

## APPENDIX

Notes for FOMC Meeting  
May 22, 1979

Margaret L. Greene

The dollar has remained buoyant in the exchange markets since mid-April. This firmness has been reflected in declines of the German mark and the Swiss franc of about  $\frac{3}{4}$  percent since the time of your last meeting--declines that were moderated by sales of \$4 $\frac{1}{4}$  billion by the authorities in the United States, Germany and Switzerland. Other continental currencies in which intervention was not so heavy fell more nearly by  $1\frac{1}{2}$  percent. The currency experiencing the most pronounced drop was the Japanese yen, which fell at one point by  $4\frac{1}{2}$  percent to a level some  $28\frac{1}{2}$  percent below its October 1978 peak. It turned around for a time following Prime Minister Okira's expression of concern over the embarrassing weakness of the yen and an indication that he would prefer the rate to be close to ¥ 200. The Bank of Japan, which had been intervening to limit the decline, then continued to operate to give support to a recovery in the rate. In all, its dollar sales since the last meeting amounted to almost . . . . . But in view of the swing in Japan's balance of payments position and the vulnerability of its economy to shortfalls in oil imports, the yen has again weakened to trade below its mid-April levels.

Turning to the dollar, it benefited this time, as in earlier periods this year, from the attraction of relatively high interest rates in the United States, from the reversal of leads and lags and of positions taken up last year, and from early signs of improvement in the fundamentals. It was buoyed by a persistent commercial demand for dollars that undoubtedly reflects, among other things, the need for dollars as the principal transaction currency for internationally traded commodities, like oil. But there were three other factors that took on particular importance during this intermeeting period.

First, concern about inflation has shifted somewhat more abroad where almost every new price index that is published points to a further intensification of price pressures, particularly at the wholesale level. The market does not think that the United States is "out of the woods" on the inflation front by any means. But release of statistics that cast doubt about the further rapid growth of the economy here, as well as the strength of the dollar and the readiness with which the Federal funds rate was moved up, have been interpreted in the market as reducing the risk that a new round of price pressures will emerge without prompting actions to keep them in check.

Second, the continuing improvement in our balance of payments position was dramatically underscored by the announcement of the smallest monthly U. S. trade deficit in two years for March. The news itself gave a renewed boost to the dollar at the end of April. And even after the immediate impact had passed, the statistical evidence of a rapid acceleration in U. S. exports and a strong improvement in the U. S. bilateral trade deficit with Japan continued to have a favorable impact on market psychology.

Third, the energy crisis took on a more serious dimension with the news of further cutbacks in production and in deliveries of crude oil, as well as unexpected crude oil price rises by several producer countries. These developments heightened the prospect of a substantial, further rise in OPEC official oil prices at the ministerial meeting in June. They also fed fears that current oil shortages might tighten further, a development that the markets judge would have more damaging consequences for Japan and for continental Europe than for the United States. Moreover, with the dollar now firmer and interest rate differentials strongly in our favor, there is a risk that oil-producing countries will place large amounts of their investible surplus in other currencies.

The Desk has continued to intervene to buy German marks. We were of course taking advantage of the strength of the dollar to obtain cover for the System's remaining swap debt in marks. As long as that debt was outstanding, we were operating for the System alone, in accordance with an understanding with the Treasury. At times, however, we intervened also to limit a sharp rise in the dollar that might produce more instability later on. It was for this reason that we operated forcefully after the March trade figures were announced. Indeed, within an hour we had purchased sufficient marks to repay in full the System's residual swap debt. All of the intervention in marks we have done since then has been on behalf of the Treasury in order to cover its exposure under the "Carter note" obligations. In all we bought \$380 million equivalent of marks for the System and \$570 million for the Treasury, for a total of \$850 million.

Meanwhile, the Bundesbank has worked hard to stem the decline of the mark, selling about \_\_\_\_\_ or so. But in recent days, the market is beginning to sense that the Bundesbank may be more constrained in its operations in the days ahead. The Bundesbank, like its counterpart in Switzerland, is becoming concerned about the abrupt absorption of liquidity that has resulted from the huge capital outflows that have occurred so far this year. Further official dollar selling just aggravates that problem. Moreover, now that the German mark has moved up to near the top of the EMS, the Bundesbank is losing room to continue selling dollars without forcing another central bank to intervene to support its currency against the mark.

