

James L. Kichline

INTRODUCTION -- FOMC BRIEFING

The staff has updated its projection of the likely performance of economic and financial activity through the balance of this year and has extended its forecast horizon to include all of 1978. We have approached this exercise with a good deal of caution. Actual developments in a short period ahead may well differ appreciably from one's expectations, and there is much greater uncertainty for a period as long as 6 quarters.

The principal policy assumptions that underlie the staff's forecast are shown in the first chart of the materials distributed this morning. For monetary policy, we have assumed growth of M_1 at a 5-1/2 per cent rate from the second quarter level through 1978. Growth of M_2 at 8-1/4 per cent is significantly less than that experienced over the past year and a half, reflecting the impact of expected increases in interest rates over the period. On the fiscal side we anticipate growth of Federal expenditures will continue to fall short of budget plans. In fiscal year 1977, expenditures are assumed to total about \$2-1/2 billion less than projected in the Administration's recent mid-year budget review. We also assume slippage of about \$6 billion in expenditures in fiscal year 1978, mainly in the defense and grant areas. For the energy program we have retained our earlier assumption of the wellhead tax beginning January 1978, which accounts for about 1/4 percentage point of our projected increase in the price deflator next year.

Mr. Zeisel will now review recent and prospective economic developments.

Joseph S. Zeisel

FOMC BRIEFING

July 19, 1977

There has been some concern recently that economic indicators may be signalling a pause in the upward momentum of the economy. Employment gains moderated in June and the unemployment rate edged up; last month's rise in industrial production of 0.7 per cent--while still quite vigorous--was somewhat under the recent rapid pace; and retail sales have shown little change over the past few months. But as is clear in the first of the

charts, the moderation in these measures has in general followed a period of unusually strong gains. As a result, the increase in real GNP for the second quarter as a whole is still estimated to have been quite strong--about a 6-3/4 per cent annual rate--close to the first quarter rise.

The immediate concern appears to stem largely from the recent easing in consumer demand. Unit auto sales have remained about level over the past three months--although at a very high rate. Excluding autos, retail sales in June were about unchanged for the second month in a row. With production rising at a vigorous pace, this recent sluggishness in demand was reflected in a buildup of stocks--especially nondurables, as can be seen in the next chart. The increase in the book value of nondurable inventories was particularly large in March and April, but more moderate in May.

Although these recent developments are uncomfortably reminiscent of the inventory problems which stunted growth of activity last year, any adjustment seems likely to be briefer this time, for several reasons. The effects of the backup of inventories have already been reflected in a cessation of growth of both employment and production in nondurable industries last month, which should assist in getting stocks back into line fairly quickly.

In addition, income gains have been quite strong, and consumer attitudes are reported to be holding up very well, suggesting that any pause in growth of consumer outlays will be short-lived. Moreover, as is evident in the next table, inventory/sales ratios for both manufacturing and trade are below last year's levels and historically quite low, reflecting a continued conservative inventory policy designed to keep stocks from getting seriously out of hand.

Although we feel the chances of avoiding a substantial or prolonged inventory adjustment are good, the recent run-up of stocks suggests less contribution to growth from this sector later this year and in 1978. Moreover, other major sources of support to activity appear likely to be losing momentum, suggesting that the economy will shortly move to a more moderate growth path from the recent close-to-7 per cent rate. Gains in residential construction activity are expected to slow soon from the recent rapid pace and housing starts to edge off in the latter half of next year in response to tighter mortgage market conditions.

We also expect less support in general from consumer outlays than earlier this year. As the next chart shows, consumer expenditures have been growing more rapidly than disposable income for over a year, and the saving rate has fallen sharply, to under 5 per cent, quite a low rate by past standards. It seems unlikely that this pattern will continue. We anticipate that consumer outlays will grow more moderately relative to income in the near term, and that the savings rate will drift up into the 6 per cent range over the next few quarters; thereafter, consumer outlays are expected to move generally in line with the rate of growth of disposable income.

The key to overall growth will most likely be the path of business capital spending. The outlook here remains uncertain. Judging from recent

indicators (presented in the next chart) the short-term prospects for capital outlays appear quite good. Commitments for future capital spending--including real new orders, manufacturing appropriations, and even construction contracts, have been on a generally upward path. But there have been some suggestions of hesitation in these data recently. In particular, new orders for nondefense capital equipment--which lead spending by about half a year--appear in the past few months to have lost some of their upward momentum. And of course the latest Commerce anticipations survey showed rather small increases for capital spending later this year.

Nevertheless, the economic and financial environment continues to appear conducive to more rapid growth in investment. Real demands have increased strongly over the past half year; the capacity utilization rate at over 83 per cent in June is approaching the point where business should begin to be concerned with the adequacy of capital stock; and the financial position of firms in general appears quite favorable.

As indicated in the next chart, it is our judgment that the basic underlying expansive forces will prevail and that capital spending will continue to rise at a reasonably rapid--although far from booming--pace over the next year and a half. The slope of real growth in investment, as projected, is similar to the average of postwar recoveries, although given the sharper decline this time, these expenditures continue to lag.

But if aggregate demands in the private sector appear likely to be somewhat less ebullient later this year, growth in activity should be provided some additional support by a more rapid rise of government spending. As the next chart shows, after swinging into surplus in the first half of 1977, the high employment budget is projected to move back into deficit in

the latter half of this year and in early '78. This \$15 billion swing toward stimulus over the next half year represents the effects of recently enacted tax reductions and increased grants to States and localities together with a July 1st rise in social security benefits.

The impact of the grants is graphically indicated in the next chart. After two years of deficit, the budget position of states and localities (exclusive of net insurance funds) moved into surplus in late 1976 as spending was curtailed and tax revenues increased. The general improvement in fiscal position has led to a less conservative borrowing posture, and supported by an increase of almost \$20 billion in Federal grants over the coming year, should result in a resumption of the long term growth in outlays. There are suggestions that this process is already underway--State and local construction increased strongly in May for the fourth month in a row, and employment rose moderately in the second quarter after declining the previous quarter.

On balance, with the prospect of less strength from inventories, housing and personal consumption, offset in part by moderately stronger capital spending and larger government outlays, we anticipate that real GNP growth will taper off to about a 5 to 5-1/2 per cent rate over the next year, and moderate further to about a 4-1/2 per cent rate in the latter half of '78. This pace of growth should still be sufficient to reduce unemployment gradually to around 6-1/4 per cent by the end of '78. As food prices ease from their recent accelerated pace, the overall rate of price rise is expected to slow--averaging slightly above 6 per cent over the projection period, about in line with the expected rise in unit labor costs.

James L. Kichline

FOMC BRIEFING

July 19, 1977

The financial counterpart of the staff's GNP forecast is contained in our flow-of-funds projection. The first chart in the financial presentation shows that total funds raised by nonfinancial sectors is expected to rise considerably in the latter half of this year and to grow moderately further in 1978. Consistent with an enlarged budget deficit, Treasury borrowing is projected to increase substantially in the latter half of this year; borrowing by other sectors continues growing through 1978 but at a slower pace than over the past two years. Although the total dollar volume of borrowing is projected to reach new peak levels, much of the increase reflects the impact of rising prices. Funds raised relative to GNP, in the bottom panel, are projected to recede moderately in 1978 although they remain high by historical standards.

At this juncture, the principal financial and nonfinancial sectors retain a good deal of flexibility to finance rising demands for funds. In the next chart, liquidity at large commercial banks so far this year remains / ^{around levels} higher than anytime in this decade. Thrift institutions, too, have high liquidity ratios and considerable capacity to increase reliance on borrowed funds. The liquidity ratio at nonfinancial corporations-- that is current assets divided by current liabilities--is also quite comfortable reflecting large additions of liquid assets over the past 2-1/2 years as well as the

paydown of short-term debt in 1975 and 1976. For households, debt servicing on mortgage and consumer-instalment loans relative to disposable personal income is now significantly less of a burden than in 1972 and 1973.

The general process of strengthening financial positions, we believe, is about at an end in this expansion. To finance activity over the next year and a half some drawdown of liquidity positions seems likely and would be associated with increasing pressure of demands for funds against available supplies. At commercial banks, the next chart, these pressures are expected to be associated with maintenance of business loan growth around recently prevailing levels. But at the same time a reduction in net inflows of savings and small denomination time deposits is likely to make banks less willing purchasers of Federal government securities. Analogous developments are likely to be occurring at other financial institutions and in nonfinancial sectors as well. We anticipate that the household sector will be called upon to acquire an enlarged volume of securities.

Thus, markets are expected to tighten and interest rates are still projected to rise, the next chart. The Treasury bill rate may reach a little over 6 per cent by yearend--when Treasury borrowing is projected to be particularly heavy--and to move higher in 1978. Bond rates are expected to edge somewhat higher from current levels, but in the absence of a significant increase in expected future rates of inflation there appear to be ample fund supplies to these markets.

PRINCIPAL ASSUMPTIONS

MONETARY POLICY

- Growth of M_1 averaging 5½% annual rate through 1978
- Growth of M_2 averaging 8¼% annual rate through 1978

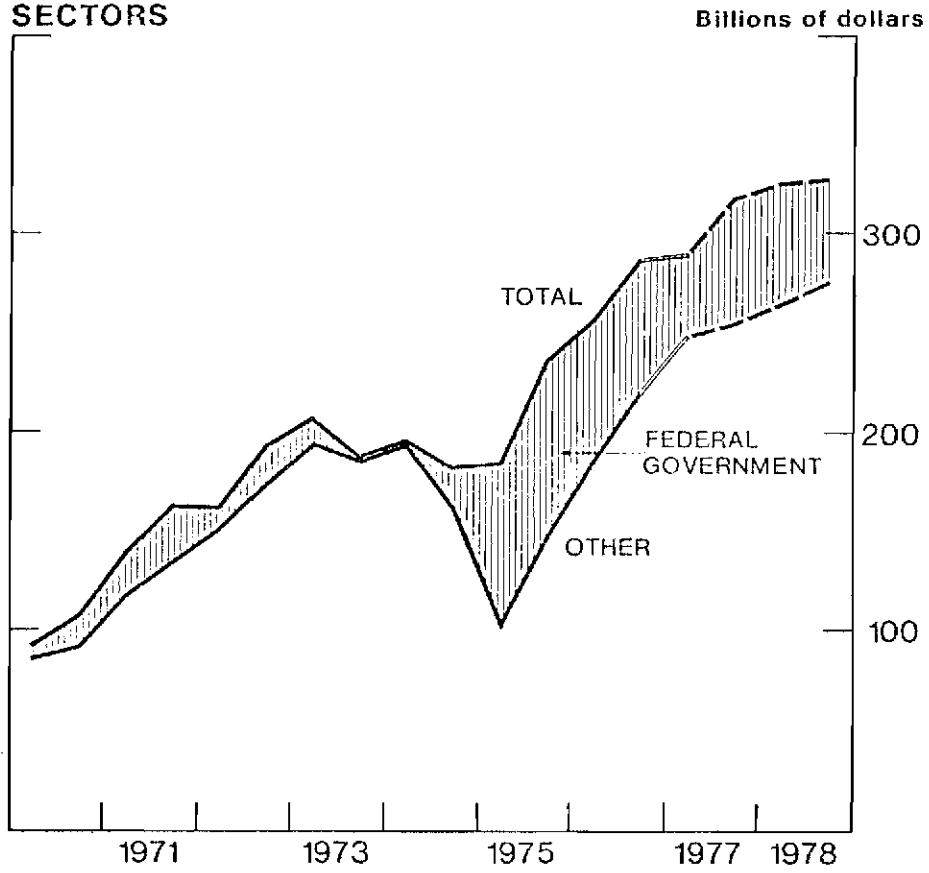
FISCAL POLICY

- Unified budget expenditures of \$404 billion in FY 1977
- Unified budget expenditures of \$457 billion in FY 1978

