Monetary Policy and the U.S. Economy in 1974

A Prelude to the Annual Report

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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Introduction

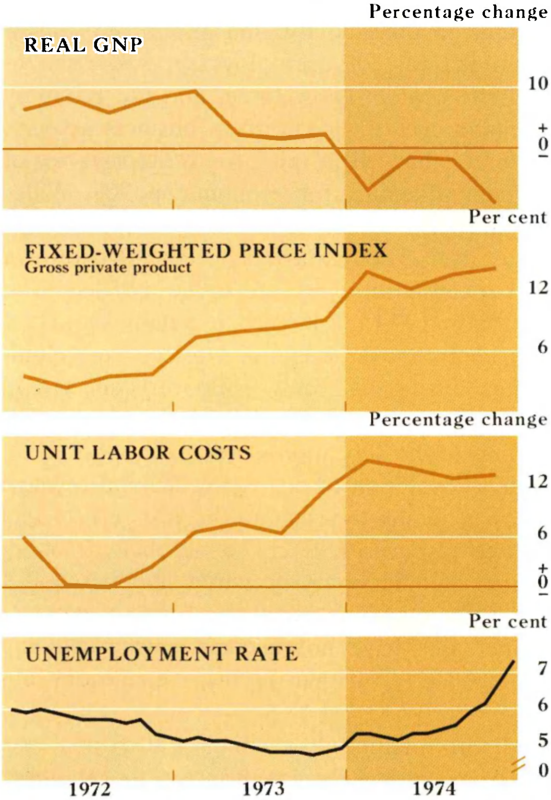
The performance of the U.S. economy during 1974 proved extremely disappointing. The persisting problem of inflation that had plagued the Nation since 1965 worsened appreciably; the general price level—as measured by the implicit deflator for gross national product—rose by more than 10 per cent, the largest increase since 1947. Equally disconcerting, if not more so, were the substantial declines that occurred in real output, in productivity, and late in the year in employment. By year-end the rate of unemployment had risen to more than 7 per cent of the civilian labor force, and the economy was in the midst of a general cyclical downturn in business activity.

The character of the forces that led to this unsatisfactory state of affairs presented a profound dilemma for economic policy. Widespread agreement exists that the United States must come to grips with inflation if seriously adverse consequences for the structure of financial, economic, and social institutions are to be avoided. The task of moderating inflation in 1974 fell largely to general monetary and fiscal policies; direct controls over wages and prices were eliminated in the spring, after having had only temporary success in moderating the increase in the average price level—and that at the cost of increasing distortions in the allocation of resources.

The effect on prices of a restriction of aggregate demand through monetary and fiscal policy generally lags behind the response of real output. However, the price response is likely to be elicited sooner when the proximate source of inflationary pressures is an excess of aggregate demand relative to aggregate supply and when expectations of further price increases have not become entrenched and pervasive. In 1974, unfortunately, neither of these conditions obtained.

The year 1974 opened with inflation proceeding at an annual rate of about 8 to 9 per cent. Expectations were widespread that the pace of price advance would continue unabated, or worsen. Real GNP had begun to decline in the first quarter—reflecting largely the effects of the oil embargo—and the gap between actual and potential real output widened over the course of the year. The rate of increase in the general price level, meanwhile, rose to the 12 to 14 per cent range in the first quarter and remained there through most of the year. Signs of moderation in the pace of inflation did not begin to appear until the closing months of 1974, after steep declines in real activity had occurred both here and abroad.

INDICATORS OF ECONOMIC PERFORMANCE



NOTE.—Changes for real GNP (based on data expressed in 1958 dollars) are at annual rates. Dept. of Commerce data.

Fixed-weighted price index: Change from preceding quarter compounded at annual rates based on seasonally adjusted data from Dept. of Commerce.

Unit labor costs are for all persons in the private nonfarm economy; percentage change from previous quarter compounded at annual rates.

Unemployment rate: Monthly data, seasonally adjusted, from Dept. of Labor.

What accounted for this stepped-up rate of inflation in the face of a growing gap between real aggregate demand and the productive capacity of the economy? Three factors deserve particular attention.

First, rising costs of petroleum and other energy products had a substantial influence on the over-all level of prices. At the retail level, prices of gasoline and motor oil in December 1974 were about 20 per cent higher than a year earlier, while costs of fuel oil and coal were 32 per cent higher. At wholesale, prices of fuel, power, and related products rose approximately 50 per cent in the 12 months ended in December 1974. Moreover, rising prices of energy and petrochemical products used as inputs in industry were an important factor driving up the costs of producing other manufactured goods. For example, prices of chemicals and allied products rose about 50 per cent at wholesale in the year ended in December 1974, and rubber and plastic products were up about 28 per cent over the same period.

Second, relaxation and ultimate termination of wage and price controls in April 1974 led to a bulge in prices of the sort that has occurred in other countries when direct controls have been removed. As noted earlier, controls had had only temporary success in moderating the pace of inflation; in early 1974, and indeed throughout 1973, the influence of the controls program had been waning. Nonetheless, some 2½ years of controls had given rise to serious distortions in relative prices and had also compressed profit margins in some industries. For many individual products, therefore, a substantial adjustment in prices was to be expected. The adjustments were particularly noticeable for finished goods—perhaps because price controls had been more effective in holding down the prices of those commodities. For example, wholesale prices of producers' finished goods had risen at an annual rate of around 5 per cent during the latter half of 1973; in 1974, however, the annual rate of increase jumped to 13 per cent in the first quarter, to 27 per cent in the second, and to 32 per cent in the third.

Third, shortages of many industrial materials, component parts, machinery, industrial equipment, and other commodities continued to plague the business community through the summer of 1974, despite the slowdown in general business activity. Excess demand in particular markets is not an uncommon condition, even when some slack exists in product markets generally. Nevertheless, the acute severity of shortages in 1974 was quite unusual in view of the sluggishness of consumer spending and the decline in residential construction that had been in process since early 1973.

The reasons for these shortages cannot be dealt with at any length here. Growth in export demands—reflecting the worldwide boom in economic activity during 1972 and 1973 and the devaluation of the dollar in international markets—was certainly a factor; so also was the relatively slow expansion earlier of productive capacity in major materials industries. But expectations of price increases and fears of continuing shortages were themselves a part of the problem, because they led to speculative buying of inventories to "jump the gun" on price increases, to hoarding of critical materials and supplies, and to ordering from several sources in the expectation that deliveries would be long delayed, if made at all.

While these three factors help to account for the step-up in the rate of price advance in 1974, they alone do not explain fully the severity of the inflation during the year. Underlying these special factors was an inflationary process that had begun much earlier and had become deeply embedded in the structure of wages, costs, and prices. The rate of increase in compensation per manhour, for example, had risen to around 8 per cent by the end of 1973, some 5 or more percentage points above the long-term rate of improvement in productivity. By the end of 1973, therefore, unit labor costs were already rising very rapidly and were putting substantial upward pressure on prices. Moreover, the rate of advance in unit costs accelerated in 1974—as productivity declined sharply and the rate of increase in compensation per manhour rose still further.

Unwinding from an inflation as pervasive as that which gripped the economy in 1974 takes time. Economic policy in 1974 did not endeavor to end the inflation at once, but it did seek to create conditions in which the process of unwinding would begin. To appreciate the accomplishments of fiscal and monetary policies in this regard, account must be taken of the significance of inflation for the movements of fiscal and monetary variables.

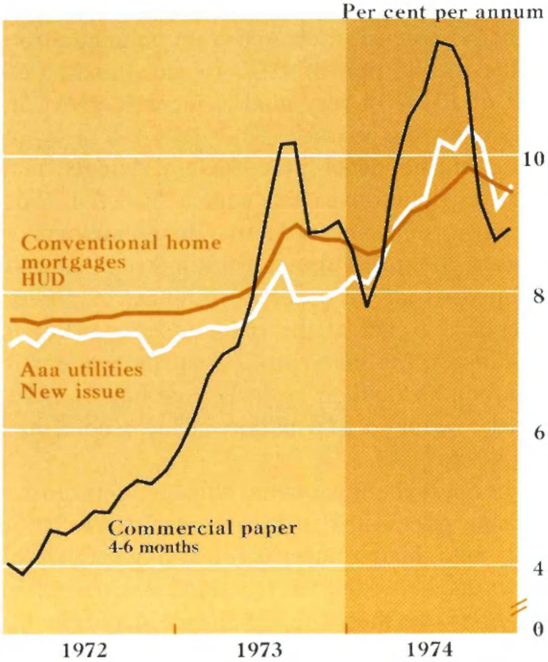
For example, total Federal expenditures as measured in the national income accounts (NIA) rose about 16 per cent from the latter half of 1973 to the latter half of 1974. This is a relatively large percentage increase by historical standards, but in large part it reflected rising prices. Federal receipts rose an estimated 13 per cent over the same period. The NIA deficit increased from an annual rate of about $2 billion in the second half of 1973 to an estimated $9 billion in the second half of 1974—a very modest increase given the steady slowing of activity over this period.

Despite this deepening of the deficit, the Federal budget may well have become more restrictive over the course of 1974. This interpretation is suggested by movements in the high-employment budget, in which receipts and expenditures are estimated as if economic activity had remained strong, in order to eliminate the effects on the budget of changes in the pace of the economy. According to Federal Reserve staff estimates, the high-employment budget was in surplus to the extent of around $5 billion in the second half of 1973, and the surplus increased to around $24 billion in the second half of 1974.

Most of this increase in the high-employment surplus occurred because of the effects of rising prices on Federal tax receipts. Inflation pushed many individuals into higher marginal tax brackets—even though their real income may have either remained unchanged or declined. Many corporations, furthermore, incurred increased tax liabilities in 1974 on what were in a sense fictitious profits—profits derived from the first-in, first-out method of inventory accounting, which fails to make allowance for replacement at higher prices of goods sold or used up in production. Thus, the inflation, by raising effective tax rates, significantly reduced the increase in disposable incomes of individuals and after-tax profits of businesses, and thereby contributed to a slowing of aggregate demand.

Monetary policy also contributed importantly to the moderation of aggregate demand in 1974. Federal Reserve policy had begun to move toward restraint in late 1972 and early 1973, but some relaxation of policy was needed during the winter of 1973–74, in an effort to compensate for some of the adverse effects of the oil embargo on economic activity. As a result of the reduction in private credit demands and the relaxation of monetary policy, interest rate levels by February of 1974 had fallen considerably below their pre-oil-embargo peaks, and growth rates of the principal monetary aggregates were appreciably above their lows of 1973.

SELECTED INTEREST RATES



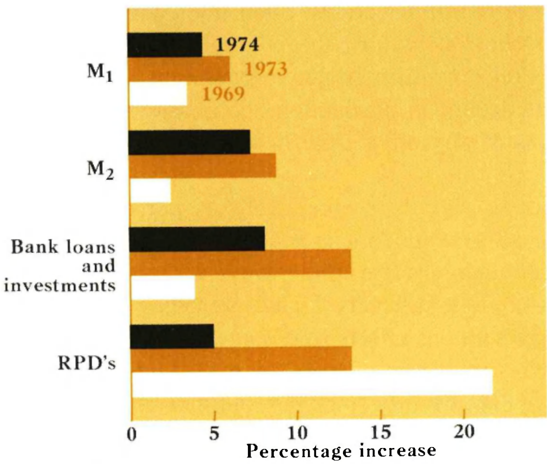
NOTE.—Monthly averages except for conventional mortgages (based on quotations for one day each month). Yields: prime commercial paper, dealer offering rates; conventional mortgages, rates on first mortgages in primary markets, unweighted and rounded to nearest 5 basis points, from Dept. of Housing and Urban Development; Aaa utility bonds, weighted averages of new publicly offered bonds rated Aaa, Aa, and A by Moody's Investors Service and adjusted to an Aaa basis.

When the threat to the economy from the oil embargo had passed, the Federal Reserve began again to exert pressure on bank reserves—chiefly through open market operations—to slow the rapid rate of expansion in money and bank credit. The Federal Reserve persisted in applying monetary restraint until late in the summer of 1974. At that time growth rates of the money stock and of bank credit were relatively sluggish, and signs of an impending cyclical downturn were multiplying. Monetary policy, therefore, began to move toward ease over the closing months of the year.

The amounts by which growth rates of the major monetary aggregates were reduced in 1974 were not unusually large. For example, total member bank reserves rose nearly as much in 1974 (7.1 per cent) as they had in 1973 (7.8 per cent). The narrowly defined money stock—M_1, which consists of currency and demand deposits—increased by 4.7 per cent in 1974, compared with 6.1 per cent in 1973. The growth rate of M_2, which includes also consumer-type time and savings deposits at commercial banks, declined from 8.8 per cent in 1973 to 7.4 per cent in 1974. The increase in total loans and investments of commercial banks did show a more appreciable moderation—from 13.5 per cent in 1973 to around 8.3 per cent in 1974. Nevertheless, as the following chart shows, the growth rates for the monetary aggregates in 1974 were well above those recorded in 1969, a prior year in which monetary policy had been quite restrictive.

In interpreting changes in these monetary variables, however, account must be taken of the effects of inflation on demands for money and credit. In 1969 the general price level was rising at a rate of around 5 per cent; in 1974, the figure was more than twice that amount. Thus, growth rates of the major monetary and credit

CHANGES IN MONETARY AGGREGATES



NOTE.—M_1 is currency plus private demand deposits. M_2 is M_1 plus commercial bank time and savings deposits other than large-denomination certificates of deposit (CD's). Loans and investments are adjusted to exclude domestic commercial interbank loans. RPD's are reserves available to support private nonbank deposits. Changes are calculated from December to December.

aggregates were actually very low in 1974 relative to demands for money and credit. In these circumstances the usual signs of severe financial restraint began to develop: Interest rates rose to unprecedented levels; stock prices plummeted; the mortgage market came under severe pressure; and the availability of loanable funds to other borrowers was curtailed.

Monetary and fiscal restraints worked jointly to moderate aggregate demand in 1974, but the volume of spending in the private sector was curbed also by several other factors. Prominent among these was the sharp rise in the price of imported oil, which transferred a substantial amount of purchasing power from U.S. consumers and businesses to the oil-exporting nations. Rising prices also resulted in transfers of real income among various economic sectors within the United States—although the effects of such transfers on aggregate expenditures are problematical—and they led to a sharp decline in the real value of financial asset holdings, which must have exerted a substantial, depressing effect on current spending and on spending plans.

All of these dampening effects on aggregate demand in 1974, moreover, occurred at a time when the economic expansion was losing momentum, and when imbalances were beginning to develop between inventories and sales and between production of capital goods and production of consumer goods. Such imbalances are often the precursors of a cyclical downturn in economic activity, as they were in 1974. When that downturn began to cumulate in the fourth quarter of the year, the decline in production and employment proved to be about as steep as at any other time in the period since World War II.

