James L. Kichline

INTRODUCTION - FOMC BRIEFING

April 19, 1977

The President's announcement last week regarding changes in his proposed fiscal program prompted the staff to alter the assumptions underlying its projection of GNP and related items. The revised projections have removed the earlier assumptions of a rebate package and an increase in the investment tax credit, which together total about $12.5 billion. We have retained other portions of the fiscal program--mainly for public employment and personal tax reform--which amount to roughly $16 billion through fiscal year 1978.

The fiscal program ultimately enacted could, of course, differ significantly from that which we have now assumed in our projections. Moreover, in coming months we will undoubtedly need to revise our assumptions to take into account other Administration initiatives. At this point we have not allowed for possible impacts of the anti-inflation program, the energy policy to be announced tomorrow, or comprehensive tax reform proposals forthcoming later this year. Thus, the expected pattern of economic developments could be influenced appreciably by public policies only now in the formative stages.

Mr. Zeisel will begin our presentations with an analysis of recent and prospective nonfinancial developments. He will be referring to the package of charts distributed this morning.

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Joseph S. Zeisel

FOMC BRIEFING

April 19, 1977

Recent weeks have brought further evidence of the increased vigor of economic activity. Production, employment, income and consumer demand all have moved strongly upward. Although some of the recent improvement undoubtedly reflects a rebound from the weather-depressed winter months and/from the effects of strikes late last year, there are indications of sufficient underlying strength to sustain an increased rate of activity over the next several quarters without the rebates formerly planned.

Industrial production is estimated to have risen by almost 1-1/2 per cent in March following a 1 per cent increase in February. (These data are/illustrated in Chart 1) Gains were widespread among producers of materials, business equipment and consumer durable goods. Motor vehicle production was particularly strong, accounting for a third of the rise in output in March.

Recent labor market developments reflect this improvement in industrial activity. Nonfarm payroll employment increased by half a million in March, and by three quarters of a million over the past two months. Employment gains were widespread, but particularly strong in manufacturing, where the workweek edged up further. The labor force also rose sharply in March, and the unemployment rate edged off only two-tenths to 7.3 per cent.

As is evident in the second chart, the resurgence of employment growth since last fall has supported strong gains in real wage and salary income--and has been accompanied by a vigorous expansion of consumer demand. Auto sales have been particularly strong. Total unit auto sales rose to a 12.2 million annual rate in March, more than a fifth above the fourth quarter. This was the highest selling rate since the spring of 1973, and appeared to be a function in large/ measure of improved consumer confidence and strong underlying demand from postponed replacement of existing cars.

Although a surge in auto sales sometimes occurs at the expense of other purchases, retail sales excluding autos have shown considerable vigor as well. These sales began moving up strongly last October, and other than a temporary weather-related drop in January, have been on an accelerated uptrend ever since, rising at a 13 per cent annual rate in the past half year.

The strength of consumer demand coupled with earlier production adjustments by year-end, had helped eliminate most of the inventory overhang that was plaguing business and it now appears that a period of restocking may be at hand. (These figures are presented in Chart 3) The book value of business inventories rose at a $28 billion annual rate in the first two months of this year--almost triple the fourth quarter pace. But since shipments have been very strong, the inventory-sales ratio remains at quite a low level, suggesting further gains in business orders, to build inventories and to meet current demands.

The outlook for business fixed capital spending is still for fairly moderate gains this year.

In general, demand appears still to be concentrated on equipment to be used in rounding-out existing facilities, rather than on major new construction to expand capacity.

Residential construction, however, has continued to show impressive strength, with a second month of strong gain following the January weather-related dip. Housing starts in March rose to a 2.1 million annual rate, the highest level since early '73. Starts in the first quarter equalled the fourth quarter total. Both single-family and multifamily starts increased sharply in March with singles exceeding their 1973 peaks. Multifamily starts remain well below their levels in the early '70's, but fundamental factors such as low and declining vacancy rates, and somewhat improved financing conditions, appear to be providing a strong base for further expansion in the multifamily sector.

These indications of increased strength in demand and activity have led us to revise up somewhat our estimate of the first quarter increase in real GNP, to about a 4-3/4 per cent annual rate. Given the underlying momentum, we are projecting a further strengthening in growth of real GNP to an average of about a 5-3/4 per cent, annual rate, over the next five quarters, ending mid-1978. For the four quarters of 1977, the rate of increase in real GNP is close to half a per cent less than we were projecting with the inclusion of the full fiscal package.

In contrast to prospects for activity, the price outlook has become somewhat less favorable, largely as a result of recent developments in the food sector. As you can see in your fourth chart, wholesale food prices have skyrocketed in the past several months--with much of the increase in coffee, and in foods affected by the severe winter weather. Some of this problem is transitory, and we expect some actual declines in fruit and vegetable prices in the next several months. But there are also signs of less favorable longer-term developments in the outlook for food prices, including a sharp rise in soybean prices, increased dairy price supports, continued water shortages in the West, and likely reductions in beef marketings later this year.