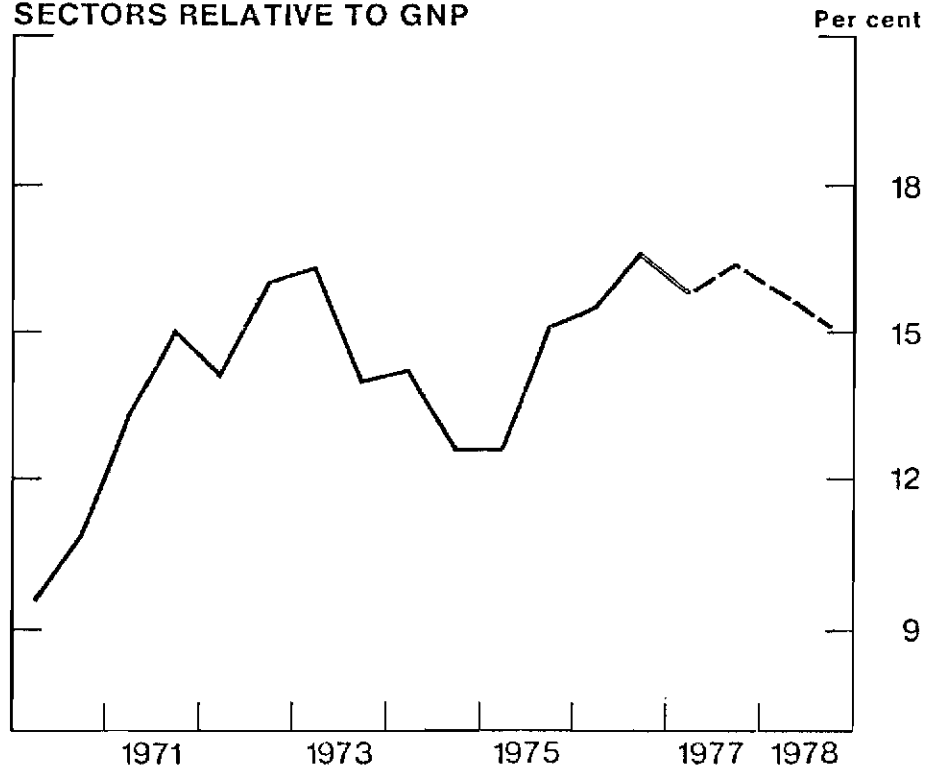
ENERGY PROGRAM

- Wellhead tax of \$3.50 per barrel on domestically produced "old" oil

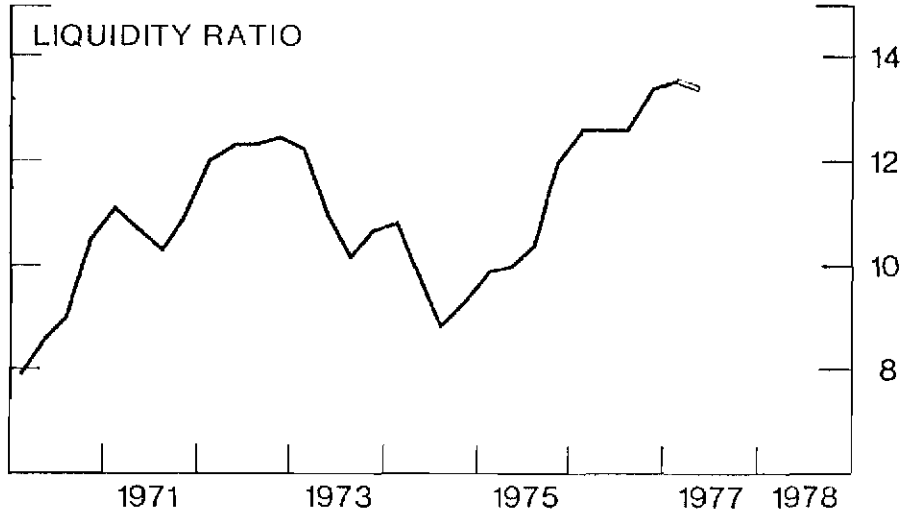
FUNDS RAISED BY NONFINANCIAL SECTORS



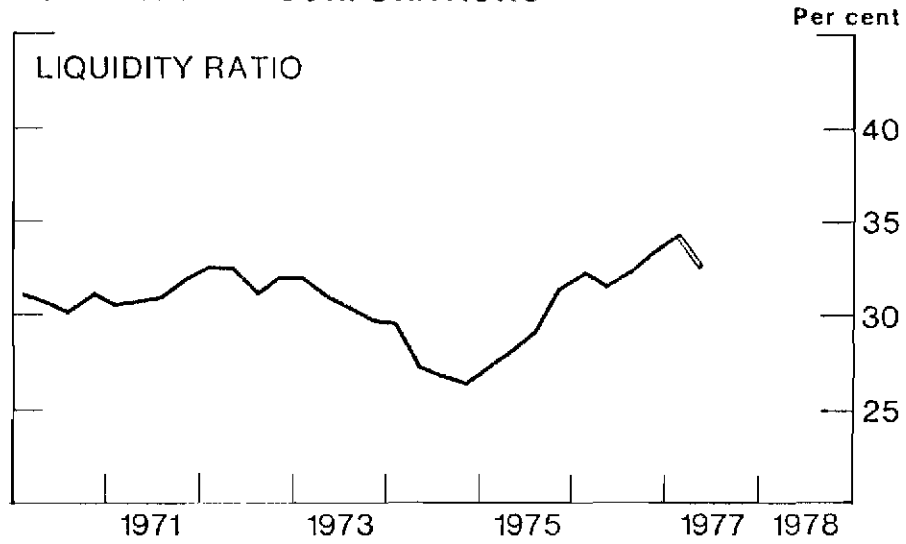
FUNDS RAISED BY NONFINANCIAL SECTORS RELATIVE TO GNP



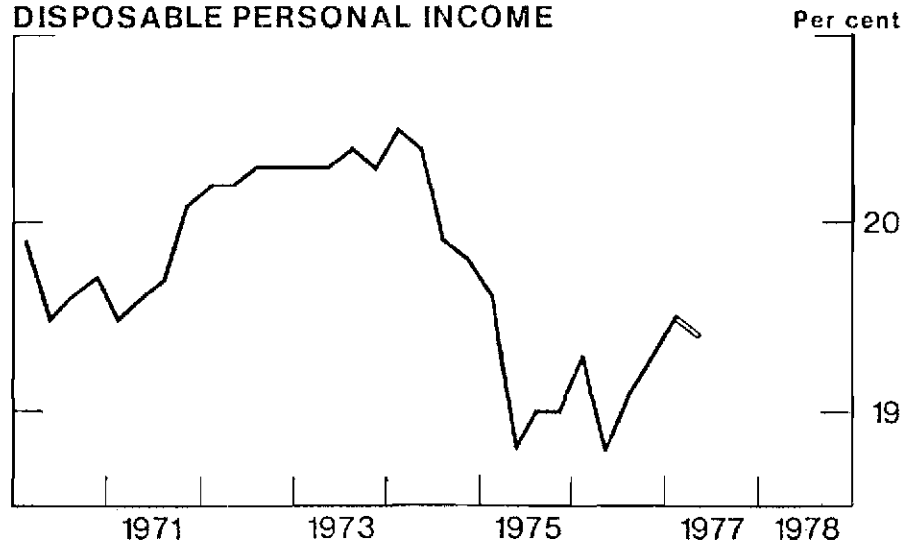
COMMERCIAL BANKS



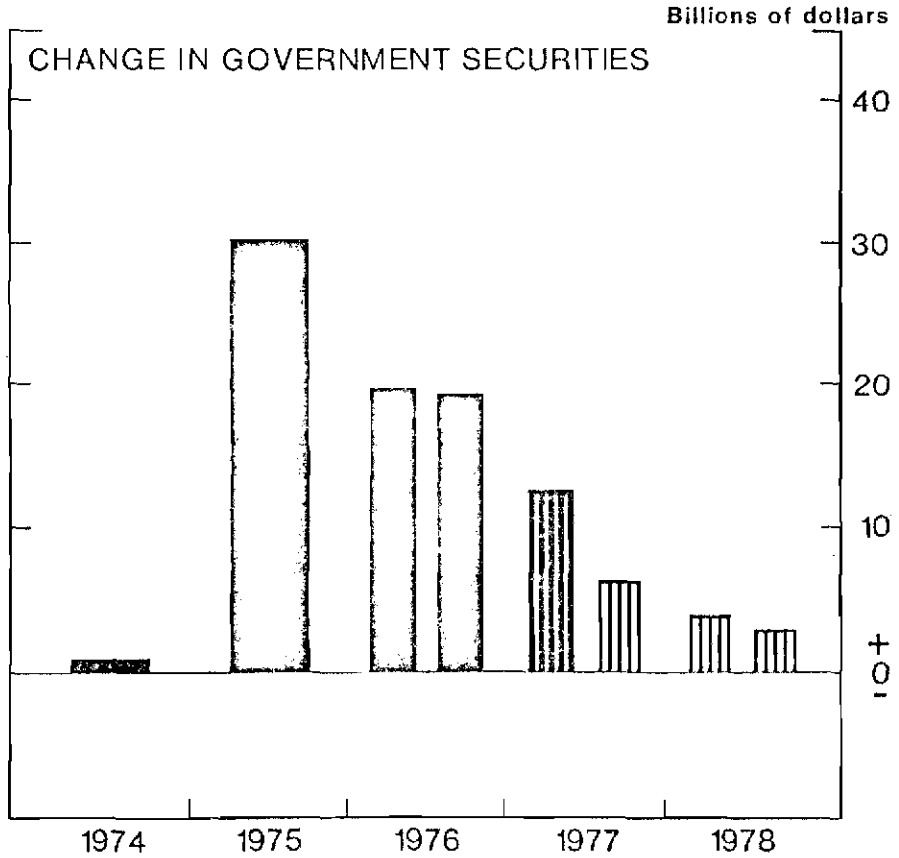
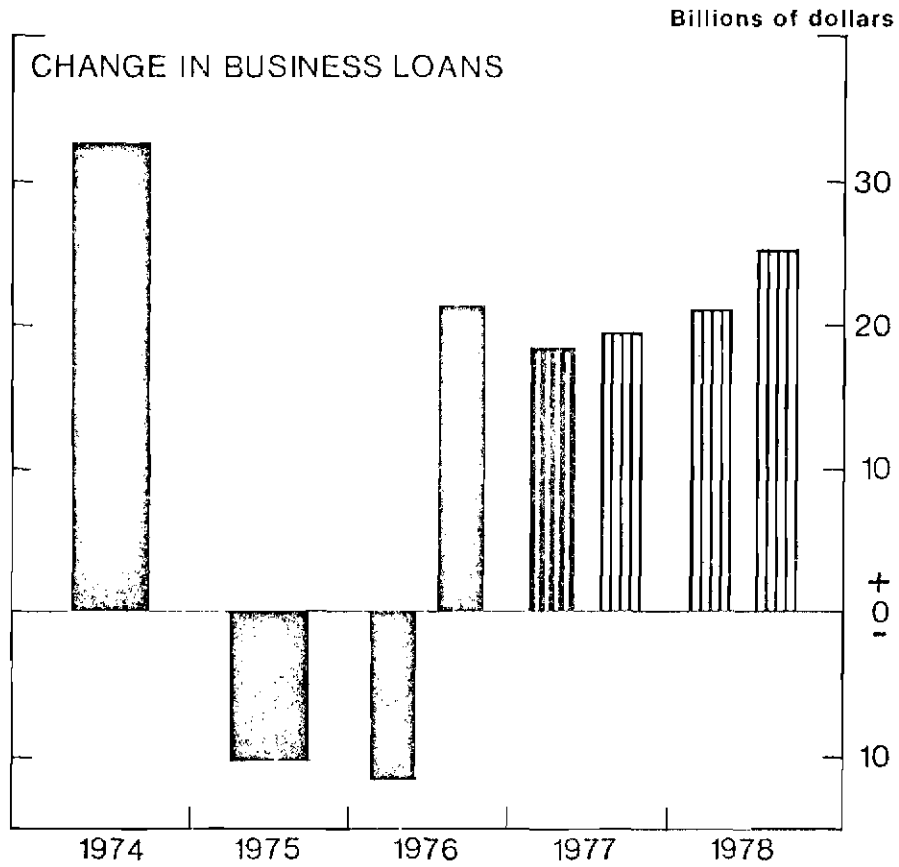
NONFINANCIAL CORPORATIONS



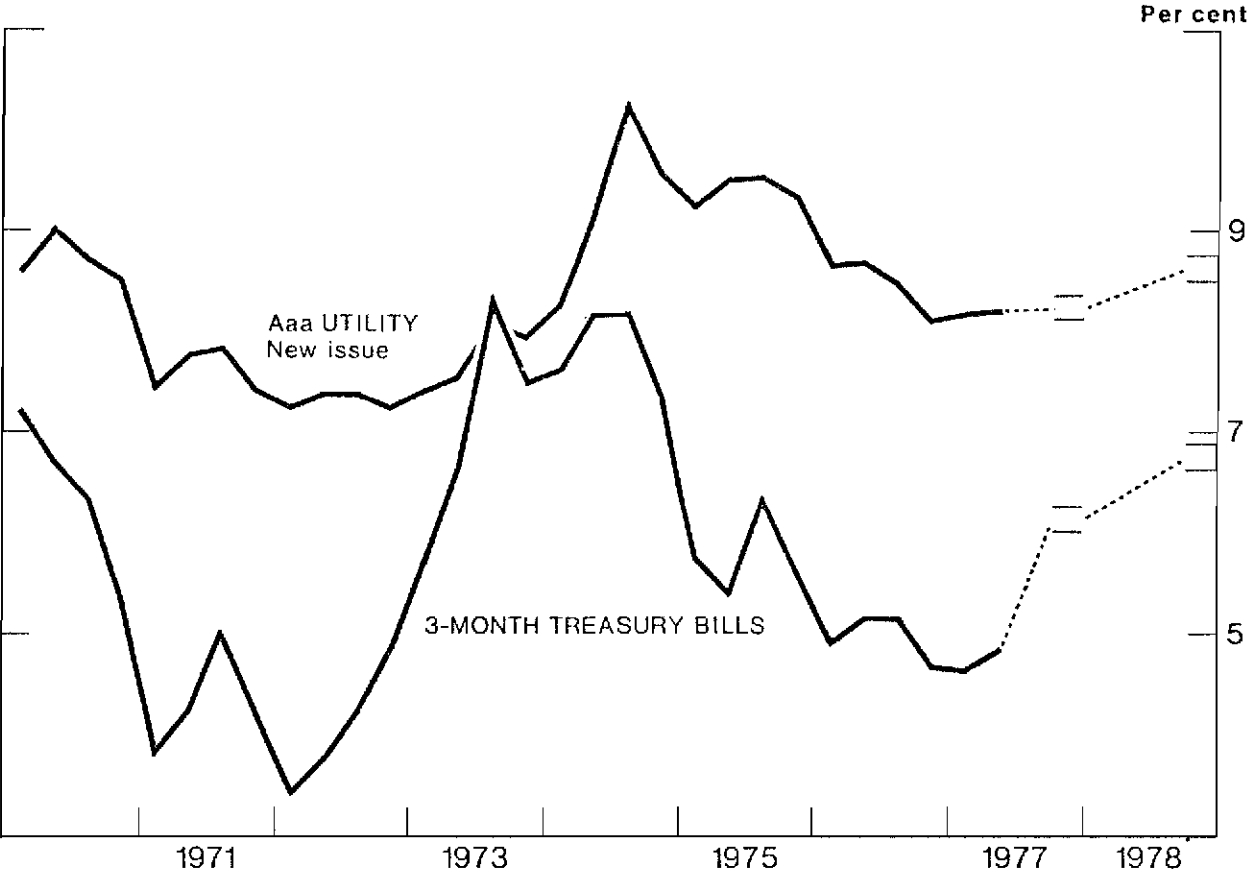
