Outlook 1977 — A Tenuous Balance

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Any attempt to forecast economic **and financial** conditions necessarily involves an exercise in judgment. In this regard, charting the probable course of developments for the U. S. economy in **1977** is subject to more than the usual vagaries of chance. For as **1976** draws to a close, the economic horizon appears clouded not only in terms of doubt as to where the economy might be going in the period ahead, but also as a consequence of the divergent views of precisely where it is at the present time. In part, these differing views as to the current state of well-being of the economy may reflect little more than the resultant of the torrent of rhetoric regarding the economy which is normally served up in an election year.

At the same time, though many of the signals from the economy at yearend were clearly indicative of softness, other indicators were amenable to a different interpretation, thus injecting a measure of ambiguity into economic prognosticating. Similarly, the behavior of the various price indexes suggested for some observers reassurance of ongoing progress in the fight against inflation, while for others the problem of accelerating inflation was again seen as a clear and present danger. Additionally, many viewers of the nation's financial scene found themselves, at yearend, attempting to explain the somewhat surprising stability that had characterized the money and capital markets throughout much of the year. Thus, even while acknowledging the considerable distance the economy had traveled since bottoming out in the spring of **1975,** the protracted so-called "pause" in the economy has served to intensify the degree of **uneasiness** on the part of the skeptics as well as to inject a note of caution into some of the more optimistic assessments of business and financial developments in the year ahead.

BUSINESS DEVELOPMENTS AND THE OUTLOOK

For those inclined to seek out favorable indicators of economic performance in **1976,** a number of measures were readily available. As the economy registered its sixth consecutive quarter of advance from the cyclical trough, total employment was well above its pre-recession peak level. The Index of Industrial Production in October **1976** was less than a percentage point away from its all-time peak of June **1974.** Real gross national product **(GNP)** moved beyond its pre-recession peak and, in the process, transformed the recovery phase of the current cyclical upswing into the growth phase. Real final sales (GNP less the change in business inventories) increased from the first quarter of the year to the third quarter, albeit, at moderate rates. In September, housing starts which had languished throughout much of the year rose sharply. A slight decline in October failed to offset the previous month's gain, and left housing starts **25** per cent above the same month a year ago. Orders for machine tools exhibited ongoing strength, as did nondefense orders for capital goods. Both the Consumer Price Index **(CPI)** and the implicit price deflator — a GNP measure of broad price changes — reflected further slowing down in the rate of price inflation from the second to the third quarter, a slowing down which was reflected in the nation's money and capital markets as well. Thus, there appeared to be little doubt about which way the economy was moving. But, as the year progressed, and, even in the face of some of the more late blooming signs of economic strength, concern was mounting as the moderation in the economy of late spring and summer was extended into early fall with signs of becoming increasingly pervasive.

Real growth in the economy as measured by GNP was at an annual rate of 9.2 per cent in the first quarter. It was sharply reduced to 4.5 per cent in the second quarter and rose by only 3.8 per cent in the July-September period. Viewed from this perspective, the so-called "pause" in the economy does not really represent a stopping of the economy's forward movement, but rather a slowing down in the rate of growth. Given the very rapid growth experienced earlier in the year, some slowing down should have been both expected and welcomed. However, an examination of the nature of the slowing down, and additional indications of more recent economic developments do raise questions as to future activity levels in the economy and the prospects for a rate of growth satisfactory to make further substantial inroads into the current high degree of unused resources.

The rapid **GNP** growth which occurred in the first quarter was largely the consequence of strong consumer spending for durable goods—mostly autos--combined with a sharp reversal in inventory investment by businessmen. The failure of inventory spending to do much since the large gains early in the year affected the development of final sales, as was noted earlier. However, the final sales developments, which appeared to some to be a positive economic sign, were not actively aided by significant growth in consumption. For, in fact, consumer spending for durables grew at an annual rate of $2.6 billion in the third quarter, down from $3.6 billion in the second quarter, and down dramatically from $9.6 billion in the first quarter. In addition, retail sales in October were only slightly above the September level, and were essentially unchanged from levels reached last June.

