Monetary Policy and the U.S. Economy in 1972

A Prelude to the Annual Report

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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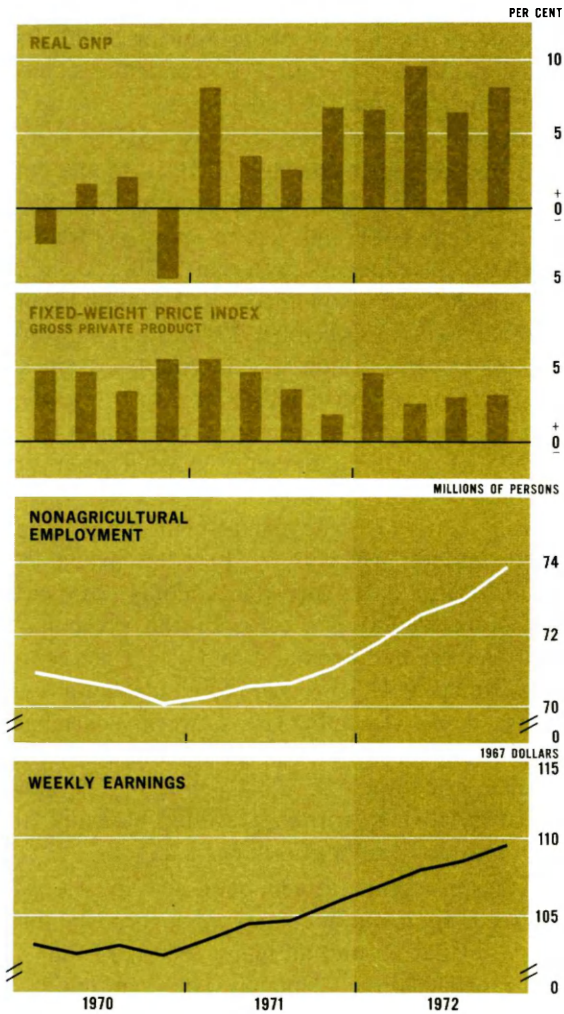
Introduction

The performance of the U.S. economy during 1972 was unusually favorable. Most aggregate measures of economic behavior showed the largest improvement since the mid-1960's.

- Real output of goods and services (GNP) grew by 7.6 per cent from the fourth quarter of 1971 to the fourth quarter of 1972. This was substantially more than the 5 per cent growth during 1971 and was in sharp contrast to the small over-all decline experienced during 1970.
- Total employment expanded by 2.4 million persons from December 1971 to December 1972, and nonfarm payroll employment by 2.7 million, the largest gains since 1966. The unemployment rate declined from nearly 6.0 per cent at the beginning of the year to about 5.0 per cent at the close.
- The rate of inflation abated somewhat after imposition of economic controls in August 1971. Over the six quarters following mid-1971, the fixed-weight price index for gross private product, which is the broadest available measure of price behavior in the private economy, rose at an average annual rate of 3.0 per cent. In the preceding six-quarter period, the rise had been at a rate of 4.7 per cent.
- Real earnings of U.S. workers rose substantially. Over the 12 months ending December 1972, weekly earnings in the private nonfarm sector advanced by 6.2 per cent, while the consumer price index rose 3.4 per cent. The slower advance in prices relative to earnings resulted basically from a strong gain in productivity, or output per manhour.

Moreover, the resurgence in economic activity was well balanced and solidly based. Real output increased vigorously throughout the year, as shown in Chart 1, and all major sectors of the economy contributed to the expansion in demand. The year featured large and steady gains in consumption, a further substantial increase in residential building, and a sizable expansion in business fixed investment. Government purchases rose 7.5 per cent from the fourth quarter of 1971 to the fourth quarter of 1972. State and local government units

1. INDICATORS OF ECONOMIC PERFORMANCE



NOTE.—Gross national product (GNP) and price index: Changes from preceding quarter compounded at annual rates, based on seasonally adjusted data from the Dept. of Commerce, Bureau of Economic Analysis. Change in real GNP is based on 1958 dollars.

Other series: Dept. of Labor, Bureau of Labor Statistics. Employment data are seasonally adjusted. Earnings are averages for private nonfarm production workers.

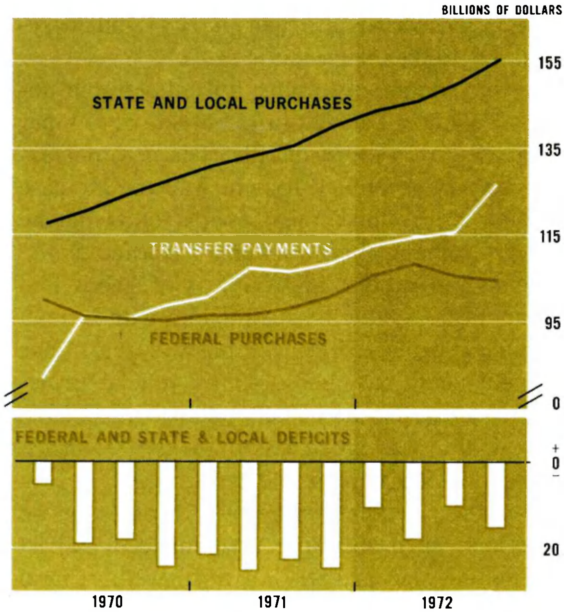
accounted for most of the increase—as shown in Chart 2 on page 6. Business inventory accumulation was larger than in 1971, but it remained quite moderate relative to the expansion in sales.

Net foreign trade, however, continued to have an unfavorable impact on domestic business. While merchandise exports rose 14 per cent in 1972, imports increased even more sharply. The vigorous expansion of the domestic economy accounted for much of the increase in imports, but higher dollar prices for foreign goods following the late 1971 changes in foreign exchange parities were also a factor. As a result, the net U.S. balance on exports and imports of goods and services was in deficit by about $4.5 billion, as compared with a small surplus in 1971 and substantial surpluses in earlier postwar years. The over-all U.S. balance of payments (as measured by official settlements) remained in heavy deficit—by about $11 billion (apart from SDR allocations)—although this was much less than in 1971 when extraordinary outflows of short-term capital had occurred.

The sharp rise in domestic spending put upward pressure on interest rates in 1972 because such spending was financed in part by very high levels of public and private borrowing. Short-term interest rates rose considerably, as reflected by an increase in the rate on 3-month Treasury bills from a low of 3.20 per cent early in the year to an average of more than 5.00 per cent in December. Long-term rates, however, changed relatively little over the course of the year. Yields on new corporate bond issues and on municipal securities declined moderately, on balance, while yields on longer-term Treasury bonds rose under pressure of increased supplies. Mortgage rates were generally stable, as both the volume of savings flowing into mortgage lending institutions and mortgage credit expansion continued at record levels.

Some narrowing in the yield spread between long- and short-term securities is typical during periods of cyclical expansion in business. But the markedly different behavior of rates in these two types of markets in 1972 was attributable in part to special factors. First, Treasury borrowing requirements, while somewhat smaller than in 1971, did put greater pressure on domestic short-term credit markets. Although foreign central banks continued to invest much

2. GOVERNMENT OUTLAYS

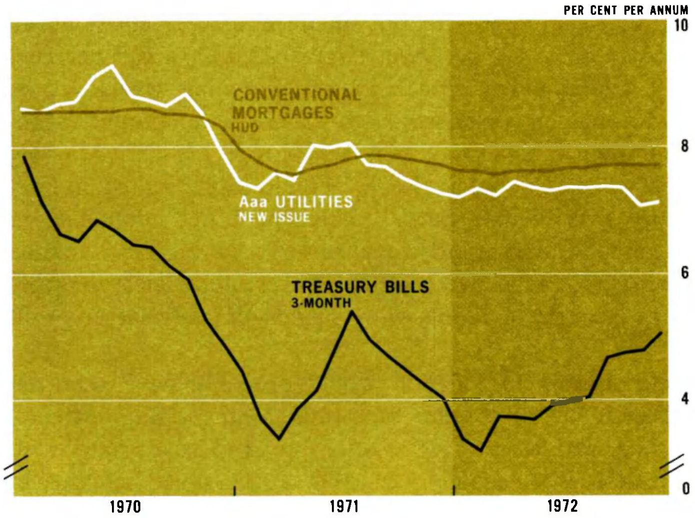


NOTE.—National Income Accounts (NIA) data at seasonally adjusted rates, from Dept. of Commerce, BEA. Transfer payments include net interest payments, subsidies, and net deficits of government enterprises. Combined deficits throughout (Q4 '72 estimated) exclude surpluses of State and local government retirement funds, which amounted to $7.4 billion (annual rate) in the final quarter of 1972.

of the expansion in their dollar reserves in U.S. Treasury debt, the over-all total of such placements was far below that of 1971. Moreover, these banks put three-quarters of the total into higher-yielding coupon issues, in contrast to their 1971 emphasis on Treasury bills. Second, the volume of private long-term security issues declined appreciably, as the flow of internal funds available to corporations from depreciation allowances and retained profits improved sharply. Finally, efforts under Phase II of the economic stabilization program to moderate the increase in wages and prices—along with the slowing in inflation that actually took place—may well have induced some decline in the inflation premium required by investors for long-term commitments of funds.

The behavior of wages and prices during 1972 was significantly more favorable, on balance, than in other recent years. There was a

3. SELECTED INTEREST RATES



For notes, see Chart 16, p. 42.

temporary bulge in the first few months following termination of the wage–price freeze in November 1971, but after that the increase in both wages and prices moderated on balance. For example, the index of average hourly earnings in the private nonfarm economy, adjusted for overtime premiums in manufacturing and for interindustry shifts in employment, rose at an annual rate of 5.9 per cent from January 1972 to January 1973. This compared with a 7.0 per cent rate of increase before the freeze in 1971.

Consumer prices of nonfood commodities rose 2.5 per cent during 1972, compared with 4 per cent in the 12 months before the freeze; increases in prices of services also slowed appreciably. Consumer food prices, however, rose nearly 5 per cent during 1972, reflecting the larger consumer demands associated with rising personal incomes and the shortages in supplies of meats and some other foodstuffs in the market. It should be noted that prices of raw agricultural products were exempted from the controls because of the serious problems inherent in balancing supply and demand at non-market-determined prices in the absence of rationing.

A major factor contributing to moderation in the inflation of nonfood commodity prices during 1972 was the stepped-up growth in productivity. Real output per manhour in the private nonfarm economy increased by 4.7 per cent, compared with a 3.5 per cent gain in 1971 and minimal growth in the preceding several years. Combined with smaller wage gains, this increase in output meant that the rising trend in unit labor costs was slowed markedly, to only about 1.5 per cent. The large rise in productivity resulted in part from the sharp gain in total output, which permitted economies in the use of manpower. Similarly, the upsurge in business volume made it possible to spread overhead costs over more sales; this permitted a large increase in profits with only moderately larger profit margins.

Thus, some slowing in inflation would probably have occurred during 1972 even in the absence of formal controls. But restraints on wages, prices, and profit margins also appear to have contributed to the moderation that actually occurred. Permissible increases in most wages and prices were limited by the program, and in some instances there were enforced rollbacks of increases that had been put into effect. Moreover, the existence of the program tended to discourage inflationary behavior in the policies and plans of business firms and the public generally.

Phase III, announced in January 1973, introduced additional flexibility into the program. But the intent remains one of strong resistance to inflationary behavior, both on a broad scale and in individual cases, and the goal is to reduce further the over-all rate of inflation.

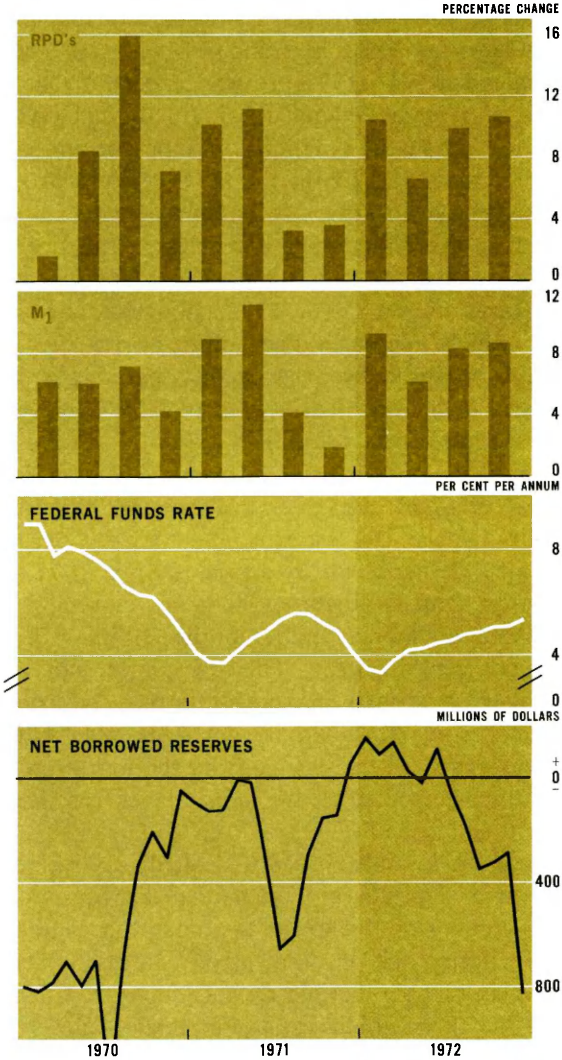
During 1972 both fiscal policy and monetary policy were directed toward encouraging more vigorous expansion in economic activity and achieving a higher level of utilization of the Nation's labor and other economic resources. As a part of the new economic program announced in August 1971, tax policy was liberalized in several respects to stimulate demands by the private sector of the economy and to provide additional spending incentives. The Federal excise tax on automobiles was repealed, the investment tax credit was reinstated at 7 per cent, and certain tax reductions that had been scheduled for later were advanced to January 1, 1972. In addition, programmed Federal expenditures were boosted, largely with respect to transfer payments and grants to State and local governments.

