FINANCIAL FORECASTS: 1974

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It is now fairly apparent that the 1974 economy will experience a sharply slower pace of real growth than in previous years. The consensus[1] opinion is that gross national product in current dollars, after expanding 11.5 percent in 1973, is forecast to increase only 7.6 percent in 1974. Personal consumption expenditures will rise to $861 billion or 7.0 percent, with most of the gain in the nondurable and service sectors. A sharp decline in residential structures is expected to result in a $210 billion level for gross private domestic investment. In terms of real GNP, 1974 economic growth appears even more dampened. After expanding nearly 6 percent in 1973, real GNP is projected to increase only 1 percent, if at all, in 1974. Predicted declines in corporate profits, housing starts, and auto sales, combined with slowed industrial production growth, make the outlook for 1974 appear rather gloomy. The final factor, prices, further clouds the picture, with the implicit price deflator predicted to rise at a 6.4 percent annual rate during the coming year.

The Arab oil embargo makes any forecast, financial or otherwise, uncertain at best. Fiscal and monetary policies will be geared to adjust to energy developments as the year unfolds. The need to take into account not only the pace of economic activity but also the rate of inflation and the dollar's position abroad presents a challenging proposition. The key for policymakers in 1974 will be flexibility.

Funds Raised in 1974 The total volume of funds raised, without regard to maturity length, is expected to register roughly $175 billion in 1974, markedly lower than the $185 billion in 1973 (Table I). The decline is attributable to a substantial drop in the volume of short-term funds, from $85 billion in 1973 to an anticipated $59 billion in 1974. Some downward pressure on short-term rates should result. On the other hand, funds raised in the long-term market are predicted to jump to $116 billion in 1974 from a 1973 level of $100 billion, foreshadowing some upward pressure on long-term rates.

[1]The "consensus" figures represent a modal average of approximately 30 individual forecasts.

There are four categories that must be examined in any discussion of the funds markets: banks, businesses, consumers, and government. The past year saw an almost unprecedented demand for bank credit. Total bank loans were roughly $31 billion, substantially higher than in 1971 or 1972. This strong demand is expected to abate in 1974 with the increase in bank credit returning to a more traditional $14 billion. The prime rate is projected to return to a level more in line with other short-term market rates ; and as the economy slows, the demand for working capital funds should diminish.

The volume of business loans will vary more dramatically in composition than in amount during 1974, with the emphasis shifting from short-term to long-term business financing. In 1973, the business sector borrowed nearly $20 billion in the long-term markets ; this figure will rise to $33 billion during 1974, with the major emphasis on the corporate bond

Table I

CONSENSUS FUNDS FORECASTS*

(billions)

	1973	1974
Funds Raised in the Short-Term Market	$ 85.3	$ 59.2
Bank loans	30.5	14.0
Consumer credit	19.9	11.5
Open market paper	5.7	10.8
U. S. Government Agencies	21.3	8.5 14.4
Funds Raised in the Long-Term Market	99.7	116.2
Mortgages	68.4	68.7
Corporate bonds	10.8	20.2
Corporate stocks	9.0	12.8
State and local	11.5	14.5
Total Funds Raised	185.0	175.4

*These numbers represent on estimation of the consensus forecasts of many well-known economists.

market. A subsequent decline in short-term business borrowing is anticipated. From a 1973 level of $36 billion, short-term financing is forecast to dip to $25 billion in the coming year as a result of the major decline in bank loans.

Consumer net borrowing in 1974 is expected to amount to $80 billion, only slightly below the 1973 level. The decrease is wholly attributable to an anticipated $8 billion decline in short-term consumer credit-installment loans-as automobile and consumer durable sales decline. The demand for mortgage funds is forecast to remain strong at $69 billion, partly because a large amount of construction begun in 1973 was carried over to 1974 and mortgage money should be more readily available in the second half of 1974. It is the consensus opinion, however, that housing activity is headed downward for 1974 as a whole.