REPORT OF OPEN  
MARKET OPERATIONS

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

For about the first third of the period since the last meeting, the Desk continued to foster a Federal funds rate around 10 percent or slightly higher, the same objective sought since the end of 1978. By April 27, it was clear that monetary growth had increased sharply in April, and while part of the bulge could be attributed to transient factors, the expectation was that two-month growth in the aggregates would be at or above the upper bounds indicated by the Committee. Following a Committee telephone consultation, the Desk began seeking a funds rate of 10 1/4 percent--implementing the change promptly, within minutes of the conference call, so that the market could be apprised before the Treasury auctioned its intermediate and long-term refunding issues.

In the next two weeks, Board staff estimates of the aggregates were raised a little higher, posing a question whether the Desk's stance should not be firmed somewhat further within the 9 3/4 - 10 1/2 percent funds range set by the Committee. Following consultation with senior Committee staff on May 4, when the Treasury auctions had just barely been completed, the Account Management retained a 10 1/4 percent objective. A week later, May 11, the Chairman expressed the view that a 10 1/4 percent objective remained appropriate, consistent with the prevailing Directive, in light of over-all financial

conditions and uncertainties in projections of the aggregates, and a majority of Committee members concurred in this view. Thus the Desk's objective remained 10 1/4 percent. The aggregate data reviewed last Friday were a shade weaker than in the previous week, and although two-month growth estimates were still above the Committee's ranges, the Account Management considered it appropriate to stay at 10 1/4 percent in the remaining few days up to today's meeting.

For the period, the funds rate averaged 10.21 percent, with recent weeks holding very close to 10.25 percent. Against the backdrop of a 3/4 percentage point difference between the funds rate and discount rate, there has been a pick-up in discount window borrowing recently--to around \$1 1/2 - 1 3/4 billion compared with average levels somewhat under \$1 billion several weeks ago. With banks meeting part of their reserve needs at the discount window, System reserve provision through open market operations was relatively modest. On an outright basis, the System bought slightly over \$1 billion of bills from foreign accounts early in the period, and this was partially offset later by sales of about \$250 million of bills to foreign accounts. Midway through the interval, temporary reserves were supplied through repurchase agreements, in part to make clear that the rise in the funds rate was meant to be quite limited. Matched sale purchase transactions were arranged daily with foreign accounts and on a number of days in the market as well.

Despite the higher Federal funds rate, other short-term market rates showed mixed changes over the period, including some declines for commercial paper and longer maturities of Treasury bills. Short bill maturities rose in yield, largely reflecting the increased supplies as several foreign countries sold dollars to support their own currencies. Net Desk sales of customer bills to the market came to more than \$5 billion since the last meeting. Since the beginning of the year, foreign account holdings of Treasury bills have declined more than \$15 billion.

In yesterday's auction of 3- and 6-month bills, the average issuing rates were 9.74 and 9.60 percent, compared with 9.61 and 9.63 percent, respectively, the day before the last meeting.

Intermediate-term yields were unchanged to somewhat lower, while most long-term yields rose during the period by about 7 basis points. Pessimism over inflation prospects appeared to weigh on sentiment, leading many participants to feel that monetary restraint would have to be maintained for a long while, and perhaps even be intensified. Bond prices rose toward the end of the period as weaker numbers on the economy were reported, but the rally seemed to be mainly dealer-inspired, with only moderate investor demand reported. Midway through the period, just after the System moved to a 10 1/4 percent funds rate, the Treasury auctioned \$2.3 billion of 10-year notes to yield 9.37 percent, and \$2 billion of 30-year bonds to yield 9.23 percent. Both yields were modern records for those maturity areas. Total bidding interest was substantial, but as often happens, dealers tended to step ahead of yield levels that

were attractive to investors, thus winding up with substantial shares of the issues and then encountering little retail demand in the initial distribution period. As a result, both securities--but especially the long bond--traded below issue price until the final few days of the period. While the rally in recent days brought the issues back above issue price, dealers still had some fair-sized holdings at the end of last week.

Finally, I should report that the Desk has added another firm--Kidder Peabody--to the list of dealers with which a trading relationship is maintained. This brings the number to 35.

James L. Kichline  
May 22, 1979

FOMC BRIEFING

A. Introduction

A literal reading of incoming information on economic activity since the last meeting of the Committee generally provides a poor guide to unfolding developments; key data have been distorted by strikes and weather effects. However, the staff's interpretation of available information has not led to a significant change in the forecast for the current or subsequent quarters. Real GNP in the first half of this year seems likely to expand at an average annual rate of 1-1/2 per cent or less, well below the pace last year, and consistent with some easing of pressures on capital and labor resources as well as product markets.

