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CONFIDENTIAL (FR)

SUPPLEMENT

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

May 11, 1973

By the Staff
Board of Governors
of the Federal Reserve System

The Domestic Economy

Industrial production. Industrial production rose 1.0 percent further in April and at 123.0 percent (1967=100) was 9.0 percent above a year earlier. Gains in output were widespread among consumer goods, business equipment and materials.

Output of furniture, some household appliances, and room air conditioners continued to increase in April, and production of television sets was maintained at advanced levels. Auto assemblies were at an annual rate of 9.9 million units compared with a 10.1 million unit rate in March. May production schedules are at about March-April level. Production of clothing, processed foods, and consumer chemical and paper products rose further in April. Output of business equipment increased 1.0 percent further and was 15.7 percent above a year earlier, with the April gains widespread among the equipment industries. Production of construction products, steel, and other durable and nondurable industrial materials also advanced strongly. Very Confidential until release Tuesday, p.m., May 15.

Retail sales. Sales in April declined 1.5 percent from March, according to the advance report. Lower sales were widespread, but most of the decline was attributable to the automotive, general merchandise, and apparel groups which have been very strong in recent months. Sales of the GAF group declined 3.7 percent. Expenditures for food were virtually unchanged from the previous month. Compared with a year earlier, sales of all types of stores increased 13.9 percent.

RETAIL SALES
(Seasonally adjusted, percentage change
from previous quarter)

	1972 Q III	1972 Q IV	1973 Q I	February	March	April
Total sales	2.6	3.7	5.7	1.3	1.7	-1.5
Durable	3.9	5.4	8.2	1.2	1.5	-1.9
Auto	4.6	6.0	7.8	.8	2.2	-2.8
Furniture and appliance	2.0	3.2	9.3	3.0	.2	- .4
Nondurable	1.9	2.8	4.4	1.4	1.8	-1.2
Food	1.7	1.7	3.7	-.8	.2	.2
General merchandise	2.6	2.0	6.1	2.5	5.2	-3.0
Total, less auto and nonconsumption items	1.9	2.9	4.7	1.4	1.6	-1.1
GAF	1.9	2.8	6.9	2.7	4.8	-3.7
Real*	1.6	2.8	3.6	.3	.5	n.a.

*Deflated by all commodities CPI, seasonally adjusted.

Census consumer buying indicators. The April survey by the Census Bureau, like the most recent Michigan and Conference Board surveys, indicated a marked increase in consumer pessimism. The index of expected new car purchases--especially for families with above median incomes--broke very sharply from the unusually high level in January. Purchase plans for furniture and appliances were lower than in the previous survey and also a year earlier. However, plans to buy houses remained close to the very high level maintained since last fall. Evaluations of both realized and expected income gains were more unfavorable in April, although still above a year earlier.

CONSUMER BUYING INDICATORS
Expected Unit Purchases of Cars, Houses,
and Household Durables 1/

	1972 April	1972 July	1972 October	1973 January	1973 April
	(Seasonally adjusted Jan-Apr 1967=100)				
All households:					
New cars	103.5	99.6	109.9	119.7	111.5
Houses	110.4	110.1	123.5	121.2	121.1
Households with above median incomes:					
New cars	99.2	98.1	107.2	118.7	102.7
Houses	106.4	105.7	123.4	121.3	120.6
Number of major appliances reported likely to be bought per 100 households	27.6	26.0	28.7	28.2	26.4
	Actual and Expected Changes in Family Income				
Current income compared to income a year ago:					
Percent reporting--					
Substantially higher	10.9	9.9	12.3	12.0	11.9
Higher	24.8	24.4	28.5	29.6	28.9
Lower	6.5	6.4	6.4	6.7	6.6
Substantially lower	6.0	4.5	5.6	5.1	5.1
Probability of income change in next 12 months					
Increase	16.1	19.9	20.1	17.1	16.6
Decrease	6.7	6.4	6.1	6.4	6.3
Difference	9.4	13.5	14.0	10.7	10.3

1/ Average of 6 & 12 month probabilities.

<u>Inventories</u>. Book value of retail trade inventories rose at a $1.9 billion annual rate in March; a $3.1 billion rate increase in nondurable goods stocks was partly offset by declines at auto and furniture dealers. The March rate of increase for total manufacturing and trade was $16.6 billion, reduced from $22.2 billion in February. For the first quarter, the rate was $21.6 billion, up from $15 billion in the fourth quarter on a book value basis but reflected price, rather than volume, increases to a far greater extent than in the fourth quarter.

CHANGE IN BOOK VALUE OF BUSINESS INVENTORIES
(Seasonally adjusted annual rate, $ billions)

	1972	1973		
	Q IV	Q I (Prel.)	Feb. (Rev.)	Mar. (Prel.)
Manufacturing and trade	14.9	21.6	22.2	16.6
Manufacturing, total	6.4	10.2	10.4	14.1
Durable	5.2	7.2	5.8	9.9
Nondurable	1.2	3.0	4.6	4.2
Trade, total	8.5	11.5	11.8	2.5
Wholesale	4.3	5.5	5.6	.6
Retail	4.2	6.0	6.2	1.9
Durable	3.3	.4	2.0	-1.2
Automotive	1.5	.4	2.2	-1.0
Nonautomotive	1.8	-.1	-.3	-.2
Nondurable	.8	5.6	4.2	3.1

NOTE: Detail may not add to totals because of rounding.

The inventory-sales ratio declined further to 1.41, about the same low level as in March 1966.

