Monetary Policy and the U.S. Economy in 1973

A Prelude to the Annual Report

BOARD OF GOVERNORS • OF THE FEDERAL RESERVE SYSTEM •

Federal Reserve System Board of Governors

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Introduction

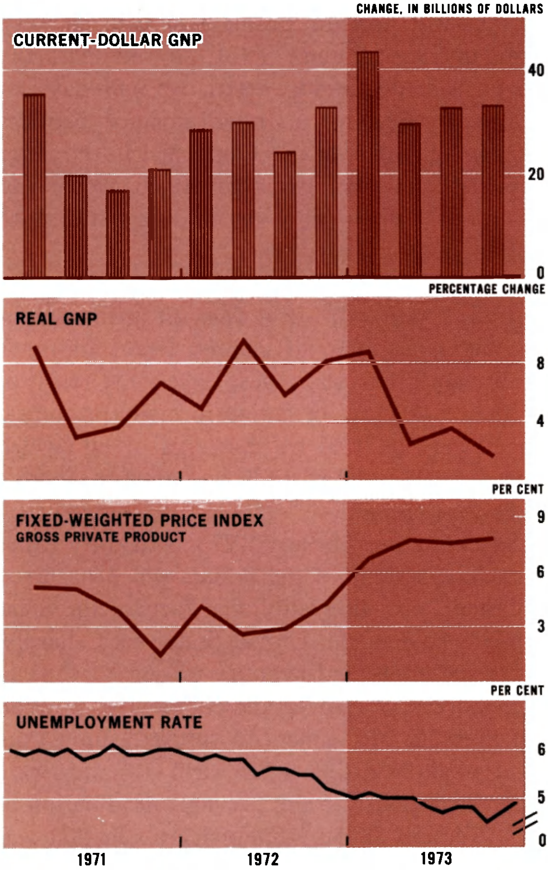
In 1973 the U.S. economy was plagued by its worst inflation since the end of World War II. Wholesale prices rose by 18 per cent during the year and consumer prices by nearly 9 per cent. At the end of the year inflation was still running strong, led by sharply higher prices for foreign crude oil and petroleum products in U.S. markets. The economic expansion, under way since 1971, slowed markedly over the course of 1973 in response to more restrictive national economic policies and the adverse effects of the rapid advance in prices on consumer buying power. Activity was also dampened in the latter part of the year by the energy shortage, which generated widespread buyer uncertainty and seriously disrupted longstanding patterns of demand for autos and other goods and services.

The exceptional strength of the 1973 inflation stemmed mainly from extraordinary shortfalls relative to world demand in the output of agricultural products and in supplies of energy. Prices of foods and fibers were affected by worldwide shortages, largely the result of poor crop yields during the 1972 growing season in many producing countries. And fuel prices were boosted by shortages of oil, which were serious at times early in 1973 and acute in late autumn, following the cutbacks in Middle East output.

The devaluation of the dollar in February 1973, and the further declines in the foreign exchange value of the dollar, which occurred during the spring and summer, provided additional fuel for the inflation. Prices of foreign goods sold in the United States rose sharply, and business demands for materials and supplies tended to shift to this country from foreign sources. Moreover, the competitive position of U.S. goods in world markets was enhanced further, stimulating foreign demands for U.S. goods at a time when such demands were already growing markedly in response to the previous devaluation of the dollar in December 1971 and to the inflationary boom that was under way in the economies of most industrial countries of the world.

The economic situation that was developing in this country also contributed to the inflation. The U.S. economy had expanded at a very rapid rate in late 1972 and early 1973 as demands for goods and services strengthened substantially further, partly in reaction to public policies instituted to encourage greater utilization of the Nation's productive resources. And consumption demands were also

INDICATORS OF ECONOMIC PERFORMANCE



NOTE.—Changes for current-dollar GNP are from preceding quarter and are based on quarterly data at seasonally adjusted annual rates. Changes for real GNP (based on data expressed in 1958 dollars) are at annual rates. Data are from Dept. of Commerce.
Fixed-weighted price index: Change from preceding quarter compounded at annual rates based on seasonally adjusted data from Dept. of Commerce.
Unemployment rate: Monthly data, seasonally adjusted, from Dept. of Labor.

buoyed in the first half of the year when households received unexpectedly large refunds of Federal income taxes.

The strong final demands in the United States and abroad bolstered the needs of manufacturers for a wide array of raw materials, and even though production of such materials increased sharply, demands often exceeded the available supplies. Thus, many producers of basic materials reached practicable capacity limits well before the over-all output potential of the U.S. economy came under strain. Inflationary conditions may have been heightened also by public response to the liberalization of the wage-price controls program early in the year. In retrospect, it appears that the move to Phase III of the program, though intended to provide needed flexibility to changing economic conditions, was widely viewed as a virtual ending of controls, and this attitude contributed to the bulge in prices that ensued.

Domestic economic stabilization policy could not have been expected to check fully these extraordinary forces of inflation. To have halted the acceleration in the over-all price rise—influenced so importantly, as it was, by sharply higher prices for food, fuel, and internationally traded industrial commodities—would have required exceptionally stringent measures, with potentially disastrous consequences for employment and economic activity. Public policies did move, however, to restrain the cumulative upward momentum in domestic economic activity—which had gained great force during the previous fall and winter—and to dampen inflationary forces stemming from the overheating.

Monetary policy, which had begun to tighten in late 1972, became progressively more restrictive through the summer of 1973. Thereafter, some actions were taken to moderate the intensity of monetary restraint. Fiscal policy also turned somewhat more restrictive in 1973, as the rise in public expenditures was curbed and the volume of tax receipts, produced by higher incomes and higher profits, grew more rapidly than outgo. And wage-price controls, reintroduced on a strict mandatory basis following the temporary price freeze in the summer, were directed toward developing and making more diffuse the price advances necessitated by continuing rapid increases in production costs.

In the effort to avoid excessive monetary expansion during 1973 the Federal Reserve made use of all its instruments of monetary policy. Through much of the year open market operations were directed toward achieving adequate restraint on the growth in bank reserves and in the monetary aggregates. In the process the Federal funds rate moved from around 5.5 per cent at the beginning of the year to a high of nearly 11 per cent in September. In the late spring marginal reserve requirements were imposed on any expansion in certificates of deposits (CD's) and other money market sources of funds at large banks beyond the amounts outstanding as of mid-May, and such requirements were increased further in September. In early July reserve requirements were raised by ½ percentage point against the demand deposits (above a $2 million base) of all member banks. The Federal Reserve discount rate was raised, in successive steps, from 4½ per cent at the beginning of the year to 7½ per cent from August on, to keep the cost of borrowing more in line with market rates. And margin requirements on stock market credit, which had been increased to 65 per cent late in 1972, were kept at that level throughout 1973, despite a steady downward trend in the use of such credit.

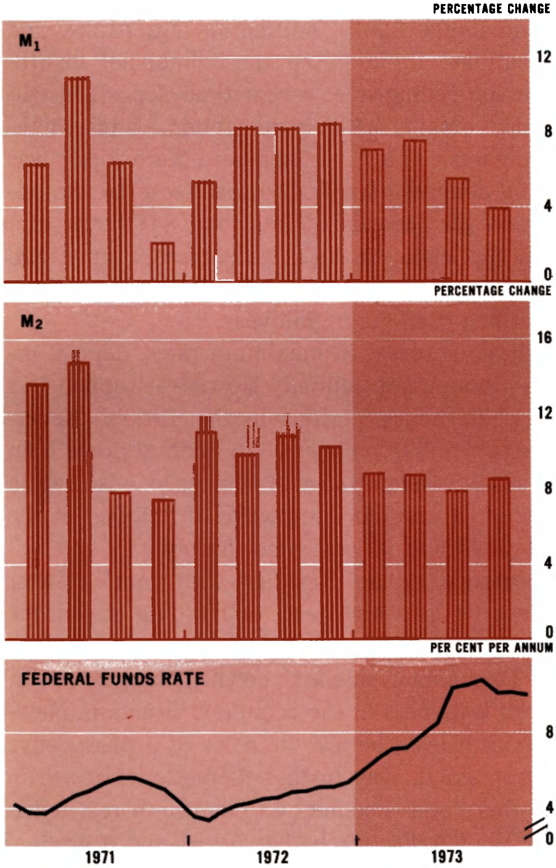
As a result of these efforts, the growth in money and credit slowed markedly relative to the continuing expansion in domestic spending. The narrowly defined money stock (M_1),[1] even after revision in early 1974 to reflect unexpectedly large growth in deposits at nonmember banks, increased 6.1 per cent from the fourth quarter of 1972 to the fourth quarter of 1973. If measures of money are expanded to include consumer-type time and savings deposits at banks (M_2) and at other depositary institutions (M_3), the resulting growth rates are 8.8 per cent and 8.9 per cent, respectively. In each case these increases were well below the 11 per cent growth in the gross national product (and total domestic expenditures) over the same period, and also appreciably smaller than those recorded in 1972.

With significantly slower growth in money and continued rapid growth in total spending, interest rates were subject to marked up-

[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. Government.

ward pressure over the first 9 months of the year. Short-term market rates, as represented by 3-month Treasury bills, rose by nearly 400 basis points from the 1972 year-end level, peaking out at just above 9 per cent in August. The interest rate charged by banks on their prime loans—those to large business customers with the highest credit rating—increased by a similar amount, from 5¾ per cent to

MONEY STOCK AND THE FEDERAL FUNDS RATE



NOTE.—Money stock, annual rates of growth calculated from daily-average figures for all 3 months of the quarter. Federal funds rate, monthly averages of daily figures. For definitions of M_1 and M_2, see notes to chart on p. 42.

10 per cent. Long-term bond yields rose less dramatically but still substantially, by around 100 basis points. And yields on FHA and VA mortgages sold in the secondary market increased by about 150 basis points—to more than 9 per cent—before declining moderately in the closing months of the year.

Because of the sharp rise in market yields, savings flows began to shift increasingly into market instruments and away from the depositary institutions (where the interest rates that can be paid are constrained by regulatory ceilings). Accordingly, in early July the Board and other Federal regulatory agencies, after consultation, raised rate ceilings applicable to commercial banks, mutual savings banks, and savings and loan associations. In addition, these financial institutions were permitted to issue ceiling-free, 4-year time deposit instruments, so that they could compete actively for funds against high-yielding market instruments. This ceiling-free authority was withdrawn later, following congressional action that required the imposition of ceiling rates on all deposits of less than $100,000. But the array of rate ceilings applicable to the various types of time and savings deposits issued by banks and nonbank institutions remained significantly higher than it had been before midyear.

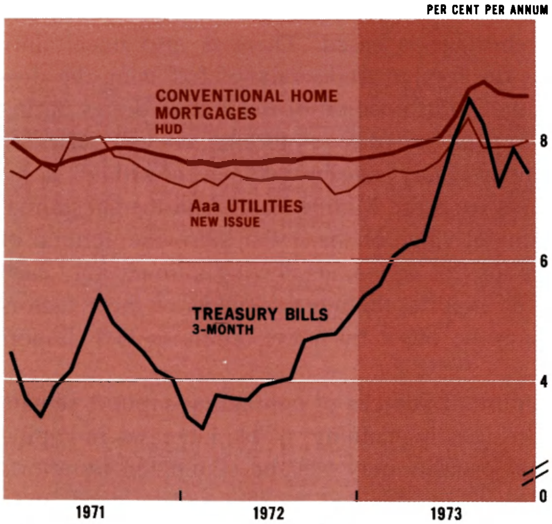
Partly as a result of these increases in maximum rates, deposit inflows to the institutions—though substantially slowed—dropped less drastically than during tight money periods in the 1960's. Nevertheless, and despite a liberal lending policy by the Federal home loan banks and support from the Federal National Mortgage Association and other Federal agencies, a marked contraction developed in the availability of mortgage credit and its cost rose sharply.

The tightening in mortgage credit, together with much higher prices for houses and the sustained high level of building during the two preceding years, combined to reduce housing starts sharply over the course of the year. Declining residential construction, however, was not the only source of weakness in the economic situation. New-car sales had begun to fall off even before the news of a prospective oil shortage, and they dropped sharply further thereafter. Growth in consumer spending for other goods declined on balance in real terms after the first quarter of 1973, reflecting higher prices and a gradual reduction in real take-home pay of the average worker. In the autumn the developing energy shortage, resulting from the embargo on direct and indirect shipments of oil from the Middle East to the United States, created new uncertainties and new fears about continued economic stability both at home and abroad.

The result was a marked slowing in over-all economic growth as the year progressed. Expansion in real GNP moderated from an unsustainably high 8.7 per cent annual rate in the opening months of the year to an annual rate of about 3 per cent in the second and third quarters combined. This reflected not only the leveling off in consumer demands but also shortages in supplies of foodstuffs and raw materials and the limitations of capacity in some critical industrial sectors. In the fourth quarter real growth slowed further, to only about 1.5 per cent (annual rate). Growth in employment also slowed toward the end of the year, and the unemployment rate—which had declined through most of the year—began to rise.

In view of these developments monetary policy in the autumn began to back away from its earlier posture of substantial restraint. Open market operations became a little less restrictive, and interest

SELECTED INTEREST RATES



NOTE.—For notes see chart on p. 37.

rates edged down in both long- and short-term markets. Savings flows to the depositary institutions improved as interest rates on market instruments were reduced, and the mortgage market eased in terms of both interest rates and the availability of funds. In December the Board reduced the marginal reserve requirement on CD's and other money market funds at large banks from 6 to 3 per cent, and in early January 1974 it cut margin requirements on stock market credit from 65 per cent to 50 per cent. The interest rate on Federal funds declined from its September high of nearly 11 per cent to about 9 per cent by February of 1974.

The move to a moderately less restrictive monetary policy was warranted by the leveling-off in the economic expansion and by the evidence of developing weakness in the economy caused by the oil shortage and other factors. But the continuation of rapid inflation and the persistence of serious supply shortages, not only in oil but also in many other product lines, counseled against any aggressive easing in policy.

In early 1974, weakness in economic activity appeared to be growing, dominated by a slowing in consumer expenditures for the goods and services most closely associated with the use of gasoline and oil products. This situation may worsen for a time; or the problem may wane, if consumers shift to the purchase of other goods and services, or if the oil shortage is eased. There is also uncertainty about the prospects for the foreign trade balance following the dramatic improvement in the export position of the United States during 1973. The quantum jump in the price of foreign oil will raise the Nation's bill for oil imports very substantially, even without a resumption of oil shipments from the Middle East. And the substantial recovery in the international value of the dollar since the autumn of 1973, along with indications of economic slowing abroad, may curb foreign demands for U.S. exports, though the effects of these factors on the trade balance may be offset by a weakening in U.S. import demands.

At the same time important sources of continuing support remain in the U.S. economy. Business is planning sizable increases in capital spending, and additional projects may well be stimulated by efforts to economize on the use of energy and by the evident need for a major effort to expand domestic capacity in the energy field and in other basic materials industries. Businesses generally have followed conservative inventory policies, and with many commodities still in very short supply, the ratio of stocks to sales remains close to its lowest level in many years. Residential building activity is likely to show some recovery later in the year from its present depressed state, as there is further improvement in the availability of mortgage money, materials, and labor.

The inflationary problems of the U.S. economy remain severe, however. Prices of materials—not only of oil but also of many other commodities—have continued to rise at a rapid pace. And many shortages remain that are capable of disrupting production schedules and deliveries. Moreover, the rise in unit labor costs has accelerated in recent quarters as increases in wage rates have been substantial and gains in productivity have come to a halt.

