor grazing conditions in several areas. Both developments had a positive effect on beef output, which explains the sluggish behavior of cattle prices during the second half of the year. In the case of hogs, the significant gains expected in 1977 pork production never completely materialized. Producers apparently exercised some caution in their expansion plans for 1977, though heavy death losses in the pig crop last winter also took its toll. Since pork output in the second half of 1977 is running below earlier expectations, prices have held up surprisingly well.

To summarize 1977 crop production, wheat output exceeded 2 billion bushels for the third consecutive year, despite drought problems early in the growing season. The corn and soybean harvests both established new records this year. Although corn output—at 6.3 billion bushels—was up only marginally from last year's record, soybean production jumped nearly a third over the 1.26 billion bushels produced in 1976 as both acreage and yields increased. Cotton production was also up

Chart 2
U.S. AGRICULTURAL EXPORTS
Fiscal Year*



*The fiscal year for agricultural exports was shifted from July 1-June 30 to October 1-September 30, beginning in 1975.

SOURCE: U.S. Department of Agriculture.

sharply in 1977, increasing about 25 per cent over 1976 levels.

THE OUTLOOK FOR 1978

Since supplies of most agricultural commodities are likely to remain large in 1978, the performance of farm prices and incomes will depend largely on future growth in demand. The slowdown in the domestic economy during the second half of 1977, together with some uncertainty about the outlook for 1978, raises a few doubts about the ultimate strength of consumer demand for food. However, further real growth in GNP is expected in 1978, which suggests that the overall demand for food will rise. Moreover, a growing population and an expanded food stamp program will likely provide additional support to the demand for farm output in the coming months.

Although world grain stocks are rising, the outlook for U.S. agricultural exports remains favorable, especially if viewed from a historical perspective. While foreign shipments may decline 5 to 10 per cent in the new fiscal period (October 1-September 30), sales will still compare very favorably with the lofty levels achieved during the last 4 years (Chart 2). In the 1977 fiscal year, shipments abroad were valued at $24 billion, 5 per cent above a year earlier. Most of this increase was attributable to larger sales of soybeans and cotton at very favorable prices. The surplus from agricultural trade, amounting to $10 billion in fiscal 1977 and to $12 billion in each of the three previous periods, has helped alleviate a serious international balance-of-payments problem in the United States. Unfortunately, this problem will continue to be worrisome in the period ahead even though agriculture will enjoy

Table 1
BALANCE SHEET FOR MAJOR CROPS
(Millions of Bushels or Tons)

	Corn (bu) Marketing Year Oct. 1 - Sept. 30		All Feed Grains (tons) Marketing Year*		Soybeans (bu) Marketing Year Sept. 1 - Aug. 31		Wheat (bu) Marketing Year June 1 - May 31	
	1976-77	1977-78†	1976-77	1977-78†	1976-77	1977-78†	1976-77	1977-78†
Supply								
Beginning Carryover	398	879	19.0	32.9	245	103	664	1,111
Production and Imports	6,218	6,368	212.7	222.2	1,265	1,683	2,150	2,029
Total	6,616	7,247	231.7	255.1	1,510	1,786	2,814	3,140
Demand								
Domestic	4,053	4,305	143.0	151.6	843	926	753	858
Exports	1,684	1,700	55.8	55.5	564	610	950	1,100
Total	5,737	6,005	198.8	207.1	1,407	1,536	1,703	1,958
Ending Carryover	879	1,242	32.9	48.0	103	250	1,111	1,182

*Marketing year begins October 1 for corn and grain sorghum, July 1 for barley and oats.
†Preliminary USDA estimates as of November 1977.
SOURCE: U.S. Department of Agriculture.

another surplus—now estimated at $8 billion for fiscal 1978.

The supply picture for 1978 contains a number of imponderables, but they probably will not affect the outlook for prices in any significant way. Generally, total meat supplies in 1978 are expected to be approximately equal to 1977 levels, with substantial increases in pork and poultry supplies offsetting probable declines in beef. In the crop sector, production levels will depend, as always, on the weather as well as on the acreage adjustments that farmers make in response to the new farm program. Given the new set-aside requirements for wheat producers and the relatively low level of prices, total crop output in 1978 is not likely to exceed 1977 levels unless extremely favorable weather conditions prevail.

Any discussion about supplies immediately raises a question about likely developments for food prices. The combination of stable meat supplies and declining grain production suggests that higher food prices are probably in the offing. However, most of the increase in 1978 is again likely to come from the higher costs associated with food marketing and processing activities after the commodities leave the farm. Any gains resulting directly from rising farm prices are expected to be small. In view of the prospects for inflation in the year ahead, 1978 retail food prices will probably average about 5 to 6 per cent above 1977 levels. This increase is roughly in line with the advances posted in the last 2 years, but well below the 14 per cent spurts experienced in 1973 and 1974.

The Outlook for Crops

Due to large harvests in 1977 and bulging carryover stocks, crop supplies for the current marketing year are more abundant than they were a year ago (Table 1). Furthermore, supplies of all major crops—including feed grains, soybeans, wheat, and cotton—are expected to more than adequately meet higher demand requirements in the coming year, which means that reserves will be growing. Consequently, Government programs will have

a significant impact on markets and producer incomes in 1978, as farmers place substantial quantities of grains and cotton under loan. These loans plus anticipated income support payments from the Government will help shore up the sagging cash flow positions of many farm operations.

In the last marketing year, farmers received prices which averaged about $2.85, $2.20, and $7.00 per bushel for wheat, corn, and soybeans, respectively. Given the probable increases in grain carryovers for the coming year, some changes can be expected in average prices—mostly down. Even with an increase in total usage and a probable reduction in 1978 production, wheat supplies seem destined to remain very large for at least another year. Consequently, wheat prices are not likely to average much above the 1977 Government loan rate of $2.25 per bushel, unless substantial quantities of wheat go under loan, exports expand, or 1978 production prospects begin to dim sharply. Although feed grain stocks are not so burdensome, supplies are still large enough to preclude sharp price rises in the year ahead. An average corn price slightly above the $2.00 per bushel loan rate seems most likely for 1977-78. Heavy use of Government loans could alter the price outlook, as could a higher-than-expected level of exports. Soybeans are about the only commodity with a balanced supply situation. Although soybean production was up sharply in 1977, total use is expected to rise moderately, thus stemming a big buildup in reserves. Therefore, soybean prices should remain profitable, although they will not match last year's average of $7.00 per bushel. An average between $5.00 and $5.50 per bushel seems most likely for the current marketing year.

A 25 per cent gain in 1977 cotton production has boosted total supplies for the 1977-78 marketing year to 16.2 million bales, nearly 2 million bales above last year. With the sharp drop that has occurred in prices, domestic consumption is expected to show some strength in the year ahead, but total usage, including exports, may still fall short of 1976-77 levels. Thus, a large carryover is in prospect for 1978, portending generally weak prices. Although the supply picture for fruits and vegetables is mixed for 1977-78, overall strength in consumer demand is expected to provide a modest boost to prices in the coming months.

