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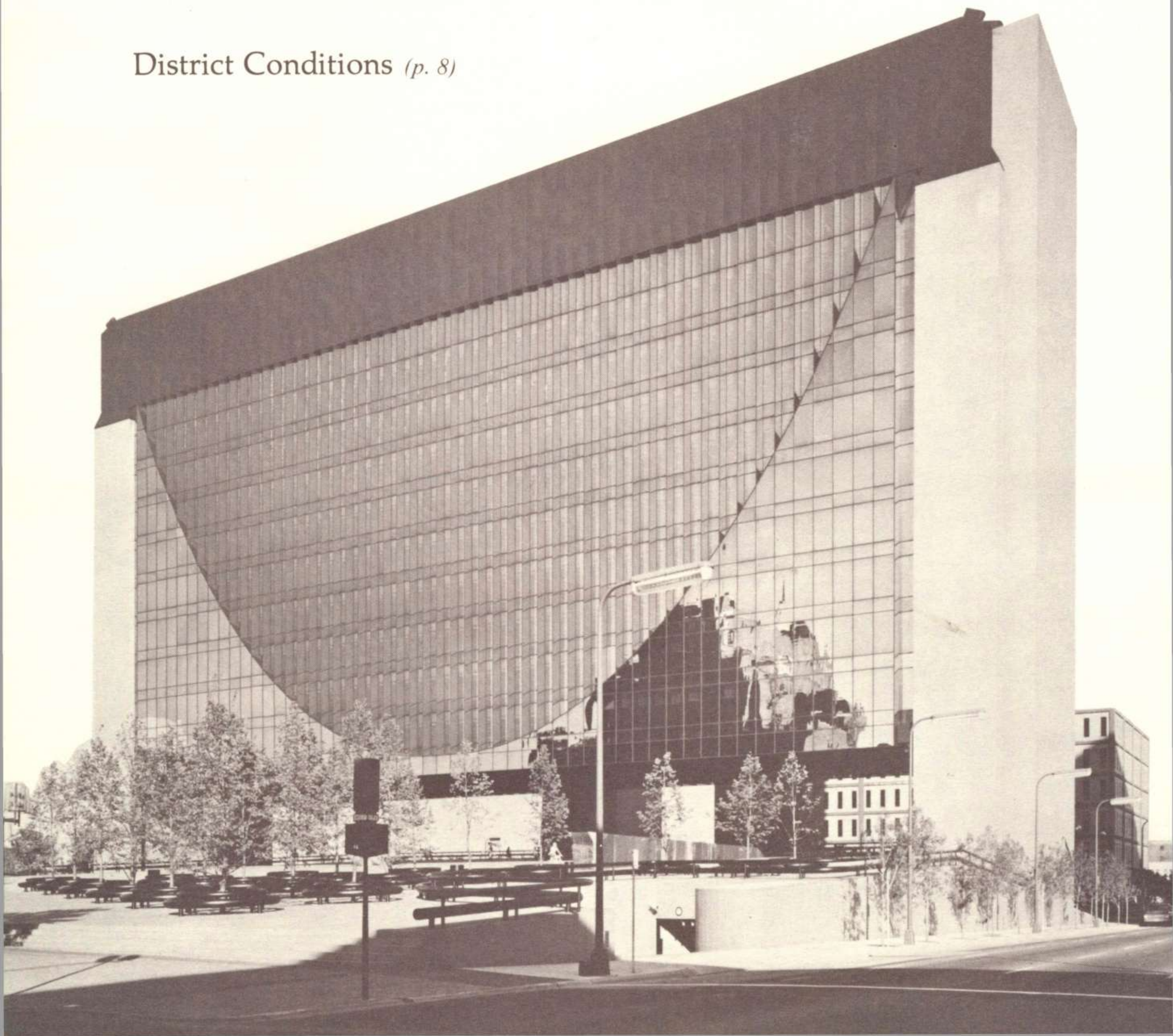

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This publication primarily presents economic research aimed at improving policy making by the Federal Reserve System and other governmental authorities.

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District Conditions*

Though still plagued by high inflation rates, economic activity in the Ninth District has grown at a healthy pace this summer, and all signs say that will continue into 1979.

The economy is healthy . . .

Compared to last year at this time, the district economy looks very good.

