Economic Developments in 1978

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AT the beginning of 1978, Administration policymakers, focusing upon the prospect of a slower rate of economic growth for the upcoming year, proposed several steps which they hoped would insure that the economy's growth would continue at a satisfactory rate.[1] Income tax cuts, designed to take effect toward the end of the year, were proposed to offset the dampening effect of increased social security taxes and the inflation-induced higher income taxes. Economic growth of 4.5 to 5 percent was forecast for 1978 on the assumption that these tax cuts would be approved. With the help of a "deceleration strategy," which included a request for voluntary moderation of prices and wages, policymakers believed that inflation could be held to about a 5.75 to 6.25 percent rate for the year.

The economy in 1978, however, did not meet these expectations. Although output of real goods and services grew at a 4.3 percent rate, the rate of inflation, as measured by the consumer price index, accelerated to 9 percent. This unexpectedly high rate of inflation caused widespread public alarm.

By the latter part of 1978, policymakers had singled out the acceleration of inflation as the most important problem facing the U.S. economy. Voluntary wage and price standards and the implied methods of enforcement (for example, the use of public exhortation and procurement sanctions) accompanied this official recognition as did a postponement of the proposed tax cuts.[2] In November the Federal Reserve and the Treasury jointly announced major actions "to strengthen the dollar in foreign exchange markets and thereby to counter continuing inflationary pressures."[3] The Federal Reserve increased certain reserve requirements for member banks, raised the discount rate by one percentage point, and the Federal Open Market Committee voted to reduce the expansion of money and credit. The Treasury announced that it would increase its monthly sales of gold beginning in December, increase central bank swap facilities, and issue foreign-currency-denominated securities in Europe. This article provides a review of the economy in 1978, including a description of the major policy actions during the year.

BUSINESS DEVELOPMENTS

Spending and Output

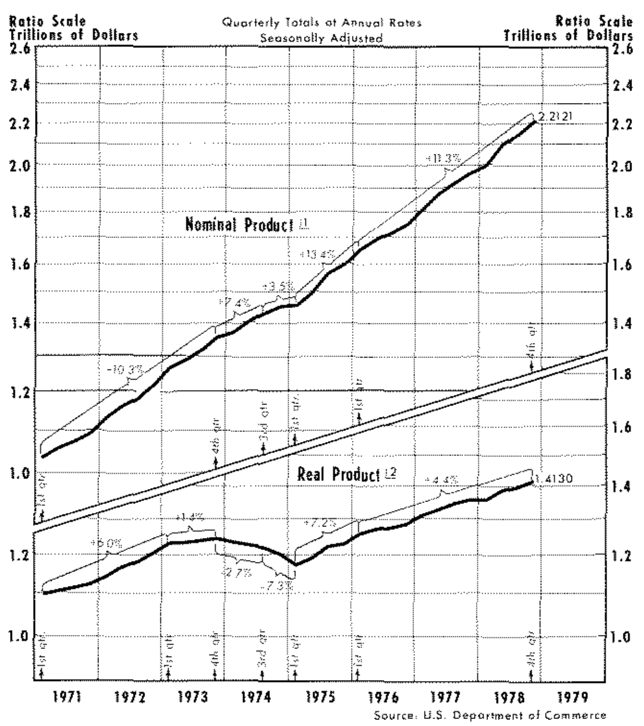
Following slow growth in the first quarter of the year, which was attributable primarily to a prolonged coal strike and inclement weather, the economy rebounded in the remaining three quarters of 1978. Growth in total spending on goods and services (Gross National Product (GNP) in current dollars) acceler-

[1]See Council of Economic Advisors, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 1978), pp. 75-76.

[2]For a description of these actions and the Administration's intentions to reduce the rate of inflation see Council of Economic Advisors, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 1979), pp. 45-52, 80-84.

[3]See "Record of Policy Actions of the Federal Open Market Committee," *Federal Reserve Bulletin* (December 1978), p. 957.

