

## NOTES FOR FOMC MEETING

March 21, 1978

Scott E. Pardee

As I pointed out at the last FOMC meeting, exchange market participants have been looking to the exchange rate of 2 German marks to the dollar or 50 cents per mark as a major benchmark. At the time of the meeting, the rate had still not reached that level, but in the bearish atmosphere which prevailed over the next days heavy professional demand for marks drove the rate right through, to as high as DM 1.99. Even though many market participants were urging or expecting the central banks to make a major stand at that level, the trading desks of both the Bundesbank and the Federal Reserve made no special effort to defend that rate for fear of making it, as we called it between us, a kind of Maginot Line. For our part, we were determined to conserve our resources for a time, with opinions expressed at the last FOMC meeting. When the dollar came under heavy pressure on the day of the FOMC meeting we sold a total of \$91 million equivalent, half of which was for System account. But over the next eight trading days the Desk remained firmly on the sidelines.

Once the rate broke through the DM 2 level, traders themselves became concerned over the possible consequences of a further sharp rise in the rate, and rumors began to circulate that Germany or the U.S., or both, would impose exchange controls. These rumors gained credence following the drastic controls imposed by the Swiss in late February-early March. Moreover, the market had caught wind of the many options being discussed by U.S. and German officials. The daily press was filled with free advice from market participants and former officials as to which of the options should be selected.

All the talk of possible action generated crosscurrents and confusion in the market, but the dollar bounced back above the 2 mark level. Indeed, when President Carter and Chancellor Schmidt let it be known that discussions would take place on the weekend of March 11-12, the dollar was bid up by nearly 5 percent from its lows.

The result of these discussions was the joint statement released in Bonn and Washington on March 13. The agreement included the doubling of the Federal Reserve swap line, the Treasury's commitment to use \$740 million equivalent of SDRs to acquire marks, and the Treasury's promise to mobilize its regular \$5 billion IMF drawing rights, if necessary. The statement also included a political commitment, on the U.S. side to act soon on energy and on the German side to act quickly if first quarter growth comes in below expectations. This was an important effort by the two governments to demonstrate that they were in broad agreement on economic questions. For the U.S. it was an effort to show that the U.S. authorities were indeed concerned about the dollar. Nevertheless, the market reacted with disappointment that the statement did not contain more of substance, and the dollar immediately came under heavy selling pressure. In effect, many of the dealers who had bought dollars before the weekend, simply dumped them back on the market. Since the announcement came late in the day in Europe, we caught the brunt of the pressure in New York. In a damage control operation we sold a total of \$273 million of marks that day, and followed up with a further \$99 million the next day. As before, these sales were split evenly with the Treasury, so the System's two-day total was \$186 million.

Since then the atmosphere for the dollar has been somewhat better, the apparent resolution of the coal strike eliminated one uncertainty. Many market participants have

also said that they have been reassured by Chairman Miller's first public pronouncements since taking office, in which he has spoken out forcefully on the need for the U.S. to deal effectively with inflation. An increasing number of dealers are at last beginning to believe that Washington may share some of the concerns which have beset the market these many months. With the resumption of a good two-way market in marks, the Desk has again remained on the sidelines over the past four trading days. Thus we operated on only three days since the last FOMC, for a System total of \$231.4 million. These marks were drawn under the swap line with the Bundesbank, raising System drawings to \$1,794 million equivalent. Meanwhile, we have been able to accumulate some \$47 million of mark balances by means of purchases from correspondents. The Treasury's debt now amounts to \$950 million equivalent of marks.

James L. Kichline  
March 21, 1978

FOMC BRIEFING

Recent indicators of business activity suggest that the economy is now rebounding from the adverse impacts of severe winter weather. But the weather apparently took a larger toll than we had thought earlier. The continued coal strike also suggests a larger depressing effect than had been assumed. Together these forces have altered the pattern of likely real GNP growth this year, reducing the current quarter growth and raising that in the middle quarters. Over the 6 quarter projection period to mid-1979, though, we have not made any significant changes and still expect real growth to average about 4-1/2 per cent at an annual rate. However, recent price performance continues disappointing and we have adjusted upward a little the projection of over-all price increases this year.