The Outlook for Livestock

Meat supplies should remain ample in 1978. Cyclical patterns in the livestock industry point to continued growth in pork and broiler supplies and to only modest reductions in beef output. Although the demand for red meat is expected to remain strong, even if economic growth slows in 1978, burgeoning pork supplies will effectively keep the lid on hog prices during the coming year. A closer examination of recent reports on hog inventories suggests that 1978 pork production will probably exceed the 1977 level by 12 to 15 per cent, marking the second year in a row for a big gain. Thus, prices during the first half of 1978 will likely run $3 to $5 below the $40 per hundredweight average that producers received in the first 6 months of 1977. If producers follow through with their preliminary farrowing plans for early 1978 (about 10 per cent above year-earlier levels), pork output could rise enough later in the year to push prices below $30 per hundredweight by yearend. Consequently, the income prospects for hog producers during the second half of the year are not particularly bright.

Compared to recent years, the outlook for cattle prices is improving because cattle inventories continue to be liquidated. However, a trend toward larger feedlot placements—reflecting lower feed costs—is expected to support fed-beef supplies at a high level in the coming months, which will effectively temper any upward price movements. As of October 1, 1977, the number of cattle on feed was 5 per cent above year-earlier levels as placements during the third quarter posted a 14 per cent gain. Consequently, slaughter of grain-finished

cattle through the first half of 1978 may rise 3 to 4 per cent over 1977. Though this increase is not expected to offset likely reductions in grass-fed slaughter, the higher proportion of fed cattle in the total slaughter mix will probably limit price gains in the fed-cattle market during the first half of 1978, and maybe in the second half as well.

The longer term outlook for cattle prices is more optimistic, however. The cattle inventory on January 1, 1978, is expected to be about 118 million head, which compares with 123 million head a year ago and a peak level of 132 million head at the beginning of 1975. Lower prices and higher feed costs have served as strong inducements to reduce herd sizes in recent years and, as a result, beef output has been very large. Since the liquidation phase of the cattle cycle may soon be drawing to a close, beef supplies are destined to start shrinking. Thus, considerable price strength in cattle prices may be in the offing over the next few years. But in 1978, prices are not likely to show unusual strength for the reasons noted earlier. Still, total beef production in the coming year is expected to drop 3 to 4 per cent below 1977 levels, and so prices on choice steers may average $2 to $3 per hundredweight above the $40 estimated for 1977.

Feeder cattle prices are now well above year-ago figures. With the adjustments that have occurred in herd sizes, prices should show additional strength in 1978, especially if feed costs remain low. Lower feed costs and higher price supports have stimulated milk production in 1977. The outlook is for production to continue exceeding year-earlier levels through midyear 1978. This will probably prevent prices from rising much above support levels, which have been raised to 80 per cent of parity under the new farm program. Thus, dairy incomes will probably show moderate gains in 1978. In the poultry industry, the prospects for larger supplies in 1978 point to probable declines in prices, which will likely depress producer incomes. Similarly, the incomes of egg producers may dwindle in the coming year if production continues to expand.

THE NEW FARM PROGRAM

General Features

The Food and Agriculture Act of 1977 is a comprehensive law that will provide substantial support to farm income. Although the new program possesses many of the same features as the expiring legislation, farmers will need to become reacquainted with various procedural mechanics—such as acreage set-asides—that have been largely ignored in recent years because of favorable market prices. Yet, the new law is far more diverse and complex than previous farm-support programs. Some of the policy changes include the organization of a food reserve to be primarily farmer controlled; the elimination of historic acreage allotments; the inclusion of certain production costs in determining target prices for wheat and feed grains; a more equitable food stamp program; and increased financial support for agricultural research and other development programs. Obviously, a program this broad—there are 18 different titles in the Act—is going to be costly. Preliminary estimates by the Government show that the annual cost for the next 4 years may run about $11 billion, with the food stamp program receiving about one-half of the total.

The most controversial features of the new farm program involve commodity supports. In short, the measure amends existing legislation for the 1977 corn and wheat crops and extends the basic support provisions now in effect for all commodities through 1981. Moreover, it raises the ceilings on Government payments to individual producers. Previously, a producer was limited to $20,000 per year for feed grains, wheat, and cotton (rice was $55,000), including disaster payments. In 1978, the ceiling is raised to $40,000 and then to $45,000 in 1979. For the final 2 years of the legislation, producers will be limited to $50,000 in benefits. However, unlike the earlier law, disaster payments will not count

against this maximum total. Following outlays of about $1.5 billion in 1977, Government payments to farmers are expected to total about $2.6 billion in 1978.

Deficiency payments from the Government arise whenever market prices fall below specified targets. Not only does the new law substantially raise the target prices for 1977 wheat and corn, bringing them up to $2.90 and $2.00 per bushel, respectively, but it also provides for further increases in 1978. For example, the target price for wheat will rise to $3.05 per bushel, assuming total production does not exceed 1.8 billion bushels; if it does, the target then drops to $3.00 per bushel. For corn, the 1978 target price will be $2.10 per bushel. Beyond 1978, target prices will be adjusted upward annually based on changes in production costs.

Government loan rates on farm commodities were also altered under the new farm program. Whenever market prices are near or below the official loan rate, farmers frequently borrow money from the Commodity Credit Corporation—a Federal entity—and use their crops as collateral. This program allows farmers to generate cash flow in their operations without having to sell at depressed prices. Unlike earlier programs, which have permitted a wide range within which loan rates could be established by the Secretary of Agriculture, the new law virtually freezes the rates on corn and wheat for the next 4 years. Unless amended at a later date, these rates will be $2.00 per bushel for corn and $2.35 per bushel for wheat.[2] However, should world prices drop below these levels, the Secretary could lower the loan rates 10 per cent each year—but not below $1.75 and $2.00 per bushel for corn and wheat, respectively—to keep U.S. prices competitive in world markets. Once the average world price in a given year moves above the U.S. price, the loan rates will "snap back" to their original levels.

A major change in the new legislation concerns the elimination of historical acreage allotments on individual farms. Previously, these allotments were used to determine production levels, set-aside requirements, and Government payments. The new law has replaced these old allotments with a "normal crop acreage base," which for 1978 will be predicated on what was grown on each farm in 1977. The designated crops used to establish the new base include almost everything except hay and pasture. The new crop acreage base, in and of itself, means very little. But when the Government announces acreage set-aside requirements, or when deficiency payments are made to farmers, the size of the base becomes very important. The actions that a farmer must take and the benefits he receives are tied directly to it.

In 1978, farmers must set aside 20 per cent of their planted wheat acreage to be eligible for Government loans and deficiency payments.[3] However, a farmer is not required to reduce his total planted acreage in 1978. In fact, he may expand his wheat acreage above 1977 levels and still be eligible for partial Government benefits, as long as he idles the required amount of land from production. The ultimate constraint is that planted acreage of all designated crops plus any set-aside requirements must not exceed the farm's "normal crop acreage base," as established in 1977.

Deficiency payments for 1978 and subsequent years will be adjusted by an "allocation factor" which will range from 0.8 to 1.0 under the new act. Each year the Secretary will announce the national farm program

[2] The loan rate for wheat in 1978 will be $2.35 per bushel only if the national average price for the 1977 crop exceeds the current loan rate of $2.25 per bushel by 5 per cent. Otherwise, the loan rate will remain at $2.25.

