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Business Conditions

Mayo testimony on inflation

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The American economy presents a study in contrasts, unparalleled in modern times. Producer durable goods industries experience unprecedented prosperity while demand for autos and some other consumer goods has been weak; strong nonresidential activity contrasts with the depressed residential sector—wages and salaries rise rapidly despite higher unemployment. Such anomolies in economic developments are explained in large degree by the all-pervading influence of rapid price inflation.

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Mayo testimony on inflation

**Statement by Mr. Robert P. Mayo, President
Federal Reserve Bank of Chicago
to the Committee on Banking and Currency,
U. S. House of Representatives, Washington, D.C.
July 18, 1974**

I am pleased to have the opportunity to meet with you today to do whatever I can to assist your Committee's inquiry into the problem of inflation in our national economy. We all agree that inflation and its attendant effects on interest rates, asset values, real incomes, and the general welfare of our citizens are indeed serious. Those of us in the Federal Reserve System share with the Congress and the Administration the desire and the responsibility to achieve our national goals of high employment, relatively stable prices, sound economic growth, and a reasonable balance in international payments. I think it is crystal clear that the Federal Reserve System is not only fully aware of the dangers and costs of continuing inflation, but is making every reasonable effort to resist and contain the current rising trend in the general price level.

In our present unusual economic environment, this is not an easy task. But the task would be even more difficult if the Federal Reserve System, as the manager of the nation's monetary system, did not possess a strong regional orientation and structure. Since I assumed my position as president of the Federal Reserve Bank of Chicago almost four years ago, I have found the economic input from the members of my board of directors most helpful as I have attempted to evaluate policy alternatives in an environment in which our national economic intelligence—even though the best in the world—is still inadequate. The existence of this strong regional structure, in my view, permits the Federal Reserve to be more flexible and responsive to a rapidly-changing economic environment that is only reflected in more formalized data with a significant time lag.

I can also report to you that the degree of public support in the Seventh Federal Reserve District for current Federal Reserve monetary policies is very strong, judging by the comments I have received wherever I go. The encouragement for continued monetary restraint comes not only from the banks but also from institutions and individuals whose own financial condition often has been and will continue to be adversely affected by continued market pressures. The public is fed up with inflation. They have finally decided that price rises have gone beyond the tolerable level. They are willing, I believe, to support effective efforts to control inflation—recognizing that there will be substantial costs involved in so doing.

I am gratified by this support. Without it we might become less confident in our resolution to accomplish the difficult task that lies ahead. Yet we must always remember that excessive zeal in combating inflation could lead to even more serious economic difficulties than those that now confront us. The current inflation has developed over a long time. It is worldwide—not just a U.S. phenomenon. But as leaders of the free world we have inflation control responsibilities that extend far beyond our own borders. It will take

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time, determination, and patience to resolve these problems.

As we choose the course to follow in combating inflation wisely, we must keep two important factors in mind—the sequence of events that has led us to our current situation and exactly where we stand at this juncture. A brief review of the past provides us with a better understanding of earlier misjudgments that should be avoided in future actions. Knowledge of the current situation is essential because the U.S. economy responds only gradually over time to the majority of forces leading to change. Therefore, we must take into account forces already set in motion that are not as yet evident. There is no such thing as instant monetary policy. Its lag is variable and not precisely predictable.

No one will deny that inflation is concerned with the relationship between the quantity of goods and the quantity of money. But that relationship in turn has many facets. The great perspective of 20-20 hindsight tells me that the growth of the money supply during 1972 and the first part of 1973 was somewhat higher than many of us wished in view of the way the underlying economic situation turned out, thus adding to some degree to inflationary pressures.

But even more importantly, we cannot ignore the fact that many other factors outside the influence of the Federal Reserve played a very important role in the unprecedented inflation of 1973-74. Those factors include the coincident strong expansion of all of the industrialized nations of the world, crop failures abroad, successive devaluations of the dollar, and the termination of the wage-price control program which was necessary, at least in its early stages, to help mitigate the effects of our deficit-riddled fiscal policy of 1967 and 1968. All of these events together produced 1973 export demand far exceeding expectations, and added price pressures to a domestic economy already operating at full capacity or beyond. Finally, of course, the oil embargo was an obvious unanticipated shock, and the substantial price impact domestically was equally unnerving.

In addition to these special factors—hopefully nonrecurring—fiscal policy, in terms of budget deficits, became too expansionary in 1971 and 1972 as the federal government worried more about large potential increases in unemployment (which did not develop) than about large increases in inflation (which did). The Federal Reserve has an independent charge from the Congress to act as a prudent manager of monetary policy. But the Fed is also charged with responsibility for maintaining an effective, viable financial system—not just fighting inflation blindly regardless of the consequences. When the Administration recommends—and the Congress authorizes—expenditures far in excess of revenues, the Treasury has no alternative but to issue more securities to pay for its spending. The Federal Reserve has, of course, a responsibility to see that the Treasury is successful in acquiring the necessary funds without significant distortion and disruption in financial markets.

