Business and Financial Outlook for 1979

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The U.S. economy in 1978 was characterized by moderate growth in total real output, an acceleration in the rate of inflation, and a worsening international situation dramatized by a sharp decline in the value of the U.S. dollar. At the same time, the domestic economy apparently was not subject to the excesses in particular sectors that typically accompany peak levels of production. For 1979, it is still an open question as to whether the economy will proceed on a moderate to slow growth path, thereby avoiding a recession, and whether meaningful progress will be made toward slowing the rate of inflation. This article summarizes business and financial developments during 1978, and suggests a guardedly optimistic outlook for the economy in 1979.

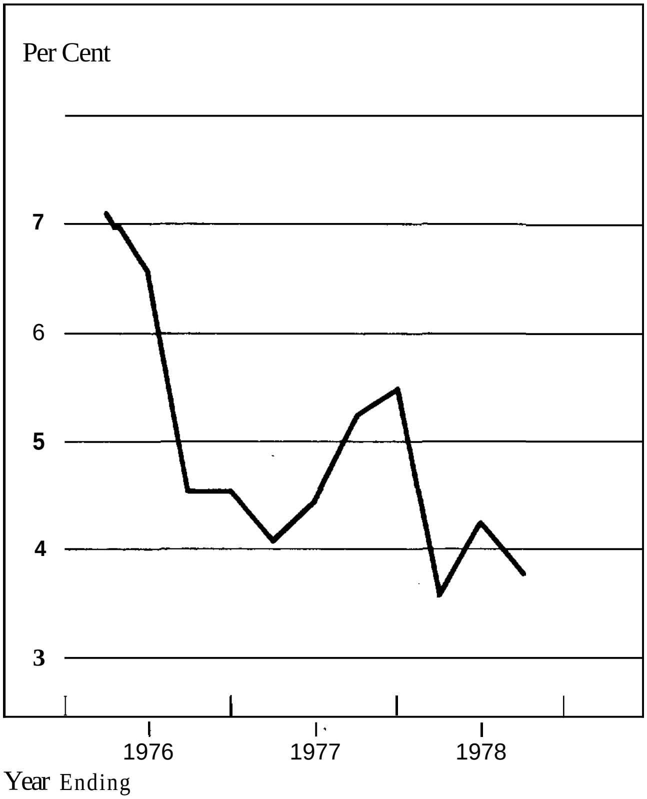
BUSINESS DEVELOPMENTS

The economic recovery from the recession trough of March 1975 has been one of quarterly spurts and pauses. During the economy's first year of expansion, total real output grew rapidly. Since that typical initial burst, the rate of economic growth has been moderate, with a discernible but not pronounced downward trend (Chart 1).

As the expansion has matured, some changes in the nature of economic growth have occurred. Spending by households on consumer goods and new homes has played a lead role through most of the recovery. But growth in real consumer expenditures has been waning, and residential construction virtually stopped growing in the latest four-quarter period (Chart 2). The slower growth in consumer spending and homebuilding was not a surprise in 1978. Less stimulus had been expected from consumer expenditures because the recession's backlog of postponed purchases of household durables typically is eliminated as an expansion ages. In the year ending with the third quarter of 1978, real consumer spending on new durable goods rose 5.6 per cent, in contrast to 9.3 per cent over the corresponding period a year earlier and 17.3 per cent during the first year of the current expansion. In the case of homebuilding, too, slower growth in 1978 had been expected as the deficiencies in the nation's stock of housing were made up and as residential construction reached a level consistent with the country's longer term rates of growth of income and population.

The gradual decline in the growth of real personal consumption expenditures cannot be attributed to a decline in the growth of real personal income. Real personal income grew 4.5 per cent in the year ending with the third quarter of 1978, virtually the same growth it averaged over the previous 2% years of the expansion. But, because of the tax-increasing effect of inflation, real disposable personal income has not grown as

