

A BUSINESS AND FINANCIAL REVIEW BY THE FEDERAL RESERVE BANK OF CHICAGO

January/February 1977

ECONOMIC
PERSPECTIVES



Review and Outlook: 1976-77

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Employment, output, personal income, and corporate profits all increased substantially in 1976. Interest rates declined, and credit was generally available in all sectors. Price inflation slowed and unemployment declined, although not as much as had been hoped. Farmers harvested bumper crops of major commodities. On the negative side were a large federal deficit, a huge negative balance of international trade, a series of costly strikes, and energy stringencies which threatened to limit economic growth. Experience of the Seventh Federal Reserve District states—Illinois, Indiana, Iowa, Michigan, and Wisconsin—was similar to that of the nation.

As 1977 begins a further advance toward full utilization of resources appears probable. Personal income is growing at a rapid pace, and corporate profits are trending upward. Liquidity positions of consumers, businesses, and financial institutions are much improved. Except for fuel, supplies of virtually all raw materials and components are adequate. Inventories are well balanced in most sectors, both in manufacturing and distribution. Spending on new plant and equipment and housing starts are expected to increase significantly. Despite favorable prospects, many observers believe that a fiscal stimulus—increases in federal spending and tax reduction—is required to speed the recovery.

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January/February 1977 ECONOMIC PERSPECTIVES

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Review and outlook: 1976-77

Business: broad improvement continues

Despite widespread dissatisfaction with the performance of the U.S. economy in 1976, impressive gains were recorded in employment, output, personal income, and corporate profits. Unemployment remained at distressingly high levels, partly because of an abnormally large rise in the labor force. The rate of inflation slowed markedly. Interest rates moved lower during the year, contrary to expectations. Credit was more available in all markets, and liquidity improved in all sectors. The experience of the Seventh Federal Reserve District states—Illinois, Indiana, Iowa, Michigan, and Wisconsin—was broadly similar to that of the nation.

In the summer and fall the rate of economic growth slowed significantly from the pace set early in the year. In part, the “pause” could be attributed to an unplanned short fall in federal outlays, major strikes, and political uncertainties. In December, however, reports on retail sales, personal income, employment, production, and factory orders indicated that growth was accelerating again. Executives and economic analysts were in virtually unanimous agreement that the upswing would continue into 1977 and perhaps throughout the year.

Predictions and results

The performance of the U.S. economy is commonly judged by three major criteria:

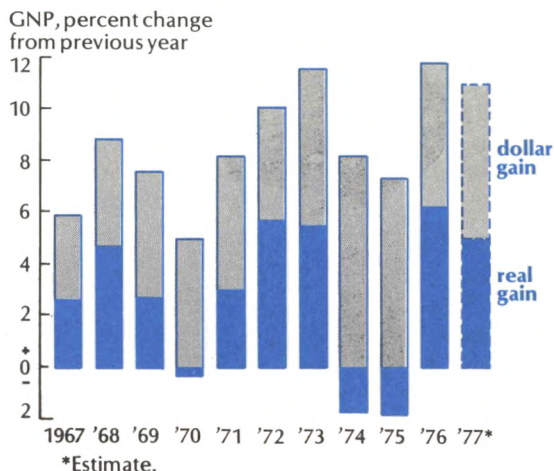
1. *Growth*—the percentage change in the gross national product—total output of goods and services—adjusted for price inflation (real GNP).

2. *Inflation*—the percentage change in the general price level measured either by the implicit price deflator derived from the relationship between current dollar GNP and constant dollar GNP, or the consumer price index (“cost of living”).
3. *Unemployment*—the number of jobless people seeking work expressed as a percentage of the civilian labor force.

In 1975 real GNP declined 2 percent for the second consecutive year, the price level increased 9 percent—slightly less than in 1974—and unemployment averaged 8.5 percent—up from 5.6 percent in 1974.

Early in 1976 virtually all forecasts called for significant improvement in the economy. On January 26, for example, the President’s Council of Economic Advisers projected a rise

Outlook for further growth remains favorable



in real GNP for 1976 of 6 to 6.5 percent, inflation at 6 percent, and average unemployment at 7.7 percent. These estimates were close to the "standard" or typical forecast. It now appears that in 1976 real GNP rose slightly more than 6 percent; inflation was just over 5 percent measured by the implicit deflator, and less than 6 percent measured by the consumer price index; and unemployment averaged 7.7 percent.

Economic results for 1976, taken as a whole, were quite close to predictions. However, most observers had expected the improvement to continue through the year at a fairly steady pace. Unfortunately, this did not occur.

Inventories and capacity

The upswing was very rapid in the first quarter of 1976 as real GNP increased at an annual rate of 9 percent. A major factor in this surge was the shift in inventory investment. In constant dollars inventories were liquidated at an annual rate of \$6 billion in the fourth quarter of 1975. In the first quarter of 1976 inventories were accumulated at a \$10 billion rate. This development reversed the experience of a year earlier when inventory accumulation at a rate of \$9 billion in the fourth quarter of 1974 changed abruptly to liquidation at a rate of over \$20 billion in the first quarter of 1975.

When inventories are declining production falls below current consumption. When inventories are rising production exceeds consumption. This phenomenon has figured prominently in every business fluctuation since World War II. The 1974-76 experience may be unique in the great variety of products affected, both hard and soft goods lines.

Inventory accumulation continued throughout 1976 for business taken as a whole, but the rate of accumulation of the first quarter did not accelerate.

In the spring rising shipments caused order lead times to lengthen for many products. Some purchasing managers feared a reappearance of the shortages that disrupted output schedules in 1973 and early

1974 and increased orders accordingly. During the summer it became apparent that fears of near-term shortages were groundless and orders for many products were cut back. Inventories of some products such as steel, textiles, appliances, and chemicals were reduced. These developments played a large role in the slowing of the rate of rise in real GNP. "Final sales," GNP less the change in inventories, continued to rise quarter-by-quarter at a fairly steady pace.

Predictions favorable again

Economic forecasts for 1977 indicate that the year ahead will closely resemble 1976. Once again the range of predictions is remarkably narrow.

Business Week, in its year-end issue, published a compilation of forecasts for 1977 by 25 individual economists and nine econometric models. The average of these forecasts shows a rise in real GNP of just under 5 percent with a range from 4.2 to 5.8 percent. Prices are expected to increase 5.5 percent with a range from 4.5 to 7.3 percent. Unemployment is expected to average 7.2 percent with a range from 6.7 to 7.6 percent. The spread between the high and low forecasts is not inconsiderable, but even the extremes provide little advice for individual executives beyond the notions that (1) the year will be fairly prosperous, (2) full employment will not be regained, and (3) inflation will continue at a high rate relative to historical standards. Within this scenario variations in results among industries and among firms within industries no doubt will be large.

In the past 30 years the annual rise in real GNP has averaged 3.5 percent. Growth was the result of an average annual rise of 1.5 percent in employment and a 2 percent average rise in output per worker. In the past decade the labor force has increased over 2 percent per year. Assuming that productivity gains continue at the historic rate, it appears that growth in real GNP must average about 4 percent per year to keep unemployment from rising. This rate of growth was exceeded in 1976 and probably will be again in 1977.

However, the economy is operating well below its potential.

Consumers spend freely

Most observers judged that consumers did their part in promoting prosperity in 1976, in contrast to the sluggish trend in business investment. Personal income rose almost 10 percent, compared to 8.4 percent in 1975. Wage and salary income increased slightly more than 10 percent, almost twice as much as in 1975. Disposable income rose 9 percent, compared to 10 percent in 1975 when taxes were reduced.

Consumer spending on goods and services increased somewhat faster than disposable income in 1976. Total retail sales rose 11 percent, and outlays on services, including rent, rose slightly more. Personal savings, disposable income less personal outlays, declined slightly and the ratio of savings to disposable income declined from 7.8 percent to about 6.5 percent, lowest in four years. The decline in the savings rate partly reflected faster growth of instalment credit.

Retail sales of the automotive group rose 23 percent in 1976, while sales of other stores rose 9 percent. Aside from passenger cars, consumers sharply increased purchases of light trucks, recreational vehicles, furniture,

television sets, other home electronics products, and certain appliances such as microwave ovens. In addition to goods, consumers increased spending substantially for services such as air travel (up 10 percent for the year), tourist attractions, insurance, rent, and tuitions.

Consumer price rise slows

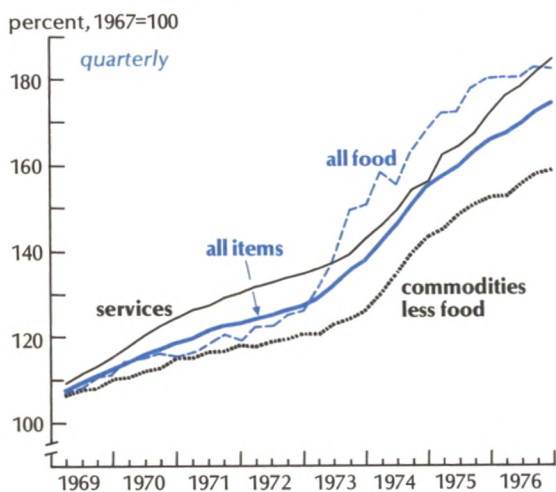
One of the most promising developments of 1976 was the reduced rate of inflation indicated by the Bureau of Labor Statistics' consumer price index. The importance of this index has increased year by year as additional labor contracts, pensions, and other contracts are "escalated" according to the changes it registers.

Consumer prices averaged 5.8 percent higher in 1976 than in 1975. This was the smallest rise since 1972, and substantially less than 9 percent in 1975 and 11 percent in 1974. Moreover, the rate of increase slowed further in the later months of the year. In November prices averaged only 5 percent above the year-earlier level.

In November food prices were up only 1 percent from the year before. This reflected a surprising 9 percent *decline* in meat prices. Other food items were up about 7 percent. Food prices had been a major factor in the very rapid price inflation of 1974-75. In the nonfood sectors especially large increases were posted last year for gas, electricity, insurance, and automobiles. With a reversal in the meat price decline highly probable, and most producers of goods and services beset by a squeeze between prices and costs, consumer prices are likely to rise somewhat more rapidly in 1977.

Analyses of the impact of wage contracts with cost-of-living adjustment clauses (COLA) typically assume that future increases in consumer prices will average 6 percent annually. Although 6 percent is only half as fast as the rise in prices in 1974, the worst inflation year, it is very rapid, compared to increases of about 1 percent annually in the early 1960s, judged in retrospect to be a period of relative price stability. Moreover, a 6 percent rate of

Rise in consumer prices moderated



price inflation compounded implies that the price level will double in 12 years.

Big rise in employment

In November total employment reached an estimated 88.1 million, up 4 million from the low of March 1975, and almost 2 million above the peak reached before the 1974-75 recession. Unemployment was estimated at 7.8 million in November, however, almost as high as in the worst months of 1975. High unemployment despite rapidly rising employment reflected an abnormally rapid increase in the civilian labor force.

The civilian labor force rose 3 percent in the 12 months ending in November, twice as fast as in the previous 12 months. When employment rises rapidly secondary workers are more likely to seek work if they learn that jobs are more available. In a typical month only about half of those seeking work lost their last job.

Nonfarm wage and salary employment was 79.7 million in November, up 3.3 million from the 1975 low, and about 1 million above the 1974 peak. As in past expansions manufacturing employment has lagged the general uptrend, when compared to earlier peaks. In November manufacturing employment was 19.1 million, up 1 million from the 1975 low,

but still 1 million short of its high.

Employment in construction was 3.4 million in November, the same as a year earlier, as activity in nonresidential construction continued at a reduced level. Most service-producing sectors showed significant gains in employment in the past year, especially in retail trade.