As a result of these changes, Federal outlays rose by $26 billion in the calendar year 1972 as compared with an increase of $16 billion in calendar year 1971. It was expected that the changes would result in a large Federal deficit for the calendar year 1972. But in fact the deficit on a national income account basis declined to $18.5 billion from $21.7 billion in the previous year. Tax revenues were buoyed by the upsurge in economic activity and, in addition, by a change in tax-withholding schedules at the beginning of the year, which resulted in substantial, continuing overpayments on individuals' taxes during all of 1972. Converted to a full-employment basis, which compares expenditures with the tax revenues that would be produced by an economy operating at high employment, the fiscal position shifted from a $4 billion surplus in calendar year 1971 to approximate balance in 1972.

Monetary policy also was in a moderately stimulative posture through most of 1972. Reserves available to support private deposits (Chart 4, page 10) were increased by 9.7 per cent as compared with a 7.2 per cent expansion during 1971. The money stock narrowly defined—that is, including currency and demand deposits—also rose more rapidly during 1972—8.3 per cent as against 6.6 per cent in 1971. This, of course, not only reflected the more vigorous growth in activity during the period but also helped to finance it. It should be noted, however, that when the increase is calculated as the change from the fourth quarter of 1971 to the fourth quarter of 1972, the money stock rose less than either real or current-dollar GNP.

The money stock more broadly defined—to include also consumer-type time deposits at commercial banks and other thrift institutions—continued to expand at about the same high 13 per cent rate as during 1971. And other sources of bank funds—mainly large negotiable certificates of deposit (CD's)—provided more funds for bank credit expansion than in 1971. Credit thus was readily available from banks and other institutional lenders to finance private and public spending. Expansion in credit and money was not large enough to satisfy all demands, however, so short-term interest rates rose considerably over the course of the year whereas

4. SELECTED MONETARY INDICATORS



NOTE.—RPD's and M_1 are quarterly changes at annual rates, based on seasonally adjusted data. RPD's are reserves to support private nonbank deposits. M_1 is currency held outside the Treasury, F. R. Banks, and the vaults of all commercial banks, plus demand deposits other than interbank and U.S. Government.

Federal funds rate and net borrowed reserves are monthly averages of daily figures.

interest rates on most long-term securities showed relatively little net change.

Upward pressure on short-term interest rates continued into early 1973, and the Federal Reserve discount rate was raised in two steps of ½ percentage point each to 5½ per cent. The discount rate had not been changed in 1972 as short-term market rates fluctuated around it, first falling below and then in the latter part of the year rising above it.

Economic activity rose especially sharply in the closing months of the year, with production, sales, and employment all expanding vigorously. Real GNP increased at an 8.0 per cent annual rate in the fourth quarter, and the unemployment rate moved significantly lower. By the year-end, the prospects seemed clearly to point in the direction of a continued substantial upward momentum in 1973.

Indications early in 1973 are that business outlays on new plant and equipment will be rising rapidly and that inventory investment may accelerate in line with the rising trend of business sales. Consumer spending, which was exceptionally strong in the fourth quarter of 1972, will very likely be buoyed in coming months by sizable refunds of Federal taxes overwithheld during 1972, as well as by continuing gains in employment and income. State and local government expenditures are to receive substantial financial assistance from the general revenue-sharing payments of the Federal Government, which commenced—with a retroactive disbursement—only very late in 1972.

Only residential construction seems likely to be moving down following 2 years of record-high activity. But both building permits and housing starts, which lead construction outlays, remained extremely strong through the end of 1972, so any appreciable decline in such outlays is likely to be deferred until the latter part of 1973.

The foreign trade outlook also appears more favorable than in 1972. Exports should be stimulated by the high and rising levels of economic activity prevailing in most major countries and by the further improvement in competitive position likely to stem from the 10 per cent devaluation of the dollar announced by the President on February 12, 1973. Domestic production that competes with imports will also be stimulated as a result of the increase in dollar prices of imported goods. Thus, the physical volume of imports will tend to be limited, although—as in early 1972—the total dollar value of imports may be inflated by these higher prices. Past experience, both here and abroad, indicates that progress toward a better balance of payments position will be slow and gradual, but the further change in dollar parity in February should make an additional contribution toward that end.

Summarizing, there is good reason to believe that the U.S. economy will continue to expand at a relatively rapid rate in the period ahead. And as the economy approaches maximum levels of practicable resource utilization, the nature of the demand–management problem facing governmental policy will be in process of change. Rather than the stimulus that was needed to encourage rapid economic recovery, the need increasingly may be to restrain the expansion in economic activity to insure that future growth will moderate to a rate consistent with the Nation's longer-run potential.

The administration's new budget plans for the remainder of the fiscal year 1973 and for fiscal 1974 recognize this need. If the spending totals proposed are not exceeded, the rise in Federal outlays during calendar year 1973 will be substantially smaller than during calendar year 1972. Tax refunds will keep the deficit large in the first half of 1973, but thereafter revenues will be expanding in line with growth in the economy. Under these conditions, the slower rise planned in Federal expenditures would imply appreciably less fiscal stimulus by the second half of 1973 and on into 1974.

Monetary policy too must be responsive to the financial requirements imposed by the needed moderation in economic growth to a more sustainable, noninflationary pace. Although expansion in the monetary aggregates continued comparatively rapid in the latter part of 1972 as demands for funds intensified, reserves to support this expansion were being provided more reluctantly, and efforts by banks to adjust their positions by other means put upward pressure on short-term interest rates. Less of the recent rise in bank reserves has stemmed from open market operations, and more from further increases in the average level of temporary bank accommodation at Federal Reserve Bank discount windows.

If the past is any guide, the firming in monetary conditions over recent months should soon result in moderation in the rate of monetary expansion. Developing monetary restraint affects monetary growth and economic activity with some lag, since it takes time for borrowers, lenders, and investors to adjust to changed financial conditions. Thus, the cumulative effects of monetary actions in 1972—particularly those initiated in the latter part of the year—will be working for some time toward restraint of monetary expansion and of aggregate demand in the future.

In any event, prospects at the beginning of the year make it unlikely that the needs of the economy in 1973 will or should call for the degree of monetary stimulus provided in 1972. Monetary policy is a flexible instrument for influencing the economic environment, however, and it will be in a position to respond to changing needs as economic developments unfold during the year.

Demands for Goods and Services

The stepped-up pace of economic expansion that became evident in the fall of 1971 strengthened measurably in 1972, and at the year-end growth was continuing at a very rapid pace. The new economic policy that had been initiated in August 1971, including a freeze on prices and wages followed by Phase II controls, contributed to the faster economic expansion as well as to the easing of inflationary pressures.

As employment and incomes rose strongly and inflationary expectations abated, consumers became more optimistic and they increased their spending appreciably. Demands for housing continued strong, and residential construction activity surpassed to a substantial extent the very high levels reached in 1971.

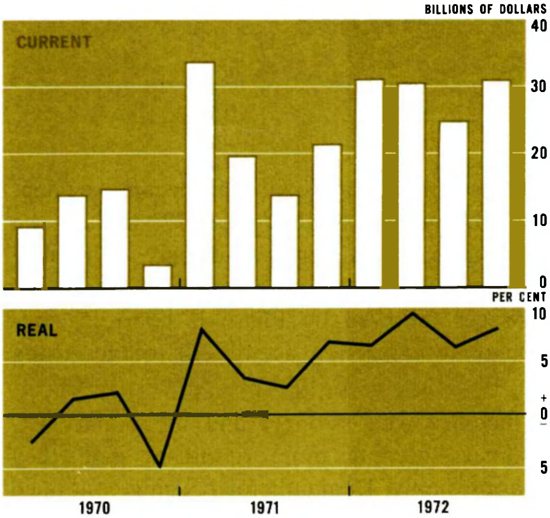
Business attitudes improved with the growth in sales and the better prospects for profits. New orders increased, and business commitments and outlays for fixed investment began to add considerably to the vigor of the expansion. As the year progressed, business also stepped up the pace of inventory investment.

Governments, too, contributed to the large advance in over-all spending in 1972. In contrast to these generally expansive demands, net exports shifted from a small surplus in 1971 to a sizable deficit in 1972, as the increase in imports far exceeded that in exports.

REAL OUTPUT

Measured in current prices, GNP increased rapidly in 1972—by almost 10 per cent for the year as a whole. At the same time, the rise in the GNP implicit price deflator slowed to 3 per cent, as compared with a 5 per cent average increase for the two preceding years. As a result, the increase in real GNP for the year as a whole amounted to 6.4 per cent—more than twice the 1971 rise and the largest since 1966. Growth in real GNP was rapid in every quarter of 1972; in the fourth quarter it was at an

5. CHANGES IN GNP



NOTE.—Based on quarterly data (constant-dollar series, 1958 dollars) at seasonally adjusted annual rates, from Dept. of Commerce, BEA. Changes are from preceding quarter.

annual rate of 8.0 per cent, about double the economy's long-run potential rate of expansion.

The surge of aggregate demands in 1972 resulted in sharp increases in industrial output and nonfarm employment and in a significant reduction in unemployment. Over the 12 months ending in December industrial production increased more than 10 per cent; consumer goods, business equipment, and materials all made appreciable contributions to this expansion. Nonfarm payroll employment was 2.7 million persons, or almost 4 per cent, above a year earlier. The unemployment rate declined during the second half of the year to 5.1 per cent in December; a year earlier the rate had been 6 per cent.

CONSUMER INCOME AND OUTLAYS

Personal income increased somewhat more sharply in 1972 than in 1971—8.5 per cent for the year as a whole compared with less than 7 per cent in 1971. Although the rate of growth in average hourly earnings slowed, employment was up sharply and

Table 1: GROSS NATIONAL PRODUCT

Type of measure	1970	1971	1972	1972[1] I	II	III	IV
	In billions of dollars						
Current dollars	976	1,050	1,152	1,109	1,139	1,164	1,195
1958 dollars	722	742	790	767	784	796	812
	Percentage change from preceding period (at annual rates)						
Current dollars	5.0	7.6	9.7	12.0	11.4	8.9	11.0
1958 dollars	−.5	2.7	6.4	6.5	9.4	6.3	8.0
Implicit deflator (1958 = 100)	5.5	4.7	3.0	5.1	1.8	2.4	2.8

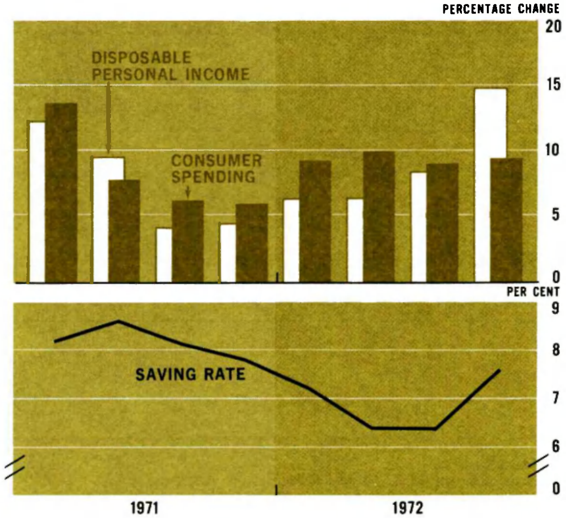
[1] Quarterly data are seasonally adjusted annual rates.
NOTE.—Basic data from Department of Commerce, Bureau of Economic Analysis.

total wages and salaries increased by 9.5 per cent, compared with less than 6 per cent the preceding year. Transfer payments—for example, social security benefits and unemployment insurance—also increased substantially, but less than they had in 1971. However, the growth in disposable personal income was somewhat less than in 1971, because the gain in such income was held down by a change in Federal income-tax-withholding schedules, which resulted in sizable overwithholdings.

Nevertheless, consumers stepped up their spending and borrowing briskly, responding to strong gains in employment, increased overtime, and strengthened confidence as evidenced by surveys relating to consumer attitudes about economic prospects and financial positions. The rate of personal saving for the year as a whole declined to about 7 per cent of disposable income, from more than 8 per cent in 1971.

In current dollars, consumer spending was about 8.5 per cent higher than in 1971. Purchases of new autos and household durable goods were especially strong, but spending for nondurable goods and services also rose considerably. Increases in the physical volume of purchases were sizable for all three major categories. In real

6. CONSUMER INCOME, OUTLAYS, AND SAVING



NOTE.—Income and spending are changes from preceding quarter, based on quarterly data at seasonally adjusted annual rates, from Dept. of Commerce, BEA. Saving rate is personal saving as percentage of disposable personal income.

terms, total consumer spending was up 6 per cent, well above the 4 per cent increase recorded for 1971.

Sales of new automobiles—both domestic-type and imports—reached a new high of 10.8 million units for the year, up from 10.2 million units in 1971. In the fourth quarter total auto sales reached an annual rate of 11.7 million units, the highest of the year. The sharp increase in purchases of household durable goods was associated not only with rising incomes but also with the record number of new housing units being completed and occupied. This large increase in consumer spending for durable goods was facilitated by a record increase in the use of instalment credit.

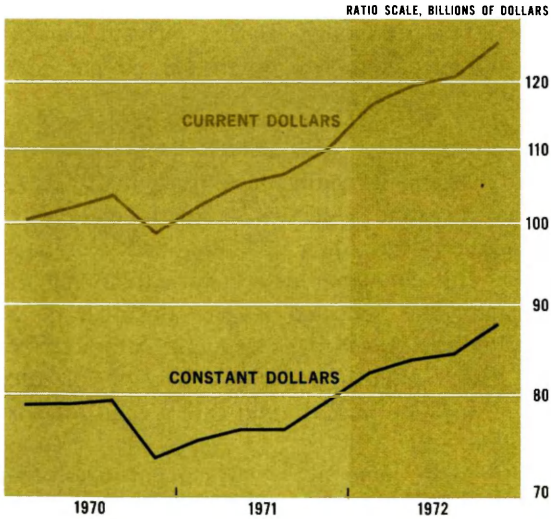
Consumer demands were still exerting a stimulating influence on the economy at the end of 1972. Incomes were advancing with exceptional rapidity as a result of continued strong gains in output and employment and of a 20 per cent boost in social security benefits, with initial payments on October 1. It is expected that the unusually large amount of tax refunds anticipated for the first half of 1973 because of overwithholding during 1972 will add to both disposable incomes and spending.