In the consumer sector, spending once again appears to be on the rise following a large drop in retail sales currently indicated for January. The dollar value of retail sales excluding autos rose considerably in February, although not enough to offset fully the earlier weakness. Sales in all major merchandise groupings advanced and have continued upward in March, according to weekly data. Moreover, unit auto sales perked up in February from the relatively low level in January, and for the first 10 days of March domestic sales were at a 9-1/4 million annual rate--the same strong pace as during the first half of last year.

To achieve the consumption spending projected this quarter and next will require good gains in sales given the weak start this year. The recent pattern of sales has been encouraging in this regard. Even more important, employment growth has been exceptionally strong, with payroll employment up over 600,000 in the first 2 months of the year, larger gains than on average during 1977. Disposable incomes will be bolstered by the growth of jobs, and by the likely return of the average length of the workweek to more normal levels with improved weather and more readily available coal supplies.

Production should also be picking up from the lackluster pace of the past several months. In February, the rise of the industrial production index failed to offset the drop in the month earlier; both weather effects and the coal strike acted to hold down the increase. But the outlook over the near-term appears good. Inventories in general remain on the lean side and the substantial growth of manufacturing employment in the first two months of the year suggest businesses plan to increase production schedules. Moreover, coal production and deliveries have been picking up in the past several weeks and it appears likely that both the direct and indirect impacts on production of the coal strike will not worsen. If the miners return to work soon, of course, we could see very strong increases in total industrial output by next month.

Construction outlays are also expected to show substantial strength in coming months. Private residential and nonresidential construction activity, as well as public construction, have all been

held back by the weather. For housing, the starts figures showed little increase in February from the depressed January performance, but the apparent strength of housing demands and outstanding mortgage commitments lead us to look forward to a strong expansion during the next several months.

Over the longer run a critical element in the staff's forecast of real economic activity is the performance of business fixed investment. Capital goods orders, construction contracts, and capital appropriations continue on an uptrend and are generally consistent with the projection of about a 14 per cent gain in total business fixed investment outlays this year. But the March Commerce survey of business spending intentions for 1978, which in the past has been reasonably accurate as such surveys go, was a disappointment; businesses reported scaling up their plans slightly to about an 11 per cent increase for the year. We are still hopeful that outlays will be raised further given the expected edging up of capacity utilization rates, resolution of an energy program and the passage of tax cuts for businesses. One can point to negative influences as well, such as the high cost of equity capital and uncertainty about future rates of inflation. In any event, the course of business spending will have a great deal to do with determining the character of economic activity later this year and on into 1979.

Domestic price developments have received a substantial amount of attention in recent weeks in view of the sizable increases

in wholesale and consumer price indexes reported so far this year. For a number of months the staff had anticipated an upsurge of inflation early in the year. It was expected that there would be a rather quick passthrough of the higher minimum wage and payroll cost increases effective in January as well as the early impacts of the decline in the exchange value of the dollar. However, we may have underestimated the upward pressures stemming from these sources. In addition, the bad weather contributed to the rise of food prices. As a result we believe the business fixed-weighted product deflator is likely to increase at a 7 per cent annual rate in the first half of the year, about 1/2 percentage point more than at the time of the last meeting of the Committee.

In our price forecasting we try to allow for special factors that may impact significantly on prices. Consistent with this approach, food and energy prices are forecasted independent of developments associated with unit labor costs, which historically have played the principal determining role in price changes over the longer-run. Incorporated in our present forecast is an upward revision of food price increases--averaging about 6-3/4 per cent for 1978--appreciably above the Agriculture Department's current expectation of increases in the 4 to 6 per cent range. A major part of this relatively high increase stems from the sharp rise in meat prices already experienced and expected in the next few months. On the energy side, prices are expected to rise less rapidly this year than last, partly because we have assumed that OPEC will not raise oil prices this year.

