Research Department
Federal Reserve
Bank of
San Francisco

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Economy Up. . . Deficit Down?

Despite their sober tone, the Administration's two basic economic documents—the Federal budget and the President's Economic Report—make for somewhat cheerier reading than their predecessor documents of a year ago. According to the Economic Report, the nation's economy is "steadily growing healthier" although it will still take "several years of sound policies to restore sustained noninflationary growth." Here are the key elements of the forecast:

- Real GNP, after two back-to-back years of 2-percent decline, should rise by a healthy 6-to-6½ percent in 1976.
- Price inflation should decelerate from 9 percent last year to 6 percent in 1976.
- The unemployment rate should fall almost a full percentage point, close to a 7½-percent average for this year.

According to the Budget report, expansion at this rate should bring about an 18-percent increase in Treasury receipts next fiscal year. The result would be a reduction in the Federal deficit from around \$76 billion in fiscal 1976 to \$43 billion in fiscal 1977, if Congress accepts the Administration's tax and expenditure proposals. (Incidentally, the fiscal '76 deficit was first estimated at \$52 billion a year ago.) The deficit is expected to be cut in half again in fiscal 1978, and the red ink is projected to give way to black in the 1979 budget. This would represent only the third Treasury surplus since 1960. In terms of its impact on the economy, the budget is expected to shift from stimulative toward restrictive over the next year or so.

Economy: towards recovery

In its general outlines, the recovery is seen from Washington as being steady and consistent, rather than vigorous or exuberant. Considering the fact that the long-run sustainable rate of growth in real output (at full employment) is generally estimated at about 4 percent, the stronger growth of the 1976-77 period will not make up all of the ground lost in the past two years.

The recovery to date has depended almost entirely upon the consumer, and the Council of Economic Advisers expects continued stimulus from that source in 1976. Because of inflation's inroads, consumer after-tax purchasing power fell nearly 5 percent between late 1973 and early 1975, but it then rebounded sharply, as the Federal tax cut and an upsurge of nearly 1½ million jobs reinforced a near-halving of the late-1974 inflation rate. Another factor helping to support the beleaguered consumer was an increase in net wealth positions, largely because of the recovery in the stock market. The consumer responded with a will to this upturn in his fortunes, so that real spending increased 4 percent last year. With conditions continuing to improve in 1976, the Council expects a somewhat higher 6-percent gain, with autos and other durable goods showing considerable strength.

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Housing and business spending should contribute at least modestly to the 1976 upturn, in the Council's view. Homebuilding's drastic shakeout meant a 62-percent decline in new housing starts from the early 1973 peak, and the 1975-76 recovery may offset only a portion of that decline because of rapidly rising construction costs and over-building in some areas. Still, with mortgage-lending institutions bulging with funds and with after-tax income increasing perhaps 11 percent, new starts could rise from 1.3 million to 1.75 million units over the course of the year. The improvement should be centered in the now-depressed multi-family sector of the market.

Businessmen ran off inventories at a record rate in 1975 and the use of industrial plant languished accordingly. Then, as the inventory-liquidation process ended, the utilization rate in manufacturing rose from about 65 percent at the lowpoint to 70 percent by year's end. This was still well below the "preferred" or most profitable rate of operation — about 85 percent — but with production expanding and with operating profits rising 25 percent in 1976, corporations may feel growing pressures to boost capital spending. In the Council's view, plant-equipment spending could rise 4 to 5 percent in real terms in 1976, compared with last year's 10-percent decline, with the emphasis on modernization of equipment rather than spending for structures. (In contrast, a recent Commerce Dept. survey indicated a continued decline in real plant-equipment spending this year.) Spending should be concentrated among manufacturers of nondurable goods, such as food, chemicals and petroleum—and also among utilities, where long-term capacity needs appear to be substantial.

Budget: balancing act

The major item of interest in the President's Budget—and possibly the chief source of contention with Congress—is the proposal to balance a $28-billion tax cut with an equal reduction from the spending level that earlier trends would indicate. This would mean only a 5½-percent growth in Federal expenditures—about half of the past decade's average rate of increase. Most of the slowdown would show up in nondefense programs, which nearly doubled in cost between 1972 and 1976.

