CONFIDENTIAL (FR)
CLASS I - FOMC

1977

FOMC CHART SHOWS

Financial

Nonfinancial

International

OCTOBER 1977

James L. Kichline
October 17, 1977

INTRODUCTION -- FOMC CHART SHOW

In our presentations this afternoon we will be referring to the package of chart materials distributed to you. The principal policy assumptions that underlie the staff's economic and financial forecast are displayed in the first chart of the package. As is customary at the time when longer-run monetary ranges are considered by the Committee, we have shifted forward the base level for assumed growth rates of the aggregates--in this case from the second to the third quarter of 1977. The growth rates of M_1 and M_2 shown are consistent with longer-run Alternative B in the Bluebook. We continue to assume some slippage in Federal expenditures in fiscal year 1978, amounting to about $3 billion from the Congressional Budget Resolution and $7 billion from the Administration's mid-year budget review. The assumption of a wellhead tax has been retained, although the fate of the Administration's entire energy program is currently in considerable doubt. In the absence of a wellhead tax our projection of inflation next year would be lowered by about 1/4 percentage point.

Mr. Zeisel will now review recent and prospective nonfinancial developments in the domestic economy.

* * * * *

Joseph S. Zeisel

FOMC BRIEFING

October 17, 1977

Recent data have been providing further evidence of a slowing in the pace of activity. It appears that the rate of economic advance dropped to under 4 per cent in the third quarter following the vigorous 7 per cent rate of the first half. We had been anticipating some moderation, but this slowdown was more than expected. I would like to address the issue of what this may imply for the economic outlook.

As is evident in the first chart, consumer demand has clearly lost considerable momentum recently. For much of the early expansion period, growth in these outlays exceeded the rise in disposable income. Instalment and mortgage debt increased sharply and the savings rate by early this year declined to under 5 per cent--an unusual low level, historically. Against this background, we had anticipated some moderation in consumer spending, but as is evident in the top panel, nonauto retail sales have been more or less on a plateau since last spring. Unit auto sales have also weakened recently, although in general they have maintained a relatively high level; the rather sharp decline in September may have to some extent reflected inventory shortages of popular imports and the late introduction of '78 domestic models. There has been some bounce-back in domestic auto sales evident in the first third of October.

Given this recent performance of retail sales, we have scaled down our projections of consumer outlays somewhat. As illustrated in the second chart, we anticipate that real consumer expenditures will grow somewhat more slowly relative to income over the next year than formerly and that the saving rate will continue to drift up somewhat into early '78. But short of a substantial shock to consumer confidence, we expect that the rise in real consumer demand will continue to be supported by growth in disposable income. As shown in the bottom panel, surveys have shown some deterioration in consumer attitudes recently, but consumer confidence overall appears to have held up quite well.

As indicated in the next chart, the recent sluggishness in demand appears to have triggered an adjustment of production and inventories. The book value of manufacturers' stocks rose at a modest $9 billion annual rate in July and increased by only $4 billion in August--the smallest monthly rise since the outright liquidation last December. This modest rate of inventory investment was a major factor in the weakness of GNP growth last quarter; in contrast, inventory investment had provided a substantial impetus to GNP growth in the second quarter.

The rapidity with which business has acted recently to adjust production when perceiving a slowing in sales has operated to keep overall inventories low relative to sales and we anticipate a resumption of growth of industrial production and inventory investment in the near term in line with increases in real demands. But caution is likely to continue to prevail and inventory investment is expected to contribute only modestly to business expansion over the next year.

Available evidence for other sectors however continues to suggest adequate support for a reasonable rate of aggregate growth over the next several quarters. As the next chart illustrates, residential construction activity has continued at a vigorous pace recently. Private housing starts in August, at a 2 million annual rate, were 6 per cent above the second quarter. Sales of new single family homes remain high, suggesting sustained strong demand, and financial conditions appear generally favorable to some further expansion in the multi-family sector into early 1978. However, the strength of overall housing activity is likely to weaken next year, as financial markets become less accommodative; we expect housing to cease to contribute to overall growth toward the middle of 1978.

The next chart illustrates some of the factors which should also help sustain a higher rate of State and local spending over the next few quarters. The rate of growth in this sector's spending in the third quarter was surprisingly modest--reflecting partly an unexpected weakness in their outlays for construction. However, as the top panel shows, employment in this sector in the third quarter continued the rapid second quarter growth, probably reflecting in part the implementation of the public service employment programs. The further expansion of this program along with growth in other Federal grants--illustrated in the bottom panel--should provide a firm basis for continued expansion of purchases, particularly in light of the substantially improved budget positions of these governmental units.

But with the contribution of each of these sectors likely to diminish over the next year, the key to sustained overall growth remains capital spending, and the outlook here continues uncertain.

As the next chart shows, indicators of short-term prospects remain good. New orders for nondefense capital equipment have been on a generally upward path, with the exception of some volatile aircraft orders. The machinery component of new capital goods orders--which is generally a better overall indicator of underlying trends in equipment spending--has shown fairly steady growth. Even more encouraging has been the surge of nonresidential building commitments. Construction contracts for commercial and industrial buildings measured in square feet has risen sharply recently to the highest level in almost three years. It is true that the first sampling of the capital spending surveys for 1978 suggests relatively modest real growth planned for next year. But the surveys now available have not had a good record of predicting spending for the coming year, and as indicated in the next chart, we still expect that capital outlays will continue to rise at a reasonable--although far from booming--pace through 1978. Actually, our projections in this sector are rather modest and as the lower line in the chart shows, would still bring the level of such outlays to only slightly above the prerecession peak after 5 years--well under the average performance in other expansions. This forecast of continued growth appears reasonable to us--given the severe lag in capital spending to date; the fact that capacity utilization in some key areas has risen to levels which should begin to trigger concern with available capacity; and the need for new more-efficient-cost-reducing equipment to help offset continued large increases in unit labor costs. Certainly the financial environment remains generally favorable to continued growth of spending.

On balance we expect real GNP growth will pick up in this quarter from the slow third quarter pace and average about 5 per cent in the next half year; as the support from housing fades the growth rate is projected to drift down, to about a 4-1/4 per cent rate in the latter half of 1978. While this staff projection is only slightly weaker than those of recent months, the sluggishness of consumer demand, and the absence of greater strength in commitments for capital outlays for the longer-term has increased the downward risk somewhat.

James L. Kichline
October 17, 1977

FOMC BRIEFING

The first chart in the next section indicates the broad contours of our economic forecast. Our evaluation of the incoming information and an assessment of likely developments has suggested that growth of real GNP will remain somewhat above longer-run trend over the forecast period. Such a rate of growth should produce some further decline in the continuing high rate of unemployment, but probably rather little given expected rapid growth of the labor force. For inflation, anticipated sizable gains in unit labor costs and other factors lead us to forecast price increases that on average seem stuck around the 6 per cent level or somewhat higher.

To finance rapid growth in nominal GNP, funds raised in credit markets, shown in the next chart, are likely to be maintained at a high level. The top panel indicates that funds raised by private nonfinancial sectors in 1978 are projected to remain close to the heavy volume estimated to be raised in the latter half of this year. Federal borrowing is expected to remain large in view of the sizable budget deficit, but moderate somewhat in the latter part of 1978. Thus, total funds raised next year will probably be around levels that are now being experienced. Such a volume of funds raised will press against available supplies, assuming efforts to restrain growth of money. Spending sectors at such times are often induced or forced to rely more heavily on internally generated funds or draw down financial asset holdings to accomplish spending plans. This we believe is in store over the year ahead.

As shown in the next chart, net mortgage originations are expected to remain large next year but the phenomenal uptrend over the past two years or so will come to a halt. By early next year this market is expected to evidence traditional signs of tightening. In association with the higher cost and reduced availability of mortgage credit, borrowing relative to new house purchases will probably tend to decline from the current extraordinary levels as less equity is withdrawn from the market. Consumer loan growth is expected to moderate as purchases of durable goods expand less rapidly than during the first half of 1977. In securities markets, demands are likely to stay strong in light of the expected generally favorable financing conditions, stemming partly from large fund flows through major bond investors--such as pension funds. Business loan growth is expected to remain around the levels experienced this year, which is in line with desires to avoid excessive reliance on short-term debt.

The next chart displays total funds supplied to markets. Thrift institutions have been major suppliers over the 1975 to 1977 period. Next year, however, we anticipate that they will be under pressure from a slowing of deposit growth and will runoff liquid assets and borrow from the Home Loan Banks. In the process they will be induced to cutback on their lending. Banks, however, are expected to supply close to the same total volume of funds in 1978 as this year, since they possess greater flexibility in acquiring funds than the thrifts. But nondepositary financial institutions and nonfinancial sectors will likely increase their supply of funds, the portion designated others on the chart.

