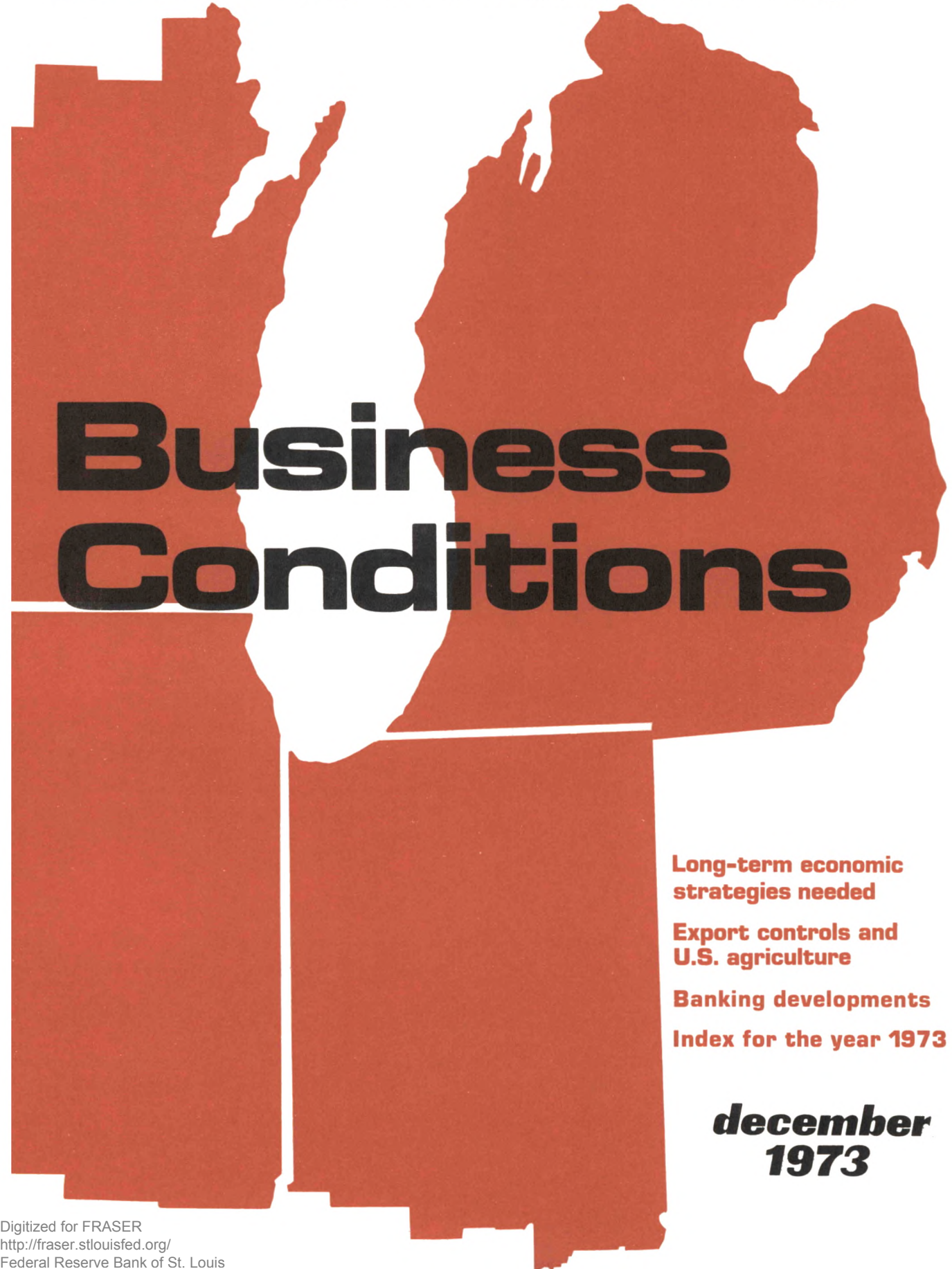
an economic review by the Federal Reserve Bank of Chicago



Business Conditions

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Long-term economic strategies needed

Excerpts from "Economic Policy Strategies for the 1970s,"
an address by Robert P. Mayo, President
Federal Reserve Bank of Chicago
before the Greater Des Moines Committee
Des Moines, Iowa
November 29, 1973

The prospects of gasless Sundays, slower highway speeds, reduced airline service, lower temperatures in homes and factories, and a less glittering Christmas have made everyone keenly aware of the "energy crisis." Seldom has public interest and concern with an economic issue developed so rapidly and so intensely.

