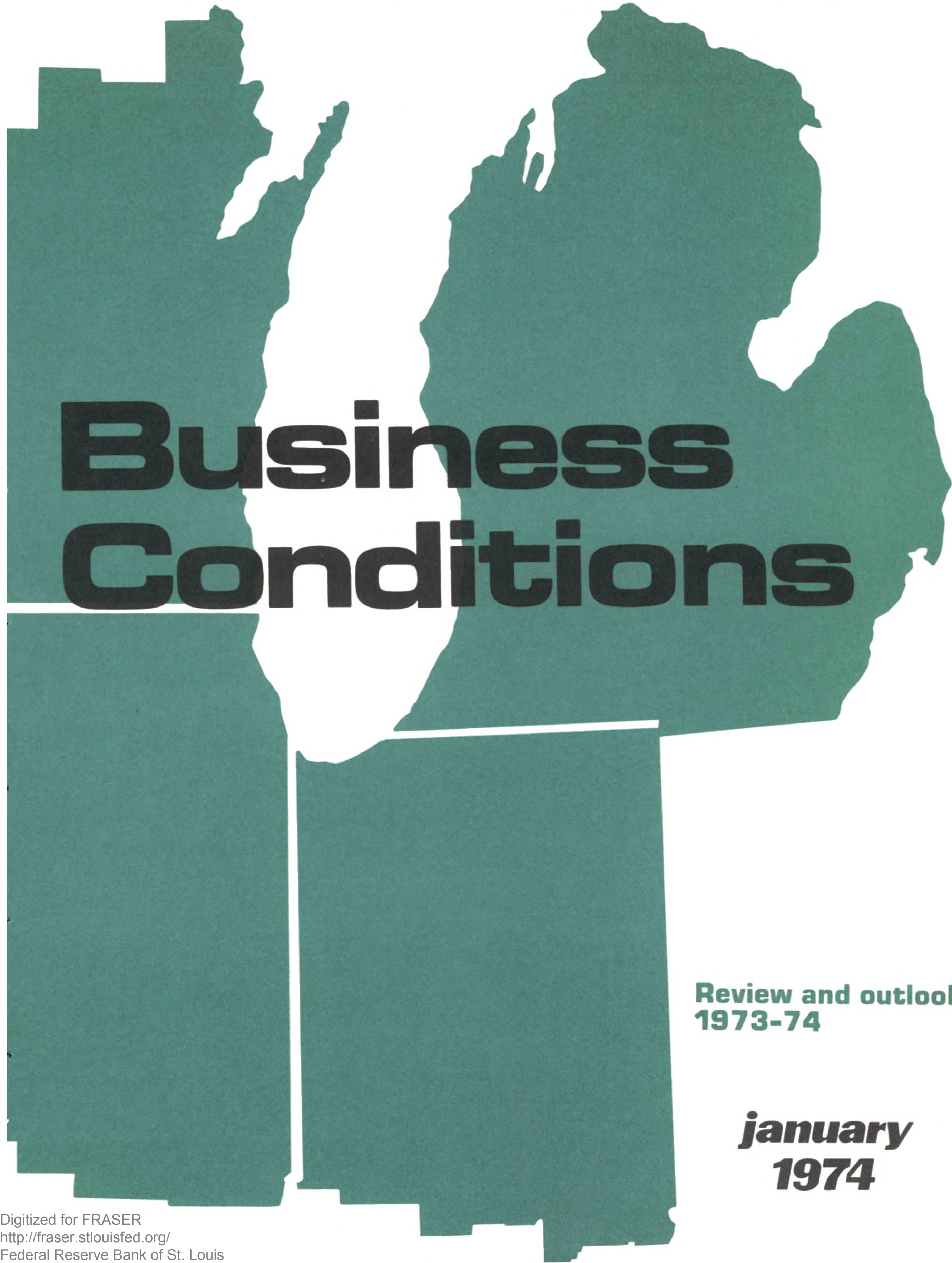
an economic review by the Federal Reserve Bank of Chicago



Business Conditions

Review and outlook
1973-74

january
1974

Review and outlook 1973-74

Last year's surge in employment and output was generally anticipated, but the rapid acceleration of inflation, widespread shortages of materials, and record short-term interest rates were not. As 1974 begins, heavy clouds dim the prospects for full-sized autos and residential construction. However, demand for business equipment and many consumer goods and services remains very strong. The ongoing energy crisis implies not only painful adjustments but also opportunities for constructive gains.

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Review and outlook 1973-74

Vigorous growth marred by inflation

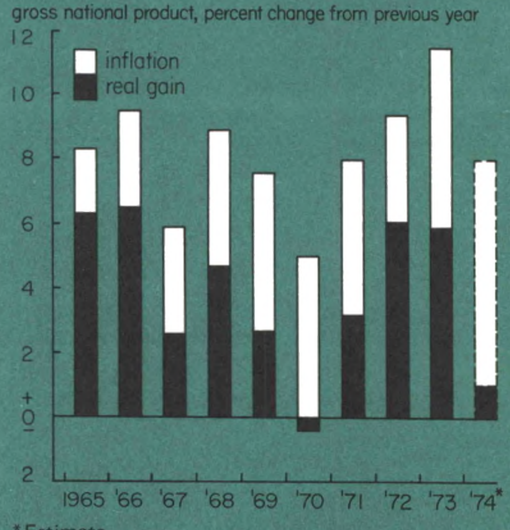
The surge in the U.S. economy in 1973 had been generally anticipated at the start of the year. Total output of goods and services, adjusted for price inflation, was up 6 percent for the year—about the same as the strong gain recorded for 1972. Except for residential construction, all major sectors shared in the rise in activity in 1973. Starting in October, Arab restrictions on oil shipments precipitated a worldwide energy crisis that was to have far-reaching effects on the economies of virtually all industrialized nations, not only immediately, but for many years to come.

The 6 percent increase in total real activity in 1973 was close to the consensus forecast at the start of the year. Published forecasts, however, drastically underestimated the rate of price inflation. The general view was that both the consumer price index and the GNP deflator would average about 3 percent higher, no worse than the rise for 1972. Instead, consumer prices averaged more than 6 percent higher, the largest year-to-year increase since 1951, the first full year of the Korean War. The inflation was paced by an explosive and unexpected rise in farm prices. Few analysts, moreover, had foreseen the strain on productive capacity and the shortages of virtually all basic materials that developed as the year unfolded. Finally, no one had prescience of the Arab-Israeli war, the resulting oil embargo, and the doubling and tripling of prices of imported oil.

Prosperity and pessimism

Despite price inflation, the economic record of 1973 was generally highly favorable. The physical volume of output of manufactured goods was almost 10 percent larger than in 1972. Payroll employment averaged almost 4 percent higher, and unemployment averaged substantially lower. Consumer purchases of almost all major goods were at record levels in physical quantities. Housing starts were lower, but the number of units finished and added to the supply was about the same as the 1972 record. Nonresidential construction and purchases of producer equipment were sharply higher. Farmers' net incomes jumped to new record levels for the second straight year. The nation's balance of international trade was in surplus after two unprecedented deficit years. Mainly because

Prices are expected to rise even faster in 1974, while real growth declines sharply



*Estimate.

of sharply rising collections of income taxes, federal government receipts about matched outlays after three years of large deficits. The increase in bank deposits and credit was somewhat less than in 1972, but, except for residential mortgages, there were no significant stringencies in the availability of funds to borrowers.

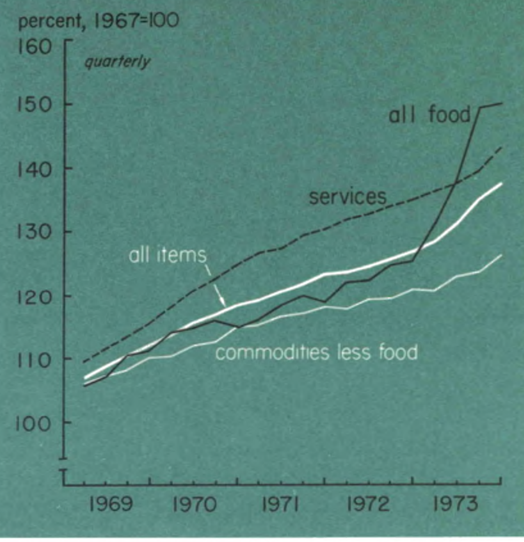
In the setting of unparalleled general prosperity in 1973, there were some loud, sour notes. Despite rising corporate profits—up 25 to 30 percent for the year—common stock prices trended downward, and at year-end stock price averages were down almost 20 percent from the record levels of a year earlier. The methods of administrating price and wage controls were resented strongly by many consumers and businessmen, often for opposite reasons. Allegations of misconduct in high echelons of government caused widespread apprehension. Surveys of "consumer sentiment" found extremely gloomy attitudes as to their future welfare. In the face of these powerful adverse psychological factors, however, businessmen continued to boost appropriations for new investment projects, and consumers continued to purchase hard and soft goods at a fast pace. Sharp reductions in consumer purchases of standard-size cars late in the year were associated more with actual and potential fuel shortages than with general pessimism.

Inflation accelerated

Early in 1973, prospects appeared favorable that prices would rise no faster than in 1972. The price surge associated with the Vietnam war had peaked in 1970 when the consumer price index (CPI) averaged 6 percent higher than in 1969. Partly because of controls and partly because of a sluggish economy, the rate of inflation ebbed to 4 percent in 1971 and to 3 percent in 1972.

As margins of unused resources of materials, facilities, and manpower nar-

Food led the rise in consumer prices last year



rowed in late 1972, the relatively rigid price controls of Phase II appeared to be hampering output and distribution in industries where demand was strong. In mid-January 1973, the Administration announced the more flexible price rules of Phase III, which placed the system of controls on a more voluntary basis. Almost immediately, food prices began to rise at a faster pace. Although the jump in food prices was mainly a result of strong demand at home and abroad at a time when some foods were in short supply, the change in the price control regulations were blamed by many.

Ceilings were placed on meat prices in March 1973 at a time when it appeared that these prices would decline because of market forces. Many consumers decided to boycott meat and many farmers decided to hold their livestock from market. Prices stayed high. In June, after a move in Congress to legislate price ceilings, the Administration declared a 60-day freeze on virtually all prices (not wages), called "Phase 3½." During the freeze, shortages of many products, especially beef, intensified. In mid-August, Phase IV was implemented with rules similar to those in effect under Phase II. From August through December, a number of industries were "decontrolled" to encourage output and to discourage exports. These included lumber, cement, most nonferrous metals, and fertilizer.

Prices surged sharply after the end of the freeze. Agricultural prices peaked in August and declined, but remained relatively high throughout the year. Virtually all nonfood prices rose month by month. In the fourth quarter, higher prices of petroleum products took the spotlight with the onset of the energy crisis.

In December, the CPI was up 8.8 percent from a year earlier. All categories except household appliances were significantly higher. Food was up 20 percent. Gasoline and motor oil was up 20 percent, rent 5 percent, and apparel 4 percent. For many families, increases in prices of essential goods and services caused hardship.

Some believe price and wage controls would have "worked" if they had been administered more rigorously, with closer supervision and stronger penalties. Others are convinced that controls have made inflation even worse. All agree that recent experience with government management of prices and wages has fallen far short of success.