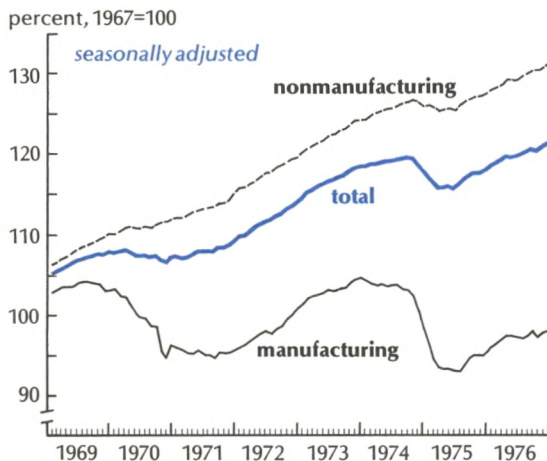
Employment increases in the Seventh District were somewhat less than in the nation, primarily because demand for various capital goods failed to revive significantly. However, unemployment rates in all district states were estimated to be substantially lower than in 1975.

Strong rise in manufacturing

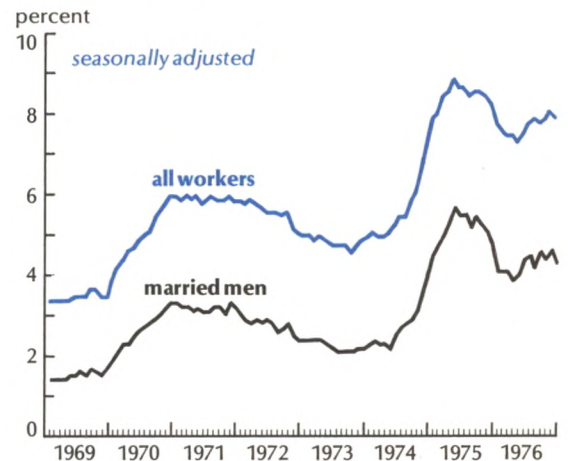
Factory output measured by the Federal Reserve's Industrial Production Index increased about 11.5 percent in 1976. This increase brought total manufacturing output for the year to a level almost exactly the same as in 1973 and 1974. Virtually all industries showed substantial gains last year. The broad categories of durables and nondurables each rose over 11 percent. Motor vehicle output was up 26 percent. Business equipment rose only 6 percent.

Manufacturing output declined 17 percent from September 1974 to March 1975, the

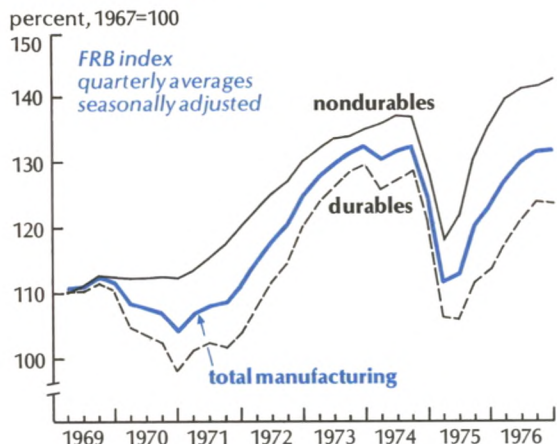
Payroll employment advanced to new record . . .



. . . but unemployment remained high



Manufacturing output neared 1974 peak



most severe drop since World War II. Durable goods declined 19 percent in this period. From the low point output rose for 17 consecutive months, although the pace of the rise moderated last summer. Output declined slightly in September and October because of inventory corrections and strikes. The November rebound regained this ground.

When manufacturing output declined last fall there were fears that further declines or at least a prolonged pause lay ahead. However, most major expansions have been interrupted in a similar fashion. This occurred in 1956, 1962, and 1967 when a pause was merely a prelude to a broad, sustained rise in activity. Factory orders increased late in the year, and most manufacturing executives anticipated further substantial gains in output.

Strikes hampered output

Labor disputes were more serious in 1976 in Midwest industries than at any time since 1970, the year of the long strike at General Motors. Most prominent were strikes in rubber, coal, motor vehicles, farm equipment, and parcel delivery service. In many cases agreements finally reached were more generous than business negotiators had anticipated when talks began.

In the first nine months of 1976 the

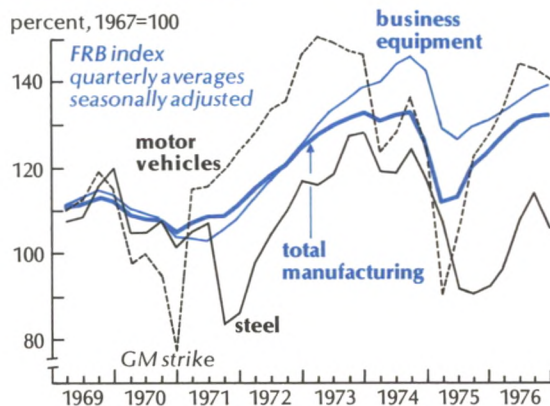
average new major labor contract resulted in first-year wage increases of 9 percent (although several were for 10 percent or more), compared to 10 percent in all of 1975. In addition, unions obtained additional benefits related to inflation protection, medical care, and pensions. Average increases in compensation for all workers were not far below the increases obtained in major labor contracts. Increased output per worker offset about half of the rise in compensation in 1976 for the private economy as a whole. Productivity gains usually are relatively large in the early stages of an expansion, but the rate of improvement tends to fall off rapidly as margins of unused capacity are narrowed.

In contrast to 1976 the coming year is expected to be characterized by relative peace in labor-management negotiations. No major deadlines will occur until July (electrical and communications) and August (steel). Moreover, the patterns established by the major settlements of 1976 probably will provide guidelines for 1977.

Steel demand disappointing

In the spring of 1976 steel analysts forecast that shipments to users and service centers would total 95 to 98 million tons for the year, compared to 80 million tons in 1975, and a record 111 million tons in 1973. For a

Motor vehicles outpaced other industries



time in the spring it appeared that the upper range of the forecasts would be reached or exceeded. Delivery times on flat-rolled products lengthened significantly and there were predictions of widespread shortages of various steel products late in the year.

Expectations of high operating rates in steel envisaged a buildup in inventories by steel users. When it became apparent that steel capacity was ample to satisfy current demands many steel users took steps to reduce inventories. In addition, heavy construction and output of capital goods and certain other products fell somewhat short of expectations. Finally, imports increased significantly. As a result, output of raw steel declined 25 percent from a peak in late May to a low point in late November. Steel output increased in December.

A price increase for flat-rolled steel scheduled for October 1 was rescinded when steel users cut orders sharply. As orders revived in November, however, a 6 percent increase in prices was put into effect on December 1.

Steel shipments actually totaled only about 90 million tons in 1976. With inventories back in line and a further increase in total consumption expected for 1977, steel shipments are expected to rise to 100 million tons, a level probably well within the capacity potential of the industry.

Automobiles and trucks

Sales of passenger cars totaled just over 10 million in 1976, including about 1.5 million imports. This was up 16 percent from 1975, but well below the 1973 record of 11.4 million. Sales of trucks totaled 3.2 million, including 240,000 imports. Truck sales were up 27 percent and approximated the 1973 record. Sales of both cars and trucks probably would have been somewhat larger, but for the 30-day strike at the Ford Motor Company.

Demand for small cars, compacts and subcompacts, was much reduced. Imports, almost all small cars, accounted for less than 15 percent of the U.S. market, down from a record proportion of over 18 percent in 1975.

Production schedules for U.S.-built small cars were reduced several times. By contrast, sales of intermediate- and large-size cars were generally excellent and various popular models were in short supply.

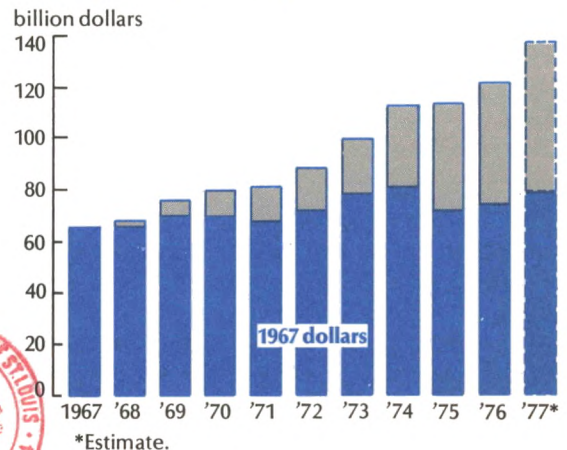
Sales of light trucks, perhaps 40 percent for personal use, were at record levels. Orders for large trucks and highway trailers also rose sharply, although they did not regain the high rate of 1974.

Motor vehicle production is expected to increase substantially again in 1977. General Motors, more optimistic than most, projects auto sales at a near record 11.25 million, and truck sales at a record 3.5 million. Major auto companies are planning large capital expenditures, mainly to improve efficiency and to meet federal standards to reduce emissions and to improve gas mileage.

Capital expenditures up slightly

Business expenditures for new plant and equipment located in the United States totaled \$121 billion in 1976, up 7.5 percent from 1975, but up only 2 or 3 percent in real terms. The performance of the capital goods sector has been disappointing to most observers. In the third quarter real GNP was about 2.5 percent above the high reached in the fourth quarter of 1973, but real spending

Further gains expected for capital spending



on nonresidential fixed investment was still 12 percent below the peak. This record compares unfavorably with earlier recoveries.

Among industries, airlines, railroads, and steel mills spent less in 1976 than in 1975. By contrast, public utilities, and the motor vehicle, food, oil, and paper industries increased spending more than the average. Most analysts expect capital spending to be up 5 to 10 percent in 1977 in real terms. Again, utilities, auto companies, and oil companies are expected to account for a large share of the rise, but all major categories of industry plan to boost outlays significantly.

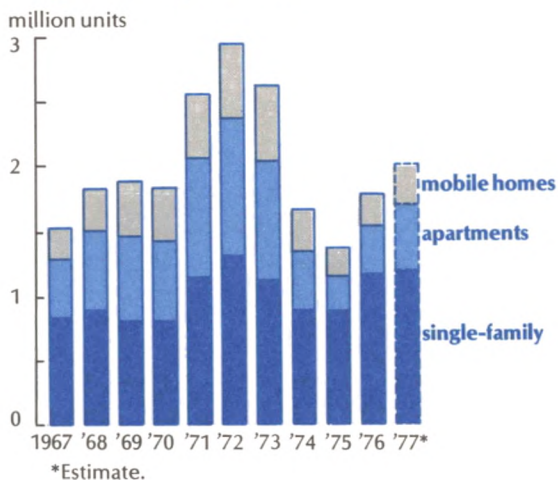
Optimism on capital spending for 1977 is supported by expected narrowing of margins of unused capacity, continued gains in corporate profits, improved business liquidity, ample availability of short- and long-term credit at rates lower than had been expected several months ago, and a slower rise in costs of construction and producer goods than in the 1973-74 boom. A crucial ingredient, however, is confidence on the part of business executives.

Home building leads construction

Early in the fourth quarter spending on construction was at an annual rate of \$150 billion, up about 10 percent from the year-earlier level. After adjustment for cost increases, construction outlays were up about 4 percent. Outlays on new housing units were up about 25 percent in real terms, but non-residential private construction was 2 percent below the reduced level of 1975, and public construction was off 10 percent.

Housing starts totaled over 1.5 million in 1976, up 30 percent from 1975, but well below the 1972 peak of almost 2.4 million. Single-family home starts, at 1.2 million, were fairly close to the 1972 level, but multifamily starts at 350,000, although up substantially from 1975, were only about one-third as many as in 1972.

