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CONFIDENTIAL (FR)
CLASS II - FOMC

January 13, 1978

SUPPLEMENT

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

By the Staff
Board of Governors
of the Federal Reserve System

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The Domestic Nonfinancial Economy

Wholesale prices of finished goods rose 0.7 per cent, or at an annual rate of 7.8 per cent, from November to December. This is sharply higher than the 3.3 per cent rate of increase over the preceding six months. Wholesale prices of all finished goods in December were 6.6 per cent higher than a year earlier.

The faster rate of increase in prices of finished goods in December was attributable to a sharp rise in the prices of consumer foods as prices of consumer nonfood goods and of producer goods rose less rapidly than in November. Prices of consumer foods posted a 1.5 per cent (17.7 per cent per year) increase from November, reflecting mainly large increases for some meats, poultry, and dairy products. Prices of consumer nonfoods edged up only 0.2 per cent with increases reported for jewlry, household furniture, gasoline, and alcoholic beverages.

Producer finished goods rose 0.5 per cent (6.3 per cent per year), a rate below those for the previous two months and somewhat below the rate of increase over the year, 7.2 per cent. Some of the items in this group which showed higher prices were electric power equipment, commercial furniture, agricultural machinery, and motor trucks.

Intermediate materials, excluding foods and feeds, rose 0.5 per cent; among the several commodities with increases were leather, tires and tubes, building paper and board, flat glass, softwood lumber and plywood, gypsum products, and electric power.

Crude materials, excluding foods and fibers, registered a 3.2 per cent rise which reflected a sharp increase for steel scrap; prices of nonferrous scrap, crude petroleum, hides and skins, and wastepaper were also higher.

On a commodity basis, industrial commodities rose 0.5 per cent with increases for metals and metal products, lumber and wood products, and fuels and related products and power contributing most to the rise.

Farm products declined 0.3 per cent over the month, and processed foods and feeds rose 0.9 per cent; the price index for farm products and processed foods and feeds increased 0.4 per cent, down from 2.3 per cent in the previous month.

The All Commodities index showed a 0.5 per cent rise when its two main components are combined.

The Bureau of Labor Statistics continues it program of gradual change in the presentation of wholesale prices, emphasing the price indexes for finished goods, for intermediate materials, and for crude materials--the three major Stage-of-Processing groupings--rather than indexes on a commodity basis. The Finished Goods Index, reflects changes in prices only of those commodities that are in the form in which they will eventually be sold to final users--both other producers and individual consumers. This index is emphasized because it does not duplicate price changes as they move through the various stages of processing as the All Commodities Index does. It should be noted that there is no change in the underlying data or concepts. The change is in the presentation of data which, it is hoped, will more accurately depict wholesale price trends.

RECENT CHANGES IN WHOLESALE PRICES
(Per cent changes at compound annual rates; based on seasonally adjusted data) 1/

	Relative Importance Dec. 76	1976	1977 QI	1977 QII	1977 QIII	1977 QIV	1977 Dec.
Finished goods	41.1	3.3	8.8	8.4	1.8	7.7	7.8
Consumer foods	10.4	-2.5	12.7	13.8	-7.5	9.2	17.7
Consumer nonfoods	18.7	4.9	8.7	6.5	5.0	4.4	2.7
Producer goods	12.1	6.4	5.5	6.1	5.8	11.4	6.3
Intermediate materials 2/	45.3	6.4	8.0	4.5	7.5	5.2	6.4
Crude materials 3/	3.8	13.5	21.7	-2.1	9.1	18.2	38.5
All Commodities	100.0	4.7	10.6	3.6	1.5	8.3	5.5
Farm and food products	21.6	-1.1	19.1	-2.5	-17.0	17.3	5.1
Industrial commodities	78.4	6.4	8.1	5.3	7.4	6.0	6.0
Industrial commodities ex. fuels and power	67.7	6.2	6.7	4.0	7.0	5.9	5.8

1/ Changes are from final month of preceding period to final month of period indicated. Monthly changes are not compounded.

2/ Excludes intermediate materials for food manufacturing and manufactured animal feeds.

