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CONFIDENTIAL (FR) January 17, 1975

SUPPLEMENT

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

By the Staff
Board of Governors
of the Federal Reserve System

The Domestic Nonfinancial Economy

Gross national product in the final quarter of 1974, at a seasonally adjusted annual rate of $1,428 billion, was $11.7 billion above the third quarter rate according to Commerce Department preliminary estimates. In real term, total output of goods and services declined at a 9.1 per cent annual rate. Prices as measured by the GNP implicit price deflator, which reflect shifts in composition of expenditures, rose at a 13.7 per cent annual rate; prices as measured by the gross private product fixed weighted price index rose at a 12.0 per cent annual rate.

Nonfarm inventory investment in the fourth quarter, at $14.4 billion, annual rate, was double that in the third quarter, and it accounted for about half the rise in total GNP. Personal consumption expenditures for durable goods and outlays for residential structures declined sharply in the fourth quarter. And consumer spending for nondurable goods rose by only a small amount. Total consumption expenditures increased by only a small amount and personal saving and the ratio of personal saving to disposable personal income increased sharply further to 8.5 per cent from 7.5 per cent. In contrast to weakness in these sectors, Federal government purchases of goods and services for national defense rose markedly--much more than indicated earlier.

In real terms, the only strength was in inventory investment and net exports of goods and services, each of which were up by a small amount. Personal consumption expenditures, residential construction outlays, and business fixed investment declined, and government purchases of goods and services were unchanged.

GROSS NATIONAL PRODUCT AND RELATED ITEMS
(Quarterly figures are seasonally adjusted.
Expenditures and income figures are billions
of dollars, with quarterly figures at annual rates.)

	1974-III		1974-IV	
	Amount	Change from 74-II	Amount	Change from 74-III
Gross National Product	1416.3	32.5	1428.0	11.7
Final purchases	1407.6	37.3	1413.5	5.9
Private	1095.3	29.4	1091.1	-4.2
Excluding net exports	1098.4	31.0	1089.9	-8.5
GNP in constant (1958) dollars	823.1	-4.0	803.7	-19.4
	-----Per Cent Change Per Year--------			
Gross National Product		9.7		3.3
Gross Domestic Product		9.4		4.0
Gross Private Product		10.1		2.2
Gross Private Nonfarm Product		10.4		2.0
GNP in constant prices		-1.9		-9.1
GDP in constant prices		-2.1		-8.9
GPP in constant prices		-2.3		-10.1
GPNfP in constant prices		-2.3		-9.0
GNP implicit price deflator		11.9		13.7
GNP fixed weighted price index		12.7		13.7
GPP fixed weighted price index		13.8		12.0

Inventories. Book value of retail trade inventories grew at a $11.1 billion annual rate in November, much below the $33.1 billion October rate and below the third quarter average growth rate of $12.8 billion. Nonautomotive retail stocks declined in November at a $1.0 billion annual rate. The annual growth rate of book value of wholesale trade inventories was $2.5 billion in November, much below both the upward revised October rate of $13.7 billion and the third quarter average rate of $8.6 billion.

For manufacturing and trade, the rate was $37.2 billion in November, much below the $71.9 billion October rate and the $59.2 billion third quarter average rate. The manufacturing and trade inventory-sales ratio rose in November to 1.59 from the October rate of 1.54.

Wholesale prices. The wholesale price index for December declined 0.5 per cent, seasonally adjusted (not at an annual rate), as the index of farm and food products dropped sharply and that for industrial commodities was unchanged.

The index of farm and food products fell 2.5 per cent, seasonally adjusted, chiefly as a result of lower prices for manufactured animal feeds, grains, fresh fruits and vegetables, cotton, wool, and soybeans. The sugar and confectionery group also declined.

The index of industrial commodities was unchanged, the first time in over 2 years that the monthly index didn't rise. Price reductions, mainly for copper, ferrous and nonferrous scrap metal, textile products, and hides and skins, offset price increases, primarily those for machinery and equipment, chemicals, and fuels. The December index gave evidence of further moderation in rates of price increase for most industrial commodity groups that showed increases.

