

an economic review by the Federal Reserve Bank of Chicago

Business Conditions

**Review and outlook
1972-73**

**january
1973**

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Review and outlook 1972-73

Strong growth with more to come

The vigorous growth of the U. S. economy in 1972 fulfilled the optimistic expectations widely held at the start of the year. Moreover, the expansion gathered momentum on a broadening base as the year progressed. At the start of 1973, the upswing was in full stride, and major sectors appeared to be heading for gains in activity that would equal or exceed those of 1972.

Federal Reserve policy remained stimulatory in 1972, and another record volume of funds was borrowed by the nonfinancial sectors. Interest rates rose moderately on short-term securities, but long-term rates, including mortgage rates, were relatively stable.

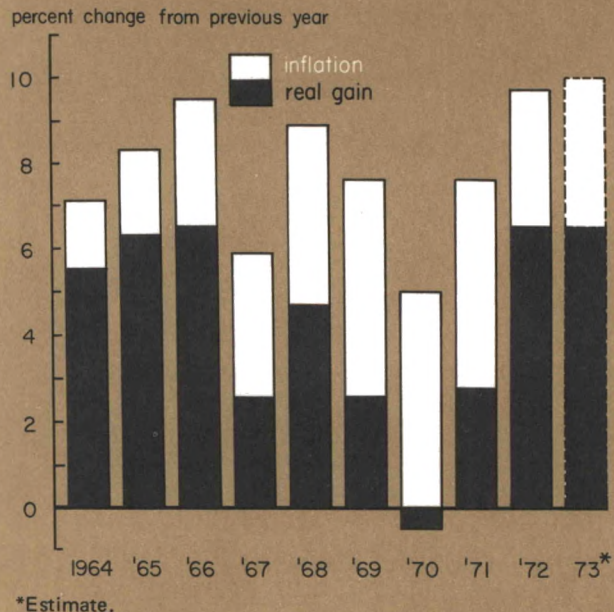
Despite attempts to hold down spending, the federal government ran a large deficit again in 1972. Tax reductions benefiting both consumers and businesses, enacted late in 1971, encouraged spending and investing. State and local government expenditures, bolstered by federal grants-in-aid, continued on a rapid uptrend.

The gross national product (total purchases of goods and services) exceeded \$1,150 billion in 1972, for a record gain of more than \$100 billion. After adjustment for price inflation, GNP rose about 6.5 percent, compared to less than 3 percent in 1971. Last year's gain was about equal to the rise for 1966, one of the largest on record.

Industrial production averaged 6.7 percent higher in 1972, following no change in 1971 and a decline in 1970. Last year's rise in industrial production fell short of the 1966 increase, but the uptrend accelerated in the last third of the year.

The farm economy was very prosperous in 1972. Although production of crops and livestock was at near-record levels, agricultural prices increased sharply.

The gross national product increased sharply in 1972, while price inflation slowed



Residential construction surpassed the most optimistic projections made at the start of the year. International trade rose even more rapidly than the domestic economy. Imports increased more than exports, with the result that the U. S. deficit on international trade was substantially higher than in 1971.

Employment averaged 3 percent higher in 1972, following very small gains in the two previous years. Sharp increases in output per man-hour enabled many employers to expand production substantially without commensurate increases in employment. Nevertheless, employment gains were rapid, and almost continuous, through the year. Because labor force growth about equaled gains in employment, the unemployment rate averaged 5.9 percent in the first five months of 1972, the same as the average for 1971. Starting in June, however, unemployment began to ease, and the rate was down to 5.2 percent by year-end.

With most sectors of the economy continuing to operate below optimal rates, competitive forces aided the efforts of the Price Commission and the Wage Board to slow the rate of price inflation. The general price level, measured by the gross national product deflator, averaged about 3 percent higher in 1972 than in 1971. This was above the 2.5 percent goal set by the Administration when the New Economic Policy (NEP) machinery was established in the fall of 1971. But it was substantially below the increases for 1970 and 1971, 5.5 and 4.7 percent, respectively, and was the smallest rise since 1966.

In the final months of the year, as margins of unused capacity diminished in many sectors, there was evidence that price and wage controls were hampering efforts to expand output. Recognizing that order lead times were stretching out, and that some economic distortions were developing, officials indicated that controls would be administered more flexibly in the new year.

Employment and unemployment

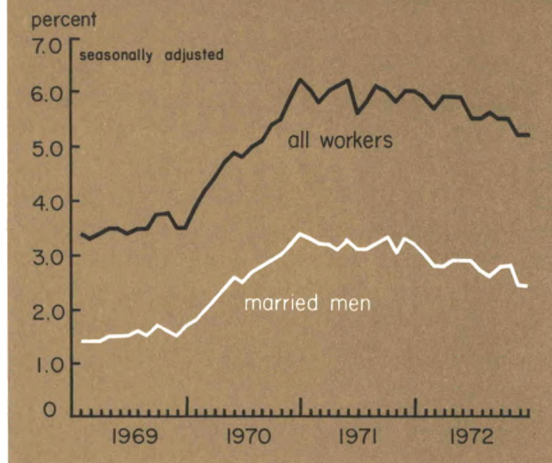
Out of a population of 210 million at the end of 1972, almost 90 million Americans were in the labor force. The great bulk of these, 74 million, were on the payrolls of nonagricultural establishments, including government; 3.6 million were working on farms; 2.4 million were in the armed forces; about 5 million were self-employed in non-farm pursuits; and 4.5 million were unemployed—without jobs but seeking work.

From December 1971 to December 1972, nonfarm employment rose 2.6 million, or 3.7 percent. In the previous 12-month period, nonfarm employment had increased only 1 million and had only just surpassed its peak of March 1970. Total employment had continued to edge up for several months after the 1969 peak in the business cycle.

The rapidity of the rise in nonfarm employment in 1972, following two sub-normal years, has been matched in the past only in the years of most vigorous economic expansion. In the Midwest, the trend



Unemployment rates declined in the second half, but continued relatively high



of employment has varied from area to area. In Iowa and Wisconsin, the recovery in employment has about equaled the national performance. Indiana, Illinois, and Michigan have done less well than the nation, but almost all major centers of employment in these states were showing sustained growth toward the end of the year.

Among major sectors, the strongest growth in employment has been in trade, services, and state and local government. Federal government employment has been relatively stable in recent years. Manufacturing employment reached 19.4 million nationally in December, a rise of 4.5 percent from a year earlier. Despite this rapid rise, manufacturing employment is still short of the August 1969 peak of 20.3 million. Average workweeks in manufacturing lengthened during 1972, and output per man-hour increased by about 6 percent. The failure of manufacturing employment to regain past peaks largely explains the fact that many highly industrialized areas of the Midwest report less favorable trends in total employment than the nation when compared with prerecession levels.

The strength of the armed forces declined from over 3.5 million men in September 1969 to 2.4 million in June 1972. Little change occurred in the second half of the year. The bulk of the over 1 million men that have been released from the armed forces entered the civilian labor force, and increased the difficulty of reducing unemployment.

In 1972, for the first time in several years, the long-term decline in farm employment was reversed. High farm output and record farm income apparently encouraged farmers to hire a limited number of additional hands.

Because the increase in employment last year was faster than the growth in the labor force, unemployment in December was estimated to be down 500,000, or 10 percent, from a year earlier. The unemployment rate of 5.2 percent was well down from the 1970-71 average of almost 6 percent, but it was well above both the 3.5 percent level of 1969 and the 4 percent rate commonly associated with "full employment." The unemployment rate for married men was 2.4 percent in December, down from the 3.3 percent high of early 1971 but above the very low 1.5 percent average rate of 1969.

In all district states except Michigan, estimated unemployment rates have remained well below the national level throughout the recession and recovery period. Even in Illinois, where employment growth has been significantly below the national trend, unemployment is estimated at about 4 percent. Michigan continues to report substantial unemployment despite rising output of motor vehicles.

If the economy expands as expected in 1973, employment should rise at least as much as in 1972, and unemployment rates should decline further. Many employers report intentions to expand their employment. These trends will accelerate if productivity gains decline from the abnormally high rates of 1971 and 1972.

Income and consumption

Personal income rose to \$935 billion in 1972, up about 8.5 percent from 1971, for the largest percentage gain in three years. Were it not for controls on wages, salaries, and dividends, last year's rise in personal income probably would have been even larger. Mainly because of overwithholding of personal income taxes, after-tax income (disposable personal income) rose less than 7 percent in 1972, down from an 8 percent rise in 1971, and the smallest percentage gain since 1967.

Despite the smaller rise in disposable income in 1972, consumption spending increased about 8.5 percent, up from a 7.8 percent gain in 1971, and except for 1968 the largest increase in more than a decade. As a result of the rapid rise in spending, personal savings (the residual obtained by subtracting personal outlays from disposable income) declined by more than 10 percent. Savings were less than 7 percent of disposable personal income in 1972, down from the abnormally high 8 percent rate of 1970 and 1971.

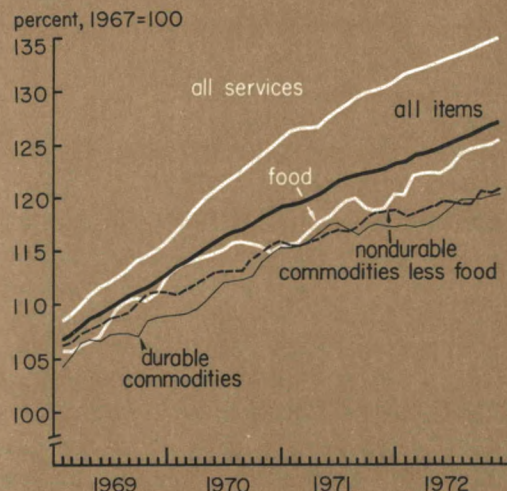
The decline in the savings rate in 1972 showed that consumer confidence had been generally restored—that people were more willing to spend and were ready to supplement current income by incurring debt at a faster pace. The change in the savings rate in 1972 added almost \$10 billion to consumption spending.

In 1972 as in 1971, consumers increased spending most on durable goods, a category that includes autos and appliances. Outlays on durables rose about 12 percent last year, while spending on both nondurable goods and services rose about 8 percent. Retail sales of most types of goods were strong throughout the year, but the uptrend gathered strength in the fourth quarter. Christmas sales were extremely strong, with some nationwide retail chains reporting the largest year-to-year gains in their history.

Consumer outlays on most nondurable goods (such as foods, apparel, and gasoline) and services (such as rent, electric power, and medical care) usually move fairly closely with income. Major cyclical fluctuations, however, occur in purchases of durable goods which often involve the use of credit. For example, purchases of durables declined in 1970, although not as much as in earlier recession years.

