

Notes for FOMC Meeting
February 28, 1978
Scott E. Pardee

By the time of the last FOMC meeting, on January 17, we had pretty well achieved the minimal objective of restoring a sense of two-way risk in the exchange market. Nevertheless, the bulk of the huge short positions and leads and lags against the dollar remained outstanding as professional dealers, corporate treasurers and portfolio managers refrained from shifting back into dollars on any significant scale. Essentially, they were waiting to see if any of the other uncertainties which troubled them--U.S. energy policy, relative growth rates in the U.S. and abroad, and the commitment of the U.S. Administration to deal effectively with inflation--might be cleared up.

But little happened in the interim to relieve these concerns. To the contrary, the uncertainties deepened as time dragged on week after week with no sign of progress. The U.S. energy bill remained bottled up in Congress. The confirmation of Mr. Miller as Chairman of the Federal Reserve became bogged down. The U.S. and German governments were still perceived as being at loggerheads on whether German policy is sufficiently stimulative. The coal strike in the U.S. gradually caught the market's attention, not so much because of the economic effects, which are expected to be reversible, but because it was another of a growing list of unresolved issues. Many market participants--as well as our central bank counterparts--told us that they were wondering if the economic policy process in the United States hadn't ground to a halt. We can argue with them, but the lack of credibility runs so deep that mere words are no longer persuasive.

For a while, at least, the Federal Reserve had reestablished its credibility in the exchange market. The market remained in fair balance, with narrow movements of exchange rates for nearly four weeks through the second week of February. Over those 19 trading days, we intervened on only 4 days, for relatively modest amounts of German marks and, for the first time since 1975, in Swiss francs.

But beginning on February 13, the market became extremely disorderly once again. A sequence of meetings--a supposedly secret meeting of the G-5 Finance Ministers, bilateral discussions between U.S. and German financial officials, the monthly Basle central bank meeting, and an OECD meeting--provided no new answers while giving the world's press a golden opportunity to rehash all the difficult issues facing the participants and then in those meetings to pick through the few statements which did emerge to see who might be the winner and who might be the losers. Needless to say, this all cast the U.S. in a bad light and the dollar came under renewed selling pressure.

As before, the Bundesbank and the Federal Reserve continued to work closely together intervening in the exchanges, but we were thrown completely on the defensive. And this is a very psychological market. We avoided the defense of any particular rate. But market psychology often hinges on benchmark rates, and when the dollar-mark broke through the DM 2.10 level, the bottom fell out of the market for dollars. This new bout of dollar selling prompted a rise of 4 percent for the German mark, 7 percent for the Swiss franc, and even 2 percent for the French franc, a currency which itself is under a cloud ahead of next month's elections.

Each day, professional dealers kept testing us openly to see if we were still there or if, among all the other apparent areas of policy indecision and discord, the more active

approach we had adopted beginning on January 4 might suddenly be abandoned. Here again, we were warned that a failure to hold the DM 2.00 level, that is, 50 cents per DM, would lead to an even greater run on the dollar.

Last Friday, with the rate falling within a few whiskers of that level, we were already in the market when indications of a possible settlement of the coal strike and announcement of new exchange controls by the Swiss authorities provided the basis for a dollar rally. As trading became hectic, the Desk participated fully both as a buyer and a seller of marks with the demonstrated objective that the rally be orderly. Our efforts were well received in the market and by our central bank counterparts.

I must advise the Committee, however, that as our operations mounted, in our consultations with the available members of the FOMC Subcommittee that morning, we at the Desk neglected to request in advance, as specified in the Procedural Instructions, formal Subcommittee approval to exceed the daily limit of \$100 million on gross transactions--purchases and sales of a currency--and the intermeeting limit of \$500 million on gross transactions in a currency. Even after sharing the day's operations with the Treasury, we exceeded both limits by a sizable margin. The available members of both the Subcommittee and the full FOMC were so advised on that same afternoon. We regret the error on our part and will take steps to avoid its recurrence.

The market since then has been somewhat quieter and so far we have not intervened this week. The dollar is some 2 percent above its lows of last Friday. As could be seen from the tremendous surge in demand for dollars once the turn came last Friday, the market remains very heavily oversold of dollars. Any combination of positive events for the U.S. will, in my judgment, lead to a massive reflux into the dollar.