The outlook for inflation is not entirely bleak, however. Adjustments in relative prices of the dimensions witnessed over the past year should not be expected to continue indefinitely, since the effect of the higher prices is to induce larger output and constrain demand. In the case of oil and other fuels, the price response to shortage conditions may still have some distance to go. In other areas, however, the outlook seems more promising. Agricultural output has been rising, and crop yields around the world generally appear to have been much more favorable in 1973. The upsurge in international demand for industrial raw materials shows clear signs of moderating, and the dollar has strengthened again in foreign exchange markets. In any event, lasting improvement in supply conditions for foods and other raw materials will be dependent on long-run structural processes that encourage increases in investment, output, and efficiency in these sectors and economy in the use of their product.

The job for monetary policy—and for economic stabilization policy generally—therefore, is to steer a course that will not exacerbate present and prospective inflationary forces, but at the same time will avoid an unacceptably severe or extended weakening in economic activity that might develop from the energy crisis. Given the many uncertainties that confront the economy, this is not likely to be an easy task. Monetary policy, however, is by its nature a flexible and adaptive instrument that can be shaped promptly to the Nation's emerging economic needs.

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Demands for Goods and Services

1973 was a year of dramatic developments in the nonfinancial sector of the economy. For the year as a whole, GNP in current dollars increased by about 11.5 per cent, but higher prices accounted for nearly half of this rise. The increase of 6 per cent in real GNP was about the same as in 1972. But after reaching exceptionally rapid and unsustainable rates in late 1972 and the first quarter of 1973—averaging about 8.5 per cent per year—growth in real terms slowed abruptly. In the fourth quarter it was down to an annual rate of about 1.5 per cent.

The rapid pace of expansion early in the year was broadly based among consumers, business, foreign trade, and government. The subsequent slowing was attributable in part to the emergence of severe pressures on supplies of many major materials, which acted to limit output increases in key demand sectors. Output of materials was ap-

Table 1: GROSS NATIONAL PRODUCT

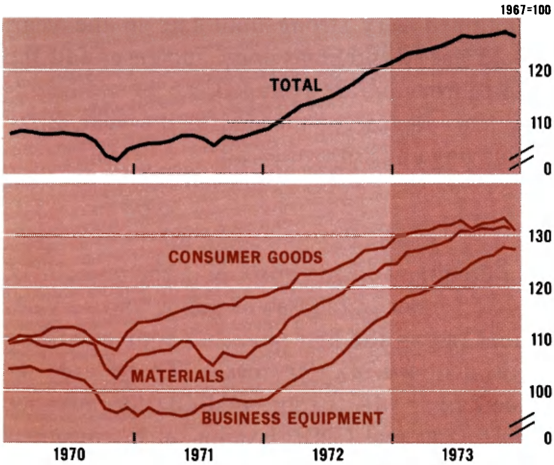
Type of measure	1971	1972	1973	1973 [1] I	II	III	IV
	In billions of dollars						
Current dollars	1,056	1,155	1,289	1,243	1,272	1,305	1,338
1958 dollars	745	791	837	829	834	841	845
	Percentage change from preceding period (at annual rates)						
Current dollars	8.0	9.4	11.6	15.2	9.9	10.6	10.5
1958 dollars	3.2	6.1	5.9	8.7	2.4	3.4	1.6
Implicit deflator	4.7	3.2	5.4	6.1	7.3	7.0	8.8

[1] Quarterly data are seasonally adjusted annual rates.
NOTE.—Dept. of Commerce data.

proaching practicable capacity limits by late spring, with capacity utilization rates for major materials industries reaching their highest levels since World War II. These pressures on capacity, and the related tightness of supplies, were maintained throughout the remainder of the year. The moderation of expansion in aggregate real output during 1973 was broadly paralleled by a slowing of growth in industrial production—to an annual rate of little more than 1 per cent in the fourth quarter, from a 10 per cent rate in the first quarter.

Although supplies and capacity in a number of industries were subject to severe strains in 1973, demands in some important sectors moderated over the course of the year. In particular, the volume of consumer real purchases slowed after an extraordinarily large increase in late 1972 and early 1973. Toward the close of the year—when the oil shortage began to affect output and employment adversely, both directly and through its effects on expectations—sales of large-size automobiles in particular were sharply reduced. Purchases of fuel and some services were also down, and for the fourth quarter as a whole total consumer purchases in real terms declined. Another factor contributing importantly to the over-all slowing in

INDUSTRIAL PRODUCTION



NOTE.—Federal Reserve indexes, seasonally adjusted.

real growth was a sharp drop in residential construction activity in the second half of the year.

In contrast, business demands for fixed capital were strongly expansive throughout the year. In fact, business equipment was the only major category of industrial production that increased virtually throughout 1973. But here too there were indications late in the year of a slowing in the rate of expansion, in part because of supply factors. And until late in 1973, supply constraints held inventory investment at exceptionally low levels for a period of cyclical expansion.

A major feature of 1973—and one that contributed materially to over-all expansion—was a turnaround in net exports of goods and services to surplus from a sizable deficit in 1972. Merchandise exports increased much faster than did imports, stimulated by strong demand conditions in Western Europe and Japan, by crop shortfalls in some countries, and by the decline in the value of the U.S. dollar in foreign exchange markets.

Pressures on industrial resources, tight supplies of farm products and other materials, strong demands abroad, and the oil crisis combined to intensify inflationary pressures. Increases in unit labor costs were also an important factor in the price rise, as gains in productivity came to a halt after the first quarter of the year while increases in average compensation per employee rose faster than they had in 1972.

Demands for labor continued very strong until late in the year. Payroll employment showed an exceptionally large increase, and the unemployment rate in the fourth quarter averaged 0.6 of a percentage point less than a year earlier; toward the end of the year, however, unemployment was moving upward.

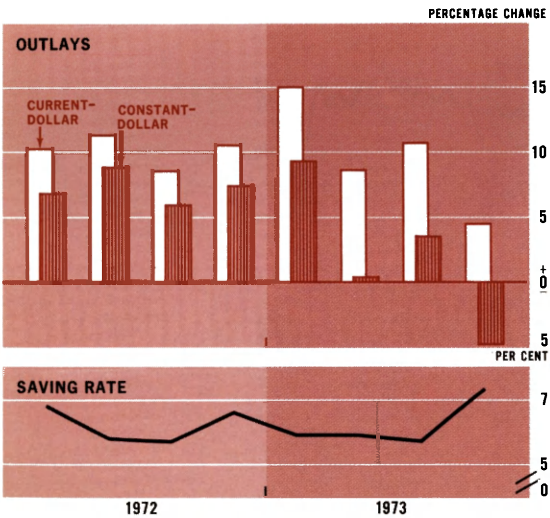
CONSUMER PURCHASES

Consumer spending was a dominant factor in shaping the contour of GNP expansion in 1973. Consumer purchases of goods and services rose to a 15 per cent annual rate in the first quarter—equivalent to a 9 per cent rate after adjustment for price increases. These large increases were major influences in the strong first-quarter advance shown in both current-dollar and real GNP. Expansion in consumer spending slowed thereafter—to an annual rate averaging close to 10 per cent for the second and third quarters, and then to 4.5 per cent for the fourth quarter. Moreover, continued price advances largely eroded these increases. For the year as a whole, however, real consumer purchases increased by 5 per cent following a 6 per cent rise in 1972.

The first quarter of 1973 was characterized by exceptionally strong advances in consumer purchases of both durable goods and nondurable goods. Continuation of the housing boom provided an impetus to sales of furniture and appliances. In addition, unit sales of new autos (domestic and foreign) reached a record 12¼ million annual rate. A sharp increase in purchases of nondurable goods reflected in part an acceleration in food prices, but sales of some other items—such as apparel—rose even faster in both current dollars and real terms.

Outlays for both durable and nondurable consumer goods were

CONSUMER OUTLAYS AND SAVING RATE

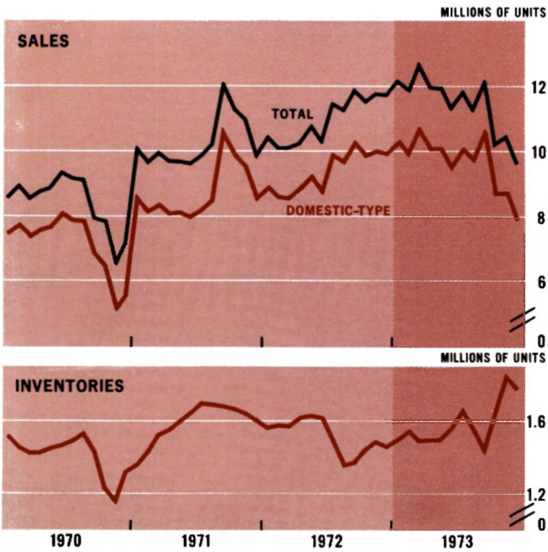


NOTE.—Outlays: Changes from preceding quarter based on quarterly data at seasonally adjusted annual rates; constant-dollar changes are based on 1958 dollars. Saving rate is personal saving as a percentage of disposable personal income. All data are from Dept. of Commerce.

maintained at relatively high levels during the second and third quarters. Auto sales eased somewhat, however, and there was some decline in real purchases of food, reflecting in part sharply rising prices and the reduced availability of meat. Expenditures on services continued to increase throughout the first three quarters in both current and constant dollars.

An outright decline—at an annual rate of close to 5 per cent—in real consumer purchases in the fourth quarter, following the earlier marked slowing, was attributable for the most part to emerging energy developments. Consumers cut back their purchases of new automobiles to an annual rate of 10 million units, off considerably from the 11.7 million rate of the second and third quarters; smaller models were in strong demand, but dealers' stocks of large cars mounted. Real purchases of gas and oil also declined, reflecting the administration's conservation program and rising prices.

AUTOS



NOTE.—Sales: Monthly data at annual rates, seasonally adjusted by Federal Reserve; domestic-type includes sales in the United States of cars produced in Canada. Inventory data, seasonally adjusted, are for domestic-type cars only. Sales, from Ward's *Automotive Reports*; inventories, from Motor Vehicles Manufacturers Association.

Contributing to the upsurge of consumer demands in early 1973 were large gains in employment and wages, as well as the anticipation of unusually large refunds of personal income taxes during the first half of the year, resulting from a step-up in withholdings in 1972. Strong growth in income helped to provide the basis for a sharp increase in spending financed with instalment credit. The large increase in social security benefits in late 1972 also stimulated consumer spending to some extent.

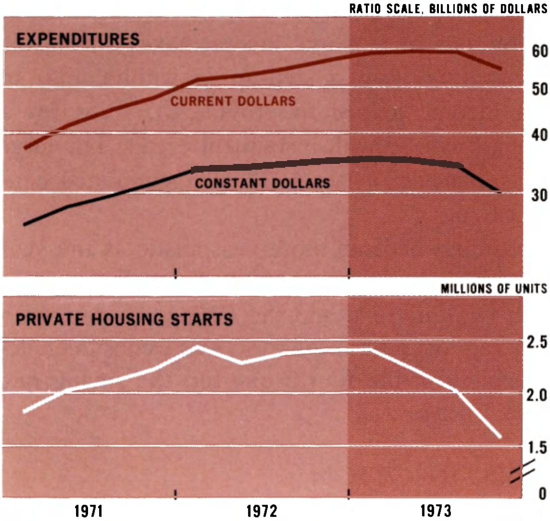
Although consumer attitudes became more pessimistic as the year progressed, consumer spending kept pace with the increase in nominal income in the middle two quarters, and the saving rate remained close to the 5.9 per cent rate of the first quarter. With consumer demands weakening appreciably in the fourth quarter, the saving rate rose sharply to more than 7 per cent.

RESIDENTIAL CONSTRUCTION

Outlays for private residential construction, which had advanced steadily since mid-1970, peaked early in the first half of 1973 and fell sharply in the fourth quarter. The decline reflected a slowing of demands in response to sharply higher interest rates and less favorable nonrate mortgage terms as well as to a substantial further rise in the costs of houses. The tightening of credit terms was particularly evident after midyear as inflows of funds to mortgage lending institutions were adversely affected by high yields on competitive investments. For the year as a whole, however, construction outlays were down only slightly from the 1972 total in real terms and were 7.5 per cent higher in current dollars.

Private housing starts held at a near-peak seasonally adjusted annual rate of 2.4 million units in the first quarter; after that they declined rapidly to an annual rate of less than 1.6 million units in the fourth quarter. For the year the number of starts totaled around 2 million units, about the same as in 1971 but down appreciably from the record 2.35 million in 1972. Multifamily structures, including an increased number of condominiums, accounted for nearly 45 per cent of total starts in 1973. The continued relatively high proportion of multifamily units was in part a response to further advances in costs, especially for land and for building materials.

RESIDENTIAL CONSTRUCTION



NOTE.—Expenditures: Dept. of Commerce data at seasonally adjusted annual rates; constant-dollar series is in terms of 1958 dollars.
Housing starts: Quarterly averages based on monthly figures at seasonally adjusted annual rates from Dept. of Commerce.

Nonsubsidized starts, which include larger and more expensive units, accounted for more than 90 per cent of the private residential total—an appreciably higher figure than in other recent years. Federally subsidized starts—new commitments for which remained largely under a moratorium instituted early in the year—were reduced to the lowest level since 1968. Domestic shipments of new mobile homes, which are not included in residential outlays or housing starts even though they provide living accomodations, dropped considerably through 1973 after reaching a peak in the first quarter. Nevertheless, the annual total of mobile home shipments was slightly above the previous record of 576,000 units in 1972.

Mortgage markets tightened markedly through the summer of 1973. Although interest rates in such markets showed some easing during the fourth quarter, they still remained at historically high levels and continued to be a deterrent to new building and to sales of old houses—particularly in States with relatively low usury ceilings.

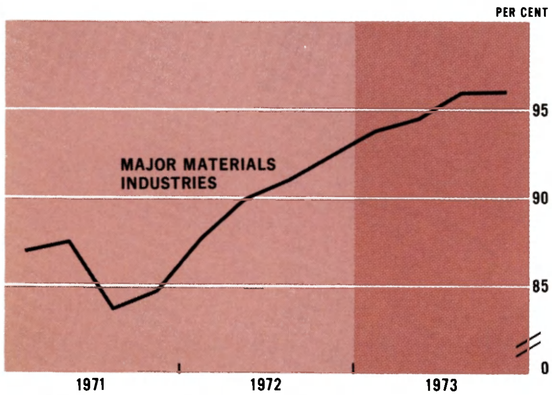
By late in the year, moreover, the energy crisis had raised new questions about methods of heating and the adequacy of transportation—creating uncertainties for the future plans of lenders, builders, and potential home-buyers alike.

BUSINESS FIXED INVESTMENT

Business fixed investment continued to provide strong support to the economy during 1973. For the year as a whole, such investment rose 15 per cent in current dollars and about 10 per cent in real terms. Both major categories of investment—equipment and construction—recorded current-dollar increases of about 15 per cent over their 1972 levels. Replacement needs and net expansion each continued to absorb about one-half of total outlays.