WHOLESALE PRICES
(Per cent changes at seasonally adjusted
annual rates) 1/

	Dec. '73 to Dec. '74	Dec. '72 to June '73	June '73 to Dec. '73	Dec. '73 to June '74	June '74 to Sept '74	Sept '74 to Dec. '74	Nov. '74 to Dec. '74
All commodities	20.9	20.2	10.9	18.2	35.2	13.4	-5.9
Farm and food products	11.0	45.8	10.4	-11.5	59.2	21.9	-29.8
Industrial commodities	25.6	10.6	10.9	34.0	28.3	8.2	0.0
Crude materials	23.0	23.0	40.4	44.3	29.1	-14.8	-39.2
Intermediate materials	28.5	12.2	11.7	38.0	32.2	8.2	2.1
Finished goods	21.2	6.3	7.1	24.5	22.7	13.3	5.3
Producer	22.6	5.4	5.3	20.0	31.8	18.7	6.2
Consumer, excl. food	20.5	6.7	8.1	26.8	18.5	10.6	4.9
Nondurable, excl. foods	23.9	8.5	11.3	35.6	19.1	7.7	.8
Durable	14.8	4.5	2.8	13.2	15.6	17.4	9.0
Consumer finished foods	13.0	27.0	18.5	-1.1	29.4	29.1	-14.7

Note: Farm and food products include farm products and processed foods and feeds.

1/ Not compounded for one-month changes.

Private housing starts dropped further from the already sharply reduced November pace, to a seasonally adjusted annual rate of 868 thousand. Building permits, however, turned upward in December. The level of starts was only slightly above the low of October, 1966, and brought the fourth quarter 1974 average to 989 thousand units, down almost a fifth from the third quarter rate and the lowest in 8 years. Unlike November, the December starts reduction was concentrated largely in single-family units. For the year as a whole all starts totaled 1.34 million units, compared with 2.04 million in 1973.

NEW HOUSING UNITS

(Seasonally adjusted annual rates, in millions of units)

	1970	1974				Per cent change in December from:	
	QI	QIII	QIV	Nov.(r)	Dec.(p)	Month ago	Year ago
Permits	1.10	.91	.77	.73	.80	+10	-38
Starts	1.24	1.21	.99	.99	.87	-12	-38
1-family	.69	.87	.75	.79	.68	-14	-12
2- or more-family	.55	.34	.24	.20	.19	- 6	-70

Merchant builder sales of new single-family homes rose in November from the very low October figure but remained well below November 1973. Builder backlogs of unsold homes were reduced only slightly further and still represented almost 11½ months' supply at the November sales rate. The median price of the mix of homes sold in November was essentially unchanged from October and continued to be above the median asking price of unsold new homes. Sales of used homes in November were again below a year earlier. The median price on such units was 8 per cent above November 1973--the smallest year-over-year increase for any month in 1974.

SALES, STOCKS AND PRICES OF NEW SINGLE FAMILY HOMES

	Homes sold 1/	Homes for sale 2/	Months' supply	Median price of: Homes sold	Median price of: Homes for sale
	(thousands of units)			(thousands of dollars)	
1973					
QI	726	426	7.0	30.4	29.4
QII	680	436	7.7	32.7	31.2
QIII	566	453	9.6	33.5	32.1
QIV	483	446	11.1	34.0	32.9
1974					
QI	525	453	10.4	35.2	34.0
QII	567	435	9.2	35.6	35.0
QIII	483	415	10.3	36.4	35.7
Aug.	457	433	11.4	35.7	35.5
Sept.(r)	481	415	10.4	36.8	35.7
Oct.	410	410	12.0	37.1	35.9
Nov.(p)	429	405	11.3	37.0	36.0

1/ Seasonally adjusted annual rate.
2/ Seasonally adjusted, end of period.