[3] Producers of feed grains may be required to idle 10 per cent of their planted acreage in 1978 to qualify for Government benefits. However, a final decision on this matter will not be made until early in 1978. If grain reserves promise to be less burdensome than presently expected, the set-aside requirement will likely be waived.

acreage needed to meet domestic and export use and to accomplish any desired increase or decrease in carryover stock. If actual planted acreage should fall below this level, a factor of 1.0 would be assured. But under no circumstances will the level be less than 0.8. Thus, if the Secretary should decide that 58 million acres of wheat will be necessary for meeting domestic and foreign demand, but producers harvest 63 million acres, the allocation factor would be 0.92 (58÷63).

In the year ahead, the Government has announced, farmers can assure themselves of an allocation factor of 1.0 (meaning that they will receive 100 per cent of any deficiency payments made) by reducing their wheat acreage 20 per cent below 1977 levels.[4] In addition, they must still set aside 20 per cent of whatever acreage they plant. Thus, a farmer who raised 100 acres of wheat in 1977 could plant 80 acres for the 1978 harvest, set aside 16 acres (20 per cent of 80), plant the remaining 4 acres in another crop, and still be eligible for a 100 per cent wheat deficiency payment. If he plants more than 80 acres of wheat and sets aside 20 per cent, the farmer is still eligible for payments, but at a reduced rate, depending on the allocation factor determined by the Secretary.[5]

The new law establishes a national grain reserve program through which 30 to 35 million tons of wheat and feed grains will be accumulated for the purpose of stabilizing markets and meeting emergencies. The reserves will be held largely by farm producers through 3- to 5-year extended Government crop loans. Once a farmer has elected to extend or "reseal" his crop loan, he must hold it to maturity unless prices should rise to certain trigger points. For example, if the market price of corn should climb above a specified point (to be determined by the Secretary) that is between 140 and 160 per cent of the loan rate—from $2.80 to $3.20 per bushel—the farmer may repay the loan and sell his crop. It is his choice. However, if the price goes above 175 per cent of the loan rate ($3.50 per bushel), the Government will call the loan. During the time that the farmer has grain stored under this program, he will receive annual storage payments from the Government amounting to 20 cents per bushel.

Implications of the New Program

Because of the wide range of options offered to farmers, assessing the overall effect of the new program on prices and incomes is a difficult task. The target prices defined in the legislation will not provide windfall profits to farmers, nor will they provide producers with an escape from bad management decisions. However, these targets will offer some protection against ruinous prices when production levels are excessive. In principle, the deficiency payments mechanism has several good attributes. Market prices are allowed to seek an equilibrium level, and if those prices are too low, a transfer payment is made to farmers to supplement their incomes. And if the prices are above targets, the payments are eliminated altogether. Over the next 4 years, Government payments to farmers could swell to very high levels because of commodity surpluses and cost escalators attached to future target prices. If surpluses and large payments to farmers become intractable problems, as occasionally in the past, farm policy will inevitably shift to greater production restraints through regulation, thereby pushing the concept of market incentives into the

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[4] If the feed grain set-aside requirement remains in effect for 1978, corn and grain sorghum producers can assure themselves of full benefits by reducing their acreage 5 per cent below 1977 levels. The required reduction for barley producers is 20 per cent.

[5] The cross-compliance requirements under the new law are more stringent than in previous programs. Formerly, producers could elect to participate in one commodity program but not in the others and still be eligible for benefits. This flexibility is eliminated with the new law. A producer of both wheat and feed grains must adhere to the provisions of both programs to remain eligible for Government loans, deficiency payments, and disaster benefits.

background. In short, farmers will be depending more on Government aid and less on market returns for their incomes.

A major shortcoming of the expiring legislation was that no provisions were made by which grain reserves could be systematically accumulated to stabilize markets. This fault is corrected in the new law through the extended crop loans that will be offered to farmers whenever supplies are burdensome and prices are low. As described earlier, most of the grain reserve will be controlled by farmers who, within certain price bounds, will decide when to store and when to sell. The program is designed to absorb excess supplies when output is plentiful, thereby lending support to prices. Conversely, when output shrinks to low levels, the grain reserve can be tapped to augment supplies and ease the upward pressure on prices. Although the mechanics are sound in theory, the program implicitly assumes that both severe shortages and huge surpluses are temporary, self-correcting phenomena. In practice, however, this may not be the case. A prolonged period of unusually favorable weather could easily lead to gigantic reserves, strict production controls, and large income supports to farmers. On the other hand, adverse weather over a number of years could quickly melt away the reserves and produce skyrocketing prices. In time, either extreme would become politically unacceptable. Thus, it remains to be seen just how well the grain reserve program will work in bringing greater stability to agricultural markets.

CONCLUSION

Although the outlook for most farm prices in 1978 is disappointing, total cash receipts from farm marketings should nearly match the levels of the previous 2 years because of expanded sales in the livestock sector and possibly higher prices for cattle. Most, if not all, of the increase that may occur in gross farm income in the year ahead will be attributable to an expansion in Government payments to farmers. Nevertheless, production costs will continue rising in 1978, mostly offsetting the expected gains in gross income. Hence, barring an unexpected spurt in exports, net farm income seems destined to remain at a relatively low level in 1978—perhaps below $20 billion. Returns of this size are not conducive to the maintenance of a strong agriculture in the long run.

Thus, the Government will have a more active role to serve, not only in 1978 but probably in future years as well, in providing farmers with some degree of economic security. Although most farm producers profess to prefer an agriculture free from Government intervention, a protracted period of depressed prices and incomes is a very unhealthy situation from the standpoint of national policy. Many criticisms can be levied against farm support programs because producers are encouraged to "farm the Government rather than their land." In the process of indulging in various forms of gamesmanship with respect to manipulating acreage set-asides and capitalizing on Government payments, producers often overlook price signals in the market and misallocate their resources in their production plans. But the free market has several shortcomings, too, including its proclivities for generating chronically low prices and incomes for lengthy periods of time. Given the public interest in maintaining adequate food stocks at reasonable prices, depressed conditions in the farm sector can not be tolerated for very long. Thus, public programs are needed to contain the excess capacity problem in agriculture and to stabilize conditions so that the industry can grow and adjust in an orderly fashion. The key is to design the programs so that they augment the market system rather than replace it. Within this context, the new farm program offers considerable promise, but a final judgment on its effectiveness rests with time.

THE BUSINESS AND FINANCIAL OUTLOOK FOR 1978

By Steven P. Zell and Carl M. Gambs

For the economy, 1977 was a year of surprises. As the year opened, economic conditions were, at best, ambiguous. Real gross national product (GNP) growth had declined precipitously from an 8.8 per cent annual rate in 1976's first quarter to a mere 1.2 per cent rate in the final quarter of the year. Other economic data also appeared to confirm this weakness. Then the coldest winter in recent history struck the nation. Massive layoffs and plant slowdowns occurred and crops were damaged by freezing and drought in various parts of the country. Many commentators viewed these developments as the death knell for the recovery. But the economy's strength had been severely understated by the data for the fourth quarter of 1976 and the effects of the cold weather were also misunderstood.

