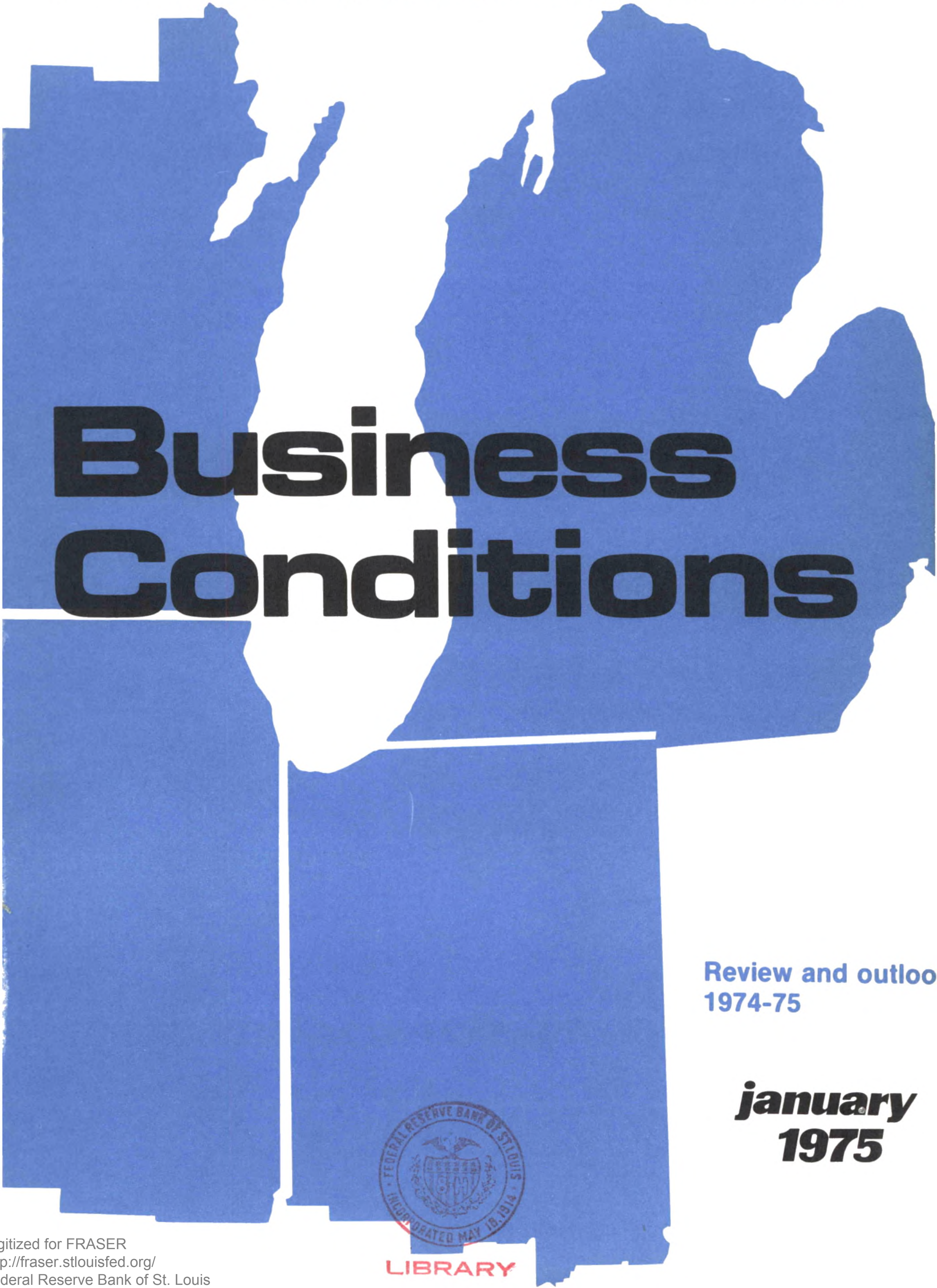
an economic review by the Federal Reserve Bank of Chicago



Business Conditions

Review and outloo
1974-75

january
1975

Review and outlook 1974-75

Soaring prices and record interest were major features in an unprecedeted array of adverse developments that hit consumers, business, agriculture, and financial institutions in 1974. The basic strength of the economy was shown in the fact that employment and output were maintained at high levels for the first three-quarters of the year. In the fourth quarter, however, a severe recession clearly was underway.

Forecasts for 1975 indicate further declines in output and continued rapid price inflation. However, more stimulative monetary and fiscal policies and corrective adjustments in prices and inventories point the way to a recovery later this year.

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Review and outlook 1974-75

A year of calamities

The U.S. economy was struck by an unprecedented series of calamities in 1974. Among them were the oil embargo, the associated international liquidity crisis, the balance-of-payments deficit, the chaotic demise of price and wage controls, widespread shortages of materials and components, record price inflation, record high interest rates, a sharply falling stock market for the second straight year, liquidity problems of some prominent financial institutions, extremely poor auto sales, a severe housing slump, the nation's first Presidential resignation, the adverse impact of drought and frost on major crops, cutbacks in expansion plans by the normally stable electric utility industry, and a new postwar high in the number of disruptive industrial disputes.

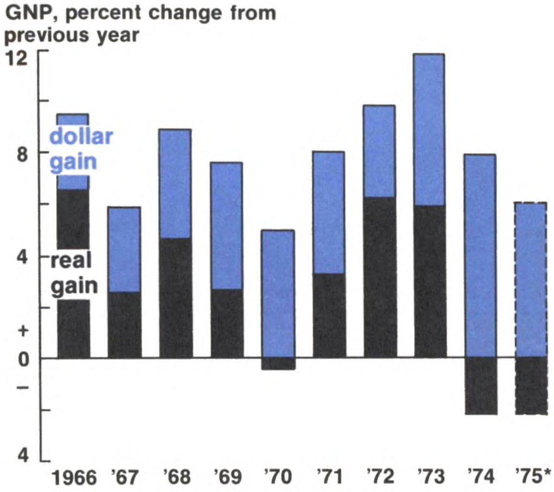
The basic strengths of the economy were manifest in the fact that output and employment were maintained at a high level for three quarters of the year in the face of massive adverse forces. In the fourth quarter, however, output and employment declined on a broad front, shortages gave way to surpluses, prices of many commodities declined, and throngs of laid-off workers taxed the facilities of state unemployment insurance offices. By year-end it was clear that the economy was in the throes of a deep recession.

The United States was not unique in its encounter with severe economic problems. Rapid inflation, unemployment, and strikes occurred in virtually all industrialized nations. Political instability, moreover, was widespread with changes in leadership in Britain, West Germany, France, Italy, Greece, Portugal, Denmark, Israel, and Japan.

Faulty forecasts

The typical economic "scenario" in early 1974 called for a modest rise in total output (real GNP) with an upswing in the second half, general price inflation of about 7 percent, a revival in residential building, gradually declining interest rates, and a substantial rise in crop production. Actual developments were quite different. Real GNP declined in each quarter and was down 2 percent for the year, price inflation exceeded 10 percent, residential construction dropped sharply

Real output is expected to decline again in 1975, while inflation slows



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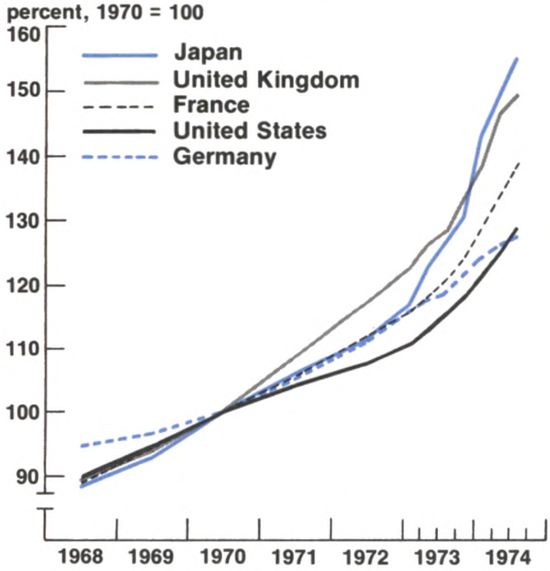
Consumer prices zoomed in major industrialized nations



after an abortive recovery, interest rates rose to all-time highs, and harvests were reduced substantially by bad weather.

In early 1975 forecasters are less optimistic than a year ago. Real GNP is expected to decline again for the year as a whole—the first two-year decline since World War II. Price inflation is expected to slow through the year. Once again, expectations point to a decline in interest rates, a revival of residential construction, bumper crops, and a general economic recovery in the second half.

The energy crisis ebbs

In the early months of 1974 analysts of U.S. economic developments focused their attention on the effects of the embargo on oil shipments by Arab nations and the associated tripling of the price of imported petroleum. The embargo, which lasted from mid-October 1973 to mid-March 1974, cut U.S. oil supplies by 2.5 million barrels per day, about 13 percent of consumption.

The oil embargo and higher oil prices had far-reaching effects. The greatest impact was on sales and output of automobiles, light trucks, and recreational vehicles. Speed limits were cut to 55 miles per hour and gasoline shortages caused a reduction in the use of vehicles for nonessential purposes. Urged by public officials (and additionally motivated by higher prices), individuals, businesses, and governments conserved fuel and electricity. Output of chemicals, plastics, and fertilizers derived from oil was curtailed.

Despite mounting pressures, the Administration decided in late February 1974 not to institute gasoline rationing. The end of the oil embargo, higher fuel prices, and a moderately lower level of general economic activity soon spelled the end of lines at filling stations and other evidences of oil "shortages." For the year as a whole, however, consumption of petroleum products was down about 3 percent from 1973 in place of a normal increase of 4 or 5 percent. Federal controls on the price and end-use of petroleum products were maintained in a modified form throughout the year.

Since World War II, total use of energy has increased closely in step with growth in output. Programs to develop domestic sources of oil, natural gas, coal, and nuclear energy are being pressed forward at the cost of many billions of dollars. Associated inflationary pressures are powerful, partly because of environmental restrictions.