Many more people have jobs. In June, almost three million people were employed, 3 percent more than a year ago. This has meant quite a drop in the unemployment rate—from 6 to 4.5 percent (seasonally adjusted).

The good labor market conditions reflect some booming district industries.

Actual production numbers are not available, but business has obviously been good at district manufacturing firms. In June, 5 percent more workers were employed there than last year. And according to our August survey of district manufacturers, second-quarter sales topped those a year ago by an average of 15 percent.

Construction has been having a busy summer too. Building permits for homes have been granted in record numbers, nearly 10 percent ahead of last year's record pace. With nearly 20 percent more contracts awarded early this year than last, commercial construction is also revving up, undeterred by temporary materials shortages.

Another industry enjoying growth has been agriculture, and its growth has been dramatic. Cash received by district farmers for their crops and livestock in June totaled $723 million, up 24 percent from a year ago. And 70 percent of the rural bankers responding to our July survey said farm earnings in their areas were greater than a year earlier. This is not only twice as big a share as in April but the biggest share in the last four years of our survey. Bankers say the improvement is due to higher crop and livestock prices, excellent crop prospects, and bigger government deficiency payments. It has been spread pretty generally throughout farm products and geographic regions.

. . . despite an inflationary fever

Employment, production, and income have been growing—everyone agrees that's good news. But prices and interest rates have too—and many people feel that's bad news.

Mainly because of higher housing and energy costs, prices have been rising faster in the Ninth District than nationally. In June consumers in the Minneapolis-St. Paul area paid prices 8.5 percent higher than a year earlier, whereas U.S. prices were up only 7.4 percent.

The district's high inflation has been accompanied by a large run-up in interest rates. In August, the prime rate (the rate banks charge their most creditworthy customers) stood at 9 percent compared with rates of 6.75 and 7 percent a year ago. Mortgage rates in many parts of the district seemed poised to hit 10 percent, about 1 percent higher than last summer.

The prognosis: More of the same

All signs indicate that the Ninth District's growth in both economic activity and inflation is likely to run right into 1979.

This is what a small experimental econometric model developed by researchers at this Bank says. Based on a rough consensus forecast of national economic conditions, this model predicts that over the next year and a half district employment will grow at about a 2.8 percent rate. If (as many forecasters believe) U.S. inflation over that time hovers around 7.5 percent, prices in the district should grow about 8.5 percent. The model predicts that construction

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

activity will remain brisk even if high interest rates persist, and retail sales should grow at a rate near 12 percent.

Of course, the margin for error in such quantitative forecasts is quite large. The district estimates are based on national forecasts which themselves have fairly large margins for error. And the district forecasts are based on the assumption that certain relationships between the nation and the region will not change. Nevertheless, other indicators of future Ninth District activity are consistent with the model's forecast of continued growth.

Most of the district rural bankers responding to our July survey said they expect farm earnings in their areas to be greater than a year ago in the next quarter, and few expect farmers to be less able to repay debt. Although only for the next three months, those expectations seem based on price trends which historically have lasted much longer.

The district manufacturers responding to our August survey said they expect healthy growth too, at least through the first quarter of 1979 (the last quarter for which a forecast was requested). They think their sales will beat those a year earlier by an average of 13 percent. Even when adjusted for the expected inflation, such increases are roughly consistent with the employment gains predicted by our quantitative model.

How can this be?

To some, this report of current and expected growth in both economic activity and inflation may seem hard to explain. Inflation imposes very real hardships on people. Isn't it necessarily, then, a drag on the economy?

Not necessarily. High inflation can affect the behavior of individuals and companies in either of two opposite ways. It may discourage spending and investment. Consumers and corporations may simply become more cautious if they see high inflation as a sign of greater economic uncertainty. But high inflation could also encourage spending and investment by giving buyers a sense of urgency. If prices are expected to grow for quite a long time and interest rates are low compared to the expected inflation, there is a real incentive to buy now, especially big things like homes, durable goods, or capital equipment which will only cost more later. For any level of interest rates, if inflation expectations are high, individuals and companies will be eager to borrow to finance these purchases.

The available regional data imply that lately this second effect has predominated in the Ninth District. If people continue to behave in this way, the economy will continue to grow even if fears of inflation are realized.