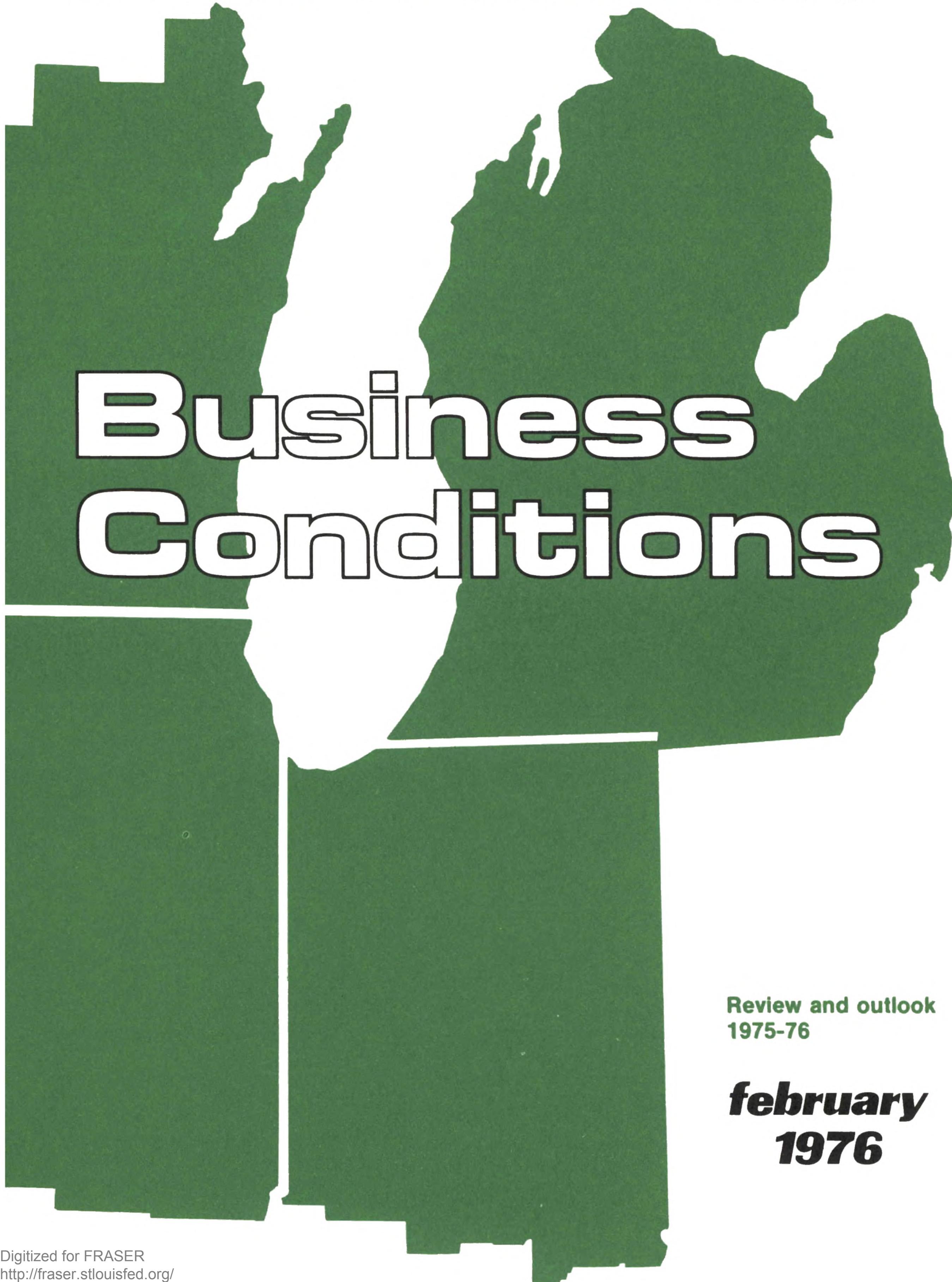
an economic review by the Federal Reserve Bank of Chicago

Business Conditions



Review and outlook
1975-76

february 1976

Review and outlook: 1975-76

Last year the U.S. economy shook off the forces that had led to the most severe recession since World War II. The expansion that began last spring retained strong momentum early in 1976. Bountiful harvests of the past year replaced the disappointing yields of 1974. A record annual foreign trade surplus succeeded a large deficit. Businesses, financial institutions, and individuals rebuilt impaired liquidity positions and prepared themselves for new ventures in an environment of restored confidence.

The unresolved economic issues early in 1976, in broad outline, are the same as a year ago: inflation, unemployment, pollution abatement, access to raw materials, and uneasy international relationships. Each of these problems, however, has moderated in severity. Moreover, trust in the future has been fortified by the knowledge that the unprecedented calamities of 1974 and early 1975 were weathered successfully and were followed by a broad-based recovery, with the basic strength and resilience of the U.S. economy intact.

Contents

Subscriptions to *Business Conditions* are available to the public free of charge. For information concerning bulk mailings, address inquiries to Research Department, Federal Reserve Bank of Chicago, P. O. Box 834, Chicago, Illinois 60690.

Review and outlook 1975-76

Business: recovery well under way

The business expansion that started in the spring of 1975 retained substantial momentum early in 1976. Fears expressed in December that the recovery was faltering and might "abort" appeared ill-founded.

The recession that began on a broad front in the fall of 1974 proved to be the deepest and most traumatic since the 1930s. The upswing that followed has been rapid and pervasive. Virtually all sectors have scored gains in the past six to eight months—although of widely varying magnitudes—and look to further gains in 1976.

All business recessions since World War II have been dominated by a shift from inventory accumulation to liquidation. Such a shift occurred in massive proportions from the fourth quarter of 1974 to the first quarter of 1975. In addition, purchases of many finished products by consumers and businesses declined during this period and construction activity, led by residential building, also dropped. Finally, many state and local governments were forced to curtail services to the public.

Production and sales of both consumer and producer durable goods outstripped the general economy both in the boom of 1973 and in the subsequent recession. In the current upswing, durables have lagged the rest of the economy. These phenomena are typical of past business cycles.

Manufacturing in the Seventh District states of Illinois, Indiana, Iowa, Michigan, and Wisconsin is concentrated in durable goods. With 16 percent of the nation's population they produce 25 percent of its durable goods and about one-third of its producer equipment. These states led the nation both in prosperity and recession, and major centers in these states continued to experience substantial unemployment early in 1976.

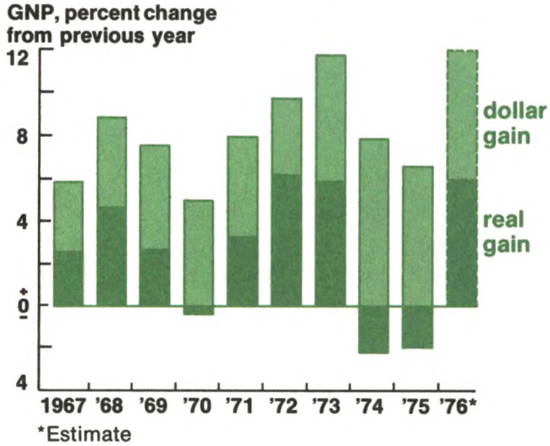
Forecasters on target

In contrast to 1974 when most projections overshot the mark, the "standard forecast" offered at the start of 1975 proved to be reasonably accurate, at least for broad measures. Some sectors—notably residential construction and steel—failed to match expectations.

Department of Commerce estimates show total output adjusted for price change (real GNP) down 2 percent for 1975 as a whole, about the same as the decline in 1974 and about as expected. Never before since World War II has real GNP declined in two successive years. Price inflation, measured by the GNP deflator, was 9 percent year-to-year, down from 10 percent in 1974. Unemployment averaged about 8.5 percent, up from 5.6 percent, and the highest since 1941.

This year's economic forecasts, whether based on relatively informal judgments or on elaborate econometric models, reveal an unusual tendency to cluster in a narrow range. Substantial growth is expected to continue through the year, while inflation moderates further. Unemployment is expected to decline again but to remain uncomfortably high. More specifically, real GNP growth is projected at about 6 percent, inflation at about 6 percent, and the average unemployment

Significant growth with less inflation seen for 1976



rate at about 7.5 percent.

While gratifying, this consensus forecast for 1976 leaves the economy well below levels associated with reasonably full employment of people and resources. Moreover, the relative price stability of the early 1960s remains an elusive goal.

Shortages change to surpluses

Throughout 1973 and most of 1974 purchasing managers were plagued with a long list of items in short supply. Fuel, metals, paper, plastics, chemicals, and components for equipment—virtually everything—could be obtained only after abnormally long waits, and premium prices often were paid for immediate availability. Problems snowballed because many buyers duplicated orders and added reserve stocks when possible. Efficiency of production and distribution was undermined. These developments compounded underlying inflationary pressures.

Complaints of shortages diminished rapidly in late 1974 and early 1975 as new orders for manufactured goods dropped sharply. The desire to obtain any available supplies gave way to inventory liquidation and hand-to-mouth buying. Lead times on new orders declined drastically and many items again were available off the shelf. By the spring of 1975 the list of items in short supply was confined largely to natural gas and a few materials and components.

Unplanned inventory accumulations continued in many sectors in late 1974 and early 1975, until production could be brought into line. Then a broad inventory liquidation began, which reached its fastest pace in the second quarter of 1975. Production declined much more than sales to final users. But general inventory liquidation can never continue indefinitely. As industry after industry completed adjustments, laid-off workers were recalled and ouput was increased. These developments were evident in soft goods, such as textiles and apparel, as early as March and April. However, inventories were still being pared in some lines, notably steel, in early 1976.

The buyers' market of 1975 was more apparent at the wholesale level than at retail. Rapid increases in worker compensation, construction costs, insurance rates, transportation charges, and prices of other services resulted in a further rise in the general price level—less than in 1974 but significantly more than in earlier years.

Consumer outlays boost activity

Consumption spending accounts for almost two-thirds of GNP, and these outlays are closely related to current income. Despite depressed economic conditions, personal income was up 8 percent in 1975, not much less than in other recent years. Wages and salaries were up only 5 percent, but transfer payments, which include social security and unemployment benefits, were up 25 percent and accounted for more than one-third of the rise in total personal income. Disposable income, aided by the tax reduction, was up 9.5 percent for

1975, even more than in 1974. In constant dollars total disposable income hit a new high last year after *declining* slightly in 1974 when inflation more than offset nominal gains.

Increases in compensation and reductions in income taxes brought an 8.6 percent rise in average spendable (after-tax) weekly earnings of workers in the private nonfarm economy last year—the largest rise in over 25 years, although slightly less than the rise in consumer prices. Many workers received increases in wages and benefits of 10 to 12 percent or more. Social security recipients were granted an 8 percent cost-of-living boost at midyear.

