

Notes for FOMC Meeting
December 19, 1978
Scott E. Pardee

From the last FOMC meeting the dollar held its own through the end of November and into early December. As a result of the November 1 package and our vigorous follow through, market participants were impressed that this time the U.S. authorities meant business. The covering of short positions and unwinding of adverse commercial leads and lags was beginning to bolster the dollar. This was particularly the case in the Japanese yen which dropped to as low as 203, down some 4-1/2 percent from the last FOMC meeting and 13 percent from the pre-November 1 high. The Swiss franc also slipped somewhat further. The German mark was steadier, partly because the Bundesbank was busy selling dollars to mop up domestic liquidity but the mark rate remained some 12 percent below the peak hit just before the November 1 package. By early December, we were beginning the process of unwinding swap debt in these three currencies and were setting up procedures by which we could acquire large volumes with a minimal effect on market psychology.

The dollar nevertheless remained extremely vulnerable to any sort of bad news—and that's about all we have had over recent weeks as far as the market is concerned. Our October trade figures, a deficit of \$2.1 billion, were in line with the gradually improving trend expected by the U.S. authorities but were worse than the previous two months and were therefore of little help. In contrast, the latest consumer and wholesale price indexes released in late November and early December were poor by any standards.

Although the initial reaction to these figures was muted, the lack of progress on the price front was clearly disheartening to the market. Traders again began to react negatively to comments by U.S. officials on economic policy and prospects, whether the comments were

quoted accurately or not. Meanwhile the convoluted negotiations over the EMS kept the market on edge and made traders reluctant to buy dollars. The outcome was for the EMS to begin on January 2 with the U.K. and Norway on the sidelines, but with France, Italy, and Ireland in.

Nervousness over the EMS had hardly passed when the political crisis in Iran built up, particularly around the weekend of December 9-10. Hot money flowed out of that country into several havens, including Swiss francs and gold. But because of the many negative implications for U.S. defense and economic policies the Iranian situation set off broader selling pressure against the dollar and remains a potential destabilizing factor today. Second, the OPEC price fixing meeting this past weekend prompted additional dollar selling before it started. The result, a 14.5 percent jump in OPEC oil prices scaled over the next year, was a disappointment since it came after many expressions of hope from U.S. officials that the 1979 increase would be substantially smaller than that. Consequently, yesterday and today have been bad days for the dollar. Since early December dollar rates have slipped back by some 4 to 6 percent against the Japanese yen, the Swiss franc and the German mark. And we have intervened again on very large scale over the past ten days, particularly in German marks.

From our operations yesterday I think we can calm the market again for a spell. But until the United States comes up with a credible improvement on inflation and on the trade balance the market will continue to dump dollars on us every time something goes wrong around the world. In the current market atmosphere, anything else which goes right for us will be ignored.

Intervention sales of currencies by the Desk during the period amounted to \$2.5 billion. Of this \$2.2 billion was in German marks, \$260 million was in Swiss francs, and \$39 million was in Japanese yen. The sharing arrangements were essentially as before, with the U.S.

Treasury and the Swiss National Bank and the Bank of Japan. Taking the System alone, the total sales amounted to \$1,431 million. As indicated, we were able to repay some debt during the period, by \$281 million. Nevertheless, with the heavy new intervention the System's outstanding drawings rose to \$4.8 billion. As of today's operations, our drawings in German marks amount to \$3,949 million, \$788 million of Swiss francs and \$106 million of Japanese yen.

Finally, per your approval by wire the System has taken over \$1.6 billion of German marks on a warehousing basis for the Treasury, following the Treasury's issuing of 3-4 year mark-denominated notes in the German capital market.

REPORT OF OPEN
MARKET OPERATIONS

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

The Account Management pursued a steady course during the period since the November meeting of the Committee, aiming for reserve conditions consistent with a Federal funds rate of about 9 7/8 percent--just slightly above the rate objective prior to the November meeting. Following a temporary strengthening just a few days after the meeting, estimates of the aggregates were progressively lowered during the period. On December 8, with M_2 growth estimated close to the bottom of its range, the Account Management faced a question as to whether to foster somewhat easier conditions in the funds market--although factors such as the continued fragility of the dollar argued for no change. Upon a recommendation by the Chairman, the Committee agreed that day to have the Manager hold the funds rate at about 9 7/8 percent unless monetary growth weakened significantly further. The data reviewed last Friday did in fact point to further weakening of growth, but against the backdrop of so little time remaining until today's meeting, the fact that one additional week of data is generally a slender basis on which to make a significant move, and fresh signs that U.S. intentions regarding the dollar were being tested in the foreign exchange markets, the decision was made to continue aiming for a funds rate around 9 7/8 percent.