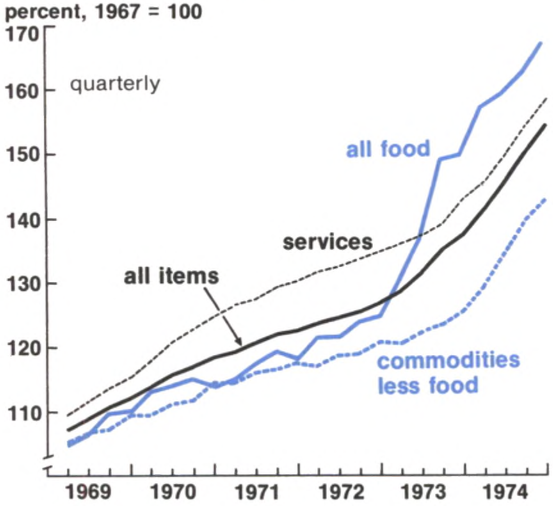
Inflation and recession

Historically, rapidly rising prices have been associated with rising employment and declining unemployment. Over the past decade economic discussions often have centered on the "trade-off" between inflation and unemployment. But in 1974 the United States was faced with rapid increases in *both* prices and unemployment. From June to December the consumer price index rose at an annual rate of about 11 percent, while unemployment rose from 5.2 percent to 7.2 percent of the labor force.

The reasons for the dilemma of simultaneous inflation and rising unemployment are many and complicated. Important special factors in 1974 were fuel shortages and shortfalls in crops. A more pervasive factor, however, is the rapid and continuing rise in labor costs per unit of output.

In February 1974 union leaders began to press for 12 percent first-year increases in compensation. These demands were based on a simple formula which added the 9 percent rise in the consumer price index in the previous 12 months to the 3 percent long-term average annual rise in productivity—output per man-hour. Some major labor contracts negotiated in 1974 provided 12 percent increases in compensation and some were even larger. The average for major contracts was 10 percent, but not all cost-of-living adjustments are included in this figure. Gains of 12 percent or more were negotiated by many union's in the building trades and in education, despite substantial unemployment in these fields. Many nonunion employers raised wages substantially to keep in line with the increases obtained by unions.

Food dominated the rise in consumer prices, but inflation was general

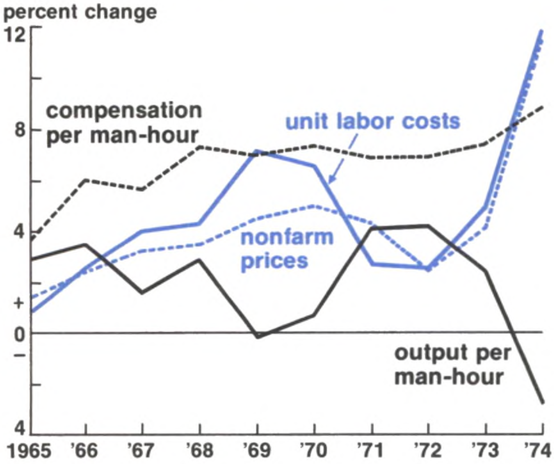


Unemployment rose rapidly to the highest level in recent years

Preliminary estimates show compensation per man-hour in the private nonfarm economy to have increased 9 percent last year. Output per man-hour, far from rising at the historic 3 percent rate, *declined* 3 percent for the first significant year-to-year drop in this measure since World War II. The combination of higher compensation and reduced productivity caused unit labor costs to rise about 12 percent in 1974. This compares with 5 percent in 1973 and less than 3 percent in 1972. Increases in unit labor costs show up in price increases, the other side of the coin. Price inflation in the private economy averaged over 11 percent last year.

Worker compensation will rise substantially again in 1975. Many workers are covered by two- or three-year contracts and cost-of-living adjustments, or their equivalents, are increasingly common for both union and nonunion workers.

Prices and labor costs surged due to wage boosts and declining productivity



Controls abolished

The legislation providing authority for price and wage controls expired on May 1, 1974. Prior to that date many industries had been exempted from controls or were operating under more flexible rules than in 1973. Nevertheless, prices of many goods and services that had been held in check by controls rose rapidly in the weeks following May 1.

The nation's experience with price and wage controls in the program instituted in August 1970 was judged unsatisfactory by virtually everyone. Some critics said controls should have been enforced more vigorously, while others argued for greater flexibility and still others rejected the whole concept.

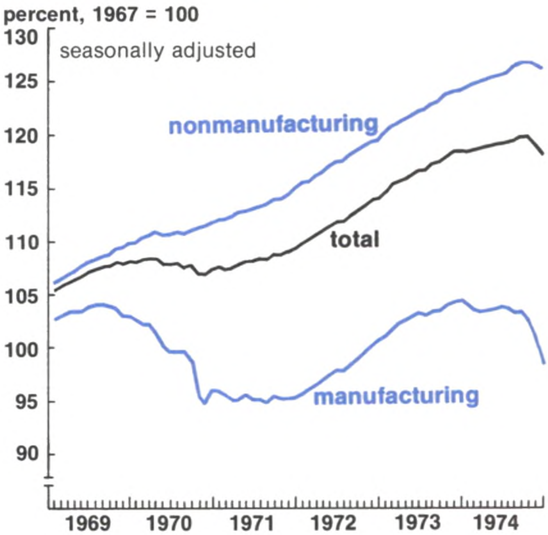
In retrospect, it is clear that price and wage controls hid increases in prices that were accomplished indirectly. Some materials were exported to obtain higher prices prevailing abroad, some manufacturers stopped producing low profit items, and hoarding of scarce materials occurred. All of these developments tended to disrupt normal market relationships. These developments exacerbated the widespread problem of shortages of materials and components that hampered production through a large part of the year. Many shortages became less severe in the third quarter, and some commodity prices declined. The drop in commodity prices broadened late in the year as economic conditions deteriorated.

Employment and income

Civilian employment averaged over 85.9 million in 1974, up 1.5 million from 1973 but a much smaller rise than in either of the two previous years. After following an erratic path since late 1973, employment hit an all-time high of 86.4 million in September 1974. A very rapid drop of 1.2 million occurred in the fourth quarter.

After-tax personal income rose 8.4 percent last year, less than the 12.6 percent gain in 1973, but faster than in most recent years. Personal outlays increased more than income in 1974, so the percentage of incomes saved was less than in 1973.

Payroll employment dropped sharply in late 1974, ending a three-year uptrend

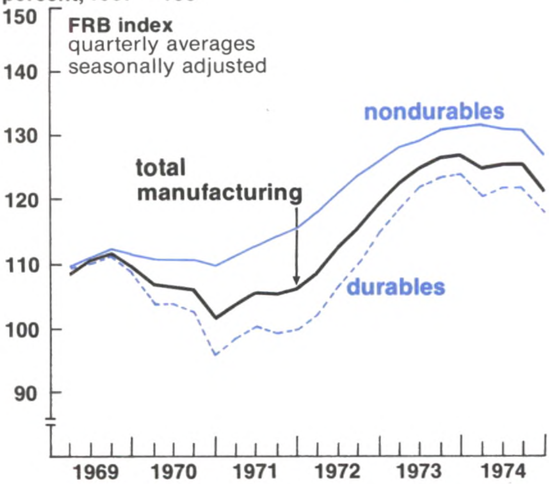


Prices paid by consumers averaged 11 percent higher in 1974, following increases of 6 percent in 1973 and 3 percent in 1972. The rise in consumer prices was the largest since the 1946-47 period when World War II price controls were removed. Food prices were up 15 percent and fuel oil and coal averaged 58 percent higher. With prices of essentials up sharply, many consumers curtailed outlays on autos, appliances, furniture, and vacation travel. Sales of virtually all big ticket items were off substantially in 1974, with especially large drops in the fourth quarter. Consumer credit was used less freely and the savings rate rose in the fourth quarter.

Factory output falls

Manufacturing output declined 1 percent last year following gains of 10 percent in 1973 and 8 percent in 1972. From January through September, total manufacturing activity was remarkably stable. The picture varied greatly by industry, however, with residential building materials and autos sharply lower than a year earlier, while output of business equipment and many consumer goods was at record levels.

Output of both durable and nondurable goods declined



Shortages of a wide variety of materials and components, including virtually all metals and chemicals, hampered production of many finished manufactured goods through the first nine months—through year-end in some cases. Strikes, more frequent than in any year since World War II, also held back manufacturing activity. The coal strike in November and December, the year's most serious single work stoppage, forced a reduction in steel output.

Manufacturing output in most industries dropped very rapidly in the fourth quarter, both because of a reduction in demand for finished goods and because businesses at all levels were attempting to reduce inventories. In December manufacturing output was down almost 8 percent from the November 1973 peak. Rapidly dwindling order backlogs indicated that the decline in factory output would continue into early 1975.

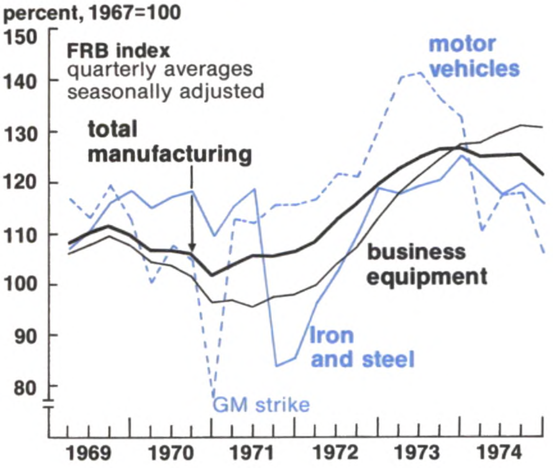
Steel, autos, and equipment

Steel mill shipments totaled 110 million tons, only slightly less than the record set in 1973. In both years mill inventories of finished and semifinished steel were reduced sharply to satisfy customer demand. Steel production would have been even larger last year but for shortages of coke, scrap iron, and ore.

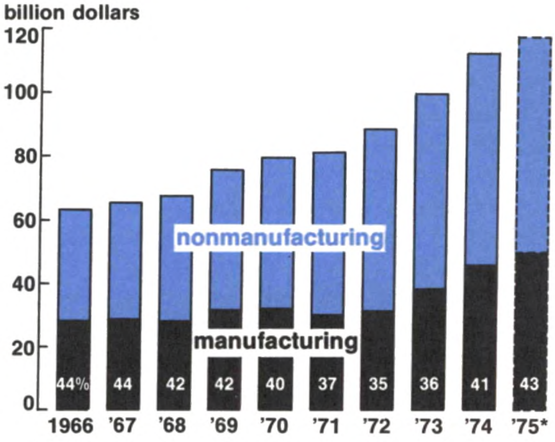
Auto producers assembled 7.3 million passenger cars in 1974, down 25 percent from the record total of 1973 and the lowest for a year not affected by a major strike since 1962. In the final months of the year output was at a rate of about 6 million units. Truck output was down about 10 percent to 2.7 million units. Demand for heavy trucks remained very strong before plummeting in the fourth quarter.

