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CONFIDENTIAL (FR)

SUPPLEMENT

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

February 9, 1973

By the Staff
Board of Governors
of the Federal Reserve System

SUPPLEMENTAL NOTES

The Domestic Economy

Retail sales. Later information has resulted in raising appreciably the advance retail sales estimates for December and lowering the November preliminary estimates a little. Most of the upward revision for December was in the automotive group. According to current data, retail sales in December increased 1.5 percent from November (instead of only 0.3 percent) and were 13 percent above a year earlier. Sales in November declined 1.0 percent from October (instead of 0.7 percent).

RETAIL SALES
(Seasonally adjusted)

| | Billions of dollars | | Percent change | | Previous month | |
|--|-----------------------------|-----------------------------|-----------------------------|-----------------|-----------------------------|-----------------|
| | November (New) <u>3/</u> | December (New) <u>2/</u> | November (Old) <u>2/</u> | (New) <u>3/</u> | December (Old) <u>1/</u> | (New) <u>2/</u> |
| Total sales | 38.7 | 39.3 | - .7 | -1.0 | .3 | 1.5 |
| Durable | 13.2 | 13.6 | .7 | .0 | .4 | 3.2 |
| Auto | 7.8 | 8.3 | .1 | -.4 | 1.7 | 6.2 |
| Furniture & appliance | 1.8 | 1.8 | .8 | .0 | -1.6 | -2.9 |
| Nondurable | 25.5 | 25.7 | -1.4 | -1.5 | .2 | .6 |
| Food | 8.1 | 8.0 | -.3 | -.9 | -2.0 | -1.3 |
| General merchandise | 6.4 | 6.3 | -3.2 | -3.0 | -.4 | -.3 |
| Total, less auto and nonconsumption items | 28.5 | 28.6 | -1.1 | -1.3 | .1 | .2 |
| GAF | 10.1 | 10.0 | -2.7 | -2.4 | -.6 | -1.0 |

1/ Advance.
2/ Preliminary.
3/ Final.

Retail sales rose 3.2 percent further in January, from the upward revised December level, according to the advance Census report. In January durable goods advanced 4 percent further and nondurable goods increased 2.8 percent, led by food sales, which were up 4.8 percent. Total January sales were 16 percent above a year earlier with durables up 23 percent and nondurables 11 percent.

Capacity utilization. The FRB's measure of the manufacturing capacity utilization rate stood at 79.7 percent in the fourth quarter of 1972, up from 74.6 percent a year earlier. Current review of individual industries suggests, however, that the amount of unused capacity in many industries early in 1973 may be significantly less than the overall number implies. It is doubtful that any great amount of economically usable excess capacity now exists in some industries such as paper, petroleum refining, cement, rubber, lumber, and certain chemical industries. The estimated utilization rate for the basic iron and steel industries is somewhat lower than for the industries listed above, but recent refusals of foreign orders by several major steel companies suggest that capacity for some types of steel may be under strain.

Among final products industries, auto and truck manufacturers appear to have been working not very far from capacity levels for some months. The machinery industries had comparatively low operating rates in the fourth quarter, but these rates were well up from the fourth quarter 1970 lows. Parts of the machinery industry, such as machine tools, still appear to have some unused modern capacity, but such idle capacity as exists appears to be unevenly distributed throughout the industry.

Inventories. Book value of manufacturing and trade inventories rose at a \$16.1 billion annual rate in December (p), unchanged from November. For the fourth quarter as a whole, the rate of book value increase was over \$2 billion higher than in the third quarter. Retail trade inventories were little changed in December but they accounted for

a large part of the increase in accumulation from the third quarter to the fourth, as auto and other durable goods retailers built their inventories at higher rate.