BUSINESS FIXED INVESTMENT

An important factor in the expansive thrust of the economy in 1972 was a marked increase in business spending for new fixed capital. Outlays for new machinery and buildings were 14 per cent higher than in 1971; measured in real terms this represented an increasee of 10 per cent.

The rise in spending for business fixed capital reflected a number of factors: the strong expansion in industrial production and an associated rise in the rate of capacity utilization; the greatly improved performance of aggregate profits; and the stimulative effects of a further acceleration in depreciation schedules and the late-1971 restoration of the investment tax credit, which applies to purchases of new equipment. For the year as a whole purchases of machinery and equipment in current dollars were about 16 per cent above the 1971 volume. Because the increase in prices of such goods in

7. BUSINESS FIXED INVESTMENT



NOTE.—Quarterly data, at seasonally adjusted annual rates, from Dept. of Commerce, BEA. Constant-dollar series is in terms of 1958 dollars.

1972 was quite moderate, most of this large rise in outlays represented physical volume. In the equipment category, truck sales were especially strong; the number of units sold was up 25 per cent from 1971. The increase in business outlays for new construction was more moderate, with little change in real terms.

Most of the increase in fixed investment outlays in 1972 occurred outside of the manufacturing sector. Expenditures by public utilities rose strongly, reflecting continued sizable gains in demands for energy as well as more rigorous standards for pollution controls. Communications and commercial firms also increased their investment sharply. The increase in spending for new plant and equipment by manufacturing firms in 1972 was much more moderate; however, the rise of 4 per cent contrasted with a decline of about 6 per cent in 1971.

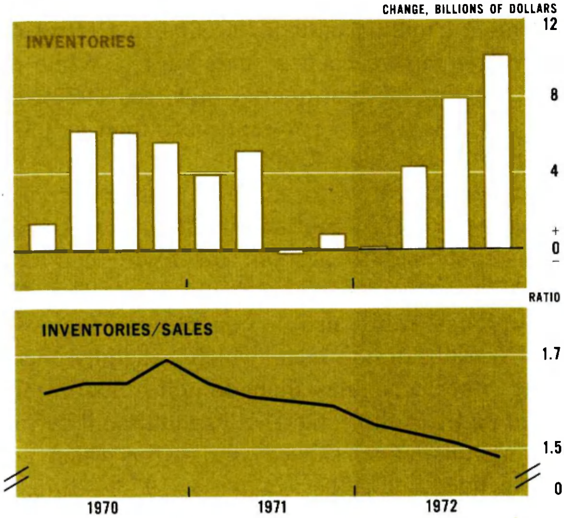
Late in 1972 businessmen's intentions to spend for plant and equipment in the year ahead appeared to be in the process of upward adjustment, reflecting—among other factors—rising orders for hard goods and a growing backlog of such orders. The survey taken by the Department of Commerce in December 1972 showed plans for a 13 per cent rise in spending for new plant and equipment in 1973, with larger increases being planned by manufacturers than by other sectors of the economy. Earlier private surveys taken in the autumn had indicated a rise of around 10 per cent.

INVENTORIES

An upturn in inventory investment finally developed in 1972. As a general rule, inventory investment increases rapidly early in a cyclical expansion, but in this one such spending had continued quite moderate throughout the first year of recovery following the fourth-quarter 1970 trough. This reflected in part the absence of any net liquidation during the 1969–70 recession. Although recovery in sales in 1971 had resulted in a decline in inventory/sales ratios, at the end of 1971 such ratios were still rather high for that stage of the cycle.

Businessmen began to increase inventory investment in the second quarter of 1972 in response to the continued rapid increases in sales and production, and the rate of such accumulation accelerated as the year progressed. Toward the year-end, accumulation reached

8. BUSINESS INVENTORIES AND SALES



NOTE.—Dept. of Commerce data: Inventory change (NIA), quarterly data at seasonally adjusted annual rates, from BEA. Inventories/sales ratio, based on book value and sales data seasonally adjusted, from Bureau of the Census; book value, end of quarter; sales, quarterly average.

an annual rate of $10 billion, as measured in the NIA accounts. With sales gains outstripping inventory increases, the ratios of inventory book values to sales in a number of areas were reduced further, and by the end of the year they were approaching historically low levels. Further growth in inventory accumulation is suggested by these low ratios, as well as by rising backlogs of unfilled orders, by more numerous reports of delays in deliveries, and by continuing rapid increases in sales.

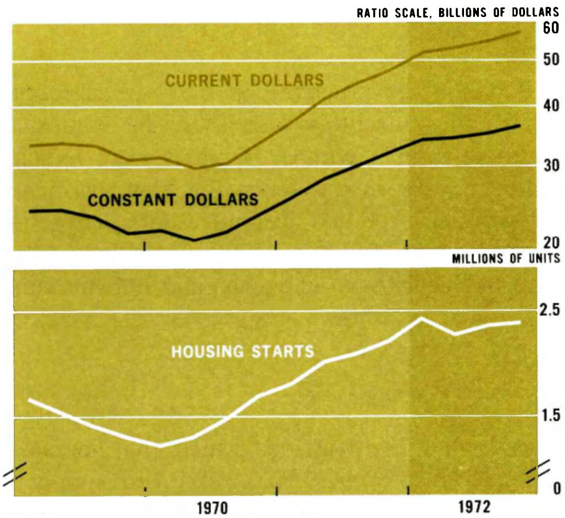
RESIDENTIAL CONSTRUCTION

Outlays for private residential construction, which had increased sharply in 1971, advanced further in 1972. A record supply of mortgage credit, available at relatively stable interest rates and on liberal terms, supported a strong expansion in demands for both new and existing dwelling units. For the year, residential outlays rose 25 per cent in current dollars and about 20 per cent in real terms.

Private housing starts accelerated to a peak seasonally adjusted annual rate of more than 2.4 million units in the first quarter of the year, almost double the low rate reached 2 years earlier. While the rate fluctuated thereafter below the first-quarter high, the 1972 total came to 2.4 million units. This was 15 per cent more than in 1971, the first year in which starts exceeded 2 million units.

Reflecting in part builders' attempts to adjust to further increases in the cost of land and other items, multifamily structures—which include condominiums—continued to account for more than two-fifths of total starts. However, upgraded demands for these and for other types of dwellings were also a conspicuous factor in the over-all advance. Nonsubsidized units, which generally incorporate more space and other amenities than do units that receive Federal subsidies, accounted for all of the rise in multifamily structures. In contrast, the number of subsidized starts—for which new commitments were suspended altogether in early 1973—dropped

9. RESIDENTIAL CONSTRUCTION



NOTE.—Dept. of Commerce data: Expenditures, quarterly data at seasonally adjusted annual rates, from BEA. Constant-dollar series is in terms of 1958 dollars. Housing starts, monthly data at seasonally adjusted annual rates, from Bureau of the Census.

appreciably in 1972 from the highs reached in 1970 and 1971. Shipments of new mobile homes, which are not included in housing starts or in residential construction outlays, also achieved a new high in 1972. Such shipments totaled about 575,000 units, an increase of 15 per cent from 1971.

At the year-end demands for housing remained strong, vacancy rates were relatively low, and mortgage funds were still in ample supply at rates little changed from a year earlier. However, it appeared unlikely that the number of starts in 1973 would match the 1972 total in view of (1) the extent to which the backlog of demand had been satisfied by sustained high levels of production (2) the large and growing number of completions of earlier starts in prospect, and (3) other factors.

GOVERNMENT OUTLAYS

Purchases of goods and services by the Federal Government rose strongly in the first half of 1972 as the result of a Government-wide pay increase in January and the rebuilding of defense inventories depleted by activities in Vietnam. In the second half of the year, however, defense purchases dropped sharply and nondefense buying slowed; as a result, Federal purchases declined. For the calendar year as a whole, Federal purchases rose about 8.5 per cent—virtually all because of increased pay and higher prices.

State and local government purchases rose by about 10 per cent in 1972—the same increase as in each of the past 3 years. Employee compensation, as usual, accounted for much of the gain. Employment rose about 4.5 per cent; about one-third of this increase represented the number of jobs added under provisions of the Public Employment Act—a program funded in large part by the Federal Government. As in other recent years, there was little growth in purchases of structures in 1972, in large part because the demand for new educational structures has lessened.

During 1972 there was a dramatic improvement in the over-all fiscal position of State and local governments. Although expenditures continued to rise rapidly, revenues rose even faster, especially in the fourth quarter when the first payments under the Federal revenue-sharing program were received. As a result, State and local governments achieved a surplus of about $12 billion (NIA basis) for the calendar year compared with a surplus of less than $5 billion in 1971 and with deficits in 1967 and 1968. However, there remained wide differences in the fiscal position of individual governmental units.

Table 2: CHANGES IN MAJOR COMPONENTS OF GROSS NATIONAL PRODUCT

In billions of dollars

Item	1970	1971	1972	1972[1] I	II	III	IV
GNP	**46.1**	**74.0**	**101.4**	**31.0**	**30.3**	**24.6**	**30.9**
Personal consumption expenditures	**37.3**	**48.1**	**56.1**	**15.6**	**17.3**	**15.2**	**17.1**
Durable goods	−.3	13.0	12.6	4.9	2.9	4.7	2.2
Nondurable goods	18.5	13.7	21.4	4.9	8.9	4.8	8.4
Services	19.1	21.5	22.1	5.8	5.7	5.6	6.5
Saving rate (level, in per cent)	*8.0*	*8.2*	*6.9*	*7.2*	*6.4*	*6.4*	*7.6*
Fixed investment	**1.1**	**16.1**	**26.2**	**10.5**	**4.3**	**3.2**	**7.9**
Residential structures	−1.4	11.4	11.4	4.3	1.2	1.6	2.6
Nonresidential	2.4	4.9	14.8	6.3	3.1	1.5	5.4
Inventory change	**−2.9**	**−1.3**	**2.3**	**−1.3**	**4.6**	**3.0**	**2.3**
Net exports of goods and services	**1.7**	**−2.9**	**−4.9**	**−2.5**	**−.6**	**1.8**	**−.1**
Exports	7.4	3.2	7.6	7.7	−.7	4.4	5.2
Imports	5.7	6.1	12.5	10.2	−.1	2.6	5.3
Govt. purchases of goods and services	**9.0**	**13.8**	**21.8**	**8.5**	**4.7**	**1.5**	**3.7**
Federal	−2.3	1.3	8.0	5.0	2.4	−2.7	−1.4
Defense	−3.3	−3.7	4.5	4.8	1.9	−3.5	−1.9
Other	1.1	4.8	3.6	.2	.7	.6	.6
State and local	11.3	12.5	13.8	3.5	2.3	4.2	5.0

[1] Derived from quarterly totals at seasonally adjusted annual rates.
NOTE.—Basic data from Dept. of Commerce, BEA.

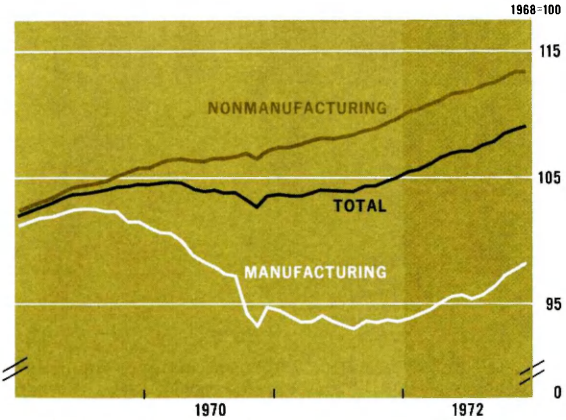
Manpower

Labor markets tightened significantly in 1972 in response to the sharp rise in real output. Gains in employment were large and persistent all year, but it was not until near midyear that the jobless rate, which had held close to 6 per cent for a year and a half, began to decline.

Growth in employment had begun to accelerate in late 1971, and it continued at a rapid pace through most of 1972. By December nonfarm payroll employment had risen by 2.7 million persons from a year earlier. Gains in manufacturing were especially strong during most of 1972, as increased spending for investment and strong demands for autos and other consumer durable goods stimulated rapid growth in employment in the major metal-producing and metal-using industries. By December total manufacturing employment, at 19.4 million persons, had risen by some 900,000 over the year, and the average factory workweek had increased appreciably. But manufacturing employment was still 900,000 below the peak level of 1969, when defense production was supporting a high level of factory output.

Employment growth also accelerated in nonindustrial activities

10. NONFARM PAYROLL EMPLOYMENT

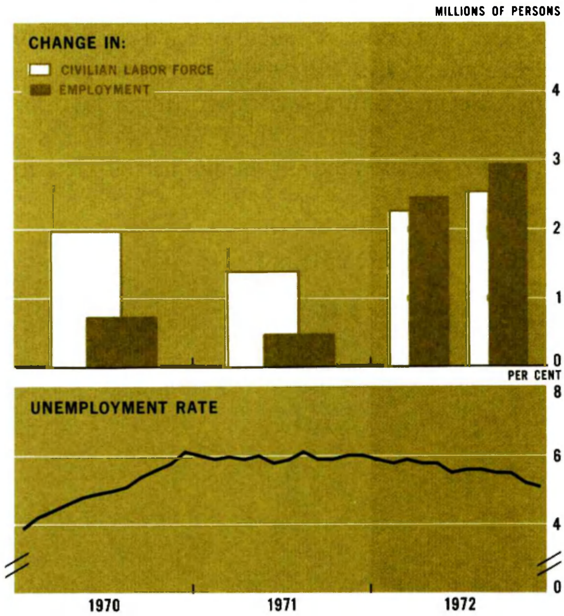


NOTE.—Based on monthly data, seasonally adjusted, from Dept. of Labor, BLS.

in 1972. In services, finance, and trade, the total number employed rose by 1.2 million, about one-third more than during 1971. Federal civilian employment was cut slightly, but State and local governments increased their payrolls by 475,000 over the year ending in December—including about 150,000 jobs provided by the Federally financed public employment program.

