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 intlationary 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 pos'twar 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.' 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

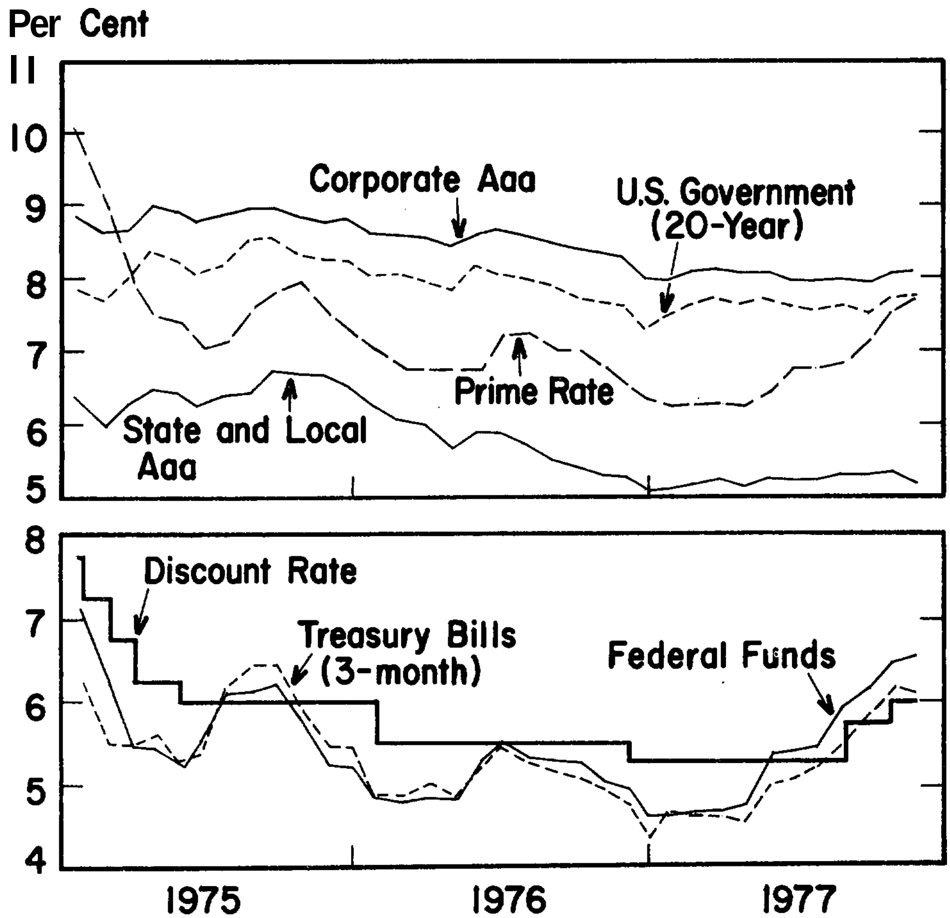
Short-term interest rates were stable in the first part of **1977,** but have risen fairly rapidly since the end of April. (See Chart **1.)** For example, the interest rate on 3-month U.S. Treasury bills averaged 4.54 per cent in April, but rose to **6.10** per cent in November. Long-term rates, on the 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,**