CHANGE IN BOOK VALUE OF BUSINESS INVENTORIES
(Seasonally adjusted annual rate, \$ billions)

| | 1972 | | | |
|-------------------------|-------|-----------------|----------------|-----------------|
| | Q III | Q IV (Prel.) | Nov. (Rev.) | Dec. (Prel.) |
| Manufacturing and trade | 13.3 | 15.6 | 16.1 | 16.1 |
| Manufacturing, total | 7.7 | 7.0 | 4.4 | 9.7 |
| Trade, total | 5.5 | 8.6 | 11.8 | 6.4 |
| Wholesale | 4.1 | 4.5 | 3.1 | 5.9 |
| Retail | 1.5 | 4.2 | 8.7 | .5 |
| Durable | - .2 | 3.3 | 6.7 | 2.5 |
| Automotive | - .6 | 1.5 | 3.9 | .9 |
| Nonautomotive | .4 | 1.8 | 2.8 | 1.6 |
| Nondurable | 1.7 | .8 | 2.0 | -2.0 |

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

Manufacturing and trade sales also increased in December and the inventory-sales ratio was unchanged at a low 1.46.

INVENTORY RATIOS

| | 1971 | | 1972 | |
|------------------------------|------|------|----------------|-----------------|
| | Nov. | Dec. | Nov. (Rev.) | Dec. (Prel.) |
| <u>Inventories to sales:</u> | | | | |
| Manufacturing & trade | 1.57 | 1.58 | 1.46 | 1.46 |
| Manufacturing, total | 1.77 | 1.76 | 1.60 | 1.62 |
| Trade, total | 1.37 | 1.40 | 1.32 | 1.31 |
| Wholesale | 1.24 | 1.26 | 1.19 | 1.18 |
| Retail | 1.46 | 1.50 | 1.41 | 1.39 |
| Durable | 2.01 | 2.10 | 1.84 | 1.80 |
| Automotive | 1.65 | 1.77 | 1.44 | 1.36 |
| Nonautomotive | 2.57 | 2.56 | 2.43 | 2.48 |
| Nondurable | 1.18 | 1.21 | 1.19 | 1.18 |

State and local government. Following a period of relatively slow growth, State and local government purchases of goods and services increased by about \$5-1/2 billion or around 15 percent during the fourth quarter of 1972. Outlays for the year as a whole rose by 10 percent, about the same rate as during the previous three years.

Outlays for employee compensation and for miscellaneous other types of expenditures, including Medicaid, continued to increase at about the same rate as during earlier quarters. However, expenditures for structures recorded their largest gain of the year, about \$2 billion according to preliminary estimates. These expenditures had actually declined earlier in the year, and despite the better fourth quarter performance, such outlays for 1972 rose by about 2 percent in current dollar terms. Increased spending for educational buildings and for miscellaneous types of construction expenditures were mainly responsible for the rise.

Revenues increased considerably during the final quarter, boosted by increasing tax receipts, responding to a buoyant economy, and by an exceptional increase in Federal grants-in-aid. These rose at an annual rate of over \$11 billion, largely due to the receipt of the first instalment of general revenue sharing funds. As a result, the fiscal position of State and local governments registered an unusually large surplus of about \$18 billion, annual rate, during the final quarter of 1972.

STATE & LOCAL GOVERNMENT PURCHASES, 1972
Quarterly increases at annual rates, seasonally adjusted
(\$ billion) 1/

| | Q I | Q II | Q III | Q IV |
|--|------------|------------|------------|------------|
| <u>Total</u> | <u>3.4</u> | <u>2.3</u> | <u>4.2</u> | <u>5.7</u> |
| Compensation | 2.3 | 1.9 | 2.4 | 2.1 |
| Structures | .0 | -1.1 | .3 | 2.1 |
| Other | 1.1 | 1.5 | 1.5 | 1.5 |
| Medical vendor payments (mostly Medicaid) | (.5) | (.3) | (.1) | (.3) |

1/ Based on preliminary Bureau of Economic Analysis data.

The Domestic Financial Situation

Commercial paper outstanding. Seasonally adjusted commercial paper outstanding increased a modest \$.1 billion in January. Increases in both bank-related paper and nonbank directly placed paper were partly offset by a \$.2 billion decline in nonbank dealer paper. A shift by some nonfinancial corporate issuers from the use of commercial paper to bank loans to satisfy short-term money requirements was responsible at least in part for this reduction. The \$.2 billion increase in directly placed paper reflected the rising fund requirements of finance company direct issuers associated with expanded net lending activity.