The reasons for this weakness are not too hard to discern. Growth in personal incomes has slowed measurably since the end of 1975. In the fourth quarter of 1975, the annual rate of increase was 10.8 per cent; and the rate fell from 9.7 per cent in the first quarter of 1976, to 9.2 per cent in the second quarter, and to little more than 7 per cent in the third quarter. Not only did the rate of gain in nominal income diminish, but workers' real purchasing power fell by 0.4 per cent in the 12 months since October 1975.[1] In 5 of the past 8 months through October, the Bureau of Labor Statistics reports that real buying power has declined. With nominal income gains slowing and with actual purchasing power reduced, it is no small wonder that consumers have shown increasing reticence to come to the marketplace in large numbers. In this connection, another point bears mentioning. As a consequence of slower income growth, the gains in consumer spending which did occur were made possible largely through reduced saving. In the four quarters through the second quarter of 1976 the saving rate averaged about 7.2 per cent. In the third quarter, that rate fell to 6.4 per cent, or lower than it has been since 1972. It is currently about three-fourths of one percentage point below the average annual saving rate which has prevailed since 1967. Thus, it would appear that, in the absence of a quickening in the growth of income, the prospects for marked increases in consumer spending are questionable.

The more recent reduced rate of growth in personal income is traceable to the reduced

[1] Workers' purchasing power refers to the buying power of production and nonsupervisory workers with families as represented by after-tax real earnings—weekly pay less Federal income tax withholdings and Social Security taxes, adjusted for changes in the CPI.

vigor in the economy with its attendant consequences on both production and employment gains. In both September and October, industrial production declined, partly reflecting the earlier auto strike at Ford Motor Company. But production gains had been moderating throughout much of the year, and this moderation was ultimately reflected in the labor market. Early in the year, employment gains had been substantial, and the unemployment rate had been declining. Beginning in June, the unemployment situation began to deteriorate, and since July, employment gains have been minimal, with actual declines in both September and October. Additionally, average weekly hours have fallen, in part contributing to the reduction in buying power alluded to earlier. With production, employment, and income growth moderating, the overall negative consequences on the performance of consumers has done little to make inroads into reducing the amount of unutilized capacity in the economy. In the July-September period, the rate of manufacturing capacity utilization as reported by the Federal Reserve Board had edged up only slightly to **80.9** per cent from **80.2** per cent in the preceding quarter. Given the uncertainty engendered by the lengthy pause, and the persistence of idle capacity, actual expenditures on new plant and equipment have been held to levels below those which might have been anticipated on the basis of earlier capital spending surveys for **1976.** Thus, an element of potential strength which was expected to play a stronger role in sustaining the current upswing has been disappointingly weak. After three consecutive monthly declines in the new factory orders through September, orders rose in October. However, excluding a very sharp increase in orders for defense capital goods, the overall rise was quite modest, suggesting that the current sluggishness in the industrial sector may persist for some time yet. Combined with softness on the consumer side as well, the potential for expansion in capital outlays may remain in abeyance for a while longer.

The lack of real vigor in much of the private sector was also evident in the public sector of the economy. Federal government purchases of goods and services, after declining slightly in the first quarter of **1976,** did rise somewhat in both the second and third quarters of the year. However, Federal outlays were substantially below their earlier budgeted levels. Indeed, even if one includes the state and local sectors, the growth of government spending has been sharply slowed in the economy this year. For example, in **1975,** government outlays rose by **12** per cent. However, in the first 9 months of **1976,** government spending was up at an annual rate of only about **6** per cent. This drop in the rate of spending clearly exacerbated the slowing of the growth of national output in recent quarters. The slower growth in Federal outlays was, in part, traceable to a shortfall in spending below projected levels, as shown by data jointly reported by the Treasury and the Office of Management and Budget. Actual Federal outlays in fiscal **1976** were nearly **$8** billion less than earlier estimates and **$3.5** billion less in the transition quarter—the third calendar quarter—than previously estimated.