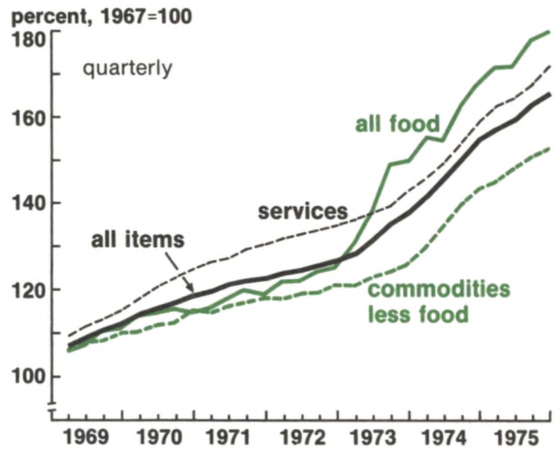
Consumption spending of individuals did not rise as much as their spendable income in 1975. The savings rate rose to 8.3 percent, up from 7.5 percent in 1974, and the highest since 1946. The higher savings rate also reflected a reluctance to use instalment debt, usually associated with the purchase of autos, furniture, and appliances. Unit purchases of these big ticket items were down sharply last year.

Prices rise further

In December the Consumer Price Index (CPI) was 7 percent above the year-earlier level and up 43 percent in five years. It had doubled in 20 years and quadrupled in 35 years. While far from a satisfactory performance, last year's rise in prices compares favorably with the rise of more than 12 percent from December 1973 to December 1974. Food and other commodities rose 6.5 percent during 1975, about half as much as in 1974. Prices of services rose 8 percent.

Although retail food prices declined early in 1975, mainly reflecting lower meat prices, the overall CPI increased each month. The year as a whole averaged 9 percent higher, less than the 11 percent for 1974 but much more than in any other recent year. Trends suggest that price inflation will moderate again in 1976. Most forecasters expect consumer prices to average 6 to 7 percent higher than last year.

Consumer price inflation moderated in 1975

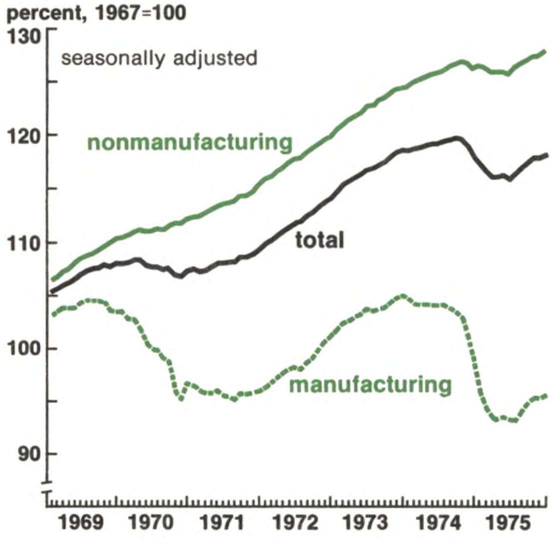


Prices of wholesale commodities were only 4 percent higher in December than a year earlier, compared to a 21 percent rise in the previous 12 months. Farm product prices were slightly *lower*, whole industrial commodities were up 6 percent. The less rapid rise in wholesale prices in 1975 reflected much larger crops, a smaller rise in fuel prices, the shift from sellers' to buyers' markets, and the fact that prices of many manufactured products surged following the end of price controls in May 1974.

Most wholesale markets continued to be buyers' markets in early 1976. Nevertheless, producers were raising prices wherever possible to improve profit margins despite substantial excess capacity in their industries because of rising costs of labor and other inputs.

Both the CPI and the GNP deflator are much less volatile than the wholesale price index. The CPI and the deflator incorporate additional costs of transportation and marketing, and they include prices of

Payroll employment rose rapidly after midyear



services not covered in the wholesale index, which covers only commodities.

Employment and unemployment

Nonfarm wage and salary employment totaled almost 78 million in December, up about 1.5 million from the June low but still about 1 million short of the record high reached in September 1974. The failure of employment to regain the earlier peak reflects the fact that economic activity has not yet fully recovered ground lost in the recession. In addition, employment gains were restricted by the lengthening of workweeks and by rapid increases in output per man-hour associated with the early stages of a recovery.

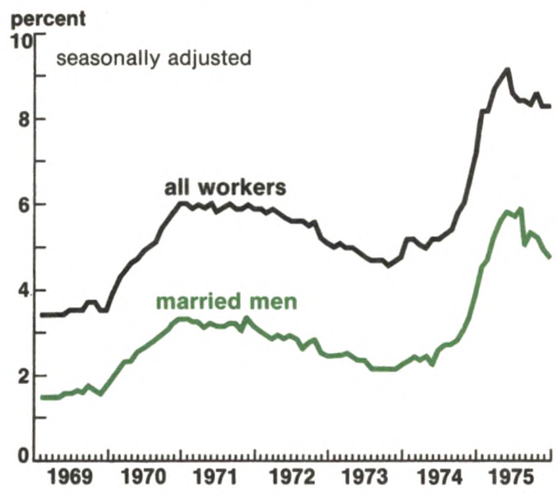
Unemployment was 7.7 million in December—8.3 percent of the civilian labor force. This was down from 8.3 million, or 8.9 percent, in May. For all of 1975 the unemployment rate averaged 8.5 percent, compared with 5.6 percent in 1974, and 3.5 percent in the late 1960s when job markets were very strong. Last year's unemployment rate was the highest since 1941, before the demands of World War II created a labor shortage.

Agricultural employment averaged 3.4 million in 1975, slightly less than in 1974 and only half the level of 25 years ago. Better equipment and improved techniques have enabled farmers to increase production with fewer workers to a much greater extent than in other industries.

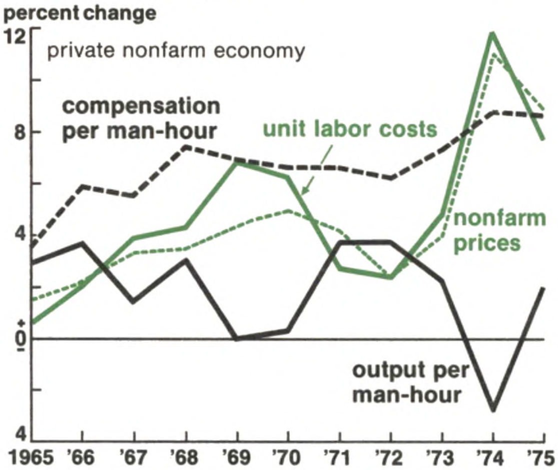
The armed forces averaged 2.2 million last year, only slightly less than in 1974. In 1968, before the Vietnam war was scaled down, the armed forces numbered 3.5 million. Unemployment rates since then have partly reflected reduced requirements of the armed forces.

Manufacturing employment averaged 18.3 million, compared to 20 million in both 1973 and 1974. Manufacturing employment reached an all-time peak in December 1973 at 20.4 million, nine months before the high in total payroll employment. Its low occurred in June 1975 at 18.1 million, the same month that total payroll employment reached a low. Only about 500,000 of the jobs in manufacturing had been recovered by December. Each recession

Unemployment receded from peak reached in May



Productivity boost slowed rise in costs and prices



has witnessed the retirement of older facilities that typically require more workers than newer installations.

Nondurables lead the upswing

Manufacturing output in physical units, as measured by the Industrial Production Index, was down 10 percent in 1975, the largest year-to-year drop since the conversion to civilian output following World War II. Factory output declined about 1 percent in 1974. As in the case of real GNP, the two-year drop in manufacturing was unprecedented in previous post-World War II recessions.

The manufacturing index reached its all-time peak of 127 (1967=100) in November 1973, just after the Arab oil embargo was proclaimed. Through the first nine months of 1974 manufacturing remained within 2 percent of the peak, but a sharp decline began in the fourth quarter. From September 1974 to March 1975 total manufacturing dropped 14 percent, one of the most drastic six-month declines on record, with durables off 15 percent and nondurables off 13 percent.

From March to December last year manufacturing rose 9 percent—a very respectable recovery. The rebound was steeper than had been expected, just as the decline had been greater than expected. Nondurables—including textiles, apparel, paper, and food—led the upswing. By December nondurable manufacturing was within 1 percent of its September 1974 level. However, durable goods—including steel, vehicles, and equipment—were still 10 percent below September 1974, and total manufacturing was still off 6 percent.

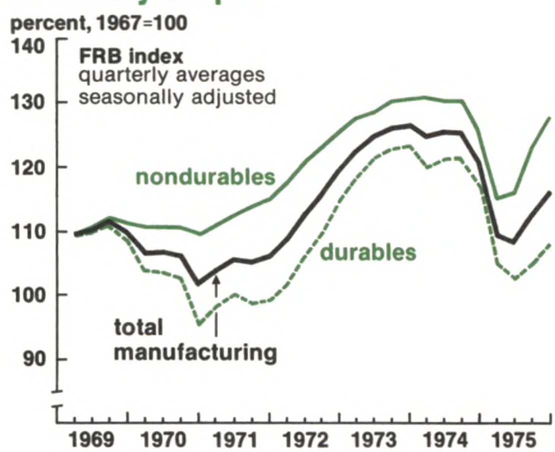
Virtually all manufacturers expect gains in output next year. With inventory liquidation programs already largely completed, it would be quite possible for new highs in total factory output to be achieved before the end of 1976 if, as expected, the general expansion continues.

Steel hard hit

Few basic industries were affected as severely by the recession as steel. In 1974 shipments of finished steel were almost 110 million tons, only 2 million tons below the 1973 record. Steel imports added 16 million tons to domestic supplies.

Most forecasts at the end of 1974 es-

Soft goods led the rebound in factory output



timated steel shipments would decline only about 10 percent in 1975. Forecasts of shipments were revised downward in several steps. Actual shipments totaled only 80 million tons, down 27 percent to the lowest level since 1963. Imports declined in proportion to about 12 million tons. Output of steel mills dropped only 20 percent because the mills rebuilt inventories that had been depleted in 1974 to satisfy user demands.

In both 1973 and 1974 steel users increased their holdings of steel substantially. Last year they liquidated steel inventories at an even faster rate. Some users were still cutting holdings early in 1976.

Demand for steel, at least for lighter products, was stimulated artificially last September in anticipation of a price increase that took effect October 1. As a result, shipments dropped back in the fourth quarter.

Early in 1976 steel producers reported substantial increases in bookings, especially from manufacturers of motor vehicles and other consumer goods. For the year as a whole shipments are expected to reach the 95 to 98 million ton range with imports also increasing somewhat.

Profits of steel companies declined sharply in 1975. Also, some estimates of steel demand in the next few years have been revised downward. As a result, a number of companies, but not all, announced postponements of capital expenditure plans pending a clarification of present uncertainties.

Motor vehicles down again

Sales and output of cars and trucks declined sharply in 1975 for the second straight year following the record levels of 1973. Nevertheless, the picture improved substantially as the year progressed, and further gains are expected for 1976.

Assemblies of passenger cars in the United States slipped from 9.7 million in 1973 to 7.3 million in 1974 and to 6.7 million last year. Except for 1970, which was depressed by the General Motors strike, car output last year was the lowest since 1961.

Truck production dropped from 3 million in 1973 to 2.7 million in 1974 and to 2.2 million last year, which was the lowest since 1971. Sales and production of heavy trucks and trailers were especially hard hit last year, and had not recovered much by year-end. Operators had purchased heavy trucks in excess of their needs in 1974 in anticipation of a federal regulation, effective March 1, 1975, that required all newly produced heavy trucks and trailers to be equipped with expensive and complicated new brake systems.

