

A review by the **Federal Reserve Bank of Chicago**

Business Conditions

January 1972



Review and outlook—1971-72

Review and Outlook—1971-72

On the threshold of faster economic growth

In the opening month of 1972, after a series of false starts, the economy appeared to be emerging from a lethargy of more than two years. Retail sales were strong, employment was rising gradually, residential construction was at record levels, and prospects for business investments in inventory and plant and equipment were improving.

The gross national product, adjusted for price changes, rose about 3 percent in 1971 after a slight decline in 1970. At the start of 1972, most forecasters expected a gain for the new year of about 6 percent, the largest advance since 1966. If growth of this magnitude is achieved, the gap between actual and potential output will be narrowed.

The decline in economic activity from the 1969 peak to the 1970 low had been shallow compared to earlier post-World War II recessions. But business recessions have two dimensions—amplitude and duration. The time the economy has operated well below potential since 1969 has been of unprecedented length for the postwar period. Among major sectors of the economy, only residential construction was operating at virtual capacity in 1971. Moreover, output in some manufacturing industries was less in 1971 than in 1970.

During the first half of 1971, the continuance of rapid price inflation in the face of substantial unused resources of manpower and facilities raised a growing chorus of dis-

satisfaction. Domestic problems were compounded by the nation's worsening international trade balance and increasing doubts concerning the value of the dollar relative to other currencies. Impatience with the apparent ineffectiveness of monetary and fiscal policies in restraining inflation and restoring general prosperity brought widespread demands for more drastic action.

On August 15, the President announced a program to deal with the nation's economic problems. He declared a 90-day wage-price freeze, suspended the convertibility of the dollar into gold, and imposed a 10 percent surcharge on most imports. He also proposed reductions in certain government expenditures and asked Congress to enact a variety of measures providing tax relief to individuals and businesses. Dubbed the "New Economic Policy," the President's program received general support.

Following August 15, a number of bodies were established to administer direct controls. These included the Cost of Living Council, the Wage Board, the Price Commission, and the Committee on Interest and Dividends. In general, the public cooperated with the 90-day wage-price freeze, and with the rules and regulations of Phase II, which began November 14.

Advances in prices and wages, on the average, had slowed somewhat prior to August 15, and it is probable that this trend

would have continued. Under controls, the rise in the wholesale and consumer price indexes slowed substantially.

Whatever success direct controls may achieve in the short run, such measures are associated with inequities and inefficiencies in the allocation of income and resources. Administration spokesmen have emphasized that the controls are temporary expedients, intended to pave the way for a return to freely competitive markets. A first step in this direction was the lifting of the import surcharge in mid-December when the international monetary authorities agreed to a realignment of exchange rates.

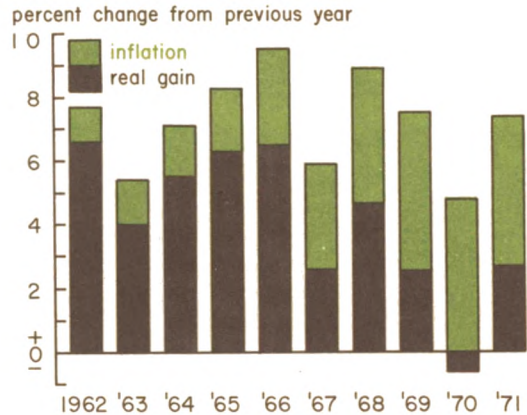
The broad record of 1971

Total outlays on goods and services, the gross national product, approached \$1,050 billion in 1971—up \$70 billion, or 7.5 percent, from the previous year. This increase was the largest on record in total dollar amount, and one of the largest of the past 20 years in percentage terms. But after adjusting for higher prices, the increase in “real” gross national product was less than 3 percent in 1971. This rise followed a slight decline (less than 1 percent) in 1970.

The lackluster performance of the economy in the past two years followed rapid, and fairly steady, gains in activity in the 1960s. In the decade, the annual rise in real GNP averaged more than 4 percent. If this trend had continued, total spending would have been \$50 to \$60 billion higher in 1971, and real activity would have been 5 or 6 percent higher than it was.

The economic slowdown is associated with the restrictive monetary and fiscal policies that were adopted, particularly in 1969, with the intention of dampening the rapid price inflation that had gathered momentum after 1965. But this was not the whole story.

GNP rose substantially in 1971, but more than half the gain reflected price inflation



The de-escalation of the Vietnam war, the curtailment of other military programs, the reduction in capital expenditures associated with the buildup of excess capacity in many industries, the drop in the birthrate, work stoppages in basic industries, and social unrest all played roles in curbing growth.

Reduced profit margins caused many business managers to hold back on new investments and new hirings. Increased apprehension concerning the security of jobs and incomes caused many individuals to restrict outlays on consumption. Cautious attitudes on spending and investing, more pervasive than at any time since World War II, blunted the impact of stimulative monetary and fiscal policies specifically designed to accelerate economic activity.

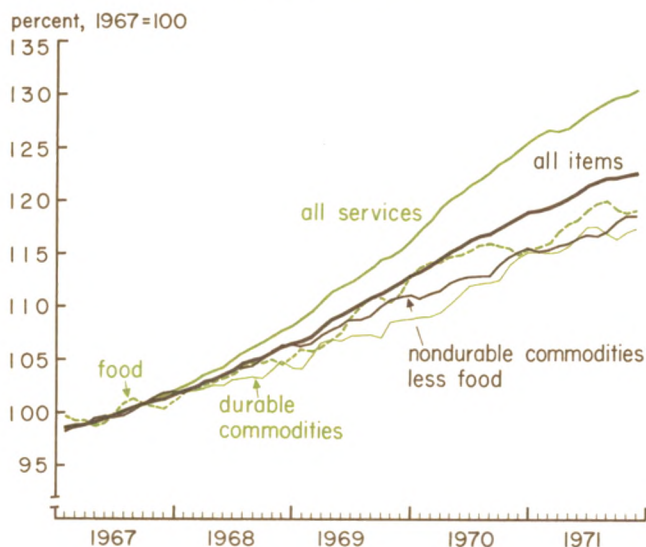
The volume of total activity in 1971 was about in line with the median forecasts made at the start of the year. However, there had been a common tendency to overestimate growth in the manufacturing sector, and to underestimate the persistence of unemploy-

ment. In addition, most projections envisaged a more pronounced retardation of price inflation than actually occurred, at least prior to the introduction of controls.

Prices, wages, and controls

Prices in the private economy had been relatively stable in the early 1960s, rising about 1 percent annually, on average, from 1960 through 1964. Interestingly, this period followed widespread concern over the failure of the free market system to halt price inflation in the late 1950s. Prices rose more rapidly in 1965, the first year of direct U. S. involvement in the Vietnam war, and the acceleration continued through 1970. In that year, prices averaged 4.9 percent higher than in 1969. The price surge of the late 1960s constituted a classic case of "demand-pull" inflation. Many companies were operating at effective capacity, and employers reported widespread labor shortages.

The rapid rise in consumer prices slowed in the second half



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Restrictive monetary and fiscal policy contributed substantially to the cooling of the expansion spending in 1969 and 1970, more effectively, in fact, than had been intended. Sluggishness induced by these policies was reinforced by a shock to confidence as businessmen, lenders, and consumers reacted to the ending of a record-long period of economic growth. As a result, attempts to revitalize the process of economic growth have been partially successful. Almost two years elapsed from the peak of the cycle in late 1969 to the summer of 1971. Margins of unused resources had increased substantially. But the rate of price inflation remained high. These factors, coupled with the international crisis, caused the Administration to turn to the standby powers that it had reluctantly accepted from Congress in August 1970 to control prices and wages.

There were clear, but scattered, signs of slowing in the rate of price inflation prior to the August 1971 freeze. Prices of nonferrous metals and many other raw materials had declined in the face of worldwide market gluts. Prices of certain finished goods, including some types of machinery and equipment, were either stable or declining. Moreover, some administered prices declined in the freeze and post-freeze periods, indicating that market forces, not controls, were the determining factor. But by and large, the economy appeared to be in the firm grip of a "cost-push" inflation when the President announced his New Economic Policy.

A wage-price spiral, "cost-push" inflation, was clearly in evidence. Despite higher unem-

ployment, and reduced employment, unions and employers negotiated the largest increases in compensation on record. With profit margins near their postwar low, business firms made every effort to pass cost increases along in higher prices. With changes in costs dominated by changes in wages in many sectors, price and wage controls appeared to many observers as the only means of halting inflation.

The wage-price freeze, ordered August 15, received general cooperation, and price increases for most nonexempt items stopped completely. Midway in the fourth quarter of 1971, on November 14, the freeze was replaced by the guidelines of Phase II administered by the Price Commission.

The goal of the Price Commission was stated to be an average advance in the general price level of no more than 2.5 percent per annum. Price increases of more or less than 2.5 percent would be approved, depending on supporting evidence from individual firms concerning cost increases, changes in worker productivity, and pretax profit margins. In November and December, the Commission issued numerous decisions concerning the pricing of products, services, and rents.

The trend in successive rulings of the Price Commission has been toward flexibility to permit businesses to operate with a minimum of interference in making specific decisions. The Internal Revenue Service, with major responsibility for investigation and enforcement of Price Commission rulings, reported in December that most companies were complying without special pressure.

The Wage Board assumed average price increases of 2.5 percent in setting its general standard of 5.5 percent per annum increases in worker compensation. The Board assumed a rise in output per man-hour near

the historic trend of 3 percent. The wage formula is the sum of the anticipated increase in average prices and the anticipated rise in productivity. Allowances in wage rulings were to be made for hardship cases, and for the need to "catch up."

The basic policies of the Price Commission, the Pay Board, and the coordinating Cost of Living Council are intended to create an economic framework that approximates free market conditions, overriding the market power of monopolistic elements in capital and labor. For this reason, administrators have followed a strategy of concentrating on the largest units in labor and industry. The degree of success achieved in this formidable undertaking probably will not be clear until 1972 is well advanced.