HOUSEHOLD DEBT REPAYMENTS RELATIVE TO DISPOSABLE PERSONAL INCOME



COMMERCIAL BANKS



INTEREST RATES



CONFIDENTIAL (FR) Class II-FOMC

*Material for
Staff Presentation at the
July FOMC Meeting*

July 19, 1977

PRINCIPAL ASSUMPTIONS

MONETARY POLICY

- Growth of M_1 averaging 5½% annual rate through 1978
- Growth of M_2 averaging 8¼% annual rate through 1978

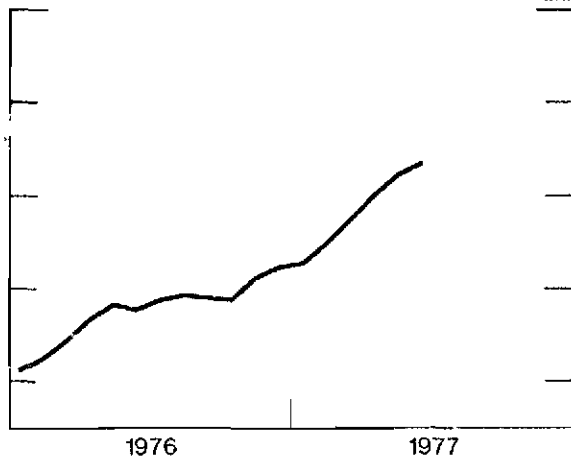
FISCAL POLICY

- Unified budget expenditures of \$404 billion in FY 1977
- Unified budget expenditures of \$457 billion in FY 1978

