Prefatory Note

The attached document represents the most complete and accurate version available based on original copies culled from the files of the FOMC Secretariat at the Board of Governors of the Federal Reserve System. This electronic document was created through a comprehensive digitization process which included identifying the best-preserved paper copies, scanning those copies,[1] and then making the scanned versions text-searchable.[2] Though a stringent quality assurance process was employed, some imperfections may remain.

Please note that some material may have been redacted from this document if that material was received on a confidential basis. Redacted material is indicated by occasional gaps in the text or by gray boxes around non-text content. All redacted passages are exempt from disclosure under applicable provisions of the Freedom of Information Act.

---

[1] In some cases, original copies needed to be photocopied before being scanned into electronic format. All scanned images were deskewed (to remove the effects of printer- and scanner-introduced tilting) and lightly cleaned (to remove dark spots caused by staple holes, hole punches, and other blemishes caused after initial printing).

[2] A two-step process was used. An advanced optical character recognition computer program (OCR) first created electronic text from the document image. Where the OCR results were inconclusive, staff checked and corrected the text as necessary. Please note that the numbers and text in charts and tables were not reliably recognized by the OCR process and were not checked or corrected by staff.

Content last modified 6/05/2009.

CONFIDENTIAL (FR)

SUPPLEMENT

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

October 13, 1972

By the Staff
Board of Governors
of the Federal Reserve System

The Domestic Economy

Seasonally adjusted sales of new homes by merchant builders rose sharply further in August to a new peak of 800,000 units. With demands generally continuing to be most pronounced for higher priced units, the median price of such homes sold also rose further, to $28,000--$1,000 more than for homes still awaiting sale. Sales of existing homes were also exceptionally strong in August, at a median price of $27,430--8 percent above a year earlier.

Reflecting the advanced pace of starts this summer, stocks of new homes available for sale from merchant builders continued upward, however. Even at the exceptional August rate of sales, stocks equaled nearly six months' supply, a relatively high level.

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)	690	357	26.9	26.5
June (r)	685	357	26.8	26.5
July (r)	701	362	27.8	26.7
August (p)	800	385	28.0	27.0

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

The industrial production index has now been calculated for September and was stronger than estimated in the Greenbook. The index is now indicated to be up 0.6 percent in September to 115.2 (1967=100) from an upward revised August index of 114.5. The September level was 7.6 percent above a year earlier. For the third quarter as a whole, growth in industrial production was at an annual rate of nearly 5 percent. Confidential until release October 17.

The Domestic Financial Situation

Mortgage market. The average return on home mortgages edged somewhat higher in September, according to FHA. In the primary market for conventional first mortgages, the average rate on both new and existing home loans rose 5 basis points to 7.70 and 7.75 percent respectively. In the secondary market, the average yield on FHA-insured new home loans edged up only 1 basis point to 7.56 percent. (Confidential until October 17.)

AVERAGE RATES AND YIELDS ON NEW-HOME MORTGAGES

		Primary market: Conventional loans		Secondary market: FHA-insured loans		
		Level (percent)	Spread (basis points)	Level (percent)	Spread (basis points)	Discounts (points)
1971 -	Low	7.55	-36	7.32	-27	2.5e
	High	7.95	52	7.97	31	7.8
1972 -	Low	7.55	15	7.45	5	3.7
	High	7.70	39	7.56	28	4.6
	Apr.	7.60	15	7.50	5	4.1
	May	7.60	22	7.53	15	4.3
	June	7.60	28	7.54	22	4.4
	July	7.65	27	7.54	16	4.4
	Aug.	7.65	28	7.55	18	4.5
	Sept.	7.70	30	7.56	16	4.6

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 percent 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 Aaa utility bonds.

e/ Estimated.

The average <u>delinquency rate on consumer instalment loans</u> at commercial banks crept up a bit further in August following June's relatively strong rise, according to the American Bankers Association series covering about 600 banks. After declining moderately last year, seasonally adjusted delinquencies of 30 to 89 days were at virtually the same rate that prevailed in the second half of 1970-- between 1.6 and 1.7 percent of loans outstanding. Although most observers would not consider this rate dangerously high, it is note-worthy that delinquencies are rising during a stage of the business cycle when they usually decline.

Among specific loan types, personal and home appliance loan delinquencies (1.93 and 2.21 percent respectively) were running at higher rates than they did in 1970, while auto loan delinquencies (1.30 percent) were still below 1970 rates.

