Notes for FOMC Meeting
August 15, 1978
Scott E. Pardee

Since the last meeting of the FOMC, dollar rates have declined across the board. As of this morning, the dollar had fallen by 15 percent against the Swiss franc, 11 percent against the Japanese yen, 6 percent against the German mark, and 3 to 6 percent against other major European currencies. Major central banks have bought in excess of $7 billion, including by the Swiss on a one-year swap basis. We have also intervened on behalf of the Federal Reserve and the Treasury in the amount of $326 million equivalent of German marks, now back to a 50-50 sharing between the System and the Treasury, and of $24 million equivalent of Swiss francs for the System.

Market sentiment toward the dollar is as bearish as I have known it in my experience at the Desk. Dealers of course note the continuing trade and current account imbalances as being fundamentally adverse for the dollar, although many admit that the latest figures show modest signs of improvement. The more immediate focus, however, is on the U.S. inflationary situation, both in terms of the poor performance of the price indicators themselves and in terms of the apparent lack of effective policies to deal with the problem. Most market participants we have talked to—and we have been deluged by calls from people here and abroad—are pessimistic on both points, for prices and for policy. Many view the dollar's decline as validating the higher rate of inflation we now have as against the Germans, Japanese, Swiss and perhaps others, and as reinforcing these inflation differentials through the process known as the vicious circle. Consequently, although dollar exchange rates by now have reached ridiculously low levels against most major currencies, many expect that relative inflation rates will make them seem less ridiculous over time.

One major element which the dollar had in its favor over recent months, a wide interest differential coupled with expectations of a further rise in rates here to widen that differential even more, has now become less effective as that expectation has faded and many U.S. interest rates have in fact receded somewhat. In this regard, [unintelligible] dollar's weakness in part to what they perceive to have been a softening in the Federal Reserve's own resolve in fighting inflation.

Two other elements of the dollar's decline have been particularly troubling to exchange market people, and indeed to our central bank counterparts. First, is the concern that U.S. policymakers have become totally indifferent to the dollar's weakness. Any number of articles in the press out of Washington, not citing names necessarily, have reinforced this impression. Second, is the fear of precipitate action by other governments in response to the dollar's fall, by OPEC—through a hike in the oil price or through a change to a basket mechanism for pricing oil—or by others in the form of draconian exchange controls or a rush to protectionism. Several thoughtful people have expressed concern that our multilateral trade and payments system is in jeopardy.

In this panorama, the Desk's stance has been that of damage control in the currencies the U.S. authorities have been prepared to operate in. This has helped contain some of the disorder but the lack of a more forceful response has been noted in the market. I might add that to the extent that the U.S. authorities have not been prepared to operate in yen—and that unwillingness has become a point of open discussion by officials here and in Tokyo—it has been taken as further evidence of our so-called indifference to the dollar's weakness.

Meanwhile, we took what opportunities we could to make further net repayments of swap debt. For the System, we repaid $282 million of German mark drawings incurred earlier

this year, which combined with the $125 million of new drawings, has brought us to an outstanding total of $666 million. The Treasury's total swap debt was also reduced, by a net $66 million to $249 million. Our swap debt in Swiss francs under the latest series of operations has risen by $24 million to $41 million.

Recommendations

On renewals of German mark swap debt, we have four drawings totaling $245.5 million coming due in September. These are second renewals and the Bundesbank agrees. I recommend that the Committee approve their renewal.

I would like to add that Mr. Gleske of the Bundesbank has written to Alan Holmes with some points the Germans would like to reconsider in the basic swap agreement, up for renewal in December. First, they suggest the even-sharing of exchange risk on drawings by us be dropped, so that we would bear all of the risk. They are prepared to accept that drawings be at their interest rates rather than the U.S. Treasury bill rate. Second, they would like to have any renewals made at current rates of exchange rather than the rate of the original drawings, in effect booking profits and losses on individual swaps on a quarterly basis. Finally, they would like to have the language tightened up on the mode of repayment, making clearer the principle that the first efforts to acquire marks would be in the market.

I have nothing to recommend today in this regard, but we are preparing a memorandum to lay out the issues for the Committee. Some of the proposed changes are of a fundamental nature and would have to be extended to the swap arrangements with other central banks as well as just the Bundesbank.

Joseph S. Zeisel
August 15, 1978

FOMC BRIEFING

Recent indicators suggest that the economy is maintaining a moderate pace of growth, off somewhat from the average of the first half. Employment and production both showed further gains in July. The Labor Department's household survey has reported wide gyrations in employment and unemployment over the past two months, but these seem to have reflected largely seasonal adjustment problems. The payroll employment series probably has been giving a more reliable picture of labor market conditions. These data show a steady rise in jobs--somewhat under the rate earlier in the year--with most of the gains in trade, services and construction. As in the previous few months, factory employment increased only a little in July.

Preliminary data on industrial production, being released this morning, indicate a rise of half a per cent last month, equal to the (revised) gains in the previous two months. Sizable increases are indicated for business equipment, construction-related products and durable materials.