Auto sales totaled a record 10.9 million in 1972, including 9.3 million domestic models and 1.6 million imports from Western Europe and Japan. Total auto sales were up 7 percent from the record of 1971, which had been inflated by special factors. Auto sales were encouraged in 1972 by the elimination of the manufacturers' excise tax in late 1971, and effective selling prices probably were held down by price controls. Auto sales would have been even larger if dealer inventories had been at more adequate levels in the last third of the year. Consumers also increased purchases of trucks and recreational vehicles.

Consumer prices increased at a slower pace, but food prices rose sharply



Except for air conditioners, sales of all types of major household appliances increased substantially in 1972, with gains ranging from 11 percent for refrigerators to 27 percent for dishwashers. The improvement in sales of most household appliances was related to the sharp increase in completions of new housing units. Sales of household furniture and color television sets both increased about 20 percent last year. Sales of virtually all household durables were at all-time record highs.

Consumer prospects for 1973

Prospects for continued strong consumer purchases of goods and services were excellent in early 1973. Most producers expect their sales to set new records again this year. Disposable personal income is expected to rise more in 1973 than last year, partly because of refunds of excessive amounts withheld for income taxes, and possibly a return to withholding on a more normal scale. The growing number of newly married couples, often with two incomes, will be increasing purchases of durable goods. The savings rate could decline further in 1973 because last year's 7 percent rate was still above the 6 percent average of the 1960s. Use of consumer credit is at a high rate, but there is reason to believe that a high rate is sustainable.

A vigorous expansion in consumer credit that began in the final months of 1971 accelerated in 1972. Total consumer credit, both instalment and noninstalment, amounted to \$153 billion at the end of November 1972, an increase of 13 percent from a year earlier. This was the largest rise for a comparable period in more than a decade.

Instalment credit—comprising loans to purchase autos, other consumer goods, home repair and modernization loans, and personal loans—totaled \$124 billion at the end of November, and accounted for 81 percent of all consumer credit outstanding.

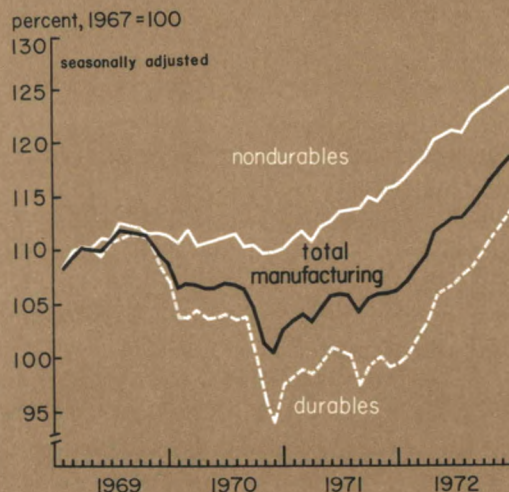
Instalment credit rose \$15 billion in the year ending in November.

As in 1972, the distribution of consumer spending in 1973 will be influenced by relative price trends. At the peak of the Vietnam war inflation in 1970, consumer prices averaged 5.9 percent higher than in the previous year. In November 1972, after a full year of controls under Phase II, the consumer price index was up 3.5 percent from a year earlier. Meat prices were up 11 percent and fresh fruits and vegetables were up 7 percent. But commodities other than foods were up only 2.5 percent. Doubtless, smaller increases in prices for durables played a role in boosting sales of these items. Upward pressures on prices of many goods and services remain very strong, and increases may be necessary if consumer wants are to be met.

New high for manufacturing

The physical volume of manufacturing activity, measured by the manufacturing component of the Federal Reserve Board's

Output of both durable and nondurable goods were at record levels at year-end



industrial production index was 7.5 percent higher in 1972 than in 1971. Last year's gain in manufacturing, the largest since 1966, was from a relatively depressed level. Manufacturing output had declined 5 percent in 1970 from the 1969 record level, and there was no year-to-year gain in 1971.

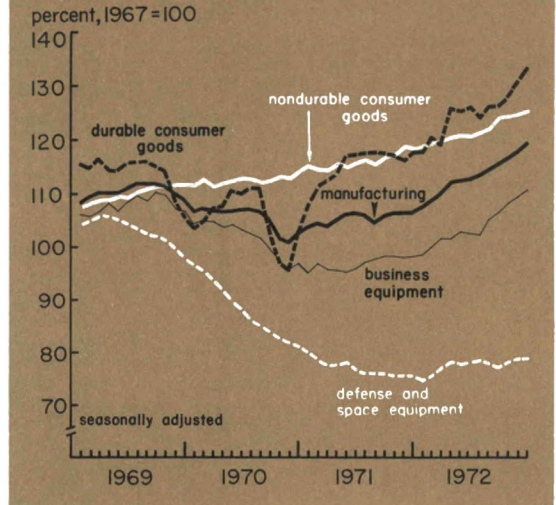
Annual data do not adequately describe the vigor of the upsurge in manufacturing during 1972. In December, output was 11 percent higher than the year-earlier level, which had been 6 percent below the peak reached in the third quarter of 1969. Increases in output were especially large in the latter months of 1972.

With 16 percent of the nation's population, the five states of the Seventh Federal Reserve District account for 26 percent of the nation's output of manufactured durable goods, and about one-third of output of business equipment of all types. In the 1969-70 recession, as in earlier business declines, durable goods, and especially business and defense equipment, absorbed the brunt of the drop in manufacturing activity. As a result, declines in manufacturing employment and total employment in the recession were more significant in this region than in the country as a whole, and the recovery in 1972 left certain large centers such as Chicago and Detroit with smaller payrolls than in 1969.

In November, output of durable goods was almost 14 percent above the year-earlier level. But this increase was just sufficient to raise durable goods output above the 1969 peak. Output of business equipment in November, although up 12 percent from a year earlier, was still about 1 percent below the 1969 peak. Nondurable goods output, by contrast, had declined only slightly in 1970 and had regained the 1969 peak in the second quarter of 1971. In November 1972, output of nondurable goods was 11 percent above the 1969 peak.

The Midwest has a less-than-proportional share of the nation's output of military products. Output of military goods

Output of consumer goods paced the expansion; business equipment output also rose



was about 3 percent higher in November than a year earlier, but it was still down about 25 percent from the peak reached in 1968 at the time of the highest level of procurement associated with the Vietnam war. There seems to be no clear evidence of a sustained uptrend in total output of military products in early 1973, but the adjustments necessitated by the sharp 1968-71 decline in procurement have been completed for several months.

Vehicles and steel

Motor vehicles comprise the most important durable goods industry, both in the United States and the Midwest. Michigan accounts for about 40 percent of the industry. In 1972, U. S. plants produced 8.82 million passenger cars and 2.5 million trucks. The truck total was up 20 percent from the 1971 level, which had set a record. Passenger car output was up 3 percent from 1971, but still was well below the 9.33 million high reached in 1965. Larger output in 1965 compared with 1972

reflected, in part, a 400,000 rise in inventories in the earlier year, compared to a slight decline in 1972. Also, U. S. manufacturers imported about 450,000 "domestic" cars net from their plants in Canada in 1972 as required under the auto trade agreement. There was virtually no trade in autos between the United States and Canada in 1965. Sales of 9.32 million "domestic" autos in 1972 was a record by a wide margin. Sales of domestics were 8.76 million in 1965.

Steel, another major industry of the Midwest, also prospered in 1972. Mill shipments totaled 92 million tons, up from 87 million tons in 1971, and close to the 1969 record of 94 million tons. Imports of steel amounted to 17 million tons, only about 1 million tons below the 1971 record high.

In the first seven months of 1971, U. S. manufacturers increased steel inventories by more than two-thirds, to 16 million tons, as a hedge against a possible strike in August. When a labor settlement was reached without a strike, inventories were reduced rapidly, and the liquidation continued through the first four months of 1972. Since last May, manufacturers' inventories of steel have been below the level existing before the strike hedge buildup began, although consumption of steel has been at a much higher rate in recent months than in 1970.

In the final months of 1972, steel users were increasing output, and steel orders increased. Lead times on new orders began to stretch out, and, at year-end, some Chicago-area steel facilities were operating at effective capacity.

In early 1973, all signs point to a substantial further rise in output of manufactured goods. Purchases of goods by consumers are very strong, and business capital expenditures are rising. Order backlogs of durable goods manufacturers have been increasing steadily since September 1971. Business inventory-to-sales ratios are at the lowest level since 1966. Inventories of

motor vehicles, steel, building materials, furniture, and oil products are very low by the standard of recent years. Work forces are being expanded, and idle facilities are being reactivated to increase output.

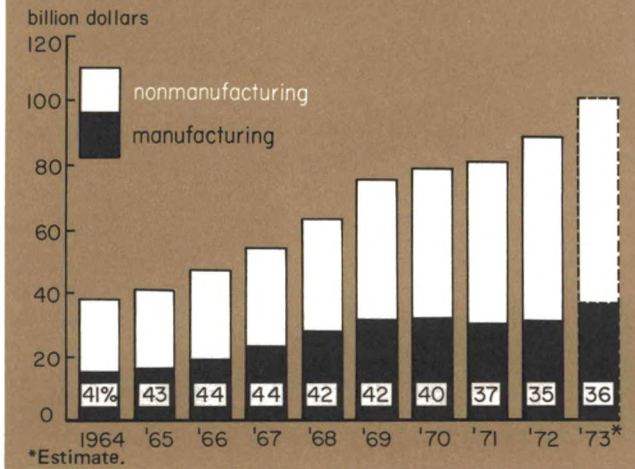
Plant and equipment outlays

Expenditures on new plant and equipment in the United States are estimated to have reached \$88.5 billion in 1972, a rise of 9 percent from 1971. This total was slightly below estimates made earlier in the year, but any shortfall apparently resulted from delays in deliveries because business firms reported plans for sharp increases in plant and equipment outlays in the first half of 1973. Capital spending increased only 2 percent in 1971. This was much less than the increase in prices of buildings and equipment, so physical volume of these investments actually declined in 1971. Less than half of the 1972 increase in outlays represented price inflation.

The rise in capital spending in 1972 was broadly based, with increases of 10 percent or more reported by the public utility, communications, commercial, mining, air transport, and durable goods manufacturing sectors. Among the major categories of durable goods, only steel showed a decline. Outlays by nondurable goods manufacturing firms were down slightly in 1972—the food processing, chemicals, and petroleum industries reported declines.