A major part of the marginal supply is expected to come from households, shown in the top panel of the next chart. Increased levels of interest rates would provide the inducement for households to purchase an increased volume of market instruments. Another way of looking at this result is through developments in money demand. Velocity growth is expected to return to historically high levels--in excess of 5 per cent--next year. Even allowing for some downward drift in money demand given nominal GNP and interest rates, we believe interest rates will need to rise further, as indicated in the bottom panel of the chart in order to restrain growth of M_1 to a 5-1/4 per cent rate. Much of the rise will likely occur in short-term rates, resulting in a further narrowing of yield differentials.

FOMC Presentation
E.M. Truman
October 17, 1977

As is shown in the top panel 'of your first international chart, the U.S. trade balance declined by $45 billion from a a largeu deficit recession-induced surplus in the second quarter of 1975 to a large deficit in the second quarter of this year. Over the same period, the decline in GNP net exports of goods and services was much less because of rising investment income and other service receipts. Real net exports of goods and services fell over the period by 15 billion 1972 dollars, about 1 per cent of real GNP in the second quarter of this year. Between the second quarter of this year and the fourth quarter of 1978, we expect a further $10 billion increase in the U.S. trade deficit, but the recorded change in net exports of goods and services in the GNP accounts should be negligible in real terms. In brief, we do not anticipate over the forecast period any net stimulus to our expansion coming from the foreign sector.

The recent swing in the U.S. trade position is in large part attributable to slower expansion in real economic activity abroad than in this country since early 1975. This pattern is illustrated in the lower panel by the ratio of real GNP in the major foreign industrial countries to U.S. real GNP. Historically, this ratio has shown an upward trend as real GNP on average expanded faster abroad than in the United States. In contrast to this trend, we expect by the end of 1973 the ratio only to return by the end of 1978 to its 1974 level. I should add that slow growth and considerable excess capacity abroad have tended to reduce upward pressure on U.S. prices during our own more vigorous expansion.

Turning to the next chart, much of the rise in the value of non-oil imports over the past two years resulted from a rise in their volume. This growth was experience during broadly based and has been consistent with experience during similar stages of previous U.S. recoveries. Over the forecast period, we expect the volume of non-oil imports to grow at a more modest pace than recently. Assuming that the price of imported oil rises by 5 per cent during 1978, and that the government stockpile program adds $3 billion to our oil bill, we expect little change in the value of oil imports over the forecast period because of the increased Alaskan oil production and the recovery of hydroelectric power generation.

On the export side, as shown in your next chart, all of the increase in the value of our non-agricultural exports since late 1974 has reflected price increases. The lack of growth in the volume of these exports- over the past two years is, of course, largely a reflection of slow growth abroad. However, over the forecast period, we expect real activity abroad to increase somewhat more rapidly, and the volume and value of our non-agricultural exports should expand commensurately. In contrast, the value of our agricultural exports is expected to decline substantially from the record-high rate in the second .quarter of this year. The volume of these exports should remain high, but, reflecting good world harvests, prices are expected to fall to their lowest levels since 1973.

In summary, we expect a more gradual rise in our trade deficit over the forecast period largely because of a pickup in non-agricultural exports. At the same time, the expansion in non-oil imports should slow, oil imports should level off temporarily, and agricultural exports will decline somewhat. Mr. Kichline will now complete our presentation.

CONFIDENTIAL (FR) CLASS II-FOMC

Material for

Staff Presentation to the Federal Open Market Committee

October 17, 1977

PRINCIPAL ASSUMPTIONS

MONETARY POLICY

- Growth of M_1 averaging 5¼% annual rate from QIII 1977 base
- Growth of M_2 averaging 7½% annual rate from QIII 1977 base

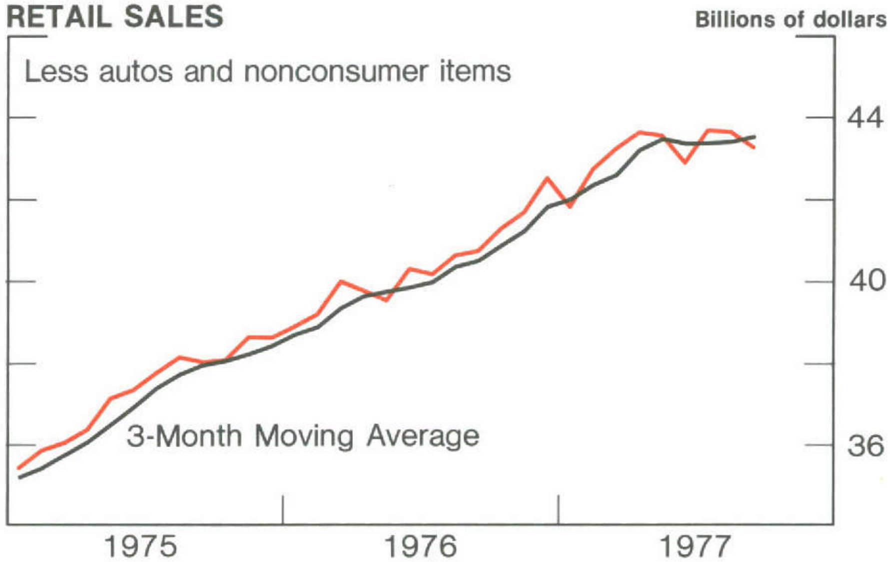
FISCAL POLICY

- Unified budget expenditures of $456 billion in FY 1978

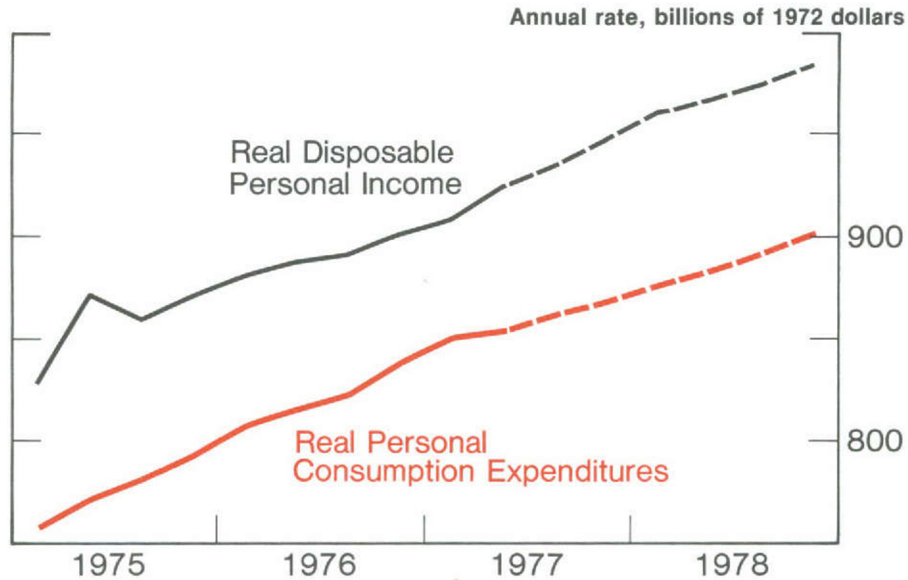
ENERGY PROGRAM

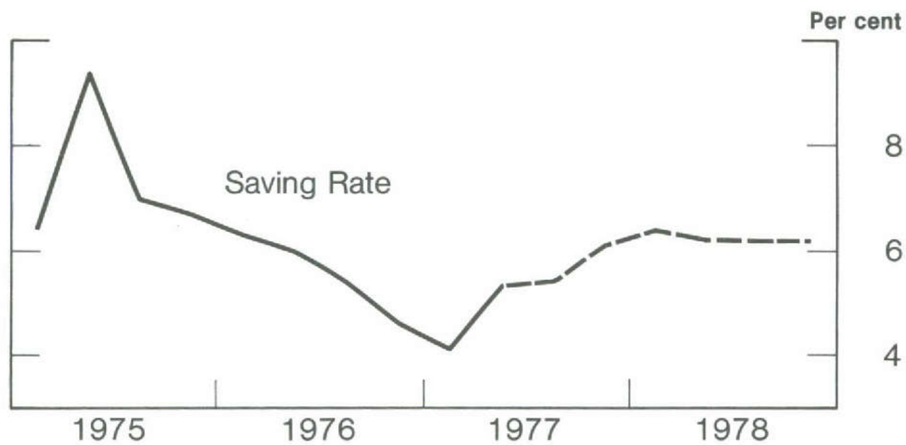
- Wellhead tax of $3.50 per barrel on domestically produced "old" oil