Chart 1
GROWTH IN REAL GNP:
1976:1 TO 1978:3

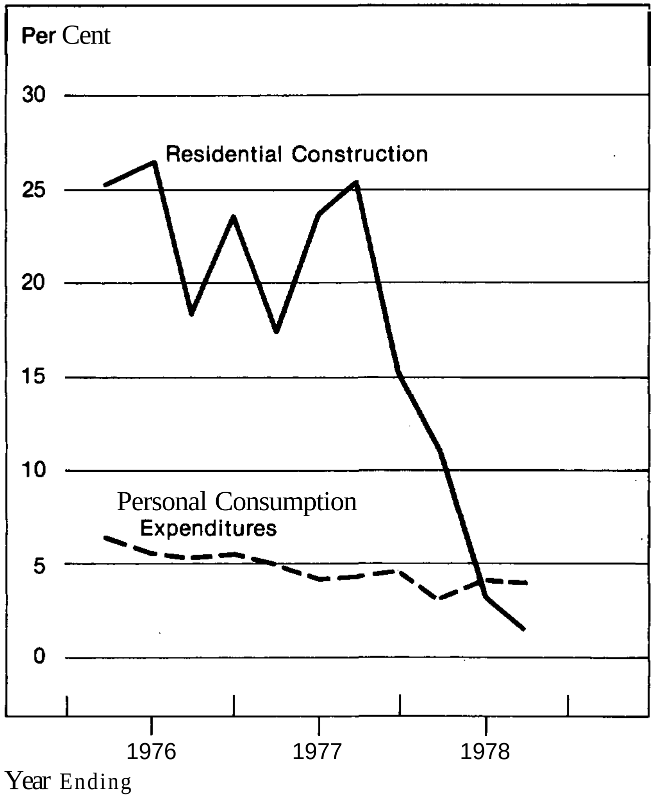


fast as real personal income.[1] More importantly, in each of the last three years, real disposable personal income has grown less than real personal consumption expenditures. As a consequence, the rate of personal saving out of disposable income has been pushed down to a very low level—5.1 per cent in the third quarter of 1978. In recent years, another increasing drain on disposable income has been the rapid rise in payments of interest to business by consumers. In the four quarters ending with the third quarter of 1978, these interest payments rose almost 18 per cent as compared with a 12 per cent increase in personal income over the same period.

Business investment in plant and equipment has supported the expansion since late 1975, in that real business fixed investment has grown faster than real gross national product in each of the last three years. Although business

[1] Real disposable personal income is real personal income less real personal tax and nontax payments. The increases in wages and salaries that accompany inflation increase the effective tax rate on personal income by putting people into higher income tax brackets. In the third quarter of 1978, personal tax and nontax payments took 15.2 per cent of personal income, the highest since 1969, and up from 13.6 per cent in the third quarter of 1975.

Chart 2
GROWTH IN REAL PERSONAL CONSUMPTION EXPENDITURES AND IN RESIDENTIAL CONSTRUCTION
1976:1 TO 1978:3

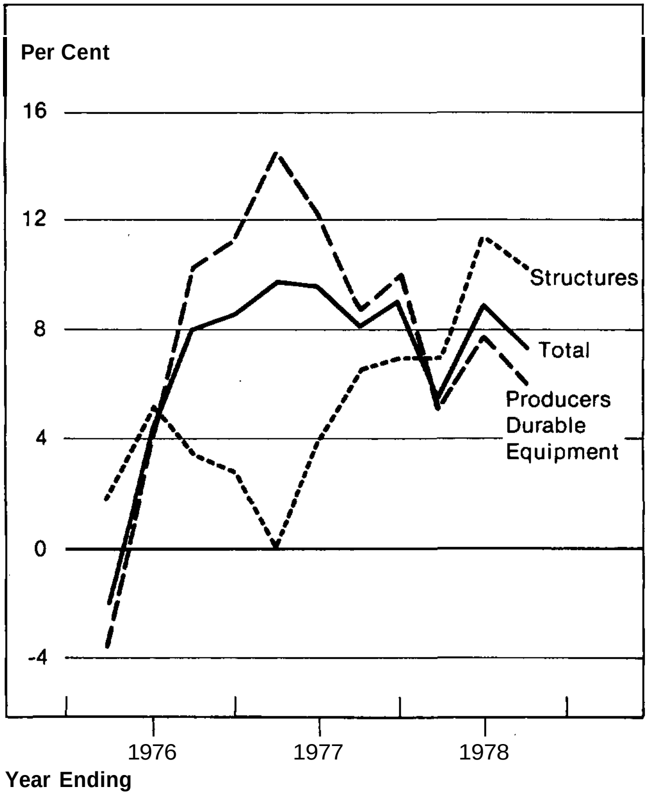


spending on plant and equipment has not increased sharply during any one-year period as in previous expansions, its average yearly rise of 7.8 per cent during the three years ending in the third quarter of 1978 compares very favorably with the three-year experiences of other recoveries.

It had been widely anticipated that some acceleration in the rate of business investment would accompany the economy's approach to full capacity in 1978. Although rates of capacity utilization have risen, the rate of growth of real business fixed investment dropped to 7.3 per cent in the four quarters ending with the third quarter of 1978, compared with about 8 per cent annually over the two previous years.

The rate of growth of business fixed investment has been fairly steady over the course of the current expansion, but the composition of this growth has changed. Growth in real business expenditures on new structures has accelerated, and growth in expenditures on equipment has slowed (Chart 3). Also, the rate of growth of business expenditures during the year ending with the