3/ Excludes crude foodstuffs and feedstuffs, plant and animal fibers, oilseeds, and leaf tabacco.

Business plans for new plant and equipment expenditures. Businesses plan to increase spending for new plant and equipment in 1978 by 10.1 per cent from such spending in 1978, for which a 13.7 percent rise had been anticipated by businesses last November. This increase for 1978, indicated by the Commerce Department survey taken in late November and December, falls within the 9 to 11 per cent increases reported in earlier private surveys. In the eight years of existence of this survey it has tended to overstate the actual change by about 0.4 percentage points, with the larges overstatement occurring in 1975. In each of the past two years, however, the December survey has understated the actual change by almost 2 percentage points.

Smaller increases in 1978 business fixed capital outlays were indicated by a majority of the industry groupings. Manufacturing firms anticipate a 10.4 per cent rise in 1978--following a 16.3 per cent in 1977, and nonmanufacturing firms plan a 9.9 per cent gain--down from 11.7 per cent in 1977.

Within manufacturing, spending by durable goods producers is expected to grow 12 per cent after rising 19 per cent in 1977 while that of nondurable goods producers is anticipated to rise 9 per cent in 1978--off from 14 per cent in 1977. The only manufacturing industries planning larger increases in 1978 than in 1977 are nonferrous metals, aircraft, paper, chemicals and "other" nondurables. Substantial increases (but smaller than 1977) are planned in the electrical and nonelectrial machinery, stone-clay-glass, textiles, food and rubber industries. Iron-ore blast furnaces and steel mills are planning an absolute drop, according to the survey--the third straight yearly decline.

Among nonmanufacturing industries, mining is planning a larger increase than in 1977. Railroads and air transportation plan about the same rise in 1978 as in 1977. Smaller increases in 1978 than last year are planned by the electric utilities, gas utilities, communications, and commercial and other groupings. The nonrail-nonair transportation area anticipates a 22 per cent decline in 1978, following a 34 per cent drop in 1977; these sharp reductions evidently in large part are associated with the completion of the construction of the Alaskan pipe line.

ANTICIPATED SPENDING FOR NEW PLANT AND EQUIPMENT: 1978
(Per cent change from 1977)

	McGraw-Hill	Merrill Lynch 1/	Rinfret 1/	Commerce 2/
All Business	11.1	10.2	8.9	10.1
Manufacturing	11.0	9.4	13.3	10.4
Durable	14.2	11.0	11.2	11.7
Nondurable	8.2	8.0	15.1	9.2
NonManufacturing	11.3	10.8	5.5	9.9
Mining	3.1	48.3	-11.0	18.6
Railroads	8.9	5.0	13.9	15.2
Nonrail Transportation	27.9	-3.1	-17.4	-1.0
Electric Utilities	11.0	10.9	14.5	11.5
Gas Utilities	4.9	7.5	7.5	14.1 3/
Communications	15.0	15.2	3.6	8.9 3/
Commercial and Other Grouping	12.0	4.5	2.7	7.9 3/

1/ Confidential.
2/ Corrected for systematic bias; without the bias adjustment, 1978 spending would show a 10.9 per cent increase.
3/ Confidential; for use within FRB only.

The Domestic Financial Economy

Securities markets. Treasury bill rates have fallen somewhat in the past few days. The three-month bill has been bid most recently at 6.56 per cent, 9 basis points below the January 10 level but still 55 basis points above its rate at the time of the December FOMC meeting. Yield indexes for corporate and municipal bonds that have become available for since printing of the Greenbook indicate that rates on these securities rose about 20 and 10 basis points, respectively, in association with the upward movement in short-term rates earlier this week.

Revisions and Corrections.

Part I. Page I-10: Private final purchases for 1976 should read $1,331.7 billion.

