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CONFIDENTIAL (FR) October 17, 1975

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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SUPPLEMENTAL NOTES

The Domestic Nonfinancial Economy

Inventories. Book value of retail inventories rose at a $12.9 billion annual rate in August following a July rate of increase of $8.0 billion and a second quarter average rate of decrease of $3.6 billion. Retail auto inventories rose at $14.3 billion rate in August having risen at a $3.0 billion rate in July and fallen at an average $1.7 billion rate in the second quarter.

For manufacturing and trade August inventories rose at a $15.5 billion annual rate following decreases at an annual rate of $4.8 billion in July and $18.8 billion in the second quarter. The manufacturing and trade inventory-sales ratio fell to 1.54 in August from 1.56 in July.

Revisions of the book value retail inventory data show slower rates of accumulation in 1974-III and 1974-IV, a slower rate of decumulation in 1975-I and a faster rate of decumulation in 1975-II. Revisions of these rates were less than $2 billion at an annual rate.

Seasonally adjusted private housing starts edged down 2 per cent in September to an annual rate of 1.24 million units. An 18 per cent increase in starts of multifamily units was offset by an 8 per cent decline in single-family starts. Total starts increased in all regions except the North Central. For the third quarter as a whole, starts averaged 1.25 million units--a fourth above the first quarter trough.

Residential building permits rose 8 per cent from August to September.

Capital expenditures. We have received the final, but still confidential, results of the Edie capital spending survey. The all-industry gain of 3 per cent is below the preliminary 5 per cent gain reported earlier. A corrected table follows:

SURVEY RESULTS OF ANTICIPATED PLANT
AND EQUIPMENT EXPENDITURES
(Figures are percentage change from prior year)

	1975 1/	1976 Edie Survey
All Industry	1.0	2.9
Manufacturing	5.3	1.3
Durables	-1.8	-2.8
Nondurables	12.1	4.7
Nonmanufacturing 2/	-2.0	4.2
Railroads	.9	-6.2
Other transportation	11.2	-34.5
Electric Utilities	-3.3	15.6
Gas Utilities	9.9	23.0
Communications	-4.9	6.2
Commercial & Other	-6.5	.1

1/ Results of BEA plant and equipment survey taken in late July and August.
2/ Includes industries not shown separately.

The Domestic Financial Situation

Mortgage market. According to the HUD(FHA) opinion survey, average interest rates on new commitments for conventional new- and existing-home mortgages increased during September by 10 and 15 basis points, respectively. Yields on FHA-insured new-home mortgages for immediate delivery in the private secondary market increased by 42 basis points to 9.74 per cent--implying discounts of 5-1/2 points on 9 per cent FHA mortgages at the end of September. These rate movements are consistent with the FHLMC series on primary market rates and FNMA secondary market yields cited in the Greenbook.

AVERAGE RATES AND YIELDS ON NEW-HOME MORTGAGES
(HUD-FHA Field Office Opinion Survey)

End of Month	Primary market: Conventional loans		Secondary market 1/: FHA-insured loans		
	Level 2/ (per cent)	Spread 4/ (basis points)	Level 3/ (per cent)	Spread 4/ (basis points)	Discounts (points)
1974-Low	8.55 (Feb.)	-66 (Sept.)	8.54 (Feb.)	- 8 (Sept.)	2.3 (Feb.)
High	9.80 (Sept.)	45 (Feb.)	10.38 (Sept.)	44 (Feb.)	6.3 (July, Sept.)
1975-June	9.00	-37	9.06	-31	4.3
July	9.00	-25	9.13	-12	4.8
Aug.	9.15	-34	9.32	-16	6.3
Sept.	9.25	-45	9.74	+ 4	5.5

1/ Any gaps in data are due to periods of adjustment to changes in maximum permissible contract rates on FHA-insured loans.
2/ Average contract rates (excluding fees or points) on commitments for conventional first mortgage loans, rounded to the nearest 5 basis points.
3/ Average gross yield (before deducting servicing costs) to investors on 30-year minimum-downpayment FHA-insured first mortgages for immediate delivery in the private secondary market (excluding FNMA), assuming prepayment in 15 years.
4/ Average gross mortgage rate or yield minus average yield on new issues of Aaa utility bonds in the last week of the month.