A sustained boom in capital expenditures occurred in the years 1964-66, when these outlays increased much faster than GNP. Only slight gains occurred in capital spending in 1967 and 1968, but 1969 witnessed another upsurge. With the slowing of the economy after 1969, especially in manufacturing, many industries found themselves with reduced sales and profits on the one hand and excess capacity on the other. The prolonged period of subnormal economic growth in 1970-71 created a

Business plant and equipment expenditures appear to be accelerating



widespread hesitancy to proceed with capital expenditure plans, especially for expansion.

In the past two years, business firms have been under strong pressure from government agencies to make expenditures to satisfy stricter environmental and safety standards. In many cases, this has meant substantial additional outlays that would not otherwise have been made, both in building new facilities and in renovating existing facilities. In some cases, plants have been closed down to avoid these investments, thereby reducing industrial capacity.

A large share of total capital outlays since 1969 has been for modernization. With the rapid expansion of the economy since early 1972, many manufacturing industries are approaching effective capacity, and expansion plans are being reexamined. Despite a continued high level of expenditure, public utilities in many areas have not been able to build adequate capacity.

Adequate financing will be available to accommodate a substantial increase in capital expenditures and working capital in

1973. Corporate profits after taxes rose about 15 percent last year, and most analysts project an approximately equal gain in 1973.

As in earlier periods of rising profits, retained earnings available for investment have increased more than proportionately. Funds from depreciation continue to rise at a rapid pace, partly because of new rules for faster write-offs promulgated in 1971. The 7 percent investment tax credit also encourages outlays by reducing net costs. Large security offerings in recent years have helped to rebuild the liquidity of many firms and have increased their capacity to incur additional debt. Ample long-term funds are expected to be available through sales of securities and loans on commercial and industrial mortgages. In the final months of 1972, commercial banks were providing a substantially larger volume of short- and intermediate-term loans than a year earlier.

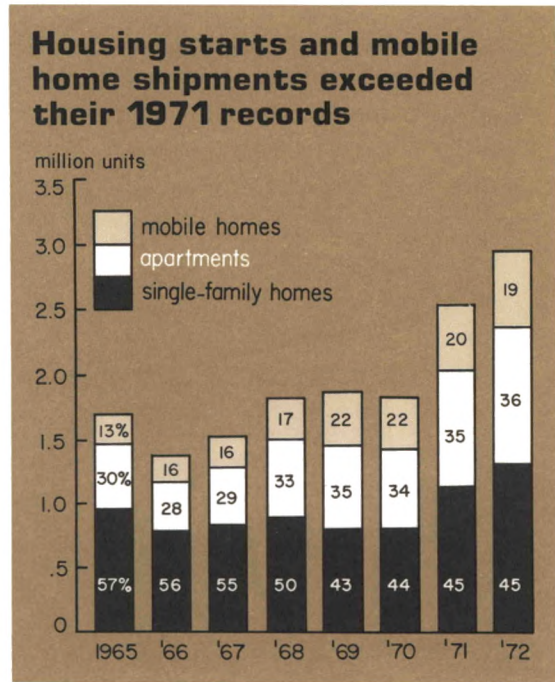
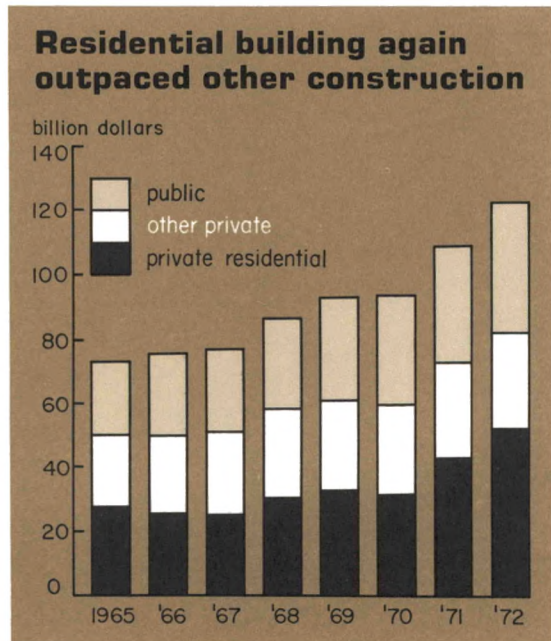
At the start of 1973, it appears that another capital expenditure boom is generating. Order backlogs of equipment producers have been rising since early 1972. In recent months, construction contracts for new manufacturing buildings have increased from a depressed base, and orders for fabricated structural steel for most types of projects have improved markedly. A government survey released in January indicates that business firms plan to spend at least 13 percent more on new plant and equipment in 1973. Unlike 1972, manufacturing firms are expected to increase outlays more than nonmanufacturing industries.

Housing surpasses expectations

Construction, led by residential building, was one of the strongest sectors in the economy again in 1972. Outlays on all

new construction totaled \$123 billion, up 12 percent from 1971. Since total construction costs increased about 5 percent, compared to 8 percent in 1971, physical activity rose 7 percent. The slower rise in construction costs during the year reflected the success of the Construction Industry Stabilization Committee in restraining wages, and the effectiveness of price controls on many construction components. A notable, and important, exception was lumber prices, which averaged about 10 percent higher than in 1971.

Residential construction outlays increased more than 20 percent in 1972 to about \$53 billion. This was 43 percent of all construction outlays. In the late 1960s, residential construction accounted for about one-third of total construction. Outlays on private nonresidential construction, led by commercial and hospital building, increased 11 percent to \$41 billion. Public construction amounted to \$30 billion, about the same as in 1971.



Home building up sharply

The housing boom that got under way in 1970 continued throughout 1972. Private housing starts totaled a record 2.4 million for the year, an increase of 16 percent from the previous year's record, and above the most optimistic forecasts at the start of the year. Included were 1.3 million single-family dwellings and 1.1 million multi-family dwellings, about the same ratio as in other recent years. In addition, a record 575,000 mobile homes were shipped during the year, an increase of 16 percent from 1971. An additional 17,000 mobile homes were purchased by HUD as temporary shelter for food victims. Together, private housing starts and mobile home shipments provided almost 3 million new housing units in 1972, far more than ever before.

Residential building activity in most large metropolitan areas in the Seventh District either declined absolutely or increased less than in the nation in 1972. The nation

as a whole reported a 14 percent rise in permits for new residential units in the first ten months of 1972. In the Chicago area—the leading area in the nation in 1971—building permits were down about 8 percent for the ten-month period. Virtually all of the decline in Chicago was in multi-family buildings.

The pattern varied in other centers. In the Detroit area, building permits were down 6 percent in 1972, with single-family units down more than apartments. In Milwaukee, permits were up 6 percent, with a large rise in apartments. Only the Indianapolis area, among large district centers, reported permits up more than the nation—by about 16 percent.

The construction outlook

In 1973, total construction outlays are expected by the Department of Commerce to increase about 7 percent. Dollar outlays for residential construction are expected to be down slightly, but remain at a

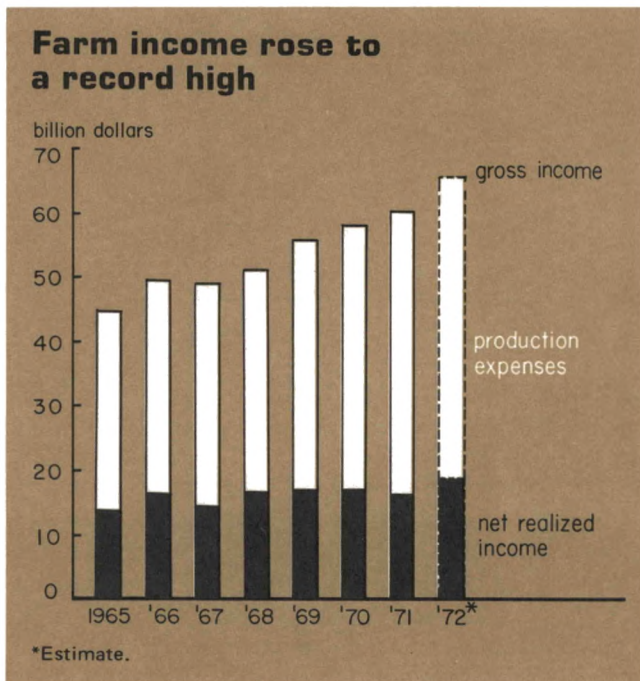
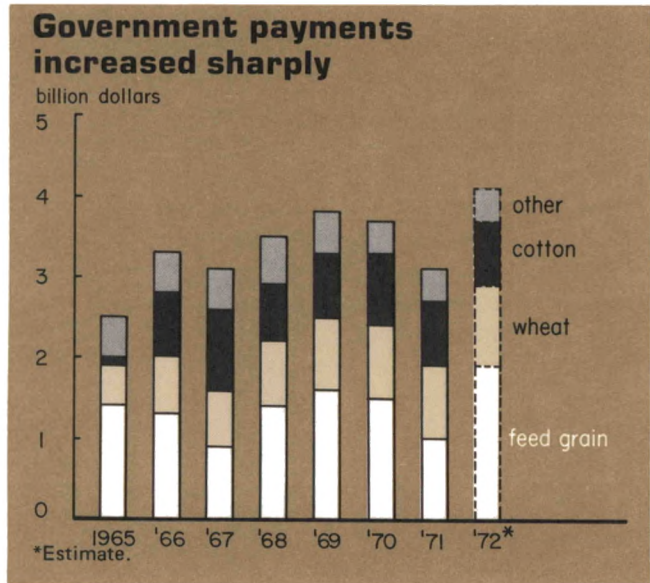
high level. Nonresidential private construction is expected to be up substantially, with the commercial and public utility sectors continuing strong and the manufacturing sector starting up again from a depressed level. Both federal and state and local outlays are expected to rise by about 10 percent, with public buildings and water and sewer systems in the lead.

Most analysts foresee a drop in private housing starts to 2.0 or 2.1 million units this year. Mobile home shipments are expected to rise again, but at a much slower rate than in 1972. Nationally, residential vacancy rates remain relatively low, although certain areas, some in the Seventh District, report vacancies on the rise. However, with a much faster rate of new household formation, and extensive demolitions, especially in large cities, housing demand should be fairly well sustained in 1973. On the financial side, a large volume of mortgage funds is expected to be available on terms approximating those prevailing in 1972.

Boom year for agriculture

American farmers in 1972 enjoyed a degree of prosperity unknown since the Korean War years. Output of major commodities was at, or near, record levels. Sharply higher prices and increased government payments combined to boost gross farm income in 1972 to a new high of \$65 billion, up more than \$5 billion from 1971. Despite rising production expenses, realized net income of farm proprietors rose about 17 percent to almost \$19 billion, nearly \$2 billion above the old record that had stood for a quarter of a century!