Weakness in economic activity seems likely to persist well into 1975—judging by the adverse tendencies evident in recent economic data. However, corrective forces are under way: Excess inventories in the auto industry—though still very high—are being worked off; businesses are making strenuous efforts to cut costs; residential building permits have shown some signs of stabilizing; conditions in financial markets have eased significantly since last summer; and the freeze in the mortgage market has begun to thaw. Fiscal actions to bolster purchasing power are under active consideration, and they are likely to be stimulating consumer and business spending before too long.

The tasks for economic stabilization policy in 1975 are indeed formidable. Clearly, a prime requisite is to cushion the forces of recession and to enhance the chances for an early and vigorous recovery in real economic activity. But great care must be taken to avoid releasing a new wave of inflationary forces.

These two objectives are not necessarily inconsistent. The special factors giving rise to a stepped-up pace of inflation in 1974 are now largely behind us, and the rate of increase in prices has begun to moderate in recent months in response to growing slack in labor and product markets. In this environment, temporary fiscal and monetary stimulants could be expected to have their principal effects in 1975 on real output and employment, and not on prices. But fiscal and monetary policies must not be permitted to depart too much, or too long, from the posture needed over the longer term to ensure an eventual return to price stability. □

Demands for Goods and Services

In 1974 the economic expansion that had been under way since late 1971 came to a halt. For the year as a whole, GNP in current dollars increased about 8 per cent, but this rise was more than accounted for by higher prices; real GNP declined by more than 2 per cent compared with a 6 per cent increase in 1973.

The sources of the recessionary trend that developed during the year were diverse. Early in the year the weakening of economic activity appeared to be selective, affecting mainly energy-intensive and related activities. As the year progressed, however, reduced demands became the dominant factor. By autumn the weakness in purchases and in industrial production began to spread to nearly all sectors of the economy. Employment dropped sharply in November and December, and by the year-end unemployment had risen to 7.2 per cent. Employment fell further in January 1975, and the unemployment rate rose to 8.2 per cent.

A major factor accounting for the dampening of demands in 1974

Table 1: GROSS NATIONAL PRODUCT

Type of measure	1972	1973	1974	1974 [1]			
				Q1	Q2	Q3	Q4
	In billions of dollars						
Current dollars	1,158	1,295	1,397	1,359	1,384	1,416	1,430
1958 dollars	793	839	821	831	827	823	804
	Percentage change from preceding period (at annual rate)						
Current dollars	9.8	11.8	7.9	4.5	7.6	9.7	4.0
1958 dollars	6.2	5.9	−2.2	−7.0	−1.6	−1.9	−9.1
Implicit deflator	3.4	5.6	10.3	12.3	9.4	11.9	14.4

[1] Quarterly data are seasonally adjusted annual rates.

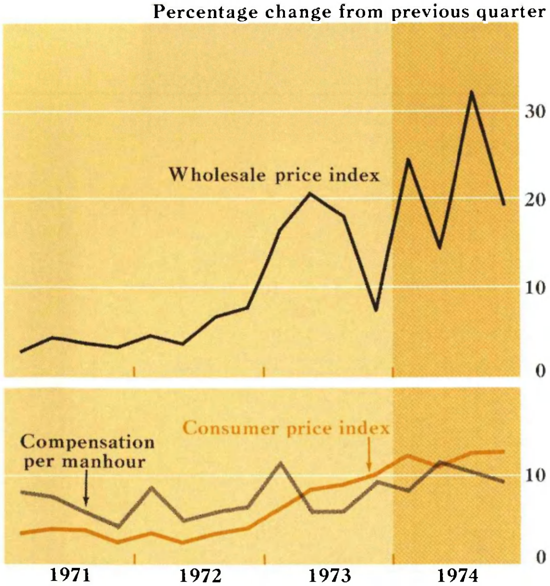
NOTE.—Dept. of Commerce data.

was the severe and pervasive rise in prices—the worst inflation since the period immediately following World War II. Consumer prices in December were 12 per cent above a year earlier. Wholesale prices had risen even more than that, and for industrial commodities the increase was more than 25 per cent. However, by year-end there were indications of some abatement in price pressures, with prices of sensitive industrial commodities down sharply and slower rates of increase in wholesale and consumer prices.

The reduction in total output early in 1974 was associated largely with the effects of the oil embargo. Most adversely affected were sales of large-size cars, but recreational and other activities closely related to the use of fuels were also hard hit. However, output of materials and business equipment remained close to record levels. Shortages of many products continued to be widely reported.

After the embargo ended in April, demands that had been

PRICES AND COMPENSATION



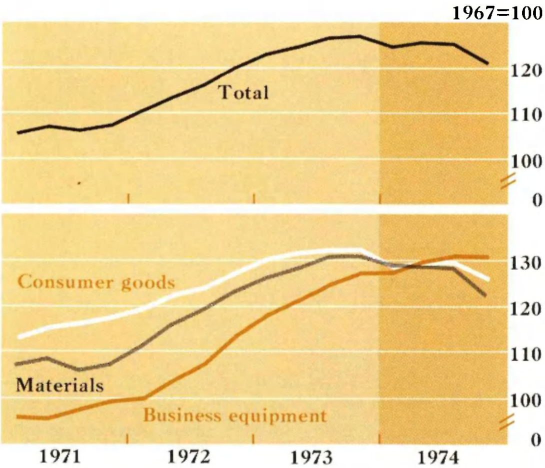
NOTE.—Changes based on quarterly data at seasonally adjusted annual rates. Compensation per manhour is for private nonfarm economy. Dept. of Labor data.

depressed by the scarcity of oil showed signs of recovery; at the same time output of business equipment and materials continued at high levels. Nevertheless aggregate demand remained weak, and the economy as a whole never resumed its upward momentum. As time went on, shortages became less acute, delivery times were shortened considerably, and pressures on capacity eased.

All major sectors of private final demand weakened appreciably in the final quarter of the year and the drop in real GNP—9.1 per cent at an annual rate—was the largest since before World War II. With real incomes continuing to fall, real personal consumption expenditures for goods dropped sharply further—paced by a plunge in sales of 1975-model automobiles. Outlays for residential construction continued to deteriorate, and housing starts fell to an 8-year low. Around midyear, many firms began to cut back on their capital spending plans, and by the fourth quarter outlays for business fixed investment were down sharply in real terms.

The intensification of recessionary forces brought with it a marked change in business inventory policies. Inventories had been rising relative to final sales in real terms since early 1973. Even so, businessmen did not move quickly to trim excessive stocks. In the last

INDUSTRIAL PRODUCTION



NOTE.—Federal Reserve indexes, seasonally adjusted.

quarter, however, as final demands declined and the supply situation improved, they made strenuous efforts to reduce stocks by cutting production. Nevertheless, there was a sharp, involuntary build-up of inventories, which resulted in further cutbacks in output and employment.

Through the summer, employment had continued to rise moderately, even though output drifted downward. The labor market was slow to adjust to sluggish demand conditions during this period, apparently in part because of the inability of businesses to perceive the developing decline in economic activity in the face of continuing shortages of materials and of the steady increases in prices.

By the final quarter of the year, however, pervasive weaknesses in demand were unmistakable, and extremely rapid adjustments occurred in the labor market. Large layoffs began in the automobile industry and quickly spread to other industries, and employment fell by a record 1.1 million in the final 2 months of the year. Unemployment rose among all labor market groups, and the rate reached 7.2 per cent by year-end. Nevertheless, output fell even more sharply than employment, and productivity continued to decline; this suggested the probability of further reductions in employment in early 1975.

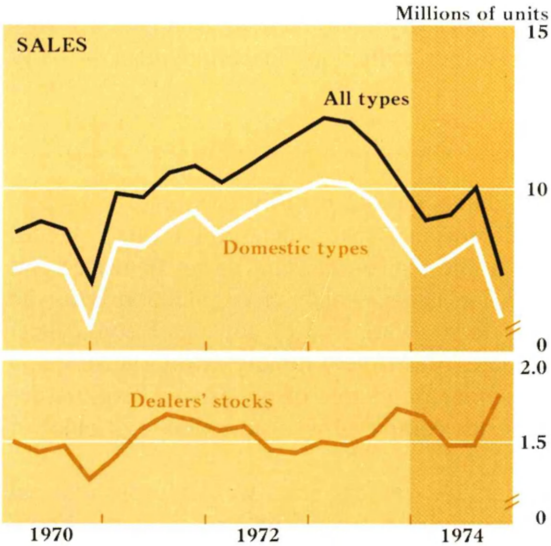
CONSUMER PURCHASES

A dominant factor in the dampening of over-all economic growth in 1974 was the weakness in consumer spending. Acceleration in prices caused a significant drop in the real purchasing power of wages and in the real value of financial assets, which in conjunction with the rise in unemployment led to a severe loss of consumer confidence. Real consumer spending deteriorated very rapidly in the fourth quarter, and for the year consumer purchases of goods and services declined 2 per cent in real terms compared with an increase of close to 5 per cent in 1973.

In late 1973 and early 1974, new car sales were sharply reduced because of the gasoline shortage. After the oil embargo was lifted, more fuel became available, but at much higher prices, and with auto prices also higher than in 1973, sales improved only moderately. Sales of 1974 models were boosted during the summer mainly because of manufacturers' announcements of sharply higher prices for the upcoming 1975 models. But the increase proved to be short-lived; in the fourth quarter total auto sales plunged by 29 per cent to a 7.4 million annual rate and sales of domestic models dropped to a 6 million annual rate. This was the lowest sales rate in 14 years except for the strike-induced decline in 1970. Sales in early 1975 remained weak and further cutbacks of production and employment were instituted. However, the introduction of price rebates in late January helped to provide some support for sagging automobile sales.

Real outlays for other durable goods, such as furniture and appliances, also weakened in 1974 but the decline was less than for autos. Similarly, spending in real terms for nondurable goods such as food, clothing, and gasoline was reduced. In contrast, although expenditures for services slowed, they continued to increase at a faster pace than the rise in prices.

AUTOS

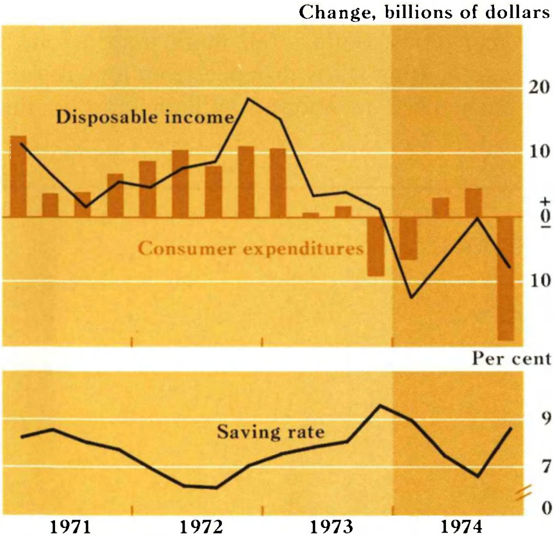


NOTE.—Sales, quarterly data at annual rates, seasonally adjusted by Federal Reserve; domestic types include sales in the United States of cars produced in Canada. Dealers' stocks, seasonally adjusted, for domestic-type cars only. Sales from Ward's *Automotive Reports*; dealers' stocks from Motor Vehicles Manufacturers Association.

Curtailment of real consumption was largely the consequence of a large and rapid decline in real disposable income. From the fourth quarter of 1973 to the fourth quarter of 1974 this decline amounted to 4.2 per cent and was more than three times as severe as the loss during the 1958 recession—up to then the largest erosion in real income since the period immediately following World War II. Reductions in real disposable income were not caused solely by the failure of wages to keep pace with inflation; an increase in the social security tax base and the impact of the progressive income tax levied on inflated nominal incomes also reduced real income after taxes in 1974.

The adverse effect on consumer attitudes of sharply declining real income and of rising unemployment was underscored by consumer surveys during the year. By the fourth quarter consumers' appraisals

DISPOSABLE INCOME, SPENDING, AND SAVING



NOTE.—Expenditures and income are in terms of 1958 dollars; changes from preceding quarter are based on quarterly data at seasonally adjusted annual rates. Saving rate is personal saving as a percentage of disposable personal income. Dept. of Commerce data.

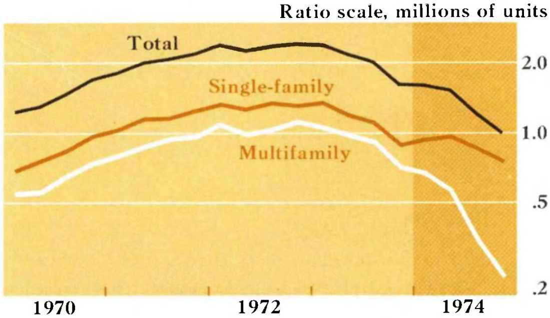
of their financial condition and of the outlook for the economy were more pessimistic than in any previous survey. While a fairly high proportion of the respondents had indicated earlier in the year that it was probably a good time to buy because of anticipated price increases, by year-end many consumers held the view that it was necessary to curtail spending because prices had become too high.

In each of the first three quarters of 1974 consumers lowered their saving rate from the high rates associated with the oil embargo of late 1973. The rate increased again in late 1974 when consumers sharply reduced their outlays for goods—in part in an attempt to maintain liquidity as unemployment worsened, inflation remained acute, and uncertainty about the future increased. Early in 1975 the administration began to take action to provide tax relief for both consumers and business, which, if enacted, could increase confidence and provide some stimulus to consumer spending.

RESIDENTIAL CONSTRUCTION

The extremely sharp decline in private residential construction activity, which had begun in 1973, continued to depress final demands during 1974. In real terms, outlays fell more than a fourth from the 1973 total. Private housing starts dropped from a peak rate of 2.4 million units in early 1973 to about 1 million units in the

PRIVATE HOUSING STARTS



NOTE.—Quarterly averages based on monthly figures at seasonally adjusted annual rates. Dept. of Commerce data.

fourth quarter of 1974—the steepest decline in the post-World-War-II period.

Record mortgage rates and curtailment of credit availability were major depressants in the housing market. In addition, the increasing costs of new homes, as well as the unusually large stocks of unsold units still held by builders, constrained single-family starts in 1974. Federal Government programs aimed at providing additional mortgage financing, generally at rates below those prevailing in the market, were expanded considerably from the low level of 1973, and these programs helped to cushion the decline in starts.

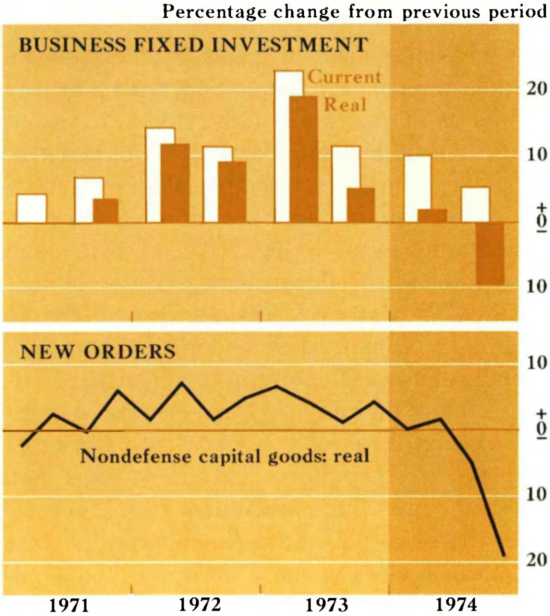
Much of the slump in housing starts in 1974 was in multifamily units. This reflected higher costs of land, labor, and materials, as well as the fact that many rental units—including those still under construction—continued to overhang the market. Financial factors also played a major role in reducing starts of condominiums and other multifamily units during the year. Builders in recent years had depended rather heavily on the real estate investment trusts for construction financing, but the financial difficulties experienced by these intermediaries in 1974 helped to cause a sharp decline in the availability of funds for construction and development purposes; under these conditions, pressures on costs of such mortgage credit continued.

