District Conditions*

Autumn brought the Ninth District just about what we predicted last summer—continued strong growth in both economic activity and inflation—and we still think these conditions will last into 1979. How good that forecast is now, however, depends mostly on how effective the national anti-inflation program is.

A pretty good forecast . . .

In our summer issue, we made a fairly confident forecast for a healthy district economy despite high inflation. With only the usual caveats about large margins for error and possible wrong assumptions, we reported the predictions of our small econometric model: based on data through June it said that in the next year and a half regional employment would grow at about a 3 percent annual rate, homebuilding would remain brisk regardless of interest rates, retail sales would grow steadily, and inflation would stay about 1 percentage point higher in the district than nationally, which meant probably a district rate of about 8.5 percent. We buttressed the model's forecast with results of our two latest surveys. Most rural bankers said in July that they expected farmers' income and ability to repay debt to improve in the next three months. And manufacturers responding in August expected large sales increases right through the first quarter of 1979.

Data available through fall generally say this forecast was good. In September, total employment in the district was 1 percent higher than in June and 4 percent higher than a year earlier. The construction industry posted the largest annual gain, a healthy 9 percent, and jobs in manufacturing and most other industries increased as much as 5 percent. Crops have been excellent across the district while prices have been high, so farm incomes moved up too; and rural bankers responding to our October survey remained optimistic. District consumer prices in August rose 10.2 percent above a year ago, considerably more than the nation's 7.9 percent and somewhat more than we predicted. The biggest deviation from our summer outlook, however, seems to be what happened to retail sales. Despite the job and income increases, in Minnesota (the only district state with this data available) they declined in late summer instead of growing.

A couple of other unexpected things happened too, though their effects have not shown up in the data yet. A shortage of transportation developed in the district's ag industry, mainly because of the huge grain crops. Thus, although most commodity prices are fairly high, many farmers have not been able to sell their crops. Elevator operators, with their bins already full, have stopped buying grain until they are sure they can deliver it to market. Something of a shortage also developed in Minnesota's mortgage market. The usury ceiling in that state floats two percentage points above an index of long-term government bond rates that recently dropped significantly while most other market rates were rising. In November, therefore, the usury ceiling dropped below market rates, so lenders cut back on their conventional mortgage lending in favor of better-paying FHA/VA loans (which are exempt from the ceiling).

. . . and we're sticking with it

Despite these new factors, we're sticking with our earlier forecast of at least another year of a growing economy and high inflation—though we're somewhat less confident about it.

We don't think either of the bottlenecks will last long enough to affect the forecast. Some form of transportation will undoubtedly materialize to meet farmers' needs soon, so overall farm income is not likely to be hurt. And the government loans exempt

*The Ninth Federal Reserve District consists of Minnesota, Montana, North and South Dakota, northwestern Wisconsin, and Upper Michigan.

from Minnesota's usury ceiling are still being made regardless of the low ceiling, so district homebuilding won't be depressed by the conventional cutback. Since the ceiling normally fluctuates quite a bit anyway, in the next month or two it is likely to be boosted back to market rates, and conventional loans will become available again.

The recent Minnesota retail sales drop is somewhat harder to interpret. It may be temporary too, just an aberrant, random dip in the statistics. Or, with farm income up, Minnesota retail sales may not be representative of the district; consumers elsewhere may still be spending freely. In either case our forecast would still be good. But this drop might indicate a fundamental change in district consumer attitudes, which would, of course, change our forecast. If retail sales are dropping because consumers have become more cautious about their spending, this would mean production and employment in the retail and service sectors will be dropping too, as will personal income generally. Since we won't know for a few months which of these interpretations is correct, all the retail sales drop does now is add uncertainty to the forecast.

Much more uncertainty stems, however, from the Administration's national anti-inflation program announced in late October. The most widely publicized part of this program is the voluntary wage and price guidelines which will be monitored by federal authorities. Workers are encouraged to limit wage demands for 1978 and 1979 to a maximum increase of 7 percent. And firms are asked to limit price increases to 0.5 percent below the average increase of the last two years, with a maximum of 9.5 percent.

So far the wage guideline doesn't seem to have many followers. National labor leaders have denounced the plan. And in at least one local labor negotiation, management is reportedly trying to stay within the guideline but workers do not appear satisfied. This wage guideline probably won't throw off our inflation forecast much.

Our biggest uncertainty

Compliance with the price guideline is a far bigger unknown. We have no evidence whether or not producers in the district plan to heed it, and its effectiveness—and how good our forecast is—obviously depends on that.

If many firms do follow the guideline, our whole forecast may be too high: inflation would be slowed in 1979, but so would economic activity. According to economic theory and experience with previous control programs, economic activity is often depressed when prices are held down artificially because shortages of the price-controlled goods develop. The low prices give firms less incentive to produce at the same time that they make goods more attractive to consumers; firms want to produce less just when consumers want to buy more. Shortages eventually translate into fewer jobs, falling income and spending, and a general economic slowdown.

Yet, many district firms may not hold their price increases to the guideline, so our forecast of both inflation and activity may still be pretty good. Under the program, in fact, firms in the industries with the highest regional inflation rates—housing, energy, and food—may be officially allowed to continue to raise prices at their 10 to 20 percent rates. This is because the program has a loophole: it won't penalize any firm for raising prices more than the 9.5 percent guideline if the firm can document that its costs have risen as fast as the price increase it plans. Since presumably most price increases have already been closely related to cost increases, and since costs of basic commodities are not subject to the guideline, price inflation in these industries will probably not slow. Because the price guideline is "voluntary," it is also conceivable that some district firms will simply ignore it. And some may even increase their prices more than planned in order to beat the mandatory controls they fear are coming.

Fall summary

It's too early to tell just what the effect of the anti-inflation program will be. We must therefore be somewhat less confident about our outlook for the Ninth District, but our best guess remains what it was last summer: healthy economic growth despite high inflation through 1979.