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SAVING TELEGRAM

Weekend Box USA (2)

Prime Minister

You may like to look at the (not very encouraging) summary.

BY BAG
FM WASHINGTON
RESTRICTED
TO FCO TELNO. 46 SAVING OF 10 SEPTEMBER 1979

MONTHLY ECONOMIC REPORT FOR THE UNITED STATES

SUMMARY

1. It is generally accepted that the US economy has entered a period of recession. GNP is estimated to have fallen at a rate of 2.4% p.a. in the second quarter and we expect a further fall during the remainder of this year. Growth in 1980 will probably be very slow. The unemployment rate rose to 6.0% in August after a long period at around 5.7%. It seems likely to reach the 7% - 8% range during 1980.

2. The inflation rate still shows no sign of moderating. Consumer prices rose by 1% in July and in August producer prices at the finished goods stage increased by 1.2%. These figures probably exaggerate the underlying inflation rate because of the particularly large short-run effects of recent increases in energy and housing prices, but we do not expect consumer price increases to fall below 10% p.a. for some time.

3. Wage increases have lagged behind prices so far this year. The Administration will soon announce new wage standards for the second year of the voluntary anti-inflation programme. These are expected to be slightly looser than the 7% standards (with exceptions) which attained reasonable compliance in the programme's first year, but maintaining adherence in the face of recent losses in real income is likely to prove considerably more difficult. Much may depend on the current negotiations in the automobile industry, which is already suffering severely from declining sales and Chrysler's financial problems.

4. Monetary policy has tightened significantly over the past six weeks. Against the background of a poor inflation picture, an acceleration in the growth of the monetary aggregates and higher interest rates abroad, the discount rate has been raised in two steps from 9½% to 10½%. The Fed has raised the key Federal Funds

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/ RATE

rate over 11¼% compared with the range of 10% - 10¼% which it had maintained for much of the year. The steeper part of this increase came soon after Paul Volcker took over as Chairman of the Fed, encouraging the markets to believe that he would exert a stronger control over the aggregates than his predecessor, William Miller. Prime rates at some major commercial banks have now risen to 12¾%, considerably higher than the previous record level reached in 1974.

5. The merchandise trade deficit fell to $1.1 billion in July, despite an increase of $0.5 billion in the month in the cost of fuel imports. In the first seven months of the year, the trade deficit has cumulated to nearly $13 billion compared with over $20 billion in the same period in 1978, mainly because of much improved export volumes. Even after allowing for the higher cost of oil imports in the remaining months of the year, the deficit on the current account of the balance of payments may fall to $5 billion compared with $14 billion in 1978. If economic activity remains depressed and oil prices do not rise further in real terms, the current account could show a surplus in 1980.

6. Congress is scheduled to pass this month a second, binding Budget resolution for the fiscal year 1980, which starts in October. Although momentum in favour of fiscal stimulus is growing, the resolution seems likely to endorse the President's original proposal of no tax cuts and a tight ceiling on Federal expenditure. Nevertheless, the actual Federal deficit in 1980 is likely to be well above the President's recommendation of around $30 billion because of rising unemployment and the tax cut issue could be reopened at any time during the fiscal year.

/ Principal

Principal Monthly Indicators

		% change (annual rate)		
		On Previous Month	Last 3 months on previous 3 months	Last 3 months on 3 mths yr earlier
Industrial Production	Jul	-1.6	1.1	4.3
Retail Sales (current prices)	Jul	4.4	1.1	8.8
Consumer Prices	Jul	12.7	13.3	11.0
Average Hourly Earnings	Aug	3.2	7.5	7.7
Index of Leading Indicators	Jul	-4.2	-5.8	-1.4
Money Stock (M1)	Jul	10.6	8.9	4.5
S & P Index of "500" shares	Jul	12.2	5.1	4.1

		Latest Month	Average of latest 3 months	Average of 3 mths yr earlier
Unemployment Rate (%)	Aug	6.0%	5.7%	5.9%
Merchandise Trade Balance	Jul	-$1.1b	-$1.8b	-$2.3b
Interest Rate on CD's	Aug	10.7	10.2	8.0

Quarterly National Expenditure Data

(1979Q2)	% change (annual rate) On 1 qtr earlier	On 1 year earlier
GNP	-2.4	1.9
Consumers' Expenditure	-3.0	2.2
Business Fixed Investment	-3.5	4.0
Government Expenditure	-3.4	0.4
Exports of goods and services	-2.7	6.4
Imports of goods and services	11.7	6.1

