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CONFIDENTIAL (FR)

SUPPLEMENT

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

August 11, 1972

By the Staff
Board of Governors
of the Federal Reserve System

The Domestic Economy

Retail sales in July increased 1.9 per cent from June with all major consumer categories of stores reporting higher sales, according to the Census advance report. Sales of durable goods rose 2.7 per cent while sales of nondurable goods advanced 1.4 per cent. Furniture and appliance sales were 2.7 higher than in the previous month and the general merchandise group was up 3 per cent. Compared with a year earlier, total July sales were up 10.9 per cent.

Seasonally adjusted sales of new homes by merchant builders continued little changed in June; at an annual rate of 692,000, the average for the second quarter was only a little below the peak reached in the first quarter of the year. Stocks of homes available for sale increased again--to 6.2 months' supply at the June rate of sales, the highest such level in more than two years. Underscoring the strength of demands, however, the rate of sales in the second quarter was associated with a further increase in the mix of transactions toward more expensive units, and the median price of homes actually sold again was above the median price of homes for sale.

Reflecting similar upgrading tendencies in the existing home market, prices of existing homes sold in June rose further to a median of $27,380. (Confidential until release August 14.)

NEW SINGLE-FAMILY HOMES SOLD AND FOR SALE

	Homes sold 1/	Homes for sale 2/	Median price of: Homes sold	Homes for sale
	(Thousands of units)		(Thousands of dollars)	
1971				
QIV	682	284	25.5	25.9
1972				
QI (r)	701	318	26.2	26.1
QII (p)	692	357	26.9	26.5
April (r)	692	320	26.8	26.4
May (r)	695	333	27.1	26.4
June (p)	690	357	26.8	26.5

1/ SAAR.
2/ SA, end of period.

Inventories. Book value of retail trade inventories declined at a $0.5 billion annual rate in June. The decline reflected a rundown in auto dealers' stocks, also shown in the unit new car data; elsewhere stocks rose, particularly at general merchandise outlets. Sales declined more than stocks and the retail inventory-sales ratio rose slightly from a downward-revised 1.40 in May to 1.41 in June. Since February, however, this ratio has remained at the lowest levels since some months in 1968.

Manufacturing and trade stocks together rose at a $6.4 billion rate in June, down from $14.9 in May. The quarterly rate was $9.9 billion, well above the first quarter rate of $5.8 billion. The business inventory-sales ratio rose from 1.51 to 1.52 in June but remains at the lowest levels since October 1966.

CHANGE IN BOOK VALUE OF BUSINESS INVENTORIES
(Seasonally adjusted, billions of dollars)

	1972			
	Q I	Q II (Prel.)	May (Rev.)	June (Prel.)
Manufacturing and trade	5.8	9.9	14.9	6.4
Manufacturing, total	3.1	4.3	4.7	8.4
Durable	2.9	3.0	5.5	3.8
Nondurable	.2	1.3	- .8	4.5
Trade, total	2.7	5.6	10.2	-2.0
Wholesale	1.0	1.7	1.9	-1.5
Retail	1.7	3.9	8.3	- .5
Durable	-.4	1.1	3.8	-2.4
Automotive	-1.1	-.5	1.6	-3.7
Nonautomotive	.7	1.6	2.2	1.3
Nondurable	2.1	2.8	4.5	1.9

NOTE: Detail may not add to total because of rounding.

INVENTORY RATIOS

	1971		1972	
	May	June	May (Rev.)	June (Prel.)
Inventories to sales:				
Manufacturing & trade	1.60	1.59	1.51	1.52
Manufacturing, total	1.85	1.82	1.69	1.71
Durable	2.26	2.21	2.02	2.06
Nondurable	1.38	1.37	1.29	1.29
Trade, total	1.37	1.36	1.33	1.34
Wholesale	1.21	1.20	1.23	1.22
Retail	1.47	1.46	1.40	1.41
Durable	2.13	2.10	1.92	1.93
Automotive	1.75	1.77	1.58	1.56
Nonautomotive	2.69	2.60	2.41	2.46
Nondurable	1.17	1.17	1.14	1.16
Inventories to unfilled orders:				
Durable manufacturing	.927	.940	.900	.876

The Domestic Financial Situation

Home mortgage rates. The average return on home mortgages changed little in July, according to the FHA. In the primary market, the average contract rate on conventional new-home loans edged higher on new-home loans to 7.65 per cent, but remained unchanged at 7.70 per cent on existing-home loans which account for the bulk of all originations in this sector of the market. In the secondary market, the average yield on FHA-insured new home loans remained at 7.54 per cent. (Confidential until August 15.)

