half even though the rate of housing starts falls off moderately. The main limitation upon housing will, of course, be availability of mortgage financing.

Perhaps the most difficult sector of the GNP to forecast this year is business inventories. In the fourth quarter of last year inventories were being accumulated at an annual rate of $9 billion. We anticipate that the rate will rise further to about $11 billion in the first quarter and to $14 billion in the second. The rate may be expected to decline, in our model, to $11 billion in the third quarter and $9 billion in the fourth. For the year as a whole, we expect an $11 billion accumulation of inventories, compared with $5 billion in 1967, during much of which inventories were being reduced.

We are estimating a decline of net exports to $4 billion this year due to rising imports and some slippage in our exports as increasing costs and prices hurt our export position.

Finally, we are estimating that physical output, as measured by the Federal Reserve Board index of industrial production, will rise by about 6 percent this year, with most of the increase occurring in the first half.

The second table attached, entitled "Financial Flows, 1961–1968", provides estimates of uses and sources of funds in the money and capital markets in 1968. They are based upon our GNP forecast and the assumptions which underlie it, notably that the tax surcharge will not be enacted. As you will see, we are estimating that total uses of funds will rise by $6.3 billion above the record total of $80.2 billion last year.

Time permits only selective comments upon items in the table. We are estimating that the total net increase in corporate bonds this year will amount to about $11 billion, compared with the record $15 billion in 1967. There are two main reasons for this reduction: (1) corporations undoubtedly stockpiled funds last year to some extent in anticipation of a credit squeeze; and (2) corporations are likely to rely more heavily this year on borrowing from the commercial banks in anticipation of a decline, as the year goes on, in corporate bond yields. As you will see, we have raised the net increase this year in bank loans to take account of this.

We have also raised the net increase in mortgages on 1–4 family properties to $13.5 billion, compared with $11.8 billion last year. As you will note in the lower portion of the table, we expect that the net increase in funds available from mutual savings banks and savings and loan associations will be somewhat lower this year due to the "pull" of higher interest returns on investments in the open market. Since these two institutions make a large part of the total mortgage loans on 1–4 family properties, it may at first seem inconsistent to raise the estimate for the net increase of 1–4 family mortgages. Our reasoning is that last year the mortgage lending institutions added substantially to their liquid asset holdings and that they will use some of this liquidity to increase their mortgage holdings. Also, the Federal Home Loan Banks are in a much more liquid position to make advances to the savings and loan associations. Finally, if there does prove to be a decline in corporate bond offerings, money should be released to the mortgage market. This will, in particular, increase availability of funds for the financing of multifamily and commercial mortgages, which is the principal reason for raising the net increase of such mortgages to $10.5 billion this year.

As will be noted in the lower panel of the table, we are estimating that funds available from the commercial banks will increase by $30 billion this year, compared with the record $34 billion in 1967. This is in accord with the view that the Federal Reserve will slow down the expansion of credit moderately this year but that it will be careful not to precipitate a credit crunch.

My forecast of general business activity and of financial flows does not suggest much relaxation of pressures in the money and capital markets this year, assuming no action by Congress on the tax surcharge. The likelihood is that during the first half of the year short- and intermediate-term interest rates will stiffen further as credit demands rise and Federal Reserve policy moves toward lesser ease. It is also probable that during the first half long-term rates will be very firm, and they may indeed edge up from current levels to the peaks of last November. With the slackening in the rate of business activity in the second half of the year, we shall probably see some softening of both short- and long-term rates.

THE PROBLEMS AND DANGERS

The forecast which I have presented suggests some very troublesome problems and dangers which I would now like to consider briefly.