Little progress was made in reducing unemployment until early summer, however, as much-larger-than-normal increases in the labor force about matched the rise in employment. Rapid gains in the civilian labor force in the winter and early spring reflected not only a rise in participation rates in response to increases in employment opportunities but also the entry into the civilian labor market of several hundred thousand young men as the size of the Armed Forces was reduced further. Toward midyear, however, growth of the civilian labor force slowed, in part because the size of the

11. LABOR FORCE, EMPLOYMENT, AND UNEMPLOYMENT



NOTE.—Basic data, Dept. of Labor, BLS. For civilian labor force and employment, 1970 and 1971 are changes from preceding year; the 1972 changes are annual rates calculated from half-year averages of seasonally adjusted data. Unemployment rate is monthly, seasonally adjusted.

Armed Forces leveled off after a decline of 1.2 million from the high in October 1968. Altogether, over the year ending in December the civilian labor force increased by more than 1.8 million persons. Reflecting continued strong gains in employment and slower growth in the labor force, the unemployment rate declined irregularly after May to 5.1 per cent in December.

The decline in unemployment was most pronounced among men 25 years of age and over—reflecting largely the strong recovery in manufacturing and blue-collar employment. Nevertheless the jobless rate for this age group, at 2.8 per cent in the fourth quarter, remained above the exceptionally low rate of late 1969. Unemployment among Negroes (10 per cent) and younger workers (about 16 per cent) changed little from the high rates of late 1971 and early 1972.

In 1973 the size of the Armed Forces is expected to decline only a little further, and growth of the civilian labor force may be closer to the 1.5 million expected per year on the basis of population growth and trends in participation rates. Such a situation would be conducive to a further reduction in the unemployment rate if employment gains continue at a rapid pace.

Table 3: LABOR FORCE, EMPLOYMENT, AND UNEMPLOYMENT

Changes in thousands of persons, except for unemployment rates, which are monthly average rates in the final quarter of each year.

Item	Year ending fourth quarter of—			
	1969	1970	1971	1972 [1]
Total labor force	2,283	1,408	1,257	1,608
Armed forces	−53	−443	−353	−262
Civilian labor force	2,336	1,851	1,610	1,869
Total civilian employment	2,102	−64	1,409	2,344
Unemployment rates (in per cent):				
Total	3.6	5.8	5.9	5.3
Men, 25 and over	1.8	3.4	3.5	2.8
Men, 20 to 24	5.6	10.5	10.3	8.7
Women, 20 and over	3.7	5.5	5.7	5.2
Teenagers, 16 to 19	12.1	17.2	16.9	15.6
Whites	3.3	5.4	5.4	4.7
Negroes and others	6.2	9.2	10.1	9.9
Heads of households	1.9	3.5	3.6	3.1
Full-time workers	3.1	5.4	5.6	4.8

[1] Data on changes from 1971 to 1972 are adjusted to allow for the introduction of new estimates for population.

NOTE.—Basic data from Dept. of Labor, Bureau of Labor Statistics.

Wages, Labor Costs, and Prices

Progress was made in 1972 in reducing inflationary pressures. The program of wage and price controls initiated in August 1971 contributed to a slowing of the rise of hourly compensation, and with gains in productivity accelerating, the rise in unit labor costs moderated sharply. Price developments, particularly as measured by the comprehensive GNP fixed-weight index for the private economy, reflected the more favorable labor cost situation and the impact of price controls. The consumer price index posted a somewhat smaller increase during 1972 than in the pre-control period of 1971, and the rise in industrial wholesale prices slowed appreciably. On the other hand, prices of farm products and processed foods increased much more rapidly than before controls.

> On January 11, 1973, the President requested a temporary extension of the Economic Stabilization Act of 1970—the legal underpinning of the wage and price control program—and announced some important changes in the Phase II program. The new program—referred to as Phase III—is intended initially to maintain, with some modifications, the basic wage and price standards established in the early period of controls, but heavier reliance is placed on voluntary compliance and self-regulation. The requirement for prenotification of wage and price increases by large firms has been eliminated. However, foods beyond the farm level, health services, and construction remain under mandatory controls. The Price Commission and the Pay Board were abolished, and authority for the new program was centralized in the Cost of Living Council.

WAGES

The Pay Board, as originally set up, was charged with the task of limiting wage increases. Accordingly, it established standards for generally permissible pay increases consistent with the announced goal of reducing the rate of price increase to a range of 2 to 3 per cent. Including an allowance of about 3 per cent for long-term growth in productivity, the general wage and salary standard established by the Board called for a limit of 5.5 per cent on increases in wages and salaries and "covered" fringe benefits. In addition, the Board permitted increases in certain other qualified fringe benefits, and this in effect raised the over-all standard for compensation to as much as 6.2 per cent. Considerable flexibility was also built into the Board's regulations, including procedures for upward adjustment in the standards if necessary to correct gross inequities and to deal with other special situations.

The rise in money wages was slower in 1972 than in 1971. For the 12 months ending January 1973 (that is, the year following the post-freeze bulge in wages), adjusted hourly earnings of production and nonsupervisory workers in private nonfarm industries—the measure that most closely approximates changes in wage rates—increased by about 6 per cent; this compares with an annual rate of increase of nearly 7 per cent both in the pre-control period of 1971 and from January 1971 to January 1972. But the slowing was concentrated in the interval from January through August. Thereafter, the rise in wages was more rapid than earlier in the year. Because of the moderation of price increases, real wages of production workers in the private sector, which had begun to advance in 1971 following several years of little or no growth, rose more than 2.5 per cent over the course of 1972.

Experience in 1972 varied among individual industries, but over

Table 4: CHANGES IN AVERAGE HOURLY EARNINGS

Seasonally adjusted annual rates, in per cent

Industry	Aug. 1970–Aug. 1971	Aug. 1971–Jan. 1972	Jan. 1972–July 1972	July 1972–Jan. 1973	Jan. 1972–Jan. 1973
Total private nonfarm	6.9	7.0	4.7	6.8	5.9
Mining	6.8	9.2	4.4	8.9	6.7
Construction	7.8	6.8	3.2	10.5	6.9
Manufacturing	6.5	6.5	4.9	6.3	5.7
Transportation and public utilities	8.7	11.8	9.4	8.5	9.2
Wholesale and retail trade	6.0	5.5	4.4	4.9	4.7
Finance, insurance, and real estate	6.9	5.0	4.8	4.8	4.8
Services	7.3	7.6	2.7	7.7	5.3

NOTE.—Average hourly earnings of private nonfarm production and supervisory workers, adjusted for interindustry shifts and, in manufacturing only, for overtime hours. Basic data from Dept. of Labor, BLS.

the entire 12 months the slowing of the rise in wages was most pronounced for the services and trade sectors. Hourly earnings in construction, which continued to be under the control of the Construction Industry Stabilization Committee, increased by about 7 per cent over the 12-month interval. In manufacturing, hourly earnings rose appreciably less than in the immediate pre-control interval. However, some industry groups realized larger increases in 1972 than in 1971. This was true especially for transportation and public utilities; in these industries there were large wage increases for telephone workers, railroad workers, truckers, and dockworkers, mainly as a result of deferred-wage increases under collective bargaining agreements negotiated before controls were introduced.

In most industries the rise in hourly earnings accelerated in the closing months of 1972. The reasons for this are not entirely clear, but the acceleration appears to reflect in part a clustering of both new and deferred wage increases roughly a year after the 1971 freeze and in part a generally stronger labor market.

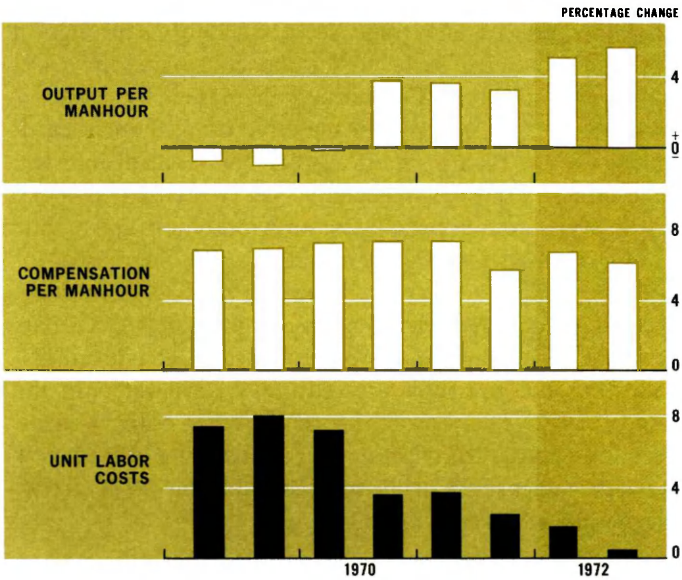
PRODUCTIVITY AND LABOR COSTS

Productivity increased sharply in 1972, as is typical of periods of strong growth in output. Output per manhour in the private nonfarm economy rose 5.1 per cent over the four quarters of 1972—double the long-term trend of 2.6 per cent. This performance exceeded the sizable 4.4 per cent rise in productivity in 1971, and it was in sharp contrast to 1969 and early 1970 when there was virtually no growth.

Employee compensation, which includes both wages and fringe benefits, increased 6.9 per cent over the course of 1972, compared with 8.1 per cent over the first half of 1971. The stepped-up pace of growth in productivity together with this slowing of the rise in employee compensation resulted in a sharp reduction of the rate of increase in unit labor costs. For the private nonfarm economy, such costs rose only 1.6 per cent during 1972—and they were virtually unchanged in the middle two quarters. This compares with increases of more than 8 per cent during 1969 and 5 per cent during 1970.

In 1973, gains in productivity may fall well short of those in 1972, particularly if real growth moderates to a more sustainable rate, as is widely expected. Further progress in restraining cost pressures is

12. PRODUCTIVITY, COMPENSATION, AND COSTS



NOTE.—Data are from Dept. of Labor, BLS; changes are based on half-year averages of seasonally adjusted quarterly estimates for the private nonfarm economy.

thus heavily dependent on the changes in wages and other employee benefits, emphasizing the importance of an effective Phase III program.

In appraising wage prospects, it should be noted that measures to restrain wage increases are continuing in Phase III. The fact that workers covered under expiring contracts have realized significant gains in real income may be conducive to some moderation in demands for higher wages. However, the number of workers involved in major contract negotiations, which was relatively small in 1972, will increase substantially in 1973. Contracts covering 4.7 million workers either expire or provide for wage reopenings. These include such key industries as trucking, railroads, rubber, electrical equipment, and autos. Furthermore, a heavy round of bargaining is anticipated in the construction industry, as many of the agreements signed in 1972 covered only one year.

PRICES

The moderation of the pace of price advance during 1972 was fairly general, except for prices of farm products, foods, and some materials. The fixed-weight price index for gross private product rose at an annual rate of about 3 per cent after a post-freeze bulge in the first quarter; this compares with an average annual rate of about 5 per cent in the first two quarters of 1971 preceding the 90-day price freeze.

Prices of food products at the farm level, which are not controlled, increased 19 per cent during 1972—considerably faster than in any other year since 1950. In December wholesale prices of livestock were 22 per cent above a year earlier; eggs, 26 per cent; and grains, 44 per cent. Prices of processed foods and feeds, however, rose less rapidly than those of farm products. Nevertheless, the average rise for this category for the year ending December amounted to 11.5 per cent. Because of the sharp rise in prices of farm products and foods, the total index of wholesale prices rose faster in 1972 than in the pre-control period from December 1970 to August 1971.

On the other hand, the rise in prices of industrial commodities moderated appreciably during 1972, reflecting mainly improvement in prices of producers' finished goods and fabricated materials. Price rises continued to be very sharp for many raw materials, including such important commodities as hides, skins, and wool. Lumber and

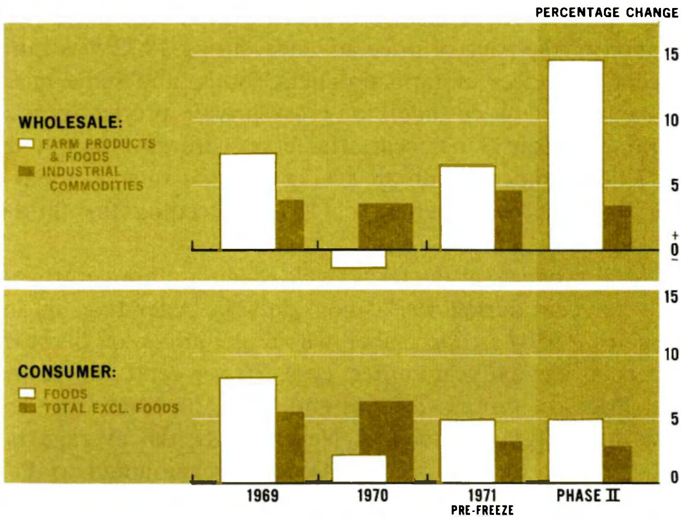
Table 5: PRICE CHANGES

Seasonally adjusted annual rates, in per cent

Item	Dec. 1969–Dec. 1970	Dec. 1970–Aug. 1971	1972				
			Dec.–Mar.	Mar.–June	June–Sept.	Sept.–Dec.	Dec.–Dec.
Wholesale prices, total	2.2	5.2	4.9	4.9	6.7	9.6	6.5
Industrial commodities	3.6	4.7	4.2	4.9	3.2	2.0	3.6
Farm products, processed foods, and feeds	−1.4	6.5	7.0	4.8	17.4	30.1	14.4
Consumer prices, total	5.5	3.8	3.6	2.2	4.6	3.2	3.4
Foods	2.2	5.0	7.2	0.0	7.0	5.2	4.7
Other commodities (less foods)	4.8	2.9	2.4	2.7	4.1	1.0	2.5
Services [1]	8.2	4.5	4.4	3.1	3.0	3.9	3.6

[1] Derived from data not adjusted for seasonal variation.
NOTE.—Basic data from Dept. of Labor, BLS.