COMMERCIAL PAPER OUTSTANDING
(Seasonally adjusted, in billions of dollars)

| | Estimated amount outstanding January 31, 1973 <u>1/</u> | Monthly change <u>2/</u> | | |
|------------------------|--|--------------------------|--------------|--------------|
| | | 1973 Jan. | 1972 Dec. | 1972 Nov. |
| Total commercial paper | 36.3 | .1 | 1.2 | -.3 |
| Bank-related | 2.7 | .1 | .1 | .1 |
| Nonbank-related | 33.6 | * | 1.2 | -.4 |
| Dealer | 12.0 | -.2 | .1 | -.3 |
| Direct | 21.6 ^{2/} | .2 | 1.1 | -.1 |

1/ Outstandings have been revised to include approximately \$2.0 billion of directly placed paper not previously included in the series.

2/ Measured on end of month basis.

NOTE: Details may not add to total due to rounding.

* Less than ± \$50 million.

Corporate profits. The fourth quarter corporate profits estimate incorporated in the Green Book projection is somewhat higher than that implicit in the 1972 year total given in the President's Economic Report which was based on quite incomplete information. The earnings reports of manufacturing companies which have recently become available suggest an estimate of corporate profits for the fourth quarter on a National Income basis which is almost seven percent higher than that implicit in the earlier estimate.

The final quarter of the firm's fiscal year is traditionally the time in which final decisions are made on write-offs, charges to various reserve and tax accounts, and other accounting matters affecting profits. The timing of the announcement of Phase III may have affected some of these decisions, since the acceleration in the rate of economic expansion and the ability to include 1972 results in the Phase III profit margin ceiling may have resulted in some companies reporting higher earnings for the year than would have been anticipated on the basis of their experience in the first three quarters. Preliminary data suggest that corporations in the food, apparel, building materials, and motor vehicles groups may take advantage of the new ceilings by including their 1972 results.

Consumer credit. The average delinquency rate on consumer instalment loans at commercial banks declined in December, but remained above a year ago, according to the American Banker Association series covering about 600 banks. After declining marginally in 1971, seasonally

adjusted delinquencies of 30 to 89 days showed consistent year-over-year increases throughout 1972. On average, delinquencies ran higher in 1972 than during the recession year 1970, though not at a rate generally considered to be dangerously high.

DELINQUENCY RATES ON CONSUMER INSTALMENT LOANS AT COMMERCIAL BANKS
(Seasonally adjusted by Federal Reserve)

(Percent)

| <u>End of period</u> | <u>1967</u> | <u>1968</u> | <u>1969</u> | <u>1970</u> | <u>1971</u> | <u>1972</u> |
|----------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| February | 1.54 | 1.25 | 1.31 | 1.54 | 1.53r | 1.54r |
| April | 1.57 | 1.30 | 1.38 | 1.50 | 1.44r | 1.55r |
| June | 1.44 | 1.32 | 1.41 | 1.57 | 1.55r | 1.67r |
| August | 1.37 | 1.33 | 1.46 | 1.63 | 1.58r | 1.69r |
| October | 1.43 | 1.27 | 1.46 | 1.66 | 1.68r | 1.83 |
| December | 1.39 | 1.35 | 1.52 | 1.60 | 1.52r | 1.67 |
| Annual average | 1.46 | 1.30 | 1.42 | 1.58 | 1.55 | 1.66 |

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

Within individual loan categories, purchased auto paper experienced the largest increase in delinquency rate last year, rising from 1.30 percent at the end of December 1971 to 1.63 percent at the end of December 1972. The acceleration in auto delinquency rates at banks is corroborated by confidential data for finance companies where auto delinquency rates started to climb above year-ago rates during the second half of 1972.

CORRECTIONS: RED BOOK

Page 36, last line should be "smaller timber producers, who-----."