About four-fifths of the increase in gross income reflected higher prices. The weighted composite of agricultural commodity



prices received by farmers averaged about 12 percent higher in 1972 than in 1971. Stronger domestic demand associated with rapidly rising disposable personal income was primarily responsible for boosting prices, especially for meat animals. Outlays on food by U.S. consumers rose 6 percent in 1972. In the second half of the year, record grain exports and weather-caused harvest delays exerted upward pressure on crop prices.

Food prices averaged sharply higher at the retail level in 1972. Unprocessed farm products have been exempt from government price controls since ceilings were imposed in 1971. In June 1972, however, the Price Commission established maximum profit margins on sales of various raw food products after the first sale. In addition,

the Administration suspended quotas on meat imports. These government actions may have had only marginal effects on supplies and prices, but the rise in food prices did slow in the second half of 1972.

Large foreign purchases of grain in the second half of 1972, together with uncertainties over the yield of U. S. harvests, pushed grain and soybean prices up further. Unprecedented Soviet purchases of grain were the major factor in the export market. These purchases totaled more than \$1 billion in 1972, thereby exceeding the minimum purchases of \$750 million of grain over a three-year period stipulated in the grain agreement between the two nations negotiated at midyear. Demand for U. S. grain was stimulated by poor crops in several foreign countries, including the Soviet Union.

Direct government payments to farmers exceeded \$4 billion in 1972—up \$1 billion from 1971 and a new record. Payments under the feed grain program totaled \$1.9 billion—nearly double the 1971 amount. (Feed grains include corn, sorghum, oats, and barley.) Payments under the wheat program also increased, but at a

much slower pace. Higher government payments reflected both a larger acreage “set-aside” and higher rates per acre.

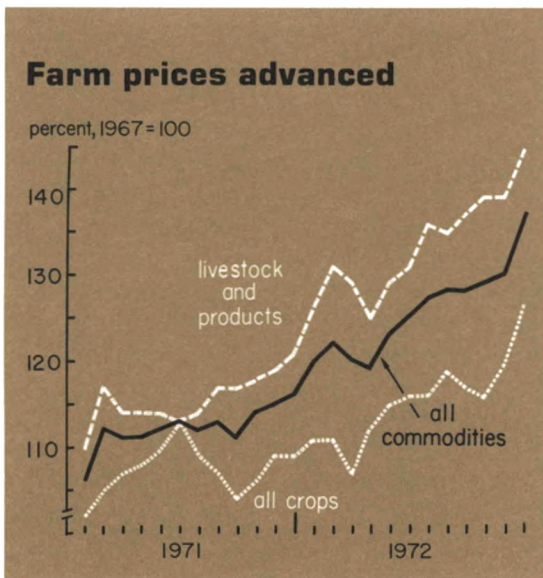
Crop acreage planted in 1972 totaled less than 300 million acres, down 9 million from 1971. Although adverse weather prevailed during the main harvesting season, increases in yields per acre resulted in record harvests for many commodities.

Midwest farmers gain

Cash receipts from farm marketings rose 10 percent or more in 1972 in each of the states of the Seventh Federal Reserve District. Income from each of the major Midwest farm commodities—beef, hogs, dairy products, corn, and soybeans—increased substantially in 1972. Government payments to district farmers were up 60 percent from 1971.

Hog slaughter was down about 10 percent in 1972. But hog prices averaged more than 40 percent above 1971 levels, reflecting both the reduced supplies and a strong consumer demand. Despite rising feed costs, especially late in 1972, profit margins on hog feeding showed marked improvement from year-earlier levels. The ratio of the price of hogs to the price of corn, a rough measure of profitability, was near record levels through most of the year.

Cattle feeders also prospered in 1972, especially in the first half. The slight increase in beef production did not match the substantial gains in consumer demand, and cattle prices averaged appreciably higher throughout the year. Prices of high-quality fed cattle reached a record \$39 per hundred pounds in mid-1972, up 18 percent from a year before. As beef slaughter increased, prices of fed cattle declined through most of the second half of 1972, but then rose sharply again in December. Feeder cattle prices reached a record high of \$50 per hundred pounds in the fall months, up 25 percent from a year before. Higher prices of feeders and feed and lower



prices for fed cattle reduced cattle feeders' profits in the second half of 1972.

Dairy farmers' cash receipts rose about 4 percent in 1972. Although milk production increased, strong demand pushed milk prices to an average of \$6 per hundred pounds, up about 3.5 percent. Per capita consumption of dairy products rose in 1972 for the first time since 1955. Wisconsin remains the nation's leading dairy state with 14 percent of total output.

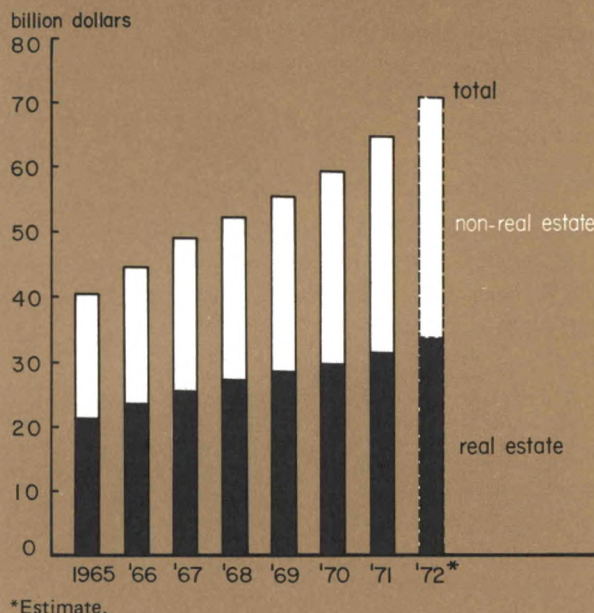
Corn and soybean farmers' profits were generally favorable in 1972, a year of unusual developments. Corn supplies were burdensome at the start of the year and prices were depressed. Soybean supplies were moderately smaller than a year earlier, and prices were about the same.

Increased demand for corn and soybeans boosted prices in the first half of 1972. This trend strengthened further during the second half of the year with the announcement of the Soviet grain agreement, and the adverse weather conditions which delayed fall harvesting. In mid-December, the soybean price topped \$4 per bushel, up \$1 per bushel from a year earlier. Corn hit \$1.60 per bushel, up 40 cents from the year before.

Farm finance

Rising farm income in 1972 was reflected in large increases in farmers' investments in land, machinery, motor vehicles, home furnishings, and other consumer goods. Purchases of farm tractors rose 20 percent over the year-earlier level in retail unit sales. The desire to increase farm size in order to achieve economies of scale in purchasing, production, and marketing activities also encouraged aggressive bidding on available tracts of land.

Farm debt increased



The gain in investments resulted in increased farm borrowings from commercial banks and other lenders. With loan funds more readily available than in recent years, and with a good record of repayments on existing loans, lenders actively sought farm loans of all types. Farm debt totaled about \$71 billion at the end of 1972, up 9 percent from a year earlier. Non-real estate loans made up 60 percent of the increase; the remainder was secured by farmland.

The farm outlook

As 1973 begins, the farm economy seems poised for another year of high income. Cash prices of livestock and grains remain near record levels, and trading in futures contracts suggests continued high prices for most commodities. Maintenance of current price levels, however, depends in large degree on continued strength of demand—especially foreign demand. More-

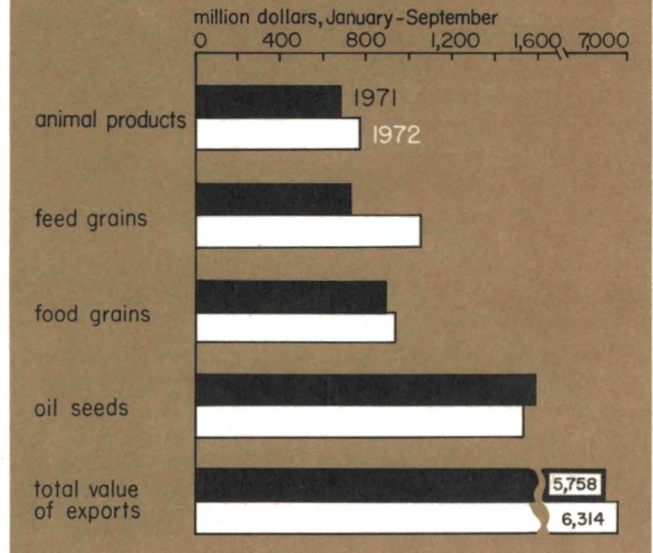
over, even if prices remain high, climbing operating expenses and expected sharply lower government payments indicate that net profits may decline from the advanced levels of 1972.

Production plans suggest record output of beef and turkeys in 1973, and output of pork and milk is expected to rise. A survey taken in December showed that farmers intended to farrow 6 percent more sows in the December-May period than a year earlier. If hog producers carry out these intentions, pork supplies during the latter half of 1973 probably will rise by a similar amount. Marketings of fed cattle probably will rise in the first half of 1973, as the increased inventory of cattle on feed reaches marketing weights. If sufficient feeders are available in early 1973, increased marketings likely will be maintained throughout the year.

Because of high prices and modifications in government programs, grain production should expand in 1973. About 12 million fewer acres of land are expected to be set aside in the feed grain program. A large portion of this will be planted to soybeans and corn, particularly the former.

Prospects for rising consumer income in 1973 indicate another large gain for consumer purchases of food. Foreign demand for U. S. agricultural commodities is widely expected to be very strong again next year, but supplies in other major agricultural nations will largely determine whether this occurs. Russia was able to boost grain output sharply following short crops in the

Foreign demand expanded



mid-1960s, and this could occur again in 1973. In six of the past ten years, Russia has been a net exporter of grain. Other grain-exporting nations will also attempt to boost production.

On balance, the farm sector is expected to record a generally favorable year again in 1973. Production of most major commodities is almost certain to rise. Expected strong demand, both domestic and foreign, probably will offset much of the price-depressing effects of larger supplies. Expanded production, coupled with favorable prices, should boost gross farm income to another record in 1973. The combination of lower government payments to farmers and the persistent rise in production expenses, however, will likely reduce net farm income from 1972's record level.

International trade and finance

In 1972, in contrast to 1971, the international financial scene was relatively free of monetary crises. The year was characterized by adjustments to the monetary realignment of late 1971, and by the beginning of negotiations to develop a formal mechanism for the reform of the international monetary system.

Currency realignments initiated by the Smithsonian Agreement of December 1971 were implemented with some difficulty. Selling pressures on the U. S. dollar continued into early 1972, and German, Japanese, and other central banks continued to absorb dollars. By late spring, however, the markets settled to an uneasy stability.