Many producers, after having added little to their capacity in recent years, approached capacity constraints during the year. This was particularly true of such major materials industries as steel, cement, petroleum, and paper and was a significant stimulus to investment. A strong corporate cash flow, a continued stimulus from the investment tax credit, and a heightening of inflationary expectations also contributed to the increase in such spending. Had it not been for materials shortages—caused in part by increased demands from abroad

CAPACITY UTILIZATION RATE



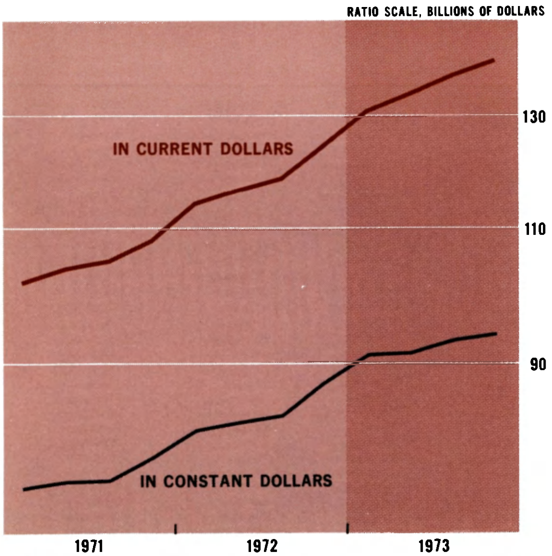
NOTE.—Average output of major materials industries, seasonally adjusted, as a percentage of their potential capacity output. Federal Reserve data.

and efforts on the part of domestic users to shift back to domestic sources—capital spending probably would have shown an even greater increase, as suggested by the fact that throughout the year actual spending consistently fell short of earlier anticipations.

Plant and equipment expenditures rose much faster in manufacturing industries than in the nonmanufacturing sector, in contrast to the pattern in 1972. Many manufacturers, particularly major materials producers, increased outlays so that they could meet the strong demands for their products and also bring production facilities up to the standards required by environmental regulation. Investment was very strong for the primary metals, paper, and stone, clay, and glass industries. Outside of the manufacturing sector, mining and public utilities registered the strongest increases.

Toward the end of the year various surveys of plant and equipment spending all pointed to sizable further increases in such spending during 1974, with manufacturers expected to continue the strong

BUSINESS FIXED INVESTMENT



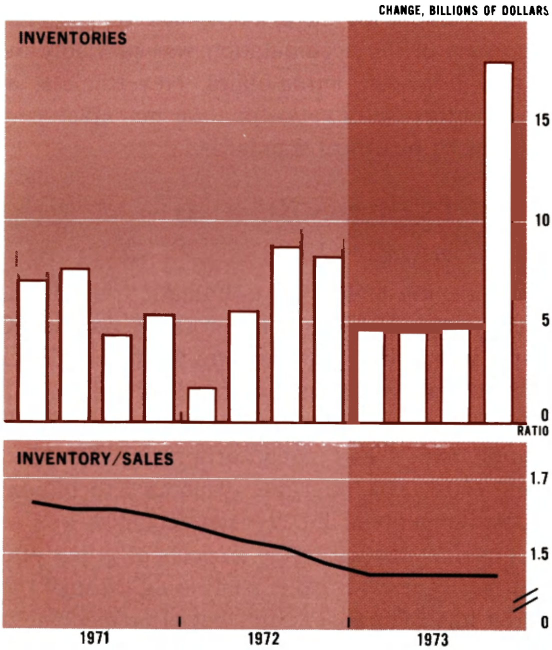
NOTE.—Dept. of Commerce data at seasonally adjusted annual rates. Constant-dollar investment is in terms of 1958 dollars.

advance of 1973. However, the surveys were conducted before the impact of the energy shortage could have been fully reflected in business plans. Accordingly, as 1974 unfolds, further revisions in plans are likely; some will be to take account of the availability and cost of energy supplies, while others will be to meet the needs for increased domestic energy output.

INVENTORIES

Inventory investment, which usually shows strong increases in a cyclical recovery, remained very modest during the first three quarters of 1973, averaging an annual rate of only $4.5 billion as measured in

BUSINESS INVENTORIES AND SALES



NOTE.—Inventory change (NIA), quarterly data at seasonally adjusted annual rates, from Dept. of Commerce.

Inventories/sales ratio, based on Dept. of Commerce seasonally adjusted data—end-of quarter book value for inventories, and quarterly averages of monthly data for sales—for manufacturing and trade establishments.

the national income accounts (NIA). Increases in the book value of inventories were much larger than the increases as measured on the NIA basis; the difference reflected the very large inventory valuation adjustments resulting from the sharp and widespread price increases during the period. The dollar volume of sales advanced even more rapidly than the book value of inventories, however, and the inventory/sales ratio reached its lowest level since early in the Korean war.

Inventory accumulation was held to a low rate during most of the year mainly by the influence of strong final demands and shortages of major materials. Stocks of finished goods, for instance, were drawn down in the primary metals and chemical industries; and unfilled orders rose by exceptional amounts in many industries.

In the fourth quarter of 1973, inventory investment accelerated to an annual rate of $18 billion. The step-up in inventory accumulation appears attributable for the most part to the slowing of final demands—particularly by consumers for large autos, and for residential construction. A large part of the accumulation was probably involuntary, notably for new large-size automobiles. Nevertheless, at the end of the year the inventory/sales ratio for total manufacturing and trade remained quite low by historical standards.

EXPORTS AND IMPORTS OF GOODS AND SERVICES

The U.S. balance of trade position underwent a dramatic transformation during 1973. Exports of goods and services rose by around 40 per cent from the previous year, while imports were up about 25 per cent. As a result the balance on goods and services shifted from a deficit of close to $4.5 billion in 1972 to a surplus of around $6 billion in 1973. Net exports, which had risen throughout the year, jumped in the fourth quarter to an annual rate of about $13 billion, reflecting some special developments in the services sector as well as an improved U.S. trade position. In real terms, exports of goods and services rose by about 20 per cent, with gains continuing through the year. Real imports rose by less than 5 per cent, but after reaching a peak in the first quarter they drifted down. While the favorable trade balance contributed to expansion of the economy in 1973, it also added to inflationary pressures by placing further demands on already hard-pressed domestic capacity as well as on domestic supplies of farm products and industrial products; in addition, the prices of imports increased appreciably.

The turnaround in foreign trade reflected both the strong economic expansion in Western Europe and Japan and the cumulative effects of the depreciation of the dollar in terms of foreign currencies. Expansion in exports was sharpest for agricultural products, which were strengthened in part by widespread crop failures abroad. But exports of nonagricultural products also rose sharply in both current dollars and real terms. By year-end the value of the dollar had risen substantially from its midyear low in terms of foreign currencies. And large increases in the dollar value of imports were in prospect because of sharp advances in petroleum prices.

FEDERAL GOVERNMENT

After registering a deficit of nearly $16 billion in calendar year 1972, the Federal budget (NIA basis) moved into balance in the spring of 1973 and then into surplus in the second half of the year. This shift was the result both of curbs on increases in expenditures and of large revenue gains generated by rising incomes and prices.

Federal purchases of goods and services, which enter directly into the GNP, rose by about 2 per cent in 1973, less than half as much as in the previous year. In real terms, purchases declined about 6 per cent, as outlays for national defense dropped sharply. Nondefense purchases, which are much smaller in dollar terms, rose less than in 1972. An increase in total Federal grants-in-aid to State and local governments reflected the fact that general revenue sharing, introduced in the latter part of 1972, was in effect for all of 1973; other grant-in-aid programs declined somewhat. A moderate increase in wages and salaries paid by the Federal Government reflected higher pay scales; during the year there was a slight decline in the Federal civilian work force as a result of sharp cutbacks of civilian employment in the Department of Defense.

Federal receipts rose by about $37 billion in 1973, compared with $30 billion in 1972. Corporate profits tax accruals were up more than 30 per cent for the year, although they changed little after the

Table 2: CHANGES IN MAJOR COMPONENTS OF GROSS NATIONAL PRODUCT

In billions of dollars

Item	1971	1972	1973	1973[1] I	II	III	IV
GNP	**78.4**	**99.7**	**133.9**	**43.3**	**29.5**	**32.5**	**33.0**
Personal consumption expenditures	**49.6**	**59.3**	**77.5**	**26.8**	**16.2**	**20.4**	**9.2**
Durable goods	12.3	13.8	13.4	9.3	.6	.0	−7.2
Nondurable goods	14.9	21.2	36.0	11.5	8.1	11.3	8.0
Services	22.3	24.3	28.1	6.0	7.6	9.0	8.4
Saving rate (level in per cent)	*8.1*	*6.2*	*6.2*	*5.9*	*5.9*	*5.7*	*7.3*
Fixed investment	**15.4**	**25.2**	**21.9**	**8.7**	**3.8**	**3.6**	**−1.4**
Residential structures	11.5	11.3	4.0	2.1	.6	− .4	−5.2
Nonresidential	3.8	13.8	18.0	6.6	3.2	3.9	3.8
Inventory change	**1.6**	**− .1**	**2.0**	**−3.6**	**− .1**	**.2**	**13.3**
Net exports of goods and services	**−2.8**	**−5.4**	**10.4**	**3.5**	**2.8**	**4.8**	**5.2**
Exports	3.4	7.2	28.5	10.0	7.5	7.3	11.9
Imports	6.2	12.6	18.1	6.5	4.7	2.6	6.6
Govt. purchases of goods and services	**14.8**	**20.7**	**22.1**	**7.9**	**6.7**	**3.7**	**6.6**
Federal	1.9	6.3	2.2	2.8	1.8	− .5	.0
Defense	−3.0	2.8	− .5	1.9	− .1	.0	−1.2
Other	4.9	3.6	2.6	.9	1.9	− .4	1.1
State and local	12.9	14.3	20.0	5.0	5.0	4.2	6.6

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

second quarter. Contributions for social insurance recorded similarly large increases, in part because of an increase in tax rates. Personal tax receipts and indirect business taxes, however, showed only moderate growth. In 1972, personal tax receipts had been boosted because of substantial overwithholding.

STATE AND LOCAL GOVERNMENTS

State and local government expenditures continued to be strongly expansive in 1973, rising by about 13 per cent. In real terms the increase was about half of that. Employee compensation and purchases of goods and services accounted for the major portion of the increase. Employment rose by nearly 400,000, a smaller advance than that recorded in 1972. This smaller growth reflected a reduction in the number of State and local employees hired under provisions of the Public Employment Act. State and local construction expenditures were up by 8 per cent in 1973, but most of this was the result of increased prices.

During 1973 the States and localities combined recorded a budget surplus of $11 billion, $2 billion less than in 1972. Federal general revenue sharing helped these governments to maintain a strong fiscal position in 1973 and at the same time to reduce substantially the amount of their long-term borrowing. Furthermore, it provided funds that were used for tax relief, a trend that is expected to continue in 1974.

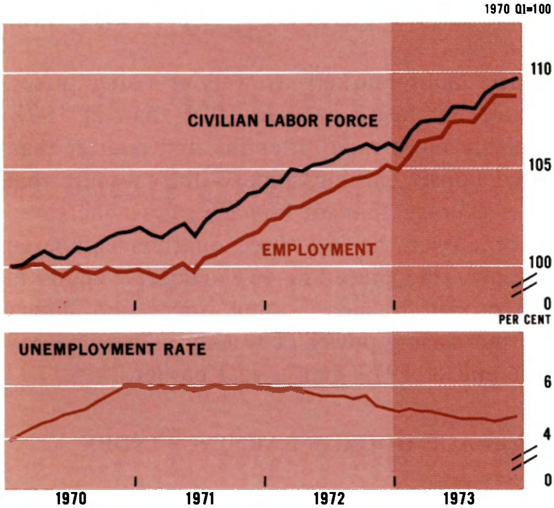
Employment and Wages

Labor markets continued to tighten through most of 1973. Strong demands for workers were associated with a rapid expansion in employment and a moderate decline in unemployment. Near the year-end, however, a slowdown in production and the onset of the energy crisis resulted in layoff announcements in automobiles, airlines, and hotels and in a number of related industries. Growth in over-all employment slowed, and there was a rise in the unemployment rate.

The civilian labor force expanded sharply in 1973 in response to the generally strong demands for labor. The increase of 2.7 million during the year compares with 2 million in 1972 and an anticipated normal growth of 1.6 million, based on long-term demographic and participation-rate trends. Most significant in the sharper rise in 1973 was a speed-up in the number of women 25 to 54 years of age in the labor force. The need to increase family income to help maintain real incomes in the face of sharply rising prices was a factor in this trend, as was the strong demand for labor. Labor force increases for most other groups were at about the same pace as in 1972—with continued large increases among teenagers and young adult women.

During the first part of the year gains in total employment about matched the large increases in the labor force, and the unemployment rate remained at about 5 per cent. In the spring and early summer, labor force growth slowed a little and the unemployment rate declined somewhat. In October the rate was 4.6 per cent, the lowest in 3½ years. Declines were evident among most labor force groups. The unemployment rate for white workers edged down to 4.2 per cent in the fourth quarter. Employment gains were also substantial among black workers during 1973, and the jobless rate for such workers declined to 8.6 per cent as compared with 9.9 per cent a year earlier. Even so, over-all jobless rates remained well above those that had been recorded during the period of extremely tight labor markets from 1966 to 1969. Near the end of 1973 the unemployment rate began to edge up as demand for labor slackened and layoffs increased; and in January 1974 there was a further substantial rise.

LABOR FORCE, EMPLOYMENT, AND UNEMPLOYMENT



NOTE.—Seasonally adjusted data from Dept. of Labor.

The rapid increase in nonfarm payroll employment in 1973 continued an expansion that had begun in the fall of 1971; the total rose by 2.7 million over the four quarters of 1973—about the same increase as during the preceding year. The employment advance was led by a vigorous increase—of three-quarters of a million—in manufacturing jobs, which brought factory employment back close to the peak level reached in mid-1969. The rise in manufacturing employment was particularly rapid in the first half of 1973. Gains were concentrated in those industries most affected by strength in materials output and business investment. But as production slowed in the latter half of the year, the pace of the increases in manufacturing employment also moderated and the factory workweek edged off from the relatively high level reached earlier in the year.

Employment growth was also strong in nonindustrial activities in 1973. In services, finance, and trade the total number employed rose by 1.3 million, slightly more than during 1972. Federal civilian employment edged off, continuing the downtrend that had begun in

1970. State and local governments increased their payrolls substantially over the four quarters of 1973 but at a slower pace than in the preceding year.

In response to tightened labor markets as well as rising prices, wages increased at a somewhat faster pace in 1973 than in 1972. The increase was appreciably more rapid after the first quarter than earlier. Thus, the adjusted hourly earnings index—the measure that most closely approximates average changes in wage rates—increased by an average 7.5 per cent over the last three quarters compared with about 5.5 per cent over the preceding five quarters. Gains in money wage rates were eroded by accelerating prices and higher social security taxes; the purchasing power of weekly take-home pay was 3 per cent less at the end of 1973 than a year earlier.

Table 3: CHANGES IN AVERAGE HOURLY EARNINGS INDEX

Seasonally adjusted annual rates, in per cent

Industry	Aug. 1970–Aug. 1971	Aug. 1971–Jan. 1972	Jan. 1972–Mar. 1973	Mar. 1973–Dec. 1973	1972 QIV–1973 QIV
Total private nonfarm	6.9	6.5	5.6	7.4	6.7
Mining	6.7	9.5	5.2	9.4	7.8
Construction	7.8	6.5	5.5	7.9	6.7
Manufacturing	6.5	6.3	5.4	7.1	6.6
Transportation and public utilities	8.7	11.6	9.2	7.6	7.7
Wholesale and retail trade	5.9	5.4	5.0	7.0	6.8
Finance, insurance, and real estate	6.9	4.8	4.0	8.2	5.8
Services	7.4	6.9	4.7	6.9	6.1

NOTE.—Average hourly earnings of private nonfarm production and supervisory workers, adjusted to exclude effects of shifts of workers among industries and fluctuations in overtime premiums in manufacturing. Basic data from Dept. of Labor.