The marked slowing in GNP growth during 1976 was due entirely to a downward adjustment in inventories from the excessive levels in the first half of 1976. Real final sales grew at a 6.3 per cent annual rate in the fourth quarter of 1976, almost twice the third quarter rate. Likewise, the effect of the weather was exaggerated. Rather than representing a permanent slowdown, the impact of the weather was more like that of a major strike, almost solely affecting the supply side rather than the demand side of the economy. Therefore, as the supply constraints eased with the end of the bad weather, output rebounded and the economy showed its strength and resiliency. Industrial production, retail sales, and personal income, which had fallen sharply, surged back even more. Thus, rather than declining, real GNP in the first quarter of 1977 grew at the rapid annual rate of 7.5 per cent, due in large part to inventory accumulation.

The second quarter of 1977 saw real GNP continue to grow at a rapid annual rate, 6.2 per cent, down slightly from the first quarter. However, the composition of GNP growth changed. Final sales, which had grown at a 3.8 per cent rate in the first quarter, accelerated to a 5.1 per cent annual rate, while the pace of inventory accumulation slowed. Whereas inventory growth contributed almost 50 per cent of the first quarter growth in real GNP, this proportion fell to only 18 per cent in the second quarter. Although the growth in personal consumption expenditures slowed down as the personal saving rate rose sharply, much of the decline was offset by residential construction and government purchases of goods and services, with the latter showing significant gains for the first time since mid-1975.

Moving into the third quarter, however, it became increasingly evident that the economy was again slowing down, as it had in the same quarter of 1976. In May, June, and July, the

index of leading economic indicators was reported as having fallen for 3 consecutive months. Though this was later revised to only small declines in May and June, other data also pointed to weakness: third quarter GNP data showed that real GNP grew at only a 4.7 per cent annual rate, inventories were essentially flat over the quarter, and final sales also slowed, to a 4.1 per cent rate. The only strong sector, in fact, was government spending.

While the growth rate of real GNP did decline over the first 3 quarters of 1977, substantial strength still remains in the business expansion. An examination of the expected developments in the major sectors of the economy, and the state of the pressures on the capacity to produce, supports this view.

THE ECONOMIC OUTLOOK FOR 1978

One of the oft-cited reasons for believing the present recovery will soon end is that its duration to date—32 months in November—is just short of the 36-month average length of other postwar expansions.[1] However, duration is a poor measure of the potential longevity of the present cycle. One reason is that the range of prior expansion periods is broad enough to obscure the meaning of the "average" expansion. Most importantly, however, the elapsed duration of the recovery has little to do with its potential longevity. Instead, it is the extent to which output growth is putting pressure on the capacity to produce which determines how long and how fast the economy can grow.

The transition from recovery to recession typically takes place after the economy's resources—labor, materials, and plant and equipment—are so fully utilized that bottlenecks develop and any further demand increases are largely translated into inflation. The slowdown in real economic growth due to physical limitations in the economy, coupled with inflationary distortions and resulting tightness in economic policy, typically tend to bring recovery to a halt.

Such developments are not yet occurring in the present recovery. In October, capacity utilization in manufacturing was at 82.8 per cent, the approximate level maintained since May, and several points below the tight conditions last existing in 1973.[2] Similarly, large numbers of workers are unemployed, the unemployment rate remains near 7 per cent, and widespread shortages of skilled labor are not yet obvious.

One excellent measure of the pressures on capacity is the ratio of the index of coincident indicators to the index of lagging indicators. The first of these series tends to move with business activity while the second, consisting mostly of business costs, tends to lag. Their ratio shows whether the factors restraining recovery (rising costs in the lagging index) are increasing more rapidly than business activity itself. When the ratio does show such a relationship, it suggests the existence of cyclical strains setting the stage for the next downturn. This ratio index is thus a leading indicator which has peaked well before the actual leading index in the last two cycles and has declined decisively an average of almost 20 months before earlier recessions. Though this index has been falling since May 1977, the decline has been slight, suggesting many more months of continued expansion. Furthermore, the lagging index, which has risen only slightly, remains well below the previous peak, and no postwar recession has occurred without the previous peak in this index being substantially exceeded.

The absence of these pressures on capacity is

[1] Actually, the frequently cited 36-month figure is misleading in that it excludes the long expansion of the 1960's. Including this period, the average recovery lasted 48 months.

[2] The capacity utilization index has seldom gone higher than 90 per cent. The highest recent level was 88 per cent in 1973, but inflationary demand pressures apparently started developing when the index was near 86 per cent.

explained by the relative severity of the recent recession. This severity can be illustrated by comparing the level of various economic measures reached in the third quarter of 1977 with the previous cycle peak (November 1973) and cyclical trough (March 1975), and contrasting those changes with the average experience in the five postwar business cycles from November 1948 to November 1973. For example, real GNP declined about 6 per cent in the latest recession and then rose about 15 per cent through the third quarter of 1977. The net result of the changes was a level of GNP about 8 per cent higher than the previous peak. Over the other postwar cycles, however, the average recessionary decline was less than 2 per cent, the average recovery to the next peak was about 23 per cent, and the average increase in GNP from peak to peak was about 21 per cent.

The relatively small improvement in the third quarter data from the 1973 peak is observed in virtually every GNP series. The contrast with prior recoveries, however, is most dramatic in the series on real business fixed investment in structures. The recent recessionary decline in investment in structures was about 19 per cent, compared with an average postwar decline of about 2 per cent. The recent recovery, however, was far smaller than average, 4 per cent versus 23 per cent. As a result, the third quarter level of investment in structures was about 15 per cent **below** the previous peak, while the average experience has been a peak-to-peak **increase** of about 21 per cent.

The strength of the continuing recovery depends, of course, on its various components, and the outlook for these sectors varies considerably. Growth in real GNP consists of the change in inventory investment and the change in final sales. The main reason for the irregular growth in GNP since the recession has been unusually large fluctuations in inventory investment. Inventory liquidation was responsible for almost halting GNP growth in the fourth quarter of 1976. Because inventory accumulation does not appear to have been nearly as excessive during the first half of 1977 as in 1976, a large correction now seems unlikely. A minor correction or no change in inventory investment seems most probable. In part because businessmen appear to have become more cautious and knowledgeable in inventory management, inventories during 1978 should grow at about the same rate as business sales.

Business sales depend most strongly upon the behavior of personal consumption expenditures, which make up about two-thirds of GNP. Consumer spending in the second and third quarters of 1977 was restricted partly by an increase in the saving rate, and especially, in the third quarter, by a slowdown in the growth in personal income. The income slowdown partly reflected both slower growth in employment and a fall in average hours worked during the third quarter. Because employment growth may now have recovered and average hours worked are more likely to rise than fall, it appears that personal income may resume a more rapid rise. Along with a flattening in the personal saving rate, this should stimulate some improvement in consumer spending throughout 1978, above the rate of the second and third quarters of 1977 but not as rapid as in the first quarter of the year.

Strength in the economy must come from other sectors as well. The two most likely candidates for this strength are business fixed investment and government spending. The lag in business fixed investment has been primarily responsible for the relatively small increase in output from the prior peak, and continued economic growth depends critically upon the future strength of this sector.[3] Signs of a recovery in this sector first appeared in the first quarter of 1977, but were entirely in business equipment, primarily in purchases of cars and

[3] On average, 10 quarters after their respective recession troughs, earlier postwar recoveries exceeded their previous peaks in real GNP by 12.5 per cent. This compares with an increase of 8.3 per cent in the current recovery.

trucks. Total business fixed investment slowed in the second quarter, despite a major increase in investment in structures, and then slowed further in the third quarter as both structures and equipment investment grew only moderately.