13. PRICES



NOTE.—Based on data from Dept. of Labor, BLS. Changes measured from last month of previous period to last month of indicated period. Pre-freeze interval extends from December 1970 to August 1971; Phase II, from November 1971 to December 1972; changes for both intervals are annual rates, based on seasonally adjusted data.

plywood also advanced at very fast rates, but price advances for other building materials and metals moderated.

Consumer prices rose 3.4 per cent over 1972 compared with an annual rate of 3.8 per cent in the pre-control period of 1971. But retail food prices advanced by almost 5 per cent and meat prices by more than 10 per cent during 1972. In contrast to food prices, there was a marked deceleration of the rise in the cost of services as well as a more moderate slowing for nonfood commodities. The full extent of the improvement in costs of services in 1972 compared with the pre-freeze months of 1971 was masked by the sharp decline in mortgage interest costs in the earlier period. When home financing costs are excluded, the rise for service costs in 1972 dropped to about half the early-1971 rate. The slowing of the rise in costs of medical care—which seems to reflect in considerable part the impact of controls—was dramatic; and rents, utility costs, and other major services rose at substantially reduced rates.

In early 1973 it appeared that a somewhat faster rise in prices was in immediate prospect. As noted earlier, some pick-up in the rise in unit labor costs seemed likely, following the marked slowing in 1972. Indeed, such costs were raised at the outset of the year, when the employer tax for social insurance was boosted sharply. Prices of farm products rose sharply further in January, and food prices are expected to continue to rise rapidly for some months. More generally, strong domestic and world demands relative to supply have been exerting increasing pressure on prices of materials, especially of internationally traded commodities.

Following an upward spurt in prices of farm products and foods in the early months of 1973, however, retail food prices may tend to level off. Contributing to this is a prospective significant increase in per capita food supplies, particularly of meats, in the second half of 1973.

Federal Fiscal Policy

In fiscal years 1971 and 1972 large Federal deficits were generally accepted as appropriate, first to cushion the recession of 1970, and then to stimulate recovery. As recovery turned into vigorous expansion, however, the administration recognized that continued sharp increases in Federal spending and large deficits would be inappropriate in the developing environment of high and rising levels of output and employment. A major effort was made, therefore, in the budget document released in January 1973 to limit increases in spending, and the expansionary thrust of fiscal policy is indicated to moderate greatly as calendar year 1973 progresses.

The unified budget deficit of $23.2 billion that was realized for fiscal year 1972, while large, was $15.6 billion less than had been projected in the January 1972 budget document. Outlays did accelerate sharply in the spring of 1972, but the anticipated speed-up was not fully realized. More than half of the $4.7 billion short-fall in spending in fiscal year 1972 was due to the unexpected delay in the enactment of revenue sharing and to lower payments on unemployment insurance. Defense spending, however, increased sharply in the spring of 1972—about in line with budget projections.

Federal budget receipts in fiscal year 1972 turned out to be $10.8 billion higher than had been projected, in part because of the rapidity of economic expansion but mainly because of an unusual amount of overwithholding of personal income taxes related to the introduction of a new withholding schedule in January 1972. This development will reduce Federal net receipts in the spring of 1973 when individuals file their tax returns for 1972.

Prior to adjournment in October 1972, Congress enacted legislation that would increase outlays in fiscal year 1973 to a level some $6 billion to $8 billion above the $250 billion proposed by the administration in September 1972. The administration requested Congress to enact a ceiling of $250 billion on outlays for the fiscal year 1973. Although such a ceiling was not enacted, the administration has indicated that it intends to hold spending to that level by adopting various economies, and by impounding appropriated funds, if necessary. The new budget indicates that economies are planned in fiscal years 1973 and 1974 in a large number of areas. In addition, the budget calls for large sales of assets (negative outlays) in these two fiscal years.

Spending in the first two quarters of fiscal year 1973 (that is, the second half of calendar 1972) was in line with the proposed $250 billion. Outlays for national defense, while still strong, fell significantly below the levels attained in the latter half of fiscal year 1972. As expected, nondefense spending increased very sharply in the last quarter of calendar year 1972, reflecting two factors: the 20 per cent boost in social security benefits, effective in October 1972, which costs about $8 billion annually; and the first payment to State and local governments under the new general revenue-sharing program, which is expected to cost more than $5 billion in the first full year. However, payments made for revenue sharing in December 1972 and in January 1973 covered revenue-sharing accruals for all of the calendar year 1972; quarterly payments, beginning in April 1973, will be much smaller.

The budget document issued in January 1973 anticipates that the deficit in fiscal year 1973 will total about $25 billion—a little larger than the deficits realized in fiscal years 1971 and 1972—but that the deficit in fiscal year 1974 will be reduced to less than $13 billion. The full-employment budget, on a unified budget basis, is projected to show a deficit of around $2 billion in fiscal year 1973 and an approximate balance in fiscal year 1974.[1]

[1] The administration's estimate of full-employment receipts does not incorporate the effect of any overwithholding that is regarded as transitory. Inclusion of such overwithholding would have reduced the full-employment deficit in fiscal year 1972 and increased this deficit in fiscal year 1973.

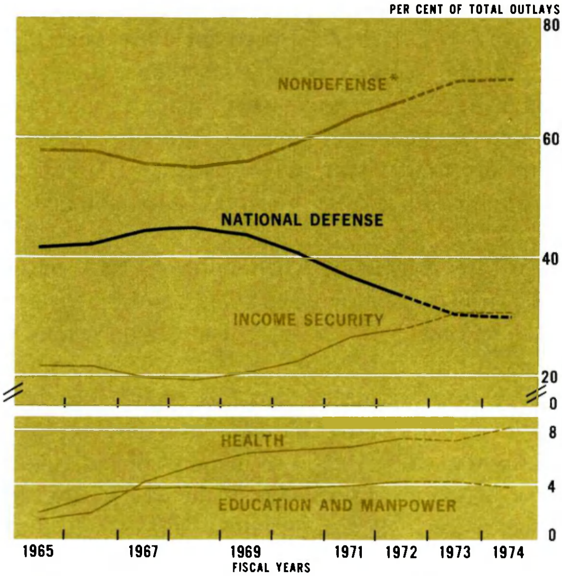
Table 6: FEDERAL BUDGET SUMMARY

Fiscal-year totals, in billions of dollars

Item	1970	1971	1972	1973e	1974e
Budget receipts	193.7	188.4	208.6	225.0	256.0
Budget outlays	196.6	211.4	231.9	249.8	268.7
Surplus or deficit (−)	−2.8	−23.0	−23.2	−24.8	−12.7
Full-employment surplus, or deficit (−)	2.6	4.9	−3.9	−2.3	.3

e Estimates.
NOTE.—Data from the *Budget of the U.S. Government, Fiscal Year 1974.*

14. CHANGING PATTERN OF FEDERAL OUTLAYS



*Three components of this total are shown below (please note differences in scales for the two grids).

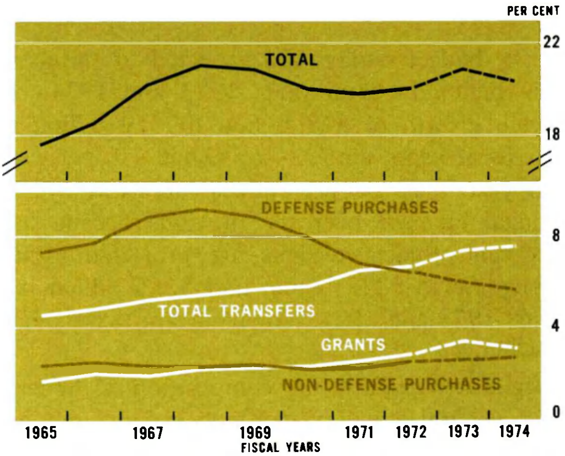
NOTE.—Data from the *Budget of the U.S. Government, Fiscal Year 1974.*

As shown in Table 6, budget outlays are expected to be about $250 billion and $269 billion in fiscal years 1973 and 1974, respectively. The projected growth of $18 billion to $19 billion in spending in these two fiscal years amounts to about 7.5 per cent annually. In the fiscal year 1972 budget outlays increased by 9.7 per cent, and the annual increase over the previous decade had averaged about 8 per cent. Budget receipts are projected in the budget document to increase to $225 billion and $256 billion, respectively, in fiscal years 1973 and 1974. No significant tax changes are proposed in the new budget.

There has been a significant shift in the composition of Federal outlays in recent years. Although outlays for national defense are projected to increase absolutely, their proportion of total budget expenditures, as may be seen in Chart 14, has declined from more than 40 per cent in fiscal years 1967 and 1968 to a projected figure of about 30 per cent in fiscal years 1973 and 1974. On the other hand, the proportion of total budget outlays devoted to "income security" has risen from less than 20 per cent a few years ago to about 30 per cent. (Social security benefits, including medicare, are the biggest component of this category, which includes also such other supports to income as Federal retirement benefits, veterans' benefits, unemployment insurance, and public assistance.) Federal outlays for health programs have also risen as a percentage of the total.

A broadly similar picture is evident when outlays (NIA basis) are shown as a proportion of full-employment GNP, as in Chart 15. It is evident from this chart that direct Federal demands on resources have decreased as a proportion of full-employment GNP along with the relative decline in defense purchases. But this decline has been offset by a large absolute and relative increase in spending for a great variety of programs that add directly to incomes of individuals without the provision of a current service—as in the case of transfer payments—and by an advance in Federal grants-in-aid to help State and local governments provide for a wide range of needs.

15. FEDERAL EXPENDITURES NIA Relative to Full-Employment GNP



NOTE.—Basic data on expenditures are from the *Budget of the U.S. Government, Fiscal Year 1974*. Data on full-employment GNP are F.R. estimates.

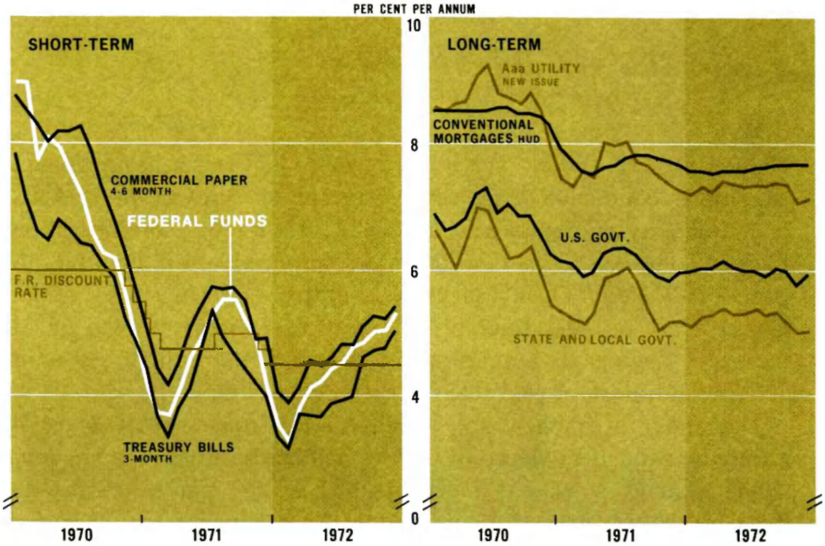
Monetary Policy and Financial Markets

Federal Reserve policy in 1972 concentrated on fostering financial conditions conducive to achieving sustainable growth in real economic activity and employment, consistent with the administration's Phase II objective of moderating inflationary pressures. To attain this goal, the Federal Open Market Committee (FOMC) took actions designed to provide reserves sufficient to support growth in the monetary aggregates appropriate to a substantial gain in economic activity and an improved rate of resource utilization.

Demands for money and credit were strong in 1972 as the economy expanded vigorously. With demands large, the narrowly defined money stock (M_1) expanded at an 8.3 per cent rate, and the bank credit proxy at a little under 12 per cent, somewhat more rapid increases than in 1971. Reserve provision through open market operations, as indicated by the rise in nonborrowed reserves to support private nonbank deposits, was more restrained than in the previous year. As a consequence, short-term interest rates rose substantially after the winter of 1972 and upward pressures continued into early 1973. The Federal Reserve discount rate was raised by ½ percentage point to 5 per cent in mid-January of 1973 and by another ½ percentage point in late February. Partly as a result of the cumulative impact of 1972's developing monetary restraint, the rate of monetary expansion moderated in early 1973.

Interest rates on long-term securities and residential mortgages remained quite stable throughout 1972, reflecting in part the slower rise in prices in the economy and the reduction of inflationary expectations. In addition, demands placed on securities markets by the U.S. Government, by State and local governments, and by businesses moderated. The total volume of external financing still remained historically high, however, and the bulk of this demand was met through financial institutions—especially the demands for consumer and mortgage loans and business demands for bank loans.

16. INTEREST RATES



NOTE.—Monthly averages except HUD (based on quotations for one day each month). Yields: U.S. Treasury bills, market yields on 3-month issues; prime commercial paper, dealer offering rates; conventional mortgages, yields on first mortgages in primary markets, unweighted and rounded to nearest 5 basis points, from Dept. of Housing and Urban Development; corporate bonds (Federal Reserve series), averages of new publicly offered bonds rated Aaa, Aa, and A by Moody's Investors Service and adjusted to an Aaa basis; U.S. Govt. bonds, market yields adjusted to a 20-year constant maturity by U.S. Treasury; State and local govt. bonds (20 issues, mixed quality), Bond Buyer.

MONETARY POLICY

In its day-to-day implementation of monetary policy during 1972, the FOMC placed somewhat greater emphasis on bank reserves while continuing to give weight to money market conditions. At the same time the longer-run financial objectives of System policy continued to be concerned with various monetary aggregates, interest rates generally, and credit conditions.