The System Account was a sizable net seller of Treasury bills during the period on an outright basis. There were purchases of bills from foreign accounts early in the interval when reserve needs more or less coincided with foreign account sales. The foreign sales were sizable at times, partly resulting from the temporarily stronger dollar in the exchange markets. About midway through the period the picture changed, and foreign accounts were large buyers of bills while the System Account was in a position to sell as reserves were being supplied by market factors. On balance, the System sold a net of \$1.2 billion bills outright. As usual, substantial day-to-day use was made of repurchase agreements and matched sale-purchase transactions to add or absorb reserves temporarily.

The institution of the new Treasury tax and loan note balance program is beginning to make some noticeable difference in Desk operations. With Treasury deposits at the Fed being held to moderate working balances, while mid-December tax receipts largely flow into the new note balance accounts, we do not expect a late December reserve need on nearly the same scale as in other recent years. Over the long pull the new tax and loan set-up should not affect the rate of growth in System holdings significantly--just the timing of purchases and sales, and particularly the magnitude of temporary reserve adjustments.

Market yields pushed higher during the inter-meeting period, reflecting the slight further rise in the funds rate, continued business strength, additional evidence of steep inflation,

and fresh signs of weakness in the dollar. Investor sentiment seems to have shifted toward a view that rates will have to rise further and remain high longer than expected earlier. There was a further upward ratchet in rates yesterday, following weekend news about the OPEC oil price increase. Some encouragement was taken earlier in the period from the moderation in monetary growth, but market participants tended to doubt that such moderation would prove lasting, and other factors tended to swamp this one. Treasury coupon issues rose in yield by roughly 30 - 70 basis points for maturities out to five years, and mostly by 25 - 50 basis points for longer issues. Treasury financing activity was fairly light in the domestic market, though the period saw the issuance of a 3 billion D-mark issue of 3- and 4-year notes, which has indirectly raised dollars for the Treasury.

Today the Treasury is auctioning \$2 1/2 billion of 2-year notes at a new high yield for a coupon issue of perhaps around 9.85 percent--up from 9.36 percent a month ago. Tomorrow, a similar-sized 4-year issue is to be auctioned, perhaps at about 9.35 percent. The two issues together approximately replace notes maturing December 31. Soon after the turn of the year the Treasury may be back to raise new money, perhaps around \$ 1 1/2 billion in the 15-year area.

Treasury bills also rose in rate during the period as foreign official buying let up or was met through sales from the System. On occasion, when the dollar enjoyed some temporary strengthening, the Desk was in a position to sell bills on

behalf of foreign accounts. Yesterday, 3- and 6-month bills were auctioned at average rates of about 9.24 and 9.52 percent, up from about 8.70 and 9.00 percent the day before the last meeting.

Dealers in Government securities are winding up another poor profit year. Losses have not been as severe as in 1977, but the mere fact of successive loss years, for the dealers as a group, is discouraging. Given the typical volatility of profits in this industry, I would not ordinarily bring the recent loss experience to the Committee's attention, but I do have some concern that some longer-term factors are at work on top of the usual volatility, and this could pose a threat to the underlying vitality of this important industry.

James L. Kichline
December 19, 1978

FOMC BRIEFING

The pace of economic activity appears to have picked up this quarter. Incoming information has been surprisingly strong and our reading of developments points to real growth for the fourth quarter around 4-1/2 per cent annual rate, about a percentage point faster than anticipated a month ago. At the same time, price increases are also running higher than seemed likely at the last meeting of the Committee, and the projected rate of inflation this quarter and next year have been raised.

Labor market developments underscore the apparent strength of recent economic activity. In November, employment rose substantially after large gains in October. For the two months combined, payroll employment increased 800,000, adjusted for the effects of strikes. Increases in employment have been widespread, but additions to manufacturing payrolls have been particularly sizable following no growth during the summer. The labor force rose considerably further in November and the employment increases led to an unchanged unemployment rate of 5.8 per cent.