As for prices of other products, we have assumed that energy costs will continue to rise more rapidly than prices generally, but at less than the recent rapid pace. As you will note, wholesale industrial prices,excluding energy items, rose in the first quarter at the somewhat accelerated pace of the second half of last year. But there have been sharp increases in some key industrial commodity prices recently, and with an earlier and larger minimum wage increase now in prospect, we have raised our projections of these prices somewhat. Overall, following an increase of about 6-1/2 per cent for the first quarter, we now anticipate a rate of rise in the gross private product fixed-weighted price index of slightly over 5-1/2 per cent over the balance of the projection period, about three-tenths more than last month. This is a fractionally slower rate than we were projecting with the inclusion of the tax rebates, however.

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The strong increase projected in nominal GNP through mid-1978 is expected to result in a further expansion of total funds raised in credit markets. The first chart shows that total funds raised are expected to rise to about $300 billion in the second half of 1977 and edge higher in the first half of 1978. Even with such a record volume of borrowing, however, the ratio of total debt outstanding to GNP would decline slightly.

The expansion of borrowing from that in 1976 is attributable to rising private credit demands--on the part of both businesses and households. Government borrowing (including Federal and State and local units) is projected to remain sizable, but appreciably less than the huge volume in 1975. Although the Federal deficit is expected to decline, it still remains large by historical standards at the same time that municipal demands for funds continue at record levels.

A key element in assessing the financial, as well as nonfinancial, outlook is the behavior of the business sector. The top panel of the next chart indicates that the staff forecast envisages considerable growth in nominal capital expenditures (including inventory investment). But internally generated funds are expected to rise at a fast pace so that the external financing gap--the difference between the two lines--remains rather moderate, especially when compared with that in 1973 and 1974.

We anticipate that funds raised in both short- and long-term markets, shown in the bottom panel, will remain near the levels of the first half of this year. These are still relatively high borrowing volumes given the size of external needs, but they are indicative of the conservative financing patterns evidenced in the business sector since late 1974. After having worked hard to strengthen their severely strained financial positions, it is likely businesses will be reluctant to permit a significant deterioration to occur anytime in the near future. In fact, the borrowing forecast is consistent with further additions to holdings of liquid assets, and the ratio of liquid assets to short-term liabilities continues to increase into 1978--although at a slower rate than in 1975 and 1976.

The volume of business short-term borrowing in the forecast is accomplished largely at commercial banks. Growth of business loans at banks is expected to be at about a 10 per cent annual rate in 1977 and the first half of 1978, about the same as in recent months. Later on this year, however, inflows of demand, savings and small time deposits--in line with the longer-run assumptions of Alternative B in the Bluebook--are expected to be insufficient to fund bank needs. Thus, banks will probably cut back on investments, begin to add to CD's outstanding, and increase reliance on nondeposit sources of funds.

Similar pressures are likely to occur at savings and loan associations, shown in the next chart. As interest rates on market instruments rise relative to deposit offering rates, net inflows of savings are likely to slow considerably. In particular, these institutions could experience sizable outflows of passbook savings deposits which seem to be highly interest elastic at this point in time.

To meet their mortgage commitments, S&L's will probably bid more aggressively for deposits, begin drawing on their currently high levels of liquid assets, and also increase borrowings from the Federal Home Loan Banks. In this environment, their willingness to extend additional commitments will decline and mortgage terms and rates will undoubtedly tighten. The over-all degree of restraint implicit in mortgage markets will probably result in a leveling off of housing starts around the end of this year.

In brief, a review of the flow-of-funds forecast suggests over-all demands for credit will press against available supplies of funds. Interest rates are likely to be under upward pressures in the second half of this year and on into 1978. Financial constraints on economic activity probably will emerge later this year, but major sectors will retain a good deal of flexibility given the general strength of financial positions.

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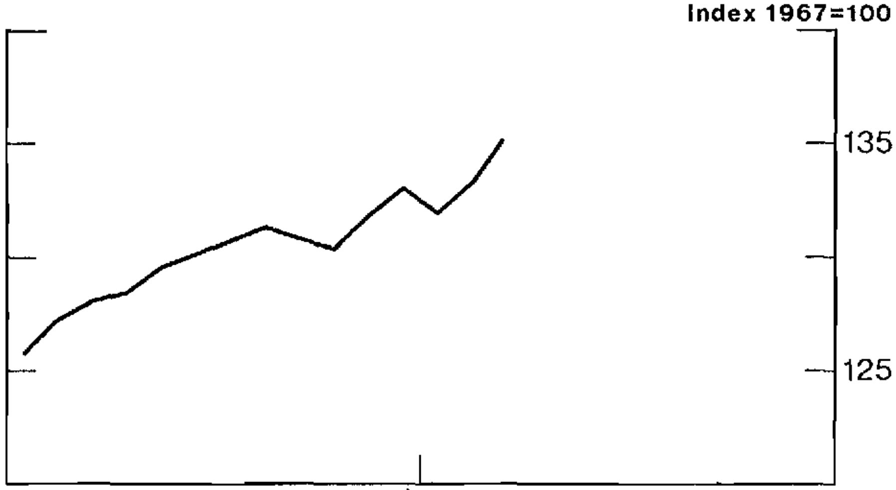
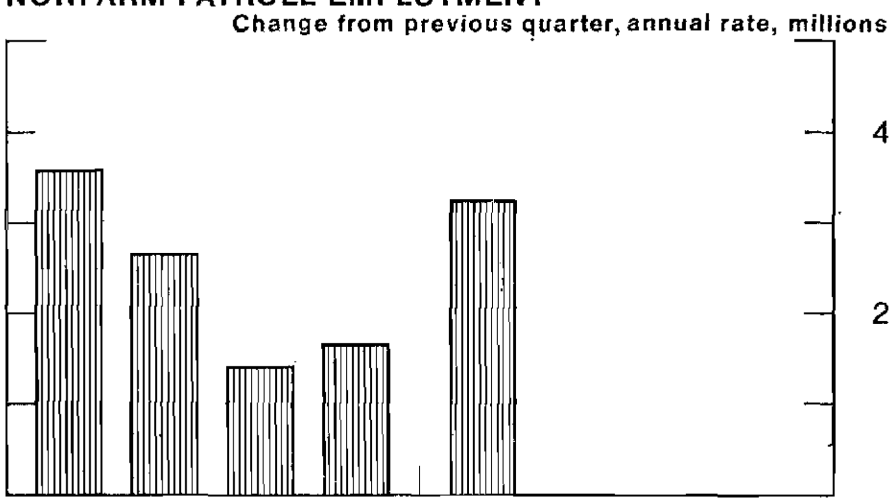
Material for Staff Presentation at the April FOMC Meeting

