

CONFIDENTIAL (F.R.)

NOTES FOR FOMC MEETING

AUGUST 17, 1976

Alan R. Holmes

Since the last meeting of the Committee, the dollar has been generally steady in the exchange markets. On the Continent, however, the EC snake has been under renewed pressure, with the German mark at the top and other currencies clustered at or near the bottom. Since Germany's inflation rate is now a shade above 4 per cent and most of the other countries in the snake arrangement have inflation rates of roughly double that, the market believes that sooner or later an exchange rate realignment within the group will be necessary. Last March when the snake was under extreme pressure, you will recall, the Germans offered to revalue in exchange for devaluations by other members of the snake. Some balked at the time and the French finally dropped out of the snake instead. With an election coming up on October 3, the German government may find it more difficult to make an overt revaluation of the mark, while the snake partners still have a variety of reasons for not devaluing against the mark at this time. There have been attempts by Germany's partners to undertake monetary, fiscal and incomes policy measures defined to restore a measure of more fundamental equilibrium within the snake. But it would take a near miracle to avoid recurrent [speculative attacks.]

A renewed sinking spell for the French franc, outside the snake but still important in intra-EC trading relations has compounded the snake's difficulties. Intervention by the Participants to maintain the margins has amounted to \$1.6 billion since the last meeting of the Committee, of which 620 million took place on last Friday alone. Much of last week's intervention was conducted in snake currencies which tended to minimize pressure on the dollar in the market.

Given the dollar's role as vehicle and intervention currency, however, speculation in favor of the mark against other currencies also tends to trigger speculation in favor of the mark against the dollar. Consequently, after nearly ten weeks of essential stability in the dollar/mark rate, a large one-shot OPEC country's sale of dollars for marks touched off additional shifts out

of dollars into marks. The mark was bid up by nearly 2 per cent against the dollar, and pulled the other snake currencies along, even as they themselves remained under heavy selling pressure.

The dollar/mark has since steadied somewhat, but remains a bit more volatile than it has been since last spring. In view of the basically parallel behavior of the U.S. and German economies at this stage of the recovery, there would seem to be little reason for the mark—and particularly its EC partner currencies—to appreciate against the dollar at this time, but the market has swung in that direction on previous occasions and we are keeping a close watch of developments. Our only entrance into the market, apart from a small purchase of marks directly from a correspondent and timing [unintelligible] Belgian francs, was the sale of \$9½ million equivalent in marks yesterday.

The pound sterling has at last steadied out to some extent and the Bank of England has made no further swap drawings. As you know, the Bank of Italy was fully repaid its \$500 million drawing on us and continues to gain reserves on balance. With the dollar easing, we have slowed our pace of purchase of Belgian francs somewhat, but were able to repay a further \$20 million, reducing the debt in that currency to \$62 million.

Lyle E. Gramley  
August 16, 1976

FOMC Briefing

Incoming statistics over the past month indicate a continuation in July of the slower pace of economic expansion that characterized the second quarter.

July retail sales figures were a disappointment. The advance estimates are, of course, subject to substantial revision, but qualitative comments in the Redbook this month support the view that consumer spending has been lackluster for a wide range of durable and nondurable goods. New auto sales seem to have improved, however, in the first 10 days of August.

Production adjustments to an undesired buildup of inventories have also continued this summer. The June rise of manufacturing and trade inventories was substantial-- at a \$40 billion annual rate, in book value terms. In July, total industrial production rose by just 0.2 per cent, as output of nondurable goods remained unchanged for the fourth successive month--that is, since March. Over this four-month period, durable goods production advanced at an annual rate of around 10%, and this kept total industrial output moving up at about a 5 per cent annual rate. In the durable goods industries, the rise of production in recent months has been concentrated in materials, particularly steel. Earlier estimates had shown a substantial expansion in output of

of business equipment, but this rise was reduced appreciably in last month's revisions

These developments in the industrial sector have left their mark on labor market conditions. Part of the rise in unemployment in June and July may be more statistical than real, but some of it reflects layoffs in nondurable goods manufacturing. Total factory employment--adjusted for strikes--has shown little or no growth over the past several months. In the service-producing industries, employment gains slowed in May and June, but were sizable in July, when a large rise also occurred in household employment and the labor force. Last month's substantial rise in employment appears inconsistent with other measures of economic performance. It may indicate--as this month's Redbook suggests--that the business community remains optimistic that the economy will soon pull out of the summer doldrums.

Our staff view of the outlook is consistent with that interpretation. We think the current pause will be temporary, as was the pause last fall.

We see no reason for believing that any fundamental change has taken place in consumer psychology. The latest surveys of consumer confidence--taken in May and June--do not show any appreciable change in consumer attitudes or intentions to buy from those prevailing earlier in the year. Moreover, employment gains have continued--though at a slower pace;

the price outlook has remained relatively favorable, and conditions in financial markets have stayed tranquil. There is therefore reason to expect the consumer to begin spending more freely in the near future.