Prospects for housing activity improved toward the end of 1974, as deposit flows to mortgage lending institutions increased—due to declines in market rates of interest—and mortgage markets eased. The likely extent of a recovery in housing, however, remains clouded by the exceptionally large inventory of units still under construction and the depressed levels of consumer confidence.

BUSINESS FIXED INVESTMENT

Business capital spending slowed and then declined during 1974, marking the end of the investment boom that had provided expansive support for economic activity since early 1972. Although current-dollar investment outlays rose by about 9 per cent during 1974, prices of capital goods increased by almost 10 per cent; thus real outlays were off fractionally. In contrast to the pattern of the previous 2 years, spending for business construction was stronger than spending for equipment, reflecting in part the severe decline in business purchases of motor vehicles.

INVESTMENT AND ORDERS

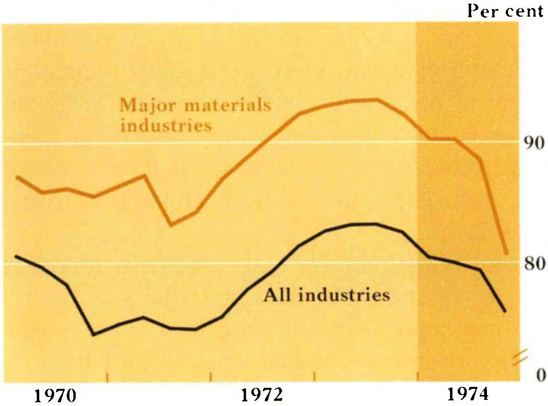


NOTE.—Changes in investment based on Dept. of Commerce data at seasonally adjusted annual rates. Orders based on quarterly averages of seasonally adjusted monthly data from Dept. of Commerce; deflation by Federal Reserve.

The downturn in real capital expenditures came late in 1974 and reflected a variety of factors—the falling off in consumer and housing demands, the sharp increase in the cost of capital equipment following the lifting of price controls, the cumulative impact of tightened financial markets, and the weakened cash-flow position experienced by many business firms. Shortages, which had played a part in holding down capital expenditures early in 1974, became less of a problem as demand weakened; and as use of capacity eased, the need for expansion of productive facilities became less urgent.

Capital outlays of most manufacturing industries remained strong in 1974, supported to some extent by sustained worldwide demands for materials during most of the year. Producers of capital goods, nonferrous metals, paper, and chemicals increased their plant and equipment expenditures substantially for the second year in a row. Sharp gains were also recorded by petroleum and iron and steel pro-

CAPACITY UTILIZATION IN MANUFACTURING



NOTE.—Utilization is average output, seasonally adjusted, as a percentage of potential capacity. Federal Reserve data.

ducers. In sectors other than manufacturing, however, signs of a downturn in real spending were evident fairly early in the year. The energy crisis had a pronounced impact on outlays in the already depressed commercial sector. Also, public utilities curtailed their plant expansion programs as projections for long-term growth were scaled down and as their financial positions deteriorated because of increased fuel prices, higher interest costs, delays in obtaining authority for higher rates, and a slowing in demands for power.

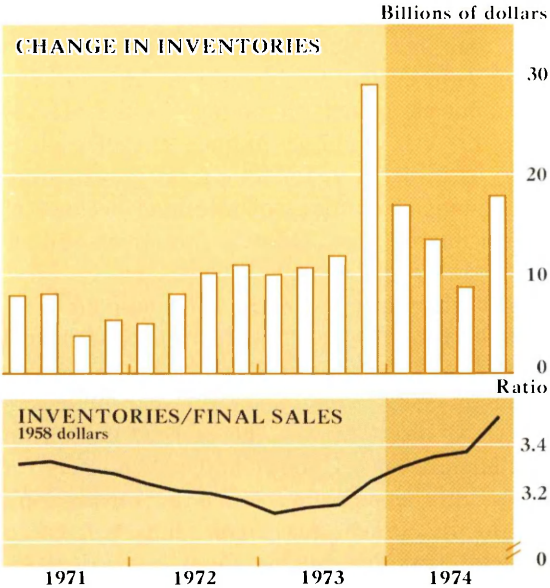
At the year-end, surveys of anticipated plant and equipment expenditures suggested that there would be a significant decline in real capital expenditures in 1975, with only industries in the materials-producing sector showing any significant year-over-year increases. Pointing in the same over-all direction was the marked decline in real new orders for nondefense capital goods and in contracts for nonresidential structures. Early enactment of the administration's proposal for increasing the investment tax credit, however, could bolster prospects for capital spending by the latter half of 1975.

INVENTORY INVESTMENT

Realization that an extensive adjustment was under way throughout the economy caused businessmen to modify their inventory policies during the second half of 1974. The stock of inventories relative to real final sales rose rather sharply until the summer when firms began to make vigorous efforts to trim excessive stocks. Although consumer and business demands deteriorated and there were sharp reductions in output and employment in the fourth quarter, the ratio of inventories to final sales rose even further—evidencing unintended accumulation. Thus, there are prospects for a substantial liquidation of stocks early in 1975, as businesses make further attempts to bring inventories into line with sales.

During the first half of 1974 producers built up stocks of goods that had previously been in short supply. This was true particularly for materials, of which there had been widespread shortages since mid-1973. But stocks of work-in-process also rose, in part because

BUSINESS INVENTORIES AND SALES



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

Inventories/final sales, based on Dept. of Commerce seasonally adjusted data for end-of-quarter book value of business inventories (estimated from inventory-change series) and total GNP final sales expressed at monthly rates. Ratio calculated by Federal Reserve.

of remaining production bottlenecks and also because sales expectations were still relatively optimistic. Late in the year, stocks of materials rose sharply further, as did those of finished goods. The accumulation of finished goods was involuntary for the most part and was especially pronounced in the automobile industry where dealer stocks reached record highs despite sharp cutbacks in production.

EXPORTS AND IMPORTS OF GOODS AND SERVICES

After having shifted from a deficit to a surplus in 1973, the U.S. balance on goods and services moved back into deficit in 1974. Much of this change was due to merchandise trade developments, but an important part was also attributable to service-account transactions. In the first half of 1974 the merchandise trade deficit totaled $3½ billion at an annual rate. Most of the weakening in the first-half balance reflected the dramatic increase in the price of imported oil, particularly beginning in the second quarter after the Arab embargo on oil shipments to the United States was lifted. In the second half the trade deficit rose to about $8 billion at an annual rate. Although the average price of imported oil leveled off at about $11.60 per barrel, the value of oil imports rose as the volume increased. Meanwhile, both the value and the volume of agricultural exports declined. Average prices of these exports rose, particularly in the fourth quarter, but the volume of shipments was reduced because of disappointing harvests.

For the year the value of merchandise imports rose by nearly 50 per cent, and the value of exports by about 40 per cent. In real terms, however, imports declined somewhat while the volume of exports increased by nearly 8 per cent. Some of these changes are due to developments in agricultural and oil commodities, but 75 per cent of all U.S. trade is in nonagricultural and nonfuel commodities. The net of these transactions for the latter two groupings had a positive effect on the over-all trade balance; that is, such transactions showed a steady improvement during the year.

The volume of U.S. nonagricultural exports remained strong throughout the first half even though foreign economic activity weakened somewhat; in the second half there were sharper reductions in economic activity abroad, and the volume of U.S. nonagricultural exports began to decline. Weakening U.S. economic activity throughout the year resulted in a decreasing volume of nonfuel imports beginning in the second quarter. Prices of both nonfuel imports and nonagricultural exports increased by about 25 per cent during the year.

The surplus in the balance on services increased in 1974 as a result of sharply improved investment income, especially for the foreign affiliates of U.S. oil firms. Partially offsetting this increase were higher U.S. interest payments to foreigners as interest rates in this country rose steeply.

FEDERAL GOVERNMENT

During periods of decline in economic activity, it is expected that reduced incomes will tend to slow the growth in Federal receipts and that the Federal deficit will increase, thereby partially cushioning the effect of reductions in spendable incomes. But this did not occur during the first three quarters of 1974. Instead, a large growth in nominal incomes, generated mainly by a high rate of inflation, resulted in a sharp increase in Federal revenues. In the face of continuing curbs on expenditures, the Federal budget thus tended to become somewhat more restrictive. However, a $7.6 billion deficit was recorded, on an NIA basis, for all of 1974—a little more than the deficit of almost $6 billion for 1973. The NIA deficit was quite small through the first three quarters of the year, but during the final quarter it increased sharply, sparked by higher unemployment benefits and a moderation in the growth of tax receipts—each a result of the deepening recession—as well as an increase in Federal pay scales.

Federal purchases of goods and services rose by almost 10 per cent in 1974, substantially above the 1.6 per cent gain in 1973. In real terms, however, total Federal purchases were down for the year. Defense spending, after having decreased slightly in 1973, rose moderately, but in real terms it declined for the second consecutive year. Real nondefense purchases, however, are estimated to have increased sharply in 1974.

Federal transfer payments continued to grow much faster than purchases of goods and services, reflecting in part a rapid rise in unemployment benefits. The two-step, 11 per cent increase in social security benefits and the Federal takeover of welfare for the aged, blind, and disabled also added to the growth in transfer payments.

Table 2: CHANGES IN MAJOR COMPONENTS OF GROSS NATIONAL PRODUCT

In billions of dollars

Item	1972	1973	1974	1974 [1]			
				Q1	Q2	Q3	Q4
GNP	**103.1**	**136.9**	**101.8**	**14.8**	**25.0**	**32.5**	**11.7**
Personal consumption expenditures	**61.9**	**76.2**	**71.8**	**16.7**	**28.5**	**32.2**	**−4.5**
Durable goods	14.5	11.9	−2.5	−.4	5.6	6.6	−14.6
Nondurable goods	21.3	38.3	42.2	12.3	11.4	13.2	2.5
Services	26.1	26.0	32.2	5.0	11.4	12.4	7.6
Saving rate (level in per cent)	*6.6*	*8.2*	*7.8*	*8.9*	*7.4*	*6.6*	*8.5*
Fixed investment	**23.4**	**23.2**	**1.6**	**−1.9**	**4.7**	**−1.2**	**−3.9**
Residential structures	11.2	3.2	−11.2	−5.2	.4	−2.6	−5.7
Nonresidential	12.2	20.0	12.8	3.3	4.2	1.5	1.8
Inventory change	**2.2**	**6.9**	**−2.0**	**−12.0**	**−3.4**	**−4.8**	**5.7**
Net exports of goods and services	**−5.8**	**9.9**	**−1.9**	**2.0**	**−12.8**	**−1.6**	**4.3**
Exports	7.0	28.0	39.0	17.6	7.3	5.1	.7
Imports	12.8	18.0	41.1	15.6	20.1	6.7	−3.5
Govt. purchases of goods and services	**21.5**	**20.7**	**32.4**	**9.9**	**8.1**	**7.9**	**10.1**
Federal	7.3	1.7	9.8	3.1	2.8	2.9	5.6
Defense	3.6	−.4	4.2	.5	.8	1.8	5.1
Other	3.6	2.1	5.7	2.6	2.0	1.1	.5
State and local	14.2	19.0	22.6	6.9	5.3	5.0	4.5

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

Federal receipts grew by $33 billion in 1974, exceeding the previous record rise of $31 billion in 1973. Personal income tax receipts increased 15 per cent—partly because of inflation; and contributions for social insurance rose by 12 per cent, reflecting in part a further increase in the taxable wage base.

Corporate profits tax accruals grew by 12 per cent, slightly less than in 1973; a sizable number of firms appear to have shifted during the year to the last-in, first-out method of inventory accounting.

STATE AND LOCAL GOVERNMENTS

State and local government purchases of goods and services rose by 13 per cent in 1974, a bit more rapidly than in 1973. In real terms, however, the year-over-year increase was only about 3 per cent, and by the final quarter real purchases were at about the same level as they had been in the fourth quarter of 1973. Higher payments for employee compensation accounted for a large part of the current-dollar increase, and construction outlays—boosted in part by Federal revenue-sharing funds—also showed a noticeable gain over 1973. The rise in average earnings of State and local government employees was off slightly from the 7 per cent increase in 1973. Employment was moderately above 1973, but very little of the increase was the result of Federally funded public employment programs.

Slackened growth in receipts reinforced the negative impact of very stringent credit conditions on the fiscal position of States and localities during 1974. For the State and local sector as a whole there was a surplus of about $2 billion—down from the $9 billion surplus in 1973. The small over-all surplus in 1974 resulted entirely from continued net accumulations of savings in State and local retirement funds, which were largely offset by deficits in other activities. In 1973 Federal revenue-sharing funds had resulted in a significant accumulation of financial assets and a reduction in the amount of long-term borrowing. State and local governments in 1974 used their revenue-sharing funds largely to increase outlays for construction and to reduce tax burdens. □

Employment, Wages, and Labor Costs

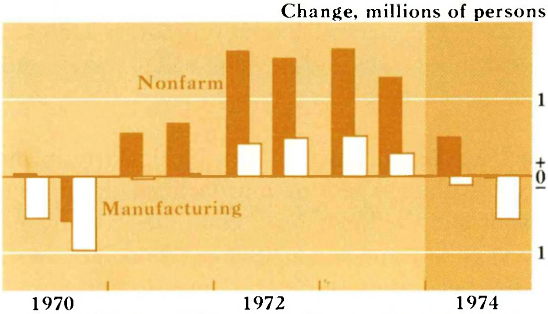
The demand for workers weakened during 1974, particularly in the latter months of the year. Although real output declined throughout the year, total employment and the labor force continued to advance moderately through the summer, and unemployment remained close to 5.2 per cent. In the fall, when general demand and output slumped, the unemployment rate began to climb rapidly; and by early 1975 it had reached a 34-year high of 8.2 per cent. Layoffs were widespread, affecting experienced workers as well as other groups in the labor force.

Most of the growth in the labor force in 1974 occurred in the late spring and summer as increasing numbers of adult women entered the labor market. Some of this growth reflected the availability of jobs—for employment was still increasing—and some the need to help maintain real family income in the face of sharply rising prices. However, labor force growth came to a halt late in the year when employment fell sharply. With jobs scarce, many unemployed workers became discouraged and left the labor market, and the number of new entrants also declined.