Inventories of cars and trucks had been very large relative to sales at the end of 1974, and production was cut sharply to bring these stocks into line. Sales of "domestic" cars, including net imports from Canada, totaled 7.1 million in 1975, down from 7.5 million in 1974 and a high of 9.7 million in 1973. Sales of imported cars, led by Japanese models, rose in 1975 and accounted for a record 18 percent of the 8.6 million cars sold in the United States.

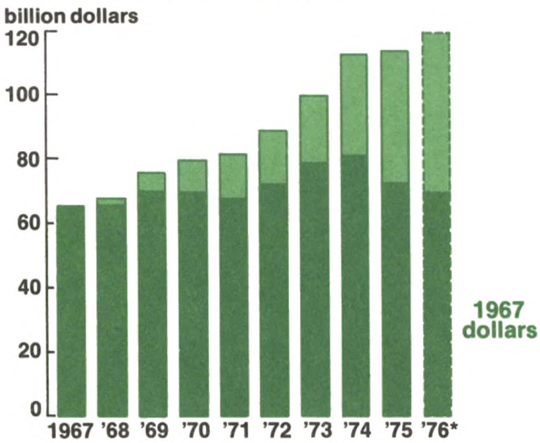
Major midwest industries are recovering from recession lows

The auto companies are confident of big gains in sales of both cars and trucks next year with sales of cars, including imports, expected to total about 10 million, while sales of trucks approach 3 million. All auto producers are engaged in vast retooling programs to produce smaller, lighter, fuel-conserving cars, some of which are offered in the current model year.

Lower spending on capital goods

Business outlays on new plant and equipment increased 1 percent in 1975 to $113.5 billion, extending a string of annual gains starting in 1961. After adjustment for higher prices, however, capital spending *declined* about 10 percent last year. Thus, the capital goods boom that started in 1972 came to an abrupt halt. A government survey released in January indicated that capital spending will rise 5.5 percent in 1976 in current dollars. But if, as respondents expect, prices rise almost as much as last year, capital spending in real terms will decline again in 1976—by about 4 percent.

Plant and equipment outlays declined in real terms



*Estimate

In 1973 it appeared that the capital spending upswing had enough momentum to carry it for additional years. Most industries had broad plans to expand capacity to eliminate bottlenecks for the goods and services they produced. In addition, large appropriations had been made to modernize and replace older facilities to increase efficiency and profitability and also to comply with regulations to reduce pollution and eliminate dangers to workers.

The energy crisis and the subsequent business recession, which increased margins of unused capacity and reduced profits, caused many firms to cancel orders for equipment already booked, and to postpone or scale down future capital spending plans. Cancellations and stretchouts of capital spending plans were still being announced late in 1975, with the steel and oil industries as prominent examples.

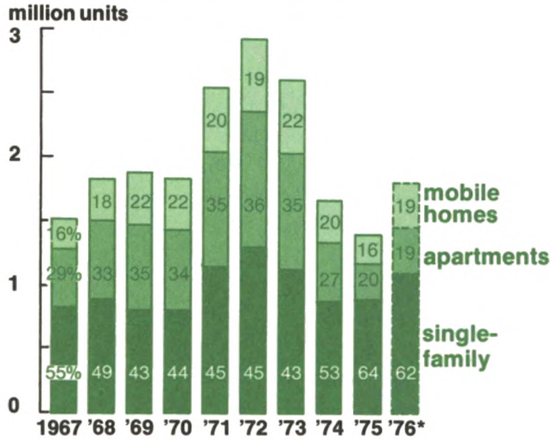
Plant and equipment spending equaled 8 percent of GNP in 1974, up from 7.6 percent in 1973. This ratio had been about 8.5 percent in the mid-1950s and again in 1966. Last year the ratio dropped to 7.6 percent, and present prospects suggest a further decline to 7.1 percent in 1976, the lowest since the early 1960s.

If the general expansion continues, business executives may reinstate some of the programs deferred over the past year and a half. But a significant rise in real outlays does not appear likely until the second half of 1976 is well along.

Construction and housing

Total construction outlays amounted to $131 billion in 1975, down 3.5 percent from 1974. Outlays on both residential and nonresidential private construction were sharply lower last year, while public outlays were somewhat higher. In real terms, however, all the major sectors showed declines. Costs rose about 9 percent for residential construction and about 11 percent for other construction, not as much as

Housing is expected to revive, ending three-year slump



*Estimate

in 1974, but still very rapid rates by past standards.

After adjustment for inflation, residential construction outlays have declined each year since the peak year 1972. Last year the adjusted value of residential construction was down 18 percent from 1974 and down 41 percent from 1972. Real outlays on other private structures were down 13 percent from 1974 and down 18 percent from the peak year 1973.

Housing starts totaled less than 1.2 million last year, down from a record 2.4 million in 1972 and the lowest since 1946. Apartment building was particularly weak. Mobile home shipments, which have sometimes partially offset declines in conventional housing, dropped to 220,000 last year, down from 570,000 in both 1972 and 1973 and the lowest number in a decade.

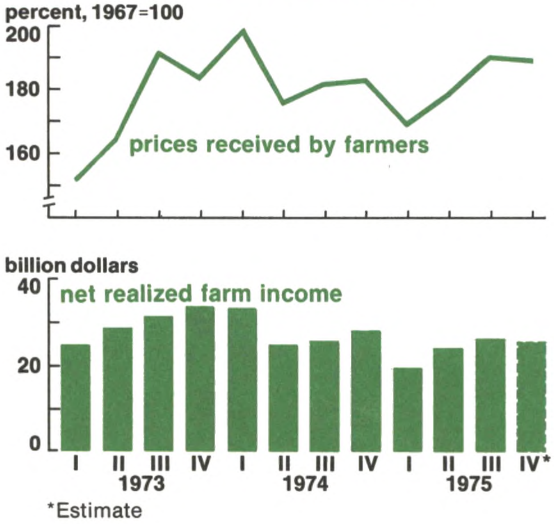
Employment in construction averaged less than 3.5 million in 1975, 14 percent less than in the peak year 1973. Average workweeks also were reduced. In some areas, building trades unions reported 25 percent or more of their members unemployed. Nevertheless, substantial increases in wages are still being implemented under three-year contracts.

The outlook for construction remained bleak as 1976 began. Overbuilding in some areas, especially of office buildings and condominiums, was still apparent. Heavy inflows of funds to thrift institutions and expanded government housing programs suggested, however, that residential mortgage financing would be more available. Most forecasts of housing starts called for a significant gain this year, but only to about 1.5 million. Prospects for industrial and commercial building remain very poor. Public construction, especially for sewer and water projects and highways, will rise as present programs are implemented.

Agriculture: a year of contrasts

Agricultural conditions changed markedly over the course of 1975. Net realized farm income fell to a low level during the first half of the year, and the boom in farmland values slowed appreciably. Livestock producers remained in the midst of a prolonged financial squeeze, in large part due to the high feed prices that followed the weather-plagued 1974 crop harvest. Crop prices, although high at the start of the year, trended downward during most of the first half. Conditions changed abruptly by midyear, however. Markedly lower meat supplies stemming from earlier production adjustments sent livestock prices to new highs during the second half of the year. Crop prices strengthened materially when it became apparent that the impact from a record domestic harvest would be cushioned by a severe shortfall in Russia.

Farm prices and income recovered in the second half



Although farm prices retreated late in the year, the more profitable developments of the second half offset much of the depressed first-half conditions. On balance, cash receipts from farm marketings in 1975 were about equal with the 1974 record, even though prices received by farmers averaged slightly lower. Increased production expenses—in part reflecting higher prices paid for chemicals, fertilizer, and seed—lowered net realized farm income to an estimated $23-24 billion, down from $27.7 billion in 1974 but still the third highest level on record.

Financial trends parallel income

The financial picture for farmers was also characterized by marked contrasts during the past year. During the first part of 1975 conditions were extremely tight as both the financially squeezed livestock producers and the crop farmers who bore the brunt of the short 1974 crop harvest had difficulties meeting debt repayment schedules. Their plight, however, was eased somewhat by the sharp increase in loan renewals and extensions accommodated by commercial lenders and the marked expansion in emergency disaster and livestock loans provided by the Farmers Home Administration. But perhaps most significantly, the financial squeeze was eased by the recovery in farm prices and incomes during the second half.

Preliminary estimates indicate farm debt outstanding rose nearly 11 percent last year, reaching a new high of $91 billion. The rise in farm real estate debt paced the overall increase, in part reflecting the continuing strength in farmland values. Although the rate of increase in farmland values slowed appreciably during the early part of 1975, sharp increases during the latter half of the year boosted the rise for all of 1975 to an estimated 14 percent. Land values in district states paced the overall gain, rising 22 percent.

Food price increases slow

Increases in food prices continued at a rapid pace last year, but the rate of gain slowed substantially from that of the previous two years. The 1975 index of retail prices for food consumed at home rose 8.3 percent above the 1974 level, about one-half the gains posted in the previous two years. The increase reflected a combination of higher livestock prices, higher processing and distribution costs, and somewhat lower supplies of food. Paced by the cutback in available meat supplies, per capita food consumption declined 1 percent last year.

Higher charges for labor and transportation continued to boost the costs of processing and distributing food which, overall, account for about two-thirds of consumer food expenditures. Hourly earnings of workers in both food manufacturing firms and grocery stores averaged about 10 percent above the year-earlier level during the first three quarters of 1975. Evidence of higher transportation charges was reflected in the more than 13 percent rise in rail freight charges for food products in 1975.

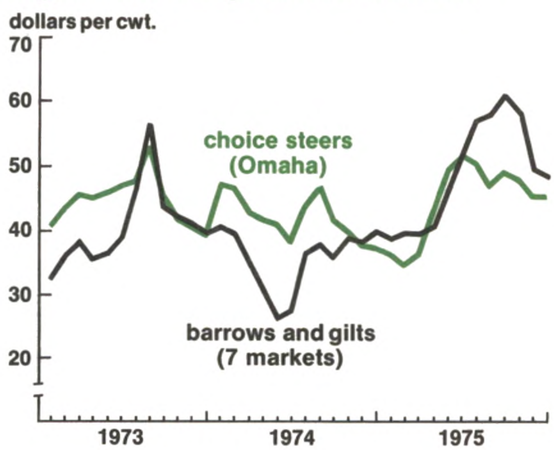
Major livestock adjustments

The short 1974 grain harvest mandated major adjustments in livestock production. Nevertheless, most observers were surprised by the rapidity and the magnitude of the changes recorded during the past year. The nation's inventory of cattle had been expanding rapidly during the early seventies and at the start of 1975 numbered 132 million head, more than 17 percent above the level in 1970. Most observers had expected it would take a minimum of two years to halt the growth in the cattle inventory, but an unprecedented volume of slaughter accomplished the feat in one year. The number of cows and nonfed steers and heifers slaughtered in 1975 exceeded the high year-earlier level by more than one-half, while the slaughter of calves was up by three-fourths. In contrast, fed cattle slaughter fell to the lowest level since the mid-sixties and accounted for only about one-half of total commercial cattle slaughter as opposed to three-fourths in a more typical year.

The drastically changed composition of cattle marketed, coupled with the incentive to economize on high-cost feed resulted in markedly lower average slaughter weights. As a result, beef production was up less than 4 percent from the year-earlier level, even though total cattle slaughter in 1975 was up 11 percent.