AVERAGE RATES AND YIELDS ON NEW-HOME MORTGAGES

	Primary market: Conventional loans		Secondary market: FHA-insured loans		
	Level (per cent)	Spread (basis points)	Level (per cent)	Spread (basis points)	Discounts (points)
1971 - Low	7.55	-36	7.32	-36	2.5e
High	7.95	71	7.97	56e	7.8
1972 - Jan.	7.60	53	7.49	42	4.0
Feb.	7.60	44	7.46	30	3.8
Mar.	7.55	33	7.45	23	3.7
Apr.	7.60	29	7.50	19	4.1
May	7.60	39	7.53	32	4.3
June	7.60	30	7.54	24	4.4
July	7.65	33	7.54	22	4.4

NOTE: FHA series: interest rates on conventional first mortgages (excluding additional initial fees and charges) are rounded by FHA to the nearest 5 basis points. On FHA loans carrying the 7 per cent ceiling rate in effect since mid-February 1971, a change of 1.0 points in discount is associated with a change of 12 to 14 basis points in yield. Gross yield spread is average mortgage return, before deducting servicing costs, minus average yield on new issues of high-grade corporate bonds with 5-year call protection.

e/ Estimated.

Corporate profits. The staff is currently estimating that corporate profits before tax for the second quarter will be around $95 billion, seasonally adjusted at an annual rate; this represents an increase of about $6.5 billion over the first quarter. Of this increase, the bulk is attributable to domestic nonfinancial business; only about $1 billion represents increases in the profits of domestic financial institutions and in profits originating in the rest of the world. Total profits, therefore, will probably show an increase of 7-1/2 per cent over the first quarter and an increase of 12 per cent over a year ago. For domestic nonfinancial business, these rates of increase are estimated at 8.4 per cent and 16.7 per cent, respectively.

Published tabulations by private sources of after tax profits from company earning reports have indicated year-to-year increases ranging from 12 to 16 per cent, the latter figure being the most recent as well as the comprehensive estimate. The recent decline in the effective tax rate implies that relative increases in after-tax profits will exceed those in before-tax profits. Moreover, these tabulations include the earnings of foreign subsidiaries; in the national income accounts such income is attributed to the rest of the world, and this component is estimated to have increased over this period at a rate considerably below that of domestic nonfinancial business.

Second-Quarter Flow of Funds

Second-quarter credit flows continued at the very high pace that had been established early in 1971, although somewhat lower than the peak rates of the second half of 1971. While U.S. Government borrowing has been sizable during 1971 and 1972, the principal basis for these large totals has been private and municipal borrowing that has been unprecedentedly high relative both to GNP and to capital outlays and state and local government deficits. These relationships continued in the second quarter, when sharp increases in home mortgage lending and consumer credit growth offset decreases in rates of municipal and business borrowing.

With the acceleration in GNP growth rate from 1971 to the first half of this year, however, the assets and debts arising from these high borrowing rates have come into more reasonable relationship to activity than they had in 1971. Last year both private debt outstanding and private holdings of financial assets were rising at somewhat faster rates than GNP and by year-end were exceptionally high in relation to GNP by historical standards. The faster growth in GNP this year has more than caught up with growth rates in credit though, and by June both debt and asset positions had decreased slightly from year end as per cents of GNP, in spite of the continued high flows of net new credit.

Funds raised. The strength in credit flows in the second quarter was entirely in household borrowing, where the increases in mortgage flows and consumer credit over both the first quarter and the 1971 rate were sufficient to offset decreases in credit to other sectors.

TOTAL FUNDS RAISED IN CREDIT MARKETS

(Billions of dollars, 1972 flows at seasonally adjusted annual rates)

	1970	1971	1972 I	1972 II	II/72 less 1971
Total, all nonfinancial sectors 1/ 2/	92.1	139.6	138.8	137.1	-2.5
U.S. Government 2/	10.1	22.2	15.9	11.6	-10.6
Other sectors	82.0	117.4	122.9	125.5	8.1
State & local govts.	13.9	20.6	17.8	13.7	-6.9
Households	22.3	41.6	47.4	59.5	17.9
Business 1/	42.7	49.6	54.6	51.1	1.5
Foreign	3.0	5.6	3.1	1.3	-4.3
Net corporate equity issues not included above	6.8	13.5	10.4	11.4	-2.1

1/ Excludes corporate equities.
2/ Net of changes in Treasury cash balances.

