

Notes for FOMC Meeting  
April 18, 1978  
Scott E. Pardee

Since the last meeting of the FOMC, the dollar has gained resiliency in the exchange market and has even firmed somewhat over recent days.

This better tone has not stemmed from an improvement in fundamentals by any means. The latest U.S. trade figures have not been encouraging. The U.S. is still without an energy bill. Recent figures show that industrial production in Japan and Germany has not been as robust as hoped. Moreover, price comparisons are less favorable than they were, with a quickening in our underlying rate of inflation while many major countries abroad continue to show progress toward greater price stability.

The market's attitude toward the dollar has nevertheless shifted away from the extreme pessimism of recent months. This mainly reflects a change in perception of U.S. policy. The various efforts of the U.S. authorities to reassure the market that they are indeed concerned about the integrity of the dollar and about domestic inflation are now generally taken to be sincere. Many market participants remain skeptical, however, that the authorities will be able to deal effectively with these problems.

For the time being, at least, the rush out of dollars seems to have stopped. Even the yen has eased back in recent days, despite news of another record trade surplus for March. In general, against currencies like the yen and the mark, there is little evidence of new short dollar positions being built up, while earlier short positions may have been trimmed somewhat. The build-up in adverse leads and lags also seems to have tapered off, and the dollar's very resiliency in the face of otherwise bad news suggests that some natural unwinding of earlier leads and lags is taking place. In addition, we have seen and

heard of shifts back into dollars by central [unintelligible] other currencies. But such evidence remains scattered. With market psychology still basically negative towards the dollar's long-term outlook, any number of adverse developments could lead to renewed heavy selling pressure.

During the four week period, we intervened on only two occasions for a total amount of \$120 million equivalent of German marks. Some \$20 million of this was financed out of System balances. The remaining \$100 million was financed by equal drawings by the Federal Reserve and the Treasury on their respective swap lines with the Bundesbank.

The Treasury has now drawn the full \$1 billion available under the January 4 swap facility. Procedures are now in place for the Treasury to use SDRs to acquire additional marks from the Bundesbank to finance further intervention. We have continued to pick up mark balances from correspondents and the Treasury has begun to share in the purchases, providing it with a modest cushion.

Federal Reserve indebtedness under the swap line with the Bundesbank now amounts to \$1,843 million. Meanwhile, the System has accumulated some \$125 million equivalent of mark balances, with the result that we actually reduced our net open position by some \$30 million over the last four weeks. To enable us to show some progress in unwinding swap debt in our next published report, which will cover the period February through April, we are considering making a modest swap repayment toward the end of this month.

PROPOSALS AND RECOMMENDATIONS FOR FOMC  
APRIL 18, 1978

During the month of May, the System has nine maturing swap drawings on the Bundesbank totaling \$304 million and four on the Swiss National bank totaling \$50 million. I recommend that the Committee approve that these swaps be renewed. They are all first renewals.

James L. Kichline  
4/18/78

Introduction -- FOMC Chart Show

In our briefings this morning we will be referring to the package of chart materials distributed to you. The first chart indicates the principal assumptions that underlie the staff's forecast of economic and financial developments. For monetary policy, the assumptions are consistent with longer-run Alternative B in the Bluebook, which incorporates a shifting forward of the base level to the first quarter of 1978. On the fiscal side, we continue to assume a \$25 billion tax cut--mainly effective at the beginning of the next fiscal year--and budget outlays in line with our assumption for the past few months. At present, a great deal of uncertainty attaches to the tax assumption; the Congress may well alter appreciably the size, composition, and perhaps timing of the Administration's proposed tax program. The crude oil tax portion of the energy program also faces an uncertain fate in the Congress.

The next chart displays several key indicators of recent economic activity. Retail sales and industrial production increased strongly late in the first quarter, after being depressed earlier by severe winter weather and the lengthy coal strike. Nonfarm employment continued to grow at an exceptional pace throughout the first quarter as businesses apparently have plans to add to production schedules. On the disappointing side, the merchandise trade deficit widened substantially in the first two months of the year. Over-all, real GNP growth was small in the first quarter but current indicators suggest we entered this quarter on a strong upbeat. Mr. Zeisel will continue the presentation with a discussion of domestic economic prospects and likely price developments.

CONFIDENTIAL (FR) CLASS II-FOMC

*Material for  
Staff Presentation to the  
Federal Open Market Committee*

*April 18, 1978*

## **PRINCIPAL ASSUMPTIONS**

### **MONETARY POLICY**

- Growth of  $M_1$  averaging  $5\frac{1}{4}\%$  annual rate from QI 1978 base
- Growth of  $M_2$  averaging  $7\frac{3}{4}\%$  annual rate from QI 1978 base

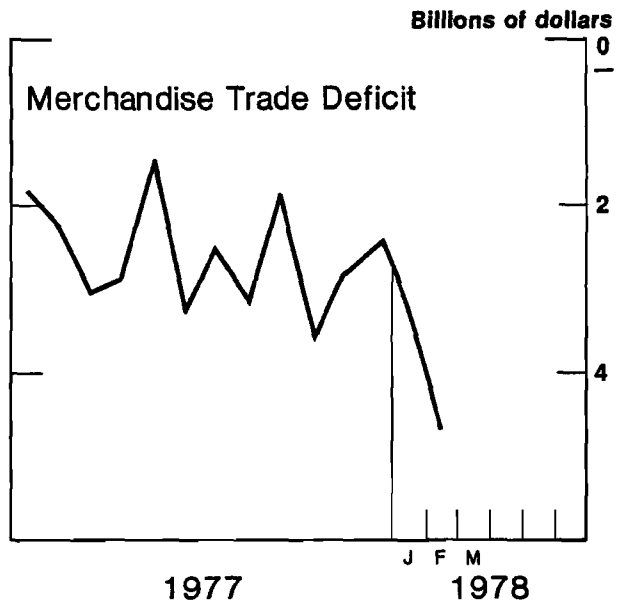
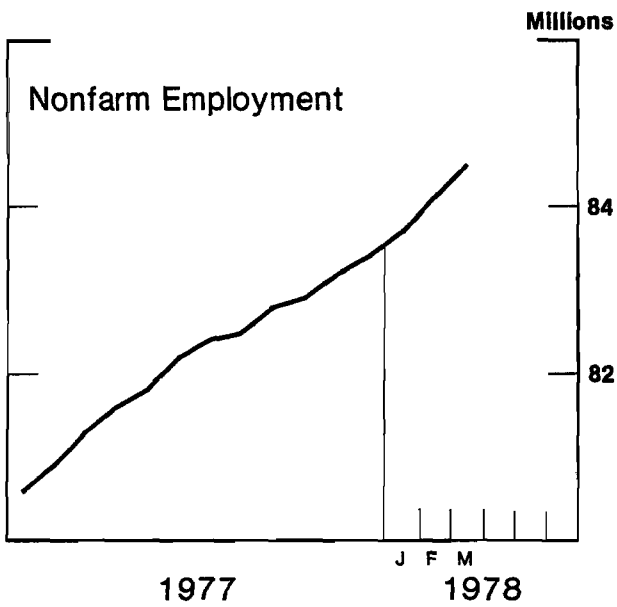
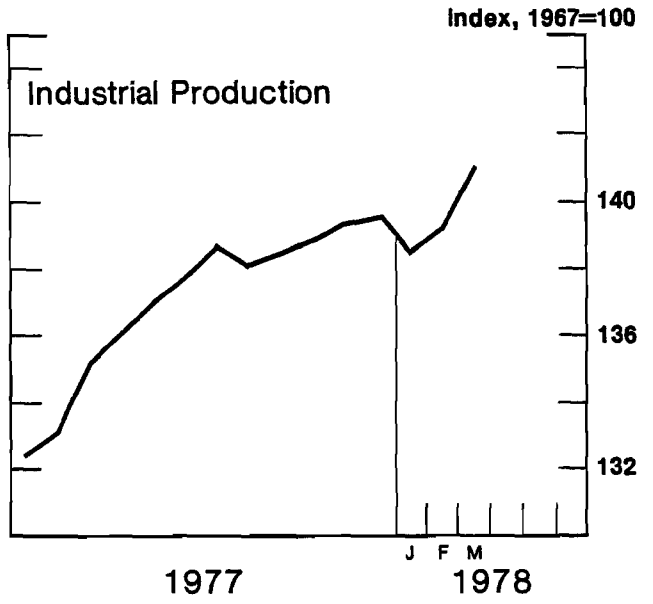
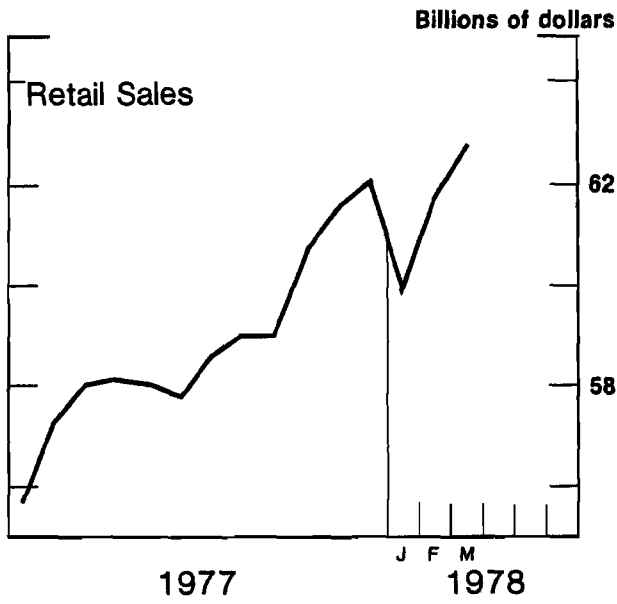
### **FISCAL POLICY**