April 19, 1977

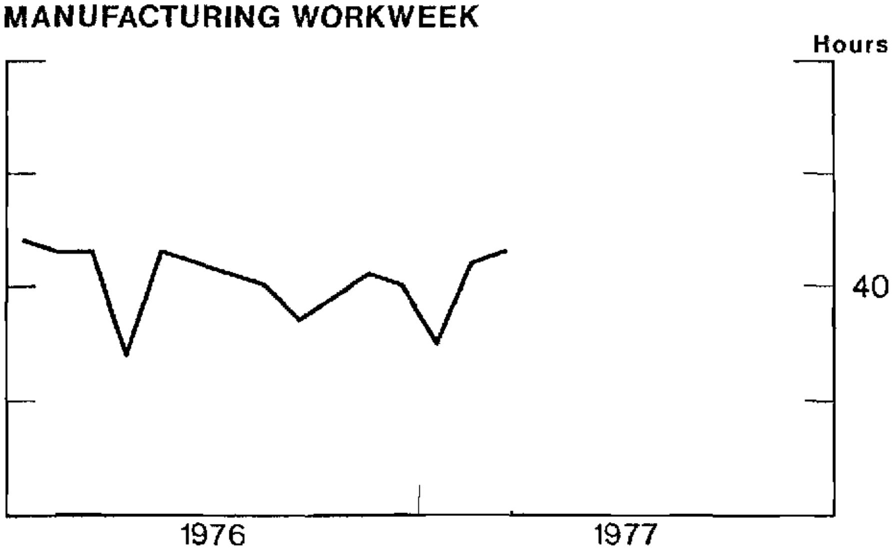
INDUSTRIAL PRODUCTION



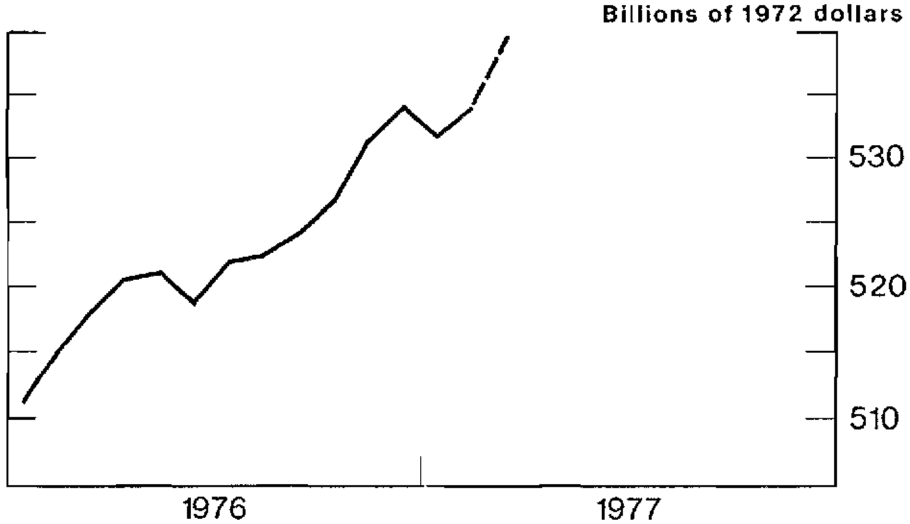
NONFARM PAYROLL EMPLOYMENT



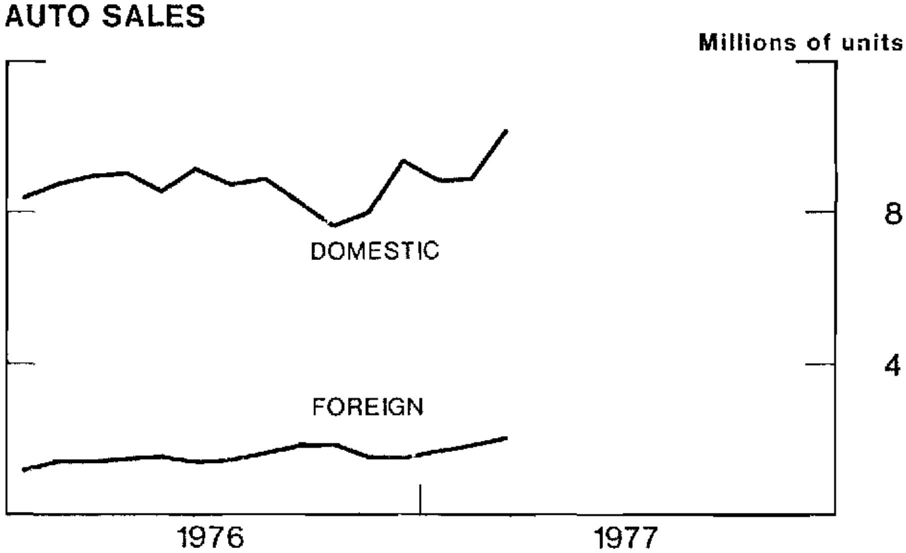