Employment and unemployment

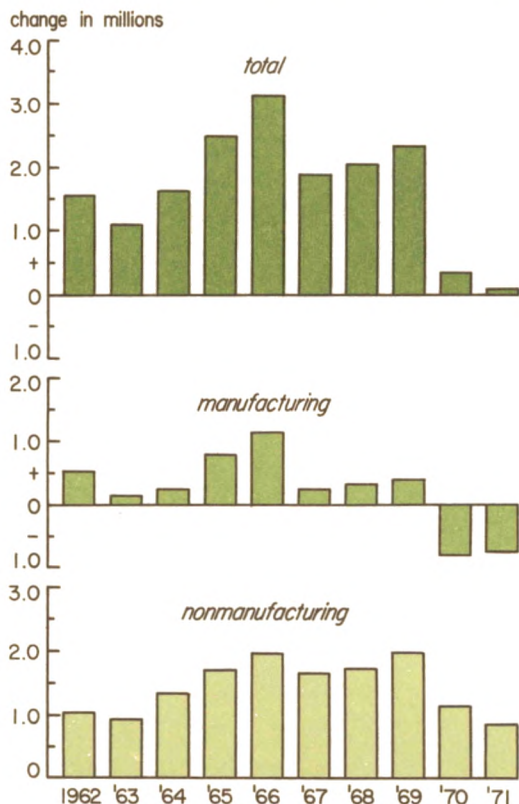
Nonfarm payroll employment averaged about 70.7 million in 1971, virtually the same as in 1970, and 0.6 percent more than in 1969. In the 1960s, payroll employment rose about 3 percent annually. If this trend had continued, employment would have averaged about 5.5 percent higher than it did in 1971—almost 4 million additional wage earners.

The unemployed, defined as people without jobs who are seeking work, averaged about 5 million in 1971—up from 4 million in 1970, and less than 3 million in 1969. Unemployment was estimated at 6 percent of the civilian labor force in 1971, compared to 4.9 percent in 1970, and a very low 3.5 percent in 1969. While some unemployment always exists, unemployment rates in excess of 4 to 4.5 percent are usually associated with an underutilized labor force.

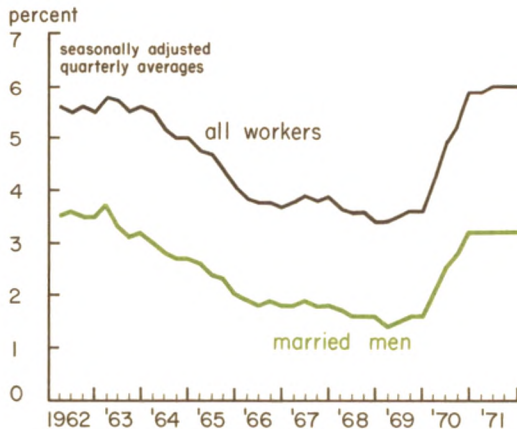
Employment had declined more in earlier post-World War II recessions than in the recent experience, and the unemployment

rate had mounted to higher levels. But, as in the case of output, the period of sub-normal demand for labor has lasted longer. In December 1971, payroll employment was still below the all-time high set in March 1970, and the unemployment rate was on the high plateau reached late in 1970. Unemployment would have been even higher were it not for a slower than normal growth in the labor force in the past two years. When jobs are hard to find, some marginal workers withdraw from the labor force, per-

Total payroll employment averaged higher in 1971, despite a manufacturing decline



Unemployment rates have remained on higher plateaus since late 1970



haps to continue school. When demand for workers is strong, faster growth in the labor force usually provides more workers than the decline in unemployment.

Employment in manufacturing averaged 18.6 million in 1971, 4 percent less than in 1970, and 8 percent less than in 1969. In fact, manufacturing employment was at the lowest level since 1965. Moreover, the manufacturing workweek averaged less than 40 hours in 1971, as it had in 1970, but this was down from 40.6 hours in 1969 and a peak of 41.3 hours in 1966.

Despite the generally poor employment performance in 1971, unemployment rates remained below the national average in all Seventh District states except Indiana and Michigan. For Indiana, the unemployment rate averaged about 6 percent, the same as for the nation. Steel mill layoffs helped to produce this result. In Michigan, unemployment averaged 8 percent in 1971, despite the large increase in motor vehicle produc-

tion. For Wisconsin, the rate was 5 percent, for Illinois, 4.6 percent, and for Iowa (primarily an agricultural state), 4 percent.

Unemployment has continued relatively high mainly because of the failure of production to rise at a faster pace. But the idling of marginal facilities with high labor inputs and the usual tendency of output to rise faster than employment in the early stages of a business revival (with resultant increases in output per man-hour) have minimized the need for additional workers. In addition, many employers have been under pressure to improve reduced profit margins and have been operating under policies that closely restrict new hirings.

Labor disputes and labor costs

Higher unemployment, and reduced demand for workers, did not create an atmosphere of stable labor relations in 1971. The number of man-days lost directly because of strikes declined to about 45 million in 1971 from 66 million in 1970. The difference mainly reflected the fact that no single strike in 1971 approached the magnitude of the two-month General Motors dispute of late 1970. Time lost in strikes in 1971 was about equal to the average for the years 1967-69, and was double the average for earlier years of the decade.

The most disruptive work stoppages of 1971 probably were the long dock strikes involving ports on all three seacoasts, which were halted late in the year by court injunctions. But labor pressure was also apparent in strikes in the railroad, coal mining, farm equipment, and communications industries. In addition, there were numerous strikes of teachers, and other groups of public employees, who had not used this device to the same degree in the past.

Major labor contracts negotiated in 1971,

including those concluded without work stoppages, typically resulted in three-year contracts providing increases in worker compensation of 9 to 10 percent annually, with especially large increases in the first year. In some industries, such as railroads and coal mining, gains in compensation were 12 percent or more. On average, negotiated increases in compensation were larger in 1971 than in earlier years, and continued the acceleration of the late 1960s. Only in the building trades, under the surveillance of the Construction Industry Stabilization Committee for five months preceding the freeze, was there a modest reduction (to about 12 percent) in annual increases in compensation.

Increases in labor costs in 1971 were less than in the two previous years in many industries because of gains in productivity—output per man-hour. The long-term average increase in output per man-hour for the private economy has been 3 to 3.5 percent annually. In both 1969 and 1970, the rise was less than 1 percent. In 1971, productivity increased about 4 percent, better than the long-term trend, but still far less than the increase in compensation provided in most negotiated contracts.

Income and retail sales

Disposable personal income, after income taxes, exceeded \$740 billion in 1971, up about 8 percent from 1970. The rise in personal outlays was somewhat larger, about 8.2 percent. As a result, the proportion of income saved declined slightly from the 1970 rate. The saving rate increased sharply in 1970 to almost 8 percent from the more normal 6 percent in 1969. Because consumption spending accounts for about 63 percent of the gross national product, relatively small changes in consumer willingness to spend often largely determine the relative

prosperity of the whole economy. Indirectly, of course, the strength of consumer spending influences business investments.

The rate of increase of both disposable income and consumption expenditures accelerated in the first quarter of 1971. These developments mainly reflected stepped-up production and sales of motor vehicles following the General Motors strike. After the wage freeze in mid-August, the rise in disposable income slowed because increases in compensation stopped, temporarily, for most wage earners. Simultaneously, however, purchases of new passenger cars increased sharply. On August 15, the President ordered the general price freeze and asked Congress to eliminate the 7 percent excise tax on passenger cars. Apparently, the public believed that car bargains were available temporarily.

Consumer purchases of most nondurable goods, such as apparel and food, were unspectacular in 1971, rising less than disposable income. But purchases of major household goods—including household appliances, furniture, and color television—were at very high rates in the second half. Manufacturers' shipments of household goods exceeded the year-earlier level by about 20 percent from August through November. Part of the strength in these items probably resulted from the need to furnish newly completed residential units, up sharply in the second half of 1971. The boom in autos and other consumer durables aided Midwest centers in Michigan, Illinois, and Indiana, which produce a large share of the nation's output.

Consumers played an important role in the improvement in activity in 1971, but, on the whole, they did not extend themselves. Many families were saving a larger-than-normal share of their current income, much of this in the form of savings deposits, be-

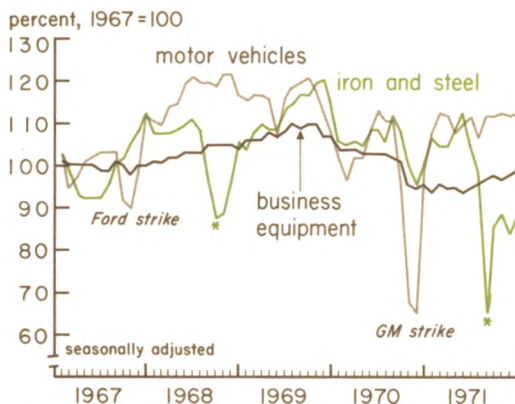
cause of uncertainties concerning job security and the possibility of a resumption of inflation at a rapid pace. Late in 1971, surveys of consumer sentiment showed no clear improvement in consumer confidence, which had been badly shaken by events of the previous two years.

Manufacturing lags the economy

The physical volume of manufacturing output, measured by the Federal Reserve Index, was slightly lower in 1971 than in 1970, and was more than 5 percent below the record 1969 level. During the 1960s, manufacturing output increased an average of 5.5 percent annually—substantially faster than the rise in real GNP, which includes all types of economic activity. If the trend of the 1960s had been continued, manufacturing output would have been about 15 percent larger in 1971 than it was.

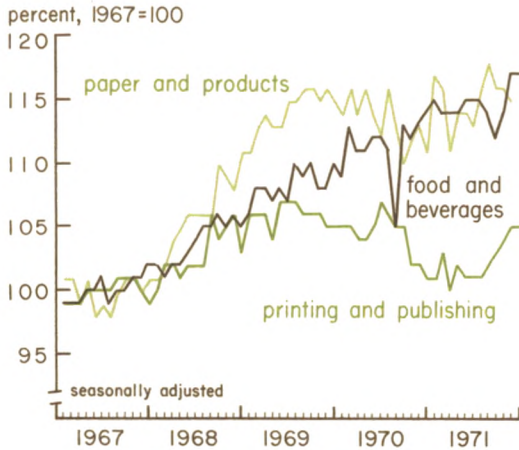
Sharper declines in manufacturing output occurred in 1949, 1954, and 1958 than in the 1969-71 period. After each of these

Output of major hard goods industries rose in late 1971, but remained below earlier peaks



*Liquidation of strike hedge inventories.

Outputs of most soft goods industries reached new high in 1971



earlier declines, however, manufacturing rose to a new record in the following year. In 1971, manufacturing output was below the level of each of the *three* previous years, starting with 1968.