The proposed tax changes are fairly direct in their intent. These changes are designed to take effect next July 1, upon the expiration of last year's tax-cut bill. The reductions would be partially offset by $6.5 billion of increases resulting from boosts in social-security taxes and in employer-financed unemployment taxes. Of the total tax-reduction package, consumers would gain $22 billion and corporations $6 billion.

Consumers and corporations
The tax cuts for individuals would take the form of an increase in the personal exemption, the substitution of a (higher) flat standard deduction for the low-income allowance, and a reduction in tax rates. The obvious intent is to place more after-tax income in the hands of consumers, to give added strength to a sector which has been the mainstay of the recovery. In addition, the Administration proposes a tax deferral on long-term ownership of common stock (7 years), to induce broader ownership of equity securities and presumably to encourage more corporations to finance through the equity route.

For corporations, the Administration proposes making permanent the tax-rate reduction and investment tax credit enacted in the 1975 legislation. Additionally, it proposes reducing the top corporate tax rate from 48 percent to 46 percent, and granting tax relief to electric utilities, which have experienced grave problems in obtaining funds from either internal or external sources.

Apart from these explicit tax reductions, the Budget contains a number of proposals—"tax expenditures," or incentives to encourage economic activity in specific sectors—which would also result in reduced taxes for individuals and corporations. One of these is a new tax credit for financial institutions against interest income received on residential mortgages. This proposal resembles the tax deferral for individuals who hold common stock long-term, in that it would broaden a specific segment of the capital market. Another incentive is designed to foster the construction of new facilities or the expansion of old facilities in areas of high unemployment, utilizing accelerated depreciation and the investment tax credit. This type of tax expenditure would involve an initial loss in Federal tax revenue in order to create jobs and reduce unemployment over the long-term.

Altogether, 1976 may be a relatively easy year to forecast, since the consensus is for continued recovery and the differences in outlook are concerned only with the speed of expansion. The Administration forecast may be towards the top of the present range of forecasts; nonetheless, it appears to be readily achievable. The fate of the Administration budget may be more uncertain, since seldom do budgets leave Capitol Hill in precisely the same form that they went up. There is still much truth to the aphorism that "The Administration proposes and Congress disposes."

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/14/76	Change from 1/07/76	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	89,166	− 595	+ 2,057	+ 2.36
Loans (gross, adjusted)—total	65,540	− 516	− 2,231	− 3.29
Security loans	1,048	− 459	− 561	− 34.87
Commercial and industrial	23,625	+ 32	− 1,140	− 4.60
Real estate	19,669	− 18	− 448	− 2.23
Consumer instalment	10,322	+ 17	+ 363	+ 3.64
U.S. Treasury securities	10,938	− 18	+ 4,634	+ 73.51
Other securities	12,688	− 61	− 346	− 2.65
Deposits (less cash items)—total*	89,774	− 1,448	+ 5,256	+ 6.22
Demand deposits (adjusted)	24,888	− 420	+ 1,378	+ 5.86
U.S. Government deposits	487	− 169	+ 155	+ 46.69
Time deposits—total*	63,011	− 435	+ 3,689	+ 6.22
States and political subdivisions	7,738	+ 12	+ 221	+ 2.94
Savings deposits	22,965	+ 348	+ 4,566	+ 24.82
Other time deposits‡	29,133	− 424	− 865	− 2.88
Large negotiable CD's	14,726	− 832	− 1,791	− 10.84

Weekly Averages of Daily Figures	Week ended 1/14/76	Week ended 1/07/76	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	− 1	97	12
Borrowings	0	0	21
Net free(+)/Net borrowed (−)	− 1	+ 97	− 9
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (−)	+ 960	+ 708	+ 1,653
Transactions of U.S. security dealers			
Net loans (+)/Net borrowings (−)	+ 481	+ 703	+ 977

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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