Pressures on capacity

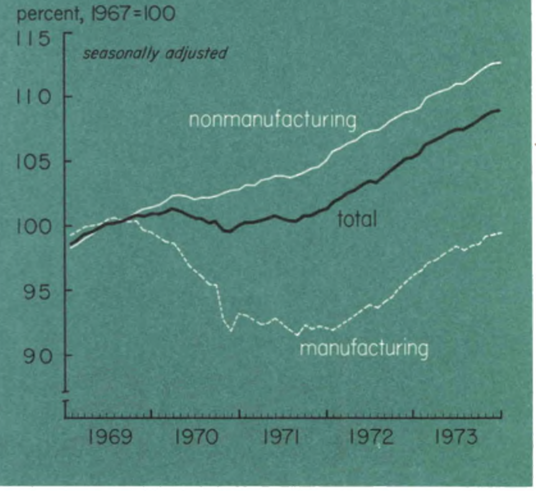
Early in 1973, there were reports of shortages and lengthening lead times for basic materials, components, and many finished products. The list grew larger as the year moved on until, by late summer, purchasing managers were saying "You name it—everything is short."

Fuel supplies were tight all year, but the problem was mitigated by slower growth in consumption associated with the mild winter of 1972-73 and by reductions in tourist travel during the summer. When the Arab oil embargo was announced in October, prospects for adequate oil supplies were already touch and go.

Most basic industries that had been plagued by excess capacity in the late 1960s and early 1970s operated at practical limits in 1973. Included were steel, nonferrous metals, coal, paper, petroleum refining, building materials, plastics, and various chemicals. Producers of equipment complained of shortages of components, especially castings, forgings, and bearings.

The shortages were only partly the result of the booming U. S. economy. Rates of inflation were even greater abroad, and this fact together with devaluation made many U. S. products (e.g., steel scrap and soybeans) attractive at prevailing prices. Moreover, during the long period of declining or very slowly growing activity in 1970 and 1971, many industries scaled down plans to expand or modernize. Finally, various metal refineries, oil refineries, foundries, paper mills, coal mines, and power plants have been closed or have operated below capacity because of the high cost of meeting pollution or safety standards. Construction of some new facilities was delayed or cancelled because of "envi-

Payroll employment increased rapidly until December



ronmental considerations." Large expansion programs were underway in most of these industries at the end of 1973.

Large gains in income

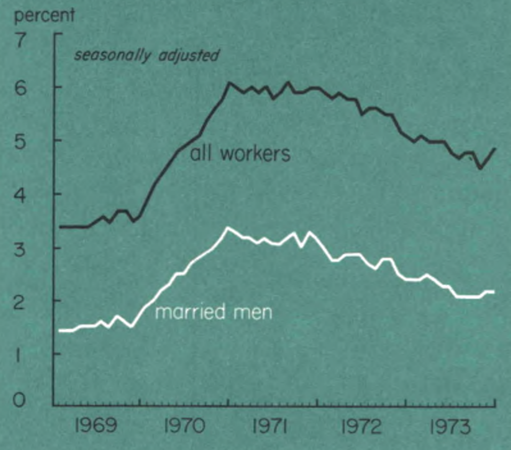
After-tax personal income was up almost 11 percent last year, compared with a rise of less than 7 percent in 1972. Subtracting the rise in consumer prices, "real" after-tax income was up 4.3 percent in 1973, compared with a 3.5 percent gain in 1972. Per capita after-tax income, adjusted for inflation, was up over 4 percent in 1973, not a record rise, but the largest since the mid-Sixties. As the year drew to a close, however, accelerated price inflation was eroding or reversing increases in buying power for many families. Pressures were growing for larger increases in annual worker compensation than the 7 percent rate of advance, including overtime and other bonuses, that held fairly steady from 1968 through 1973.

Consumers spent freely in 1973. Their buying power was supplemented with a 16 percent rise in consumer credit outstanding. Consumer outlays on all goods and services rose almost 11 percent, somewhat more than the increase in after-tax income. Spending on goods was up 12 percent while outlays on services, including rents, were up 9 percent. The rate of increase from a year earlier slowed late in the year, but almost entirely because of a drop in sales of full-sized automobiles. Sales of all nonautomotive stores were up 13 percent from a year earlier in December, while sales of auto dealers were down 12 percent.

Steady employment rise

Payroll employment rose steadily in 1973, continuing the pattern of 1972. In December, 76.7 million were employed at nonfarm jobs, 2.7 million, or 3.7 percent, more than a year earlier. A similar large rise had occurred in 1972, when the economy

Unemployment averaged lower, but decline ended in the fourth quarter



was recovering rapidly from the somewhat depressed conditions that followed the 1969-70 recession.

By far the most rapid increases in employment last year occurred in the durable goods manufacturing industries—including steel, autos, and machinery—which are especially important in the Midwest. But substantial gains in employment also were reported for all major categories except the federal government. Payroll employment rose slightly in December, despite reports of large layoffs in the airline and auto industries associated with the fuel crisis. Many of these workers were still on the job when the employment data were gathered in mid-month.

As employment increased in 1973, estimated unemployment, until late in the year, trended downward. The national unemployment rate averaged 4.9 percent, down from 5.6 percent in 1972 and 5.9 percent in 1971, but well above the 3.5 percent average estimated for 1969. For married men, the unemployment rate averaged 2.3 percent in 1973, compared to 1.5 percent in 1969. Despite these data, other evidence suggested that labor markets were just as tight in 1973 as in 1969. Quit rates in manufacturing were as high as in the earlier year, while layoff rates were lower. Many employers reported serious shortages of qualified workers, not only skilled workers, but also "warm bodies."

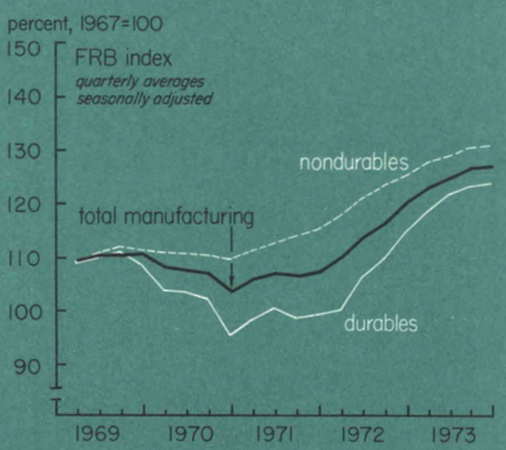
Pressures on the labor supply, and associated high turnover rates and absenteeism, were factors in slowing gains in productivity—increases in output per man-hour. Productivity for the nonfarm economy had increased about 4 percent in 1971 and 1972 after two years with little or no growth. Last year's rise was significantly less.

Durables lead manufacturing

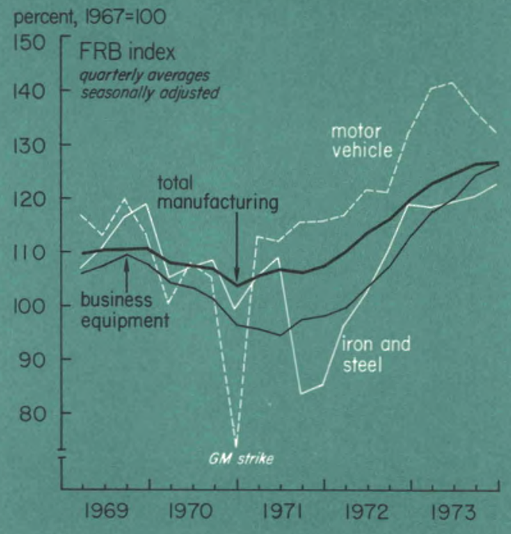
The 10 percent rise in the physical volume of manufacturing activity in 1973 followed an increase of over 8 percent in the previous year. These successive gains reflected a return to full capacity in most major industries. Manufacturing output had declined 5 percent in 1970, and had showed no year-to-year gain for 1971.

Manufacturing output in 1973 was 13 percent above the prerecession level of 1969. Despite this larger output, manufacturing employment averaged 2 percent less last year than in 1969. At 40.6 hours, the average workweek in manufacturing was about the same in both years. Clearly, the manufacturing industries have achieved remarkable increases in output per man-hour.

Output of manufactured goods rose rapidly for three quarters



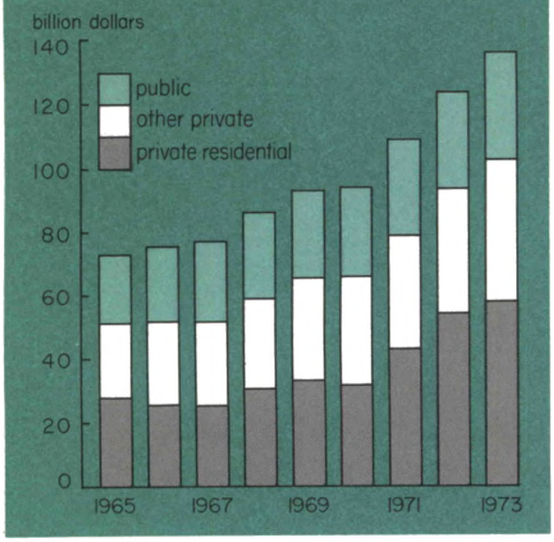
Passenger car output declined in the second half, but equipment and steel rose



Output of durable goods was up over 12 percent in 1973, while output of nondurables rose 6 percent. Compared with 1969, however, durables were up 11 percent while nondurables were up 17 percent. The durable goods industries with their more expensive, longer-lasting products always decline more than nondurables in recession periods and always rise faster when recovery is well underway.

Among the major industries concentrated in the Midwest, output of motor vehicles was up 12 percent in 1973 (in the industrial production index), steel was up 13 percent, and business equipment was up over 15 percent. All three were operating at record levels and at virtual capacity.

Construction outlays rose sharply in 1973, but mainly because of higher costs



Motor vehicles reach new highs

The U. S. auto industry produced almost 9.7 million cars and over 3.0 million trucks in 1973, both records by wide margins. Deliveries of passenger cars to U. S. customers totaled over 11.4 million last year, including almost 1.8 million imports from Western Europe and Japan. U. S. production about equaled sales of "domestic" cars, but inventories were substantially larger at year-end. Net imports of autos from the Canadian subsidiaries of U. S. auto companies totaled about 400,000 units.

Sales of both large and small autos exceeded production capacity through the first three quarters of 1973. After the introduction of new models, however, it became apparent that most full-sized cars were not selling well, in large part because of high consumption of gasoline caused by pollution control devices and other factors. Sales of full-sized cars weakened further as the year drew to a close. A sales decline already underway was greatly worsened by prospective shortages and high prices of gasoline. At year-end, auto manufacturers were straining every effort to increase output of compact and subcompact cars, demand for which continued very strong. The rise in sales of imports to a new record in 1973, in place of an expected decline, also reflected desires to conserve gasoline.

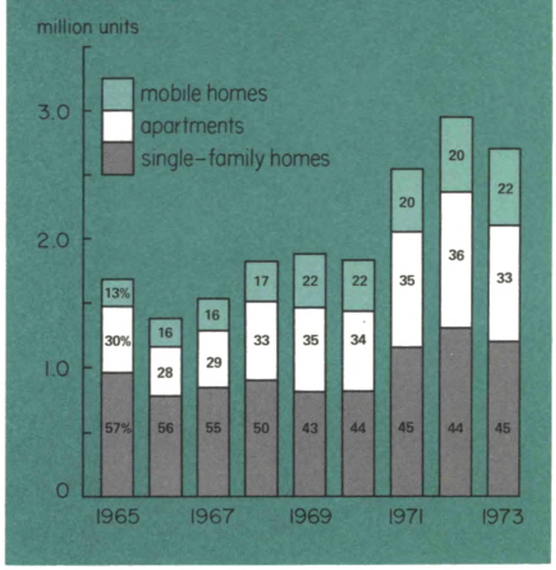
Unlike the case for autos, the truck boom continued in late 1973, especially for heavy-duty trucks. The 3 million trucks produced and sold in 1973 represented a rise of over 50 percent from the total produced and sold in the prosperous year 1969. Truck manufacturers expect to repeat their 1973 successes this year.