Consumer demand, by comparison, has been showing less ebullience recently. The dollar volume of retail sales, other than autos and nonconsumption items, increased by 0.6 per cent last month--which was somewhat of a disappointment following the lack of advance in June. Substantial gains were reported in July by durables stores, where sales were also particularly strong in the second quarter. According to recent surveys, consumers continue to evaluate buying conditions as favorable for large durable goods, because of anticipated price rises. Auto sales, especially, appear to have benefited from such attitudes. However, car sales--which had been running at an exceptional 12 million annual rate--slipped in July to a still-high 11 million pace. It it too early to tell whether the July figures signal a return to a rate more consistent with income growth and replacement demand.

Housing activity, however, appears to have held up quite well recently in the face of tighter mortgage market conditions. The 2.1 million annual rate of starts in June was about the same as in the

three preceding months, and only slightly below the very strong pace in the fourth quarter of last year. But single-family starts have turned down, while there has been a pick-up in the multifamily category.

In the business sector, capital spending has been particularly strong recently. But there are also indications that gains may be more moderate in upcoming quarters. New orders for nondefense capital goods declined in June and they have shown virtually no change over the past four months. Orders for machinery, a good indicator of underlying demand for heavy capital equipment, were below the December level.

Construction contracts, which have a fairly long lead time, have also shown signs of leveling off recently, but there appears to be sufficient momentum to sustain growth in this component of capital spending through next year.

Among other sectors, State and local spending apparently has begun to slow, following sharp gains early in the year. Expenditures

for construction edged down in June, and the growth of employment has slackened substantially in the past few months.

On balance, we now anticipate an annual rate of real GNP growth of about 3-1/4 per cent, this quarter, slightly less than the projection last month. There seems little on the horizon to suggest a significantly stronger pace of expansion over the balance of the projection period. We continue to expect a slowdown in aggregate housing activity, with starts slipping to about a 1.7 million unit annual rate by next spring, and holding there through '79. The prospect of less momentum to capital investment, and the likelihood of continued restraint in government outlays also suggest more moderate gains in real income and consumer spending.

There are some positive factors in the outlook--for one, a projected improvement in our net export position. Furthermore, the tax cut anticipated for the beginning of next year should result in a temporary filip to business activity. But as we have

indicated before, this fiscal action--whether it be the House-passed $16 billion cut, or something closer to the Administration proposal--would do little more than offset the effects in 1979 of scheduled social security tax increases and the revenue drag resulting from the interaction of inflation and the progressive income tax.

Over-all, we continue to project a rate of real GNP increase averaging around 3-1/2 per cent through the end of 1979. Growth in real output is projected to rise to about 4 per cent in the first half of next year in response to the assumed tax cut, but to slip back to about 3 per cent in the second half, as the effects of the fiscal action dissipate.

In this general environment, employment gains should slow significantly further. There is likely to be little additional improvement in unemployment, in fact a slight rise in the jobless rate is projected toward the end of 1979.

The prospect of continued high rates of inflation remains a key negative element in the outlook. Over the first half of this

year, retail prices accelerated to a 10-1/2 per cent annual rate from the 6-3/4 per cent pace during 1977. While food prices have been a major source of the acceleration, other prices have also moved up more rapidly. Excluding food and energy items, consumer prices have risen at about a 9 per cent annual rate so far this year, compared to a 6-1/2 per cent increase during 1977.

There are signs that food price increases are finally moderating as expected--the food component of the Producers Price Index declined in July. But the advance of food prices is projected to remain more rapid than in the past few years, and there is little prospect that the pressure of rising costs on nonfood prices will ease. Unit labor costs are likely to continue rising at a rapid pace, with recent large price increases reflected in bigger wage settlements in the heavy round of negotiations scheduled for next year. And, of course, inflation can be expected to accelerate somewhat in early '79 as a consequence of the scheduled boost in social security taxes and the minimum wage. In sum, we continue to project a rate of price increase ranging between 7 and 7-1/2 per cent through the end of 1979.

FOMC MEETING

AUGUST 15, 1978

REPORT OF OPEN
MARKET OPERATIONS

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

Desk operations since the last meeting of the Committee were directed steadily at achieving a Federal funds rate within a 7 3/4 - 8 percent range. This objective was slightly above the 7 3/4 percent rate sought prior to the July meeting, though about in line with the rates prevailing in the market shortly before that meeting. Incoming information on the monetary aggregates first weakened and then strengthened during the past month, but on the whole suggested growth rates within the Committee's bands of tolerance, thus calling for no change in the Desk's approach as the period progressed.

While we had some concern at the time of the last meeting that it might be difficult to promote a funds rate very slightly above 7 3/4 percent without having the market carry the rate immediately to 8 percent, in fact this task proved to be easier than anticipated--in part through luck. Considerable firmness in the money market at the start of the interval provided opportunities to show resistance to an 8 percent rate, while soon afterward there were opportunities to resist the 7 3/4 percent lower bound. For the whole period, funds averaged very close to 7 7/8 percent.