Page I-11: Changes in GNP Related Items for following components should read:

	Projected	
	1977	1978
Personal consumption expenditures for services	58.9	60.5
Residential fixed investment	22.9	17.8
Business fixed investment	23.3	23.5
Government	33.4	46.2
Federal	15.0	17.0
State and local	18.5	29.2

INTEREST RATES
(One day quotes--in per cent)

	1977 Highs	1977 Lows	1977 Dec. 19	1978 Jan. 12
Short-Term Rates				
Federal funds (wkly avg.)	6.65(12/28)	4.47(1/5)	6.54(12/21)	6.58(1/11)
3-month				
Treasury bills (bid)	6.36(10/13)	4.39(4/28)	5.95	6.56
Comm. paper (90-119 days)	6.68(12/30)	4.63(1/10)	6.63	6.74
Bankers' acceptances	6.75(12/29)	4.66(1/3)	6.60	7.00
Euro-dollars	7.56(12/29)	4.88(1/5)	7.13.	7.56
CDs (NYC) 90 days				
Most often quoted new	6.70(12/21)	4.50(1/5)	6.70(12/14)	6.87(1/11)
6-month				
Treasury bills (bid)	6.55(10/13)	4.54(1/3)	6.34	6.85
Comm. paper (4-6 mos.)	6.75(10/18)	4.63(1/7)	6.64	6.77
CDs (NYC) 180 days				
Most often quoted new	6.92(11/9)	4.65(1/5)	6.85(12/14)	7.00(1/11)
1-year				
Treasury bills (bid)	6.64(10/13)	4.66(1/3)	6.47	6.94
CDs (NYC)				
Most often quoted new	7.10(12/28)	5.00(1/5)	7.08(12/14)	7.25(1/11)
Prime municipal note	3.65(12/30)	2.65(1/7)	3.60(12/16)	3.65(1/6)
Intermediate- and long-term				
Treasury (constant maturity)				
3-year	7.40(12/29)	5.73(1/3)	7.27	7.72
7-year	7.77(12/29)	6.50(1/3)	7.60	7.94
20-year	8.00(12/29)	7.20(1/3)	7.88	8.20
Corporate				
Seasoned Aaa	8.30(12/28)	7.87(1/5)	8.21	8.38p(1/13
Baa	9.18(2/25)	8.77(9/9)	8.99	9.15p(1/13
Aaa Utility New Issue	8.36(12/16)	7.90(1/5)	8.36(12/16)	8.70p(1/13
Recently offered	8.48(12/30)	7.95(1/5)	8.38(12/16)	8.66p(1/13
Municipal				
Bond Buyer index	5.93(2/2)	5.45(11/17)	5.55(12/15)	5.75
Mortgage--average yields in FNMA auction	8.98(12/26)	8.46(1/12)	8.89(12/12)	9.13(1/9)

APPENDIX A*
BUSINESS LOANS AT RATES BELOW PRIME

Recently, some interest was expressed concerning the frequency with which banks are lending to businesses at interest rates below the prevailing prime rate. This appendix presents some preliminary survey evidence concerning below-prime business loans at banks generally and discusses two particular programs which facilitate such lending.

Evidence from recent surveys, discussed below, suggests that in the past year banks may have been somewhat more inclined to make business loans at rates below the prime rate than earlier in this recovery. However, due to the noncomparability of surveys this year with previous surveys and to the reluctance of lending officers to discuss the nature of the loans made below prime, this fragmentary evidence should be interpreted as only suggestive of a possible shift in lending policies. A concrete development is the introduction of various innovations to make business loans at more competitive rates without violating the nominal prime rate convention. Two such programs are the commercial paper adjustment facility and increasing use of bankers acceptances.

Evidence of General Rate Cutting

Responses from the 50 large banks in the Survey of Terms of Bank Lending (STBL) for August indicate that half of the sample had extended one or more loans to business borrowers at rates below the prime rate.1/ Nine of these large banks had made more than two below-prime rate loans, and one large New York bank had a significant number of such loans. These responses suggest a slightly more prevalent inclination to make below-prime loans than in earlier surveys this year, and the proportion of respondents indicating loans made below the prime was considerably higher this year than had been reported in a previous survey which was taken quarterly from 1967 until late 1976.2/ Nearly all the latest below-prime loans reported were in denominations of $1 million or more; thus, these loans represented a much larger proportion (about 10 per cent) of the volume of loans made than of the number of loans made.

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* Prepared by Perry D. Quick, Economist, Banking Section, Division of Research and Statistics.