INVENTORY RATIOS

	1972		1973	
	Feb.	Mar.	Feb. (Rev.)	Mar. (Prel.)
Inventories to sales:				
Manufacturing and trade	1.56	1.53	1.42	1.41
Manufacturing, total	1.73	1.70	1.57	1.57
Durable	2.07	2.04	1.86	1.87
Nondurable	1.32	1.30	1.21	1.20
Trade, total	1.39	1.36	1.28	1.26
Wholesale	1.24	1.22	1.16	1.14
Retail	1.48	1.44	1.36	1.34
Durable	2.07	1.96	1.71	1.68
Automotive	1.72	1.62	1.34	1.30
Nonautomotive	2.56	2.44	2.25	2.24
Nondurable	1.21	1.19	1.17	1.16

New homes sold by merchant builders turned downward in March from last winter's advanced pace and, at a seasonally adjusted annual rate of 674,000, were only slightly above the comparatively low level in March of 1972. Partly reflecting this development, homes available for sale rose to a new high both absolutely and in terms of months' supply--7.7 at the March rate of sales. Prices of homes sold also increased in March, to a median of $31,500--15 percent above a year earlier; but, with demand for upgraded units still a factor in the market, the median price of the units sold was some $2,000 greater than the median price of units awaiting sale. In March, the median price of existing homes sold was $28,540, about a tenth above a year earlier. The year-to-year gain in sales of such homes was 8 percent.

NEW SINGLE FAMILY HOMES SOLD AND FOR SALE

	Homes Sold 1/	Homes for Sale 2/	Median price of Homes Sold	Median price of Homes for Sale
	(Thousands of units)		(Thousands of dollars)	
1972				
QI	688	318	26.2	26.1
QIII	733	386	27.9	27.1
QIV (r)	761	402	29.0	28.3
1973				
QI (p)	716	430	30.5	29.4
January (r)	738	420	20.1	28.5
February (r)	735	426	29.9	29.1
March (p)	674	430	31.5	29.4

1/ SAAR.
2/ SA, end of period.
p - Preliminary   r - Revised.

The Domestic Financial Situation.

Flow of funds, first quarter. Borrowing by private nonfinancial sectors in the first quarter maintained the very high rates of flow of the fourth quarter--almost 15 percent of GNP as against 11- to 13- percent rates in the preceding two years. Business bank loan growth was large enough to offset both the reduction in commercial paper outstanding and a sharply reduced volume of corporate and municipal security flotations. Bank loans increased from a 16 percent share of the total flow in the fourth quarter to 39 percent of private credit in the first.

In the supply of credit market funds, Federal Reserve and foreign flows were both sharply increased in the first quarter and together supplied about 28 percent of total funds raised during the quarter. Private direct credit supply was predominantly from banks and other financial institutions, while private nonfinancial investors made a sizable transfer of funds out of market instruments and into negotiable CD's and other time deposits at banks. Liquid assets of private investors increased less rapidly than GNP, however, and for the first time since 1970 the ratio of private liquid assets to GNP decreased. This reflected in large part the heavy volume of credit supply from official and foreign sources.

Flow of Funds Summary, First Quarter 1973

Table 1. Funds Raised in Credit Markets
(Seasonally adjusted annual rates)

	1970	1971	1972	IV/72	I/73p	Change, IV/72 to I/73
			Billions of dollars			
Total funds raised by non-financial sectors	101.6	156.3	170.7	214.6	203.9	-10.7
U.S. Govt. securities	12.8	25.5	17.3	36.1	21.9	-14.2
All other	88.8	130.8	153.4	178.6	181.9	3.3
State and local govt. sec.	13.8	20.2	14.5	13.9	3.4	-10.5
Corporate & fgn. securities	28.0	33.7	26.1	25.5	18.7	-6.8
Mortgages	25.8	47.0	65.4	72.9	64.8	-8.1
Consumer credit	4.3	10.4	19.2	26.1	25.3	-.8
Other	16.8	19.5	28.3	40.3	69.7	29.4
			Per Cent of GNP			
Total funds raised	10.4	14.9	14.8	18.0	16.5	-1.5
U.S. Govt. securities	1.3	2.4	1.5	3.0	1.8	-1.2
All other	9.1	12.5	13.3	14.9	14.7	-.2

Table 2. Supply of Funds to Credit Markets
(Billions of dollars, seasonally adjusted annual rates)

	1970	1971	1972	IV/72	I/73p	Change, IV/72 to I/73
Total funds supplied to non-financial sectors	101.6	156.3	170.7	214.6	203.9	-10.7
By: U.S. Govt. agencies[a]	12.7	6.0	9.3	8.1	13.9	5.8
Foreign	10.9	27.2	10.8	13.1	38.8	25.7
Federal Reserve	5.0	8.8	.4	-1.6	22.2	23.8
Commercial banking	31.6	49.8	67.0	86.3	92.6	6.3
Savings institutions	16.9	42.1	49.8	49.4	53.1	3.7
Other finance	33.1	33.1	39.5	46.8	35.4	-11.4
Finance sector funds raised in credit and equity mkts.[b]	13.1	9.6	19.6	28.3	25.4	-2.9
Pvt. domestic nonfinancial sectors						
Direct advances in markets	4.5	-1.0	13.3	40.8	-26.7	-67.5
Deposits and currency	63.9	95.7	104.4	100.8	133.5	32.7
Total	68.4	94.7	117.7	141.6	106.8	-34.8
Liquid asset holdings as per cent of GNP[c]	83.0%	83.7%	84.6%	84.6%	84.0%	-.6%
Commercial bank advances as per cent of total	31.1%	31.9%	39.3%	40.2%	45.4%	5.2%

a/ Includes Federally sponsored credit agencies.
b/ Funds raised by sponsored credit agencies, banks, and private nonbank finance.