Gross National Product



[1] GNP in current dollars.
[2] GNP in 1972 dollars.
Percentages are annual rates of change for periods indicated.
Latest data plotted: 4th quarter

ated at a relatively rapid 13 percent rate in the year ending fourth quarter of 1978. This four-quarter growth rate has been exceeded only once (I/75 to I/76) since the current expansion began in March 1975. Real output of the economy, as measured by GNP adjusted for price changes, grew only slightly more than 4 percent in 1978 which represents a slowing from the 5.5 percent increase in 1977. The economy ended the year with rapid growth in output and spending. In the fourth quarter, total spending increased at a 15.0 percent annual rate and output grew at a 6.4 percent rate.

The growth rate of industrial production accelerated during the year and was still expanding rapidly in the final quarter. From IV/77 to IV/78, industrial production grew 7.4 percent after expanding 5.9 percent in the previous four-quarter period. This relatively rapid rate of growth contributed to a rise in the utilization of manufacturing capacity. In the fourth quarter, the Federal Reserve Board capacity utilization index reached 85.8 percent, compared to 82.9 percent a year earlier. In the past 10 years, this rate of utilization has been exceeded only during the period from late 1972 through mid-1974.

Table I

Selected Economic Indicators
(Compounded Annual Rates of Change)

Output:	1978 (IV/77-IV/78)	1977 (IV/76-IV/77)	Expansion (I/75-IV/78)
Real GNP	4.3%	5.5%	5.1%
Components of Real GNP			
Personal Consumption Expenditures	4.1	4.8	5.1
Gross Private Domestic Investment	5.3	15.5	12.7
Nonresidential Fixed Investment	8.5	9.1	5.5
Residential Fixed Investment	−0.2	15.3	14.4
Government Purchases of Goods & Services	1.8	5.1	2.0
Federal Government Purchases	−1.2	6.3	1.8
State & Local Government Purchases	3.6	4.3	2.2
Prices:			
GNP deflator	8.3	6.1	6.4
Consumer Price Index	9.0	6.6	6.9
Producer Price Index	9.6	6.0	6.5

Table I displays several indicators of business activity for 1977, 1978, and the entire current expansion. The overall expansion has exhibited differential growth rates across the various sectors. For example, real consumer spending, which played an important role in the early stages of the expansion, slowed to a 4.1 percent increase for the year ending IV/78. This slowing is associated with a moderation of real disposable income growth from 5.4 percent in 1977 to 3.4 percent last year. Increases in social security taxes, which went into effect in January, and higher effective tax rates, induced by a progressive tax structure based on nominal incomes accompanied by inflation, contributed to the slower rate of growth.

The strongest component of total real spending was nonresidential fixed investment which grew 8.5 percent in 1978 and which has grown faster than real GNP in each of the last three years. Real investment in commercial and industrial structures in 1978 increased 13.2 percent. On the other hand, investment in producers' durable equipment grew 6.2 percent over the year — considerably slower than the rate that was expected as the economy approached full capacity. Real residential fixed investment, which has made significant gains over the course of the current expansion, declined by 0.2 percent in 1978 despite a

Table II

Labor Force and Employment Growth — 1978
(Percent change, IV/77-IV/78)

Civilian Labor Force	3.0%	
Civilian Employment	3.9	
Employment in:		
Agriculture		1.3%
Manufacturing		8.6
Mining		14.4[1]
Transportation and Utilities		4.4
Trade		4.5
Finance		3.0
Service		4.4
Government		1.4
Contract Construction		11.2

[1]The coal strike beginning in the fourth quarter of 1977 affected this figure. If the month of December is dropped from the IV/77 average, employment growth was only 7.5 percent over the year.

SOURCE: U.S. Department of Labor.

total of over 2 million housing starts. In the previous three years, real residential fixed investment grew at an annual rate of 14.9 percent.