When excess capacity exists in the economy, and the money and capital markets are quiet, the Treasury can handle deficit financing and refund maturing issues fairly easily. But, as the economy approaches capacity output and the deficits persist because of fiscal policy lags, the Treasury must compete with other market participants for increasingly scarce financial resources. Under these circumstances, continued large Treasury financings, particularly with an ever-shortening debt maturity structure, can have significant impacts on market interest rates. In order to avoid serious disruptions in private capital markets, then, the Federal Reserve is under pressure to allow more rapid increases in monetary aggregates than would be the case in the

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absence of debt management pressures. The net result of assisting deficit financing in an economy which has already generated sufficient momentum to achieve very high employment levels is, of course, inflation.

The Congress has not, of course, intentionally placed this burden on the Treasury and the Federal Reserve. It is a residual burden—albeit a heavy one. Rather, my experience as a Treasury debt management official, as Director of the Bureau of the Budget, and as a Federal Reserve Bank president, indicates to me that this situation arises from a fundamental flaw in governmental coordination of economic policy and public finance up until the present time. There is great need for a system to review all of the authorizations of the Congress and their spending implications in totality, taking into account the impacts of these actions not only in specific areas but also on financial markets and the growth of economic activity in general.

I testified a year ago before the congressional budget reform committee as a strong proponent of the proposal that the Congress establish a Joint Committee on the Budget to provide the Congress with an independent view of the whole budgetary picture, and with an analytical staff capability of its own to lessen its factual dependence on the Executive Branch. I am most enthusiastic about your recent approval of such overall fiscal control. The cynics say it won't work because of the deep-seated jealousies of congressional committees. I disagree. It can work and I believe congressional leaders will see to it that it does.

I now turn my attention to a few key issues in our current environment. We know that once the economy is operating close to full capacity, monetary growth in excess of the growth of the capacity to produce goods and services will sustain general price inflation and will result in higher interest rates as ongoing rates of inflation are built into those rates. In such a situation, we must ask why the rate of inflation, and interest rates, cannot be decreased simply by reducing the rate of monetary growth.

The answer lies in the fact that we, as a nation, have more than one economic goal. In addition to our desire and need to reduce the rate of increase of the general price level, we must consider the effects of any contemplated restrictive actions on unemployment and on overall economic growth. And, we must be cognizant of the sectoral ramifications of various degrees of constraint—the housing sector being the most obvious example currently, as it was in 1966 and 1969. Nor can we neglect the needs of small businesses and our local governments. Finally, we must always remind ourselves that any actions we do take will have their principal effects not today, but some months hence. We should not expect immediate price restraint from restrictive actions. We also must take great care that we do not overstay whatever restriction is adopted and precipitate a serious economic downturn. The problem is made even more difficult by the limited ability to forecast future economic developments.

The tradeoff relationship that exists between the rate of general price increase and the rate of unemployment is unstable and is therefore of limited usefulness as a guiding principle of economic policy. Nevertheless, the relationship cannot be ignored as we assess the alternatives open to us at any time. A restrictive monetary policy can result in increased unemployment far more quickly than it can result in decreased inflation. And we know that the expectations of consumers, businessmen, government officials, and financial market participants play a critical role in a situation of persistent inflation. These expectations are affected primarily by performance—not by promises—and even then very slowly. We must move cautiously

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yet firmly with our restrictive actions and be prepared to adhere to those policies long enough for the effects to be felt.

A reduction in the rate of inflation—and in price level expectations—will eventually produce a decline in interest rates. But this result will occur only after an appreciable lag. When economic activity is stimulated to a point where the rate of output in dollars exceeds real capacity output, the initial response of interest rates to the adoption of a restrictive monetary policy will be *increased* rather than *decreased* interest rates. Given our reliance on general monetary and fiscal restraint, declining interest rates will occur only after aggregate demand is reduced, thereby reducing demands for money and credit. As prices respond, the rate of inflation will then subside and expectations of inflation will be reduced. It is only then that the inflation premium in interest rates will be eroded—not before.

We have seen a good example of the shorter-run relationship between restraint in monetary growth and market interest rates during the past six months or so. During this period, the U.S. economy suffered from inflation stemming from (1) past fiscal and monetary stimulus, (2) relaxation—and then termination—of a wage-price control program that had overstayed its welcome and its usefulness, (3) the effects of shortages in energy and agricultural products, and (4) international developments. When it became clear that the Federal Reserve was moving further to restrain these inflationary forces, interest rates, as you all know so well, increased rapidly. Demands for money and credit exceeded expectations reflecting in part the sharper-than-anticipated rate of general price increases.