Sharp upswing for single-family homes



Easier credit terms, including lower interest rates, have helped to boost home construction in the past year. Sales of new and existing homes combined have been at record rates despite price increases averaging close to 10 percent. Apartment construction is still at relatively low levels because of a residual of vacant units resulting from overbuilding in the early 1970s. Vacancy rates have been declining, however, and higher rents justify more proposed projects.

The National Association of Home Builders has projected a rise in housing starts of 15 percent in 1977 to about 1.75 million units with increases for both homes and apartments. Expanded federal programs to build subsidized units might increase these totals. Some gains are expected also for commercial and industrial construction, but only to a limited degree. An overhang of unrented office buildings and stores is still reported in most areas, and industrial companies are emphasizing purchases of equipment relative to new construction.

Agriculture: expansions highlighted developments

A broad-based expansion in livestock production and another bumper grain harvest highlighted agricultural developments in 1976. Meat production rose 9 percent from the year-earlier level to establish a new record high. Although soybean production fell sharply and weather problems raised concern about the outcome for other crops, increased acreage boosted the 1976 grain harvest 3.5 percent above the year-earlier record. The increased output contributed to a substantial moderation in retail food price pressures. Moreover, farm earnings edged somewhat above the 1975 level, although earnings during the latter part of the year proved unfavorable for many farmers.

Farm earnings rose slightly last year as a result of the expanded livestock production and the second consecutive year of bumper crop harvests. Although the increased output placed considerable downward pressure on commodity prices during the second half, the composite of prices received by farmers averaged about the same in 1976 as in 1975. Increased marketings, however, boosted farmers' cash receipts by 6 percent in 1976 to an estimated \$95 billion. Higher production expenses offset most of the increase in gross receipts and held net realized farm income marginally above the estimated 1975 level of \$22.7 billion.

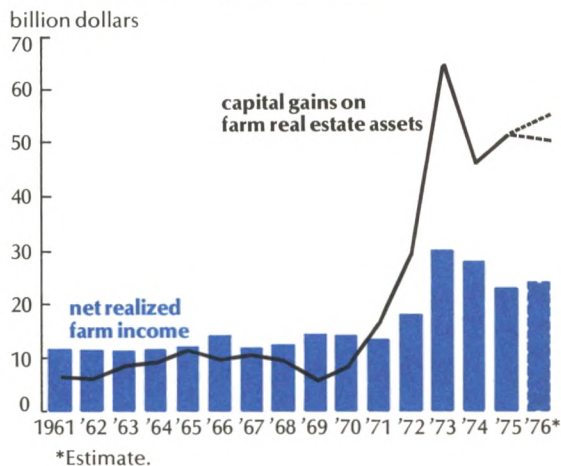
The earnings picture for Seventh District farmers was mixed last year. High prices and increased output rendered 1976 one of the most profitable years for dairy farmers. Hog producers enjoyed excellent returns during the first half but a second-half plunge in prices resulted in losses on hogs marketed late in the year. Cattle prices were below break-even levels for most farmers throughout 1976. Increased marketings from the 1975 corn and soybean harvest offset lower prices and boosted returns to most dis-

trict crop farmers throughout most of last year. However, low grain prices late in the year and the drought-reduced output of some crop farmers probably limited receipts in the fourth quarter.

Farmland values soar

Continued large increases in asset values—primarily real estate—further heightened the net worths of most individual farmers, particularly in district states. Farmland values in the Seventh Federal Reserve District rose 29 percent in 1976, the largest annual rate of gain since the current boom started in 1973. As a result of the past four years of phenomenal growth—particularly in Illinois, Indiana, and Iowa—farmland prices in the Seventh District now average about 140 percent higher than the ending 1972 level. A number of factors have contributed to the explosion, including fewer farms offered for sale, the strong expansion incentives of existing farmers, and the grow-

Gain in farm real estate values outstrip farm income again in 1976



ing interest of outside investors—both domestic and foreign—who are seeking security and inflationary hedges in an asset with a historical track record for appreciation.

A record increase of over \$10 billion boosted outstanding farm debt past the \$100 billion mark by the end of 1976. The large increase reflected farmers' strong demands for new borrowings and an accommodative posture among lending institutions. Larger purchases and higher prices for both production inputs and capital items contributed to the strong farm loan demand. Preliminary evidence suggests capital expenditures by farmers for machinery and equipment and for real estate improvements rose to \$13.4 billion in 1976, up from \$12.7 billion the previous year and double the level of a decade earlier.

As the year closed, declining commodity prices contributed to some difficulties in the farm loan portfolios of lenders. Among district states the problems were most evident in Iowa and Wisconsin, reflecting losses to cattle feeders and/or drought-reduced crop output. A comparatively large proportion of the rural bankers in those states, for example, were experiencing slower farm loan repayment rates and increases in loan renewals, extensions, and refinancing.

Food prices

Last year's rise in retail food prices slowed to one-fourth the average annual increase of the preceding three years. The slowing reflected record per capita food supplies, which reduced the pressures on raw material prices and offset some of the increased costs of food manufacturing, processing, and distribution. The year-to-year gain in retail food prices narrowed to less than 1 percent in the fourth quarter and averaged only 3.1 percent for all of 1976.

Higher prices for food consumed away from home and for imported foods accounted for most of last year's rise. For example, the index of retail prices for food consumed away from home averaged 6.8 percent above the year-earlier level, while that for grocery store food prices averaged only 2.1

percent higher. Among individual categories of grocery store foods, large increases were evident in coffee and fish prices, symbolic of the pressures exerted by imported foods. Reflecting this, the index of retail prices of domestically produced farm foods sold in grocery stores fell well below year-earlier levels in the latter part of 1976 and for the entire year averaged only 1.1 percent above the 1975 level. A sharp decline that carried meat prices to the lowest levels in about 18 months accounted for most of the reduced pressures on domestically produced foods during the latter part of 1976.

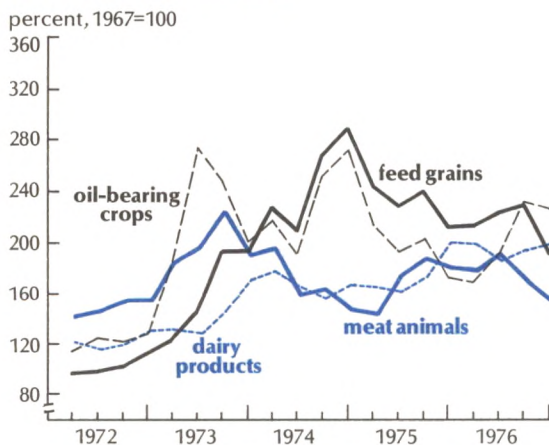
Commodity review

The record U.S. crop harvest in 1975 accommodated a substantial boost in utilization last year as well as a rebuilding of carryover stocks. Both domestic utilization and exports of soybeans rose to record levels. For grains the most striking development was the large volume of exports, reflecting USSR purchases following its disastrous 1975 harvest. U.S. corn exports, for example, surpassed the 1975 peak by over 30 percent.

New crop production prospects were again buffeted by a number of weather scares last year, both domestically and worldwide. Domestically, the most apparent damage occurred in the Plains with considerable impact on winter wheat and feed grain production as well as hay and pasture. In addition, drought and late spring frosts in some areas curtailed fruit and vegetable production. Outside of the United States weather-related crop cutbacks were most apparent in Western Europe where grain production fell to an estimated 123 million metric tons, down 7 million tons from the poor year-earlier harvest and well below the original expectations of around 142 million tons.

Despite these weather problems near-ideal conditions in most other major grain-producing areas of the world were more than offsetting. As a result, world production of wheat and coarse grains for 1976/77 is expected to reach an estimated billion metric

Grain and meat animals pace second-half decline in prices received by farmers



tons, up 5 percent from the 1973/74 record and 11 percent more than a year earlier. Among the United States' major competitive grain-exporting countries—primarily Canada, Argentina, and Australia—grain production rose to 119 million metric tons, up 14 percent from a year earlier despite a weather-related setback in Australia. Among major importing countries the most noteworthy “turnarounds” occurred in the Soviet Union and India. The 1976 wheat and coarse grain harvest in the Soviet Union equaled the 1973 record of 211 million metric tons, substantially above the disastrous 132 million ton output of 1975. Another bumper harvest in India last year resulted in overburdened storage facilities and prompted the government to halt purchases of grains in world markets and to give some consideration to exporting grains, a development that would mark a first for India.

The United States also contributed to the rise in world grain production as last year's expansion in planted acreage offset adverse weather conditions. Planted acreage of both corn and wheat—the two principal grain crops—rose to the highest levels since 1949 and was more than 7 percent above the acreage planted to those two crops in 1975. It now appears the 1976 grain harvest in this

country rose to 252 million metric tons, 3.5 percent above the previous 1975 record and 17 percent above the 1970-74 average.

The combination of rising carryover stocks and record new crop production held 1976 average grain prices below year-earlier levels. Chicago prices of corn averaged \$2.70 per bushel—down 20 cents from the 1975 average—while wheat prices averaged \$3.20 per bushel—down 40 cents. The downward pressures were particularly strong in the latter part of the year when corn and wheat prices bottomed out at around \$2.35 and \$2.60 per bushel, respectively, the lowest in around three and a half years.

In contrast to grains the soybean market tightened in 1976. Planted soybean acreage fell sharply last spring when weather conditions and price relationships encouraged farmers to plant grains. Reduced acreage and lower yields cut soybean production about one-fifth from the 1975 level. These developments caused soybean prices to rise from a low of around \$4.65 per bushel in the early part of 1976 to a high of \$6.85 late in the year. For all of 1976 prices averaged \$5.80 per bushel, 40 cents above the 1975 average.

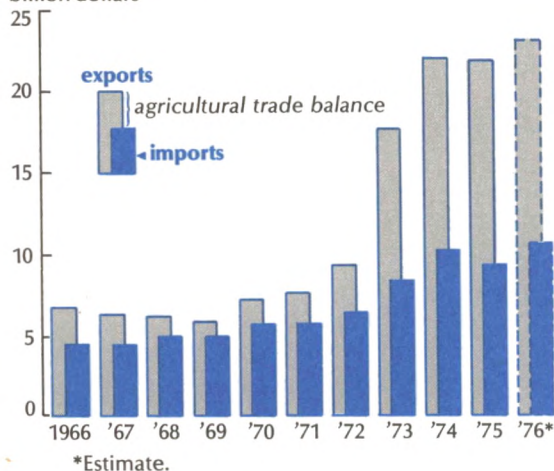
Livestock production

Livestock production expanded sharply last year, with new record highs established for several individual commodities. Total red meat production rose more than 8 percent from the year-earlier level and surpassed the previous 1971 high by 5 percent. Poultry production also rose to a record high, surpassing the 1975 output by 13 percent. Following three years of stable output, milk production rose 4 percent to a decade high. Egg production, unchanged from a year earlier, was the only major livestock commodity that did not increase significantly last year.

The record output of red meat represented gains in both pork and beef production. Because of a large movement of cattle into feedlots in the latter part of 1975 and early 1976, fed cattle marketings last year rose nearly one-fifth above the nine-year low recorded in 1975. Cow and nonfed steer and heifer

Agricultural exports edged higher last year

billion dollars



slaughter, although down somewhat from the abnormally high year-earlier level, remained large in 1976 as the liquidation phase of the cattle cycle continued. During the past two years heavy slaughter rates and declining calf crops reduced the inventory of all cattle from 132 million head to an estimated 121 million at the end of 1976. The decline is the most pronounced turnaround in the cattle inventory since the mid-1930s and reflects the financial losses that have plagued the entire cattle sector most of the time since late 1973.