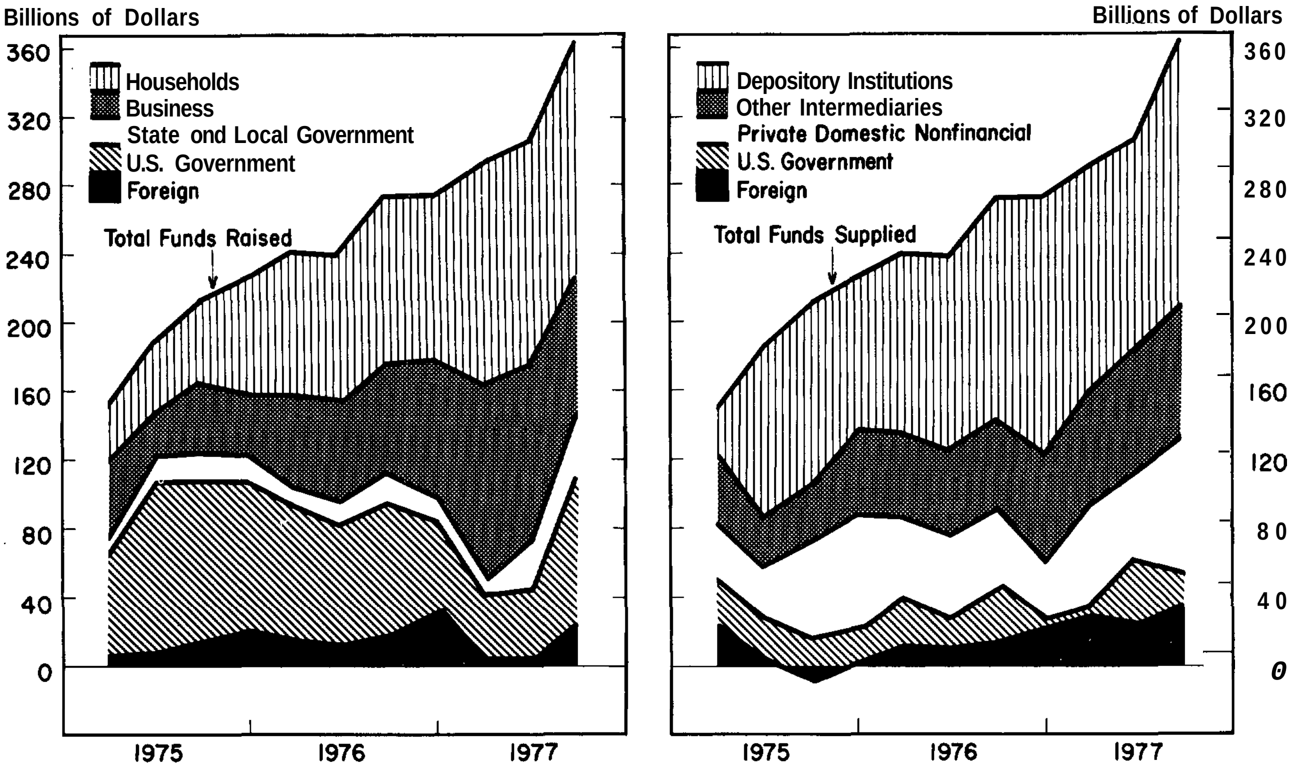
Chart 1
SELECTED INTEREST RATES, 1975-77



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

Chart 2
BORROWING AND LENDING IN CREDIT MARKETS
(Seasonally Adjusted Annual Rates)