While total employment rose slowly and unevenly during the first three quarters of 1974, employment in goods-producing industries remained weak throughout the year. Manufacturing employment, which had shown a vigorous expansion in 1973 before slowing late in the year, declined by about 165,000 in the first 9 months of 1974. Meanwhile, total nonfarm payroll employment rose by 900,000, significantly less than in the same period of 1973 but a large gain for a period when real GNP was declining. Growth in employment was confined to service-producing industries. State and local government employment also expanded through the summer at a somewhat faster rate than in the preceding year, and Federal Government employment edged up modestly for the first time since 1970.

In the autumn factory jobs began to decline rapidly, especially in the auto and auto-related industries and in the heavy machinery,

EMPLOYMENT



NOTE.—Payroll employment, seasonally adjusted data from Dept. of Labor. Change is from preceding half-year.

textile, and apparel industries; at the year-end manufacturing employment was nearly 1.2 million below a year earlier. The factory workweek also declined significantly as overtime work was curtailed and many workers went on part-time schedules. Labor demand in the construction industry was weak, reflecting the depressed conditions of the housing market. Demand for workers in nonmanufacturing sectors also softened considerably, and total payroll employment fell by more than a million in the late fall.

The unemployment rate rose from 4.8 per cent at the end of 1973 to an average of about 5.2 per cent during the first half of 1974, largely because of job cuts in specific sectors directly affected by the energy crisis. In contrast, the rapid rise in unemployment in the fall of 1974 affected all categories of workers, particularly experienced workers in manufacturing industries. By December the unemployment rate for adult men had increased to 5.1 per cent from 3.0 per cent the previous year; women and teenagers had also experienced substantial increases in unemployment. Employment of minority groups declined over the year, and their unemployment rate—at 12.8 per cent at the end of 1974—remained double that of white workers, who had also experienced sharp increases in joblessness.

The increase in unemployment was one of the most rapid of the postwar era, and much of the rise was accounted for by experienced, full-time workers who had lost their jobs. In contrast, the impact of layoffs of teenagers was moderated to some extent by their withdrawal from the labor force—a typical cyclical phenomenon. Adult women, however, have experienced a relatively larger increase in unemployment than in earlier cycles, probably because they had stronger labor force attachment than previously.

Table 3: LABOR FORCE, EMPLOYMENT, AND UNEMPLOYMENT

Item or category	1971	1972 [1]	1973 [1]	1974
	Change during year, thousands of persons			
Total labor force	1,191	1,568	2,543	1,844
Civilian labor force	1,544	1,830	2,687	1,917
Total civilian employment	1,350	2,305	3,041	148
	Monthly average rate in Q4, per cent			
Unemployment rates—Total	5.9	5.3	4.7	6.5
Men, 20 years and over	4.3	3.6	3.0	4.7
Women, 20 years and over	5.7	5.2	4.7	6.5
Teenagers, 16–19 years	16.9	15.5	14.3	17.5
White	5.4	4.7	4.2	5.9
Negro and other	10.1	9.9	8.6	11.8
Blue collar	7.3	5.8	5.2	8.3
White collar	3.4	3.3	2.8	3.7
Heads of household	3.6	3.0	2.8	4.0
Full-time workers	5.6	4.7	4.3	6.2

[1] Data on changes from 1971 to 1973 are adjusted to allow for the introduction of new estimates for the population.

NOTE.—Basic data from Dept. of Labor.

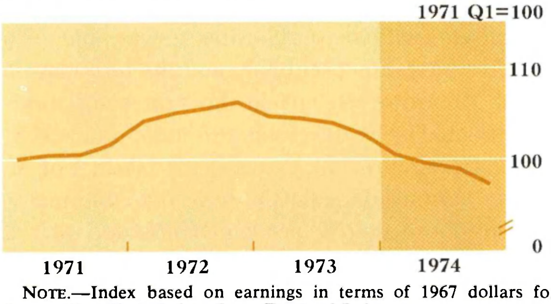
Wage increases accelerated sharply in 1974, mainly because workers were attempting to offset losses in purchasing power, but also because of a heavy collective bargaining schedule and the termination of wage controls on April 30. However, late in the year some moderation in wage increases seemed to be developing in many industries, probably reflecting the deterioration in the demand for labor. For all of 1974 the average hourly earnings index—the best available measure of wage rates—grew by more than 9 per cent compared with a 6.5 per cent increase in 1973; the increase in 1974 was led by larger-than-average gains in manufacturing and construction.

The continued erosion of purchasing power in 1974 was apparent in all measures of real income. Average real spendable earnings of a production worker with three dependents—the most widely used measure of take-home pay—continued to decline, and the reduction was the largest for any postwar year. At the year-end such earnings were more than 9 per cent below the peak in the fall of 1972. As a result, an increasing number of workers involved in contract negotiations demanded, and received, cost-of-living escalator clauses, which tied future wage increases to future price increases. In 1974 about 5.5 million workers were covered by collective bargaining contracts that included escalator clauses; this number, the highest on record, was about 600,000 more than in 1973.

The collective bargaining schedule in 1974 was heavy, and it included major contract settlements in the steel, aluminum, can and container, telephone, and mining industries. In their efforts to offset rapid price inflation, union bargainers obtained first-year pay raises of 11 per cent, up sharply from 6 per cent in 1973. Although wage catch-up pressures are likely to continue, the combination of slack labor markets and a relatively light collective bargaining schedule in 1975 may result in the moderation of wage pressures—especially if inflation slows.

Reflecting large increases in wages and fringe benefits, hourly compensation in the private nonfarm economy accelerated from the already rapid pace of 1973 to about a 9.5 per cent increase during

REAL WEEKLY EARNINGS

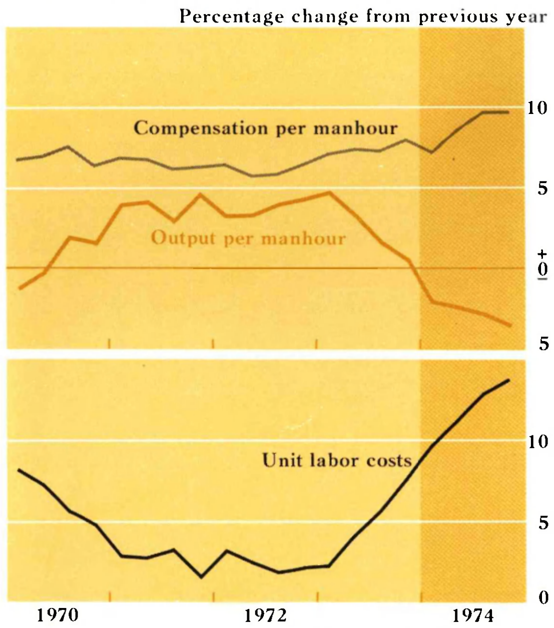


NOTE.—Index based on earnings in terms of 1967 dollars for worker with 3 dependents. Seasonally adjusted data from Dept. of Labor.

1974 although some slowing was evident in the final quarter of the year. Productivity declined throughout the year in one of the most pronounced and prolonged downturns of the postwar era. Nonfarm output per manhour had begun to drop after early 1973, and it has declined for seven consecutive quarters; between the final quarters of 1973 and 1974 nonfarm productivity was off a total of 3.6 per cent.

It is possible that data problems may have led to some overstatement of the erosion in productivity. Nevertheless, the unusually weak productivity performance in 1974 is consistent with the hesitancy on the part of businessmen to make cost-cutting adjustments in employment in the face of rising prices and profits at a time when the initial softening of demands was quite selective.

PRODUCTIVITY AND COSTS



NOTE.—Annual rates of change from corresponding quarter a year earlier for the private nonfarm economy; based on seasonally adjusted data from Dept. of Labor.

Although manufacturing productivity was not so weak as productivity in the nonfarm economy as a whole, there was little growth in the factory sector during 1974. Due to the combination of declines in productivity and of increases in hourly compensation, unit labor costs for the private nonfarm economy in the fourth quarter were about 14 per cent above their year-earlier levels. This too was a record increase for the postwar period. Rising unit labor costs tended increasingly to exert upward pressure on prices. □

Price Developments

Inflationary pressures in the economy have been persistent since the mid-1960's, but they have become much more intense in the past few years. In 1974 the impact was particularly acute as prices continued to climb at an accelerated rate, operating through a number of channels to dampen demands for goods and services.

The increase in prices during 1974 exceeded to a significant degree the 9 per cent rise in wages, and the purchasing power of wage earners continued to drop. Revenues from the very large increase in the price of oil accrued largely to foreign producers—thereby reducing spending in this country; only a relatively small portion of this revenue was reflected in the increased sales of U.S. exports. Furthermore, the progressive feature of the personal income tax, combined with rising nominal incomes, served to reduce real incomes during the year. On a per-household basis real disposable income began to decline about mid-1973, and since then it has fallen more than in any comparable period since that immediately following World War II. Moreover, the real value of the financial assets held by consumers has been depressed by a falling stock market.

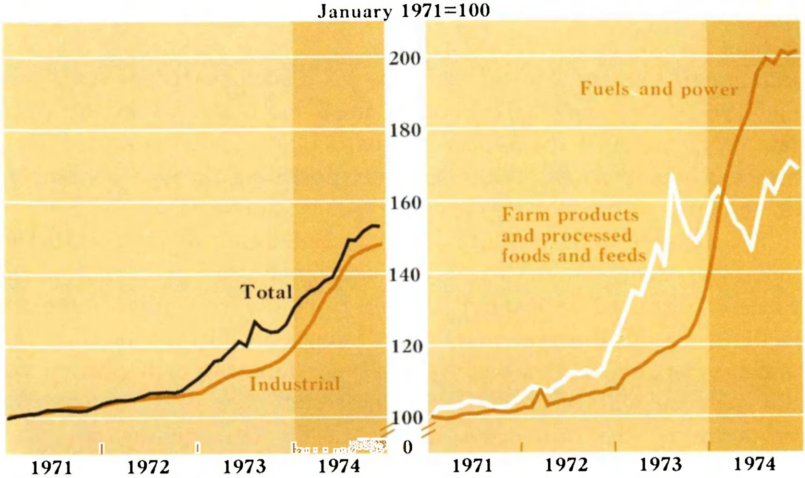
As a consequence, there was a substantial, adverse reaction to rising prices among most income groups during 1974, and consumption expenditures weakened considerably. Purchases of autos, mobile homes, and other consumer durable goods fell sharply, as higher and higher prices for essentials forced families to allocate a larger proportion of their budgets to food, fuels, and housing.

The business sector was also adversely affected by inflation. Corporate profits before taxes in 1974 were higher than in 1973 because of enormous inventory gains. However, since replacement of inventory stocks had to be made at inflated prices, the true corporate financial position was much less favorable than suggested by before-tax profits data. This probably had a significant impact on the realization of investment plans.

SOURCES OF INFLATION

The current inflation had its roots in a number of volatile and at times unanticipated developments, some originating in this country

WHOLESALE PRICES

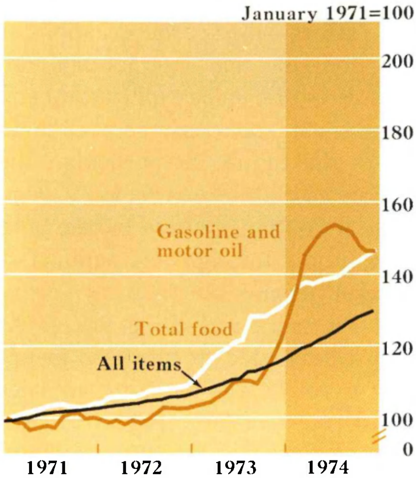


NOTE.—Dept. of Labor data.

and some abroad. World demands for U.S. farm products continued to be strong during 1974. Furthermore, with disappointing harvests in the United States, stocks of both food grains and feeds continued to be low, and prices remained at high levels. Food grains and feeds occupy a strategic position in food production, and their advanced prices have had far-reaching repercussions on prices of meat and other foods in this country.

More important in 1974, however, was the impact of the extraordinary increase in the price of fuel, which extended well beyond the rise in oil and gasoline prices—contributing substantially to the ongoing inflation and exerting a major influence in ending the 1971-73 economic expansion. By the summer of 1974 the price of imported crude oil had more than tripled from its pre-embargo level, and prices of domestically produced oil had risen sharply too. Since imports of crude and refined oil account for more than one-third of domestic consumption, the average cost of crude in U.S. markets more than doubled, and price increases for refined products exceeded 80 per cent. Prices of coal also soared, and natural gas and electric rates climbed by about a third during the year.

CONSUMER PRICES



High levels of international demand also helped to fan inflationary trends in the U.S. economy well into 1974. Foreign demands on U.S. suppliers—particularly for food, basic materials, and business equipment—remained exceptionally strong. These pressures arose from a number of factors, including the boom in industrial activity in the major industrialized nations, the continued impact of the dollar devaluations, and the effects of U.S. wage and price controls, each of which made U.S. products more attractive on the world market.

The phaseout of price and wage controls by the spring of 1974 was also a factor. Wholesale prices of major industrial commodities surged—particularly for metals, chemicals, producers' equipment, and some consumer goods. Metals contributed about as much to the rise in wholesale prices in 1974 as any other major commodity group. Wholesale prices of many consumer nonfood items, such as furniture, apparel, and household appliances, also moved up at a brisk pace, in part a response to the higher post-controls costs of materials.

Inflation was also intensified in 1974 by the exceptionally sharp jump in unit labor costs, which was noted earlier. In 1972 and 1973 such costs had risen by 2.7 and 5 per cent, respectively, but during 1974 the rate of increase was at a record 11.6 per cent.

The combination of these diverse factors—the special situation for fuels and food, continuing strong domestic and international demands, the removal of controls, high rates of capacity utilization, and accelerating labor costs—led businessmen and consumers alike to expect widespread price increases in the future. In particular, the higher rate of inventory accumulation undoubtedly reflected a good deal of hedge buying in anticipation of continued sharp increases in prices. Similarly, growth of unfilled orders through late summer—some of which may have been the result of multiple ordering—probably reflected efforts to circumvent shortages and rising prices. At times during the year consumers also attempted to purchase in advance of price increases. A striking example was the surge in sales of 1974-model cars after the announcement of large price increases for the 1975 models.

Inflation gathered momentum during 1974 in part because of these heightened price expectations. But late in the year, as demand weakened on a broad front and uncertainty increased, the inflationary expectations of businessmen probably became a less dominant force and rising costs a relatively more important one in sustaining the increases in prices. Consumer attitudes also shifted, and as noted above, by the end of the year many thought it was a bad time to buy because prices were too high.

PRICE MOVEMENTS

Inflation in 1974, as reflected by broad measures such as the implicit GNP deflator, the consumer price index, and the wholesale price index, increased substantially faster than in 1973—indeed faster than in any other year since early in the postwar period. By the end of 1974, the implicit deflator for GNP had risen 12 per cent from the end of 1973 compared with 7 per cent during the previous 12-month period. The consumer price index also showed a 12 per cent increase in 1974, compared with a rise of less than 9 per cent in 1973. Nonfood commodities led the advance in consumer prices, but prices of services also accelerated significantly. Wholesale prices rose even more rapidly—21 per cent during 1974 compared with 15 per cent during the previous year.