1/ The STBL surveys 350 banks each quarter to get the terms and amounts for a sample of business and construction loans made in the five days preceding the survey. The 50 large banks provide information on about 160 business loans per bank each survey.

2/ The Quarterly Interest Rate Survey was replaced after November 1976 by the STBL.

The contrast between the proportion of total loans reported as below prime in the STBL and that of the previous survey must be interpreted as only suggestive of a change in loan pricing policies. The two surveys are not strictly comparable because of changes in the sample of respondents and some improvements in the calculations of the effective interest rates charged. Moreover, in the previous survey, there was usually a small percentage of loans reported as below prime. On closer investigation, however, most of these were found to involve renegotiations of loans in default or loans involving other special circumstances. While this appears to be the case with some of the below-prime loans reported in the STBL this year, a significant number appear to have characteristics suggestive of new loans at specified below-prime rates.[1/]

Members of the Bank Contact Group in New York and Chicago attempted to query a few lending officers on the character of loans at their banks made under prime. If cooperative at all,[2/] these officers generally cited certain special factors which influenced the rate on the loan. Most of the below-prime loans at the one New York bank with a significant number of such loans were in the money market lending area. These were "matched funding" loans, of fixed maturity, not prepayable, not under commitment, with Eurodollars as the source of funding, and with the rate set as a markup over the Eurodollar rate. The bank's lending officer indicated that such loans were not new and were generally in competition with Euro markets. He also volunteered that the bank was making short-term floating-rate loans with rates set at about 120 per cent of the commercial paper rate. According to the lending officer, both kinds of below-prime loans cited above are not related to the prime rate because they are "money market loans." One Chicago bank reported that it lost a customer to a New York bank because he got a loan at 90 basis points under the (7-3/4 per cent) prime. Also reported was that one bank was making loan offers at rates below 7-3/4 per cent even as it increased its prime rate to 8 per cent.

In summary, it appears that banks are making new business loans under prime and are doing so with slightly greater frequency. However, they are reluctant to admit that they have broken from tradition and virtually always cite "special factors" for such loans. In

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1/ Loans involving renegotiation of earlier loans in default usually have long maturities with rates considerably below the prime rate. In the August STBL a number of loans for amounts over $1 million were short-term and at rates 25 to 100 basis points under the prime rate, suggesting "arms length" negotiated loans to large borrowers rather than renegotiation of old loans.

2/ Some officers denied that their banks made such loans even though the survey indicates below-prime loans were being made in each recent reporting period.

addition to an apparent general trend to more aggressive loan pricing, there are some specific lending programs which banks may use to lend to preferred customers at rates below prime without violating the letter of their traditional pricing policies. These include the development of commercial paper adjustment facilities and the substitution of bankers acceptance financing for straight business loans, discussed below.

Loans to Commercial Paper Issuers

On November 8, Morgan Guaranty introduced a short-term lending program which it called a Commercial Paper Adjustment Rate Facility. The facility allows high-grade commercial paper issuers which maintain backup lines of credit with Morgan to borrow for up to ten days at a small markup from the bank's cost of funds. According to the announcement, the interest rate quoted for the facility was around 25 basis points above the Federal funds rate. While it was announced that the rate charged could float over the term of the loan, Morgan officials explained in private contacts that there was no explicit rate-setting formula and that they would attempt to maintain some rate stability. Bank officials emphasized in their press statements that this facility was designed to complement the commercial paper market and not to substitute for it. It was designed to provide a source of temporary funds if an issuer needed funds at the end of the day or wanted to delay an issue for a few days to wait for more favorable market conditions.

On November 30, Wells Fargo announced that it would offer a service similar to Morgan's facility. Like the Morgan plan, this program has been offered to the largest corporations--both financial and nonfinancial--currently issuing commercial paper. The Wells facility offers a longer maximum maturity (29 days) and has a fixed, rather than floating, interest rate over the term of the loan. Wells Fargo officials did not disclose an explicit current interest rate for their program, but it is expected to be competitive with Morgan's.[1/]

Conversations with commercial paper dealers and direct placers indicate that most expect that the facilities will have only a marginal impact--perhaps complementary--on the commercial paper market. While loans made under the new facilities are currently priced about 1 percentage point below the prime, the rate on such loans is still around 50 basis points above rates on short-term (less than 30 days) commercial paper, which recently have been in the 6-1/2 to 6-5/8 per cent range.