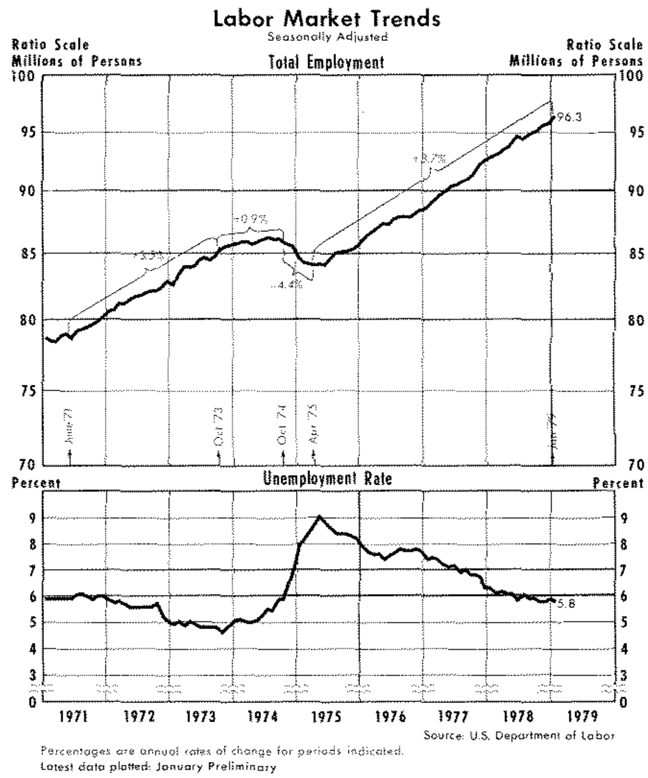
Employment

An additional 3.6 million workers were employed from IV/77 to IV/78. This represents a 3.9 percent rate of employment growth in 1978, close to the average rate for the entire expansion period. In the 1961-69 expansion — the only other expansion since World War II which lasted as long as the current one — annual employment growth averaged only a little over 2 percent. Employment gains were observed across all industries in 1978 with service and cyclical industries (especially contract construction) achieving the largest gains (see Table II).

The percentage of total civilian employment to civilian noninstitutional population of working age (16 years and over) provides another way of assessing the current employment picture. In December this ratio was almost 60 percent — higher than at any time in the previous 30 years.

Since the second quarter of 1975, when the unemployment rate peaked at about 9 percent, employment gains have been strong relative to labor force growth. As a consequence, significant progress in lowering the unemployment rate was achieved in 1978. The unemployment rate dropped from 6.6 percent in IV/77 to 5.8 percent in IV/78.

Despite recent employment gains, the unemployment rate remained about one percentage point above



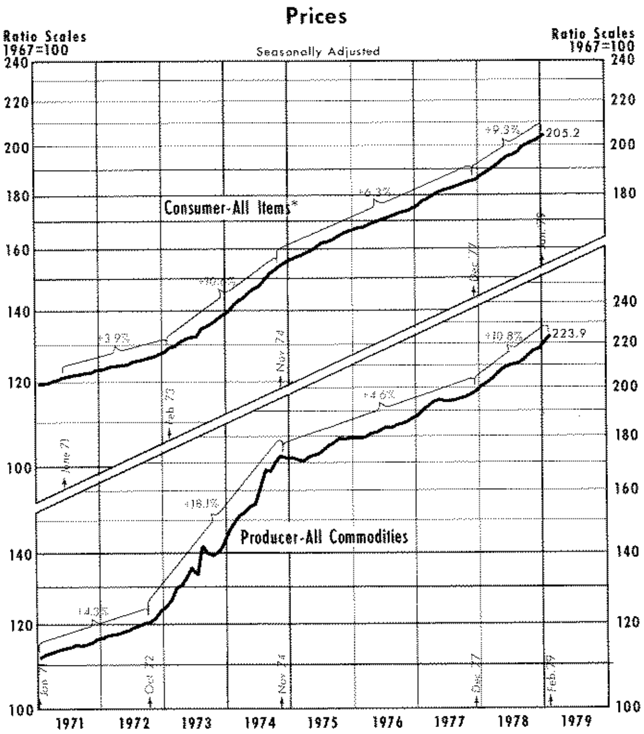
its low point in the previous expansion (IV/70 to IV/73). Several factors have contributed to maintaining the unemployment rate at a relatively high level compared to historical experience. One of these is the exceptional growth of the labor force in recent years. In the past three years, it has grown at a 2.9 percent annual rate, compared to a growth rate of 1.7 percent during the previous 30 years.