Following the run-up of oil prices that began in the autumn of 1973, accelerating prices for industrial materials paced the rate of inflation. Wholesale prices of fuel and power rose at an annual rate of about 70 per cent from September 1973 to midyear 1974 but then slowed to about a 10 per cent rate by the fourth quarter. Higher fuel prices had a substantial impact on prices of other materials, which had been compounded by very large post-price-control adjustments and intense international demand pressures earlier in 1974. By September prices of steel mill products and nonferrous metals were more than 40 per cent above a year earlier. Prices of other materials rose sharply too—especially paper and paper products, and most chemicals. By the year-end, however, there were signs of considerable moderation in the materials component of the wholesale price index. This was in sharp contrast to the extremely rapid rates of gain that had been registered in the first three quarters.

The extraordinary increases in materials prices, as well as post-controls adjustments, led to sharp advances in prices of finished goods. Prices for producers' machinery and equipment accelerated during the year, influenced also by strong foreign demand; the annual rate of gain in such prices rose from 6 per cent in the fourth quarter of 1973 to more than 30 per cent during the third quarter of 1974. In the fourth quarter these price increases also began to slow.

Although food prices were not so important a factor in inflation in 1974 as they had been in 1973, advances continued at high rates during the year. Because the U.S. harvest of feed crops was disappointing and stocks were never rebuilt from depleted levels, prices of grains and feeds continued high during most of the year. Dramatic rises in sugar and sugar-based products as well as in fats and oils contributed disproportionately to the advance in food prices at retail; prices of sugar and sweets more than doubled during the year. However, late in the year prices of sugar and oils declined at the wholesale level. By the second quarter the farm–retail spread had increased to about one-fourth above its year-earlier level, and it continued high throughout the year, contributing also to the advanced levels reached by retail food prices despite declines at the farm level for livestock and other products.

Fuels led the advance in consumer prices of nonfood commodities in the early months of 1974. Although fuel prices peaked about midyear, accelerated advances for other goods led to sharp rates of rise in consumer prices in the third quarter. Prices of nonfood items at retail were up about 13 per cent in 1974; in addition to fuel, large increases were recorded for household durable goods, paper products, and a wide variety of other goods. Service costs also rose faster after the lifting of controls, and particularly large increases were registered for gas and electricity and for medical and household services.

In the last quarter of 1974 levels of economic activity fell and the impact of post-controls adjustments and rising materials costs tapered off. Prices of several industrial materials had actually declined since the spring—notably textiles, metal scrap, and copper, as well as lumber and hides, which were well below their 1973 highs. The rise in wholesale prices of industrial commodities was at an 8 per cent annual rate in the final 3 months of the year, down from the average annual rate of rise of about 30 per cent in the earlier three quarters; the gain in consumer prices slowed to a 10 per cent rate in the fourth quarter, compared with the 13 per cent average posted over the first 9 months of the year.

Table 4: PRICE CHANGES

In per cent

Group	Dec. 1971–Dec. 1972	Dec. 1972–Dec. 1973	Dec. 1973–Dec. 1974	1974 (seasonally adjusted compounded annual rates)			
				Dec.–Mar.	Mar.–June	June–Sept.	Sept.–Dec.
Wholesale prices, total	6.5	15.4	20.9	24.5	12.2	35.2	13.4
Industrial commodities	3.6	10.7	25.6	32.3	35.7	28.3	8.2
Farm products	18.7	36.1	−1.9	6.2	−48.0	56.6	7.4
Processed foods and feeds	11.6	20.3	20.9	13.1	−12.0	60.2	33.7
Consumer prices, total	3.4	8.8	12.2	14.2	10.3	14.2	10.1
Foods	4.7	20.1	12.2	19.4	3.1	12.3	14.6
Commodities less foods	2.5	5.0	13.2	16.0	13.7	16.2	7.3
Services	3.6	6.2	11.3	9.2	11.0	13.9	10.9

NOTE.—Based on data from Dept. of Labor. Services are not seasonally adjusted.

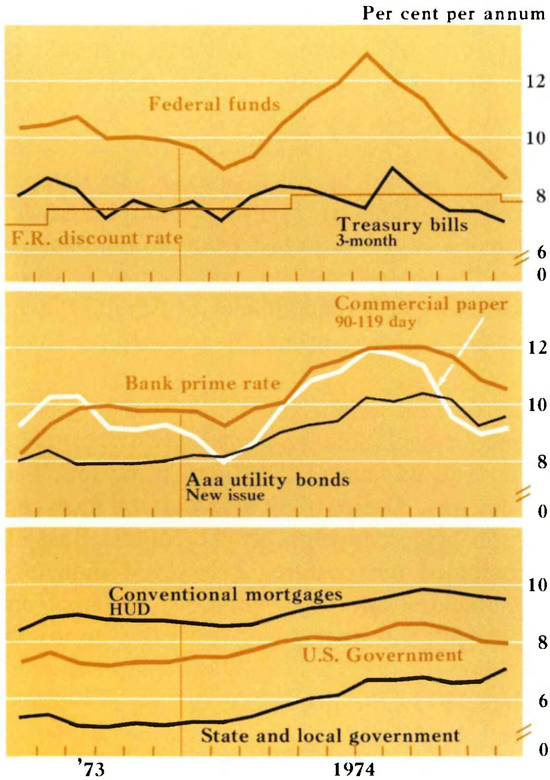
Monetary Policy and Financial Markets

Policy choices confronting the Federal Reserve were especially difficult in 1974. The need to slow the rapid advance in prices remained urgent. But as recession emerged, so too did questions as to how soon and how much the policy of strong resistance to inflation should be modified. Efforts by the System to restrain credit expansion—and thereby inflationary pressures—were also complicated in late spring when the interaction of tight money and rapid price advances excited fears in market circles of a general liquidity squeeze. To dampen these market apprehensions, Chairman Burns announced the System's readiness to serve, if needed, as a lender of last resort to nonbanking firms as well as to banks. This helped to calm concerns in financial markets regarding the possibility of serious financial instability, even though no widespread reliance on System emergency credit actually materialized.

In seeking a workable trade-off among the year's changing—and sometimes conflicting—requirements, the System's policy targets and the mix of instruments used to implement them had to be modified at several points along the way. During the early part of the year, when the economy was still being depressed by the Middle East oil embargo, the System continued the posture of lessened monetary restraint that had been initiated in late 1973 when dislocations from the embargo began. Implementation of this less restrictive approach led to continuation for a time of the declines in short-term interest rates that had begun in late 1973. The Federal funds rate, for example—which is watched closely in financial circles as a bellwether of System policy intentions—dropped from around 9⅞ per cent at the turn of the year to about 8⅝ per cent in mid-February.

By late February, however, it was becoming evident that all of the monetary aggregates were again expanding at rapid rates. Therefore—once a lifting of the oil embargo had been assured—the System moved to counter this accelerating growth of the aggregates. In the months that followed, the combination of increased monetary restraint, continuing rapid inflation, and ballooning business credit demands produced a sharp, general tightening of credit markets. Interest rates rose well above earlier historical highs—in the case of the Federal funds rate, to a peak of around 13½ per cent shortly

INTEREST RATES



NOTE.—Monthly averages except for home mortgages (based on quotations for one day each month), F.R. discount rate, and prime rate (predominant rate quoted by commercial banks to large businesses). Yields: U.S. Treasury bills, market yields on 3-month issues; commercial paper, dealer offering rates; conventional mortgages, yields on first mortgages in primary markets unweighted and rounded to nearest 5 basis points, from Dept. of Housing and Urban Development; 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*.

after midyear. With the whole complex of short-term rates moving rapidly higher, the Federal Reserve discount rate was raised in late April from 7½ to 8 per cent.

The general tightening of credit was accentuated during the spring and summer by a shift of lenders to more conservative loan policies. This process was triggered by the publicized difficulties (and eventual failure) of the Franklin National Bank in the United States and the failure of two smaller banks in Germany—one of which was a major factor in foreign exchange markets. All of these failures resulted from loose management practices that led to heavy trading losses on foreign exchange. At about the same time a major electric utility company in this country announced that it was forgoing its quarterly dividend payment for the first time in history and was selling two partly completed electric generating plants because it could not borrow the funds needed to complete them.

There was widespread concern in financial circles that such evidence of financial difficulty at a few firms might represent the tip of the iceberg, presaging additional business failures in future months. Lenders responded to this anxiety by tightening their credit standards. In the squeeze that followed, many lesser-rated borrowers found their access to securities markets partially or completely curtailed, and they were forced to fall back on standby credit lines at banks. Since banks experiencing these unexpected loan demands were also finding it necessary to pay sharply higher costs for money market funds, they increased their own loan rates to cover the added costs. In the process the rate on prime business loans at major banks was pushed to a peak of 12 per cent early in July, well above the year's low of 8¾ per cent reached in late February. For borrowers with quality ratings of less than prime, interest charges on bank loans—to the extent that credit was available to such borrowers—rose in some cases to levels as much as 4 percentage points above the prime rate.

The severe problems being created for some firms by tighter and more costly credit, as well as the possible implications of this tightness for future economic activity, were strongly reflected in the performance of the stock market. While stock prices had posted moderate net advances early in the year when interest rates were still declining, they turned down as interest rates began to rise again, and then fell dramatically during the spring and summer period of maximum financial strain. From its midwinter high to its early fall low, the composite stock index of the New York Stock Exchange dropped 39 per cent—and at the low was nearly 50 per cent below the record high reached in early 1973.

As typically happens in periods of general monetary restraint, the credit squeeze on some types of firms was greater than on others. However, special financing problems that resulted from the very rapid inflation made the squeeze more pervasive in mid-1974 than in some earlier periods of tight money. The types of institutions most affected included some—such as the nonbank thrift institutions—that are typically disadvantaged in periods of general monetary restraint because of their inability to compete effectively for funds against high yields on market securities; others—such as the relatively new real estate investment trusts (REIT's)—that had been less involved in short-term financing during earlier periods of tight money; and still others—such as bank holding companies and electric utilities—that were beset with special problems that had not been present in the earlier periods.

The fears of a liquidity crisis that had developed in financial circles during late spring and early summer were substantially dissipated as the summer progressed. Although statistical indicators were still flashing mixed signals on the state of the economy, the prospects for renewed economic expansion appeared to be dimming, and credit demands—particularly from businesses—were receding from their earlier patterns of rapid growth. At the same time expansion in the full complex of money and credit aggregates turned sluggish, reflecting with a lag the steep advances in interest rates and the adjustments in institutional lending policies that had developed earlier in the year. Average growth in the narrowly defined money stock, for example, slowed to an annual rate of 1.6 per cent from the month of June to the month of September. Expansion of the money stock as more broadly defined also slowed very sharply as growth in time and savings deposits at banks and other thrift institutions dropped abruptly.

The Federal Reserve reacted to these changes by shifting to a somewhat more accommodative open market policy. This adjustment was quickly reflected in a sharp, general decline in short-term interest rates, as illustrated by the Federal funds rate, which fell more than 200 basis points between early July and mid-September. In September the Board of Governors removed the 3 per cent marginal reserve requirement from large time deposits and comparable nondeposit bank liabilities whose maturities exceeded 4 months—thus providing a modest supplement to the reserves made available through open market operations.

The marked third-quarter drop in the complex of short-term market interest rates began to be reflected in some general pick-up of growth in the monetary aggregates during the fourth quarter, when sizable net inflows of savings were resumed following a short period of substantial disintermediation during the summer. The improvement was most pronounced at nonbank thrift institutions. Late in the fourth quarter, however, the unexpectedly sharp deterioration in economic activity tended to slow demands for money and credit and thus to offset some of the stimulus to growth in the aggregates stemming from earlier declines in interest rates. This was especially evident in the narrowly defined money stock, which grew at an annual rate of only 2 per cent during December and then declined in January 1975.

To help counter this weakness, the System made use of all of its major policy instruments: open market operations, to expand the supply of nonborrowed reserves available to banks; reductions in reserve requirements, to increase the credit-expansion potential of the existing supply of reserves; and cuts in the discount rate, to reduce the cost of reserves borrowed from the System. Cuts in the discount rate were made in three stages: a ¼ percentage point reduction, to 7¾ per cent, effective December 9; a ½ percentage point reduction, to 7¼ per cent, effective January 6, 1975; and a ½ percentage point reduction to 6¾ per cent, effective February 7, 1975.

The reductions in reserve requirements were also made in three stages. One, already noted, reduced the marginal reserve requirement on longer-dated bank obligations in late September. The second, in late November, was applied to selected categories of both time and demand deposits; it released about $700 million of reserves to the banking system 2 weeks later. The third lowered the structure of graduated requirements applicable to demand deposits, beginning in the week of January 30, 1975; it released about $1.1 billion of reserves 2 weeks later.[1]

The weaker credit demands that developed as a consequence of the recession, together with the more expansive course of monetary policy, triggered further sharp declines in short-term interest rates over the fourth quarter. By year-end the Federal funds rate had dropped to 8 per cent, and by early February 1975 it was close to 6¼ per cent. Long-term rates—which had continued to rise on balance during the third quarter despite the large general decline in short-term rates—also turned down in the fourth quarter. However, large current and prospective borrowings by businesses in capital markets and the prospect of unprecedented deficit financing by the Federal Government in the months ahead limited the extent of these declines. Moreover, yields on State and local government securities reached their yearly highs during December when serious questions developed regarding the ability of certain key municipal borrowers to continue to service their large and growing debt burdens.

By early 1975 the widespread concerns of the preceding summer about the possibilities of a full-scale liquidity crisis had dissipated. But the unexpectedly sharp deterioration in over-all economic activity posed broad questions about credit quality and encouraged institutional lenders to continue maintaining relatively conservative loan policies despite the general easing of money market conditions. Although interest rates had declined substantially further after the turn of the year, the unprecedented volume of Federal deficit financing that loomed ahead was raising some questions in market circles about the likely course of interest rates over the somewhat longer run.

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[1] The November action included a reduction of ½ percentage point in the requirement on that portion of net demand deposits in excess of $400 million, the elimination of the remaining marginal reserve requirement on large-denomination time deposits, and a restructuring of the basic requirement on time deposits. The reserve requirement on all time deposits with original maturity of at least 180 days and on the first $5 million of shorter-maturity time deposits was set at 3 per cent; the requirement for the remainder of shorter-maturity deposits was set at 6 per cent. The lower reserve requirement on longer-term deposits was intended to provide an incentive for banks to improve their liquidity by lengthening the maturities of their liabilities.

The January 1975 action included a reduction of 1 percentage point on that portion of net demand deposits in excess of $400 million, and a reduction of ½ percentage point on that portion of such deposits under $400 million.

MONEY AND CREDIT AGGREGATES

The various measures of money and credit growth continued to exhibit occasional periods of erratic movement in 1974. This was particularly true of the narrowly defined money stock at key points in the year. As a result, although the Federal Open Market Committee continued to place important emphasis on the behavior of M_1 as a target of monetary policy, the performance of M_1—particularly in the short run—had to be carefully evaluated in relation to growth patterns of other major aggregates as well as to changes in interest rates.