No one can forecast with any confidence the day or week that will occur. The underlying picture has improved in some ways; for example, the German and Japanese economies have begun to grow again. In the meantime, the System and the Treasury have run deeply into our swap availabilities. For the period as a whole we sold a further \$675 million of marks, split evenly between the Federal Reserve and the Treasury. During the period since the last FOMC meeting, the System drew a further \$338 million of marks under the swap line, raising our total drawings to \$1.563 billion equivalent on the \$2 billion facility. The Treasury, drawing pari passu with us since January 4, has drawn \$719 million equivalent on a line set originally for \$1 billion. In Swiss francs, our drawings from recent operations stand at \$69 million. When you turn to recommendations, Mr. Chairman, Alan Holmes will lay out our thinking on what to do if the dollar continues to be under pressure, further depleting our resources, or we begin to run out of time on our objective to repay swap drawings within six months.

James L. Kichline
February 28, 1978

FOMC BRIEFING

Since the last meeting of the Committee, a great deal of attention has been directed to the adverse impacts on economic activity of both the severe winter weather and the coal strike. Information available so far on business activity in the current quarter appears to paint a very weak picture, following the vigorous expansion of final sales in the last quarter of 1977. It is clear that the weather and coal strike have distorted the available statistics, and they will continue to do so for the next few months. The two key issues in assessing the current and prospective economic situation at this juncture seem to be first, the way the pattern of economic activity may be altered by weather and strike effects and second, to what extent underlying strength of activity may be eroding, if at all.

On the basis of past experience with both severe weather and strikes we judge that there will be little permanent loss of output and sales. From the weather side, activity now appears in process of recovering and seems likely to snap back strongly in March and April. The coal strike until mid-February or so had little apparent economic impact beyond the direct effects. The bulk of the reduction in coal output occurred in December and there was only a small further reduction in January, accounting for about .1 of the .7 per cent drop in industrial production for that month. By mid-February a special Labor Department survey of large firms in 11 coal-dependent States indicated only about 10,000 factory workers were laid off due to indirect effects of the strike.

Assuming a resolution of the coal strike soon and that the severe weather is behind us, we anticipate a quite rapid rebound of activity over-all. Thus, by the end of the second quarter it is expected that the effects will have been largely washed out. In the current quarter, the staff's forecast of real GNP has been lowered 1 percentage point to 4-1/2 per cent at an annual rate. In order to achieve this growth, a brisk recovery in activity is required since for January the dollar value of retail sales is indicated to have declined 3 per cent from the month earlier, housing starts fell nearly 30 per cent, and industrial production--as I mentioned--declined .7 per cent.

Abstracting from weather and strike effects, a reassessment of underlying strength in the economy accounts for part of the downward revision in growth this quarter and for that over 1978 as a whole. In 1978 real GNP growth is forecast to be about 4-1/2 per cent, or around 1/4 percentage point less than a month ago. This is still a strong performance at this stage in an expansion and sufficient to result in a small, further reduction in the current unemployment rate of 6.3 per cent.

There are 3 sectors in which we have become somewhat less sanguine given recent developments, namely autos, housing, and total government purchases of goods and services. The projection of auto sales has been reduced 150,000 units in 1978 from the 11 million unit sales pace we had forecast as of January. Auto sales have been erratic from month-to-month, but nevertheless have been softening on average for more than half a year. On the negative side, new car prices have

risen relative to prices of used cars and to prices of other durable goods, thereby acting as a depressant on new car sales. Consumers have continued to take on large volumes of additional debt, and in the aggregate now have less capacity for further indebtedness than earlier in this expansion. Moreover, the downsized-intermediate GM models have received a lackluster response from consumers. But there are important positive factors as well--income growth has been fairly strong and is forecasted to continue expanding at a good rate, longer-run demographics are favorable, demands for fuel-efficient vehicles are likely to encourage new car purchases, and dealers reportedly are beginning to cut prices. Our current forecast represents, we feel, a reasonable balance of diverse forces and if realized would be a strong performance for the auto industry over 1978 as a whole.

In the housing area, the pattern of activity anticipated during the first half of the year has been disrupted by weather. But, in addition to changes in pattern, we have reduced housing starts expected for the year to 1.9 million, or down a little more than 100,000 thousand units from our previous forecast. In dollar terms, real residential construction outlays are expected to decline somewhat more than previously forecast; the decline begins in the third quarter and continues over the balance of the forecast period. Deposit flows at thrifts in recent months have been weaker than we thought earlier and forecasted growth has been reduced as well. Lending terms and conditions have also tightened somewhat more than expected by this time and will probably be more restrictive over the year on average. Hence, while demands for housing

are expected to remain strong given the preferences for housing in an inflationary environment, financial supply constraints at the margin seem likely to hold back potential growth.