Moreover, the labor force now contains a larger proportion of women and teenagers than previously. Last year, participation in the labor force for both of these groups rose to record highs. The participation rate for adult women increased 1.5 percentage points to 50.1 percent, and the teenage participation rate jumped 1.6 percentage points to 58.5 percent.[4]

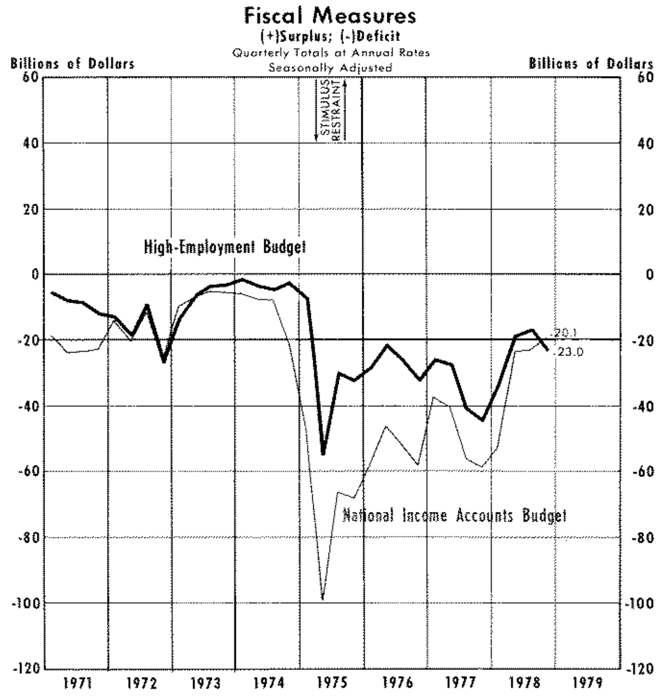
Prices

Prices, as measured by the GNP deflator, increased 8.3 percent from IV/77 to IV/78, up sharply from the 6.1 percent increase in 1977 and the 4.7 percent increase in 1976. Both the producer price index and the

[4]Participation rates measure the proportion of persons in a specific population group that are either employed or seeking employment.



Percentages are annual rates of change for periods indicated.
*CPI for Urban Wage Earners and Clerical Workers.
Latest data plotted: Consumer-January; Producer-February



Sources: U.S. Department of Commerce and Federal Reserve Bank of St. Louis
Latest data plotted: 4th quarter

consumer price index also showed similar accelerations last year (see Table I).

At the retail level, consumer prices increased at a 9 percent rate in 1978. However, there was considerable variation in the price increases among particular components. Food prices, for example, represented a sizable component of the general price increase as retail food prices rose 11.6 percent.[5] Strong demand for housing coupled with raw material shortages and higher mortgage rates resulted in a 9.9 percent rise in the housing component of the consumer price index. Prices for services increased 9.5 percent in 1978. Both durable and nondurable commodity prices rose 8.6 percent over the year.

FISCAL AND MONETARY DEVELOPMENTS

Fiscal and monetary actions have an important influence on the economy's level of output, employment, and prices. Fiscal actions can be measured by the level of government purchases of goods and services and by the form of financing these purchases. Monetary actions can be evaluated by examining the growth of monetary aggregates and the level of interest rates.