Housing lags total construction

Construction outlays totaled $136 billion last year, up 10 percent from 1972. Most of the rise reflected inflation because construction costs increased about 8 percent, even more than in 1972.

Housing starts declined sharply in the second half of 1973, after a strong showing

Housing starts declined in 1973 as mortgage funds tightened



in the first half, as mortgage funds tightened. For the year as a whole, starts totaled 2.05 million, down 14 percent from the 1972 record of 2.37 million, but about equal to 1971, the second highest year.

Despite the decline in starts, the dollar value of residential construction activity was about 8 percent larger in 1973, partly because of inflation and partly because of the fact that some houses started in 1972 were completed in 1973. A variety of problems, particularly shortages of cement, bricks, plywood, plumbing fixtures, and asphalt delayed many projects.

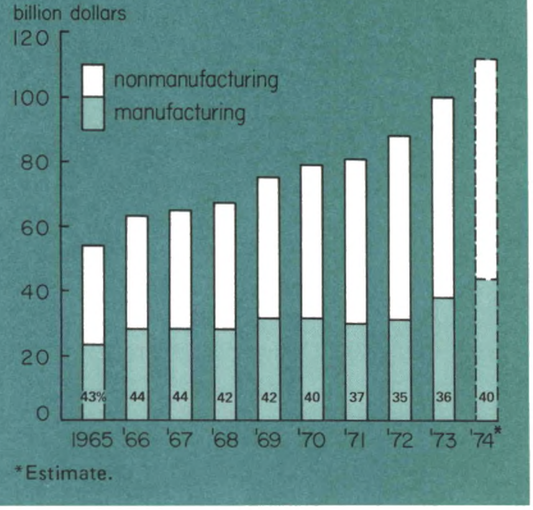
Public construction activity was about the same in 1973 as in 1972, after adjustment for higher costs. This was because of economy drives and because of reduced needs for public structures such as schools and hospitals.

Aside from the public and residential sectors, most types of construction spending rose substantially in 1973. The dollar value of manufacturing structures was up 28 percent, following three years of declining activity. Commercial and utility construction were both up 16 percent.

Permits for new housing and contract data compiled by F. W. Dodge indicate that the construction trends of 1973 will continue in 1974, at least in the early months of the year. In the first 11 months of 1973, contracts for manufacturing buildings were up 55 percent, commercial projects were up 19 percent, and there was a large backlog of work for public utilities and communications systems.

Prospects for strength in industrial, commercial, and utility construction in 1974 are supported by a recent government survey which indicates total plant and equipment spending by U. S. businesses will be up 12 percent in 1974, compared to 13 percent in 1973. Manufacturing outlays are expected to rise 17 percent, compared to 21 percent last year. The utilities are expected to increase capital spending by about 15 percent, compared to 12 percent last year.

Surge in plant and equipment outlays is expected to continue in 1974



As the year closed, the picture for residential construction continued to appear very dim. Savings inflows to thrift institutions, which provide the bulk of mortgage funds, improved in the fourth quarter, but lenders were reluctant to increase commitments for mortgage loans significantly. In addition, there were widespread complaints that prospective home buyers were "not looking," apparently waiting clarification of economic uncertainties.

Big rise for farm income

Farmers experienced their second straight year of unprecedented prosperity in 1973. Net income of farm operators reached $25 billion, up more than $5 billion from the record set the previous year, and up almost $10 billion from the average for the 1967-71 period.

Receipts from farm marketings increased 35 percent in 1973, almost entirely because of sharply higher prices. Physical supplies of major crops were larger than in 1972, but slaughter of cattle and hogs was smaller. Led by meat, retail food prices averaged 14 percent more than in 1972.

With a strong boost from greatly expanded exports—especially wheat, corn, and soybeans—prices of grains and livestock soared to record levels. The composite index of farm prices had averaged 126 (1967=100) in 1972, up 13 percent from 1971. The increase in 1972 had been concentrated in the second half. In early 1973, many analysts thought that increased supplies would slow, or even reverse, the rise in farm prices and help moderate general price inflation. Experience was quite different. The composite farm price index rose spectacularly last year. The index reached a peak of 207 in August—62 percent above the year-earlier level.

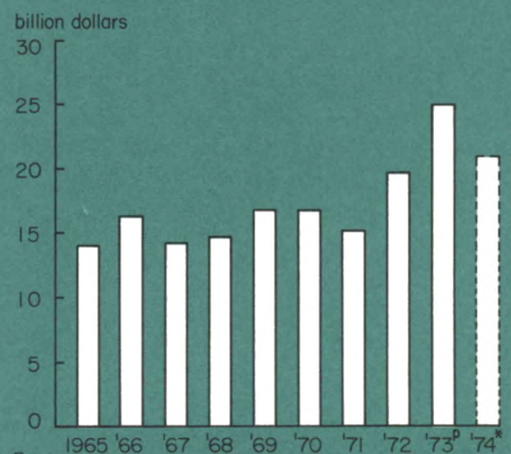
With reports of record harvests, farm prices declined sharply after August 1973. Nevertheless, for the year as a whole, prices averaged 36 percent above 1972, and 60 percent above the average for the period 1967-71.

Why prices surged

Farm price trends were spectacular in 1973, not only because of the strong overall rise, but also because of extremely wide fluctuations. Prices were influenced by changes in price control programs, changes in export restrictions, worldwide prosperity accompanied by rampant inflation, and shortfalls in world supplies of certain agricultural commodities.

Sharply rising livestock prices, which led farm price increases early in the year, were temporarily checked by the imposition of ceiling controls on wholesale and retail meat prices in late March, and by a widespread consumer meat boycott in the first week of April. However, strong upward pressures on livestock prices resumed by midyear when it became apparent that price controls (the Administration's general price freeze in mid-June included all food prices) were disrupting desired increases in production and altering normal marketing patterns. Shortly after the relaxation of controls on all food prices except beef, on July 19, public concern over meat short-

Net farm income soared last year, but moderate decline is seen for 1974



pPreliminary.

*U. S. Department of Agriculture estimate.

ages added fuel to upward price pressures. Many consumers were stocking their freezers. Livestock prices crested at 61 percent above the year-earlier level in August. Although fourth-quarter declines more than offset the summer surge, livestock and product prices remained about one-fourth above the year-earlier level at year-end.

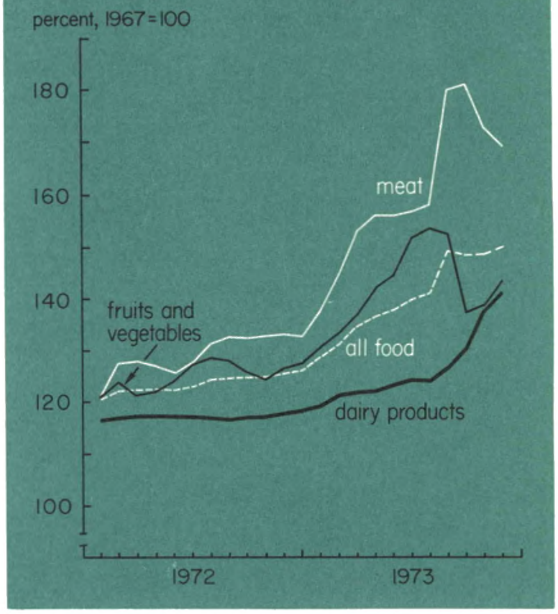
Crop prices also fluctuated widely during the year. Tight world supplies made domestic markets particularly sensitive to the vagaries of weather, export developments, and governmental policies. Crop prices were at exceptionally high levels as 1973 began, partly because of weather conditions that delayed 1972 harvests and partly because the record movement of agricultural exports was shifting into high gear.

The government released over 40 million acres from set-aside programs for planting in the early months of 1973, and farmers responded by increasing total planted acreage to the highest level since 1959. Nevertheless, crop prices rose almost continuously in the first half of the year. Cold and wet spring weather across the nation delayed planting of field crops, hampered vegetable harvests, and frosted budding fruit trees, thereby helping to boost prices. World shortages of fish meal gave further impetus to skyrocketing soybean prices. In June, the government temporarily restricted exports of oilseeds and high-protein feed concentrates. But this and other actions were only partially effective in restraining prices. The basic problem was that world demand for farm products was rising rapidly and supplies were tight.

Like meat prices, crop prices reached their peaks in August, and then declined as bumper field crops were harvested in the fall. Nevertheless, at year-end, the overall index of crop prices was 52 percent above the year-earlier level.

Rising farm-level prices were quickly translated into higher retail food prices, despite various control measures. Food prices rose sharply during the first three quarters, then stabilized in the fourth quarter. Food, which accounts for less than 20 percent of the budgets of most families, was responsible for about half of the rise in the overall consumer price index.

Meat paced the large increase in 1973 food prices



Rising consumer incomes enabled consumers to pay higher prices for food. But price boosts also reflected limited supplies. Dollar expenditures were up sharply in 1973, but, in physical terms, per capita food consumption was down 1.5 percent—the first decline since 1965. Meat consumption was down 6 percent and accounted for most of the shortfall. But consumption of poultry, eggs, and vegetables also was somewhat lower.

The export boom

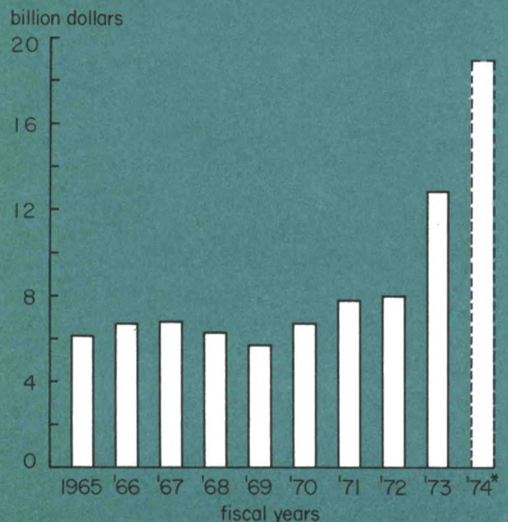
U. S. exports of agricultural commodities totaled about $17 billion in 1973, 85 percent over the previous record in 1972! While a large part of the increase reflected higher prices, shipments of wheat were up

75 percent, while corn was up 48 percent. Despite export controls that sharply curbed third-quarter exports of oilseed products, shipments of soybeans rose 9 percent for the year.

Increased exports reflected strong economic growth in almost all industrial countries. The position of the United States as the major holder of world supplies was strengthened by poor 1972 harvests in many other nations. Exports also were strongly stimulated by the dollar devaluation early in the year.

The negotiated sale of agricultural commodities to the Soviet Union was an important factor in higher foreign demand, but agricultural exports were larger to all major foreign markets. Exports to Japan were nearly double the year-earlier level in fiscal 1973, while those to the European Economic Community (EC) were up by one-half. Combined, the increase in exports to Japan and the EC accounted for almost one-half of the total increase in agricultural exports in fiscal 1973. Well-publicized U. S. agricultural exports to Russia, up sevenfold in fiscal 1973, accounted for only 16 percent of the total increase in U. S. exports.

Agricultural exports surged with strong world demand



*U. S. Department of Agriculture estimate.