There are several indications, however, that the desired pickup may, in fact, take place. New orders for nondefense capital goods rose sharply in August and September after a deep July decline. Contract awards for commercial and industrial buildings now appear to have begun their long-awaited recovery. Capital appropriations rose 4 per cent in the second quarter following a 2 per cent gain in the first quarter and a 21 per cent rise at the end of 1976. Unspent backlogs of appropriations have reached record levels. Finally, machine-tool orders are healthy once again and backlogs have been climbing steadily.

Two other indications of a pending recovery in capital investment are the current level of capacity utilization and corporate cash flow. Though the level of capacity utilization is below the bottleneck range of 1973, it is near the point where a number of industries must expand their investment in order to maintain efficient production. Similarly, the ability of corporations to finance investment from their gross savings has improved markedly in recent quarters. Gross savings of nonfinancial corporations were 83 per cent of investment in plant and equipment from 1968-72 but fell to only 64 per cent in 1974 as gross savings plummeted.[4] Though retained earnings still remain relatively low, a substantial improvement has occurred so that in the first half of 1977 nonfinancial corporations were able to finance 95 per cent of their investment through their after-tax cash flow.

[4] Gross savings of nonfinancial corporations are calculated as the sum of retained earnings on a national income and products account (NIPA) basis and capital consumption allowances with adjustments. Retained earnings (NIPA) are corporate profits with inventory valuation and capital consumption adjustments minus corporate tax liability and dividends.

The residential construction picture is mixed. The small third quarter decline in residential expenditures was disappointing following the strong second quarter showing. This was especially true in light of the rapid pace of third quarter housing starts which exceeded a 2-million-unit annual rate, almost 8 per cent above the second quarter. Because there is a lag between new starts and GNP-measured investment, the near-term future may again show a rise in this sector. However, starts are at a very high rate which is unlikely to be exceeded in 1978. Because of this, the contribution of the residential construction sector in 1978 GNP growth will probably be relatively moderate.

The economic recovery in the United States, though less above its earlier peak than at the same stage in prior postwar recoveries, has been stronger than that in other countries. Because of this relative strength and because of the tremendous increase in oil imports, net exports of goods and services were a negative factor in real GNP growth from the third quarter of 1976 through the second quarter of 1977. This drag on the economy was reversed to a small gain in the third quarter. Nevertheless, the foreign sector is not likely to make a significant contribution to GNP growth until a better recovery is achieved by U.S. trading partners.

Government purchases of goods and services provided a strong boost to the economy in the second and third quarters of 1977 following almost 2 years of stagnation. Although purchases by state and local governments rose at over a 6 per cent annual rate in these 2 quarters, their budgets remain sharply in surplus. Given these surpluses, a high level of borrowing, and large Federal transfer payments for public employment and other programs, spending by these governments will likely contribute significantly to GNP growth in 1978. Similarly, the Federal Government is projecting a substantial increase in its deficit for fiscal year 1978 over fiscal year 1977. The over $13

billion deficit increase is due to a projected expansion of outlays rather than to a shortfall in receipts and, therefore, represents substantially greater economic stimulus than that provided by the 1977 budget. Further stimulus will be provided should a reduction in personal and business taxes be introduced in 1978.

The outlook for the individual sectors suggests that the economy will continue to grow at a moderate rate, perhaps between 4 per cent and 5 per cent in real GNP from the end of 1977 to the end of 1978. However, whereas personal consumption expenditures, inventory changes, and residential construction alternated in providing the impetus for expansion in most of the quarters since the trough, government purchases and business fixed investment should play a larger role in 1978.

IMPLICATIONS FOR RESOURCE USE AND INFLATION

In the first year of recovery, from the recession's trough in the first quarter of 1975 to the first quarter of 1976, employment in the economy grew 2.5 per cent. In the year to the first quarter of 1977, employment growth accelerated to 2.9 per cent. It then experienced its fastest growth in the second quarter of 1977, at a 6.3 per cent annual rate, before falling to a 2.0 per cent annual rate in the third quarter. Despite the rapid employment gains experienced in this recovery, which raised the employment-population ratio to just short of its all-time high, the almost equally large growth in the civilian labor force left the overall unemployment rate at 7.0 per cent in the third quarter of 1977. The unemployment rate was thus only 1.1 percentage points below its level at the trough in the first quarter of 1975, and was far higher than the 4.7 per cent level in the quarter before the recession began. During 1978, the unemployment situation can be expected to continue to improve as employment grows more rapidly than the civilian labor force. One reason is the projected doubling of public service employment outlays during fiscal 1978. However, given only the moderate growth rate expected for real GNP, the overall unemployment rate is likely to decline only slightly by the end of 1978.

The underlying rate of inflation in the economy is directly related to the growth in unit labor costs, the difference between the rate of increase in labor compensation and the rate of increase in labor productivity. Even in the face of high unemployment and unused capacity, labor compensation in the private nonfarm economy has grown very rapidly during both the recession and the recovery. Compensation increases are due to increasing output per worker as well as to expanded coverage of escalator clauses in collective bargaining agreements, and to the incorporation of high inflationary expectations and high rates of past inflation in wage demands. The average quarterly increase in hourly compensation was at an annual rate of 8.7 per cent from the first quarter of 1975 to the third quarter of 1977, and at an 8.8 per cent rate in the first three quarters of 1977. Productivity increases in the same two periods, however, averaged only 3.5 per cent and 2.8 per cent, respectively. As a result, unit labor costs increased at a quarterly average annual rate of 5.2 per cent over the longer period and 5.9 per cent in 1977. Overall prices in the economy have tended to move in tandem. The GNP implicit price deflator, the broadest measure of domestic price changes, grew over the two periods at quarterly average rates of 6.0 per cent and 5.8 per cent.

Increases in the consumer price index, another measure of inflation, have recently moderated from the very high rates observed in the first half of the year. Fluctuations in this series due to food and energy price changes are likely to continue. Nevertheless, the underlying rate of inflation continues to be determined by movements in unit labor costs. If productivity increases over the next year continue to occur at about a 3 per cent rate, the rate of inflation will be determined largely by changes in labor

compensation—the sum of wages, benefits, and employers' contributions to social insurance programs.

Increases in the wage component of labor compensation have recently accelerated. In the unionized sector of the economy, the effective level of wage increases—prorated over all workers in major collective bargaining settlements—was at an annual rate of 8.9 per cent in the first 9 months of 1977, contrasted with an 8.1 per cent rate during all of 1976. Similarly, for all nonsupervisory workers in private nonagricultural industries, the adjusted average hourly earnings index rose at an annual rate of 7.9 per cent in the first 10 months of the year, compared with a 7.1 per cent rise from December 1975 to December 1976. During 1978, wages might have been expected to rise about 8.5 per cent. However, the overall growth rate of wages will tend to be increased by the 15 per cent increase in minimum wages which goes into effect on January 1, 1978. The growth in total labor compensation will be further exacerbated by large legislated increases in unemployment insurance taxes and Social Security contributions. Because of these programs, the rate of increase in labor compensation may be raised by about 1 percentage point. In addition, the new agricultural assistance program will also contribute to inflationary problems. As a result, there seems little likelihood that the current high rate of inflation will soon be significantly reduced. Instead, given a low-to-moderate growth rate of real GNP, the underlying rate of inflation in 1978 may be increased by about 1 percentage point because of the increased costs described above.