Another troublesome area for the economy was the foreign sector. In the third quarter, net exports of goods and services fell by nearly **$6.0** billion to an annual rate of $3.4 billion. This drop from the preceding quarter was wholly traceable to a sharp rise in imports of petroleum products, as exports remained at the level of the earlier quarter. And finally, to add to the picture of an economy confronted by uncertainties, the index of industrial commodities prices at wholesale rose in October by a full percentage point, or at a **12** per cent annual rate. This marked the fifth consecutive month in which this component of the Wholesale Price Index (WPI) had risen by relatively large amounts and was in marked contrast, as noted earlier, to the' generally declining trend of price increases exhibited by the CPI during roughly the same period.

Looking ahead to 1977, the outlook is far from certain. The likelihood that the economy might move from its current growth plateau onto a higher growth path is not overly strong. For this to occur, some evidence of ,increased strength from the consumer sector must appear. Perhaps the degree of enthusiasm with which the 1977 auto models are greeted by the buying public will provide a clue as to whether consumer confidence is on the rise and will manifest itself as a more positive factor in the months ahead. However, the early indications, while not conclusive, are not very encouraging, and the obstacles to be overcome, as noted earlier, remain formidable. The average price of a 1977 auto-over $6,000—represents yet another hurdle.

Similarly, the potential for significant further improvement in the homebuilding sector in 1977 would seem to rest with the multi-family component, rather than in single-family dwellings. Despite the rise in single-family starts in September and October, which carried them to their highest rate in nearly 4 years, the median price of a new single-family dwelling—now in excess of $45,000—along with mortgage rates which remain high by historical standards, would appear to impede any major stimulus to the economy from this sector. The potential for strength may appear better in the multi-family sector, as vacancy rates are historically quite low. Yet concern over the overall profitability of rental and condominium units continues to restrain investment in this sector. Nevertheless, given the fact that starts are running at approximately one-third of their earlier peak rates, the potential for growth certainly exists. It should be noted that any increased activity in homebuilding would tend to reinforce consumption spending through increased purchases of furniture and appliances.

As noted earlier, since the spurt in inventory investment early this year, businessmen have pursued a cautiously conservative policy. One consequence of this is that the ratio of business inventories to sales is quite low. This suggests that any evidence of strengthened economic activity would likely prompt a somewhat more expansive role for inventory investment than in recent quarters. Should this occur, the pace of production and employment gains would firm up as well. The recent McGraw-Hill survey of plant and equipment spending plans for 1977 indicates that dollar outlays are expected to rise 13 per cent over 1976 levels, or 6 per cent in real terms after allowing for expected cost increases for new facilities and equipment. Given the shortfall in these outlays which has already occurred this year, the 1977 survey results are not unusually strong. In any event, their realization is contingent upon sizable reductions in the large amount of idle capacity presently available and some resolution of the uncertainty on the part of businessmen. This, in turn, will depend upon the degree of strength evidenced in the months ahead in the other key sectors of the private economy alluded to earlier. Thus, for the economy in 1977 to shift toward a higher rate of growth will depend upon a number of crucial pieces, of a self-reinforcing nature, falling neatly into place. Unfortunately, at this writing, there is no high degree of assurance that this will, in fact, occur in 1977.