MANUFACTURING WORKWEEK



REAL WAGES AND SALARIES

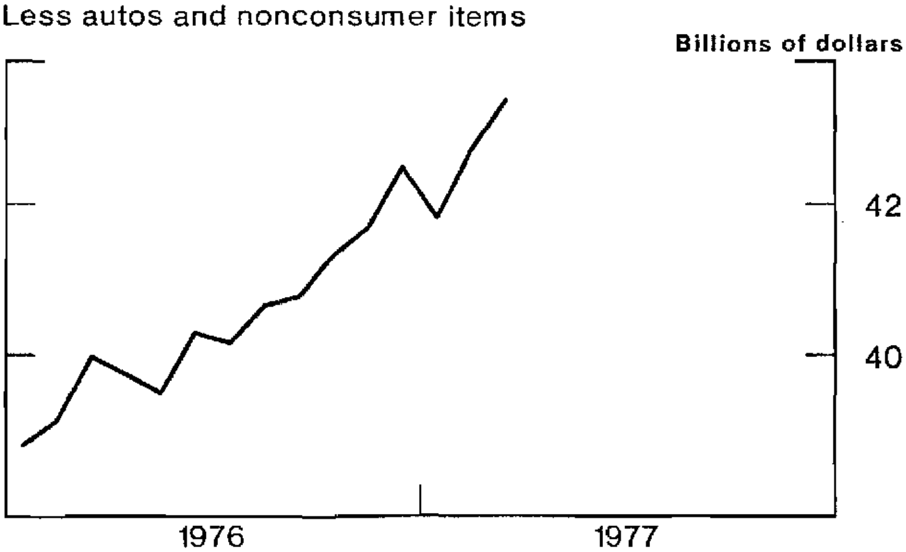


AUTO SALES

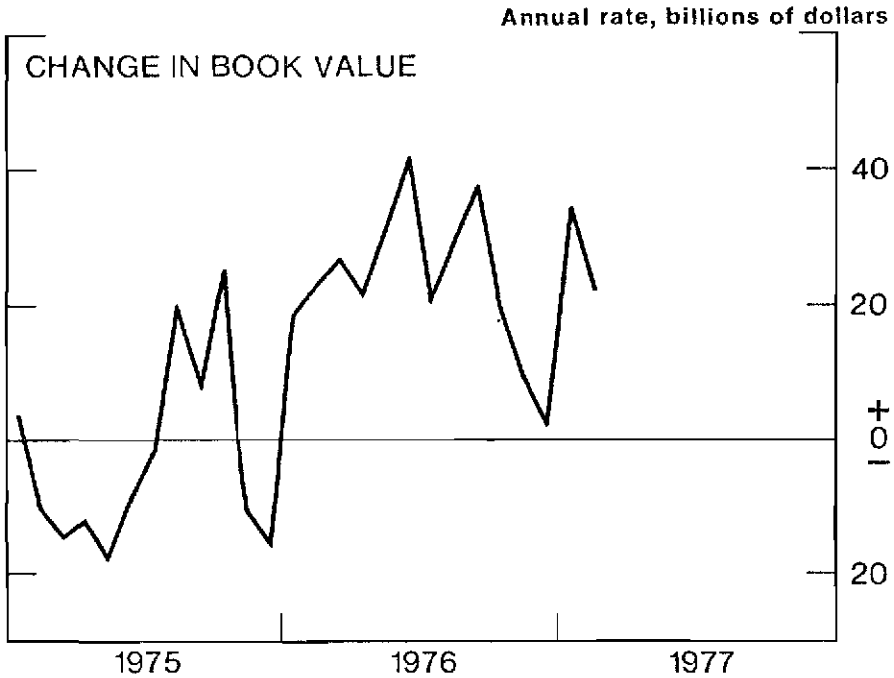


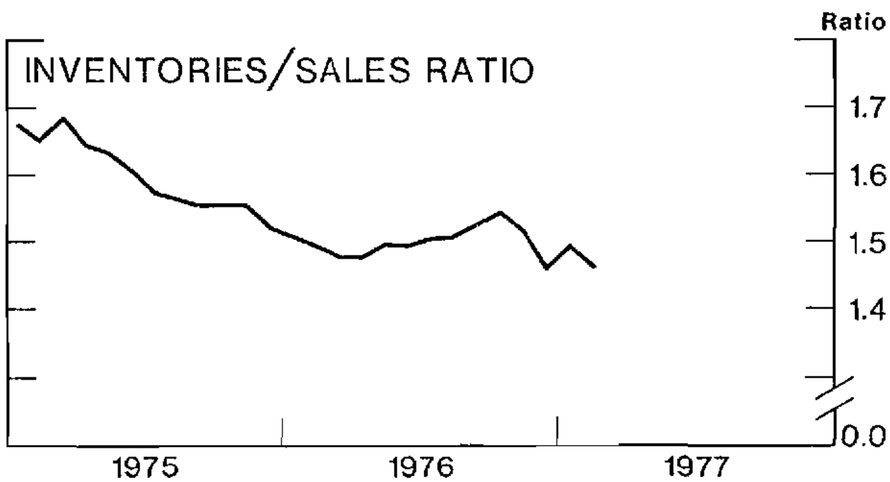