INTEREST RATES

	1973			
	Highs	Lows	Apr. 16	May 10
Short-Term Rates				
Federal funds (wkly. avg.)	7.60 (5/9)	5.61 (1/3)	6.84 (4/11)	7.60 (5/9)
3-month				
Treasury bills (bid)	6.55 (4/3)	5.12 (1/4)	6.19	6.00
Comm. paper (90-119 day)	7.13 (5/10)	5.63 (1/12)	7.13	7.13
Bankers' acceptances	7.38 (5/10)	5.75 (1/11)	7.38	7.38
Euro-dollars	9.25 (3/2)	5.81 (1/5)	7.81	8.50
CD's (prime NYC) 60-89 day Most often quoted new	7.25 (5/9)	5.38 (1/3)	7.00 (4/11)	7.25 (5/9)
6-month				
Treasury bills (bid)	6.81 (4/3)	5.38 (1/4)	6.40	6.40
Comm. paper (4-6 mo.)	7.25 (4/6)	5.63 (1/12)	7.13	7.13
Federal agencies	7.19 (3/28)	5.64 (1/3)	6.92	6.90
CD's (prime NYC) 180-269 day Most often quoted new	7.00 (5/9)	5.63 (1/3)	7.00 (4/11)	7.00 (5/9)
1-year				
Treasury bills (bid)	6.76 (3/16)	5.40 (1/4)	6.34	6.47
Federal agencies	7.36 (4/3)	5.86 (1/2)	7.18	7.24
CD's (prime NYC) Most often quoted new	7.00 (5/9)	5.75 (1/3)	7.00 (4/11)	7.00 (5/9)
Prime municipals	4.15 (4/4)	3.20 (1/3)	3.95 (4/11)	4.00
Intermediate and Long-term				
Treasury coupon issues				
5-years	6.92 (3/16)	6.23 (1/4)	6.57	6.77
20-years	6.98 (5/9)	6.04 (1/3)	6.83	6.97
Corporate				
Seasoned Aaa	7.32 (3/26)	7.10 (1/2)	7.24	7.26
Baa	8.12 (4/5)	7.88 (1/12)	8.10	8.03
New Issue Aaa Utility	7.52 (3/14)	7.29 (1/10)	7.51 (4/4)	7.40 (5/2)
Municipal				
Bond Buyer Index	5.35 (3/21)	5.00 (1/17)	5.07 (4/11)	5.10
Mortgage--implicit yield in FNMA auction 1/	7.92 (4/30)	7.69 (1/8)	7.86 (4/2)	7.92 (4/30)

1/ Yield on short-term forward commitment after allowance for commitment fee and required purchase and holding of FNMA stock. Assumes discount on 30-year loan amortized over 15 years.

CORRECTIONS

GREENBOOK: Page II-3, paragraph 1, add at end of the paragraph:

The housing agencies, particularly the FHLBanks and FNMA, can thus be expected to continue as relatively heavy borrowers in the securities markets.

REDBOOK: Page - iii -

Delete sentence beginning line 4 and the remainder of that paragraph. Insert the following new paragraph:

The Boston academic contacts disagreed in their policy recommendation. One rejected a more restrictive policy. The other recommended a monetary growth rate of 4 percent even if that entailed rising short-term interest rates. However, this recommendation was somewhat less restrictive than the 3 percent he suggested last month.

SUPPLEMENTAL APPENDIX A

GERMAN GOVERNMENT INTRODUCES FISCAL RESTRAINT MEASURES*

The German government announced a series of restrictive fiscal measures on May 9 and 10 designed to slow Germany's high and accelerating rate of inflation. 1/ The measures include:

a. imposition of an 11 per cent tax (equal to the prevailing rate of the value added tax) on outlays for plant and equipment for up to two years starting May 9;

b. suspension of fast write-off provisions on plant and equipment for one year;

c. elimination of similar provisions governing depreciation of privately owned homes;

d. a cutback in projected public sector borrowing, with the federal government to reduce planned borrowing from DM 3.8 billion to DM 2.1 billion and the länder (state) and municipal governments being ordered (by authority of the Growth and Stability Law of 1967) to decrease borrowing to DM 4.3 billion (from DM 7.1 billion) and DM 7 billion (from DM 8 billion), respectively;

e. a decrease in joint federal and länder expenditures on public works in 1973 of about DM 1 billion -- or 10 per cent -- below original plans;

f. a reduction this year in discretionary expenditures by the federal government of DM 700 million (The länder and municipalities were urged to cut such expenditures, too. They were also requested to freeze revenue in excess of amounts originally budgeted, as the federal government promised to do when it announced its draft budget for 1973 in February.);

1/ Recent developments in the German economy and the 1973 outlook (prior to the new restrictive measures) were discussed in the Greenbook of May 9, III 16-27.

*Prepared by Martin Kohn, Economist, Division of International Finance.

g. a request to pensions funds to divert to the Bundesbank this year DM 2.5 billion which they would otherwise have lent to other borrowers, with the Bank to pay interest on these funds but keep them frozen;

h. a reduction in the income level above which the federal government plans to impose a non-refundable 10 per cent income tax surcharge, starting July 1.