In commenting on the growth of Federal Spending in his State of the Union message, the President indicated that where spending is curbed, the U.S. Treasury may be legally obligated to spend more than $360 billion in FY '76 even if no new programs are enacted. The President, therefore, has asked for a moratorium on any new spending initiatives, and he reinforced this request by issuing the following preliminary FY '76 Budget estimates:

	Fiscal Years			Per cent Change	
	1974	1975e	1976e	75/74	76/75
Revenues	264.9	280	303	6%	8%
Outlays	268.4	314	349	17%	11%
Deficit	3.5	34	46		

The FY '76 expenditure estimate shown above appears to have been derived in the following way:

Administration's Base Estimate	$360 billion
Plus: increased outlays assoc. with energy proposal	7 1/
Less: saving resulting from 5% ceiling placed on pay and programs tied to CPI	6
Less: proposed budget reductions and other actions	11.5
Administration's Preliminary FY '76 estimate	$349 billion

1/ Consists of $3 billion higher Federal costs due to oil price hike, $2 billion new payments to compensate State and local government and $2 billion in cash payments to low income people.

A number of adjustments need to be made in order to compare the above budget spending total with the staff projections shown in the January 15 Greenbook. We did not assume the energy related outlays nor the 5 per cent ceiling on increases in renumeration. We did, however, incorporate a major portion of the other requested reductions. Once, these adjustments are made, spending according to the Administration basis would appear to be $314 billion in FY 1975 and $351 billion in FY 1976. These figures indicate a substantially higher underlying spending estimate by the Administration, since the corresponding Greenbook figures were $309 and $343 billion. The reasons for these differences in terms of specific programs are as yet unknown, hence the extent of error in our estimates cannot yet be evaluated.

The Domestic Financial Situation

Mortgage market. According to the HUD (FHA) opinion survey, average interest rates on new commitments for conventional new- and existing-home mortgages fell further during December to 9.45 per cent. Private secondary market yields on FHA-insured new-home mortgages were 9.51 per cent at year end--87 basis points below the recent high at the end of September. These movements are generally consistent with the FHLMC series on primary market rates and FNMA secondary market auction yields reported in the Greenbook.

AVERAGE RATES AND YIELDS ON NEW-HOME MORTGAGES
(HUD-FHA Field Office Opinion Survey)

End of Month	Primary market: Conventional loans: Level 2/ (per cent)	Primary market: Conventional loans: Spread 4/ (basis points)	Secondary market 1/: FHA-insured loans: Level 3/ (per cent)	Secondary market 1/: FHA-insured loans: Spread 4/ (basis points)	Secondary market 1/: FHA-insured loans: Discounts (points)
1974-Low	8.55 (Feb.)	-66 (Sept.)	8.54 (Feb.)	- 8 (Sept.)	2.3 (Feb.)
High	9.80 (Sept.)	45 (Feb.)	10.38 (Sept.)	44 (Feb.)	6.3 (July, Sept.)
Jan.	8.65	40	--	--	--
Feb.	8.55	45	8.54	44	2.3
Mar.	8.60	- 4	8.66	2	3.2
Apr.	8.90	- 8	9.17	19	5.1
May	9.15	6	9.46	37	5.3
June	9.25	-25	9.46	- 4	5.3
July	9.40	n.a.	9.85	n.a.	6.3
Aug.	9.60	-39	10.30	31	5.8
Sept.	9.80	-66	10.38	- 8	6.3
Oct.	9.70	-33	10.13	10	4.6
Nov.	9.55	-13	--	--	--
Dec.	9.45	n.a.	9.51	n.a.	3.8

1/ Any gaps in data are due to periods of adjustment to changes in maximum permissible contract rates on FHA-insured loans.
2/ Average contract rate (excluding fees or points) on commitments for conventional first mortgage loans, rounded to the nearest 5 basis points.
3/ Average gross yield (before deducting servicing costs) to investors on 30-year minimum-downpayment FHA-insured first mortgages for immediate delivery in the private secondary market (excluding FNMA), assuming prepayment in 15 years.
4/ Average gross mortgage rate or yield minus average yield on new issues of Aaa utility bonds in the last week of the month.