The upturn in pork production during the second half of last year was almost as remarkable as the downturn that occurred in 1975 when hog slaughter fell to a 35-year low. Hog slaughter continued at a reduced level during the first half of 1976, but then soared more than one-fifth over the low year-earlier levels during the second half. Overall, last year's hog slaughter was up about 8 percent, but still the lowest—with the exception of 1975—since the mid-1950s.

The record-breaking output of red meats resulted in markedly lower prices for livestock. Choice steer prices at Omaha averaged about \$39 per hundredweight last year, a four-year low and down from \$45 a year earlier. Hog prices at major markets fell to the

low \$30s during the latter part of 1976, but for the entire year averaged \$43.75 per hundredweight, down from the 1975 average of \$49.

Dairy farmers boosted milk production 4 percent in 1976, which proved to be their most financially rewarding year in a long time. The increased output reflected a smaller-than-normal decline in dairy cow numbers and a large increase in output per cow as a result of lower feed prices. An unusually strong consumer demand for dairy products boosted milk prices and sharply curtailed the amount of government purchases necessary to support prices at established levels. Although milk prices received by farmers fell below year-earlier levels late last year, the overall average for 1976 was \$9.70 per hundredweight, \$1 above the 1975 average.

The 1977 outlook

Present conditions support prospects for further increases in livestock production for the early part of 1977. Pork production will likely exceed year-earlier levels throughout 1977, although large first-half increases of around one-fifth will narrow appreciably later in the year. The increased pork output will likely offset the envisioned declines in beef production and hold total red meat supplies slightly above first-half 1976 levels. The prospective decline in beef production reflects anticipations that lower feed prices and higher fed cattle prices will result in a substantial decline in cow and nonfed steer and heifer slaughter. Fed cattle marketings are expected to average close to year-earlier levels during the first half. In addition to red meats, projections for the first half of 1977 suggest further slight year-to-year increases in poultry and milk production.

The precariously tight grain supply/demand balances of recent years eased significantly with last year's large world grain harvest. The easing is particularly evident for wheat, although the feed substitutability of wheat for corn carries implications to all feed grains. Current estimates indicate world grain stocks at the end of 1976/77 might rise to a five-year high of 156 million metric tons, up 42

percent from the lows of the past two years and nearly equal to the average annual level of the sixties. Domestically, ending stocks of grain are likely to exceed 48 million metric tons, up nearly 75 percent from the low two years earlier and the highest in five years. The bulk of the domestic increase reflects an accumulation that will likely carry ending wheat stocks to the highest level since 1963.

Whether the 1977 grain harvest will contribute to further easing in the supply/demand balance for grains hinges heavily on domestic and worldwide weather conditions. Domestic plantings of corn and wheat are expected to decline this year because crop price relationships will likely encourage larger plantings of soybeans and cotton. The decline in harvested acreage, however, might not be too significant if weather conditions permit a recovery in the proportion of the planted acreage that is harvested for grain. And with any improvement of consequence in per acre yields, domestic grain production this year could surpass last year's record. At the same time, however, there is concern about low subsoil moisture reserves presently evident throughout much of the Midwest and the Plains. While such conditions are not yet a clear indication of problems during the growing season, they nevertheless point out the importance of timely and sufficient moisture supplies this spring and summer.

The implications of a third consecutive year of record domestic grain production—should it occur—vary widely depending on the output in other areas of the world. Perhaps closest attention in this respect will be devoted to the Soviet Union. Current es-

timates indicate that the USSR substantially boosted plantings of winter grains—which account for about one-third of its annual grain harvest—last fall. While the increase in plantings is an early indication of a potentially large Soviet grain harvest, the greater variability in Soviet weather conditions precludes any such foregone conclusions.

The overall measure of agricultural commodity prices in 1977 is not expected to vary much from last year. Among individual commodities, however, cattle prices are expected to average higher, while prices of hogs and milk will likely fall below year-earlier levels. Corn and wheat prices, barring widespread adverse weather conditions for this year's crops, will also trend below 1976 levels, while soybean prices will average higher. Cash receipts from farm marketings will likely be higher this year on the strength of a larger volume of grain marketings and higher soybean prices. Net realized farm income, however, may decline from last year's level.

Retail food price pressures are expected to remain fairly moderate at least during the first half of this year. The sharp declines experienced in meat prices during the latter half of 1976 will likely be checked early this year by rising beef prices. Moreover, continued increases of substantial magnitude are expected for some imported foods, particularly coffee and perhaps fish. Costs of processing and distributing foods are also expected to continue upward at a rate at least comparable to the overall rate of inflation. These developments suggest retail food prices might average 3 to 4 percent above year-earlier levels during the first half of 1977.

International: a road to recovery

The deepest recession of the postwar period, experienced by virtually all countries around the world in 1974 and 1975, abated during 1976. The recovery began in late 1975 and continued throughout 1976. However, the momentum of the recovery, which appeared strong in the first part of the year, slowed considerably in the latter part. Economic growth, as measured by the expansion in the gross national product (GNP) and corrected for changes in prices in the world's 24 major industrial countries comprising the membership of the Organization for Economic Cooperation and Development (OECD), slowed from around a 6 percent annual rate during the first six months to about 3 percent during the balance of 1976. The slower rate of growth in the latter part of the year seriously impeded these countries' efforts to reduce unemployment, which in most countries had been hovering around postwar peaks. At the same time, however, the rapid rate of inflation that plagued the world economy in the past several years moderated considerably during 1976, as the rate of increase in the consumer prices slowed from well over 13 percent, experienced in the 24 major industrial countries during 1974, to just below 8 percent in 1976.

Patterns of growth

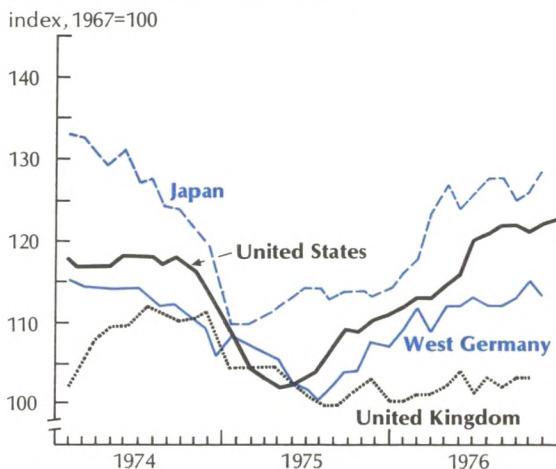
The ever-growing volume of world trade has led to the development of economic interdependence among nations. This interdependence has caused the cyclical movements in the economies of individual countries to become highly synchronized. Indeed, the severity of the 1974-75 worldwide recession was in large part attributable to the mutually reinforcing, coinciding adverse trends in major countries. Declining demand for goods and services in one country had an impact not only on the industrial and commercial activities in that country, but also on activities in countries that were important

suppliers of raw materials and finished products in the markets of that country—and vice versa. Similarly, the countercyclical measures taken by individual countries in an effort to deal with declining domestic production and rising unemployment provided a self-enforcing impetus to recovery for all the countries in late 1975 and early 1976.

The vigorous rate of economic expansion that the United States, Japan, and Germany experienced in early 1976 was of particular importance as a stimulus to recovery in other countries. However, by midyear the rate of expansion of these three major countries slowed considerably in the wake of cautious economic policies followed by the governments in their effort to moderate domestic inflation. The rate of growth of the real GNP in the United States slowed from a 6½ percent annual rate in the first half of 1976 to 4 percent in the second half, in Japan from 8½ percent to 3¼ percent, and in Germany from 7 percent to 3¼ percent.

These slowdowns accentuated the problems of other major countries where the

Industrial production in major industrial countries slows down in late 1976



Economic events in 1976—a chronology

Jan 1 Minimum wage raised from \$2.10 to \$2.30 per hour; maximum income for Social Security taxes raised from \$14,100 to \$15,300.

— State S&Ls in Illinois allowed to offer non-interest-bearing negotiable orders of withdrawal (NOW accounts).

Jan 2 Dow industrial stock average closes at 859—proves to be low for the year. (See Sep 21.)

— Futures trading in Treasury bills begins on the Chicago Mercantile Exchange.

Jan 5 J. Charles Partee joins the Federal Reserve Board, succeeding Jeffrey M. Bucher.

Jan 14 John Dunlop resigns as Secretary of Labor; replaced by Wm. J. Usery.

Jan 19 Federal Reserve System reduces discount rate from 6.0 to 5.5 percent.

— State of the Union address suggests \$394 billion budget for fiscal year 1977.

Jan 21 Major banks reduce prime rate to 6.75 percent, lowest in three years.

Jan 26 Council of Economic Advisers predicts 6 percent inflation for 1976, 6 to 6.5 percent rise in real GNP, unemployment to average 7.7 percent.

Feb 12 Court authorizes W. T. Grant to liquidate.

Feb 13 Stephen Gardner joins Federal Reserve Board, succeeding George W. Mitchell.

Mar 1 Federal Reserve Board amends Regulation Q to allow member banks in New England states to offer NOW accounts, implementing new federal law.

Mar 5 British pound closes at \$1.98, under \$2.00 for first time.

Mar 16 France withdraws franc from Economic Community (EC) “joint float,” following sharp drop in the British pound.

Mar 30 Department of Housing and Urban Development reduces maximum rate on single-family home mortgages from 8.75 to 8.5 percent.

Apr 1 San Francisco public transit shut down by strike that lasts to May 9.

— Consolidated Railroad Corporation (ConRail) takes over insolvent northeastern railroads.

Apr 5 James Callaghan succeeds Harold Wilson as British Prime Minister.

Apr 13 \$2 bill reintroduced after 10 years.

Apr 20 U.S. aluminum producers protest Jamaica bauxite taxes as “expropriation.”

Apr 21 Rubber strike begins at four large companies. (See Aug 29.)

May 3 Federal Open Market Committee announces reduction in upper end of long-term growth ranges for M1 and M2.

May 14 Federal Trade Commission issues revision of the holder-in-due-course doctrine relating to consumer credit.

May 20 New York State permits S&Ls and mutual savings banks to offer checking accounts.

May 24 British and French supersonic Concorde land at Dulles Airport.

— FOMC announces policy record to be released a few days after each meeting.

May 26 New York Mercantile Exchange reports heavy defaults on potato futures contracts.

Jun 1 Prime rate raised to 7 percent, reversing downtrend.

— David M. Lilly joins Federal Reserve Board, succeeding Robert C. Holland.

Jun 2 International Monetary Fund auctions gold at \$126 per ounce, first of a series.

Jun 5 Teton Dam on Upper Snake River bursts with heavy loss of life and property.

Jun 7 Prime rate raised to 7.25 percent.

Jun 23 Marcor shareholders approve merger with Mobil Corp.

Jun 28 Federal Reserve Board issues major revision of its Index of Industrial Production.

Jun 29 General Electric agrees to labor pact to raise wages 33 percent over three years, assuming 6 percent annual rise in consumer prices.

Jul 1 Social Security payments raised 6.4 percent.

Jul 17 Severe frost hits Brazil’s coffee crop.

Jul 20 London gold price drops to \$105.50 per ounce, 31-month low.

Jul 27 Treasury announces budget deficit was \$65.6 billion for fiscal 1976.

— FOMC announces reduction in upper end of growth ranges for M2 and M3.

Aug 2 Prime rate reduced to 7 percent as downturn resumes.

Aug 9 New Illinois law sets usury rate on home mortgages at 2½ percent above yield on long-term federal bonds.