FINANCIAL DEVELOPMENTS AND OUTLOOK

Economic expansion requires financial expansion, as households, firms, and governmental units borrow to help finance increased purchases. During economic expansion, the demand for funds in credit markets frequently rises more rapidly than the supply of funds. Thus, interest rates frequently increase as short-term rates did in 1977.

This section discusses the behavior of interest rates during 1977, as well as the demand for and supply of credit. It then looks at prospective developments for 1978, and at developments in the foreign exchange markets.

Financial Developments in 1977

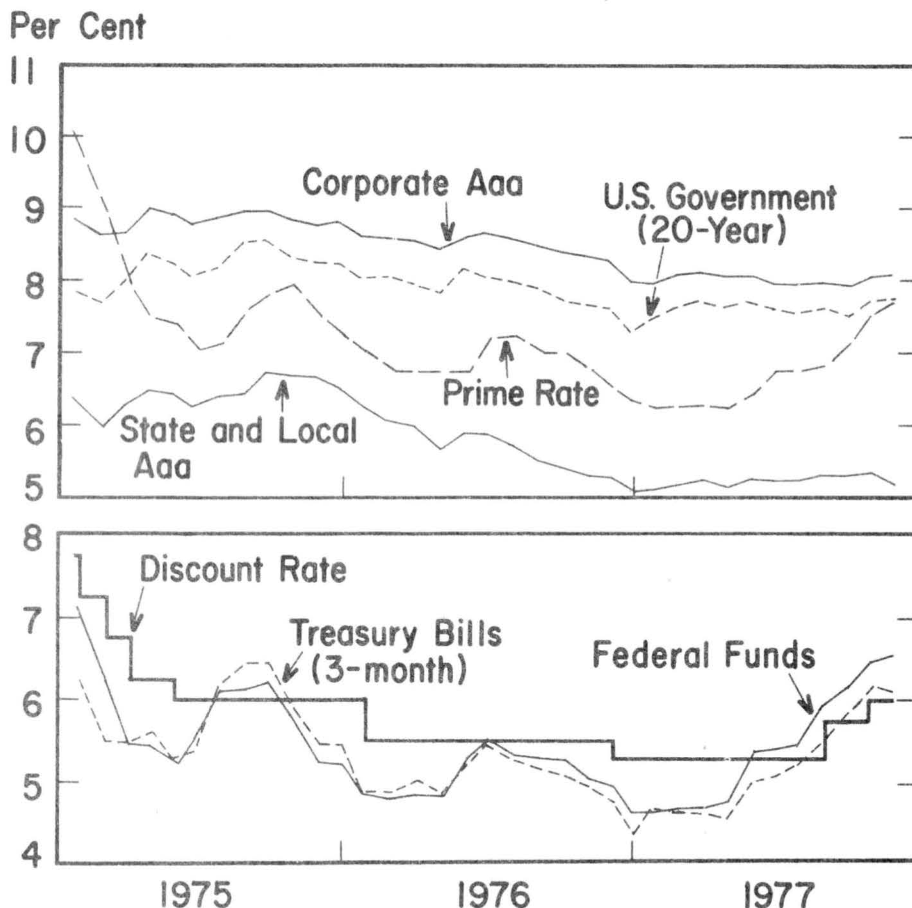
Short-term interest rates were stable in the first part of 1977, but have risen fairly rapidly since the end of April. (See Chart 1.) For example, the interest rate on 3-month U.S. Treasury bills averaged 4.54 per cent in April, but rose to 6.10 per cent in November. Long-term rates, on the other hand, were relatively stable throughout 1977. Average yields on Aaa corporate bonds, for example, varied between 7.88 per cent and 8.12 per cent between January and November, with both the high and low occurring in the first three months of the year.

The behavior of interest rates in 1977 contrasts with that of 1975 and 1976 when interest rates generally declined. However, the upward movement in short-term interest rates in 1977 conformed to the more common tendency for interest rates to rise during periods of economic expansion. In this respect, the marked stability of long-term interest rates during the year is somewhat surprising. It probably reflects a reduction in inflationary expectations during 1977, an occurrence not usually part of an economic expansion.

The 1977 rise in short-term interest rates was due in part to the large increase in the demand for funds during the year (Chart 2). During the first three quarters of 1977, nonfinancial borrowers—households, nonfinancial businesses, governments, and foreigners—raised funds at an annual rate of $321 billion, up sharply from the record $258 billion level borrowed in 1976.

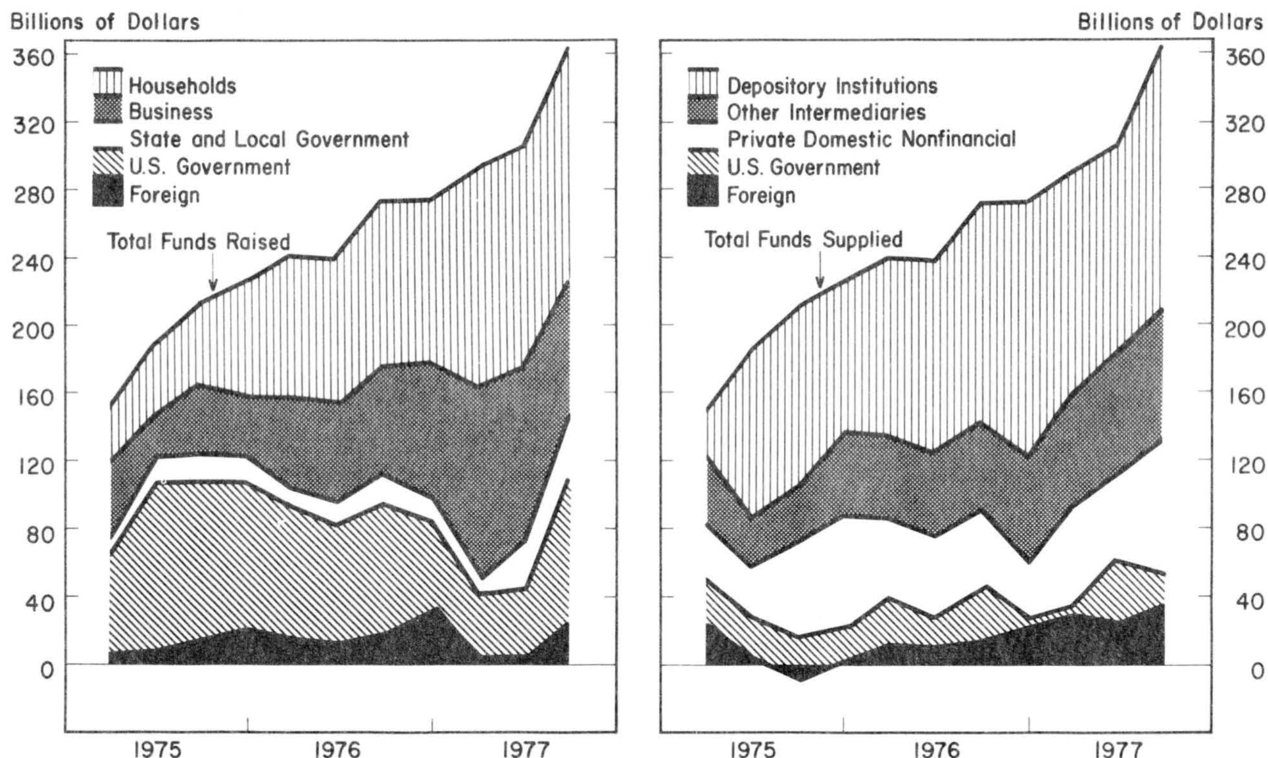
The U.S. Government contributed significantly to the strong demand for funds in 1977,