- Tax cut of \$25 billion in FY 1979
- Unified budget expenditures of \$455 billion in FY 1978 and \$500 billion in FY 1979

### **ENERGY PROGRAM**

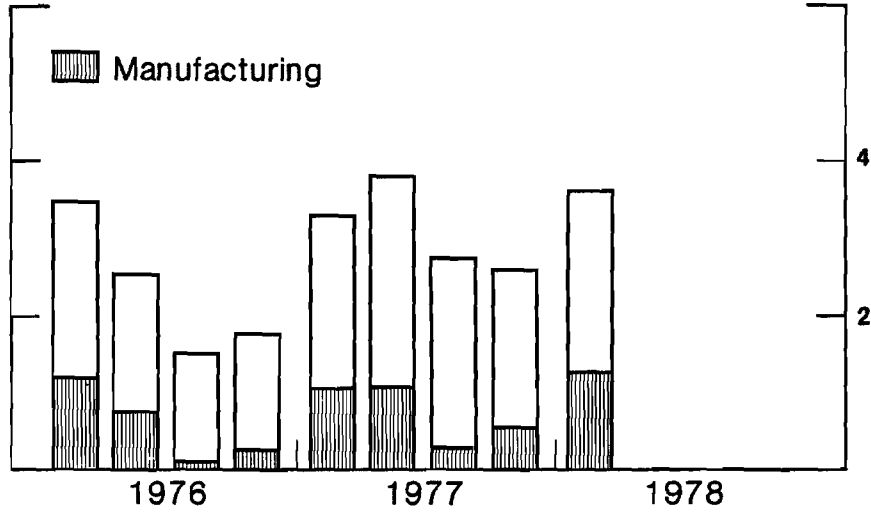
- Wellhead tax of \$3.50 per barrel on domestically produced "old" oil beginning mid-1978