Aug 26 Federal Reserve Board liberalizes seasonal borrowing privilege for member banks.

Aug 29 Rubber workers begin to return after 130-day strike. (See Apr 21.)

Sep 1 Mexican peso drops sharply after government withdraws support.

Sep 8 Chairman Mao Tse-tung of China dies at 82.

Sep 15 UAW strike begins at Ford Motor Co. (See Oct 14.)

Sep 16 Congress agrees on federal spending target of \$413.1 billion for fiscal year beginning Oct 1, 1976.

Sep 21 Dow industrial average closes at 1015, highest since Jan 1973—proves to be high for the year. (See Jan 2.)

Oct 4 Prime rate reduced to 6.75 percent.

— Earl Butz resigns as Secretary of Agriculture; John Knebel named Acting Secretary.

— Supreme Court upholds ruling that electronic terminals established by banks are branches; illegal in Illinois.

— Omnibus Tax Reform Act of 1976 extends anti-recession tax cuts, retains 10 percent investment tax credit, etc.

Oct 7 The Bank of England raises its minimum lending rate to a record 15 percent.

Oct 14 Milton Friedman awarded Nobel prize for economics.

— Ford Motor Co. begins to reopen plants after 30-day strike. Compensation per hour to rise 13 percent in first year. (See Sep 15.)

Oct 16 Currency values in EC joint float are realigned.

Oct 18 HUD reduces maximum rate on FHA home mortgages to 8 percent.

Nov 1 Prime rate reduced to 6.5 percent.

Nov 2 Carter elected President; Democrats retain large majorities in Congress.

Nov 5 Russia announces big grain crop.

Nov 10 Department of Agriculture estimates 1976 corn crop at record 6.06 billion bushels.

Nov 11 FOMC announces reduction in upper end of growth range for M1, and an increase for M2 and M3.

Nov 19 Federal Reserve reduces discount rate from 5.5 to 5.25 percent.

Nov 22 New York State’s highest court rules the moratorium on New York City’s notes as unconstitutional.

Nov 28 Australian dollar devalued.

Dec 1 Major steel companies raise prices of flat-rolled products by 6 percent.

Dec 2 New Aaa bond yields 7.9 percent, lowest in three years.

Dec 3 Employment rose in November, but jobless rate is estimated at 8.1 percent.

Dec 5 Conference Board panel unanimously predicts uninterrupted economic growth in 1977.

Dec 10 Large New York bank reduces its prime rate to 6 percent, lowest since February 1973.

Dec 16 Most OPEC nations announce a 10 percent rise in crude oil price effective Jan 1; Saudi Arabia announces a 5 percent increase.

Dec 17 Federal Reserve Board reduces reserve requirements on demand deposits of member banks. — 91-day Treasury bills yield 4.38 percent, lowest in four years.

Dec 20 Richard J. Daley dies at 74; mayor of Chicago for 21 years.

— Two large banks announce reduction in passbook savings rate to 4.5 percent.

Dec 29 Federal Reserve Board issues rules against credit discrimination based on age, race, color, religion, or receipt of welfare—extension of rules on sex and marital status.

process of the recovery was already being hampered by high rates of inflation, balance-of-payments difficulties—and by closely connected foreign exchange market pressures against their currencies. In the United Kingdom, with inflation running in excess of 15 percent, with foreign trade experiencing a large deficit, and with the British pound depreciating sharply on the foreign exchange market, the authorities pursued restrictive policies throughout the year. As a result, the real Gross Domestic Product increased by only 1 percent in 1976. In Italy the rampant inflation and the recurring pressures against the country's currency triggered by massive capital outflows, forced the government to adopt measures that dampened the country's economic growth during the year. In France large balance-of-payments deficits forced the authorities to withdraw the French franc from the European Community's "joint float" arrangements early in the year and to tighten its economic policies.

The combined impact of these developments in the major industrial countries resulted in a marked slowdown in the growth of the world economy in the second half of 1976. But despite the slowdown the overall performance of the world economy in 1976, as a whole, was considerably better than during the previous year. The economy was on a firm road to recovery.

Problems of developing countries

The resumption of economic growth in industrial countries in late 1975 and early 1976 was accompanied by increased demand for raw materials. The rising demand and the resulting firming of prices provided some relief for many of the less-developed countries for whom exports of these commodities provide a major source of income. But it was only partial relief. Deep-rooted economic problems, combined with rapidly rising aspirations of their peoples, continued to plague the economic conditions of these countries during 1976. Drought, crop failures, the past sharp increase in the price of oil, and the low demand for their products due to

slow economic growth abroad have caused large current account deficits for the developing countries. The already large indebtedness of these countries (estimated at \$151 billion at the end of 1974) increased further during 1975 and 1976 as a result. Increasing militancy of many of these nations in demanding assistance for solution of their problems became a distinct feature on the world economic scene during 1976.

The U.S. balance of payments

The renewal of economic growth in the United States and in countries abroad during 1976 was reflected in the substantial shifts in the U.S. balance of payments. The U.S. merchandise trade account shifted abruptly from a record surplus during 1975 to an annual rate deficit of about \$8 billion during the first 10 months of 1976. The cause of the shift has been the divergence in the rate of economic recovery between here and abroad. Following the U.S. economy's upward turn in the latter part of 1975, imports began to rise. The rise accelerated sharply during the first half of 1976 as imports rose 16 percent above the last half of 1975. The level of imports stabilized during the latter part of 1976 as the momentum of the economic expansion in the United States moderated. But in spite of this leveling off, U.S. imports during the second half of last year were about 12 percent above first-half levels. The most rapid increases took place in imports from Japan and the OPEC countries as demands for energy increased with the pickup of economic activity.

U.S. exports continued to expand throughout the year but at a rate considerably lower than imports. This reflected a slower rate of economic recovery abroad than was experienced in the United States. U.S. exports to industrial countries rose 7 to 8 percent above 1975 levels through the first three quarters of the year. However, over the same period exports to OPEC countries were up only 13 percent in 1976, compared with a 76 percent increase in 1975. This expected slowdown in the rate at which OPEC countries imported U.S. goods was largely because of the

limited absorption capacity of these relatively underdeveloped economies. U.S. exports to the non-OPEC less-developed countries (LDCs) were down 2 percent from 1975 during the first three quarters of 1976. This reflected the continuing economic difficulties of the LDCs in sustaining economic expansion; the higher costs of their oil imports diverted their demands from capital goods and food imports typically supplied by the United States.

International capital markets responded to the generally improved U.S. economy and to the resulting strengthening of the U.S. dollar vis-a-vis major foreign currencies in 1976. Particularly notable was the renewed

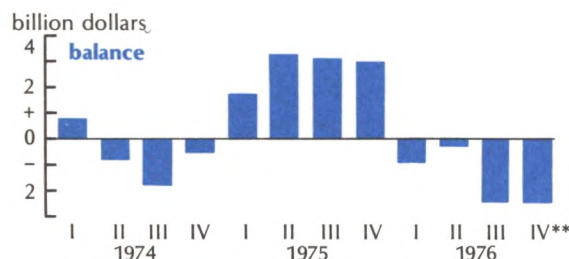
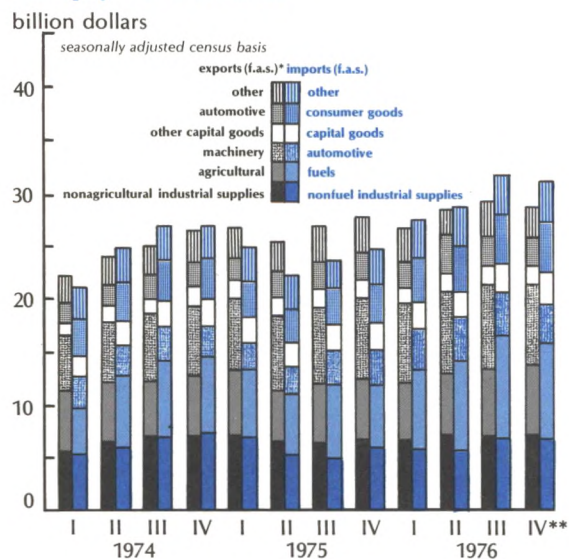
placement of substantial funds in U.S. capital markets in 1976 by OPEC countries. Capital outflows from the United States also increased. The U.S. banks were major contributors to this outflow as the weak domestic loan demand made it attractive for U.S. banks to deploy funds abroad.

International activities in the district

Last year witnessed a further broadening of international activities in the Seventh Federal Reserve District. While current data on the volume of exports originating in the district are not available, it is generally believed that the Illinois, Indiana, Iowa, Michigan, and Wisconsin manufacturers and farmers significantly increased their share of total U.S. exports—up from about the 25 percent share historically experienced. This was particularly true for exports of agricultural commodities. As the world's increased demand for food sharply boosted U.S. agricultural exports, the district's share of these exports rose from 23.7 percent in fiscal 1975 to 26.9 percent in fiscal 1976.

International financial and banking activities in the district also continued to expand during 1976, following the trend that began in the early 1960s. At the beginning of 1960 the

The U.S. trade balance turns sharply into deficit

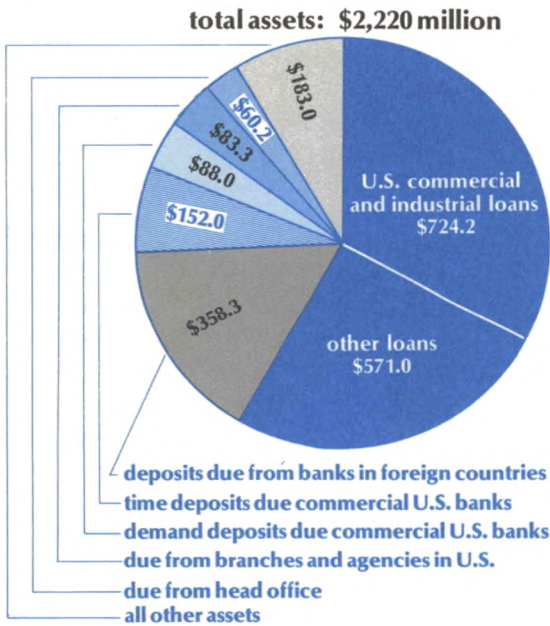


*Domestic and foreign merchandise excluding military grant-aid shipments.
**Fourth quarter figures based on October-November data.

Foreign claims of the district banks continue to rise



Assets of the district's foreign banks double in 1976



district banks' total claims on foreigners amounted to \$100 million; by September of 1976 the total stood at \$22.6 billion. There have been three major channels through which this growth took place: (1) head office lending; (2) expansion of activities of the foreign branches of the district banks; and (3) establishment and growth of branches and subsidiaries of foreign banks in the district.

Until 1974 the expansion of direct international lending by the district bank was hampered by the Voluntary Foreign Credit Restraint (VFCR) program instituted by the government in 1965 to shore up the country's balance-of-payments position. After the termination of the program in 1974, foreign lending expanded rapidly. By the end of 1975 the district banks' claims on foreigners rose to \$3.7 billion, and toward the end of 1976 the total amounted to \$4.1 billion.

Far more important, however, has been the usage of overseas facilities as on-the-location lending outlets. While in 1960 no Seventh District bank maintained foreign facilities, by 1970 district banks had 33 branches abroad, with assets amounting to \$4.4 billion. By 1976 district banks had 77 branches abroad with total assets of \$17.8 billion.

The most recent developments in the district's international banking has been the emergence of the presence of foreign banks in Chicago. The influx was made possible by the legislative action of the Illinois General Assembly in 1973. By 1976 there were 22 branches of foreign banks and two fully owned foreign subsidiaries operating in Chicago. Their total assets at the end of September 1976 amounted to \$2.2 billion. Most of these were commercial and industrial loans to U.S. residents. This attested to the full integration of foreign banks into the banking environment in the Seventh Federal Reserve District.