The volume of funds raised by the government sector is predicted to advance slightly in 1974 to $23 billion. The U. S. Treasury is expected to maintain its modest level of borrowing at almost $9 billion, an increase of less than $1 billion over 1973. State and local governments are forecast to increase their financing more dramatically to nearly $15 billion, with the volume of security issues up substantially. The agency market during 1974 is predicted to reduce its financing needs sharply to $14 billion from $21 billion last year. A decline in the volume of funds needed to support the housing industry is anticipated, although recent data indicate the drop-off may not be as large as originally predicted.

The Interest Rate Outlook Interest rates are undoubtedly the most volatile part of any financial forecast. The past year was a bitter experience for rate forecasters, and as a result, most predictions for 1974 mention interest rates in the briefest fashion. The consensus view, as shown in Table II, is that short-term rates will decline from the very high levels reached in August and September 1973. The decline will be moderated by the atmosphere of inflationary expectations that pervades the money markets, but such factors as a decreased demand for short- and intermediate-term credit combined with the expectation of a less stringent monetary policy should exert a downward thrust on short-term rates. On the other hand, rates in the long-term sector are predicted to be almost unchanged from 1973; however, stronger-than-anticipated demand for funds in the long-term markets along with intensified inflationary expectations could push long-term rates to new highs in 1974. A closer look at the anticipated behavior of some individual rates may produce a clearer picture of 1974 predictions.

Table II

CONSENSUS INTEREST RATE FORECASTS*

(percent)

	Year 1973	Second half avg. 1973	Year 1974
Treasury Bills†	7.07	8.05	6.35
Commercial Paper†	8.11	9.39	7.30
Prime Rate	8.01	9.45	7.34
Aaa Corporate Bonds	7.63	7.62	7.75
Aa Utility	7.76	8.14	7.87

*These numbers represent an estimation of the consensus forecasts of many well-known economists.

†Three-month maturity.

Short-term rates As Table II indicates, the consensus rate on three-month Treasury bills is expected to decline some 60 basis points by the close of 1974 to a level of 6.35 percent. This figure is over 125 basis points below the average rate for the second half of 1973. Relatively modest Treasury needs combined with a reduced demand for short-term funds account for the downward pressure on bill rates. In the market for prime, three-month commercial paper the rate declines are predicted to be more dramatic. By the close of 1974 the commercial paper rate should be down just about 80 basis points from 1973 at 7.30 percent, over 200 basis points below the average rate for the second half of last year. Closely related to the commercial paper rate is the rate charged prime bank borrowers-the prime rate. After rising to 10 percent on several occasions during 1973, the prime rate is forecast to drop below 7½ percent by late 1974, or over 200 basis points below the average rate for the entire second half of 1973. The consensus forecast places the prime rate in closer proximity *to* the commercial paper rate than the traditional 50-75 basis point spread, but corporate financing patterns among other things will dictate a tight parallel between the commercial paper and prime rates during 1974.

Long-term rates The consensus forecast for 1974 shows long-term rates rising slightly over 1973 levels. The rate on new issue Aa utility bonds is expected to be at 7.87 percent at the close of 1974, up just over 10 basis points. The heavy bond calendar for the coming year is the primary stimulus behind the upward shift in the utility rate. As cash flows fail to keep pace with investment spending and inflationary expectations strengthen, the rate on Aaa corporate

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bonds should rise during 1974, though not dramatically. The consensus forecast shows the corporate rate at 7.75 percent in 1974, up 12 basis points. The rate could move sharply higher if forecasters have underestimated the volume of long-term financing needed by the business sector in the coming year.

Monetary Policy The course of monetary policy plays an important role in shaping conditions in the financial markets. The conflicting forces of slowed economic growth, a high inflation rate, an improved international monetary situation, and a relatively low level of anticipated Treasury financing will be pulling against each other in the coming year, each trying to influence the course of monetary policy. The consensus of the forecasts shows that a policy of relative ease is anticipated with moderate growth in the aggregates. A 5.7 percent M_1 growth rate is forecast for 1974. The monetary authorities are expected to be moving toward a policy that allows the aggregates to expand at a pace consistent with balanced economic growth and long-term price stability, carefully avoiding unnecessarily sharp movements in interest rates.

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