Recent developments in the CD market. Further investigation of the large CD increase in September and early October, mentioned in the Greenbook, indicates that over 90 per cent of the net CD expansion was concentrated at six banks in New York City, Chicago, and San Francisco. The banks' motivations in acquiring such large amounts of CD money apparently were unrelated to current or prospective loan demands. Some of the banks were positioning funds in order to show greater liquidity on quarterly statements, and these banks have reported large net runoffs since the end of September. Others, particularly the large net issuing banks in New York City, were building up liquidity over a somewhat longer time span in preparation for possible adverse market impacts of New York City financing difficulties and publicity concerning other high risk assets. There are some indications from these banks that they have achieved their current liquidity goals, and the expansion in CD's is expected to slow considerably in coming weeks.

CORRECTIONS:

Part II - Section III, page 5, Table - Recent Treasury Note Auctions - Last column of figures was omitted:

Auction date	Yields Current (10/14/75)
Sept. 16	7.78%
Sept. 24	7.88%
Oct. 7	8.02%

Part II - Section IV, page 10 - In the U. S. Merchandise Trade table the fuel import value for July-August should read 29.5 instead of 24.5.

Part I - page I-8 - Exports: 1975-IV $138.0

State and local government surplus or deficit (-) (N.I.A. basis):

1975-III	2.8
IV	8.1
1976-I	10.4
II	10.9
III	8.9
IV	6.9

Net exports of goods and services (Balance of payments):

	1975-I	12.7
Exports	1975-I	148.4

INTEREST RATES
(One day quotes - in per cent)

	1975			
	Highs	Lows	Sept. 15	Oct. 16
Short-Term Rates				
Federal funds (wkly. avg.)	7.70(1/8)	5.13(5/21)	6.28(9/17)	5.82(10/15)
3-Month				
Treasury bills (bid)	6.90(1/2)	4.88(6/16)	6.50	5.97
Comm. paper (90-119 day)	9.00(1/2)	5.38(6/2)	6.75	6.38
Bankers' acceptances	9.00(1/1)	5.40(5/30)	6.90	6.50(10/15)
Euro-dollars	10.25(1/3)	5.69(5/21)	7.44	6.94
CD's (NYC) 90-119 day				
Most often quoted now	9.00(1/1)	5.38(6/11)	6.88(9/10)	6.38(10/15)
6-month				
Treasury bills (bid)	7.03(8/25)	5.18(6/11)	6.99	6.20
Comm. paper (4-6 mo.)	8.75(1/2)	5.38(5/23)	6.75	6.63
Federal agencies	7.67(1/2)	5.68(6/12)	7.46	n.a.
CD's (NYC) 180-269 day				
Most often quoted new	8.38(1/1)	5.75(6/18)	7.80(9/10)	7.13(10/15)
1-year				
Treasury bills (bid)	7.35(8/21)	5.37(2/5)	7.34	6.46
Federal agencies	8.00(8/25)	6.03(2/20)	7.94	n.a.
CD's (NYC)				
Most often quoted new	8.00(1/1)	6.00(3/12)	7.75(9/10)	7.50(10/15)
Prime municipals	4.35(8/15)	3.40(2/7)	4.20(9/12)	4.00(10/17)
Intermediate and Long-Term				
Treasury coupon issues				
5-years	8.56(9/16)	6.93(2/19)	8.56	8.10(10/15)
20-years	8.71(9/16)	7.58(2/21)	8.68	8.37(10/15)
Corporate				
Seasoned Aaa	9.02(4/30)	8.57(2/26)	8.97	8.84
Baa	10.63(1/20)	10.27(4/3)	10.38	10.37
New Issue Aaa Utility	9.80(4/3)	8.89(2/6)	9.64(10/11)	9.53p
Municipal				
Bond Buyer Index	7.48(10/9)	6.27(2/13)	7.40(10/11)	7.29
Mortgage--average yield in FNMA auction	9.95(10/6)	8.78(3/10)	9.70(9/8)	9.95(10/6)

SUPPLEMENTAL APPENDIX A*
RESIDENTIAL CONSTRUCTION LOAN COMMITMENTS

A special survey of more than 250 residential construction lenders[1/] was conducted jointly by the Federal Reserve and the Federal Home Loan Banks during the first week of October just prior to the recent general strenghtening of financial markets. The results of the survey suggest that--apart from normal seasonal influences--the volume of new residential construction loan commitments has declined somewhat from the advancing pace of 3-months earlier and will decline further through year-end.