Net mortgage borrowing by households in the second quarter, at a $37 billion annual rate, was larger than the $32 billion rate of total new-housing purchases and thus included sizable financings against land and existing homes. The rise in mortgage flows from the first quarter originated mainly in savings institutions in reaction to the first-quarter surge of deposit inflows. For savings and loan associations, second-quarter mortgage flows were about equal to deposit growth, after a first quarter when they had been less than half as large.

Municipal borrowing has been on a decreasing trend over the last year, following the 1970-71 surge in post-crunch financing. During this period the NIA surplus for state and local governments jumped from $5 billion in 1971 to a $14 billion rate in the second quarter, and with construction fairly static their needs for external financing have been decreasing. Business borrowing has been at about the 1971 rate this year and is still high in relation to capital spending, even though outlays this year have been at a $14 billion higher rate than last. The decrease in business credit flows this year have been in net bond issues, offset by modest increases over 1971 in loan flows. Equity offerings are also down somewhat from 1971. With the rise this year in cash flow, business continues to accumulate liquid assets in sizable amounts.

FUNDS SUPPLIED IN CREDIT MARKETS

(Billions of dollars, 1972 flows at seasonally adjusted annual rates)

	1970	1971	1972 I	1972 II	II/72 less 1971
Total credit supplied to nonfinancial sectors 1/	92.1	139.6	138.8	137.1	-2.5
By: Foreign lenders	10.3	26.4	13.9	-.4	-26.8
Public agencies, net 1/	9.4	10.0	9.8	1.4	-8.6
Intermediaries, net 1/	65.3	99.0	121.8	107.7	8.7
Commercial banking 1/	30.3	47.3	59.1	43.4	-3.9
Nonbank finance	35.0	51.7	62.7	64.3	12.6
Private domestic non-financial sectors	7.0	4.2	-6.8	28.2	24.0
U.S. Govt. securities	-7.6	-13.1	-18.2	11.7	24.8
Commercial paper	-1.2	-2.1	-3.8	1.6	3.7
Other	15.8	19.4	15.2	14.9	-4.5
Net corporate equities not included above	6.8	13.5	10.4	11.4	-2.1
Net purchases by:					
Intermediaries	8.8	17.9	17.1	12.0	-5.9
Other	-2.0	-4.4	-6.7	-.6	3.8

1/ Net of changes in Treasury cash balances at Federal Reserve and commercial banks.

Sources of credit supply. Foreign central banks were essentially out of the U.S. Government securities market in the second quarter after six quarters during which they had bought at least half of and in some quarters far more than the total net issues of Governments. This second quarter change was reflected in major increases in Government security purchases by individuals and nonfinancial businesses, with the rise offset to a large extent by decreased flows from these investors into institutional deposits and money holdings. The decrease in deposit flow was in both savings institutions and commercial banks, although at banks there was a strong enough growth in CD's to increase the total flow into time deposits over the first-quarter rate. As mentioned earlier, savings institutions increased their mortgage lending sharply in the second quarter in the face of diminished deposit flows. This was in contrast with the first quarter, when more than half of deposit flows into savings and loan associations went into liquid assets or repayment of Home Loan Bank debt.

PRIVATE DOMESTIC NONFINANCIAL SECTORS

(Billions of dollars, 1972 flows at seasonally adjusted annual rates)

	1970	1971	1972 I	1972 II
Financial investment flows				
Direct lending in credit markets	7.0	4.2	-6.8	28.2
Flows into deposits and money	63.9	95.7	117.4	89.0
Total	70.9	99.9	110.6	117.2
Asset holdings, end of period				
Billions of dollars	$993.0	$1,092.5	$1,117.1	$1,149.4
Per cent of GNP	100.3%	101.3%	100.7%	100.9%
Credit market debt, end of period				
Billions of dollars	$1,107.1	$1,217.2	$1,247.2	$1,278.2
Per cent of assets	111.5%	111.4%	111.6%	111.2%

<u>Private financial assets</u>. The sharp swing by individuals and business as investors from deposits to Government securities was within a total flow into financial assets--deposits and credit market instruments--that was consistent with the 11 per cent growth rate in GNP during the quarter. These private financial assets, which had been 101 per cent of GNP in 1960 and 100 per cent in 1965 were again at that relationship at the end of 1970, after a sharp dip to 97 per cent in 1969. The high rate of credit expansion in 1971 built these asset holdings up to the 1960 level of 101 per cent of GNP at the end of the year. While private financial asset flows continued large in the first half of this year, the higher rates of GNP growth we have had were sufficient to hold the relationship through June to slightly under the 101 per cent relationship. Private debt has been about 111.5 per cent of financial assets since the end of 1969. That relationship was maintained through the first half of this year.