# CURRENT ECONOMIC INDICATORS



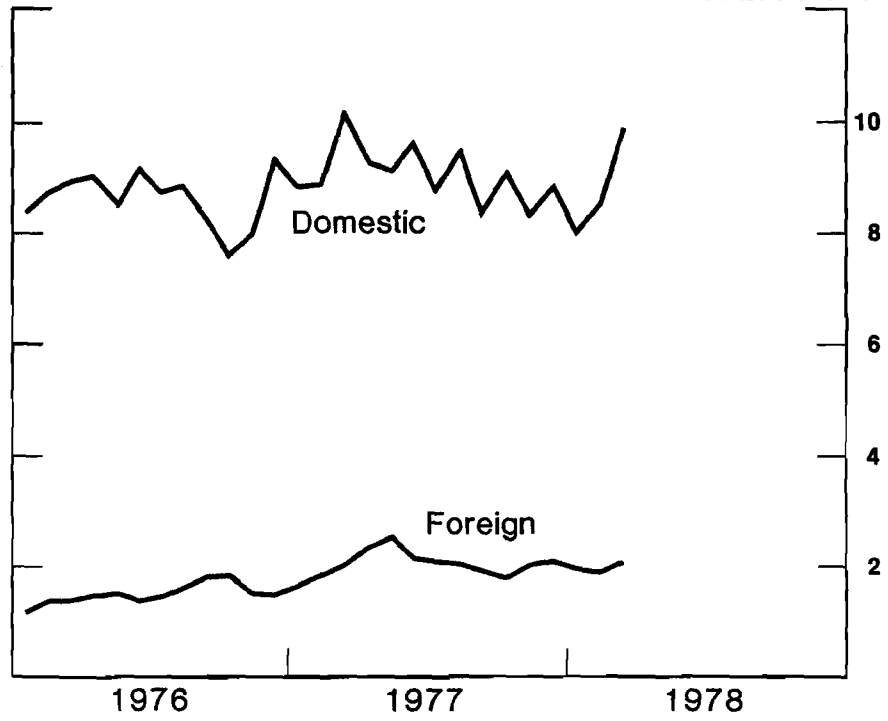
### NONFARM EMPLOYMENT

Change from previous quarter,  
annual rate, millions



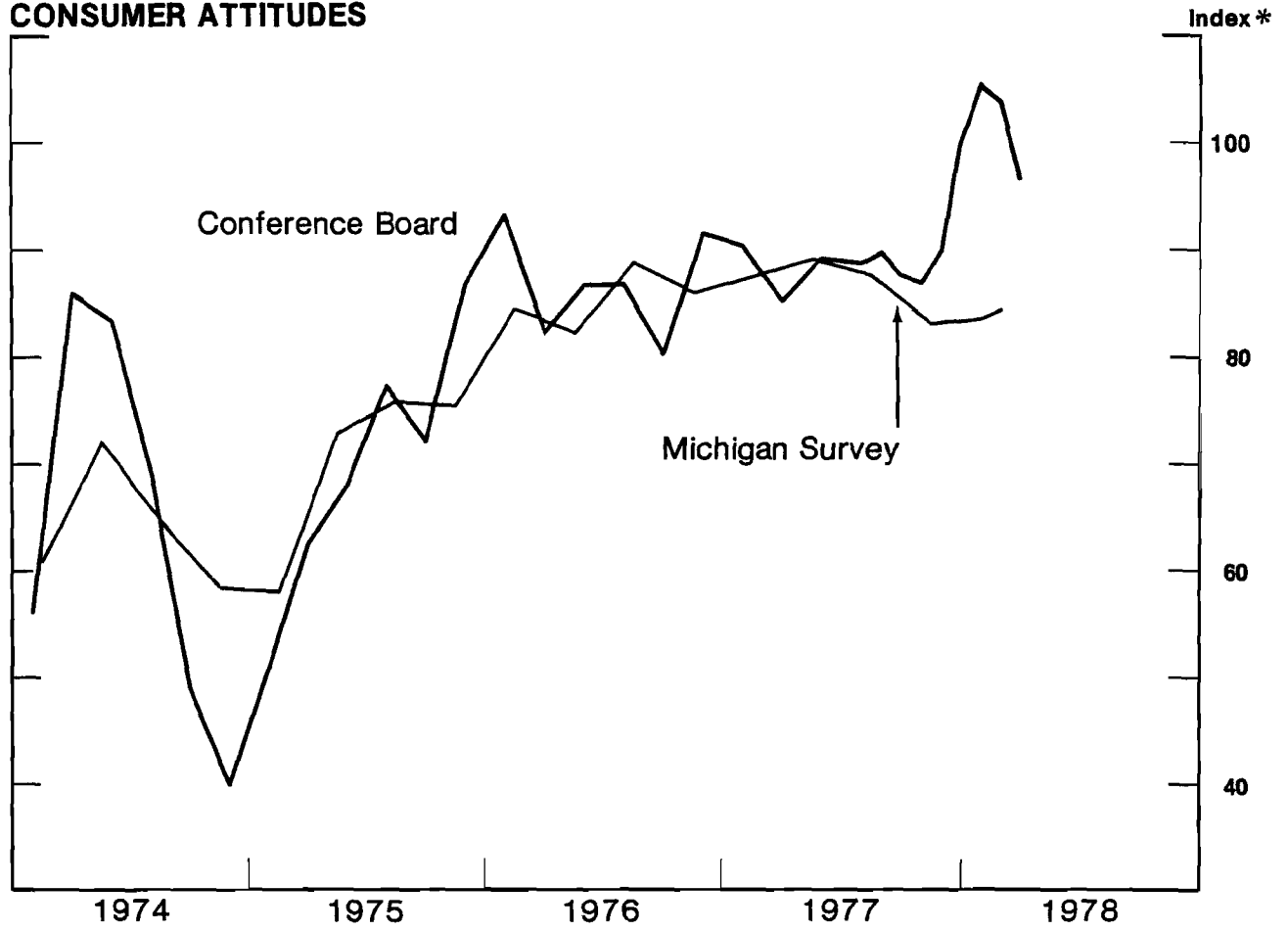
### AUTO SALES

Millions of units



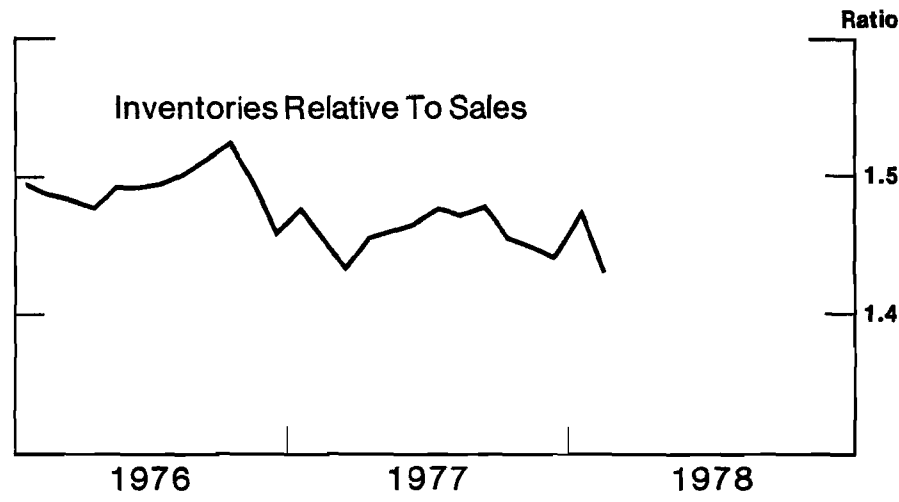
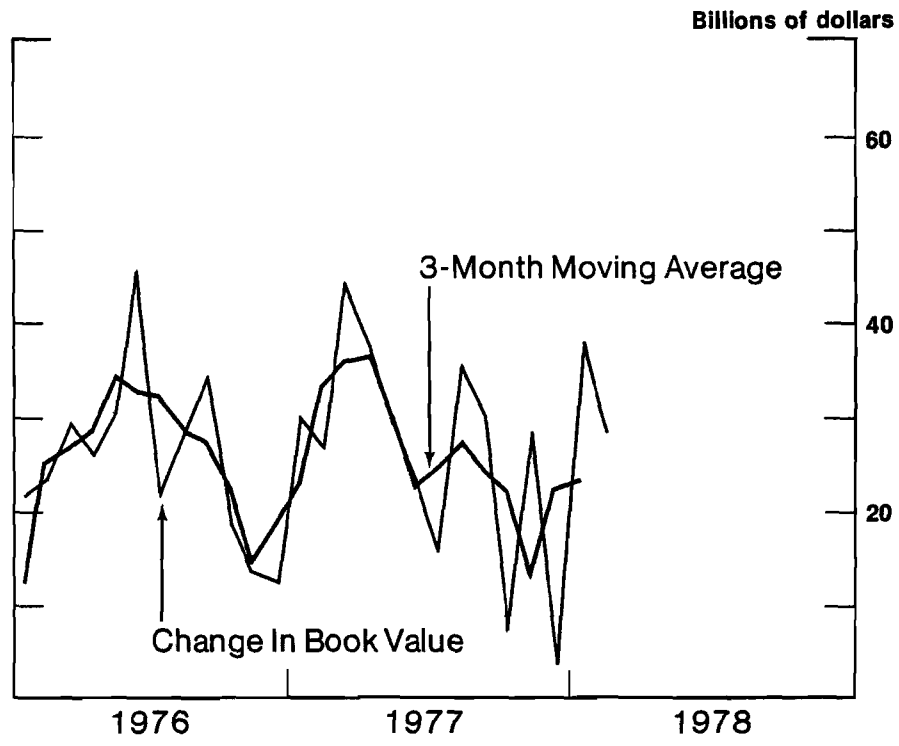


# CONSUMER ATTITUDES



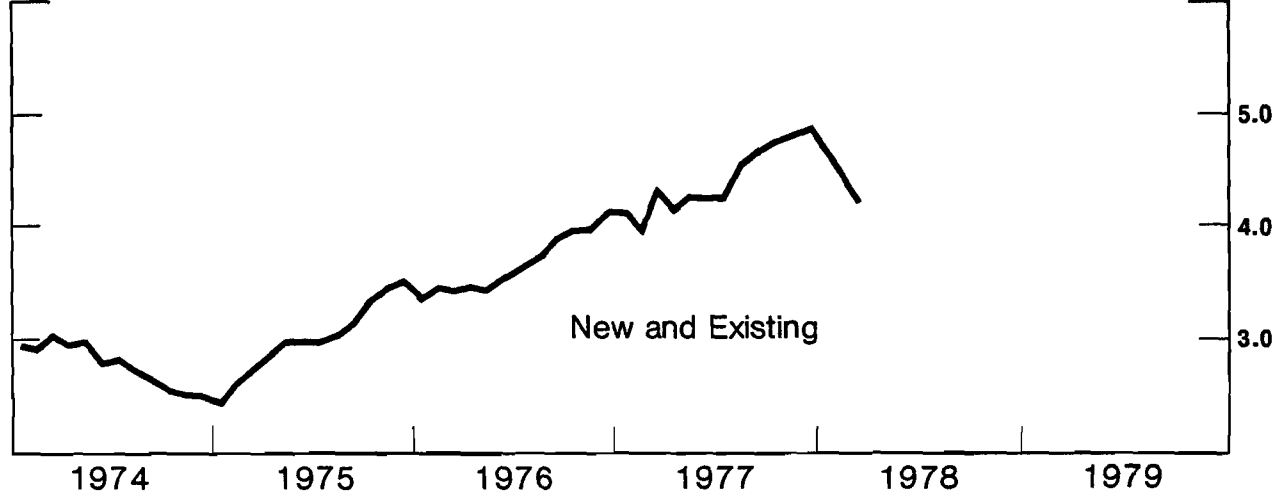
\* Michigan Survey Research Center Index of Consumer Sentiment (1966 Q1= 100) and Conference Board Index of Consumer Confidence (1969-1970=100)