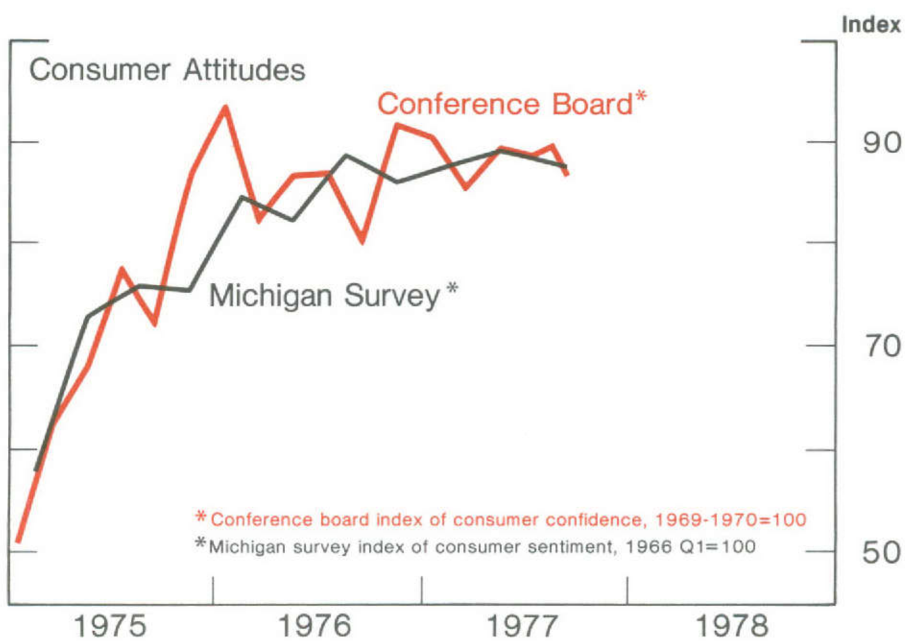
RETAIL SALES



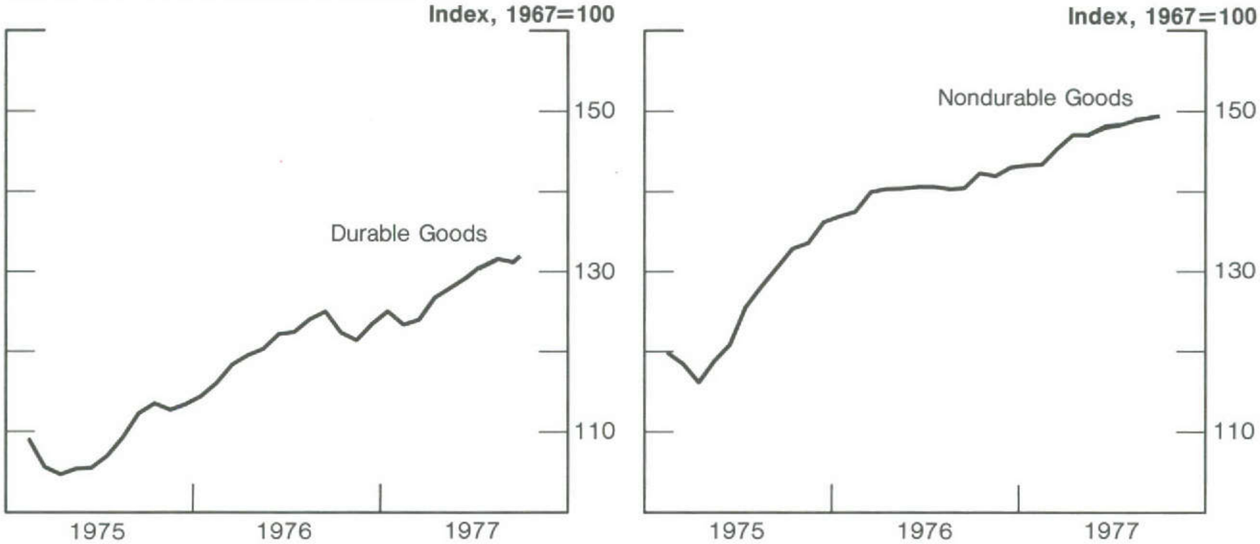
TOTAL AUTO SALES


Annual rate, billions of 1972 dollars
Real Disposable Personal Income
Real Personal Consumption Expenditures
900
800
1975
1976
1977
1978

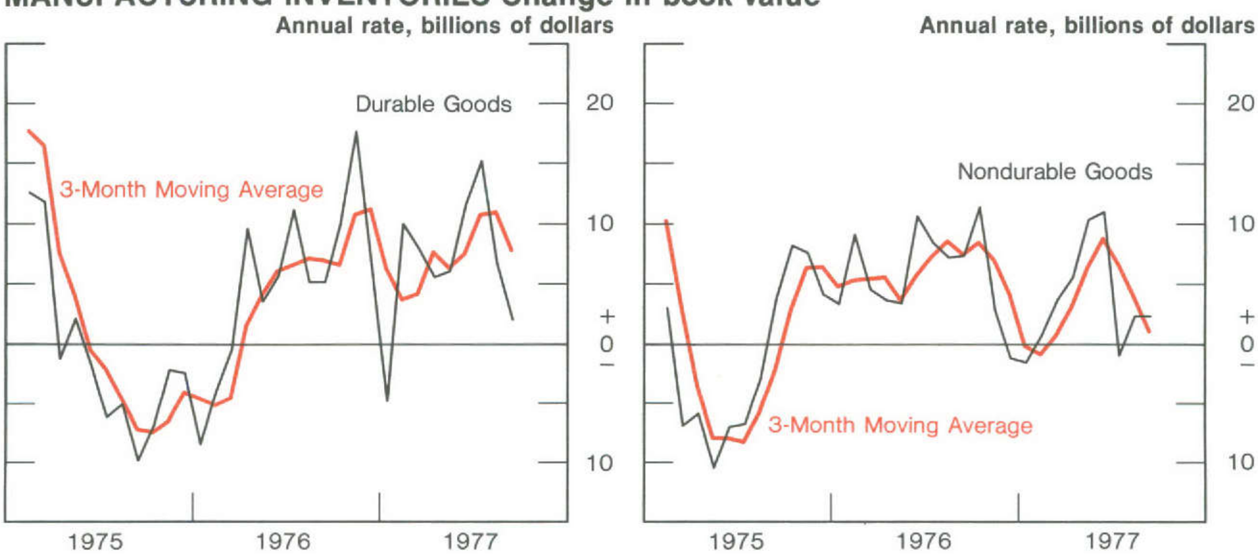

Per cent
Saving Rate
8
6
4
1975
1976
1977
1978

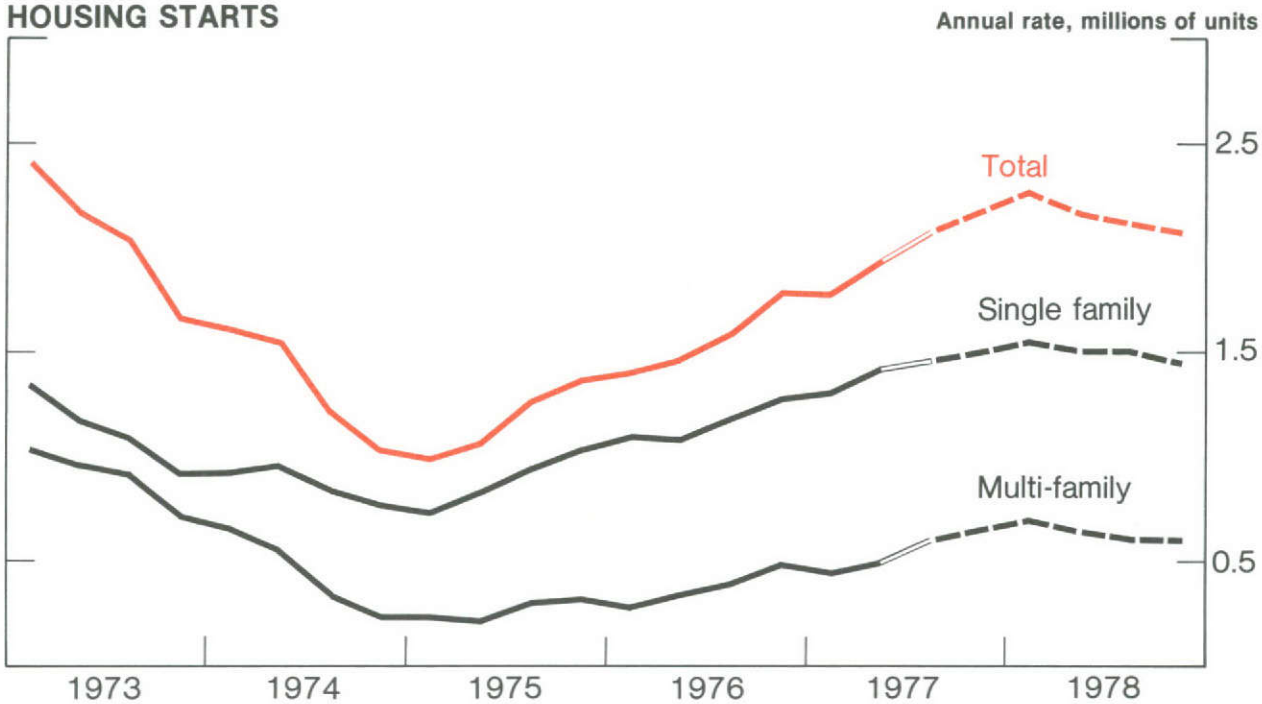

Index
Consumer Attitudes
Conference Board*
Michigan Survey*
90
70
50
*Conference board index of consumer confidence, 1969-1970=100
*Michigan survey index of consumer sentiment, 1966 Q1=100
1975
1976
1977
1978