A number of factors help explain the sluggish performance of manufacturing since 1969 as compared to other sectors. First, economic activities of the trade and service industries and of general government are always more stable during business adjustments than output of goods, purchases of which are often postponable. Second, imports of goods increased more than exports during this period. Third, additions to inventories were small relative to increases in sales of goods in many lines. Fourth, sharp declines in output of both business and defense equipment, had a greater relative effect on manufacturing than on total activity.

Within the manufacturing sector, output of durable goods—mainly items made of wood or metal—is always hit more severely

in a general decline than are nondurables, such as chemicals, paper, petroleum products, and food and beverages. Output of durables of all types declined in both 1970 and 1971, and was 10 percent below 1969 in the latter year. Output of nondurables, however, declined only slightly in 1970 and rose to a new high in 1971. Even so, output of nondurables remained well below the growth trend traced in the 1960s. As a result, most producers of nondurables, like producers of durables, had unused capacity and faced competitive markets in both 1970 and 1971.

Differences in the overall impact of the recession on cities and regions have depended largely on the types of manufacturing concentrated in these places. The five states of the Seventh Federal Reserve District, with less than 16 percent of the nation's population, produce more than 25 percent of its durable goods. On the whole, therefore, the recession was more severe in this region than in the nation, just as the uptrend in the 1960s had been more vigorous.

Record year for autos and trucks

In 1971, sales of passenger cars, including imports, totaled 10.3 million and sales of trucks reached 2.1 million—both new records. These results exceeded the projections of auto executives at the start of the year that were regarded as optimistic by some observers.

In the first quarter of 1971, sales of both cars and trucks were at abnormally high levels, reflecting the recovery following the long strike that ended in November 1970. After most of the backlog of sales had been made up—perhaps 600,000 cars and trucks—demand for motor vehicles slowed somewhat from April until mid-August. The surge in demand that followed the price freeze

and the proposed elimination of the excise tax helped the motor industry to achieve its goals for the year as a whole.

Plants in the United States assembled 8.6 million passenger cars and 2.1 million trucks in 1971. Truck output was at a new high—exceeding the 1.95 million units produced in both 1968 and 1969—and well above the strike-depressed total of 1.7 million for 1971. Auto output, also far above the 6.6 million for 1970, was below the 8.8 million produced in 1968, and the 9.3 million record set in 1965. Almost 500,000 cars of the new supply of “domestic” makes in 1971 represented net imports from Canada, as required under the trade agreement. In 1965, imports from Canada had been insignificant.

Demand for new models of domestically-produced small cars, competitive with overseas imports, was very strong in 1971, pressing productive capacity to the limit. Demand for luxury-type cars and sport models continued to ebb, on the other hand, following the trend of recent years.

U. S. producers had hoped that demand for cars imported from overseas, mainly Germany and Japan, would decline in 1971. Actually, sales of imported cars hit a new high of 1.6 million (16 percent of total deliveries to U. S. customers), up from 1.3 million in 1970 and double the total of 1967. Sales of imports would have been even larger were it not for the dock strikes.

As 1971 drew to a close, auto industry executives were again optimistic. Despite a distinct slowing in sales in December, sales of passenger cars were projected at 10.5 to 11 million for 1972. No further increase was expected in the share of the car market taken by overseas imports. The import surcharge was removed in late December, but currency realignments imply that prices of imports will be up by as much as 16 percent.

In addition, foreign producers have experienced even more severe upward cost pressures than have U. S. producers. Truck sales were projected at about 2.2 million for 1972, another record, with demand for heavy trucks expected to be strong.

Steel output at reduced level

Every three years since 1959, the major steel firms, accounting for about 80 percent of the industry's output, have successfully negotiated settlements with the United Steel Workers without a general work stoppage. In each case, the increase in wages and benefits agreed upon has closely resembled the contracts negotiated earlier in other major industries. In each case, the period prior to the contract deadline has been accompanied by a surge in output and shipments of steel; and the period following the deadline has seen a corresponding sharp decline. As a result, the effect on the general economy has been about the same as if a strike lasting about two months had, indeed, occurred.

Shipments of steel from U. S. mills totaled 62 million tons in the first seven months of 1971—about equal to the record for the period set in 1968, which also included a buildup of strike-hedge inventories. Most users of steel added a supply cushion of at least 60 days requirements, some from foreign sources, as a precaution against a work stoppage. Inventories of manufacturers totaled 16 million tons at the August 1 deadline, up from 9 million tons at the start of the year. In July, shipments were 9 million tons; in August, less than 4 million. Shipments rose gradually each month following August, but were still far below normal in December. Laid-off workers were being recalled periodically, but unemployment in steel centers remained high.

For 1971 as a whole, shipments of steel products from U. S. mills totaled 88 million tons. This amount was exceeded in several recent years, including 91 million tons in 1970, and the 94 million ton record in 1969.

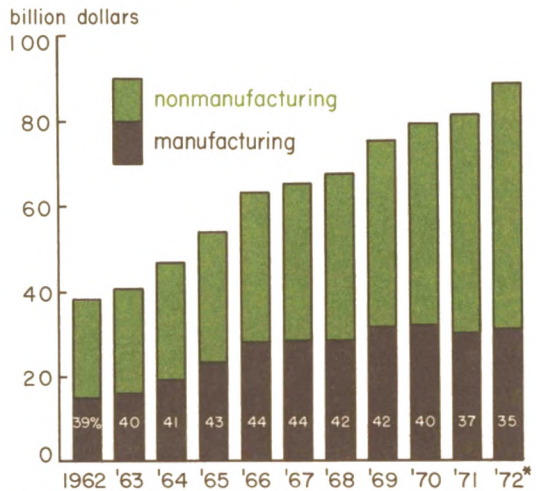
Consumption of steel is estimated to have been about 5 percent higher in 1971 than in 1970. Shipments were lower, however, because of the adverse change in the foreign trade balance. Imports of steel rose from 13 million tons in 1970 to 17 million in 1971. Exports declined from 7 million tons in 1970 to less than 3 million in 1971. The net change, therefore, was about 8 million tons. Without this shift, steel shipments presumably would have reached a record 96 million tons in 1971.

With the liquidation of strike-hedge inventories completed, steel executives expected operations to return to normal in early 1972. Imports probably will decline somewhat in 1972 because of negotiated quotas, a reduced price differential, and the absence of a strike threat. A strong rise in the general economy probably would boost steel mill shipments for the year to a new high of 95 million tons, or more.

Capital expenditures lag

In 1971, total expenditures for new plant and equipment by businesses in the United States, at \$81.4 billion, were only 2 percent higher than in 1970. Because prices averaged about 5 percent higher in 1971, the physical volume of these investments was about 3 percent less than in 1970. Among the major sectors of industry, public utilities showed the greatest strength with plant and equipment outlays up 18 percent. Outlays of manufacturing companies, on the other hand, declined 6 percent, even before adjustment for price increases. Outlays of the durable goods manufacturing industries were

Outlays for plant and equipment rose slightly in 1971; a larger rise is expected for 1972



*Outlays planned in January.

down more than 9 percent.

Almost two-thirds of plant and equipment expenditures consist of equipment. The states of the Seventh Federal Reserve District produce almost one-third of the nation's producer equipment, and much larger shares of the nation's farm, construction, railroad, and highway transport equipment. Most of these companies have had insufficient orders in 1970 and 1971 to maintain the work forces built up during the capital spending boom of the last half of the 1960s.

It is axiomatic that a strong uptrend in general business typically is accompanied by a more than proportional increase in plant and equipment expenditures. Similarly, periods of decline or subnormal growth are characterized by reduced demand for these investments, especially for expansion purposes. To place orders for expensive new equipment, a high degree of confidence in prospects for future profits is essential.

In 1971, production of business equipment of all types, as measured in physical terms by the Federal Reserve Index, was 11 percent below the 1969 high. Like the auto and steel industries, equipment producers were affected adversely by a shift in the balance of trade. Changes in output among various types of equipment showed marked variations. Output of electrical generating equipment and motor trucks was at record levels in 1971. Output of machine tools, commercial aircraft, and steel mill equipment, however, was down by 20 percent or more. Output of defense equipment, not included in plant and equipment expenditures and not a major factor in most Midwest centers, was down almost 30 percent in 1971 from the 1968 record.

In the second half of 1971, accumulating evidence suggested that a general revival of plant and equipment spending had begun. Total production of producer equipment rose slowly but steadily after midyear. Surveys of business intentions indicated that total outlays on plant and equipment would rise 8 to 10 percent in 1972, about as much as the rise anticipated for the gross national product. Such a prospect does not suggest

a new boom in plant and equipment spending, but it indicates solid improvements in place of the decline from 1969 to early 1971.

Although the major factor determining the trend of capital outlays is the rate of growth in demand for goods and services produced by these facilities, outlays can also be stimulated, at least temporarily, by favorable tax measures. In June 1971, the Treasury published its Asset Depreciation Range System (ADR), which was approved in a somewhat less stimulating form by Congress late in the year. These rules permit many buyers to write off purchases of new equipment for tax purposes at a rate 20 percent faster than allowed formerly. In addition, the Congress approved a reinstatement of the 7 percent investment tax credit (retroactive to April 1, 1971) that had been repealed in 1969. The investment tax credit (approximately equivalent to a price cut of similar proportion), coupled with faster depreciation, will activate some marginal investments. Finally, U. S. equipment producers will be aided by the realignment of international currencies that makes the prices of their products more competitive with those of foreign companies.

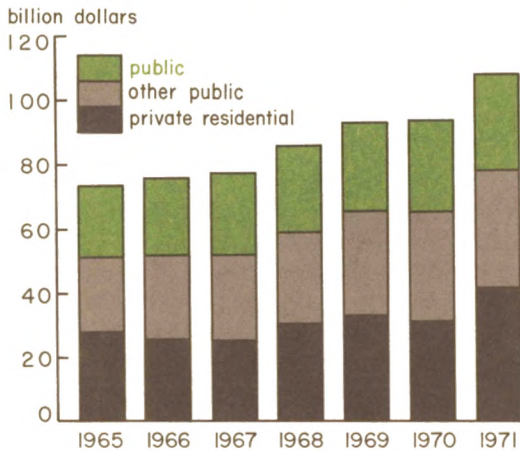
Residential building leads construction

Outlays on new construction totaled \$109 billion in 1971, up 15 percent from 1970. Because construction costs rose at least 8 percent, less than half of the rise in construction outlays represented an increase in physical activity.