Balance of Payments

(1979Q1)	Latest quarter	Previous quarter
Current Account ($ billion)	0.2	-0.3

Exchange Rate

		Actual % Change On Previous Month	On Year Earlier
Dollar effective rate	Jul	-2.2	-2.3

/ ECONOMIC ACTIVITY

ECONOMIC ACTIVITY

7. Virtually all parts of the economy exhibited discernible weakness in the first half of 1979. Consumers expenditure rose - compared with the second half of 1978 - at only 1% p.a., while government expenditure dropped by 1% p.a. and housing by nearly 10% p.a. Even the 7% p.a. rise in exports was significantly offset by continued import growth. An increase in production for inventories, probably largely involuntary, and an encouraging amount of business fixed investment helped to produce a 1% p.a. increase in GNP but it is clear that towards the end of the period output was dropping significantly. Disruptions caused by the petrol shortage probably explain a significant part of this decline (as did weather and labour problems earlier in the period) but the principal factor seems undoubtedly to have been the squeeze in real incomes which is unlikely to be quickly reversed.

8. Industrial production rose by 2% p.a. between the half-years, although as with other parts of the economy this disguised a virtually flat performance between December and June. The business equipment sector was the only one to run counter to this trend, even though a definite slowdown compared with 1978 was evident. July showed a small drop in overall industrial output. A substantial fall in production in the automobile industry was again the major component.

9. Declining automobile sales were also the main identifiable feature in the weak consumers expenditure figures. The drop of nearly $2 billion in 1972 prices in the second quarter was equal to the entire fall (3% p.a.) in personal consumption in the quarter although some of this expenditure was presumably diverted to other goods. Despite extensive marketing campaigns by the industry and large financial bonuses to customers, car sales continued weak into July and August. Retail sales as a whole declined in July in volume terms and it does not look as if there was the bounce-back in consumers expenditure in the third quarter that seemed possible when the petrol shortage first eased. Some department stores have nevertheless reported encouraging preliminary figures for August sales.

10. The personal savings ratio rose to 5.4% in the second quarter despite a fall of over 1% p.a. in real personal disposable income. This was its highest level for over two years, and nearly ½% above average 1978 levels (on revised data). Part of this rise may have been an involuntary result of petrol problems, but the recent sharp drops registered in indices of consumer confidence (the Conference Board survey, for example, showed falls in virtually every month this year) and the reductions in real financial wealth caused by high inflation rates suggest that this could be followed by further increases. Consumer debt outstanding rose at an appreciably slower rate in June.

11. Housing is still showing unexpected resilience to higher interest rates and declining real incomes. Starts fell only to a 1.8 million annual rate in July and revised data for the second quarter show activity only 5% below peak 1978 levels. Net inflows into the thrift institutions were weak in July, but

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the net outflow of April (not seasonally adjusted) has not threatened to reoccur. Mortgage rates have now risen above 11¼% with large regional disparities (causing occasional severe supply problems) because of usury ceilings in some States.

12. Business fixed investment is finally showing signs of impending weakness. Rates of growth this cycle have been disappointing but nevertheless very steady, with construction latterly showing a lot of strength. New building contracts have now however started to ease and orders figures for equipment are showing sizeable reductions. New orders for nondefence capital equipment (in money terms) fell nearly 7% in July to their lowest point this year. The steel industry, which was surprisingly buoyant in 1978 and early 1979, is now beginning to suffer. Although the latest BEA survey of capital spending plans for 1979 showed some increase from the previous survey, it still pointed to a weak performance in the final two quarters of the year in volume terms.

13. Much has been written about the inventory situation in this cycle, but the position is still not particularly clear. The automobile sector was already overstocked even before the petrol crisis occurred because of failures (particularly by Ford and Chrysler) to match production to the current pattern of demand. Desperate attempts are now being made to clear 1979 model cars to make room for the 1980 models (although production has also been maintained at higher levels than necessary because of an excess of components which will not fit the new models).

14. Outside the automobile sector, there are as yet few visible problems, but its ripples are nonetheless certain to spread. Retail stores will also not long be able to sustain their financial position in the face of declining sales without some retrenchment. The largely involuntary increase in inventory accummulation in the second quarter was worth ½% of GNP (2% p.a.).

EXTERNAL ACCOUNT

15. The deficit on merchandise trade fell to $1.1 billion in July, about half the size of the average deficit recorded in the first half of the year. Apart from a steep, $0.5 billion rise in the cost of fuel imports, imports dropped sharply. The improved competitiveness which the US attained through dollar depreciation in 1977 and 1978 seems to have had a significant impact on import volumes, whose rate of growth has recently moderated appreciably. Together with the effects of the slowdown in aggregate activity, it looks as if this might lead to a drop in volumes in the current quarter. Exports have meanwhile been growing very strongly, the main rise having been registered through 1978 but apparently consolidated in the first half of 1979.