RETAIL SALES

Less autos and nonconsumer items

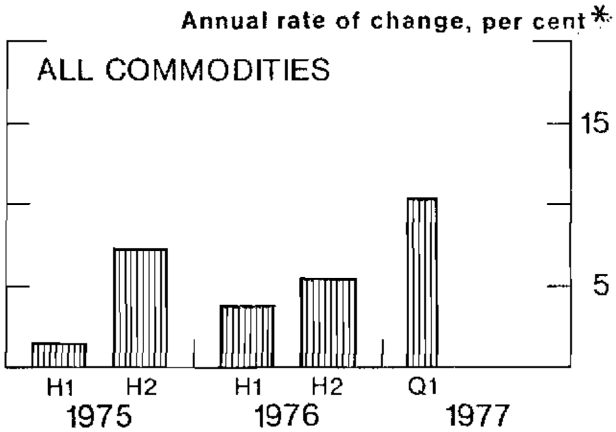


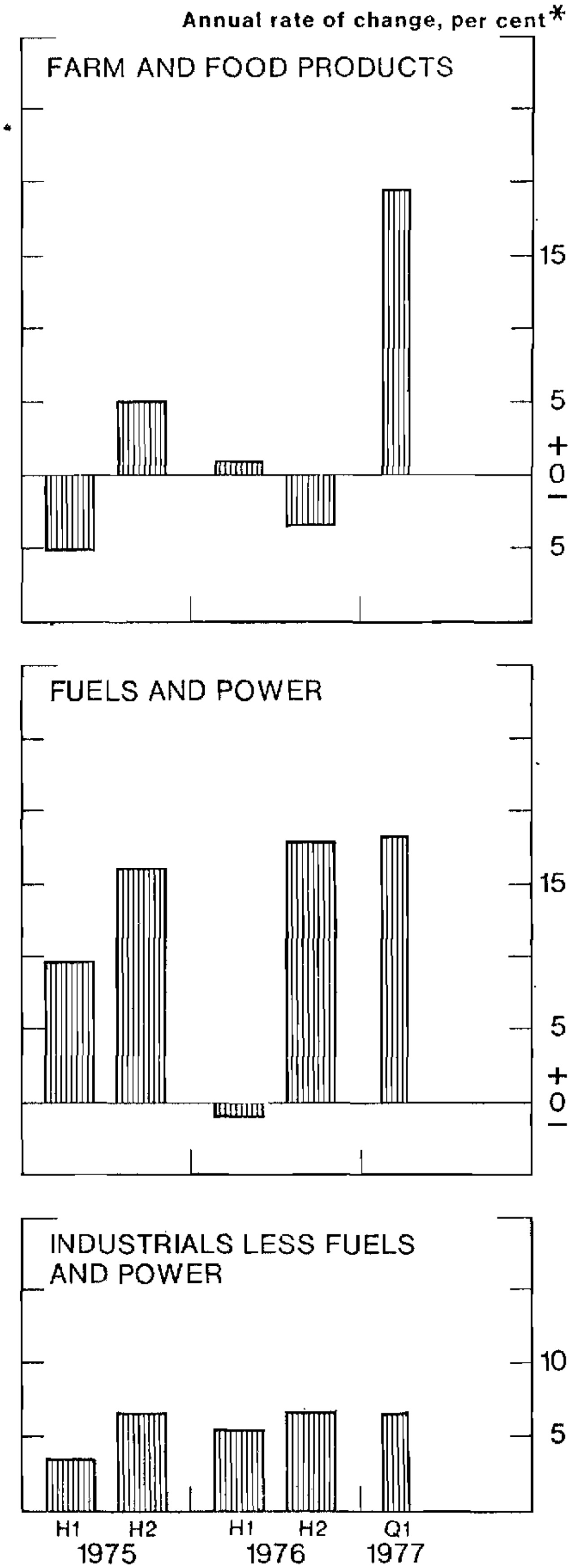
BUSINESS INVENTORIES