Market interest rates have increased so far and so fast this year in response to our efforts to restrict availability of funds to banks that new questions have arisen about the operations of our nation's financial markets. The economy has been subjected to a highly unusual shock by the arbitrary and very sudden increases in petroleum prices. Underwriting these price increases fully by monetary expansion is, of course, self-defeating if the monetary expansion simply results in further price increases. But there is more to it than that.

Increases in energy prices of the magnitude we have witnessed require reallocation of real consumer and business spending throughout our economy. Spending patterns will shift either toward more dollars spent on energy, away from other areas, or there will be a reduction of energy use—or some combination of the two will occur. In a textbook economy that adjusts instantaneously to rapid and large changes in relative prices, such a reorientation could take place without undue strain. But the economy of this country does not adapt that quickly to changes of such magnitude. Thus, insistence that increases in energy prices be treated as relative price changes that should not be permitted to increase the general price level at all runs the serious risk of an economic downturn. It seems preferable to me to permit a portion (but as little as is reasonable) of these nonrecurring price increases to be reflected in increases in the general price level in order to provide additional time for adjustment to the new environment. On both of these grounds—minimizing financial market adjustment problems and adapting carefully to the sudden changes in energy prices—and the aftermath of the 1973 upsurge in agricultural prices as well—I believe monetary aggregate growth in recent months modestly in excess of what might be considered "normal" guidelines is appropriate.

We are sailing on uncharted seas. Our 1974 economic environment is a new experience in terms of supply constraints. Reliance on past patterns and relationships as a guide to policy making and policy execution has been less than

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adequate. Therefore, we are still operating in a highly unpredictable environment, one in which the broad outlines of an unfolding situation are only now becoming a little clearer. Here again I am thankful for the role that our regional Federal Reserve bank board of directors plays in clearing away some of the clouds of uncertainty.

Under these circumstances, an *overly* protective or timid appraisal of the ability of financial markets to withstand strain, or an *excessive* accommodation of highly unusual price increases, would have the effect of worsening inflation. And, throughout our discussion, we must bear in mind that the sharp increases we have seen in key prices are only beginning to appear in their secondary effects on prices of other products—and in wages.

We do not have the ability to perform miracles. We have no magic wands to wave. Our own analysis of economic developments during the second quarter of 1974 indicates that we have passed through the critical period of serious petroleum shortage reasonably well, all things considered. Unemployment did not increase significantly and our economic decline seems to have leveled off. Yet we are just now facing what in many ways is the more serious phase of the problem. Inflation continues and will accelerate in many areas in response to earlier price increases. Markets remain unsettled. Uncertainty is still a major factor.

While the current situation may seem to present only limited grounds for optimism, I believe we now have the opportunity to reduce our inflationary problem without imposing unacceptably high social costs in human misery and foregone output. The downturn in the first quarter was not accompanied by a large increase in unemployment, and pressure to be fiscally expansive in order to reduce unemployment has not been strong. There is some promise of relief from price pressures in the agricultural area in the coming months. Petroleum products are at least available once again even though prices are high. Finally, viewed against the background of recent price performance, monetary policy has already set in place restraining forces that will act as a brake on inflation and interest rates over the months ahead.

In conclusion, I want to remind all of us that we as a nation cannot reasonably expect to eradicate inflation during the next two or three years. If our policies are successful, they will be successful only in reducing the *rate* of inflation gradually. Nor should we as a nation ask *monetary* policy to carry the entire burden of inflation control. The social costs and adverse sectoral impacts of relying on a single general type of policy are simply excessive. It is absolutely essential that specific and general *fiscal* policy measures be coordinated with monetary policy during the coming period if we are to dampen inflation.

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The trend of business

In the summer of 1974, the American economy presents a study in contrasts, unparalleled in modern times. In the face of unprecedented prosperity in the producer durable goods industries, demand for autos and some other consumer goods has been weak. A similar dichotomy is evident in construction, where strong nonresidential activity contrasts with the badly depressed residential sector. Other anomalies are found in the acceleration in price inflation and in the more rapid rise in wages and salaries despite easing of supplies of certain goods and services and higher employment.

These unusual economic trends are taking place against a backdrop of very special circumstances. These include the oil embargo and its aftermath; the ending of general price and wage controls; and the extremely rapid rise in interest rates in the second quarter. Perhaps the greatest shock has been the sheer magnitude of price inflation in the past year. Few analysts would have predicted the "double-digit inflation" (10 percent or more annual rate), which has profoundly affected business and consumer thinking about vital decisions.