The incoming information and prospects still seem to support a rise of unit labor costs this year of around 6-1/4 to 6-1/2 per cent. Thus the odds appear to favor some slowing in price increases as the year progresses and the influence of special factors such as food prices tend to become less important. But this is by no means a sure thing. The experience we are now going through will have feedback effects on wages and prices, and inflationary expectations could worsen considerably. In short, in the absence of an effective Administration anti-inflation program, the risks appear weighted toward higher rather than lower rates of inflation.

REPORT ON OPEN  
MARKET OPERATIONS

Mr. Sternlight made the following statement:

Desk operations in the three weeks since the last meeting have been directed at steady maintenance of reserve conditions/with a Federal funds rate around 6 3/4 percent. Within a few days after the meeting, new evidence suggested that growth in the monetary aggregates, taken together, was very low in the specified ranges. Given the money market directive and the fact that this appraisal was based on only one week's additional data, the Account Management continued to seek a funds rate at the 6 3/4 percent level that has prevailed since early this year. Additional evidence a week later confirmed the impression of weak growth in the February- March period--to an extent that would have called for a slightly more accommodative posture. This evidence was reviewed during a Committee conference call on March 10, and the Committee instructed the Account Management to retain the 6 3/4 percent funds rate objective for the time being, in view of the fragile condition of the dollar internationally and of some evidence that the weakness in the aggregates reflected the unusually severe winter weather and the coal strike. The aggregate data reviewed last Friday showed essentially the same pattern and the Desk accordingly held its objective unchanged through today.

In practice, the funds rate has held very close to 6 3/4 percent throughout the period--perhaps due to market inertia and the habit-forming effects of a condition that had persisted for some two months. Reserve management went more smoothly than in the

previous storm-ravaged period--both for the banking system and the Trading Desk.

The System bought a net of about \$100 million of Treasury bills from foreign accounts, and a little over \$1 billion of Treasury coupon issues of various maturities in the market to meet reserve needs following the mid-March tax date. Temporary reserves were provided through repurchase agreements at the beginning and end of the period, while in the middle portion, when a rundown of Treasury cash augmented bank reserves, the Desk arranged temporary reserve absorptions through matched sale-purchase transactions. Matched agreements were also made with foreign accounts each day, to absorb redundant reserves. Part of the temporary reserve injection late in the period was done in the form of 14-day nonwithdrawable repurchase agreements-- a technique that appeared to generate a broader market response than the 7-day agreements employed on similar past occasions.

Yields on Treasury issues declined somewhat over the period. For intermediate and longer coupon issues the 5 to 10 basis point decline reflected market reaction to the sluggish performance of the aggregates, and of the economy, and the conclusion of market observers that a near-term firming of System policy was not likely. Still, an undertone of wariness remained, as weakness in the dollar internationally weighed on sentiment, and as many participants felt that the economy and the aggregates might rebound in a couple of months.

Rates pushed lower in the bill market despite the steady Federal funds rate. A major factor there has been the unremitting Desk purchases of bills for foreign accounts as those countries accumulated dollars in their efforts to keep their currencies from

appreciating. Since the last meeting of the Committee three weeks ago, our purchases of bills for foreign accounts came to around \$5 1/2 billion. Indeed, it is surprising in light of this that bill rates did not decline even more than they did--though the decline did pick up a little steam yesterday. Three- and six-month bills were auctioned yesterday at about 6.21 and 6.55 percent, compared with 6.43 and 6.71 percent the day before the last meeting.

A 2-year Treasury note for \$3 billion, raising about \$150 million new money in the market, is to be auctioned tomorrow. Early talk for this auction is around 7.50 percent, compared with 7.70 percent for a similar maturity a month earlier. Upcoming Treasury offerings in the next few weeks will probably include some \$2 1/2 billion of five-year notes, and several billions of cash management bills maturing in late April or late June, in order to meet the early April cash low point. The second quarter as a whole should see a paydown of Treasury debt.