In early summer, the British pound came under pressure. The United Kingdom experienced a deteriorating balance of trade and serious labor unrest. Fearing devaluation, many holders of sterling balances began selling sterling on the foreign exchange markets. After absorbing a large volume of the unwanted sterling in an effort to maintain a fixed exchange rate, the British government ceased to support the pound at the par value agreed upon in the Smithsonian accord, allowing the pound to "float." The exchange value of the pound subsequently declined sharply, and by year-end was 2.5 percent below its pre-Smithsonian level.

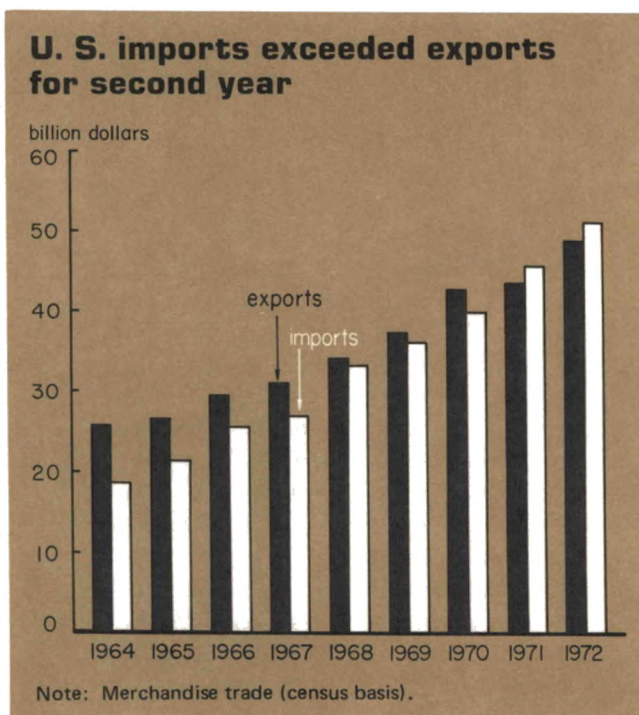
The Smithsonian Agreement revalued the Japanese yen upward relative to the U. S. dollar and other major currencies, but Japan's trade surpluses continued to increase. This stimulated expectations of a further upward revaluation of

the yen and further currency inflows to Japan. On numerous occasions, the Bank of Japan absorbed dollars to keep the yen from appreciating above the limit allowed by the Smithsonian accord.

The Japanese government initiated various programs to reduce its surpluses in international accounts. These included reductions in tariffs, restrictions on selected exports, and encouragement of foreign investments. But at year-end, pressure in exchange markets on the existing yen/dollar exchange rate continued.

Search for a new system

The realignment of the exchange rates agreed upon at the Smithsonian meeting dealt with only one aspect of the problems



that have plagued the functioning of the international monetary system for many years. Although many important trade and monetary issues remained unresolved at the end of 1972, some progress was made during the year.

In the trade area, in February 1972, an agreement was reached by the major trading nations that resulted in immediate, but limited, trade concessions by the European Economic Community (EEC) and Japan. These nations also endorsed a new set of trade negotiations that are scheduled to begin late in 1973 under the auspices of the General Agreement on Tariffs and Trade (GATT).

In the monetary area, the most important step in 1972 was the establishment of the "Committee of Twenty" at the annual meeting of the International Monetary Fund. The new body is charged with responsibility for negotiating the reform of the international monetary system. This group, consisting of representatives from industrial as well as developing countries, began its regular meetings in late 1972. It is expected to present a report for the reform of the international monetary system to the full membership of the International Monetary Fund in September 1973.

Another development was a move by EEC countries toward the eventual establishment of a common currency. Members of the EEC agreed to maintain the value of their respective currencies within a narrower range (2.25 percent) than the 4.5 percent band of fluctuation around the U. S. dollar permitted by the Smithsonian Agreement. Although forced to withdraw from the agreement when the pound was floated in June, Britain is expected to re-join the EEC agreement when a new fixed central rate is established for the pound. Establishment of a unified European currency would create a well-defined monetary bloc composed of the nine member nations of the expanded EEC—nations that account for 40 percent of world trade.

Many observers believe that realization of this goal is still far in the future.

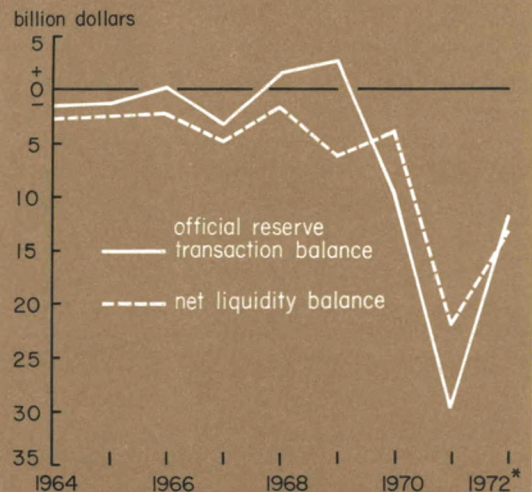
The U. S. balance of payments

The most dramatic occurrence in the U. S. balance-of-payments picture during 1972 was the sharp deterioration in the trade account. Through November, the trade account was in deficit at an annual rate of nearly \$6.4 billion. The deficit in 1971, the first since 1888, was \$2 billion.

During the first 11 months of 1972, U. S. imports were up nearly 22 percent from the year-earlier period. Increases have been especially large in petroleum, wood products, machinery, automobiles, and various other consumer goods.

Rising economic activity abroad, coupled with the currency realignment, have helped to increase U. S. exports 12.5 percent in the January-November period. Dock strikes in the last quarter of 1971

U. S. balance of payments improved but remained in large deficit



Note: Preliminary data.

*January-September seasonally adjusted annual rate.

reduced both imports and exports. U. S. exports were boosted in the second half by sales of food and feed grains to Russia, China, and others. Deals were also being negotiated with Communist countries for the purchase of U. S. machinery and other products.

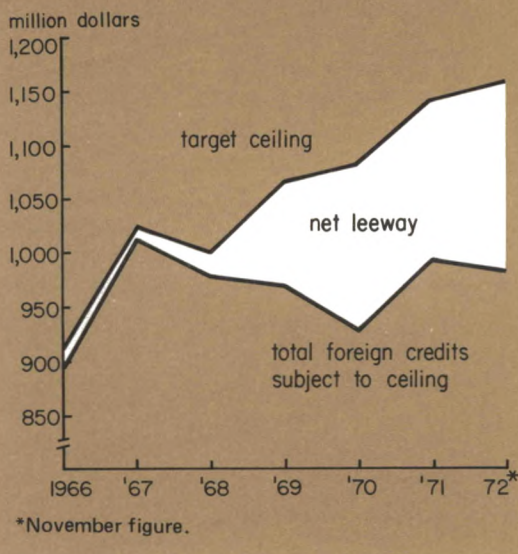
As generally expected, the positive impact of foreign currency revaluations on the flows of trade began to be reflected only gradually in the U. S. trade figures during the latter part of the year. Improvement is expected to continue. For 1972 as a whole, however, the initial adverse impact of the currency value changes, which increased prices of imported items, and a faster rise in economic activity in the United States than abroad caused the U. S. trade account to deteriorate.

In spite of the deteriorating trade balance, the U. S. balance of payments improved in 1972. The Official Reserve Transaction balance, an indicator of foreign exchange market pressures on the dollar, was in deficit by \$9 billion for the first three quarters. This compares with a deficit of \$24 billion for January-September 1971. The Net Liquidity balance, a rough measure of the potential pressure on the U. S. international liquidity position, was in deficit by \$10 billion during the first three quarters, compared to \$18 billion during the same period in 1971.

Midwest international activities

Seventh District states benefited from the surge in exports of agricultural products and capital equipment during 1972. (Illinois and Iowa rank first and second in total exports of agricultural products.) Exports of soybeans continued very large. But exports of feed grains, which accounted for about 17 percent of total agricultural exports for the January-September period, showed a larger gain—up 46 percent from the comparable period in 1971. Illinois, Iowa, and Indiana rank first, second, and

Foreign lending by district banks subject to VFCR was on the increase



fourth among the states in exports of feed grains. District manufacturers of machinery participated in the 10 percent rise in these exports in the first nine months of 1972.

The expansion of international activities of district banks continued through 1972. The number of banks engaged in foreign lending, and reporting under the Federal Reserve's Voluntary Foreign Credit Restraint (VFCR) program, increased from 29 at the beginning of 1972 to 33 near the end of the year. Their total claims on foreigners were above \$1.5 billion, while their claims subject to the VFCR ceiling stood at close to \$1 billion.

The expansion of district bank facilities abroad also continued. At the beginning of the year, 17 district banks operated 40 branches abroad. Near year-end, 19 district banks were operating 49 branches. In addition, four new foreign branches of district banks had been approved by the Board of Governors and applications for two foreign branches were pending.

Highlights in government finance

Purchases of goods and services by government at all levels totaled about \$255 billion in 1972, up about 9.5 percent from 1971. The increase was about the same, proportionately, as the increase in GNP. In the years 1969-71, total government expenditures rose less than GNP, reflecting declines in national defense outlays. Last year, national defense outlays increased by about 7 percent. State and local expenditures on goods and services increased by more than 10 percent in 1972, matching the increases of the three previous years.

Defense outlays have accounted for two-thirds or more of total federal government purchases each year since 1940, when the World War II rearmament program got under way. In both 1967 and 1968, at the peak of the Vietnam war activity, defense outlays exceeded \$78 billion and accounted for almost 80 percent of all federal outlays on goods and services. Defense outlays leveled off in 1969 and then declined in 1970 and 1971 as the number of men in the armed forces was reduced and military procurement declined sharply. The rise in defense outlays from \$71 billion in 1971 to \$76 billion in 1972 reflected mainly a boost in military pay and a moderate increase in procurement. Even so, the share of total federal purchases going to defense declined again in 1972—to about 72 percent.

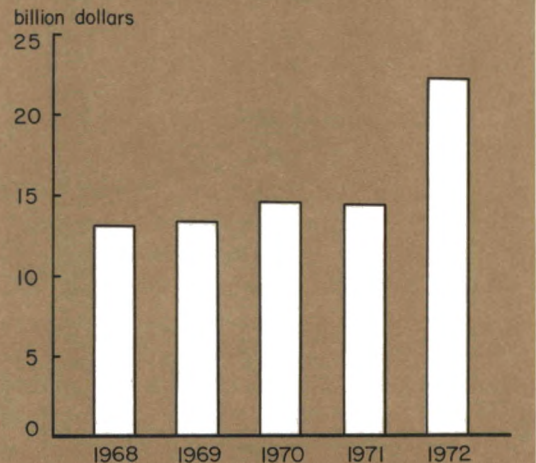
Federal purchases of goods and services, other than defense, rose at a fast pace in each of the past two years, reaching a record \$30 billion in 1972. The rise in non-defense outlays mainly resulted from higher salaries and increased activity on construction projects. Federal government employment averaged under 2.6 million in 1972, about the same as in 1971 and about 100,000 below the level of earlier years.

