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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

June 29, 1977

TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

Attached for your information is a memorandum from Mr. Zeisel dated June 28 and entitled "Projection of Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCA)."

This memorandum was prepared in response to a question by Governor Wallich at the June 21 FOMC meeting.

Attachment

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Date June 28, 1977

To Federal Open Market Committee

From Joseph S. Zeisel

Subject: Projection of Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCA)

This note is in response to the question by Governor Wallich at the June 21 FOMC meeting on the reasons for the projected decline in the Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCA) over the period from 1977-QII to 1978-QII.

The sharp surge in prices during the winter was reflected in an equally sharp rise in the IVA[1/], which almost doubled between 1976-QIII and 1977-QI. The recent acceleration of the rise in prices was caused in large part by numerous weather and energy-related special factors, and as the effects of these special factors on prices diminish over the projection period, the IVA tends to drift down[2/]. For 1977 as a whole, the absolute level projected for the IVA, at $20 billion, is more than $5 billion greater than the level recorded for 1976; in our judgment this is consistent with an acceleration of the increase in the fixed-weighted price measure for gross business product from 5-1/4 per cent in 1976 to 6-1/4 per cent expected in 1977.

1/ All references to the size of either the IVA or CCA are in absolute value terms, since both have negative signs in the NI accounts.

2/ Econometric work done at the Board suggests that movements in the IVA are especially sensitive to prices of nondurable consumer goods. Food is a very important component of these prices, and our projection for the rise in food prices calls for considerable moderation beginning in 1977-QIII.

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The CCA is used to adjust book profits for the discrepancy between tax-based and "economic" measures of depreciation. It consists of two major components--first, an inflation adjustment (negative) which corrects for the discrepancy between historical acquisition and replacement costs and second, an obsolescence adjustment (positive) which corrects for the use of accelerated depreciation methods, which act to overstate economic obsolescence. At present, the CCA is negative because the inflation adjustment is only partly offset by the obsolescence adjustment. We expect the absolute value of the CCA to decline over the projection period for the following reasons: first, we expect price increases to moderate later this year, causing the size of the inflation adjustment to be reduced; second, as the investment recovery continues and the use of accelerated depreciation grows, the obsolescence adjustment will increase and thus provide even more of an offset to the inflation adjustment.

TABLE ATTACHED

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INVENTORY VALUATION ADJUSTMENT
and
CAPITAL CONSUMPTION ADJUSTMENTS

(Billions of Dollars)

	1976		1977				1978				
	III	IV	I	IIP	IIIP	IVP	IP	IIP	1975	1976	1977P
Inventory Valuation Adjustment	-12.6	-20.0	-23.1	-20.8	-18.8	-17.3	-15.8	-15.8	-11.4	-14.6	-20.0
Capital Consumption Adjustment	-15.7	-16.4	-17.0	-15.5	-14.0	-13.0	-11.5	-10.5	-11.5	-15.5	-14.9

p = Staff projection of June 15, 1977.