The implications of relative scarcities or shortages for economic stabilization policies—and here I mean the use of both monetary and fiscal policies to achieve and maintain stable prices and relatively full employment—are not simply abstract, theoretical exercises of concern to economists and the armchair policymaker. It seems clear to me that shortages of supply serve to constrain our achievable economic goals, at least in the short run, and the public must be aware of those constraints if the public is to give realistic direction to policy efforts, to have realistic expectations of the results that can be achieved, and to make realistic assessments of economic policies and economic policymakers.

Unfortunately, public expectations of the performance of economic policies, even in the absence of scarcities, have been greater than those policies could be reasonably expected to achieve, attributable I am afraid to policymakers and economists who promised more than they could deliver. Since the 1930s, the intent of government policy has been to foster actively economic well-being, economic stability, and economic growth. Implicit in these actions has been the belief that national policies could solve many of our economic problems. In practice, over this period the results have been mixed, but generally successful.

The basic emphasis of fiscal and monetary policy over the past few decades has been on the management of the demand for goods and services. Nevertheless, supply considerations have not been ignored. We have, for example, affected supply through agricultural support programs and minimum wage legislation, even though supply effects may not have been the primary or sole objective of these programs. We have also taken the existing limits of capacity growth into account in our planning. But the basic thrust and emphasis have been on influencing and affecting private and public demands for goods and services.

The reasons for our lack of complete success in following this demand-oriented scenario highlight some of the difficulties that economic policy faces in a changed environment where supply constraints may exist to a serious degree. Clearly, there have been a number of periods in our history in which we were unwilling or unable to restrain demands on our productive potential and inflation resulted. You will recall that in the early 1960s the economy was characterized by stable prices, but an unemployment rate of about 5½ percent. Demand was stimulated. The demands of the Vietnam War, with heavy pressures on man-

power and other productive resources, plus the initiation of vast new government social programs—demands not covered by commensurate tax increases—reduced the unemployment rate to 3½ percent by 1969. At the same time, however, inflationary pressures mounted. These expansionary policies sowed the seeds of an inflationary cycle from which we have not by any means fully extricated ourselves. During this period, we simply asked too much from this economy in terms of both public and private goods. Total supply could not adjust as rapidly as demands increased and price pressures resulted. This is another way of saying that public expectations for the economy exceeded the economy's ability to deliver. And public expectations for economic policy have exceeded the capacity of policy to deliver.

Obviously, if we are rapidly moving toward an environment in which our population growth and per capita resource demands exceed availability, we end up with the apocalyptic conclusion of "Doomsday." This I reject completely. Exhaustive studies have shown that there is no foreseeable limitation on supplies of basic natural resources. Extreme pessimism is also unwarranted because it attaches insufficient weight to the impressive array of adaptive mechanisms through which a market economy such as ours responds to shifting patterns of resource scarcity. Technological change and changes in relative prices are powerful mechanisms.

I do not mean to play down the short-run adjustment problem we face. But even in the short run the price mechanism can and does work. With limited supplies, price signals will activate the adjustment mechanism. And, it is within our current capabilities to provide relief and assistance to any groups in the society that would otherwise bear a disproportionate share of the adjustments such price signals might bring about.

Even if we were confident that we could adjust to supply constraints we still haven't eliminated the difficulties for economic policy, and we must have realistic expectations of what these policies can deliver. First, the adjustment takes time. In the presence of shortages, policies designed to expand total output, and perhaps increase employment through demand management, may work more slowly than they would without supply constraints. Second, the process of adjusting supplies upward will, in a market economy, require increases in prices for some period at least. It is the price mechanism that communicates the demands for increased capacity, raw materials, or new technologies.

Even with improvements in the speed of adjustment, it will, I fear, be difficult to achieve both of our goals of full employment and price stability simultaneously. It may even be impossible if we insist on defining our short-run goals too restrictively—say 4 percent unemployment and 2 percent inflation. In the presence of short-run nonhuman resource limitations, we may not always be able to achieve full employment before generating price pressures on our other resources. Adaptation may simply not be that rapid.

The process of achieving the goal of minimum unemployment could put us in a future position where not only is the goal of price stability outside its range of tolerance but also where it is impossible to continue to achieve acceptable rates of unemployment. The objective of economic policy controls cannot be simply to get us from where we are to where we would like to be. The optimal policy is one that brings the economy to a desired point in the "best way." Policy actions set in motion a whole train of events that if not carefully watched can bring us to a state beyond the targeted point that is untenable.

All this means simply that our policies must be conceived within a broader time frame than in the past. Our short-run successes of economic policy may not look as

good as they have in the past, but over a longer time span perhaps they will be closer to what we really want.

What then are the appropriate policy considerations for the remainder of this decade? What are the alternative strategies in a changing environment? I do not pretend to have the policy answers completely and clearly identified. Most of these views will require further evaluation.