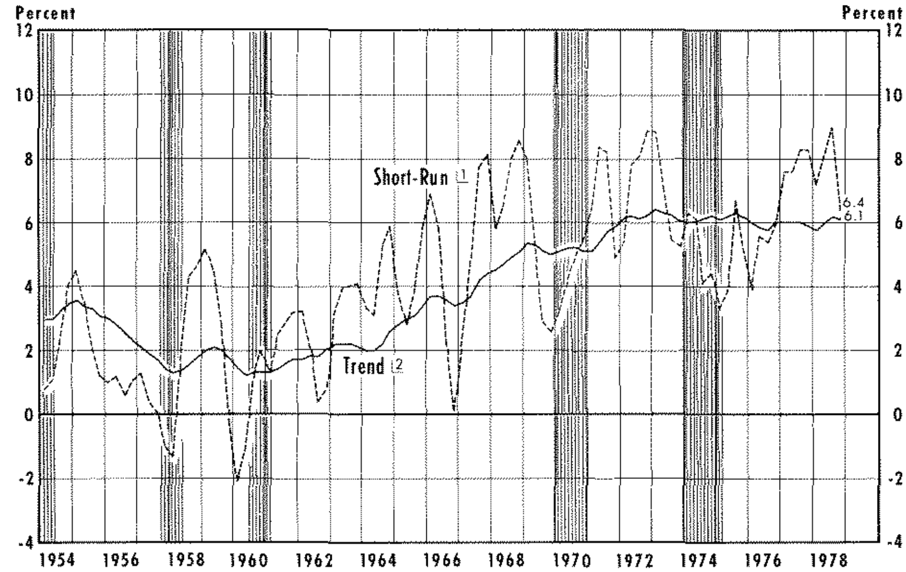
Fiscal Developments

Growth of real Government spending has shown a mixed pattern in recent years. Government purchases showed little growth in the first two years of the expansion. Between I/75 and I/76, real Government spending advanced 1.9 percent, and over the following four quarters declined 0.6 percent. However, this pattern was reversed beginning in 1977 as real government spending increased more than 5 percent for the year.

This spending, however, grew 1.8 percent last year. The greatest spending stimulus originated from state and local governments. From IV/77 to IV/78 state and local purchases in constant dollars rose 3.5 percent. In the first two quarters of 1978, these purchases grew at a much faster 4.6 percent rate but slowed to a 2.6 percent rate in the final two quarters. Continued federal aid, attributable in part to the 1977-78 stimulus package, contributed to the rapid rate of growth in the first two quarters. Included in the package were

[5]For a review of the rapid food price increases in 1978 see Neil A. Stevens and Clifton B. Luttrell, "1979 Food and Agricultural Outlook," this *Review* (February 1979), p. 19.

Rates of Change of the Money Stock (M_1)



Shaded areas represent periods of business recessions.
[1] Two-quarter rate of change.
[2] Twenty-quarter rate of change.
Latest data plotted: 4th quarter

special countercyclical aid and fiscal assistance grants. Large revenues from inflation and economic growth also helped sustain the pace of expenditures throughout the year.

The high-employment budget, a measure of the Federal budget adjusted for cyclical revenue and expenditure changes, indicates that the high-employment deficit declined in 1978 (see chart). The reduction resulted from both a lower-than-expected rate of government expenditures and a higher rate of tax revenues. The spending shortfall for fiscal 1978 was approximately 2.5 percent of total expected outlays. Higher inflation and real economic growth moved individuals into higher tax brackets and thus increased total tax revenues. Also, tax cuts which were scheduled to become effective October 1, were postponed until January 1, 1979. The budget deficit, however, is still quite large compared to similar points in past business expansions. On a National Income Accounts basis, the budget deficit for 1978 was $29.8 billion.