As regards the last measure, the draft budget of February stipulated that the surcharge be applied to corporations, single persons with incomes over DM 100,000 and married couples with incomes over DM 200,000. Under the May 10 proposal, incomes over DM 24,000 in the case of single persons and over DM 48,000 in the case of married couples will be subject to the additional levy. Despite this revision, however, the number of persons expected to have to pay the surcharge is still limited -- about 800,000 according to the government. The proceeds -- which are to be frozen at the Bundesbank -- are now expected to total DM 4.6 billion in a full year, compared to only DM 2.4 billion under the original plan.

The restraint package put forward May 9 and 10 is intended to supplement the Bundesbank's monetary policy, which has been progressively tightened for about a year now, and to reinforce the moderately restrictive character of the draft budget. The principal deflationary measures in that budget, in addition to the income tax surcharge, included an increase in the tax on mineral oil, tighter depreciation rules for buildings, and a cut in tax benefits for investment in less developed areas in Germany.

The February budget called for federal government spending of DM 120 billion (almost 13 per cent of projected GNP this year) and revenue (not including the surcharge) of about DM 116 billion. The government also instituted a so-called "stability loan," designed to raise about DM 4 billion from the non-bank public this year, in several installments. The proceeds of the loan, like those from the surcharge, are to be frozen at the Bundesbank. DM 1.5 billion has already been raised. The efficacy of the stability loan as a deflationary instrument has been questioned on the ground that it probably results in the diversion of savings from one form to another rather than in the creation of new savings.

Many of the measures announced this week will require parliamentary approval. But once enacted, they will be effective retroactive to May 9.

The prospects for Parliamentary passage of the government's program appear bright. Though the ruling Social Democratic Party (SDP) is in a minority in the second house of Parliament -- the Bundesrat -- the universal concern over inflation virtually insures a favorable reception for the government's proposals in both houses. It is true that the surcharge in the draft budget in February encountered strong opposition in the Bundesrat. But the objections focused primarily on the eventual disposition of the proceeds rather than on the merits of the surcharge itself.

New Measures May Ease Labor Discontent

That the government, in tightening fiscal policy, limited increases in personal taxes to middle and higher income groups implies its concern that increasing the tax burden in lower income brackets would give added impetus to the upward trend of wage demands. These demands have intensified in response to the failure of inflation to abate. In April consumer prices were about 7-1/2 per cent higher than a year earlier. From April 1971 to April 1972 the increase had been only 5.1 per cent. The high increases in the cost of living are reflected in a recent escalation in the size of wage settlements. In early 1973, agreements were providing for relatively moderate annual increases in wage rates of about 8-1/2 per cent. In a key settlement last month, the paper and printing workers received a raise of almost 11 per cent. Even higher wage boosts were expected in other industries before the government acted this week.

Like representatives of other institutions in Germany, important labor leaders have of late been pointing to the need for a stabilization program. Now that the government has introduced one, inflationary expectations may diminish and wage demands may be correspondingly reduced.

However, how effective the government's fiscal restraint measures will prove remains to be seen. The government apparently acted on the premise that a necessary condition -- though not a sufficient one, given the importance of inflationary expectations -- of slowing inflation is to reduce the rate of real economic growth, now running in excess of 7 per cent a year. With capacity already tight, such rapid growth is clearly exerting strong upward pressure on prices. But the measures of May 9 and 10 may not be sufficient to reduce growth promptly or substantially. The success of the government's program depends to a significant degree on inducing a slower rate of expansion in business investment than was envisaged prior to the unveiling of this week's stabilization package. (Private fixed non-residential investment was expected to increase, in real terms, by 5 to 6 per cent from 1972 to 1973. It had shown virtually no increase from 1971 to 1972.) However, the impact on investment is likely to occur only with a lag, since the investment tax so critical to damping investment applies only to plant and equipment ordered after May 9. Consequently, the large backlog of capital now on order is not subject to the tax.

SUPPLEMENTAL APPENDIX B: THE TREASURY"S PROPOSALS FOR TAX CHANGE*

On Monday, April 30, 1973 the Treasury's 1973 proposals for tax reform were made public. In his testimony before the House Ways and Means Committee, Secretary Schultz indicated that the proposed tax changes were not intended to raise revenue, and that the first full year net revenue impact would be a loss of $.6 billion. Instead the changes were designed to simplify the tax forms and insure that all persons pay their 'fair share of taxes while, at the same time, retaining certain tax incentives which encourage economic growth.

In this appendix we discuss the principal features of the Treasury's tax proposals including: (i) repeal of the existing minimum tax on individual preference income which is replaced by two new provisions applicable to individuals--a concept of "Minimum Taxable Income" designed to "prevent the combination of exclusions and itemized deductions from offsetting more than one-half of a taxpayer's income", and a Limitation On Artificial Accounting Losses" designed to reduce the benefits from certain tax shelters; (ii) a new more simplified tax form; (iii) an investment credit for the oil industry applicable to exploratory drilling expenses; (iv) an annual credit for tuition paid to non-public schools; (v) a subsidy to state and local government to encourage taxable bond issues, and a new Treasury bond designed for purchases by state and local government with the proceeds of advance refunding bonds. Other assorted provisions dealing with foreign source income, political contributions, and regulations governing commercial preparers of tax returns are not discussed in this appendix.

I. Two Provisions to Replace the Minimum tax on Preference Income

(a) Minimum taxable income.