CORRECTIONS: Table 1-5, GROSS NATIONAL PRODUCT AND RELATED ITEMS, should read:

	1973 Projection
Gross national product in constant (1958) dollars	838.8
GNP implicit price deflator	151.1

INTEREST RATES

	1972 Highs	1972 Lows	July 17	August 10
Short-Term Rates				
Federal funds (wkly. avg.)	4.69 (8/9)	3.18 (3/1)	4.62 (7/12)	4.69 (8/9)
3-month				
Treasury bills (bid)	4.14 (7/3)	2.99 (2/11)	3.92	3.86
Comm. paper (90-119 day)	4.88 (7/20)	3.75 (2/29)	4.88	4.62
Bankers' acceptances	4.75 (7/25)	3.83 (2/23)	4.75	4.62
Euro-dollars	5.94 (3/27)	4.62 (3/8)	5.75	5.62
CD's (prime NYC)				
Most often quoted new	4.88 (7/12)	3.50 (2/23)	4.88 (7/12)	4.62 (8/9)
Secondary market	5.00 (7/12)	3.50 (2/16)	4.94 (7/12)	4.72 (8/9)
6-month				
Treasury bills (bid)	4.68 (7/3)	3.35 (1/10)	4.43	4.39
Comm. paper (4-6 mo.)	4.88 (7/25)	3.88 (3/3)	4.88	4.75
Federal agencies	5.05 (7/5)	3.79 (2/17)	4.98	4.76
CD's (prime NYC)				
Most often quoted new	5.00 (8/9)	3.88 (2/23)	5.00 (7/12)	5.00 (8/9)
Secondary market	5.30 (7/5)	3.70 (2/2)	5.12 (7/12)	5.10 (8/9)
1-year				
Treasury bills (bid)	5.09 (6/30)	3.57 (1/8)	4.86	4.73
Federal agencies	5.38 (7/10)	4.32 (1/17)	5.28	5.06
CD's (prime NYC)				
Most often quoted new	5.38 (8/9)	4.62 (1/19)	5.38 (7/12)	5.38 (8/9)
Prime municipals	3.15 (4/13)	2.35 (1/12)	3.05 (7/12)	2.90
Intermediate and Long-Term				
Treasury coupon issues				
5-years	6.28 (4/13)	5.47 (1/13)	5.94	5.96
20-years	6.22 (4/14)	5.95 (1/14)	6.00	5.92
Corporate				
Seasoned Aaa	7.37 (4/24)	7.14 (1/17)	7.19	7.19
Baa	8.29 (1/3)	8.17 (1/19)	8.23	8.23
New Issue Aaa	7.42 (4/14)	6.86 (1/14)	7.34 (7/12)	7.24 (8/9)
Municipal				
Bond Buyer Index	5.54 (4/13)	4.99 (1/13)	5.44 (7/12)	5.24 (8/9)
Moody's Aaa new issue	5.25 (7/13)	4.65 (1/13)	5.25 (7/13)	5.10
Mortgage--implicit yield in FNMA auction 1/	7.63 (8/7)	7.54 (3/20)	7.62 (7/10)	7.63 (8/7)

1/ Yield on short-term forward commitment after allowance for commitment fee and required purchase and holding of FNMA stock. Assumes discount on 30-year loan amortized over 15 years.

SUPPLEMENTAL APPENDIX A

RECENT DEVELOPMENTS IN AGGREGATE PRICE INDEXES*

According to the revised fixed-weight index for the private product (GPP) the rate of inflation has moderated very substantially. In the years 1969, 1970, and the first half of 1971, prices were rising at a rate of nearly 5 per cent, but over the year ending in last June, including the freeze period, the rate of rise dropped to little more than 3 per cent. The preliminary estimate for the second quarter is also about 3 per cent.

AGGREGATE PRICE INDEXES
(Per cent change at seasonally adjusted annual rates)

	GPP fixed weight index 1/	GPP deflator	GNP deflator
1971 - QI	5.5r	4.8r	5.9r
QII	4.6r	4.3r	4.4r
QIII	3.5r	2.8r	2.9r
QIV	1.7r	1.0r	1.5r
1972 - QI	4.5r	4.2r	5.1r
QII	3.1p	2.0p	2.1p

1/ 1967 weights.

The increase in the GNP deflator has recently been reduced more sharply than other aggregate indexes, but this measure reflects changes in the economy other than prices. In the first quarter the GNP deflator rose at a rate of about 5 per cent, reflecting in part a Federal pay-raise. In the second quarter, the rise in the GNP deflator dropped to almost 2 per cent; this low rate of advance reflected in part a decline in the weight of Government employment, which has a high deflator, as well as favorable shifts in weights in the private sector. Such shifts in weights have held the rise in the deflator for the private product (GPP) below that for the comparable fixed-weight index for over a year.