INTEREST RATES

| | 1972 | | 1973 | |
|-----------------------------------|---------------------------|--------------|--------------------|--------------------|
| | Highs | Lows | Jan. 15 | Feb. 8 |
| <u>Short-Term Rates</u> | | | | |
| Federal funds (wkly. avg.) | 5.38 (12/20) | 3.18 (3/1) | 5.66 (1/10) | 6.21 (2/7) |
| 3-month | | | | |
| Treasury bills (bid) | 5.19 (12/19) | 2.99 (2/11) | 5.27 | 5.44 |
| Comm. paper (90-119 day) | 5.63 (12/29) | 3.75 (7/29) | 5.75 | 6.13 |
| Banker's acceptances | 5.63 (12/29) | 3.75 (2/23) | 5.88 | 6.50 |
| Euro-dollars | 6.31 (12/5) | 4.62 (3/8) | 6.06 | 7.00 |
| CD's (prime NYC) | | | | |
| Most often quoted new | 5.50 (12/27) | 3.50 (2/23) | 5.63 (1/10) | 6.25 |
| 6-month | | | | |
| Treasury bills (bid) | 5.39 (12/29) | 3.35 (1/10) | 5.56 | 5.66 |
| Comm. paper (4-6 mo.) | 5.63 (12/29) | 3.88 (3/3) | 5.75 | 6.13 |
| Federal agencies | 5.64 (12/29) | 3.79 (2/17) | 5.78 | 6.16 |
| CD's (prime NYC) | | | | |
| Most often quoted new | 5.63 (12/27) | 3.88 (2/23) | 5.75 (1/10) | 6.38 |
| 1-year | | | | |
| Treasury bills (bid) | 5.55 (9/22) | 3.57 (1/8) | 5.51 | 5.78 |
| Federal agencies | 5.86 (12/26) | 4.32 (1/17) | 6.01 | 6.37 |
| CD's (prime NYC) | | | | |
| Most often quoted new | 5.75 (12/27) | 4.62 (1/19) | 5.85 (1/10) | 6.38 |
| Prime municipals | 3.20 (12/27) | 2.35 (1/12) | 3.25 | 3.45 |
| <u>Intermediate and Long-term</u> | | | | |
| Treasury coupon issues | | | | |
| 5-years | 6.32 (9/14) ^{1/} | 5.47 (1/13) | 6.31 | 6.56 |
| 20-years | 6.22 (4/14) | 5.71 (11/15) | 6.85 ^{2/} | 6.89 ^{2/} |
| Corporate | | | | |
| Seasoned Aaa | 7.37 (4/24) | 7.05 (12/7) | 7.14 | 7.23 |
| Baa | 8.29 (1/3) | 7.89 (12/29) | 7.89 | 7.98 |
| New Issue Aaa Utility | 7.60 (4/21) | 7.08 (3/10) | 7.29 (1/10) | 7.46 |
| Municipal | | | | |
| Bond Buyer Index | 5.54 (4/13) | 4.99 (1/13) | 5.03 (1/10) | 5.16 |
| Mortgage--implicit yield | | | | |
| in FNMA auction ^{1/} | 7.72 (10/16) | 7.54 (3/20) | 7.68 (1/8) | 7.69 (2/5) |

^{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.

^{2/} This rate now reflects the yield on the Treasury's new 20-year, 6-3/4 per cent bond that was auctioned on January 4.

APPENDIX A: A NEW INDICATOR OF CHANGES IN
INVENTORIES OF INDUSTRIAL MATERIALS*

A summary description is provided below of a new economic series--the IP Materials Inventory Change Indicator--which was developed in the latest general revision of the industrial production index and is described and charted in the recently published *Industrial Production: 1971 Edition*, pages 106-111. The IP Materials Inventory Change Indicator is a current measure of constant dollar net investment in inventories of materials and parts which are primarily used in further industrial processing. The focus is on investment in materials stocks because such investment fluctuates widely over the cycle and because short term movements in stocks of materials can largely be derived from industrial production indexes.^{1/}

The IP Materials Inventory Change Indicator is derived directly from the published production indexes for materials and products ^{2/} plus an estimate of net imports of materials. The production and importation of materials comprise the new supply of materials which add to stocks of materials. The industrial production of products final to the industrial sector serves as a proxy for consumption of materials which diminishes stocks. The rate of investment in stocks of materials increases when the production index for materials rises relative to the index for products final to the industrial sector. The rate of investment is reduced when materials output declines relative to the output of products.