In an attempt to assure that no taxpayer of means can escape paying at least a minimum tax, the Treasury has defined for persons a concept called 'Minimum Taxable Income." Tax preference items 1/ are added to normal adjusted gross income and then personal exemptions and a standard $10,000 deduction are subtracted. This net sum is then divided by two and defined as the taxpayer's Minimum Taxable Income, (MTI). The taxpayer is to be taxed on MTI or on his taxable income calculated according to present law, whichever is larger. Relative to the current

*Prepared by David M. Reaume, Economist, Government Finance Section.

1/ Which are (1) the excluded half of net long-term capital gains, (2) depletion in excess of a property's cost basis; (3) exempt earned income from foreign sources, and (4) the nontaxable bargain element in certain stock options.

situation, this provision may increase the tax liability of some high income taxpayers, in particular those with large deductions. However, it appears that other taxpayers--those with large amounts of realized capital gains or depletion allowances and small deductions--may pay less under the proposed tax system because an additional provision calls for the repeal of the 10 per cent minimum tax on the preference income of persons. 2/ (The tax on preference income of corporations is to be retained.) Because the possibility of an overall reduction in the tax on capital gains and oil income is not explicitly mentioned in the Treasury's Report, perhaps clarification at a later date will indicate that the reduction was unintended.

(b) The "Limitation on Artificial Accounting Losses" (LAL).

Current law allows a taxpayer to concentrate property related expenses into the first few years of a property's life. Any loss generated in this period can be used to offset or "shelter unrelated income of the taxpayer. For taxpayers currently in high marginal tax brackets but destined to be in a lower bracket in the future, the effect of the shelter is to reallocate income to a period when the taxpayer's marginal rate is lower. The savings to the taxpayer is derived from the lower (future) tax rate and postponement of tax payment, the latter savings being equal to the present value of the additional income he can earn on the postponed taxes. The Treasury's proposal will prohibit the taxpayer from using "artificial accounting losses from one activity to offset income from an unrelated activity. 3/ Thus the loss is restricted to a level

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2/ While the unreported half of long-term capital gains is added to adjusted gross income so that both halves would seem to be in the tax base, the last step of division by two in arriving at MTI ensures that only one-half of capital gains will enter MTI. Since inclusion of only one-half of capital gains in the base is no different from the present treatment of capital gains, the receipt of capital gains income no matter how great appears to have no effect on whether or not a taxpayer is forced to use MTI instead of his current tax base. Similar but not identical conditions hold with respect to the treatment of "excess oil depletion allowances. The possibility of a reduction in tax liability occurs because of the related Treasury proposal to repeal the current 10 per cent tax on preference income over $30,000 per year which currently applies to one-half of capital gains and the other preference items. Whether MTI and the repeal of the tax on preferences will raise or lower a taxpayer's total tax bill depends upon the size of his preference income, his wage and salary income, and the level of his normal deductions. Generally speaking, taxpayers with high wage and salary income, high deductions (over approximately 50 per cent of earned income), and preference income under $30,000 per year will be taxed heavier under the proposed plan. Taxpayers with high preference income and low deductions relative to earned income will receive a tax break.

3/ Artificial deductions are defined to include, among others, depreciation in excess of straight line, intangible drilling and development costs when they are expensed, and amortization of rehabilitated housing in excess of straight line.

such that net income from the shelter is zero. Any additional deductions must be postponed until some future period when net income from the activity to which the loss applies is positive. Secretary Schultz noted that the deductions are not lost but are postponed until the investment generates income, and that therefore the intended investment incentive is still partially in effect.

II. Simplification of Tax Forms.

A taxpayer may choose to use a new more simplified tax form, designated 1040S, instead of the present long form. In essence the new form together with a single auxiliary form reduces to two the number of forms most taxpayers must use. However, in certain special cases, for example when one declares moving expenses, the long form would still be required. Included on the new general form are spaces in which to enter miscellaneous income, charitable contributions, child care expenses, old age credits, and capital gains and losses. As a further simplification, Treasury has proposed that a new miscellaneous standard deduction of $500 be substituted for the combined total of a portion of the current medical expense deduction, the $100 dividend exclusion, the deduction for gasoline taxes paid, the sick pay exclusion, and the first $200 of those deductions listed under miscellaneous deductions on the present tax form. Admendments to the child care deduction and the retirement income credit are also proposed. The various simplification measures are estimated to result in a revenue loss of $4 billion in the first full year of operation. 4/

III. Investment Credit for Exploratory Drilling.

A 7 to 12 per cent investment credit for exploratory drilling expenses is also proposed by the Treasury to encourage new exploration in the United States. For purposes of the credit an 'exploratory well is defined as one which is bottomed not less than two statue miles horizontally from the nearest well which is capable of commercially producing oil or gas or was previously so productive, or which is bottomed at least 3,000 feet below the lower limit of a commercially producible deposit penetrated by any such closer well. The credit applicable to dry wells is 7 per cent while an additional 5 per cent is received for productive wells.

IV. Tuition Credit.

The Administration also proposes a personal income tax credit for tuition paid for non-religious instruction in non-public, non-profit primary and secondary schools. The credit would be limited to 50 per cent

4/ Additional revenue loss is possible. Current tax law restricts deduction of long-term capital losses to the total of short-term gains, long-term gains, and $1,000 of ordinary income. The $1,000 limitation on the deduction of net long-term losses against ordinary income does not appear to be incorporated into the proposed new forms. However, because it is not mentioned in the text it is likely that this omission was not intended.

of the tuition cost, up to $200, for each child. The tax benefit is phased out for higher income taxpayers by reducing the credit by 5 per cent of adjusted gross income in excess of $18,000. The annual revenue loss attributable to this provision is estimated to be $450 million.