Of greatest concern to me is the point I made earlier, that is, the tendency for public expectations to outrun realities in the economic sphere. This isn't a new problem, but with shortages—even though correctable or adjustable over time—it takes on added seriousness for economic policy. If we fail to recognize that available economic resources form a constraint upon national abilities to achieve our goals, the gap between expectations and realities will widen. It isn't necessary to write a whole scenario before it becomes clear that the wider the gap, the greater the public concern, the greater the demands for action, and the greater the likelihood of ineffectual or inappropriate short-run economic policy actions.

This does not mean that any of us are opposed to an improved quality of life or that we must adopt an "anti-environmentalist" stance. But it does mean the realization that decisions to produce public benefits impose costs. We need to weigh these costs and benefits not only for the particular program or policy action under consideration but also against all of the other programs with benefits and real resource costs. In terms of public policy, this suggests the need for congressional budgetary reform, especially in putting an end to fragmented consideration of expenditures and by relating expenditures to prospective revenues and the nation's broader needs and desires. It is essential that congressional responsibility for resource allocation be performed with the same emphasis on the total outcome that is given to the preparation of the budget by the Executive branch.

The old goal choice or trade-off between unemployment and price stability still exists, but in a world of even short-run shortages, new difficulties are added. We will have to look more carefully beyond the short-run effects that we can achieve to the longer-run conditions we may create. More flexible fiscal policies may be a part of the answer, as would appear to be policies and programs to smooth out or shorten the time necessary to make adjustments. But I would be misleading you and contributing to excessive expectations of policymakers' abilities if I suggested that we have all—or even most of—the answers. Our knowledge of control procedures for this type of environment is still limited but it is growing.

The current and short-run prospects of our economy are a matter of concern but not of alarm. The economy can and will adjust to the developing environment of relative shortages. It was in the process of doing so before the recent burst of public awareness. And based on my earlier experiences in fiscal policy and my current experiences in monetary policy, I know that although it will be a difficult challenge we have the capability of meeting it.

Export controls and U.S. agriculture

Agricultural exports from the United States surged to an unprecedented $12.9 billion during fiscal 1973, 60 percent higher than the previous record in 1972, and the Department of Agriculture has forecast that the value of agricultural exports will continue at a strong pace into 1974. In some respects, the performance of U. S. farm products in world markets in 1973 came as a welcome boost to what had been generally sagging exports. But this development has had some undesirable repercussions.

Strong worldwide demand for agricultural commodities in conjunction with poor crops in numerous major production areas created a domestic shortage of basic commodities and led to controversy over public policy toward agriculture. For decades, U. S. policy has been aimed at promoting agricultural exports. Elements of this policy have included subsidizing export shipments through concessional sales for nonconvertible foreign currency, barter arrangements, and direct dollar subsidies to exporters. In recent years, public policy has been directed toward reducing government assistance and promoting commercial dollar sales in traditional and new markets. In 1973, as strong domestic and foreign demand collided with limited domestic supplies to push prices of agricultural raw materials and retail foods to record-high levels, this policy of export promotion and limited export subsidies came under widespread attack. The U. S. Government responded to the apparent shortages by imposing temporary export quotas on selected agricultural commodities.

The economics of export controls

The rules and guidelines of the General Agreement on Tariffs and Trade (GATT), with which the major world trading nations generally comply, contain limited provisions permitting a country to impose quantitative restrictions, such as quotas, on exports without the spector of sanctions being initiated by countries injured by the action. The conditions under which GATT permits the imposition of export quotas require a justification based on the national security of the exporting nation or to prevent or relieve critical shortages of foodstuffs or other essential products, provided that all contracting countries are assured equitable shares of the international supply (GATT articles XI-2, XX-j, and XXI).

Export controls take various forms. They include tariffs (not allowed in the United States),[1] quotas (legislated or "voluntary"), and such subtle restrictions as differential availability of export finance credit and currency exchange controls. Export tariffs are often imposed by the governments of developing countries as a means of obtaining revenue. Export tariffs regulate quantity by restricting the number of units sold through the rationing process of a higher price. Export quotas, on the other hand, directly control the quantity that can be exported because once the quota level is reached exports are halted—regardless of price.

[1] There is a constitutional question as to whether an export tax can be imposed by the U. S. Government. Article I, Section 9, of the Constitution reads in part "No Tax or Duty shall be laid on Articles exported from any State." The general interpretation has been that direct export taxes are prohibited. This provision was apparently included in the Constitution in response to Britain's taxation of the Colonies' exports and as an assurance to the states that the new federal government could not tax their exports—such taxes were a key motivating factor in the American Revolution.

Export quotas are a routine procedure for groups that desire to affect world price levels. Viable multinational commodity agreements, such as the International Coffee Agreement, or the Organization of Petroleum Exporting Countries may use export quotas to regulate the quantity (scarcity or abundance) of a product on the world market, and consequently the price of the product. Such multilateral quota agreements usually have the intent of stabilizing a world price within some agreed-upon range (occasionally they take on monopoly cartel characteristics). This is typically accomplished through the allocation of quotas among exporting countries —and often among importing countries as well.