District farmers share gains

Farmers in Seventh District states account for more than one-fifth of total U. S. receipts from farm marketings. The rise in their total receipts somewhat exceeded the 35 percent gain for the nation. Receipts from crops in this region were up 65 percent, while receipts from livestock were up 27 percent.

Cattle production was fairly profitable in the first half of 1973. However, in the latter part of the year, many producers suffered losses because of lower prices and higher production costs and feeding was curbed. Production was down 5 percent for the year as a whole. Prices of choice steers rose steadily in the first half and then jumped to a record $56 per hundred pounds in August. As beef supplies improved, this price dropped to $40 late in the year. For 1973 as a whole, prices averaged 27 percent higher than in 1972.

Profits for some cattle producers were reduced because of higher prices paid for feed and feeder stock. Moreover, feeding efficiency was lowered in 1973 by a ban on certain feed additives, the poor quality of the 1972 corn crop, and by the substitution of corn for high-priced, protein-rich feed supplements.

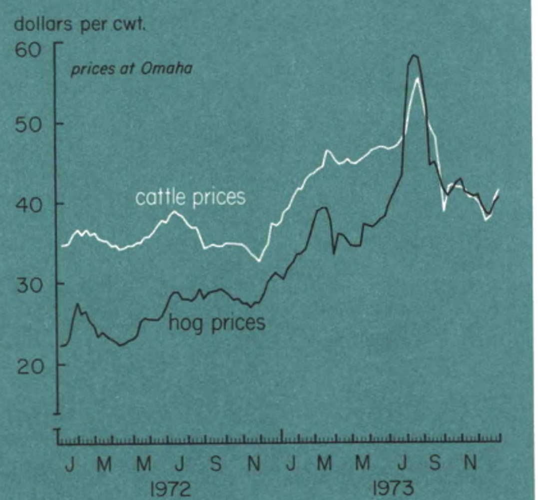
Hog production was much more profitable last year. Because of a 7 percent decline in hog marketings, reduced beef supplies, and strong consumer demand, hog prices averaged 54 percent above year-earlier levels during 1973. Prices rose very rapidly in the first quarter and again in the summer. Hog prices reached a record $59 per hundred pounds in mid-August. As supplies picked up seasonally in September, hog prices fell sharply and stabilized at around $42 per hundredweight through the fourth quarter.

Dairy farmers' operating margins were very tight in 1973 until late in the year. Milk prices averaged 16 percent above 1972 levels, but feed prices rose even more. As a result, the milk/feed price ratio—pounds of concentrate ration equal in value to one pound of milk—fell to the lowest level since 1965.

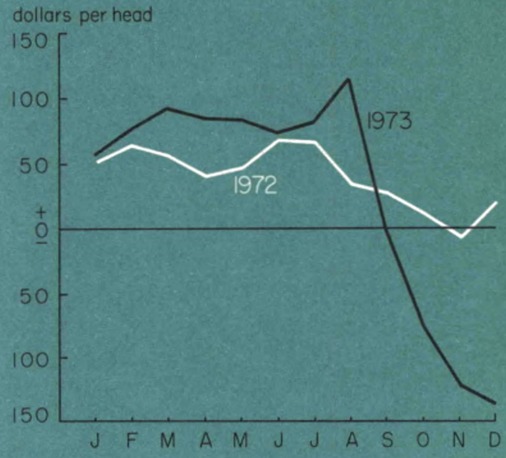
High prices curtailed the feeding of high-protein concentrates which led to a slight reduction in milk output per cow—the first decline in nearly 30 years. Also, there was a slight acceleration in the downtrend in cow numbers. These factors combined caused a 3 percent reduction in milk production in 1973. With consumer demand strong, stocks of a number of dairy products fell to low levels. Several proclamations during the year temporarily relaxed import quotas for nonfat dry milk, cheese, and butter.

Corn and soybean farmers generally benefited the most from last year's agricultural boom. Despite larger supplies of both crops, prices were well above year-earlier levels throughout the year. Booming export demand coupled with accelerated rates of domestic utilization carried corn prices at Chicago to a peak of nearly $3 per bushel in August—more than double the year-earlier level. Subsequent price declines, reflecting improved worldwide production prospects, caused corn prices to fall back. The upward surge in soybean prices was checked at a high of $12 per bushel near midyear. By harvesttime, soybean prices had retreated to less than $6 per bushel, compared to $3.50 a year earlier.

Cattle and hog prices held well above year-earlier levels, but . . .



. . . profit margins on fed cattle plunged after August



SOURCE: Iowa State University.

Financial picture brighter

Farmers benefited in 1973 both from sharp gains in net farm income and from one of the largest increases in land values ever recorded. According to the U. S. Department of Agriculture, farmland values in November were up more than 20 percent from year-earlier levels. The rise in land values was particularly large in Iowa.

The improved financial position of farmers, along with strategies for minimizing income tax liabilities, stimulated heavy capital spending in 1973. During the first three quarters, investment in new equipment was up 24 percent from the previous year. Unit sales of farm tractors, rose 25 percent, and even more would have been sold but for capacity limitations of manufacturers.

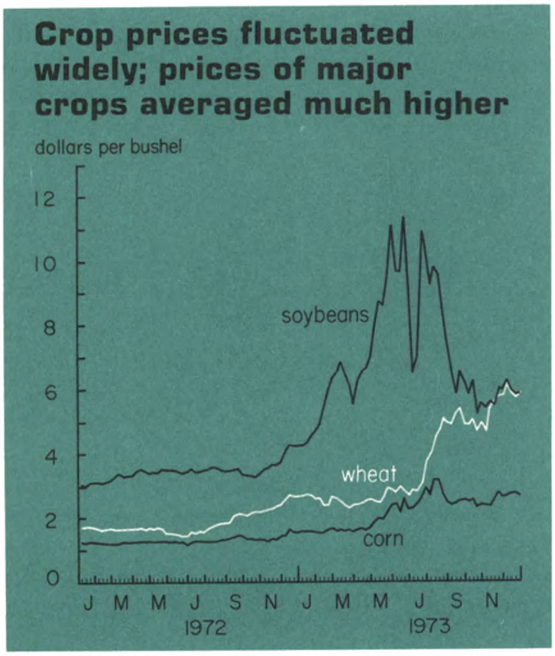
While increasing their assets, farmers also increased their debts. At year-end, farm debt exceeded $80 billion, up almost 9 percent during the year.

The agricultural outlook

The farm sector appears poised for another prosperous year, but not so favorable as in 1973. For the first time in 40 years, farmers will be almost completely free of controls over prices and production.

In 1974, farm prices are expected to rise in the first half and decline in the second half. For the year as a whole, prices are expected to average about the same as in 1973.

Production expenses are expected to rise on a broad front, with especially large increases for fuel, fertilizer, and chemicals. Government payments will be virtually eliminated in 1974 due to new procedures



established by the Agriculture and Consumer Protection Act of 1973. If expectations on receipts and expenses are realized, net farm income will be down $3 to $5 billion from the high level of 1973.

Crop plantings in 1974 will be encouraged by high prices, elimination of all set-aside requirements in the various farm programs, and the unusually large amount of field preparations accomplished this past fall. Analysts expect plantings to rise by around 12 million acres, provided weather conditions are favorable and fuel and fertilizer supplies are adequate. This would represent a 4 percent increase from 1973 and a 12 percent increase from the 1968-72 average.

Available supplies of soybeans are well above last year, while supplies of corn are lower. Consequently, prospective price relationships between corn and soybeans are likely to encourage a shift in acreage from soybeans to corn.

Livestock prices are expected to rise in the first half of 1974 because of reduced supplies. Placements of cattle in feedlots were sharply below year-earlier levels during the latter part of 1973, reflecting poor profit margins. Feedlot placements are expected to rise in early 1974, but significant year-to-year increases in beef slaughter are not anticipated until the second half.

Pork supplies also probably will be below year-earlier levels through most of the first half of 1974. Farrowings may increase if feeding margins remain favorable. As in the case of beef, however, sizable increases in hog slaughter supplies are not likely until after midyear.

Food prices are expected to rise on a broad front in the early part of 1974. Prices of meat, dairy products, and processed fruits and vegetables all appear headed upward because of short supplies. Price increases probably will be small compared to 1973, however, and there is reason to hope that a period of relative stability will begin before midyear.

Economic events in 1973—a chronology

January 1 European Economic Community is expanded to include Britain, Denmark, and Ireland.

January 5 Freeze on new commitments for subsidized housing.

January 11 The Dow industrial index closed at a record 1052.

January 12 Phase III liberalizes wage and price controls.

January 12 Acreage set-aside requirements ended for wheat.

January 18 Major oil companies place customers on allocation.

January 29 Peace in Vietnam announced.

January 29 Officials see prospects for reduced inflation as "exceedingly favorable."

February 2 Acreage set-aside requirements reduced for feed grain program.

February 5 Purchasing Managers Association reports shortages of many materials and components.

February 12 The dollar is devalued by 10 percent relative to other major currencies.

March 2 Foreign exchange markets closed because of massive sales of dollars.

March 15 Sales ordered from strategic materials stockpiles.

March 19 European exchange markets reopen with EC currencies in "joint float."

March 19 Atomic Energy Commission says nuclear power is needed to avoid dependence on Middle East oil.

March 26 The Joint Economic Committee recommends return to stricter wage/price controls.

March 29 Ceilings established on prices of beef, pork, and lamb.

April 5 Mississippi floods worst in 30 years.

April 19 Federal Reserve grants seasonal borrowing privileges to member banks.

April 26 CID issues guidelines for two-tier prime rate.

May 1 Treasury revises prospective deficit downward because of higher receipts.

May 1 U. S. oil import quotas ended.

May 16 Fed's Regulation Q ceilings suspended for all large CDs.

May 16 Three percent marginal reserve requirement announced for large CDs over specified base amount.

May 17 "Watergate Committee" begins hearings.

June 4 July soybean futures hit $12 per bushel, up from $3.50 a year earlier.

June 13 Sixty-day price freeze announced, called "Phase 3½."

June 28 Export restrictions placed on soybeans, oilseeds.

June 29 German mark is revalued by 5.5 percent.

June 29 Increase of .5 percentage point announced for reserve requirements on member bank demand deposits over $2 million.

July 1 Export controls placed on steel scrap.

July 5 Interest rate ceilings raised for savings and small-denomination time deposits, and suspended for four-year, $1,000 minimum accounts.

July 5 Export controls extended to 41 farm commodities.

July 13 Federal Reserve "swap lines" with foreign central banks reactivated and expanded.

July 18 Price freeze ends for health care and all foods except beef.

July 19 All acreage set-aside requirements eliminated for 1974.

August 12 General price freeze ends and Phase IV begins.

August 17 Chicago branches of foreign banks authorized by the Illinois Foreign Banking Office Act (effective October 1).

September 7 Marginal reserve requirements on CDs raised an additional 3 percentage points.

September 9 Soybean, cottonseed export controls relaxed.

September 10 Thirteen-week Treasury bills sold at 9.02 percent, for an investment yield of 9.35 percent.

October 1 Remaining agricultural export controls removed.

October 2 Mandatory allocations ordered on oil products.

October 6 Egypt and Syria attack Israel.

October 15 New law requires interest ceilings on time deposits of less than $100,000.

October 16 Posted price of Arab crude oil raised 70 percent.

October 17 Arab nations announce reductions in oil shipments.

October 22 Cease fire arranged in Arab-Israeli war.

October 25 Fertilizer industry exempted from price controls.

October 26 International trade surplus for the third quarter was the largest since 1965.

November 1 Airlines reduce scheduled flights.