Prospects

Progress toward recovery from the deepest recession of the world's economy since the 1930s was perhaps slower than was desirable. But the progress was marked by determination of national governments to deal in cooperative spirit with the economic adversities besetting them. Individual national policies aimed at dealing with specific problems confronting their domestic economies have been, by and large, developed in a way so as not to impinge on the goals and economic objectives of other nations. This cooperative spirit bodes well for the future. As individual nations, including the United States, are in the process of reassessing their economic policies to determine whether further stimulus is needed, the past record holds a promise for the future that their combined actions will result in a mutually reinforcing impetus to economic growth.

Government: a year of change and surprise

Last year was one of change and surprise in federal government fiscal activity. The big change was the official introduction of the new Congressional budgeting procedure and the new fiscal year. The surprise was that the deficit was between \$11 and \$17 billion less than expected for the 15 months from July 1, 1975 to September 30, 1976. This lower deficit resulted primarily from lower spending, not larger receipts, during the first nine months of calendar 1976.

Congress implements change

The most obvious part of the change in government financial operations was the new starting date for the fiscal year. Federal government budgeting had been based on a July 1 to June 30 fiscal year since 1843. Beginning with 1976 (fiscal 1977), the budgeting year will run from October 1 through September 30. As a result, 1976's third quarter (July 1-September 30) was a sort of accounting limbo, part of no fiscal year, and referred to as the transition quarter.

Formal consideration of the budget begins nine months before the start of the new fiscal year when the President submits his budget to Congress. Congress may accept or modify his proposals and must establish its revenue and spending plans in a joint resolution by May 15. After all individual appropriations bills have been considered, Congress then must adopt a second joint resolution setting firm objectives for appropriations, outlays, and revenue. For fiscal 1977 this resolution set expenditures at \$413.1 billion, revenue expectations at \$362.5 billion, and an anticipated deficit of \$50.6 billion. Although the budget process for fiscal 1977 is now complete, the new Congress can still accommodate programs proposed by the incoming administration if it so decides. This would require passage of a new joint budget

resolution in addition to the appropriate authorization and appropriations bills.

It is clear that Congress has developed both the capability and the mechanisms for controlling the nation's purse, and can, as the actions of Congress on the 1977 budget show, evolve a budget that substantially modifies the proposals of the administration.

New tax legislation

The Congress also completed major tax legislation in 1976. For most taxpayers, whose incomes are primarily in the form of wages and salaries, this new legislation has little impact beyond continuing through 1977 the tax reductions that had been enacted for 1975. Taxpayers with large incomes from investments face higher taxes as a result of tightening of the "minimum tax" provisions and reducing tax preferences available from a variety of tax shelters. Corporations with major overseas operations lost some deductions available from foreign tax credits, while rule changes on the investment-tax credit benefited airlines, railroads, and shipbuilders. This credit was continued through 1980 at the 10 percent level.

One of the biggest changes in existing law was the treatment of taxes on estates and gifts. These two previously separate levies have been merged. The \$60,000 exemption has been replaced by a tax credit that effectively removes the tax from most smaller estates. Extended payment schedules and favorable evaluation methods provide additional relief for estates where the major holding is a small business or farm. Taxes on larger estates were increased by stricter treatment of capital gains and by restrictions on generation-skipping trusts.

Spending shortfalls

The lower than expected level of federal spending during the first nine months of 1976

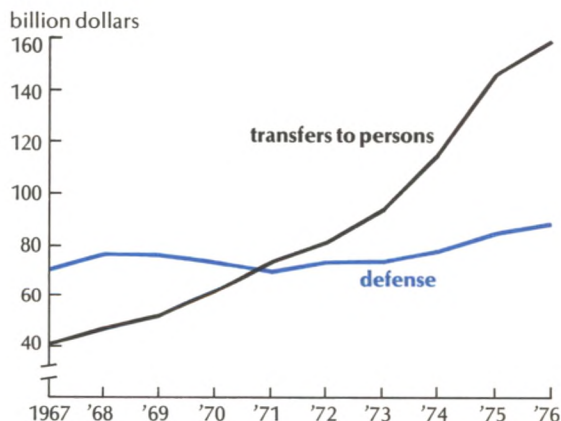
first became obvious after final results for fiscal 1976 showed spending at least \$5 billion lower than planned. At that time it was believed that since spending authorizations could be carried into the transition quarter the \$5 billion shortfall would be made up by more rapid spending then. When this spending failed to materialize, various theories were put forward to explain the discrepancy: lower than expected price increases for government purchases, lower interest rates, unanticipated financial transactions, overly large contingency allowances, and over-estimation of the speed with which new programs could be initiated by the Defense Department. All of these things probably contributed to lower spending, which was broadly spread through all facets of government. It is now believed that little of these unspent funds will add to spending in 1977. However, spending did accelerate in the fourth quarter of 1976 to a rate in line with the \$413 billion planned for the new fiscal year.

Spending and revenue distribution

Federal revenue for calendar year 1976, measured on a National Income Accounts (NIA) basis, totaled about \$330 billion, up 15 percent from 1975. Personal income tax payments of about \$145 billion were 15 percent above the previous year, when large rebates were made for 1974 taxes in addition to lowering of withholding rates during 1975. Contributions for social insurance were about \$106 billion, up 12 percent from 1975. Corporate income taxes furnished about \$56 billion, up over 30 percent from last year. (In 1975 profits were below 1974 levels despite the rapid growth in the second half.) Expenditures (NIA) totaled about \$385 billion, up 8 percent from the previous year. The deficit was nearly \$60 billion, down substantially from the \$71 billion level of 1975.

Social Security programs alone accounted for over \$90 billion in 1976. Recipients received a 6.4 percent cost-of-living adjustment in July based on the increase in the Consumer Price Index over the previous year. Effective January 1, 1977, the

Personal transfers speed ahead of defense spending



ceiling income on which taxes will be collected was raised to \$16,500 from the \$15,300 effective in 1976. An increase in taxes for unemployment insurance was passed during 1976 to be implemented in two steps. In 1977 the rate goes from 0.5 to 0.7 percent, but the base remains \$4,200. In 1978 the base on which the tax is collected goes from \$4,200 to \$6,000. Thus this tax on employers will be doubled over the next two years to replenish the unemployment trust fund, depleted by high claims levels of the past two years.

State and local problems continue

State and local governments in the aggregate spent over \$245 billion (NIA) during 1976. This amount was about 8½ percent higher than in 1975, the slowest rate of year-to-year growth since 1964. The vast majority of these expenditures went for the purchase of goods and services, over \$230 billion, and nearly 60 percent of that sum was spent on compensation of employees. Employment increased about 2½ percent, the slowest rate since 1954. Nevertheless, payroll costs climbed by 10 percent indicating that average wages paid by state and local governments increased 7-7½ percent over the level in 1975.

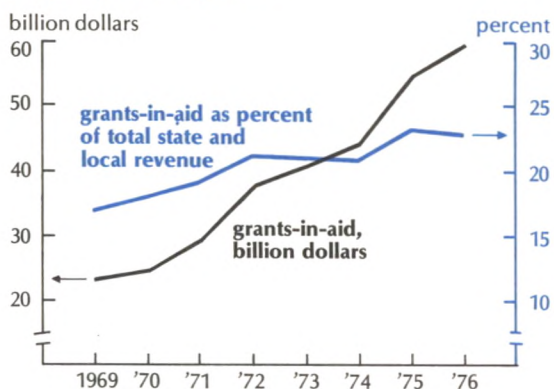
Revenues of state and local governments totaled about \$260 billion in 1976, up about 10

percent from 1975. While these revenues were enough to provide an operating surplus of about \$11 billion, this was not enough to cover the cost of social insurance funds. Overall, state and local governments had a deficit of about \$2 billion. This represents a considerable improvement from the \$5 billion deficit incurred in 1975.

The facts that state and local governments' revenues grew faster than expenditures and that the aggregate deficit was lower in 1976 than in 1975 suggest that state and local governments strengthened their positions during the past year. However, for most of these governmental units this improvement in apparent financial condition was achieved only by stringent restraints on services provided to their constituencies. In many cases there were sharp cutbacks both in services offered and in employment. New York City, because of the magnitude of its problems, received the largest amount of attention in the press. The city reduced fire, police, and teaching staffs, cut back on transportation services, imposed tuition for the first time on the city college system, and attempted to implement many other cost savings. Even these steps failed to provide the city with enough cash to meet its operating expenses while paying back its debt. The debt repayment problem was met by purchases of long-term debt by the city employees' pension funds. Holders of short-term paper were given the option of converting their claims to long-term debt or accepting a moratorium on principal payment and reduced interest rates. Thus it was expected the city could balance its budget and begin debt repayment over a three-year period. Late in the year New York State's highest court found the debt moratorium unconstitutional. At year-end a new plan for debt restructuring was yet to be agreed upon.

While New York City's problem involved the most money, many other local governments faced problems which were equally difficult for them considering their

Total federal aid grew but its importance declined slightly during 1976



size. Detroit, despite taking many of the same steps New York had taken to reduce costs, remains in severe financial difficulty. Many school systems, of which Chicago's is the largest, closed early for the summer vacation or for the Christmas holiday because they had run out of money or because budgets could not get voter approval.

The outlook

The financial status of both the federal government and state and local governments for the coming year is going to be strongly affected by the steps taken by the new administration. It seems clear that some combination of tax reduction and increased spending will be proposed, increasing the federal deficit above the \$50 billion level set by the Congressional budget resolution. Governors and mayors have been urging the federal government to provide more help, particularly for education and welfare. It seems likely that state and local governments will receive some additional help directly through federal funding for public service jobs. Indirect benefits from increased tax collections could result from federal stimulus of the general economy.

Finance: funds widely available

Credit markets in 1976 were easier, on average, than in 1975. Moderate gains in economic activity were accompanied by stronger credit demands from the private sector; U.S. Government borrowing needs, although high, were lower than 1975 requirements. Meanwhile, increased earnings, savings, and efforts to build liquidity produced a very large supply of investment funds, especially through financial intermediaries.

With the objective of encouraging non-inflationary expansion in the economy, Federal Reserve policy sought a moderate rate of monetary growth. Reserves to support deposit growth were provided at a lower average cost to banks. The discount rate was reduced twice—from 6 to 5½ percent in January and by another quarter to 5¼ percent in November. In mid-December the Board of Governors acted to reduce reserve requirements on demand deposits at member banks.

On balance, these forces resulted in lower interest rates and greatly increased fund availability. Although lenders continued to pay close attention to credit quality, financial institutions were in a good position to meet the needs of creditworthy borrowers. Competition for loan business and lower money market interest rates led to easier loan terms. Time and savings deposits rose rapidly as market yields declined. In view of this inflow and declining returns on loans and investments, a considerable number of banks and thrift institutions had reduced rates paid on some categories of deposits by year-end.

Record credit flows

On the basis of data covering the first three quarters of the year, it appears that the overall volume of funds raised in the credit markets (exclusive of flows to financial intermediaries) was in the neighborhood of \$250 billion, nearly one-fifth higher than in 1975. Treasury and federal agency borrowing

declined from 40 to 30 percent of the total, but remained the largest component. Funds raised by other borrowers were about 10 percent below the record 1973 totals despite an increase of roughly 30 percent in prices over the past three years. Local governments sold a record volume of new issues as market receptivity in this sector improved markedly. Household borrowing through consumer and residential mortgage credit was up almost 60 percent over 1975. Businesses tapped the markets for about one-quarter more, including equities, than in the previous year despite net paydowns of bank loans.