# BUSINESS INVENTORIES



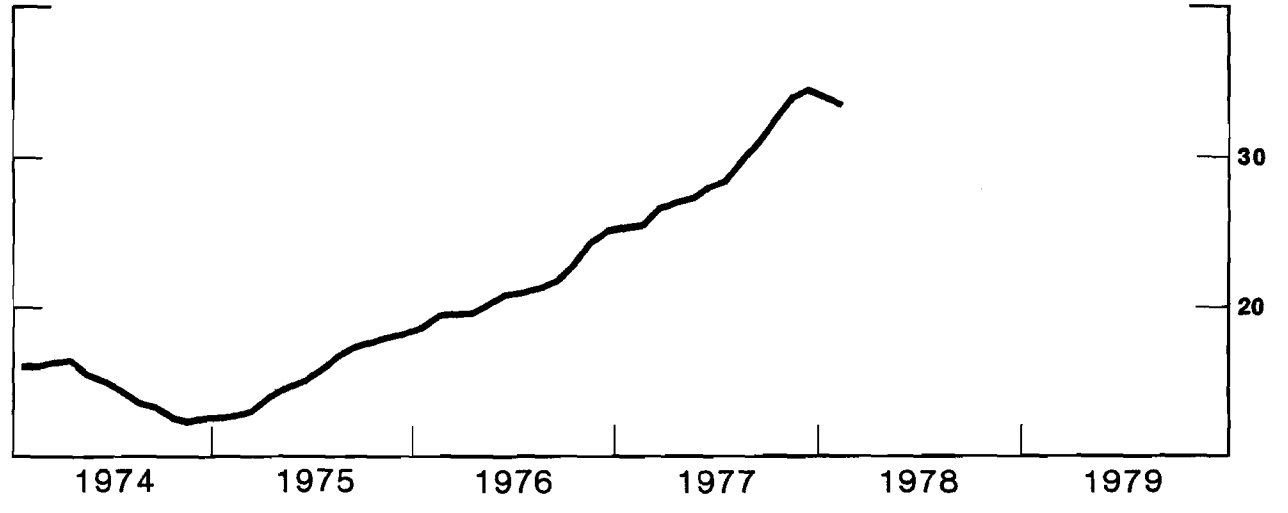
### HOMES SOLD

Millions of units



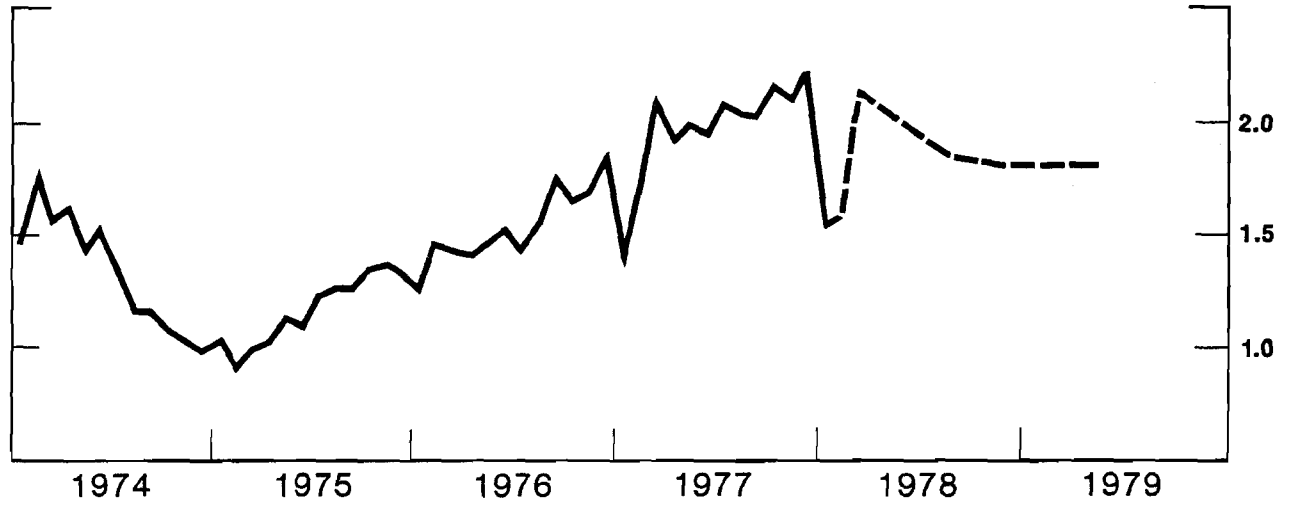
### OUTSTANDING COMMITMENTS AT SAVINGS AND LOAN ASSOCIATIONS

Billions of dollars

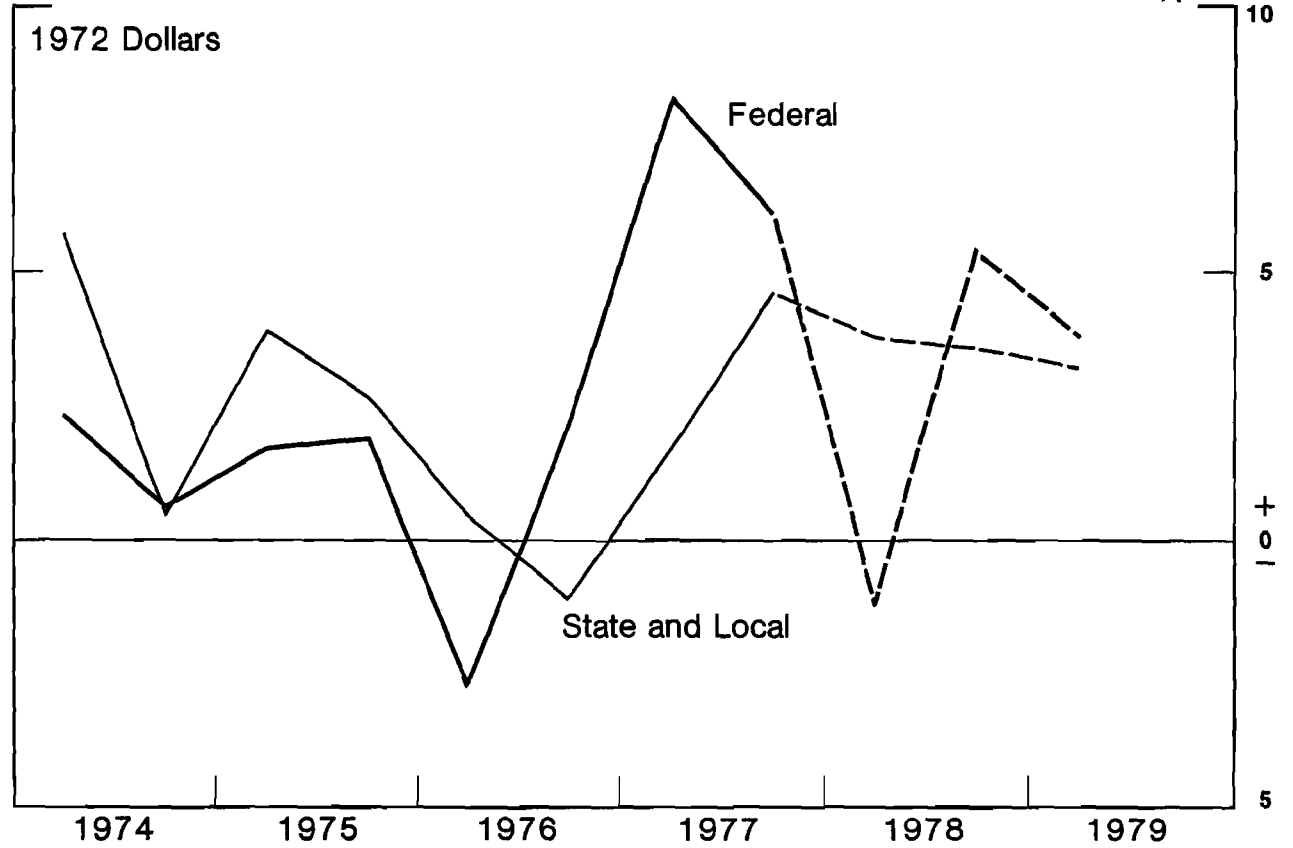