12 Construction costs increased much faster than the average price level throughout the

1960s. From 1966 to 1971, prices of new structures increased almost 37 percent, while all prices in the private economy rose 21 percent. In this interval average, hourly compensation for the building trades increased 50 percent. Prices of most building materials rose also, but by a much smaller proportion. Further large gains in labor

Residential building led the rise in construction outlays



costs are expected for 1972 and 1973, as three-year contracts negotiated in 1970 and 1971 are implemented.

Private residential construction—up 32 percent in 1971—was the star performer for the year in the construction sector, and in the entire economy. Outlays on nonresidential private construction and public construction both increased about 7 percent, and were probably down slightly after adjustment for inflation. Within nonresidential construction, manufacturing was by far the weakest sector, with outlays about 25 percent lower in 1971. Outlays on commercial, educational, and hospital buildings were up about 20 percent.

With more families being formed, with growing programs of federal subsidies for both rental and purchased dwellings, and continued ready availability of mortgage funds, a high level of housing starts is virtually assured for the first half of 1972. Even with some slowing in the second half, most analysts expect housing starts in 1972

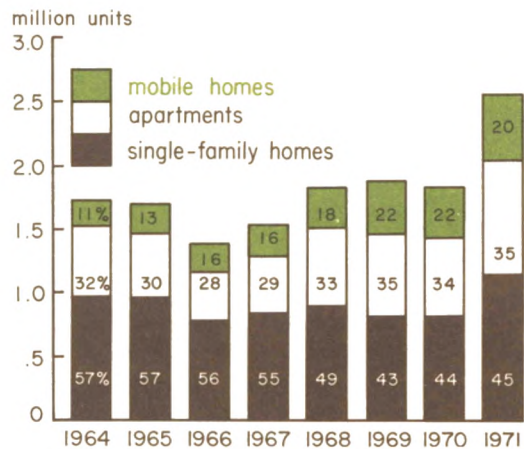
to equal the 2 million record for 1971. Shipments of mobile homes also are expected to duplicate their 1971 record of 500,000 in 1972.

Outlays on nonresidential private construction are expected to rise more in 1972 than in 1971. Manufacturing building activity has leveled off after a sharp decline, and is expected to rise somewhat in 1972. Commercial construction will remain at a high level because of continued needs for shopping facilities and other consumer-related structures. But construction of large office buildings is now on a downward slope. Outlays on public construction are likely to increase steadily in 1972 because of pressing needs for water and sewerage works, highways, and other public facilities.

The home-building boom

Just over 2 million housing units were started in 1971, breaking a record of 1.95 million set in 1950 at the peak of the resi-

Both housing starts and mobile home shipments set new records



dential construction boom that followed World War II. Housing starts had not approached the 1950 total in any year prior to 1971. Less than 1.5 million units were begun in 1970—about the average for the decade of the 1960s. Other housing was provided by 500,000 new mobile homes, one-fourth more than in 1970.

The rise in residential construction has been especially strong in the Seventh District, with most large centers in the region reporting larger gains in permits for new houses than the nation. In the Chicago area, 67 percent more permits were issued in 1971 than in 1970. The Chicago area led all other metropolitan areas in housing starts in 1971.

The current upsurge in residential building got underway in the second quarter of 1970, gathered strength in the first half of 1971, and increased quarter-to-quarter throughout the year. In its initial stages, the housing boom was fueled by aggressive credit support channeled to the mortgage markets by the Federal Home Loan Bank System, and the secondary market activities of the Federal National Mortgage Association. These activities tapered off in 1971 as the inflow of savings to savings and loan associations (S&Ls) and mutual savings banks (MSBs), major suppliers of home mortgage credit, increased sharply.

In November 1971, savings capital of savings and loan associations was up 19 percent from a year earlier, almost three times the increase of the previous 12-month period. Mortgage loans of these institutions were up 14 percent. Mutual savings bank deposits were 14 percent higher than a year earlier in November 1971, while holdings of mortgages were up 7 percent. The thrift institutions, especially the S&Ls, concentrate on single-family homes. A large share of the credit needed to finance multifamily structures has been provided by life insurance companies, pension funds, and other institutions although here, too, the S&Ls and the MSBs were the largest lenders in 1971. In late 1971, many commercial banks with ample loanable funds were expanding their mortgage loan portfolios.

Interest rates on home mortgage loans, which had peaked in the summer of 1970, declined in the remainder of 1970 and in 1971. From a 1970 high of 8.6 percent, average rates on conventional new home mortgages declined to 7.6 percent by April 1971. The downtrend was reversed in the following months, reaching 7.9 percent in August. Rates had declined again to about 7.6 percent by December. Substantial ease in the mortgage markets was indicated by lower downpayments and longer maturities, as well as lower rates.

Agricultural developments

Net income of farm operators apparently declined slightly in 1971 to about \$15.5 billion. In 1970, farm income had declined about 7 percent from the near-record total for 1969. After a depressed first half, farm income rose sharply in the second half of 1971, reflecting larger crops and higher livestock prices. Overall, farm income in Seventh District states followed the national trend, but results varied for individual farmers depending on their major products.

Fears of a renewal in 1971 of the corn blight infestation and drought that destroyed 15 percent of the 1970 crop fortunately proved to be unfounded. Partly because of government policies that encouraged the planting of additional acreage, farmers harvested a record corn crop. Scarcity turned to surplus, and corn prices, which had averaged more than \$1.50 a bushel in the first half of 1971, were down by about one-third in the final months of the year. Prices of other major grains also declined in the second half, but by smaller proportions. The dock strikes that reduced crop exports played a role in depressing grain prices.

In contrast to prices of grain, prices of soybeans were well-maintained in 1971. World demand for vegetable oil and protein meal has continued to outrun production.

Milk prices rose again in 1971. For the second consecutive year, government support prices were increased, despite rising production and mounting stockpiles of surplus dairy products.

Prices of agricultural products were exempted from price controls, both during the freeze and in Phase II. But restrictions were applied to prices of nonfarm production

items purchased by farmers. This slowed the rate of increase in farm production costs.

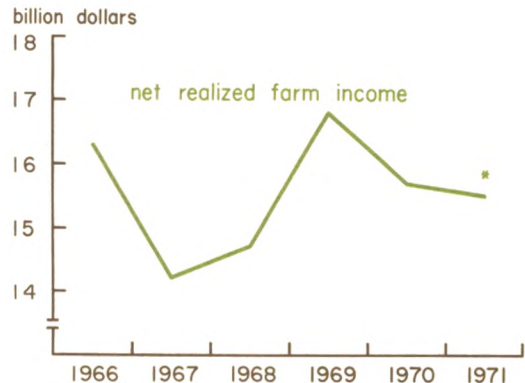
Other government policy changes favorable to farmers included new shipping rules that encouraged grain sales to communist countries, and, in December, direct government purchases of corn were begun to support sagging prices.

In 1972, higher cash receipts are expected for both livestock and crops. Most of the anticipated gains probably will come from increased sales of cattle and hogs. With increased government payments and a slower rise in production expenses, net farm income could rise by 5 percent or more for the year.

Fluctuations in corn prices

Corn prices were unusually erratic in 1971. A virulent new form of leaf blight disease, reinforced by widespread drought, sharply reduced the 1970 corn crop. Short supplies, strong demand for corn for feeding, and speculation over a serious recur-

Farm income down again in 1971



*Estimate.

rence of blight caused corn prices to soar in the first half of 1971. By June, prices were \$1.58 per bushel at Chicago—the highest level in 20 years. In addition, the government's 1971 feed grain program substantially relaxed the controls on the number of acres that could be planted to corn.

As summer progressed, two things became clear: blight was not going to be a serious threat to the crop, and yields per acre were going to be at or above record highs. The result was a 5.5 billion bushel corn crop—35 percent larger than the previous year and 16 percent above the record set in 1967. Harvesttime prices dropped to less than 90 cents per bushel at country markets—over one-third below their midyear highs and the lowest level in several years.

But corn prices rebounded during the closing weeks of 1971. Late in the year, the government began to make outright purchases on the open market in an effort to bolster sagging corn prices. U. S. exports of grain, temporarily cut off by dock strikes

at all U. S. coastal ports and by a grain elevator operators' strike at the Port of Chicago, began to move in mid-December.

More than anything else, government operations will determine production and prices of corn during 1972. Over the next few months, corn prices will depend largely upon the magnitude of direct government purchases and the extent to which farmers take advantage of the government loan program. During the latter part of the year, production and price prospects will be largely influenced by the degree of participation in the 1972 feed grain program.

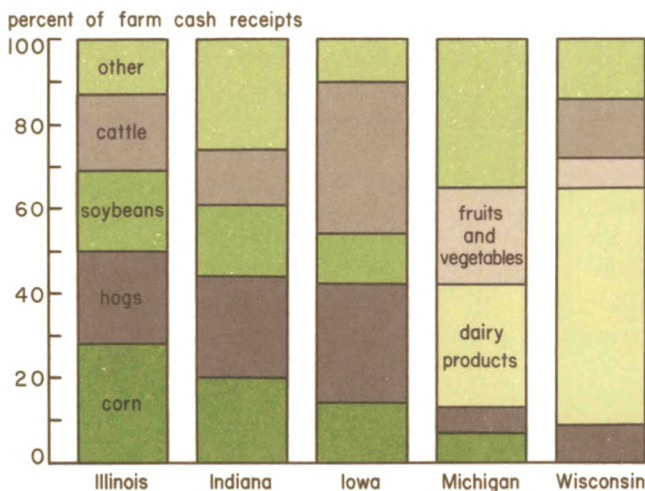
Direct purchases of corn thus far have been small, but corn placed under loan is running nearly triple the year-earlier level. Continued heavy use of government loans should hold corn prices throughout most of 1972 near the national average support level of \$1.08 per bushel plus storage charges.

Recently announced guidelines for participation in the 1972 feed grain program will substantially increase the number of feed grain acres idled. Modifications in the 1972 program were designed to remove around 38 million acres from production—more than double the acreage idled in 1971. Such a large increase in acreage idled would likely keep corn prices and prices of other feed grains (grain sorghum, oats, and barley) from dropping to the harvesttime lows experienced in 1971. Participants in the program also will benefit from larger government payments.

Soybean demand strong

Soybean producers reaped higher profits in 1971 than did corn producers. Many Midwest

Source of farm income varies by state



farmers grow both. Soybean supplies were tight and prices relatively high throughout the year. Prices averaged around \$2.90 per bushel—the highest since 1966.