16. The President committed the US, in his major energy speech in July, to keep net oil imports below 8.2 million barrels per day in 1979. Although gross imports are now running at slightly above this level, the low rate of imports recorded during the spring and the continued export of over 0.2 mbd mean that the target over the year in net terms should be easily met. Similarly, with an extra 0.2mbd of oil expected from Alaska next year, mandatory conservation measures (reinforced now by price increases) and low final demand in

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the economy, a ceiling of 8.5 mbd net for 1980 would be attained without difficulty or the need for quota schemes.

17. The dollar had a generally quieter period after the beginning of August following falls in June and July. Interest rate differentials are now being restored and the slowdown in the US economy, together with the reduced trade deficit, has improved confidence. Worries nevertheless persist in the markets about the underlying inflation rate and the political climate in the US. The authorities spent about \$5½ billion net in foreign exchange (nearly all Deutschmarks) in the May-July quarter to support the dollar. This necessitated a re-activation of the swap lines with the West German and Swiss authorities.

FINANCIAL MARKETS

18. Short-term interest rates rose substantially during August and early September, with the Fed pushing the key Federal Funds rate apparently into the 11¼% - 11½% range compared with levels of below 10½% in July. The first major increases came during the period of uncertainty in the foreign exchange markets when the Cabinet changes were being formulated, but these were soon followed by further rises after Paul Volcker took over as Chairman of the Federal Reserve Board. The discount rate was raised in the middle of August, for the second time in a month, to a new record rate of 10½%.

19. Since his nomination by the President, Volcker has made several public statements in which he has reiterated a Fed Chairman's traditional resolve to combat inflation and maintain a sound dollar. The fact that these statements have been followed by Fed action to raise interest rates significantly when the monetary aggregates have not been unambiguously getting out of hand and whilst the economy has been visibly slowing has reinforced their credibility. But it is not yet clear whether these latest moves were designed mainly with this psychological effect in mind or whether they represented the start of what will be a consistently tighter line by the Federal Open Market Committee. Clearly the strength of the dollar is still an important consideration. Although there are fears that further increases in interest rates are likely to make the recession more severe, there has been little evidence to date of a traditional "credit crunch" developing. Not even the housing sector has yet experienced a serious shortage of funds.

20. Prime rates at all the major commercial banks were raised to a record 12¼% at the end of August and some again to 12¾% in early September after further Fed tightening, release of worse data on wholesale prices and evidence of some renewed strength in business borrowing at the New York banks. The stock market lost some of the ground it had gained in the July-August period, the Dow Jones Industrial Average index falling back below 870.

/ LABOUR

LABOUR MARKET AND PRICES

21. The unemployment rate rose sharply in August to 6.0% after nearly a year around the 5.7% level. Although changes in unemployment normally lag changes in output there had been some surprise that the unemployment rate had not shown signs of increasing earlier, a phenomenon attributed partly to a slowing in the rate of growth of the labour force (perhaps itself associated with the form of the activity slowdown) and partly to a growing tendency towards labour hoarding in the major cyclical industries. However, the size of the August increase may have been exaggerated by seasonal measurement problems.

22. Wage negotiations between the Union of Automobile Workers and the automobile industry seem to be proceeding towards a settlement near to the contract date of 14 September, although there are reported to be considerable problems over union pressure for an automatic indexing arrangement for pensions of existing retirees. If a strike results, the UAW have announced that General Motors, the largest and financially by far the healthiest of the companies involved, would be the target.

23. Consumer prices rose by a further 1% in July, taking the level 11.3% above that of a year earlier. Energy prices continued to be the main proximate cause. There was more disturbing news on the wholesale side, with producer prices of finished goods rising 1.1% in July and 1.2% in August. The latter figure included a surprising reacceleration in food prices. Forecasts of a moderation in inflation rates later this year had previously depended to a considerable extent on an expected flat or declining path for food prices.

ECONOMIC PROSPECTS

24. The sluggishness which the economy has shown since the beginning of this year seems certain to continue well into 1980. We expect to see GNP showing a decline for the last three quarters of 1979 and probbly the beginning of 1980, although of course there may be occasional fluctuations in this path. Some recovery seems possible in the second half of 1980, particularly if tax cuts are implemented fairly soon, but this will probably not prevent the unemployment rate from rising to around 8% by the end of the year.

