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CONFIDENTIAL (FR)
CLASS II - FOMC

February 14, 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

The Domestic Nonfinancial Economy

The wholesale price index for January fell 0.3 per cent, seasonally adjusted (not at an annual rate), to a level 17.2 per cent above that of a year earlier. This was the second consecutive monthly decline in the total index. It reflected lower prices for farm and food products which were partially offset by a rise in prices of industrial commodities.

WHOLESALE PRICES
(Per cent changes at seasonally adjusted compound annual rates)1/

	Jan'74 to Jan'75	Dec'73 to Mar'74	Mar'74 to June'74	June'74 to Sept'74	Sept'74 to Dec'74	Dec'74 to Jan'75
All commodities	17.2	24.5	12.2	35.2	13.4	-4.0
Farm products	3.4	10.8	-29.3	59.2	21.9	-30.5
Industrial commodities	23.8	32.3	35.7	28.3	8.2	6.3
Crude materials	16.6	88.7	10.4	29.1	-14.8	-16.7
Intermediate materials	26.9	32.6	43.7	32.2	8.2	6.9
Finished goods	20.2	23.1	25.9	22.7	13.3	11.1
Producer	22.7	13.2	27.2	31.8	18.7	15.5
Consumer	18.9	28.3	25.3	18.5	10.6	8.9
Nondurable, excl. food	21.5	40.4	30.9	19.1	7.7	9.9
Durable	13.6	11.3	15.0	15.6	17.4	4.4
Consumer finished foods	8.8	17.3	-16.7	29.4	29.1	-10.8

Note: Farm products include farm products and processed foods and feeds.
1/ Not compounded for one-month changes.

The index of farm and food products decreased 2.5 per cent, seasonally adjusted, mainly as a result of declines for grains, soybeans, and manufactured animal feeds.

The index of industrial commodities rose 0.5 per cent, seasonally adjusted, with most of the rise accounted for by increases for machinery and equipment, fuels and power, woodpulp and paper products, chemicals, and nonmetallic minerals. The index is 23.8 per cent above the level of a year ago.

Wholesale trade inventories. Book value of wholesale trade inventories fell at an annual rate of $2.8 billion in December, in contrast to the upward revised November growth rate of $6.8 billion and the fourth quarter annual rate of $5.9 billion. This fourth quarter rate of accumulation is below the third quarter rate of $8.6 billion.

Data on retail inventories in December have just been received, and they show little change for the month.

Merchant builder sales of new single-family homes dropped sharply in December to a seasonally adjusted annual rate of 364,000 units--a record low for the series which began in 1963. The December sales rate brought the fourth quarter 1974 average to nearly a fifth below the third quarter and the lowest in 8 years. Although builder backlogs of unsold homes at year-end were still quite large--13 months' supply at the current sales rate--they were a tenth below their year-earlier level. The median price of the mix of homes sold in December increased from that in November and continued above the rising median price of unsold units. In the market for existing homes, sales in December were below a year earlier for the third consecutive month. The median price of such units rose to $32,720--11 per cent above December 1973.

SALES, STOCKS AND PRICES OF NEW SINGLE-FAMILY HOMES

	Home sold 1/	Homes for sale 2/	Months' supply	Median price of: Homes sold	Homes for sale
	(thousands of units)			(thousands of dollars)	
1973					
QI	726	426	7.0	30.4	29.4
QII	680	436	7.7	32.7	31.2
QIII	566	453	9.6	33.5	32.1
QIV	483	446	11.1	34.0	32.9
1974					
QI	525	453	10.4	35.2	34.0
QII	567	435	9.2	35.6	35.0
QIII (r)	489	414	10.2	36.2	35.7
QIV (p)	400	401	12.0	37.3	36.2
Sept. (r)	500	414	9.9	36.2	35.7
Oct. (r)	412	409	11.9	37.2	35.9
Nov. (r)	423	403	11.4	37.2	36.0
Dec. (p)	364	401	13.2	37.5	36.2

1/ Seasonally adjusted annual rate.
2/ Seasonally adjusted stock at end of period.

The Domestic Financial Situation

Mortgage rates. According to the HUD(FHA) opinion survey, average interest rates on new commitments for conventional new-home mortgages fell substantially further during January to 9.15 per cent, while rates on commitments for existing-home mortgages fell to 9.20 per cent. Private secondary market yields on FHA-insured new-home mortgages were 8.99 per cent at the end of January--52 basis points below the December rate and 139 basis points below the high at the end of September.