Monetary Aggregates

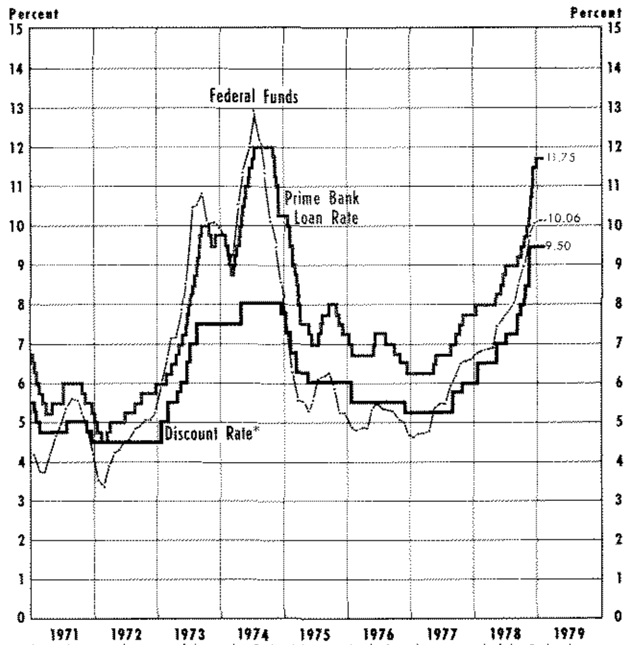
The rate of money growth has been found to be associated with the growth of total spending, prices, and the level of interest rates in the economy. Continuing rapid growth of the money stock had a significant influence in propelling the growth of total spending in 1978. M1, defined to include demand deposits and currency in the hands of the public, grew at a 7.6 percent annual rate over the two years ending IV/1978 — the fastest rate of growth registered over any eight-quarter period since World War II and well above the twenty-quarter trend rate of money stock growth of about 6 percent.

In contrast, M1 growth fell to a 4.4 percent annual rate in the final quarter of 1978. M2 (M1 plus net time deposits) displayed a similar pattern, growing at an 8.7 percent rate in the first three quarters but slowing to a 7.9 percent rate in the final quarter. The rate of growth of M2 was particularly slow in the final two months, increasing at a 3.8 percent rate.

Expansion of the money stock results primarily from the growth in the monetary base, which is the major determinant of the banking system's ability to create deposits.[6] Growth of the monetary base demonstrated a mixed pattern in 1978. In the first three quarters, the base grew at an annual rate of 9.4 percent — just above the 9 percent annual rate for the two years ending in the third quarter — and M1 increased at an 8.2 percent annual rate over this same three-quarter period. The growth of the monetary base slowed markedly in the final two months of the year to a 7.0 percent rate.

[6]For a description of the monetary base, see Anatol B. Balbach and Albert E. Burger, "Derivation of the Monetary Base," this *Review* (November 1976), pp. 2-8.

Short-Term Interest Rates



*Rate changes when one of the twelve Federal Reserve Banks has the approval of the Federal Reserve Board to change its discount rate. Data used is the day that rate is in effect.
Latest data plotted: February
Date of latest rate change: Discount Rate-November 1, 1978; PBLR-December 26, 1978

Interest Rates

Short-term interest rates on financial assets rose sharply last year. For example, the Federal Funds rate, which was at 6.56 percent in December 1977, rose to over 10 percent by the end of 1978. Long-term interest rates also increased as evidenced by a one percentage point rise in the yield on Corporate Aaa bonds.

Interest rates are established by forces of supply and demand for credit. Therefore, interest rate movements reflect not only the impact of current monetary actions on the supply of credit but also the impact of changes in the demand for credit. *Both* of these factors were responsible for higher interest rates in 1978. Demands for bank credit were quite strong as evidenced by a 15.5 percent increase in total loans over the year despite the general rise in interest rates. A reduced flow of reserves restricted the ability of the banking system to increase deposits in the final months of the year. In the final two months of 1978, commercial bank reserves *fell* at a 1.3 percent annual rate compared to an 11.6 percent growth over the previous six months. The combined effects of continued strong growth of loan demand and reduced rate of growth in the monetary base resulted in a further rise in interest rates in the final months of 1978.