V. Provisions Affecting State and Local Governments.

Two significant proposals have been made with respect to the issuance of debt by state and local governments. The first asks that State and local governments be allowed the option of issuing Federally taxable bonds. The Federal Government will pay an interest subsidy to the issuers equal to 30 per cent of the net interest expense incurred. The hope is that such bonds will be attractive to pension trusts and other exempt organizations and will lend stability to the market for State and local debt by enabling those governments to compete more effectively with corporations" when interest rates on tax free securities are under upward pressure. This proposal is also favored by tax reformers who have argued that the current system of subsidizing State and local governments via the exemption of their obligations from Federal tax is inefficient because it costs the Treasury more than the benefit to State and local governments.

A second provision aimed at State and local governments calls for the creation of a new Treasury bond for purchase by these governments when investing the proceeds of advance refunding issues. Currently these proceeds are invested in relatively low yield securities because of the Federal law discouraging "arbitrage" profits. 5/ The issuers of these low yield securities receive a windfall because they borrow at artifically low rates. By allowing the Treasury to offer an alternative security in which State and local governments may obtain a yield "equal to the yield permitted under present law plus an additional one-fourth of one per cent" the arbitrage gain may be redirected into the U.S. Treasury.

5/ The Tax Reform Act of 1969 provided that municipal bonds would lose their tax exempt status if issued in expectation of investing the proceeds in higher yielding securities.

APPENDIX C: DEMAND DEPOSIT OWNERSHIP FIRST QUARTER 1973*

Demand Deposit Ownership data for all commercial banks (Table 1) indicate a slightly larger decline in total gross IPC demand deposits (daily averages, not seasonally adjusted) in the first quarter of 1973 than in the first quarters of the two preceding years for which data are available. The survey suggests that weakness in the money supply in the first quarter was broadly based by IPC ownership category with every IPC sector--except foreign--showing contraseasonal weakness or virtual seasonal changes over the period. Most of the total decline (97 percent) occurred at non-financial businesses with the quarterly pattern roughly similar to that occurring in 1971 and 1972. Demand deposits held by financial businesses also fell, apparently contraseasonally, as did deposits of miscellaneous IPC owners ("all other"). Household holdings of demand deposits rose only marginally, but it is difficult to determine from previous data what the normal first quarter pattern is for this sector. The data, however, do not suggest an unusual reduction in household holdings of demand balances, and thus, do not lend support to the hypothesis that first quarter slowing in M_1 reflected a large shift of money from households to the corporate sector as the result of the spurt in retail sales.

Foreign IPC deposits rose by $200 million in the first quarter. Furthermore, all of this increase occurred at the large weekly reporting banks in February--the month when international uncertainties resulted in a large outflow of funds to foreign countries.

Some additional insight is gained from disaggregating these data between weekly reporting and non-weekly reporting banks (Table 2). As might be expected, most of the first quarter decline in both total and corporate deposits occurred at the larger banks. At the smaller banks, consumer deposits showed a relatively strong increase, while financial business deposits increased only moderately.

Monthly data for the weekly reporting banks suggest that the first quarter weakness in IPC deposits--especially business deposits--was not concentrated early in the quarter as in the previous two years. In the early years, first quarter declines were associated with slowing in January and February, with all the deposit categories usually beginning to expand again in the last month of the quarter. This year, however, both non-financial and financial business deposits continued to decline in March.

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* Prepared by Martha Strayhorn, Economist, Banking Section, Division of Research and Statistics.

Table 1

Change in Level of Gross IPC Deposits by Ownership
Category, All Commercial Banks 1/
(Billions of dollars)

Year	Financial Business				Nonfinancial Business				Households			
	QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV
1970	n.a.	n.a.	0	0.3	n.a.	n.a.	2.7	4.6	n.a.	n.a.	2.4	2.2
1971	1.0	-0.2	-0.2	0.6	-6.4	3.3	1.9	6.9	0.8	1.8	1.2	1.2
1972	1.7	-2.3	0	0.9	-5.8	5.0	4.0	7.8	-3.9	5.7	2.6	1.8
1973	-0.1				-6.5				0.2			

Year	Foreign				All Other				Total			
	QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV
1970	n.a.	n.a.	- .2	-.1	n.a.	n.a.	.4	.3	n.a.	n.a.	5.3	7.3
1971	.1	-.1	- .1	.1	.3	0	-.8	1.0	-4.2	4.9	2.1	9.7
1972	0	0	0	.1	1.6	-1.3	.4	.8	-6.3	7.1	7.0	11.4
1973	.2				-.5				-6.7			

1/ Changes are based on daily averages of last-month-in quarter to last-month-in-quarter, not annualized. Data are before deduction for cash item in process of collections.

Figures may not sum to total due to rounding.

Table 2

First Quarter Change in Level of Gross IPC Demand Deposits by Ownership Category, at Weekly Reporting Banks vs. Non-Weekly Reporting Banks 1/
(Billions of dollars)

	Financial Business			Nonfinancial Business			Households		
Year	WRB	NON-WRB	TOTAL	WRB	NON-WRB	TOTAL	WRB	NON-WRB	TOTAL
1971	.7	.3	1.0	-3.7	-2.7	-6.4	.6	.2	.8
1972	-.4	2.1	1.7	-2.7	-3.1	-5.8	.3	-4.2	-3.9
1973	-.3	.2	-0.1	-5.4	-1.1	-6.5	-.7	.9	.2

	Foreign			All Other			Total		
Year	WRB	NON-WRB	TOTAL	WRB	NON-WRB	TOTAL	WRB	NON-WRB	TOTAL
1971	0	.1	.1	.2	.1	.3	-2.2	-2.0	-4.2
1972	0	0	0	.1	1.5	1.6	-2.7	-3.6	-6.3
1973	.2	0	.2	-.1	-.4	-.5	-6.4	-.3	-6.7

1/ Changes are based on daily averages of last-month-in-quarter to last-month-in-quarter, not annualized. Data are before deduction for cash items in process of collection. Only data for total and weekly reporting banks are reported; thus figures for non-weekly reporting banks are residuals.