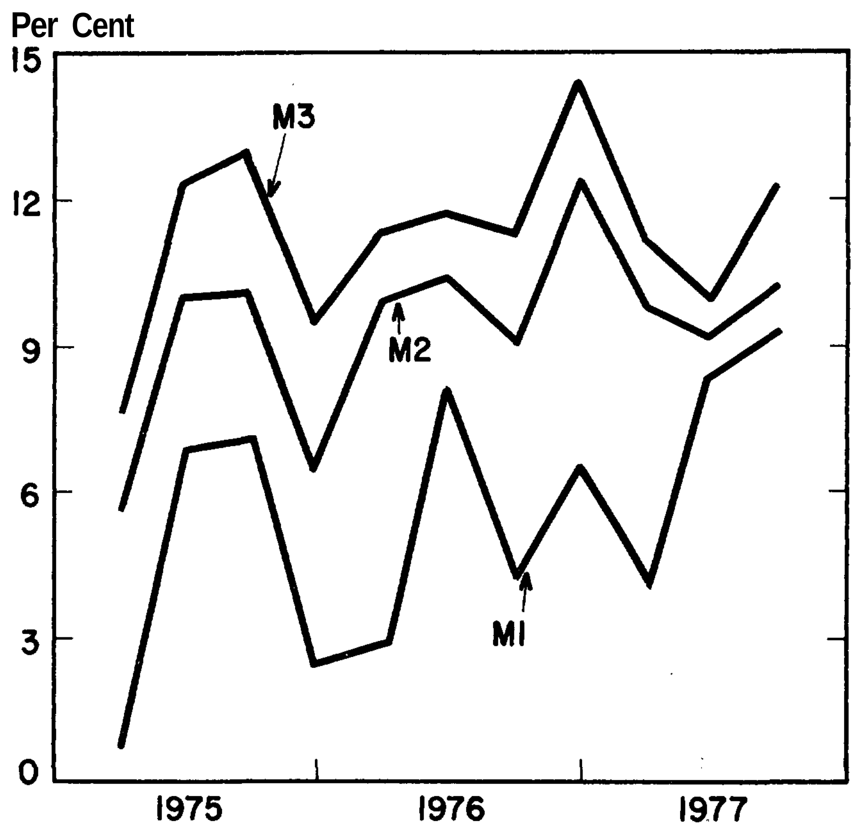


were able to sharply expand their lending in 1977 because their deposits rose rapidly, reflecting rapid growth in the money stock measures.[5] During the year ending in the third quarter of 1977, M1, the narrowly defined money stock, grew at a 7.3 per cent rate, M2 increased at a 10.9 per cent rate, 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.

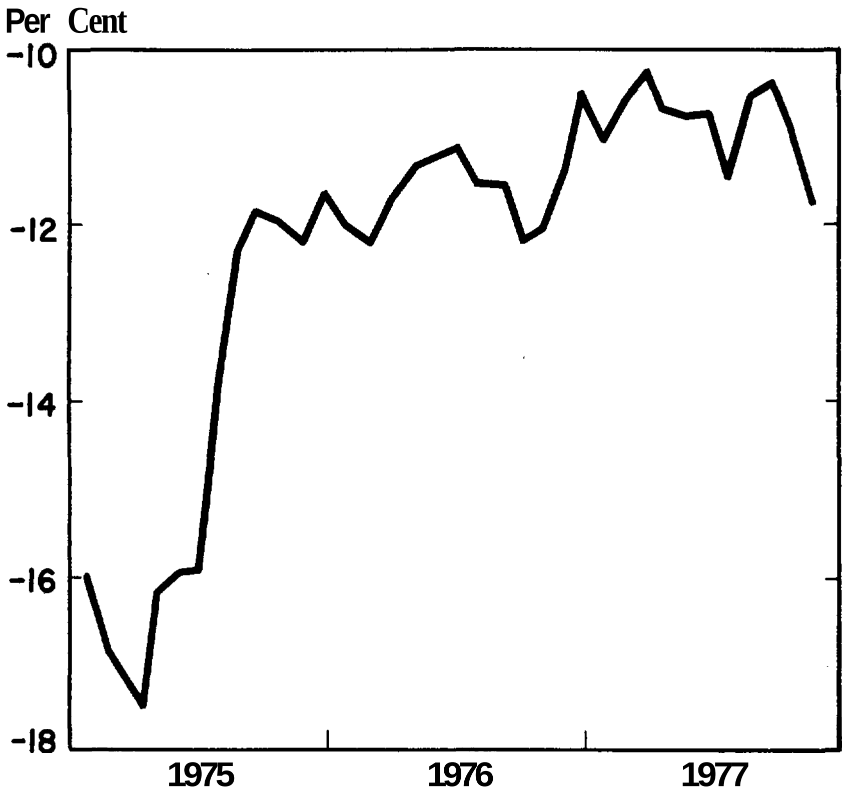
Another major source of funds to financial markets in 1978 will be saving by the private sector with the amount of saving determined primarily by the level of income in the economy. Since it is generally believed that income growth will be somewhat less in 1978 than in 1977, the supply of new funds from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