For 1974 as a whole, the key measures of money experienced slower growth rates than in 1973, whereas the adjusted credit proxy continued to expand at about its 1973 pace. However, these annual averages mask rather substantial quarter-to-quarter changes in growth patterns, particularly for M_1 and the adjusted credit proxy. In addition, the annual growth rate shown for M_1 included rather different patterns of change for its two components—demand deposits and currency in circulation. Whereas expansion in demand deposits slowed to only 3 per cent for the year, currency expanded by an unusual 10 per cent as the continuing rapid inflation created growing public needs for cash to pay for consumer outlays.

The quarterly growth rates for the aggregates shown in Table 5 identify significant patterns of change within the year. In the first quarter, for example, the relatively rapid growth rates of M_2 and M_3 mirrored inflows of savings to banks and other depositary intermediaries that were being encouraged by the further over-all decline in short-term market rates. First-quarter growth in M_1, on the other hand, reflected the combination of contraction at an annual rate of nearly 3 per cent in January followed by growth in February and March at an annual rate of roughly 9.5 per cent. The January contraction was attributable chiefly to a sharp reduction in foreign demand balances at the start of the year from the extraordinarily high levels reached at the end of 1973.

The dramatic increase in bank credit during the second quarter—when growth in the bank credit proxy rose to more than a 20 per cent annual rate—was attributable chiefly to three factors. Over-all business needs for funds were exceptionally large; high interest rates

Table 5: GROWTH IN MONETARY AGGREGATES

In per cent

Period	Measures of money M_1	Measures of money M_2	Measures of money M_3	Adjusted credit proxy
1972	8.7	11.1	13.1	11.3
1973	6.1	8.8	8.7	10.4
1974	4.7	7.4	6.7	10.2
1974—Q1	5.5	9.3	8.8	8.2
Q2	7.0	7.9	6.6	20.4
Q3	1.6	4.5	4.0	6.6
Q4	4.6	7.0	6.9	4.3

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. Government.

M_2 = M_1 plus time deposits at commercial banks other than large negotiable certificates of deposit at weekly reporting banks.

M_3 = M_2 plus deposits of mutual savings banks and savings capital of savings and loan associations.

Adjusted credit proxy = Total member bank deposits subject to reserves, plus Euro-dollar borrowings, loans sold to bank-related institutions, and other nondeposit items.

NOTE.—Incorporates revisions in money stock and related measures based on benchmark data for nonmember banks derived from Reports of Condition through October 1974, as well as revisions in seasonal adjustment factors. 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.

were discouraging bond financing; and as the quarter progressed, investors in commercial paper and corporate securities tended to back away from obligations of borrowers with less than top quality ratings. To accommodate this upsurge in demands for bank credit, banks themselves were forced to bid aggressively for funds through expanded sales of large CD's and increased borrowing from nondeposit sources. As a result, the outstanding volume of large CD's grew nearly $13.5 billion over the quarter, contributing substantially to the upward pressure on short-term rates. In contrast to the credit proxy, growth of M_2 and M_3 slowed during the second quarter as the attractiveness of yields on competing market securities increased relative to maximum rates payable on thrift accounts.

While growth of M_1 continued to show considerable variation from month to month, it expanded rapidly over the second quarter, as Table 5 shows. Both the variability and the rapid growth were significantly influenced by the ebb and flow of foreign deposits. This reflected temporary accumulations of demand deposits resulting from the transfer of greatly expanded payments to oil producers. Because some producing countries had not yet perfected procedures for making timely investment of the expanding proceeds from oil sales, a significant part of these proceeds were accumulated for brief periods in demand balances, causing growth rates for M_1 to show noticeable short-run changes. As the year progressed and the processing of oil funds became more routine, the erratic impact of foreign transactions on the money stock became less significant.

Growth in all of the key money and credit aggregates slowed substantially in the third quarter. This change was attributable both to the lagged impact of earlier, steep advances in interest rates and to the developing weakness of the economy. With loan demands falling off, banks were able to cut back significantly on both their sales of large CD's and their acquisitions of nondeposit funds, so growth in the adjusted credit proxy dropped abruptly. At the same time, high interest rates on market securities were cutting deeply into flows of funds to thrift accounts at banks and other intermediaries. Thus, for both M_2 and M_3 growth was also appreciably slower.

During October and November further declines in short-term interest rates from their early summer highs tended to encourage more rapid growth of both M_1 and M_2. In the two succeeding months, however, this pattern of expansion was substantially modified, as the marked general deterioration in over-all economic activity tended to offset much of the stimulus to money demands arising from further declines in interest rates. The failure of the adjusted credit proxy to expand with other aggregates during the fourth quarter was attributable in part to the general weakening of demands for bank credit as economic activity slowed. In addition, however, many borrowers were adjusting their debt structures and were turning to new capital market financing in lieu of bank borrowing.

BANK RESERVES

Total reserves of commercial banks grew almost as rapidly in 1974 as in 1973, and nonborrowed reserves grew significantly faster, as Table 6 shows. Much of the growth in nonborrowed reserves occurred in the fourth quarter, however, when member bank borrowing dropped off sharply. Patterns of change in total reserves also varied considerably from quarter to quarter, as did those of the money and credit aggregates they supported.

Table 6: GROWTH IN BANK RESERVES

Item	1973	1974	1974 Q1	1974 Q2	1974 Q3	1974 Q4
	Annual rate, in per cent					
Total reserves	7.8	7.1	1.3	20.1	8.2	4.1
Nonborrowed reserves	7.2	9.1	1.2	.8	5.6	34.4
Reserves available to support private nonbank deposits (RPD's)	9.3	7.2	5.7	19.1	9.1	.7
	In millions of dollars					
Memoranda:						
Total change in RPD's [1]	2,706	2,896	467	1,578	793	58
By type of deposit:						
Required reserves for—						
Private demand deposits [1]	527	406	19	110	3	274
Time deposits other than large negotiable CD's [1]	883	790	193	208	245	144
Large negotiable CD's and nondeposit sources of funds [1]	1,272	1,751	428	1,197	548	−422
Excess reserves	25	−51	−173	64	−4	62

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

Growth of total reserves was particularly dramatic in the second quarter when heavy demands for bank credit were being financed by expanded sales of large-denomination CD's and when System concerns about possible general malfunctioning of credit markets were greatest. Nonborrowed reserves showed very little growth in the second quarter, however, because a sizable part of the over-all increase in demand for total reserves during this period was being met by the large emergency credits advanced by the Federal Reserve to the Franklin National Bank. Franklin was forced to borrow heavily starting in May—substantially raising the average level of total borrowing from the System; this reduced the need for provision of reserves through open market operations.

While growth of total reserves was less dramatic in the third quarter than in the second, it remained above the average for the year, with general growth in business demands for bank funds still sizable. By the fourth quarter, however, reduced demands by businesses for short-term funds, together with the continuing more cautious approach of banks to lending, were reflected in a commensurate reduction in bank needs for reserves. Consequently, the growth in total bank reserves slowed somewhat further.

Early in the fourth quarter nonborrowed reserves showed a sharp spurt when the Franklin National Bank was closed through regulatory action. As a part of this action, Franklin's large outstanding debt to the Federal Reserve was transferred through agreement of the regulatory agencies to a form that was reflected in the banking statistics as nonborrowed reserves. Over the rest of the quarter, however, and in early 1975, nonborrowed reserves continued to grow rapidly. Much of this expansion reflected System provision of reserves needed to offset heavy reserve drains arising from member bank repayment of borrowings at the Reserve Banks. Reduced member bank borrowing was encouraged by the sharp reductions in private money market rates to levels at or below the System discount rate. In late January and early February member bank borrowing at the Federal Reserve averaged only a little over $100 million, most of which was attributable to emergency lending by banks that were experiencing difficulties acquiring funds from private sources.

AGGREGATE FLOWS OF FUNDS

The nonfinancial sectors of the economy raised an estimated $176 billion in credit and equity markets during 1974, or about $12 billion less than they had raised in 1973. Since GNP increased 8 per cent from 1973, there was a large decline in the ratio of funds raised to GNP. Although declines in this ratio have marked other periods of credit stringency, the extent of the drop in 1974 can be viewed as a measure of the tautness that characterized financial markets during most of the year.

In addition to the shrinkage in total credit flows during 1974, there were marked changes in the structure of funds provided relative to 1973. Most notably, private domestic financial institutions accounted for an appreciably smaller share of total funds placed in credit and equity markets than in 1973—62 per cent versus 72 per cent—and of total funds supplied to nonfinancial sectors—65 per cent versus 75 per cent. Foreigners, on the other hand, supplied a substantially larger volume of funds, primarily to the Government securities market, as a sizable portion of the receipts from oil exports were invested in the United States.

Households also accounted for a larger proportion of funds supplied in credit and equity markets during 1974—11 per cent versus

Table 7: FUNDS RAISED IN CREDIT AND EQUITY MARKETS BY NONFINANCIAL SECTORS

In billions of dollars

Sector, or type of instrument	1973	1974	1974 [1] Q1	Q2	Q3	Q4
Total funds raised	**187.4**	**175.7**	**174.5**	**207.2**	**174.7**	**146.4**
By sector:						
U.S. Government [2]	9.7	13.0	11.3	1.4	18.2	21.0
Other	*177.6*	*162.7*	*163.3*	*205.8*	*156.4*	*125.5*
Nonfinancial business	85.1	88.9	91.5	111.0	87.0	66.0
State and local government	12.3	15.8	14.3	17.7	14.4	16.9
Households	72.8	42.5	42.3	52.6	47.4	27.8
Foreign	7.5	15.5	15.3	24.5	7.6	14.7
By type of instrument:						
U.S. Government securities	9.7	13.0	11.3	1.4	18.2	21.0
Corporate and foreign bonds	10.2	20.9	19.6	20.7	18.2	25.1
Corporate equities	7.2	3.3	6.3	4.5	−.4	2.8
State and local government debt [3]	13.7	17.0	15.6	20.0	15.1	17.0
Mortgages	*73.2*	*55.0*	*56.5*	*69.3*	*47.4*	*46.9*
Residential	51.7	38.8	38.7	47.5	35.3	34.0
Other	21.4	16.1	17.9	21.7	12.1	12.9
Bank loans n.e.c.	38.6	29.9	36.4	47.8	21.3	14.1
Open market paper	1.8	14.9	12.2	18.6	21.2	7.7
Consumer credit	22.9	9.6	8.2	17.2	15.8	−2.6
Other loans	10.0	12.1	8.4	7.8	17.7	14.4

[1] Quarterly data are at seasonally adjusted annual rates.
[2] Public debt securities and budget agency securities.
[3] Includes both long- and short-term borrowing.

SOURCE.—Federal Reserve flow of funds accounts.

9 per cent in 1973. This reflected the continued allocation of a sizable share of the increase in their financial assets to market instruments as opposed to deposits and currency. Of their 1974 net gain in financial assets, households placed 18 per cent directly in stocks and credit market instruments, roughly the same as in 1973. In contrast, during 1970, 1971, and 1972—when rate relationships did not encourage disintermediation—direct investments in market securities had been negligible or even negative.

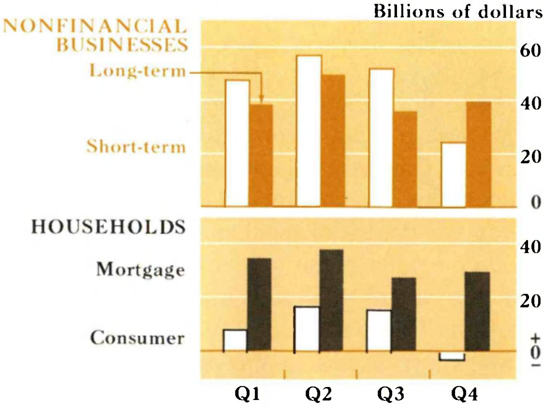
There were also significant changes in the sectoral breakdown of funds used. The weakness in sales of consumer durable goods and the rising ratio of household indebtedness to income were reflected in a marked decline in consumer credit flows. And reduced deposit growth at thrift institutions contributed—along with rising building costs and peak mortgage rates—to a shrinkage in flows of residential mortgage credit. As a result, aggregate flows of funds to households fell sharply, whereas funds raised by other nonfinancial sectors—especially businesses and foreigners—rose substantially.

As pronounced as the year-to-year changes in the composition of fund flows were, they were not nearly so dramatic as the shifts that occurred within 1974. Abrupt changes in economic conditions—and in some instances, the adjustments in monetary policy made in response to those changes—caused remarkable shifts in the level and composition of financial flows from quarter to quarter.

Early in the year when the oil embargo was depressing both economic activity and interest rates, businesses were encouraged to expand their borrowing in long-term markets. Firms that had postponed such financing in 1973 were particularly active. As a result, corporate and foreign bond sales—net of redemptions—which had been running at an annual rate of $10.5 billion in the fourth quarter of 1973, rose to a $19.6 billion rate in the first quarter of 1974.

Declines in market interest rates early in the year also helped to sustain the improved flows to nonbank thrift institutions that had developed in late 1973. This stimulated an increase in commitments to make future residential mortgage loans and accounted in part for the upswing in such loans during the second quarter.

BORROWING BY SELECTED SECTORS, 1974



NOTE.—Short-term is bank loans and other loans. Long-term is corporate bonds and mortgages. Flow of funds data.

Demands for credit intensified over the second quarter, particularly in short-term markets, as the slide in economic activity slowed temporarily and rapid inflation augmented business needs for inventory financing. Commercial banks were the focus of much of this increase in credit demands.

Table 8: FUNDS SUPPLIED IN CREDIT AND EQUITY MARKETS

In billions of dollars

Sector supplying	1973	1974	1974 [1]			
			Q1	Q2	Q3	Q4
All sectors	**239.4**	**216.7**	**208.4**	**254.3**	**242.3**	**161.8**
All sectors to nonfinancial sectors	187.4	175.7	174.5	207.2	174.7	146.4
U.S. Government and sponsored credit agencies	23.3	29.9	15.2	30.2	39.0	35.3
Less funds raised by sponsored credit agencies	19.6	21.6	9.3	24.3	33.9	19.2
Federal Reserve System	9.2	6.2	−.9	13.1	10.7	1.7
Foreign sources	3.5	13.2	5.9	17.4	6.4	23.1
Private financial intermediaries	*172.3*	*134.3*	*152.9*	*174.7*	*114.1*	*95.5*
Commercial banks	86.7	61.8	78.7	96.8	41.4	30.3
Thrift institutions	35.4	27.8	43.9	27.1	17.2	23.2
Insurance and pension funds	37.0	40.3	30.8	43.5	40.8	46.3
Other	13.1	4.3	−.4	7.3	15.0	−4.3
Less funds raised by private financial intermediaries	32.4	19.4	24.6	22.8	33.7	−3.9
Private domestic nonfinancial investors	*31.1*	*33.1*	*35.4*	*18.9*	*72.0*	*6.1*
Households	21.5	22.8	12.0	16.8	54.6	8.0
Nonfinancial businesses	9.2	6.4	16.8	9.4	10.9	−11.6
State and local governments	.4	3.9	6.7	−7.4	6.5	9.8
MEMO: Net change in deposits and currency held by private domestic nonfinancial sectors	88.8	77.9	97.3	109.0	29.0	76.2

[1] Quarterly data are seasonally adjusted annual rates.