The broader federal picture

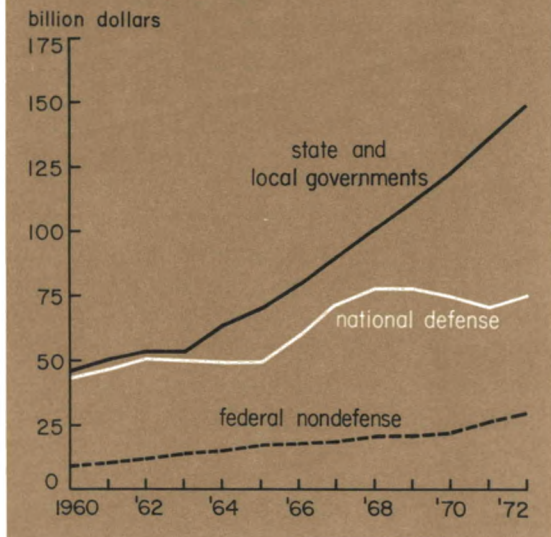
Total federal expenditures include several major classes of outlays in addition to purchases of goods and services. In calendar 1971, total expenditures on a national income accounts basis were \$221 billion—\$98 billion in purchases of goods and services, \$75 billion in transfer payments (principally Social Security and other pensions), \$33 billion in grants-in-aid to states and municipalities, \$14 billion in net interest, and \$5 billion in other areas. In 1972, federal expenditures totaled almost \$250 billion, about two and one-half times expenditures on goods and services alone. Except for interest, all classes of federal expenditures increased significantly in 1972.

Federal receipts totaled nearly \$230 billion in 1972, increasing about as much as expenditures. On a national income ac-

Overwithholding of personal income tax deductions increased sharply



Government purchases of goods and services rose in all major sectors



counts basis, the deficit was about \$20 billion, only slightly less than the \$22 billion deficit recorded in 1971, the largest since World War II. A variety of tax reductions for individuals and businesses were enacted in late 1971 and were in effect for all of 1972.

The 1972 federal deficit would have been even larger were it not for overwithholding of personal income taxes through payroll deductions. Overwithholding from payrolls occurs every year, but in 1972 the amount was about \$7 billion more than normal. The reason was that taxpayers did not adjust declared exemptions, as expected, following the adoption of a new and higher withholding schedule in January 1972. While taxpayers were expected to file statements with employers that would reduce these deductions, millions did not do so. Excess payments will be refunded in the spring and summer of 1973. The overall effect of overwithholding, therefore, will be to shift part of the deficit that would have been incurred in 1972 into 1973.

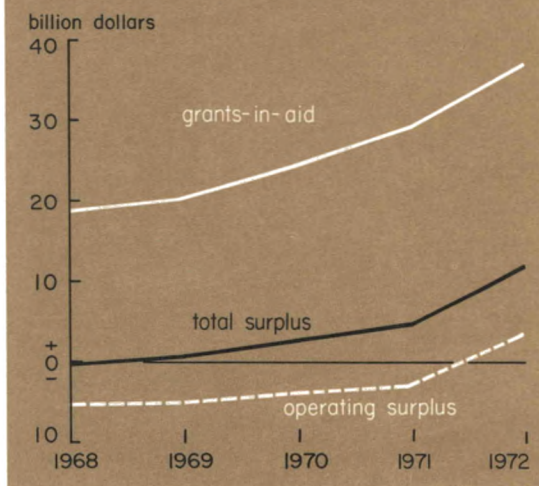
Social Security benefits in 1972 totaled over \$50 billion, up \$5 billion from 1971. This additional expenditure was about evenly split between the normal increase in the number of recipients and the 20 percent increase in benefits effective with October payments.

The Administration has indicated a determination to closely restrict any rise in total federal expenditures in 1973. Even so, a substantial deficit is widely expected.

States and municipalities

Expenditures of state and local governments have grown each year since World War II. Population has increased, and demands for public services—police, fire, health, education, and highways—have expanded rapidly. Total purchases of goods and services by state and local governments approached \$150 billion in 1972, and exceeded federal purchases by 40 percent. As recently as 1967, federal purchases exceeded state and local purchases, as they

Larger federal grants helped state and local governments achieve surpluses



had in virtually every year since World War II.

State and local government purchases of goods and services have accounted for a steadily rising share of GNP. This proportion rose to almost 13 percent in 1972, compared to less than 10 percent in the early 1960s, and less than 7 percent 20 years ago.

Federal grants-in-aid to state and local governments reached \$38 billion in 1972, up \$9 billion from 1971, and double the total of 1967. These transfers are earmarked primarily for welfare, education, and highways. It is expected that the share of state and local government expenditures financed by grants-in-aid will rise further in the future because many states and municipalities have been experiencing difficulty in raising additional funds through taxes and borrowing.

Revenue sharing accounted for about one-third of the \$9 billion increase in grants-in-aid in 1972. But other programs

also expanded substantially. Partly because of federal help, but also because of increased tax collections, many state and local governments were in a strong financial position in 1972. In the aggregate, these governments showed a surplus on a national income accounts basis of about \$12 billion for the year. While much of this "surplus" is earmarked for pension funds and related reserves, a net operating surplus of nearly \$4 billion was achieved in 1972.

While most grants-in-aid must be spent for specific purposes, revenue sharing funds are specifically designed to be used at the discretion of the recipient. Revenue sharing funds will total about \$6 billion in 1973. Some government units have already announced that at least part of these funds will be used for tax reduction. Even before the first distributions were made, however, unions representing government employees made demands that the funds be used for wages and other employee benefits. Pressures also exist to boost welfare programs.

Large expansion in money and credit

The Federal Reserve System in 1972 continued to pursue policies intended to foster economic expansion while holding back the rate of price inflation. Bank reserves were provided to support a record growth in bank credit and large gains in the money stock and time deposits. Short-term interest rates rose moderately through most of 1972 after reaching a nine-year low in February, but long-term rates were relatively stable. As in 1971, credit was generally available to all classes of borrowers.

No change was made during the year in the rate charged by the Federal Reserve banks on member bank borrowings. This rate had been lowered from 5 percent to 4½ percent in two steps late in 1971, when market interest rates were declining.

Reserve requirements for member banks were restructured late in the year, but this was managed so as to minimize the impact on financial developments. In late November, after several months of rapidly increasing stock market credit, the Board of Governors raised margin requirements on purchases of regulated stocks from 55 percent to 65 percent, restoring the level prevailing prior to December 1971.

Total funds raised by the nonfinancial sectors in the money and capital markets in 1972 approached \$165 billion, about 5 percent more than in 1971, and 50 percent more than in any earlier year. Total mortgage credit, including nonresidential loans, increased about 35 percent more than in 1971. The share of total credit channeled into mortgages rose sharply, reflecting very strong growth in deposits of savings and loan associations and increased mortgage lending by commercial banks and insurance companies.

With substantial growth in both residential mortgage loans and consumer

credit, net borrowings by the household sector exceeded \$60 billion, up 45 percent from the 1971 record. Funds raised by the business sector totaled about \$67 billion, up about 7 percent from the 1971 record. After two years of very heavy financing in the capital markets, gross proceeds of corporate sales of stocks and bonds in 1972 were about 13 percent less than in the previous year. But bank loans to business rose much more than in 1971, and outstanding commercial paper, which declined in 1971, increased moderately.

Issues of securities by state and local governments, net of retirements, declined about 25 percent from the very high 1971 level. Net issues of securities by the U. S. Treasury and federally sponsored agencies combined were about 20 percent less than in 1971. This occurred despite a somewhat larger budget deficit for the calendar year.

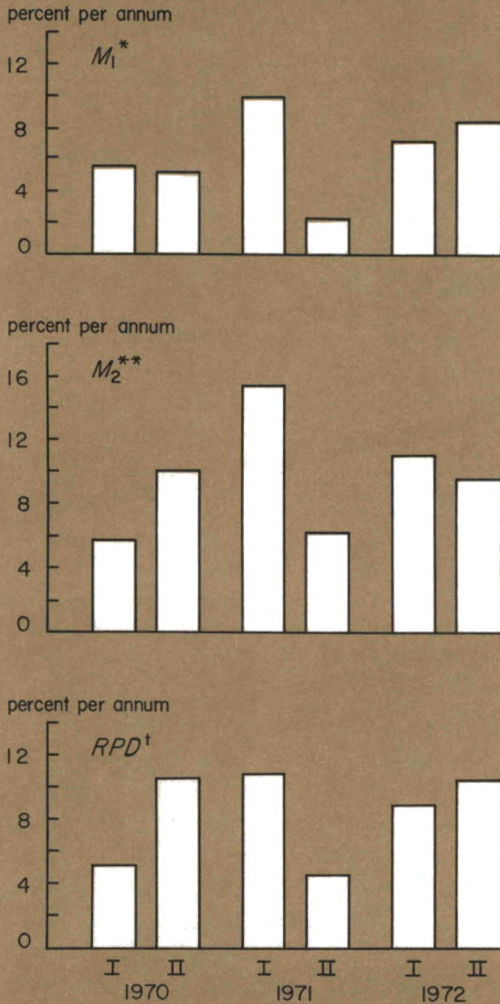
Both commercial banks and savings and loan associations increased their share of total funds advanced in the credit markets. Inflows of savings to S&Ls totaled \$34 billion, up 19 percent from 1971 and three times as much as in any earlier year. For the first time, funds supplied by S&Ls surpassed insurance companies and pension funds combined.

Record commercial bank growth

Total loans and investments of all commercial banks in the United States rose by more than \$75 billion in the 12 months ended December 27, 1972, or 15 percent. In previous years of strong gains—1967, 1968, and 1971—bank credit expanded by 11 or 12 percent, and average annual growth in the 1960s was 8 percent.

Loans accounted for more than 80 percent of the dollar increase in bank

Money and bank reserves expanded to support economic growth



*Currency and demand deposits held by the public.
 **M₁ plus time deposits other than CDs over \$100,000.
 †Reserves available to support deposits other than U. S. Government interbank.
 Note: Changes are based on seasonally adjusted average daily amounts in December and June.

credit. Business, mortgage, consumer instalment, and security loans all shared in the rise. Mortgage and consumer loans, with gains of 20 percent and 17 percent, respectively, increased significantly in importance in bank portfolios. This trend began in 1971, when business demands for bank credit were weak and banks actively sought other profitable outlets for funds. As 1972 progressed, business loan demand strengthened. For the year as a whole, commercial and industrial loans rose 12 percent, more than twice the gain in the previous year.