The marginal increase in beef production was more than offset by a dramatic cutback in pork production. Hog inventories at the beginning of 1975 were at a nine-year low and falling rapidly. Sharply curtailed farrowings reduced the December 1974-May 1975 pig crop to a 40-

Livestock prices shot to new highs after a depressive first half



year low, setting the stage for exceptionally short pork supplies in the latter half of the year. Overall, the number of hogs slaughtered in 1975 fell to a 35-year low, reducing pork production some 17 percent from the 1974 level.

Relatively high livestock prices coupled with lower feed prices support prospects for somewhat larger supplies of both beef and pork in 1976. The movement of cattle into feedlots picked up sharply during the latter part of 1975, boosting the year-end inventory of cattle on feed 28 percent above the low year-earlier level. If the trend continues, as expected, fed cattle slaughter would register significant gains throughout most of 1976. Beef supplies will continue to be augmented by a large volume of cow and nonfed steer and heifer slaughter, although this component of total beef production is expected to trend downward from recent highs during most of 1976.

Although pork production will remain well below year-ago levels during most of the first half, supplies will be more abundant than during the summer of 1975. Moreover, a recent report of farrowing intentions portends year-to-year gains in pork production during the second half of 1976. Most observers anticipate the second-half gains will more than offset the first-half declines.

Dairy farmers were also confronted by high feed prices early last year which, in conjunction with seasonally declining milk prices, squeezed operating margins. But during the second half of the year, milk prices received by farmers rose from the June low of $7.94 per hundredweight to $10.20 by year-end, up from $8.25 a year earlier. Total milk production for all of 1975 about equaled the comparatively low levels of the previous two years.

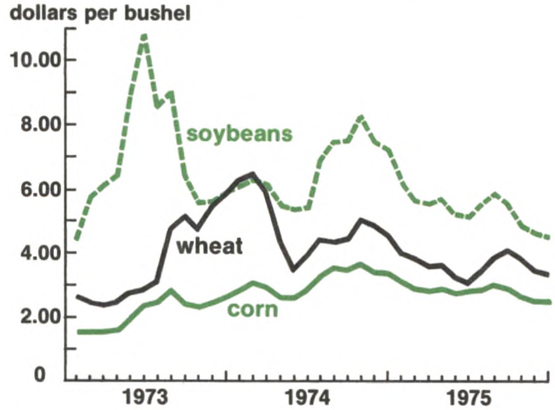
Dairy farmers can expect more favorable returns in 1976 if feed prices remain relatively low. Although milk prices will decline seasonally during the early part of the year, the milk/feed price ratio should hold well above year-earlier levels, an occurrence that would support prospects for marginal increases in milk production.

Recovery in crop production

Feed grain and soybean supplies were substantially below year-earlier levels following the disasterous fall harvest in 1974. Corn supplies were down 19 percent, while soybean supplies were down 13 percent. The reduced supplies necessitated major reductions in both domestic utilization and exports. For the marketing year that ended September 30, 1975, domestic utilization of corn fell 21 percent—reflecting the cutback in livestock feeding activity—while exports of corn declined nearly 8 percent. Domestic utilization of soybeans during the year ending August 31, 1975 declined 13 percent, while soybean exports—in the face of relatively large world supplies of competitive oilseeds—fell 22 percent.

Despite the short supplies crop prices generally trended downward during the first half. Evidence that the adjustments in livestock production would be sufficient to stretch the available feed supplies pro-

Prices strengthened at midyear due to Russian crop failure



vided the bulk of the downward pressures during the early part of the year. The downward momentum was reinforced by an ideal spring planting season that buoyed early hopes for a record 1975 crop harvest.

The downtrend reversed abruptly around midyear, however. Domestic crop production prospects were scaled downward—albeit somewhat excessively—as much of the western Corn Belt experienced an extremely dry spell during July and August. Moreover, evidence that the Soviet Union would have another major crop shortfall began to mount in early July—an event that led to the following developments during the remainder of the year:

- Soviet purchases of 13.2 million metric tons of U.S. grains.
- Brief moratoriums on U.S. grain sales to the USSR and Poland.
- The International Longshoremen's Association's one-month boycott of loading grain on ships destined for the USSR.
- Agreements to revise and extend the U.S./USSR maritime accord.
- A five-year grain agreement requiring the USSR to purchase at least 6 million metric tons of U.S. grains annually.

The Soviet crop disaster—which was ultimately labeled the worst in a decade—generated an aura of uncertainty that hung over domestic markets for several months. Nevertheless, crop prices were in a pronounced downtrend during the latter part of the year. Year-end corn prices were at a two-year low, while soybean prices were the lowest in three years. Contributing factors included the moratoriums on grain sales and indications that Soviet purchases of U.S. grains might fall short of initial expectations. In addition, the completion of a record corn harvest and a near-record soybean crop was ample evidence that supplies for the 1975/76 crop marketing years would be more than sufficient to cover a record volume of exports as well as provide a significant rise in domestic consumption.

The 1976 crop outlook is highly tentative at this early stage. Planted acreage is expected to register a slight rise this spring although weather conditions will play an important role in determining actual plantings. A recent planting intentions report indicated farmers intend to boost planted corn acreage 4 percent this year, while cutting soybean acreage 7 percent. Consumption of fertilizer, after declining for the first time in many years in 1975, is expected to be up in 1976.

Crop prices are expected to hold fairly stable in the near term, since any significant increase in domestic utilization will be somewhat delayed until the current recovery phase in livestock production has progressed a little further. Export shipments of grain, which were moving at a record pace during the latter part of 1975, will continue strong in the near term. Some price strength could be triggered by delayed foreign purchases of U.S. grains and soybeans, although large pending harvests in the Southern Hemisphere plus a pickup in marketings by farmers could be offsetting.

In addition to fundamental developments, crop prices throughout 1976 will be heavily influenced by weather conditions. Although domestic stocks have improved, grain stocks worldwide remain at a precariously low level. Adverse weather conditions in any major grain-producing area of the world would likely trigger another round of upward pressures on grain and soybean prices. For the time being, however, such concerns are held somewhat in abeyance by preliminary prospects for record or near-record crop production in the United States in 1976.

International: world economy turns upward

The world economy experienced a deep recession combined with a high level of inflation in 1975. Virtually no country was spared this experience; the interdependence among nations that provided a mutually reinforcing mechanism for sharing in economic progress during the years of prosperity provided the mechanism of transmitting adverse economic trends in 1974 and early 1975. In many countries the levels of economic stagnation and unemployment were the deepest since the thirties.

Governments responded with domestic programs and policies designed to restore noninflationary economic growth. Significantly, these measures evolved within a spirit of international cooperation rather than being self-serving, "beggar-thy-neighbor" actions that contributed to the downslide and prolongation of recession in the thirties. For example:

- Only a few countries have introduced import restrictions and multilateral trade negotiations launched last year brought 87 nations together in an effort to reduce barriers to trade—in contrast to the proliferation of protectionist policies in the thirties;
- The vast international network of private financial intermediaries, buttressed by cooperative policies of national authorities and international financial institutions, weathered the difficulties experienced by a few institutions and continued to provide financial resources to businesses and countries in need—in contrast to international financial panics that accompanied such difficulties in the thirties;
- Officials representing the member nations of the International Monetary Fund continued their efforts to develop an international monetary system that would serve the commercial needs of all nations—in contrast to widespread competitive devaluations of the thirties.

Upturn in the industrial economies

The decline in economic activity that began in late 1973 and ultimately led to the most severe recession in the postwar era bottomed out in some industrial nations by mid-1975 and in virtually all by year-end. The combined gross national product of the 24 major industrial countries that comprise the Organization for Economic Cooperation and Development (OECD) was estimated to have registered an increase in real terms at an annual rate of 3.75 percent in the second half, compared to a 5.1 percent seasonally adjusted annual rate drop in the first half and a decline for 1974 as a whole.

The 1974-75 recession was noteworthy for the similarity with which the components that contributed to its depth and duration recurred in the industrial nations of the free world. Growth in consumption expenditures, which typically had been a major source of growth in real GNP in the industrial countries, dropped sharply in early 1974. Private residential construction, already suffering from the consequences of the restrictive monetary policies followed by most countries in efforts to contain inflation in 1973, was hard hit. Faced with declining overall demand, businessmen in major industrial countries responded almost uniformly by cutting back capital investment and by adjusting inventories.

Economic events in 1975—a chronology

JAN 2 The Dow industrials close at 632, low for the year. (See July 15.)

JAN 6 Federal Reserve Board reduces the discount rate from 7.75 to 7.25 percent.

JAN 7 Chrysler offers rebates to new car buyers—other makers follow.

JAN 8 New claims for unemployment compensation reach record level.

JAN 10 American Beef Packers' bankruptcy leaves farmers with uncollected checks.

JAN 14 Prime rate is reduced to 9.75 percent by major New York bank.

JAN 15 State of the Union message calls for substantial tax cuts.

JAN 17 Major countries propose a fund to aid participating countries in financial difficulties caused by high oil prices.

JAN 19 Chemical Bank acquires troubled Security National Bank of Long Island.

JAN 20 Federal Reserve Board reduces reserve requirements on demand deposits.

JAN 24 Prime rate is reduced to 9.5 percent.

JAN 30 Fidelity Mortgage Investors files under Chapter 11, second sizable REIT to do so.

FEB 3 Administration budget shows fiscal 1975 deficit at $35 billion and fiscal 1976 deficit at $52 billion. (See May 30.)

FEB 5 Federal Reserve Board reduces discount rate to 6.75 percent.

FEB 14 Multilateral Trade Negotiations to reduce barriers to international trade begin.

FEB 25 New York State's Urban Development Corporation defaults on notes.

FEB 28 New York City cancels a $260 million issue of tax-anticipation notes.

MAR 6 Voluntary prior-approval controls on grain exports cease after five months.

MAR 7 Federal Reserve Board submits draft legislation to establish federal chartering and control of foreign banks operating in United States.

MAR 10 Federal Reserve Board reduces discount rate to 6.25 percent.

MAR 24 Federal Open Market Committee agrees to publish its domestic policy directive 45 days after adoption instead of 90 days later.

MAR 29 Bill is approved to cut individual and corporate income taxes by $22.8 billion.

APR 7 Federal Reserve Board authorizes member banks to permit phoned withdrawals or transfers from savings accounts.

APR 9 Federal Reserve Board announces a reduction from 8 to 4 percent in the reserve requirement on foreign borrowings.

APR 14 Implementation of new beef grading standards is postponed pending litigation.

APR 29 Saigon surrenders to Viet Cong, ending 30-year war.

MAY 1 Trading under SEC-ordered negotiated broker fees begins on NYSE.

— President Ford vetoes emergency farm bill that calls for higher support prices for grains.

— Federal Reserve Board reports money-growth targets for the coming 12 months to the Senate for the first time.

MAY 5 Ford requests additional $1 billion for the rapidly expanding food stamp program.

MAY 14 Congress adopts first concurrent resolution specifying budget targets under the Congressional Budget Act of 1974.

MAY 16 Federal Reserve reduces discount rate to 6 percent.

MAY 22 Senate launches an investigation of corruption in grain export inspections.

MAY 30 Midyear budget review projects fiscal 1975 deficit at $43 billion and fiscal 1976 deficit at $60 billion. (See Feb. 3.)