Savings and loan associations--which accounted for an unusually large share of residential construction loan commitments during the first 6-months of 1975 (half of all 1- to 4-family, and one-fourth of the multifamily total)--were especially pessimistic about their ability to maintain recent volumes. More than half of the savings and loan associations responding expected some decline over the fourth quarter.

Taken by themselves, the survey results seem to suggest that the rate of housing starts by mid-1976 may be somewhat less than now projected by the staff. However, the results are partly a reflection of the fears of S and L managements that rising interest rates will curtail deposit inflows over the period ahead. If rates on market securities were to rise less than these lenders appear to anticipate, the shift in commitment activity suggested by the survey might not develop as they foresee.

The survey results indicate that the key factor contributing to unchanged or lower commitment volume at S and L's was insufficient current and expected cash flows. At commercial banks and mortgage companies, on the other hand, the key factor was weak builder demand due to unsold or unrented inventories of dwelling units and high construction costs. This

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* Prepared by Albert M. Teplin, Economist, Mortgage, Agricultural, and Consumer Finance Section, Division of Research and Statistics.

1/ The survey involved informal interviews with 122 commercial banks, 44 mortgage companies, and 110 savings and loan associations. These three types of financial institutions currently account for about 90 per cent of all residential construction loans.

latter reason--while not at the top--also ranked high on the S&L list. Increased emphasis on portfolio liquidity at commercial banks, and restrictive usury ceilings in areas where mortgage banking firms are active were also important reasons given for unchanged or reduced commitment volumes at these institutions.

The survey strongly suggests that the relative weakness in multifamily housing construction--a particular focus of the survey--may continue for some time into the future. Few of the lenders queried reported any recent increase in construction loan commitments for such properties as compared with 3-months ago. In fact, while most respondents reported no change in their volume,1/ over a fifth of the mortgage companies and savings and loan associations and 15 per cent of the commercial banks stated that their current dollar volume was substantially smaller than in early July. Furthermore, although only a few mortgage companies expected the volume of multifamily construction loan commitments to decline from now through year-end, about 40 per cent of the commercial banks and savings and loan associations looked for a reduction.

Expectations of the few commercial banks and savings and loan associations reporting increased volumes of both 1-to 4-family and multifamily construction loan commitments in early October differed considerably. Nearly all of the savings and loan associations in this category expected commitments to reverse their recent increases, or at best remain unchanged, through year-end. But a high proportion of the commercial banks in this group foresaw further increases in their residential construction loan commitment volume.

1/ Some respondents noted that "unchanged" translated into no activity whatsoever in the periods covered.

TABLE 1

REPORTED CHANGES IN THE
VOLUME OF NEW COMMITMENTS
FOR RESIDENTIAL CONSTRUCTION LOANS

1. Now compared with 3 months ago: 1/

	1- to 4-family properties			Multifamily properties		
	Commercial banks	Mortgage companies	Savings and loan associations	Commercial banks	Mortgage companies	Savings and loan associations
	(Per cent reporting)					
a. Substantially larger	3	3	2	1	0	2
b. Moderately larger	20	8	14	4	2	8
c. Essentially unchanged	52	57	30	71	67	46
d. Moderately smaller	18	15	32	9	9	21
e. Substantially smaller	8	18	23	15	21	23

2. Anticipated through year end: 1/

	1- to 4-family properties			Multifamily properties		
	Commercial banks	Mortgage companies	Savings and loan associations	Commercial banks	Mortgage companies	Savings and loan associations
	(Per cent reporting)					
a. Substantially larger	0	3	0	0	0	0
b. Moderately larger	8	11	7	4	5	3
c. Essentially unchanged	52	67	38	54	80	49
d. Moderately smaller	32	16	36	36	8	23
e. Substantially smaller	8	3	20	6	8	25

Note: Totals may not add to 100 due to rounding. The survey, taken during the first week of October, included 122 commercial banks, 44 mortgage companies, and 110 savings and loan associations.
1/ Apart from normal seasonal influences.