The bank reserve measure emphasized by the FOMC was reserves available to support private nonbank deposits (RPD's)—total member bank reserves less reserves required against U.S. Government and interbank deposits. Because short-run fluctuations in the latter two types of deposits have only limited impact on economic activity and are often large and erratic, the System generally is prepared to accommodate changes in demands for those deposits. In view of the inherent volatility of U.S. Government and interbank deposits, growth in RPD's is considerably more stable on a month-to-month and quarter-to-quarter basis than that for total reserves. However, RPD's too fluctuate fairly widely in the very short run, because week-to-week and month-to-month movements in private demand deposits, which serve as the principal medium of exchange in the economy, are highly volatile.

In the first quarter of 1972 System open market operations provided for fairly rapid expansion in RPD's, as monetary policy was directed toward creating conditions favorable to rapid economic recovery and toward making up for the shortfall in the growth of M_1 (currency plus private demand deposits adjusted) late in 1971. Since growth in the monetary aggregates had proceeded at very high rates during February and March, however, the System subsequently provided nonborrowed RPD's more reluctantly, and RPD growth slowed to an annual rate of about 6.5 per cent in the second quarter—considerably less than in the first. Expansion in M_1 also dropped substantially below its first-quarter rate.

Table 7: GROWTH IN BANK RESERVES

Item	1971	1972	1972			
			I	II	III	IV
	In per cent [1]					
Total reserves	7.2	10.6	10.4	12.6	3.6	14.2
Reserves to support private deposits (RPD's)	7.2	9.7	10.4	6.6	9.9	10.6
Nonborrowed reserves	8.1	7.1	10.7	13.1	−.8	4.8
Nonborrowed RPD's	8.2	5.9	10.7	7.2	5.0	.4
	In millions of dollars [2]					
MEMO: Borrowed reserves	−244	1,096	−20	−41	360	789

[1] Quarterly changes, shown at seasonally adjusted annual rates, are calculated from the average amounts outstanding (adjusted for changes in reserve requirements) in the last month of each quarter. Annual changes calculated from December averages.

[2] Quarterly changes are calculated from the average amounts outstanding (seasonally adjusted and adjusted for changes in reserve requirements) in the last month of each quarter, not annualized. Annual changes calculated from December averages.

In the second half of the year continued rapid expansion in economic activity resulted in increased bank demands for reserves to support additional credit and in monetary expansion. While the growth rate of total RPD's rose again to the high levels reached in the first quarter, reserve provision through open market operations was increasingly restrained, and more of the reserve expansion late in the year was the result of increased borrowing by member banks from the Federal Reserve Banks. During the last quarter of the year nonborrowed RPD's increased by a nominal amount, but banks increased their average borrowings by more than $700 million.

Although bank reserves grew rapidly during 1972 as a whole, growth in the demand for reserves was even greater, and this contributed to a tightening of money markets as the year progressed. Until about mid-February, short-term interest rates continued the decline that had begun by the fourth quarter of 1971, as reserves expanded rapidly. During the second quarter, however, demands for money and bank credit increased faster than the Federal Reserve was willing to supply reserves, and the excess demand for funds generated upward pressures on market rates of interest. This pattern continued during the remainder of the year, and by the end of December most short-term rates had increased more than 2 percentage points from their February lows. Even so rates were still somewhat below the high levels experienced in July 1971.

Following the increase in open market rates, commercial banks adjusted their prime rates upward in several stages—from a low of 4½ per cent in early spring to 6 per cent just before the year-end, and then to 6¼ per cent in early 1973. (As already noted, the Federal Reserve discount rate, unchanged at 4½ per cent throughout 1972, had been raised to 5 per cent in mid-January 1973 and to 5½ per cent in late February.) While short-term rates increased, most longer-term rates showed little change on balance, reflecting the substantial flows of funds into capital markets and the continuing moderation in long-term credit demands in securities markets during most of the year.

In addition to its strictly monetary policy actions the Federal Reserve made several other regulatory changes in 1972 that had significant effects on financial markets. One area of action related to stock market credit. In the early months of 1972 total credit extended by brokers and banks for the purpose of purchasing or carrying securities had expanded substantially. When it subsequently appeared that further growth in stock market credit might contribute to inflationary pressures, the Board of Governors raised initial margin requirements on stocks in an effort to forestall such growth. This increase, effective November 24, raised requirements to 65 per cent from the 55 per cent level that had prevailed since December 1971. In an earlier security credit action—effective September 18, 1972—the Board had introduced a technical amendment to its margin regulations designed to improve the quality of stock market credit; under the amendment, customers with low-margin accounts must increase their equity when offsetting sales and purchases of stock collateral are made on the same day.

On November 9 the Board instituted two key changes in its Regulations D and J that affected the reserve positions of member banks. These changes were not designed to meet any general monetary policy objective but rather to restructure reserve requirements against Federal Reserve member bank deposits on a more uniform basis (Regulation D) and to speed up and modernize the Nation's check-clearing system (Regulation J). In an effort to neutralize the impact of the changes insofar as monetary policy was concerned, implementation was timed to coincide with a period of regular seasonal reserve needs and was coordinated with open market operations. The net effect of these two regulatory changes was to provide about $1.1 billion of the seasonal reserve need.

Prior to the change in Regulation D there were two classifications of banks for reserve purposes: reserve city and country. Most banks in the major financial centers were classified as reserve city banks, and all other banks were classified in the country bank category. Under that system some smaller banks carried the heavier reserve requirements of a reserve city classification simply because of their geographical location, whereas a few large banks benefited from their country bank status.

Over the years the large reserve city banks have tended to exhibit greater deposit volatility than the smaller country banks. Such conditions indicated a need for the reserve city banks to maintain greater liquidity in the form of reserves, as protection against potentially large deposit outflows. However, with the evolution of our modern-day banking system, credit markets have become national in scope, and reserve requirements based on geographical considerations are no

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In addition to its strictly monetary policy actions the Federal Reserve made several other regulatory changes in 1972 that had significant effects on financial markets. One area of action related to stock market credit. In the early months of 1972 total credit extended by brokers and banks for the purpose of purchasing or longer appropriate. The change in Regulation D eliminated the geographically based distinction between reserve city and country banks for reserve purposes and established a new system of graduated reserve requirements for net demand deposits that is based solely on the amount of deposits and is applicable to all member banks.[2]

The effect of the change in Regulation D alone was to reduce member banks' required reserves by roughly $3.2 billion in the aggregate. With the exception of a few very large banks that had previously enjoyed country bank status, each member bank realized some reduction in its required reserves, with the exact amount depending on the amount of the bank's deposits and its previous status as reserve city or country bank.

Prior to the November 9 change in Regulation J, most member and nonmember banks located outside Federal Reserve Bank or branch cities had been required to remit funds one or more business days after the checks were presented for payment by the Federal Reserve. Most banks located within such cities, in contrast, had been required to remit on the same business day the checks were received.[3] Initially, the reason some banks had been permitted to remit on a delayed basis was because of transportation and communication problems. Specifically, banks that were located a considerable distance from Federal Reserve clearing facilities needed additional time in order for remittance drafts to reach their Federal Reserve office.

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[2] According to this system the required reserve ratios applicable to the various portions of a bank's deposits are as follows:

Amount of net demand deposits (in millions of dollars)	Reserve percentage applicable
2 or less	8
2–10	10
10–100	12
100–400	13
Over 400	17½

Previously the required reserve ratio on the first $5 million of net demand deposits had been 17 per cent for reserve city banks and 12½ per cent for country banks, and the required ratio on such deposits of more than $5 million had been 17½ and 13 per cent, respectively.

[3] Nonmember banks remit for checks presented by the Federal Reserve through member bank correspondents.

However, expanded use of both carrier services and wire transfers of funds has greatly improved the communication among banks and has removed the need for additional remittance time. Recognizing these developments, the change in Regulation J required essentially all banks to whom the Federal Reserve presents checks for collection to remit on the same day that the checks are presented.

The effect of the change in Regulation J was therefore to give rise to a once-and-for-all drain of reserves at the banks that had previously benefited from delayed remittance for their checks. In the aggregate, before counting offsets, this drain amounted to roughly $4.4 billion. Slightly more than half of this aggregate was offset by reserve gains due to faster crediting by the Reserve Banks on checks presented to them for collection that are drawn on banks in the same Federal Reserve territory as the collecting bank. If this partial offset is taken into account, the reserve drain for member banks resulting from the change in Regulation J amounted to about $2.1 billion. For those banks that experienced a significant adverse effect, temporary waivers of penalties on reserve deficiencies are being permitted to cushion the impact of the changes.

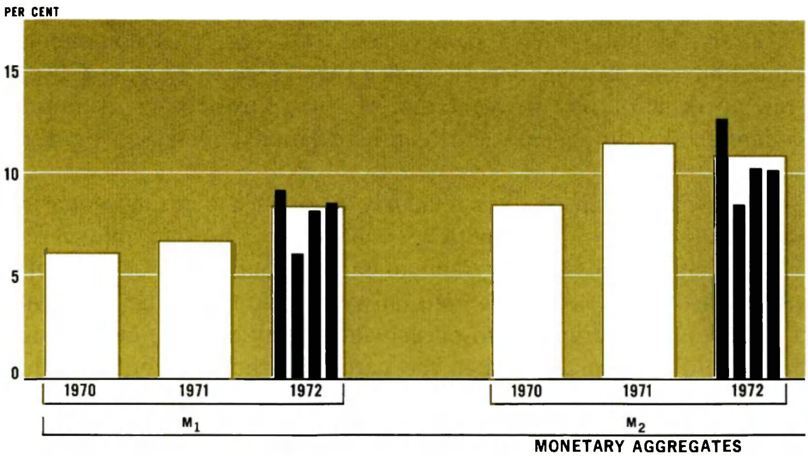
In addition to the 8.3 per cent growth in M_1 already noted for 1972, the broadly defined money stock, M_2 (M_1 plus commercial bank time and savings deposits other than large negotiable CD's), grew at a rate of 10.8 per cent, and M_3 (M_2 plus deposits at mutual savings banks and savings and loan associations) increased by 12.9 per cent.

The expansion in M_1 was relatively even on a quarter-to-quarter basis, but the month-to-month growth showed considerable variation. Because of essentially random factors that affect demand for money in the short run, it is not unusual for months of large growth or months of little growth to occur without any evident, clear cause that would explain demand in the particular short period. For this reason much less weight is given to monthly movements than to quarterly movements as a factor to be considered in monetary policy decisions.

The following examples indicate how extreme the monthly movements in the money stock may be—and some of the reasons. After rapid expansion early in 1972, growth in M_1 slowed in May and June, reflecting not only System efforts to slow the rate of expansion in RPD's but also the build-up in U.S. Treasury balances as a result of higher withholding rates on 1972 personal tax liabilities. On the other hand, in both July and December, expansion in M_1 was unusually large. In July most of the growth in M_1 occurred around the holiday period. In December the rapid growth resulted in some part from a contraseasonal increase in demand deposits held by State and local governments that reflected the disbursements of Federal revenue-sharing funds early in December. The December expansion was followed by little net change in M_1 on the average in January 1973.

Consumer-type time and savings deposits increased sharply through the early months of 1972 when market yields on competing assets were falling relative to the rates offered on such deposits. Thus, first-quarter growth rates of the broader measures of the money stock, M_2 and M_3, were not only considerably above the growth rate for M_1, but also at the highest levels since the first quarter

17. GROWTH IN MONETARY AGGREGATES

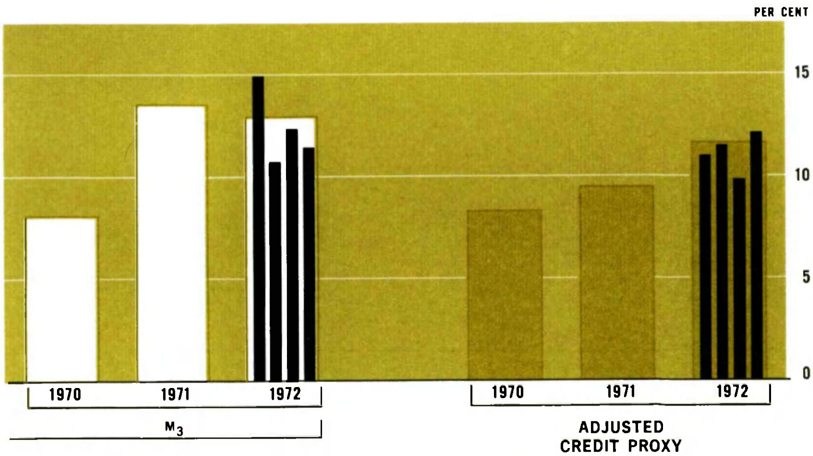


M_1: Currency held outside the Treasury, F.R. Banks, and the vaults of all commercial banks, plus demand deposits other than interbank and U.S. Govt.
M_2: M_1 plus time deposits at commercial banks other than large certificates of deposit.
M_3: M_2 plus deposits of mutual savings banks and savings capital of savings and loan associations.

of 1971. Thrift deposits expanded somewhat less rapidly as 1972 progressed, but net inflows remained quite strong despite the increasing attractiveness of yields on competing open market securities. Some larger commercial banks had lowered rates on consumer-type accounts at the beginning of the year in an effort to keep such accounts from experiencing excessive growth, but by July most banks were offering rates at or close to ceiling levels.

Growth in bank credit during 1972—as measured by the adjusted credit proxy[4]—was supported not only by increases in demand and consumer-type time and savings deposits but also by a sharp rise in net sales of CD's. Commercial banks bid aggressively for such funds, and negotiable CD's outstanding increased by more than $10 billion between January and December, an amount that exceeded the sizable increase recorded in the preceding year. Banks did not borrow any significant amounts in the Euro-dollar market during 1972, in part because of the high marginal reserve requirement

[4] Total member bank deposits subject to reserve requirements, plus Euro-dollar borrowings, bank-related commercial paper, and certain other nondeposit items.