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

End of Month	Primary market: Conventional loans: Level 2/ (per cent)	Primary market: Conventional loans: Spread 4/ (basis points)	Secondary market 1/: FHA-insured loans: Level 3/ (per cent)	Secondary market 1/: FHA-insured loans: Spread 4/ (basis points)	Secondary market 1/: FHA-insured loans: 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.)
July	9.40	n.a.	9.85	n.a.	6.3
Aug.	9.60	-39	10.30	31	5.8
Sept.	9.80	-66	10.38	- 8	6.3
Oct.	9.70	-33	10.13	10	4.6
Nov.	9.55	-13	--	--	--
Dec.	9.45	n.a.	9.51	n.a.	3.8
1975-Jan.	9.15	15	8.99	- 1	3.8

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 rate (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.

INTEREST RATES

	1974 Highs	1974 Lows	1975 Jan. 20	1975 Feb. 13
Short-Term Rates				
Federal funds (wkly. avg.)	13.55(7/3)	8.81(2/27)	7.17(1/22)	6.28(2/12)
3-month				
Treasury bills (bid)	9.74(8/23)	6.93(2/6)	6.42	5.62
Comm. paper (90-119 day)	12.25(7/17)	7.75(2/22)	7.25	6.38
Bankers' acceptances	12.50(8/15)	7.75(2/26)	7.35	6.45
Euro-dollars	14.38(7/16)	8.25(2/18)	8.13	7.63
CD's (NYC) 90-119 day				
Most often quoted new	12.00(9/4)	7.88(2/20)	6.63(1/22)	6.25
6-month				
Treasury bills (bid)	9.86(8/23)	6.80(2/19)	6.45	5.70
Comm. paper (4-6 mo.)	12.13(7/10)	7.50(2/22)	7.25	6.38
Federal agencies	10.63(8/28)	7.16(2/19)	7.02	6.14(2/11)
CD's (NYC) 180-269 day				
Most often quoted new	11.90(8/21)	7.50(2/27)	7.00(1/22)	6.35
1-year				
Treasury bills (bid)	9.65(8/23)	6.37(2/15)	6.44	5.60
Federal agencies	10.18(8/26)	7.01(2/19)	7.16	6.27(2/11)
CD's (NYC)				
Most often quoted new	9.75(7/17)	7.00(2/27)	7.00(1/22)	6.00
Prime municipals	6.50(7/12)	3.70(2/15)	3.70(1/22)	3.50(2/14)
Intermediate and Long-Term				
Treasury coupon issues				
5-years	8.79(8/23)	6.72(2/14)	7.44	7.09(2/11)
20-years	8.72(8/26)	7.40(1/4)	7.82	7.68(2/11)
Corporate				
Seasoned Aaa	9.40(10/8)	7.73(1/2)	8.78	8.63
Baa	10.53(12/2)	8.54(1/2)	10.63	10.45
New Issue Aaa Utility	10.61(10/2)	8.05(2/13)	9.45(1/23)	9.02p(2/13)
Municipal				
Bond Buyer Index	7.15(12/12)	5.16(2/6)	6.59(1/23)	6.27(2/13)
Mortgage--average yield in FNMA auction	10.59(9/9)	8.43(2/25)	9.37(1/13)	8.98(2/10)

CORRECTION:

Part II - Section III,page III-T-1. Table - Selected Domestic Financial Data

In January, M_1 declined at a 9.7 per cent annual rate, not the +9.7 per cent rate shown in the table.

SUPPLEMENTAL APPENDIX A
PROBLEMS OF THE ELECTRIC UTILITIES*

Prospects for moving toward the President's goal of energy independence may have been impaired by the unfavorable set of developments that plagued the electric utility industry during 1974. These developments were brought to a head by the oil embargo of late 1973 which abruptly multiplied the cost of fuel. Even though most State utility commissions permit automatic adjustments for higher fuel costs, recovery of these costs is not complete and in any event tends to be delayed from two to four months.

The sharp jump in fuel prices--along with the general inflation of other utility operating costs and steeply rising financing costs--forced substantial increases in utility rates during 1974. High utility rates and energy conservation measures led, in turn, to reduced demands for utility services. This increased the relative burden of the industry's heavy fixed costs, added to unit operating costs, and put further upward pressures on utility rates.

With the utilization of existing plant being cut back by reduced demand, the utilities trimmed plans for capital expansion. Unfortunately, these cutbacks tended to center on programs for expanding nuclear generating capacity, since these require the largest initial capital investments and were adding most severly to the squeeze on the industry's financing capacity. Over the longer run these deferrals of nuclear plant expansion may prove costly, because nuclear facilities promise the most substantial savings in operating expenses.