Output of producer goods was up 6 percent in 1974. Through most of the year de-

Business equipment output remained strong, but motor vehicle output plummeted



Total plant and equipment outlays are expected to rise more slowly



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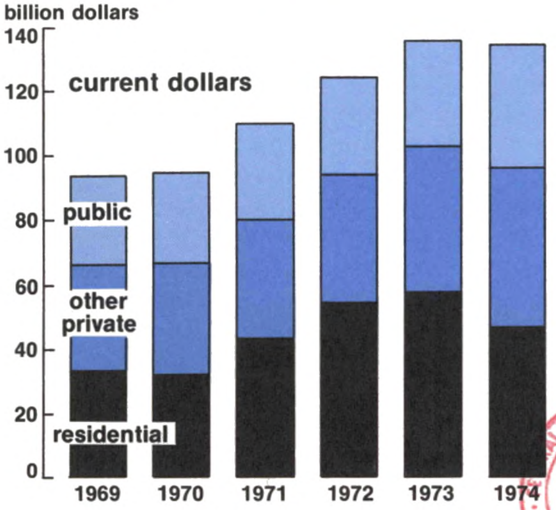
mand for virtually every type of equipment for agriculture, construction, mining, transportation, chemical processing, materials handling, and metalworking was so strong that lead times on new orders were two or three times as long as normal. At year-end order backlogs for heavy equipment for basic industries were still large.

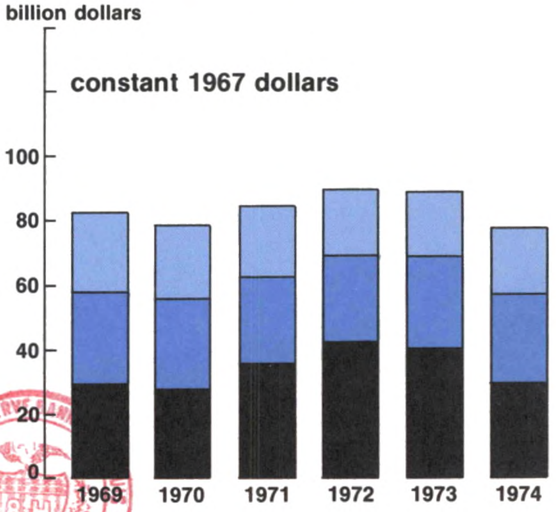
Housing and construction

The value of construction put in place in 1974 exceeded $134 billion, only 1 percent less than in 1973. After adjustment for inflation, however, construction activity was down 13 percent and was at the lowest level since 1968. Residential construction

Construction spending was down only slightly in current dollars . . .



but was down sharply after adjustment for inflation



was off much more than the total. In sharp contrast, industrial construction rose substantially as manufacturers pushed expansion plans.

Housing starts dropped to 1.34 million, compared to 2.06 million in 1973 and a record 2.38 million in 1972. By December the rate of housing starts had dropped to less than 900,000. Factory shipments of mobile homes, which had been maintained near 575,000 units in both 1972 and 1973, dropped to 375,000 in 1974, and the annual rate late in the year was only 220,000. The net addition to the housing stock was well below the rate of net household formation in the fourth quarter of 1974. An easing of credit availability could be expected to help sales of both conventional housing and mobile homes.

With expansion programs well underway, industrial construction will probably remain at a near record level in 1975. Electric utilities, however, have been reducing construction budgets since midyear. Commercial construction probably will continue at a reduced level, especially in areas where a surplus of office and shopping space exists. Release of federal funds for construction of water and sewerage systems, and for various other public works, suggests an increase in total public construction.

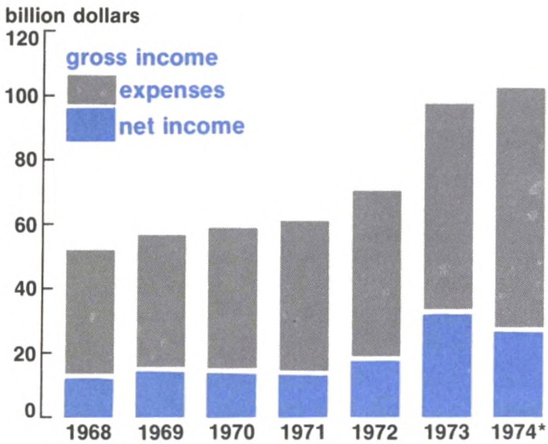
Mixed year for farmers

Highly adverse weather conditions and substantial losses on cattle feeding operations dominated the farm picture in 1974. Gross farm income rose to a record level, nevertheless, because of higher crop prices and increased marketings of livestock. Profits were lower, however, as a result of a 16 percent rise in prices paid by farmers and the near-elimination of government payments. Net farm income dropped from a record $32 billion in 1973 to about $27 billion, but was still well above any earlier year. Results for various farm sectors varied widely.

Crop growing conditions proved to be the worst in many years. A sequence of floods in the late spring, severe drought in the summer, and an early frost dashed initial hopes for a large rise in total crop output. The total crop harvest was the lowest since 1970, with corn and soybeans especially hard hit.

The combination of reduced production and continued strong demand, domestic and foreign, caused crop prices to average almost one-third higher than in 1973. Livestock prices, conversely, averaged substantially lower because of increased marketings.

Net farm income declined as rise in expenses offset larger receipts



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Bad weather cuts crops

Early in 1974 grain producers planned to boost production substantially. Projections based on surveys of planting intentions indicated a large expansion in total crop acreage and probable record harvests for most major crops. A primary concern was the apparent shortage of fertilizer.

By late spring bad weather began to take its toll. Drought plagued the wheat crop, while heavy rains in the Corn Belt substantially delayed the completion of corn and soybean plantings. In the summer the Corn Belt was hit by drought with resulting poor stands and slowly maturing plants. Finally, frosts in late September and early October prematurely ended the growing season throughout most of the Corn Belt. Nationwide, these conditions resulted in:

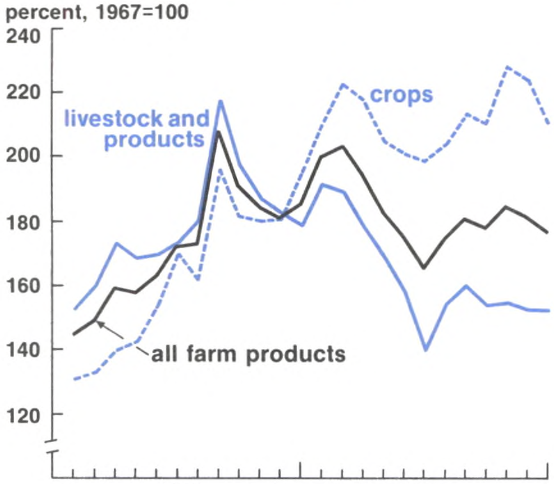
- A 1.8 billion bushel wheat harvest, up only 5 percent despite a 21 percent rise in planted acreage.
- A 4.7 billion bushel corn crop, down 18 percent from 1973 even though planted acreage was up 8 percent.
- A 1.2 billion bushel soybean harvest, down 20 percent compared to only a 5 percent drop in planted acreage.

As these developments unfolded, the Chicago cash price for corn moved from a 1974 low of $2.55 per bushel in early May to a high of $3.95 in early October. Following much the same pattern, soybean prices rose from $5.35 to about $9.00 per bushel. Although significant contraseasonal price declines occurred late in the year, both corn and soybean prices were about 25 percent above year-earlier levels at the end of 1974. Wheat prices, however, were substantially below year-earlier levels.

Reduced supplies of grain necessitate that both domestic utilization and exports of grains and soybeans must decline sharply from the high levels of the past few years. Recent adjustments by livestock producers may have trimmed domestic feed grain demand about in line with available supplies, but indications of foreign demand remained substantial early in 1975. Carryover stocks prior to the 1975 harvest will be below the reduced levels of last year.

Preliminary estimates indicate that winter wheat plantings in the fall of 1974 were up 6 percent to a 22-year high. Plantings of feed grains and soybeans this spring also are expected to be higher. Larger plantings, coupled with greater availability of fertilizer, equipment, and supplies suggest record 1975 harvests, assuming normal weather conditions.

Farm prices averaged record high in 1974, but downtrend prevailed most of the year



Livestock farmers hurt

Lower livestock prices coupled with markedly higher feed prices resulted in losses for many livestock producers, particularly cattle feeders and dairy farmers. In some cases feedlot operators sustained losses in excess of $100 per head of cattle sold. Cumulative losses of cattle feeders since the end of the third quarter of 1973 are estimated at $1.7 billion, about 15 percent of their annual receipts.

The financial squeeze on livestock producers caused a substantial reduction in both the numbers of cattle moving through feedlots and the inventory of hogs held for breeding purposes. Despite reduced feedlot activity, cattle slaughter was up about 9 percent last year, with sharply higher slaughter of cows and range-fed steers and heifers adding to the supply. Similarly, hog slaughter rose 6 percent from the low 1973 level, paced by a 28 percent rise in sow slaughter. Increased slaughter boosted red meat production in 1974 near the record established in 1971.

Red meat production may decline somewhat in 1975 with a sharp reduction in pork more than offsetting an anticipated rise in beef. Inventories of hogs and pigs are low and producers' farrowing intentions are down from last year. Pork production per capita may decline from 67 pounds last year to less than 60 pounds, the lowest level in 40 years. On the other hand, record total cattle inventories suggest a substantial increase in cattle slaughter. Inventories of cattle on the range are large. The number on feedlots is 26 percent below the year-earlier level.

Despite higher prices, dairy farmers also experienced a severe cost/price squeeze. Milk prices received by farmers averaged $8.31 per hundredweight during 1974, well above the 1973 level of $7.14.

Nevertheless, the milk/feed price ratio—a rough measure of profitability—averaged 1.34, down from 1.47 a year ago and 1.73 in 1973. These conditions fostered heavy culling of the dairy herds—particularly during the first half of the year—and held down the rise in milk output per cow. Consequently, total milk production for 1974 declined slightly from the 21-year low established in 1973.

Consumer resistance to sharply higher retail prices of fluid milk implied a 4 percent decline in sales, somewhat more than the decline in output. As a result, a larger quantity of milk was used in manufactured dairy products, such as cheese, dry milk, and butter. Rising supplies of these products reduced wholesale prices in the summer and triggered large government purchases to support prices.