INTEREST RATES

	1974 Highs	1974 Lows	1974 Dec. 16	1975 Jan. 16
Short-Term Rates				
Federal funds (wkly. avg.)	13.55(7/3)	8.81(2/27)	8.72(12/18)	7.22(1/15)
3-month				
Treasury bills(bid)	9.74(8/23)	6.93(2/6)	7.14	6.49
Comm. paper(90-119 day)	12.25(7/17)	7.75(2/22)	9.13	7.50
Bankers' acceptances	12.50(8/15)	7.75(2/26)	8.95	7.60
Euro-dollars	14.38(7/16)	8.25(2/18)	10.25	8.25
CD's (NYC)90-119 day				
Most often quoted new	12.00(9/4)	7.88(2/20)	8.75(12/18)	7.38(1/15)
6-month				
Treasury bills (bid)	9.86(8/23)	6.80(2/19)	6.96	6.49
Comm. paper (4-6 mo.)	12.13(7/10)	7.50(2/22)	9.00	7.50
Federal agencies	10.63(8/28)	7.16(2/19)	7.54	7.21(1/15)
CD's (NYC) 180-269 day				
Most often quoted new	11.90(8/21)	7.50(2/27)	8.00(12/18)	7.25(1/15)
1-year				
Treasury bills (bid)	9.65(8/23)	6.37(2/15)	6.59	6.44
Federal agencies	10.18(8/26)	7.01(2/19)	7.40	7.31(1/15)
CD's (NYC)				
Most often quoted new	9.75(7/17)	7.00(2/27)	8.00(12/18)	7.00(1/15)
Prime municipals	6.50(7/12)	3.70(2/15)	4.40(12/20)	4.10(1/17)
Intermediate and Long-Term				
Treasury coupon issues				
5-years	8.79(8/23)	6.72(2/14)	7.23	7.31(1/14)
20-years	8.72(8/26)	7.40(1/4)	7.84	7.80(1/14)
Corporate				
Seasoned Aaa	9.40(10/8)	7.73(1/2)	8.85(12/16)	8.84(1/15)
Baa	10.53(12/2)	8.54(1/2)	10.53(12/16)	10.64(1/15)
New Issue Aaa Utility	10.61(10/2)	8.05(2/13)	9.51(12/18)	9.37p
Municipal				
Bond Buyer Index	7.15(12/12)	5.16(2/6)	7.08(12/18)	6.90
Mortgage--average yield in FNMA auction	10.59(9/9)	8.43(2/25)	9.52(12/16)	9.37(1/13)

CORRECTIONS:

GROSS NATIONAL PRODUCT AND RELATED ITEMS

	1975 Proj.	1975 I	1975 Projection II	III	IV	1976 I	II
Disposable income	1064.4	1019.7	1062.4	1088.8	1086.8	1110.4	1133.0
Personal saving	93.6	80.9	104.5	105.6	83.2	86.9	91.0
Saving rate (per cent)	8.8	7.9	9.8	9.7	7.7	7.8	8.0
Corporate profits and I.V.A.	90.5	89.6	83.3	90.9	98.2	102.6	104.8
Corporate profits before tax	115.9	119.5	111.0	115.0	118.0	119.5	119.5
Federal government receipts and expenditures (NIA basis)							
Receipts	288.2	294.0	270.2	277.5	311.2	321.0	324.8
Surplus or deficit (-)	-47.8	-29.7	-58.9	-63.7	-38.9	-35.9	-38.6
State and local government surplus or deficit (-), (NIA basis)	-2.1	-2.2	-3.1	-2.5	- .5	- .9	- .6
Industrial production (1967=100)	116.9	116.5	115.2	116.8	119.1	121.2	122.4
Capacity utilization, mfg. (per cent)	71.3	72.1	70.6	71.0	71.7	72.3	72.3
Major materials (per cent)	74.2	75.4	72.9	73.5	74.9	75.9	76.2
	--------------------In Per Cent Per Year-------------------------						
Disposable income	8.8	6.2	17.8	10.3	- .7	9.0	8.4
Corporate profits before tax	-17.7	-32.8	-25.6	15.2	10.8	5.2	.0
Federal government receipts and expenditures (NIA basis)							
Receipts	-1.2	-3.6	-28.7	11.3	58.2	13.2	4.8
Industrial production	-5.9	-15.8	-4.2	5.6	8.1	7.3	3.9

