Research Department
Federal Reserve
Bank of
San Francisco

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Gloomy Portents

The message contained this year in the Administration's basic economic documents—the Economic Report of the President and the Federal Budget—is indeed a sobering one, but it is a prognosis with which few observers are prepared to disagree. Compared with the euphoria evident in last year's documents, the spirit contained in the 1974 reports is practically gloomy.

The official outlook this year is for sluggish growth and the highest rate of price inflation since 1947. Gross national product is expected to grow by 8 percent to a level of $1,390 billion. In more normal times, a growth rate of this magnitude would be a most heartening development, but the growth foreseen for 1974 is due almost entirely to rising prices. With the inflation rate projected to rise to 7 percent, the growth of real output would be a meager 1 percent —the poorest record since the slight decline recorded during the 1970 recession year. In the bargain, the unemployment rate is expected to average above 5½ percent for the year.

Hard first half

Energy-crisis dislocations and the accompanying slowdown in business activity are expected to be most severe in the first two quarters of the year. Chairman Herbert Stein of the Council of Economic Advisers concedes that total output will probably decline in the first quarter, and recently released January statistics support his belief. However, Stein is not yet ready to concede that the downturn will continue into the second quarter, because of the strengths that are evident in several important sectors of the economy.

Declining activity is already apparent in consumer durable goods, principally autos, and in residential construction. The initial employment impact showed up in the January data, as unemployment increased to 5.2 percent of the civilian labor force and payroll employment fell by 260,000. Manufacturing was especially hard hit, most noticeably in the auto industry, where producers shut down a number of plants to prepare for a change-over to smaller models. Airlines and travel-oriented industries (hotels, motels, restaurants and resorts) were also hampered by the curtailment of travel due to serious fuel shortages.

Expansion and timidity

The outlook for 1974 will not be unrelievedly grim, according to the Administration's economists. Business spending for plant and equipment could rise 12 percent to a level of $136 billion, as corporations strive to expand and modernize facilities that were inadequate to cope with last year's strong demand. Homebuilding activity should begin a slow recovery later this year, although housing starts (at 1.7 million units) may fall 20 percent below the 1973 average for the year as a whole.

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Consumer-spending growth should match the 8-percent increase in GNP. Yet in the face of uncertainty, consumers may tend to conserve the real value of their savings rather than maintain earlier patterns of spending. Thus, the personal savings rate could rise far above last year's 6-percent figure, closer to the 8-percent figure reached during the sluggish 1970-71 period. Despite this evidence of timidity in consumer spending decisions, auto sales could rebound in the second half following the first-half sales slump.

Government spending, like business spending, is expected to be a sustaining force in 1974. The rein on the Federal budget will not be so tight as last year, and Federal purchases of goods and services should rise about 10 percent—several times the 1973 increase. State-and-local government spending, with a gain of about 12 percent, should continue on its long-term uptrend. Incidentally, because of this strong long-term growth, state-local expenditures today are roughly half again as large as Federal expenditures.

Farewell to controls?

Some of the more interesting passages of the Economic Report analyze the recent ineffectiveness of wage-price controls in containing inflation. Not only has the track record been rather poor from the standpoint of curbing the price upsurge, but in the CEA's opinion, controls have actually interfered with business plans to expand output as a means of meeting demand pressures.

Probably not by coincidence, several measures were taken to remove controls within the past week alone. Wage and price controls were lifted from the largest retail firms, attendant upon the agreement that they will not exceed profit margins registered in 1973. As a consequence of this and earlier decontrol decisions, almost 60 percent of the economy is now free of controls. The authority to continue wage-price controls expires April 30 in the absence of legislation to maintain them.

In another area, last week recorded the end of the interest-equalization tax upon foreign securities, the Commerce Department's controls over corporate direct investments abroad, and the Federal Reserve's guidelines on financial institutions' lending and investment overseas. These controls, which date from attempts in the 1960's to check the outflow of American capital, now seem inappropriate in light of the recent improvement in the U.S. balance-of-payments position and the strong position of the dollar in foreign-exchange markets.

Budget as policy tool

The Administration's budget for fiscal 1975 calls for expenditures of $304.4 billion and revenues of $295.0 billion, yielding a deficit of $9.4 billion. The spending increase represents a rise of almost $30 billion over the fiscal 1974 level, but nearly three-fourths of this gain comes under the heading of "relatively uncontrollable items." These expenditures include such items as interest on the public debt and programs maintained by specific Congressional legislation.

The budget message does not propose the impounding of appropriated funds, thus suggesting that last year's controversy over this anti-inflationary tool will not be repeated. Indeed, the President stated specifically that the Administration "will be prepared to support economic activity and employment by additional budgetary measures if necessary." These measures will probably take the form of programs to promote public employment, as an offset to the layoffs in the private sector.

The expenditure tables contain few surprises, especially since 90 percent of the spending increase will go to programs already on the books. The Department of Defense is slated for $85.8 billion in fiscal 1975, an increase of $6.3 billion; this is the largest Pentagon budget in history. The total includes about $2 billion of funds for the Trident missile-submarine program, including $600 million for the missiles alone.

Energy research is scheduled to receive $1.8 billion, with nearly a quarter of that devoted to coal-research projects. The sagging residential-construction industry is slated for a shot in the arm, with the number of subsidized housing units rising from 187,000 units in fiscal 1974 to 285,000 units in fiscal 1975. The budget document also includes the Administration's plans for welfare reform and a national health program, but it does not include any requests for funding at this time.

The scenario for 1974 may not be a happy one as it is foreseen from the banks of the Potomac. Nonetheless, the Administration documents contain a realistic assessment of the problems of rising unemployment and a continuing high rate of inflation. They provide a useful starting-point from which to sally forth to meet the challenges of a difficult transition year.

Herbert Runyon

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/23/74	Change from 1/16/74	Change from year ago Dollar	Change from year ago Percent
Loans gross adjusted and investments*	78,709	− 504	+9,479	+ 13.69
Loans gross adjusted—total*	59,836	− 422	+9,236	+ 18.25
Securities loans	1,003	− 252	− 325	− 24.47
Commercial and industrial	20,716	− 206	+2,796	+ 15.60
Real estate	18,420	+ 45	+3,174	+ 20.82
Consumer instalment	9,145	+ 7	+1,219	+ 15.38
U.S. Treasury securities	6,153	− 99	−1,087	− 15.01
Other securities	12,720	+ 17	+1,330	+ 11.68
Deposits (less cash items)—total*	74,872	− 304	+7,358	+ 10.89
Demand deposits adjusted	21,581	− 643	+1,166	+ 5.71
U.S. Government deposits	904	+ 84	− 206	− 18.56
Time deposits—total*	51,223	+ 524	+6,426	+ 14.34
Savings	17,681	− 17	− 668	− 3.64
Other time I.P.C.	23,476	+ 411	+5,910	+ 33.64
State and political subdivisions	7,399	+ 177	+ 745	+ 11.20
(Large negotiable CD's)	11,021	+ 250	+4,336	+ 64.86

Weekly Averages of Daily Figures	Week ended 1/23/74	Week ended 1/16/74	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	− 12	13	10
Borrowings	120	267	209
Net free (+) / Net borrowed (−)	− 132	− 254	−199
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions Net purchases (+) / Net sales (−)	+1,864	+1,580	+366
Transactions: U.S. securities dealers Net loans (+) / Net borrowings (−)	+ 206	+ 180	− 81

*Includes items not shown separately.

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