Contract bargaining activity was heavy in 1973 with about 4¾ million workers affected in many of the key, pattern-setting industries. In the environment of accelerating price increases, new or improved cost-of-living clauses became a major bargaining issue. Negotiations also focused on substantial gains in fringe benefits—particularly on early retirement, higher pension payments, and increased medical coverage.

Prices, Labor Costs, and Profits

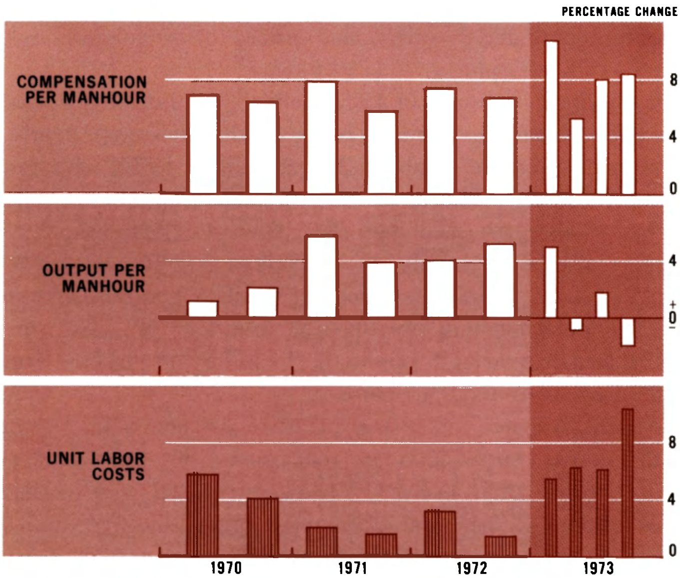
Inflationary pressures were exceedingly strong in 1973, with prices showing the largest sustained increases since 1946. The fixed-weighted price index for private GNP—a broad measure of price change—increased almost 8 per cent from late 1972 to late 1973, more than double the increase over the preceding year, and wholesale and consumer prices rose at close to record rates. Strong demands in this country and abroad exerted extraordinary pressures on supplies. World supplies of foodstuffs were short, and industrial activity rose to very high levels in Western Europe and Japan, generating strong demands for U.S. exports and high prices for imports—a situation aggravated by the decline in the value of the dollar relative to other currencies. In this country, unit labor costs rose much faster than in 1972. Supplies of livestock products declined, and shortages of materials were acute throughout 1973. Late in the year the embargo on oil shipments to the United States by Middle East producers precipitated a crisis, and prices of petroleum and products began to rise sharply.

Prices of raw materials soared in 1973, reflecting a business boom of worldwide proportions. Spot prices of raw industrials rose nearly 60 per cent after an increase of about 25 per cent in 1972, with especially large increases for nonferrous metals, steel scrap, and cotton. The cost of many semiprocessed materials, such as chemicals, textiles, and paper, also rose rapidly as operations neared the upper limits of plant capacity. Wholesale prices of finished goods rose less rapidly than did materials until an upsurge in prices of petroleum products in the fourth quarter brought the increase for the year for nonfood finished goods to about 15 per cent.

Unit labor costs exerted increasing pressure on prices in 1973. In the fourth quarter such costs in the private nonfarm sector were 7 per cent above their late 1972 level, compared with an increase of only about 2.5 per cent during the preceding year. Failure of productivity to grow in the private nonfarm economy was the major factor in the acceleration of labor costs. Growth in output per manhour came to a standstill in the second and third quarters, as the expansion of real output slowed in the private nonfarm sector, and in the final quarter there was an actual decline in productivity. Altogether, growth in productivity amounted to only 1 per cent from late 1972 to late 1973. But in addition, growth in compensation per manhour increased somewhat, from about 7 per cent during 1972 to 8 per cent in 1973, in part because of increased costs to employers from higher social security taxes.

Part of the rise in prices in 1973 also reflected widening profit margins. Corporate profits before taxes rose rapidly in the first half of 1973, to an annual rate almost one-third above the 1972 level. Then they leveled off. A good part of the gain in reported profits reflected the increased value of inventories resulting from sharply rising prices. Adjusted for inventory valuation, the estimated rise for the year 1973 was 20 per cent. The share of profits adjusted for inventory valuation in the value of output of nonfinancial corporations im-

LABOR COMPENSATION, PRODUCTIVITY, AND COSTS



NOTE.—Annual rates of change for the private nonfarm economy; changes are from preceding half year or quarter and are based on seasonally adjusted data from Dept. of Labor.

proved slightly during the year. Nevertheless, it was less than it had been in 1969 and was considerably smaller than in years prior to 1969.

Table 4: PROFITS OF NONFINANCIAL CORPORATIONS

Share of value of product, in per cent

Item	1969	1971	1972	1973[1]
Product originating	100.0	100.0	100.0	100.0
Profits before tax[2]	12.5	10.7	11.1	11.7
Other charges against product	*87.5*	*89.3*	*88.9*	*88.3*
Compensation of employees	65.7	65.9	66.2	66.3
Interest	2.5	3.0	2.8	2.8
Indirect taxes[3]	9.3	9.9	9.5	9.2
Capital consumption allowances	9.9	10.5	10.4	10.0
Addendum: Profits plus capital consumption allowances	22.4	21.2	21.4	21.7

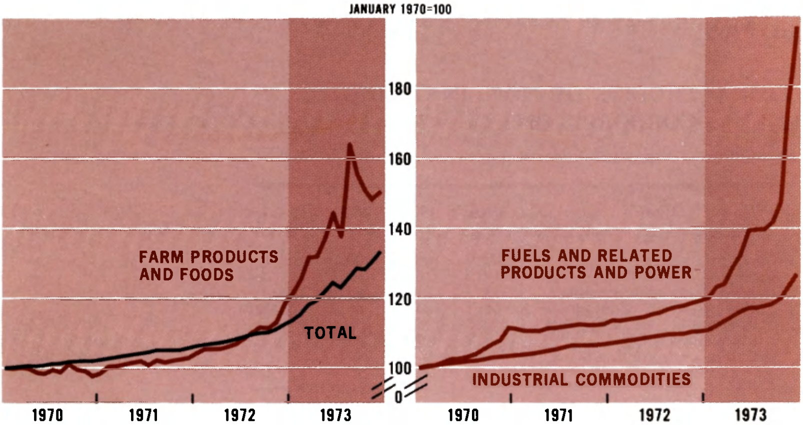
[1] Preliminary.
[2] Including inventory valuation adjustment.
[3] Including transfer payments to persons less subsidies received.
NOTE.—Dept. of Commerce data.

FIRST-HALF PRICE DEVELOPMENTS

The first half of the year began with a liberalization of Phase II price controls in early January and ended with a price freeze in June. The sharp price rise in this period was led by an extraordinarily rapid increase in wholesale prices of farm products and foods—a seasonally adjusted annual rate of almost 50 per cent from December to June. Prices of crops reacted to a rapid rise in the volume of exports of wheat, corn, and soybeans—which brought stocks in this country down to exceedingly low levels. Livestock prices also rose very sharply, for the most part in response to declining supplies.

In order to restrain rapidly rising meat prices, ceilings on red meat were imposed at the end of March for processors and distributors. This slowed the increase for meats, but food prices as a whole continued to rise very fast until a general freeze was put into effect in June. Unfortunately, price controls and the steep further climb in prices of feeds and feed grains, which had begun in late 1972, contributed to the drop in supplies of livestock and also of poultry, eggs, and milk.

WHOLESALE PRICES

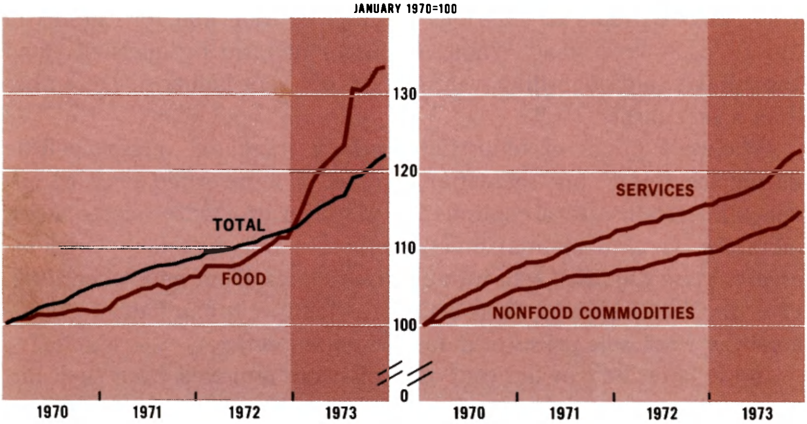


NOTE.—Based on seasonally adjusted indexes from Dept. of Labor.

At the same time the rate of increase in prices of industrial commodities was accelerating to an annual rate of almost 13 per cent; this contrasts with an increase of only 3.6 per cent for all of 1972. The acceleration in 1973 followed the introduction of Phase III price control regulations in early January. A temporary and short-lived bulge in prices had been expected—to correct some of the distortions that had arisen under Phase II—but as the months progressed, price advances showed no indications of slowing.

The underlying factors responsible for the stepped-up pace of the increase in industrial prices were much more fundamental than relaxation of controls. As noted earlier, one important influence was that the value of the dollar depreciated further in terms of other major currencies to a level more than 20 per cent below its May 1970 value. In addition, a more rapid rate of price increase abroad than in this country was helping to make U.S. exports generally more competitive in world markets while raising the dollar price of imports. This shift in relative prices affected all traded commodities, but it was most notable for materials costs, which soared in dollar terms in response both to the drop in the foreign exchange value of the dollar and to strong world demands.

CONSUMER PRICES



NOTE.—Based on seasonally adjusted indexes from Dept. of Labor.

The rise in consumer prices also accelerated in the first half of 1973, reaching an annual rate of 8 per cent. Food prices, rising at an annual rate of more than 20 per cent, contributed most to the speed-up. The rise in prices of nonfood commodities, however, was also faster than in 1972.

SECOND-HALF PRICE DEVELOPMENTS

In an effort to brake the surge in prices, a general price freeze of 60 days was imposed in mid-June; the only exemptions among domestic prices were rents and farm products at the initial point of sale. The freeze in retail prices tended to hold down prices at the farm level, and a profit squeeze on producers developed when feed and other costs continued to rise. To avoid disruptions in supply, the freeze on prices of food was relaxed in mid-July to allow retailers and distributors to pass through to consumers the higher cost of commodities at the farm level (except for beef). Prices of livestock and meat rose dramatically after this move. At the same time world shortages were causing a further upward surge in prices of wheat, corn, and soybeans. Between mid-July and mid-August the increase in prices of farm products was the most rapid since World War I.

Between mid-August and December the onset of favorable harvests removed fears of a serious shortage in food and feed grains in the 1973–74 crop year. Wholesale prices of farm products declined accordingly, although they were still 36 per cent higher in December than a year earlier.

Wholesale prices of industrial products increased relatively little during the freeze, but thereafter resumed a more rapid pace of advance in response to a continued increase in production costs. Price increases were substantial and widespread, but especially large increases were recorded late in the year for petroleum and other fuels. Over the fourth quarter fuels accounted for more than half of the increase in wholesale prices of industrial commodities.

In the latter half of the year controls were removed from such important items as lumber, cement, fertilizers, and many nonferrous metals and from new autos following an agreement with major producers to limit increases during the 1974 model year. In early 1974 controls were removed from some other items and the administration indicated that it planned to permit price and wage controls to lapse after the April 30 expiration date of the enabling legislation—except for health care and petroleum.

Consumer prices meanwhile increased at an annual rate of 9.6 per cent in the second half of the year, with retail prices of foods again

Table 5: PRICE CHANGES

In per cent

Series	Dec. 1970– Dec. 1971	Dec. 1971– Dec. 1972	Dec. 1972– Dec. 1973	1973 (Seasonally adjusted annual rates)			
				Dec.–Mar.	Mar.–June	June–Sept.	Sept.–Dec.
Wholesale prices, total	4.0	6.5	18.2	21.1	23.4	13.2	15.5
Industrial commodities	3.2	3.6	14.8	10.2	14.9	4.5	31.3
Farm products	8.1	18.7	36.1	77.3	61.0	67.3	–28.1
Processed foods and feeds	4.7	11.6	20.3	37.1	31.9	14.8	1.3
Consumer prices, total	3.4	3.4	8.8	8.6	7.4	10.3	9.0
Foods	4.3	4.7	20.1	28.6	14.7	28.8	9.2
Other commodities (less foods)	2.3	2.5	5.0	4.0	5.4	2.6	7.9
Services	4.1	3.6	6.2	3.6	4.5	7.4	9.4

NOTE.—Based on data from Dept. of Labor.

tures were up by 8 per cent in 1973, but most of this was the result of increased prices.

During 1973 the States and localities combined recorded a budget surplus of $11 billion, $2 billion less than in 1972. Federal general revenue sharing helped these governments to maintain a strong fiscal position in 1973 and at the same time to reduce substantially the amount of their long-term borrowing. Furthermore, it provided funds that were used for tax relief, a trend that is expected to continue in 1974.

Monetary Policy and Financial Markets

In the early months of 1973 the need for further measures to restrain excessive economic expansion and a growing inflationary momentum seemed clear. Real output in the domestic economy was growing at an unsustainably rapid rate, key industrial sectors were approaching effective production ceilings, and prices were moving sharply higher. Although much of the steep price advance in the first half of the year resulted from increased dollar price quotations on internationally traded commodities—reflecting the decline in the foreign exchange value of the dollar—general pressures on resources from domestic demands were also high. Since money and credit had grown rather rapidly in 1972, the need for slower growth in 1973 was evident.

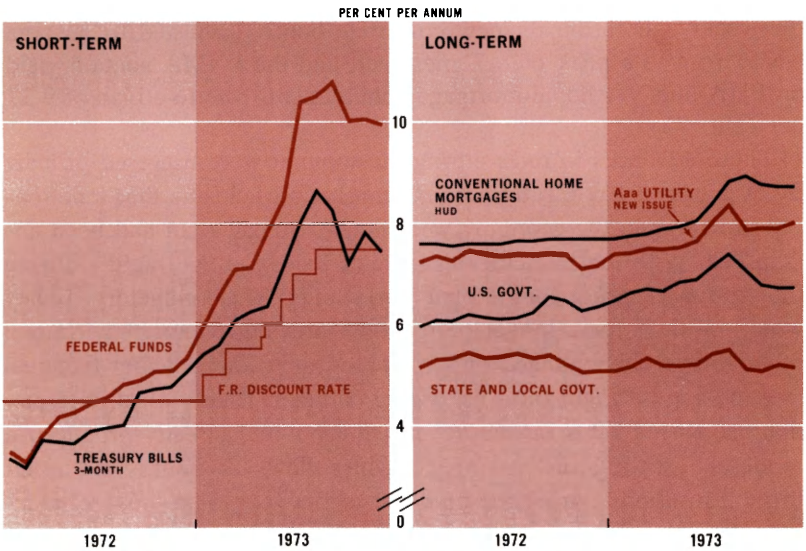
The Federal Reserve began strengthening its resistance to excessive monetary expansion near the end of 1972. This shift was intensified early in 1973 and then extended through a series of tightening actions until late summer. The principal policy thrust, as usual, came from open market operations, but successive increases in the Federal Reserve discount rate—from 4½ per cent at the end of 1972 to 7½ per cent in late August of 1973—supplemented and reinforced the open market initiative. In addition, several selective increases in bank reserve requirements were introduced in the late spring and summer to reinforce the pattern of general tightening.