The unsettling influence of these unexpected developments is providing a stiff test of the soundness of the nation's economic structure. Since World War II, a series of tests, each differing in significant degree, have been weathered in a manner that has belied the fears of the extreme pessimists.

The big contrasts

Producers of virtually all types of business equipment—for manufacturing, construction, agriculture, mining, and transportation—have been straining to increase output and contain rising order backlogs. In contrast, production and sales of passenger automobiles have been far below last year, and, although output will be relatively high in the third quarter, no signs of the hoped for revival in consumer demand had appeared by early summer.

Most types of construction activity—factories, commercial structures, public utility facilities, and public works—are at high levels, limited in many cases by availability of materials and components. But residential construction is off sharply. Housing starts were almost 30 percent below last year in the second quarter. Moreover, prospects for a significant improvement in the flow of mortgage funds in the near future are dim.

Thus far in 1974, total output of goods and services has only about matched the year-earlier level. Following historical trends, a rise of 4 percent or more would have been anticipated. Sharply lower activity in some sectors—especially autos, residential construction, and mobile homes—has released a large volume of resources for other industries. Nevertheless, shortages of materials and components continue to limit output in many industries and prices of goods and services, on average, have advanced at a much more rapid rate than in the first half of 1973, thus reflecting, in part, the impact of higher food prices. Production also has been limited by a series of strikes, more prevalent than in any recent year, and affecting a wide variety of activities in manufacturing, construction, and private and public services.

Unemployment rates are higher than last year in most areas, and sharply so in the automotive centers. Although easing of

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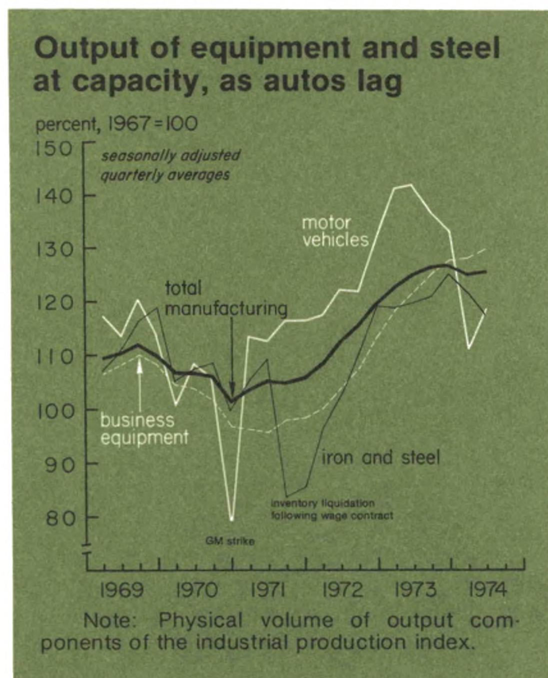
demand for labor should tend to moderate increases in worker compensation, wage boosts in recent months have substantially exceeded those recorded a year ago.

Part, but not all, of the explanation for the acceleration in prices and wages this year reflects the end of all wage and price controls, except for petroleum, on May 1. Price and wage controls had been impeding wage and price adjustments in most sectors since August 1971.

Other contrasts are found in the financial sectors. Corporate profits have been rising at a rapid pace since 1970, and forecasts for the increase expected this year have been revised upward. Both rising profits and rapid inflation, presumably, should be favorable for the stock market. Quite the contrary, common stock prices have been weak since early last year, and in early July averaged lower than at any time in the past three and one-half years.

Monetary aggregates, bank loans and investments, and security issues by both corporations and municipalities increased at a rapid pace in the first half of 1974. A conspicuous reduction in availability of funds has occurred only in the residential mortgage sectors. Even so, interest rates on all types of private and public obligations increased sharply—to record levels in most cases. Many analysts, correctly foreseeing a lack of growth in the general economy, had expected lower rates—even as late as mid-March.



Output of equipment and steel at capacity, as autos lag

Note: Physical volume of output components of the industrial production index.

Why the contrasts?

The anomalies in economic developments in 1974 are explained, to a large degree, by the all-pervading influence of rapid price inflation. Strong demands that press against capacity, coupled with rising prices, stimulate capital expenditures by businesses able to raise the necessary funds. On the other hand many consumers, finding their real earnings reduced by inflation, hesitate to incur financial commitments that may require additions to already heavy burdens of debt. Lower real wages, reflecting price inflation, also lead to demands for larger increases in compensation in situations where bargaining power can be exerted.