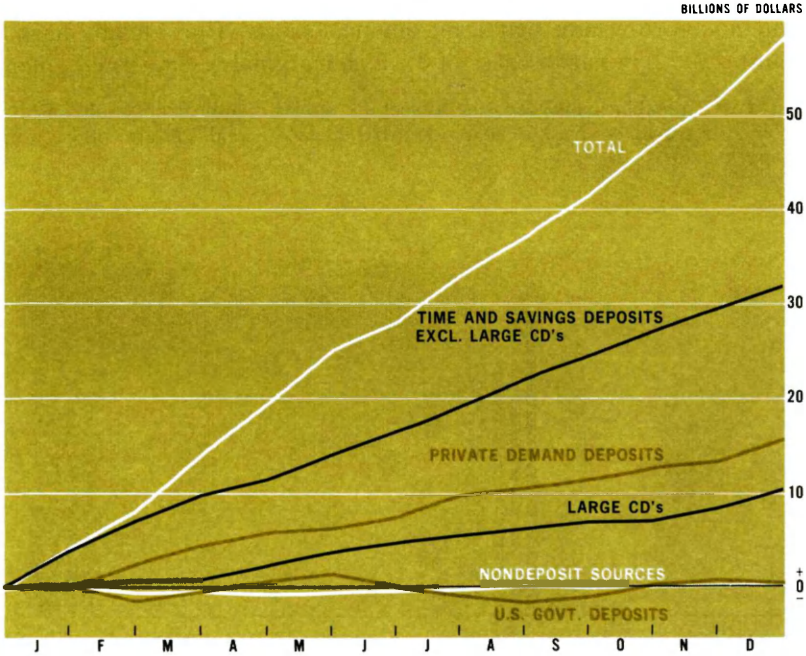
Adjusted credit proxy: Total member bank deposits subject to reserves, plus Euro-dollar borrowings, bank-related commercial paper, and certain other nondeposit items.

NOTE.—Quarterly rates of growth derived from daily-average data for last month of the quarter relative to those for last month of preceding quarter.

on this type of borrowing and in part because of the availability of domestic CD's.

The expansion in CD's did not begin until after the first quarter, when growth in other time deposits began to slow, but it continued strong throughout the remainder of the year with only minor slowdowns occurring in June and October. As yields on alternative short-term money market instruments began to rise, and as business loan demands on banks continued strong, banks increased offering rates on CD's in order to compete for additional funds. By the end of December rates on negotiable CD's sold by prime New York banks had reached 5½ per cent—2 percentage points above the first-quarter

18. MAJOR SOURCES OF BANK FUNDS, 1972



NOTE.—Time and savings deposits other than large certificates of deposit and private demand deposits are for all commercial banks. Time and savings deposits other than large CD's exclude those due to domestic commercial banks and to the U.S. Govt. as well as balances accumulated for repayment of personal loans. Large CD's are negotiable CD's issued in denominations of $100,000 or more by major commercial banks. U.S. Govt. deposits and nondeposit sources of funds data are for member banks only.

low. With month-to-month fluctuations in total demand deposits and total time deposits partly offsetting one another, the bank credit proxy maintained relatively stable growth throughout the year, increasing at about a 10 to 12 per cent annual rate in each of the four quarters.

INTERMEDIATED CREDIT FLOWS

As a result of several factors—including the nature of credit demands, the strong preference on the part of the public for demand and time deposits, the associated developments in interest rates, and others—financial institutions supplied a substantially larger volume of funds than in 1971. Banks, other depositary institutions, and contractual institutions such as insurance and pension funds accounted for more than four-fifths of the total advanced, an even larger share

Table 8: FUNDS SUPPLIED TO NONFINANCIAL SECTORS IN CREDIT AND EQUITY MARKETS

In billions of dollars

Sector supplying	1971	1972	1972			
			I	II	III	IV
All sectors	**156.3**	**168.1**	**139.4**	**161.2**	**153.9**	**216.9**
U.S. Govt. and sponsored credit agencies	6.0	8.9	11.0	7.9	9.3	7.4
Federal Reserve System	8.8	.2	3.8	5.6	−6.3	−2.2
Foreign sources	27.3	10.8	17.2	−3.0	16.5	12.7
Private financial institutions	*124.9*	*153.2*	*137.5*	*139.3*	*151.0*	*184.8*
Commercial banking	49.8	65.3	57.3	49.6	64.8	89.1
Savings institutions	42.1	49.6	49.5	48.8	49.9	50.1
Insurance and pension funds	30.2	32.8	27.2	37.0	31.7	35.2
Other	2.8	5.5	3.5	3.9	4.6	10.4
Net funds raised in credit and equity markets by financial institutions [1]	9.6	19.6	9.7	17.9	22.5	28.2
Funds advanced by private domestic nonfinancial sectors in credit and equity markets [2]	*−1.0*	*14.4*	*−20.3*	*29.3*	*5.8*	*42.4*
Households	−16.8	.4	−27.5	16.0	−4.9	17.7
Nonfinancial business	8.1	4.8	−1.2	7.7	.9	11.4
State and local governments	7.7	9.3	8.4	5.6	9.8	13.2
MEMO: Net change in institutional deposits and currency held by private domestic nonfinancial sectors	95.7	107.2	122.0	87.2	106.1	113.2

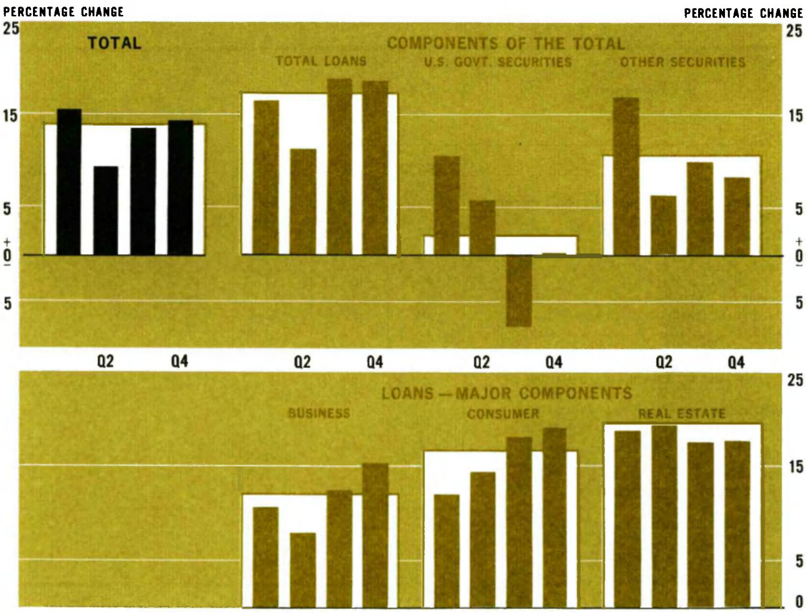
[1] Bonds, notes, commercial paper, loans from home loan banks, equities, and mutual fund shares. Includes borrowing by Federally sponsored credit agencies.
[2] Total funds advanced *less* amounts supplied by groups above *plus* net credit and equity funds raised by financial institutions.
NOTE.—Data from flow of funds accounts. Quarterly data are at seasonally adjusted annual rates.

than in the preceding year. Funds advanced directly by domestic nonfinancial sectors increased following a small decline in 1971, while foreigners accounted for a substantially reduced—though appreciable—volume of identified domestic credit supplies, a reflection of the smaller accumulation of dollars by foreign central banks.

Total loans and investments at commercial banks rose substantially from the 1971 year-end level, exceeding by a sizable margin the $50 billion growth during 1971. Banks channeled more than 80 per cent of the 1972 increase in their available funds into loan expansion and put less in securities than they had in 1971.

Strengthening of loan demands at banks was the principal reason why banks showed less interest in acquiring securities in 1972. However, another factor was that Treasury financings were smaller than in 1971. After the first quarter of the year banks added only

19. BANK CREDIT, 1972



NOTE.—Quarterly data are changes based on seasonally adjusted totals at annual rates. Total loans and investments and business loans have been adjusted for transfers between banks and their holding companies, affiliates, subsidiaries, or foreign branches.

marginally to their holdings of U.S. Government securities. On the other hand, acquisitions of other securities—primarily State and local government issues, but also Federal agency securities—were larger than those of Treasury securities, even though they too remained well below the high rates of late 1970 and early 1971.

Banks channeled a considerable proportion of their increased resources into business loans, which expanded at especially rapid rates in the last two quarters of 1972. Early in the year, most of the expansion in such loans was concentrated at banks outside New York City, which tend to serve the needs of smaller regional firms. Meanwhile, larger corporations continued to rely on other sources—including a greater volume of internally generated funds—for financing. In the second half of the year, however, both banks in New York City and those outside encountered strong credit demands from corporations seeking working capital to finance inventories and enlarged operations. As businesses sought more credit at banks, they sought less in capital markets.

Consumers borrowed record amounts during 1972 to finance purchases of durable goods. As a result of their borrowing at commercial banks, the banks' share of total consumer credit increased during the year.

Real estate loans extended by commercial banks also rose rapidly in a year when total mortgage debt was expanding at the fastest rate since 1955. However, approximately two-thirds of the growth in residential mortgage debt outstanding in 1972 was accounted for by nonbank savings institutions, with savings and loan associations maintaining their dominance in that market.

Despite the record level of demands, which carried housing starts to a new high, contract interest rates on residential mortgages remained relatively stable. This reflected the availability of mortgage funds from both bank and nonbank sources and some secondary support from Government sponsored agencies. Insofar as the volume of net lending on Government-underwritten residential mortgages is concerned, there was some further moderation, however, reflecting in part increased competition from conventional mortgages on which lower downpayments were instituted by savings and loan associations following further liberalization of regulations by the Federal Home Loan Bank Board in 1971.

DEMANDS ON SECURITIES MARKETS

Demands on securities markets moderated in 1972, as total funds raised by corporations and government units declined and corporations met a larger share of their reduced financing needs through mortgages and bank loans. Flotations of securities by the U.S. Government, by State and local governments, and by corporations all fell below the substantial volumes issued in 1971. This reduction of demand pressures on securities markets was an important factor contributing to the stability of long-term interest rates during the year.

Table 9: FUNDS RAISED IN CREDIT MARKETS BY NONFINANCIAL SECTORS

In billions of dollars

Sector, or type of instrument	1971	1972	1972 I	1972 II	1972 III	1972 IV
Total funds raised	**156.3**	**168.1**	**139.4**	**161.2**	**153.9**	**216.9**
By sector:						
U.S. Govt. [1]	25.5	17.3	5.4	17.5	8.3	38.1
Other	*130.8*	*150.8*	*134.1*	*143.7*	*145.6*	*178.8*
Nonfinancial business	63.0	70.6	64.4	72.1	62.0	83.9
State and local governments	20.6	14.6	16.2	11.7	16.7	13.8
Households	41.6	62.0	49.3	58.4	64.8	74.9
Foreign	5.6	3.5	4.2	1.6	2.0	6.2
By type of instrument:						
U.S. Govt. securities [1]	25.5	17.3	5.4	17.5	8.3	38.1
Corporate and foreign bonds	20.3	13.7	12.9	14.7	13.0	14.3
Corporate equity	13.5	12.4	10.3	15.9	11.8	11.4
State and local govt. debt [2]	20.2	14.4	15.1	12.9	16.1	13.5
Mortgages	*47.0*	*64.3*	*54.5*	*64.2*	*68.2*	*70.2*
Residential	34.9	46.8	39.0	46.4	49.6	52.1
Other	12.1	17.5	15.5	17.8	18.5	18.0
Bank loans n.e.c.	13.0	21.6	17.1	14.7	19.0	35.6
Open market paper	−.4	−.3	2.9	.3	−5.5	1.0
Consumer credit	10.4	19.2	13.1	18.0	18.7	26.1
Other loans	6.9	5.5	8.1	2.9	4.3	6.8

[1] Public debt securities and budget agency securities.
[2] Includes both long- and short-term borrowing.
NOTE.—Data are from flow of funds accounts; quarterly figures are at seasonally adjusted annual rates.

Several developments that have already been mentioned helped to hold down the Treasury cash deficit in 1972. One was the larger-than-anticipated increase in tax revenues. Another was that the growth in Federal spending was restrained. As a result of these and other developments, the Treasury was able to reduce its borrowing from the public during the calendar year to about $15 billion, more than $9 billion less than it had borrowed in 1971. This reduction was a major factor in reducing supply pressures in the securities markets.

Continued weakness in the U.S. balance of payments and its associated impact on international flows of funds led to sizable accumulations of dollars by foreign central banks. Although these funds would probably have been invested in U.S. markets in any event, accumulation in central banks directed their investment in marketable ($4.3 billion) and nonmarketable ($3.8 billion) Treasury issues. These purchases supplied more than half of the Treasury's total borrowing needs.

Table 10: U.S. GOVERNMENT FINANCE

In billions of dollars

Item	1970	1971	1972
Deficit	**11.4**	**24.8**	**17.4**
Amount financed by changes in cash assets and other items	–.5	....	2.1
Total borrowing from public	**11.8**	**24.8**	**15.3**
Net Federal Reserve purchases of Treasury securities	5.0	8.1	–.3
Net Treasury borrowing from private investors:			
Marketable:			
a. Foreign	7.5	15.2	4.3
b. Other	–1.5	–10.3	3.6
Nonmarketable:			
a. Foreign	1.9	11.1	3.8
b. Other	.3	2.1	3.4
Borrowing from all sources by budget agencies	–1.3	–1.4	.7
Memoranda:			
Net borrowing by Government sponsored agencies	8.2	1.1	3.1
Federal Reserve purchases of agency issues	....	.5	.8

It should be noted, however, that acquisitions of marketable Treasury debt by foreign official institutions had been much larger in 1971 than they were in 1972. Furthermore, the U.S. public had been a large net seller of such debt in 1971. While acquisitions of marketable debt by the public in 1972 amounted to about $3.5 billion, this represented a shift of nearly $14 billion from 1971 since the public had sold more than $10 billion in that year.