### HOUSING STARTS

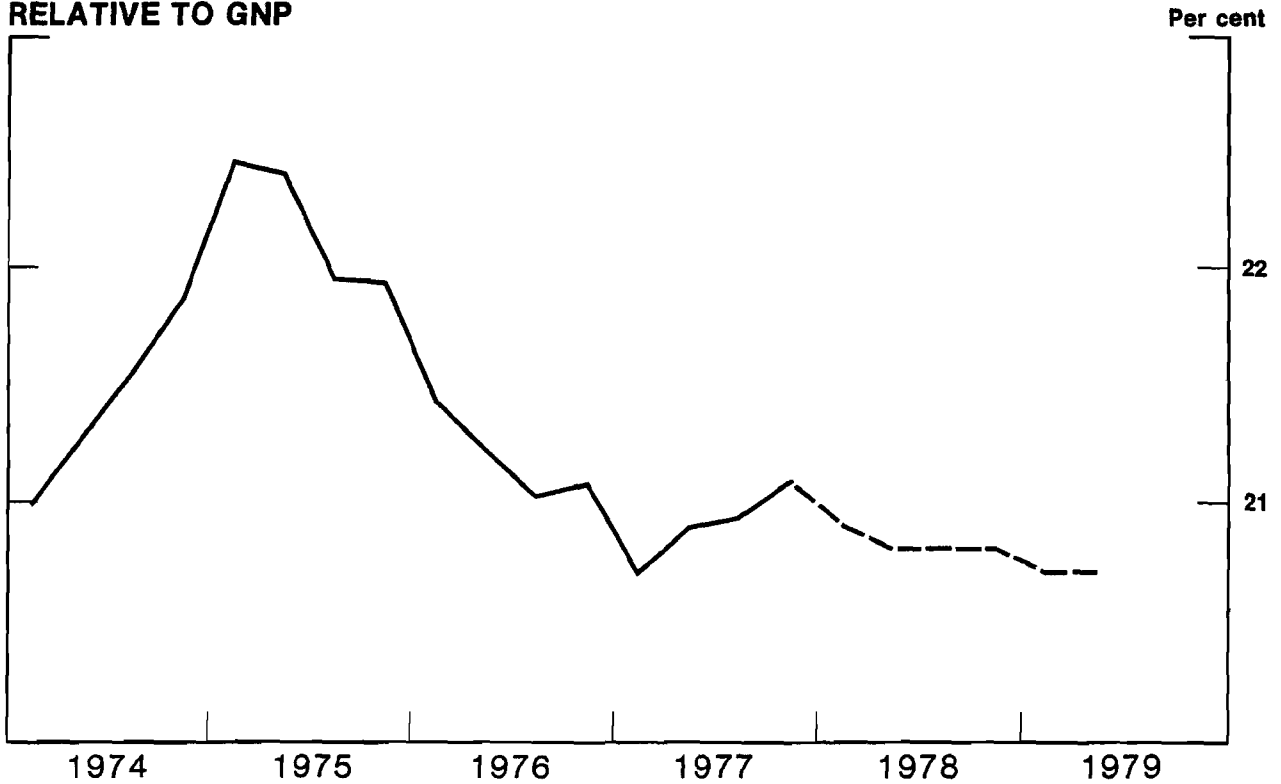
Millions of units



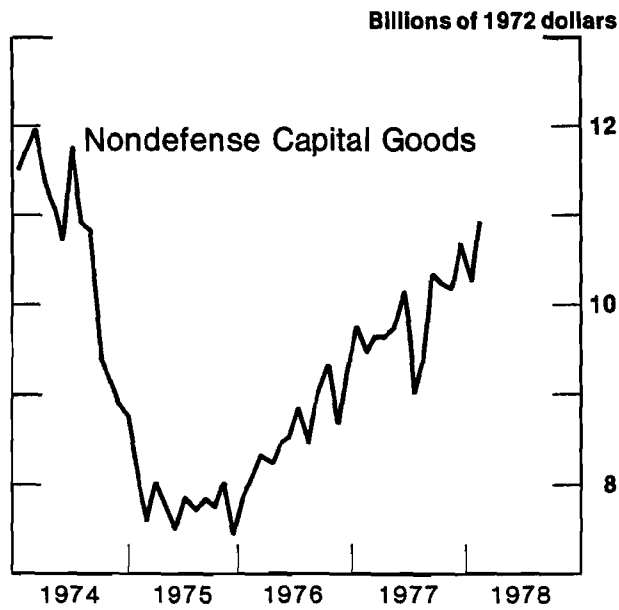
**GOVERNMENT PURCHASES OF  
GOODS AND SERVICES**



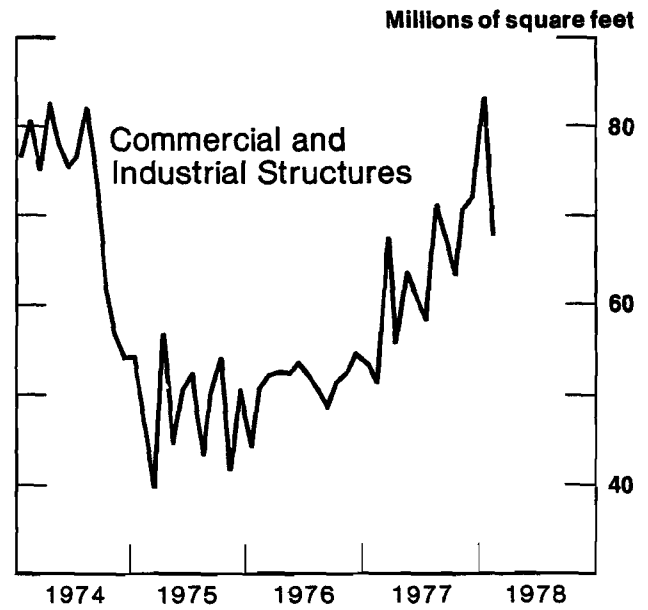
**GOVERNMENT PURCHASES  
RELATIVE TO GNP**



