At SOMC meetings in 1974 and 1975 a continuing debate regarding the economic effects of the sharp increase in the world price of oil on real economic capacity was initiated. The basic argument was that the significant and unanticipated increase in the price of oil, reduced the economic value of the existing stock of capital that had been designed to be economically efficient at substantially lower energy prices. The wealth transfer from oil consuming nations to oil exporting nations was reflected in the decrease in the present value of long-lived productive assets (stock prices) and a decline in actual current output in oil consuming nations.

The magnitude of the loss and the effects on future growth potential have been debated during the past three years. Alternative assumptions are illustrated in the attached table. The importance of the issue lies in the implications for increased inflationary pressure that would be associated with a given acceleration in the growth of total spending. In other words, how much and how long can stimulus be maintained before reacceleration of inflation becomes highly probable?

Columns I and II in the table show assumptions of potential real output that were discussed at previous SOMC meetings. The estimates in columns one are based on the assumptions that higher energy prices and other "real shocks" reduced potential output by 4.5 percent of the actual Q4/1973 level, but the trend growth remained at 3.5 percent. Column II shows a one-time decrease of the Q4/1973 level of only 2 percent, and a decrease of the trend growth to only 3 percent.

More recent estimates based on work by Rasche and Tatom are shown in columns III and IV. Column III shows levels for 1978 based on a continuing trend growth of 3.5 percent and column IV is based on a trend growth of potential at 3 percent.

The table also shows the maximum growth possible from Q4/1977 to Q4/1978 to reach potential by 1978. Under the assumptions discussed at previous SOMC meetings and shown in columns I and II, the potential level will be exceeded early in 1978. Under the estimates based on Rasche-Tatom, the potential level will be reached by year's-end or in early 1979.

Policy Implications

It must be clearly emphasized that the analysis underlying these estimates of real economic capacity do not imply that higher output levels cannot be reached. Much of the existing physical capacity can be put into
production, but it is only economically viable (profitable) to do so at higher output prices. In spite of relatively low capacity utilization numbers during the past three years, basic industries have continued to meet demand increases with price increases. The data shown in the table suggest that further acceleration of inflation should be expected at least by 1979 unless a marked slowing occurs in the growth of total spending.

JLJ

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