Delinquency Rates on Consumer Instalment Loans at Commercial Banks
(Seasonally adjusted by Federal Reserve)

(Percent)

	1967	1968	1969	1970	1971	1972
February	1.54	1.25	1.31	1.54	1.52	1.49
April	1.57	1.30	1.38	1.50	1.43	1.52
June	1.44	1.32	1.41	1.57	1.53	1.63
August	1.37	1.33	1.46	1.63	1.54	1.66
October	1.43	1.27	1.46	1.66	1.69	
December	1.39	1.35	1.52	1.60	1.49	

NOTE: Delinquency rates are number of contracts delinquent 30-89 days as a percentage of number of accounts outstanding.

INTEREST RATES

	1972 Highs	1972 Lows	Sept. 18	Oct. 12
Short-Term Rates				
Federal funds (wkly. avg.)	5.15 (10/4)	3.18 (3/1)	4.69 (9/13)	5.09 (10/11)
3-month				
Treasury bills (bid)	4.81 (10/12)	2.99 (2/11)	4.65	4.81
Comm. paper (90-119 day)	5.25 (10/12)	3.75 (2/29)	5.13	5.25
Bankers' acceptances	5.38 (10/12)	3.75 (2/23)	5.25	5.38
Euro-dollars	6.00 (10/12)	4.62 (3/8)	5.31	6.00
CD's (prime NYC)				
Most often quoted new	5.38 (10/11)	3.50 (2/23)	5.00 (9/13)	5.38 (10/11)
6-month				
Treasury bills (bid)	5.26 (9/25)	3.35 (1/10)	5.14	5.17
Comm. paper (4-6 mo.)	5.38 (10/12)	3.88 (3/3)	5.13	5.38
Federal agencies	5.51 (9/25)	3.79 (2/17)	5.42	5.41
CD's (prime NYC)				
Most often quoted new	5.50 (10/11)	3.88 (2/23)	5.38 (9/13)	5.50 (10/11)
1-year				
Treasury bills (bid)	5.55 (9/22)	3.57 (1/8)	5.44	5.40
Federal agencies	5.80 (9/27)	4.32 (1/17)	5.76	5.79
CD's (prime NYC)				
Most often quoted new	5.75 (10/11)	4.62 (1/19)	5.63 (9/13)	5.75 (10/11)
Prime municipals	3.20 (9/14)	2.35 (1/12)	3.20 (9/14)	3.15
Intermediate and Long-Term				
Treasury coupon issues				
5-years	6.32 (9/14)	5.47 (1/13)	6.22	6.19
20-years	6.22 (4/14)	5.91 (8/22)	6.04	6.02
Corporate				
Seasoned Aaa	7.37 (4/24)	7.14 (1/17)	7.23	7.21
Baa	8.29 (1/3)	8.06 (10/12)	8.08	8.06
New Issue Aaa Utility	7.60 (4/21)	7.08 (3/10)	7.34 (9/13)	7.48
Municipal				
Bond Buyer Index	5.54 (4/13)	4.99 (1/13)	5.38 (9/14)	5.16
Mortgage--implicit yield				
in FNMA auction 1/	7.69 (10/2)	7.54 (3/20)	7.63 (9/5)	7.69 (10/2)

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.

CORRECTIONS

Page I-7, paragraph 2, beginning at end of line 6 insert in empty space---"production of most household appliances declined about a tenth and production of household furniture was apparently unchanged. Preliminary data"---

APPENDIX A: RECENT CHANGES IN PRICE RELATIONS*

The first part of this article describes shifts in major components of the wholesale price index and the consumer price index which have resulted in a faster rise in the WPI over the past year than in the CPI--reversing a pattern of relatively smaller increases in the WPI established over the last two decades. This is followed by an exploration of some of the factors contributing to the sustained increase in prices of industrial materials and components after trends have moderated in other price series.

Changes in the Relation Between the WPI and the CPI. The CPI rose about three times as fast as the WPI in the period 1960-65 (measured from August to August), over 1-1/2 times as fast in the period 1965-70, and slightly faster in the year ending in August 1971. Over the year ending this August, however, the WPI increased at a faster rate than the CPI.

The explanation lies both in the behavior of components common to the WPI and the CPI--finished consumer goods prices--and in the behavior of other items--services (only in the CPI) and materials and producer goods (only in the WPI).

Retail prices of consumer goods, excluding foods, rose at a rate about 50 per cent higher than that of wholesale prices of consumer commodities--excluding foods--during the inflationary upswing of 1965-70. In 1969-70 and the following year, the gap between the two series narrowed somewhat, although both rose at accelerated rates. Over the year ending this August, the rise in consumer goods prices at retail slowed considerably more than at wholesale--in fact, both series rose only about 2 per cent. This represented a rather marked deceleration from 1965-70 in the rate of rise in consumer prices of non-foods--a change which did not occur in the wholesale prices. Moreover, food prices have increased even faster at wholesale than at retail in recent months, reversing the relation obtaining in the 50's and 60's.