* Prepared by Mary Smelker, Senior Economist, Division of Research and Statistics.

The inflation in consumer prices, particularly those for services, has subsided substantially this year. The CPI adjusted to exclude mortgage costs rose at a rate of 4.7 per cent in the first half of last year compared to 3.3 per cent in the same period of this year, and the PCE fixed weight index exhibited a similar drop. (The CPI before adjustment also indicates a lessening of price rises, but the degree of improvement since early last year is to some degree masked by falling mortgage rates at that time.)

CONSUMER PRICES
(Per cent changes in quarterly averages, seasonally adjusted annual rates)

	CPI	CPI less mortgage costs	PCE fixed weight index 1/
1971 - QI	3.8	4.5	5.3r
QII	3.8	5.0	3.6r
QIII	4.0	4.1	3.4r
QIV	2.4	2.2	1.5r
1972 - QI	3.9	3.8	3.6r
QII	2.5	2.8	3.1p

1/ 1967 expenditure weights
p - Preliminary.
NOTE: CPI changes have been computed on the basis of quarterly averages for comparability with the PCE index.

The stabilization program had an immediate effect on prices of consumer services, which have continued to rise at considerably reduced rates compared to the pre-freeze period. 1/ Rents and medical cost increases have slowed particularly. Food prices rose sharply in the first quarter, but changed little in the second quarter, according to the CPI. Non-food commodity prices have generally been affected less by the stabilization program than services; nevertheless, partly because of cuts in apparel and gasoline prices in June, nondurable goods price increases were small in the second quarter. On the other hand, durable goods price rises continued large last quarter, even though much of the new car price increase occurred earlier in the year. (The July CPI is expected to show a larger gain than in June, reflecting in part a larger than seasonal rise in food prices. Apparel prices may not show the usual drop in July following June reductions.)

1/ Note, however, that the revised estimate for service costs in the aggregate index show slower rates of increase in 1970 and 1971 than the earlier estimates.

The investment sector has also experienced less inflation this year. Machinery and equipment prices are rising less rapidly than in pre-freeze periods, although price increases slowed appreciably in 1971, prior to the freeze. Some slackening in the pace of advance in construction workers' wages also appears to be reducing the rapid advance in construction costs. For residential construction, however, there may be little comparability between the second quarter estimate, which is based on indexes of construction cost, and estimates for earlier periods, which are based on Census surveys of sales prices of new one-family homes. 2/

The wholesale price index has failed to show the improvement in the post-stabilization period characteristic of the other major indexes. In Phase II, (November through July) farm products and processed foods and feeds have risen as sharply as in the 8 months prior to the freeze, and the rise in industrial commodities (materials and finished goods) has been almost as fast.

In part, this reflects the fact that services, which have slowed appreciably, are excluded from the WPI. In part it reflects the fact that the WPI includes goods at all stages of fabrication whereas other indexes reflect predominately finished goods. The latter have continued to rise at substantial rates at wholesale, but much less rapidly than materials, especially crude materials. As shown below, the more volatile wholesale prices of finished consumer goods, both food and non-food, have advanced more than retail prices in the November-June period, but the discrepancy will probably narrow in the months ahead. The fast rise in materials prices, on the other hand, suggests continued upward pressure in costs. Seldom has the divergence between materials price increases in the industrial sector and finished goods increase been so large over so long a period.

2/ The revised estimates, which reflect gains in productivity and fluctuations in entrepreneurial margins, show less increase in 1970 and 1971 than the construction cost series they replace.

WPI AND CPI - SELECTED SERIES
(Per cent changes, seasonally adjusted annual rates)

	Dec. 1970 to Aug. 1971	Aug. 1971 to June 1972	Nov. 1971 to June 1972
WPI - all commodities	5.2	3.6	5.2
industrial commodities	4.7	2.8	4.3
industrial materials	6.2	3.3	4.9
finished commodities (except foods)	2.7	2.0	3.3
CPI - all items	3.8	2.7	3.1
services less home finance 1/	6.7	3.0	3.5
Consumer foods			
WPI	6.8	3.8	5.4
CPI 2/	4.5	3.2	3.7
Other consumer goods			
WPI	2.2	1.9	2.9
CPI 3/	2.5	1.7	2.2
Producers equipment			
WPI	3.7	2.2	4.1

1/ Confidential, excludes mortgage costs, property taxes and insurance. Not seasonally adjusted.
2/ Food at home.
3/ Excludes used cars and home purchase.