JUN 4 Ford signs Securities Reform Act expanding powers of the SEC.

JUN 5 Suez Canal is opened to traffic for the first time since the 1967 war.

— British referendum strongly supports membership in Common Market.

JUN 6 U.S. unemployment rate hits 9.2 percent in May, highest since 1941, but employment rose substantially.

— Usury rate of 9.5 percent on Illinois home mortgages is extended to January 1, 1977.

JUN 9 A New York bank reduces prime rate to 6.75 percent—low for the year.

JUN 10 New York legislature creates Municipal Assistance Corporation (Big MAC) to issue bonds to redeem New York City debt.

JUN 30 Treasury completes mailing $8 billion in income tax rebates and $1.5 billion in special social security payments.

JUL 1 Social security payments are boosted 8 percent in cost-of-living adjustment.

JUL 2 Emergency Housing Act of 1975 authorizes GNMA to buy an additional $10 billion in below market rate mortgages.

JUL 15 The Dow industrials close at 882, high for the year. (See Jan. 2.)

JUL 17 U.S. grain companies announce large sales to Russia.

— U.S. and USSR space ships hook up.

JUL 18 "Dumping" charges are filed with the U.S. Treasury against foreign auto producers.

AUG 11 Moratorium is placed on further grain sales to Russia.

SEP 2 Federal Reserve Board permits preauthorized transfers from savings accounts for any bill payments.

SEP 5 The IMF announces agreement on steps to eliminate the role of gold in international finance.

SEP 9 Longshoremen end month-long refusal to load ships carrying grain to Russia.

SEP 12 New Illinois law permits NOW accounts (Negotiable Orders of Withdrawal) at state S&Ls effective January 1, 1976.

OCT 2 W.T. Grant Co. files bankruptcy proceedings under Chapter 11.

OCT 14 Canada imposes selective price and wage controls.

OCT 15 Federal Reserve Board announces reduction in reserve requirements on deposits with original maturities of four years or more.

OCT 20 U.S./USSR grain agreement ends moratorium on sales to Russia.

OCT 22 American City National Bank (Milwaukee) is declared insolvent.

OCT 28 Equal credit opportunity regulations become effective.

NOV 3 President Ford reshuffles cabinet.

NOV 10 The Federal Reserve Board permits member banks to offer business corporations savings accounts up to $150,000.

DEC 8 Federal Home Loan Bank Board permits S&Ls to offer variable rate mortgages on multifamily and commercial properties.

DEC 11 USDA estimates Soviet grain production at 137 million metric tons—lowest in a decade.

DEC 12 Second concurrent Congressional resolution on the budget targets a deficit of $74 billion for fiscal 1976.

— Ford signs bill repealing federal law supporting state "Fair Trade" acts.

DEC 15 Industrial Production Index rises in November for the seventh straight month.

DEC 23 Last minute compromise bill extends 1975 tax cuts for six months.

DEC 26 Federal Reserve Board lowers reserve requirements on time deposits with original maturities of 180 days to four years.

The bottoming in the decline of private residential construction and the pickup in private consumption expenditures combined with a resumption of business inventory accumulation were the major sources of strength that turned around the economies of the United States, Canada, France, Germany, Japan, Italy, and the United Kingdom in the second half of 1975. The upturn was the strongest by far in the United States, where real GNP was estimated by the OECD to have risen at an annual rate of 8 percent. In Canada, Japan, France, and Germany the rise was between 2 and 3 percent, while in Italy it was less than 1 percent. In the United Kingdom, however, the decline in economic activity continued through the second half.

Price pressures moderate

Sluggish economic activity in 1975 helped dampen the inflationary pressures that had plagued the industrial countries mentioned above for several years. The annual rate of consumer price increase in these seven countries slowed to about 9 percent in the six months ending October 1975, compared to a 15 percent increase in the same period in 1974.

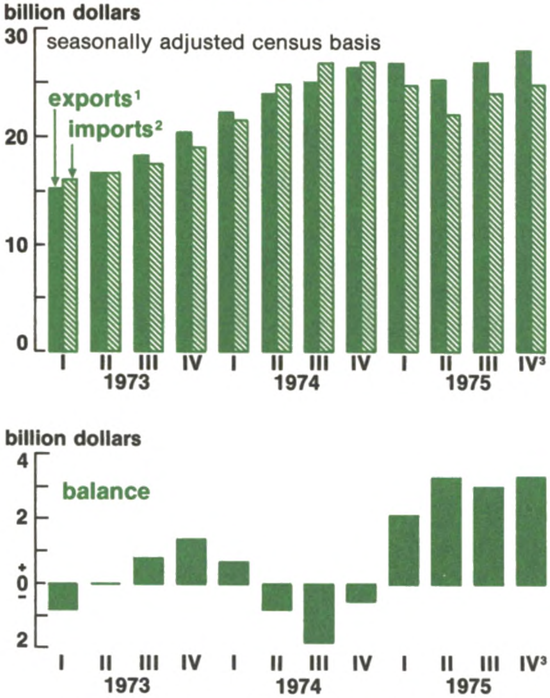
Several developments accounted for this price trend. Commodity prices, which rose sharply in the face of short supplies and boom demand in 1973 and early 1974, dropped in 1975. The price index (1970=100) of industrial materials (excluding fuels), which stood at 97 in 1972, rose to a high of 204 by April 1974 and then declined steadily to 125 by October 1975. Food commodities prices, which rose to 281 on the index scale by November 1974, declined to a low of 194 in June 1975. Even a subsequent rebound in food prices (largely due to the Russian crop failure that boosted the world demand for wheat and frost in Brazil that reduced the expected coffee crop) left the index well below the 1974 high. Energy prices, which were led up by the fourfold increase in the price of oil by OPEC in late 1973 and early 1974, rose only moderately in 1975. Finally, the depressed state of the economies of the industrial countries, and in a few instances—for example, the United Kingdom and Canada—the imposition of government controls, resulted in some moderation of wage-cost pressures reflecting a marked change in wage bargaining attitudes.

International payments positions

The OPEC quadrupling of crude oil prices in late 1973 and early 1974 produced a massive deficit in the international payments position of industrial nations in 1974. The current account balance (which measures international flows of goods, services, and transfer payments) of the 24 OECD countries deteriorated sharply, from a $2.5 billion surplus in 1973 to a $33 billion deficit in 1974. In 1975 the deficit was reduced to a mere $6 billion. The most important factor in this swing was the reduction in the counterpart current account surplus of the oil-exporting countries. Their surplus declined as demand for oil eased in the face of declining economic activity worldwide and consumer resistance to high prices, and as their imports from industrial countries increased.

The deepening of the current account deficit of the developing countries also contributed to the improvement in the current account balance of the industrial countries. The deterioration in the current account deficit of developing countries—from $2.5 billion in 1973, to $17.5 billion in 1974, and to $27 billion in 1975—was related to higher prices for oil and industrial goods needed for their economic development, coupled with declines in the prices of the raw commodities that typically represent the major source of revenue for these nations. Given the low level of financial reserves of these countries, the deficits

The U.S. trade surplus hit a record level in 1975



[1]Domestic and foreign merchandise excluding military grant-aid shipments.
[2]Imports are customs value basis for 1973 and f.a.s. value basis in 1974 and 1975.
[3]Fourth-quarter figures based on Oct.-Nov. data.

were invariably financed by borrowing abroad. As a result, the already heavy external debt burden of these countries increased further in 1975, thereby imposing an additional constraint on the financing of the economic development of the countries.

Reforming the payments system

The joint efforts of nations to restructure the international monetary system, which began in 1971 following the demise of the Bretton Woods arrangements, continued in 1975. The continued, relatively smooth functioning of the floating exchange rate regime adopted by many countries as an ad hoc response to unsettlements in the foreign exchange market apparently softened the opposition of some countries to the adaptation of such a system on a more permanent basis. Following extensive negotiations during 1975 within the Interim Committee of the IMF comprising representatives of member nations, an agreement was reached in early 1976 to formalize such a system in the Articles of Agreement, thus laying a foundation for a future monetary system.

It is expected that a system where countries are authorized to "float" their currencies in response to supply and demand conditions in the foreign exchange markets, and as a reflection of basic economic trends within their economies, will be better able to accommodate the needs of international commerce. Other elements of the reform included steps to reduce the role of gold in international monetary arrangements. The plight of the developing nations received special attention during the negotiations. Measures were adopted to increase the flow of financial assistance to them.

The U.S. role in the world economy

The U.S. international trade position changed abruptly as the nation's merchandise trade balance shifted from a deficit in 1974 to a record high surplus in 1975. The shift occurred as the value of exports expanded by over 10 percent, while imports declined by over 6 percent from 1974 levels.

Nonpetroleum imports fell consistently from a peak reached in October 1974, and petroleum imports (in terms of both value and volume) began to slacken early in 1975. The advance in the value of exports continued during the year despite widespread recession in most industrial markets abroad. Exports to developed areas in 1975 increased by less than 5 percent over 1974 levels—most of the increase taking place in higher shipments to Canada. The largest increase, both in percentage and value terms, occurred in shipments to the petroleum-exporting countries, up 25 percent in 1975. These countries increasingly used their high oil revenues to expand consumption and build up industrial foundations. This was reflected in strong U.S. exports of capital goods (especially nonelectrical machinery).

The strong trade balance was reflected in the U.S. current account balance trade in goods and services, including net income from foreign investments, private transfers of remittances and pensions, and U.S. government nonmilitary grants. Following a deficit of $3.4 billion in 1974, the current account showed a surplus of $9.3 billion during the first three quarters of 1975.

The depressed credit demand in the United States and relatively high levels of credit demand in foreign markets led to a $15.2 billion increase in the net claims of U.S. banks (including branches and agencies of foreign banks in the United States) on foreigners (including foreign branches of U.S. banks) in the first ten months of 1975. Placement of funds in the Eurodollar market, either directly or via related institutions such as overseas branches, have been a prime channel for movement of funds out of the United States. U.S. bank liabilities to foreigners (excluding custody holdings of Treasury bills and certificates) fell $5 billion through October 1975. Of this decrease $2 billion represented a reduction in foreign-owned demand deposits. The net result of these foreign transactions was a reversal of the system's historic debtor position. At the end of October 1975 the net creditor position of the U.S. banking system in relation to foreigners stood at $800 million.

Other capital flows reflected in the U.S. balance-of-payments accounts also were significantly influenced by world economic conditions. U.S. direct investment abroad slowed, as did foreign investment in the United States. But the unusually strong performance of the U.S. current account in the first nine months led to a $2 billion surplus in the "basic" balance (the balance on current account and long-term capital)—the first in recent history.

The improvements in the U.S. balance-of-payments position, combined with improved prospects for the U.S. economy in the latter part of 1975, led to a considerable strengthening of the exchange value of the dollar relative to major currencies. By year-end the value of the dollar in terms of a trade-weighted average of 14 major currencies was some 3.5 percent above the level at the beginning of the year.