The prospects for a strong rise of business fixed capital spending also seem good. We have now had six consecutive monthly increases in new orders for nondefense capital goods. In real terms, these new orders have risen at an annual rate of around 25 per cent in the first half of this year. Moreover, construction contract awards for commercial and industrial buildings are finally showing a convincing degree of improvement. I would doubt seriously that the recent slowdown in consumer spending, and in the rate of industrial expansion, has had any significant negative effect on business capital spending plans.

The housing sector, moreover, seems likely to provide a moderate stimulus to overall activity during the next several quarters. Sales of new and existing homes have perked up recently; mortgage credit is still in ample supply, and conditions in the multi-family sector are gradually improving.

Since the fundamental forces making for expansion do not appear to have changed, the staff's projection of real GNP growth for the latter half of 1976 and for 1977 has not been altered significantly. We still expect total real output to advance during this and the next five quarters at an annual rate of around 5 per cent. To be sure, there is greater uncertainty, and also greater downside

risk, associated with that forecast now than there was a month or two ago. But continuation of a moderate rate of economic growth still looks like a reasonably good bet.

Just a few remarks about recent price developments. As you know, the rise of industrial commodity prices at wholesale accelerated last month to 0.7 per cent. This step-up principally reflected increases in prices of metals that had been in the pipeline earlier, and increases in crude petroleum prices that resulted partly from new weights adopted for "new" and "old" oil in the price index. It does not seem to indicate a significant worsening in the underlying rate of inflation. There are, however, additional increases in metals prices still in the pipeline.

Wage rate increases last month also moved up a bit--but we expected larger increases in the second half of this year because of the timing/<sup>of</sup> new and deferred settlements under collective bargaining contracts.

These new data on wages and prices do not suggest a need for reappraisal of the price outlook. The staff still expects the rate of inflation to stay in the 5 to 5-1/2 per cent range through the end of next year.

FOMC Briefing  
S. H. Axilrod  
August 17, 1976

The staff once again expects growth in  $M_1$  to be moderate, on average, over the next few weeks. A considerable drop in Treasury balances is projected for September, and this might lead to some acceleration of  $M_1$  growth in that month. But we would expect growth over the two month August-September period to be around a 6 per cent annual rate--not far from the mid-point of the FOMC's longer-run  $4\frac{1}{2}$ -7 per cent range.

The projected 6 per cent August-September growth rate is, however, a little slower than the  $6\frac{1}{2}$  per cent average annual rate of growth in  $M_1$  that has prevailed over the six-month period encompassing the months of February through July. At such a rate of increase,  $M_1$  growth since the early part of this year has been running about 4 percentage points stronger than it had from mid-1975 through the first month of 1976.

With growth in nominal GNP somewhat slower thus far this year than during the latter half of 1975, the accelerated expansion in  $M_1$  seems to suggest at least that the downward shift in the demand for money relative to GNP that was so evident last year is proceeding much more slowly. Whether the downward shift in  $M_1$  demand has come to an end, or is in process of being reversed, is more doubtful. If the downward shift in  $M_1$  demand had been reversed, one would have expected short-term interest rates to rise in the first half of 1976. Such rates now are about  $\frac{1}{4}$ -- $\frac{3}{8}$  percentage point higher than they were in early 1976, but they remain about one percentage lower than they were in the summer of

1975. Moreover, our large scale econometric model suggests that a reversal is not yet in process.

In any event, a belief that the relationship between growth in  $M_1$  and GNP will soon move back toward--though probably not to--historically more usual patterns is the principal reason why the staff persists in projecting higher interest rates over the next several quarters. Given projected GNP growth and assuming  $M_1$  expands on average at just under a 6 per cent annual rate from now until mid-1977, the income velocity of  $M_1$  would expand at around a  $4\frac{1}{2}$  per cent annual rate over the next three quarters. It would be unusual if such an increase in velocity--occurring when economic expansion is well into its second year--were not accompanied by at least some rise in short-term interest rates.

$M_2$  and  $M_3$  have been expanding more rapidly relative to the FOMC's ranges than  $M_1$ . Growth in time and savings deposits other than money market CD's is expected to slow in August from the rapid July pace. We have assumed that about  $2-2\frac{1}{2}$  percentage points of this slower growth rate results from diversion of funds to pay for the new 8 per cent, 10-year Treasury note. Given some rebound in growth of consumer-type time and savings deposits in September it appears that  $M_2$  may grow at about a  $9\frac{1}{2}$  per cent annual rate from July to September--around the upper end of the Committee's longer-run range. Over the six months ending in July  $M_2$  had increased at about an 11 per cent annual rate.

While longer-run trends in the monetary aggregates, given projected GNP, suggest that interest rates may turn up later, the odds favor continued stability of interest rates over the next few weeks.



Certainly, credit market conditions appear calm. The Treasury has already raised the bulk of its third quarter cash need, and thus will not be returning to the market in size until later in the fall. The corporate and municipal bond calendars appear relatively modest through September. And while there have been a few signs of a pick-up in short-term business credit demands, these remain relatively light--and may not show any significant strength until later this year.