Given the available information on physical output and labor inputs, total industrial production is estimated to have risen .7 per cent last month. This gain is a couple of tenths faster than the two preceding months, and resulted in a further rise of capacity utilization to around 85-3/4 per cent in manufacturing. Output of both products and materials advanced appreciably, with strength in most output categories.

Over-all, the rise in industrial output does not seem to be piling up in inventories given the indications of a sizable increase in private final purchases this quarter. In particular, personal consumption expenditures now look quite strong, and this sector accounts largely for the upward revision to projected real growth this quarter. Total auto sales for the quarter seem to be on track at a little over an 11 million unit annual rate, our expectation of a month ago. But excluding autos, total retail sales are now reported to have increased considerably in October--instead of declining as first indicated--and in November such sales are reported to have jumped 2-1/2 per cent. The retail sales data, of course, are subject to sizable revisions and the picture could look quite different a month from now. However, given the current sales reports and even assuming no further growth in December, personal consumption expenditures would likely show an increase in the neighborhood of 5 per cent annual rate in real terms.

A key issue at the present time is how one perceives the recent strength in employment, production, and sales and what that strength may portend for economic developments in the quarters ahead. The staff has read the developments as raising the level of activity in the current and following quarters, but not affecting significantly the pattern of real growth after the current quarter. Real GNP growth is still expected to moderate throughout the next year and to increase 2 per cent from the fourth quarter of this year to the fourth quarter of 1979.

Prospective developments in both consumption and investment suggest a moderation of economic activity, offset only slightly by

improved performance of net exports and a little larger rise of total Government purchases. In the consumption area, rapid spending increases so far this quarter have coincided with substantial gains in income attributable to the recent surge of employment growth. But looking ahead, demand prospects outside the consumer sector point to slower employment and income growth. The projection of slower consumer spending is not associated with a significant increase in the savings rate. The savings rate at 5 per cent currently is already quite low and the forecast suggests consumers will continue to substitute real for financial assets. Nevertheless, the cumulative impact of heavy and increasing debt burdens, persistent high inflation and sluggish real income growth will take their toll on consumer ability and willingness to spend.

In the residential construction area, expenditures in real terms began declining in the third quarter and seem likely to continue on a downward path through next year. However, housing activity in terms of both starts and sales has been well maintained. Sales of both new and existing houses rose strongly in October, and starts in November edged up to slightly over a 2.1 million unit annual rate. The general expectation of a further tightening of mortgage market conditions along with unusually good weather may have tended to accelerate starts and home sales. Looking ahead, though, the housing sector is not expected to support activity, rather it is a question of the timing and extent of decline.

Business fixed investment spending is expected to continue rising next year, but at a considerably slower rate than in 1978.

Although new orders, production, and shipments of capital goods recently have been strong, those developments tend to mask some longer-run negative factors. Both capital appropriations and surveys of planned expenditures suggest slower growth. The new orders data in particular may be giving some misleading signals, as part of the orders are for export and a good deal of the recent strength reflects commercial aircraft orders with long lead times. Even with some scaling up of the reported spending plans, which is built into the staff forecast, expansion of business investment spending is likely to slow next year.

On the price side, revisions of past data and new information have not been encouraging. Producer and consumer price indexes continue to show rapid price increases, with energy prices in particular up sharply this quarter. Energy prices are expected to continue under strong upward pressures in 1979, even without allowing for the larger OPEC price rise than we had assumed. Moreover, recently available data on unit labor costs for the third quarter are much worse than indicated earlier and will probably deteriorate further this quarter. Over-all, the gross business product fixed weighted deflator is now expected to rise around 8 per cent this quarter and about 7-3/4 per cent in 1979.

In any forecasting exercise there is, of course, the possibility that events may turn out differently than anticipated. One can't assess in a rigorous fashion the likelihood of being wrong for a judgmental forecast, but there are techniques available for doing so with econometric model forecasts. At the present time the quarterly econometric model forecast for 1979 is not much different than the

Greenbook forecast. The model simulations now indicate less than a 1 in 10 chance that the GNP deflator will rise less than 7 per cent next year and about a 1 in 4 chance inflation will be 9 per cent or greater. For real GNP growth next year, there is a 1 in 4 chance of growth exceeding 3 per cent and a similar chance of 2 consecutive quarters of negative growth. These numbers are suggestive of the difficult nature of the current economic situation, with significant risks of accelerating inflation or recession.