Chart 1
SELECTED INTEREST RATES, 1975-77



especially after midyear. The Government borrowed at an annual rate of $84 billion in the third quarter, up from $39 billion in the second quarter and $41 billion in the first quarter of 1977. Household borrowing increased in 1977 as it has throughout the recovery, due to the financing of the high levels of home buying and consumer durable goods purchases. In the first three quarters of 1977, household borrowing was at an annual rate of $131 billion, compared with $90 billion in 1976. Borrowing by nonfinancial business also rose in 1977, with the first three quarters running at an annual rate of $98 billion, up from $64 billion. The increased borrowing by nonfinancial businesses was the result of the increase in business investment in both new production facilities and larger inventories.

On the supply side, all major suppliers of funds to credit markets increased their lending in 1977 (Chart 2). The largest source of new funds in 1977, as in 1976, was the nation's depository intermediaries—commercial banks, savings and loan associations, mutual savings banks, and credit unions. These institutions lent new funds at an annual rate of $135 billion during the first three quarters of 1977, up from $125 billion in 1976. Depository intermediaries

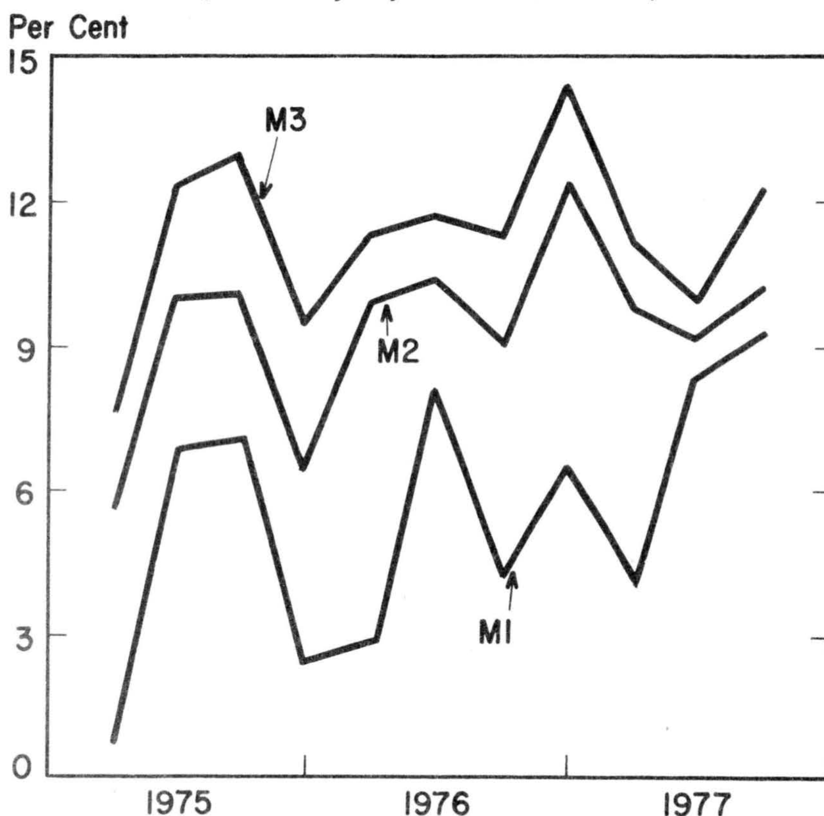


were able to sharply expand their lending in 1977 because their deposits rose rapidly, reflecting rapid growth in the money stock measures.[5] During the year ending in the third quarter of 1977, M1, the narrowly defined money stock, grew at a 7.3 per cent rate, M2 increased at a 10.9 per cent rate, and M3 grew at a 12.6 per cent rate. These growth rates were somewhat above the growth rate ranges that had been projected by the Federal Open Market Committee (FOMC) for this period. The projected ranges were 4.5 to 6.5 per cent for M1, 7.5 to 10.0 per cent for M2, and 9.0 to 11.5 per cent for M3.

The rates of growth of the monetary aggregates accelerated during the course of 1977. (See Chart 3.) M1 grew at a 4.2 per cent annual rate in the first quarter, an 8.4 per cent rate in the second quarter, and at a 9.3 per cent rate in the third quarter of the year. M2 increased at an annual rate of 9.9 per cent in the first quarter, slowed slightly to a 9.2 per cent rate in the second quarter, and increased

[5] M1 is demand deposits of commercial banks other than domestic interbank and U.S. Government deposits, less cash items in the process of collection, and Federal Reserve float; foreign demand balances at Federal Reserve Banks; and currency outside the Treasury, Federal Reserve Banks, and vaults of commercial banks. M2 is M1 plus time and savings deposits of commercial banks other than negotiable certificates of deposit of $100,000 or more of large weekly reporting banks. M3 is M2 plus deposits of mutual savings banks and savings and loan associations plus credit union shares.

Chart 3
GROWTH RATES OF MONETARY AGGREGATES
(Seasonally Adjusted Annual Rates)



at a 10.3 per cent rate in the third quarter. In response to the rapid growth of the money stock, the Federal Reserve System acted to reduce the flow of reserves to the banking system. This tended to reduce the supply of funds to credit markets and place upward pressure on short-term interest rates beginning in the second quarter of the year.

The Financial Outlook

Turning to prospective developments, assuming moderate economic growth, the demand for funds is likely to show only a moderate increase in 1978. It seems likely that the level of Federal borrowing may average somewhat more during 1978 than in 1977. However, borrowing by households, which has been the major source of increased credit demand throughout the economic recovery, is likely to show little, if any, increase in 1978. This is because the most important uses of funds borrowed by households are to finance the purchase of homes and automobiles. Sales of both new homes and autos, which have been at very high levels in 1977, are expected by most analysts to show little increase in 1978.

The extent of business demand for credit in 1978 will depend on the degree that business investment increases. If, as expected, increases in business investment continue at the moderate rates experienced in 1977, the demand for credit by businesses will be only

moderately strong. A full-fledged investment boom, on the other hand, would lead to very large increases in the demand for credit by businesses.

In summary, the most widely accepted expectations about the economy imply that increases in credit demand are likely to be more moderate in 1978 than in 1977. However, unexpectedly strong demand from the business sector could develop in the unlikely event of an investment boom. Another possible source of unexpectedly large demands for credit would be an unexpectedly large Government budget deficit as a result of larger than expected tax cuts or expenditure increases.

On the supply side, one source of funds to credit markets will be the monetary expansion which will take place as the Federal Reserve continues to seek growth in the monetary aggregates. For the period from the third quarter of 1977 through the third quarter of 1978, the FOMC projects that the growth rate of M1 will be between 4.0 and 6.5 per cent. M2 is projected to grow between 6.5 and 9.0 per cent, and M3's growth rate is projected to be between 8.0 and 10.5 per cent. These growth rates are only slightly lower than the targets that have been in effect during 1977, but are significantly below the growth which actually occurred. Thus, the supply of funds to financial markets from monetary expansion is likely to be less in 1977 and 1978.