Commercial bank holdings of investment securities continued to rise but at a much slower pace than in 1971. Additions to portfolios of Treasuries were small and were mainly related to the underwriting and distribution of new issues. A larger share of holdings were in shorter maturities. Net acquisitions of other securities, largely state and local issues, were down one-third from 1971 with the greatest reduction in longer maturities.

Deposit expansion again provided the bulk of the funds needed to finance increases in loans and investments. Total deposits of all commercial banks rose \$70 billion, or 13 percent. As in other recent years, time deposits were the major source and accounted for 60 percent of total deposit growth. Total time deposits at all commercial banks rose more than \$40 billion, or 16 percent. In both 1970 and 1971, when declines in market rates caused investors to shift funds from direct investments to bank deposits, time deposits increased 18 percent.

Net inflows of personal savings deposits and small denomination CDs were less than in 1971 but larger than in any previous year. These inflows slowed after the first quarter. Partly for this reason, major money market banks increased their sales of large negotiable certificates of deposit. Big CDs rose by about \$10 billion to a new peak of almost \$45 billion at year-end. Total demand deposits at all

commercial banks, including U. S. Government deposits, rose about 11 percent in 1972, compared with a 6 percent gain the previous year.

With ample funds provided by deposits, banks were not interested in tapping nondeposit sources, mainly Euro-dollar borrowings and commercial paper issued by bank holding companies. Little change occurred in these borrowings in 1972 after a decline from more than \$21 billion in early 1970 to \$5 billion at the end of 1971. Eurodollar rates were well above domestic money market rates throughout the year. A proposal by the Board of Governors to reduce applicable reserve requirements on Eurodollar borrowings from 20 percent to 10 percent and to eliminate the reserve-free base was still pending at year-end.

Total capital accounts of commercial banks rose by \$5 billion in 1972, in part reflecting the need to restore capital-to-deposit ratios eroded by strong deposit gains. More than \$2 billion was raised by banking organizations through the public sale of capital notes and debentures. Most of this debt, however, was issued by bank holding companies, the funds becoming available to the subsidiary banks indirectly through holding company purchase of bank assets.

Holding company banking has become a major feature of the U. S. banking structure in the past two years. With the rapid spread of one-bank holding companies, most major banks are now operating under such organizations. More than 500 acquisitions of banks by holding companies have been approved by the Board of Governors since early 1971.

The Board also announced a number of amendments to and interpretations of Regulation Y, governing bank holding companies, during 1972. These changes mainly relate to permissible nonbanking activities of bank holding companies. Major rulings allowed these companies to provide specified investment advisory and insurance

agency services. But certain other activities, including management consulting, property management, and operation of savings and loan associations, were disallowed.

Regulations affecting member banks

In addition to its actions affecting bank holding companies, the Board of Governors made important changes in Regulation D, dealing with reserve requirements, and Regulation J, dealing with check collection. These actions were designed to reduce the burden and inequities of reserve requirements on member banks and to improve the efficiency of the payments mechanism. They were intended to be neutral with respect to monetary policy.

A new schedule of reserve requirements on demand deposits under Regulation D results in equal required reserves for banks with the same amount of deposits, regardless of location. This schedule reduced required reserves for most banks, releasing a total of about \$3.2 billion, or roughly 10 percent of the reserves required before the change. The Regulation J amendment required all banks to pay for checks presented by the Federal Reserve on day of presentment, thus eliminating an estimated \$2 billion in Federal Reserve float (credits given to banks receiving payment for checks prior to collection from the paying bank). Changes in D and J were made effective simultaneously. Implementation of these changes in the fall, when additional reserves were needed to support seasonal deposit expansion, helped to cushion the net impact on excess reserves.

A proposed change in Regulation A, governing the extension of credit by Federal Reserve banks, was still outstanding for comment at year-end. This proposal would add to the regulation a specific authorization to extend seasonal credit to small banks in order to assure their ability to accommodate the seasonal needs of their communities.

Monetary aggregates

The money supply (M_1), defined as demand deposits and currency in the hands of the public, had increased at an annual rate of only 2.4 percent in the second half of 1971. The money supply (M_2), more broadly defined as M_1 plus time deposits other than CDs, also had increased at a below normal pace. More rapid increases in these monetary aggregates were believed necessary to achieve a more rapid expansion of the general economy.

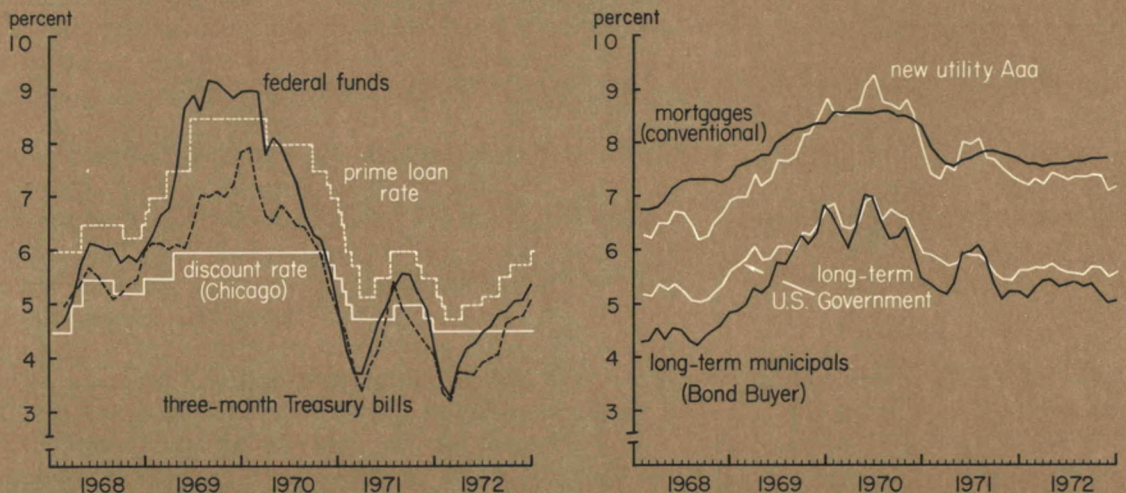
Meeting in January, the Federal Open Market Committee (FOMC) decided to implement its monetary growth objectives by specifying a rate of growth in reserves available to support private deposits (excluding both Treasury and interbank deposits) "RPDs," rather than "money market conditions," as the immediate operating target of System open market actions. This change in technique was adopted with the expectation that it would improve the System's ability to achieve its policy objec-

tives—growth rates in the monetary aggregates thought to be consistent with non-inflationary economic expansion.

Until late February, the supply of reserves consistent with desired rates of monetary growth exceeded demands, and short-term money rates continued the decline that began in August. As monetary expansion accelerated after February, however, System open market operations became less accommodative. The more restrictive posture was reflected in a higher federal funds rate—the rate at which banks borrow overnight reserves from each other—and in a higher level of member bank borrowing at the Reserve banks. The federal funds rate rose from an early February low of about 3.20 percent to about 5.35 percent in mid-December. Borrowings by member banks rose from less than \$100 million in the first quarter to an average of more than \$1 billion in December.

The increase in M_1 from December 1971 to December 1972 was about 8 percent, compared to 6 percent in the previous

Interest rates were lower, on average, than in the three previous years



Note: Market rates are monthly averages of daily figures.

12 months. The December 1971 level, however, was below the desired trend. Growth in M_2 in 1972 was only slightly less than the 11 percent 1971 gain.

Despite growing monetary restraint, RPDs increased slightly faster in the second half of 1972 than in the first half. The change in RPDs associated with a given change in M_1 or M_2 is affected by the mix of deposits between demand and time and the distribution of deposits between large and small banks. Prediction of these relationships was particularly difficult late in 1972, when changes in Federal Reserve regulations affecting Federal Reserve float and required reserves became effective. Sufficient reserves must be supplied to support actual deposit increases even if they are above desired levels. However, future deposit expansion may be discouraged as the federal funds rate rises or the supporting reserves can be obtained only by borrowing from the Federal Reserve.

Other interest rate developments

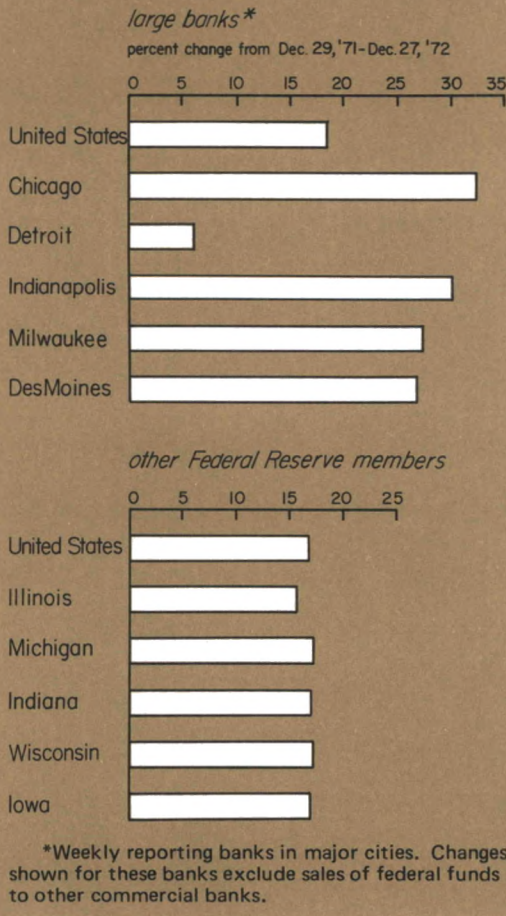
The three-month Treasury bill yield moved above 5 percent late in the year—up almost 2 percentage points from the February low, but still under the level of August 1971. Increases in bill rates reflected both increased Treasury issues and much smaller purchases by foreign central banks as compared with 1971. Increases in commercial paper rates and bank offering rates on CDs during 1972 left these rates well below the levels of August 1971. The prevailing prime lending rate at the nation's major banks, which had dropped from a pre-NEP level of 6 percent to 4.75 percent in January, was adjusted upward gradually. Just before year-end, a 6 percent prime rate again became general. There was little further movement toward the adoption of a floating prime rate beyond those few large banks that initiated it late in 1971. Moreover, some of those banks took steps to suspend or modify their formulae.