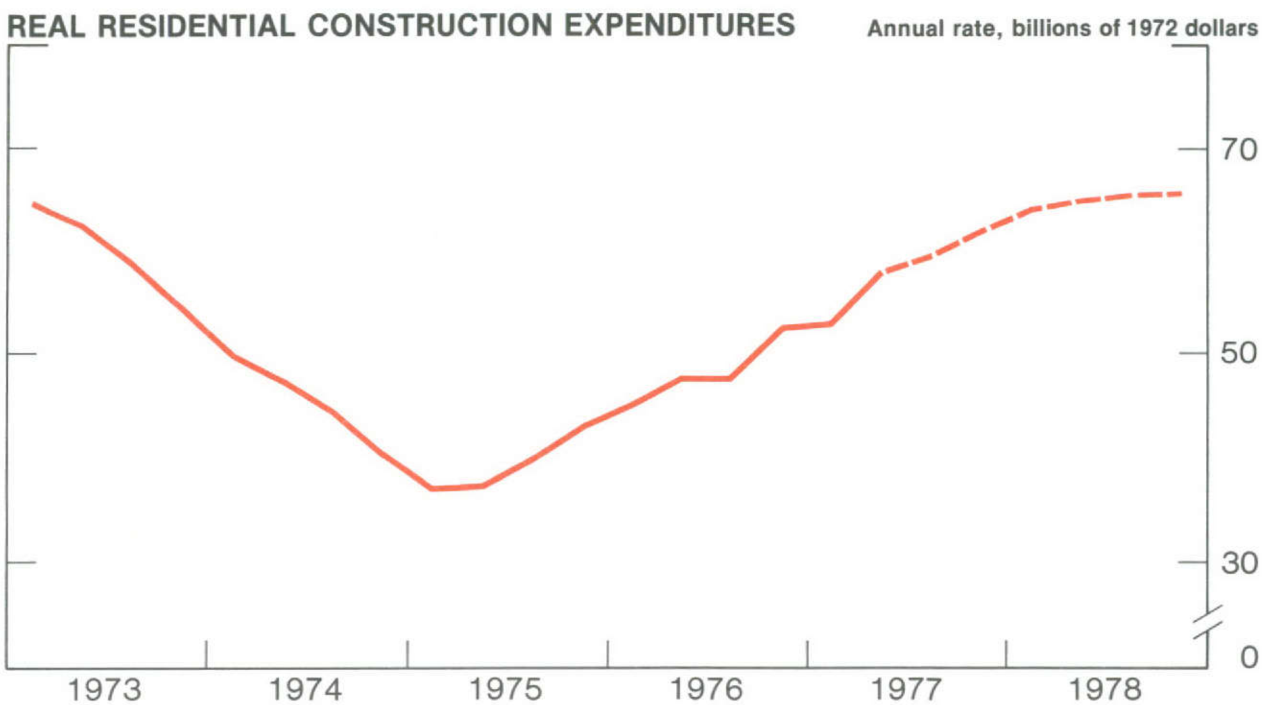
OUTPUT IN MANUFACTURING



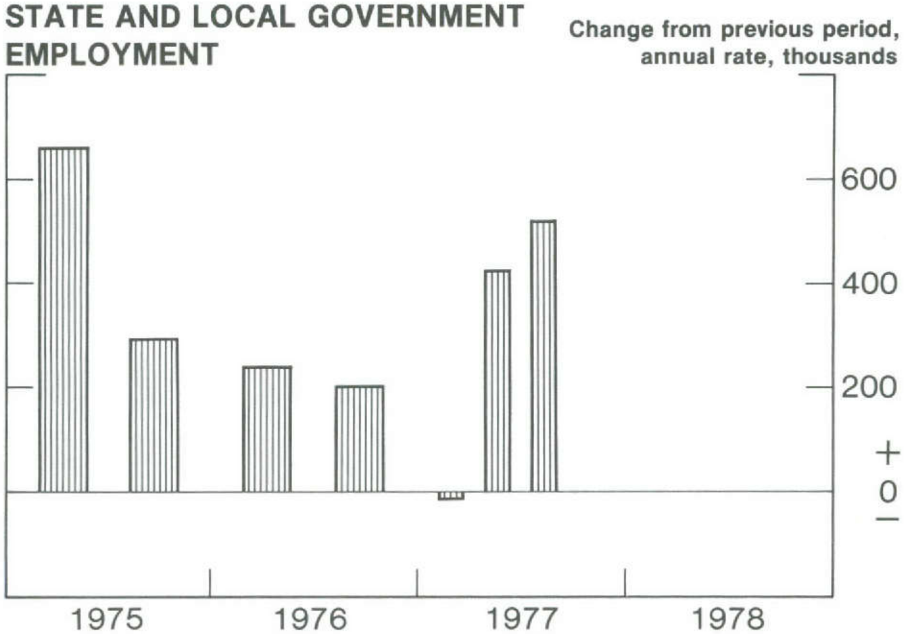
MANUFACTURING INVENTORIES Change in book value



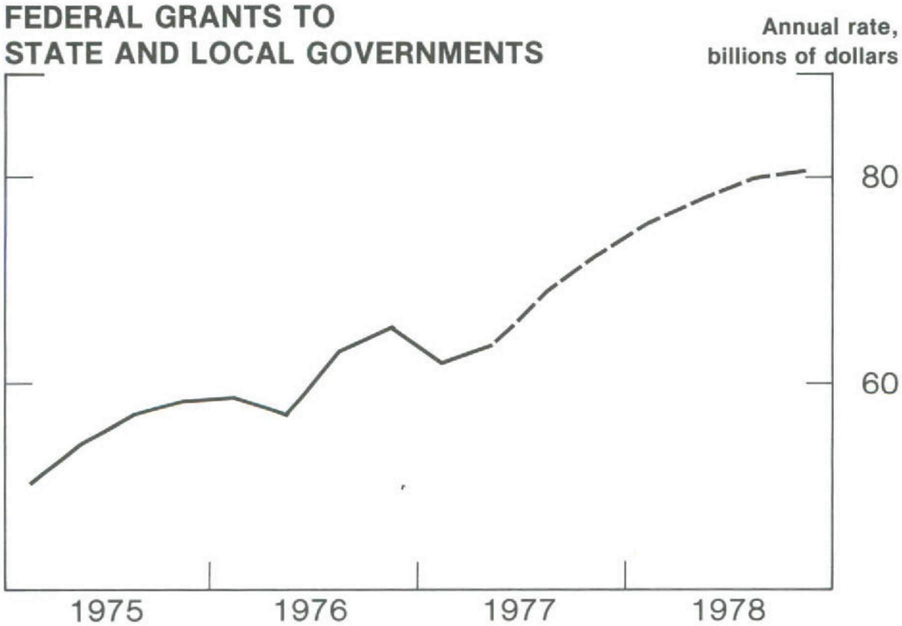

HOUSING STARTS
Annual rate, millions of units
Total
Single family
Multi-family
2.5
1.5
0.5
1973
1974
1975
1976
1977
1978


REAL RESIDENTIAL CONSTRUCTION EXPENDITURES
Annual rate, billions of 1972 dollars
70
50
30
0
1973
1974
1975
1976
1977
1978