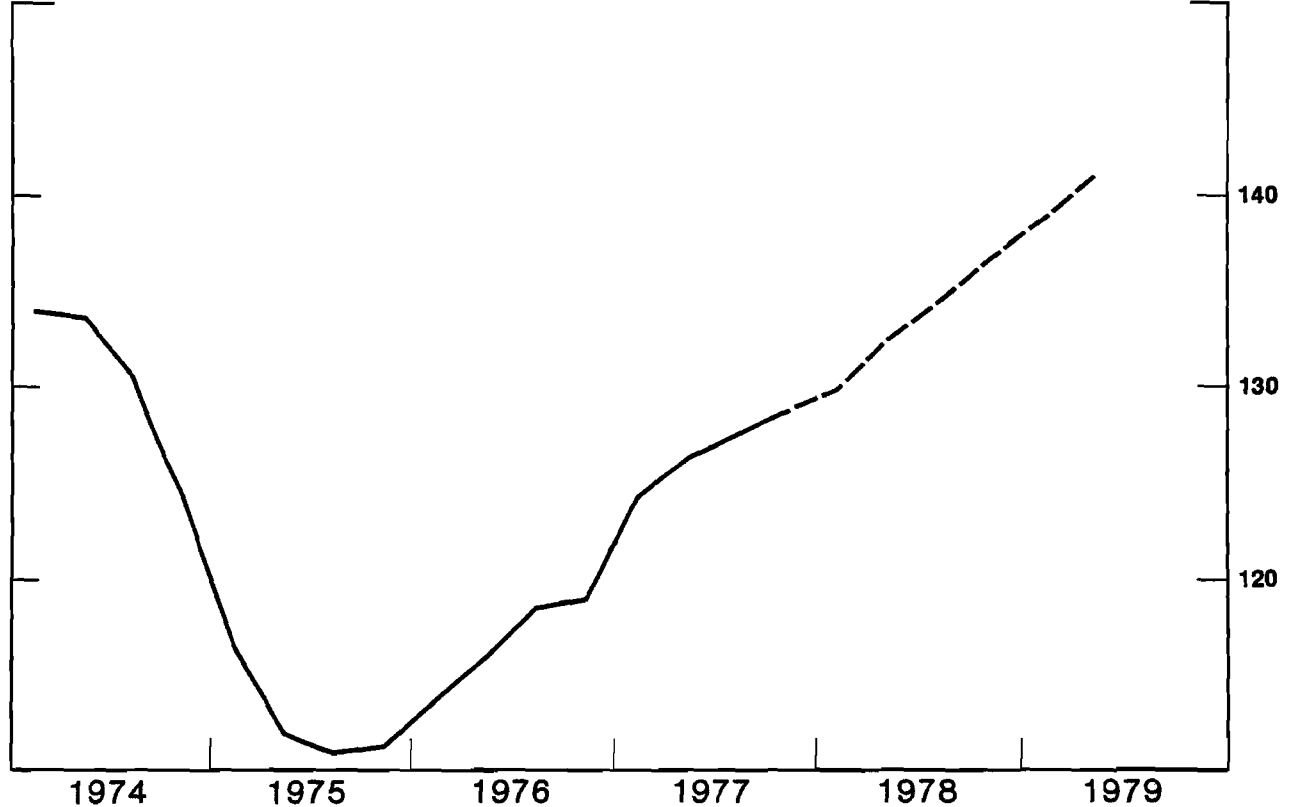
### REAL NEW ORDERS

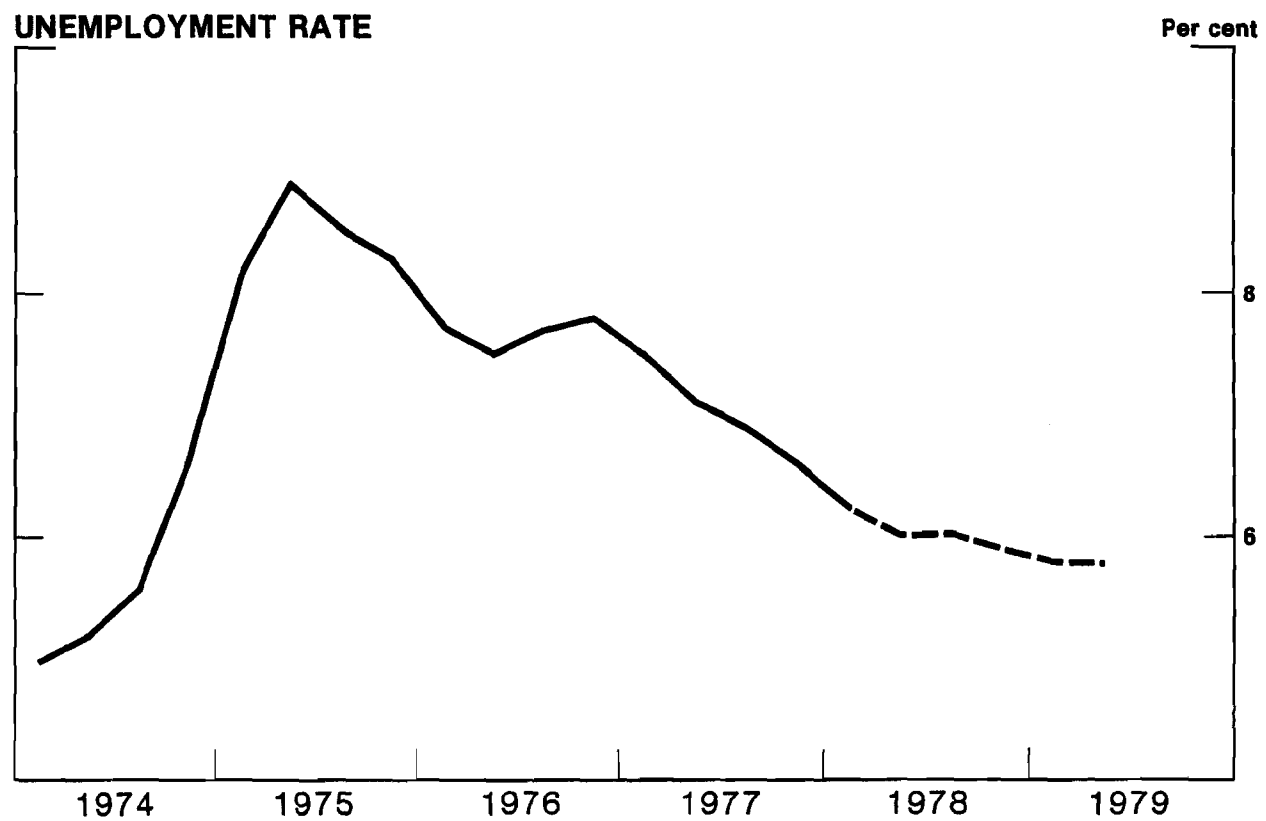
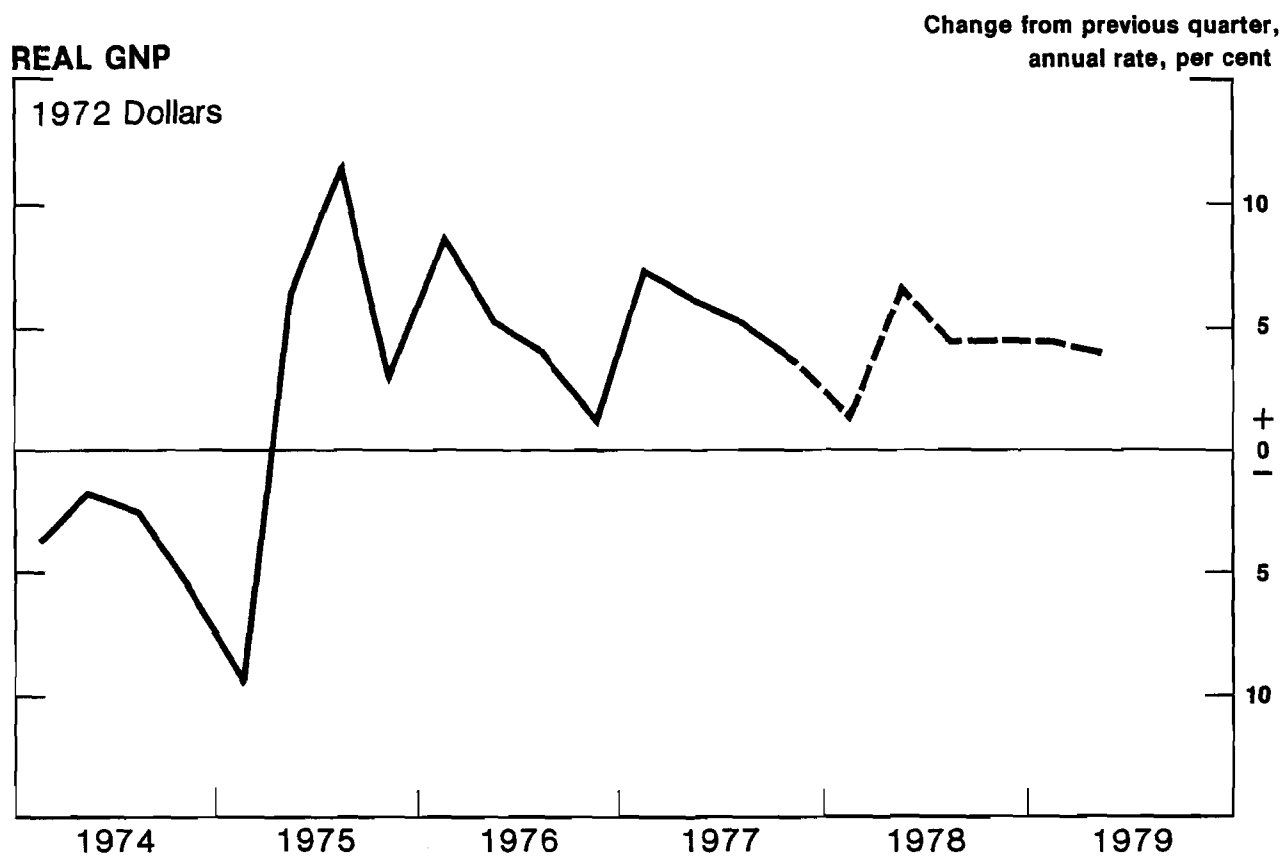