SOURCE.—Federal Reserve flow of funds accounts.

Demands for bank credit in the spring were also augmented because financial investors were placing increased emphasis on the creditworthiness of borrowers. Lower-rated companies often found that they had to pay a much higher rate than prime issuers in order to sell commercial paper. Even for issuers of medium-grade paper, the premium over the prime commercial paper rate rose from roughly ½ percentage point in the winter to 1½ percentage points in the early summer. And some firms found that they could not sell commercial paper at all. Firms whose access to the paper market was thus restricted had to fall back on lines of credit at banks.

Bank loans to foreigners also expanded at a faster rate in the second quarter. But so too did deposits of foreigners, since commercial banks were serving as intermediaries for enlarged oil payments to foreigners.

The steep, general rise in short-term interest rates resulting from the spring and early-summer accumulation of pressures on banks was not reflected in the market for short-term U.S. Treasury securities where yields showed little net change during the first half of the year. In this period the supply of Treasury bills available to the public was reduced substantially by heavy buying on the part of both foreign central banks (partly with dollars obtained in foreign exchange market intervention) and the Federal Reserve (through open market purchases to supply reserves). As a result, rate spreads between Treasury bills and private instruments of similar maturity widened to almost 4 percentage points.

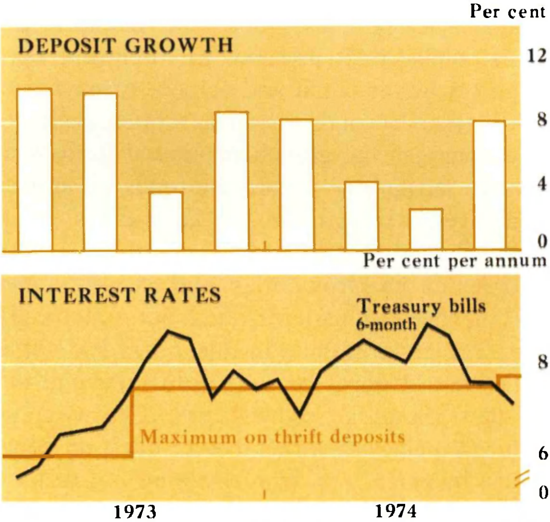
This rate spread had important repercussions on credit flows. First, funds of foreign central banks, which previously had been placed almost entirely in Treasury bills and other Government obligations, were placed to some extent in bankers' acceptances, which at that time were still being guaranteed by the Federal Reserve. Supplies of acceptances available for purchase grew very rapidly in the second and third quarters, when credit demands of foreigners were being diverted to U.S. sources by the credit and balance of payments policies of foreign governments. Second, the higher rates available on private instruments encouraged the growth of mutual funds that invest in liquid assets; these institutions pooled the funds of smaller investors and purchased diversified portfolios of large CD's, commercial paper, and other short-term assets.

The rise in private short-term rates from late winter to midsummer was accompanied by an increase in long-term rates, but as typically occurs in periods of sharp, general advances in rates, the yield curve took on a pronounced downward slope. As long-term rates and the cost of equity capital in the stock market moved upward, many companies put off long-term financing—favoring bank loans or commercial paper. Some firms, however, had no real option but to proceed with bond or stock financing—especially in the public utility industry where long-term funds were required for fixed investment expenditures. Thus, despite the high costs of capital, the volume of long-term financing was maintained through the second quarter.

Even in the third quarter, when yields on new top-quality corporate bonds reached record levels above 10 per cent, the aggregate volume of new offerings remained large for a summer period. The sale of a sizable volume of floating-rate notes—primarily by bank holding companies—accounted for much of this sustained volume. These securities proved very attractive to small investors because of the high initial rates and the option of redemption on specified dates.

The combination of high market yields and the availability of attractive new types of financial instruments cut deeply into the supply of funds flowing to thrift institutions during the second and third quarters. The summer attrition was also augmented because the Treasury, at congressional insistence, restored the low, $1,000-minimum denomination on high-coupon note issues that it offered in the August refinancing. Even though the Federal home loan banks made advances to savings and loan associations totaling $5.7 billion

THRIFT INSTITUTIONS' GROWTH, AND INTEREST RATES



NOTE.—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.

Interest rates: Monthly data. Rate on Treasury bills is average of yields at weekly auctions. Thrift institutions, highest rates payable on consumer-type deposits at mutual savings banks and savings and loan associations for longest certificates (2 years through June 1973, 4 years through Dec. 22, 1974, and 6 years beginning Dec. 23, 1974).

during the second and third quarters and other Federally sponsored agencies provided funds to the mortgage market, residential mortgage rates rose nearly as much as bond rates, reaching 10 per cent in the fall, and loan commitments fell sharply. Although subsequent declines in market rates brought a resumption of net deposit inflows, the smaller backlog of loan commitments and the reduction of demands for mortgage loans associated with the deterioration of the economy resulted in a slowing of mortgage debt formation over the second half of the year. Thrift institutions therefore used their improved flows of funds to repay debt and to rebuild liquid asset holdings.

The limited supply of Treasury bills available to the public that was characteristic of the first half of the year began to be reversed in August, as the Treasury became a substantial net borrower. This caused a sizable late-summer advance in bill yields, which sharply narrowed the earlier, wide spreads between them and other short-term rates. Then, as other short-term rates declined, Treasury bill rates shared in the downtrend.

Consumer reluctance to purchase new autos and other large-ticket durable goods cut deeply into consumer credit flows during the fourth quarter, reducing both direct demands on banks for instalment credit and indirect demands from finance companies. Consumer credit growth was also limited by the stricter quality standards being applied by lenders in response to the rising rate of loan delinquencies and the negative outlook for employment.

In addition to the Government sector, the principal area of credit markets where demands picked up toward the year-end was the corporate bond sector. Cyclically depressed tax revenues and rising expenditures forced the Federal budget into deeper deficit and required increased issuance of debt. In the corporate sector businesses took advantage of the general easing of bond market pressures to sell a near-record volume of long-term debt. Much of the corporate bond volume was in the intermediate-term maturity range—5 to 10 years.

The weakness of the economy and the repayment of short-term debt with the proceeds of longer-term financings were reflected in a sharp slowing of short-term business credit expansion in the fourth quarter. The sum of bank loans to nonfinancial businesses and of

Table 9: U.S. GOVERNMENT FINANCE

In billions of dollars

Item	Calendar year 1972	1973	1974
Deficit	**17.4**	**7.9**	**10.9**
Amount financed by changes in cash assets and other items	2.1	.....	−.8
Total borrowing from public [1]	**15.3**	**7.9**	**11.8**
Net Federal Reserve purchases of Government securities [2]	−.2	8.6	2.1
Net Treasury borrowing from private investors—			
Marketable:			
Foreign	4.5	−5.4	6.8
Other	3.3	−4.1	3.2
Nonmarketable:			
Foreign	3.9	5.6	−3.2
Other	3.8	3.2	3.0
Memoranda:			
Net borrowing by Government-sponsored agencies	3.5	16.3	16.6
Federal Reserve outright purchases of sponsored agency issues	.6	.5	2.5

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

commercial paper issued by such firms, which had grown at seasonally adjusted annual rates of from 18 to 25 per cent in the first three quarters of the year, rose at a rate of less than 3 per cent between September and December. The deceleration of the bank component of short-term credit also was attributable in some measure to conservative lending postures by banks in light of prospective loan losses, reduced liquidity, and concern about the adequacy of bank capital.

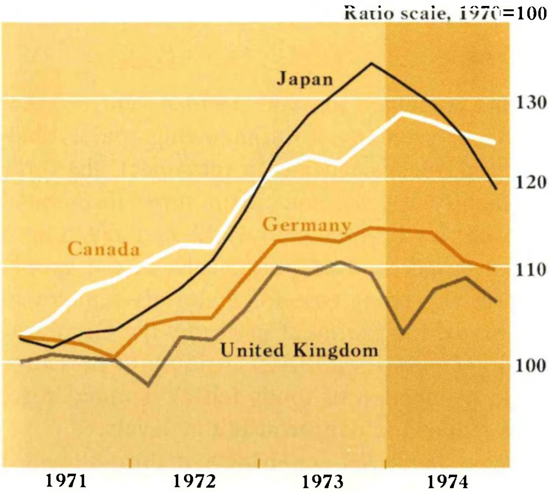
International Developments

A series of dramatic events combined to make 1974 a year of great economic stress in the world economy, foreshadowing major challenges for economic policy in the year ahead. In retrospect, the force initiating much of the difficulty was the coincident surge in demand in nearly all industrial countries beginning in 1972 and reaching a peak after mid-1973. That surge exposed bottlenecks in the supply of many basic commodities, and rising costs of materials aggravated demand inflation and facilitated the raising of prices by the Organization of Petroleum Exporting Countries (OPEC). Adding to pressures on consumer prices, world production of foods fell as demand rose, and food inventories were reduced to dangerously low levels.

Faced with these problems, industrial countries had shifted toward policies of demand restraint in 1973. This shift added to the already strong depressing effect on demand of higher oil prices, bringing a slowdown in industrial production by early 1974. By the end of the year industrial countries were operating well below capacity. For the industrial countries (other than the United States) as a group, it appears that real GNP rose only slightly over 1 per cent in 1974 (in the 1960–70 period growth had averaged 6.3 per cent annually) and would be far below the long-run average in 1975. If the U.S. performance is included, real GNP growth for the 2 years would be considerably lower.

Policymakers are constrained in their efforts to revive demand by rates of inflation that are far too high in every country, though some countries have been more successful than others in restraining inflation. In terms of GNP deflators, industrial countries as a group experienced a price increase of 12½ per cent in 1974 compared with a 3.6 per cent annual average in 1960–72. Weaknesses in prices of many industrial commodities began to show up clearly by mid-1974, but upward pressure on prices was sustained by several factors: escalating wage settlements as labor attempted to maintain or restore purchasing power; declining productivity as capacity utilization fell off; short supplies of foodstuffs; and the maintenance by OPEC of the high price of oil despite declining demand and great excess capacity.

FOREIGN INDUSTRIAL PRODUCTION

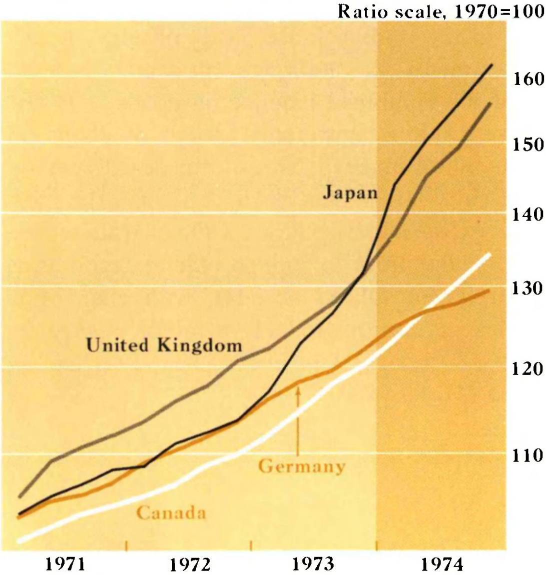


NOTE.—Seasonally adjusted quarterly data from Organization for Economic Cooperation and Development. Q4 partly estimated.

When the oil producers quadrupled the price of oil, they created not only pervasive stresses on world prices and economic activity but also a challenge to the stability of world capital markets and to international economic cooperation. Financial markets have been strained as oil-consuming countries have borrowed on a long-term basis to finance their deficits, while OPEC countries have tended to concentrate on those kinds of assets that best meet their needs for liquidity, safety, and yield.

To satisfy these needs, the OPEC countries placed their investible surplus (the amount left from receipts from exports and investment income after payment for imports and outlays for military purposes and aid)—probably amounting to some $55 billion in 1974—mainly in money market assets in the United States (20 per cent) and in the U.K. and the Euro-currency markets (50 per cent). They also made large investments in direct loans to industrial oil-consuming countries (10 per cent) and in loans to the special oil facility established in the International Monetary Fund and to other multinational institutions (6 per cent). The remainder was dispersed through many channels, including some longer-term investments in industrial countries.

FOREIGN CONSUMER PRICES



NOTE.—Seasonally adjusted quarterly data from Organization for Economic Cooperation and Development. Q4 partly estimated.

The world's banking system faced multiple problems in 1974. Commercial banks needed to adjust not only to the vast inflow of OPEC funds and the financing requirements of oil consumers, but also to the weakening of confidence caused by the failure of a few banks with large losses in foreign exchange and other dealings. In addition, banks generally recognized that they had been expanding their operations more rapidly than was prudent in relation to their capital resources. Reacting to this situation and to the measures taken by concerned monetary authorities to preserve sound banking systems, banks tightened both their domestic and their foreign lending operations.

U.S. INTERNATIONAL TRANSACTIONS

The course of U.S. international transactions is reflected in the balance of payments accounts and also, under a system permitting substantial exchange-rate movement, in changes in the exchange rate for the dollar. In terms of broad aggregates of international transactions, the surplus on goods and services declined slightly from 1973 to 1974, with a sizable drop in the trade balance partly offset by higher net income on foreign investments. Private long-term capital outflows rose sharply in 1974, and the combined balance on goods, services, remittances, and long-term capital registered a deficit of about $8 billion, compared with $1 billion in 1973. Short-term private capital outflows, net, were only slightly larger than in 1973, though the gross flows through banks were extraordinarily large. Official transactions included an increase in U.S. liabilities to foreign official accounts of $9.4 billion—almost entirely for OPEC account, with changes in holdings by other countries netting out to only a minor change for

Table 10: U.S. INTERNATIONAL TRANSACTIONS

In billions of dollars, seasonally adjusted

Item	1973	1974[e]	1974			
			Q1	Q2	Q3	Q4[e]
Merchandise trade balance	**.5**	**−5.8**	**−.1**	**−1.6**	**−2.6**	**−1.5**
Exports	70.3	97.1	22.3	24.1	24.6	26.1
Imports	−69.8	−102.8	−22.3	−25.7	−27.2	−27.6
Investment income, net	5.3	8.8	3.1	1.8	2.2	1.7
Other service transactions, net	−1.4	−.5	−.1	−.4	(1)	......
Balance on goods and services	**4.3**	**2.6**	**2.9**	**−.2**	**−.3**	**.2**
Remittances and pensions, net	−1.9	−1.9	−.4	−.5	−.5	−.5
U.S. Govt. grants and capital, net	−3.5	−3.8	−1.2	−.9	−.8	−.9
Long-term private capital, net	.1	−5.0	.5	−1.0	−2.0	−2.5
Balance on current account and long-term capital	**−1.0**	**−8.1**	**1.8**	**−2.5**	**−3.6**	**−3.7**
Short-term private capital, net	−2.0	−3.3	−1.8	−3.8	2.6	−.2
Of which- Foreign assets of U.S. banks	−5.0	−17.1	−5.0	−6.6	−2.0	−3.6
Foreign liabilities of U.S. banks	4.2	15.0	4.7	2.8	4.0	3.4
Liabilities to foreign official agencies	5.1	9.4	−.8	4.9	1.4	3.9
Of which- Oil-exporting (OPEC) countries, not seasonally adjusted	(.4)	(9.4)	(1.0)	(2.4)	(3.9)	(2.1)
Change in U.S. reserve assets	.2	−1.4	−.2	−.4	−1.0	.1
Errors and omissions	−2.3	3.4	1.0	1.8	.6	−.1
MEMO: Official settlements balance	−5.3	−8.0	1.0	−4.5	−.4	−4.1
Official settlements balance excluding liabilities to OPEC countries, not seasonally adjusted	−4.9	1.4	2.0	−2.2	3.6	−2.0

[1] Less than $50 million.
[e] Estimated.