For the most part, Desk operations were addressed to temporary reserve needs or excesses--with substantial repurchase agreements at the opening of the period, and to a lesser degree around August 1 and 9. Matched sale-purchase transactions were

arranged almost every day with foreign accounts and in the market on several occasions when funds tended to ease. Outright operations included purchases of $311 million of bills early in the interval from foreign accounts, and sales of $689 million of bills to those accounts from August 3 to 8. Also in early August, the System sold $173 million of short-term Federal agency issues in the market, an operation that was taken readily in stride as the way had been prepared through earlier comments to market participants. With large reserve needs looming for next week, the Desk will probably be undertaking a sizable purchase of Treasury coupon issues today for delivery tomorrow or Thursday.

The System's move to a slightly firmer funds rate at the start of the period elicited only a small reaction, as most market participants had expected such a move. Indeed, with many expectations focussed on a funds rate of 8 percent, the Desk's more modest move helped spark a substantial price rally that extended over much of the period. The market was ripe for a rally, in view of deep short positions among primary Government securities dealers and many other active trading accounts around the country. Aided by news of more moderate growth in the aggregates, indications of lessened momentum in the economy, and official comments suggesting that a peak in rates might be near, there was a pick-up in investor demand and a scramble--frantic at times--to cover short positions. Toward the end of the period the market gave up some of its large gains as there was disappointment with the latest wholesale price number, and as further reflection gave analysts little reason to conclude that fundamentals had changed so

significantly. Even so, rates on Treasury securities for the entire interval were down by about 20 to 40 basis points.

The Treasury's August refunding came in the midst of the rally and was well received though sharp price gyrations made bidding difficult. The new 3, 7 and 30 year issues were sold at yields some 15 to 30 basis points below those contemplated at the start of the period. The 3-year issue ended the period at a substantial premium over its issue price, the 7-year note closed virtually at the issue price after having been above it for several days, and the long bond was nearly 1 point below issue price. Dealers have now distributed nearly all of their moderate take-down of the 3-year issue, and most of the 7-year notes, but they still hold a sizable amount of the long bonds.

With the help of new supplies available from the Treasury, primary dealers filled in the deep $1.5 billion net short position of a month ago in over-1-year maturities. At one point soon after the refunding they were in a net long position of about $1.1 billion in over-1-year issues, but that was worked down to about $300 million by last Friday, and a further drop is likely today if, as noted, the System buys coupon issues to meet upcoming reserve needs.

Compared with the coupon market, developments in the bill market were relatively subdued in the past month. Rates were down about 10 to 25 basis points, despite the slightly higher funds rate, partly reflecting more substantial foreign official demands and greater dealer willingness to hold inventories.

In yesterday's auction of 3- and 6-month bills, the average issue rates were about 6.89 and 7.26 percent, down from 7.11 and 7.50 percent the day before the last meeting.

FOMC Briefing
S. H. Axilrod
Aug. 15, 1978

Following moderate growth at about 5½ per cent, annual rate, in June and July, M-1 is projected to expand at a more rapid 7½ per cent annual rate in August and September. Such a growth rate is more representative of the underlying demand for money--given GNP--as it has developed since the latter part of 1976. The slower growth of June and July probably can be explained to a great extent as part of the averaging out process that naturally follows a burst in monetary growth as unusually large as the 19 per cent annual rate of M-1 expansion in April.

In addition, there is the possibility that the June-July expansion in M-1 was held down by the very sizable $7 billion increase in U.S. Government deposits that took place over that two-month period. However, we have never been able to find any consistently close relationship between the behavior of Government deposits and the money supply. Still, if the June-July expansion in Government deposits did happen to absorb more private demand deposits than the public needs at the current level of nominal GNP, a compensating rather rapid expansion in M-1 should soon take place as the public attempts to restore cash balances to desired levels. We have not allowed, except to a small degree, for such an effect in our August-September projections. The strengthening of M-1 growth that we foresee basically represents, as mentioned earlier, a return closer to the underlying trend of the past year and a half or so.

Both M-2 and M-3 are also expected to show relatively strong rates of expansion in the period immediately ahead. In the August-September period, growth

of M-2 is projected at about 9 per cent and of M-3 at about 9¾ per cent --in both cases around the upper limits of their longer-run ranges. Both banks and savings and loan associations have recently been bidding rather aggressively in the market to obtain funds to meet strong credit demands--banks through ceiling-free large denomination time deposits and savings and loan associations through the new 6-month money market certificate. And we do not expect much more than a modest slowing in such inflows over the weeks ahead.

This projected pattern of behavior in the monetary aggregates, if it develops, would indicate that all of the M's-- and particularly M-1--could be running strong relative to their longer-run ranges. As a result, the Committee may wish to consider widening the Federal funds rate range at this meeting to allow more flexibility to move the rate upwards if that proves necessary to help restrain monetary growth within desired bounds. And I might add, Mr. Chairman, that M-1 may give a better signal of any need for funds rate adjustments in the period ahead than the broader aggregates since it is not affected by any lingering stock adjustments in the public's asset holdings that may be taking place as a result of introduction of the new 6-month money market certificate--not to mention that it may better reflect underlying inflationary pressures on the aggregates.