APPENDIX D: MAJOR MATERIALS CAPACITY UTILIZATION*

Introduction

A family of capacity utilization series describing utilization developments in a group of basic materials industries recently has been developed on an experimental and confidential basis. These series are not consistent with the published FRB series on the rate of utilization in all manufacturing.

The industries composing the major materials group are raw steel, aluminum ingots, copper refining, man-made fibers, paper, paperboard, cement, petroleum refining, broadwoven fabrics, and yarn spinning. The new major materials utilization series is similar in both industry composition and methodology to a series with the same name which the Board staff produced for several years prior to 1962. The present series differs from the former, however, in including broadweaving but excluding coke, wood pulp, and several chemical industries for which basic capacity data are no longer available. Present plans call for the addition of coke, wood pulp, and softwood plywood to the current major materials series as soon as that can be done.

The physical capacity data used in estimating the individual industry utilization rates are generally based on industry-wide surveys of establishments conducted either by industry associations or Government agencies, which provide data on year-end capacity for each of the industries except steel. Because of the key role in the economy which many of the component industries play, the major materials utilization series has broader implications for many analytical purposes than the industries included in the series explicitly.

The following discussion presents a brief overview of economic developments as related to the new Major Materials Utilization series followed by a brief description of the methodology by which the series was constructed.

Overview of Recent Developments in Major Materials Industry Utilization

Table 1 presents utilization rates for the major materials group and its industry components for 1972 and 1973, and Table 2

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* Prepared by Nathan Edmanson, Economist, Business Conditions Section, Division of Research and Statistics.

presents equivalent annual data for the 1960's. The major materials rate was just under 94 per cent in the first quarter of 1973, up from a low of 82 per cent in the third quarter of 1971. The first quarter 1973 level is the highest for any postwar quarter except one. This upswing in utilization reflects not only the substantial upswing in output, but also a reduced rate of capacity growth: capacity grew at an average of 4.1 per cent per year from 1966 to 1971, but only at 2.1 per cent from 1971 to 1972. The reduced rate of capacity growth is to some extent a normal cylical event, but there were a number of contributory special circumstances, examples of which are discussed below.

Table 1

MAJOR MATERIALS CAPACITY UTILIZATION
RECENT QUARTERLY AND MONTHLY DATA
(per cent)

Industry	1972				1973	1973		
	I	II	III	IV	I	Jan.	Feb.	Mar.
Total	87	89	91	92	94	91	94	95
Broadweaving	85	86	86	88	87	84	87	90
Spinning	92	91	90	88	86	84	86	87
Paper	93	95	96	99	96	94	96	97
Paperboard	94	96	99	96	97	97	96	97
Man-made Fibers	87	94	92	92	98	95	98	100
Petroleum Refining	92	92	94	95	95	95	95	95
Raw Steel	74	80	86	92	95	90	97	97
Copper Refining	71	74	77	71	79	84	77	77
Aluminum	85	89	93	92	95	92	95	98
Cement	95	89	91	92	94	94	100	100

Source: Federal Reserve Board, Business Conditions Section.

The industry figures of Table 1 show that the major materials utilization upswing was broad-based, as six of the component industries rose to high levels in 1972 and 1973: petroleum refining, man-made fibers, steel, aluminum, paper, and paperboard. A seventh industry, cement, showed a high utilization rate in the first quarter, but is not included in this listing because the high first quarter of 1973 level is believed to be a seasonal phenomenon. All of the six mentioned were in the 95-100 per cent range in the first quarter, and petroleum refining and man-made fibers were at ten-years highs.

Table 2

MAJOR MATERIALS CAPACITY UTILIZATION
ANNUAL DATA, 1961 - 1972
(per cent)

Industry	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972
Total	79	81	84	89	91	92	87	90	91	86	85	90
Broadweaving	82	85	84	89	92	93	86	88	87	85	84	86
Yarn Spinning	94	99	100	99	96	100	95	96	94	86	92	90
Paper	89	90	91	94	95	97	91	96	100	93	89	96
Paperboard	85	88	89	92	94	97	89	91	98	91	90	96
Man-made Fibers	75	85	88	91	93	87	80	92	87	78	83	91
Petroleum Refining	82	83	86	87	88	92	93	93	91	91	90	93
Raw Steel	68	67	77	88	90	90	90	85	89	81	74	83
Copper Refining	72	75	74	77	79	77	51	62	76	76	66	73
Aluminum	77	85	93	99	100	100	100	93	100	99	91	90
Cement	74	73	74	77	78	78	74	77	80	76	82	87

Source: Federal Reserve Board, Business Conditions Section.

The following discussions describe selected industry highlights within the major materials group.