Milk production this year will probably remain at a reduced level, even though low prices for slaughter cows will lessen the incentive to cull dairy herds. Lower production is anticipated at least for the first part of 1975, as high grain prices result in altered feeding rations. Lower feed prices and higher support prices may stimulate production later in the year.

Trade restrictions imposed

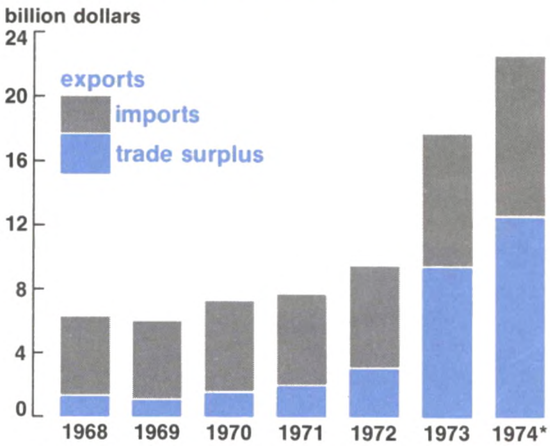
Various governments imposed restrictions on trade in agricultural products last year. Japan and the EC imposed several measures to restrict beef imports, partly to conserve foreign exchange and partly to protect local producers faced with rising world supplies. In April Canada placed an import embargo on cattle and beef produced with DES, a diet supplement used in the United States to hasten growth of cattle. The Canadian embargo was replaced in August by a system of import quotas.

The United States also restricted trade in farm products last year. In October concern over the small grain harvests and an unexpectedly large USSR grain purchase led to "voluntary" export controls on wheat, feed grains, and soybeans. In November the United States attempted to force a removal of the Canadian import quotas by imposing quotas on imports of Canadian livestock and products.

Despite the trade restrictions, U.S. agricultural exports in 1974 rose 27 percent to $22.5 billion. All of the increase reflected higher world prices. Moreover, reduced shipments, in physical volume, in the second half completely offset first-half gains. In physical volume, corn shipments were down 9 percent and wheat shipments were almost one-third less, but soybean exports were 8 percent higher.

Grain exports will be down sharply in the early months of 1975, in physical terms, largely because of reduced supplies. Higher prices, however, probably will hold the value of agricultural exports near year-earlier levels at least in the first half of 1975. Large crop harvests in 1975 would boost supplies for export. Foreign demand for current consumption may not recover rapidly, but lower prices would enhance demand to restore world reserve stocks.

Surging exports boosted the trade surplus in the agricultural sector



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Higher food prices

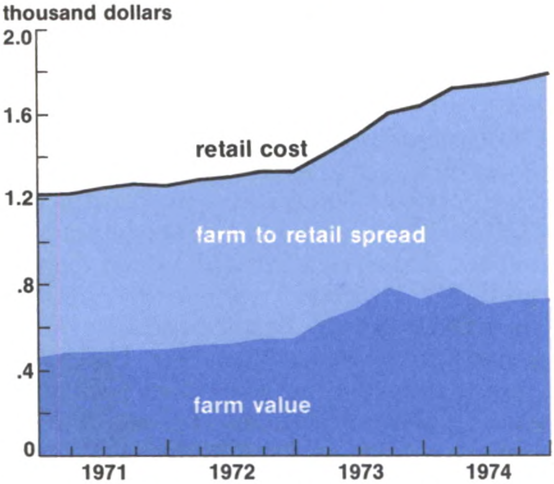
Retail prices of food consumed at home averaged 15 percent above year-earlier levels in 1974, only slightly less than the 16 percent rise in 1973. Increases in food prices were particularly large early in the year when prices of fruits and vegetables, dairy products, and cereal and bakery products rose rapidly. Despite higher prices, per capita food consumption rose to a record high last year following the slight downturn in 1973.

Total outlays on food rose 17 percent to $154 billion, one of the largest increases on record. Higher processing and distribution costs accounted for nearly four-fifths of the rise, much more than in 1973.

Labor costs accounted for about 44 percent of total food processing and distribution costs. Average hourly earnings in the food processing and distribution industry were up more than 10 percent last year, somewhat more than for workers generally. Other factors included large increases in costs of rail and truck transportation, packaging materials, and energy. Although accounting for only about 4 percent of the total marketing bill, rising profits were also a factor.

Food prices will continue to rise rapidly in 1975, especially in the first half with a slower rise possible in the second half. Reduced livestock marketings probably will boost average farm prices and processing and distribution costs will continue to rise. Consumers can be expected to attempt to maintain spending on food even if purchases of nonfood items are curtailed. Moreover, increased participation in government food programs will tend to support overall food demand.

Higher market basket food costs reflected wider farm-to-retail price spreads



Note: The market basket contains the average quantity of food purchased annually per household.

Farm land values and debt

Farm land values continued to rise rapidly in 1974 despite reduced net income. Nationally, land prices were up about one-fifth. For the fourth consecutive year the appreciation in land exceeded net farm income. In the district, increases in farmland prices ranged from a low of 14 percent in Michigan to a high of 30 percent in Illinois, according to a survey of country bankers.

Although credit conditions were more restrictive, rising land values and the resulting demand for credit to finance farmland transfers led to a 15 percent boost in outstanding farm real estate debt in 1974. Non-real estate farm debt also rose rapidly. Total farm debt reached $95 billion at the end of 1974, up $11 billion from the year-earlier level and the largest increase on record.

World trade patterns disrupted

Virtually all nations experienced rapid price inflation in 1974 in the face of slowdowns or declines in output of goods and services. With sharp increases in oil prices playing a major role, policymakers were forced to deal with massive imbalances in international payments, much greater than in 1972 or 1973. Poor crops, shortages of many industrial materials, and widely fluctuating commodity prices created further complications. Concern over international liquidity and the viability of business and financial institutions also became intense during the year. Widespread political instability and changes in the governments of several major nations reflected chaotic economic developments.

Permeating the international developments of 1974 were issues concerning petroleum—its availability, its cost, and its financing. Initial concern centered on cutbacks in production and restrictions on exports by members of the Organization of Petroleum Exporting Countries (OPEC). The restrictions included an embargo by several Arab OPEC members on oil shipments to the United States, the Netherlands, South Africa, and Rhodesia. The embargo was initiated in October 1973 and began to be relaxed in March 1974. As production cutbacks and export restrictions were relaxed, the availability of oil was no longer an immediate problem. Attention increasingly focused on the surge in oil-import prices, which for the United States reached an average of about $11.70 per barrel (customs valuation) in August. This compared with average imported prices of $7.30 in January 1974, $3.60 in October 1973, and $2.70 in January 1973. Along with the multifold increase in petroleum prices came the issue of paying for and financing oil imports—the complex of issues that commonly became known as oil funds recycling.

Prior to the oil price increases at the turn of the year, the United States—with exports exceeding imports in 1973 for the first time since 1970—anticipated another trade surplus in 1974. Instead, as the year progressed the United States was faced with prospects for a trade deficit of several billion dollars. Countries such as Britain or Italy were confronted with trade account deficits much larger than anticipated earlier. Germany was one of the few oil-importing countries that recorded a trade account surplus in 1974.

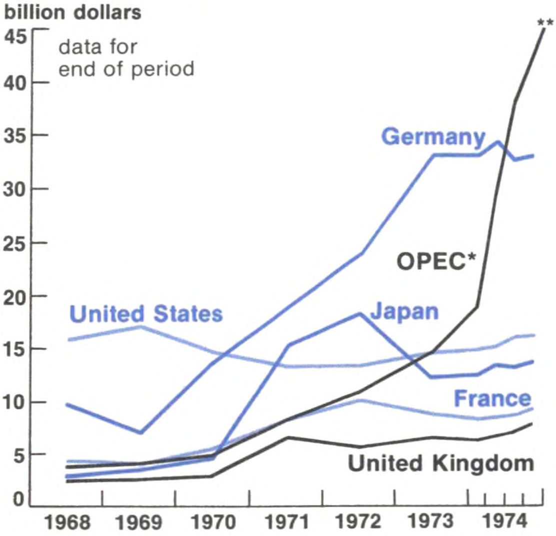
Investing oil funds—financing oil imports

Combined, the countries of OPEC accumulated a trade account surplus in 1974 that has been estimated as equivalent to $60 billion from oil sales of about $95 billion. The abrupt increase in financial wealth and the consequent redistribution of world resources from oil-importing countries to oil-exporting countries became the focal point of international economic and monetary activity during the year. An immediate problem was faced by oil importers—how to finance the additional billions of dollars worth of oil imports. Soon thereafter, oil exporters, many of them with small populations and limited needs for imports, had to make difficult decisions on how to utilize the sudden influx of billions of dollars worth of oil fund receipts.

Various means were employed by the oil-importing countries to finance oil deficits. Consortia bank loans and government-to-government loans were used extensively. The International Monetary Fund (IMF) established a special oil facility with funds obtained primarily from loans by oil-exporting countries. Oil exporters also made grants and loans to developing countries. Other arrangements included bilateral trade agreements between oil exporters and oil importers.

OPEC countries sought investment outlets on a large scale, primarily in short-term securities in the United States, the Euro-currency markets, and Britain. Smaller amounts were placed in other countries, both developed and developing, and in international institutions such as the World Bank. Through year-end, relatively few funds had been placed either in longer-term debt instruments or in equities.

International reserves were profoundly affected by higher-priced oil



*Includes data for ten OPEC members; Algeria, Equador, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Saudi Arabia and Venezuela.

**End of December data, except for end of November data for Iraq and Saudi Arabia.

Many industrial countries, especially Japan and the Western European countries, provided incentives to increase exports in 1974. Partly, this was to help pay for higher-priced imports, oil, and other commodities, and partly to offset sagging domestic demand. These efforts had limited success because of falling demand for imports in most developed countries.

International monetary reform

The International Monetary Fund's Committee of 20 which had been formed in 1972 and charged with developing the framework for a new world monetary system reported at midyear that "... in view of present uncertainties related to inflation, the energy situation and other unsettled conditions, it is not appropriate to attempt to determine the full details of all aspects of the future international monetary system, many of which can better be decided in the light of future developments."