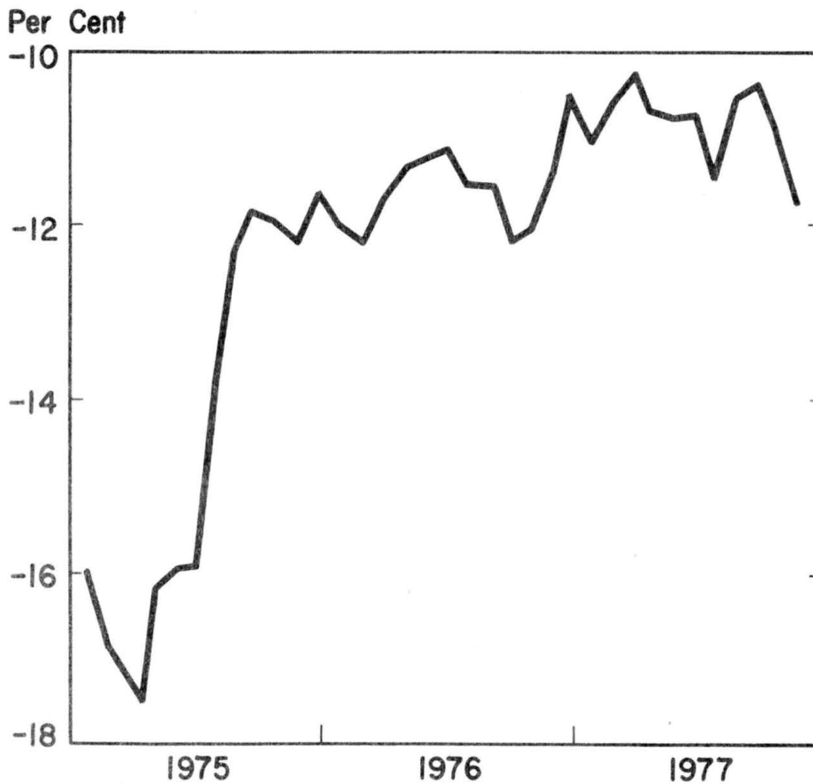
Another major source of funds to financial markets in 1978 will be saving by the private sector with the amount of saving determined primarily by the level of income in the economy. Since it is generally believed that income growth will be somewhat less in 1978 than in 1977, the supply of new funds from private savings is likely to be somewhat lower in 1978 than in 1977.

Thus, the outlook is for a somewhat smaller increase in the total of funds supplied to credit markets in 1978 than in 1977. Since the demand for funds is also likely to increase less in 1978 than in 1977, the smaller increase in supply does not necessarily mean that financial markets will come under a great deal of pressure in 1978. On the contrary, it appears that there will be adequate credit to finance continuing economic expansion without putting severe pressures on the credit markets, provided an investment boom does not develop and an unexpectedly large increase in the Government's budget deficit does not occur.

Some observers have expressed concern that certain sectors, particularly housing, may experience credit stringency even if the overall supply of credit is adequate. It has been suggested that increases in short-term interest rates may lead to disintermediation—that is, the movement of funds out of financial intermediaries directly into credit market instruments—which will particularly affect the savings and loan associations (S&L's). Since the S&L's are the major source of mortgage funds, such a development would inevitably hurt the housing industry.

However, S&L's have become less vulnerable to disintermediation over time. Perhaps the most important reason for reduced vulnerability is the reduced importance of passbook savings accounts relative to certificate accounts as sources of funds. Approximately 60 per cent of S&L deposits are now in the form of certificate accounts, rather than in passbook savings accounts which can be withdrawn on demand, a situation which clearly reduces the sensitivity of the S&L's deposits to higher interest rates. In addition, S&L's are still relatively liquid, and have drastically reduced their borrowings from the Federal Home Loan Banks (FHLB's). At the end of 1974, 7.3 per cent of S&L funds came from borrowings from the FHLB's, while in October of 1977, this ratio stood at 3.9 per cent. Thus, there is substantial room for S&L's to increase their borrowing to continue mortgage lending. In addition, in recent years, S&L's have begun issuing mortgage-backed securities. The ability to issue these securities should help to reduce the effects of any disintermediation that does

Chart 4
EFFECTIVE DOLLAR DEVALUATION*
(From May 1970)



SOURCE: Morgan Guaranty Trust Company, **World Financial Markets.**
*Effective devaluation is the average trade-weighted change of the dollar relative to the May 1970 parities of 15 major countries.

develop since it provides an alternative source of funds for mortgage lending.

International Monetary Developments

The performance of the dollar in foreign exchange markets was mixed during 1977. The dollar declined in value relative to the currencies of a number of other major industrial countries. For example, a comparison of exchange rates at the end of 1976 with those prevailing in mid-November 1977 showed the dollar down 19.4 per cent relative to the Japanese yen, 11.1 per cent relative to the Swiss franc, 6.9 per cent relative to the U.K. pound, and 5.0 per cent relative to the German mark. However, the U.S. dollar was up 8.9 per cent relative to the Canadian dollar. Since Canada is our most important trading partner, trade-weighted indexes[6] show

[6] Trade-weighted indexes of the value of the dollar calculate the value of the dollar relative to a market basket of foreign currencies. Each currency is weighted by the amount of trade carried out between the country that issues it and the United States.

the dollar with relatively little change during 1977 (Chart 4).

A major reason for the decline in the dollar relative to the value of currencies of some other major industrial nations has been the large trade deficits incurred by the United States in 1976 and 1977, coupled with the large surpluses of Germany and Japan. The U.S. trade deficit was at an annual rate of $30 billion through the first three quarters of 1977. The size of the deficit is due primarily to large imports of foreign oil at high prices, and to the fact that the rate of economic growth has been quite weak in many of our major export markets.

Several factors will affect the value of the dollar relative to other currencies in 1978. Of particular importance will be changes in the level of the U.S. trade deficit. Unless there are major changes in the prices of U.S. exports (as would happen if there were an unexpected increase in foreign demand for U.S. agricultural products), major improvements in the U.S. trade deficit will depend on the health of the economies of major U.S. export customers. Increased growth in these economies would greatly assist U.S. exports and lead to increases in the value of the dollar. On the other hand, an unexpectedly large increase in the price of imported oil would weaken the U.S. trade position and the value of the dollar.

CONCLUSION

The first three quarters of 1977 were characterized by a progressive slowing of the rate of economic growth and, beginning in the second quarter, by increases in short-term interest rates. This combination of events has led to some concern that the rate of economic growth will be quite low in 1978.

This article's analysis suggests that the economy will grow at a moderate rate in 1978. Continued expansion of all sectors of the economy can be expected. However, growth in 1978 is likely to be dependent primarily on the growth of business investment and Government expenditures rather than on the stimulus from the consumer sector which has so far characterized this economic recovery.

The financial sector will likely provide sufficient funds to finance moderate economic growth in 1978. While the supply of credit is expected to grow less rapidly in 1978 than in 1977, expected reductions in the growth of the demand for credit are likely to prevent any severe shortage of funds from occurring.