25. Because activity levels at the beginning of 1979 were considerably higher than 1978, GNP should show a growth rate between the years of about 1½%. Between 1979 and 1980 there is not likely to be much net growth. The inflation rate as measured by the Consumer Price Index may start to ease within the next few months and into 1980, but this is more a result of the particular way in which the index is constructed and the short-term effect of recent increases in energy and housing prices than it is a symptom of a deceleration in the underlying rate of inflation. We expect the CPI to increase by nearly 12% through the year 1979 and about 10% between 1979 and 1980 with some signs of deceleration being evident through the year. The deceleration in 1980 should bring CPI increases more nearly in line with trend increases in unit labour costs which have recently been in the 8% - 9% p.a. range. Some temporary acceleration in wage costs is expected over the next year as employees seek to recover recent losses real earnings, but the combination of a weak economy,

/ tight

tight monetary policy and the Administration's anti-inflation standards are expected to prevent this becoming too sizeable.

26. The trade balance may deteriorate over the next few months as the full effects of the oil price increases and the recovery of oil import volumes is felt, but the underlying position seems definitely to be improving. For the year as a whole, we expect to see a decline in the merchandise trade deficit, measured on a census basis, from $28.5 billion in 1978 to around $24 billion in 1979. This estimate is of course still subject to a wide margin of error, but it would imply a current account deficit of the order of $5 billion for 1979 compared with $14 billion in 1978. Looking ahead to 1980, the current account deficit should improve further as import demand slackens and exports maintain the levels they have gained as a result of recent improvements in competitiveness. Much depends on movements in the terms of trade, particularly with respect to oil, and on how much world growth slows next year, but we expect that the current account will probably be in rough balance in 1980.

27. The risks to this forecast seem mostly on the negative side. High interest rates and continuing high rates of inflation threaten to raise the personal savings ratio even higher than we have assumed and to cut further into the housing sector and business investment. This would cause a much deeper and perhaps prolonged recession. The inflation rate continually seems to exceed predictions and there is a far higher probability of wages accelerating above the levels assumed than of their moderating from this year's rates. However, the balance of risk on the current account seems to be in the direction of a substantial surplus appearing in 1980. Should the recession prove to be severe, and particularly if import volumes plummet the way they did in the 1975 recession, a surplus of the order of $10 billion would seem quite possible unless oil prices rise much faster than the general rate of inflation.

POLICY OUTLOOK

28. The main topic of interest at the moment is whether a tax cut will be put in place during the fiscal year 1980, which starts this October. Congress is scheduled to complete work on the second Budget Resolution towards the end of this month, and in the limited time available it does not seem likely that there will be any change from the policy proposed by the President in January and adopted provisionally by the Congress in May. This held tax rates at essentially their present levels and put a tight ceiling on Federal expenditure. However, the issue can be raised again any time during the financial year and speculation centres on whether the President will withdraw his recently repeated rejection of a tax cut and propose in his January Budget message that Congress act speedily to make major reductions in personal, business or pay-roll taxes.

29. The tax cuts most widely discussed would provide relief of the order of $20-$25 billion in calendar 1980. These would not be much larger than necessary simply to offset fiscal drag and other previously legislated changes, but they would clearly make the balanced-budget target in fiscal 1981 impossible to achieve. The

/ administration

administration is particularly concerned about the psychological and political costs of what would be seen as a softening of its resolve to reduce inflation if it were to propose significant tax cuts.

30. The Administration is also facing major questions of principle over the handling of Chrysler's difficulties. The company has severe structural and managerial problems which predate, but have been magnified by, the current low level of demand in the automobile industry and an acute shortage of cash. Chrysler lost over $200 million in the second quarter of the year and expect losses for the whole year to exceed $700 million. They are about to present a detailed request for Federal aid, probably in the form of advance tax credits and loan guarantees, and have already disposed of some of their assets and laid off workers to show their determination to deal with the crisis. Treasury Secretary, Miller, has, however, already reiterated his opposition to cash help and has put limits on the size of loan guarantee he might be prepared to recommend to Congress.

31. The Senate failed to complete work on the Windfall Profits Tax on oil companies before the Congressional recess and there are few signs of speedy passage of the measure now that Congress has resumed. Interest is focussed mainly on the way in which proceeds from the tax might be spent in order to promote domestic production or conservation.