Developments in components of the two series which are not in common--industrial materials in the WPI and service costs in the CPI--have also tended to reverse the previous relation between the two indexes. Services were by far the fastest rising component of the CPI during the period of rising inflation. In the year ending in August 1970, service costs rose by 8 per cent, an increase twice as large as in either food or non-food commodities. In 1971, however, a decline in mortgage rates helped to reduce the rate of service price increases, and over the past year they have risen more slowly yet under the impact of the stabilization program and delayed effects of

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

the economic slowdown. Although service cost advances have continued to outpace the rise in non-food commodity prices, the spread has narrowed.

Table 1

CHANGES IN SELECTED PRICE SERIES
(In per cent)

	Years ending in August				
	annual rates 1960-1965	1965-1970	1969-1970	1970-1971	1971-1972
Total index					
WPI	0.5	2.6	3.4	4.0	4.4
CPI	1.3	4.3	5.6	4.4	2.9
Consumer goods (exc. foods)					
WPI	0.0	2.2	2.9	3.5	2.2
CPI	0.6	3.3	4.1	4.0	2.0
Consumer foods					
WPI	1.0	3.2	1.6	3.1	6.0
CPI (food at home)	1.5	3.4	4.0	3.1	3.9
CPI					
services	2.0	5.9	8.1	5.5	3.4
WPI					
Industrial materials and components (FRB)	0.1	2.6	4.1	4.8	3.8
Finished products (excl. foods) (FRB)	0.2	2.6	3.5	3.9	2.2
Producers' equipment	0.6	3.4	4.7	4.6	2.3

While the substantially slower rise in service costs in the past year exerted a moderating effect on the CPI, a steady and substantial rise in materials prices has tended to maintain the rate of increase in the wholesale index. Although increases have moderated since the period just prior to stabilization, they remain higher than during the inflationary upswing of the late sixties and are comparable to those in 1970. Moreover, for the last three years, industrial materials have advanced much faster than finished commodity prices, showing little effect of either the economic slowdown in 1969 and 1970 or of the stabilization program. Since the relative importance of intermediate materials in the industrial sector of the WPI is somewhat higher than that of finished products, this has helped sustain a strong advance in the WPI.

Materials and Finished Goods Prices. Although it is customary (see Table 2) for materials prices to rise faster than finished goods in a recovery, the discrepancy in the last three years has been large, and its duration very unusual. Recently, however, prices of finished products have accelerated, while materials price increases moderated in September. Some commentators have questioned the validity of the industrial materials price indexes. According to the Townsend-Greenspan consulting firm as quoted in the Wall Street Journal of September 22, there is a "serious question whether intermediate goods have in fact increased at so high a rate. A substantial part of this component of the index represents list or nominal prices and there is considerable evidence in selected industries that actual price realizations have significantly lagged behind increases."

WPI
Table 2. CHANGES DURING PERIOD OF EXPANSION IN PRICES OF INDUSTRIAL MATERIALS AND FINISHED PRODUCTS
(Percentage changes at annual rates)

	INDUSTRIAL MATERIALS AND COMPONENTS (FRB)	FINISHED PRODUCTS (FRB)
Periods of Expansion:		
October 1949-July 1953	4.4	3.1
August 1954-July 1957	3.7	3.1
April 1958-May 1960	1.3	0.9
February 1961-November 1969	1.3	1.3
November 1970-August 1972	4.8	2.4

Townsend-Greenspan ascribes the fast apparent rise in materials prices this year to price controls. The argument is that producers want to establish high prices against the possibility that ceilings might be reimposed or controls tightened.

There are several flaws in this argument. In the first place, ceiling prices are not based on list or quoted prices, but on realized prices in a base period. Higher list prices would not help to establish a high ceiling. It would also seem that if the indexes are exaggerating the rise in materials prices because of producers' desire to get list prices up, the same would be true of finished goods; but, as we have seen, finished goods prices have risen more slowly. In addition, this argument fails to explain why the divergence between materials and finished goods prices developed in early 1971 prior to the price control program. And it throws no light on the related question of why retail prices of consumer finished goods in the past year have risen only about as fast as wholesale prices of the same items, whereas formerly they were rising much faster.

Finally, it is difficult to believe that the gap between price quotations and realized prices is widening. Although the WSJ article quotes researches of Stigler and Kendall, the latter's thesis is that the gap between list and realized prices widens in a recession, as discounting from list increases. In a recovery, prices tend to return to list before list prices rise.

In this recovery, prices of primary metals--a major material--often heavily discounted--have remained weak. But they are probably nearer list than they were two years ago after the downswing in nonferrous prices or last year after the build-up of steel inventories. The rise in the materials index this year owes much to textiles, lumber and plywood, hides and skins, and leather products for which it would be preposterous to suppose the climb in quoted prices was faster than actually occurred. Excluding these volatile prices, the advance in industrial materials prices is reduced from 3.8 per cent over the past year to 2.5 per cent.