Late in the summer, with real growth in the economy having moderated and with further slowing apparently in prospect, the System moved away from its policy of persistent tightening. This change was prompted by concern that the cumulative effects of earlier restrictive actions might eventually result in a greater dampening of real economic activity than was desired. Near the end of the year repercussions of the Middle East oil embargo added a special depressant to domestic activity but at the same time heightened expectations of further price increases.

During the period of policy tightening, growth in the key monetary aggregates slowed significantly, both in absolute terms and in relation to the expansion of GNP. M_1, for example, grew at an average annual rate of about 5 per cent over the first three quarters of 1973, while current-dollar GNP was expanding at close to a 12 per cent annual rate. In contrast, during 1972 M_1 had grown somewhat more than 8.5 per cent, while GNP had increased 9.5 per cent.

For the shorter period from June to September of 1973, growth in M_1 dropped to around zero. Although it accelerated in the following quarter to about a 7.5 per cent annual rate, temporary factors were influencing the results in both quarters. A more accurate reflection of the trend of policy is thus provided by the 3.7 per cent annual growth rate over the two quarters combined. During 1973 as a whole, M_1 increased by 5.7 per cent; meanwhile the broader meas-

INTEREST RATES



NOTE.—Monthly averages except for home mortgages (based on quotations for one day each month) and F. R. discount rate. Yields: U.S. Treasury bills, market yields on 3-month issues; conventional mortgages, yields on first mortgages in primary markets, unweighted and rounded to nearest 5 basis points, from Dept. of Housing and Urban Development; Aaa utility 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.

ures of money —M_2 *and* M_3—both grew by a relatively moderate 8.6 per cent.

In the course of policy tightening, interest rates trended upward —especially in short-term markets where credit demands tended to concentrate. The weekly average yield on 90-day Treasury bills, for example, reached a peak of nearly 9 per cent by August, some 3.9 percentage points above its level at the end of 1972. Over roughly the same period the comparable quotation on 90- to 119-day commercial paper—to which some large commercial banks relate their prime lending rate—rose 4.9 percentage points to 10.5 per cent.

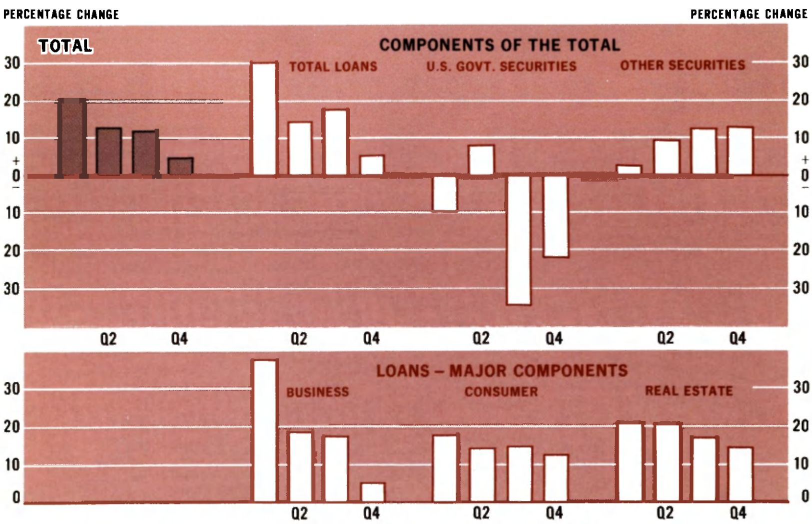
Until early summer bond yields showed a relatively small response to the upward thrust of short-term rates. This sluggishness reflected the combination of a moderate volume of new bond offerings and widespread market expectations that less rapid economic expansion would lead to lower interest rates late in the year. As the summer progressed, however, sharp further increases in short-term rates were reflected in sizable advances in both bond yields and mortgage rates; the weekly quotation on new corporate bonds (adjusted to an Aaa basis) rose to a peak of 8.52 per cent, and the FNMA auction yield on FHA and VA home mortgage commitments rose to a high of 9.37 per cent.

These advances in rates during the summer were triggered primarily by a growing realization among market participants that inflationary pressures in the economy were much stronger than had been anticipated. With the monetary aggregates having grown rapidly during the spring, market participants concluded that monetary policy would be tight for a longer period than previously expected. Among other things, this changed outlook raised questions whether financial intermediaries might not be facing another round of disintermediation. Rising rates on market instruments had already produced a moderate slowing of consumer savings flows to banks and other thrift institutions during the first half of the year. The squeeze intensified rapidly in the early summer and brought threats of sizable net outflows, particularly at nonbank institutions. In order to limit the impact of sharply rising market rates on flows to intermediaries, Federal supervisory agencies raised ceiling rates payable on thrift accounts, effective in July.

Later, when it became evident that domestic economic expansion was continuing to moderate, that growth in the monetary aggregates had slowed, that the U.S. balance of payments was strengthening dramatically, and that monetary policy was no longer tightening, market interest rates receded significantly from their summer highs. These declines, in combination with the earlier increases in ceiling rates at thrift institutions, relieved pressures on the financial intermediaries. By the year-end short-term rates were generally 1.5 percentage points or more below their summer highs, with long-term rates down roughly 0.5 of a percentage point from theirs.

A special factor affecting the structure of short-term credit flows during the year was the program of the Committee on Interest and Dividends (CID) regarding the rates that banks charge on loans to their prime business customers. Early in the year, when CID constraints prevented the prime loan rate from keeping pace with advances in commercial paper rates, prime rate customers turned in-

BANK CREDIT, 1973

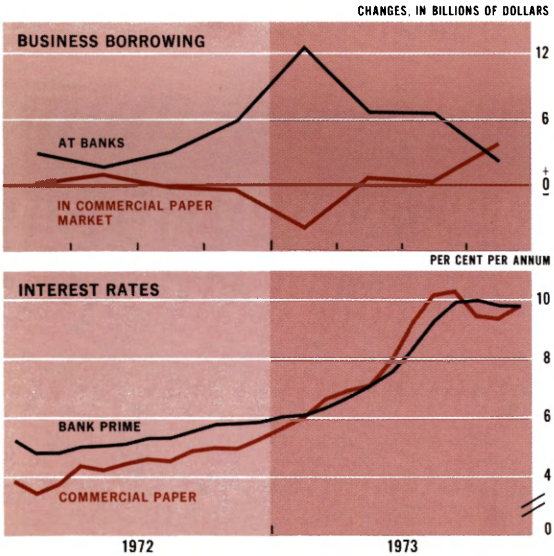


NOTE.—Quarterly data; changes are based on seasonally adjusted totals at annual rates. Total bank credit and business loans have been adjusted for transfers between banks and their holding companies, affiliates, subsidiaries, or foreign branches.

creasingly to their bank lines as the cheaper source of credit. To help meet these enlarged demands, banks were forced to bid aggressively for short-term funds at rising rates. Meanwhile the outstanding volume of more costly commercial paper declined sharply.

When the resulting upsurge in bank credit began to produce an inordinate expansion of business loans at the expense of other borrowers, the CID in mid-April introduced a "two tier" approach to rates on business loans. This system allowed rates on large prime loans to move in concert with advances in market rates, but at the same time limited rate increases on smaller loans. Changes in the outstanding volume of large prime loans tend to be more volatile than for other loans and thus frequently require banks to bid for needed loan funds at high marginal rates—for example, in the market for

SHORT-TERM BUSINESS BORROWING AND SELECTED INTEREST RATES



NOTE.—Business borrowing: Quarterly changes in seasonally adjusted commercial and industrial loans at commercial banks and in non-bank-related commercial paper issued through dealers. Interest rates: Monthly averages of daily figures for bank prime rate (rate charged large-business customers with the highest credit rating) and for commercial paper (rate offered by dealers on 30- to 59-day paper).

large CD's. By late summer resulting upward adjustments in the top "tier" had moved the prime rate back into fairly close alignment with market rates. Subsequently, when market rates receded faster than the prime rate, business loan growth at banks was substantially reduced and commercial paper expanded again.

Two other financial developments in 1973 also bear special mention. One was the sharp reversal—from the first half to the second half—in the value of the U.S. dollar in foreign exchange markets. The other was the large decline in prices of corporate stocks in this country.

Depreciation of the dollar during the first half of the year—in addition to having a major impact on commodity prices, as discussed earlier—tended during the periods of peak dollar outflow to dampen growth in the monetary aggregates and to widen spreads between Treasury bill and other short-term interest rates. Bill rates rose less than other short-term rates because foreign central banks concentrated their reinvestment of dollar acquisitions largely in Treasury bills. Later in the year, when the dollar improved dramatically, these temporary influences on the aggregates and on Treasury bill rates reversed direction.

The drop in stock prices from the yearly high reached in January to the yearly low of early December amounted to 25 per cent in the New York Stock Exchange index, the largest downswing in this series since the 1969–70 recession. On other stock exchanges and in the over-the-counter market price declines were even larger. This general erosion of stock values was attributable to a complex of influences, including the energy crisis and the special economic uncertainties introduced by changes in the administration's price control program, as well as the more traditional concerns about stock values when interest returns on alternative types of investment instruments are high and rising.

MONETARY POLICY

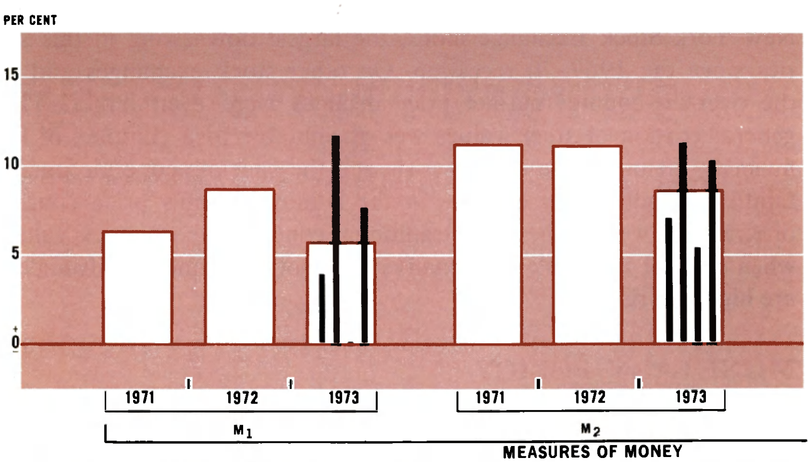
The economic situation with which monetary policy was confronted in 1973 was an exceptionally difficult one. Since so much of the inflationary pressure that emerged as the year progressed was the result of developments in world markets not directly amenable to U.S.

monetary controls, the Federal Reserve had to do its limited best to constrain the pressures that were building up within the economy while at the same time avoiding possible dislocations in the functioning of the domestic financial system.

In the day-to-day implementation of monetary policy, the Federal Open Market Committee (FOMC) continued to rely on a number of indicators to guide its actions. These included various measures of the money stock; bank credit; interest rates; and bank reserves. Occasional erratic short-run behavior in each of these required a continuing check on changing relationships among all of them in order to spot temporary aberrations in particular series. Thus, while a good deal of emphasis was placed on growth in the narrowly defined money stock as a guide to policy, this was always done within the context of a continuing assessment of the relationship of this measure to other key variables.

Monetary aggregates. The behavior of M_1 in 1973 again gave rise to difficulties in interpreting the short-run course of monetary policy.

GROWTH IN MONETARY AGGREGATES

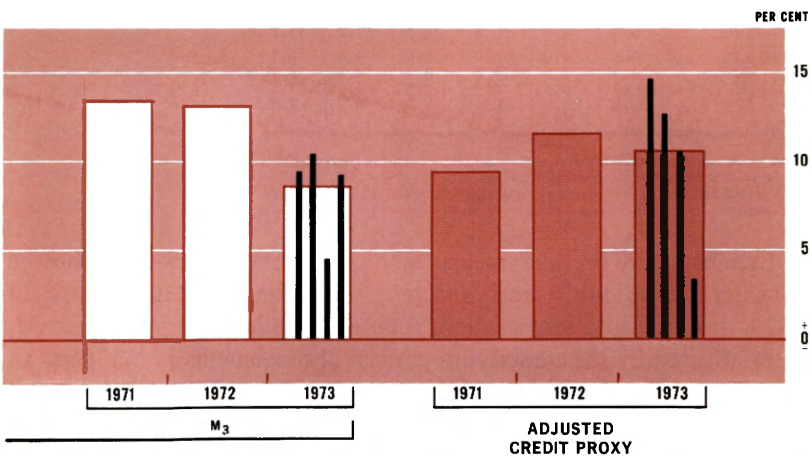


M_1: Currency held outside the Treasury, F.R. Banks, and the vaults of all commercial banks, plus demand deposits other than interbank and U.S. Govt.
M_2: M_1 plus time deposits at commercial banks other than large certificates of deposit.
M_3: M_2 plus deposits of mutual savings banks and savings capital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

On both a month-to-month and a quarter-to-quarter basis its growth pattern showed large variations attributable to special factors other than basic transactions demand.

In January, for example, growth in M_1 slowed when State and local governments shifted revenue-sharing funds, which had been received in December, from demand deposits into time deposits and other investment instruments. Also, speculation prior to and following the dollar devaluation in February, and the subsequent floating of major currencies against the dollar, resulted in massive transfers of private funds to foreign assets, which may have reduced holdings of domestic cash balances temporarily.

The first-quarter slowing of growth in M_1 was followed by an upsurge during the second quarter to an annual rate of about 11.5 per cent. Although part of this acceleration may have reflected an adjustment to compensate for slower growth in money balances over the previous 3 months, unusually large refunds of personal income taxes in April and May also may have swelled demand balances and contributed to the faster second-quarter growth.



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

NOTE.—Seasonally adjusted quarterly rates of growth derived from daily-average data for last month of the quarter relative to those for last month of preceding quarter, annualized.

Given this unusually strong April-May performance, some slowing in the growth of the money stock during the second half was to be expected, as the impact of high and rising interest rates in the spring and summer induced people to reduce non-interest-earning cash balances to minimum levels consistent with transactions needs. While the actual third-quarter slowdown was substantially larger than could be accounted for by these influences, the subsequent acceleration of growth in M_1 during the fourth quarter also seems to have been affected by special factors. Uncertainties related to the oil embargo may have led the public to increase its desired holdings of cash during November and December. Also, the post-Christmas and post-New-Year holidays in Europe seem to have led to some temporary build-up of uncleared foreign demand balances in U.S. banks at the year-end.

Table 6: ALTERNATIVE MEASURES OF QUARTERLY GROWTH IN THE MONEY STOCK

Annual rates, in per cent

Period	M_1		M_2		M_3	
	M	Q	M	Q	M	Q
1972—IV	9.9	8.4	10.6	10.2	11.8	11.8
1973— I	3.8	7.0	6.9	8.8	9.4	10.7
II	11.5	7.5	11.1	8.7	10.4	9.1
III	−.2	5.5	5.2	7.9	4.5	7.2
IV	7.5	3.9	10.1	8.5	9.2	7.3

M = Rates calculated from daily-average levels in the final months of the current and the preceding quarters.
Q = Rates calculated from daily-average levels for all 3 months of the quarter.