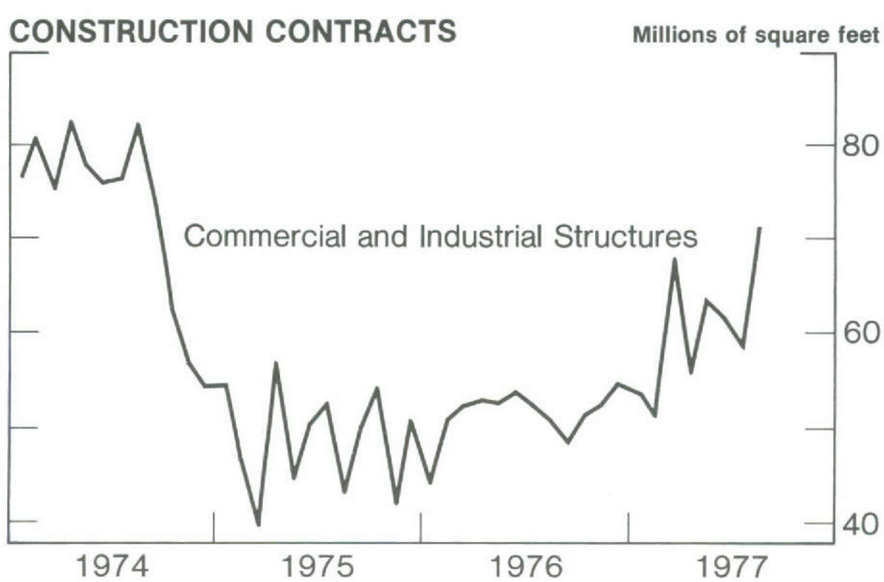
STATE AND LOCAL GOVERNMENT EMPLOYMENT

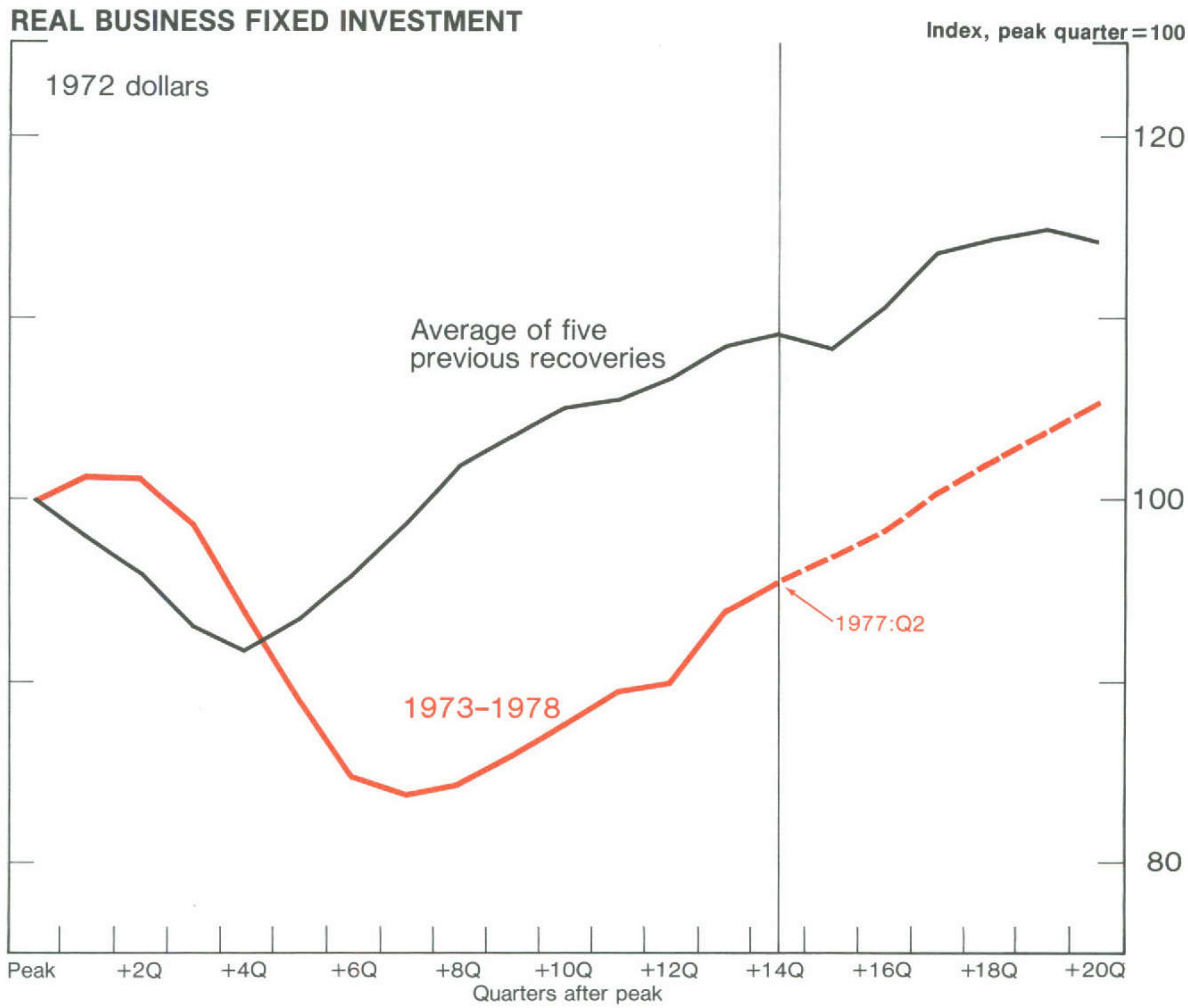


FEDERAL GRANTS TO STATE AND LOCAL GOVERNMENTS

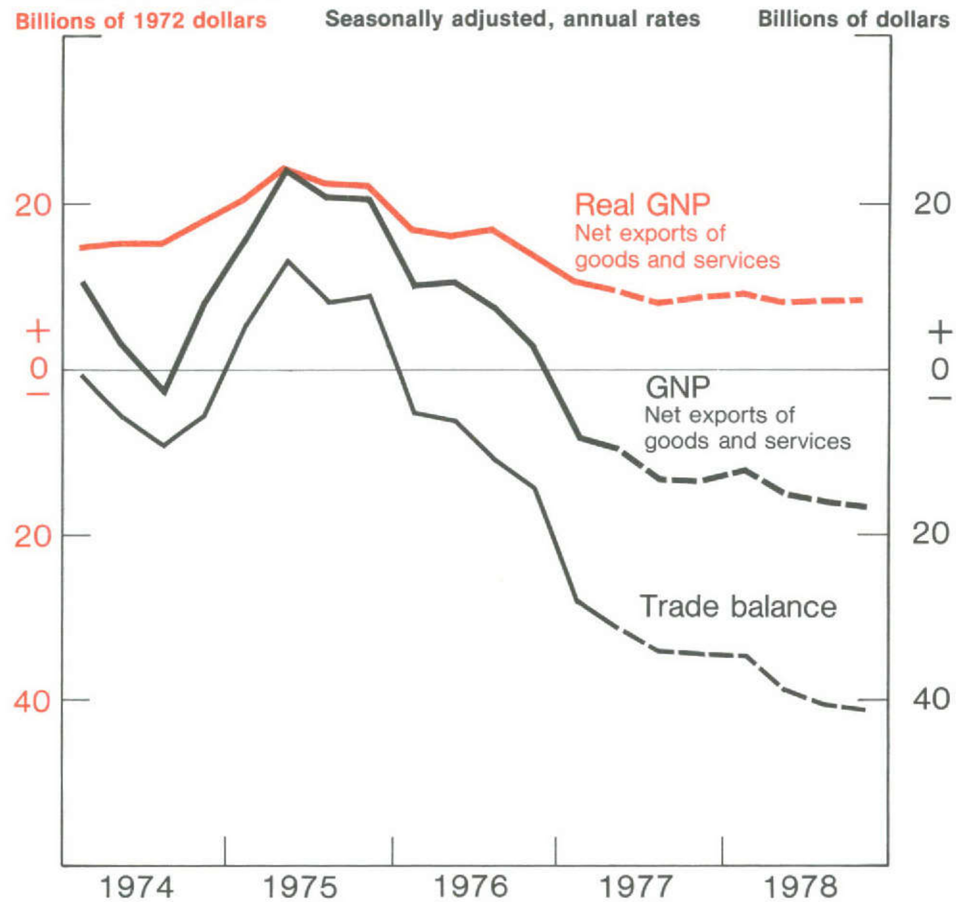



REAL NEW ORDERS
Billions of 1972 dollars
Nondefense Capital Goods
Total
Machinery*
*Confidential FR staff tabulation
12
10
8
6
4
1974
1975
1976
1977

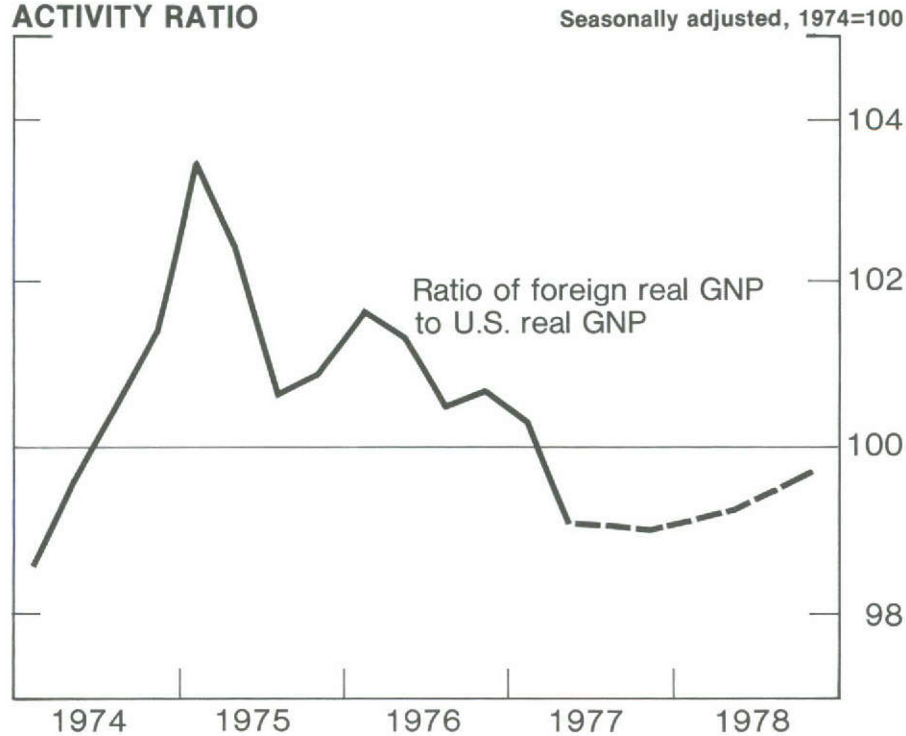

CONSTRUCTION CONTRACTS
Millions of square feet
Commercial and Industrial Structures
80
60
40
1974
1975
1976
1977