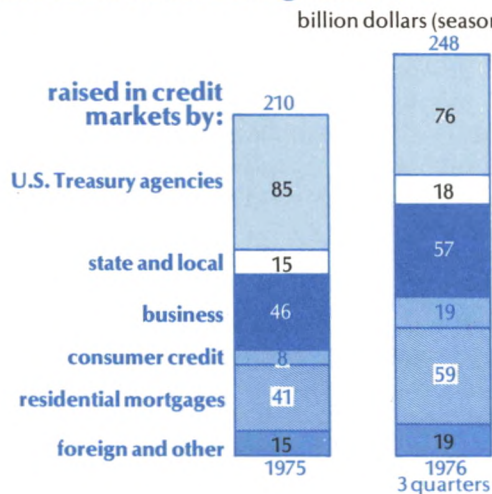
Market absorption of this record volume at lower interest rates attests to the huge supply of funds available for investment. Moreover, as market interest rates declined, savings and time deposits at financial intermediaries became relatively more attractive, and a large portion of investment funds reached the Treasury and the mortgage market through these channels.

The portion of funds advanced to non-financial sectors by commercial banks had been relatively small in 1975 and shrank somewhat further in 1976—to less than 10 percent of the total compared with 35 percent in 1973 when business credit demands were very strong. By contrast, nonbank financial institutions accounted for more than half of the total supplied as their deposit growth broke all previous records.

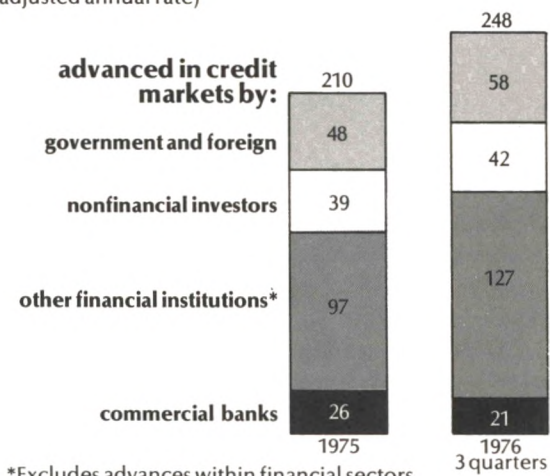
Business loans remain weak

The modest expansion in bank credit was largely a reflection of the weakness in business loan demand, although acquisition of Treasuries slowed also. Continuing the downtrend that persisted throughout 1975, business loans at all commercial banks declined through midyear but were up about 1 percent for the year as a whole compared with a 4 percent decline in 1975. Smaller banks accounted for the gain. In late December

Credit flows reached new record as private sector borrowing rose . . .



. . . but banks' share continued to shrink



commercial and industrial loans at large city banks were still \$3 billion below year-earlier levels and would have been off even more except for the acquisition of highly liquid bankers' acceptances. Major corporations continued to pay down their bank borrowings with the proceeds of security sales, while rising earnings and cautious inventory policies cut their overall needs for outside financing.

While the banking industry enjoyed heavy savings inflows, growth in demand deposits continued modest and the large city banks allowed their negotiable certificates of deposit to decline as major businesses repaid loans. With little patronage by their principal customers, these banks found it difficult to use all available funds profitably even though smaller businesses borrowed more. The need to increase capital also acted as a constraint on deposit and loan expansion.

As usual, changes in the prime loan rate lagged market interest rates. But despite an unusually large spread between commercial paper rates and the prime rate at major banks during most of the year, expansion in commercial paper was also relatively small, reflecting business' modest needs and preference for longer-term financing. Meanwhile, for some banks that rely heavily

on the money market as a source of funds, lower average interest costs helped to strengthen earnings that had been depleted by unusually heavy loan losses in the two previous years and to improve capital ratios.

As the year drew to a close, however, competition for loan business intensified. Most major banks reduced the prime to 6¼ percent and a few moved it down to 6 percent—the lowest in nearly four years. Nonprice terms were also reported eased somewhat, with more flexibility in compensating balance requirements and some term loans made at fixed rates. Some commercial banks acted to reduce their average cost of funds by ceasing to offer long-term high rate certificates and/or by reducing rates offered on some maturities below the applicable legal ceilings. Before year-end at least two regional banks announced reduction in the passbook savings rate. Such actions, however, appeared to be much less widespread for banks than among nonbank thrift institutions.

Interest rates—downtrend extended

The year began and ended with relatively easy conditions in the credit markets. Money rates and most bond yield averages were off by 100 basis points or more from December

1975 to December 1976. The downtrend was interrupted in the second quarter as money demand rose and the Federal Reserve supplied reserves to the banking system less freely in order to restrain rapid monetary expansion. The federal funds rate, which responds quickly to the availability of reserves required to support deposit growth, rose from the prevailing $4\frac{3}{4}$ percent level to about $5\frac{1}{2}$ percent. As the lull in activity persisted and money growth slowed by midyear, however, the System resumed a more accommodative posture, and the fed funds rate declined gradually to a new four-year low of around $4\frac{5}{8}$ percent before year-end.

Securities markets were extremely sensitive to any developments affecting expectations of policy changes. Long-term yields rose along with money rates in the spring but were affected also by the large amount of corporate securities offered, some in anticipation of rising interest costs.

Wide spreads between short- and long-term rates persisted for an unusually long time. In the second year of earlier recoveries, short-term interest rates have usually risen rapidly while bond rates continued to edge

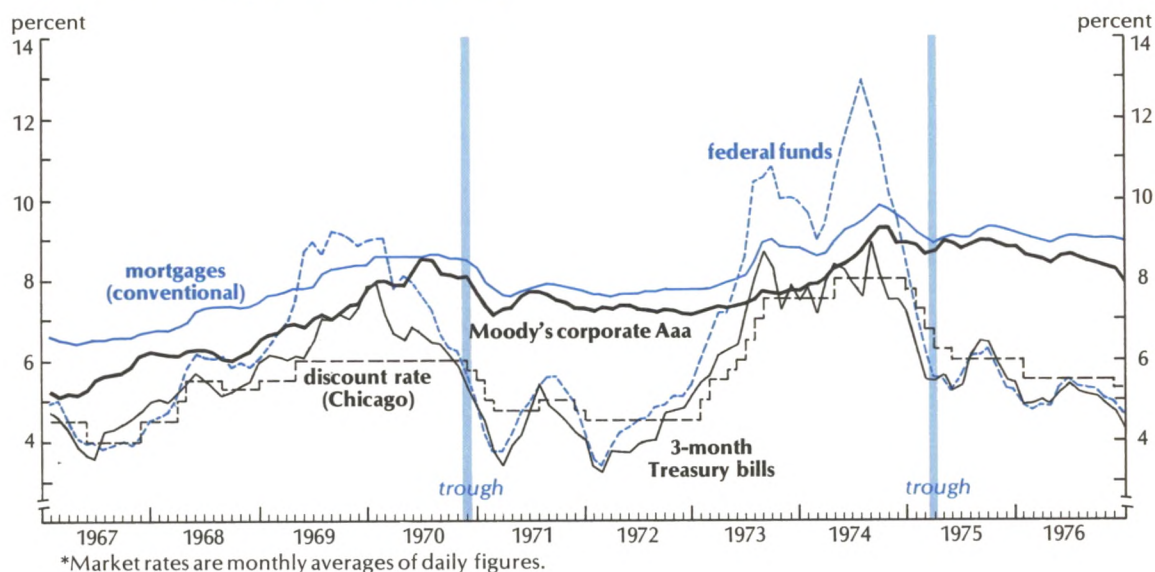
down or to rise with a marked lag. In December, however, Moody's Aaa corporate bond yield average was still 360 basis points above 3-month Treasury bills, not much different from the spreads prevailing 20 months earlier.

The steepness of the yield curve over such a prolonged period reflects several factors that were less important in earlier cycles. These include a strong preference for liquidity on the part of both lenders and borrowers, investor expectations of continuing inflation, and the Treasury's policy of lengthening the average maturity of the public debt by much greater use of intermediate and long-term obligations rather than bills in its financings.

Monetary aggregates and policy action

In its efforts to provide a healthy financial environment for income expansion without inflation, the Federal Reserve pays close attention to the rate of expansion in the money supply on the theory that it is an important element in the economy's spending potential. The "monetary aggregates" include a number of measures of money.

Long-term interest rates lagged decline in money rates more than in the previous recovery



Besides currency and commercial bank demand deposits held by the public (M_1), broader concepts of money embrace various interest-bearing financial assets with a high degree of liquidity, particularly time and savings deposits. These aggregates, especially M_1 , often fluctuate rather widely in the short run and are not subject to direct control by the monetary authorities. Nevertheless, growth trends can be influenced over periods of several weeks or months.

The Federal Reserve System, in supplying reserves to the banking system to support deposit growth, pursues its monetary objectives via its influence on the price of these reserves in the market—the federal funds rate. The policy decision process involves an estimation of the level of this key money market rate consistent with the desired rate of monetary expansion in the weeks ahead. That level depends largely on the strength of credit demands in that same period.

The path of the fed funds rate over the course of 1976 was affected by the System's efforts to counteract developing trends in the monetary aggregates outside the growth ranges believed conducive to a healthy economy. Thus, following the rapid first-quarter increase in activity and the sharp April rise in the monetary aggregates, reserves were supplied through open market operations only at a somewhat higher federal funds rate. But as money growth slowed during the extended pause in the economic expansion, the System again accommodated reserve needs at a lower interest rate level.

Actual growth in the monetary aggregates over the year as a whole was generally consistent with the prospective ranges specified in the Board of Governors' quarterly reports to the Congress. (See table.) The so-called target ranges for M_1 , M_2 , and M_3 are set by the Federal Open Market Committee (FOMC) for annual periods from the average of the latest calendar quarter to the same quarter of the following year. Included in M_2 , besides M_1 , are savings and time deposits at commercial banks other than large negotiable CDs. M_3 has all the components of M_2 plus deposits and shares of mutual savings

banks, savings and loan associations (S&Ls), and credit unions. During much of 1976 narrowly defined money supply tended to expand at the low end of the ranges specified while the broader aggregates were on the high side. In the final quarter M_1 was 5½ percent higher, M_2 11 percent higher, and M_3 13 percent higher than a year ago—all somewhat faster than 1975 growth.

The growth targets were themselves modified in the course of the year. Late in January the FOMC reduced the low end of the M_1 range, applicable to the period from fourth-quarter 1975 to fourth-quarter 1976, from 5 to 4½ percent. The upper end of the M_1 range was reduced from 7½ to 7 percent in July and again to 6½ percent in November. Since actual growth was already well below those levels, these changes did not entail any need to apply restrictive actions, but rather indicated the FOMC's resolve to resist any sustained tendency for monetary expansion to rise at a pace believed likely to aggravate inflation. The top ends of M_2 and M_3 were also lowered by 1 percentage point as higher market interest rates around midyear temporarily slowed savings inflows. But part of this was restored in the final quarter.

In setting the ranges and in judging whether the performance of the aggregates is satisfactory, the Committee takes account of developments that may change the relationship between the rates of expansion in money and income and between various concepts of money. Changes in payments practices in recent years have entailed substantial shifts from M_1 into M_2 and M_3 . A significant factor in 1976 was the buildup of business savings deposits. These deposits, first permitted up to \$150,000 per account at commercial banks in November 1975, were estimated to be in excess of \$6 billion at year-end. Such balances can be transferred to checking accounts when needed.