Indeed, there would appear to be an equal likelihood that the economy may simply continue on a growth path that would imply a protracted period of significant underutilization of its capital and labor resources. In this regard, the prospective role of fiscal policy in 1977 does not appreciably alter this likelihood. The second joint congressional budget resolution for fiscal 1977 significantly increased the level of grants-in-aid to state and local governments from $58.7 billion in fiscal year 1976 to $71 billion in 1977. Thus, real growth in state and local government spending in 1977 should rise about 5 per cent. Despite this, overall Federal budgetary projections for the current fiscal year suggest little, if any, net contribution toward stimulus is to be expected from fiscal policy currently in place. Should it be found desirable to inject a measure of fiscal stimulus into the economy, quick action may be impeded somewhat. For, given the new budgetary procedures in effect, any tax or spending changes in the **1977** budget would require the convening of the congressional budget committees of both houses in order to come up with a new joint resolution approving the size of the new taxing and spending totals—a time-consuming procedure. Thus, the ability of the Chief Executive to quickly bring about either a tax cut and/or an increase in spending to stimulate the economy has been impaired. To this should be added the depressant effects both here and abroad of the rising costs of energy, at a time when already sluggish growth is common not only to a number of the more industrialized economies, but also to less-developed countries.

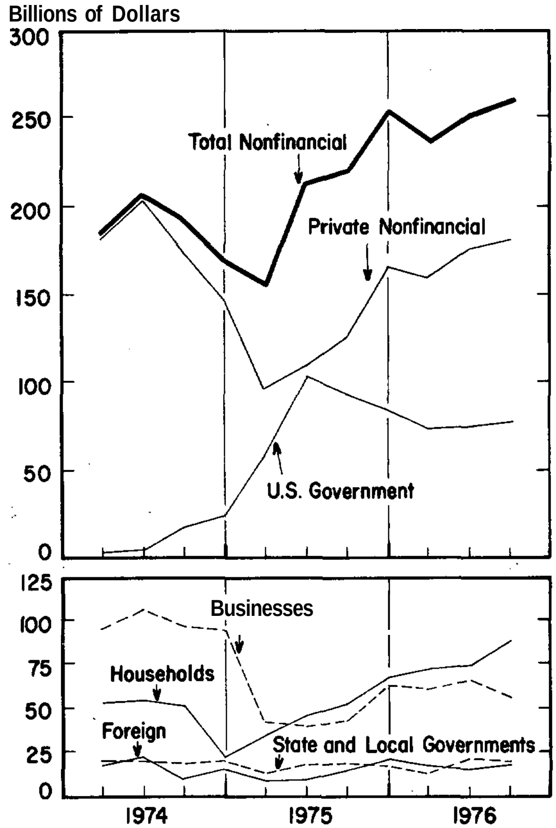
This view of the real economy and its prospects in the forthcoming year suggests a higher than usual degree of uncertainty. However, any view of the outlook is incomplete in the absence of a careful consideration of the financial factors that may affect the period ahead. For the outlook for the economy must allow for the interaction between both financial and economic developments. .

FINANCIAL DEVELOPMENTS AND IMPLICATIONS

Financial conditions in the coming period will be importantly influenced by the demand for credit to help finance prospective outlays for goods and services. Also, the supply of funds available to satisfy credit needs will play a significant role in determining future developments. Recent and prospective credit demand and supply conditions are treated in the following pages.

As would be expected in a period of generally rising economic activity, the demand for funds in the nation's credit markets was quite strong in **1976.** (See Chart **1.**) In the first three quarters of the year, nonfinancial **borrowers—**