Present indications are that most of the contrasts in economic developments will continue for several months. The capital goods boom retains great momentum. Expansion programs in basic industries—steel, chemicals, paper, and petroleum—now underway, will take years to complete. Consumer purchases of autos remain sluggish and dealer inventories are ample. Residential construction is not likely to revive significantly without a return to a more normal structure of interest rates. Growth in the labor force probably will tend to raise unemployment further in the absence of very large gains in employment, which are not now foreseen. Shortages of basic materials such as steel, aluminum, chemicals, and paper remain troublesome, and further price increases

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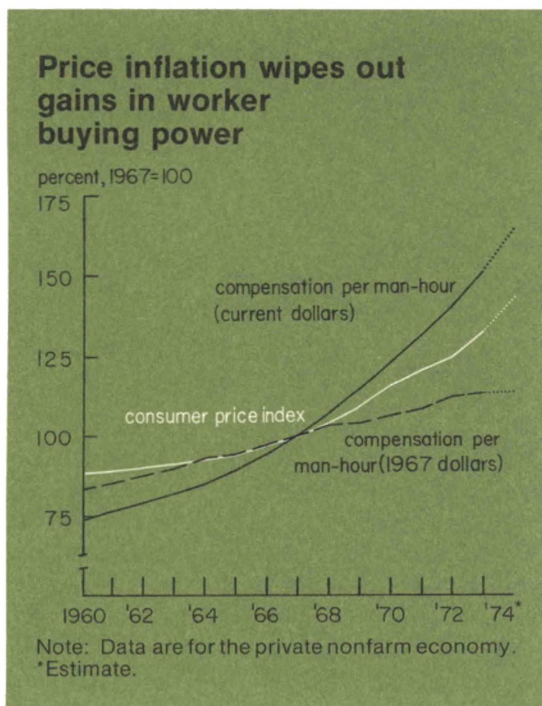

Note: Data are for the private nonfarm economy.
*Estimate.

are almost certain. The rate of rise in the overall price level, however, may moderate in the second half of 1974 as oil prices stabilize and lower prices for various foods and raw materials at wholesale are reflected, at least partially, at the retail level.

Capacity limitations

The acceleration of price inflation in 1973 and 1974 was due, in large part, to the rapid runup in agricultural prices and the doubling and tripling of prices of crude oil from the Middle East and other foreign sources. But limitations on the economy's ability to produce a wide variety of goods and services also played, and are still playing, a vital role. Prices reflect both supply and demand, as any economics student knows, but many forecasters have long emphasized demand, assuming ample capacity with output free to rise. This helps explain the widespread tendency last year to underestimate the current inflation.

In the 1930s and 1940s, most economists rightly saw depressed conditions as the result of inadequate demand. The remedy was boosting income and buying power through easier credit and expansionary fiscal policy. Until recent years, historical relationships seemed to support the thesis that effective demand, almost exclusively, determined levels of output. This was never completely true, however, and since the mid-1960s, especially since 1972, capacity and supply limitations have been increasingly evident.

In late 1972, order lead times began to stretch out and some manufacturers placed customers on allocation. As demand pressed on capacity, the rigid price and wage controls of Phase II became increasingly untenable, and in January 1973, the more flexible Phase III was substituted. Even with higher prices, lists of shortage items grew larger month by month in 1973. By last fall, these lists included most types of steel, nonferrous metals, cement, oil, coal, plastics, chemicals, paper, and transportation services. Some firms, especially smaller ones, reported "everything" in short supply. Many firms, large and small, appointed "expediters," reminiscent of World War II, to round up critical items, even paying premium prices, when necessary.

Inadequate facilities to produce basic materials, components, and finished goods in the face of strong demands partly reflect the slowdown in capital expenditures in the 1970-71 recession. The gradual depletion of our most economical mineral deposits, and plant closings required by environmental regulations, also were factors.

Oil, steel, etc.

Inadequate supplies of petroleum products and coal had been a problem throughout 1973. Producers were rationing limited supplies voluntarily, and there were demands for government rationing.

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The Arab oil embargo, lasting from October 1973 to March 1974, was superimposed on an already tight supply situation. The resulting reduction of almost 15 percent from the anticipated supply of petroleum products in the first quarter was responsible, directly and indirectly, for a rather sharp slump in the U.S. economy.

In late 1973 and early 1974, there were dire forebodings as to the impact of fuel shortages, especially gasoline, on auto sales, recreation-related businesses and activities, and on residential and commercial construction. In the second quarter, however, a number of factors combined to end the oil crisis—resumption of shipments from the Middle East, conservation measures, and sharply higher prices, which restrained consumption. In June, consumption of petroleum products in the United States about equaled the year-earlier total instead of the 5 percent increase that probably would have occurred with ample supplies. There were few "shortages" because higher prices held down sales. Nevertheless, the fuel crisis has not passed away permanently. The temporary respite is possible only because the United States is deepening its dependence on Arab oil.