NOTE: In the January 15 Greenbook, there were some computational errors in the GNP tables. This table shows corrected figures for Part I, pages 8, 9, 10, and 11.

SUPPLEMENTAL APPENDIX A*
STATE AND LOCAL GOVERNMENT OUTLOOK

During 1974, states and localities experienced a deterioration in their fiscal position. Expenditures rose rapidly as a result of accelerating wage demands by public employees and higher prices for goods and services. In contrast, the growth of receipts was curtailed by tax reductions, reduced gasoline consumption and a slowdown in economic activity toward the end of the year. Own-source revenues which include personal taxes, indirect business taxes and corporate profits taxes, grew by only $11.7 billion in 1974, as compared to $13.3 billion in 1973 and $16.6 billion in 1972. The rate of increase of Federal grants continued to moderate in 1974, rising at rates well below those prevailing in 1971 and 1972. After a very sharp rise of $8.4 billion in 1972, caused largely by the initial distribution of revenue sharing funds, grants increased by only $3.1 billion in 1973 and by approximately $2.8 billion in 1974. As a result of these developments, the NIA surplus of state and local governments dropped from $9.2 billion in 1973 to approximately $1.8 billion in 1974.

When the receipts and expenditures of social insurance funds are excluded, the current fiscal positions of states and localities is much worse. Unlike their Federal counterparts, the surpluses of state-local insurance funds are not available to finance current operating deficits or capital spending projects. As a result, they are usually excluded from the overall national income accounts measure when assessing the fiscal health of these governments. On this basis, the operational surplus (or deficit) which excludes surplus social insurance funds, recorded a large $8.2 billion deficit in 1974, following surpluses of $3.9 billion in 1972 and $.1 billion in 1973. (Estimates of the state and local surplus for the period 1967 to 1974 can be found in Table I).

*Prepared by James Fralick, Economist, Government Finance Section, Division of Research and Statistics, and Martha Scanlon, Economist, Capital Markets Section.

Table I

State and Local Surplus or Deficit
(billions of dollars)

	A NIA Surplus or deficit	B Surplus Social Insurance Funds	Operational Surplus or deficit A-B
1967	-1.6	4.4	-6.0
1968	- .3	5.0	-5.3
1969	.7	5.7	-5.0
1970	1.8	6.5	-4.7
1971	3.4	7.3	-3.9
1972	12.3	8.4	3.9
1973	9.2	9.1	.1
1974	1.8	10.0	-8.2
1975 est.	-2.0	10.8	-12.8

The fiscal position of states and localities is likely to deteriorate even further in 1975. Cost induced expenditure increases and previously negotiated wage settlements will continue to put upward pressure on purchases. Partially offsetting this increase in current operating expenditures, is an expected sharp contraction in the growth of construction outlays. Nevertheless, the rate of growth of state and local purchases is expected to be 10 per cent in 1975 down only slightly from the 13 per cent gain posted in 1974.

In the absence of any structural changes--such as the imposition of new taxes or legislated rate increases in existing ones--revenues are expected to grow at a rather sluggish 8.7 per cent, just slightly higher than the 7.2 per cent gain registered in 1974. Inflation, of course, will continue to provide additional growth in general sales taxes and state personal income taxes.

But further erosion of the property tax base, through reductions and exemptions--particularly for the aged and the poor--and pressure from the courts to shift the financing of schools to other means, will partially offset these inflation induced revenue gains. Moreover, Federal grants--stimulated in part by an expanded public employment program--are expected to grow only modestly with the rate of increase probably insufficient to ease the state and local governments' overall budgetary problem.