Reflecting the cyclical nature of the demand for inventories of materials, the production index for materials has risen more than the index for products in expansions and has fallen more in contractions, as the following table shows.

*Prepared by Richard Raddock, Economist, Division of Research and Statistics.

- ^{1/} The coverage of the IP Indicator is broader than the Census stage-of-fabrication grouping of materials and supplies so classified by purchasers. The IP measure also includes inventory investment in work-in-process and finished goods inventories by producers of industrial materials. A chart comparing the IP Indicator with comparable constant dollar book value data monthly from 1954-72, can be found in Industrial Production: 1971 Edition, page 109.
- ^{2/} Various tests indicate that refinements in weighting procedures, selection of base period relationships, and allowances for agricultural materials would not greatly improve the results for the 1954-72 period.

PERCENT CHANGES IN IP INDEXES DURING
IP EXPANSIONS AND CONTRACTIONS

| Expansions | | | Contractions | | |
|----------------------|-----------|----------|-----------------------|-----------|----------|
| Period ^{1/} | Materials | Products | Period ^{1/} | Materials | Products |
| Oct. 1951-July 1953 | +20 | +16 | July 1953-Apr. 1954 | -15 | -6 |
| Apr. 1954-Aug. 1957 | +27 | +21 | Aug. 1957-Apr. 1958 | -19 | -9 |
| Apr. 1958-May 1960 | +29 | +19 | May 1960-Dec. 1960 | - 9 | -5 |
| Dec. 1960-Oct. 1966 | +68 | +54 | Oct. 1966-Mar. 1967 | - 4 | -1 |
| Mar. 1967-Sept. 1969 | +16 | +12 | Sept. 1969-Nov. 1970s | -10(-8) | -7 (-5) |
| Nov. 1970-Dec. 1972s | +18(15) | +15(13) | | | |

s--November 1970 was affected by an automobile strike. The numbers in brackets cover the periods beginning and ending in December 1970.

^{1/} The periods are those for expansions and contractions of the total industrial production index.

The cyclical behavior of the production indexes for materials and products and therefore of the IP Materials Inventory Change Indicator supports the traditional multiplier-accelerator theory of the cyclical aspects of economic activity in which inventory investment is assumed to be an endogenous factor that accentuates the cycle. During upswings, sales rise, delivery times lengthen and upward pressure on prices increases; consequently, purchasing agents order materials further ahead and thereby accelerate demand, production, and employment. The higher levels of orders and inventories may prove excessive when the advance in the economy slows down; orders and inventories are then reduced, initiating or accentuating a downswing in production and employment.

Since 1954, the IP Materials Inventory Change Indicator has usually led National Bureau reference dates at peaks, but with considerable variation in length of lead; the Indicator has been roughly coincident at troughs.

Movements of the IP Materials Inventory Change Indicator are often dominated by changes in the production or consumption of durable materials, highly cyclical elements in the economy. Some of the Indicator's largest movements, however, are not indicative of general cyclical movements, but of specific events such as pre-strike steel build-ups and subsequent run-offs. Automobile strikes also are evident first with a short, but sharp accumulation of materials and then a subsidence. Partly for this reason, the Indicator has exhibited more turns than have actually occurred in overall economic activity.

The table below shows recent data for the IP indexes for materials and products, the IP Materials Inventory Change Indicator in constant dollars and comparable changes in deflated book value materials inventories.

| | PRODUCTION INDEXES (1967-100) | | MATERIALS INVENTORY CHANGES (Billions of 1963 dollars, S.A.A.R.) | |
|----------|----------------------------------|----------|---|-----------------------|
| | Materials | Products | IP Indicator | Book Values <u>1/</u> |
| 1970 QIV | 104.1 | 103.7 | - .6 | +1.4 |
| 1971 QI | 107.2 | 105.0 | 2.3 | - .8 |
| QII | 108.9 | 106.0 | 3.9 | -1.3 |
| QIII | 106.2 | 106.7 | - .7 | -3.4 |
| QIV | 107.2 | 107.6 | 1.3 | + .3 |
| 1972 QI | 111.1 | 109.4 | 3.2 | -2.1 |
| QII | 115.6 | 111.8 | 4.3 | -2.1 |
| QIII | 117.8 | 113.3 | 6.0 | +2.3 |
| QIV | 120.6 | 117.1 | 4.6p | + .7p |

1/ Especially compiled totals for current dollar change for materials using the same definition as in the IP Indicator; deflated by Federal Reserve.