Several interim arrangements were put in operation by the IMF, however, including the oil facility designed to assist members in financing the initial impact of higher petroleum costs. Further, the valuation of the international reserve asset SDR was tied to a basket of 16 currencies, rather than solely to the U.S. dollar. In addition, a set of general principles was established to guide central banks in the appropriate management of floating exchange rates so as not to aggravate international exchange problems of other countries. To monitor the operation and adjustment process of the monetary system, a new 20-member IMF interim committee was established.

Trade balance shows deficit

U.S. merchandise exports rose 38 percent in 1974 to $98 billion, while imports rose 45 percent to $101 billion. The

Economic events in 1974—a chronology

JAN 2 Nixon signs bill to reduce speed limit to 55 mph.

JAN 3 Federal Reserve Board reduces margin requirements on stock purchases from 65 to 50 percent.

JAN 18 The Federal Energy Office says that the Arab oil embargo is fully effective.

JAN 29 All U.S. controls on foreign investments are suspended.

JAN 31 Independent truckers begin 11-day strike to protest high fuel prices and reduced speed limit.

FEB 21 The AFL-CIO Executive Council decides on a 12 percent target for wage boosts.

FEB 28 Nixon says "no gas rationing" despite lines at gas stations.

MAR 8 The International Bauxite Association is established as an aluminum ore cartel.

MAR 8 Henry C. Wallich joins the Federal Reserve Board.

MAR 13 The Dow industrials close at 892, the high for the year. (See Dec. 6.)

MAR 18 Arab oil embargo is lifted.

APR 4 Shortages ranging from "abrasives to zinc" are reported.

APR 12 The United Steel Workers agree to a pattern-setting three-year pact providing for a 40 percent increase in wages and benefits.

APR 15 Thrift institutions report savings losses as "disintermediation" returns.

APR 24 Consolidated Edison omits a dividend for the first time in its history, reflecting the financial squeeze on electric utilities.

APR 25 The Federal Reserve discount rate is raised from 7.5 to 8 percent.

APR 30 The Economic Stabilization Act expires, ending general price and wage control authority; the Committee on Interest and Dividends expires.

MAY 2 Minimum wage rises from $1.60 to $2.00 per hour.

MAY 8 William Simon succeeds George Shultz as Secretary of the Treasury.

MAY 10 Franklin National Bank omits dividend due to foreign exchange losses.

MAY 24 First Mortgage Investors omits a dividend, reflecting the financial difficulties of many REITs.

JUN 4 Various electric utilities are reported to be deferring expansion projects.

JUN 26 Germany's Bankhaus Herstatt collapses with worldwide repercussions.

JUL 3 The fed funds rate averages a record 13.5 percent in the previous week.

JUL 3 Major banks raise their prime rates to a record 12 percent.

JUL 5 Emergency Livestock Credit Act guarantees loans to hard-hit farmers.

JUL 12 Usury ceiling on Illinois home mortgages is raised from 8 to 9.5 percent until July 1, 1975.

JUL 12 Congressional Budget and Impoundment Control Act of 1974 becomes law. (See Dec. 11, 1974.)

JUL 16 The Labor Department reports more strikes than at any time since World War II.

JUL 18 Reports indicate machinery output slowed by shortages of major components.

JUL 23 The Federal Financing Bank sells its first debt.

JUL 24 Citicorp sells $850 million of innovative variable rate notes.

AUG 9 Gerald Ford becomes President as Nixon resigns.

AUG 12 The Department of Agriculture says drought will hurt the crops.

AUG 20 Industry sources report very weak demand for major appliances, except freezers.

AUG 20 Financial press carries reports of many firms shifting to LIFO to cut taxes.

AUG 26 The Treasury sells 3-month bills at a record 9.91 percent yield. (See Dec. 20.)

AUG 28 The Bell System sells 40-year bonds at a record 10 percent.

SEP 4 The Federal Reserve Board eliminates marginal reserve requirements on longer-term CDs.

SEP 9 Purchasing managers report no rise in new orders in August, first time since January 1971.

SEP 10 FNMA auction of commitments produces a record 10.6 percent yield.

SEP 18 Natural gas suppliers announce sharp cutbacks to industrial users.

SEP 19 Builders report funds for residential and commercial construction all but dried up.

SEP 23 A very early frost hits crops in the northern Cornbelt.

SEP 25 The Federal Reserve Board establishes a higher discount rate on loans to member banks requiring exceptionally large assistance for long periods.

SEP 27 The President's "Economic Summit" meeting is attended by 800 delegates.

OCT 6 President Ford obtains cancellation of large grain sales to USSR.

OCT 7 Voluntary export controls are placed on grains and soybeans.

OCT 8 The Comptroller of the Currency declares the Franklin National Bank insolvent.

OCT 8 President Ford's program to fight inflation includes a 5 percent tax surcharge.

OCT 11 Businesses report that shortages suddenly have given way to surpluses.

OCT 15 Heavy layoffs are announced by appliance producers.

OCT 29 Phillip E. Coldwell joins the Federal Reserve Board.

NOV 5 Elections give Democrats large majorities in Congress.

NOV 12 The coal strike begins. (See Dec. 9.)

NOV 13 Federal Reserve Board approves a restructuring of reserve requirements to encourage longer-term time deposits.

NOV 20 Auto makers announce layoffs and capital outlay reductions as sales slump.

NOV 27 FDIC insurance coverage is raised from $20,000 to $40,000.

NOV 29 Many textile firms report layoffs.

DEC 6 The Dow industrials close at 578, lowest since October 1962. (See Mar. 13.)

DEC 6 The Federal Reserve Board authorizes banks to issue six-year investment certificates yielding up to 7.5 percent.

DEC 9 The Federal Reserve discount rate is reduced from 8 to 7.75 percent.

DEC 9 The Comptroller of the Currency says 150 banks are under scrutiny.

DEC 9 Coal production resumes at some mines. (See Nov. 12.)

DEC 11 Congress exercises its new power over Presidential impoundment of funds by rejecting most proposed spending cuts.

DEC 19 Oil companies are reported to be cancelling plans to expand refining capacity.

DEC 20 The Treasury sells 3-month bills to yield 6.96 percent. (See Aug. 26.)

DEC 20 Congress approves the Trade Reform Act permitting new international trade negotiations.

DEC 24 Long lines are reported at unemployment offices.

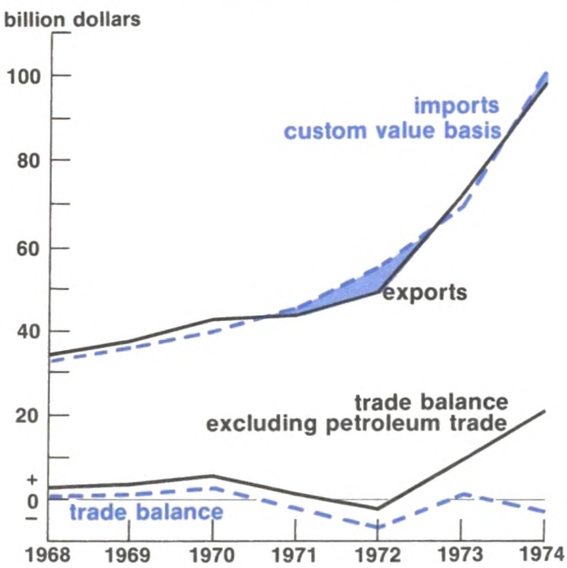
DEC 31 American citizens can buy gold, first time in 40 years.

resulting $3 billion deficit reversed a $1.4 billion surplus recorded in 1973. This deficit reflected higher prices for imported oil. The physical volume of oil imports was down slightly from 1973, but the total cost rose from $8 billion to almost $25 billion as prices averaged more than three times as high.

Without the sharp rise in oil prices, a substantial trade surplus probably would have been achieved last year. Crude oil and petroleum products accounted for one-fourth of total imports, compared with 11 percent in 1973. A large share of the rise in other exports and imports also reflected higher prices.

Exports rose last year on a wide front. The value of exports of industrial supplies and materials was up 55 percent, and that of nonautomotive capital equipment was up 40 percent. These two broad categories have accounted for about 60 percent of U.S. exports in recent years. The value of exports of consumer goods, agricultural commodities, and motor vehicles also rose substantially.

U.S. nonpetroleum trade increased sharply in 1974



Exports and imports of services and earnings on investments also are important in the nation's balance of payments. While complete data are not yet available for 1974, it appears that the United States had a surplus on services and on earnings on investments, although not so large as the deficit on merchandise.

Trade reform

The "Trade Reform Act of 1974," passed late in the year, became law in January 1975. A major provision authorizes the President to enter multilateral negotiations directed toward reductions in tariffs and in non-tariff trade barriers. The law also provides for preferential reductions of selected tariffs on goods from most developing countries (OPEC members are a major exception) and permits the conditional extension of most-favored-nation tariff status to additional countries—primarily the USSR.

Government assistance to firms, individuals, and communities suffering economic injury resulting from a relaxation in trade barriers is expanded by the act. The President also is granted greater discretion in retaliating against "unfair" trade practices of other countries. The new act provides the President with increased flexibility in charting U.S. trade policy, but the Congress retains veto power over selected administration trade decisions.

International finance

Various restrictions on international transfers of funds were removed or relaxed in major western countries early in the year. The Federal Reserve System's Voluntary Foreign Credit Restraint Program restricting foreign investments of financial institutions and the Commerce Department's Foreign Direct Investment Program restricting investment of nonfinancial firms were terminated in

January. The Treasury Department's Interest Equalization Tax discouraging investments in foreign securities by U.S. residents was effectively terminated when the tax rate was reduced to zero in January 1974. The tax was allowed to lapse at midyear when the law on which it was based was not renewed.

Intense uneasiness developed in financial circles around midyear concerning the state of bank liquidity in leading industrial countries. Substantial losses were incurred in foreign exchange transactions by several international banks. In response, the governments of major countries—including the United States, the United Kingdom, Germany, and Switzerland—imposed regulations restricting foreign exchange dealings by banks and/or required detailed reporting of bank positions in foreign currencies.

International banks were heavily involved in the placement of oil funds during the year. Their activities included facilitating investments of oil funds and the negotiation of multinational, multibank loans to governments to assist in financing balance-of-payments deficits. U.S. banks also greatly expanded their role in financing foreign trade, with outstanding bankers' acceptances financing third-country trade almost quadrupling to $10.1 billion as of December 31, 1974, up from $2.7 billion a year earlier.

The international banking sector of the Chicago banking community expanded further in 1974. By year-end, 19 state licenses for branches of foreign banks had been approved for the Chicago "Loop" area, up from four a year earlier. Three additional applications were pending at the end of 1974. The number of Chicago-based Edge Act banking subsidiaries conducting an international banking business increased from three in 1973 to six in 1974.