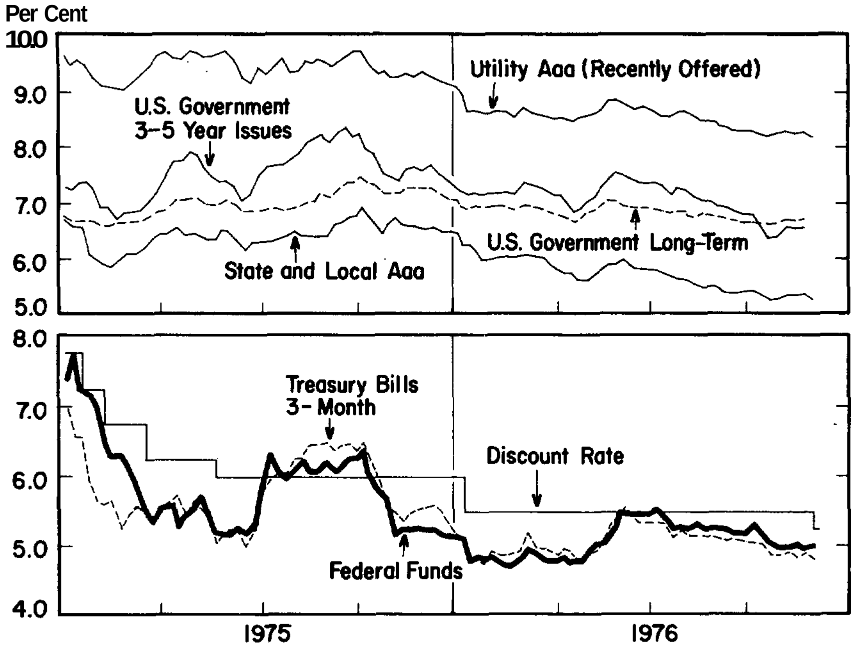
Chart 1
BORROWING IN CREDIT MARKETS
1974-76



governments, nonfinancial businesses, households, and foreigners—raised funds at an annual rate of **$248** billion--compared with **$210** billion in **1975,** which was a record yearly high. Moreover, borrowing levels have been high relative to economic activity as well as in dollar volume. In the first three quarters of **1976,** borrowings amounted to **14.8** per cent of GNP, a larger percentage than in the year **1975** and about the same as the record yearly high set in **1972.**

Recent high borrowing levels reflect to an important extent borrowing by the U. S. Treasury to finance the Federal government's budgetary deficit. Credit market borrowing by the private sector has been only moderately

Chart 2
SELECTED INTEREST WAVES, 1975-76



large. Thus, private sector borrowing at an annual rate of **$172** billion during the January-September period amounted to **11.2** per cent of private **GNP**,[2] higher than **1975** but noticeably less than in most recent years.

Among private sectors, households have raised the most funds. To help finance home purchases and outlays for durable goods, households borrowed at an annual rate of **$78** billion in the first three quarters of the year, compared with $50 billion in **1975.** Reflecting modest capital outlays, as noted earlier, and an ample flow of internal funds, business borrowing has been more moderate than households, and concentrated in long-term markets. In total, businesses raised funds at an annual rate of **$61** billion in the first **9** months of **1976,** compared with **$48** billion in **1975.** In addition, state and local governments have been important borrowers in **1976.**

[2] **GNP** minus Federal government purchases of goods and services.

The heavy borrowing of recent quarters has taken place in an atmosphere of stable financial markets. Short-term interest rates moved within a fairly narrow band throughout **1976.** (See Chart **2.)** For example, on a weekly average basis the Federal funds rate moved between a low of **4.70** per cent established in mid-February and a high of **5.58** per cent set in early July. Since July, the funds rate has drifted down and at the time of this writing was around **4.75** per cent. Long-term interest rates were on a declining trend throughout most of the year. To illustrate, 'yields on recently offered Aaa utility issues declined from around **9** per cent at the beginning of the year to around **8** per cent at the end of November.

Monetary policy has made an important contribution to the financial stability of the past year or so. In seeking to promote economic recovery and growth, the Federal Reserve System has fostered growth in money at fairly rapid rates compared to historical experience.

Table 1
GROWTH RATES OF SELECTED MONETARY AGGREGATES
(Seasonally Adjusted Annual Rates)