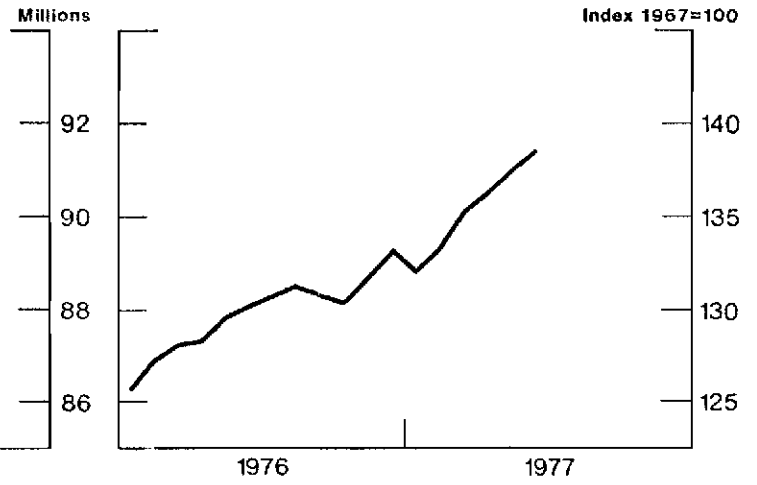
ENERGY PROGRAM

- Wellhead tax of \$3.50 per barrel on domestically produced "old" oil

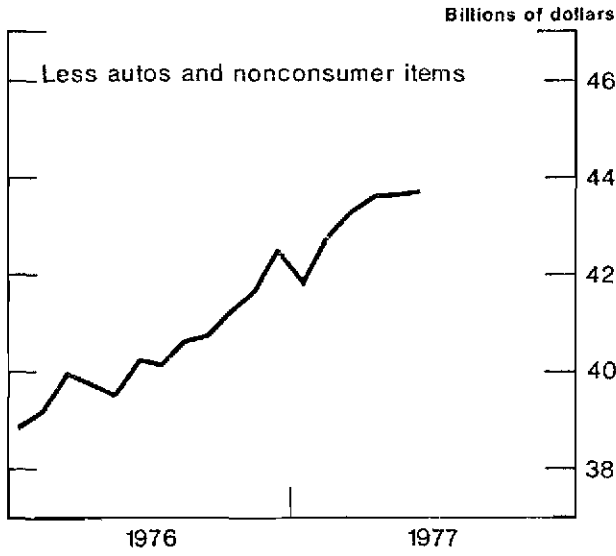
TOTAL EMPLOYMENT



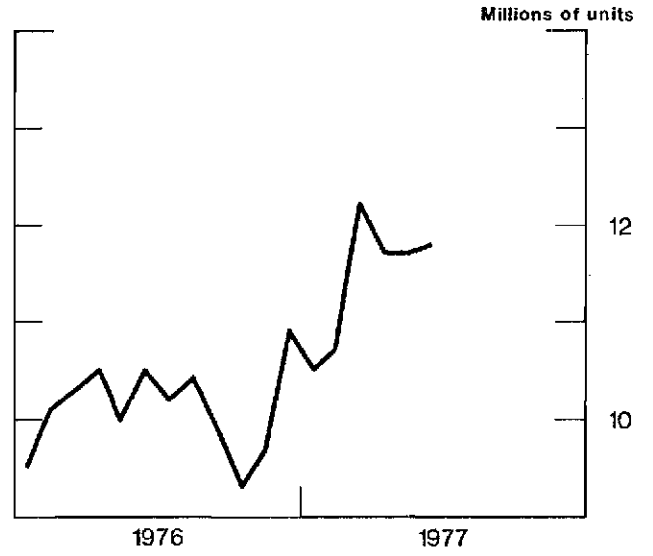
INDUSTRIAL PRODUCTION



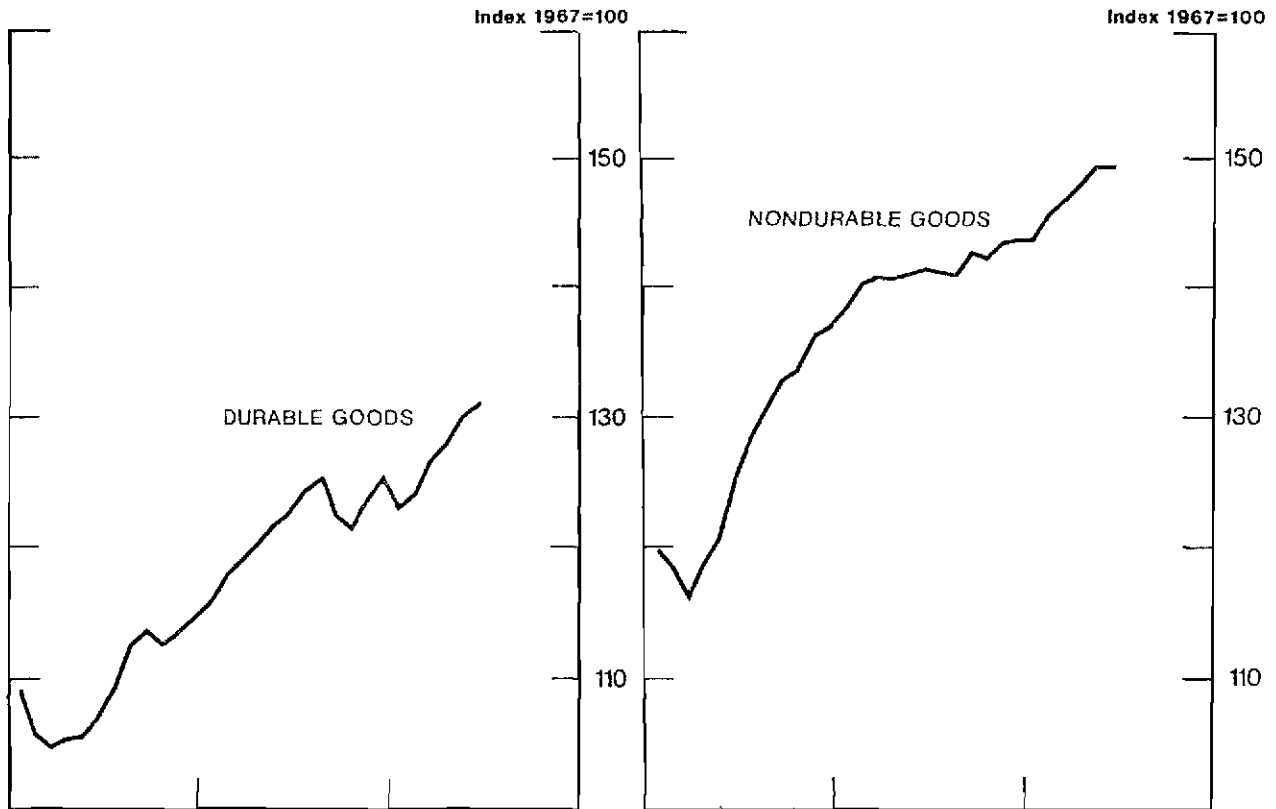
RETAIL SALES



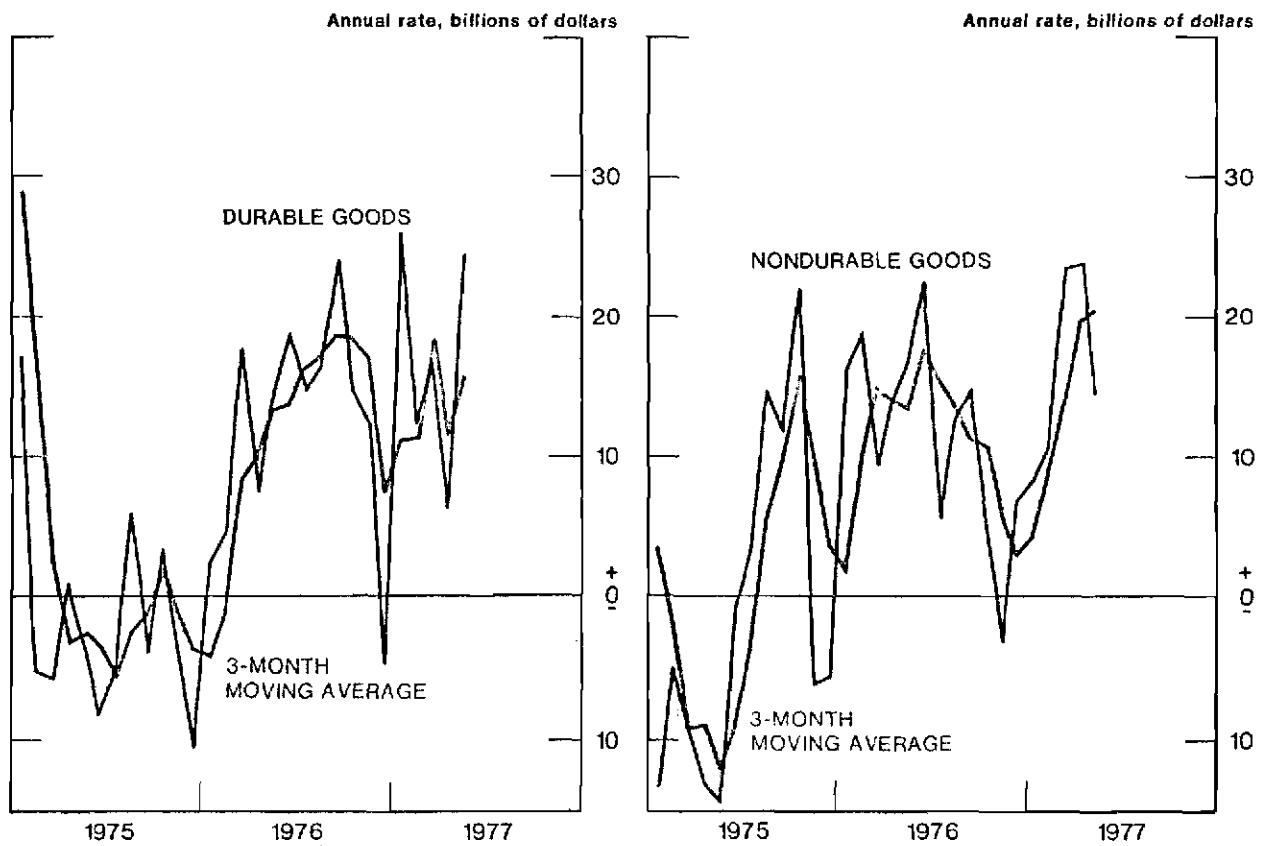
TOTAL AUTO SALES



OUTPUT IN MANUFACTURING

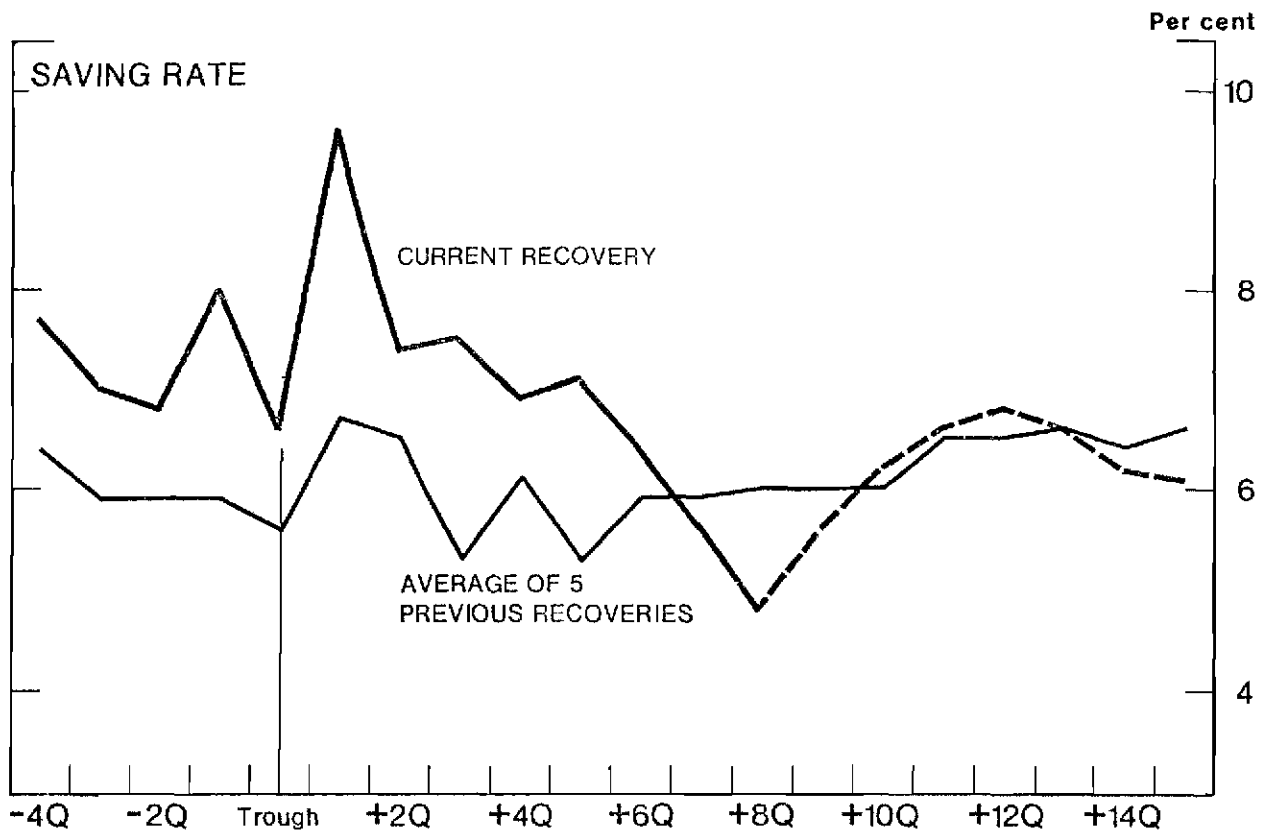
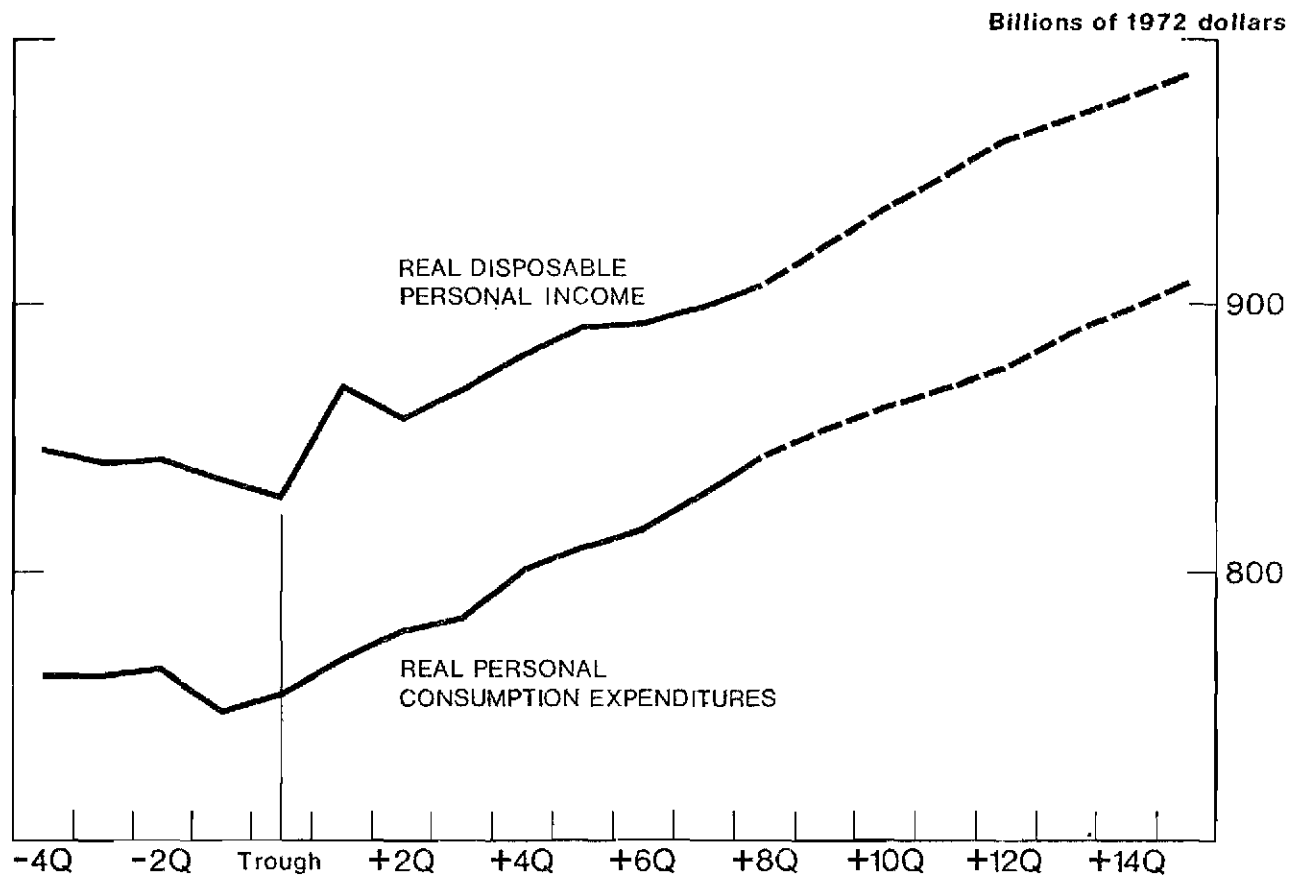


BUSINESS INVENTORIES Change in book value

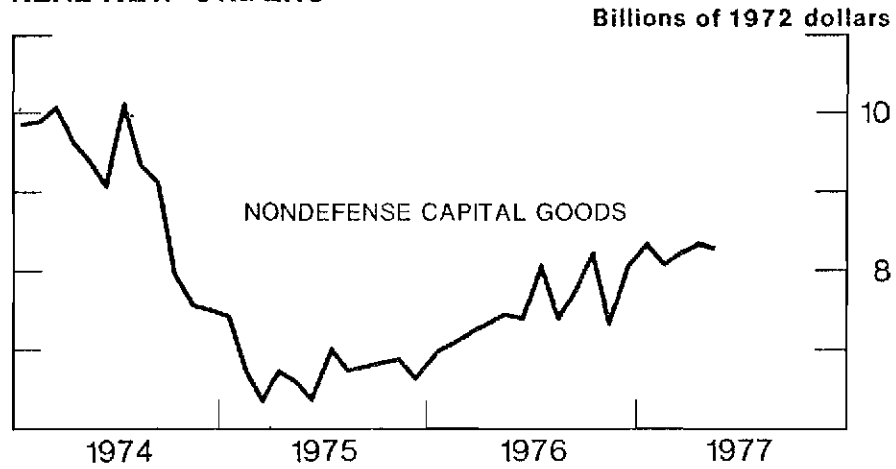


RATIOS: INVENTORIES TO SALES

	Total mfg. & trade	Manufacturers			Total trade	Retail Trade	
		Total	Durable	Non- durable		Durable excl. auto	Nondurable goods stores
1970	1.65	1.90	2.34	1.39	1.39	2.68	1.17
1971	1.61	1.83	2.22	1.37	1.40	2.63	1.19
1972	1.53	1.67	2.00	1.29	1.38	2.55	1.20
1973	1.47	1.59	1.90	1.22	1.34	2.49	1.20
1974	1.52	1.68	2.08	1.24	1.36	2.56	1.24
1975	1.60	1.80	2.34	1.26	1.39	2.66	1.19
1976	1.50	1.64	2.03	1.22	1.36	2.56	1.19
1976:QI	1.50	1.65	2.07	1.21	1.36	2.53	1.19
QII	1.51	1.64	2.03	1.22	1.37	2.57	1.22
QIII	1.53	1.67	2.04	1.27	1.38	2.64	1.21
QIV	1.51	1.65	2.03	1.25	1.37	2.57	1.18
1977:QI	1.47	1.58	1.93	1.20	1.36	2.63	1.20
QII (May)	1.46	1.58	1.91	1.21	1.34	2.54	1.20