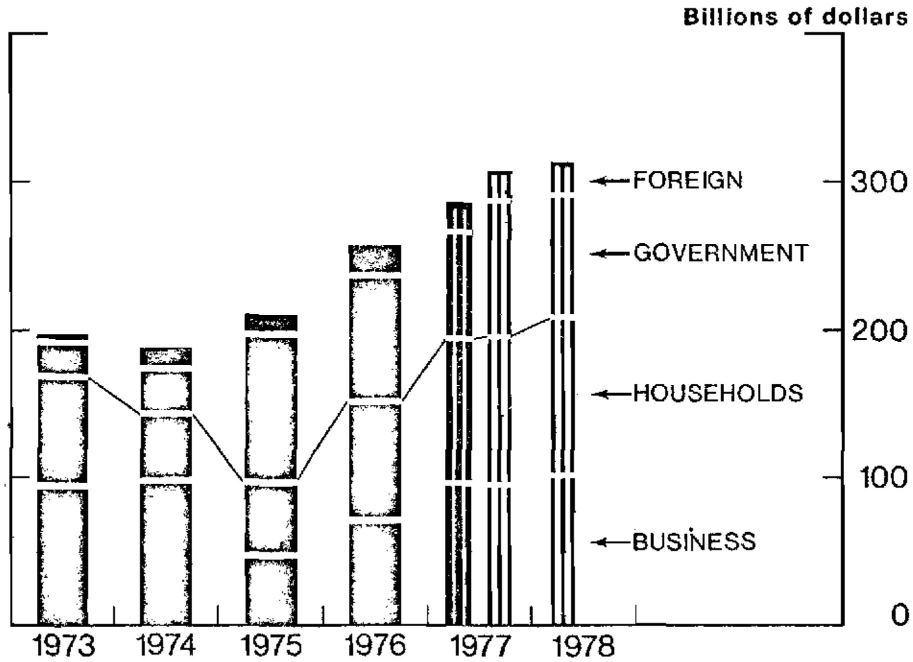
WHOLESALE PRICES



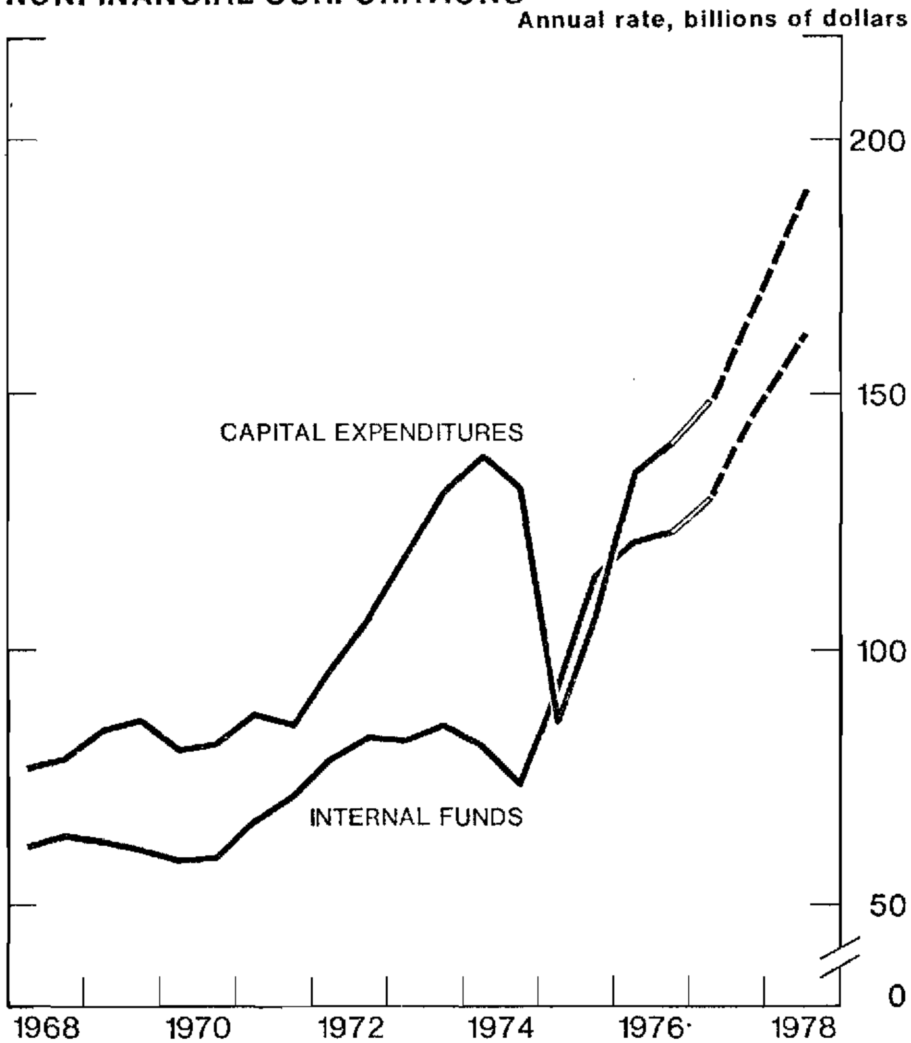


*Changes are from final month of preceding period to final month of period indicated.