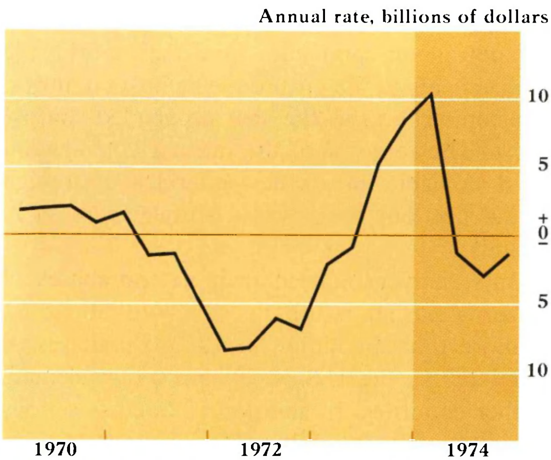
NOTE.—Details may not add to totals because of rounding.
SOURCE.—U.S. Dept. of Commerce and F.R. estimates.

the year. There was also an increase of $1.4 billion in U.S. reserve assets. During the year errors and omissions in the accounts were generally on the receipts side, suggesting some net unrecorded inflow of capital.

As in the case of other countries, the jump in oil prices was the greatest single influence affecting both current and capital transactions in 1974, but other factors were also at work. The effective depreciation of the dollar since 1970 by about 16 per cent was probably still having a significant effect on the trade balance, supporting a strong export performance and restraining imports. On the other hand, the removal of controls on outflows of U.S. private capital in January (while barriers to inflows were coming down in other countries), together with declining interest rates in the United States early in the year and again toward the end of the year, tended to encourage the outflow of capital from the United States.

Despite an additional cost of over $18 billion for imports of fuels in 1974, the over-all trade balance declined by only $6 billion. Exports, in value terms, rose by $27 billion, including a rise of about $4 billion for agricultural exports. In volume terms agricultural ex-

BALANCE ON GOODS, SERVICES, AND REMITTANCES



NOTE.—Dept. of Commerce data at seasonally adjusted annual rates. Q4 partly estimated.

ports were about 10 per cent lower in 1974 than in 1973, but nonagricultural exports were up by 12 per cent, following a strong—22 per cent—increase in 1973. The 1974 performance was especially impressive, given the weakening of demand in other industrial countries.

On the import side, nonfuel imports rose about $15 billion in 1974, but in volume terms they were cut back by about 2 per cent, reflecting in large part the decline in domestic economic activity. The volume of fuel imports was about 3 per cent less in 1974 than in 1973, but the price (unit value) of a barrel of imported crude oil rose from an average of $3.33 in 1973 to $11.00 in 1974.

It appears that net receipts of investment income scored a substantial gain in 1974—rising to a record of about $9 billion, compared with $5.3 billion in 1973. Most of the increase reflected larger profits by the petroleum companies from their foreign operations, though these may now diminish as initial inventory profits will not be repeated and ownership of the crude-oil-producing properties is relinquished to the host countries.

Long-term private capital transactions appear to have resulted in a net outflow of about $5 billion in 1974, based on incomplete data. This would be the largest net outflow since the imposition of capital controls in the early 1960's and a considerable shift from the near-balance in these flows in 1972 and 1973. Early in the year the net flow was inward, reflecting primarily the collection of funds in this country by international petroleum companies from their worldwide sales in advance of disbursements to the oil-producing host countries. Payments of taxes and income shares as the year progressed sharply raised the rate of outflow. The removal of the interest equalization tax in January 1974 did not spur major new offerings of foreign issues now relieved of the tax, but there was a sizable increase in offerings of Canadian bonds.

Foreign private investors sharply reduced their net purchases of U.S. securities other than Treasury issues in 1974—to about $1 billion, compared with more than $4 billion in 1973. Purchases of U.S. corporate stocks fell off as the U.S. stock market weakened, along with markets in other countries. In addition, U.S. corporations offered much smaller amounts of their bonds in foreign markets since they no longer needed to borrow abroad to satisfy the requirements of the controls on outflows of funds from the United States. Foreign direct investments in the United States, apart from special transactions related to certain petroleum companies, were substantially less than the 1973 peak amount.

Short-term private capital flows were very large in both directions in 1974, but preliminary data suggest that there was only a small increase in the net outflow from the United States. U.S. banks provided large amounts of credit to foreign countries, especially Japan, increasing their short- and long-term claims on foreigners by $18 billion in the year. The elimination of controls at the beginning of the year and the lower cost of borrowing in the United States for part of the year tended to raise the outflow from the U.S. offices of banks. After August there was some reduction in the rate of bank lending, in part because a number of the early borrowers had taken care of their needs for the year or had arranged borrowings from OPEC sources, and in part because of the general tightening of banks' lending policies. However, bank lending to foreigners was stepped up again in the closing months of the year. Although the increase in banks' foreign claims was enormous by past standards, it was nearly matched by a $15 billion increase in their liabilities to private foreigners—primarily through their branches and other banks in the Euro-dollar market.

In addition to magnified flows of private short-term capital, a major new element in the U.S. balance of payments in 1974 was the direct acquisition of U.S. money market assets by authorities of the OPEC countries. Such acquisitions amounted to about $9½ billion for the year, mainly in purchases of U.S. Government obligations.

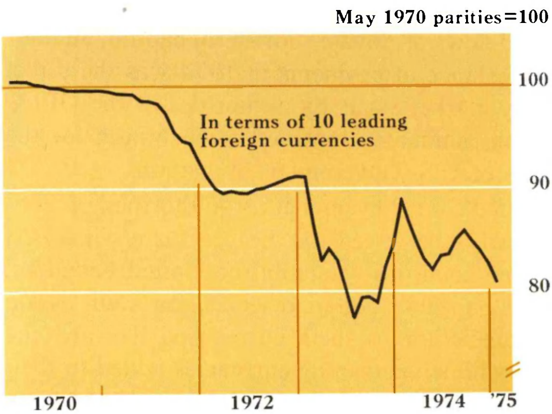
Funds held in the United States by monetary authorities of non-OPEC countries were nearly unchanged for the year as a whole. At times during the year some countries—notably the United Kingdom, Italy, and Japan—drew on their dollar reserves, as well as on borrowings, to limit depreciation of their currencies. Toward the end of the year countries with strengthening currencies added to their holdings of dollar assets in the United States. U.S. reserve assets rose mainly as a consequence of drawings of dollars by some countries from the IMF.

INTERNATIONAL FINANCIAL SCENE

International financial markets were under strong pressures in 1974 arising from the uncertainties created by the flow of oil payments and revenues; by rampant world inflation; and toward the end of the year, by the onset of worldwide recession. Exchange rates showed considerable variability as the market reacted to each new bit of information in this uncertain environment. The weighted-average exchange value of the U.S. dollar varied by about 10 per cent over the course of the year, and rates of exchange between the dollar and some continental European currencies varied by much more than that.

These fluctuations in exchange rates encouraged a number of banks—notably European banks—to take large open positions, particularly in the first half of the year, and some of these banks reported large foreign exchange losses. Such losses were directly responsible for the failure of a German bank that was relatively small in terms of its total assets but was a major participant in the exchange market; hence its failure had widespread effects. After that failure the volume of interbank trading declined sharply, as banks

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.

restricted their dealings to only those banks deemed most credit-worthy and reduced their limits on foreign exchange lines to nonbank as well as bank customers.

This extreme contraction of the market subsequently eased, but in general, banks have maintained a more cautious attitude toward exchange market transactions and have substantially tightened internal control procedures related to such transactions. In some major countries the authorities have increased their surveillance and/or control over banks' foreign exchange operations in the aftermath of the experience of foreign exchange losses by some banks in their jurisdictions.

After appreciating very sharply in the fourth quarter of 1973 and into January of 1974, the dollar depreciated from the end of January through mid-May, declining by 10 per cent on a weighted-average basis. Major factors in the dollar's depreciation in this period included the removal of controls on capital outflows by the United States and the relaxation of restrictions on inflows by most major foreign countries; the demonstration by several European countries of their willingness to engage in large-scale official borrowing in the Euro-currency markets to support their currencies while paying more for oil; and the continuation of large export surpluses in Germany, despite sharply higher oil payments, at a time when the trade balances of most other industrial countries were moving heavily into deficit.

The dollar's slide ended in mid-May with reports that the Federal Reserve, the German Federal Bank, and the Swiss National Bank had agreed upon the desirability of concerted exchange intervention in markets. Sharp increases in U.S. interest rates relative to foreign rates and, after June, market uneasiness stemming from the difficulties of some German banks contributed to a strong dollar until early September. At that time U.S. interest rates began a rather steady decline that continued into 1975, and the dollar's exchange value followed U.S. interest rates downward. By the year-end the dollar had depreciated by some 4.4 per cent from the beginning of the year on a weighted-average basis. Contributing to this decline in the dollar's exchange value was the asymmetry in intervention policies between countries with weaker currencies and those with strengthening currencies. Intervention sales of dollars by countries supporting weaker currencies exceeded purchases of dollars by countries resisting the appreciation of their currencies. The net effect of these operations was to add to the market supply of dollars, depressing the dollar's average exchange rate.

The Euro-currency market continued to expand at a very rapid rate during the first 4 months of 1974. The disclosure in May of the financial difficulties of a large U.S. bank, followed in June by the aforementioned failure of a German bank, led to greater caution on the part of lenders in the market and brought the market's growth to a halt. Between the end of April and the end of September there was a slight decline in the external foreign-currency liabilities of banks in London, the market's largest center. In part this leveling reflected an actual cutback in interbank redepositing. During this period lenders began to discriminate more sharply among borrowers and to evaluate risks more carefully. This caution produced a rate structure involving many more tiers than before, with smaller or lesser-known banks paying substantial premiums for funds, and also brought about a greater concentration of deposits with the larger banks.

In the fourth quarter, growth of the market resumed as concern for the safety of banks engaging in the Euro-currency business lessened somewhat. A factor that may have contributed to this easing of tensions in the Euro-currency market was the statement issued by the Governors of the Bank for International Settlements on September 9 to the effect that the Governors were satisfied that means were available to provide temporary liquidity to sound banking institutions and that those means would be used if and when necessary.

The rise in oil prices had a variety of impacts on the Euro-currency market. The oil-exporting countries placed perhaps 40 per cent of their estimated $55 billion surplus on current account in the Euro-currency market in 1974, generally at call or in other very short maturities. In London the oil-exporting countries' share of the gross total of Euro-currency deposits rose from 5 per cent at the end of 1973 to 14 per cent at the end of September 1974.

In the first quarter of 1974 new commitments of longer-term Euro-currency loans rose dramatically as several European governments sought funds to pay for oil. But commitments declined in the next two quarters, partly because lending banks became more wary of lending for balance of payments purposes. Italy, which had borrowed heavily in the market for longer-term loans in recent years, did not enter the market for further loans after early spring. In indirect reflection of swollen bills for oil imports, Japanese banks increased their takings from the Euro-currency market very sharply in the first half, for which they were obliged to pay substantial premiums. But their net borrowings do not appear to have increased much, if at all, in the second half of the year as the Japanese authorities moved to curb additional net foreign borrowings by the banks.

Reflecting the tightening of credit availability, spreads on Euro-dollar loans to nonbank borrowers widened by about ½ to ¾ percentage point between May and October, and there was a marked shortening of the average maturity of Euro-dollar loans of more than 1 year.

Gold was the subject of heightened interest as its dollar price nearly doubled from the middle of the fourth quarter of 1973 to the end of the first quarter of 1974 when the price reached $180 per ounce. As inflation in the major countries accelerated, people apparently sought refuge in gold. In the second and third quarters prices for gold fell sharply, influenced in large part by soaring interest rates, particularly on dollar assets. In the fourth quarter, however, interest rates declined, again particularly on dollar assets; this decline, together with the anticipation of U.S. residents' newly legalized purchases of gold at the close of the year, pushed the price to a new high in London of $195.25 per ounce in late December. When demand by U.S. residents for the 2 million ounces of gold offered by the U.S. Treasury in early January 1975 turned out to be unenthusiastic, the price dropped to a range of $170 to $180 per ounce in mid-January.

At the turn of the year many acute problems beset the world economy that will test severely the determination of countries to deal with their domestic concerns while contributing to the achievement of common interests. Many countries are faced with sagging economies and would normally look to an improved trade balance as a source of support—and many will do so with the added incentive of covering the cost of imported oil. But many industrial countries will have to revise their customary view of what constitutes an acceptable trade balance. Even though a considerable gain in exports to the oil producers can be expected, the industrial oil-consuming countries as a group must accommodate a large deficit with the OPEC countries, and any individual country's efforts to gain a trade advantage through restrictive devices would be at the expense of other oil-consuming nations. In addition to the matter of oil imports there are major discrepancies in the balance of payments performance of individual industrial countries that will require adjustment.

Apart from the adjustments needed to accommodate differences in economic performance, some of the industrial countries, and many of the less-developed countries, will need to finance continuing incremental payments for oil and related products. Such financing requirements could go beyond the limits of their ability to borrow on reasonable terms from the market.

Recognizing such needs, the Ministers of the Group of Ten at a meeting in Washington in January 1975 agreed that a solidarity fund open to all members of the Organization for Economic Cooperation and Development should be established, and the Interim Committee of the Board of Governors of the IMF agreed that the Fund's Oil Facility should be continued for 1975 with new resources of SDR 5 billion to be sought—primarily from the OPEC countries. Also in connection with the energy problem, the International Energy Agency was organized in 1974 for the purpose of implementing a program designed to deal with shortages of oil and to develop substitute energy sources.

In this period of severe economic change, it is especially difficult to make progress on the basic issues of the international monetary system. Nevertheless, discussion has continued on those issues; tentative agreement was reached in January on an increase in IMF quotas to SDR 39 billion, and the Executive Directors of the Fund were instructed to draft a number of amendments to the Articles of Agreement involving most of the outstanding issues, including the role of gold and the legalization of floating exchange rates. Through effective use of these institutional structures it should be possible to act in cooperation to meet the many acute problems of the world economy. □