The unilateral imposition of export quotas such as the United States imposed on oilseeds in the summer of 1973 is usually done in order to assure adequate domestic supplies at lower prices than those prevailing in world markets. Export quotas of another form have come into play since around 1960. These are the so-called "voluntary" quotas imposed by particular industries or by the government of an exporting country in order to avoid having an importing country impose import quotas. For example, in 1969, under strong pressure from the U. S. Government, "voluntary" quotas were imposed by the Japanese and Common Market steel industries on exports to the United States. In 1971, under similar circumstances, Hong Kong, Japan, South Korea, and Taiwan accepted voluntary quotas on synthetic and wool textile exports to the United States.

Basis for export quotas

The imposition of export quotas may increase the earnings of an exporting country if the export demand for the commodity is little affected by an increase in price—and if alternative foreign sources of supply are not available. Both conditions appear to apply to agricultural commodities, at least in the short run. Imposition of quotas, however, carries a political cost for the exporting country vis-a-vis the foreign countries cut off from the supply. This cost might be felt in a loss of goodwill and possible retaliatory trade moves by trading partners, and loss of status as a reliable source of supply. In addition, by artificially reducing demand—and thereby forcing down the domestic price—the exporting country runs the risk of discouraging expansion in domestic production of the commodity in short supply. Such a shortfall could exacerbate the worldwide supply situation in the longer term, and make it all the more difficult to rescind the export quota without stimulating a price rise, the avoidance of which prompted the imposition of the quota in the first place.

Another hazard is the snowballing effect of the unilateral imposition of export controls. As traditional importers attempt to obtain needed supplies from alternative suppliers, the alternate suppliers may be forced to restrict exports in order to assure adequate domestic supplies at politically acceptable prices. Such conditions obviously would seriously disrupt market conditions, to say nothing of the potential damage to political goodwill.

The summer of '73

U. S. authorities imposed export controls in an attempt to insure adequate domestic supplies. In mid-June 1973, the Commerce Department began to require exporters to report their export commitments of oilseeds and grains. By late June, when the first data were in, it appeared that outstanding export commitments of oilseeds exceeded the level of supplies available for export prior to the new crop harvest. The tightness of the supply-demand relationship at that point had already forced domestic prices up sharply as market forces reacted to allocate the short-run

supply. Faced with these developments, and with the sharp advances in domestic food prices in general, the government's position, as reflected in the President's speech of June 13, was that U. S. consumers should not be forced to compete with foreign consumers for U. S.-produced commodities solely on a price basis. The simplest means of rearranging the allocation of the available supply, it appeared, was by temporarily cutting off a major portion of the market—that is, the export market.

On June 28, 1973, the Administration, acting under provisions of the Export Administration Act of 1969, imposed an embargo on the exportation of soybeans and cottonseed, and on their meal and oil products. On July 2, the embargo was lifted in favor of licensing controls on soybeans, cottonseed, and most of their derivative products. (Oils were freed from license requirements on this date.) All export contracts in force as of June 13 were reduced by 50 percent of the unshipped soybeans and 40 percent of the unshipped soybean meal. New licenses, good until September 15 for soybeans and October 15 for meal and cake, were issued for the reduced quantities.[2]

On July 5, the Office of Export Control reimposed export license requirements on soybean and cottonseed oil, and brought 39 other oilseeds, oilseed products, and protein supplements under licensing requirements. On September 8, export licenses were permitted at 100 percent of contracted amounts, and on October 1, the export licensing system was revoked.

The imposition of controls on U. S. exports of agricultural commodities was preceded by a number of interrelated developments that accentuated the tightness of such supplies in world markets and put unusual pressures on U. S. agricultural markets. These included:

1. The devaluation of the dollar vis-a-vis other major currencies.
2. Poor crops in many major grain-producing countries during 1972 (and the winter and spring of 1972-73 in

[2] The June 13 date apparently was used because the President made the first public reference to the possibility of agricultural export controls on that date.