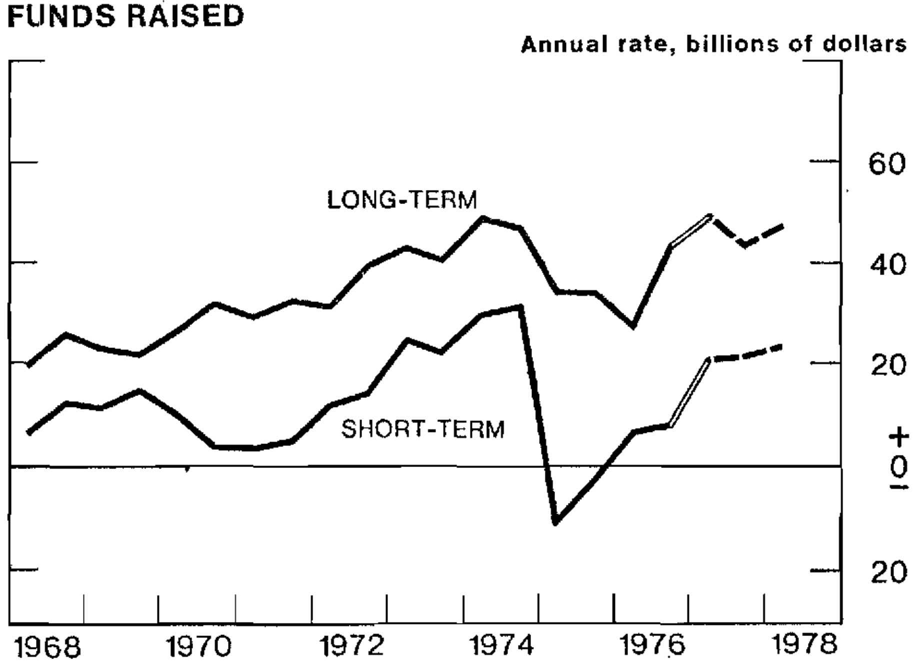
FUNDS RAISED



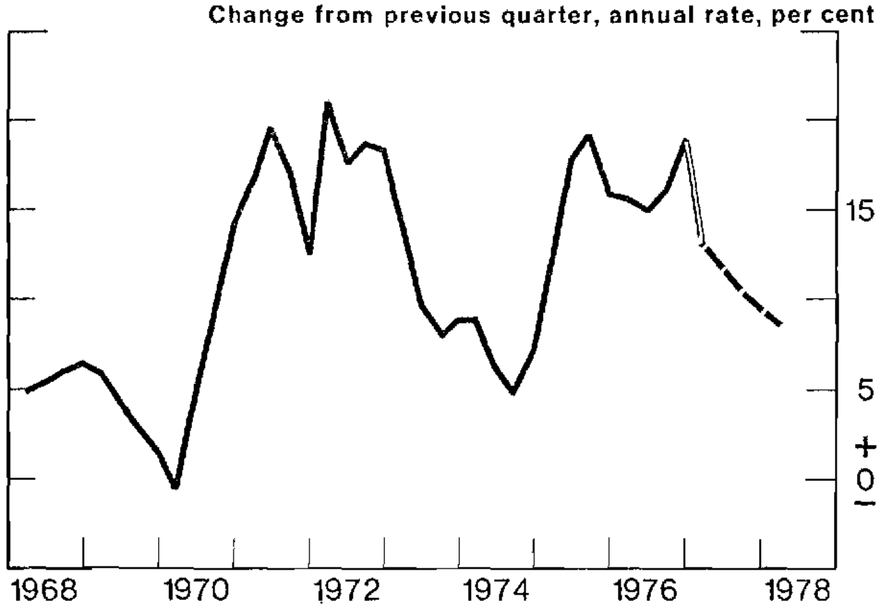
NONFINANCIAL CORPORATIONS



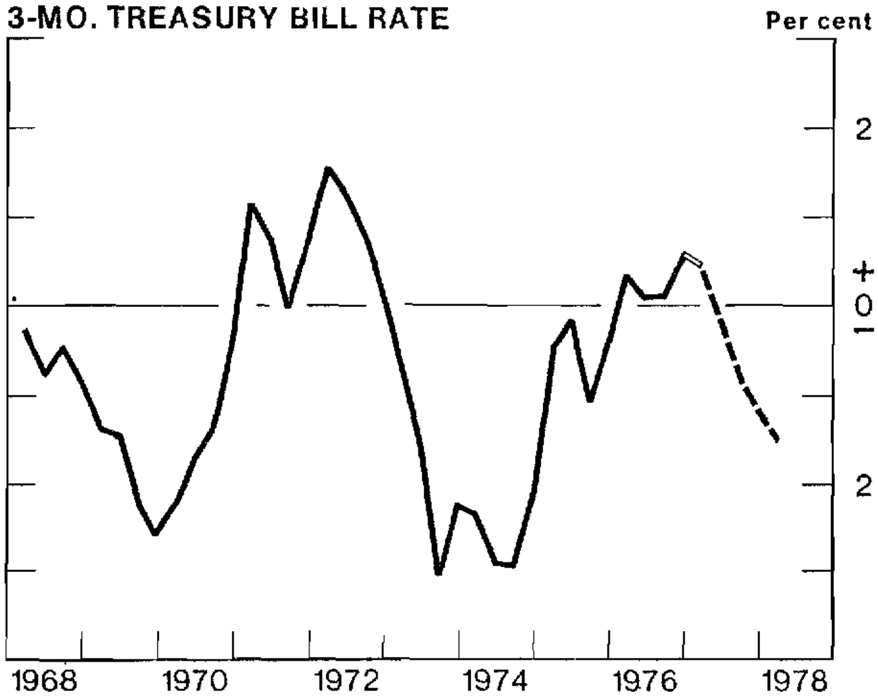
FUNDS RAISED



DEPOSIT GROWTH AT S&L's



PASSBOOK CEILING LESS 3-MO. TREASURY BILL RATE



REPORT ON OPEN
MARKET OPERATIONS

Reporting on open market operations, Mr. Sternlight made the following statement.