### CONSTRUCTION CONTRACTS



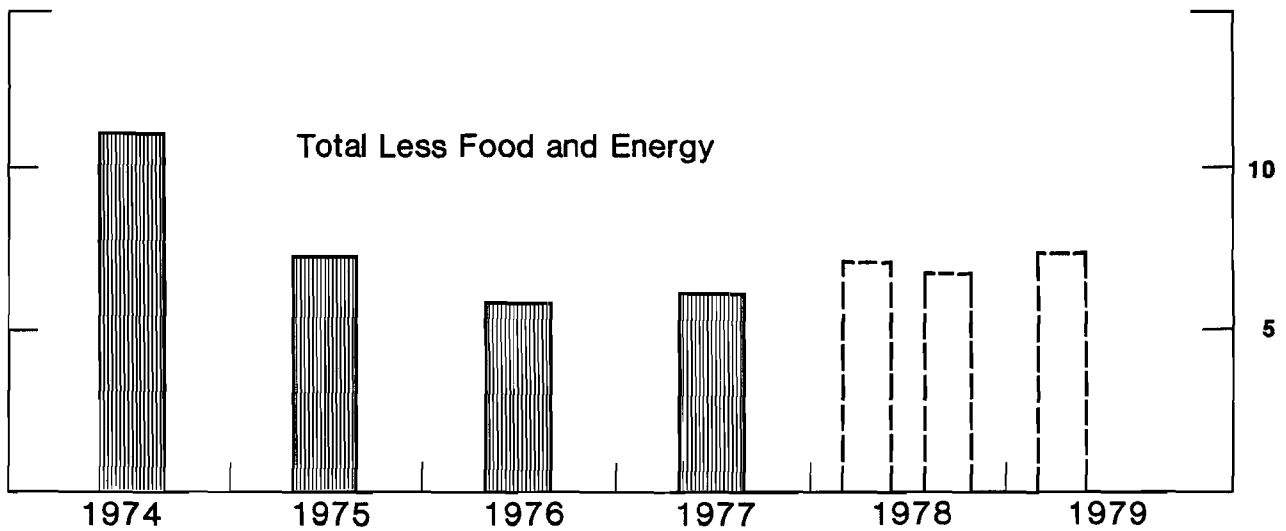
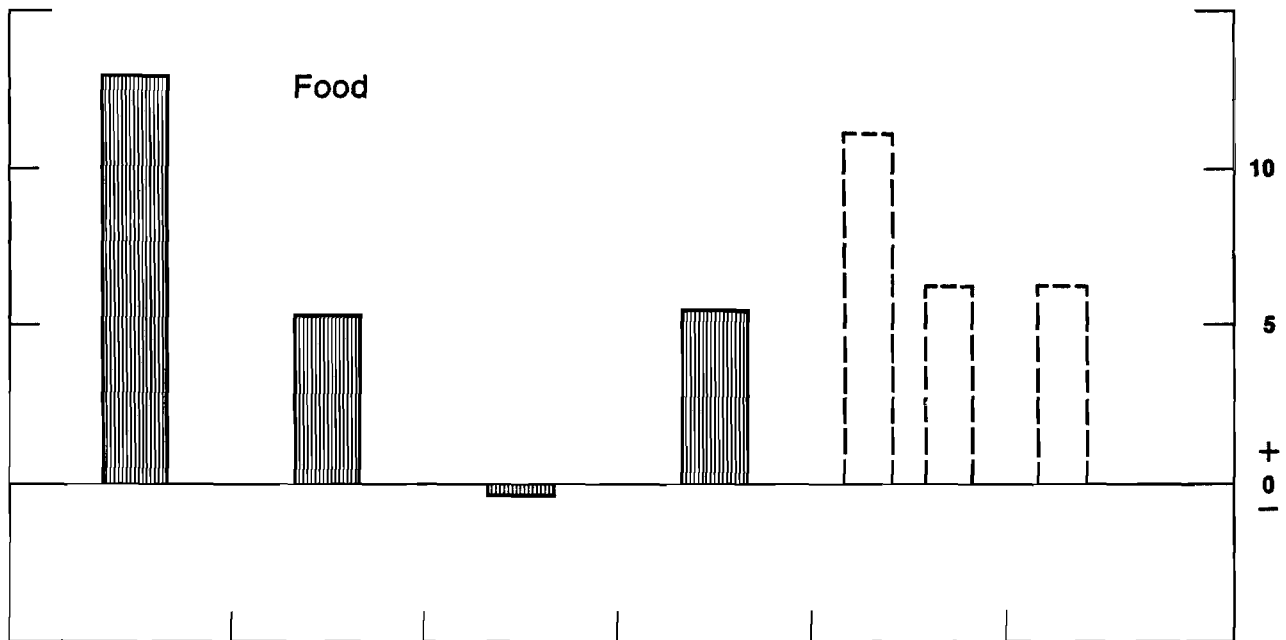
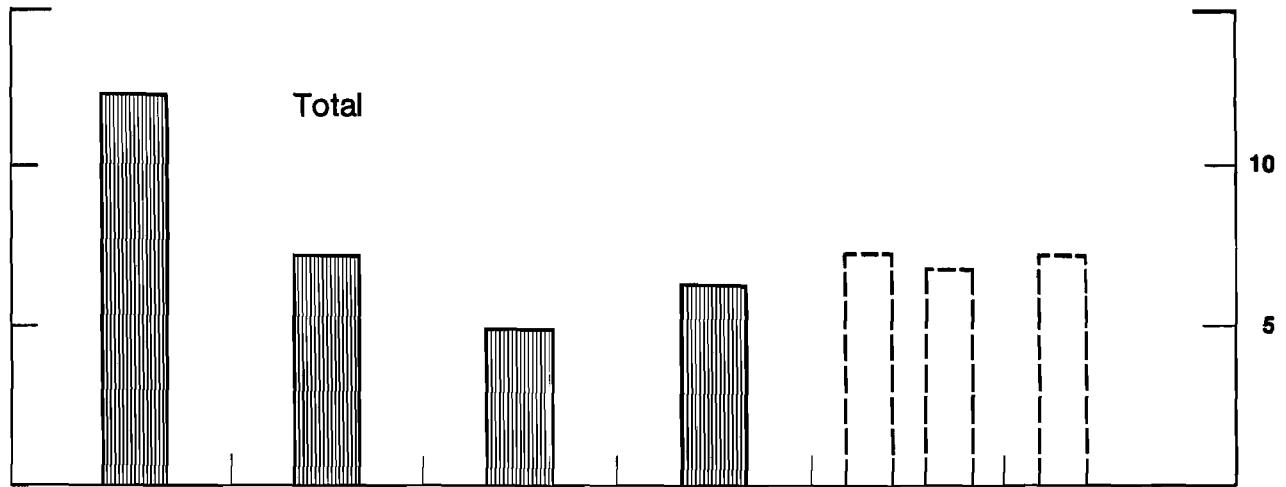
### REAL BUSINESS FIXED INVESTMENT



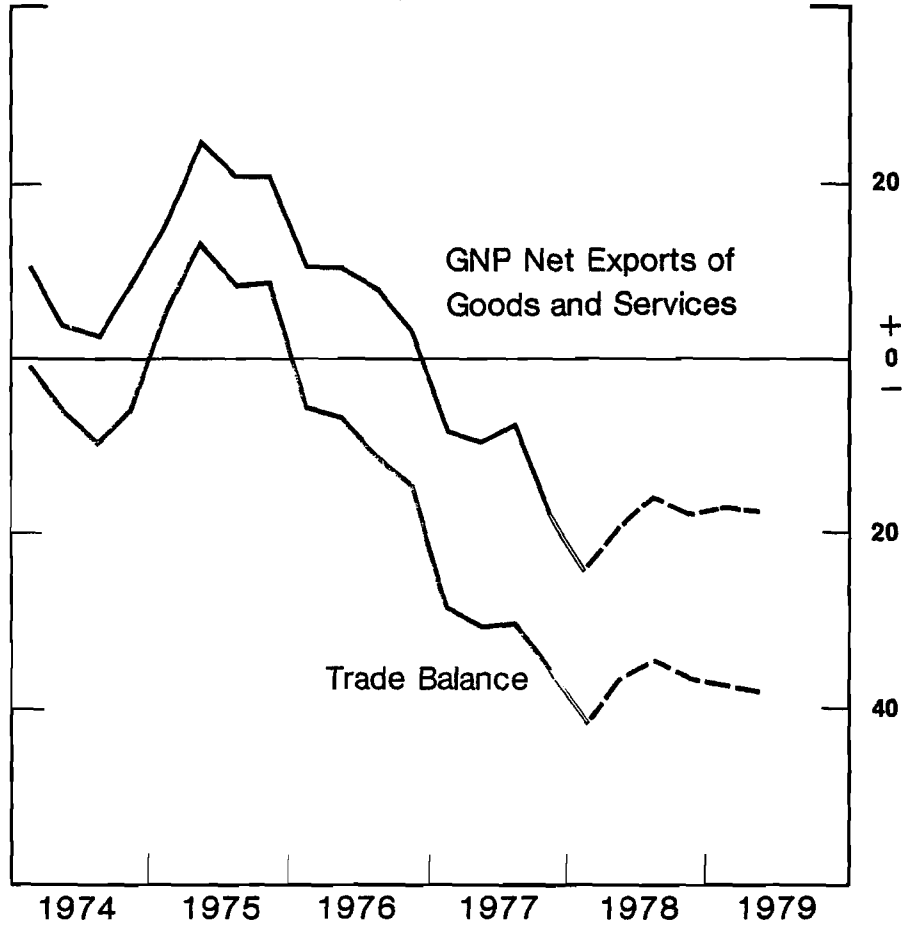


# GNP PRICE INDEXES

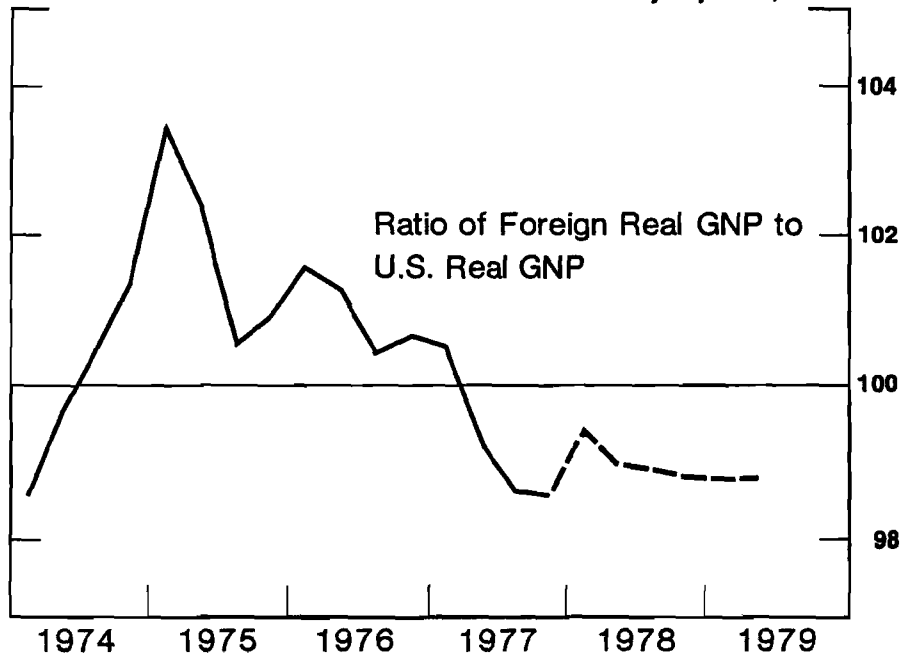
Change from previous period,  
annual rate, per cent