Expansion in broader measures of the money stock also showed considerable monthly and quarterly variation over the course of 1973—though to a lesser extent than M_1. While shifts in M_2 and M_3 were affected by the underlying pattern of movements in M_1, flows of funds into consumer-type time deposits also exhibited significant changes during the year. These variations in the growth of thrift accounts reflected changes in the relative appeal of such deposits to savers, as spreads between ceiling rates on such accounts and the yields on competing market securities widened and then narrowed again over the course of the year.

The preceding review of changing growth patterns in the monetary aggregates has focused on rates of change between months at the ends of successive quarters. Because this approach provides a relatively current measure of recent tendencies, it has often been stressed by the FOMC in taking current policy action. To gain better perspective on the longer sweep of growth trends in the aggregates, however, it is useful to consider changes in average growth rates from one quarter to the next, where all months in the quarter are included. While this approach does not give quite so timely a measure of recent developments, it is less affected by temporary aberrations. Thus it provides a better perspective on the underlying thrust of policy. When data for 1973 are arrayed on the latter basis, they show more clearly (than the month-end to month-end measures) the underlying trend toward slower growth of the money stock during the year. Recent changes for both measures are shown in Table 6.

Bank credit and bank reserves. Changes in the bank credit proxy and in reserves against private nonbank deposits (RPD's) were also affected by special influences over the course of the year. For example, during the first quarter of 1973 when commercial paper rates rose relative to bank loan charges, encouraging such a rapid growth in bank loans to businesses, the expanded sales by banks of large CD's to accommodate these business demands contributed to a sharp acceleration in growth of the credit proxy. While this influence moderated significantly after introduction of the two-tier prime rate, growth in the proxy remained quite rapid during the second quarter, as the chart on page 43 suggests. In the fall, however, when commercial paper became cheaper than bank credit as a source of business funds, growth in business loans at large banks, in CD's, and in the credit proxy all slowed abruptly.

During 1973 the FOMC continued to use RPD's as an operating tool to help guide the Manager of the System Open Market Account in making the day-to-day adjustments in bank reserves needed to achieve the Committee's objectives for longer-run growth in the money and credit aggregates. However, relationships between given changes in the supply of RPD's and desired growth rates in M_1, M_2,

Table 7: GROWTH IN BANK RESERVES

Item	1972	1973	1973 I	1973 II	1973 III	1973 IV
	Annual rate, in per cent					
Total reserves	10.6	7.8	6.4	6.9	10.6	6.1
Reserves required to support private deposits (RPD's)	10.1	9.3	7.8	12.5	14.2	1.4
	In millions of dollars					
Memoranda:						
Total change in RPD's [1]	2,938	2,692	568	927	1,086	111
By type of deposit:						
Required reserves for:						
Private demand deposits [1]	1,481	539	30	154	67	288
Time deposits other than large negotiable CD's	871	896	139	187	309	261
Large negotiable CD's and nondeposit sources of funds [1]	487	1,232	470	559	730	−527
Excess reserves	100	25	−70	27	−21	89

[1] Figures have been adjusted for changes in reserve requirements.

and the credit proxy were even more difficult to predict than usual. The rapid expansion of large CD's in the spring and early summer, and their subsequent sharp contraction—at the higher marginal reserve requirement in effect since May—first absorbed and then later released large amounts of reserves. Because of these added complications, greater stress was placed in the implementation of monetary policy on the performance of the money and credit aggregates themselves as intermediate targets and less on RPD's.

Interest rates. In addition to focusing on the behavior of the money and credit aggregates, the FOMC took into account movements in market rates of interest. In the short run the Federal funds rate provides an especially sensitive guide to monetary policy since it is directly responsive to Federal Reserve actions. This is the rate that member banks that are temporarily short of deposits at the Federal Reserve pay to borrow such reserves for one day from member banks that have temporary excesses. When the System acts to expand or contract the total supply of reserves available to banks, its actions are quickly reflected in changes in the level of the Federal funds rate.

The general pattern of changes in interest rates also reflects the strength of credit demands. Consequently, when current and prospective credit demands are large, as they were in 1973, pressures on the financial institutions supplying funds tend to become cumulative and to lead to general advances in the whole complex of interest rates. This pattern of change is clearly indicated by the chart on page 37. All short-term rates followed the steep rise of the Federal funds rate during the first three quarters of 1973, although—for the reasons noted earlier—the bank prime rate lagged behind the commercial paper rate until early fall, and spreads between the Treasury bill rate and other short-term rates varied at key points in the year. The abrupt rise in long-term rates during the summer—with home mortgage rates experiencing the steepest advance—is also shown in the chart.

Some of the 1973 rise in interest rates to new historical highs undoubtedly reflected investor expectations of further inflation in domestic prices. However, long-term rates, which are the ones most affected by inflationary expectations, showed a relatively modest increase until the third quarter. Although such rates did move up rapidly in that quarter, the increase was largely reversed after short-term rates turned down in the fall.

Other policy actions. General advances in short-term market rates and aggressive efforts by banks during the first quarter of 1973 to finance large demands for business loans forced rates on longer-maturity bank CD's of $100,000 or more up against their regulatory ceilings early in the second quarter. Since rate ceilings on shorter-term CD's had been suspended much earlier—in the summer of 1970—the question arose whether such ceilings should be reimposed or whether the remaining CD ceilings should be suspended.

The Board of Governors elected in mid-May to suspend rate ceilings on all large CD's. This action was taken as part of a regulatory approach designed to minimize distortions in financial markets by restraining credit expansion through rising costs of funds, rather than through the quantitative limitations inherent in interest rate ceilings. To make this cost effect more significant, the Board imposed a supplementary reserve requirement of 3 percentage points on the amount by which the outstanding volume of CD's and similar instruments exceeded the average of such deposits outstanding at mid-May, or $10 million, whichever was greater.[1] By late August, when the offering rate on CD's reached 10.50 per cent, this action had increased the cost of CD funds to banks by more than 35 basis points. A further supplementary 3 per cent reserve requirement was imposed in late September, following a sharp, further rise in outstanding CD's, and then removed in early December when the Middle East oil crisis raised questions about the economic outlook.

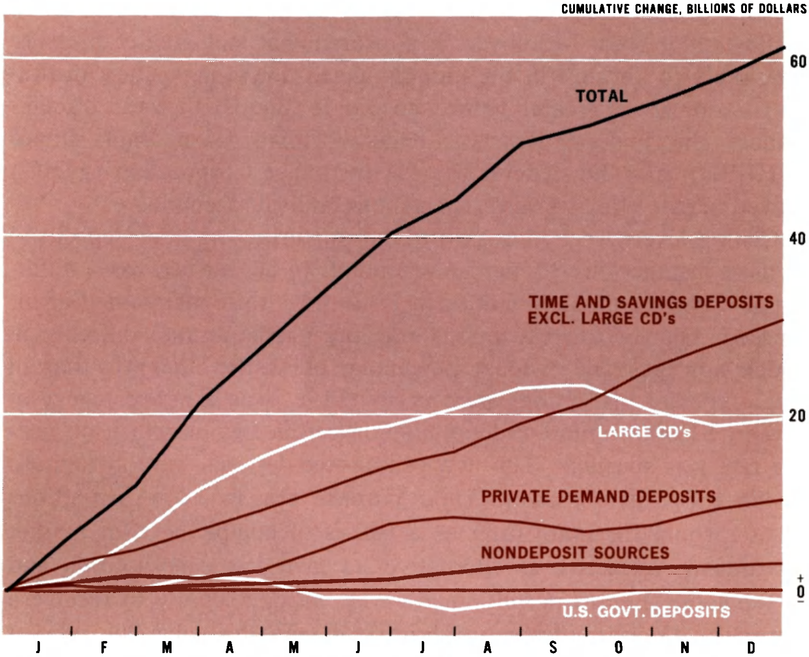
The suspension of rate ceilings and the imposition of supplementary reserve requirements on CD's had the combined effect of permitting banks to bid freely for CD funds, while at the same time increasing the cost of such funds. These costs were passed on to customers—chiefly large business borrowers—in the form of higher interest rates, and in this way they exerted a marginal constraint on credit expansion. At the same time, adoption of this new technique put the banks on notice that additional marginal increases in reserve requirements might be forthcoming if bank credit were to expand too rapidly.

In addition to these marginal reserve requirement actions, a more general change in reserve requirements was adopted in June (to become effective in July) as a means of reinforcing the increasingly restrictive thrust of open market operations. In this case reserve requirements were raised by ½ percentage point on all member bank

[1] At the same time Euro-dollar reserve requirements were reduced from 20 to 8 per cent and the reserve-free base for Euro-dollars was reduced in several steps that would result in its complete elimination by March 1974. These changes made the requirements on Euro-dollar funds comparable to those on CD's and similar finance instruments (including the marginal 3 per cent requirement).

When the Board imposed the new reserve requirement on member bank CD's in May, Chairman Burns, on behalf of the Board, sent a letter to key nonmember banks requesting their cooperation in conforming to the new regulations. Specifically, such banks were requested to hold reserve deposits against increases in large CD's and in net borrowings from foreign banks in excess of base-period levels.

MAJOR SOURCES OF BANK FUNDS, 1973



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.

demand deposits in excess of $2 million. The action absorbed a little more than $850 million of bank reserves.

DISINTERMEDIATION

As noted earlier, rising market rates during the spring began to exert growing pressures on flows of funds into consumer-type thrift accounts at financial intermediaries. Because the boom in the housing market had created a huge demand for mortgage credit, and because the level of mortgage commitments outstanding at savings and loan associations and mutual savings banks had expanded to record levels, this deceleration in deposit growth placed these intermediaries in a substantial bind. Moreover, it appeared that still greater pressure was likely to develop in the months ahead unless depositary institutions were given greater leeway to bid for funds. In these circumstances the Federal Reserve, Federal Home Loan Bank Board (FHLBB), and the Federal Deposit Insurance Corporation (FDIC) moved in early July to raise rate ceilings on thrift accounts.

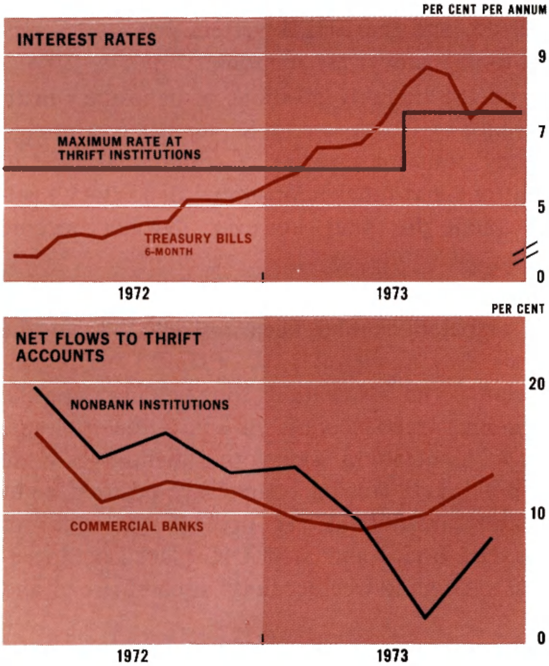
Ceiling levels were increased for all maturities of time deposits—in most instances by ½ percentage point. In all but two cases differentials favoring the nonbank thrift institutions were maintained or increased. One of the exceptions was the passbook rate differential, which was cut from ½ to ¼ percentage point; the other was that all three types of institutions were permitted to issue a new category of 4-year, $1,000 minimum-denomination certificates on which no ceiling rate was specified. The new ceiling-free deposits were introduced on an experimental basis. Their purpose was to allow institutions greater room for innovation as a means of competing with market instruments attractive as alternatives to saving in deposit form, and at the same time to permit small savers an opportunity to receive a return on their savings more consistent with the value the market was placing on those funds.

Following the liberalization of rate ceilings, depositary institutions moved aggressively to counter the effects of rising market rates on their deposit flows. Promotion of the 4-year, ceiling-free deposits was particularly active. While there was considerable variation in the terms offered on such accounts—with a few institutions linking their rates to price indexes, to market rate series, or to the commercial bank prime rate, and quoting rates as high as 9 per cent—the bulk of the rates offered ranged between 7 and 7½ per cent.

During the summer all types of depositary institutions suffered declines in passbook accounts. But these run-offs were offset in varying degrees by inflows to certificate accounts—largely the ceiling-free deposits. Commercial banks fared best—maintaining the same 10.4 per cent seasonally adjusted annual rate of growth for all consumer-type time and savings deposits as had been recorded in the second quarter. Deposits at nonbank thrift institutions, which would have registered a substantial decline had it not been for interest crediting in this period, grew at a seasonally adjusted annual rate of only 2.0 per cent for the quarter.

Although rates on ceiling-free accounts that were tied to various indexes were most prevalent at banks, thrift institutions generally were offering average rates as high as, or higher than, those at banks. This may indicate that banks had somewhat greater success than thrift institutions in holding their old accounts. If so, the inter-

SELECTED INTEREST RATES AND THRIFT DEPOSIT GROWTH



NOTE.—Interest rates: Monthly data. Treasury bills, averages of daily rates on 6-month bills. Thrift institutions, averages of highest ceiling rates payable on consumer-type deposits at mutual savings banks and savings and loan associations. During the period July 1–Oct. 31, 1973, when the rate ceiling on 4-year, $1,000 minimum-denomination consumer-type certificates of deposit was suspended, most institutions offered rates no higher than 7½ per cent on these deposits.

Net flows are quarterly changes, at seasonally adjusted annual rates, in consumer-type time and savings accounts at commercial banks, in total deposits at mutual savings banks. and in savings capital at savings and loan associations.

est rate differential that has long existed in favor of the nonbank thrift institutions may have resulted in a concentration of the more interest-sensitive consumer-type funds in those institutions, which would suggest that competition from high market rates was greater for them than for banks. Active efforts by the nonbank institutions in recent years to expand their high-yielding, certificate-type accounts no doubt contributed to this apparently higher degree of interest sensitivity.

The lack of new deposit inflows necessitated sharp adjustments in the portfolios of nonbank thrift institutions. Liquidity ratios declined significantly, facilitated in the case of the savings associations by a lowering of liquidity requirements by the FHLBB. Commercial bank lines of credit were utilized, and the FHLB System provided a record amount of advances to its member associations.

As general pressures on the liquidity positions of depositary institutions intensified, the Board of Governors on September 6 approved in principle a contingency plan for emergency credit assistance to savings and loan associations and other nonmember depositary institutions. Action to implement this plan, however, did not become necessary in 1973.

At the start of the experiment with 4-year, ceiling-free accounts, only savings and loan associations had been restricted as to the amounts of such accounts they might offer; the FHLBB had established a limit at 5 per cent of an association's outstanding deposits. Depositors sought the ceiling-free accounts in substantial volume, however, and a number of associations soon found themselves close to their limits and in a potentially weaker competitive position compared with other depositary institutions. To prevent distortions of flows among institutions, the Board and the FDIC placed comparable 5 per cent restrictions on ceiling-free accounts at commercial and mutual savings banks.

Despite this regulation, commercial banks achieved better deposit flows than nonbank thrift institutions during the summer, and this led in October to legislation requiring the Federal regulatory bodies to place rate ceilings on all categories of consumer-type time and savings accounts. To implement this legislation, ceilings of 7¼ per cent for commercial banks and 7½ per cent for mutual savings banks and savings and loan associations were established on the 4-year accounts, effective November 1.