As the year progresses and as the state and local fiscal position worsens, the pressure for tax increases should grow. Given the likely Federal tax cut, state and local governments might take the opportunity to raise their own tax rates. However, an electorate already facing the financial strains brought on by rising unemployment and continued inflation is likely to resist any new taxes. On the expenditure side, many jurisdictions are likely to propose expenditure cuts, but implementation will be difficult given the desire by the states and localities to maintain existing service levels. In view of these constraints on needed fiscal adjustments, the deficit of state and local governments in 1975 is expected to be $2.0 billion on an NIA basis and $12.8 billion on an operational basis. 1/

Given these rather dreary fiscal prospects, State and local demands on securities markets can be expected to rise in calendar 1975. The outlook for bond yields, however, remains clouded, since it will depend importantly on the willingness and capacity of major institutional investors to absorb new issues. In 1974, gross financing in municipal bond markets dropped to $22.7 billion from the previous year's high of $24.0 billion, chiefly because heavy customer loan demands and the high cost of market funds kept commercial banks from adding to their security portfolios. Acquisitions of municipals by casualty companies--the other major institutional buyer--were also limited in 1974 by the severe erosion of casualty company surpluses resulting from the combination of sharply higher loss claims and drastically reduced stock prices.

1/ It should be noted that the overall figures conceal wide differences in the experiences of individual governments. A number of states will continue to run sizeable surpluses whereas other states and many cities will be in a less enviable position.

The President's recently announced energy proposal includes a $2 billion increase in Federal grants to help states and localities meet an expected increase in fuel costs. Since the increase in revenues (grants) is expected to equal the increase in fuel related purchases, the NIA deficit for 1975 should remain at the $2.0 billion level described above.

Although the volume of new municipal bond offerings picked up some early last fall, the increase was not sustained through the fourth quarter. Part of this fourth quarter slackening probably reflected normal seasonal financing patterns; but, in addition, market conditions were disrupted late in the quarter by the financing difficulties of New York City. 1/ This disruption reversed a market downtrend in municipal bond yields that had begun in late summer. At year end, the Bond Buyer 20-bond yield index averaged 7.08 per cent, nearly 2 percentage points above the level prevailing at the start of 1974.

Bond markets may improve somewhat during 1975, as money market pressures ease and commercial banks and other institutional investors restructure their investment portfolios. But, a heavy calendar of new State and local issues early in the year--before dealer inventories have been worked down--would no doubt slow downward adjustments in municipal rates. Furthermore, there is some speculation that banks may acquire fewer municipals in the first half than otherwise as a result of reduced incentives for tax preference income and greater emphasis on rebuilding their liquidity positions perhaps at the expense of increasing their portfolio of long term bonds. Easing in municipal bond markets may also be slowed by spillover effects from the anticipated heavy financing demands of the Treasury.

While many state and local units postponed bond offerings in 1974, short term borrowings in the tax-exempt sector rose to a record high of $29 billion. New York City accounted for a large proportion of the short term financings, tapping the market for over $7.4 billion during the year. New York's financing difficulties late in the year became apparent, when the city had to pay a record rate of 9.48 per cent on $600 million of notes sold December 2.

1/ In December, New York City paid an average rate of slightly more than 9.4 per cent on two issues of short-term notes totaling $600 million. The December sale followed a large New York City financing in October which had sold poorly. Although the New York experience should not be considered as characteristic of municipal market conditions generally--since the terms were affected by the exceptionally large calendar of New York offerings in earlier months, as well as an unusual amount of public attention focused on the City's financial plight--the large volume of New York issues did sharply increase dealer inventories and thus had an impact on the market's willingness to absorb new issues.

While other higher rated municipalities have received more favorable terms on note issues than New York City, in general, pressures in these markets have prevented tax-exempt rates from dropping substantially, despite recent easing in other markets. While the outlook for such rates calls for some decrease, the depth of decline in municipal rates may not be as great as in other short term yields. Indeed, expected demands in this market, resulting from worsening fiscal prospects of state and local governments, may even exceed the record levels of last year.