Building materials for residential construction, such as lumber and wallboard, have become more available as was to be expected with the plunge in housing starts. Prices of most nonferrous metals have declined sharply in world markets, suggesting a better supply-demand balance. But most of the shortages plaguing purchasing managers have continued into the current summer, and some have gotten worse.

With the improvement in oil supplies, the most pervasive shortage has been steel—through all product lines. Despite intense efforts to maximize output, raw steel production recently has been behind last year's level. Limitations on output primarily reflect needed deferred maintenance, bottlenecks in blast furnace capacity, and shortages of raw materials, especially coke.

Total output of goods and services has been limited, not only by basic materials such as oil and steel, but also by availability of components—castings are the biggest headache—restricted factory capacity for finished goods, and inadequate transportation.

Vast capital expenditure programs are underway to break the bottlenecks in the U.S. economy. But many of these projects will take two, three, and more years to complete. Businessmen are being told that steel, aluminum, paper, and certain chemicals will be in tight supply for three to five years.

Wages and productivity

Last February, labor leaders stated that in 1974 unions would demand first year increases in worker compensation of 12 percent. Last year, increases in compensation per man-hour in the private economy had average 7.6 percent—above the 7 percent average of the 1968-72 period, and the highest since 1951.

The arithmetic of the demand for a 12 percent wage increase was simple—3 percent for increases in productivity (output per man-hour) based on historical trends, plus 9 percent for the rise in the consumer price index, the "cost of living," from January 1973 to January 1974. "Real wages" (adjusted for inflation) of most workers began declining in the second half of 1973. This decline has continued through the first half of 1974.

At the time, the proclamation of the demand for 12 percent wage boosts seemed extravagant, merely a card on the bargaining table. In April, however, the bellwether steelworkers settled for a three-year package said to be worth 40 percent, about 12 percent per year compounded. In late May, a delayed statement from the United

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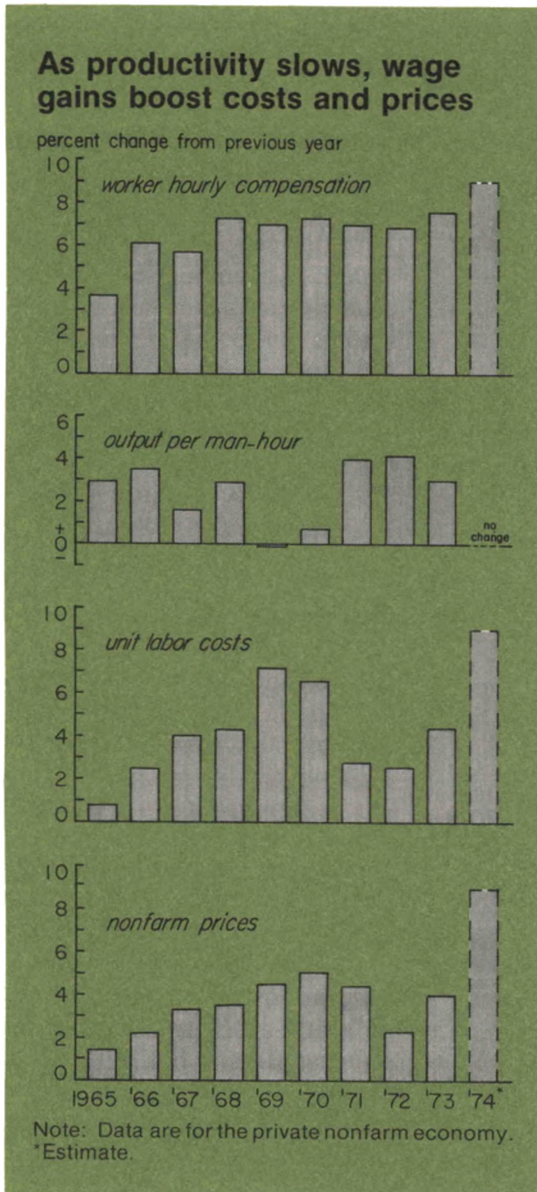

Auto Workers indicated their settlement with the auto companies last November was worth 11.6 percent per year. In the past two months, many union agreements have provided for first-year wage boosts in two digits—some in excess of 12 percent.

In May and June, following the end of wage controls, many employers granted substantial across-the-board wage increases to nonunion workers partly to compensate for increases in living costs, but also to compete effectively for workers in local labor markets. Many employers automatically grant white collar workers increases in wages and benefits obtained by plant workers through collective bargaining.