By late September, however, the worst of the deposit outflow problem for the nonbank thrift institutions had already passed. By that time short-term interest rates had eased from their historic peaks, and a considerable proportion of interest-sensitive deposits apparently had been shifted into market instruments. Deposit growth at thrift institutions accelerated in October and attained an 8.0 per cent rate over the fourth quarter, while consumer-type time and savings deposits at commercial banks grew at a 12.5 per cent rate.

AGGREGATE FLOWS OF FUNDS

Funds raised by nonfinancial sectors of the economy during 1973 are estimated to have totaled $183 billion, compared with $166 billion in 1972. Although the increase in total funds raised was not appreciably different from the increase in 1972, there were considerable differences in credit market conditions in the 2 years. One clue to these differences is that the ratio of the flow of funds to nonfinancial sectors to GNP fell from 1972 to 1973, as it usually does during a period of increased credit stringency, rather than rising as it had in 1972. Furthermore, while total funds raised increased persistently from quarter to quarter in 1972, they dropped steadily in 1973 from a first-quarter peak. And beneath the aggregate data there were significant changes in the composition of fund flows that reflected governmental policies on interest rate ceilings, the differential effects of monetary policy on various sectors, and other factors.

One important change in the flow of funds in 1973 was the reduced role of the private financial institutions as providers of credit. Commercial banks, thrift institutions, insurance and pension funds, and other private financial intermediaries accounted for 66 per cent of the credit obtained by nonfinancial sectors—down from 83 per cent in 1972. In contrast, the portion supplied by private domestic nonfinancial lenders—notably households and businesses—rose from about 6 to 15 per cent. This, of course, is the counterpart of the phenomenon of disintermediation noted earlier.

Another sector accounting for an increased proportion of the Nation's credit supply was the Federal Government and the Federally sponsored credit agencies. Because of the important role that these agencies have come to play in supplying credit to the secondary mortgage market as well as to primary market lenders, the share of total funds supplied by the Federal sector reached 20 per cent in the third quarter, when deposit flows to thrift institutions were weakest; this was a sharp rise from the first-quarter ratio of 7 per cent.

Table 8: FUNDS RAISED IN CREDIT AND EQUITY MARKETS BY NONFINANCIAL SECTORS

In billions of dollars

Sector, or type of instrument	1972	1973	1973			
			I	II	III	IV
Total funds raised	**166.1**	**183.2**	**219.2**	**175.6**	**171.8**	**170.1**
By sector:						
U.S. Government [1]	17.3	9.7	32.7	1.2	−9.7	14.7
Other	*148.8*	*173.5*	*186.5*	*174.4*	*181.5*	*155.3*
Nonfinancial business	69.8	87.0	94.2	87.9	91.8	78.0
State and local governments	12.3	8.8	6.4	6.3	12.1	10.7
Households	63.3	70.9	71.7	73.1	77.0	61.8
Foreign	3.4	6.7	14.3	7.1	.7	4.8
By type of instrument:						
U.S. Government securities	17.3	9.7	32.7	1.2	−9.7	14.7
Corporate and foreign bonds	13.2	11.8	8.7	12.5	13.5	16.1
Corporate equities	10.0	5.5	4.0	6.0	3.9	8.2
State and local govt. debt [2]	11.9	8.9	6.1	6.5	12.3	10.7
Mortgages	*67.3*	*72.2*	*68.3*	*81.4*	*80.0*	*59.0*
Residential	50.0	52.0	50.5	60.5	56.8	40.4
Other	17.4	20.2	17.8	21.0	23.2	18.6
Bank loans n.e.c.	21.8	41.3	75.1	33.9	36.4	19.8
Open market paper	−1.6	2.5	−10.8	4.0	4.0	12.8
Consumer credit	19.2	22.9	25.7	24.7	22.5	18.8
Other loans	7.0	8.5	9.6	5.4	8.9	10.0

[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.

The proportion of credit supplied by the foreign sector changed over the course of 1973; after an extended period as a net supplier of funds, the rest of the world became a net demander during the last three quarters. In 1972 and the first quarter of 1973—before the U.S. dollar was allowed to float in foreign exchange markets—foreign central banks engaged in operations to support the dollar and through these actions they accumulated large holdings of dollars. These dollar accumulations were invested in U.S. securities, primarily marketable and nonmarketable Treasury issues. As the year progressed, however, the U.S. dollar gained strength—first on the basis of improved trade and balance of payments statistics, and later because of the differential impacts of the Middle East oil embargo. This led foreign central banks that were seeking to maintain exchange parities of their currencies to liquidate large amounts of their dollars assets.

The volume of credit supplied by the commercial banking sector was exceptionally large, but it declined strikingly as the year progressed. Expansion of bank loans and investments occurred at a rapid pace in the first quarter, moderated in the next two quarters, and then slowed to a very modest rate in the last quarter of the year. Loans outstanding increased by $69 billion over the year. While

Table 9: FUNDS SUPPLIED TO NONFINANCIAL SECTORS IN CREDIT AND EQUITY MARKETS

In billions of dollars

Sector supplying	1972	1973	1973			
			I	II	III	IV
All sectors	**166.1**	**183.2**	**219.2**	**175.6**	**171.8**	**170.1**
U.S. Govt. and sponsored credit agencies	8.3	21.7	14.9	23.2	34.8	14.3
Federal Reserve System	.2	9.3	20.5	3.5	1.4	12.0
Foreign sources	10.7	4.6	36.7	−8.1	−7.6	−2.5
Private financial institutions	*165.8*	*168.9*	*214.2*	*183.0*	*151.4*	*126.8*
Commercial banking	69.8	85.3	114.2	88.6	79.8	58.5
Savings institutions	49.3	35.6	57.3	42.0	22.7	19.9
Insurance and pension funds	32.5	35.9	37.7	35.4	33.2	37.7
Other	14.2	12.1	5.0	17.0	15.7	10.7
Net funds raised in credit and equity markets by financial institutions [1]	28.4	48.7	50.3	55.2	69.9	19.3
Funds advanced by private domestic nonfinancial sectors in credit and equity markets [2]	*9.6*	*28.3*	*−16.7*	*29.2*	*61.8*	*38.9*
Households	3.1	12.5	−19.2	16.0	40.4	13.0
Nonfinancial business	4.6	14.3	6.2	15.4	16.0	19.5
State and local governments	2.0	1.5	−3.7	−2.1	5.3	6.3
MEMO: Net change in deposits and currency held by private domestic nonfinancial sectors	102.2	90.6	124.7	97.0	66.8	74.0

[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.

bank investments in "other" securities also expanded—by about $11 billion—all but $2 billion of this portfolio increase was offset by liquidation of Treasury issues.

In an examination of the composition of the demand for funds in 1973, strength of business, mortgage, and consumer instalment credit stands out clearly, as the chart on page 39 shows. This strength was most pronounced in the first half of the year when real economic activity was strongest and before interest rates rose to their highest levels. In contrast, the credit demands of State and local governments and of the Federal sector were relatively moderate. Most State and local units enjoyed more comfortable financial positions as a result of Federal revenue sharing and of large tax revenues generated by rapidly rising incomes. The volume of tax-exempt bond offerings was down slightly from 1972, despite the continued rapid growth of industrial revenue bonds for pollution control. In the Federal sector rapid growth of tax revenues, in combination with restraints on expenditures, reduced the Treasury's unified budget deficit to a level

Table 10: U.S. GOVERNMENT FINANCE

In billions of dollars

Item	Calendar year		
	1971	1972	1973
Deficit	**24.8**	**17.4**	**7.9**
Amount financed by changes in cash assets and other items	....	2.1	....
Total borrowing from public	**24.8**	**15.3**	**7.9**
Net Federal Reserve purchases of Treasury securities	8.1	− .3	8.6
Net Treasury borrowing from private investors:			
Marketable:[1]			
Foreign	15.5	4.5	−5.4
Other	−11.9	3.4	−4.1
Nonmarketable:			
Foreign	10.9	3.9	5.6
Other	2.2	3.8	3.2
Memoranda:			
Net borrowing by Government sponsored agencies	1.1	3.5	16.3
Federal Reserve purchases of agency issues	.5	.8	.6

[1] Includes Treasury securities as well as securities issued directly by budget agencies. The ownership distribution is approximate.

far below earlier projections; thus the limited demands of the Treasury provided an offset to the substantial needs of Federally sponsored credit agencies.

Consumer demands for durable goods remained exceptionally strong in the first quarter of the year. The $25.3 billion annual rate of increase in consumer credit outstanding during that quarter was only slightly below the record of the previous quarter; commercial banks accounted for more than one-half of the gain. As was indicated earlier, the growth in consumer expenditures for durable goods declined after the first quarter and became negative in the fourth quarter when auto sales declined markedly, for the most part because of the fuel shortage. As of mid-1973 the ratio of consumer indebtedness to disposable personal income stood at a record high, and loan delinquencies were unusually large for a business cycle expansion.

Also adding to the debt burden of the household sector was the massive growth of mortgage debt. Growth of such credit reached a record volume in the second quarter of 1973, but it continued to expand at nearly as fast a pace in the third quarter, as borrowers took down prior commitments for loans. As the year progressed, however, the rate of growth in mortgage debt was affected by the cutback in housing starts that had begun in the spring. While thrift institutions played their customary role as the leading providers of residential mortgage credit during 1973, commercial banks accounted for a substantial proportion of the flow of funds to the mortgage market. For the year as a whole these banks supplied $18.9 billion of mortgage credit, up from $16.8 billion in 1972; in contrast, the amount of funds supplied by the thrift institutions declined from $37.6 billion to $32.3 billion. An increase in credit from Federally sponsored agencies provided a partial offset to the reduced participation of the thrift institutions.

The nonfinancial business sector acquired $87 billion from the credit and equity markets in 1973, a 25 per cent increase over the preceding year. The exceptionally large flow to businesses in the first quarter was attributable in part to the use of bank loans to finance purchases of higher-yielding liquid assets, such as large CD's, and to reduce outstanding commercial paper debt. For the year as a whole, however, the dominant factor in explaining business demands in the credit and equity markets was the growing gap between capital outlays and internal funds generated. Needs for external funds normally expand at a rapid rate in the advanced stages of a business cycle, but during 1973 special factors were also limiting the growth of internal funds—notably, exhaustion of available tax-loss carry-forwards and the liberalization in mid-1973 of CID restraints on dividend payouts.

The external financing requirements of businesses in 1973 were met largely in the debt markets—in particular, short-term debt markets. Equity financing was not attractive because share prices showed substantial declines during most of the year. Offerings of corporate bonds were considerably less than in 1972; in fact, the volume of publicly offered bonds was the smallest since 1969. Given the improvement in their liquidity positions over the period since 1970, corporations apparently felt that they could, without undue risk, postpone long-term financings in the hope of obtaining lower long-term rates later. As short-term rates remained relatively high toward the end of 1973, and as prospects for inflation worsened, calendars of issues of new corporate bonds began to build up—perhaps indicating a shift in interest rate expectations and a movement to fund short-term debt.

The initial focus of the heavy demands by businesses for short-term credit was on the commercial banking system. Restraints imposed by the CID on the bank prime rate had led, by late 1972, to the development of a rate spread that favored borrowing from banks as opposed to the sale of commercial paper. Thus large corporations were heavy demanders of bank loans, and so too were smaller firms for which banks are the only regular source of credit. Furthermore, as market rates of interest rose and commercial banks raised their offering rates on large CD's, some prime borrowers perceived an opportunity to arbitrage by borrowing at the artificially low prime rate and then relending at the CD rate. As a result, the expansion of business loans at commercial banks reached a record level in the first quarter of 1973 while commercial paper outstanding dropped sharply. Total business credit, however, still increased at a record rate.

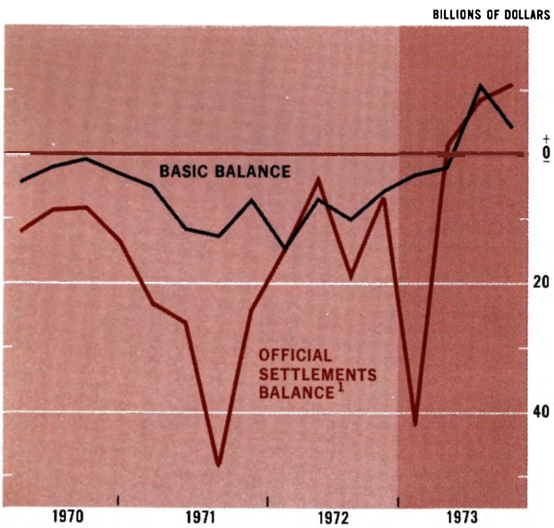
During the late spring and summer, rate differentials began to shift in the direction of favoring borrowing in the commercial paper market—a movement that was influenced by the two-tier prime rate concept introduced by the CID in April, and by the imposition of marginal reserve requirements on large CD's and selected nondeposit liabilities, noted earlier. Growth in business loans at banks decelerated in the second and third quarters, while commercial paper gradually resumed a positive trend. In September, however, market rates of interest dropped sharply, causing commercial paper rates to decline relative to the bank prime rate. During the fourth quarter business loan growth at banks was quite moderate, as commercial paper expanded rapidly.

International Developments

During 1973 the U.S. balance of payments registered steady gains in the goods and services balance, and net flows of private long-term capital were inward for the year. As a result the basic balance (current account plus long-term capital flows) for the year moved into surplus for the first time since 1957, a striking reversal of the $10 billion basic deficit in 1972.

In the early part of the year, however, confidence that the balance of payments would recover was at a low ebb and massive flows of funds into other currencies precipitated a second devaluation of the dollar in February. Subsequently six of the members of the Euro-

U.S. BALANCE OF PAYMENTS



[1] Excludes SDR allocations.
NOTE.—Dept. of Commerce data at seasonally adjusted annual rates; fourth quarter partly estimated.

pean Economic Community (EEC) allowed their currencies to float against the dollar, while remaining fixed among themselves. After a period of stability in the spring, the six EEC currencies, led by the German mark, appreciated against the dollar as well as against the Canadian dollar, the British pound, and the Japanese yen. By July the dollar had dropped substantially relative to EEC currencies, and on a weighted average basis the dollar exchange rate against 10 leading foreign currencies was about 23 per cent below the level of May 1970 and 15 per cent below the level at the start of 1973.

Exchange rates stabilized after the middle of July following moderate amounts of intervention by the Federal Reserve and the German Federal Bank. In the autumn the exchange rate for the dollar began to appreciate markedly, reflecting improvement in the U.S. trade balance. A major new impetus to the strengthening of the dollar was imparted by the actions of the Middle East oil producers in announcing limitations on production in October, followed by the more than threefold boost in the price of oil exports by the producing countries in two steps in October and December.

Limitations on supply, even if applied most severely to the United States, were expected to be more harmful to the economies of other countries more dependent on oil imports as a source of energy for industry. When increases in production were resumed, attention shifted to the huge increases in the monetary reserves of oil-producing countries that would result if the new price structure were sustained, and the general view was that these asset accumulations would tend to strengthen the dollar relative to other currencies because of the likelihood that U.S. money and capital markets would provide the best opportunity for absorbing investment flows of such potential magnitudes, both directly and through the Euro-dollar market.