REAL BUSINESS FIXED INVESTMENT
Index, peak quarter = 100
1972 dollars
120
100
80
Average of five previous recoveries
1973–1978
1977:Q2
Peak
+2Q
+4Q
+6Q
+8Q
+10Q
+12Q
+14Q
+16Q
+18Q
+20Q
Quarters after peak

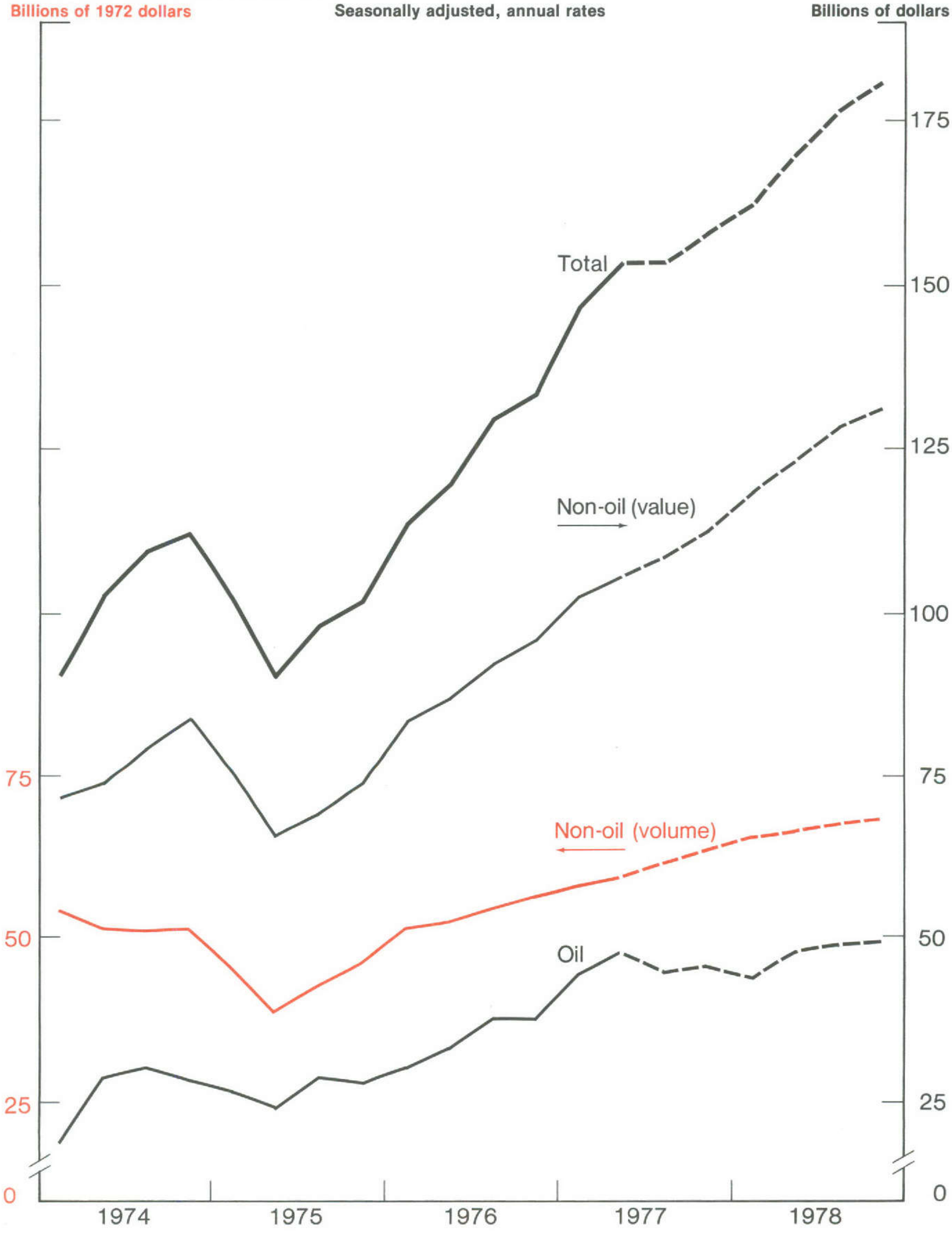
NET EXPORTS

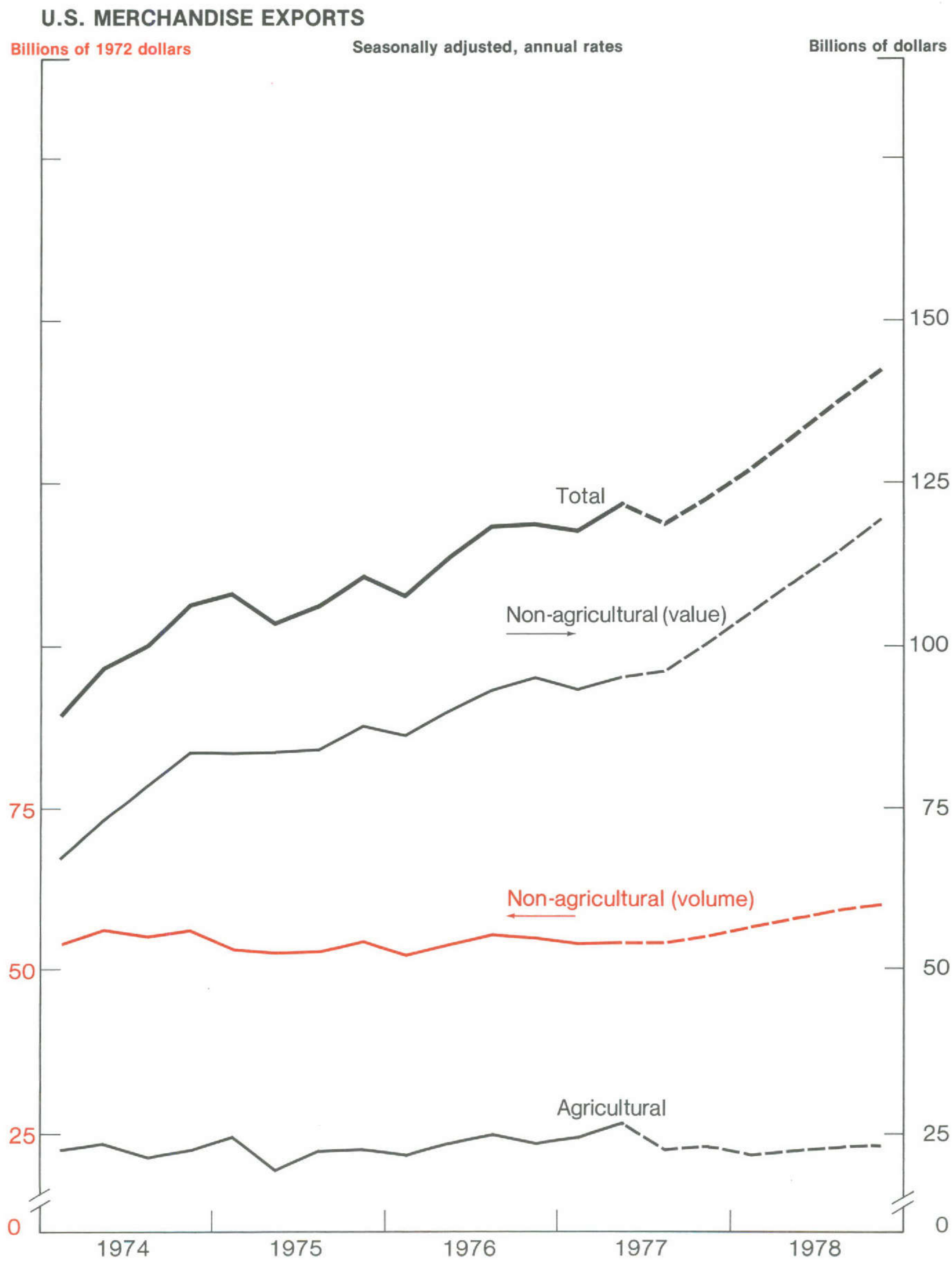


ACTIVITY RATIO



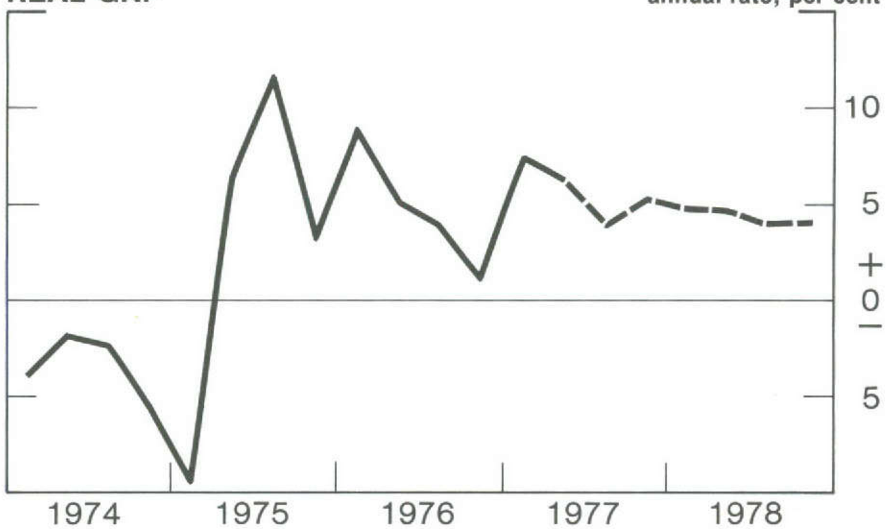
U.S. MERCHANDISE IMPORTS




U.S. MERCHANDISE EXPORTS
Billions of 1972 dollars
Seasonally adjusted, annual rates
Billions of dollars
Total
Non-agricultural (value)
Non-agricultural (volume)
Agricultural
150
125
100
75
50
25
0
1974
1975
1976
1977
1978