FOMC Briefing  
S. H. Axilrod  
3/21/78

After rising in early January following upward adjustments in the discount and Federal funds rates, market interest rates have subsequently changed very little. In the short-term sector of the market, the 3-month Treasury bill rate is something of an exception. It has declined about 40 basis points from its January high, in large part because of continued substantial bill purchases by foreign official accounts as a result of exchange market operations. Private short-term rates have also drifted downward somewhat in sympathy.

In long-term markets, municipal bond yields have declined almost 20 basis points from their turn-of-the-year peaks, but corporate and Treasury bond yields have shown little net change from their early January highs. The higher level of corporate bond yields has persisted despite a marked drop-off in corporate bond offerings thus far this year. However, the U.S. Treasury has continued to press a large amount of intermediate and longer-term securities on the market, and its offerings have tended to maintain rates in long-term markets as a whole.

Continuation of the higher level of short- and intermediate-term interest rates has led to sustained relatively slow growth in time and savings deposits subject to rate ceilings at banks and thrift institutions. Only longer-term time deposits at thrifts bear an effective yield above yields on competitive market instruments, and even there the advantage is slight. As a result, in order to meet

mortgage loan commitments, savings and loan associations have had to increase their indebtedness to Federal Home Loan Banks by more than \$1 billion per month (seasonally adjusted). With thrifts coming under liquidity pressure, primary mortgage market interest rates have risen about 25 basis points in February and March, and there have also been field reports of some tightening of other mortgage lending terms.

The upward adjustment of the interest rate structure in the first quarter has been accompanied by a slowing in growth of M-1, M-2, and M-3. However, the slowing in M-1 growth--to about a 5 per cent annual rate in the revised series--probably still reflects in part the lagged effect on money demand of the relatively rapid rise in short rates that took place from April to October of last year. In addition, the slowing also reflects the temporarily depressing impact on money stemming from the economic effects of recent severe weather and the coal strike. Whatever the exact cause of the recent slowing in M-1 growth, it has in turn contributed to the stabilization of market interest rates because market participants as a result came to believe that additional Federal funds rate increases would probably be delayed, despite the unfavorable position of the dollar in exchange markets.

The policy alternatives presented to the Committee assume that M-1 growth at more nearly the relatively rapid pace of 1977 will shortly be resumed. The restraint exerted on M-1 growth of the

substantial 1977 rise in interest rates is probably now exhausted, the recent rise in short rates has been relatively small, and we expect accelerated economic expansion in the months ahead to increase transactions demands for cash. Thus, we have projected growth in M-1 in April at around a 9-10 per cent annual rate, and growth over the two-month March-April period at around a 7 per cent annual rate.

In considering whether such growth rates are tolerable, the Committee may, of course, wish to take account of the facts that M-1 growth in the first quarter was at about the mid-point of its longer-run range and that growth in M-2 and M-3 was at the lower end of their longer-run ranges. On the other hand, the Committee may also wish to take account of the staff's view that--given the outlook for GNP--growth in M-1 over the balance of the year is likely to remain well above the FOMC's longer-run range unless the Federal funds rate soon begins to rise.

If and as sizable M-1 growth is resumed, markets will, in any event, become more sensitive to the likelihood of future interest rate increases--with the result that, for example, more cautious dealer attitudes toward their positions could lead to some anticipatory rate increases. Fundamentally, though, significant further interest rate increases will probably await an actual monetary policy move toward more tightness. In the event of such an action, I would expect interest rate hikes in both short- and long-term markets, with a further noticeable adjustment probably

in the mortgage area as the effective yield on longer-term time deposits at thrifts also falls below the yield on competitive market instruments and the rate of deposit inflows to thrifts falls further.