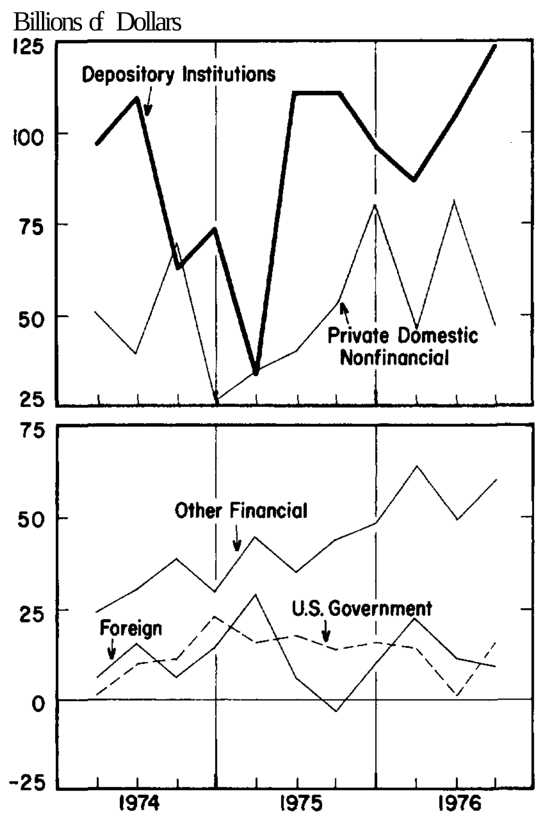
	M1	M2	M3
1975 Q4	2.3	6.4	9.4
1976 Q1	2.7	9.7	11.2
1976 Q2	8.4	10.8	12.0
1976 Q3	4.1	9.2	11.6
1976 August	5.9	9.2	12.7
1976 September	− 0.4	9.5	13.1
1976 October	13.7	15.7	16.4
1975 Q3 to 1976 Q3	4.4	9.3	11.5

The Federal Reserve's policy with regard to money growth is reflected in the targeted growth rate ranges for the monetary aggregates that the System adopts. For example, for the target period from the third quarter of 1975 to the third quarter of 1976, the Federal Reserve's targeted range for M1, the narrowly defined money supply, was 5 to 7.5 per cent. M2's targeted range was 7.5 to 10.5 per cent, and M3's range was 9 to 12 per cent.[3]

In general, money supply measures increased during the year ending in the third quarter of 1976 at rates consistent with growth rate ranges adopted by the Federal Reserve. M1 is to some extent an exception in that its growth rate was 4.4 per cent, somewhat below the targeted range. (See Table 1.) However, both M2 and M3 rose at rates in the upper part of their target ranges. M2 increased 9.3 per cent and M3 rose 11.5 per cent.

Growth in the monetary aggregates has allowed the nation's private depository institutions to supply large amounts of funds to credit markets during the past few quarters. Credit market lending by the nation's banks and savings institutions-savings and loan associations, mutual savings banks, and credit unions—increased very sharply in the second quarter of 1975 and remained at high levels throughout the latter part of 1975 and in the first three quarters of 1976. (See Chart 3.) These consistently large lending volumes contributed significantly to stability in credit markets. Even so, funds supplied by the nation's depository institutions have not been

Chart 3
LENDING IN CREDIT MARKETS, 1974-76



[3] M1 is defined as demand deposits of commercial banks other than domestic interbank and U. S. Government, less cash items in 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 savings deposits, time deposits open account, and time certificates of deposit other than negotiable CD's of $100,000 of large weekly reporting banks. M3 is M2 plus the average of the beginning and end-of-month deposits of mutual savings banks, savings and loan shares, and credit union shares (nonbank thrift).

unusually large relative to total demand. During the three quarters ending in the third quarter of **1976,** depository institutions supplied 43 per cent of total funds raised in credit markets, about the same as in **1975** but below the average of recent years.

Willingness of private nonfinancial investors to supply funds directly to credit markets also has contributed to recent financial stability. Direct lending by households, businesses, and state and local governments has been at record levels during the first three quarters of **1976,** amounting to **$58** billion, or about 24 per cent of total demand. Heavy lending by private investors is somewhat unusual during a period of stable or declining interest rates. Typically, rising interest rates are required to induce nonfinancial investors to acquire direct investments in volumes of the magnitude that has occurred in recent quarters.