November 7 President outlines steps for fuel conservation.

November 16 Alaskan pipeline bill signed.

December 5 The Dow industrials closed at 788, low for the year. (See January 11.)

December 6 Price controls end for 40 nonferrous metals.

December 7 Marginal reserve requirements on CDs reduced by 3 percentage points.

December 10 Rates on U. S. savings bonds raised from 5.5 to 6.0 percent.

December 12 Federal Energy Office announces regulations for oil usage.

December 17 Daylight Saving Time enacted (effective 1-6-74).

December 24 Arab nations announce an additional 100 percent increase in posted prices for crude oil.

December 29 Large layoffs planned by auto firms, airlines.

International scene in flux

International developments last year, as in 1972, were dominated by adjustments to correct imbalances in the international accounts of major trading nations. Prolonged surpluses for some nations and chronic deficits for others had forced the abandonment of fixed exchange rates in August 1971. The industrialized nations then began a cooperative effort to formulate a new and more effective system. These efforts continued through 1973.

Market forces associated with imbalances in international accounts, rather than a preconceived plan, determined the nature and sequence of adjustments in 1973. Accelerated price inflation on a worldwide scale worked to keep foreign exchange markets in turmoil. At various times, speculative activities exerted a powerful influence. In October, the shock of the Arab oil embargo, which suddenly intensified the world energy crisis, altered the existing structure of international trade and finance to a marked degree.

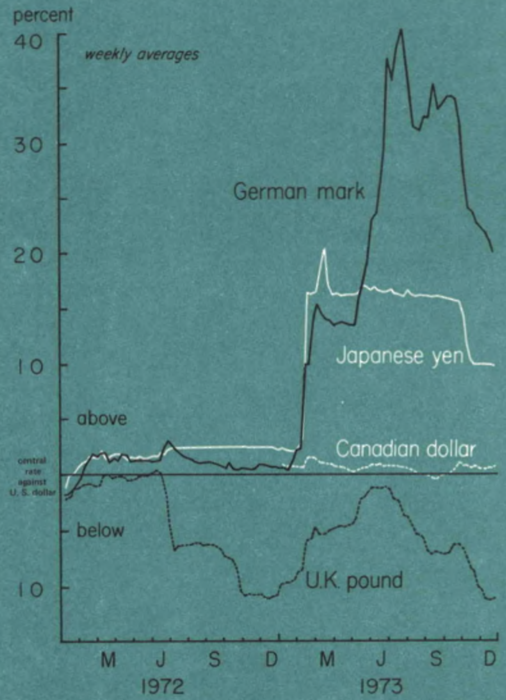
Foreign exchange markets

It was apparent early in 1973 that the realignments of international currencies agreed to at the Smithsonian Institution in December 1971, and implemented in 1972, had failed to accomplish their purpose. Despite devaluation of the dollar, the U. S. foreign trade deficit in 1972 was over $6 billion, more than three times the trade deficit for 1971, which had been the first such deficit of the century. Moreover, some foreign countries that had revalued their currencies relative to the dollar because of chronic surpluses, continued to run large surpluses in early 1973. These developments caused foreign exchange market participants to anticipate additional currency realignments.

Large sums were transferred from currencies considered to be candidates for devaluation to currencies that were deemed likely to appreciate. These pressures first converged on the weak Italian lira and the strong Swiss franc.

Confronted with a large outflow in late January, the Italian authorities terminated their commitment to maintain a relatively fixed exchange rate for the lira. Italy

Dollar values of foreign currencies jumped, but declined near year-end



Note: Data are weekly averages of daily offered rates in the U. S. market as a percent above or below central rates as established by the December 1971 Smithsonian agreement. The Canadian dollar is the percent above average market rate in January 1972.

adopted a "two-tier" exchange rate system of the type maintained by France and Belgium since 1972. On one tier, funds obtained from current transactions could be converted at a rate that was officially maintained at a relatively fixed rate relative to other currencies. On the other tier, payments on capital transactions were converted at a rate that "floated" in response to supply and demand.

Contrary to Italian experience, the Swiss were confronted with massive inflows of speculative funds in anticipation of an upward revaluation. Abandoning efforts to maintain fixed exchange rates, the Swiss decided to allow their currency to float.

After the floating of the Italian and Swiss currencies, speculative funds flowed to Germany and Japan. These transfers became so heavy that on February 9 foreign exchange markets throughout the world were closed. After intensive negotiations, international monetary authorities announced, on February 12, that the U. S. dollar would be devalued by 10 percent against major European currencies and the Japanese yen would be set afloat. When exchange markets reopened, the yen rose 16 percent above its previous dollar parity.

Despite the drastic actions, speculative activities soon resumed. In early March, the exchange markets were closed again, and were not reopened until mid-March after some new steps had been agreed to. The mark was revalued by 3 percent, and members of the European Economic Community (EC) adopted a "joint float." Under this arrangement, the currencies of Belgium, Denmark, France, Germany, and the Netherlands of the EC—plus nonmembers Norway and Sweden—were maintained by their authorities within plus or minus 2.25 percent margins relative to each other, but were allowed to float relative to all other currencies. By the end of March, therefore, efforts to maintain fixed exchange rates for major currencies by official intervention had been abandoned for the time being.

In April and early May, the weighted average price of major currencies in terms of dollars had tended to stabilize at a level 10 percent above the Smithsonian parities. Later in May, however, major currencies again began to rise relative to the dollar. By midyear, the average dollar price of these currencies had increased an additional 10 percent. The uptrend in these exchange rates was marked by very sharp day-to-day fluctuations. The joint float became increasingly difficult to maintain, partly because of growing differences in internal economic conditions among EC countries. Germany, with a vigorous economy, a large and growing trade surplus, and the strongest EC currency, revalued again by 5 percent in late June.

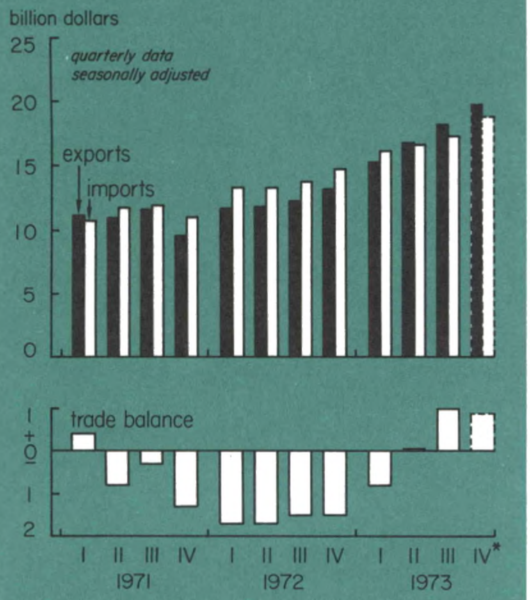
In July, the Federal Reserve System joined central banks of other major nations in periodic interventions in foreign exchange markets. The Federal Reserve negotiated with 14 major central banks and the Bank for International Settlements to increase reciprocal lines of credit ("swap lines") from \$6 billion to almost \$18 billion. Under these arrangements, the Federal Reserve borrowed foreign currencies needed for intervention.

Minor speculative flurries occurred during the remainder of the year. But concerted efforts of central banks in dealing with abrupt fluctuations in the foreign exchange markets provided an environment in which a system of more flexible exchange rates could operate despite differing economic conditions in individual countries. Starting in November, the dollar appreciated rapidly relative to other major currencies, largely because sharply higher oil prices and uncertain supplies were expected to have a smaller impact in the United States than in other industrialized countries.

The U. S. balance of payments

Two devaluations followed by further depreciation of the dollar through the

U.S. trade surpluses in 1973 were the first since early 1971



*Based on October-November figures.

workings of the floating exchange rate system sharply reduced the foreign currency cost of U. S. goods in world markets last year. These reduced foreign currency prices coupled with worldwide prosperity produced a rapid improvement in the U. S. trade account in 1973, especially after the first quarter.

In 1973, the United States had a small merchandise trade surplus, compared to a record $6 billion deficit in 1972 (census basis). The value of U. S. exports was up more than 40 percent last year. Agricultural exports paced the rise, but exports of industrial raw materials, consumer goods, and capital equipment also showed large gains.

U. S. imports were up about 25 percent in 1973. Very substantial gains were reported for industrial materials, capital goods, agricultural products, automotive products, and consumer goods.

Almost 25 percent of the total increase in imports consisted of crude oil and refined oil products. The value of petroleum imports was up about 70 percent from 1972, partly because of higher prices, but also because of an increased volume facilitated by a gradual relaxation of oil import quotas in the first half of 1973. Arab restrictions on oil exports reduced U. S. imports of Middle East oil late in the year.

A large part of the rise in U. S. exports in 1973 reflected higher prices. Measured by the Department of Commerce's unit value index, prices of U. S. exports, led by agricultural products, averaged 13 percent higher than in 1972. But the rise in physical volume was more than 25 percent, and for nonagricultural commodities the larger volume accounted for over two-thirds of the value increase. In contrast to exports, the increase in the value of imports in 1973 was due largely to higher prices. Except for fuel, which increased in volume throughout most of the year, the volume of imports was only slightly higher in 1973 than in 1972.

The improvement in the U. S. trade account in 1973 was reflected in other

After years in deficit, the U.S. balance of payments improved markedly in 1973

measures of the nation's international economic performance. The "basic balance," which includes long-term capital flows as well as goods and services (but excludes volatile short-term movements of capital), showed a $1 billion surplus for the first nine months of 1973, compared to an $8 billion deficit for the same period a year earlier. A large inflow of funds for direct investment in the United States, and for purchases of U. S. securities, contributed to the swing. Apparently, the basic balance continued in surplus in the fourth quarter. Hopes had been high that a trade surplus and a payments surplus could be achieved again in 1974, but sharply higher prices for imported oil and prospects for slower economic growth in Europe and Japan cast a shadow on optimistic projections.

Foreign banks in Chicago

The Illinois Foreign Banking Office Act, approved in August 1973 and effective October 1, permits foreign banks to establish state-licensed branches in Chicago's "Loop." By year-end, seven large foreign banks had filed applications for Chicago branches with the Illinois Commissioner of Banks and Trust Companies, four licenses had been issued, and one branch had opened for business.

Licensees and applicants for branches include some of the largest and best-known foreign banks. Already licensed are the National Westminster Bank and Barclays of the United Kingdom (the latter's office opened on La Salle Street in November); the Banco Commerciale Italiana; and the Swiss Bank Corporation. Applications were pending at year-end for the Banque Nationale de Paris, the Banque de l'Indochine (France), and the National Bank of Greece. In addition, several Japanese banks have expressed interest in Chicago branches.

Branches of foreign banks in Chicago had been preceded in recent years by state-chartered affiliates. Such banks had been established by the Dai-Ichi Kangyo Bank and the Bank of Tokyo (both Japanese) and the Banco di Roma.

Also reflecting the cosmopolitan development of the banking industry in Chicago are the Edge Act subsidiaries established, or in the process of organization, by U. S. banks headquartered elsewhere. The Edge Act of 1919 authorizes the Federal Reserve Board to charter and regulate corporations to engage in an international banking business. These corporations may trade in foreign exchange, finance international trade, and make foreign loans. They may hold time and demand deposits of foreign residents and of U. S. residents when these deposits are directly related to international transactions. Unlike banks, they may acquire equity investments in foreign corporations. Five Edge Act corporations have been approved for Chicago. Three in operation include subsidiaries of the Bank of America and the Crocker National (both of California) and the First National City Bank of New York. Subsidiaries of the Chase Manhattan and the Bankers Trust (both of New York) also have been approved.