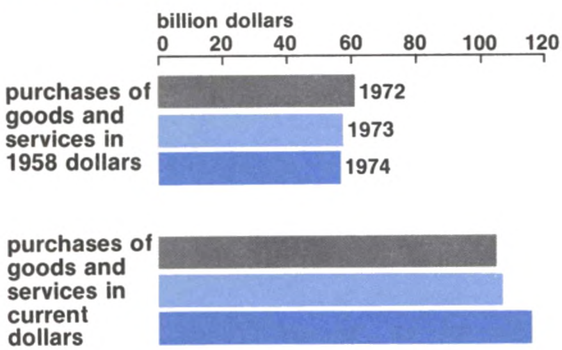
Government purchases accelerate

Purchases of goods and services by federal, state, and local governments exceeded $308 billion in 1974, up 12 percent for the fastest rise since 1967. As in the private sector, prices and salaries ("services" purchased by governments are largely salaries) paid by governments rose rapidly. Little, if any, increase in total spending occurred after adjustment for price increases. Few new programs were implemented and some were curtailed or postponed at the federal and the state and local levels.

Federal purchases rose 9 percent to $116 billion, while state and local purchases rose 13 percent to $192 billion. Federal purchases were 8.3 percent of GNP, virtually the same as in 1973 when this ratio was the lowest since 1950. State and local purchases were 13.8 percent of GNP, continuing the steady rise from 5 percent of GNP just after World War II. Over one-fifth of all state and local outlays are now financed through federal grants-in-aid. These grants support a wide variety of functions, especially education.

As usual, defense spending dominated direct federal purchases accounting for $79 billion, or 68 percent of the total. Although defense purchases were up 6 percent from 1973, they merely returned to the level of 1969. Last year's rise was largely accounted for by salary increases for military personnel and expenses required to complete the transition to an all-volunteer armed service. The armed services numbered 2.2 million in the second half of 1974, down from a peak of 3.6 million in the autumn of 1968. The last draftees were discharged in November.

Inflation drives up federal purchases



Federal civilian employment averaged 2.73 million, up 2.6 percent from 1973. State and local employment averaged 11.56 million, up 4.3 percent. Federal employment returned to the 1970 level, after three years of declines, while state and local employment averaged almost 18 percent higher than in 1970.

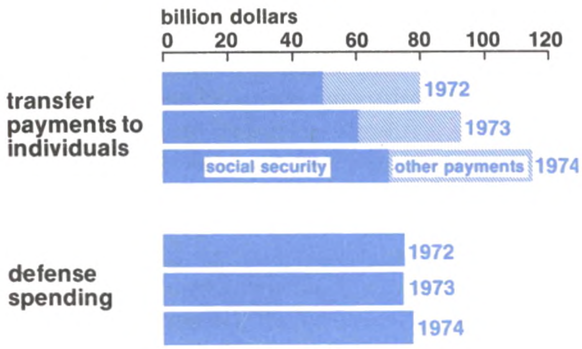
Federal receipts and outlays

Total federal outlays include a wide variety of nonpurchase expenditures that are not included in the federal government sector of gross national product. Nonpurchase expenditures have accounted for an increasing portion of total federal outlays since 1953. Since 1969 they have accounted for more than one-half the total, and in 1974 they exceeded 60 percent of the total.

Federal outlays in 1974 totaled almost $299 billion, an increase of $34 billion over 1973. Of this increase, $24 billion went for nonpurchase expenditures and $10 billion for purchases of goods and services.

Federal nonpurchase expenditures are mainly transfer payments to persons, grants-in-aid to state and local governments, and interest. Social security

Federal payments to individuals increasingly exceed defense outlays



payments alone took $70 billion of the $114 billion of federal transfer payments to persons during 1974. Individuals received an 11 percent increase in social security benefits last year. Other transfer payments to persons include veterans' benefits and unemployment insurance.

The most recent major change in social security legislation linked the level of benefits to the consumer price index. As a result, an increase in benefits of almost 9 percent is scheduled to become effective in July 1975. In a related development income subject to social security taxes was raised to $14,100 on January 1, 1975, an increase of $900.

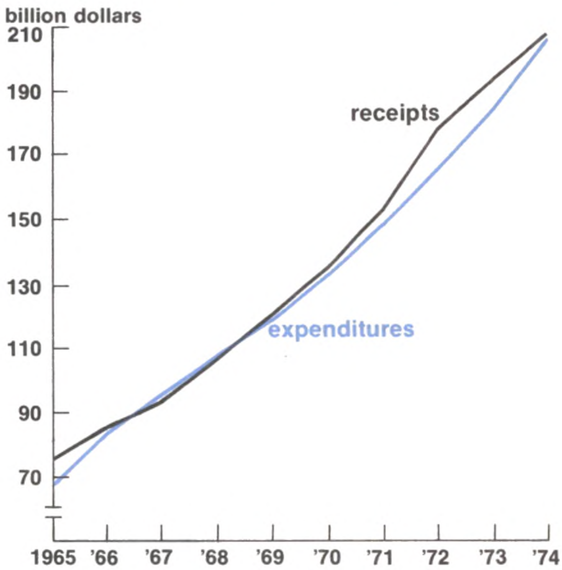
The federal deficit (National Income Accounts basis) was about $7.6 billion in 1974, up from $5.6 billion in 1973 and substantially smaller than the $17.5 billion recorded for 1972. Government programs for dealing with the major problems of recession, inflation, and energy shortages are not established in detail, but tax reductions and increased outlays are virtually certain. Prospects for lagging receipts—reflecting both a declining economy and probable tax reductions—and increased spending point to a very large federal deficit in 1975, probably the largest since World War II.

State and local finance

Total outlays of state and local governments (about 90 percent are for purchases of goods and services) have increased about 11 percent each year for the past decade. Last year these outlays reached $206 billion. The total would have been larger were it not for the fact that the federal government took over payments to the blind and to certain other types of disabled individuals during the year.

Revenues of state and local governments increased less in 1974 than in 1973, partly because of the slowing of the economy, but also because many state and local governments used federal revenue sharing funds to reduce taxes. A common form of tax relief was the reduction of property taxes for senior citizens, the blind, and disabled. No new federal programs to aid state and local governments were initiated in 1974, and some existing programs were constrained by Presidential impoundment of funds appropriated by Congress.

State and local government surplus narrowed in 1974



As 1975 began, the combination of the business slowdown and continued inflation suggested that expenditures of state and local governments would continue to grow faster than revenues. Legal requirements will force many of these governments to cut outlays or raise taxes to achieve balanced budgets, and others will attempt to do so to avoid increasing their debts.

Stringent conditions are not universal. Several states again are considering tax cuts because of accumulated or anticipated surpluses, following the trend of 1973 and 1974. Most states, however, are implementing or are considering tax increases for the first time in several years. Local governments have less tax flexibility than state governments. Many cities and counties have announced freezes on hirings and some have laid off personnel in recent months.

Financial markets strained

While the gross national product was 8 percent larger in current dollars in 1974 than in 1973, net funds raised in the credit markets declined slightly. The money supply (M_1), defined as demand deposits plus currency in the hands of the public, rose 4.5 percent in the 12 months ending in December, compared to 6 percent in the previous 12 months.

With the supply of loanable funds limited, strong demands for credit, especially from business, pushed short- and long-term interest rates to record highs. In the fourth quarter, reduced economic activity combined with easier monetary policy caused interest rates to decline.

Faced with the need to finance rising investments in inventories and fixed assets at inflated prices, the business sector raised substantially more funds last year than in 1973. Nevertheless, many firms encountered a cash squeeze and were forced to take steps to pare expenses and investments. The volume of credit channeled to the household sector was lower in 1974 as residential construction and purchases of durable goods declined. State and local governments required about as much financing as in 1973, while federal cash borrowing was up almost 50 percent. Borrowing by federal agencies assisting housing increased significantly. Total federal agency borrowing again exceeded direct Treasury borrowing.

As in earlier periods of credit restraint, savings flows shifted from deposit-type accounts to direct market investments in search of higher yields—a process known as "disintermediation." As a result, savings and loan associations and mutual savings banks were hard put to honor commitments to make mortgage loans. The commercial banking system was less affected by disintermediation because major money market banks were able to sell large certificates of deposit (CDs) exempt from rate ceilings. Savings inflows improved in the fourth quarter, both at thrift institutions and at commercial banks.

Money, credit, and short-term rates

As 1974 began, most interest rates were below their 1973 peaks. Further declines, especially in short-term rates, were generally expected. Forecasts of declines in interest rates, widely publicized as late as March and April, were believed to be consistent with projections, accurate in retrospect, of continued sluggish economic activity throughout the year.

These expectations failed to materialize as the Federal Reserve, in its concern with inflation, refused to provide the reserves necessary to accommodate the very heavy credit demands. Monetary policy in 1974 was focused on the achievement of quantities of money and credit judged consistent with stable economic growth. As a result, interest rate developments were related mainly to two factors—the strength of current credit demands and investors' views about the future rate of inflation. The Federal Reserve continued to supply the liquidity necessary to cushion the impact of temporary disturbances in the financial markets. But, an expansion in money and credit sufficient to keep interest rates stable in a period of rapidly rising expenditures could only fuel inflation which, in turn, would ensure even higher interest rates in the long run.

With the end of the oil embargo and rapid price acceleration, credit demands rose sharply and M_1 expanded at an annual rate of more than 9 percent in February and March. Although later revised downward, at midyear estimated second-quarter growth was at a 7 percent annual rate, for a five-month pace near 8 percent. Bank loans to business rose at a 24 percent seasonally adjusted annual rate in the first half.