Several factors have encouraged direct investment by nonfinancial investors. An important factor has been the decline in the rate of inflation which encouraged investors to undertake long-term commitments even though nominal yields were lower than previously. For example, in recent quarters, the household sector (households, personal trusts, and nonprofit organizations) has acquired large volumes of corporate bonds, state and local government bonds,' and mortgages.

An additional factor contributing to direct credit market lending in **1976** has been efforts by business firms to restructure their balance sheets and to rebuild liquidity positions. In the process of restructuring balance sheets, businesses, especially corporations, borrowed very heavily in long-term credit markets. Corporations raised $42 billion in these markets in the January-September period, which accounted for almost **17** per cent of total borrowing by all nonfinancial sectors. Due to rising profits and modest capital outlays, businesses were able to use a portion of these borrowed funds to improve their liquidity positions by repaying bank loans. In addition, corporations acquired large volumes of liquid assets, mainly U. S. Government securities. In the process, they supplied funds directly to credit markets. During the first three quarters of **1976,** for example, direct corporate lending totaled $14.5 billion—about one-third of the amount corporations borrowed in long-term markets. Thus, a significant portion of the pressure on financial markets that resulted from long-term corporate borrowing was alleviated by direct corporate lending.

Another important factor that encouraged direct lending by nonbank investors was the availability of large volumes of high quality U.S. Government securities. The role these securities played in liquidity rebuilding by corporations was mentioned earlier. In addition to businesses, other nonfinancial investors, such as state and local governments, acquired large amounts of U. S. Government securities. Thus, during the January-September **1976** period, private (non-Federal) domestic **nonfi**nancial investors supplied funds to the **U.S.** Government at an annual rate of **$29** billion—about 34 per cent of the total funds raised by the Treasury.

In **1977,** the demand for funds in the nation's credit markets will reflect economic events as they unfold. Smaller budget deficits may be expected to reduce the demand for funds by the U. S. Treasury. The extent to which such a decline may be offset by increases in private borrowings will depend on the actual strength of the economy. While a greater demand for funds will place upward pressure on interest rates, their behavior will depend on the supply of funds as well as the magnitude of the rise in the demand.

As noted earlier, one sector that is a potential source of increased borrowing in **1977** is the residential mortgage market, especially the multi-family sector. In line with the **uptrend** in housing starts and residential construction expenditures, home mortgage borrowing has been large in recent quarters. However, total residential mortgage borrowing has been held down somewhat by weakness in the multi-family sector. Thus, if privately financed multi-family housing starts strengthen, and if single-family starts continue at current high levels, borrowing in the residential mortgage market might increase substantially.

Nonmortgage household borrowing is another area of potential increase in the demand for credit market funds in **1977.** In helping finance their consumption spending, households borrowed fairly heavily in **1976.** However, compared to the level of consumer outlays, these borrowings were considerably lower than in earlier years. Thus, there is some leeway for increases in consumer instalment credit and other household borrowing. These increases could be substantial if consumer outlays for durable goods move up sharply in **1977.**

The potential for sizable borrowing by businesses in **1977** does exist. Business borrowing was moderate in **1976** as internal funds were ample and businesses did not undertake large capital outlays, nor did they accelerate their rate of investment in inventories since **early** in the year. The flow of internal funds is likely to continue to be adequate to permit businesses to increase their capital outlays somewhat without undertaking large increases in credit market borrowing. However, a combination of large gains in plant and equipment expenditures, along with more aggressive inventory rebuilding programs could lead to noticeable increases in the business demand for credit market funds.

It must be noted that much of this discussion regarding the demand for funds in **1977** is predicated upon the potential for strength which exists in the economy. However, as was noted earlier, for this potential to be realized—for the economy to move to a higher growth path—it would be necessary for a number of crucial pieces of a self-reinforcing nature to fall neatly into place. And, given the obstacles discussed, such an eventuality is not assured at this writing. In the event that the economy continues on its current growth path, the demand for funds would not likely increase much, and may even decline somewhat.