The government's formula for wage and salary increases under controls was for increases of 5.5 percent—3 percent for higher productivity, and 2.5 percent for inflation, the hoped-for slower rate of rise in the consumer price index. The mirage of the 2.5 percent inflation factor has long since evaporated. In 1973, consumer prices averaged 6 percent above the 1972 level, and, in the spring, the index was up 11 percent from a year ago.

The 3 percent long-term productivity factor likewise is in doubt in 1974. Productivity in the nonfarm private economy rose 4 percent in 1971 and 1972, before dropping to 3 percent last year. In 1969 and 1970, however, there had been virtually no gain in total productivity. With declines in productivity in the fourth and first quarters, and probably in the second quarter as well, prospects for a significant rise for 1974 as a whole are poor. When productivity does not rise, increases in wages are translated directly into increases in unit costs, and, ultimately, into approximately equivalent increases in prices.

Unit labor costs in the nonfarm private economy averaged 4.4 percent higher in 1973, approximately the difference between the increase in productivity and the increase in compensation per man-hour. Related prices increased almost as much as labor costs last year.

Recent trends suggest that average compensation per man-hour for the entire private economy will rise about 9 percent in 1974. If there is no increase in productivity, unit labor costs and prices also can be expected to rise by a similar amount.

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The clouded future

Accelerated inflation has blurred the readings provided by the dollar volume of such important measures as personal income, retail sales, corporate profits, capital outlays, construction activity, and inventory investment. Dollar totals can be "deflated," using various price indexes, but such adjustments are never exact and margins of error tend to widen when price increases are very large. As a result, the underlying strength or weakness of the real economy is more difficult to evaluate.

Analysis also is hampered by the marked contrasts between strength in business investment and weakness in some types of consumer purchases. Such contrasts are especially apparent between areas in the diversified region of the Seventh District—Illinois, Indiana, Iowa, Michigan, and Wisconsin.

Pricing policies have been drastically altered in the past year because of rapidly rising costs of labor and other factors of production. Many business firms are now specifying "price at time of delivery" rather than "at time of order." More and more, escalator clauses are being incorporated in contracts on long lead time items in an attempt to maintain profit margins. There are frequent reports, moreover, of sellers insisting that contracts be renegotiated to incorporate rising costs—sometimes unilaterally scrapping contracts—with the result that the tendency of contractual arrangements to slow price inflation is less effective.

Aside from reducing the volume of funds available for residential construction, very high interest rates have been partly responsible for decisions of some utilities and other businesses to slow investment plans. Interest rates not only are high historically, they have remained high for a longer period of time, and adjustments necessarily have influenced a wider than usual range of activities.

Ironically, the greater difficulty in preparing accurate forecasts under conditions of capacity restraints, rapid price inflation, high interest rates, and other fast-moving developments—both foreign and domestic—makes forecasting more necessary than ever for all decision makers.

George W. Cloos

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Banking developments

Financing expansion at banks

Asset expansion depends on a bank's ability to acquire funds through an increase in liabilities or capital or both. During the Sixties, time and savings deposits replaced demand deposits as the major source of bank funds. This shift reflected several factors, including the development of bank liability management, whereby banks sought funds to accommodate loan demand without liquidating securities. At the same time, rising interest rates encouraged holders of demand deposits to minimize nonearning transactions balances. This meant banks had to be more competitive in securing interest-bearing funds. Bank efforts to attract time and savings deposits involved increasing the rates paid, a move facilitated by upward adjustments in Regulation Q ceilings and by offering such new instruments as small-denomination CDs and new types of open-account time deposits. In addition, the biggest banks marketed large negotiable CDs, competing in the national money market for funds. Later in the Sixties, these banks placed increasing emphasis on nondeposit sources.

At the end of 1968, time and savings deposits were funding half of the total assets of the "average" district bank (as measured by an average of individual bank ratios). Demand deposits equaled 40 percent and reserves and capital accounts equaled 8.75 percent of total assets. Since 1968, total assets of the average bank have increased 80 percent and the methods of obtaining funds to support this expansion resulted in further shifts in the composition of sources of funds. Time and savings deposits continued to increase more rapidly than total assets in each year after 1968 and were equal to around 56 percent of total assets of the average bank at year-end 1973. This growth occurred despite the limitations imposed by Regulation Q ceilings when market rates exceeded the ceilings in 1969 and 1973. Demand deposits as a percent of total assets declined to 33 percent during this period. Ratios of reserves and capital accounts to total assets increased in 1969 and 1970 when Regulation Q ceilings precluded effective competition for time and savings deposits and nondeposit sources, thus limiting asset growth to a slower rate than the growth in reserves and capital.