32. The Administration has published preliminary proposals for the second year of its voluntary anti-inflation programme. Final details will be made public in the middle of the month, but the Administration has already confirmed that the reference period will continue to be an October-September year. It is likely that the new wage and price standards will cover both years of the programme taken together but at a slightly higher rate than the first year standards. This will give more flexibility to those who complied fully with the standards during the first year. Efforts are still being made to find some formula which will gain acceptance by organised labour.

/ Expenditure

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Expenditure on GNP (quarterly data)
(1972 prices $b sa annual rate)

	1979(2)	% pa change over last qtr		% pa change over same qtr yr earlier	
GNP	1422.1	-2.4		1.9	
Personal Consumption	914.8	-3.0		2.2	
durables	144.5	-14.3		-2.2	
nondurables	344.0	-4.6		1.4	
services	426.3	2.7		4.6	
Business fixed investment	145.9	-3.5		4.0	
Housing investment	57.2	-3.4		-6.1	
Change in business inventories	18.5	12.3	(A)	15.6	(A)
Govt purchases of goods & services	272.3	-3.4		0.4	
Federal	98.2	-11.0		1.7	
State & Local	174.1	1.2		-0.3	
Net exports of goods & services	13.4	17.0	(A)	12.3	(A)
Exports	116.2	-2.7		6.4	
Imports	102.8	11.7		6.1	
Price deflator (1972=100)	163.8	9.2		8.6	
GNP (current prices)	2329.4	6.7		10.7	
Net exports (current prices)	-7.6	-4.0	(A)	-7.6	(A)

B Monthly indicators

	Month		% pa change over 1 mth earlier	3 mths earlier	year earlier
Industrial production	Jul	152.1	-1.6	3.5	3.4
Capacity utilisation mfg	Jul	85.6	-5.4	1.4	0.9
Retail Sales ($b current prices)	Jul	71.7	4.4	2.1	8.3
Car Sales (m units pa)	Jul	10.5	228.4	-19.7	-4.1
Housing Starts (m units pa)	Jul	1.8	-58.3	12.9	-14.5
Merchandise exports ($b)	Jul	15.7	63.8	62.3	34.4
Merchandise imports ($b)	Jul	16.8	-10.8	19.8	15.3
Civilian employment (Hsehld Svy)	Aug	96.9	-3.8	2.4	2.3
Unemployment Rate (%)	Aug	6.0	5.7 (A)	5.8 (A)	5.9 (A)
Consumer Price Index (1) (2)	Jul	218.9	12.7	12.8	11.3
Producer Price Index (2)					
finished products	Aug	217.3	15.4	11.7	11.1
all commodities	Aug	238.1			13.2
Average hourly earnings (pnf adj)	Aug	231.0	3.2	6.5	7.6
Average hourly earnings (pnf)	Aug	6.2	0	4.7	7.7
Composite indices					
12 leading indicators	Jul	139.3	-4.2	-1.7	-1.3
4 coincident indicators defl	Jul	145.0	-0.8	2.2	3.2
6 lagging indicators	Jul	166.0	12.3	10.2	15.7
Inventory levels ($b cur prices)	Jun	$406.7b (A)	$401.7b (A)	$391.7b (A)	$360.4b (A)

(1) All urban consumers

(2) % changes are seasonally adjusted; levels are not seasonally adjusted.

(A) Implies actual value in the period specified NOT percentage change.

/ Monetary

Monetary indicators

	Latest Month		% change at annual rate over previous 4 wks	13 wks	52 wks
Federal reserve credit outstanding $b sa(1)	Aug	131.3	-0.7	9.0	0.7
Monetary base $b (1)	Aug	149.5	12.9	11.5	8.5
M1 $b	Jul	372.1	10.6	8.8	4.9
M2 $b	Jul	914.0	13.5	11.3	7.7
Total bank reserves(1) $b	Aug	41.1	9.2	6.5	8.4
Consumer instalment credit	Jun	292.5	22.4	21.9	17.1
Commercial & industrial loans by all commercial banks	Jul	259.9	5.7	20.6	17.7

	Latest Month		Previous Month	3 mths Previous	Year Previous
Commercial bank prime rate(1)	Aug	11.88	11.50	11.75	9.10
3 mth Treasury bills	Aug	9.51	9.26	9.62	7.08
Corporate Aaa bonds	Aug	9.23	9.20	9.50	8.69
3 mth CD rate	Aug	10.67	10.14	10.17	8.04
US Govt bond rate (20-yr)	Aug	8.96	8.94	9.21	8.45
Federal Funds rate	Aug	10.92	10.50	10.24	8.03

(1) Average of latest 4 weeks