Prospects

As 1976 began the world economy appeared well on the road to recovery from the deepest recession and most widespread inflation in over thirty years. For the major industrial countries the OECD has forecasted a 4 percent real rate of growth and moderation in the rate of inflation (as measured by the rate of change in consumer prices) from 10 percent in 1975 to about 8 percent in 1976. This represents a considerable improvement over the experience of the past two years—but still below the historical standards established by these countries. The growth will be insufficient to create enough employment opportunities for those currently out of work and for the entrants into other labor markets. In 1976 the industrial world will be confronted with the task of coping with the social and political consequences of relatively high unemployment.

The developing countries will benefit from the increased imports of the industrial world as their recovery progresses in 1976. However, for a great majority of developing countries (particularly those saddled by large international indebtedness) many severe problems will remain.

Government: income supports

In 1975 the federal government acted to speed the recovery from the recession and relieve the hardships associated with the highest unemployment rates since World War II through tax cuts, greater spending on existing social programs, and new and broader income-support programs. Both corporations and individuals benefited from the tax cuts. For corporations the major changes were reduced taxes on the first $50,000 of profits and an increase in the investment tax credit from 7 to 10 percent. For individuals a broad spectrum of changes reduced payroll withholding schedules about 10 percent from previous levels. In addition to "normal" refunds of $26 billion in overwithheld payroll taxes, individuals received rebate payments totaling nearly $8 billion—up to $200 per return on taxes paid during 1974. A special tax credit for purchasers of new homes was designed to stimulate the housing market. This credit, applicable against the 1975 tax liability, was 10 percent of the cost of the home, up to a maximum of $2,000.

Taken together, the tax rebates, refunds, and lowered withholding payments undoubtedly played a major role in supporting consumer spending during the second half. At the same time these changes lowered federal tax revenues about $20 billion below what they otherwise would have been, and caused the first year-to-year decline, about $5 billion, since 1970. Lowered receipts and record federal expenditures produced a $73 billion deficit for calendar 1975 on the national income accounts basis (NIA), the accounting system consistent with gross national product and national income measures.

Support for people and governments

Social security beneficiaries received a one-time $50 special payment in June as a result of legislation enacted along with the tax cut. They also got an 8 percent increase effective in July to conform with the change in the Consumer Price Index. The maximum income against which the social security tax is collected was raised to $14,100 for 1975, up $900 from the 1974 level, partially offsetting the effect of the income tax cuts for some individuals. The tax base for 1976 is $15,300.

Unemployment insurance was expanded to include previously uncovered individuals, and the benefit period was extended from 52 to 65 weeks. Unemployment benefits paid during 1975 totaled nearly $17 billion, about two and one-half times as much as in 1974. As more individuals became eligible, spending for the food stamp program was about $5.5 billion in 1975, 50 percent higher than the 1974 level.

The reductions in taxes and expansion of income-support programs combined to affect personal income in two unusual ways. First, disposable income, that portion of income left after taxes, increased by $93 billion, almost $2 billion more than the increase in gross personal income. The share of total income going for taxes declined from 14.8 percent in 1974 to 13.6 percent in 1975. Second, federal government transfer payments supplied nearly 14 percent of disposable income in 1975, up from about 12 percent in 1974. The $32 billion year-to-year increase in these payments provided over one-third the total increase in disposable income for 1975.

The sharp increase in federal assistance to individuals was paralleled by rapid growth in the level of grants-in-aid to state and local governments. These grants totaled $54 billion in 1975, up almost 24 percent from the 1974 level. The $10 billion increase in grants provided nearly half the total increase in state and local revenues that occurred during the year.

Federal expenditures

The federal government expended a total of $357 billion during 1975 (NIA), up $57 billion from 1974. Eighty percent of this increase was for nonpurchase expenditures such as assistance to individuals and state and local governments, but also including such things as grants to foreign governments and interest costs. The importance of these nonpurchase expenditures has been growing, while the importance of government purchases of goods and services has trended downward since World War II. In 1975 purchases of goods and services amounted to only slightly more than one-third of all federal expenditures—$123 billion, about $11 billion above the 1974 level. After allowing for inflation, there was probably a slight decline in the real level of federal spending for goods and services.

Historically, the largest portion of federal purchases of goods and services has been for defense. The combined civilian and military employment of the Defense Department accounts for about 75 percent of total federal employment, and most of the equipment the federal government purchases is for military use. However, the defense share of purchases has been declining steadily from nearly 41 percent of total expenditures in 1969 to about 23 percent in 1975. As a result of this declining trend, defense spending has held at less than 6 percent of gross national product since 1973 while, in 1975, total federal government expenditures were 24 percent of GNP.

Congressional budget reform

A major innovation in the planning of the federal budget became operative in 1975 with the implementation of the Congressional Budget Reform Act of 1974. Under the provisions of the act Congress is required to examine the budget as a whole, to set revenue and spending objectives, and to adjust taxes and appropriations to conform with the objectives. The act also moved the start of the fiscal year from July 1 to October 1 beginning with fiscal 1977—allowing Congress nine months to carry out the budget process each year. Fiscal 1976 (July 1, 1975 through June 30, 1976) was to be used as a trial period prior to full implementation for fiscal 1977. Congress, choosing to proceed as if the act were binding for fiscal 1976, set spending and revenue estimates both for fiscal 1976 and the interim quarter that precedes the start of fiscal 1977. The actions taken by Congress under the new procedures specified a total deficit of about $95 billion for this 15-month period on a unified budget basis, the accounting system used in the budget process.

Late in December Congress passed a bill extending the tax reductions of 1974 through the first half of 1976. The bill included a statement that spending in fiscal 1977 would be held to a minimum practical level, with resulting savings used for further tax cuts. In January 1976 the President proposed a fiscal 1977 budget of $395 billion in expenditures and further tax cuts leading to a $43 billion deficit. Whether these goals can be achieved is uncertain, but most observers believe that, at the least, the present tax reductions will be extended for the full year.

The outlook for federal government expenditures in calendar 1976 is clearer than usual because plans and proposals are already defined for nine months. It is generally expected that spending will approach the $400 billion level and the deficit will be close to the 1975 level—$73 billion (NIA).

State and local governments

The aggregate figures for receipts and expenditures of state and local governments make 1975 look typical. Total expenditures, $222 billion, were larger than in 1974 but grew slightly less than the 11 percent rate that has been the norm for the past decade. In a typical year over 90 percent of state and local expenditures are earmarked for purchases of goods and services; this trend was repeated last year when $208 billion went for such purchases. Revenues grew to keep pace with spending, leaving an operating surplus of $10 billion. However, this was not enough to cover the $11 billion needed for contributions to social insurance, which includes public employee medical and disability insurance, and reserves for pension plans.

Behind these totals lie some serious financial problems for many state and local governments. Only the large increases in federal grants-in-aid prevented either sharp expenditure reductions or substantial tax increases. If grants-in-aid grew only as fast as other sources of revenue, these jurisdictions would have faced an aggregate deficit of $8 billion rather than the $1 billion deficit they actually experienced. Virtually every source of state and local tax revenue was adversely affected by 1975's unfavorable business conditions. Even with a strong upturn in business activity the lag in collections of property taxes will have a depressing effect on revenues well into 1976.

Virtually every state now faces problems related to unemployment compensation. When a state has exhausted its reserves to make these payments, it borrows from the federal government, but these borrowings must be repaid in later years. The high levels of unemployment that prevailed during 1975 all but exhausted reserves. In 1976 most states will have to raise the tax rate for this insurance to restore reserves to adequate levels.

Most state and local governments are required by law to operate with balanced budgets, and many jurisdictions raise taxes or pare expenditures to meet this requirement. However, accounting and financing procedures that would not be acceptable in the private sector occasionally have been used to satisfy statutory requirements. The use of such procedures came into sharp focus in 1975 with the news that New York City would be unable to meet its needs for operating funds or to pay off outstanding notes as they came due. Officials from both New York State and New York City made a determined effort to obtain massive federal assistance. Only after the state offered substantial help to the city, and after the city promised to curtail expenditures sharply did the Administration approve federal assistance in the form of a $2.3 billion, three-year loan against which the city could draw, with the provision that the borrowings be repaid by the end of each fiscal year. It remains to be seen whether drastic new taxes and cuts in expenditures can return the city to a sound fiscal basis over the next three years.

New York City was not the only governmental unit that faced massive problems in 1975. The government of Massachusetts, for example, was forced to place its full faith and credit behind its housing agency to obtain refinancing and also had to make drastic expenditure cutbacks. Philadelphia had difficulty in floating a financing issue; Detroit experienced serious problems in obtaining financing. Richmond, Virginia, a community with sound financing practices and a good record, received no bids on a relatively small bond issue because of a law suit over an annexation action that had been pending for years and had not interfered with borrowing in the past.

The revelation of financial problems in so many jurisdictions undoubtedly played a major role in the elections in November when voters across the country defeated referendums for many new bond issues. The failure of voters to approve these issues may slow state and local government capital expenditures for several years to come.

Finance: market pressures ease

Reduced credit demands and a more stimulative monetary policy combined to ease overall pressures on the financial markets in 1975. Many specific credit problems remained, however, especially in real estate and municipal finance areas.

Efforts to revive the economy through monetary stimulation helped to lower short-term interest rates, but easing actions had to be tempered by the overriding need to avoid setting off a new wave of inflation and subsequent economic decline. The public's holdings of demand deposits and currency (the money supply, narrowly defined) grew at a pace generally believed consistent with the long-run growth potential of the economy. Time and savings deposits, except negotiable certificates, grew quite rapidly for the year as a whole. Because of changes in practices and regulations affecting their use, such balances now can perform many of the functions ascribed to checking accounts.

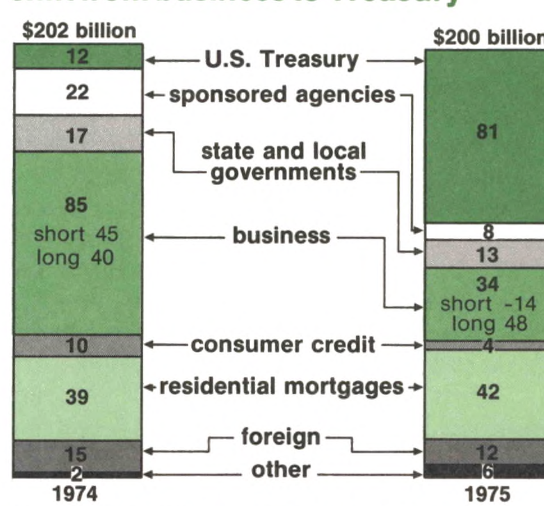
The total volume of funds raised in the credit markets was about the same as in 1974, but the composition changed greatly as the recession drastically reduced private credit demands and produced a record federal budget deficit. State and local new financing was moderately below the 1974 peak level, partly due to special problems in that market caused by New York City's difficulties.

The pattern of credit flows reflected efforts by both businesses and households to strengthen financial positions strained by the rapid inflation and high interest rates that preceded the recession. Consumers reduced debt and increased savings relative to income. Businesses improved liquidity by repaying short-term borrowings, partly by refinancing bank loans in the capital markets. With market interest rates down sharply from last year's peak levels, personal savings were channeled to financial intermediaries in record volume. Residential mortgage loans rose more than in 1974 although less than the very large increases in the two previous years. Lenders and investors continued to pay close attention to credit quality. The improved liquidity of consumers and many businesses, including banks, helped to restore a firmer basis for future growth.