While the changes in sources of funds for the "average" bank followed the trends of the "average" district commercial bank, the changes spotlighted the differences in alternative sources in relation to bank size. For the average bank in each size group, time and savings deposits provided the largest share of funds and demand deposits the second largest share both at year-end 1968 and year-end 1973, but the difference between the shares increased substantially over the period. Whereas the

Major source of funds

	1968	1969	1970	1971	1972	1973
	(percent of total assets)					
Demand deposits	40.07	39.02	36.54	34.46	34.29	33.08
Time and savings deposits	49.98	50.44	52.65	54.98	55.48	56.33
Selected non-deposit sources[1]	.13	.24	.24	.25	.39	59
Other liabilities[2]	1.07	1.27	1.43	1.43	1.41	1.56
Reserves and capital accounts	8.75	8.98	9.09	8.82	8.39	8.40

*Average of ratios for Seventh District commercial banks as of December 31.

[1]Gross purchases of federal funds, securities or loans sold under repurchase agreements, and other liabilities for borrowed money.

[2]Outstanding acceptances liability plus other liabilities except mortgage indebtedness.

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average ratio of demand deposits to total assets for each size group declined from 5 to 10 percentage points, the increases in the average ratio of time and savings deposits to total assets ranged from .25 to 6 percentage points. Averages for asset size groups under $50 million show increases in ratios of time and savings deposits to total assets which were within 1 percentage point of offsetting declines in ratios of demand deposits to total assets, reflecting the limited alternatives for smaller banks. Shortfalls were progressively larger for larger asset-size groups. Relative to total assets, demand deposits shrank most at the biggest banks, declining from 42 percent to 32 percent. Despite the volume of negotiable CDs issued by banks in this group, the ratio of time and savings deposits to total assets rose only 3 percentage points to 47 percent. Relative increases in "nondeposit" liabilities provided the major offset. The average ratio of "nondeposit" liabilities for the largest banks increased 7.7 percentage points between year-end 1968 and year-end 1973 and surpassed reserves and capital accounts as the third largest source of asset financing.[1] Because no attempt has been made to net certain uses against certain sources, the nondeposit ratio could be as high for a bank solely performing a broker or dealer function in money market transactions as for a bank purchasing funds for its own account. Even so, the increase in the nondeposit liabilities ratio over the past five years reflects a significant development in financing assets expansion. Because the largest banks have the most alternatives for obtaining nondeposit liabilities, the average ratio for these banks would be expected to be highest. Most smaller banks do not acquire nondeposit liabilities but in those that do this source of funds has become increasingly important. The percent of banks in each size group reporting nondeposit liabilities and average ratios for these banks at year-end 1973 were:

Asset size	Percent of banks	Average ratio
(mil. dol.)	*(percent)*	
5 and under	*	2.86
6-15	6.0	3.00
16-25	9.8	2.30
26-50	17.8	2.91
51-100	34.1	4.26
101-250	54.6	4.85
251-500	88.5	7.01
Over 500	100.0	10.58

Despite the efforts of the largest banks to obtain funds, the very largest banks recorded a much slower asset growth than did smaller banks over the past five years. For banks over $500 million, assets averaged only 53 percent larger. In contrast, asset growth averaged 82 percent or more for banks in the $6 million to $50 million asset-size groups and 70 percent or more for banks in other size groups. ■

[1]In figuring the nondeposit liabilities ratio, the numerator is composed of gross purchases of federal funds, plus securities or loans sold under agreement to repurchase, plus other liabilities for borrowed money. If Eurodollars obtained from a bank's own foreign branch, which are included in "other liabilities," or loans sold outright to bank holding companies or other affiliates were added, the nondeposit liabilities ratio would be slightly higher.

Composition of sources of funds, by asset-size

Asset-size	Demand deposits	Time and savings deposits	Selected nondeposit liabilities	Other liabilities	Reserves and capital accounts
(million dollars)	*(percent of total assets)*				
5 and under	37.78	50.27	.08	.88	10.97**
6-15	33.12	57.21	.20	1.17	8.27
16-25	31.84	58.54	.20	1.68	7.70
26-50	31.91	57.40	.55	2.28	7.79
51-100	30.76	57.62	1.45	2.37	7.74
101-250	31.65	55.43	2.65	2.45	7.76
251-500	32.82	50.82	6.20	2.27	7.88
Over 500	31.95	47.17	10.58	2.83	7.33

*Averages of ratios for Seventh District commercial banks as of December 31, 1973.

**Excluding banks formed in 1973, this ratio is 9.45.

[1]Gross purchases of federal funds, securities or loans sold under repurchase agreements, and other liabilities for borrowed money.

[2]Outstanding acceptances liability plus other liabilities except mortgage indebtedness.

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