B. Recent Developments in Economic Activity

1. Revised GNP statistics for Q1 available since staff's forecast prepared, but main sectoral revisions anticipated and therefore will not have notable influence on our forecast.
  - a) Both net exports and business fixed investment were revised up appreciably while other sectors lowered;
  - b) In the aggregate little net change; growth of real GNP reduced slightly, to roughly 1/2% annual rate, and inflation--as measured by business product fixed weight deflation--remained near 10% annual rate.
2. Information on activity so far this quarter is limited but generally weak, such as the labor market report for April.
  - a) Sharply reduced rate of growth of total nonfarm employment in April with small decline in manufacturing sector, unemployment rate edged up 0.1 to 5.8 per cent.

- b) However, data distorted because survey taken during last week of Teamsters' strike and also a period of religious holidays;
  - c) We anticipate stronger employment growth in May and June, but substantially less than in late 1978 and early this year.
3. Industrial production also weak in April.
- a) Decline in total industrial production index of 1.0% for the month, with reductions widespread among industries.
  - b) Output of motor vehicles and parts especially depressed, due principally to the impact of the trucking dispute.
  - c) Drop in output brought rate of capacity utilization in manufacturing down to about 85 per cent, the lowest level since the summer of last year.
  - d) Staff forecast anticipates a rebound of output later this quarter, but even so it seems likely that capacity utilization rates will fall short of their highs reached a few months ago.
4. In the consumer sector, pace of retail sales continued sluggish in April.
- a) Nominal value of total retail sales rose only 1/2 per cent, which undoubtedly translates into a decline in real terms. Auto sales declined--notably for intermediate and large cars--while increased sales of nondurable goods were fueled largely by higher prices.
  - b) Given the performance earlier this year, the level of sales in real terms in April was about back to that prevailing in early fall of last year.

- c) There are a variety of scattered reports suggesting the gasoline situation may be depressing retail sales to some extent. Allowed for some slippage in energy-related durable goods purchases, such as recreational vehicles.
  - d) Over-all, the current forecast implies a pickup in sales later this quarter, although sluggish growth of income is expected to act as a constraint on expansion of consumer outlays throughout the forecast period.
5. Reports available on the residential construction sector indicate a perceptible slowdown of activity is in process.
- a) Housing starts in April were at a 1-3/4 million unit annual rate, a shade below the month-earlier pace.
  - b) Both starts and permits in April were 16 per cent below the average level of the fourth quarter.
  - c) Moreover, financial conditions in mortgage markets have tightened further as indicated by continued increases in interest rates, declines in mortgage commitments, reduced deposit flows to thrift institutions, and qualitative reports of more cautious lending behavior.
  - d) These developments have led us to reduce the forecast of housing starts by about 50,000 units this year and next.
6. In the business investment sector, the latest information generally relates to March.
- a) Both shipments of capital goods and nonresidential construction activity were strong in March, in association partly with a rebound from the earlier severe winter weather.

- b) It seems likely that the strong pattern of business fixed investment spending will carry over into the current quarter.
  - c) Beyond the current quarter growth of investment expenditures is expected to moderate in response to slowing of sales and reduced pressures on capacity utilization. The performance of new orders for capital goods and contracts for nonresidential construction are consistent with this view. Spring survey results of anticipated spending conducted by McGraw Hill and Merrill Lynch are also consistent with slower expansion, after allowance is made for the systematic overstatement of outlays by both surveys.
- C. In sum, the staff forecast of the economy still portrays a pattern of small real growth in 1979 and 1980. At the present time inflation is expected to remain substantial, but reaching a peak rate in the current quarter and moving irregularly lower later this year and in 1980.
- 1. Both food and energy price increases have been huge so far this year and have played a major role in boosting rates of inflation.
  - 2. We anticipate continued large, but nonetheless slower increases in these prices beyond the current quarter. For food prices there are now growing hints of some relaxation of pressures; consumer food prices declined in the April Producer Price Index and both spot and futures market prices for beef and pork have tended to ease in recent weeks.
  - 3. Even so the process of returning to a semblance of price stability will probably be lengthy, given historical experience, and inflation is not expected to fall below 8 per cent until the latter half of 1980.

D. Finally, it should be noted that we have not revised our projections to incorporate new assumptions regarding fuel shortages. Outlook on the supply side is quite unclear, although the persistence and spread of shortages could well have a damping impact on activity.