In addition to New York City, there have been a few recent reports of financing difficulties by major municipalities, such as Cleveland and Detroit. Generally, these reports are of potential problems in cities that are having fiscal difficulties and may have to go into the market with medium or lower credit ratings. Investors have shown a clear preference for shorter maturity, high quality bonds and demanded high premiums from lower rated units. This preference is evidenced in the Bond Buyer indices. The spread between the 20-bond index and the 11-bond index of municipal yeilds increased from 13 basis points at the beginning of 1974 to a record 46 basis points at year-end.

The 11-bond index is a subset of the 20-bond index and includes those 11 issues with the highest ratings. This composite rating of the 11-bond index is equivalent to the second best rating by Moody's Investors Serivce, while the average of the 20-bond index falls between the second and third rating by this agency. 1/ The increasing spread between the two indexes indicates that in all probability there will be wide differences in the experience of individual governments in the bond markets during coming months. Units that have low ratings may expect to face serious difficulties in floating bonds without incurring sizable costs, even if other market rates continue to move down. In some cases, legal ceilings on the rate a State or municipality may pay for borrowed funds may effectively keep them out of the municipal market. In contrast, high quality names may find borrowing conditions improved, although still costly by historical standards.

1/ The spread between the two indexes may also reflect slight differences in the average maturity of the included bonds. However, it is reasonable to assume that most of the increase in the spread in the last year was associated with quality differences.

Municipal Bond Yields
(Indices are as of the first Thursday of each month)

	In per cent		
	20-Bonds	11-Bonds	Difference
1974 - Jan.	5.18	5.05	.13
Feb.	5.16	5.04	.12
Mar.	5.27	5.16	.11
Apr.	5.73	5.61	.12
May	5.91	5.78	.13
June	6.01	5.83	.18
July	6.64	6.42	.22
Aug.	6.70	6.44	.26
Sept.	6.88	6.56	.32
Oct.	6.68	6.34	.34
Nov.	6.66	6.33	.33
Dec.	6.89	6.50	.39
1975 - Jan.	7.08	6.62	.46

SUPPLEMENTAL APPENDIX B
RECENT MOVEMENTS IN CURRENCY AND DEMAND DEPOSITS*

In 1974 rates of growth in both the money stock (M_1) and the demand deposit component of M_1 were lower than in the preceeding four years. The growth rate of currency, on the other hand, accelerated to a post-war high.

TABLE B - 1

MONEY STOCK, CURRENCY, AND DEMAND DEPOSITS
ANNUAL GROWTH RATES
Seasonally adjusted

Period	Money Stock	Currency	Demand Deposits
Annual 1/			
1969	3.5	6.0	2.8
1970	6.2	6.7	5.9
1971	6.1	7.1	6.0
1972	8.7	8.2	8.9
1973	6.1	8.3	5.5
1974	4.5	9.9	2.9
Quarterly 1/			
1973-QI	3.4	7.3	2.3
QII	11.3	9.7	11.8
QIII	0.6	6.1	-1.0
QIV	8.7	9.3	8.6
1974-QI	5.4	11.0	3.8
QII	6.5	8.2	5.9
QIII	1.6	7.4	-0.2
QIV	4.1	11.6	1.8

1/ All growth rates calculated from end of period monthly averages.

A staff study undertaken to determine the causes of these divergent growth rates found that the rapid 1974 expansion in currency

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growth could be readily explained by factors believed to influence the public's demand for currency. However, the slow growth of demand deposits in the last half of the year was difficult to explain. No fully convincing rationale for the slow rate of growth of the demand deposit component of the money stock could be offered.