With regard to the supply of funds, their availability will depend, to some extent, on the course of monetary policy. In this connection, the long-run growth rate ranges announced by Federal Reserve Chairman Burns for the period from the third quarter of **1976** to the third quarter of **1977—for M1, 4.5** to **6.5** per cent; for M2, **7.5** to 10 per cent; and for M3, **9** to **11.5** per cent—will permit the nation's private depository institutions to continue to supply ample volumes of funds to credit market borrowers.

As in **1976,** an important determinant of the overall availability of funds to credit markets in **1977** will be the willingness of private nonfinancial investors to supply funds by acquiring credit market instruments. This will depend importantly on the outlook for inflation. If investors feel that continued progress is being made in reducing the rate of inflation, they will be encouraged to make commitments in credit markets. This would enlarge the supply of funds and tend to foster a financial environment characterized by relatively stable interest rates. Under these conditions, interest rate stability would be especially likely to prevail in **1977** in the absence of substantial increases in demand for credit market funds. Moreover, even if demand should rise markedly, expectations of a further reduction in the rate of inflation would encourage a continuation of financial market stability. On the other hand, a marked increase in inflationary psychology would place interest rates under strong upward pressures. In this case, any rise in the demand for credit would likely result in upward movements in interest rates. Such a development could destroy the stable financial environment that is needed for continued economic growth. In this connection, it is understandable that many observers have expressed concern over some signs of heightened inflationary pressures, directed most recently at the behavior of industrial prices at wholesale.

SOME CONCLUDING OBSERVATIONS

For the past 5 months, the industrial commodities component of the WPI has risen at relatively high and accelerating rates. In October, the rise was a full 1 per cent, or at an annual rate of 12 per cent, thus heightening fears of a renewed round of stepped-up inflation. However, these developments were at variance with the decelerating trends in price increases in both the CPI and the GNP implicit price deflator, and they appear to be equally at odds with the tone of aggregate demand conditions which have been prevailing in the economy during that same period. In part, this may be due to the fact that the WPI reflects list or quoted prices, rather than actual transaction prices as in the case of the CPI. Thus, the behavior of the WPI raises some questions as to its reliability at this time as a measure of underlying inflationary trends. This point has been acknowledged by the Government's Council on Wage and Price Stability. On the wage front, the rate of increase in unit labor costs has been moderating throughout the year as a result of somewhat lower increases in wages and increased productivity occasioned by gains in output. In fact, major collective bargaining agreements in the first 9 months of 1976 carried lower labor cost increases than those of the same period a year earlier.

This is not to say that concern over inflation and efforts to reduce it further are misplaced. Nor should it in any way cause people to fail to recognize the significant progress that has been made in moderating the rate of inflation. And where needed, such efforts should be pursued. On the other hand, neither monetary nor fiscal policies are completely suitable tools for dealing with price increases which may be largely unrelated to underlying excess demand conditions. To the extent that rising prices stem from such outside sources as OPEC, or from a fear on the part of businessmen that price controls may be in the offing, or where they arise in market circumstances where structural problems impede the competitive process, it might prove very costly, in an environment of economic slack, to combat those sources of inflation with policy tools which restrict aggregate demand in the overall economy.

The levels of unused capacity and unemployment that have persisted well into the recovery and growth period suggest that the economy does need to grow more vigorously than in recent quarters. Indeed, one of the tangible benefits of such growth would be the increased output and productivity gains that would help to dampen the inflationary impact of expected wage increases. Yet, as noted in the preceding analysis, such growth is not assured. The economy is in a tenuous state of balance. Thus, public policies must be especially sensitive to the numerous and sometimes contradictory signals given off by the economy. In particular, attention should be given to signs of further economic weakness even as public policies continue their pursuit of the restoration of price stability. At the same time, both the restoration of price stability and the prospects for improved economic growth would be enhanced by public policies that aggressively address themselves to the economy's ongoing structural problems.