Devaluation reduced the impact of U.S. price increases in major foreign markets*

	No. 2 U. S. wheat, U. K. markets			U. S. soybean meal, Rotterdam		
	U. S. dollars	Japanese yen	German marks	U. S. dollars	Japanese yen	German marks
	$/bushel	*Y/bushel*	*DM/bushel*	*$/mt. ton*	*Y/mt. ton*	*DM/mt. ton*
1971						
July	2.04	729	7.06	106.07	37,909	367.00
October	1.90	626	6.35	101.34	33,371	338.48
1972						
January	1.82	565	5.84	105.42	33,733	338.40
April	1.79	546	5.69	116.05	35,372	369.04
July	1.79	539	5.67	124.88	37,601	395.87
October	2.58	777	8.26	138.62	41,738	443.58
1973						
January	3.04	916	8.63	219.50	66,113	623.38
April	2.87	762	8.15	243.25	64,583	690.83
July	4.26	1,118	9.88	580.00	152,250	1,345.60
Percent change						
July 1971-July 1972	−12	−26	−20	18	−1	8
July 1972-July 1973	138	107	74	364	305	240

*In August 1971, the United States declared the dollar inconvertible into gold, and major world currencies began "floating" vis-a-vis the dollar. In December 1971, agreement was reached whereby the dollar was devalued and major foreign currencies were revalued. In February 1973, the dollar was again devalued and major foreign currencies again began to "float." From July 1971 to July 1973, the value of the yen and mark increased, relative to the dollar, by about 36 and 49 percent, respectively.

the southern hemisphere).

3. A continued upgrading of diets in markets traditionally supplied by U. S. agricultural exports.

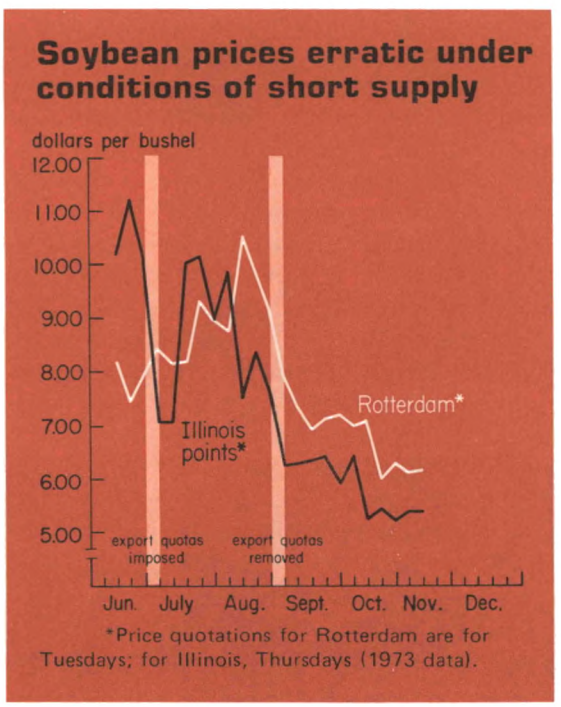
4. Expanding trade between the United States and the USSR and China, with the emphasis on U. S. agricultural exports.

5. Mounting worldwide demand for high protein foods—especially meats and animal feed—coupled with a worldwide shortage of high protein fish meal.

6. Reduced stockpiles of U. S. Government-owned grains.

Impact of export controls

The brief duration of the U. S. export quotas (June 28 through September 8) prevented the full impact of these actions from being felt on critical raw materials in world markets. Nevertheless, some of the impact stemming from the controls was clearly apparent. Domestic soybean prices declined dramatically immediately after quotas were imposed, although prices increased again in late July and early August. A sustained decline in prices occurred only after a record 1973 soybean crop appeared certain, and eventually stabilized at a level far below early summer. Foreign soybean prices advanced irregularly until a downturn in mid-August, also reflecting the record crop prospects.



The most obvious of the short-run consequences was the contagious nature of agricultural export controls. Shortly after the U. S. oilseed quotas were in place, Canada imposed quotas on selected oilseeds and protein products. Argentina, Brazil, Greece, India, Israel, Pakistan, and Spain also imposed export restrictions on oilseeds or high protein crops. Had the U. S. Government succumbed to pressures to place export quotas on wheat and corn, the breadth of reciprocal foreign protective export restrictions, considering current production and stock levels, would no doubt have been even greater.

As it is, the European Economic Community (EC) embargoed exports of hard wheat (durum) and wheat products, and Argentina installed wheat quotas. Australia and Canada, both of which funnel wheat exports through government marketing boards, markedly slowed exports. A nationwide rail strike in Canada also slowed exports. Widespread restrictions, however, naturally increased demand pressures on the unrestricted, but limited, U. S. wheat supply earlier this year. Record wheat crops in Canada and the USSR have since relieved some of that pressure.