Most recently, financing difficulties of the utilities have been somewhat relieved by the development of easier conditions in credit markets. Moreover, the President is proposing a number of special programs to encourage business investment spending which--if adopted--should provide some stimulus to the electric utilities.

Financial Status of Electric Utilities

The recent unfavorable effects of high utility rates and reduced electricity sales on utility profits are shown in the following table.

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* Prepared by Margaret H. Pickering, Economist, Capital Markets Section, Division of Research and Statistics, and Stephen Roach, Economist, National Income, Labor Force and Trade Section.

CORPORATE PROFITS BEFORE TAX AND
INVENTORY VALUATION ADJUSTMENT
(billions of dollars)

	Total Domestic Nonfinancial	Electric, Gas and Sanitary Service Utilities
1972	69.3	4.1
1973	78.2	4.2
1973 - I	78.2	4.1
II	78.6	3.8
III	78.1	4.5
IV	77.9	4.2
1974 - I	73.8	2.5
II	77.0	2.6
III	76.4	3.0

Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Even before this 1974 deterioration in earnings, the electric utility industry was suffering from illiquidity. Since 1966, current liabilities have exceeded current assets, and, the gap has widened over the past year, reflecting, in large part, the need to finance much more expensive fuel inventories. In contrast, other nonfinancial corporations during this period generally experienced moderate increases in working capital.

During the 1974 period of peak financing pressure, the combination of weaker earnings performance and continued heavy bond financing substantially widened the spread of interest rates paid by electric utilities over those paid by industrial firms in the same bond-rating category. Thus, spreads between interest rates on new Aa utility bonds and industrial bonds in the same quality category rose from 20-30 basis points early in 1974 to 80-90 basis points during the summer. Most recently, with the general decline of interest rates, these spreads have narrowed to 30-40 basis points.

The omission of its traditional quarterly dividend by the Consolidated Edision Company of New York in April played a large role in triggering the increased market sensitivity to the quality of electric utility debt and equity issues during the summer. This change of attitude was highlighted by actions of the bond-rating services which downgraded the bond ratings of an unusually large number of electric utilities during the months surrounding the Consolidated Edison omission.

The general deterioration in the financial position of electric utilities during 1974 was reflected in a rash of postponements of scheduled debt offerings, reductions in the size of issues being offered, switches from longer-term to medium-term maturities and lengthening of call protection, as well as in sharp increases in interest rates paid. These financing difficulties were compounded by the fact that electric, gas, and water utilities had to sell an estimated $13.5 billion in long-term debt and equity issues during 1974, compared to only $10.3 billion in 1973. The mix between new debt and equity financing was heavily skewed toward debt, because additional equity financing at the prevailing extremely low stock prices would have meant severe dilution of existing owners' equity.

Capital Spending

The electric utilities have played an increasing role in investment spending over the last few years, expanding their share of business plant and equipment expenditures from 11.8 per cent in 1969 to about 16.2 per cent in 1974. But since 1972, the growth in their capital outlays has been decelerating and is expected to decelerate further during 1975.

PLANT AND EQUIPMENT EXPENDITURES OF PUBLIC UTILITIES
(per cent change from prior year)

	1970	1971	1972	1973	1974 1/	1975 2/
Public utilities	13.2	16.4	11.1	10.1	10.1	4.2
Electric	19.1	20.8	12.6	9.9	10.7	1.2

1/ Anticipations reported in November Department of Commerce survey.
2/ Anticipations reported in December Department of Commerce survey.

The erosion of anticipated expenditures became particularly evident during 1974. Early in the year, there occurred a slight step-up of investment plans, but as 1974 progressed, and the ramifications of the energy crisis became apparent, demand for power slowed. This, together with increased fuel costs and significantly tighter financial markets, led to sharp cancellations of planned outlays.

Altogether, cancellations, delays and stretch-outs announced during 1974 aggregated more than $20 billion, including about 60 per cent of planned outlays for nuclear-related facilities. A McGraw-Hill survey conducted in October 1974 indicated that 89 per cent of electric utilities had cut back capital expenditures during the year. Of those cutting back, 34 per cent cited inadequate demand as the principal reason, while 24 per cent cited high interest rates. A poor stock market and material shortages were also cited as factors contributing to reduced outlays, though by fewer respondents.