Interest rates on short- and long-term Government securities followed divergent patterns during 1972. Short-term rates, which had declined rather sharply following the imposition of the President's new economic program in August 1971, reversed course in early 1972 and rose significantly over the last 9 months of the year in association with the large demands for short-term credit generated by the accelerating economy and the progressive firming in monetary policy.

Long-term rates, on the other hand, remained quite stable throughout 1972. The lack of significant upward yield pressure in this sector enabled Treasury debt managers to be increasingly innovative in their approach to financing the debt. One of their announced aims, in addition to maintaining the average maturity of the debt, was to develop a viable market in long-term Government issues. Toward this end the Treasury issued a total of $3.4 billion of securities to the public in the 10-year maturity area in the February, May, and August refundings. In addition, it sold $625 million of 20-year bonds in early January 1973; this was the longest maturity offered to investors in about 10 years.

In contrast to the Federal sector, State and local governments moved into a budget position of substantial surplus during 1972. Net issues of securities by these governments declined from the peak volume of 1971. There was relatively little growth in capital outlays, and nonborrowed funds were readily available, as both tax revenues and Federal grants increased. Expenditures rose less rapidly than did receipts, and these governments were able to strengthen further their liquidity positions, which had already been improved by the large volume of securities sold in late 1970 and 1971.

Interest rates on long-term municipal bonds fluctuated in a narrow range during 1972. Although banks reduced their acquisitions of these securities during the year, the impact of this reduction on interest rates was offset by the decline in new-issue volume and by the increase in purchases by fire, casualty, and marine insurance companies, which were seeking tax-exempt income.

Corporate nonfinancial businesses also benefited from the rising pace of economic activity in 1972. The general improvement in earnings, the increase in capital consumption allowances under the Asset Depreciation Range guidelines, and the slower-than-usual growth in dividend payouts resulting from restraints applied by the Committee on Interest and Dividends as part of the Phase II controls program all contributed to a substantial rise in the availability of internal funds of corporations. Furthermore, like State and local governments, corporations had engaged in record amounts of long-term financing late in 1970 and in 1971, and in that way they had restructured their balance sheets and improved liquidity positions in the aggregate.

Corporations needed larger amounts of funds in 1972 because of rising outlays for plant and equipment and growing needs for working capital. However, they reduced their dependence on securities markets by financing a larger proportion of their needs with internally generated funds, bank loans, and mortgages. Public offerings of bonds by corporations dropped significantly, the drop more than offsetting a slight increase in private bond placements and equity offerings. The decline in capital market financings was particularly evident for manufacturing corporations. Public utilities continued to rely on the securities markets to meet their needs for growth and modernization, and they utilized equity capital to a larger extent than usual. Financial firms continued to enter the long-term bond markets in large numbers in 1972, in order to improve their capital positions and to prepare for the task of financing the growing short-term credit needs of the economy.

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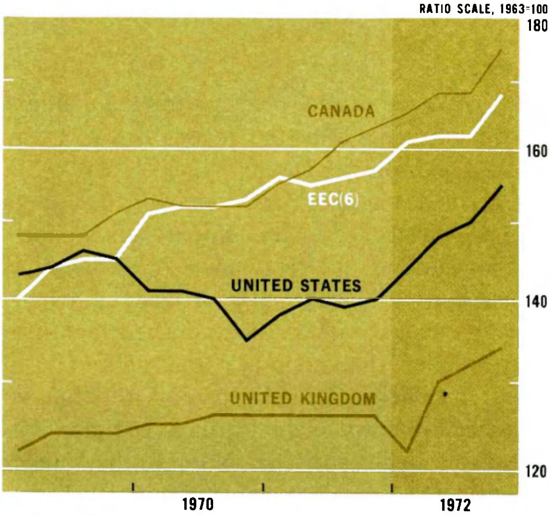
U.S. Balance of Payments

Attention was focused in 1972 on the lack of progress toward equilibrium in the U.S. balance of payments after the realignments of exchange rates agreed to at the Smithsonian meeting in December 1971. The year was relatively free of hectic speculative activity, but pressure on the pound sterling at midyear led to the temporary abandonment of a fixed rate for that currency and a renewal of speculative flows into some other European currencies. Also, a large and persistent flow of funds to Japan, coupled with an undiminished Japanese trade surplus, enormously swelled that country's international reserves. Though there were large inflows of foreign capital to purchase U.S. securities, and some sizable inflows of liquid funds at times, for the year as a whole there was no significant repatriation to the United States of the capital that had moved to other currencies in 1971.

The failure of such a return flow to materialize reflected in part the relatively higher levels of interest rates abroad, especially in the early months of the year, and in part the continuing uncertainty about the eventual effects upon U.S. exports and imports of the exchange-rate changes of 1971. After early 1972, exchange rates against the dollar of the currencies of most industrial countries remained above their central rates or parities, and many countries adopted controls or various types of special reserve requirements or other barriers to protect them from large inflows of foreign capital.

Soon after the end of 1972 exchange markets became increasingly unsettled, as the extent and persistence of the large U.S. deficit and the counterpart surpluses of some other countries were more clearly perceived. Speculation against the dollar in favor of other currencies, primarily the German mark and the Japanese yen, rose dramatically in late January and early February of 1973. In the light of these conditions, and because of the need to achieve a speedier adjustment of the underlying imbalance in U.S. international transactions, the President announced on February 12 that he would request Congress to authorize a devaluation of the dollar by 10 per cent. This step was taken in consultation with other countries and in the expectation that its effects on the exchange rates for the dollar in terms of the cur-

20. INDUSTRIAL PRODUCTION



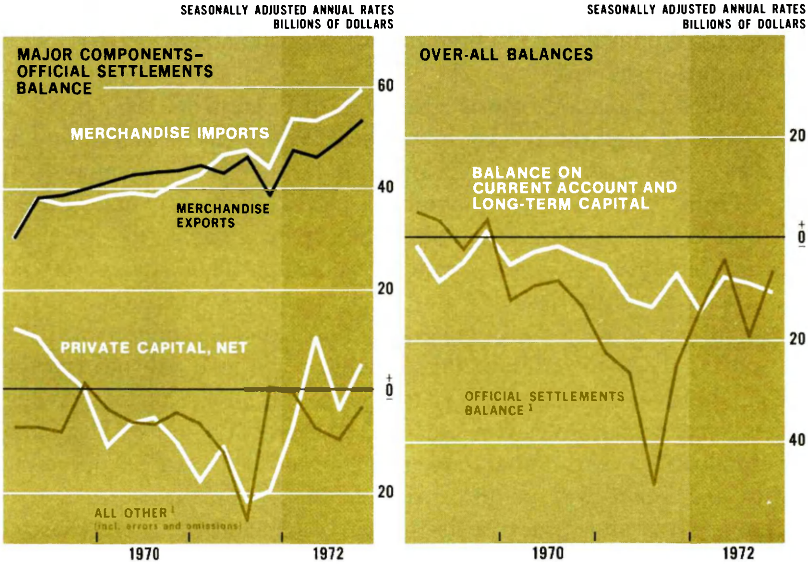
NOTE.—Seasonally adjusted quarterly data from the Organization for Economic Cooperation and Development. Data for fourth quarter of 1972 partly estimated.

rencies of other industrial countries would in general not be neutralized by other par-value changes. The Japanese yen was allowed to float, and it quickly appreciated by about 16 per cent relative to the U.S. dollar.

In the course of 1972 economic activity rose in most industrial countries but lagged somewhat behind the upswing in the U.S. economy. In a number of European countries price inflation was accelerating early in the cyclical advance. Monetary restraint was commonly adopted as a countermeasure, and several countries moved to offset interest-induced inflows of funds through special controls or reserve requirements. In the United States also, short-term interest rates were rising, as demand in most sectors of the private economy strengthened rapidly.

A large over-all deficit was registered in the U.S. balance of payments in 1972, but it was not swollen by an enormous net outflow of capital as had happened the year before. In terms of official settlements, the deficit for the year was $10.8 billion (apart from SDR allocations) compared with more than $30 billion in 1971. The balance on current account and long-term capital (the so-called basic balance) probably registered a deficit somewhat greater than the $9.3 billion deficit of 1971. There were divergent swings in the current-account and capital-account components of the basic balance: The balance on goods and services worsened by about $5 billion in 1972, to a deficit of about $4.5 billion, while net long-term capital flows probably improved by a somewhat smaller amount.

21. U.S. BALANCE OF PAYMENTS



[1] Excludes SDR allocations.

GOODS AND SERVICES

A number of factors combined to push the U.S. trade balance to a deficit of $6.8 billion in 1972—about $4 billion larger than the one in 1971. The major influence was the rapid rise of economic activity here in advance of similar developments abroad. In addition, prices of U.S. imports rose sharply, responding to both the devaluation and the general increase in world prices, while export prices in terms of dollars increased much less. These changes in relative prices were only just beginning in 1972 to yield the reallocations of production and consumption patterns necessary to halt the worsening trend in the U.S. trade balance that had been developing since 1965.

The strongest feature of U.S. export performance in 1972 was the rise in shipments of agricultural products—from $7.8 billion in 1971 to a total of $9.5 billion. By the last quarter of 1972 such shipments were at an annual rate of $11 billion, reflecting the shortage of these commodities in Russia and other countries and a very rapid rise in their prices. Sales of agricultural products in 1973 are expected to continue at a very high rate. Exports of machinery and industrial supplies, supported by the build-up in economic activity abroad, were rising during the year.

While the value of exports rose by 14 per cent from 1971 to 1972, the value of imports rose by 22 per cent. Prices (as measured by unit values) rose 3 per cent for exports and 7 per cent for imports. In real terms, imports rose by about 14 per cent, about double the rise in real GNP, a typical reaction of imports to a sharp step-up in demand. Increases in imports were registered in all major commodity groups; a particularly significant feature was the acceleration of petroleum imports from $3¾ billion in 1971 to $4¾ billion in 1972.

During 1973 the trade balance should begin to benefit measurably from the devaluation of 1971; the net effects of the further realignment of exchange rates early in 1973 will probably not be large until the following year. Other strong influences will also be operating. Most important will be the evolution of demand pressures and of relative costs and prices in the United States and in other industrial countries. This factor will be helpful if this country can continue to moderate inflationary pressures, and if other countries move steadily toward reasonably full utilization of their productive capacity. The United States will also need to compete more effectively for the trade of nonindustrial countries, many of which will be able to increase their imports in 1973 on the strength of their reserve gains in recent years and of a continuing rise in demand for their exports.

There was some reduction in the surplus in the nontrade elements of the U.S. current account in 1972. Part of this resulted from smaller net receipts of investment income, as interest payments to foreigners —mainly interest paid to foreign official holders of claims against the United States—rose faster than receipts from U.S. direct investments abroad. There was also an increase in net U.S. military expenditures as military sales fell off.

CAPITAL FLOWS

In 1972 the net outflow of long-term private capital from the United States was probably less than $1 billion—a striking shift from the recorded net outflow of more than $4 billion in 1971. One change between the two years was in direct-investment outflows, which apparently declined from their record high in 1971. A striking feature of developments in 1972 was the upsurge in foreign purchases of U.S. corporate securities. For the year as a whole such purchases totaled some $4.5 billion, including $2.4 billion of corporate stocks purchased in U.S. markets, of which $1 billion came in the fourth quarter, and $2 billion of debt issues offered by U.S. corporations in foreign markets, mainly to finance direct investments abroad.

Net outflows of U.S. Government grants and credits were somewhat less in 1972 than in 1971, but they were rising at the year-end and they will probably be considerably larger in 1973.

Table 11: U.S. BALANCE OF PAYMENTS

In billions of dollars, seasonally adjusted

Item	1971	1972 [e]	1972			
			I	II	III	IV [e]
Merchandise trade balance	**−2.7**	**−6.8**	**−1.7**	**−1.9**	**−1.6**	**−1.6**
Exports	42.8	48.8	11.8	11.4	12.3	13.3
Imports	45.5	55.7	13.5	13.4	13.9	14.9
Services, remittances, pensions, net	1.9	.8	.1	−.0	.3	.3
U.S. Govt. grants and credit, net	−4.4	−3.6	−.9	−.6	−.8	−1.2
Long-term private capital, net	−4.0	−.6	−1.0	.8	−.1	−.1
Balance on current account and long-term capital	**−9.3**	**−10.2**	**−3.6**	**−1.8**	**−2.2**	**−2.6**
Nonliquid short-term private capital, net	−2.4	−1.5	−.5	.6	−.5	−1.0
Errors and omissions	−11.0	−2.8	.8	−1.1	−1.9	−.6
Liquid private capital, net	−7.8	3.7	−.1	1.4	−.2	2.6
Of which: Liabilities to foreign commercial banks	−6.9	3.9	.5	1.0	.3	2.1
Official settlement balance (excluding SDR allocations)	**−30.5**	**−10.8**	**−3.4**	**−1.0**	**−4.8**	**−1.6**

[e] Fourth-quarter data partly estimated.

NOTE.—Dept. of Commerce data with some F.R. estimates. Details may not add to totals because of rounding.

Recorded flows of private short-term capital in 1972 were inward, on balance, in contrast to a net outflow of more than $10 billion in 1971. Whereas in 1971 there had been an outflow of nearly $7 billion to commerical banks abroad when U.S. banks repaid all but a relatively small part of their borrowings in the Euro-dollar market, in 1972 there was a sizable inflow as the U.S. agencies and branches of foreign banks brought in short-term funds from abroad. (The agencies and branches of foreign banks are not subject to the same reserve requirements on their liabilities to foreigners as are banks that are members of the Federal Reserve System).

Large swings in the "errors and omissions" item in the accounts provide a crude indicator of flows of funds in response to speculative pressures. Apart from such flows this balancing item is usually negative, and its normal level in recent years has been around $1 billion. According to early estimates, the balancing item in 1972 was larger than normal, but far smaller than the $11 billion figure for 1971, most of which had represented capital outflows through unrecorded hedging and through leads and lags in commercial payments.