Petroleum refining.--The petroleum refining utilization rate, based on crude runs to stills, was 95 per cent in the first quarter, up from 90 per cent in the third quarter of 1972. This increase reflects increasing runs to stills which have been in response to rising demand for petroleum products, but it also reflects very slow growth in capacity in recent years: less than one per cent per year in 1971 and 1972 as contrasted with an average annual growth of 4.9 per cent in 1969 and 1970. Two reasons for this slow growth were the need to meet pollution standards, and uncertainty regarding future oil import policy. A third factor which has probably affected adversely investment in refinery capacity expansion is that since 1969, major oil companies' rate of return on invested capital has declined in the U. S., but has risen overseas.1/

Man-made fibers and broadweaving.--Utilization in the man-made fibers industry was extremely high in the first quarter--98 per cent--and was up dramatically from the fourth quarter of 1970, when it stood at 76 per cent. Utilization in the broadweaving industry, a major consumer of man-made fibers, has not shown an increase parallel to that of man-made fibers utilization.

Part of the explanation for this disparate performance is in the fact that a significant proportion of the increase in man-made fiber output went into the production of knit cloth, not reflected in broadweaving utilization. This hypothesis is supported by evidence of a dramatic increase in the number of circular knitting machines in the U. S.: approximately 23,000 at the end of 1972, up from approximately 17,000 at the end of 1971.2/

A second element in the dramatic increase in the man-made fibers utilization rate is substitution away from cotton in fabric making as the price of cotton rose in 1972 and 1973. This resulted in weaving mills' increasing their consumption of man-made fibers without increasing their output correspondingly.

1/ The Chase Manhattan Bank, N.A. "Financial Analysis of a Group of Petroleum Companies," 1962-1971.

2/ Based on a telephone interview with persons in the American Textile Manufacturers' Institute.

Paper and paperboard.--In the first quarter of 1973, utilization in paper and board was in the 95-100 per cent range, and industry sources report short periods with output in excess of 100 per cent of capacity. The paper and paperboard industries' rise in utilization reflects a comparatively slow rate of capacity growth: growth averaged approximately 2.0 per cent per year in the 1970-1972 period, but was never below 3.5 per cent per year from 1964 through 1969. Part of the explanation appears to be in the diversion of significant amounts of plant and equipment expenditures from basic capacity expansion to expansion of paper fabricating facilities, pollution control facilities, and investments in activities unrelated to paper and board production.

Steel.--Steel capacity utilization has been pushed to high levels by a widespread boom in steel demand. First quarter utilization was 95 per cent, up from 74 per cent in the 1972 first quarter. The rapid rise of basic steel utilization reflects also comparatively slow capacity growth. One condition contributing to this slowness is the fact that steel companies have found investment opportunities in steel fabricating more profitable in recent years than investment in basic steelmaking. A second contributing factor is that many marginal facilities, which have traditionally constituted the industry's peak load capacity, have been written off in recent years as being obsolescent or too expensive to bring into conformity with requirements of pollution control laws.

Inventories and shortages.--The recent upswing in major materials utilization was quite abrupt as compared with that which occurred in the 1961-1966 period. The very abruptness of the rise raises the possibilities of shortages of some materials, as materials producers have had very little time to adjust capacity; and shortages' have in fact been reported by purchasing agents in various instances in recent past. Table 3 shows, however, that there was a significant increase in the rate of materials inventory accumulation concurrent with the rise in utilization rate. This suggests that an inventory cushion of industrial materials has been built up which would prevent widespread industrial materials shortages for the time being, even though little excess productive capacity appears to exist in materials industries.

Nevertheless, the current situation is tight enough that important shortages are likely to appear in selected areas. For example, stocks of motor gasoline are expected to be abnormally drawn down with the summer season's heavy gasoline consumption. Gasoline

Table 3

MAJOR MATERIALS UTILIZATION AND INDUSTRIAL MATERIALS INVENTORY CHANGE

	Year and Quarter								
	1971				1972				1973
Item	I	II	III	IV	I	II	III	IV	I
Major Materials Utilization (per cent)	87	87	82	84	87	89	91	92	94
Industrial Materials Inventory Change (Billions of 1963 dollars)	1.92	2.62	-1.20	-1.14	1.29	3.56	4.37	3.90	4.45

Source: Federal Reserve Board.

shortates may appear only sporadically this summer, but the anticipated large inventory drawdown could have serious implication for heating oil supplies in the coming winter and gasoline supplies the following summer. Also, there have been a number of reports from purchasing agents of lengthening order backlogs among materials suppliers, if not outright shortages.

Capacity growth acceleration.--Some available evidence appears to suggest some faster growth in major materials capacity. The FRB production index for manufacturing equipment has risen at a 19 per cent annual rate in the six-month period which ended with March, 1973. A rise in equipment production rates can be expected to anticipate a rise in the rates of new equipment installation, which would be consistent with an increase in the manufacturing capacity growth rates. Some of this increase would presumably take place in materials industries.

Recent surveys of plant and equipment spending provide additional reasons for anticipating an increase in the capacity growth rate, as reports that business anticipates a substantial increase in expenditures for new plant and equipment in the materials industry in 1973.

Methodology of the Major Materials Utilization Series

Major materials utilization is a weighted average of utilization rate series computed separately for each of the component industries. For each of these industries,annual physical unit output and year-end capacity originate either with the Census Bureau or with an industry association. The Steel industry is the only component industry for which capacity is not available for the end of each year, and an interpolation procedure making use of steel industry investment data is used to estimate capability in years for which it is not available.

Quarterly capacity is estimated by linearly interpolating between the year-end points, which are based on large-scale establishment surveys. Quarterly output is estimated by distributing the annual physical output through the year in the same way as the appropriate industrial production index. Quarterly utilization is quarterly output divided by quarterly capacity. The major materials aggregate uses the value added weights used in the industrial production index aggregates.