In the government sector, prospective growth of expenditures has been reduced over the forecast period. For Federal expenditures, we have made some minor technical adjustments to conform more closely to the pattern of outlays in the Administration's budget message and have also allowed for the acceleration of spending in the fourth quarter of 1977. At the State and local level, however, expenditure growth has fallen short of earlier indications--most recently growth in the fourth quarter was revised down to only 4-1/4 per cent in real terms, the same as the preceding quarter, and employment gains in recent months have been relatively small. We now anticipate that State and local spending this year will grow a little less rapidly than GNP, a reflection of continued fiscal conservatism for these units as a group.

Finally, I would like to note that while we have not changed our view of the outlook for inflation over the next year or so, food prices have accelerated recently and it now appears that average prices over the next several months may rise somewhat more than the 6 per cent plus underlying rate. But the run-up in food prices appears likely to be transitory and since we are no longer assuming an OPEC price increase in July, the rate of over-all price rise should moderate slightly in the second half of this year. For the year as a whole, we project an increase in prices averaging about 6-1/2 per cent.

REPORT OF OPEN
MARKET OPERATIONS

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

Desk operations since the Committee's January meeting have aimed steadily at maintaining reserve conditions consistent with a Federal funds rate around 6 3/4 percent. Estimated growth of the aggregates for the January-February period remained reasonably well within the Committee's ranges throughout the six-week interval, holding in the upper part of the ranges in the first few weeks but then weakening to the lower halves of the ranges in the later weeks. Operations were impacted by the severe weather conditions, which caused reserve management problems for banks, and very large projection misses for the Desk. On a few days the storms threatened to impede the Desk's ability to operate in the market. Somewhat remarkably in the face of these difficulties, and in good part through luck, reserve conditions remained close to those desired on average over the period. The funds rate averaged 6.76 percent and individual weeks were within a range of 6.72 to 6.80 percent.

The Desk undertook extensive operations in maintaining this steady climate of reserve availability. Outright activity was largely on the selling side, to offset the release of reserves from declines in required reserves and decreases in currency in circulation, as well as temporary swings in the Treasury balance and float. About \$2.7 billion of bills was sold to foreign accounts and another \$1.1 billion of bills was redeemed in several

auctions over the course of the period. At the start of the interval, about \$550 million of coupon issues had been purchased in the market, and some \$380 million of bills was bought from foreign accounts in early February--in part because it would have been difficult to execute those foreign sell orders on certain days seriously impacted by snow. The heavy preponderance of outright sales and redemptions from the System Account made it desirable to obtain a temporary increase from the Committee in the leeway to effect net changes in the size of the System Account between meetings of the Committee.

The Desk also made extensive use of short-term repurchase agreements and matched sale-purchase transactions with the markets to provide or absorb reserves temporarily. In addition, the Desk executed short-term matched transactions each day with foreign accounts, providing an investment outlet to those accounts at times when this meshed with System reserve objectives. On several occasions when System objectives made this appropriate, the Desk arranged only a part of the foreign orders with the System Account while the balance was executed with the New York Reserve Bank and then offset by corresponding Reserve Bank repurchase agreements with the market. This was in accordance with the authorization adopted at the last meeting. Starting tomorrow, it is planned to charge a fee of 2 basis points to foreign accounts in arranging repurchase agreements for them either with the System Account or with the New York Reserve Bank.

Market interest rates showed little net change in the period since the last meeting, declining slightly for shorter

maturities and rising somewhat for intermediate and longer issues. Yields declined a bit in the opening week or two as new supplies from the Treasury and other borrowers looked manageable and published monetary data gave little reason to suggest any near-term firming. The Treasury's February refunding issues were well-received in this atmosphere. Toward the middle of the period, yields backed up as the market took note of temporarily more robust money growth, weakness in the dollar, and signs of increased credit demands especially from Federally sponsored credit agencies. Distribution of dealers' takings of the February refunding issues proceeded, but only at a moderate pace and at price concessions. Near the end of the period, yields edged down again, spurred chiefly by the slowing of monetary aggregates and the view of some that weather induced slowdowns in the economy are likely to postpone the move to higher rates that is still the predominant expectation for later in the year.