Chart 3
GROWTH IN REAL BUSINESS INVESTMENT IN PLANT AND EQUIPMENT: 1976:1 TO 1978:3



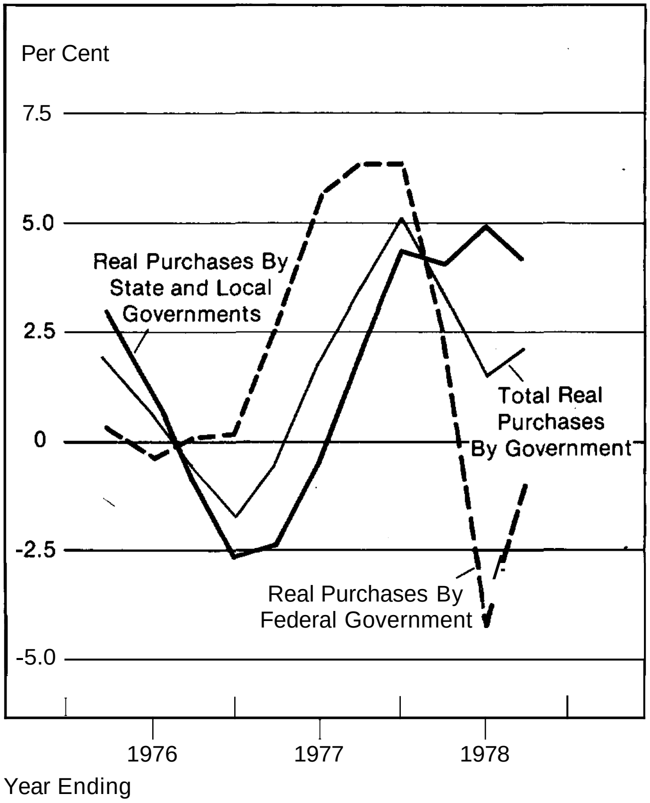
third quarter of 1978 shows a greater decline in manufacturing than in nonmanufacturing. These developments may decrease the chances for improving productivity gains, since gains in productivity are typically greater in the manufacturing sector than in the **nonmanufac-** tunng sector.'

[2]**Productivity** gains in manufacturing have been more than twice those in the rest of the private nonfarm economy since the recession trough early in **1975.** In the decade from the third quarter of **1968** through the third quarter of **1978,** productivity in manufacturing has increased at an average annual rate of 2.4 per cent as compared with a 1.4 per cent average annual increase in the private nonfarm economy as a whole.

Government purchases have grown unevenly since the recession's trough in early 1975. As Chart 4 shows, growth in real purchases by Federal and state and local governments actually declined in 1976 and then grew moderately in 1977. During the first half of 1978, these purchases fell again but then bounced back in the third quarter. As purchasers of goods and services, state and local governments have recently provided more support to the expansion than has the Federal Government, whose stimulus has decreased markedly from 1977 (Chart 4).

The Federal Goverment deficit for calendar

Chart 4
GROWTH IN FEDERAL AND STATE-LOCAL GOVERNMENT EXPENDITURES: 1976:1 TO 1978:3



year **1978** is projected to be about $34 billion, down from **$71** billion in **1975,** $54 billion in **1976,** and **$48** billion in **1977.** State and local governments, as a group, will run a projected **$27** billion surplus **in** calendar year **1978.** The fiscal impact of all levels of government, therefore, is currently approaching a combined government balanced budget. As a result, the budgetary effect of all governments combined has been toward less stimulus as the recovery has matured.

The general level of prices in **1977,** as measured by 'the implicit GNP price' deflator, increased **5.9** per cent over **1976.** During the first three quarters of **1978,** the deflator rose at an annual rate of **8.4** per cent, and is projected to average about **7.5** per cent above the level in **1977.**

Several factors contributed to accelerating inflation in **1978.** In the private business sector, unit labor costs rose **8.8** per cent from the third quarter of **1977** to the third quarter **1978.** This increase compares with **6.5** per cent over the comparable period a year earlier. Some of the acceleration in unit labor costs, which make up about seven-tenths of unit costs, can be attributed to a more rapid rate of increase in compensation per hour, from **8.4** per cent to

9.2 per cent in the periods defined. But most of the acceleration in unit labor costs resulted from a decline in productivity gains, from **1.8** per cent to **0.3** per cent. Finally, unit nonlabor payments (profits, rents, and interest) also accelerated to 5.6 per cent from **4.9** per cent in the same periods.

The increase in compensation per hour for the year ending with the third quarter of **1978** was greater than the rate of inflation over that period. Consequently, real compensation per hour rose 2 per cent. But compensation per hour includes Social Security contributions and the cost of employee benefits, and is calculated before income tax deductions. Once allowance is made for these nonspendable parts of compensation, the purchasing power of take-home pay for the average worker fell over **3** per cent from September **1977** to September **1978.**

BUSINESS OUTLOOK

Prospects for continued economic growth in **1979** were good as of October **1978.** Late that month, the **U.S.** Department of Commerce reported that economic growth had been moderate in the third quarter of **1978,** inflation had slowed, and productivity had registered a sizable gain. Even later in October, the Department of Commerce reported that. the index of leading economic indicators had risen sharply in September after a previous increase in August. The decline in the rate of inflation in the third quarter of **1978** was encouraging, but developments in prices at the producer level threatened an acceleration in prices at the retail level. Specifically, prices of finished goods at wholesale rose at a **10.9** per cent annual rate in September and October. Even more disturbing, prices of goods at intermediate stages of production rose at an annual rate of **12.2** per cent in those two months, and prices of crude materials increased at an annual rate of **31.1** per cent.