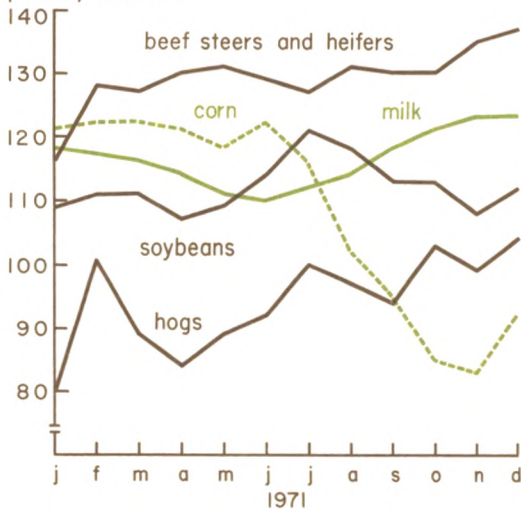
Unlike most farm commodities, the demand for soybeans has consistently outpaced the steadily increasing supply. Foreign demand has been the key. During the past five years, U. S. exports of soybeans increased 70 percent, while domestic production increased 30 percent. In 1971, well over one-half the crop was exported, either as soybeans or as processed oil and meal.

Soybean exports, too, were curtailed by U. S. dock strikes in 1971. Occurring when prices were at harvesttime lows, the strikes reinforced the usual downward seasonal pressure and caused prices to dip temporarily below year-earlier levels. Prices strengthened when export activity was resumed in December.

For soybeans, as for corn, government actions during 1972 will influence production

1971 farm prices show divergent trends

percent, 1967=100



and prices. While the feed grain program is designed to reduce feed grain acreage, it will also encourage expanded soybean acreage. An innovation in the 1972 program will permit farmers participating in the program to plant soybeans on feed grain acreage and still receive program payments. This provision, along with prevailing price relationships between soybeans and feed grains, would appear to favor a rather large increase in soybean acreage. The Department of Agriculture estimates an increase of 10 percent from the 43 million acres planted in 1971. Such an increase would be quite large compared with past years, and if achieved would likely cause soybean prices to decline more than seasonally during the latter part of 1972.

Cattle prices high

Cattle prices rebounded sharply early in 1971 from the depressed levels of 1970. Prices remained on a plateau for much of the year, and then, in the fourth quarter, they rose 16 percent above the year-earlier level. Higher prices prevailed, despite somewhat larger beef slaughter. Total beef output was up about 3 percent for the year with most of the increase occurring during the summer months.

Midwestern cattle feeders curtailed operations through most of 1971, primarily because of the high cost of corn. High corn prices caused many farmers to sell their corn for cash. But by year-end, Corn Belt farmers, partly in response to low corn prices, had reversed the decline in the number of cattle on feed. Iowa, with a 4 percent increase in numbers on feed as of December 1, regained its place from Texas as the nation's leading cattle feeding state.

Cattle feeders are expected to market about 5 percent more animals in 1972 but

perhaps at only moderately lower prices. Higher employment and income may increase demand for beef and bolster prices. Lower grain prices will help maintain profit margins, but higher prices paid last fall for feeder stock may offset lower feed costs.

Hog profits recover

Many hog producers suffered losses during the first part of 1971, but returns improved in the final months of the year. Hog marketings from January through July ran about one-tenth larger than a year earlier, while prices averaged nearly one-fourth lower. By contrast, marketings during the final quarter of 1971 dipped about 2 percent below the very large year-earlier volume. Prices of hogs rose to around \$20 per hundredweight by year-end—about \$3 per hundredweight above the first-half average and \$5 per hundredweight above the one-year-earlier average.

Hog raising is a major enterprise on many Seventh District farms, and it appears likely that income from hogs will show the sharpest increase of any major product group in 1972. The number of hogs on farms in early December totaled 7 percent fewer than the year before, and farmers are expected to continue reducing farrowings through mid-year. Hog marketings, therefore, are likely

to run well under the year-earlier level throughout 1972. The reduction in supplies probably will result in further increases and boost cash receipts substantially. Net incomes are likely to be up even more due to comparatively low feed prices.

Higher returns to dairying

Cash receipts from dairy product sales were up 4 percent in 1971. Early in the year, government support prices for milk were raised from \$4.66 to \$4.93 per hundredweight. Milk consumption by consumers continued to decline, reflecting higher prices and increased consumption of substitute dairy products. Increased government purchases of dairy products were needed to maintain prices, which averaged 3 percent higher than the previous year. Government stocks of dairy products were 14 percent above the year-earlier level in the late fall, and were equal to more than 7 percent of total annual production.

Returns to dairy farmers probably will continue favorable during 1972. Abundant supplies of grain and hay, coupled with the largest supply of herd replacements in more than a decade, point to further increases in milk production. Moreover, prices will be maintained close to or above 1971 levels by government purchases.

International developments in a critical year

1971 was a momentous year in international monetary affairs. Not since the early Thirties had the world been confronted with an international financial crisis of such scope and severity. For a period of several months, from August until late December, foreign exchange markets were in an unsettled state. Uncertainties concerning the value of the dollar relative to other major currencies hampered foreign trade and international flows of funds. Concerned with the threat to the collective prosperity of the free world, monetary authorities of the major noncommunist countries applied themselves to the task of reestablishing a smoothly functioning payments mechanism.

A preview to the August crisis occurred in early May, when large shifts of speculative funds forced a temporary closing of foreign exchange markets throughout Europe. The markets were reopened after several governments took steps to correct the conditions that encouraged speculative flows of funds: Switzerland and Austria revalued their currencies relative to the dollar by 7 and 5 percent, respectively; West Germany, the Netherlands, and Belgium adopted floating exchange rates.

This prelude to other monetary upheavals culminated on August 15, when the President of the United States suspended the convertibility of the U. S. dollar into gold.

The convertibility of the dollar into gold was the touchstone of the international gold exchange standard as it had existed since World War II. Suspending convertibility effectively terminated that system. Monetary authorities throughout the world recognized the need for restructuring the system to con-

form to the realities of the Seventies. Months of intensive negotiations followed. In late December, a general realignment of major world currencies was agreed upon. The President announced he would ask Congress to provide for the formal devaluation of the dollar in terms of gold. Many important issues remained to be resolved, however, and monetary negotiations continued in early 1972.

Long-run factors

Last year's financial crisis was the product of both short- and long-run factors. Superimposed at a point in time, these forces caused a temporary breakdown of the payments mechanism.

The fundamental long-run problem was the inability, or unwillingness, of major countries to deal decisively with persistent deficits, or surpluses, in their balance-of-payments accounts. For more than 20 years, deficits had been recorded in the U. S. balance-of-payments accounts, and the size of these deficits had tended to increase, despite a variety of measures introduced to stem the flow. Payments deficits were associated with cold war military programs and large-scale U. S. private investments in foreign countries as well as a growing tendency for U. S. buyers to rely on imported goods. Increasingly, in the late 1960s, attention was directed to the declining surplus in the U. S. balance of merchandise trade, which was converted to a deficit in 1971.

The counterparts of U. S. payments deficits have been surpluses in the accounts of foreign countries, especially Germany and Japan. For many years after World War

II, foreigners welcomed U. S. deficits which helped to replenish war-depleted monetary reserves. Eventually, however, and particularly since the late 1950s, the deficits were viewed as potentially troublesome. Payments surpluses abroad led to accumulation of an increasing volume of dollars in the hands of foreign official institutions that represented claims on the diminishing U. S. gold stock. Some nations converted excess holdings of dollars into gold, thereby reducing U. S. reserves. As these trends continued despite efforts to bring them to a halt, confidence in the dollar as a reserve currency eroded.

Short-run factors

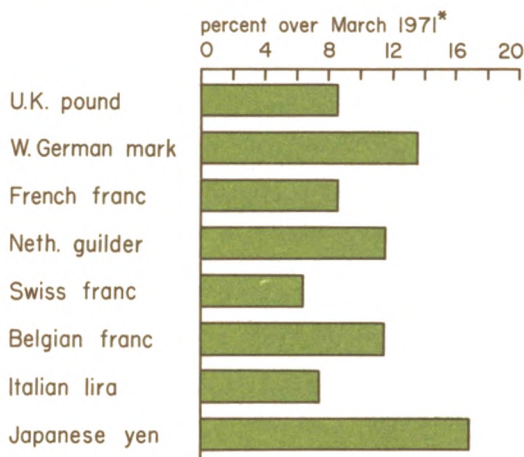
In recent years, short-term developments reinforced the long-term factors undermining confidence in the dollar. In 1968 and 1969, U. S. monetary and fiscal policies were directed toward cooling domestic price inflation. With strong demand for loans and a scarcity of loanable funds, large U. S.

banks supplemented their resources by foreign borrowing. A large volume of foreign-owned dollars (so-called Eurodollars) were borrowed for relending to domestic customers. As a result, a large portion of the dollar overhang that had built up abroad was absorbed temporarily.

In 1970, U. S. monetary policy was eased to increase the supply of loanable funds. Domestic deposits increased rapidly, and interest rates declined. U. S. banks began to repay their foreign borrowings. At the end of 1970, these debts had declined to about \$8 billion—half the amount outstanding a year earlier. Repayments accelerated further in the early months of 1971, and by May outstandings totaled only \$1.5 billion.

Eurodollar repayments, plus the continued growth of dollar claims from the payments deficits, flooded foreign central banks with dollars, especially those of Germany and Japan. Speculation arose that various countries would revalue their currencies to stem dollar inflows. The possibility held out a chance of quick profits to speculators selling dollars for other currencies.

Major currencies appreciate relative to the dollar



The crisis deepens

The flow of dollars reached a peak in early May. On a single day, May 4, over \$1 billion reportedly was absorbed by the West German central bank. On May 5, the German bank reportedly picked up another billion dollars in the first 40 minutes of trading. Confronted with this deluge, the German foreign exchange markets were closed. As speculators moved to dump dollars in other markets, these too were closed.

The limited realignment of exchange rates that took place following the closing of the markets in May eased pressures somewhat. But confidence in the dollar was not restored. When speculation intensified again

in August, drastic action appeared to be required. As part of his economic stabilization program, the President halted the conversion of dollars into gold and imposed a 10 percent surcharge on most imports.