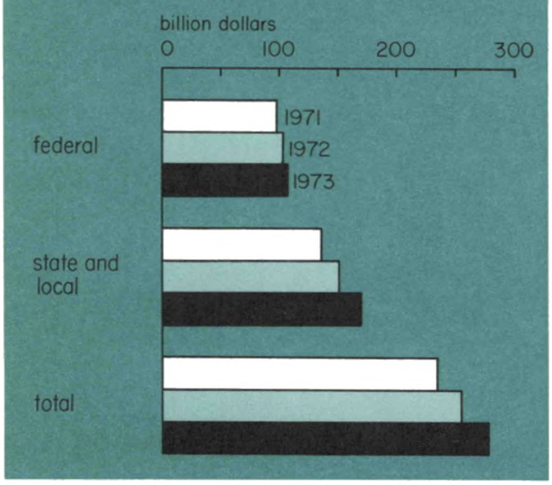
Banks headquartered in the Midwest have steadily broadened and deepened their facilities and capabilities to engage in international activities. Such services provided by local banks are now complemented increasingly by Chicago offices of foreign banks and of domestic banks headquartered in financial centers of the East and West Coasts. These developments reflect the expanding involvement of the Midwest in international trade and finance.

Government budgets near balance

Purchases of goods and services by federal, state, and local governments totaled almost $280 billion in 1973, up 9 percent from 1972. The gross national product (GNP), which includes all spending on goods and services, increased more than 11 percent in 1973. For the fifth straight year, total government purchases increased less than GNP. Government purchases accounted for 21 percent of GNP last year, down from 23 percent in 1968, but about equal to the proportions recorded in the years 1961-66.

Federal government purchases increased only 3 percent in 1973 to $107 billion, with most of the rise in nondefense spending. Defense spending was about $75 billion, almost exactly the same as in 1972, and below the $78 billion reached in 1968 and 1969. The size of the armed forces was reduced slightly in 1973 and equipment purchases were lower, but rising costs, mainly reflecting pay increases and reenlistment bonuses, offset these factors.

The 1973 increase in federal purchases lagged the increase for state and local units



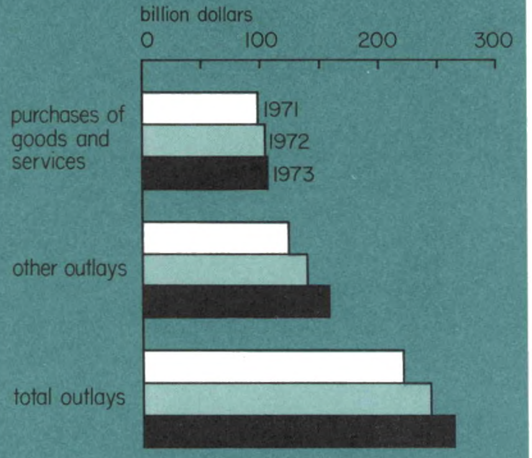
Aside from defense, federal purchases of goods and services largely consist of wages and salaries and civilian construction. Federal civilian employment, which averaged 2.62 million in 1973, was almost exactly the same as in 1972. Mainly because of higher salaries, federal purchases of goods and services for nondefense purposes reached $33 billion last year, up about $2.5 billion.

Purchases by state and local governments, with a strong assist from federal grants-in-aid for various programs, increased 13 percent in 1973 to about $170 billion. In most years since World War II, federal purchases of goods and services exceeded combined purchases of states and municipalities. Starting in 1968, however, state and local purchases have exceeded federal purchases every year, and by a widening margin. In 1973, federal expenditures were only 8 percent higher than in 1968, while state and local expenditures were up almost 70 percent. State and local employment has continued to increase year-by-year and in 1973 it averaged 11 million, almost 400,000 more than in 1972. While federal civilian employment averaged 4 percent less in 1973 than in 1968, state and local employment averaged 21 percent higher.

Federal outlays and receipts

Total federal outlays include large amounts that are not counted as purchases of goods and services. On the national income accounts basis, total federal outlays were about $265 billion last year, up 8 percent from 1972. (The national income account concept of federal outlays and receipts differs somewhat from the more commonly cited "unified budget.") Non-

Total federal outlays again increased much faster than purchases



purchase outlays are dominated by transfer payments (including social security and unemployment compensation), which rose 15 percent in 1973 to about $95 billion. This large rise mainly reflected the 20 percent boost in social security payments, effective in October 1972. Next most important are grants-in-aid to state and local governments, which rose 9 percent to $41 billion, and interest, which rose over 17 percent to about $16 billion.

Total federal revenues about matched outlays in 1973, following large deficits in each of the three previous years. The approximate balance of outlays and receipts reflected larger-than-anticipated increases in personal and corporate income taxes, especially the latter.

Over $22 billion was paid in refunds on personal income taxes in 1973, mainly in the spring. This figure was about $7 billion more than normal because of changes in the withholding schedule that became effective in January 1972. Apparently, individual taxpayers still have not reduced their withholding deduction to compensate for this factor, and refunds probably will be even larger in 1974 than in 1973.

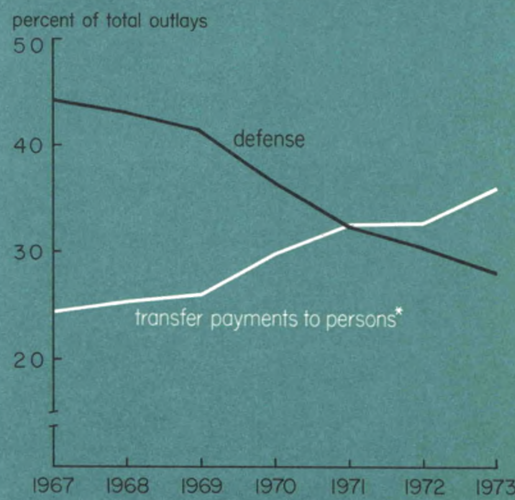
It had been hoped in mid-1973 that the approximate balance of federal outlays and receipts in 1973 would be repeated in 1974, although, of course, at a higher level for both. Ramifications of the Arab-Israeli war and the associated energy crisis will raise expenditures from earlier estimates. Any worsening in the general economy will tend to reduce receipts.

Another development that will raise outlays in 1974 is the legislation enacted at year-end that will boost social security payments by 7 percent in April and by an additional 4 percent in July. To help pay for these increases, the wage base for social security taxes was raised from $10,800 to $13,200, effective in January 1974.

State and local governments

Total outlays by state and local governments approached $184 billion in 1973.

Federal transfer payments have exceeded defense outlays since 1971



*Federal government transfer payments to persons, which totaled about $93 billion in 1973, include social security and medicare payments, all federal retirement payments, railroad retirement benefits, veterans benefits, and several other small programs of payments to individuals.

Over 90 percent of this represented purchases of goods and services. Pay increases for employees account for a substantial portion of the rise in total state and local outlays. Other expenses also increased. Expenditures for school systems, the largest single element in state and local budgets, have increased at a slower pace in recent years reflecting smaller enrollments in the lower grades. But outlays on law enforcement, safety, and welfare have continued to rise rapidly.

Receipts of state and local governments totaled $195 billion in 1973. The net surplus (national income accounts basis) was almost $11 billion, somewhat less than in 1972. After setting aside pension reserves, land purchases, and other similar items (excluded from the national income accounts definition of expenditures) state and local governments had an operating surplus of about $2 billion in 1973. Many state and local governments reduced tax rates last year, in contrast to the steady increases in past years. Federal grants-in-aid provided state and local governments with about $41 billion, over 20 percent of their total revenues. About $6 billion of these grants were in the form of general revenue sharing.

State and local government finance may feel a double impact from the oil shortage during the coming year. Motor fuel taxes supply significant revenues, and these will be directly affected by reduced sales. Moreover, many local governments, particularly school districts, will have to pay sharply increased fuel bills.

Slowing of the growth of the overall economy may impose new strains on state and local finance in 1974 if outlays grow more rapidly than revenues. The overall surplus position is likely to decline in 1974, and operating budgets will probably show a deficit in the aggregate. The 1972-73 trend of using federal revenue-sharing funds to reduce state and local tax rates probably will not continue.

Slower growth in money and credit

Federal Reserve policy actions in 1973 were designed to slow the expansion of money and credit in order to moderate price inflation while permitting continued growth in real activity. Bank loans and investments, the money supply, and consumer-type time and savings deposits rose less rapidly than in 1972. With credit growth restricted and loan demand strong from most sectors, short-term interest rates rose to the highest levels in this century.

Funds raised in the money and capital markets by all borrowers—individuals, businesses, and governments—totaled about $175 billion in 1973. This was about 6 percent more than in 1972, and the smallest percentage increase since 1969, also a year of credit restraint. Expansion in commercial bank loans and investments accounted for an estimated 42 percent of total funds raised. This compares with 45 percent in 1972 and 19 percent in 1969. Savings and loan associations and other thrift institutions provided a smaller proportion of total funds in 1973, mainly because of the diversion of savings to higher-yielding money market instruments in the second half.

Business loans at banks rose by a record amount in 1973, but sales of corporate securities declined. Consumer credit also rose at a record pace last year, but residential mortgages outstanding increased relatively less than in 1972. Federal borrowings were reduced in 1973 because of the smaller budget deficit. State and local governments, on balance, had budget surpluses, although smaller than in 1972, but their net security issues were also smaller.

Record increase in bank loans

Bank credit grew very rapidly in the first half of 1973 but slowed markedly in the second half. For the year as a whole, loans and investments at all commercial banks including loans sold to affiliates rose by about $71 billion, or 13 percent, compared with the postwar record increase of 15 percent in 1972. Loans accounted for virtually all of the increase in loans and investments. Total loans rose at a 30 percent seasonally adjusted annual rate in the first quarter. The annual increase in loans was 18 percent—about the same as the very large increase in 1972. Bank portfolios of real estate and consumer loans, which had risen very sharply in 1972, continued to expand rapidly, although the pace declined in the final quarter.

Business loans dominated bank credit growth last year, rising 21 percent, compared with a rise of less than 12 percent in 1972. Demand for bank credit by commercial and industrial firms was unusually strong through mid-August. In part, this resulted from increased working capital needs associated with the business expansion. In addition, through most of the year, bank loans were a relatively cheap source of funds to large borrowers that normally cover a substantial portion of their short-term financing needs by selling commercial paper in the open market. Increases in bank lending rates were restrained by the guidelines set by the Committee on Interest and Dividends (CID), while open market rates were left free.

The effects of the abnormal rate structure were most pronounced early in the year. Business loans expanded at a seasonally adjusted annual rate of almost 40 percent in the first quarter. In that period, outstanding commercial paper declined by more than $3 billion, offsetting about one-third of the dollar rise in bank loans. Given the rate constraint, it was difficult for banks to control the volume of loan takedowns of commitments generated through the aggressive efforts of loan officers in the previous two years of slack loan demand.

In early April, the heads of the federal bank supervisory agencies sent letters to all large banks urging them to review their loan commitment policies and to maintain records by which the appropriateness of these commitments could be judged. This was the first of several efforts to persuade banks to restrain overall credit expansion while giving adequate attention to the needs of local customers, including smaller business firms.

Many banks, at the suggestion of the CID, adopted a "two-tier" prime rate. Under this arrangement, banks were able to adjust, at least partly, loan charges to large national borrowers to money market interest rates while holding down charges paid by smaller firms except as justified by increases in costs to the bank. The "big prime" posted by the major banks moved in 16 steps of a quarter point each from 6 percent at the start of the year to 10 percent by late September. Nevertheless, for most of the year, the prime rate was below related market-determined rates.