Against this background, the Administration announced a domestic anti-inflation program in late October and a program in support of the dollar internationally on November **1.** The anti-inflation program includes elements of fiscal restraint, regulatory reform, and voluntary wage-price restraint in the private sector. As such, it is intended to influence the forces of both cost-push and demand-pull inflation. The dollar defense program, which is discussed later, will also have an impact on domestic growth and inflation. Taken together with recent evidence on the performance of the economy, these policy programs contribute to an outlook for slower total real output growth, but promise little, if any, reduction in the rate of inflation in **1979.**

In assessing the business outlook for **1979,** sources of potential weakness may be found in both the household and business sectors of the economy. In the household sector, moderate income growth and large numbers of families in the prime buying age groups should support continued modest growth in real personal consumption expenditures. But **growth in** personal income and in retail sales have slowed recently, while price rises are again accelerating. These factors, along with the weight of consumer debt, a net increase in tax burden, and the likelihood of a rising personal saving rate, will act to restrain the growth of consumer spending in the period ahead.

Business spending for 'inventories has not been excessive in this expansion, and is not likely to be a problem unless sales decline sharply. Inventory-to-sales ratios are still in relatively good balance, but the output of consumer goods has risen slightly faster than real retail sales in recent months. A continuation of growth in real business fixed investment is expected, but early surveys of spending intentions for **1979** project only a small real increase over 1978. Other leading indicators of capital spending tend to support the implication of the surveys that the contribution of business fixed investment to total output growth will be modest.

Real residential construction spending was virtually flat over the first three quarters of 1978, and there is little reason to believe that housing will make a positive contribution to growth in 1979. While financing for housing has been maintained well, given the high level of market interest rates, such a situation is not likely to continue indefinitely. Housing starts remain at a high level, but they have been edging downward since the end of 1977—as have building permits. Furthermore, recent economic policy moves have led both industry and government forecasters to revise downward their estimates of 1979 housing starts.

Such performance by these major spending sectors—which account for more than three-fourths of total real purchases—suggests output growth below the 3.9 per cent averaged over the first three quarters of 1978. This expected performance presumes both continued relatively low rates of increase in real government purchases and the possibility of a significant increase in net exports. One consequence of total real output growth below the economy's long-run potential—a not unlikely outcome in 1979—will be a rising overall unemployment rate.

The problem of inflation is likely to remain serious in 1979. If the rate of increase in the Consumer Price Index in the fourth quarter of 1978 is the same as in the third quarter, the Bureau of Labor Statistics estimates that the full-year rise for 1978 will be about 9 per cent. Increases in the underlying rate of inflation, as indicated by changes in unit labor costs, show a similar picture. In the private business sector during the first three quarters of 1978, compensation rose about 10 per cent, productivity grew about 0.5 per cent, and unit labor costs increased about 9.5 per cent (all SAAR). The rate of unit labor cost increase declined somewhat following the first quarter, however, and the full-year increase may be around 9 per cent or slightly below. Labor cost increase, and ,hence the basic inflation rate, probably will not improve much in 1979 unless the Administration's incomes policy is very effective. The program's importance is underlined by the significant number of pattern-setting contract negotiations upcoming in 1979, against a background of large CPI increases and with the desire of union bargainers to catch up with past inflation and to keep up with anticipated inflation. At the same time, slower growth in total output should lessen the upward pressure of demand on prices.

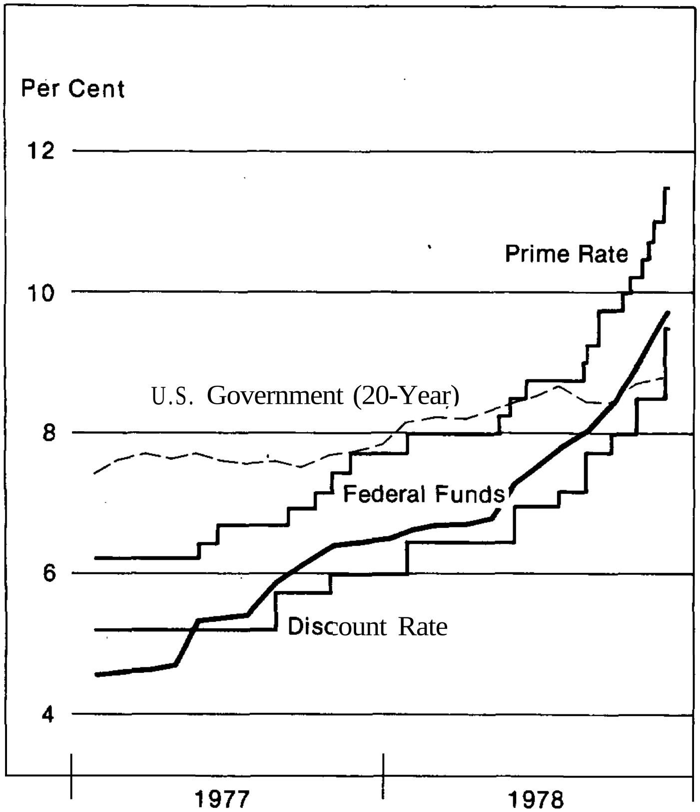
FINANCIAL DEVELOPMENTS AND OUTLOOK

The financial sector of the nation's economy interacts closely with the real sector, as developments in the financial sector affect and are affected by movements in production, employment, and prices. This section analyzes developements in domestic and international financial markets in 1978 and discusses the outlook for these markets in 1979.