REAL GNP

Change from previous quarter, annual rate, per cent

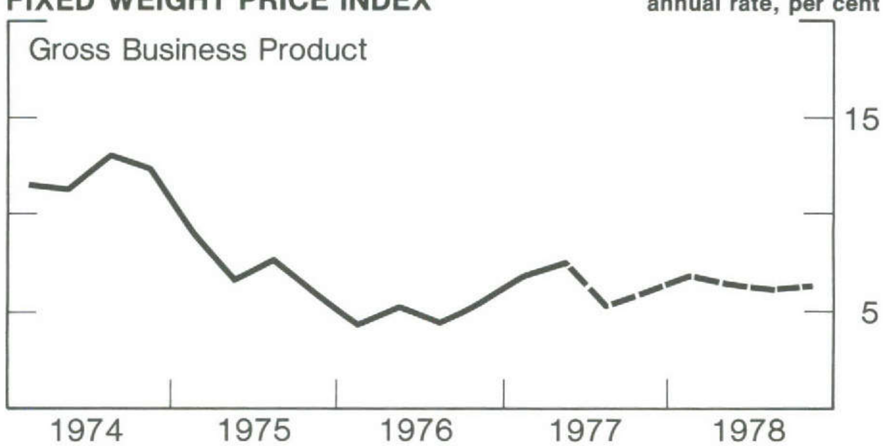


UNEMPLOYMENT RATE

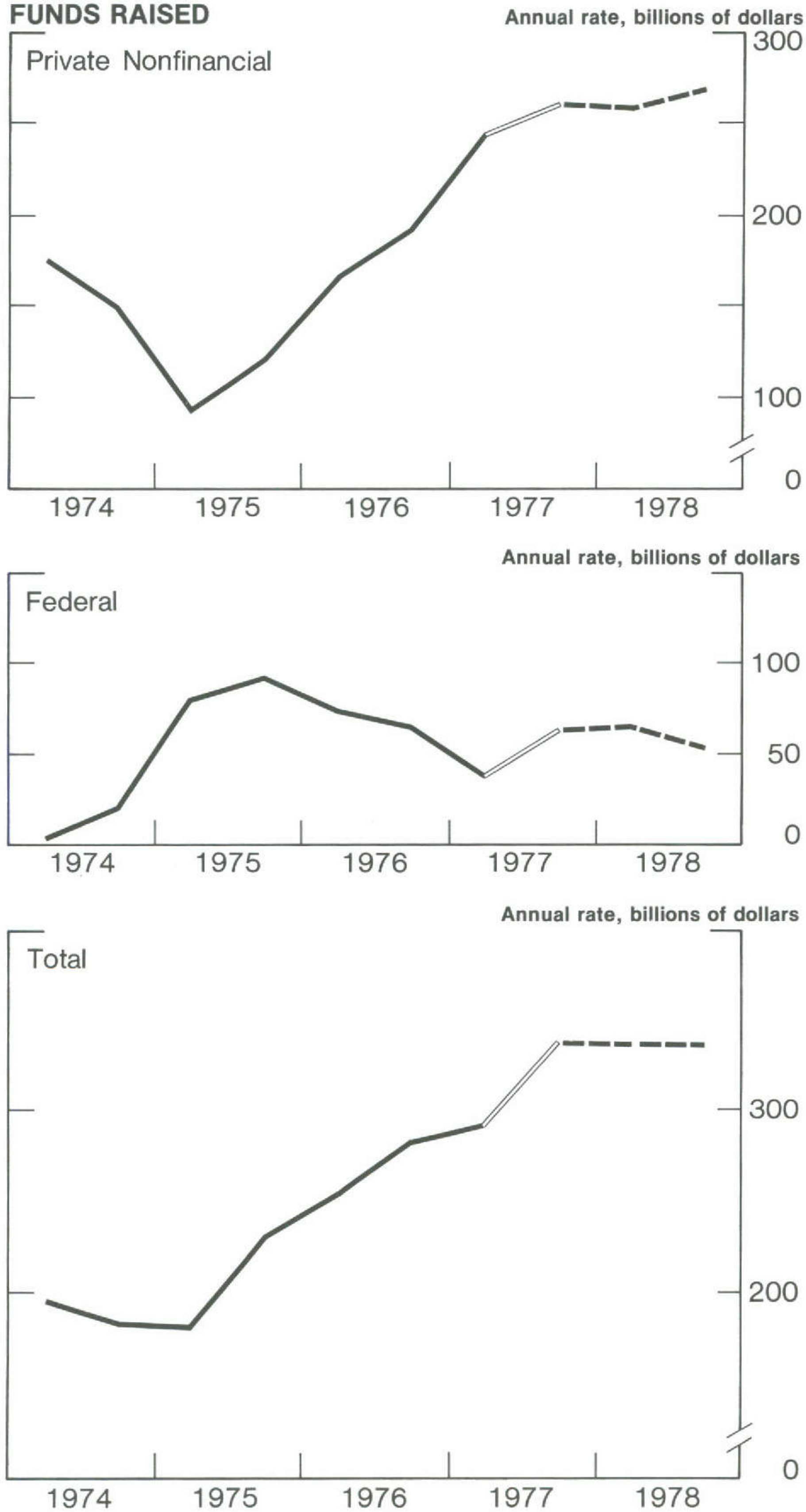
Per cent

FIXED WEIGHT PRICE INDEX

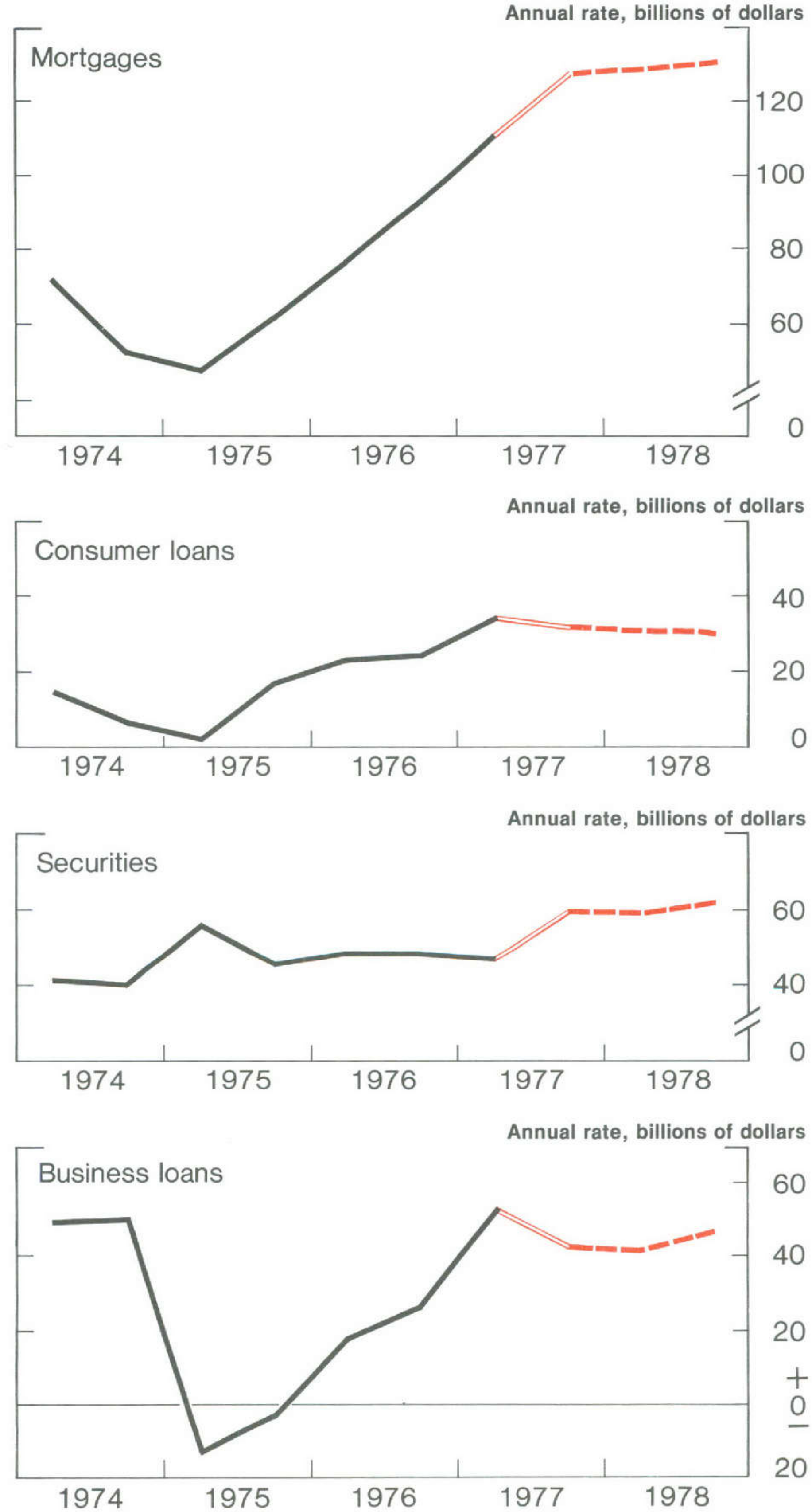
Change from previous quarter, annual rate, per cent

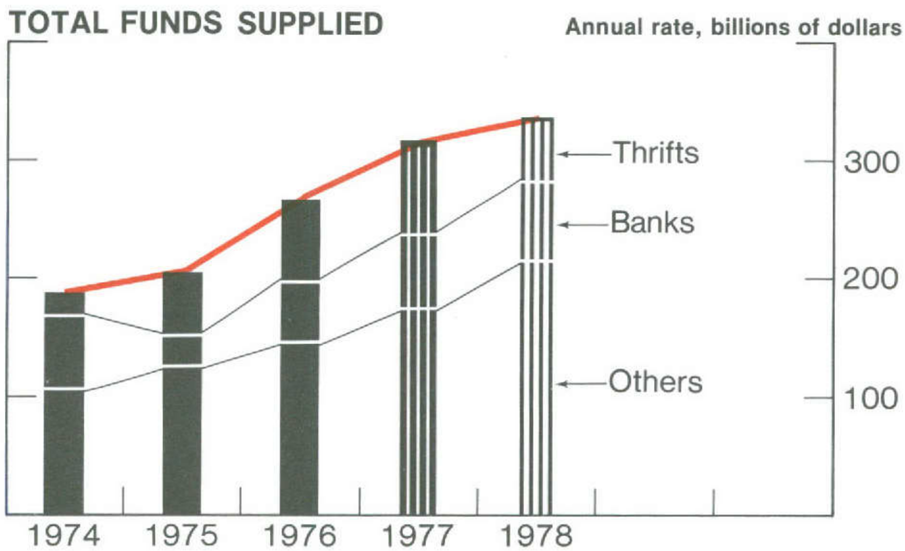


FUNDS RAISED

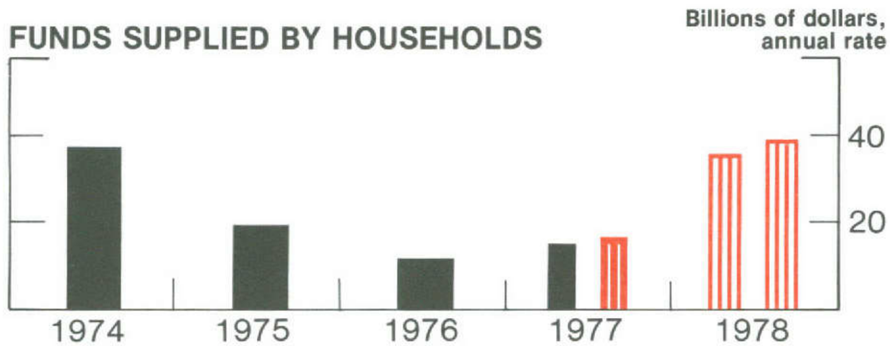


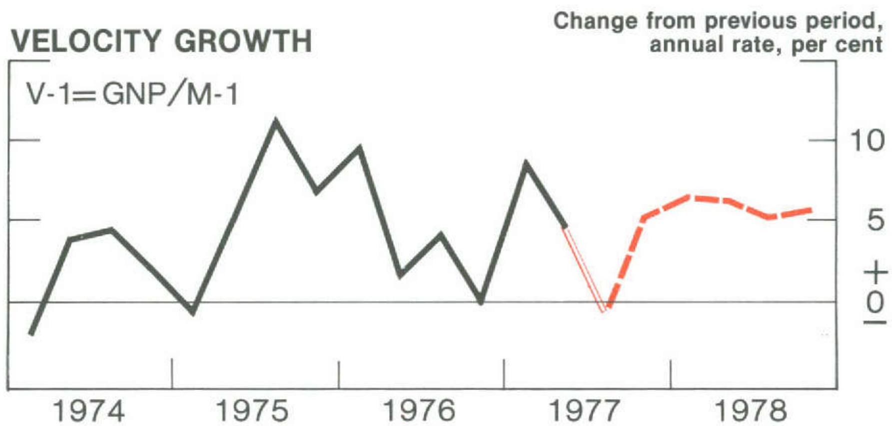
PRIVATE DOMESTIC BORROWING