INTERNATIONAL DEVELOPMENTS

International economic developments played an important role in influencing monetary policy actions during 1978. For example, the Federal Reserve gave international developments as a reason for five of the seven discount rate changes last year. The dollar fell relative to most currencies throughout much of 1978, especially with respect to the Japanese yen, German mark, British pound, and French franc. The dollar's decline was particularly pronounced in the third quarter of 1978. By the end of October, the dollar had declined 10.3 percent on a trade weighted basis from its value at the beginning of the year.

On November 1, the Federal Reserve Board and the U.S. Treasury announced that official support of the dollar would be significantly increased. The discount rate was raised a full percentage point and, effective November 2, a supplementary member bank reserve requirement of 2 percent was imposed on time deposits in denominations of $100,000 or more, obligations of affiliates, and ineligible acceptances. In addition, there was an announcement of increases in gold sales and an allotment of additional funds for foreign intervention in exchange markets. Following the November 1 announcement, the foreign exchange value of the dollar rose steadily until early December and then declined slightly. By late December, the value of the dollar in terms of the Japanese yen and Swiss franc was only somewhat below its November peak. In terms of most other major currencies, however, the dollar had fallen back to its lower levels of mid-October by the end of December.

FINANCIAL INNOVATIONS

Two major financial innovations occurred in 1978. Beginning on June 1, commercial banks and other thrift institutions were authorized to issue money market certificates. Starting November 1, commercial banks were permitted to introduce an automatic transfer service between savings and checking accounts. These innovations have had a significant and continuing impact on the economy.

Money Market Certificates

Money market certificates (MMCs) are nonnegotiable time deposits issued in denominations of $10,000 or more with original maturities of 26 weeks. The maximum permissible rate of interest on new MMCs issued by commercial banks is equal to the discount

Table III

Growth of Money Market Certificates

	Interest Rate on 6-month Treasury Bills[1]	Commercial Banks[2]		Mutual Savings Banks[3]		Savings & Loan Associations[4]
		Number of Offering Institutions	Amount Outstanding ($ millions)	Number of Offering Institutions	Amount Outstanding ($ millions)	Amount Outstanding ($ millions)
June 7	7.16%	6,455	$ 774	224	$ 847	$ —
June 28	7.23	7,963	2,055	258	1,596	5,400
July 26	7.50	8,961	5,470	273	3,504	11,790
August 30	7.47	9,825	7,792	331	5,009	15,080
September 27	7.98	9,886	9,679	364	6,136	19,338
October 25	8.56	10,552	13,858	319	8,908	26,660[5]
November 29	9.00	11,065	19,729	349	10,841	34,630[5]
December 27	9.52	11,658	22,956	431	12,822	40,790[5]
January 31	9.48	11,972	31,855	451	17,538	55,000[5]

[1]New issue rate, for week ending Saturday four days earlier than date shown.
[2]Based on a sample of 527 commercial banks.
[3]Based on a sample of 95 mutual savings banks.
[4]Data for end of month.
[5]Estimated figures; FSLIC - insured associations.
SOURCE: Federal Reserve releases G.13, H.6 and Federal Home Loan Bank Board *News*.

yield (auction average) on the most recent weekly six-month Treasury bill auction. The interest rate ceiling for new MMCs issued by mutual savings banks and other thrift institutions is one-quarter of a percentage point above that for commercial banks.