Since the last meeting, the Treasury has raised about \$6 1/2 billion in the coupon market (plus foreign add-ons). They are expected to be out of the coupon market until two-year notes are sold for payment at the end of March. Sizable bill financing is likely in the next few days to get over the March low point in cash, probably in the form of cash management bills, while a similar type of borrowing is probable in early April. For the whole period since the last meeting, most intermediate- and long-term coupon issues were up about 1 to 10 basis points in yield. On the other hand, three- and six-month bills were auctioned

yesterday at around 6.43 and 6.71 percent, down a bit from 6.54 and 6.76 percent just before the last meeting.

Open market operations were approved, ratified and confirmed.

There has been a distinct moderation in growth of the monetary aggregates thus far this year. It now appears as if M-1 in the first quarter will expand at an annual rate well within the FOMC's longer-run range after a sustained period in which it ran well above the range. Meanwhile, M-2 and M-3 appear as if they will grow at the low end, or below the lower limit, of their ranges in the current quarter. As the Committee will recall, last year they grew at rates near the upper limits of their respective ranges.

I believe that the first quarter moderation of upward pressures on M-1 is likely to be temporary, provided that our projection of expansion in nominal GNP is in the ball park. Thus, while the alternative short-run policy specifications before the Committee indicate a low growth in M-1 on average over the February-March period, I would expect ensuing two-month periods to be considerably stronger at current interest rates. In fact, our projections for the February-March period assume that growth in March will be at about a 7 per cent annual rate. And it is likely, given current interest rates, that the underlying demand for M-1 over the balance of the year will be on that order of magnitude, or a little higher, if the behavior of M-1 last year, and implications of our econometric models, are any guide. Thus, in the face of relatively strong underlying demand for M-1, we believe short rates will rise $1\frac{1}{4}$ - $1\frac{1}{2}$ percentage points between now and the fall if actual M-1 growth is to be restrained to around the mid-point of the Committee's longer-run range.

While the demand for M-1 seems to be basically strong under current conditions, the demand for M-2, and also M-3, looks as if it will remain relatively weak. This is in part because the artificial constraint of ceiling rates on savings and small-denomination time deposits is serving to divert funds from banks and thrift institutions to market instruments in view of the current, attractive level of market rates. M-2 is a little less affected than M-3 on purely technical grounds since the \$90 billion of large-denomination ceiling-free time deposits at non-weekly reporting banks included in these aggregates are a larger proportion of M-2 than of M-3. Large-denomination time deposits at thrift institutions are also in M-3, but they are of no practical significance since thrift institutions do not account for a significant share of the large-denomination market.

But this technical distinction does not alter the basic economics of the current situation. Both banks and thrift institutions are being forced to rely more on relatively high cost market borrowing to maintain credit flows--banks on large CD's and savings and loan associations on advances from the Home Loan Bank System, which in turn has increased its cash borrowing in the market.

In general, the artificiality of deposit rate ceilings makes it very difficult to interpret M-2 and M-3 as indicators of monetary policy. Assuming no change in the Federal funds rate, if deposit rate ceilings were higher, and hence inflows of time and savings deposits larger, the consequent more rapid growth in M-2 and M-3 for the most part would represent a redistribution of deposit and credit flows.

Banks and thrift institutions would have more lendable funds from deposits, but they would be more costly deposits. Moreover, so long as the Federal Reserve did not change its Federal funds rate objective, the average level of market interest rates would be little changed, although there would probably be distributional effects on individual rates.

An upward adjustment in the ceiling rate would, however, probably change the attitude of thrift institutions toward mortgage lending. They may become somewhat less reluctant to make new mortgage commitments, so that housing may be somewhat stronger than otherwise. Such an effect from a rise in ceiling rates would signify an easier monetary policy only if the increase in spending for housing were not matched by a decrease in other forms of spending. In the short-run, it is doubtful that there would be a one for one decrease in other forms of spending. Over a one-year period, therefore, an upward adjustment in ceiling rates, given the funds rate, might be associated with somewhat greater private spending and hence might be said to represent a somewhat easier monetary policy. But this effect is probably small.

Although it is necessary to allow for the probability that deposit ceiling rate adjustments may have marginal effects on spending, I would still conclude--on the basis of the preceding analysis--that M-1 is a better indicator of monetary policy under current circumstances than are the broader aggregates.