The IP Indicator shows a build-up of materials in the first half of 1971 in expectation of a steel strike in July; a slight reduction in inventories occurs in the third quarter when steel output was reduced sharply. Thereafter the Indicator shows a steady increase in the rate of accumulation until peaking in the third quarter of 1972 and subsiding somewhat in the fourth quarter to still substantial rates of accumulation. The preceding reflects the fact that from August 1971 to September 1972, the production index for materials rose 14 percent, while the index for products rose only 8 percent. During the fourth quarter of 1972 a relatively rapid expansion in the products index implies a more rapid rise in consumption of materials than in their production and a reduction in the rate of accumulation of materials inventories.

In contrast, the comparable deflated book value materials inventory change series showed continued decumulation from September 1971 until the third quarter of 1972 when it began to show an accumulation, probably reflecting in part earlier production developments.

The IP Materials Inventory Change Indicator supplements our knowledge of the current state of materials inventory investment. The IP Indicator has been subject to less random movement and revision than deflated monthly materials inventory change derived from Census Survey data. The Indicator is especially useful in checking current trends in inventory investment because cyclical movements dominate random movements quickly. The Indicator also summarizes longer run excesses in production and accumulation of materials which imply eventual declines in materials production and employment.

From time to time, we expect to comment on this measure as a supplement to the production story in the Greenbook.

APPENDIX B: PHASE III PRICE AND WAGE STABILIZATION PROGRAM*

Phase III is a quasi-voluntary program with a price goal fairly similar to Phase II--a rate of rise of 2-1/2 percent or less by the end of the year. For wages, present standards apparently will continue pending review by the new Labor-Management Advisory Committee and subsequent decision by the Cost of Living Council.

The principle of cost pass-through--price increases not exceeding cost increases--remains, but the profit margin constraint is revised in two important ways. Firms may now use a fiscal year ending during Phase I or Phase II as an alternative to one or both base years, previously limited to two of the three fiscal years preceding August 15, 1971. In addition, firms may increase average prices up to 1-1/2 percent without being subject to the rule; under Phase II only firms with zero price increase on all items were exempt.

Mandatory controls, essentially similar to present regulations, will, however, continue for construction wages and for prices and wages in the health services and food industries--the latter including processors, services, wholesalers, and retailers.

For the remainder, pre-notification and approval of price increases are no longer required. However, approximately 800 firms, with annual sales of \$250 million or more, must still file quarterly reports on prices, costs, and profits, and the approximately 3,500 with sales of \$50 million or more must keep records and produce them on request. With respect to wage changes, the minimum size for required quarterly reports is set at 5,000 employees and, for record-keeping, 1,000. Firms will also be monitored through spot checks and audits.

The Cost of Living Council, which will administer the program, has the authority to intervene in case of unsatisfactory compliance. It may block price and wage increases and impose legally binding decisions, including possible rollback orders. The Council also has the authority to reimpose mandatory controls on an industry or sector when deemed necessary.

In other areas, rent controls are abolished, for the 30 percent of units reported as not already exempt. Regulatory agencies and regulated industries are expected to follow the criteria established by the Price Commission. With respect to farm prices, the emphasis is on improving supply. Among other measures, Department of Agriculture decisions affecting supply--marketing orders and agreements, marketing guides, purchases of food for distribution programs--are to be cleared with the Cost of Living Council.

*Prepared by Lucy Cifuentes, Economist, Division of Research and Statistics.

It has seemed likely to the staff for some time that the rate of inflation would increase this quarter because of higher labor costs, rising food prices and the delay of auto price increases. The extent to which the outlook for prices will be affected by the advent of Phase III will depend on the reaction of labor and management to the more flexible regulatory structure and to policy decisions yet to be made. The largest corporations may go slow in raising prices, partly because of monitoring and the possible re-imposition of mandatory ceilings. But, with demand improving, price increases may be more probable in the broad areas now decontrolled.