The introduction of MMCs enabled thrift institutions to reduce substantially the extent of disintermediation which had threatened to become a problem since the middle of 1977 when market interest rates began to rise above the legal ceiling rates on time and savings deposits. After June 1978, as the new issue rate on six-month Treasury bills rose — from 7.16 percent for the week ending June 7 to 9.58 percent by the end of December — the growth of MMCs surged (Table III), resulting in continuing high levels of mortgage lending and residential construction.[7]

Automatic Transfer from Savings

The automatic transfer service (ATS), available since November 1, 1978, represents a new type of individual savings account. By providing for the automatic transfer of funds from ATS savings accounts to cover checks written against their checking accounts, banks enable individuals to earn interest on balances which had previously been held in their non-interest-bearing demand deposit accounts. Outstanding balances in ATS accounts at commercial banks are estimated to have been $4.3 billion in the week ending Jan. 31, 1979 (Table IV).

Table IV

Balances in Automatic Transfer Accounts[1]

(Millions of dollars)

		Insured commercial banks[2]	Mutual savings banks[3]
1978 November	8	$ 770	$ 2
	15	1,360	5
	22	1,720	6
	29	2,005	8
December	6	2,475	9
	13	2,835	10
	20	3,005	11
	27	3,245	11
1979 January	3	3,760	13
	10	4,025	15
	17	4,310	n.a.
	24	4,215	n.a.
	31	4,305	n.a.

[1]Excludes commercial and mutual savings banks in the New England states and mutual savings banks in Alaska, Washington, and Wisconsin.
[2]Based on a sample of 351 commercial banks.
[3]Based on a sample of 73 mutual savings banks.
SOURCE: Federal Reserve H.6 release.

[7]For a detailed analysis of the impact of MMCs on disintermediation, see R. Alton Gilbert and Jean M. Lovati, "Disintermediation: An Old Disorder With a New Remedy," this *Review* (January 1979), pp. 10-15.

The importance of ATS is that, depending upon the extent to which individuals utilize these new savings accounts, growth of the monetary aggregates will be affected during the transition period in which demand deposits, and perhaps, other time and savings deposits, are transferred into the new ATS accounts. In particular, growth of M1 is likely to be reduced, and growth of M2 is likely to be increased, until full adjustment to the ATS innovation occurs.[8] In addition, the issue of re-defining the monetary aggregates is now under consideration, in part because of the introduction of the ATS accounts.

SUMMARY

Economic events in 1978 were disappointing to most economic analysts who had anticipated faster growth and slower inflation than actually occurred last year. In response to the largely unexpected acceleration of inflation in 1978, public policy has recently been directed towards devising ways to reduce the rate of growth of prices over the upcoming year. Included in this program are wage and price guidelines, planned reductions in the level of federal deficits, and the widely publicized actions announced on November 1, 1978.

In addition to these policy actions, data for the final two months of 1978 and January 1979 reveal that growth in the monetary aggregates slowed substantially when compared to previous periods in 1978 (Table V). Growth in the monetary base was reduced to a 6.7 percent annual rate from its 10.6 percent annual rate of growth over the previous six months. Sharp reductions in the rates of growth in both M1 and M2 accompanied the decrease in the rate of growth of the monetary base. However, it is still too early to tell whether these reduced growth rates in the monetary aggregates will be sustained long enough to have significant impacts on economic growth or the rate of inflation.

Table V

Growth Rates of the Monetary Base and Monetary Aggregates

(Compounded Annual Rates of Change)

Period	Monetary Base[1]	M1	M2
Last 3 months (10/78 - 1/79)	6.7%	−1.8%	2.1%
Previous 3 months (7/78 - 10/78)	10.9	8.3	10.9
Previous 6 months (4/78 - 10/78)	10.6	8.0	10.0
Previous 10 months (12/77 - 10/78)	10.0	8.2	9.2

[1]Uses of the monetary base are member bank reserves and currency held by the public and nonmember banks. Adjustments are made for reserve requirement changes and shifts in deposits among classes of banks. Data are computed by the Federal Reserve Bank of St. Louis.

[8]For a more detailed analysis of the impact of ATS on the money supply process, see John A. Tatom and Richard W. Lang, "Automatic Transfers and the Money Supply Process," this *Review* (February 1979), p. 2.