The cutbacks in capital spending programs may have unfavorable future impacts on customer utility rates and the goal of energy self-sufficiency, because the bulk of the reductions have been in nuclear plants. While these plants require huge initial investments, they provide tremendous cost savings once they become operational. Some industry observers estimate that average operating costs of a nuclear facility may be less than one-third the cost of an oil-fired plant. In curtailing their nuclear programs, utilities have thus opted for lower construction costs at the expense of higher future operating costs, which they will then pass along to users.

Even with the sharp cutback in capital expenditures, however, the level of anticipated outlays remains large. Thus, the back-log of unspent appropriations at the end of last September (the most recent date for which figures are available) still amounted to over 15 quarters of outlays at the September quarter rate. Even though some of this planned spending may never materialize, the amount of budgeted funds is still substantial.

Program for Energy Independence

In his State of the Union Address, the President outlined proposed legislative action designed to aid electric utilities, and in particular to stimulate investment in electrical power plants other than oil- and gas-fired facilities. The most important of these proposals include liberalized investment tax credits, preferred stock dividend deductions and mandated reform of State regulatory commission practices. The likely impacts of these proposed changes are summarized below:

The President's proposals include:

1. Investment tax credit (legislative). The first of the proposed legislative changes would do the following:

(a) Permanently eliminate the current discrimination against utilities, raising the present 4 per cent credit to the 7 per cent applicable to other industries.

(b) Temporarily increase the credit for all industries to 12 per cent for one year, retroactive to January 1, 1975. The 12 per cent rate also would be continued an additional two years for investment in electrical power plants other than oil- and gas-fired facilities.

(c) Raise the limit on the maximum amount of credit against tax liabilities for utilities from the current 50 per cent to 75 per cent for 1975. Thereafter, the limit would decline in 5 per cent steps over the next five years, returning to the present 50 per cent general limitation in 1980.

For those utilities paying taxes these proposals should be effective in arresting deterioration in financial positions as well as in stimulating investments designed to reduce reliance on oil and gas. The proposal to raise the limit on the tax credit from 50 to 75 per cent of tax liabilities should be particularly useful for the many utilities that have had credits they were unable to use even with only a 4 per cent credit.[1/] But, a substantial number of the weakest firms may be untouched by these tax reductions; indeed, an estimated one in five of all electric utilities currently pay no Federal income taxes and have substantial unused tax loss carry-forwards. For example, Consolidated Edison of New York has not paid Federal income taxes since 1969.

2. Preferred Stock Dividend Deductions (legislative). This change in the tax laws, first proposed in October, would permit all corporations issuing preferred stock to deduct the resulting dividends from taxable income, thereby encouraging equity financing.

1/ Weidenbaum, Murray L., Financing the Electric Utility Industry, Edison Electric Institute, New York, N.Y., 1974, p.94.

As with the investment tax proposals, the desired effects will be limited to those utilities that pay income taxes. Utilities taking advantage of this dividend deduction also would be confined to firms that have leeway under their indenture restrictions to undertake additional preferred stock financing. The overall impact of this proposal would be limited because corporate holders of preferred stock already enjoy an 85 per cent exclusion of dividends; with preferred dividends being wholly deducted by the issuer, the 85 per cent exclusion for stockholders would no longer be available.

3. <u>Mandated Reform of State Utility Commission Practices</u> (Legislative).

The legislation would:

(a) Set a five month limit for rate or service proceedings.

(b) Require fuel adjustment pass-throughs, including taxes.

(c) Require that construction work in progress be included in a utilities rate base.

(d) Allow cost of pollution control equipment to be included in the rate base.

Inclusion of construction work in progress in the rate base may be particularly important. As estimated by some industry observers, such actions would boost revenues by 10-12 per cent, with the largest increases obviously accruing to those companies with the largest construction programs. Frequently, such firms are in the poorest financial position simply because of their large capital outlays. This increase in revenues would considerably augment the potential effectiveness of the investment tax credit proposals, as indicated above.

A five month limit on rate proceedings might also have a significant impact on earnings, since in the years 1971-73, 70 per cent of proceedings stretched beyond this time.[1]

1/ Weidenbaum's, Op. Cit., p.108.

4. Energy Resources Council Study (Administrative). The Council will review the entire regulatory process and financial situation relating to electric utilities, in order to determine what further reforms or actions are needed.

5. Expedited Energy Facilities Siting and Improved Safeguards (Legislative).

Laws designed to assure more rapid energy facility siting (and licensing in the case of nuclear plants) are proposed. An increase of $41 million also is requested in 1976 budget appropriations for nuclear safety, safeguards, and waste management.

The benefits for the industry emanating from Proposals 4 and 5, however, would likely be limited.