The short-run scars from the 1973 bout with export controls apparently are not serious. One fact is quite clear, however: when a major supply source, like the United States, unilaterally resorts to export controls on a critical commodity, it places inordinate pressures on alternative supply sources and on importers relying on a stable supply source. With U. S. quotas

Grains led the export surge in fiscal 1973

	Grains		Oilseeds			
	Feed grains unmilled	Wheat and flour	Soybeans	Other oilseeds and oilseed products	Other agricultural commodities	Total agricultural exports
	(billion dollars)					
1970	1.0	0.9	1.1	0.6	3.1	6.7
	(27)	(6)	(37)	(34)	(10)	(17)
1971	1.1	1.2	1.3	0.8	3.4	7.8
	(11)	(28)	(19)	(32)	(9)	(16)
1972	1.1	1.1	1.4	0.8	3.7	8.1
	(2)	(−13)	(9)	(6)	(8)	(4)
1973[P]	2.3	2.3	2.3	1.2	4.7	12.9
	(107)	(123)	(65)	(44)	(30)	(60)

Note: Figure in parentheses represents percent change from previous year.
[P]Preliminary.

now removed, presumably the restrictions imposed by other governments gradually will be withdrawn—Canada's oilseed restrictions are a case in point.

But the brush with export controls is likely to make the future more difficult, if not directly for U. S. agriculture then for U. S. delegates at the new round of international trade negotiations which began September 12, 1973.

Trade relations

Foreign reaction to the U. S. imposition of export controls was sharply critical. During the early stages of the controls, Japan, the largest single importer of U. S. oilseeds and a country highly dependent upon a steady supply of soybeans for human consumption and for conversion into animal feed, sent a delegation to Washington with the hope of obtaining assurance of continued regular supplies. Officials of the European Economic Community and of individual EC countries, especially France, were particularly acrid in their reactions. The EC views the U. S. imposition of export quotas on agricultural products as a curious turn, given the long-held U. S. position that the EC's common agricultural policy severely restricts U. S. exports to that area. (U. S. export quotas were imposed on commodities not subject to severe EC import restrictions.)

A basic question raised by the use of export quotas—that is, restricting access to supply—is one that needs to be dealt with in the current round of international trade negotiations. The question is, is open access to markets, as a goal, to apply to exports, as it has to import trade in the postwar world?

A separate problem is of equally long-term significance. In spite of the temporary imposition of export quotas on oilseeds and protein products, the United States will continue to push for long-term expansion in farm commodity exports. Even at historically high prices during 1973, U. S. farm products remained highly competitive in foreign markets because of the dollar devaluations and the high rates of inflation abroad. But an element of uncertainty has entered the picture, and a key question now is, what action, if any, will foreign governments take to reduce their dependency upon the United States in order to assure a regular, stable, and expanding supply of agricultural commodities?

The fact that the United States could actually find itself in a situation where supplies of farm commodities were so tight that quotas were imposed must have been as disturbing to foreigners as it was to many domestic consumers. It is reasonable to expect foreign buyers to be searching for, and encouraging, the development of alternative sources of supply. Brazil, for example, is rapidly increasing its still-limited production of soybeans. Britain and Japan are reported to be moving quickly toward the commercial production of a

high protein animal feed supplement derived from petroleum (another resource with availability problems). Of course, alternative supply sources will not be developed overnight. The United States remains in the best position among world agricultural producers to expand production, and in 1974 an expansion is anticipated.

In 1974, U. S. wheat production is expected to increase to 47 million metric tons, 11 percent above the 1973 level, and feed grains are projected to increase to 191 million metric tons, 6 percent above 1973. U. S. wheat exports as a percent of production are projected to decline from about 76 percent to 66 percent. The export share of feed grains is projected to remain at about 19 percent of production. Foreign production of feed grains and wheat in 1974 is expected to increase about 6.5 percent from the 1973 level. In spite of the production increases, however, stocks of grain that will be available at midyear 1974 in major exporting countries are expected to be lower than at midyear 1973, indicating another year with a potentially tight supply situation.

Oilseed and protein meal exports* are increasing in major exporting countries more rapidly than production

	Exports			Production		
	U. S.	Foreign	Total	U. S.	Foreign	Total
	(million metric tons)					
1967	8.4	10.8	18.0	20.9	24.7	45.7
1969	9.9	10.8	20.8	24.8	24.7	49.6
1971	13.4	11.3	24.7	25.2	28.1	53.4
1973[e]	15.1	12.3	27.3	28.7	28.3	56.9
Percent change 1967-73	80.0	13.8	42.7	37.0	14.2	24.6

*Includes soybeans, fish meal, peanut, sunflower, cotton, flax, rapeseed, copra, and palm kernel (tonnage in terms of soybean meal equivalent at 44 percent crude protein).

[e]Estimate. Foreign figures assumed resumption of Peruvian anchovy fishing in March 1973 which did not occur.

What's in store?

Based on the experience of export controls imposed during 1973, a central question concerning international trade is now beginning to be raised. In an increasingly interdependent world, what international provisions can be established that guarantee open access to markets?