An even greater impact on the expansion in broad money aggregates comes from fluctuations in market interest rates. Deposits have always served a mixture of savings and transactions functions, but the greater interest-sensitivity of savers in recent years

Broad aggregates accelerated more than M₁

<u>Annual</u>	<u>M₁</u>		<u>M₂</u>		<u>M₃</u>	
	<u>Final quarter</u>	<u>Final month</u>	<u>Final quarter</u>	<u>Final month</u>	<u>Final quarter</u>	<u>Final month</u>
<i>(percent change over year ago)</i>						
1971	6.7	6.5	11.4	11.4	13.5	13.5
1972	8.4	9.2	11.2	11.4	13.3	13.4
1973	6.2	6.0	8.8	8.8	9.0	8.8
1974	5.0	4.7	7.7	7.2	7.1	6.8
1975	4.4	4.1	8.3	8.5	11.1	11.3
1976*	5.4	5.8	10.9	11.3	12.8	13.1

<u>Quarterly</u>	<u>Average</u>	<u>Final</u>	<u>Average</u>	<u>Final</u>	<u>Average</u>	<u>Final</u>
		<u>month</u>		<u>month</u>		<u>month</u>
<i>(percent change from previous quarter)</i>						
1976-1	2.7	4.5	9.7	11.0	11.2	12.3
2	8.4	6.8	10.8	9.3	12.0	11.0
3	4.1	4.1	9.2	10.3	11.6	13.1
4*	6.0	7.3	12.1	12.9	14.0	13.7

*Preliminary.

. . .and prospective growth ranges were adjusted to reflect structural shifts

<u>Date established</u>	<u>Base quarter</u>	<u>End quarter</u>	<u>M₁</u>		<u>M₂</u>		<u>M₃</u>	
			<u>Specified range</u>	<u>Actual</u>	<u>Specified range</u>	<u>Actual</u>	<u>Specified range</u>	<u>Actual</u>
<i>(percent change from base to end quarter)</i>								
1975 Apr.*	75-I	76-I	5.0-7.5	4.9	8.5-10.5	9.6	10.0-12.0	12.2
July	75-II	76-II	5.0-7.5	5.2	8.5-10.5	9.6	10.0-12.0	12.0
Oct.	75-III	76-III	5.0-7.5	4.4	7.5-10.5	9.3	9.0-12.0	11.5
1976 Jan.	75-IV	76-IV	4.5-7.5	5.4	7.5-10.5	10.9	9.0-12.0	12.8
Apr.	76-I	77-I	4.5-7.0		7.5-10.0		9.0-12.0	
July	76-II	77-II	4.5-7.0		7.5- 9.5		9.0-11.0	
Nov.	76-III	77-III	4.5-6.5		7.5-10.0		9.0-11.5	

*Initial projection from March to March. Later ranges based on average for quarter.

NOTE: All data are annual rates of change in seasonally adjusted daily average amounts.

has increased the variability of this mix. When yields on short-term investments, such as Treasury bills, fall below returns available on deposits, investment-type funds flow into deposits, swelling M₂ and M₃. This was the situation as 1976 drew to a close.

District banking

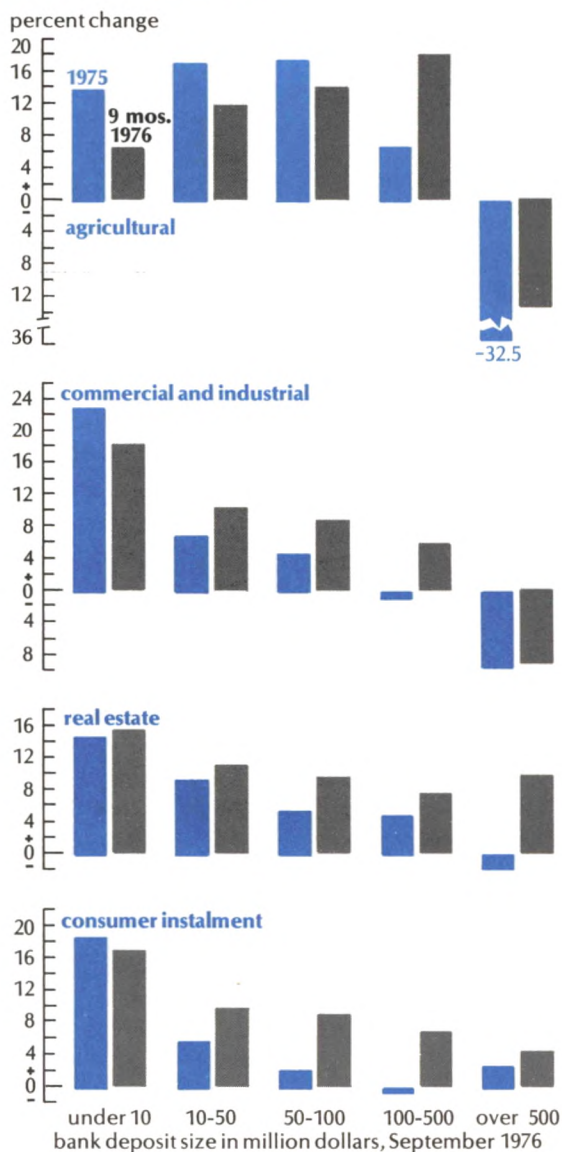
Reports from district member banks provide evidence of very substantial contrasts within the banking industry with respect to the impact of 1976 economic developments. District membership covers banking institutions with widely diverse business—from the multibillion dollar multinational giant to the small country bank whose services are oriented toward the residents of rural communities. While a relatively few major banking institutions dominate banking trends as measured by the total dollar volume of assets and liabilities, these trends often vary significantly from the experience of the great majority of smaller banks. Almost 70 percent of member banks in this district have total deposits of less than \$50 million, while the 20 largest banks account for more than two-thirds of the assets and deposits of all member banks in the district.

Total loans and investments of all district members rose 6 percent in the year ended November 24, 1976, compared with 2 percent in the previous year. Loans declined by 1 percent at the large banks in the four largest district cities while rising 10 percent at other banks. The primary reason for this difference was the heavy repayment of business loans by large corporate customers of the major banks. At smaller banks business loans rose much faster than in 1975, reflecting rising credit needs of smaller businesses that do not borrow directly in the capital markets. Real estate and consumer loans rose faster at both large and small banks. Agricultural loans rose sharply at the small banks, as farm income declined. The very large banks reduced credit to agriculture—a very small portion of their business.

Most banks continued to build up their security portfolios, although at a slower pace

than in the previous year. These gains, except in Michigan, were generally larger in the major cities where loan demand was weaker. In 1976, as in 1975, almost three-fourths of the rise in investments was in Treasuries, which now account for 40 percent of total portfolios—up from 30 percent two years ago. At the large banks almost two-thirds of the in-

Loans were stronger at the smaller banks



Member bank asset and deposit changes reflect area differences in credit demands

	<u>Loans¹</u>	<u>Securities</u>	<u>Demand deposits</u>	<u>Time and savings deposits</u>
(percent change, Nov. 24, 1976 from Nov. 26, 1975)				
Large banks ²				
U.S. total	0.8	9.5	1.8	- 0.9
Chicago	- 2.1	17.0	0.6	- 8.3
Detroit	- 1.1	0.8	- 6.7	5.7
Indianapolis	- 4.2	29.4	6.5	4.2
Milwaukee	5.4	22.4	1.0	5.0
Des Moines	16.2	21.5	0.7	3.8
Other member banks				
U.S. total	11.3	9.7	5.4	14.3
Illinois	11.2	8.8	4.1	11.4
Michigan	10.9	10.8	4.3	12.0
Indiana	10.2	15.4	7.9	13.1
Wisconsin	9.7	9.9	0.7	10.8
Iowa	17.9	9.0	- 1.2	17.3

¹Excludes federal funds sold.

²Weekly reporting banks.

crease in Treasury securities were in the one-to five-year maturity category, and holdings of longer-term issues nearly doubled. Lengthening in the average maturity of Treasury portfolios reflected both the larger proportion of longer issues sold and banks' efforts to maintain investment income in the face of declining short-term interest rates.

Time and savings deposits were again the major source of funds of member banks, with gains ranging from 11 to 17 percent in the five states excluding the major city banks. The relatively modest growth or decline at the city banks reflects the liquidation of almost \$3 billion in large negotiable CDs, concentrated at the very large Chicago banks. Demand deposits were strongest at Indiana banks, while financing problems of Iowa farmers held down checking accounts at Iowa banks.

Deposit trends of district banks are affected not only by income, savings, and general swings in market interest rates but also by developments affecting their ability to compete with other financial institutions. Such competition takes two major forms—the amount of interest paid on deposits and deposit services offered. Regulation Q prohibits payment of interest on demand deposits and sets the maximum rates that banks can pay on consumer savings-type deposits, generally $\frac{1}{4}$ percentage point below those imposed on thrift institutions. With a growing number of S&Ls and credit unions now offering third-party payment services, the unique advantage banks once had as the sole sellers of checking accounts and the full package of financial services is diminished.

New developments in electronic funds transfer systems (EFTS) have important implications with respect to deposit competition. Off-premise teller machines and point of sale terminals in retail outlets have been ruled branches for banks but are not branches for S&Ls. Moreover, laws of district states governing branching are much more restrictive for banks than for S&Ls, especially in Illinois. Most state legislatures are now considering changes in the statutes that would be more compatible with growing EFT capability. The specifics of these changes plus the results of the considerable amount of litigation already in process on new practices eventually will define new limits to the areas of competition. But the strength of credit demands will have an important bearing on how vigorously banks press these limits.

Ahead: another year of growth

As 1977 begins, the U.S. economy seems poised for a renewal of vigorous growth. The pause of the summer and fall may have prolonged the expansion by encouraging caution in decision making by businesses and consumers. Investments in inventories and capital goods have remained moderate. Consumers have increased spending sharply, but at a sustainable pace.

In many respects the economy is stronger at the start of 1977 than it was a year ago. Price inflation slowed significantly last year, instead of accelerating as some had feared. Interest rates declined instead of increasing, as had been widely expected. Liquidity ratios of consumers, business firms, and financial institutions improved. Ample credit is available, currently, in all major sectors. Financial strains have eased for insurance companies, some troubled large cities, and even for real estate investors.

Last year's economic performance was marred by a series of major strikes. Labor negotiations scheduled for 1977 are not expected to lead to important work stoppages.

On the world scene the U.S. experience in recession and recovery compares favorably with that of most other industrialized nations. Although a large trade deficit was recorded for 1976, the U.S. dollar strengthened relative to the currencies of various nations with more serious problems of containing inflation.

A glance at the favorable side of the

economic picture should not obscure the pressing problems that remained unresolved. Substantial advances in output and employment have not reduced the rate of unemployment. Price inflation continues at an uncomfortably rapid pace. Major cities continue to show signs of decay in contrast to the vigor of outlying suburban areas. Financial stringencies have forced reductions of outlays for urgent public needs. The nation is becoming increasingly dependent on uncertain supplies of oil from abroad. A growing share of investments by business firms must be devoted to nonproductive outlays required to retard environmental deterioration. The federal budget continues to show deficits of a magnitude undreamed of a decade ago.

Few observers believe that another business recession is imminent. Nevertheless, there is widespread concern that economic growth in 1977 will be insufficient to reduce substantially the number of idle workers, a potentially explosive situation. As a result, there are strong pressures to stimulate the economy by more rapid expansion in money and credit, increases in federal outlays, a reduction in federal taxes—or by a combination of such methods. The pressing task for public policy early in 1977 will be the choice of measures to promote growth without significantly accelerating inflation and encouraging the excesses that ended, prematurely, the expansion of the early 1970s.

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