Financial Developments in 1978

Interest rates trended upward during 1978, with short-term rates rising substantially more than long-term rates (Chart 5). Short-term interest rates rose in January, remained relatively stable from February through April, and rose from May through November with particularly strong increases in October and early November. Long-term interest rates increased through the first half of the year and reached a temporary peak in mid-July. Following this peak, long-term rates declined somewhat, but then rose above the level of mid-July late in the year. Interest rates, particularly short-term

Chart 5
SELECTED INTEREST RATES, 1977-78



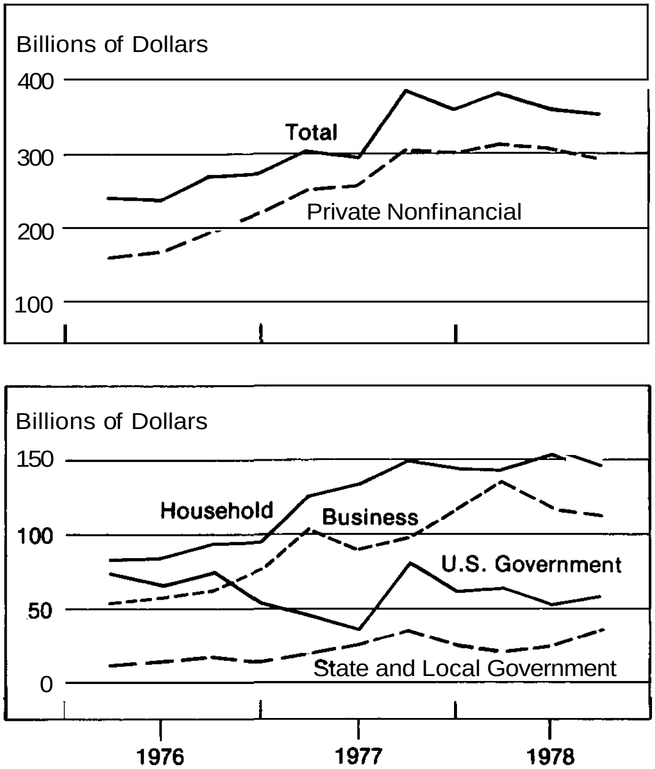
rates, increased sharply in early November in response to the actions taken by the Federal Reserve and the Administration to stabilize the international value of the dollar.

The increase in interest rates in 1978 may be attributed to several interrelated factors. One was continued strength in the demand for funds in credit markets. During the first three quarters of 1978, nonfinancial borrowers—households, nonfinancial businesses, Governments, and foreigners—raised funds at an annual rate of $366 billion, compared with $340 billion in 1977 (Chart 6). However, the rate of growth in borrowing by the nonfinancial sectors of the economy slowed sharply during 1978, as is generally the case during periods of rising interest rates. Borrowing rose 8 per cent in 1978, compared with 29 per cent in the previous year and 32 per cent in 1976.

Federal, state, and local governments have used less credit in 1978 than in 1977 and the growth of business borrowing has diminished also. The major source of lower growth in borrowing, however, has been the household sector, especially for home mortgages.

After two years of very rapid growth, mortgage borrowing declined during the first three quarters of the year to an annual rate of

Chart 6
BORROWING IN CREDIT MARKETS



$91 billion, compared with $93 billion in 1977. Home mortgage borrowing, however, did not decline as sharply in 1978 as in past periods of rising interest rates. Previous reductions in mortgage borrowing have been attributed to increases in the cost of home ownership from higher mortgage and construction interest rates, and from sharply reduced mortgage availability when ceiling rates on deposit liabilities have prevented thrift institutions from competing for funds. In 1978, however, high interest rates had a lesser impact on demand because the high rate of inflation of home prices encouraged borrowers to pay the high interest rates. Moreover, mortgage funds were more available in 1978, in part because money market certificates of deposit allowed thrift institutions to compete more effectively for funds. These certificates carry a maximum interest rate equal to the new 6-month Treasury bill rate when offered by commercial banks and ¼ per cent higher when offered by savings and loan associations (S&L's) and mutual savings banks. Money market CD's have been highly successful in maintaining the flow of funds to thrift institutions, particularly S&L's. A Federal Home Loan Bank Board survey showed that large S&L's were obtaining 7.3 per cent of their deposits from money market CD's at the end of October.

Table 1
MONETARY GROWTH RATES
(Annual Rate in Per Cent)

Year	M1	M2	M3
1975	4.6	8.4	11.1
1976	5.8	10.9	12.8
1977	7.9	9.8	11.7
1978*	8.0	8.2	9.3
1978:Q1	6.2	6.9	7.7
1978:Q2	9.9	7.9	7.8
1978:Q3	7.6	8.9	10.0

*Growth rate for four quarters ending in third quarter of 1978.