Currency growth in 1974. The annual data shown in the preceeding table indicate a gradual acceleration in the rate of currency growth for each year since 1969, but the increase in the growth rate for 1974 was larger than in prior years. The 9.9 per cent growth in currency last year appears to have reflected the 8.9 per cent growth in nominal consumer expenditures over the same period. This variable captures the transactions motive for holding currency and in the Board's quarterly econometric model plays an important role in determining the demand for currency. Indeed, simulation of the model accurately predicted the higher growth rate of this component of M_1.

The behavior of currency by denomination shown in Table B-2 also conformed to the expected pattern in a year of high inflation, because the rate of growth of large denominations exceeded that of coin and small denominations. As prices in general rise, cash transactions necessarily involve higher nominal amounts. To facilitate these transactions more easily, the public will tend to decrease the fraction of their currency held in small denominations and the rate of growth of large denominations will then exceed the rate of growth of small denominations. Table B - 2 shows that this was the case in every year since 1969. The growth in currency by denomination in 1974 was not surprising, therefore, despite press accounts to the contrary.

A more detailed examination of currency denomination by Reserve Districts revealed no extraordinary movements. The differences in growth by District were no larger than would normally be expected.

Demand Deposit growth in 1974. The degree of slowdown in the growth of the demand deposit component of M_1 in the last half of 1974 was not forecast by either judgmental or econometric projections by the Board staff. The expansion in nominal GNP at a 5.9 per cent annual rate of growth from the second to the fourth quarter of 1974, and the sharp decline in short-term interest rates, beginning last summer, would suggest that the public's demand for demand deposits should have slowed somewhat in the third quarter, but begun to rise in the fourth quarter. While this pattern in fact developed, the rates of growth in both quarters were lower than expected; private demand deposits were essentially unchanged in the third quarter, and rose at less than a 2 per cent rate in the fourth quarter.

TABLE B - 2

DENOMINATIONS IN CIRCULATION
ANNUAL GROWTH RATES

Year[1/]	Total in Circulation	Coin and Small Denomination Currency[3/]	Large Denomination Currency[4/]
1969	6.0	5.2	8.0
1970	6.4	5.2	9.1
1971	7.5	6.1	10.8
1972	5.8	6.0	10.5
1973	9.6	5.9	12.3
1974	10.7	7.8	16.4

1/ All growth rates calculated from November to November.

2/ Outside Treasury and FR Banks.

3/ Coin and $1 through $20 denominations.

4/ $50 through $10,000 denominations.

Several conceivable explanations were ruled out upon investigation. Substantial upward revision in preliminary demand deposit data or downward revision in preliminary nominal income data was considered unlikely. A major shift in the sectoral demand for deposits was not borne out by the data on demand deposit holdings by individuals, partnerships and corporations. Changes in compensating balances, minimum balance requirements, and "Now" accounts were judged to have been relatively unimportant.

Consideration was also given to the impact on demand deposits of the sharp increase in money market mutual funds and variable rate notes, but it was felt that the growth of these assets -- which tend to substitute more for interest bearing deposits and money market instruments than for demand deposits -- could explain only part of the weakness in demand deposits.

The staff also considered the impact of declining public confidence in the safety of commercial banks. Did the failure of Franklin National significantly reduce the public's faith in the soundness of the banking system? One poll suggests that 36.2 million

Americans would have mentioned Franklin National's financial difficulties if asked in late October 1974. However, the continued strong growth of total time deposits is difficult to reconcile with a crisis of confidence in banks.

The interpretation of this slow growth of private demand deposits is made more complicated because it could reflect an upward shift in banks' demand for free reserves (perhaps because of increasing bank caution) as well as a downward shift in the public's demand for demand deposits (for whatever reason). To the extent that the demand has shifted downward, lower interest rates and/or higher nominal income than previously thought are required to produce a given rate of growth of deposits. To the extent that banks have also become more cautious lenders, more reserves than otherwise are needed to produce a given rate of growth of demand deposits.

Since the staff cannot at this time isolate the sources of the shifts in public and bank behavior, it is perhaps prudent to assume that the shifts are temporary -- suggesting that private demand deposits will soon respond more predictably to interest rates, income and reserve movements.