TABLE 2

MAJOR REASONS CITED FOR NO CHANGE OR DECLINE IN CONSTRUCTION LOAN COMMITMENTS

	Relative importance as ranked by: 1/		
	Commercial banks	Mortgage companies	Savings and loan associations
Weak demand for funds from builders mainly because of:			
(a) High cost of land, labor, and/or materials................	2	3	5
(b) High cost of borrowing..........	3	1	3
(c) Large unsold and/or unrented inventories of dwelling units.........................	1	2	4
(d) Restrictive local environmental requirements....................	7	8	7
Residential construction loan policies more or no less restrictive due mainly to:			
(e) Insufficient current cash inflows at institution..................	10	7	1
(f) Insufficient expected cash inflows at institution..................	9	9	2
(g) Significant loan delinquency and/or foreclosure problems............	8	6	9
(h) Restrictive usury ceilings on construction and/or permanent mortgage loans.........................	5	4	8
(i) Increased emphasis on portfolio liquidity......................	4	-- 2/	-- 2/
(j) Other not included in a through i.............................	6	5	6

1/ Listed in order of number of times mentioned. Lenders were asked to include as many major factors that applied at their institution.

2/ Not applicable.

SUPPLEMENTAL APPENDIX B*
THE CANADIAN PROGRAM OF WAGE AND PRICE RESTRAINTS

In recent months Canada has been less successful than most other industrial countries in combating inflationary pressures. In recent months inflation has been proceeding at approximately an 11 per cent annual rate. This rate compares with year-over-year increases of over 12 per cent in 1974, 9 per cent in 1973, and slightly over 5 per cent in 1972 and 1971. High wage settlements negotiated in the second quarter, incorporating an average annual increase in base rates of 18.8 per cent, raise the spectre at even higher inflation rates. Rapid increases in both prices and wages and the resulting deterioration of Canada's international competitive position have caused particular concern in view of already large recent and projected current account deficits.

On October 13 Prime Minister Trudeau announced a program of wage and price restraints to take effect October 14. The program is to last for at least 3 years and includes initial guidelines delineating permissible increases in incomes, prices, interest rates, rents, and dividends, along with the establishment of administrative machinery to enforce the guidelines. Legislation which would establish the machinery for enforcement of the guidelines is being introduced in the Parliament. Little parliamentary opposition is expected because the Prime Minister enjoys a majority and the major opposition party has recently called for wage and price controls.

Description of Guidelines

The guidelines for wage and salary increases limit percentage increases to the sum of a "basic protection factor", a productivity factor, and an adjustment for past wage and salary experience.

The "basic protection factor" is designed to protect workers against future price rises. Initially, it will be set at 8 per cent during the first year of the program, 6 per cent during the second year, and 4 per cent during the third year. If the consumer price index in any year increases by an amount greater than the basic protection factor, the factor for the following year will be adjusted upward by the difference between the two rates. If the consumer price index increases by less than the basic protection factor, however, no downward adjustment will be made.

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*Prepared by Wendy E. Takacs, Economist, World Payments and Economic Activity Section, Division of International Finance.

The productivity factor, set at 2 per cent per year, allows wages to increase in line with increases in national productivity. This factor was chosen on the basis of on the average increase in productivity, defined as real GNP divided by the number of employed persons, of 2.08 per cent for the 1954-1974 period.

The adjustment for past wage and salary experience is determined by a comparison of the average annual increase of an employee group[1] over the previous two years (or the period of an existing contract, if greater than two years) with a national benchmark, set at the increase in the consumer price index for that period plus 2 per cent. If a group's have been lower than the benchmark, it would be allowed a corresponding additional annual increase up to a maximum of 2 per cent. Similarly, if the past average increase exceeded the benchmark, a reduction of up to 2 per cent would be made. The maximum allowable percentage increases during the first year of the program will thus range from 8 per cent to 12 per cent, depending upon the magnitude of past wage increases.

In addition to the percentage limits, annual salary increases are limited to a maximum of C$2400, regardless of past wage experience. However, increases of up to C$600 will be permissible even if the amount exceeds the calculated allowable percentage increase. Increases in wages and salaries resulting from promotions from one established level to another do not contravene the guidelines. Employers are obligated, however, to avoid changing the proportion of employees in the various categories in a way which would result in an increase in average pay for the group in excess of the guidelines.

The <u>guidelines for price increases</u> incorporate the general principle that increases in prices should be limited to net increases in costs. Profits per unit of output, in dollar terms, would thus be restricted to average per unit profits existing prior to adoption of the guidelines. Firms are expected to reduce prices if costs decrease. If the price in effect at the time of the announcement is atypical, the firm may select another price which was in effect during the previous 30 days. Firms are expected to refrain from increasing the price of any individual product more frequently than once every three months. Firms will be permitted to set prices on the basis of forecasts of cost increases.