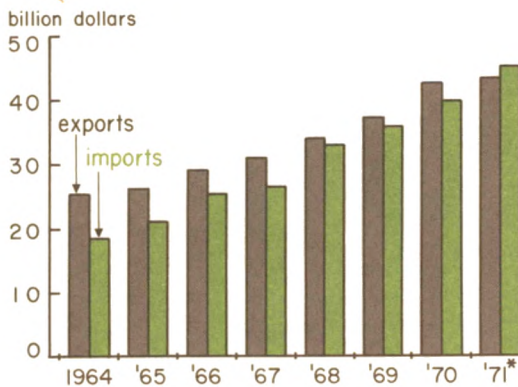
These measures set the stage for a fundamental reassessment of international monetary and trade arrangements. In mid-December, the major trading countries agreed to a general realignment of exchange values for virtually all world currencies, and to a widening of the band within which the rates are allowed to fluctuate.

U. S. balance of payments, 1971

The two principal measures of the U. S. balance-of-payments position are the Net Liquidity Balance and the Official Reserve Transaction Balance. Both were strongly influenced in 1971 by the speculative flow of funds accompanying the international monetary crisis.

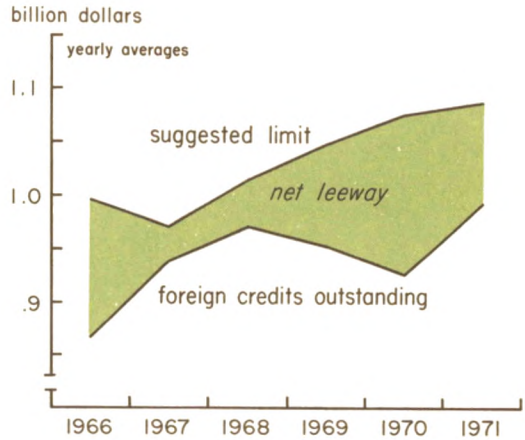
The Net Liquidity Balance is intended as a broad indicator of potential pressures on

U. S. imports exceeded exports in 1971



*January-November seasonally adjusted annual rate.

Foreign credits of district banks under Voluntary Foreign Credit Restraint Program reach new high



the dollar resulting from changes in the U. S. international liquidity position. This balance showed a deficit of \$17.6 billion for the first three quarters—a figure roughly four times as large as the deficit recorded for the same period last year.

The Official Reserve Transaction Balance is intended as an indicator of the exchange markets' pressures on the dollar during the reporting period. This balance was in deficit by \$23.4 billion for the first three quarters, more than double the record-high deficit for 1970 as a whole.

The deterioration in the U. S. foreign trade account was the most disturbing development in 1971. For the year, the trade deficit was over \$2 billion—the first deficit in this century.

Special factors, including the dock strikes and strike-hedge buying of foreign steel, helped create the 1971 trade deficit. The pickup in domestic economic activities in

1971 also tended to favor increased imports. But for many years imports have been threatening to surpass exports as U. S. buyers found cheaper sources abroad for a growing variety of raw materials and finished goods.

Imports were 14 percent higher than a year earlier—well above the annual average 8 percent growth in the 1960s. Exports rose by only 2.0 percent in 1971. The slow growth in exports reflected, in part, slackening economic activity abroad.

The deterioration in the country's trade account signaled clearly the need for realignment of the exchange values of world currencies relative to the dollar. Devaluation of the dollar will tend to restore the trade surplus. In addition, negotiations to ease foreign restrictions on U. S. exports are expected to produce positive results.

International finance in the Midwest

Plants in the Seventh Federal Reserve District supply almost 25 percent of all U. S. exports of manufactured goods, and farm-

ers in this region contribute almost 23 percent of U. S. agricultural exports. As a result, the slow growth of exports affected many district businesses in 1971.

Monetary pressures abroad were reflected in the activities of district banks. In May, and again in August, outstanding foreign credits subject to the Voluntary Foreign Credit Restraint Program administered by the Federal Reserve System rose to record highs. Customers abroad used existing bank lines of credit extensively. In addition, severe shortages of funds developed in foreign money markets, particularly over month-ends. As a result, loans of some banks substantially exceeded the lending limits suggested under the program. Ceilings were exceeded for the first time since the inception of the program in 1965.

Bankers acceptances issued by the banks in the district reached an all-time high, in excess of \$400 million in September 1971. The sharpest increases occurred in acceptances financing imports, and in acceptances financing storage of goods.

Developments in government finance

Purchases of goods and services by all sectors of government—federal, state, and local—totaled about \$233 billion in 1971, up 6 percent from 1970. For the third year in a row, total government purchases increased less rapidly than the gross national product. This overall result, however, reflected a significant decline in outlays on national defense that was more than offset by higher outlays on other programs, especially education and welfare.

Federal purchases of goods and services were almost \$98 billion in 1971—slightly more than in 1970, but less than in either of the two previous years. The decline in defense spending, which accounts for about three-fourths of federal purchases, was about matched by a 20 percent increase in nondefense purchases. In addition to purchases of goods and services, federal budget expenditures include transfer payments under various pension and welfare programs

—up almost 20 percent in 1971—and grants-in-aid to state and local governments—up 25 percent.

Total federal expenditures were \$220 billion in 1971 on the national income accounts basis, and exceeded receipts by almost \$20 billion. This deficit was by far the largest recorded since World War II. The large deficit primarily reflected relatively slow growth in receipts from income taxes because of the business slowdown. However, receipts were reduced by faster depreciation and by the tax relief measures included in the Revenue Act of 1971, approved in December.

Outlays on national defense were \$71 billion in 1971, down 5 percent from 1970 and 9 percent less than the 1969 peak. Declines in defense outlays have occurred in recent years, despite increases in military salaries and higher prices of purchased goods and services. The winding down of the U. S. involvement in Vietnam has played a dominant role in the military cut-back, but reductions have also been made in programs not directly related to the war. In 1971, defense outlays were less than 7 percent of GNP, compared to more than 9 percent in 1968. The proportion of defense spending to total economic activity in 1971 was the lowest since 1950, prior to the Korean War. Defense outlays are expected to rise in 1972 mainly because of higher military salaries, but the proportion of GNP allocated to defense probably will decline again.

The rise in nondefense federal outlays in 1971 occurred in the face of economy programs restricting purchases and new hirings by federal agencies. In the final months of the year, some postponed construction projects were activated. But federal agencies continued to operate under a directive to

reduce their staffs by 5 percent below the August 1971 level by mid-1972.

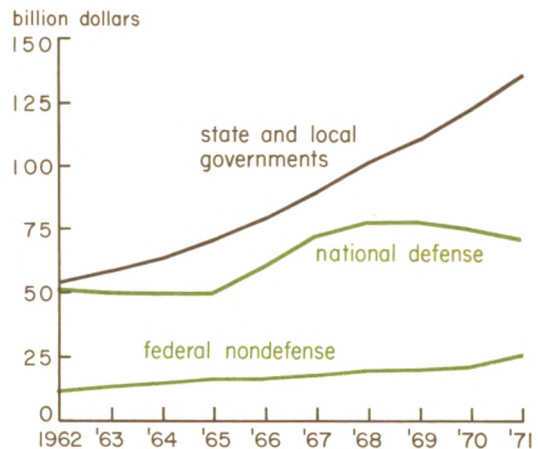
State and local governments

Outlays of state and local governments totaled about \$135 billion in 1971, up almost 11 percent from 1970. The share of the gross national product channeled to state and local government programs has increased almost every year since World War II. In 1971, state and local outlays accounted for 13 percent of GNP. In 1961, this proportion was less than 10 percent.

In addition to purchases of goods and services, state and local governments paid about \$17 billion in transfer payments to individuals in 1971. State and local transfer payments, mainly for pensions and welfare programs as in the case of federal transfers, have been increasing much faster than purchases of goods and services in recent years.

By far the largest share of state and local government outlays is for education. Rapid

Most types of government spending rose in 1971, while defense expenditures declined



growth in school enrollments appears to have passed. Enrollment in the elementary grades 1-8 peaked in the school year 1969-70 and low birthrates suggest a continued decline. But population shifts—rural to urban, central cities to suburbs, and North and Northeast to West and South—have worked to sustain pressure for new school facilities. In addition, despite the growing surplus of trained people, teachers' organizations have been able to boost compensation at a rapid rate. Along with the business adjustment, these factors brought financial stringency to many school systems. Problems have been accentuated where voters have refused to approve new bond issues or increases in property tax rates.

Property taxes account for more than half of all state and local revenues, and a much larger share of the budget of many school systems. Uncertainty over the future role of the property tax, a matter of concern for many years, was increased by a ruling of the Supreme Court of California on August 30, 1971, that apparently requires a restructuring of that state's system of school finance. The ruling was based on

an interpretation of the U. S. Constitution that it is inequitable to spend less on the education of children living in areas with a relatively small property tax base. The California decision does not apply in other states, but some observers view the development as a further stimulus to the long-standing trend for state and federal governments to supplement the revenues of local school districts.

State and local outlays on public assistance, or welfare, have been growing even faster than school budgets. About half of the total cost of public assistance is borne by the federal government, but the burden on state and local governments is heavy and growing, particularly for those with large concentrations of welfare recipients.

The fastest growing form of public assistance is the program of Aid to Families of Dependent Children (AFDC). In mid-1971, AFDC payments covered more than 10 million people. Total payments were at an annual rate of more than \$6 billion. A year earlier, recipients numbered about 8 million, and payments were at an annual rate of about \$4.5 billion.

Money and credit—an overview

The Federal Reserve System, on balance, continued in 1971 the accommodative monetary policy of 1970, with the twofold objective of fostering economic expansion while restraining price inflation. Bank reserves were provided in sufficient quantity to support a relatively large expansion of money and credit. Funds remained generally available throughout the year. Interest rates on all classes of borrowings

averaged lower in 1971 than in 1970, and declined in the closing weeks of the year. The Federal Reserve banks reduced their lending rate to member banks to keep in line with short-term market rates. Also margin requirements of purchasing or carrying stocks were lowered by the Board of Governors.