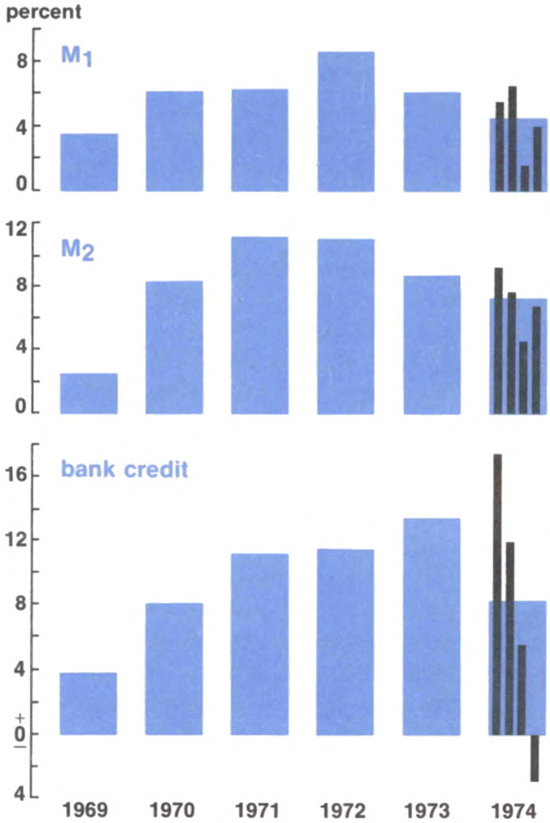
As these developments unfolded, the System allowed money market conditions to tighten in order to moderate the rate of monetary growth. The basic discount rate was increased from 7.5 to 8 percent in April, and short-term market interest rates rebounded to new record levels. The prime lending rate of the large commercial banks moved to a record 12 percent in July, and formulas calculated by some banks indicated an even higher rate. Yields on 3-month Treasury bills approached 10 percent in the summer, and the federal funds rate (paid on borrowings by one bank from another) reached 13.5 percent.

Money market pressures were intensified beyond the degree sought by the Federal Reserve by news of liquidity problems of various banks, other financial institutions, and business firms, both here and abroad, and problems created by international flows of oil-related funds. Assurance by the Federal Reserve authorities that moderate bank deposit expansion would be supported and that individual temporary liquidity problems would be alleviated by the "lender of last resort" helped to ease these tensions and interest rates receded from peak levels in the late summer.

Although the money market had eased markedly by September, third-quarter growth in M_1 was quite small—less than 2 percent annual rate when measured between June and September and about 3.5 percent if the third-quarter average is compared with the second-quarter average. The broader measure of money, M_2 (which includes commercial banks' savings and time deposits other than large negotiable CDs as well as the components of M_1) and bank credit also leveled off as time deposit inflows slowed and restrictive bank lending policies began to affect loan volume.

Continuation of the slow third-quarter expansion rates in the aggregates was not considered consistent with the economy's longer-run needs, and the System continued to move cautiously to a more accommodative posture.

Growth in money and bank credit slowed in 1974



Note: M_1 = daily average of currency + demand deposits held by the public. M_2 = M_1 + time deposits other than negotiable certificates of deposit over $100,000. Bank Credit = Loans (including those sold to affiliates but excluding domestic interbank loans) and investments at all commercial banks.

Changes are seasonally adjusted annual rates, last month of period relative to last month of preceding period.

The money supply and bank deposits grew at a somewhat faster rate in the fourth quarter than in the third quarter. By year-end the federal funds rate had dropped back to 8.5 percent, and most other short-term market rates were near the levels prevailing at the start of the year. The Federal Reserve's discount rate was cut to 7.75 percent in December and to 7.25 percent in early 1975.

Long-term rates also rise

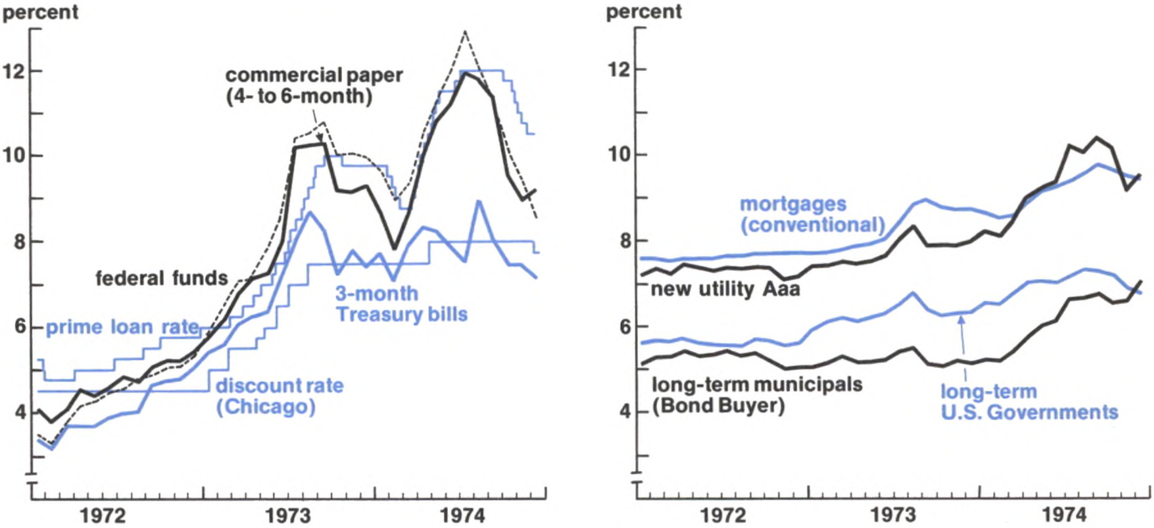
The volume of corporate debt securities sold publicly was twice as large in 1974 as in 1973. Movements in long-term interest rates generally followed the pattern of short-term rates, but, as usual, with a lag and with smaller fluctuations. Heavy marketings of securities pushed rates to record levels in the late summer with top-rated issues bearing yields of over 10 percent on five- to seven-year maturities. Many corporate issues were postponed or canceled.

The spread in yields between top-rated corporate securities and lower-grade issues was especially large in 1974, and this spread widened as the year proceeded. This reflected concern over the financial health of firms especially hard hit by inflation, high interest rates, and declining profits and sales. Some firms were unable to sell new securities on acceptable terms and some issuers of commercial paper found that they could not place their notes with investors.

The volume of tax-exempt municipal issues sold was about as large in 1974 as in 1973. Yields on municipals reached their highs for the year in December at over 7 percent. Proposed new municipal issues were postponed at various times during the year because of adverse market conditions.

Although the volume of mortgage loans declined in 1974, rates on new mortgages set record highs. Nationally, rates on new conventional home mortgages averaged 9.8 percent in September. In some states these rates were well over 10 percent. Usury ceilings held rates at lower levels in some states, but

Most interest rates had receded from record levels by year-end



Note: Market rates are monthly averages of daily figures.

these laws also had the effect of restricting the flow of mortgage funds. Mortgage rates eased moderately late in the year.

Smaller rise in bank loans

Commercial bank loans increased about 11 percent last year, about 40 percent less than in each of the two previous years. (These comparisons exclude loans to other domestic commercial banks.) Moreover, the pace of loan expansion slowed markedly as the year progressed.

Loans to business borrowers rose very rapidly in the first eight months of the year but at a much slower rate thereafter. Inflation increased needs for funds to finance inventories and receivables of manufacturers and trade firms. In addition, demand for loans from public utilities, real estate investment trusts (REITS), finance companies, and foreign banks was unusually strong. In some cases these borrowers were forced to turn to the banks because of difficulties in selling securities or commercial paper.

Real estate loans rose less than 10 percent in 1974, after rising 20 percent in each of the two previous years, and rose at an annual rate of only 5.6 percent in the second half. Consumer instalment loans rose at a much slower pace than in 1973 because of the slump in sales of automobiles and other durables.

The slower growth in bank loans in the second half resulted, in part, from more selective lending policies, reflecting both urgings of the monetary authorities and the desire of banks to improve their liquidity and asset quality. More restrictive lending practices were evident in the fact that large banks allowed an unusually large spread to develop between their prime lending rate and the market rate on commercial paper—an alternate source of funds for some firms. At year-end, 90-day commercial paper rates were down to about 9 percent, but most large banks still posted a 10.5 percent prime rate. The slowing in the rise of bank loans also reflected declines in demand from some industries with reduced volumes of activity and the repayment of bank loans with the proceeds of security sales.

Bank sources of funds

Time and savings deposits in 1974 again provided the major source of bank funds. However, time and savings accounts, other than CDs in denominations of $100,000 or more, rose only moderately because these deposits are subject to interest rate ceilings and higher yields were available on money market instruments.

All certificates of deposit of $100,000 or more have been exempt from interest ceilings since May 1973. As a result, major banks selling CDs were able to compete freely in the money markets for funds to support loan expansion in contrast to earlier periods of monetary restraint.

The net increase in negotiable CDs outstanding in 1974 was almost $29 billion, a new record. In the summer the rates paid on prime CDs reached a high of 12.25 percent, and some banks paid even more. Because funds could be obtained by selling CDs, banks made relatively little use of "nondeposit" sources of funds such as Eurodollars and sales of assets to bank holding companies, both important in 1969.

Commercial banks acquired some funds by sales of Treasury securities in the second half. Their holdings of other securities, mainly municipals, continued to rise, but at a slow pace.

Throughout the year many banks supplemented their resources through purchases of federal funds and through sales of Treasury and U.S. agency securities under repurchase agreements. For weekly reporting banks these liabilities averaged about $12 billion higher in 1974.

Member bank borrowings from Federal Reserve banks reached a record total of almost $4 billion outstanding in late summer. A substantial portion of this amount reflected a loan to the troubled Franklin National Bank, eventually acquired by another bank. Exclusive of this loan, member bank borrowings ranged between $1 billion and $2 billion until December, when outstandings declined to the lowest level in more than two years.

Regulations and guidelines

Amendments to Federal Reserve regulations and other actions taken by the Board of Governors during 1974 were mainly related to monetary policy, bank liquidity problems, and the uneven impact of tight money on flows of credit to various sectors of the economy.

Regulation A, governing lending to member banks by Federal Reserve banks, was amended in September to permit the application of a "special" discount rate, higher than the basic rate, to member banks requiring exceptionally large assistance over prolonged periods. The special rate was set initially at 10 percent—2 percentage points above the basic discount rate. The purpose of the special rate is to limit any rate advantage for long-term assistance when the basic discount rate is below market rates.

An October amendment to Regulation A permitted loans secured by residential mortgages at the lowest discount rate. Pursuant to the authority granted in the Emergency Home Purchase Act of 1974, Federal Reserve banks were authorized to make advances on the security of residential mortgages at the discount rate applicable to loans secured by eligible collateral as defined in the Federal Reserve Act, which had previously excluded long-term loans.