Another factor leading to increased interest rates during 1978 was a tendency for the money supply to grow more rapidly than the long-run growth ranges established by the Federal Reserve. Through the first three quarters of 1978, the growth ranges adopted for the major monetary aggregates have been 4 to 6½ per cent for M1, 6½ to 9 per cent for M2, and 7½ to 10 per cent for M3.[3] As seen in Table 1, the growth rate for M1 has exceeded its range in 1978 and growth rates for M2 and M3 have generally been within their ranges. To maintain the growth rates of the aggregates within their ranges the Federal Reserve held back on the flow of reserves to the banking system, which resulted in upward pressure on-market interest rates.

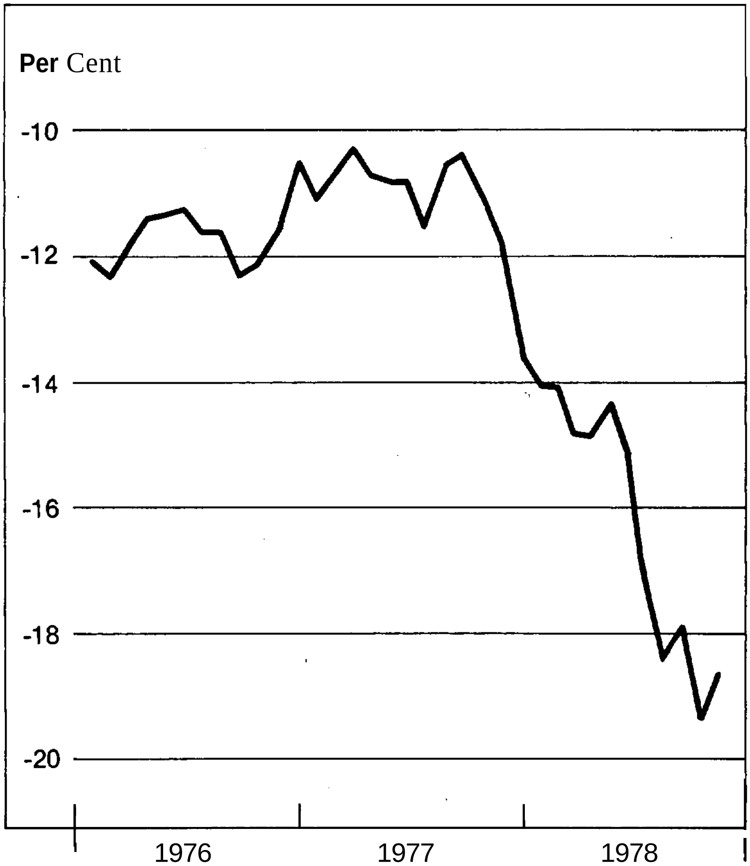
The divergent pattern of M1 and the broader monetary aggregates over the last two years reflects the sensitivity of the growth of time and savings deposits—which are not included in M1—to the differential between deposit rate ceilings and money market interest rates. When market rates greatly exceed ceiling rates, as in 1978, the growth rate of time and savings accounts at commercial banks and nonbank thrift institutions declines. In the third quarter of 1978, however, the growth of M2 and M3 accelerated somewhat at the same time as the growth of M1 was falling. This acceleration was due largely to the introduction of money market CD's. Without these CD's it seems unlikely that the growth rates for these broader aggregates would have increased.

International considerations also affected monetary policy and interest rates in 1978. For example, on August 21, and on November 1, the Federal Reserve increased its discount rate in response to declines of the dollar in foreign exchange markets. The dollar fell relative to other currencies throughout most of 1978, with the decline being particularly pronounced in the latter part of October (Chart 7). By October 31, the dollar had declined 9.3 per cent on a trade-weighted basis from its value at the beginning of the year. Over the same period the dollar had declined 16.4 per cent relative to the German mark, 25.2 per cent relative to the Japanese yen, 24.7 per cent relative to the Swiss franc, and 7.6 per cent relative to the U.K. pound. A 6.6 per cent increase in the value of the U.S. dollar relative to the Canadian dollar was the primary reason for the fact that the dollar declined less on a trade-weighted basis than relative to most other major currencies.