In contrast to the upward trend in money market interest rates, long-term rates were generally stable throughout the year, and surveys of consumer loan rates indicated some shading downward. New high-grade utility issues sold at somewhat lower yields in December than in January, and one major index of municipal bond yields dropped to a low for the year in November. FNMA auction rates for mortgage funds moved in a narrow range between 7.54 and 7.72 percent. Stability in long-term rates was attributable to several factors—the lower volume of new security issues, the wide spread between long and short rates, the continued large supply of investment funds, and shifts by nonbank investors into longer maturities. The slower pace of price inflation under price controls may have reduced expectations that bond yields would soon move higher.

Seventh District banking

Growth in deposits and credit at banks in the Seventh Federal Reserve District closely mirrored the national trend. Total credit outstanding at district member banks rose 15 percent in 1972, with loans alone rising almost \$9 billion, or 21 percent, for the biggest gain since 1965. Loans accounted for more than 95 percent of total credit growth at the 55 large banks that report detailed credit statements weekly and 76 percent of growth at other member banks. Holdings of municipal and government agency securities increased 8 percent in 1972, less than half the 1971 gain. Little change occurred in holdings of Treasury securities. Total deposits rose more than \$7 billion, or 12 percent, in 1972, the same rate as in the previous year, with time deposits accounting for more than three-quarters of the dollar gain. Reduced holdings of cash and reserves (partly reflecting lower reserve requirements) and some increase in borrowed funds permitted bank credit to grow faster than deposits.

Banks in most district areas shared in loan expansion



Loan demand was very strong throughout the district. At the weekly reporting banks in the major cities of the five district states, increases in total loans (excluding sales of federal funds to other commercial banks) for the year ended December 27, 1972 ranged from 6 percent in Detroit to 32 percent in Chicago. For all large banks in the United States, the gain was 19 percent. Loan growth at the smaller banks in all states of this district was strong and about in line with the 15 percent nationwide increase.

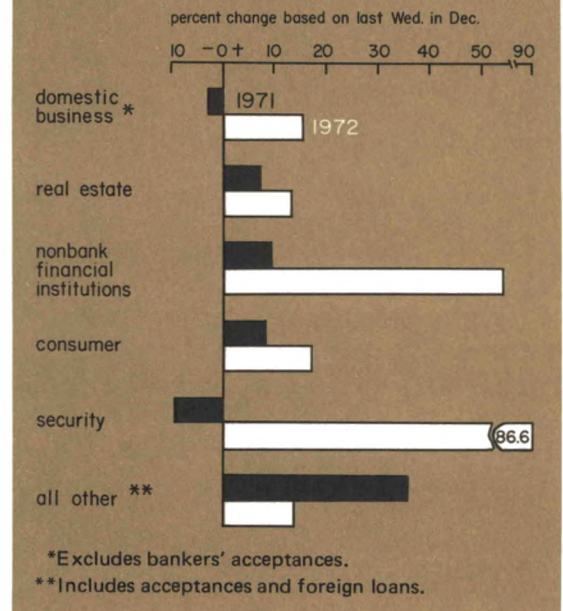
Information from large district banks

indicates that growth in all major types of loans has been substantial. Real estate loans rose 13 percent, about twice as much as in 1971, but below the 19 percent gain reported for all the large banks in the United States. Additional funds channeled into the mortgage market were reflected in loans to nonbank financial institutions, which include mortgage companies. These loans accounted for one-fourth of the increase in total loans at large banks. Consumer installment loans rose 17 percent, compared with 8 percent in 1971. Loans on securities accounted for nearly 18 percent of the rise in total loans.

Business loans up

Demand for bank loans by business firms fluctuated during the year but was strong overall. Total commercial and industrial loans at the large district banks rose 12 percent in 1972, compared with nominal

All major types of loans at large district banks rose much faster



increases in each of the two previous years.

Exclusive of foreign loans and acceptances the gain was almost 16 percent in 1972. Foreign loans and acceptances, which had risen sharply during the foreign exchange crisis in 1971, were paid down during 1972. The gain was not evenly distributed among district centers—20 percent in Milwaukee, 35 percent in Des Moines, 22 percent in Chicago, 12 percent in Indianapolis, and 1 percent in Detroit.

Most of the increase in business loans was in the public utility, retail and wholesale trade, service, and construction sectors. Loans to durable goods manufacturers, which account for about one-fourth of outstanding credits at large district banks, changed little in 1972 after a significant decline in 1971. Because credit needs of many large corporations were reduced by sales of securities and rising earnings, competition among the major banks for these loan customers was strong.

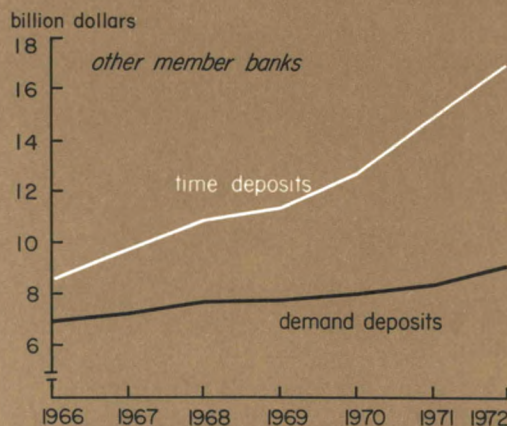
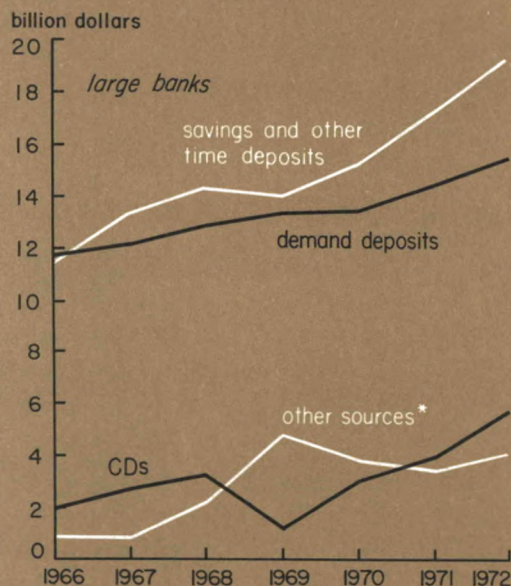
Term loans with maturities of more than one year remained about the same proportion, 50 percent, of all outstanding business loans of the large district banks. At some banks, however, a major portion of the net growth in business loans was in term loans. Certain banks emphasized “cap” loans made for periods up to seven years. Like most other term loans, interest rates of cap loans can be adjusted, but a maximum charge is specified.

At smaller member banks (all except the 55 large weekly reporters), the end-of-year composition of loans is not yet available. In the first half of 1972, these banks expanded real estate loans by 6 percent, business loans by 7 percent, and consumer loans by 8 percent—all faster than in the same period of 1971.

Deposit trends

Time deposit growth continued to outpace demand deposits at both large and small banks, and accounted for three-

Time deposits continued as the major source of funds at both large and small banks



Note: Data are averages of Wednesdays in December.

*Nondeposit sources, including net purchases of federal funds from other banks.

fourths of the dollar increase in total deposits. Inflows to personal accounts were slower than in 1971 but still very strong. Most banks continued to pay the maximum rates allowed under Regulation Q on savings, 90-day notice contracts, and small certificates. Some banks that had stopped offering higher-interest accounts began to promote them again. Savings deposits at the large weekly reporting banks rose 8 percent in 1972, down from the 12 percent 1971 gain. These banks reported a 22 percent rise in time deposits other than savings accounts, with more than half of the rise in negotiable CDs of \$100,000 or more. The aggressiveness with which particular banks bid for CD funds was related to the strength in their loan demand. CDs of the major Chicago banks rose about \$1.8 billion, or 70 percent. In Detroit, on the other hand, CDs declined slightly.

Total time deposits of the smaller banks were up 14 percent in 1972, only moderately below the 17 percent 1971 gain. With the exception of Michigan, growth in total deposits at the smaller banks was less than at the large banks that offer negotiable CDs.

Both large and small banks relied more on borrowed funds in 1972. At the large banks, the main source of funds other than deposits was the purchase of federal funds from other banks. Net purchases of federal funds by the five largest Chicago banks averaged over \$1.5 billion daily in 1972, up about 20 percent from 1971. Borrowing from the Federal Reserve Bank of Chicago by reserve city banks was negligible in the first quarter but averaged about \$50 million in the final quarter. Country bank borrowings from the Federal Reserve bank followed a similar pattern.

Will 1973 match 1972?

The momentum in the economic expansion is clearly apparent in early 1973, both in the Midwest and in the nation as a whole. Employment and personal income are rising, and consumers are spending freely. The increase in business plant and equipment expenditures appears to be gathering steam. Most industries are increasing production and are attempting to build inventories. The Administration is maintaining a close rein on federal government expenditures, but outlays of state and local governments are expected to increase at least as rapidly as in 1972. The only sector likely to decline significantly this year is residential construction, and increases in nonresidential construction probably will more than offset such a development.

Projections for the U. S. economy in 1973 offered by analysts both in government and in private pursuits show a remarkable similarity. In general, 1973 is expected to repeat the experience of last year, with the gross national product rising about 10 percent—with perhaps 6.5 percent representing real growth and 3.5 percent reflecting price inflation. Employment is expected to rise as much in 1973 as in 1972, and the unemployment rate is expected to edge down below the 5 percent level. Loanable funds are expected to be readily available at interest rates not much higher than in 1972.

Opinion is divided concerning the desirability of continuing the framework of price and wage controls imposed in 1971. But there is little doubt that upward price pressures will be stronger this year, at least for nonfarm products. Margins of unused facilities and manpower are significantly less than a year ago. Rising order backlogs

of manufacturers have been accompanied by longer lead times in the past several months. Some manufactured products are being allocated to customers according to past requirements. In December and January, there were widespread shortages of natural gas and oil.

Substantial increases in output per man-hour in the past year and one-half have greatly reduced increases in labor cost per unit of output. Large increases in labor costs in the years 1968-70 had exerted strong upward pressures on prices. Increases in productivity always occur in the early stages of a strong business expansion. But as less experienced workers are added and less productive facilities are utilized, increases in productivity can be expected to moderate. If so, continued increases in wages, even at the reduced rates of 1972, will push unit labor costs up again. Another problem may be increased numbers of work stoppages. Man-hours lost because of strikes were at a relatively low level in 1972. Labor contracts covering 4.5 million workers, many in pace-setting industries, are up for negotiation in 1973. Contracts negotiated in 1972 covered only 2.8 million workers. If this year's labor agreements can be concluded on a noninflationary basis and without disruptions of production, prospects for price stability would be enhanced.

The 1972 experience proved once again that the U. S. economy will respond, although perhaps stubbornly, to expansionary monetary and fiscal policies. In 1973, an unresolved question is raised once again: Can the nation maintain high-level prosperity over an extended period without rekindling the fires of inflation?