Treasury the major borrower

Federal government net borrowing exceeded $80 billion in calendar 1975, accouting for roughly 40 percent of the funds raised in the domestic credit markets. This compares with a 5 percent share in the previous year. Inclusion of sponsored agency borrowing, largely in support of the housing market, would raise the federal component to 43 percent in 1975 against 15

Funds raised in credit markets shift from business to Treasury



Source: Flow of funds, 1975 partly estimated.

percent in 1974. Concern that so huge a financing operation might either require excessive money creation or "crowd out" private sector financing needed to spur the recovery proved largely unfounded. The successful placement of Treasury issues at declining interest cost and without inflationary money growth evidences the weakness of business and consumer expenditures and related credit demands.

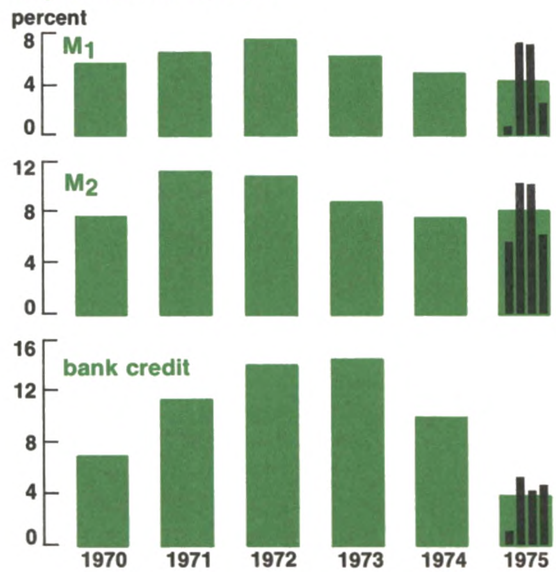
The greater Treasury borrowings took up the slack left mainly by the business sector. Nonfinancial businesses reduced total funds raised by 60 percent compared with 1974 as nearly one-third of the growth in longer-term obligations and equities was offset by repayment of bank loans. Because of the high returns demanded by investors on truly long-term obligations, an unusually large share of new corporate debt issues carried maturities in the five- to ten-year range. Postponements and withdrawals were frequent, especially of issues carrying less than top credit ratings.

Aggregates and money rates

The Federal Reserve System sought to ease conditions in the credit markets to the degree consistent with a monetary growth adequate to support recovery while reducing the rate of inflation. The Federal Open Market Committee (FOMC) continued to try to achieve growth rates in the monetary aggregates consistent with these objectives. Besides the narrowly defined money supply (M_1), attention is also given to M_2, which adds savings and time deposits at commercial banks other than large negotiable certificates of deposit to the M_1 components, and to M_3 which also adds in deposits at savings and loan associations (S&Ls) and mutual savings banks (MSBs) and credit union shares.

As the year began, all the aggregates were relatively weak, mainly reflecting the demand deposit component. Short-term interest rates were in the midst of the steepest decline on record. The federal funds rate, which is very sensitive to Federal Reserve operations, already had fallen from a mid-1974 peak above 13 percent to around 8½ percent at the start of the year. By early March it dropped below 5½ percent—the lowest level in more than two years. It continued to edge down toward 5 percent through most of the second quarter. Meanwhile, the basic discount rate applicable to advances to member banks was reduced in four steps from 7¾ percent to 6 percent by mid-May. Reserve requirements on demand deposits were reduced ½ percent on all strata of demand deposits in January and on longer-maturity time deposits later in the year.

Broad money grew faster than M_1 or bank credit



NOTE: M_1 = currency and demand deposits held by the nonbank public, M_2 = M_1 plus commercial bank savings and time deposits other than negotiable certificates of $100,000 or more. Annual changes based on daily averages for final quarters. Quarterly changes based on averages for months in quarter. Bank credit = loans (including loans sold to affiliates and excluding domestic interbank loans) and investments of all commercial banks on last Wednesday of year or month.

Eurodollar reserve requirements were reduced from 8 percent to 4 percent in May in order to make the cost of these funds more comparable with alternative sources.

Early in the second quarter, the FOMC specified target growth rates (annualized and seasonally adjusted) of 5 to 7½ percent in M_1, 8½ to 10½ percent in M_2, and 10 to 12 percent in M_3. These ranges, applicable over a 12-month horizon reaching to the second quarter of 1976, were considered consistent with objectives on the basis of developments at that time.

The rise in M_1 in May and June seemed much greater than could be explained by the income tax rebates and supplementary social security payments. Evidence of a revival of economic activity suggested that the demand for money would strengthen, and the Treasury's estimates of financing needs continued to be revised upward. Taking account of these factors, in late June the Federal Reserve adopted a somewhat less accommodative posture, permitting the federal funds rate to rise to around 6 percent. It remained in a narrow 6 to 6¼ percent range throughout the summer. Most other market interest rates moved appreciably higher in response to the higher funds rate, heavy Treasury borrowing, efforts to prevent default on New York City obligations, and expectations that strengthening activity would require additional monetary restraint.

Despite the strong upsurge in GNP in the third quarter, there was little further expansion in M_1. The average level in the three months, however, was about 7 percent (seasonally adjusted annual rate) higher than the second-quarter average. Savings flows also slackened late in the third quarter as higher offering rates on Treasury issues again attracted small investors. Almost half of the two-year 8⅜ percent notes sold in September was allotted to noncompetitive bidders—mostly small banks and individuals—despite the $5,000 minimum denomination.

In early October the FOMC acted to ease money market conditions in order to stimulate renewed growth in the aggregates and also in recognition of the possible adverse effects of unsettled financial markets on the economic recovery. Sufficient reserves were provided to lower the federal funds rate back to the 5 to 5¼ percent range where it remained through year-end. Meanwhile, the 12-month target ranges for the monetary aggregates were updated to a third-quarter base. The M_1 range was unchanged, while the M_2 and M_3 ranges were widened to 7½ to 10½ percent and 9 to 12 percent, respectively.

Savings deposits strengthened again as rates on market instruments declined, but demand deposits, as measured by available statistics, followed an unusually erratic path with only a modest gain on balance. Fourth-quarter annual growth rates (based on quarterly averages of daily figures) were about 2½ percent for M_1 and 6 percent for M_2—both short of the desired pace. Expansion in bank credit, which is an important factor in money creation, rose only 4 percent in 1975—the smallest gain since 1969.

After adjustment of the data for deposits at nonmember banks and based on revised seasonal adjustment factors, December to December growth was 4.2 percent for M_1, 8.3 percent for M_2 and 11.2 percent for M_3. Bank time deposits other than money market certificates of deposit (CDs) rose 12 percent, savings at S&Ls and MSBs rose 16 percent, and credit union shares were up 20 percent compared with 1974 growth of 9, 6, and 12 percent, respectively.

New payments practices

Both measurement and interpretation of the monetary aggregates have had to take account of the increased use of interest-bearing deposits for transactions purposes. Installation of electronic funds transfer equipment and other efforts by banks, often in cooperation with nonbank thrift institutions, to improve customer services have increasingly blurred the functional distinction between checking and savings balances.

This trend was facilitated by amendments to Federal Reserve regulations intended to remove restrictions that put member banks at a disadvantage compared with their competitors. During the year member banks were permitted to pay bills for their customers through preauthorized transfers from savings accounts, to accept telephone requests from customers to transfer funds from savings to checking accounts, and to open savings accounts for profit-making organizations to a maximum of $150,000. The latter grew very rapidly from November 10, when the new rule became effective, through year-end.

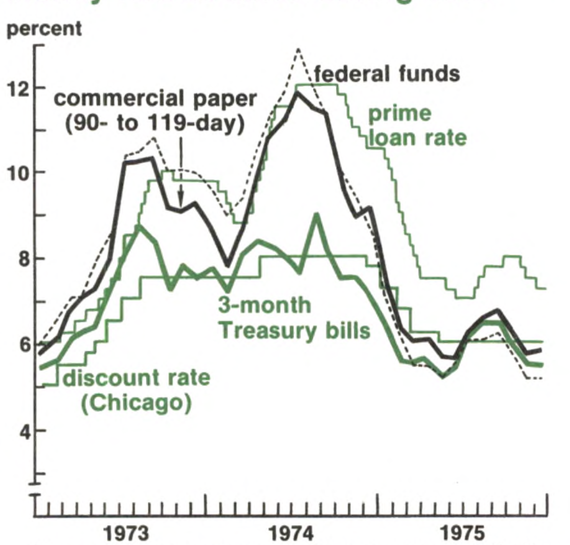
Other developments that may result in further shifts from cash to savings-type accounts include the increasing number of states permitting negotiable orders of withdrawals (NOWs) on savings balances at both banks and S&Ls, and the direct deposit of social security checks.

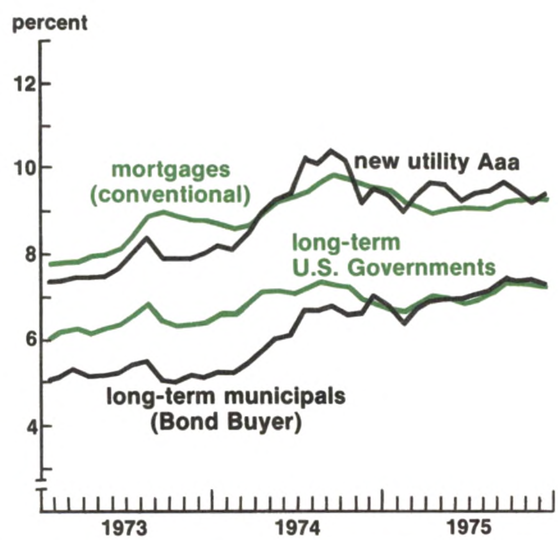
Long-term interest rates stay high

In contrast to the significant decline in money market interest rates, yields on most categories of long-term bonds and mortgages remained within a fairly narrow range, less than one percentage point below 1974 peaks.

The financial problems of New York City and the efforts to resolve them dominated the tax-exempt market. A major municipal yield index hit a temporary all-time high of 7.67 percent in late September, largely reflecting price declines on obligations with less than top quality ratings. Some municipal issuers, caught in the backlash of New York's financial problems, had to pay unprecedented rates and a number of planned issues were withdrawn. In response to investor concern issuers began to disclose their financial condition in greater detail,

Bond and mortgage yields did not parallel money rate declines during 1975





Note: Market rates are monthly averages of daily figures.

and in some localities planned expenditures were cut severely.

Both corporate and municipal gross issue volume set all-time records. The stickiness of yields evidenced investors' reluctance to lengthen the maturity of their portfolios despite a wide yield advantage. In part this reflected continued concern about the effect of future inflation on the value of long-term fixed-return assets.

Yields on most Treasury coupon issues were a little higher at the end of the year than at the start, although these also showed a declining trend in the fourth quarter. To stabilize this sector of the markets, a larger-than-usual portion of Federal Reserve System reserve supplying operations was effected through purchases of coupon issues. Of a $7.2 billion net increase in securities held outright by the Federal Reserve, $6.2 billion were Treasury coupon issues and the rest were agencies. In 1974, when housing agencies were heavy borrowers, the System bought less than $2 billion in coupons and $3 billion of agencies.