The decline of the dollar was due in large part to continuing international concern with U.S. inflation and the U.S. balance of trade deficit. During the first ten months of 1978, the deficit in the U.S. balance of trade totaled $24.8 billion, up $3.6 billion over the first ten months of 1977. However, the trade balance in the June to October period was slightly improved

[3] 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 7
EFFECTIVE DOLLAR DEVALUATION
(From May 1970)

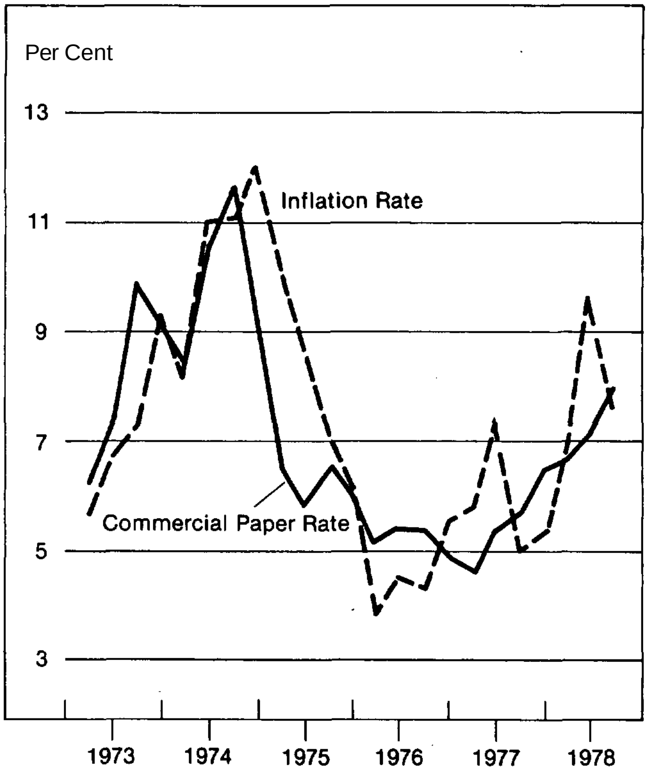


NOTE: The effective devaluation of the dollar measures the percentage depreciation of the dollar, since May of 1970, against a basket of 15 major currencies. This index is calculated using a geometric average, with weights based on each country's percentage share of U.S. exports and imports.

from 1977. The substantial declines in the dollar, the improvements in the balance of trade, and evidence that **U.S.** economic growth was moderating while foreign growth rates were accelerating led to a belief by some that the dollar was undervalued in international currency markets. Nevertheless, the dollar continued to decline through the end of October.

On November 1, the Federal Reserve and the **U.S.** Treasury announced a number of actions designed to strengthen the international value of the dollar. These included an increase in the Federal Reserve discount rate from 8½ to **9½** per cent, an increase of member bank reserve requirements equal to 2 per cent of time deposits in denominations of **$100,000** or more, increased sales of **U.S.** gold, and a variety of

Chart 8
INFLATION AND 3-MONTH COMMERCIAL PAPER RATES



NOTE: The rate of inflation is the quarter to quarter rate of change in the GNP implicit price deflator expressed as an annual rate.

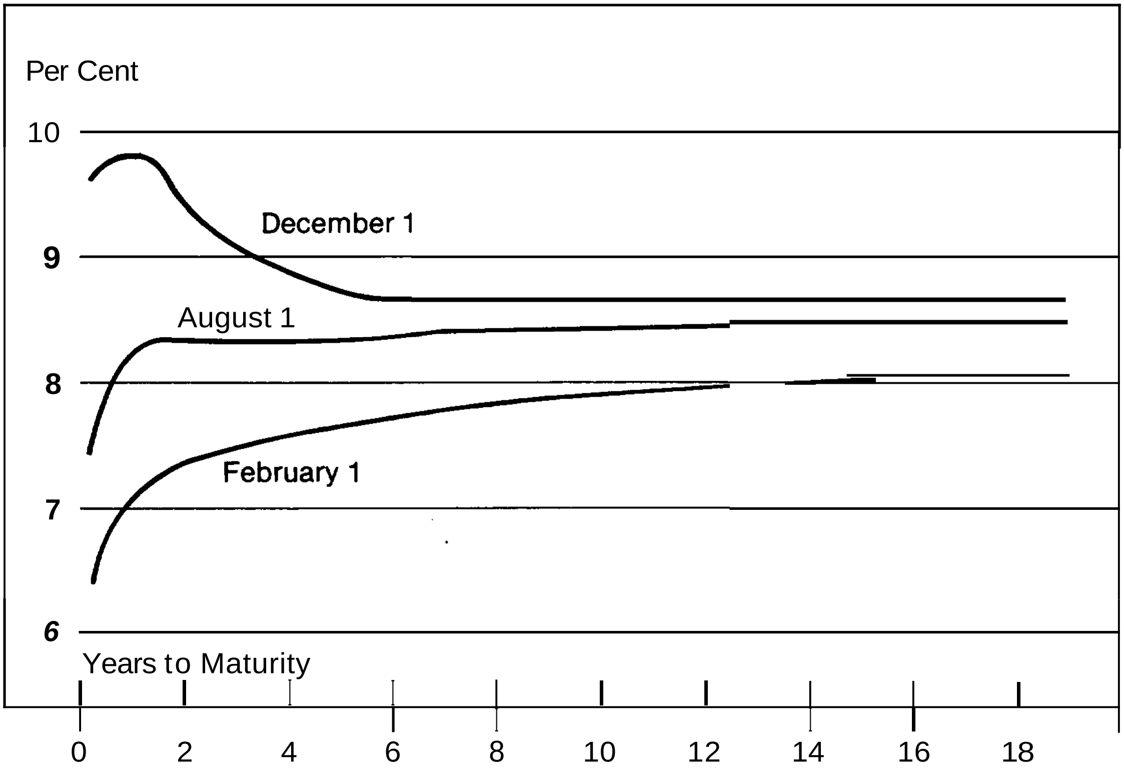
actions to increase the capacity for U.S. intervention in foreign exchange markets.