1/ Reliable sources report that at least five other large banks are making loans on a similar basis to high-rated borrowers. To date, however, these banks have made no public statements about such facilities.

Indeed, those borrowers we contacted who have used the facilities to date said they took such loans in lieu of bank loans previously made at the prime rate.[1/]

Perhaps the most significant characteristic of the Wells program is that it corroborates the bank's recent statements that it intends to deemphasize the prime rate in pricing its business loans. A declaration of its intention appeared in a recent report to stockholders:

> "As part of our continuing appraisal of the banking environment and our own methods of doing business, Wells Fargo is currently examining the function of a prime rate--the base lending rate to preferred corporate customers. It is our belief that the role of a prime rate is diminishing and that in the future considerably less emphasis should be focused on its fluctuations. Our prime rate is determined by our own internal cost of funds, the current competitive situation, and trends in interest rates as they affect Wells Fargo Bank. As a result of our examination of the prime rate, we anticipate that we may be making more frequent changes in our prime rate, and that at times--such as during the third quarter--we may lag behind other banks even more often than in the past, while at other times--such as occurred early in October--we may change our rate before other banks change theirs.
>
> We intend to remain in a highly competitive posture in the banking industry, and our study of the subject is intended to help us do so."

Bankers Acceptances

Press reports earlier in the year suggested that banks may have been using bankers acceptances to lend to business borrowers at interest rates below the prime rate.[2/] Bankers acceptances generally trade at rates under prime, near the rate on CDs; current quotations for 90-day acceptances are around 7 per cent. However, the borrower also must pay a commission charge, traditionally set at 1½ percentage points but, in recent years, as low as 1/8 to 1/4 percentage point.[3/]

1/ Loans made to finance companies are not classified as business loans; thus, the characteristics of such loans would not be reported in the STBL.

2/ A bankers acceptance is a time draft drawn on a bank which the bank "accepts" or promises in writing to honor unconditionally at the time of maturity. These acceptances also are not covered in the STBL.

3/ Even with a 1/4 percentage point commission and a 20 per cent compensating balance requirement, the effective rate on acceptances is 1 percentage point below the effective prime rate.

Acceptances outstanding increased in 1976 by about \$4 billion; during the first ten months of 1977 acceptances outstanding grew \$1.4 billion to \$23.9 billion at the end of October. By comparison, business loans at commercial banks increased \$4.7 billion in 1976 and \$16.2 billion in the first ten months of 1977 to a level of \$202 billion.

Informal contacts with bank officials earlier this year generally resulted in each official claiming it was "other banks" who were using acceptances to undercut the prime but that his bank was not engaged in this practice. However, subsequent discussions with lending officers show that a bank often offers the borrower a menu of financing alternatives, with the borrower choosing on the basis of relevant rates. Thus, a bank can quote a favorable rate on acceptances in order to gain the business of that borrower. In fact, several banks indicated that they have extended the range of customers to whom acceptance financing is offered. In only one instance, however, did a bank official admit that his bank had switched from loans at the prime rate to cheaper acceptance financing in order to keep customers' business.

Using bankers acceptances for business lending is somewhat limited by banks' general aversion to creating other than "eligible" acceptances.1/ Eligible acceptances generally involve imports, exports and overseas trade, or types of domestic transactions restricted by the kind of goods involved and documentation of ownership. Recently, a few banks have investigated the market potential for ineligible acceptances, especially finance bills. Finance bills are unsecured acceptances which substitute for working capital loans. Rates on finance bills are still below the prime rate, but slightly higher than on eligible bankers acceptances because banks must maintain reserves against such ineligible acceptances if they are sold out of the bank's portfolio. While little use of this financing alternative has been made to date,2/ bank officials report that ineligible acceptances could grow substantially in the future.

1/ "Eligible" bankers acceptances are those which may be used for collateral at the Federal Reserve discount window.

2/ Finance bills outstanding are currently less than \$150 million.