In the fourth quarter, the growth in business loans was little more than the expected seasonal trend. A major factor accounting for reduced demand for bank loans after September was the decline in commercial paper rates relative to bank lending rates. In addition to shifting back to the paper market for short-term funds, many large corporations increased their sales of securities in the last quarter. For the year, however, corporate offerings of long-term securities, including common stocks, were about one-fourth smaller than in 1972.

As usual in a period of monetary restraint, commercial bank holdings of U. S. Government securities declined in 1973. Many banks liquidated Governments to provide loanable funds, but the net reduction in total bank holdings of federal debt also reflected smaller Treasury cash borrowing. By contrast, bank portfolios of non-Treasury securities rose in 1973, although by less than in either of the two previous years. A relatively large portion of net acquisitions of these securities were obligations issued by federally-sponsored agencies. Offerings by these institutions were more than three times the 1972 total. Outstanding obligations of the Federal Home Loan Banks alone rose by more than $8 billion. Large security sales by these institutions helped finance advances to member savings and loan associations whose ability to meet heavy mortgage commitments was impaired by shifts of funds from deposit-type accounts to higher-yield market investments.

Sources of bank funds

Both demand deposits and personal savings-type deposits rose less rapidly in 1973 than in 1972. Nevertheless, these sources provided roughly $35 billion to commercial banks. In order to meet strong loan demand, the nation's major banks also bid aggressively for money market funds through sales of negotiable certificates of deposit (CDs). Outstanding negotiable CDs of $100,000 or more at the nation's major banks rose $23 billion in the first three quarters. Some of this was allowed to run off in the fall as loan growth slowed and the imposition of marginal reserve requirements increased the cost of funds from this source. Nevertheless, at year-end, CDs totaled $64 billion—an increase of almost $20 billion for the year and equal to more than one-fourth of the net increase in total bank credit. In 1969, CDs declined by $12 billion, or about 50 percent.

The banks' ability to expand deposits last year was maintained as a result of changes in the Federal Reserve's Regulation Q governing maximum interest rates payable on deposits. Ceilings on large-denomination CDs maturing in 90 days or more were suspended in mid-May. (Ceilings on shorter-maturity CDs had been suspended since mid-1970.) Ceilings on passbook savings and smaller time deposits were liberalized in early July. These amendments made it possible for banks to remain competitive with other types of investments for business and consumer deposits.

As market interest rates rose, the rates that had to be paid in order to sustain deposit growth, coupled with CID guidelines aimed at holding down bank lending charges, reduced bank profit margins. These developments induced more restrictive lending policies. Moreover, as the cost of funds in the money market soared above bond yields, the incentive to acquire securities was reduced. Both of these factors contributed to the slower growth of bank credit in the second half of the year.

Because banks continued to have access to money markets in 1973, they raised only about $3 billion net from "nondeposit" sources. These sources, including bank borrowings from foreign branches, and sales of loans either to their own holding companies or to other nonbank affiliates, were tapped extensively in 1969 when severe deposit outflows occurred.

An important source of funds for the major money market banks was the purchase of federal funds—overnight loans from other banks. For a group of about 50 large banks that report these transactions to the Federal Reserve, net daily purchases rose to almost $15 billion in mid-December, compared with about $10 billion in the peak week of 1972. Interbank lending does not add to the resources of the banking system as a whole, but it transfers funds from selling banks to buying banks. For individual banks, the choice between "buying deposits" and obtaining funds through other channels is largely determined by relative costs. These relative costs are affected by contract interest rates, reserve requirements, and other factors.

Rate ceilings and reserve requirements

Changes in Regulation Q made by the Federal Reserve Board in 1973 were accompanied by similar actions by the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board which, respectively, set ceilings on rates paid by insured nonmember banks and savings and loan associations (S&Ls). Adjustment of rate ceilings reduced, but did not entirely prevent, "disintermediation"—outflows of funds to market instruments. Before ceilings on large CDs with maturities of 90 days or more were suspended on May 16, related market rates had moved above the ceiling on these instruments, and only very short-maturity CDs (30 to 89 days), already free of ceilings, could be sold. This created problems for bank managements and placed heavy upward pressure on market interest rates in the under-90-day area.

In mid-June, the Federal Reserve Board, in an attempt to slow the expansion of bank credit, increased reserve requirements (under Regulation D) on large-denomination CDs and bank-related commercial paper from 5 to 8 percent on amounts in excess of a specified base. (Banks with less than $10 million in outstandings were exempt.) This increased the cost of these funds and tended to make credit more expensive. Large nonmember banks were urged to voluntarily increase their reserves by a like amount. An additional 3 percent marginal reserve on large CDs was imposed from early October until mid-December. On June 21, the 20 percent reserve requirement on Eurodollars above each bank's reserve-free base was reduced to 8 percent, but with a provision for the base to be phased out. Also in June, reserve requirements were applied to funds acquired through sales of "finance bills" (working capital or "ineligible" acceptances). These actions, overall, increased the cost of money market funds to banks, but also placed the various instruments on a more uniform footing. In July, reserve requirements on demand deposits over the first $2 million at each member bank were increased by one-half of 1 percent.

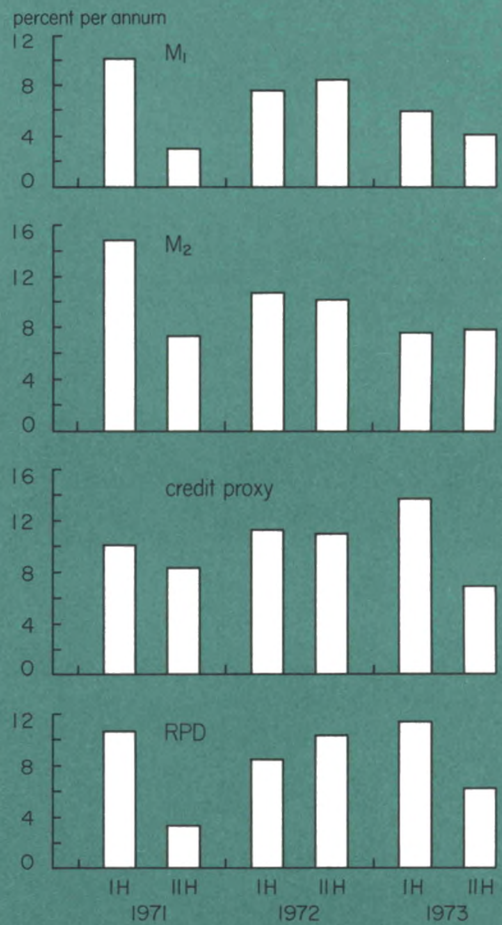
A new schedule of maximum rates payable on savings and time deposits other than large CDs was announced at the start of the third quarter. It permitted banks to increase rates paid on passbook savings and various maturity categories of time deposits up to four years by a range of .25 to .75 percent. Rate ceilings were removed entirely on deposits of at least $1,000 with maturity of four years or longer at both banks and thrift institutions (so-called "wild card" certificates). Higher rates offered on the ceiling-free deposits helped to stem the transfer of funds from banks into direct market investments. Most banks were soon paying 7 to 7½ percent on these instruments. To reduce competition, bank issues of ceiling-free deposits were limited to 5 percent of each bank's total time and savings deposits.

Higher rates notwithstanding, thrift institutions reported substantial net outflows in August and September, in large part reflecting shifts of personal funds into Treasury bills. Yields on new three-month bills were above 9 percent at their peak. In response to the unfavorable S&L experience and reduced availability of mortgages, Congress passed legislation requiring restoration of the ceilings on all consumer-type deposits. Effective November 1, ceilings on four-year, $1,000 minimum deposits were set at 7¼ percent for banks and 7½ percent for S&Ls. Limits on outstandings were removed. By this time, market rates had eased and deposit flows had improved. Thrift institutions reported net inflows of funds through year-end. Nevertheless, most savings institutions remained very cautious in making new commitments.

Monetary aggregates

Preliminary data show that demand deposits and currency held by the public (M_1) rose 5 percent from December 1972 to December 1973, compared with 8 percent in the previous year. The broader measure, M_2, which includes time deposits other than CDs in addition to demand deposits and currency, rose about 8 percent

Expansion of monetary aggregates was slower



Note: Changes based on seasonally adjusted daily average amounts in December and June. M_1= currency + demand deposits held by the public. M_2 = M_1 + time deposits other than CDs over $100,000. CP = member bank deposits + bank-related commercial paper + nondeposit sources. RPD = reserves available to support private nonbank deposits.

last year, also less than in 1972. The expansion in M_1 was concentrated in two periods—in the second quarter and again toward year-end.

The Federal Reserve System influences trends in monetary aggregates mainly through actions that affect the volume of reserves of member banks. As in 1972, the Federal Open Market Committee chose the growth rate in reserves available to support private deposits (RPDs) as its short-run guide. Changes in this measure were believed to be closely associated with changes in M_1 and M_2. RPDs rose about 9 percent in 1973, slightly less than in 1972. RPDs include reserves supporting large CDs as well as private demand and consumer-type time balances. Changes in the composition of deposits between time and demand, shifts between banks with different average percentage reserve requirements, and changes in the marginal requirements on CDs all tended to alter the relationship between RPDs and the monetary aggregates. Because of the heavy use of CDs to acquire loanable funds in 1973 and because of the imposition of the marginal reserve requirements on these liabilities, the growth pattern of RPDs resembled that for bank credit more than that for either M_1 or M_2.

Member bank borrowing

Advances to member banks by the Federal Reserve banks rose very rapidly in the early part of 1973 and remained at historically high levels through the rest of the year. Daily average borrowings reached a peak of over $2.5 billion in the last week of August, compared with a high of $1.7 billion in the 1969-70 period of monetary restraint. In the final quarter, outstanding borrowings ranged from $1.2 billion to $1.5 billion, still well above the levels prevailing in the two previous years.

A new factor affecting the volume of borrowing was an April amendment to Regulation A, implementing the "seasonal borrowing privilege." Qualifying banks (defined as banks subject to significant and persistent drains of funds resulting from recurring seasonal loan and demand patterns, and that do not have reliable access to national money markets) were given the privilege of borrowing from Federal Reserve banks in predetermined amounts for specified time periods. This arrangement was intended to help such banks better serve their communities. Nationwide, "seasonal borrowing" reached a peak of less than $200 million in August, declining to less than $50 million by year-end.

A major reason for heavy member bank borrowings was the fact that the cost of these funds was relatively low. Moreover, the amount of reserves made available through Federal Reserve open market operations was limited under the restrictive monetary policy. A series of increases brought the discount rate to an all-time high of 7½ percent on August 14, up from 4½ percent in early January. Nevertheless, the discount rate was more than 2 percentage points below the federal funds rate during most of the year. Because use of the discount window over a prolonged period of time is deemed inappropriate, however, banks were kept under pressure to repay their indebtedness. This encouraged the adoption of restrictive loan policies that helped to slow credit expansion.

Interest rates

Demand for short-term funds was so strong in 1973 that interest rates rose to unprecedented levels. At its late-summer peak, the three-month Treasury bill rate was above 9 percent, more than double the level of a year earlier. Major banks were paying almost 11 percent on federal funds and short-term CDs, and were charging their prime customers 10 percent on short-term business loans. In late September, bill yields and commercial paper rates dropped sharply, apparently because of expectational factors. These expectations were not validated by other developments, however, and short-term rates rose again. Although the August peaks were not regained in most areas, various factors caused fluctuations in short-term rates through the balance of the year. These included liquidation of U. S. debt by foreign central banks whose trade positions had deteriorated, interruption of Treasury financing caused by the delay in raising the federal debt ceiling, and widespread uncertainties related to the energy shortage. At year-end, most money market rates, although 1 to 2 percentage points below their 1973 peaks, were near the highs of 1969.