With strong savings flows into mortgage lending institutions and moderate housing demand, mortgage loan rates softened, but not as much as corporate yields. These patterns worked toward a restoration of a more normal rate relationship between these investment sectors and thus toward a better supply of mortgage funds. At year-end the HUD national average rate on conventional new home loans was still above 9 percent, but local commitments were reported available at 8¾ percent.

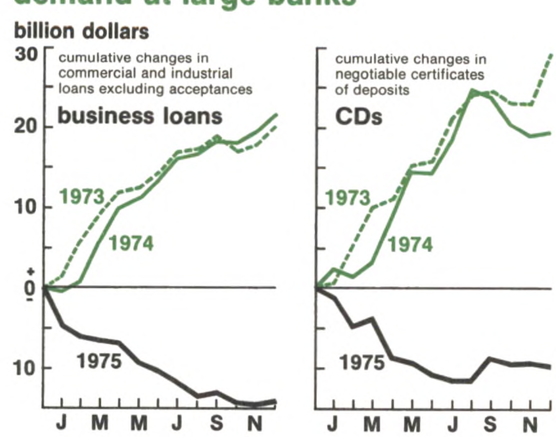
Bank loans and CDs drop

After more than a decade of very rapid growth, 1975 was a year of pause and consolidation for the banking industry. The 1974 concerns about a possible liquidity crisis in the banking system were largely dissipated, but many bankers still had to deal with problems in construction and land development loans, and charge-offs of loan losses were unusually large. To cope with these problems, most banks took steps to build their liquidity and capital positions. Improved earnings contributed to these efforts.

Outstanding loans at domestic offices of the major city banks declined more than $18 billion, or 6 percent. Smaller banks, where cyclical fluctuations are normally less, reported only very modest gains in loans. Total loans of all commercial banks dropped over 1 percent for the year—the first decline for any year since World War II. The bulk of the decline was due to net repayments by commercial, industrial, and financial businesses—firms which had relied very heavily on bank loans in 1973 and 1974. Consumer and real estate loans also were much weaker than usual. This weakness persisted through much of the year, although it was less apparent in the fourth quarter.

The major factor in the liquidation of business loans was reduced demand stemming from declining inventories, lower tax liabilities, and funding of debt in the capital market. But conservative bank lending policies also restrained new loans. With widespread concern about loan losses

CDs reflect business loan demand at large banks



and erosion in the market value of some important state and municipal securities, most banks continued to keep credit standards tight.

During the early part of the year many bankers were content to see loans fall from the extremely high levels built up over the two previous years. By the fourth quarter there was evidence of renewed interest in expanding loans, but not at the expense of earnings margins or credit standards. The net increases in business loans that were reported in November and December (seasonally unadjusted) were due entirely to the acquisition of bankers' acceptances, which, though classified as business loans, are effectively short-term money market investments. Reductions in the prime lending rate of the major banks, which closed the year at 7¼ percent, lagged the decline in other short-term rates, restoring a better margin over the cost of funds.

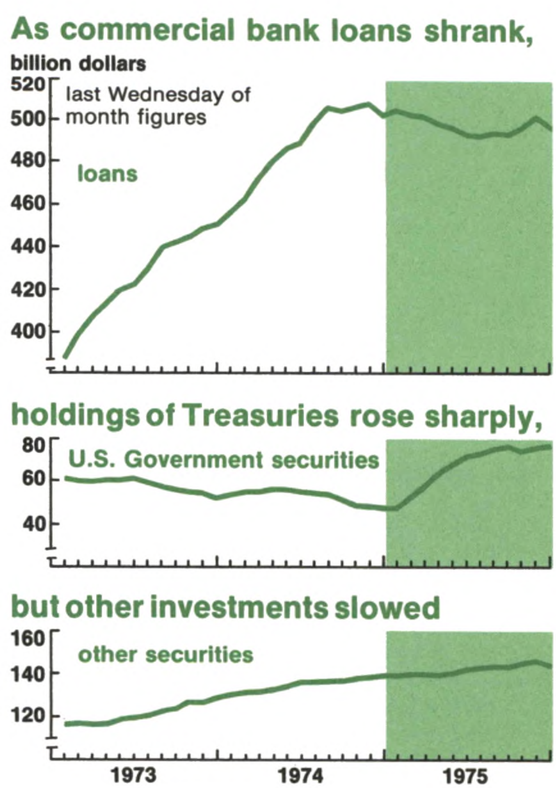
Sources of bank funds last year contrasted sharply with 1974. With savings flows generally strong and the need for loanable funds declining, the major banks permitted a significant runoff of maturing negotiable CDs. These obligations of the large banks declined almost $10 billion net during 1975. Nonnegotiable CDs in $100,000 denominations declined almost $4 billion. Average maturities of negotiable CDs were extended to a modest degree. At year-end 9 percent of outstandings had maturities of six months or more, compared with 4 percent at the end of 1974. Those due in three months or less declined to 72 percent of outstandings from a 1974 peak of 84 percent.

In the fourth quarter, in order to encourage banks to improve liquidity by lengthening the maturities of interest-sensitive deposit liabilities, the Federal Reserve Board reduced reserve requirements on time deposits maturing in four years or more from 3 percent to 1 percent and on 180-day to four-year maturities from 3 percent to 2½ percent, so long as average reserves on all time deposits do not fall below the legal 3 percent minimum.

Investment securities up sharply

Bank acquisitions of U.S. Governments and other securities more than offset the contraction in loans. Holdings of Treasuries at all commercial banks rose almost $30 billion—a 60 percent increase and roughly 35 percent of the net increase in federal marketable debt. Bank demand for government securities was an important element in the successful completion of Treasury financings.

Although banks' Treasury portfolios have trended downward since World War II, they generally have shown a contracyclical pattern, with increases replenishing liquidity between periods of strong loan demand. This pattern also reflects opportunities for trading profits



when interest rates decline. An additional factor in 1975 was the incentive to upgrade investment quality in the face of historically high loan losses. Perhaps most important of all was the fact that the Treasury was the principal source of credit demand in the economy. In line with liquidity objectives banks generally stayed with short maturities. Data from the Treasury ownership survey indicate that, through November, maturities within one year rose from 35 to 44 percent of bank holdings, while the proportion five years or more to maturity dropped by about one-third. Three-fourths of the year's net increase in Treasuries held by the major city banks matured in less than a year.

By contrast, bank acquisition of tax-exempt securities, which were almost double Treasuries in bank portfolios as 1975 opened, was well below normal. This reflected less need for tax-exempt income at some banks as well as general concern about the quality of state and municipal obligations. The major city banks reported a $5 billion decline in their total loans and investments.

Seventh District banking

Although contraction in loans was reported by the large banks in the district's major cities, smaller banks in Illinois, Indiana, and Iowa continued to show relatively good gains, reflecting agricultural credit needs. In the aggregate, member banks increased investments by three times as much as loans declined. U.S. Treasury securities accounted for three-fourths of the investment expansion, but unlike the national experience, holdings of municipals rose faster than in 1974. Many smaller banks shifted some funds they had been placing in the fed funds market into Treasuries as the sharp decline in the fed funds rate made sales less attractive.

The district data illustrate the greater impact of cyclical fluctuations on large city banks compared with the smaller institutions. At the large banks loans declined more and deposits rose less or not at all. Savings inflows were substantial, but some large-denomination deposit certificates were not replaced at maturity. As measured at year-end, total deposits at all district member banks were up only 1 percent in 1975, compared with 8 percent in the previous year. For most banks the ratio of loans to deposits, often used as an inverse indicator of liquidity, declined.

Banks in most district areas improved liquidity in 1975

	Loans[1]	U.S. Govt. securities	Other securities	Total deposits	Loans as percent of deposits 1/1	Loans as percent of deposits 12/31
	(percent change, Jan. 1 to Dec. 31, 1975)					
Large banks[2]						
U.S. total	- 6.8	+ 68.4	- 3.4	+ 1.9	73.4	67.1
Chicago	- 7.1	+ 71.4	+ 6.1	- 6.6	84.0	83.6
Detroit	- 3.2	+ 29.1	+ 8.2	+ 0.7	72.7	69.8
Indianapolis	- 5.6	+ 42.5	- 3.1	+ 4.7	80.9	72.9
Milwaukee	- 6.0	+307.8	-12.8	- 0.4	80.9	76.3
Des Moines	- 2.5	*	+10.2	+11.1	57.3	50.3
Other member banks						
U.S. total	+ 4.4	+ 38.8	+ 6.6	+ 4.4	77.8	77.8
Illinois	+ 4.7	+ 37.6	+11.5	+ 7.9	56.5	54.8
Michigan	- 0.2	+ 40.1	+ 6.6	+ 4.4	67.9	64.9
Indiana	+ 4.7	+ 56.9	+ 8.3	+ 8.1	57.9	56.1
Wisconsin	- 3.3	+ 48.3	+ 7.6	+ 4.3	67.2	62.2
Iowa	+12.2	+ 35.6	+13.4	+12.2	56.6	56.5

*Less than .05 percent.

[1]Excludes federal funds sold and domestic interbank loans.

[2]Weekly reporting banks.

Ahead: prospect for expansion

Aided by a major tax reduction, larger government transfer payments to individuals, and a stimulative monetary policy the U.S. economy shook off the forces of decline in the spring of 1975 and began a new expansion that continued in early 1976. Bountiful harvests replaced the poor yields of 1974 and assured an ample supply of food for the new year. The huge foreign trade deficit of 1974 was replaced last year by a record surplus. Many businesses, financial institutions, and individuals improved their eroded liquidity situations last year. Early in 1976 interest rates were generally lower than a year earlier. Lenders remained cautious, but new loans were increasingly available. Prospects are favorable that the expansion would continue throughout the year.

As usual, doubts are being expressed about the durability of the current expansion. Confidence is still a scarce commodity despite three quarters of real growth. Few prognosticators are prepared to predict, however, that the uptrend will give way to a new decline before the year is out. The shortest expansion since World War II, following the 1957-58 decline, lasted two years. The others lasted three years or more. Apparent letdowns early in the expansions that started in 1949 and in 1970 reflected the temporary effects of major strikes in basic industries. Vigorous debates are in progress concerning the most appropriate fiscal and monetary policies to promote maximum growth while avoiding a reacceleration of inflation. While policy views differ, there is complete accord among leaders in government, finance, and industry that the United States cannot afford a new recession before the wounds of the recent decline are healed.

The consensus forecast suggests reachievement of the levels of real GNP reached in the fourth quarter of 1973 by the fourth quarter, possibly by the third quarter, of 1976. Sales of most types of equipment purchased by both consumers and producers, however, probably will not achieve 1973 highs this year, but their climb back should be well advanced.

The record level of activity reached in the fourth quarter of 1973 represented a "superboom" and predated the energy crisis. The following recession was long and severe. If the fourth-quarter 1973 level is reachieved by year-end, the "round trip" will have taken three years—twice as long as in earlier post-World War II recoveries. Even so, margins of unused resources of workers and facilities will be sizable late this year.

The unresolved economic issues in early 1976 in broad outline are much the same as a year ago: inflation, unemployment, pollution abatement, access to sufficient raw materials, and uneasy international markets—all are still present. Progress has been made, however, toward moderating these problems. Hope for the future has been buttressed by the knowledge that the unprecedented calamities of 1974 and early 1975 were followed by a broad-based recovery with the basic strength and resiliency of the economy intact.