Another factor contributing to the rise in interest rates in **1978** was an increase in inflationary expectations. When inflationary expectations increase, lenders require higher interest rates to compensate for inflation. As may be seen by Chart **8—which** shows the relationship between inflation and the interest rate on 3-month commercial paper—major movements in interest rates generally parallel the rate of inflation. Between the fourth quarter of **1977** and the third quarter of **1978,** the rate of inflation increased from 5.4 per cent to **7.7** per cent, while the interest rate on 3-month commercial paper was increasing from 6.5 per cent to **8.0** per cent.

Prospective Developments

The financial outlook for **1979** is particularly uncertain. Some factors, such as the maturity structure of interest rates, suggest that a peak in market interest rates may occur in the near future. Chart **9** shows that the yield-to-maturity curve for Government securities is downward

Chart 9
YIELDS ON U.S. GOVERNMENT SECURITIES, 1978



sloping due to short-term rates being higher than long-term rates. A downward sloping yield curve implies that holders of Government securities expect prices of securities to be higher and interest rates on securities to be lower in the future than at present. These expectations of higher prices lead investors to bid for the longer term securities, which places upward pressure on their prices and downward pressure on their yields. Downward sloping yield curves typically exist when interest rates are at cyclical peaks. However, a downward sloping curve does not necessarily imply that a peak is imminent. In previous periods, downward sloping yield curves have sometimes existed for a number of months before the peak in interest rates occurred.

The future course of interest rates depends importantly on the strength of the demand for credit, which depends in turn on the course of the economy. As mentioned earlier, the economy is expected to be growing in **1979** at a slower rate than in **1978.** Under these circumstances, the demand for credit may expand at a pace that will not place heavy pressures on financial markets.

As in **1978,** interest rates will also be affected by the behavior of the monetary aggregates and by the efforts of the Federal Reserve to maintain moderate growth in the aggregates.

The growth rates for the monetary aggregates in 1979 will be affected by a recent innovation—automatictransfer accounts (AT's). AT's, which banks began offering on November 1, 1978, allow funds to be shifted automatically from savings accounts to demand accounts when the balance in a checking account reaches zero or some other preauthorized level. These accounts are expected to lead to a reduction in the growth of M1 during 1979, as some funds will be deposited in savings accounts rather than in demand accounts. For this reason, the Federal Reserve's growth range for M1 for the period from the third quarter of 1978 to the third quarter of 1979 has been set at 2 to 6 per cent compared with the previous range of 4 to 6½ per cent. Ranges for M2 and M3 were left unchanged at 6½ to 9 per cent for M2 and 7½ to 10 per cent for M3. If the growth rates of the monetary aggregates tend to exceed these ranges—as might occur if the economy's growth rate is strong—the Federal Reserve may respond by holding back on the supply of bank reserves, which would tend to place upward pressure on interest rates. If, on the other hand, the growth rates for the monetary aggregates are slower than the ranges, as would be likely to occur if the economy is weak, the Federal Reserve may respond by increasing the supply of bank reserves, placing downward pressure on interest rates.

The performance of the dollar on exchange markets is another factor that will affect monetary policy and interest rates in 1979. The decisive action taken by the Federal Reserve and the Treasury on November 1 has reversed the downward trend of the dollar in international markets. Whether the gains will be maintained will depend importantly on the rate of inflation in the United States in 1979. In addition, the rate of growth of the economies of our trading partners and the price of OPEC oil will have a major impact on the dollar's future value.

Besides affecting the dollar's value, developments with regard to inflation will have a direct impact on interest rates in 1979. A reduction in the rate of inflation would, if maintained for an extended period, tend to reduce inflationary expectations and thus would tend to put downward pressure on interest rates. On the other hand, a stable financial environment will be extremely difficult to achieve if the rate of inflation continues to accelerate.

CONCLUSIONS

The first three quarters of 1978 were characterized by moderate economic growth, by serious ,inflation, and by rising interest rates. The latter two elements in the economic picture have led some analysts to fear that a recession may occur in 1979. This article suggests, however, that the dynamics of the business cycle expansion itself, in conjunction with economic policy already in place, are more likely only to reduce the rate of real output growth further in 1979. The reduction in growth below the economy's long-run potential growth rate is likely to be associated with a rise in the unemployment rate and only slight reduction in the rate of inflation in 1979.

The prospective reduction in the economic growth rate in 1979 will tend to remove some of the pressures on interest rates and financial markets. Moreover, any reduction in the rate of inflation, even though slight, will work in the same direction. Thus, financial markets in the coming year may exhibit a degree of stability not shown over the past year. If so, the stability will contribute to the expected continued moderate growth in the overall economy.