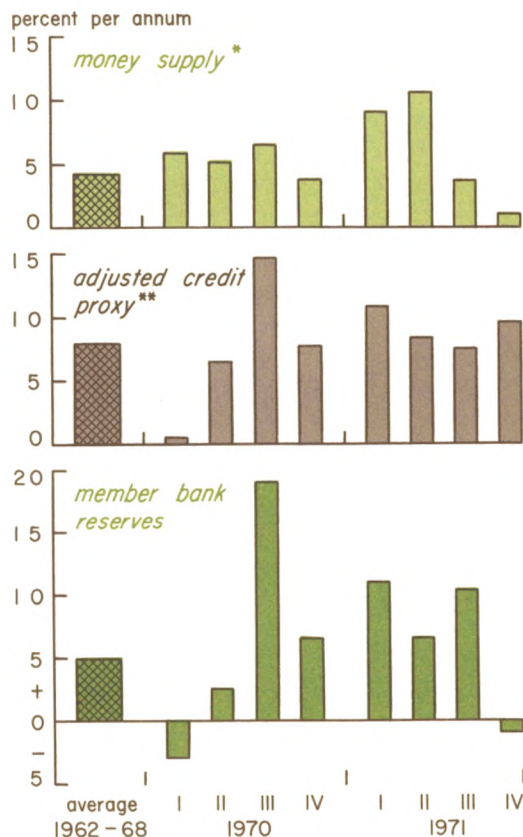
Total funds raised in the nonfinancial sector of the economy rose by the record amount of more than \$150 billion in 1971,

up more than 50 percent from 1970. All major sectors—businesses, households, and governmental units—borrowed record amounts, with the exception of the federal government during World War II. Residential mortgages led the growth in credit in financing the housing boom. The increase in consumer credit outstanding was about three times as large as in 1970, with growth in auto credit especially rapid in the second half. New corporate security issues totaled \$45 billion, up from \$39 billion in 1970 and \$27 billion in 1969. However, the volume of outstanding commercial paper sold by business firms changed little for the year as a whole. The strong uptrend in the use of commercial paper had halted in 1970, following defaults on notes issued by the Penn Central. New issues of long-term municipal bonds totaled almost \$25 billion in 1971, compared with \$18 billion in 1970 and \$12 billion in 1969. On the whole, demands for long-term credit were stronger than for short-term credit.

A large portion of the funds supplied to the credit markets were channeled through financial intermediaries—including savings banks, savings and loan associations, and insurance companies, in addition to commercial banks. Each of these classes of institutions reported strong inflows of funds. Interest rates on time and savings accounts became increasingly attractive to private investors in 1971, as yields on market securities declined.

Savings deposits of savings and loan associations rose about \$28 billion in 1971, 2½ times as much as in 1970. S&Ls provided the largest share of the mortgage financing on residential properties. Mutual savings banks also increased holdings of mortgages sharply in 1971, but corporate securities accounted for more than half of the rise in

Financial aggregates show diverse quarterly growth patterns



Note: Changes are calculated from seasonally adjusted average daily amounts in last month of each quarter.

*Currency and demand deposits held by the public.

**Total member bank deposits plus nondeposit sources.

their portfolios. Corporate securities absorbed the major share of the net rise in life insurance company investments.

Trends at commercial banks

Deposits at commercial banks increased 25

much more in 1971 than in 1970. Total deposits of member banks rose about 12 percent. Following the trend of recent years, time deposits increased more than demand deposits. Time deposits rose almost 20 percent in 1971, compared with a 6 percent gain in demand deposits. Time deposits now comprise almost 60 percent of all deposits of U. S. member banks.

During the first half of 1971, all types of time and savings deposits at commercial banks rose more rapidly than in 1970. Time and savings deposit inflows accelerated following the relaxation of Regulation Q ceilings in 1970. As a result, banks regained outflows that occurred during the restrictive monetary policy of 1969. These inflows accelerated as market interest rates declined. As 1971 progressed, however, desired levels of deposits were restored, and the major banks became less aggressive in issuing negotiable certificates of deposit (CDs). Inflows of personal time deposits also slowed in the second and third quarters as market interest rates rose, but accelerated again in the fourth quarter.

The rise in bank credit in 1971 was somewhat less than the rise in total deposits. Nondeposit sources of funds—Eurodollars, bank-related commercial paper, and other types of borrowings—continued the decline that began in 1970. When these sources of funds supplemented deposits substantially in 1969, loans and investments rose more than deposits. From a peak of more than \$21 billion in early 1970, nondeposit obligations declined to less than \$5 billion at the end of 1971.

Strong deposit expansion in 1971 enabled the banks to expand investment portfolios while accommodating a moderate increase in loan demand. Business demand for bank credit was sluggish and a larger-than-usual

share of bank funds were channeled into mortgages and consumer loans. Banks were the major purchasers of state and local securities. Preliminary estimates indicate that municipals accounted for more than one-third of the total funds invested by banks last year.

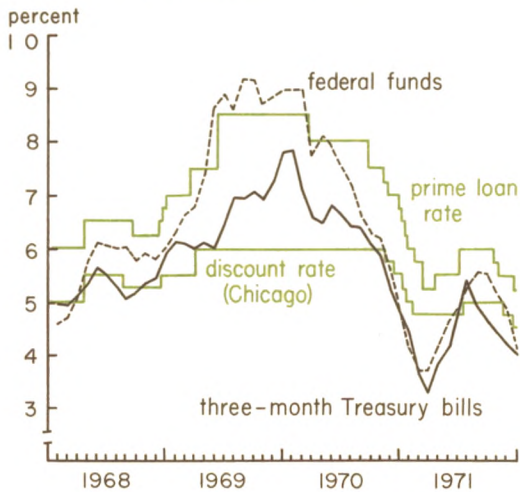
Growth in commercial bank deposits was associated with increases in the “monetary aggregates”—money supply and bank credit—often used to gauge the degree of stimulation provided to the economy by monetary policy. Money supply, defined as the sum of demand deposits and currency in the hands of the public (M_1), rose a little more than 6 percent in 1971, compared with 5 percent in 1970. In 1971, however, most of the growth occurred in the first half.

Monetary aggregates that reflect growth in time deposits, of course, increased substantially in 1971. Total commercial bank credit and the “adjusted credit proxy” (total deposits plus certain nondeposit sources of funds) both rose about 10 percent in 1971. The increase in 1970 had been 8 percent, near the average for the 1960s.

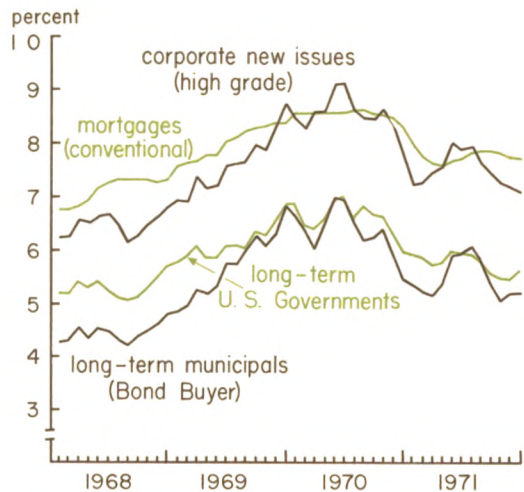
Total bank reserves increased \$2 billion, or 7 percent, in 1971. During most of the year, sufficient bank reserves were provided through open market operations so that banks did not have the need to borrow from the Federal Reserve banks in substantial volume. In July and August, however, when the money market was taut, member banks borrowed a daily average of more than \$800 million from Federal Reserve banks. In December, when credit conditions had again eased markedly, Federal Reserve advances averaged just over \$100 million.

Changes in the accommodative posture of the System within the year were reflected in the federal funds rate—the rate at which banks trade in reserves among themselves.

Interest rates resumed downtrend after midyear rebound



Note: Data are monthly averages except discount and prime rates.



This rate was already down to about 4 percent at the start of the year from the 1970 high of over 9 percent. It reached a low of about 3.30 percent in early March. Thereafter, as the System took action to moderate the very rapid monetary expansion, the funds rate moved up again and averaged above 5.50 percent in August and September. As the System tried to encourage further growth in M_1 in the fourth quarter, this rate again declined, dropping below 4 percent by year-end.

Interest rates decline after August

Both long and short interest rates were lower at the end of 1971 than at the start. But there were wide swings within the year. Most rates had declined very sharply in 1970 from the unusually high levels reached in late 1969 and early 1970.

After dropping in the first quarter 1971, market rates rose and, by August, were

back to start-of-year levels. Treasury bill yields increased more than 200 basis points in this period. Returns on new high-grade corporate bonds increased 150 basis points. The prime rate, charged by large banks to top-graded borrowers, was raised to 6 percent in early July after having dropped from $8\frac{1}{2}$ to $5\frac{1}{4}$ percent in less than 12 months. The Federal Reserve discount rate, which had been reduced from $5\frac{1}{2}$ percent to $4\frac{3}{4}$ percent in January and February, was increased to 5 percent in July.

A number of special factors contributed to the rise in rates from March to August. A larger than expected volume of new security issues exerted upward pressure on long-term yields. Concern about the international position of the dollar tended to boost both short- and long-term rates. In addition, widespread concern with the failure of price inflation to abate probably helped to boost interest rates.

High long-term interest rates in recent years are believed, by many analysts, to reflect an "inflation premium." Lenders try to obtain, and borrowers are willing to pay, interest rates high enough to compensate for the expected decline in the purchasing power of the dollar over the period the loan is outstanding.

Whatever the merits of the inflation premium theory, a gradual decline in rates accompanied the price freeze and the slower growth in the monetary aggregates that occurred in the second half of 1971. The downtrend in rates was encouraged also by some reduction in the volume of new corporate and municipal issues. More important, large purchases of U. S. Treasury obligations by foreign official institutions reduced the supply available to private investors.

By year-end, money rates and security yields were near their first-quarter lows. The decline in interest rates for 1971, as a whole, of course, reflected the greater availability of funds relative to credit demands. Nearly all major banks were posting rates on prime loans at 5¼ percent. The discount rate had been cut to 4½ percent—the lowest level since early 1968.

In late 1971, some major banks in New York announced that they would experiment with "floating" prime rates tied in

various ways to current money market rates. Some banks in other cities followed this lead.

Seventh District banking

In 1971, deposits of Seventh District banks that are members of the Federal Reserve System increased more than \$7 billion, or 12 percent. Deposits at all U. S. banks increased by the same proportion. The rise in total loans and investments at district banks also paralleled the national increase, but district banks reported somewhat smaller increases in mortgage and consumer loans and a somewhat larger increase in holdings of municipal and other non-Treasury securities.