1/ The guidelines apply to "groups", defined as bargaining units or combinations of employees which employers have established for the administration of pay. The guidelines limit the average increase to all members of a group, but, within the group, the salaries of some individuals may increase faster than the average, provided others increase more slowly. In the case of professionals, such as doctors or lowyers, the "group" may be as small as one individual.

Prices received by farmers and fishermen for their products will be exempt from the guidelines. The government will also continue to permit the price of energy to rise in "a series of orderly steps" toward world levels.

Firms exporting their products will be expected to sell abroad at world market prices. Firms also supplying the domestic market will be expected to ensure that the domestic market is fully satisfied, in terms of quantity, at a price consistent with the guidelines. If a firm can demonstrate the impracticality of different export and domestic prices, it may price all sales at world market prices, but its profits would be subject to a special levy.

Guidelines for interest rates follow the same rule as other price increases. Increases in service charges and interest rates charged by banks and other financial institutions must be justified by increases in the interest rates which they pay or increases in their operating and other expenses.

The guidelines for rent increases proposed to the provinces, which have constitutional responsibility for rents, will be based on the principle of a percentage ceiling on rent increases, with exceptions only when justified by increased costs. To maintain incentives for construction of new rental housing, new structures will be exempt from control for at least five years following completion.

The guidelines for dividends allow no increases in the dollar amount of dividends per share during the first year of the program. Exceptions may be permitted if a firm can demonstrate that an increase was n ecessary to raise new equity capital, or that the dividend of the previous year was atypically low.

Enforcement of Guidelines

Legal enforcement of the guidelines will be limited to specified firms and their employees. These include: a) firms which employ over 500 employees; b) firms whose employees take part in industry-wide bargaining; c) firms in the construction industry which employ more than 20 employees; d) Federal departments, agencies, and corporations; e) participating provincial governments and their agencies, including municipal institutions; f) individuals or other firms carrying on a business that is a profession. These groups cover approximately 4.3 million of Canada's 9.4 million workers. Other groups may be added to the list in the future. The government is counting on voluntary compliance with the guidelines on the part of groups not subject to enforcement procedures.

To monitor and enforce the guidelines the government is establishing an Anti-Inflation Board and appointing an Administrator. The Anti-Inflation Board will monitor movements in prices, profits, compensation and dividends, identify movements contrary to guidelines, and negotiate with parties involved to bring increases within the guidelines. If the consultations and negotiations do not succeed in brining the increases within the guidelines, the Anti-Inflation Board will refer the increases to the Administrator. If the Administrator finds that the increases are contrary to the guidelines he will be empowered to enjoin the party concerned from contravening the guidelines and impose penalties. The decisions of the Administrator may be appealed to an Anti-Inflation Appeal Tribunal and the Federal Court of Appeal, in turn. The Cabinet may rescind orders of the Administrator or instruct him to vary his orders.

Assessment

The newly announced wage and price controls supplement other recent Canadian anti-inflationary measures. Concern over an acceleration of inflation led the Bank of Canada to raise the bank rate from 8-1/4 to 9 per cent on September 3 to prevent an excessive expansion of the money supply. In his October 13 speech Prime Minister Trudeau also announced decreases in government expenditures in addition to those already contained in the June 23, 1975 budget, including limiting the growth of the federal public service in 1976-1977 to 1.5 per cent over the level authorized in 1975-76.

Much of the success of the program will depend upon the willingness of that half of the economy not subject to enforcement to voluntarily follow the guidelines, and the degree of participation by the provinces.

The Canadian provinces enjoy considerable autonomy and have jurisdiction over some key elements of the program. The Federal government has asked the provinces to participate in the anti-inflation program by following the wage guidelines with respect to provincial and municipal employees, and price guidelines with respect to provincial regulatory and marketing boards. The provincial governments also have constitutional responsibility for rents, and are being asked to implement the program of rent control. Quebec has decided to establish a wage-price board in line with the federal restraint program. Several provincial premiers expressed tentative support for the proposals but indicated that they felt it necessary to study them further.

Designed as a medium-term program, the restraint measures are not likely to reduce Canada's inflation rate quickly. Permissible wage increases for the first year of the program are about as high as the current inflation rate. Moreover, the guidelines will not affect contracts and agreements already concluded, which will allow recent high wage settlements to be translated into price increases for the duration of existing contracts.