Profit-margin ceilings may at present be restraining increases in finished goods prices more than those of materials. The base period, the average of the best two of the three fiscal years 1968, 1969, and 1970, included one to two years of cyclically low margins for most industries. Since materials industries are more cyclical than finished goods industries, they may have more room to move up under their profit margin limitation. Such finished goods as apparel, consumer foods, and tobacco, for example, are probably pressing against their ceiling. Of the intermediate prices of materials, lumber and plywood are reputed at or above ceilings, while leather products have been classified in a special category of volatile products. Industries which produce these products may pass on increases in raw materials prices, dollar for dollar.

One reason for the slower rise in finished goods prices than materials prices in this recovery--as in other recoveries--is the higher degree of fabrication and thus a higher proportion of labor costs. When the climb in labor costs per unit abates, as it has in the last two years, finished goods benefit the most.

Materials Markets Since the Slowdown. A brief review of particular materials markets in the last two or three years reveals a number of special situations. The slowdown in the economy which began in 1969 brought little abatement to the climb in materials prices in 1969 or early 1970. Part of the reason for the delay was the rising level of demand in Canada, Europe, and Japan for industrial materials. In addition, in the United States, continued high levels of steel production, new laws restricting use of highly-polluting fuels, and inelastic supplies of fuels caused a very sharp climb in prices of major fuels. However, after mid-year 1970, sensitive industrial materials prices moved down sharply, led by non-ferrous metals. In addition, prices of steel mill products, which had increased sharply in the first half of 1970, slowed appreciably. Lumber and plywood prices continued to decline because of a low level of housing activity. These influences helped moderate the rise in materials prices in late 1970 and early 1971.

In 1971, prior to the freeze, there was a disturbing resurgence of price rises for materials. Sensitive materials prices rose little, but steel mill products prices were raised several times as inventories were built up in fear of a strike in the fall. Prices of lumber and wood products reversed, and began to climb sharply as housing activity increased. Cotton textiles rose further and synthetic textiles began to climb. These developments occurred despite a very partial recovery in the United States and somewhat reduced levels of activity abroad.

In 1972, activity abroad failed to strengthen until after mid-year, contributing to dull markets for some internationally-traded commodities. However, high automobile output and record housing activity led the continued recovery in the U.S., and output of producer goods strengthened.

Normally, these developments should have resulted in strong metal markets. Steel inventories were very high, however, with the result that over the last year iron and steel prices rose only 2.5 per cent, the smallest gain in recent years. Production of defense products, including aircraft, moreover, had been sharply cut, reducing the need for aluminum. Non-ferrous metals prices were consequently stable overall, reflecting over-capacity in aluminum and easy world supplies of copper. Thus, the strong thrust in materials prices this year has been outside the metals area. The rise appears especially large considering this fact, continued excess capacity in many industries, less than full employment, and price controls.

Among the materials which have risen sharply since the fall of 1971 are lumber and plywood, textiles, and hides and leather. Fuel prices have also increased very substantially. Except for lumber and plywood, for which demand has attained record levels, the price increases stem either from reduced supplies or increased demand with relatively inelastic supplies.

Among building materials, price rises in the last year would undoubtedly have been greater except for controls. With housing activity at new records, the rise in construction materials prices dropped to 4.0 per cent in the year ending in August from 8.5 per cent in the preceding year. In late summer, many wood products and concrete materials products were at (or above) ceiling levels.

Wool and cotton textiles rose over 10 per cent last year and synthetics over 5 per cent. In the main, this reflects reductions in the supply of natural fibers, which are not under price control.

Synthetic fibers had room to move up under their ceiling; at any rate, they are produced in large part by companies under term-limit pricing agreements.

The 112 per cent rise in hides and skins over the last year reflected an international shortage which left the United States as the world supplier. Leather prices increased 23 per cent.

Fuel prices continued their long-term upswing, with coal rising 4.7 per cent, gas fuels 6.6 per cent, and electric power, 5.9 per cent.

Although the above commodities are responsible for much of the rise in materials prices, increases have been widespread. Declines have occurred in industrial chemicals since September 1971, in rubber and plastic products, and in flat glass. Wood pulp prices stabilized but waste-paper prices are up over 20 per cent.

Materials price advances slowed in September, but the improvement may prove temporary. Industrial production is on the upgrade both in the U.S. and abroad so that sensitive materials prices could suddenly strengthen. Fuel prices seem likely to continue to move up substantially further; at the moment supplies of some petroleum products are reported short of potential needs. Steel producers, whose labor costs rose in August 1972, are reported to be planning an increase in prices for late this year or early next.