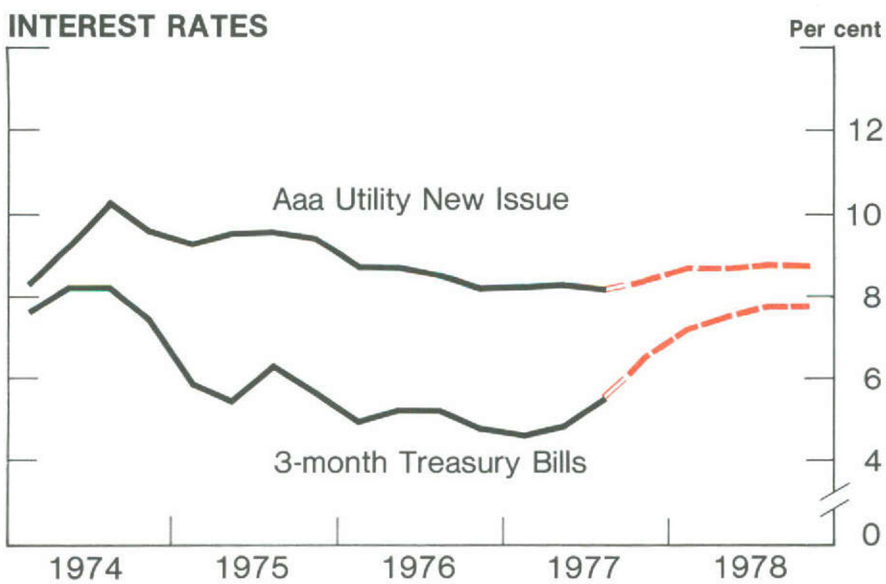




TOTAL FUNDS SUPPLIED
Annual rate, billions of dollars
Thrifts
Banks
Others
300
200
100
1974
1975
1976
1977
1978


FUNDS SUPPLIED BY HOUSEHOLDS
Billions of dollars, annual rate
40
20
1974
1975
1976
1977
1978


VELOCITY GROWTH
Change from previous period, annual rate, per cent
V-1=GNP/M-1
10
5
+
0
−
1974
1975
1976
1977
1978


INTEREST RATES
Per cent
Aaa Utility New Issue
3-month Treasury Bills
12
10
8
6
4
0
1974
1975
1976
1977
1978