FINANCIAL FORECASTS: 1975

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Conditions in financial markets were extremely volatile during 1974, primarily as a result of unforeseen developments in the economy. Last year was a very bad year for forecasters, but who would have anticipated double-digit inflation, the worsening energy problem, and the sharp fall in output and increase in unemployment in the fourth quarter. Because many of these factors that played havoc with the 1974 forecasts must still be dealt with in 1975, this year's forecasters are justifiably reticent about the soundness of their predictions. It is for this reason and in the interest of dependability that the predictions used for this "consensus" were limited to those compiled after mid-January of this year, after some of the major uncertainties were clarified. Forecasts compiled before the fourth quarter GNP figures were announced, before the latest deficit estimates were available, or before the President's economic package was unveiled would obviously be premised on the wrong set of economic variables, thus rendering them obsolete.

Apart from the other problems, the energy situation makes any forecast, financial or otherwise, uncertain at best. Fiscal and monetary policies will be geared to adjust to developments as the year unfolds. The key for policymakers in 1975 should be flexibility.

FUNDS RAISED IN 1975

The total volume of funds raised, without regard to maturity, is expected to register roughly $167 billion in 1975, somewhat lower than the $172 billion raised in 1974 (Table I). The decline should affect all maturity lengths to some degree, but the severest impact of the reduction is expected to be felt in the short-term sector of the market, where volume should drop from $93 billion in 1974 to an anticipated $88 billion in 1975. The decline in the long-term market should be negligible, with volume remaining close to last year's figure at $79 billion. Some downward adjustment in short-term rates should occur during the year; long-term rates might also decline slightly but to a lesser degree than in the short-term sector. Four categories of borrowers that must be examined in any discussion of the funds markets are: banks, business, consumers, and government. The past year saw an unprecedented demand for bank credit as the spread between the prime rate and the commercial paper rate moved out of traditional alignment. Total bank loans were roughly $34 billion this past year, exceeding the figure for 1973, which was also high by historical standards. The demand for bank credit eased during the fourth quarter of 1974, and for 1975 as a whole bank loans should total a more moderate $13 billion. In conjunction with this, the prime rate is expected to continue to decline to a level more in line with other short-term rates during 1975.

The volume of business loans is expected to vary dramatically both in size and composition during 1975, with the emphasis shifting from the short-term to the long-term market. In 1974 the business sector raised approximately $28 billion in long-term funds; this figure is forecast to increase only slightly to

Table I

CONSENSUS FUNDS FORECASTS*

($ Billions)

	Actual 1974	Forecast 1975
Net Funds Raised in the Short-Term Market	93.4	88.2
Bank Loans	34.1	12.8
Consumer Credit	9.6	3.1
Open Market Paper	16.6	9.4
U. S. Government	10.0	54.1
Agencies	23.1	8.8
Net Funds Raised in the Long-Term Market	79.1	79.0
Privately-held Mortgages	36.0	34.7
Corporate Bonds	23.3	28.0
Corporate Stocks	4.5	3.3
State and Local	15.3	13.0
Total Funds Raised	172.5	167.2

*These numbers represent an estimate of the consensus forecasts of many well-known economists; all forecasts were compiled after the President's economic package was revealed in mid-January.

about $31 billion in 1975. The composition of this borrowing should shift, however, so that in the coming year there would be a jump in corporate bond volume up to $28 billion, with stock volume sliding down to roughly $3 billion. A subsequent dramatic shift in short-term business borrowing is expected to accompany the realignment in the long-term market. Short-term financing in the business sector, which jumped to an astounding $50 billion last year, should fall off to only $22 billion in 1975. The forecast for sharply lower bank loan volume accounts for most of this contraction.

Consumer demand for funds in 1975 is expected to be very light. Net borrowing by consumers is forecast to amount to only $38 billion, off from $46 billion this past year. The decrease is wholly attributable to an anticipated $7 billion decline in short-term consumer credit—instalment loans—as automobile and consumer durables sales remain at low levels. The volume of privately-held mortgage funds should total approximately $35 billion in the coming year. Even though inflows at thrift institutions are expected to continue throughout the year, mortgage demand is likely to be weak. Mortgage money should be more readily available in 1975 than in the past year, but the nominal cost is expected to remain high by historical standards.

The most dramatic development in the funds markets this year should be the anticipated record level of government borrowing. Forecast at $76 billion, the volume of funds raised by the Federal Government, state and local governments, and the Agencies would account for 45 percent of the total funds raised in 1975. This dramatic upsurge in government borrowing is attributable to the anticipated sharp jump in Federal Government borrowing from $10 billion in 1974 to an expected $54 billion in 1975. These figures are subject to a wide degree of fluctuation, and the forecasts for Federal borrowing range from a low of $41 billion to a high of $65 billion. Whatever the figure might turn out to be, the Federal Government will definitely need a large supply of funds to finance the proposed "economic" and "energy" packages.