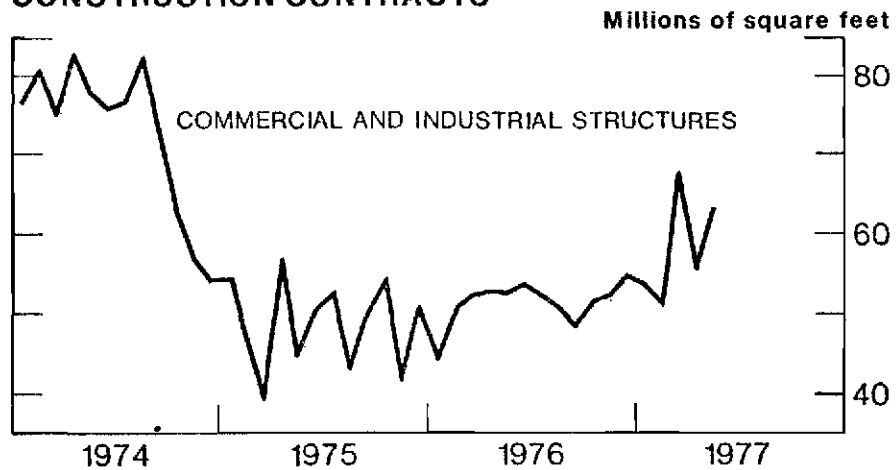
REAL NEW ORDERS



REAL NEW CAPITAL APPROPRIATIONS

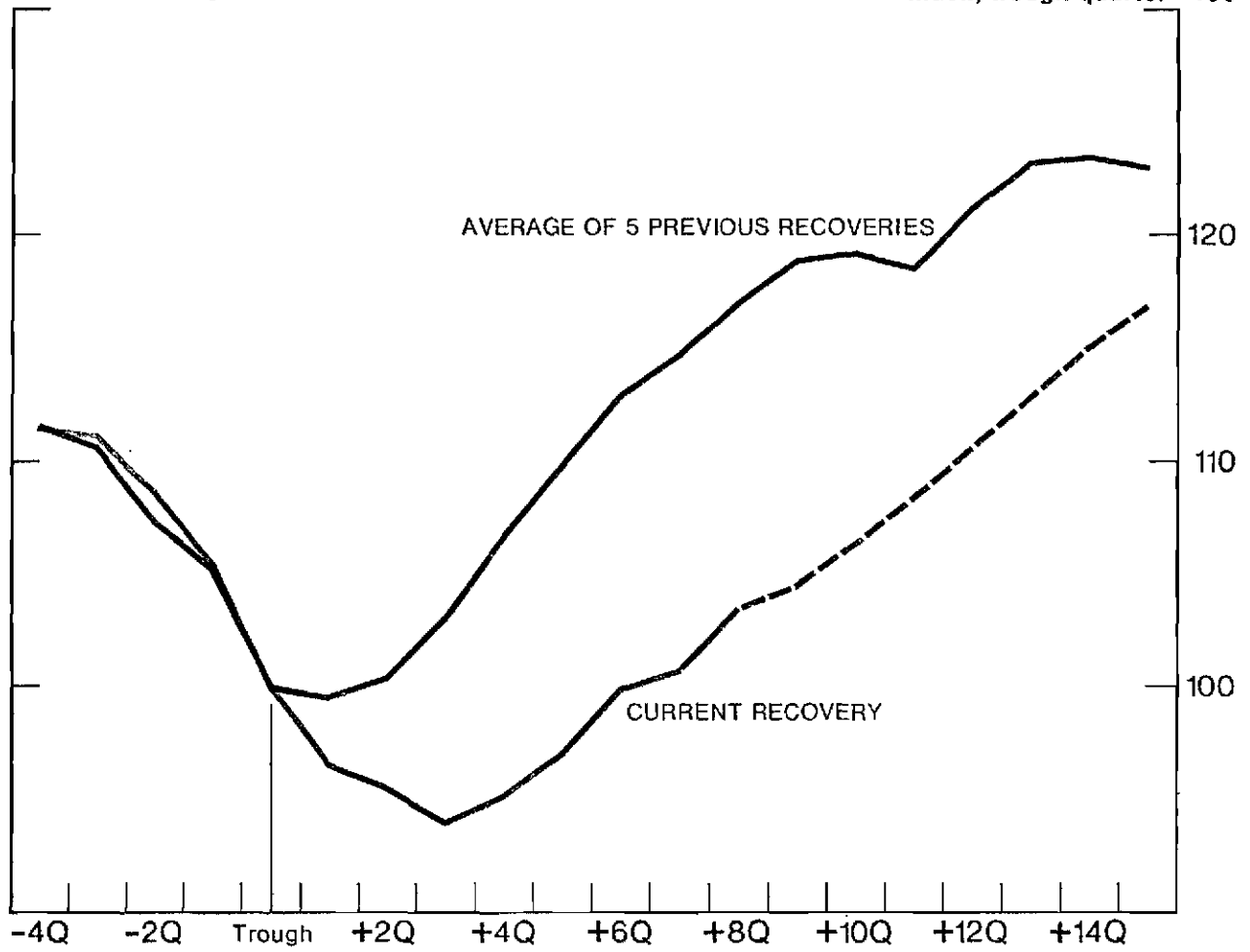


CONSTRUCTION CONTRACTS



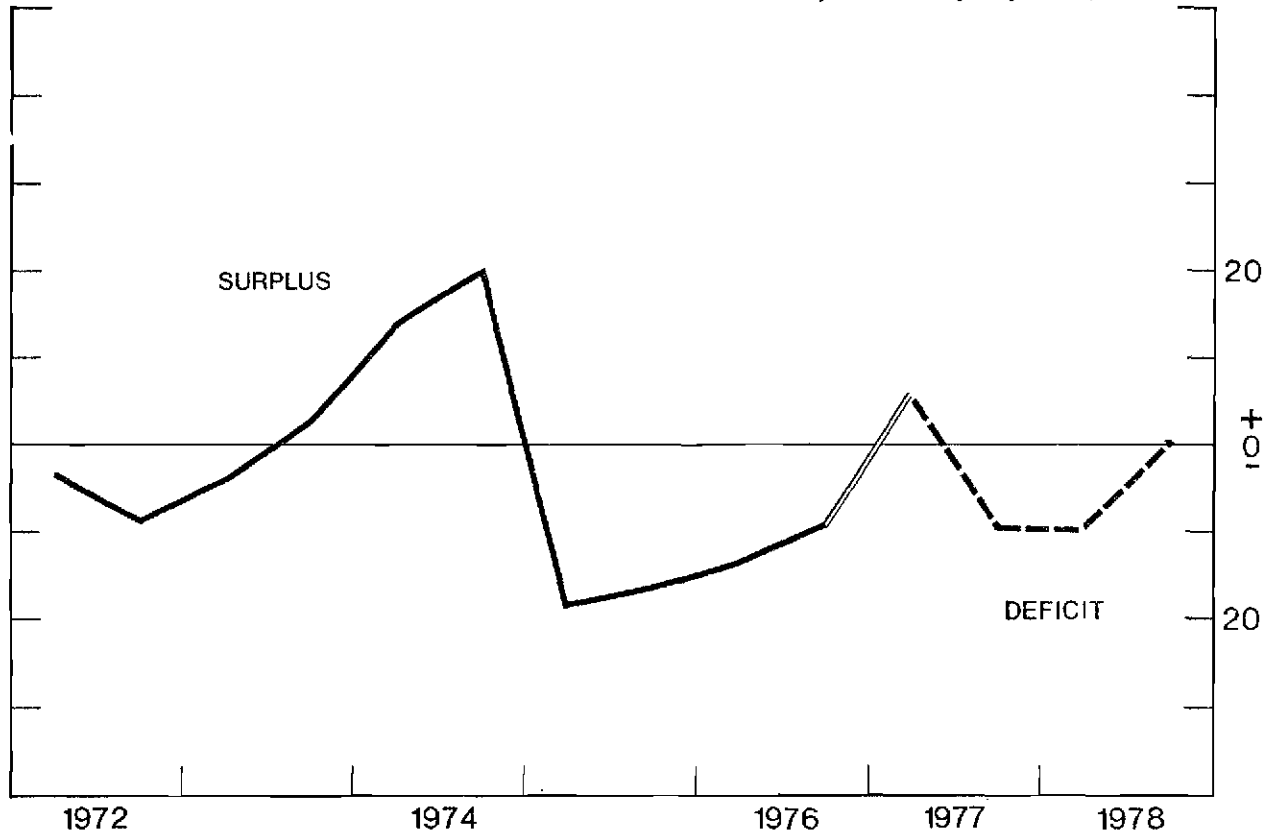
REAL PLANT AND EQUIPMENT EXPENDITURES 1972 dollars

Index, trough quarter = 100

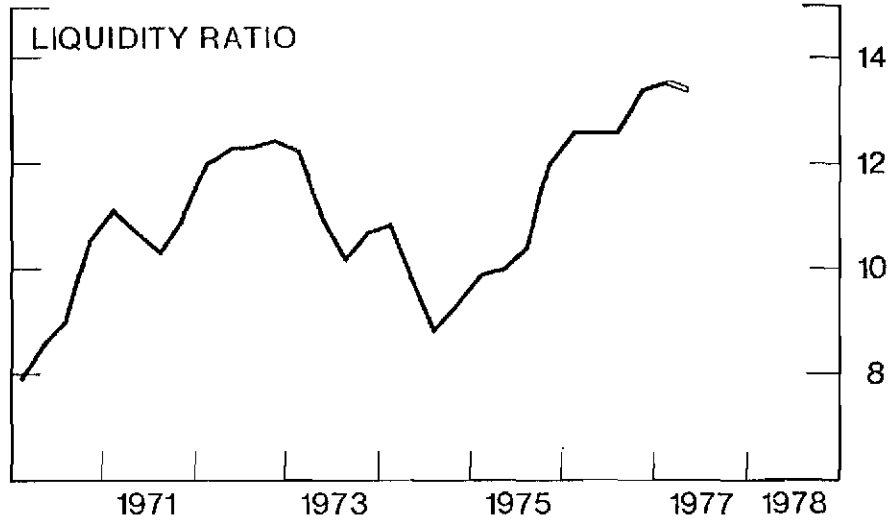


HIGH EMPLOYMENT BUDGET

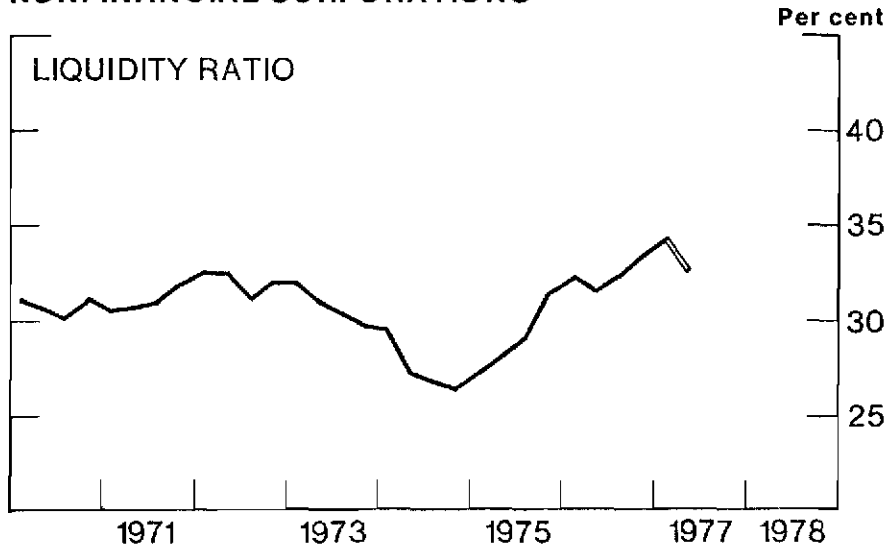
Billions of dollars, seasonally adjusted, annual rates