Until the summer of 1973, the term "open access" was generally interpreted as freedom of exporting countries to ship goods to importing countries without undue import restrictions. In June-July 1973, it became apparent that open access had another face, that is, the freedom of an importing country to purchase goods (critical or noncritical) from an exporter without undue export restrictions being imposed. Fortunately, across-the-board restrictions on exports of selected U. S. agricultural commodities were short-lived. In October, the selective access to petroleum supplies by ten Middle Eastern nations provided an abrupt and more stringent example of the vital importance of open access to supplies.

The conflict boils down to political expedience as opposed to economic rationale. The rule book of international trade, the General Agreement on Tariffs and Trade, has only limited provisions concerning restricted access to supply in international trade. It is of considerable importance that the "Tokyo Round" of trade negotiations, now in the preliminary stages, consider rules of trade aimed at achieving and enforcing open access of supply.

Jack L. Hervey

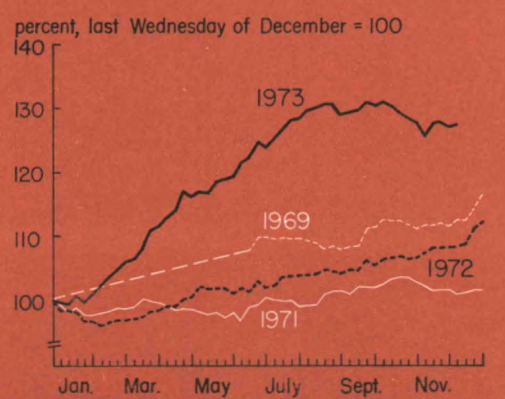
Banking developments

Business loans lose steam

Bank loans to commercial and industrial borrowers declined during the first six weeks of the fourth quarter following record-breaking expansion for the first three quarters of 1973. Normally, business credit demands are heaviest in the fall when funds are needed to finance the processing of agricultural products and a build-up in inventories for the holiday season.

The recent weakness in bank loan demand reflects both the slowing pace of the business expansion and the elimination of an abnormal rate structure that made bank loans attractive relative to other short-term sources of credit throughout the first nine months of the year. About 40 percent of net funds raised by corporate business in the financial markets was in the form of bank loans in the first nine months, compared with just over 25 percent in 1972 and 30 percent in 1969. At the large weekly reporting banks, the nine-month rise in commercial and industrial loans (including those transferred to affiliates) was 20 percent nationally and 30 percent in the Seventh District. This huge expansion in bank loans to businesses has dwarfed the 1969 experience, and despite the contraction early in the fourth quarter, it appears that the relative gain for the year probably will exceed any year since 1950.

Business loan growth slows



Note: Loans at 55 district banks. Includes loans sold to affiliates beginning June 1969.

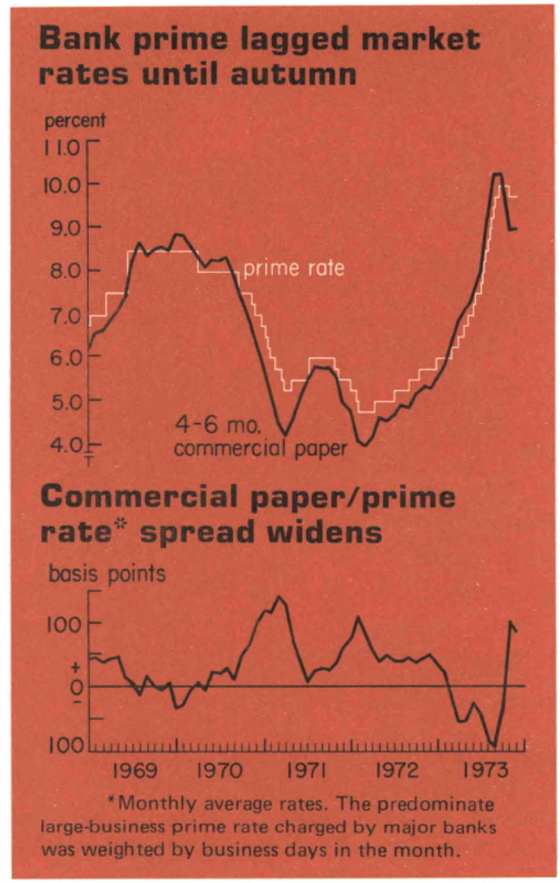
Rate spread a factor

The atypical behavior of business loans at commercial banks thus far in 1973 is clearly related to the relationships between the interest rate on bank loans, which is set by the lending bank, and the rate that must be paid in order to sell short-term promissory notes (commercial paper) to investors, a rate that must be competitive with other returns available in the money market. Many large, well-known corporations can choose between these two routes in satisfying their short-term financing needs, and the choice is largely determined by relative costs. These costs include more than just the nominal interest rate payable on the obligation—for example, the compensating balance required by a bank and the costs of issuing and servicing commercial paper.