Member bank reserve requirements (Regulation D) were restructured to encourage the issuance of time deposits with longer maturities and thus improve bank liquidity. Supplemental or "marginal" reserve requirements were removed. These had been applicable to large time deposits and certain other obligations above a base amount since early 1973. The basic requirement on time deposits with initial maturities of less than 180 days was increased from 5 percent to 6 percent, except for the first $5 million to which a 3 percent requirement continued to apply. On time deposits issued to mature in 180 days or more the requirement was reduced from 5 percent to 3 percent. In addition, the required ratio of reserves to demand deposits over $400 million was reduced from 18 percent to 17.5 percent. These changes, on balance, released more than $1 billion of reserves in the fall when seasonal needs were increasing and made additional funds available to most member banks.

Early in the year the Board submitted to Congress a proposal to require all types of financial institutions whose deposits are used by the public in making payments to hold reserves in accord with a specified schedule. Very small nonmember institutions would be exempted under the plan. The major purpose of the proposal was to improve monetary control and reduce the competitive disadvantage borne by member banks as a result of monetary action. The proposal did not result in any legislative action in 1974.

Regulation Q, governing deposit interest rates, was amended to encourage longer-maturity deposits and enable banks to compete more effectively for them. As of December 23, member banks were permitted to offer up to 7.5 percent on "investment certificates" in minimum denominations of $1,000 maturing in six years or more. Parallel action taken by other supervisory authorities set a 7.75 percent ceiling on similar certificates issued by thrift institutions.

In connection with legislation that increased insurance coverage per account from $20,000 to $40,000 and to $100,000 for public time and savings accounts, the Board amended Regulation Q to permit member banks to accept savings accounts of governmental units and to pay the same rate as thrift institutions (7.75 percent) on time deposits of less than $100,000 of governmental units.

Under conditions of severe restraint on overall credit expansion, a major public policy concern in 1974 was the allocation of available credit among competing demands. Because of existing credit lines and loan agreements and access to the money and capital markets, large national corporations were generally able to obtain adequate financing despite increasingly restrictive bank lending policies. Other sectors, especially residential building, were seriously weakened because available credit supplies were sharply curtailed. In recognition of the problems facing commercial banks in allocating funds among customers, the Federal Advisory Council, a group of 12 leading bankers that meets periodically with the Federal Reserve Board, formulated a statement setting forth suggestions as to the most appropriate uses of loanable funds. The Council emphasized the need to meet working capital and investment needs of basically sound businesses and to provide equitable credit distribution to the homebuilding and consumer sectors. Loans for acquisitions and speculation were deemed unsuitable. This statement was forwarded by the Board to all member banks in mid-September to serve as a guideline for lending policies.

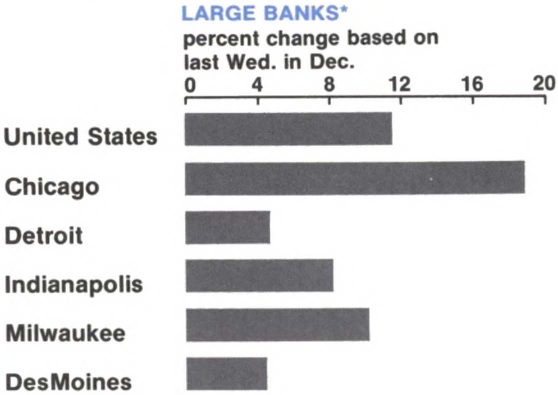
Seventh District banking

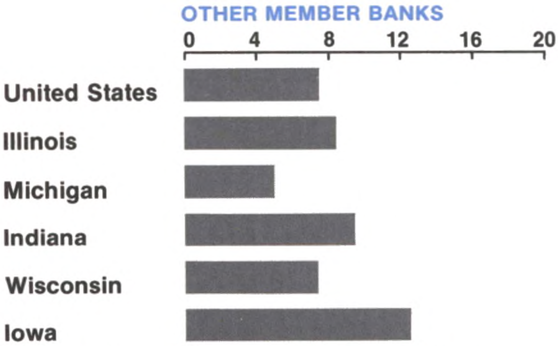
Credit expansion at district member banks fell short of the high growth rates of the previous two years but was slightly greater than the national pace. Excluding interbank loans but including loans sold to affiliates, total loans and investments of district member banks rose 9 percent in 1974, compared to 15 percent in 1973. As in other recent years, bank loans expanded more rapidly (11 percent) than total bank credit. Holdings of U.S. Treasury securities declined 3 percent, while holdings of other types of securities, primarily obligations of states and political subdivisions, rose 7 percent—less than in other recent years.

In keeping with the national pattern, credit expanded more rapidly at large banks than at small- and medium-sized banks. Loans at large district banks that submit weekly condition reports increased 13 percent for the year, despite a fourth-quarter decline. The largest percentage increases—each up more than 20 percent—were recorded for agricultural loans, loans to nonbank financial institutions, and commercial and industrial loans. Gains in consumer instalment loans and real estate loans were the slowest since 1971, while loans on securities declined from a year earlier. Loan expansion varied greatly among these banks by areas, ranging from less than 5 percent in Des Moines and Detroit to 19 percent in Chicago. Virtually all of the 1974 gains in Chicago, Detroit, and Milwaukee were recorded during the first half of the year.

Loan growth at smaller district banks that do not report loans by type was a little over 8 percent, with gains ranging from 5 percent in Michigan to more than 12 percent in Iowa. First-half data on loan composition at all district banks other than large weekly reporting banks indicate slower growth than a year ago for all major types of loans. Real estate loans were up 6 percent, a slower rate of expansion than in either the first or second half of 1973. First-half gains in both consumer loans and agricultural loans were around 3 percent. In 1973 agricultural loans posted annual gains of 19 percent, and consumer loans were up 14 percent. Commercial and industrial loans at these banks increased

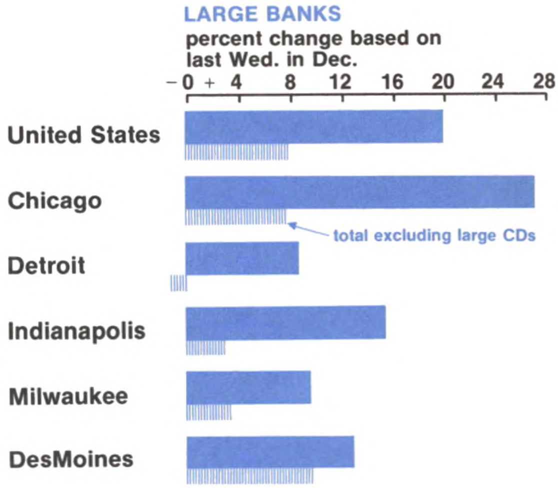
Variations in rates of loan expansion in the district were similar to. . .

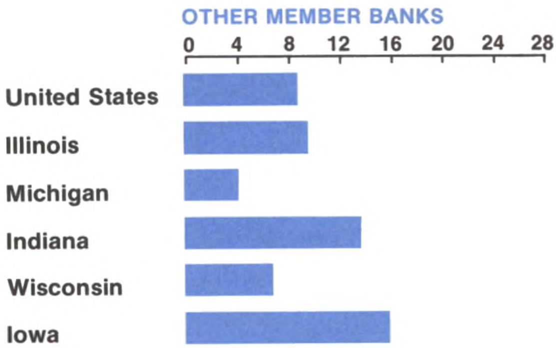




*Data for the largest banks in major cities include loans sold to affiliates but exclude domestic commercial interbank loans.

the patterns of growth in time and savings deposits





almost 9 percent in the first half of 1974, about 1 percentage point below the first-half 1973 gain but twice the pace recorded for the second half of 1973.

Collected demand deposits were virtually the same on average in December 1974 as a year earlier, and district banks, therefore, had to rely on interest-bearing funds to finance the increase in loans and investments. Time and savings deposits at all district member banks increased 14 percent with large banks up 17.5 percent and other banks up 9.6 percent. Excluding large CDs, time and savings deposits at large banks rose just over 4 percent.

Deposit inflows at large banks were augmented by increased use of such non-deposit sources of funds as net purchases of federal funds, securities sold under repurchase agreements, other borrowings, amounts due their own foreign branches, and loans sold to affiliates. Funds from these sources increased 15 percent or $1.2 billion, one-third as much as in 1973.

Light in the tunnel

Early in 1975 the downswing in the economy retained strong momentum. Unemployment moved to the highest rate since before Pearl Harbor, and few employers were recruiting. Consumer confidence was at a low ebb and even families not directly affected by unemployment were spending cautiously. Many business firms were cutting prices and/or cutting production to reduce inventories. Capital expenditures were still rising, but price inflation accounted for most of the gain and many companies were reevaluating expansion plans in view of declining demand and falling profits.

Monetary policy became more stimulative in the fourth quarter of 1974, and further steps toward ease were taken in early 1975, including successive cuts in the discount rate and a reduction in reserve requirements on demand accounts of member banks. Meanwhile, federal spending was accelerating partly because of increased payments to the unemployed and partly because deferred programs, e.g., water pollution control, were reactivated. Both the Administration and Congressional leaders were advocating substantial tax reductions for both consumers and businesses. The prospects of an extremely large federal deficit in fiscal 1976 was not likely to deter massive use of fiscal policy to reverse the economic downturn.

The decline in activity has been accompanied by adjustments that will help promote a recovery, as in earlier downturns. Prices of many commodities, components, and finished goods have declined from the inflated levels reached in 1974. Shortages that had hampered many activities have largely disappeared. Funds for mortgages and other purposes have become more available at lower rates. Production in some industries has been below final demand in recent months. All postwar recessions have been predominantly inventory recessions which were necessarily limited in duration because stocks of goods must be maintained at levels adequate to serve customers' needs.

The opening paragraph of this issue of *Business Conditions* enumerates a long list of calamities that struck the U.S. economy in 1974. The likelihood of such a confluence of unfavorable developments again in 1975 seems remote. The severity of the current decline in activity has encouraged comparisons with the Great Depression of 1929-33 when total output declined by more than half and the unemployment rate rose from 3 to 25 percent. The analogy, however, is not appropriate.

The experience of the 1930s led to the creation of institutions and policies—later refined and expanded—that were intended to limit any future economic decline. Included are deposit insurance, mortgage insurance, mortgage amortization, unemployment compensation, social security, medicare, vastly expanded private pensions and insurance, enhanced powers of the Federal Reserve and other financial agencies, farm income supports, and greatly improved statistical tools, all factors helping to alleviate distress and moderate declines in income, output, and employment.

Finally, there is the almost universal determination to use the full power of the federal government to maintain a viable private economy. A cruel lesson was learned in the Great Depression and its like will not be seen again.

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