In other sectors of the government market, the volume of funds raised in 1975 is expected to decline. The Agencies who were frequent borrowers in 1974, should need only $9 billion in 1975, less than half last year's total. State and local governments are forecast to borrow $13 billion in the coming year, slightly below their 1974 level of borrowing.

Although there is currently a great deal of serious debate on the subject, the consensus of the forecasts predicts that there will be enough funds available to satisfy all borrowers in 1975 at current or lower levels of interest rates. One opinion holds that the massive Government borrowing necessary to support the anticipated 1975 budget deficit will overwhelm the markets, causing a dearth of funds for the private sector. This opinion is premised on the assumption that in 1975 the borrowing needs of the private sector will be stronger than is usually characteristic of a recessionary period. There are two main reasons for this assumption: (1) heavy financing of oil consumption both at home and abroad, and (2) large external financing needs of business because of generally tight liquidity positions. The opposing opinion speculates that although business borrowing is expected to remain firm in the long-term sector, short-term business borrowing will abate. This fact, combined with sharply lower anticipated levels of consumer and Agency demand for funds, should free-up abundant funds for other potential borrowers, thus averting any credit crunch. The consensus of the forecasts seems to agree with this latter argument.

Table II

CONSENSUS INTEREST RATE FORECASTS*

	1974	1975
Treasury Bills†	6.99	6.00
Commercial Paper†	9.25	6.75
Prime Rate	10.25	8.00
Aaa Corporate Bonds	8.91	8.80
Aa Utility	9.51	9.40

*These numbers represent an estimate of the consensus forecasts of many well-known economists; all forecasts were compiled after the President's economic package was revealed in mid-January.

†3-month maturity.

THE INTEREST RATE OUTLOOK

Interest rates are undoubtedly the most volatile part of any financial forecast. The past year was a bitter experience for most rate forecasters, and as a result, most predictions for 1975 mention rates only briefly, if at all. It is impossible to predict the behavior of interest rates without knowing other variables such as money supply growth. A small change in the rate of growth of the money supply can permeate rate structures and alter rate relationships and behavior patterns. For this reason, there is necessarily a wide margin for error in interest rate forecasting. The consensus view, as shown in Table II, is that short-term rates will continue to decline from the levels prevailing at the end of 1974. The decline

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will be moderated and may be reversed if intensified inflationary fears begin to pervade financial markets later in the year or if the economic recovery is unexpectedly strong. But such factors as a decreased demand for short-term funds combined with the expectation of a less stringent monetary policy may exert downward pressure on short rates. Long-term rates may continue to exhibit strong inflationary premiums throughout 1975 if some strong evidence of easing pressure on prices is not clearly visible. These rates are expected to move slightly lower, however, as a minimal decline in the long-term volume and an improved economic outlook help to ease some rate pressures. The downward movement in long-term rates will lag short-term rate declines, and the movement should be far less volatile. Toward the close of 1975, rates may move up in both long- and short-term markets as the economic recovery gets under way and especially if money supply growth is too rapid and inflation is refueled. A closer look at the anticipated behavior of some individual rates may produce a clearer picture of 1975 predictions.

Short-term rates As Table II indicates, the consensus rate on three-month Treasury bills is expected to decline some 100 basis points by the close of 1975 to a level of 6.00 percent. Anticipated heavy Treasury activity in the short-term market combined with a reduced demand for short-term funds account for the predicted downward pressure on bill rates. In the market for 3-month, dealer-placed commercial paper, the rate declines are predicted to be more dramatic. By the close of 1975 the CP rate should be at 6.75 percent, dropping lower early in the year and then moving back up to this level. This rate is 250 basis points below the year-end 1974 figure and even more sharply below the 1974 high. Closely related to the commercial paper rate is the rate charged prime bank borrowers—the prime rate. After rising to a whopping 12 percent in 1974, the prime rate is forecast to end 1975 at 8.00 percent; a rate below this level is forecast for the first half of the year. Such an adjustment would bring the prime rate into more traditional alignment with the commercial paper rate, although the spread would continue to be slightly wider than normal.

Long-term rates The consensus forecast for 1975 shows long-term rates declining only slightly from rates at the end of 1974, with no dramatic movement expected. The rate on new issue Aa utility bonds should fall to 9.40 percent, 10 basis points below 1974, while the rate on Aaa corporate bonds is expected to close 1975 at 8.80 percent, again only 10 basis points below the level at the end of 1974. The pattern of rate behavior in the long-term sector could shift dramatically if forecasters have underestimated corporate financing needs for 1975 or if due to factors outside the corporate market, inflationary expectations become re-entrenched in the second half.

MONETARY POLICY

The behavior of the monetary aggregates plays a critical role in shaping conditions in financial markets. The conflicting forces of slowed economic growth, inflation, reduced productivity, and high unemployment will be pulling against each other in the coming year, each exerting an influence on 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 money supply growth rate in the range of 6.5 to 8 percent is the consensus forecast, with the caution by forecasters that the monetary authorities must move toward a policy that allows the aggregates to expand at a pace consistent with balanced economic growth and long-term price stability, carefully avoiding the rekindling of inflationary fires.

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