Historically, the spreads between the prime loan rate—the basic rate a bank charges its most creditworthy customers—and rates on various categories of commercial paper tend to vary within a fairly narrow range over time except when banks wish either to attract or repel loan business or when commercial banks as a group are under pressure from public policy to lag behind rising market rates.

A longer-term comparison of the prime loan rate prevailing at the nation's major banks and the average rate quoted by dealers on four- to six-month commercial paper shows that the prime generally has been above the paper rate except in tight money periods. This spread was modestly negative for brief periods in 1969-70 but, on a monthly basis, fluctuated within a positive range of 5 to 140 basis points from the spring of 1970 to February 1973. The development of a negative spread of more than 60 basis points late last winter reflected efforts by the Committee on Interest and Dividends, in connection with the Administration's price control policies, to restrain the price of credit, especially to small businesses. This gap between bank loan charges and the cost of borrowing in the market led to a more than $9 billion increase in business loans of big banks in the first quarter, a period when there is normally little or no net gain. This was accompanied by a $3 billion decline in outstanding dealer-placed commercial paper.

In April, many large banks adopted a "two-tier" prime that enabled them to gradually adjust the "large borrower rate" to the market rate. Prime rate adjustments became more frequent and the spread narrowed but remained negative. About the same time, many banks adopted more restrictive lending policies and tightened nonprice lending terms to stem the flood of business loan demand rooted in strongly expanding economic activity. For the second and third quarters together, business loans at the large banks expanded by another $9 billion, while commercial paper remained level. Only in late September, after the prime reached 10 percent, did the sharp decline in market rates, generated in part by expectations of a weaker economy, restore the positive spread. The reversal was so abrupt, in fact, that it imposed a greater-than-normal penalty on bank loans. Many borrowers switched back to the paper market, and in October, dealer paper



expanded by nearly $3 billion—about double the contraction in business loans.

Subsequent downward adjustment in the prime rate and a partial rebound of market rates restored a more normal spread by early November, and this condition is likely to minimize shifts between these two sources. If it persists, bank loan trends in the months ahead will be more reflective of the overall demand for short-term business credit. The outlook for bank loan demand is clouded by prospective energy shortages, and by the degree to which corporations will go to the capital markets both to fund outstanding short-term obligations and planned increases in capital expenditures.

Corporate bond issues have been moderate in 1973, as increased earnings added to liquidity and many corporate treasurers stayed short in the hope that funding could

Pattern of loan growth was similar for most major industrial groups

	Percent change in commercial and industrial loans of large district banks with original maturities of			
	1 year or less		Over 1 year	
	Jan.-Sept.	Oct.	Jan.-Sept.	Oct.
Manufacturing				
Metal and machinery	+57	−10	+ 18	+ 2
Food, liquor, tobacco	+28	−13	+ 47	− 1
Other manufacturing & mining	+64	−10	+ 39	− 1
Trade	+23	+ 1	+ 29	+ 2
Utilities	+66	−10	+ 9	− 1
Construction	+33	− 5	+ 64	−13
Services	+13	+ 3	+ 14	+ 3
Foreign	+16	− 4	+ 42	+26
Acceptances	−71	+ 3	−	−
All other	+25	− 8	+271	+ 4
Total	**+32**	**− 6**	**+ 31**	**+ 2**

Note: Based on reports of 18 large Seventh District banks. Excludes loans sold to affiliates.

be done later at lower cost. Issues of bonds and equities together accounted for less than one-fourth of total external corporate financing in the first three quarters. When short-term rates declined in early 1970, long-term corporate bond yields softened initially but, under pressures generated by a huge volume of new issues, rose to their peak levels in that cycle almost six months later, while business loans declined. If capital expenditures planned for next year are not cut back significantly, heavier reliance on the bond market can be expected. But because credit, though costly, has remained available to business in 1973, unlike the 1969 experience, the necessity for businesses to issue long-term obligations appears less urgent in 1974 than it was in 1970.

Some district dimensions

The nine-month rise and subsequent weakness in business loans were relatively more pronounced in this district than nationally. Reports by the largest district banks on loans classified by borrower categories show a similar profile for all the major industrial groups, with strong increases through late summer followed by a leveling-off or decline thereafter. But as of mid-November, net dollar gains were substantially above the year-ago period in all except the construction and service groups. The contraseasonal decline in loans to food processors since mid-August reflects paydowns on the large increases placed on the books three to six months earlier, partly in connection with last summer's surge in commodity prices, that have more than offset borrowing to cover normal fall credit needs.

The recent declines at district banks were concentrated in short-term loans, except in the construction sector. While total loans of the largest banks declined almost $350 million during October, term loans—outstanding loans with original maturities longer than a year—rose $100 million.

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*Banking developments is a regular feature of *Business Conditions.*