Desk operations through most of the period since the last meeting of the Committee were directed at maintaining reserve conditions consistent with the 4 5/8 - 4 3/4 percent Federal funds rate fostered since January. Very early in the period it appeared that money supply was growing rapidly but the signs were not strong enough to call for a change in the Desk's posture, and indeed subsequent weeks' data did not confirm that early burst of strength in March. Toward the end of the period, however, weekly data indicated a significant pick-up in money supply growth in early April, suggesting that M_1 growth would exceed the Committee's growth range for March-April. Expansion of M_2 was still estimated to be within its range, though in the upper part. In response, the Desk has aimed in the past few days for reserve conditions consistent with Federal funds trading around 4 3/4 percent. The extent of the Desk's response to the stronger monetary growth was tempered by the proximity of today's meeting which provides an opportunity to review policy in light of modifications in the Administration's fiscal stimulus plans.

As events worked out, the funds rate tended to the higher side of the 4 5/8 - 4 3/4 percent range in the first half of the period, with particular tightness at the end of the March 23 statement week. Later in the interval, funds were more often around the lower end of that narrow band. To some extent, the Desk's ability to achieve close control of the funds rate has been impeded by the volatility of factors affecting reserves--especially the Treasury balance--as banks sometimes permitted large reserve deficiencies or excesses to accumulate which were then difficult to deal with as the reserve averaging week drew to a close. In the last few days, the Desk sought to encourage a return of the funds rate to around 4 3/4 percent by unobtrusively withdrawing some reserves early in a week when projections indicated a need for additional reserves. This could lead to greater-than-desired tightness by the end of the current reserve week.

Because of the large swings in reserve factors, Desk transactions in the past month were again mainly addressed to temporary needs to add or drain reserves. Repurchase agreements, mainly in the early part of the period, totaled almost $18 billion, while matched sale-purchase transactions exceeded $40 billion (much of it reflecting the overnight transactions with foreign accounts). On an outright basis, the System bought just under $300 million of Treasury coupon issues in the market early in the period and later sold about $260 million of bills to foreign accounts. In the last few days, looking ahead to large reserve needs in upcoming weeks, the System has purchased about $370 million of Treasury bills, mainly from foreign accounts.

Meeting the exceptionally large reserve needs now projected for the next two weeks may require a combination of sizable outright Treasury bill and coupon purchases, as well as substantial repurchase agreements. If it appears that we will have difficulty in meeting these needs, we may get some help from a temporary let-up in Treasury calls on their tax and loan account balances.

The maturity of bankers' acceptances holdings drained $42 million of reserves since the last meeting, reducing the outright portfolio of acceptances to $130 million. The total will be below $100 million by early May and zero by the end of October. The System's announcement of a discontinuation of outright purchases of acceptances caused little comment in the market. No doubt, the continuation of repurchase agreements in these securities softened any potential market impact. So far, foreign central banks have continued to buy acceptances outright through our Desk, and this, too, has been reassuring to the market.

Interest rates moved narrowly through most of the period since the last meeting, but with a marked decline last Thursday when it became known that the Administration was dropping its plans for tax rebates. Even before that date, there had been a small rate decline, on balance, partly reflecting growing market doubts about whether the rebates would be passed by Congress, and also reflecting market views that the moderation of monetary growth made any System move toward higher rates unlikely for a while. The market's sense of relief was such last Thursday, in the wake of the rebate announcement, that publication of an unusually large weekly money supply increase coupled with news of the large industrial output rise in March, did little to dent the day's price gains.

For the period, intermediate-term Treasury coupon issues declined in yield by about 20 - 40 basis points while longer bonds were down by 10 - 30 basis points. Dealers' coupon positions have been moderate throughout the period, climbing temporarily when the Treasury sold new 2- and 5-year issues but quickly coming down again as the securities were distributed--since market participants have had the view, at least up to the time of the rebate withdrawal, that rates are likely to turn higher later in the year. In hectic trading last Thursday, dealers rebuilt their coupon positions, somewhat--though still to moderate levels.

In the bill area, yield declines were small. Three- and six-month issues were auctioned yesterday at average rates of about 4.49 and 4.71 percent, down from 4.55 and 4.81 percent the day before the last meeting.

The Treasury is auctioning $1.5 billion of 2-year notes today, to replace a similar maturing amount. As of yesterday, the market was expecting a yield around 5.80 percent--down from about 6 percent in the two previous auctions of this maturity. A week from tomorrow, the Treasury is expected to announce the terms for refunding $4.3 billion of maturing May 15 notes. At this point, it seems reasonable to expect the Treasury to raise little or no new money in its May offering, which could include a combination of intermediate- and long-term issues. The System holds about $3.5 billion of the maturing note issues and we expect to exchange these, as usual, for new issues in about the proportions offered to the public.