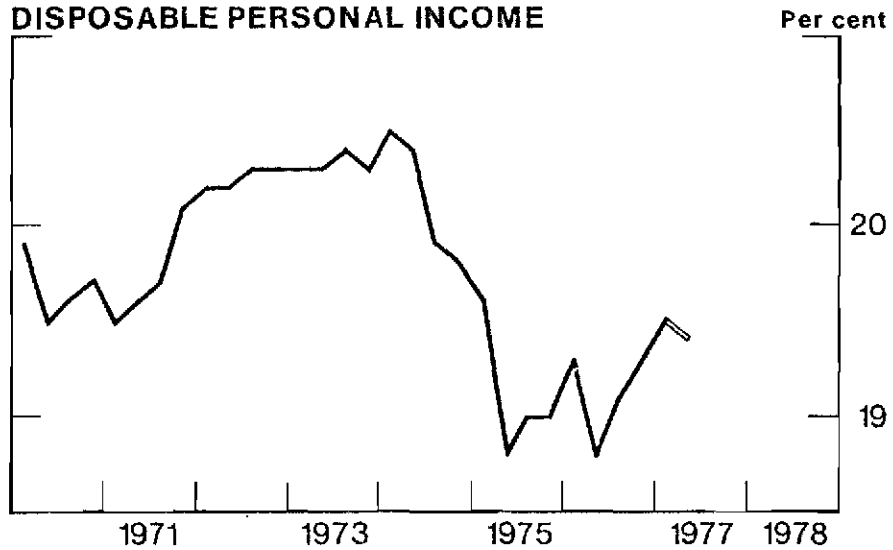
COMMERCIAL BANKS



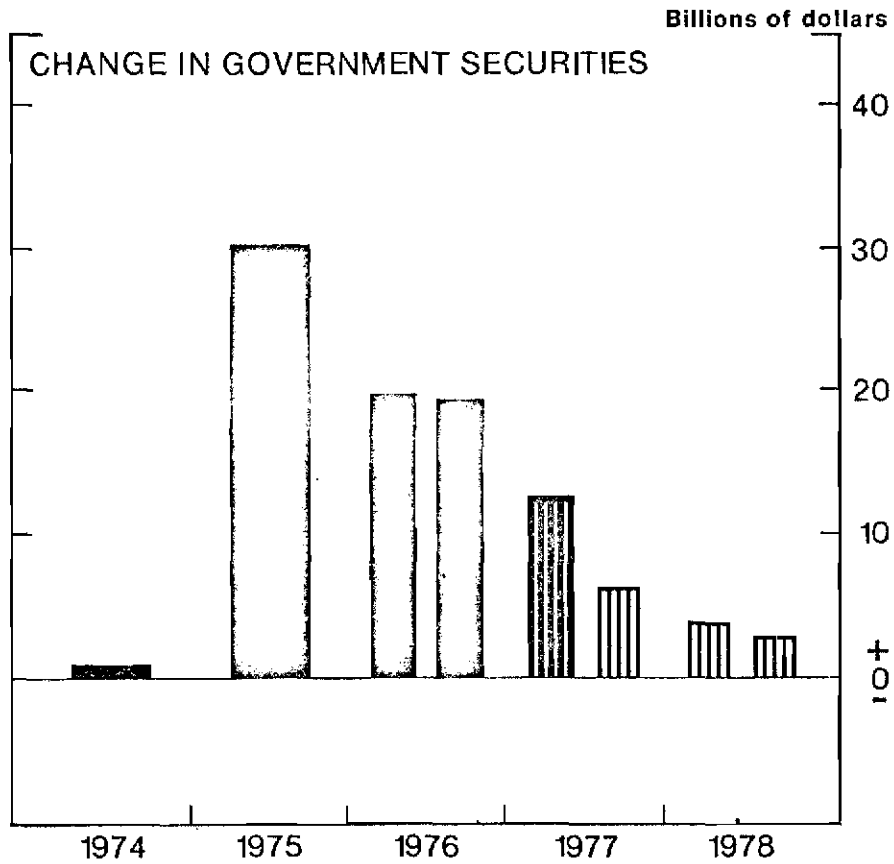
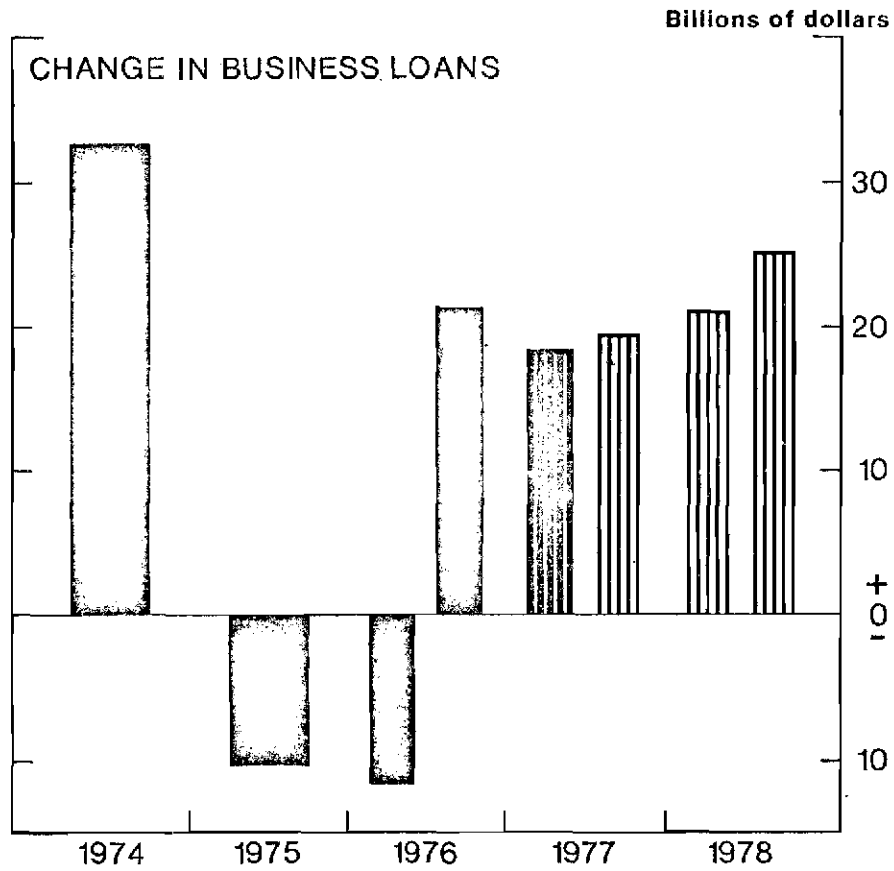
NONFINANCIAL CORPORATIONS



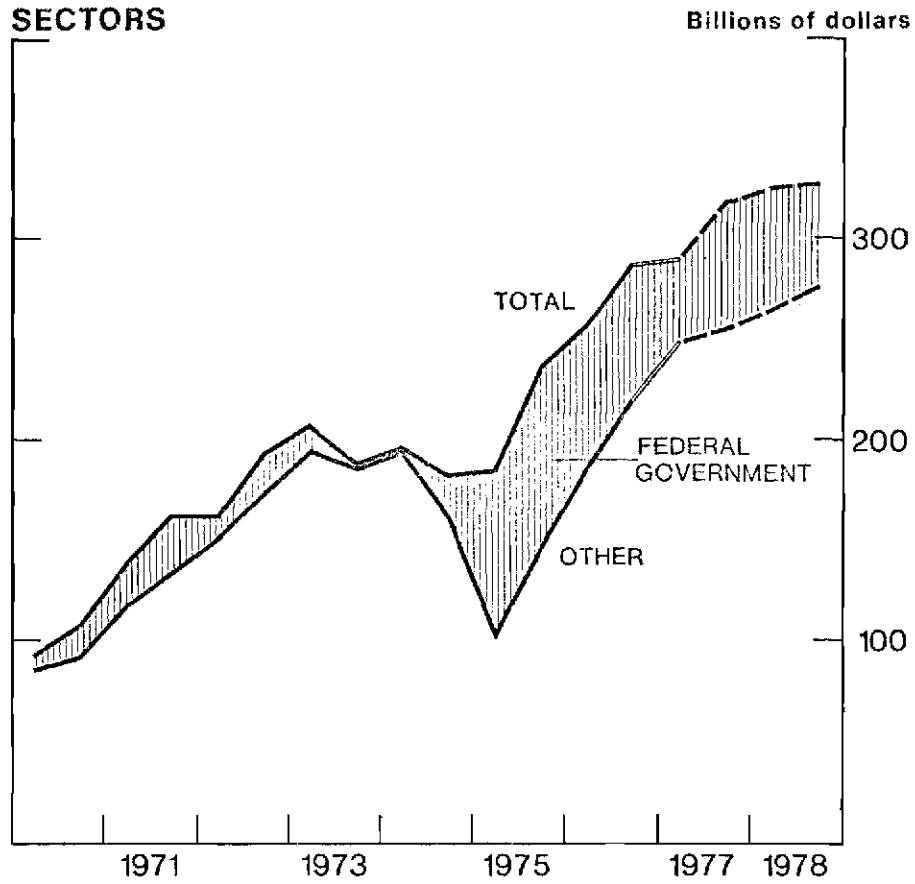
HOUSEHOLD DEBT REPAYMENTS RELATIVE TO DISPOSABLE PERSONAL INCOME



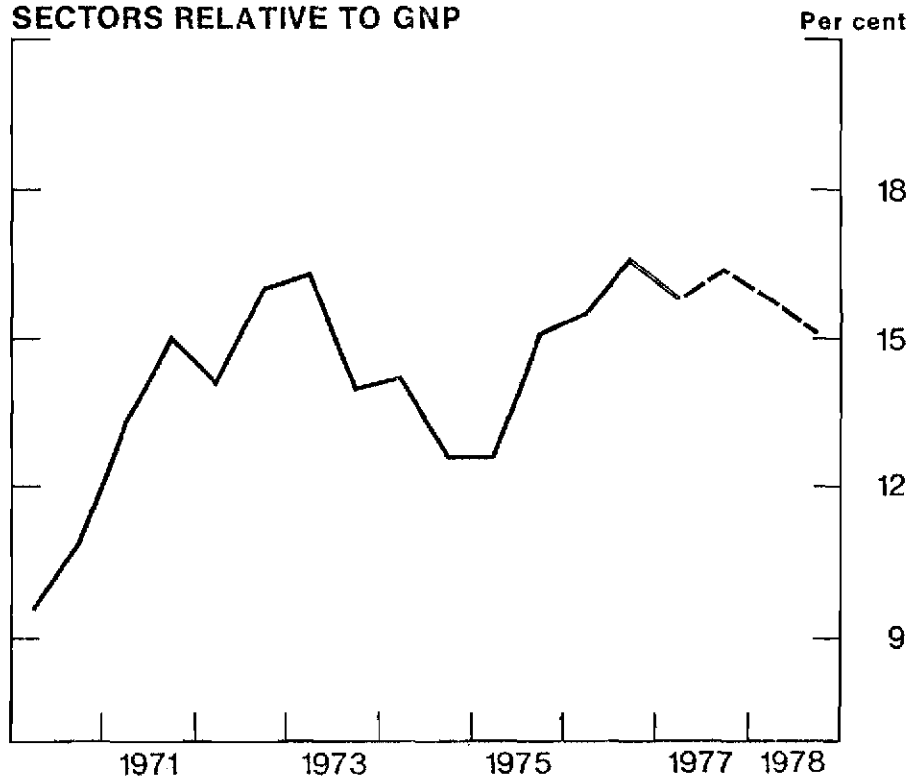
COMMERCIAL BANKS

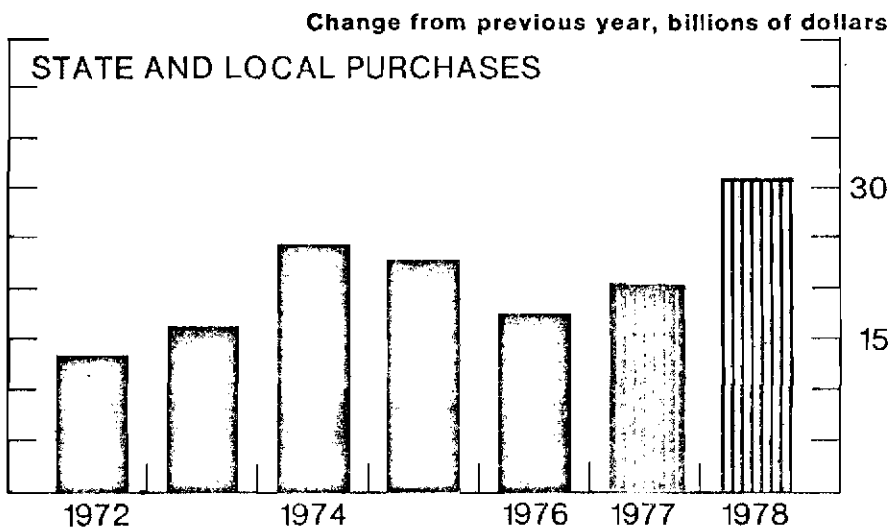
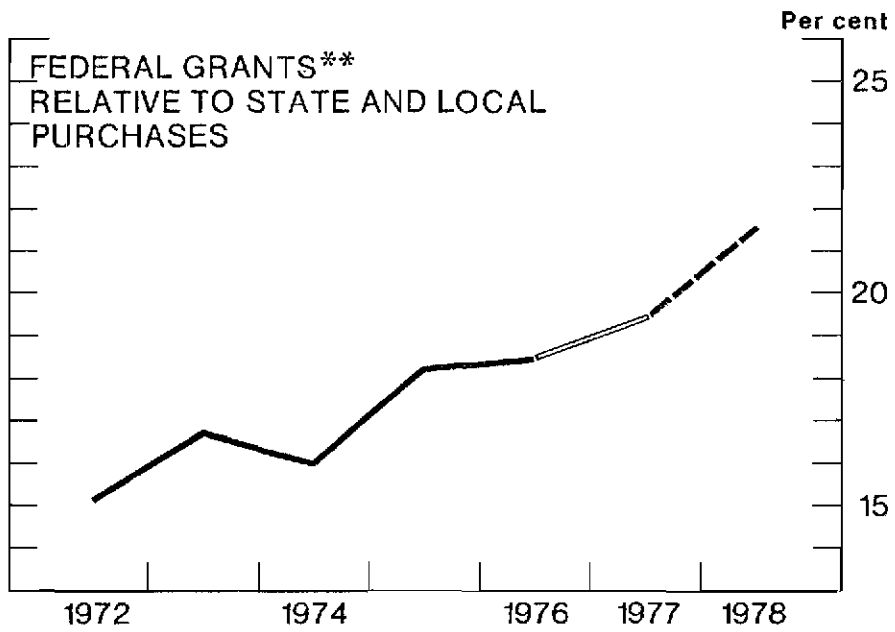
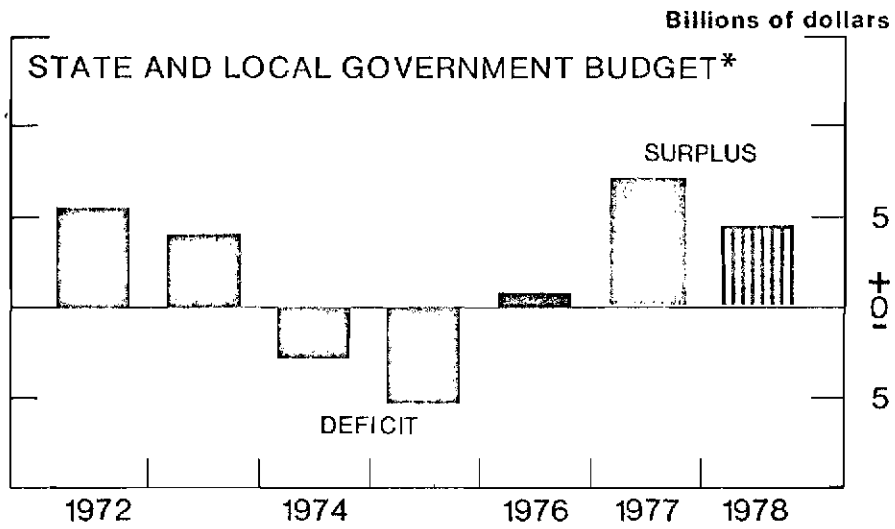