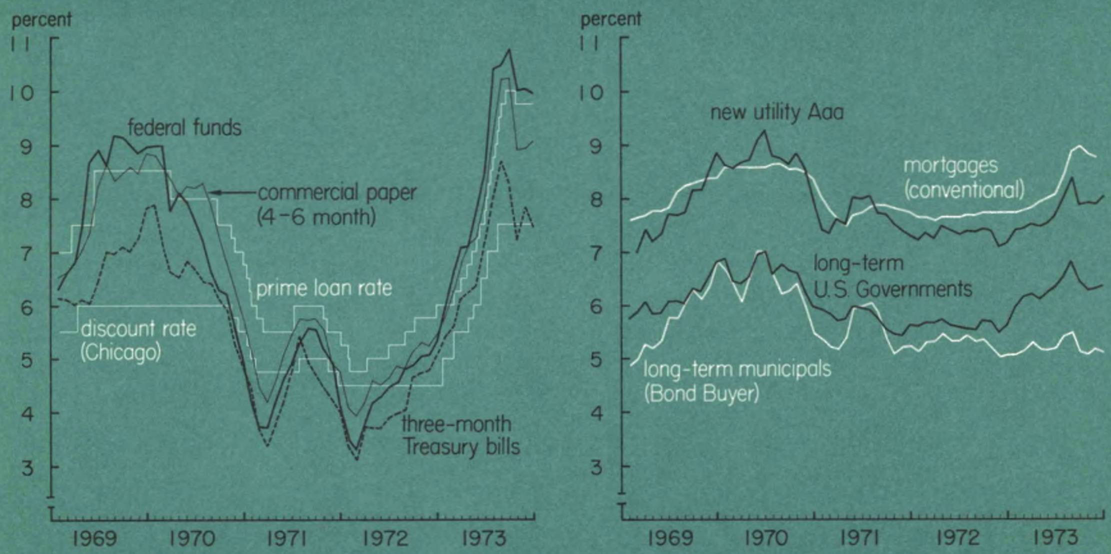
Movements in long-term rates were much less spectacular than movements in short-term rates in 1973. New issues of high-grade corporate bonds were yielding about 7 percent in late 1972. These rates moved up to about 8 percent in the summer and remained near that level to year-end. Even higher levels had been reached in late 1969. Rates on tax-exempt municipals were relatively stable throughout the year, somewhat above the 5 percent level. Rates on long-term Treasuries averaged about 60 basis points higher in 1973 than in 1972.

Home mortgage rates moved up gradually in the first half of 1973 and then increased sharply in the summer as the supply of mortgage funds was curtailed. Effective rates on new mortgages reached 9 to 9.5 percent in states without usury ceilings. In addition, downpayments were raised and credit standards were tightened. Where effective usury ceilings existed, as in Illinois, availability of mortgage funds was reduced further.

District banking

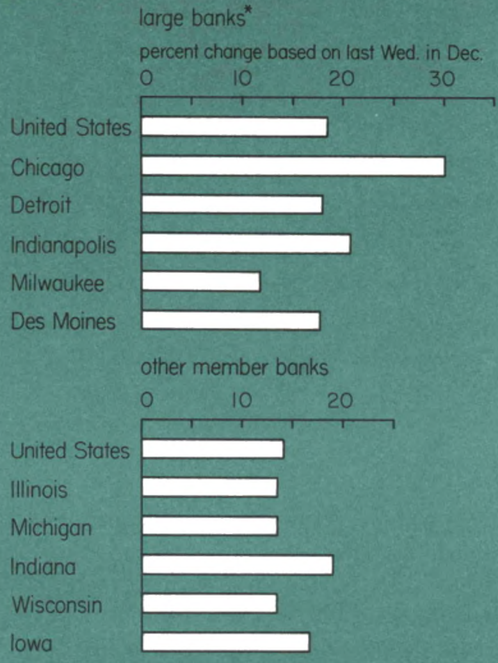
Credit growth at banks in the Seventh Federal Reserve District outpaced the rapid expansion of bank credit nationally. Deposit growth, however, was close to the national trend. As a result, district banks re-

Short-term interest rates set records, but most long-term rates remained below their 1969 highs



Note: Market rates are monthly averages of daily figures.

Loan expansion was strong throughout the district



*Data for the largest banks in major cities include loans sold to affiliates but exclude sales of federal funds to and loans to other commercial banks.

lied more heavily on nondeposit sources of funds than banks elsewhere.

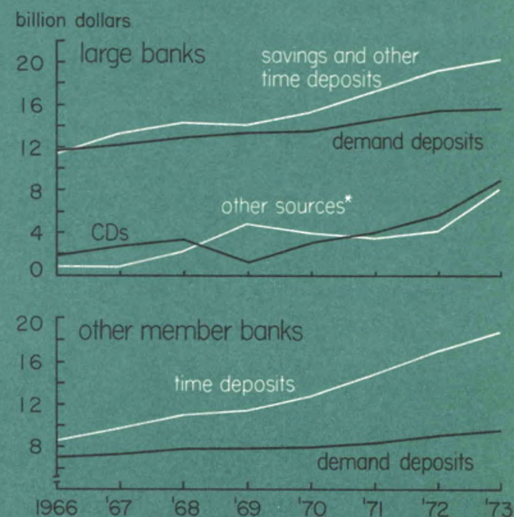
Virtually all of the expansion in member bank credit was accounted for by loans, which rose $10 billion, or 21 percent. Holdings of U. S. Treasury securities declined almost $1 billion, offsetting about two-thirds of the dollar gain in holdings of municipals, agencies, and other securities. Portfolios of non-Treasury securities rose 10 percent, compared to 7 percent in 1972 but less than the 16 percent average annual increase in the five previous years.

The gain in loans matched the gain in 1972—the strongest recorded since 1965. Loan growth at large banks was more rapid than at small- and medium-sized banks. Including loans sold to affiliates, the gain at the 55 large banks that report detailed statements each week was 23 percent, reflecting exceptionally strong expansion in Chicago in the first half.

Loan composition

Commercial and industrial loans at large district banks increased more than 30 percent in 1973—twice as rapidly as in 1972. These loans accounted for half of the rise in all loans. Real estate and consumer instalment loans increased almost as fast as in 1972. Real estate loans rose 12 percent in 1973, compared to almost 14 percent in 1972. By contrast, in the 1969 period of high interest rates, real estate loans increased only 5 percent, following a 15 percent gain in 1968. Some of the $1 billion increase in bank loans to nonbank financial institutions in 1973 represents additional funds that flowed into mortgages through mortgage companies.

Time deposits remained most important source of funds for district member banks



Note: Data are averages of Wednesdays in December.

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

Loan composition at smaller banks that do not report this breakdown weekly is not yet available for the end of the year. In the first half of 1973, however, gains in the major types of loans at these banks equaled or exceeded the first-half 1972 gains. Real estate loans and business loans each rose about 8 percent at these banks in the first half of 1973, and consumer loans (both instalment and single-payment) increased 9 percent. Agricultural loans were up about 8 percent, compared to 4 percent for the first half of 1972.

Financing asset expansion

District member banks financed the 1973 growth in bank credit mainly with interest-bearing liabilities. Collected demand deposits averaged only 1½ percent higher in December 1973 than the previous December at large city banks, and 5 percent above December 1972 at other member banks. The gain in time deposits at smaller banks was less than 10 percent, compared to 14 percent in the previous year.

Time deposits at large banks increased $4.2 billion, or 17 percent. This gain included an increase of more than $3 billion in large CDs. After marginal reserve requirements were imposed in June, however, the increase in outstanding CDs slowed appreciably. The higher cost of CD funds and expectations that interest rates would decline made the federal funds market a more attractive source of funds. By November, net purchases of federal funds by district money market banks were more than double the first-quarter average.

In the effort to retain personal savings deposits, many banks introduced the higher-rate, four-year, $1,000-minimum deposits. As of October 31, 72 percent of district member banks were offering such deposits, and outstandings amounted to $1.5 billion. Much of this total resulted from shifts within the same banks from other types of accounts. At the large banks, passbook savings and all other small-denomination accounts of individuals and businesses increased less than $800 million for the year as a whole.

Member bank borrowing from the Federal Reserve Bank of Chicago averaged $250 million daily in 1973, compared to $40 million in 1972. Large banks borrowed about $200 million per day in the first quarter, but the average for the last three quarters was about $100 million. Loans to smaller banks rose steadily until August, the peak month of seasonal borrowing under the new seasonal borrowing privilege. More than one-third of all district members were accommodated at the discount window at some time during 1973—the largest number since the early days of the System.

Energy and the outlook

Even prior to the Arab oil embargo in October 1973, there was a widespread view that economic growth would slow markedly in 1974. Residential construction, passenger cars, and recreational vehicles were headed down and there was little hope for an early reversal.

Formal projections of economic aggregates published near the turn of this year have been generally similar. Real growth for 1974 is expected to be zero to 2 percent, down from 6 percent in 1973, while prices are expected to rise even more than last year. Residential construction, full-sized cars, and all activities related to travel and recreation are expected to be sharply lower, while nonresidential construction and business equipment are expected to be substantially higher. Exports of most goods are expected to continue to rise faster than imports, but higher oil prices jeopardize the favorable trade balance so recently achieved. Almost all forecasts see the economy weakest in the first half of 1974, with real activity down very slightly, followed by a recovery in the second half.

Two successive quarterly declines in real GNP are widely accepted as marking "a recession." Normally a recession is characterized by declining demands throughout the private economy. But many activities that are expected to decline or grow more slowly in 1974 will reflect shortfalls in supplies. Under these circumstances, forecasts of the general economy have less meaning than usual for consumers, businesses, and financial institutions.

Forecasts looking a year or more ahead should never be regarded as immutable blueprints of the future. Vital developments in 1973, such as the rate of price inflation, the strength of consumer purchases of durable goods, the extent of the capital spending boom, the degree of improvement in the balance of trade, the very sharp rise in short-term interest rates, and the severity of the fuel crisis were not foreseen in the "consensus forecast."

Seldom before has there been such a sharp contrast in the prospects for major sectors of the economy. Early in 1974, it appeared that steel, nonferrous metals, plastics, cement, and many other materials released by declining sectors would be employed readily elsewhere. Reemployment of manpower released by declining sectors, however, is hampered by limited mobility of the work force. This raises the spectre of a cumulating "regular" recession, a possibility which will be closely watched by monetary and fiscal authorities.

The energy crisis has its obvious "losers," such as large cars, recreational activities, petroleum refining and distribution, airline travel, and highway construction. But there are also many "winners," such as small cars, "do-it-yourself" activities, petroleum drilling and exploration, coal mining, nuclear power, railroads, and urban transport.

In January 1974, official statements indicated that the fuel shortfalls would be appreciably less than had been feared. In part, this was because of the rapid adjustments made by consumers, businesses, and governments. The United States has a far better energy situation than most other industrialized nations, as was reflected in the recent strengthening of the dollar. Nevertheless, for years to come, the problems of production and efficient use of energy will have a high priority in private and public planning. Many necessary adjustments will be painful and lengthy, but ingenuity and sound planning will merit large rewards.