As usual, the large banks in major cities were affected more by changes in credit conditions than were most smaller banks. But these differences were much less in

Changes in deposits and credit at large city banks¹

	Seventh District		United States	
	1970	1971	1970	1971
	(percent)			
Deposits				
Demand	- 6.6	8.0	- 2.5	3.2
Savings	2.4	12.2	3.0	12.5
Other (ex. big CDs)	13.8	13.6	15.5	14.8
CDs over \$100,000 (bil. dol.)	(1.9)	(1.0)	(15.2)	(7.9)
Credit				
Loans—total ²	4.1	7.1	3.8	6.9
Business ²	0.6	1.6	0.6	2.4
Real Estate	0.6	7.2	1.8	11.8
Consumer	5.4	8.0	6.9	10.1
Financial institutions	10.4	9.5	3.8	6.4
Security	11.2	2.4	9.4	3.5
U. S. Government securities	15.5	- 2.3	17.4	2.3
Other Securities	19.1	22.6	24.0	17.0

¹Includes 331 banks—55 in the Seventh District—with deposits greater than \$100 million that report detailed condition statements weekly. Annual changes based on data for December 31, 1969, December 30, 1970, and December 29, 1971.

²Includes loans sold to affiliates.

1971 than in either of the two previous years.

Over three hundred banks with deposits of more than \$100 million, including 55 in the Seventh District, report details of their assets and liabilities to the Federal Reserve System each week. These weekly reporting banks account for more than half of deposits of all U. S. commercial banks. Tabulations of reports from these large banks provide a fairly accurate picture of changes in assets and liabilities at all U. S. banks. But trends at

smaller banks often diverge significantly from the pattern at large banks. For this reason, the following discussion treats developments at large banks separately from those at small banks.

In the year ended December 29, 1971, demand deposits of large district banks increased 8 percent, compared with 3 percent for all large banks in the United States. Demand balances often show marked fluctuations as funds flow from one area to another. In 1970, demand deposits declined more at large district banks than at all large banks in the United States. Growth varied greatly among major cities. At Indianapolis banks, demand deposits were up 26 percent. At Detroit banks, the rise was 18 percent. Chicago banks, however, reported a rise of only 3 percent.

Changes in deposits and credit at smaller banks¹

	Seventh District		United States	
	1970	1971 (percent)	1970	1971
Deposits				
Demand	- 1.2	5.3	1.3	6.8
Time and savings	11.9	17.0	13.4	16.3
Credit				
Loans ²	8.0	11.8	8.1	11.7
U. S. Government securities	4.5	3.8	5.4	7.1
Other securities	14.2	23.3	18.8	20.0
Selected loan categories (1st half of year)				
Business	6.3	7.2	2.5	5.0
Real estate	0.7	3.6	1.1	3.8
Consumer	- 0.3	5.9	1.9	5.5
Agricultural	2.1	5.5	7.4	7.5
Federal funds sold	25.2	17.3	16.3	- 0.2

¹Deposits and credits are for all member banks other than the large city bank groups. Annual changes based on data for December 31, 1969, December 30, 1970, and December 29, 1971. Changes for loan categories are based on data for country member banks.

²Includes sales of federal funds.

More than two-thirds of the deposit gains of large district banks for the year 1971 was in the form of time and savings deposits—up \$3 billion. The rise was divided about equally among passbook savings, other consumer-type time accounts, and negotiable certificates of \$100,000 or more.

Revival of passbook savings

A significant development of 1971 was the renewed rapid growth of passbook savings accounts. Most large banks have paid 4½ percent, the maximum allowed under Regulation Q, on passbook savings since the ceiling was raised from 4 percent in early 1970. In the years preceding 1971, a large share of the rise in higher-rate time accounts came from passbook savings, often from shifts within the same bank. Last

year, however, passbook savings deposits rose more than 12 percent at large district banks, the same as the rise reported for all large banks in the United States. This compares with a 2½ percent gain in 1970.

Net inflows to savings-type time deposits, other than passbook savings, increased more than \$1 billion at large district banks in 1971, almost 14 percent. A similar rise had occurred in 1970. Despite reductions in rates earned on loans and investments in late 1971, no major district banks announced changes in rates paid.

Because of the large rise in savings funds in 1971, and the moderate demand for loans, major banks were less active in promoting sales of large negotiable CDs, and offering rates were reduced. Outstanding CDs increased about \$1 billion during the year at large district banks. The rise in outstanding CDs for large banks, both in the district and in the United States, had been twice as large in 1970, when the outflows of 1969 were being restored.

Loans and investments of the large banks increased 8.5 percent in 1971, compared with a 1970 growth of 7.6 percent. The nationwide increase for large banks was about 8 percent in both years.

Total loans at large banks increased 7 percent in 1971, both in the district and in the nation. The rise was larger than in 1970. All three major loan categories—loans to business, loans secured by real estate, and consumer credit—increased relatively more than in 1970. District banks, however, reported slower growth in each of these loan categories than did all banks.

Business loans weak

Commercial and industrial loans, which account for more than 40 percent of the total loans at large district banks, rose less

than 2 percent in 1971 for the second consecutive year. All large banks in the United States reported a slightly larger rise. The only categories of borrowers showing strength were bankers' acceptances and foreign loans, which surged following the suspension of dollar convertibility in August.

Slow demand for business loans reflected the sluggish trend of investments in inventories and plant and equipment, and was associated with the very large volume of corporate security issues. In addition, internally generated funds available to business firms increased because of both higher retained earnings and larger depreciation charges.

Much of the weakness in total business loans in late 1971 stemmed from net repayments by manufacturing firms, especially in metals and metal products industries. Demand for business loans was below the expectations of some major money market banks that lend to national companies. Some banks whose loans are oriented more to local customers reported business loan demand to be relatively strong.

With business loan demand slack, large banks increased mortgage and consumer loans. Real estate loans increased 7 percent at the large district banks, compared with 12 percent nationally. Consumer loans were up 8 percent in the district, compared with 10 percent nationally.

The lag in mortgage and consumer loans at district banks reflected the importance in district totals of large Chicago banks, which do not have branches in suburban areas. These banks have limited access to consumers. Chicago banks have almost half of all loans of all large district banks, but only one-sixth of the real estate loans and only one-fourth of the consumer loans.

Large district banks reduced portfolios of

Treasury securities slightly in 1971, while all large U. S. banks reported a small increase. Most large banks had rebuilt holdings of Treasuries in 1970, after paring holdings to the minimum level consistent with collateral needs in 1969. The average maturity of banks' government security holdings lengthened in 1971. In part, this trend reflected purchases of bonds issued by the Treasury under the exemption from the 4¼ percent rate ceiling, authorized by legislation early in 1971. In addition, banks dealing in Treasury securities increased holdings of longer-term issues.

The largest increase in earning assets of major banks in 1971, both in the district and in the United States, occurred in portfolios of municipals. The "other securities" category, mainly municipals, rose almost 23 percent at district banks in 1971, after a 19 percent increase in 1970. Holdings increased \$1.2 billion, twice the increase in consumer and real estate loans combined, and accounted for almost 40 percent of the rise in total earning assets. Wide variations occurred within the district. Detroit banks increased their municipals by less than 10 percent, while Indianapolis banks reported an increase of more than 50 percent.

Developments at smaller banks

Total deposits of smaller member banks increased 12 percent in 1971—both in the district and nationally. Demand deposits at smaller district banks rose 5.3 percent, compared with 6.8 percent nationally. However, time and savings deposits at smaller

district banks increased 17 percent in 1971—slightly more than the increase for all smaller banks.

Surveys of smaller banks in the district in late 1971 showed relatively few reductions in rates paid on regular savings deposits. However, a number of banks reduced their certificate rates, and some banks ceased to offer long-term certificates.

Loans and investments of the smaller banks followed the national pattern, although district banks reported a smaller increase in Treasury securities and a larger increase in municipals. Like the large city banks, their portfolios of securities other than Treasuries increased more than 20 percent. Loans rose almost 12 percent—about one-third more than in 1970.

District country banks continued to increase their sales of federal funds in 1971. An outstanding development at country banks in recent years is the extent to which these banks have used the federal funds market by loaning reserves overnight to other banks, usually big city correspondents. These transactions fluctuate sharply from day to day at individual banks, but they represent a sizable transfer of loanable funds.

Participation of country banks in the federal funds market has expanded gradually over the past decade. This development has been partly responsible for the decline in excess reserves of the banking system. A strong impetus for sales of funds occurred in 1969 when large banks paid as much as 9 percent for one-day loans of reserves.

Economic expansion in 1972

Seldom before have analysts of economic trends been so closely in agreement on the prospects for a new year. The rise in total real activity is expected to be double the less than 3 percent gain estimated for 1971. Price inflation is expected to moderate further. Employment is expected to increase at a faster pace. Unused resources of facilities and manpower are expected to decline, but the return to “full employment” is generally not expected until 1973.

At the start of 1971, a widely-expressed view held that consumers possessed the key to the general business outlook. On the whole, consumers did their part, especially in purchases of new homes, autos, recreational equipment, and household durables. But many families remained cautious and continued to save relatively high proportions of their incomes. Consumers retained the potential to expand purchases.

Residential construction retains a strong momentum. Business inventories are almost certain to expand at a more rapid pace in 1972. Any further increase in final sales to consumers will require additions to stocks of both hard and soft goods. Recent surveys of business plans to invest in new plant and equipment indicate larger growth in 1972.

Public expenditures probably will increase at a faster pace than private spending in 1972. Partly, this is because of higher salaries at all levels of government, and higher employment in the state and local sectors. In addition, public construction will increase because of pressing needs.

None of the major sectors of the economy appeared to be weakening at the start of 1972. If favorable prospects for spending by consumers, businessmen, and government are realized, the erosion of confidence would be reversed.

The realignment of international currencies that occurred in late 1971 will help to correct the deficit in the U. S. trade balance. A rise in exports relative to imports would increase factory outputs.

Monetary policy provided for rapid growth in money and credit in 1971. Many businesses and consumers were able to rebuild their liquidity to desired levels. At the start of 1972, lending institutions had ample funds, and all classes of borrowers were able to obtain favorable terms.

In late 1971, pervasive uncertainties were said to be restraining decision-makers. Some of these uncertainties were resolved by year-end. The Economic Stabilization Act and the Revenue Act of 1971 were approved after hanging fire for months. Faster depreciation, the investment tax credit, and a variety of tax changes beneficial to individual taxpayers were in force, and would help support private spending.

But the primary uncertainty facing decision-makers, public and private, was the question of the true strength of the economy as reflected in income, sales, and new orders. If the favorable economic “scenario” drawn by analysts unfolds as projected, confidence in future prosperity—the normal state of mind in the United States—will be restored.