FUNDS RAISED BY NONFINANCIAL SECTORS



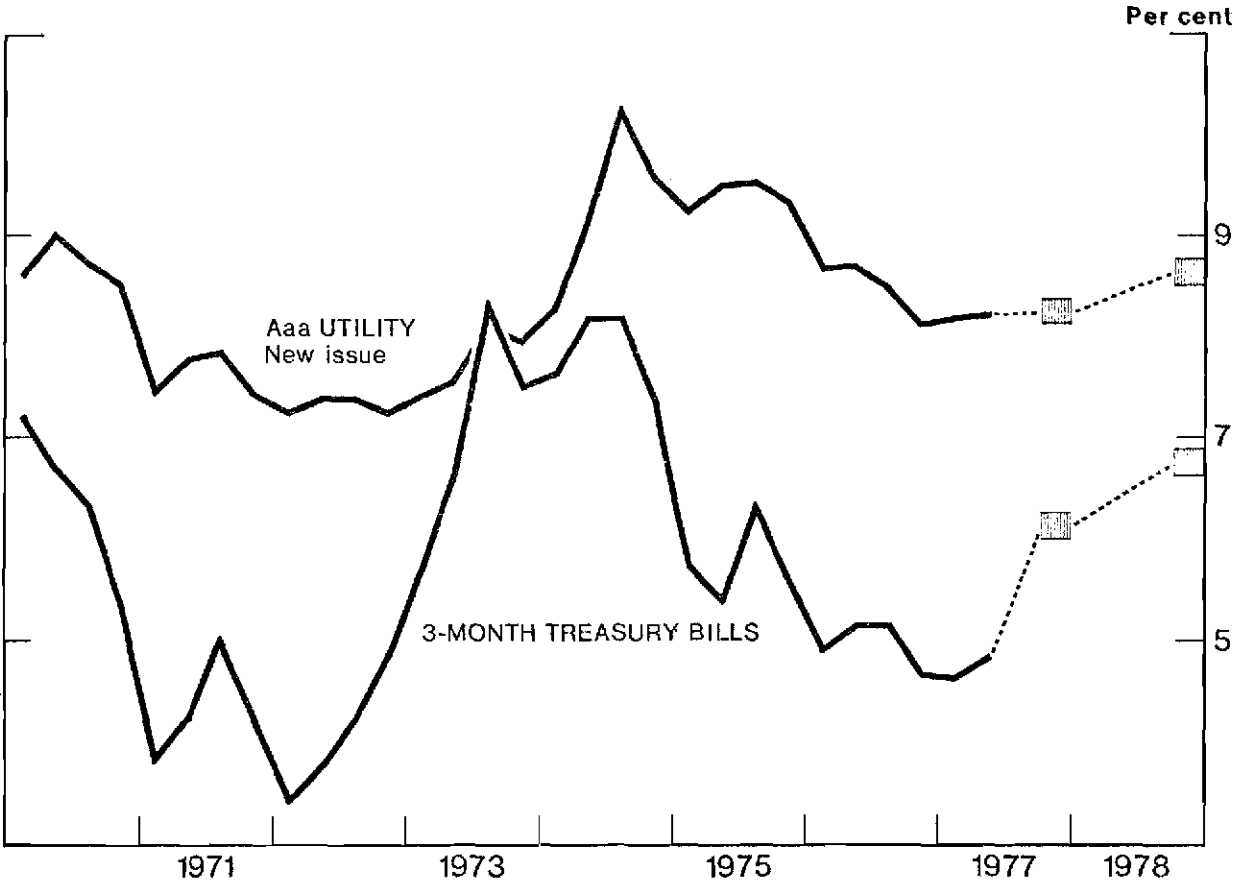
FUNDS RAISED BY NONFINANCIAL SECTORS RELATIVE TO GNP





*Net of social insurance funds.
 **Less public assistance grants. 1976 estimated.

INTEREST RATES



REPORT ON OPEN
MARKET OPERATIONS

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

Desk operations since the June meeting of the Committee have been aimed steadily at maintaining reserve availability consistent with Federal funds remaining around 5 3/8 percent. Estimates of monetary growth gradually strengthened during the period but projections did not quite reach the point that would call for a firming stance by the Desk, given the emphasis of the directive on maintaining prevailing money market conditions. The actual rate averaged almost exactly 5 3/8, although it was a bit higher in the early part of the period when the System was injecting reserves, and a shade lower in the latter weeks of the interval when the System turned to absorption. Even the massive complications in reserve management near the end of the period due to the power failure in New York led to little deviation in the funds rate, in part because market participants are well inured to that rate level which has prevailed since late April.

Early in the interval, to help meet the large reserve need occasioned by the buildup in Treasury deposits after the mid-June tax date, the System bought nearly \$1.2 billion of Treasury bills in the market and about \$580 million of bills from foreign accounts. Later in the interval, outright holdings of bills were reduced by \$300 million through redemption in an auction while about

\$750 million of bills were sold to foreign accounts. Outright purchases in the first half of the period were supplemented by short-term repurchase agreements--in particularly large size around the June 30 to July 5 period when reserve needs were great and banks were managing their reserve positions cautiously because of the end-of-quarter statement date and the extended July 4 weekend.

The System Account arranged matched sale-purchase transactions on a few occasions in the market in order to absorb reserves, and arranged such transactions with foreign accounts each day of the period--in line with the interim procedure indicated at the last meeting of the Committee, pending receipt of an IRS ruling that would resolve the question of tax liability on the part of foreign accounts. The draft request for such a ruling has been reviewed by Treasury tax officials, and according to my latest information should be ready for formal presentation to IRS, with support from the Treasury, within a few days.

Early in the interval, interest rates moved somewhat lower against a background of modest perceived growth in money supply and a market view that Treasury needs were continuing to turn out lighter than expected. A further strengthening influence in the Treasury coupon sector was the low level of dealer inventories; in fact, positions in over-one-year maturities were net short by around \$500 million near the start of the period. In this atmosphere the market showed good bidding interest in a \$1.5 billion auction of two-year notes early in the period and particularly aggressive interest in

a \$1.5 billion auction of 15-year bonds on June 29. In that auction, dealers bid ahead of existing customer interest and took down a large share of the issue in hopes that customer purchases would develop at the lower rate level set in the bidding. As it turned out, market sentiment became much more cautious after June 29--initially, it seemed, because investor interest was laggard at the auction. Later, the market softened further in the wake of larger money supply numbers and a growing view that both private and governmental credit needs would increase in the second half of the year. The price of the new 15-year bond fell about 1 1/2 points from its auction average to the end of the period--but investor interest developed at the lower prices and dealers managed to work down their holdings of the new bonds as well as other issues. From a mid-period high of around \$1.2 billion, dealers' holdings of over-one-year issues fell back to a net short of about \$600 million by last Friday. On balance over the period, yields on intermediate-term Treasury issues rose about 10 to 25 basis points, while for the more actively traded longer bonds yields were up only 2 to 4 basis points. The two-year note being auctioned today is expected to go at around 6.30 percent, compared with 6.14 percent in the two-year note auction a month ago.

To some extent, the dealers' current short position reflects the prevalent market view that interest rates are likely to rise moderately over the balance of this year. In addition, market participants have begun to focus on the upcoming Treasury refunding to be announced a week from tomorrow--in which it is anticipated

that perhaps up to \$3 billion of new money might be raised on top of refunding \$3 1/4 billion of maturing issues held by the public. The System Account, incidentally, holds about \$850 million of the maturing August 15 issue and we plan as usual to exchange these notes for new securities in about the proportions that are offered to the public.

In the Treasury bill market, rates rose by some 10 to 25 basis points over the period, despite the steady Federal funds rate and sizable week-to-week paydowns of bills by the Treasury. Underlying the rate rise, apparently, was the market view that paydowns would soon be discontinued, as well as the widespread view that general credit market pressures--along with a less accommodative System posture--would tend to produce somewhat higher rates in the months ahead. In yesterday's auction of 3- and 6-month bills, the respective issuing rates were about 5.21 and 5.44 percent, compared with 5.01 and 5.22 percent the day before the last meeting.

Finally, I might note that the markets weathered the disruptions due to the July 14 blackout about as well as could be expected. Actual transactions activity in New York or between New York and other areas was suspended that day, thus virtually shutting down the Government securities market and severely curtailing most other financial markets. Fortunately, there was active communication that day, mainly by phone, and this set the stage for what seems to have been on the whole an orderly subsequent resolution of the myriad problems created by skipped deliveries and payments.