Recovery in the U.S. balance of payments was supported by the continuing effects of the exchange rate changes that had begun in 1970, and also by the steep rise in the quantity and price of agricultural exports. Economic activity abroad continued to advance, supporting export gains, while real output in the United States was slowing down, reflecting in part supply bottlenecks. The improvement in the trade balance during the year, in real terms, was a considerable offset to the slackening in the growth of effective demand in other sectors of the economy. However, while rising demands abroad aided the U.S. trade balance, they also added to upward pressures on prices, especially for world-traded basic commodities, and helped to expose a growing problem of imbalances between demand and available supply.

Despite supply problems and the gyrations in exchange rates, world trade in real terms grew at a phenomenal rate in 1973. At times pressures on particular exchange rates became severe and led either to sizable interventions by monetary authorities or to wide fluctuations in exchange rates, but on the whole the successive crises were accommodated by the market without major disruption.

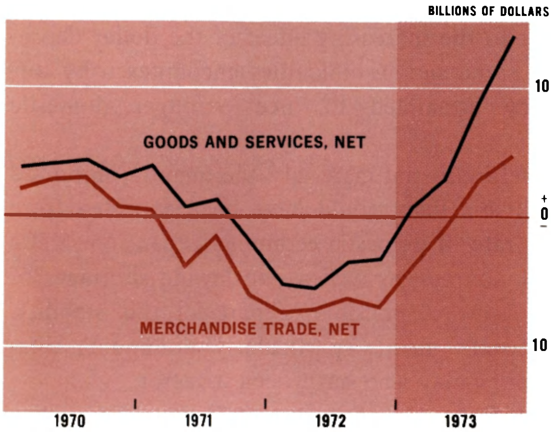
As the year ended, the improvement in the exchange value of the dollar accelerated, despite large sales of dollars by some foreign monetary authorities. During January 1974 the weighted-average exchange rate for the dollar came near the rate at the beginning of 1973. In view of the change in the balance of payments outlook, the controls on outflows of U.S. private capital were relaxed in December 1973 and terminated in January 1974. A moderate drop in the exchange value of the dollar followed the termination.

PROGRESS TOWARD EQUILIBRIUM

The U.S. trade balance swung into a small surplus in 1973, the first surplus in more than 2 years and a dramatic turnaround from the $7 billion deficit in 1972. Exports rose very steeply, by nearly 45 per cent, while imports increased by a more moderate 25 per cent. The expansion in exports was paced by an exceptionally large rise in shipments of agricultural commodities as harvests outside the United States were far below normal and the U.S.S.R. and People's Republic of China became large purchasers of U.S. farm products. Price increases accounted for over two-thirds of the increase in the value of agricultural exports in 1973, as world demand exceeded available supplies.

Exports of nonagricultural commodities also rose quite sharply—by over 30 per cent—in 1973. More than half of the increased value of such exports reflected larger volume. Major reasons for the growth in nonagricultural exports were the strong economic expansion abroad and the cumulative effects of the depreciation of the

GOODS AND SERVICES



NOTE.—Dept. of Commerce data at seasonally adjusted annual rates.

dollar that had begun in 1970 and had made U.S. goods much more competitive in world markets. Also the tightening of price controls in June held domestic prices of some goods below world prices (in dollars) of comparable products, encouraging export sales at higher dollar prices by domestic producers of fertilizers, chemicals, and various metals. This incentive to export was partially removed later in the year as the Cost of Living Council removed or relaxed domestic price controls on metals and fertilizers.

As a result of the exceptionally rapid growth in the volume of U.S. exports of manufactures, the U.S. share of total world trade in manufactures rose in 1973, after many years of decline.

The increase in the value of imports in 1973 stemmed almost entirely from higher prices; import volume remained stable except for fuels, which increased steadily throughout most of 1973. Near the end of the year, however, the volume of oil imports dropped as a consequence of the embargo by Middle East oil-producing countries.

The volume of nonfuel imports in 1973 was very slightly higher than in 1972, and this behavior was evident in most major import commodity categories—automobiles and other consumer goods, industrial materials (other than fuels), and foodstuffs. Only in capital equipment did the volume of imports rise strongly. The decline in the import volume of other types of finished goods is probably attributable in large part to the increasing effect of the dollar depreciations, combined with some supply difficulties encountered by foreign producers as they attempted to meet stronger domestic demands.

With respect to nonfuel industrial materials, the quantity imported rose only slightly, much less than would have been expected from past relationships to the rate of domestic economic expansion. Shifts of user demands to U.S. sources, as well as worldwide shortages of these goods, apparently were responsible in part for this stability. Increased availability of some metals (particularly aluminum) from U.S. Government stockpiles may also have been a factor.

Improvement in the U.S. trade balance in 1973 was reflected in balances with most areas. The trade deficit with Japan, which had persisted for many years and had totaled $4 billion in 1972, fell to about $1¼ billion in 1973, with only small monthly deficits recorded in the second half. The trade balance with Western Europe, which had shifted from a traditional surplus with those countries to a deficit in 1972, swung back into a substantial surplus in 1973. The trade balance with the less developed countries as a group also improved in 1973. The balance with Latin America and the Middle East countries improved despite the increase in oil imports from those regions, but a trade deficit with Africa developed because of larger oil imports from that area. A considerably enlarged trade surplus with Eastern Europe in 1973 reflected the heavy shipments of grain and soybeans to the U.S.S.R.

The outlook for the U.S. trade position in 1974 depends, to a considerable degree, on the effects of the present energy crisis. The import bill for petroleum could rise to more than $20 billion in 1974 compared with about $8 billion in 1973, even if quantities continue to be reduced by the embargo. Prospects for exports are clouded by the possibly severe effects of the energy problem on economic growth in other industrial countries and on the import capabilities of some developing countries whose oil import costs may be especially burdensome. In addition, one effect of the recovery in the value of the dollar in the exchange markets since mid-1973 is likely to be the erosion of some of the competitive shift derived from the earlier rate movements.

The usual U.S. surplus from investment income and services increased substantially in 1973, rising to a total of nearly $6 billion, more than double the surplus in 1972. Returns on U.S. investments abroad rose very sharply (in terms of dollar amounts) as a result of the change in exchange rates, stronger economic activity abroad, and higher petroleum prices. Interest payments to foreigners on their assets in the United States also rose in 1973, but more moderately. Sales of military equipment to foreigners increased sharply while military expenditures abroad showed little change. Also, receipts from foreign travelers to the United States rose more than expenditures abroad by U.S. travelers.

Flows of long-term private capital tended to strengthen the U.S. balance in 1973, despite a major outflow of U.S. direct-investment capital early in the year when further depreciation of the dollar was expected. Thereafter outflows by U.S. investors diminished, while foreign investors placed record amounts in the United States to purchase equity securities and to finance growing foreign direct investments in this country. Net foreign purchases of U.S. corporate stocks were nearly $3 billion for the year.

Inflows of foreign capital for direct investment, that is, investment involving a substantial voice in management, appear to have approached $2 billion in 1973—far exceeding any previous experience. Such inflows were spurred in part by the lower exchange value of the dollar and the consequent rise in the relative advantage of producing goods in the United States. There may also have been some inflows directly or indirectly out of the rising revenues of the oil-producing countries. However, a factor of growing importance may have been the restoration of confidence in the comparative strength and stability of the U.S. economy.

Flows of U.S. private capital in shorter-term forms were strongly outward in the first quarter of the year—including large unrecorded outflows—but were a less significant element thereafter. After market rates of interest in the United States moved up sharply in the first half of the year, and the dollar strengthened in the market, there were inflows of foreign funds to U.S. banks.

Table 11: U.S. BALANCE OF PAYMENTS

In billions of dollars, seasonally adjusted

Item	1972	1973 [e]	1973 I	1973 II	1973 III	1973 IV [e]
Merchandise trade balance	−6.9	.7	−1.0	−.3	.7	1.2
Exports	48.8	70.3	15.3	16.8	18.2	20.0
Imports	55.7	69.6	16.3	17.0	17.4	18.9
Services, net	2.3	5.8	1.1	.9	1.4	2.3
Balance on goods and services	−4.6	6.4	.2	.7	2.2	3.5
Remittances and pensions	−1.6	−1.8	−.4	−.4	−.4	−.6
U.S. Govt. grants and capital, net	−3.5	−3.6	−.7	−.6	−.9	−1.5
Long-term private capital, net	−.2	.9	−(1)	−.3	1.7	−.4
Balance on current account and long-term capital	−9.8	1.9	−.9	−.6	2.5	.9
Nonliquid short-term private capital, net	−1.6	−4.0	−1.8	−1.4	.2	−1.0
Errors and omissions	−3.1	−5.8	−3.8	.4	−1.2	−1.2
Liquid private capital, net	3.5	2.6	−3.9	1.9	.6	4.0
Of which: Liabilities to foreign commercial banks	3.9	2.9	−1.9	.7	.8	3.2
Official settlements balance (excluding SDR allocations)	−11.1	−5.3	−10.5	.3	2.1	2.7

[e] Estimated.

[1] Less than $50 million.

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

Late in 1973 a broad relaxation of the restraints on capital outflows from the United States was announced—and such controls were terminated in January 1974. At the same time other countries were reducing their barriers against inflows of foreign capital, reflecting the shift that had been occurring in balance of payments positions.

INTERNATIONAL MONETARY SCENE

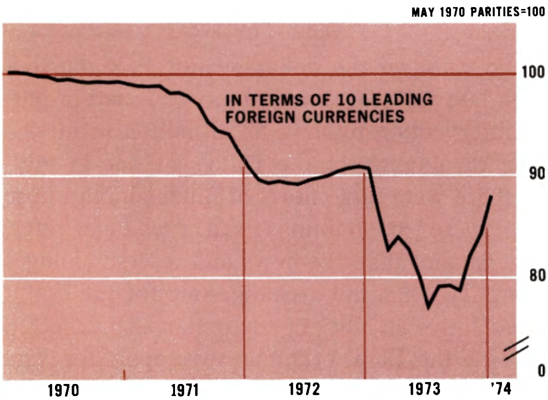
During 1973 financial and foreign exchange markets were affected strongly by changes in the outlook for the balance of payments of the United States and other major industrial countries. Early in the year the U.S. dollar came under severe selling pressure, as there was continuing skepticism about the prospect for adequate improvement in the U.S. trade balance in response to the Smithsonian realignment of exchange rates. Large flows of funds from the United States to EEC countries with strengthening trade positions—notably Germany

—produced a U.S. deficit on official reserve transactions of more than $8 billion in the first 2 weeks of February. Following the February 12 devaluation of the dollar by 10 per cent, there was a partial reversal of the earlier flows, but by early March renewed heavy demand for European currencies led to further large reserve gains by EEC countries; all official intervention in exchange markets ceased; and these markets were officially closed.

In early March six EEC countries (Germany, France, Belgium, Luxembourg, the Netherlands, and Denmark) plus Norway and Sweden agreed to maintain a fixed exchange rate relationship among their currencies, while permitting them, as a group, to float against the dollar. After exchange markets were officially reopened on March 19 on the new basis, the exchange rate for the dollar against these EEC currencies remained relatively stable until mid-May, when demands for EEC currencies increased sharply, reflecting in part political and economic uncertainties in this country and in part the strong German trade account and the progressive tightening of financial policies in Germany.

With the demand for German marks pulling rates for all EEC currencies higher against the dollar than they otherwise would have

INTERNATIONAL VALUE OF THE U.S. DOLLAR



NOTE.—Monthly-average market exchange rate of U.S. dollar against 10 major foreign currencies weighted by foreign trade in 1972. The weight for each currency is the share of that country's total trade (exports plus imports) in the total trade of the 10 countries plus the United States.

been, by mid-1973 the dollar had depreciated against the EEC currencies by an average of 15 per cent from its February level. The German mark was revalued at the end of June. However, the dollar remained strong against the currencies of our major trading partners —Japan and Canada—and, reflecting sales of dollars by Japan while most other central banks were not intervening in the market, there was actually a reduction in U.S. official reserve liabilities in the second quarter of the year.

By early July exchange markets for the dollar against EEC currencies had become disorderly. Beginning July 10 the Federal Reserve undertook intervention to stabilize the exchange rate for the dollar, drawing on recently enlarged swap lines, and sold $273 million of foreign currencies (marks, French francs, and Belgian francs) by the end of the month. This action was reinforced by coordinated purchases of dollars by the German Federal Bank and relaxation of a credit squeeze in the German interbank market. The appearance of central bank intervention, together with the joint statement on July 18 of the Chairman of the Federal Reserve Board of Governors and the Secretary of the Treasury that intervention would take place "in whatever amounts are appropriate for maintaining orderly market conditions," helped to restore exchange markets to more normal functioning. The dollar strengthened by about 3 per cent during the first weeks of August, and the Federal Reserve purchased the currencies required to repay the drawings it had recently made on the swap network.

Thereafter the exchange value of the dollar against EEC currencies changed little through late October; this stability reflected in part further Federal Reserve intervention totaling $236 million in marks, particularly following the revaluation of the Dutch guilder in mid-September. At that time there were large flows of funds among those European countries that were maintaining fixed exchange rates, although these flows were smaller than the flows and reserve changes that had occurred in February when the exchange rate for the dollar had also been fixed. The relative stability of the dollar also reflected continued sales of dollars by the Bank of Japan to support the yen. These sales led to an official settlements payments surplus for the United States of $2 billion in the third quarter.

At the end of October the demand for dollars began to increase markedly, reflecting a fundamental reassessment of the underlying strength of the U.S. balance of payments. The proximate cause for the shift was publication of a large trade surplus for the month of September, but of more lasting importance was the shift in market judgment concerning the impact on international payments of sharply higher oil prices. Between late October and the year-end the dollar had appreciated by 8 per cent on the average, despite central bank sales of substantial amounts of dollars. As a result the United States had a surplus of nearly $3 billion in the official reserve transactions balance during the final quarter of 1973. From year-end 1973 through late January 1974 the dollar appreciated still further, accompanied by heavy foreign central bank intervention. Following the removal of U.S. capital controls on January 29, and the subsequent decline in U.S. interest rates, however, the dollar depreciated and by late February was back to slightly below its year-end levels.

The periods of exchange market pressure during the year were accompanied by sharp increases in the market price of gold. When exchange markets stabilized, these increases were partly reversed, but the price of gold rose sharply again in early 1974. In mid-November 1973 the United States and the other participating European countries agreed to terminate the agreement of March 1968 regarding official gold transactions, removing an obstacle to official sales in the private market and thus permitting greater flexibility of action in the future.

Against the background of adjustment and accommodation to the strong forces that were influencing payments developments during 1973, officials continued to work on the development of agreed rules under which the international monetary system might function with more stability in the years ahead. The Committee of Twenty of the International Monetary Fund presented a First Outline of Reform at the Fund's annual meeting in Nairobi in September. This report set forth the general shape of a possible reformed system. Among other things it suggested a regime of stable but adjustable exchange rates, with provision for floating exchange rates in particular situations. After the Nairobi meeting, technical groups were organized to examine in detail various aspects of the system. These include the process of adjustment of payments imbalances; provisions for the settlement of international payments imbalances and for official intervention in exchange markets; global liquidity and the possible consolidation of outstanding reserve currency balances; and the transfer of real resources to developing countries.

While discussions of monetary reform issues look to the future functioning of international economic relationships, they are continuously influenced and modified by the changing economic environment and, in turn, provide one of the forums for dealing multilaterally with pressing current problems. The effects of the energy crisis on economic activity, and especially on international trade and financial relationships, were a major concern of the meeting of the Committee of Twenty in January 1974 and of the special conference on energy problems held in Washington in February.