**NET EXPORTS**      Seasonally adjusted, annual rates, billions of dollars

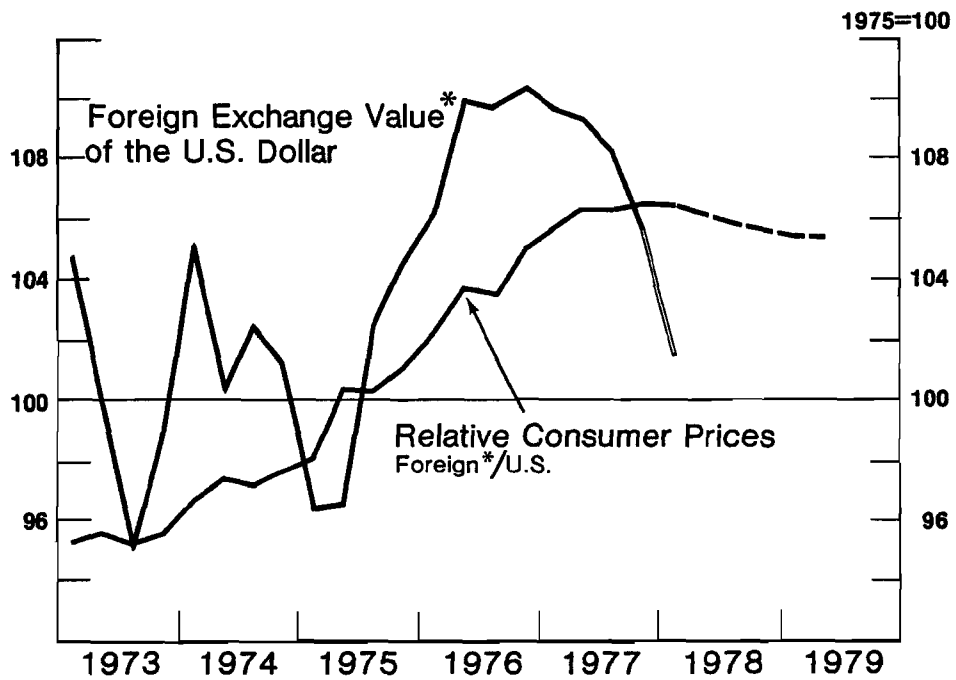
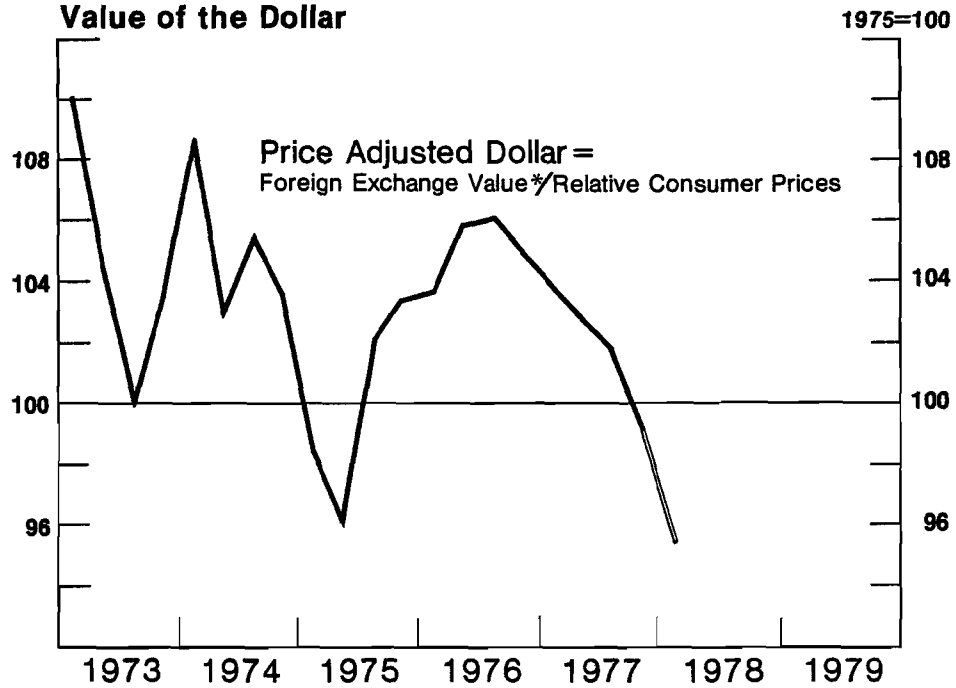


**ACTIVITY RATIO**      Seasonally adjusted, 1974=100





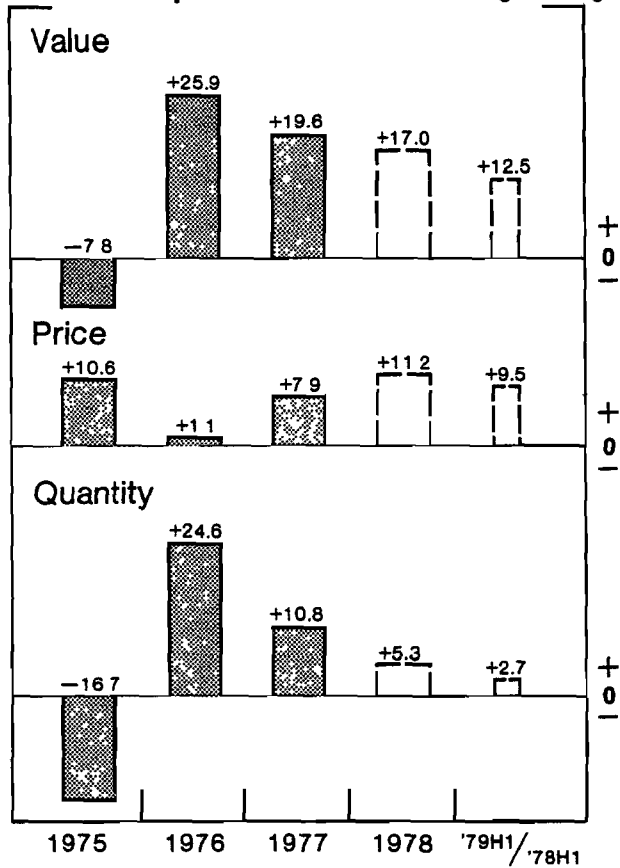
**U.S. INTERNATIONAL PRICE COMPETITIVENESS**  
**CPI Adjusted Foreign Exchange**  
**Value of the Dollar**



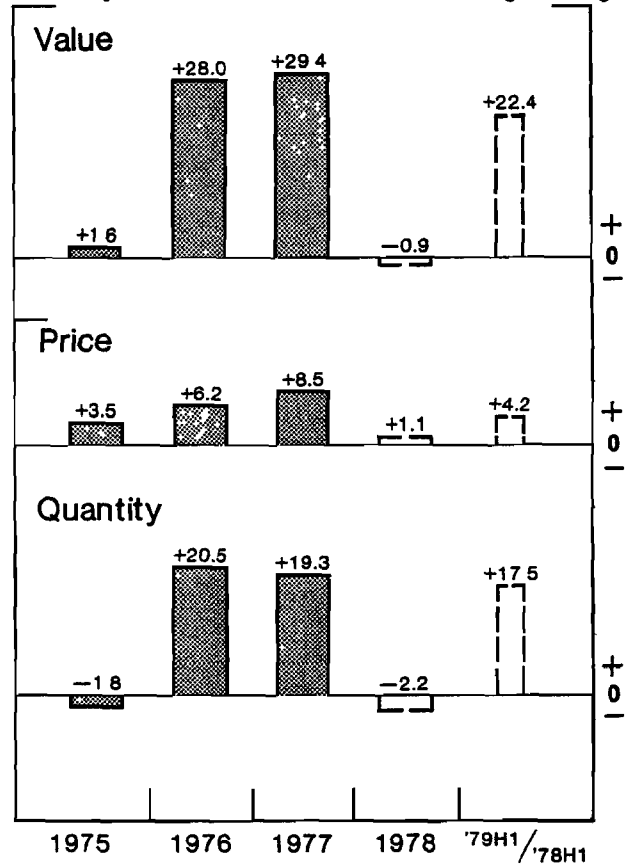
\* Weighted average against G-10 countries plus Switzerland using total 1972 trade of these countries.

# U.S. MERCHANDISE TRADE

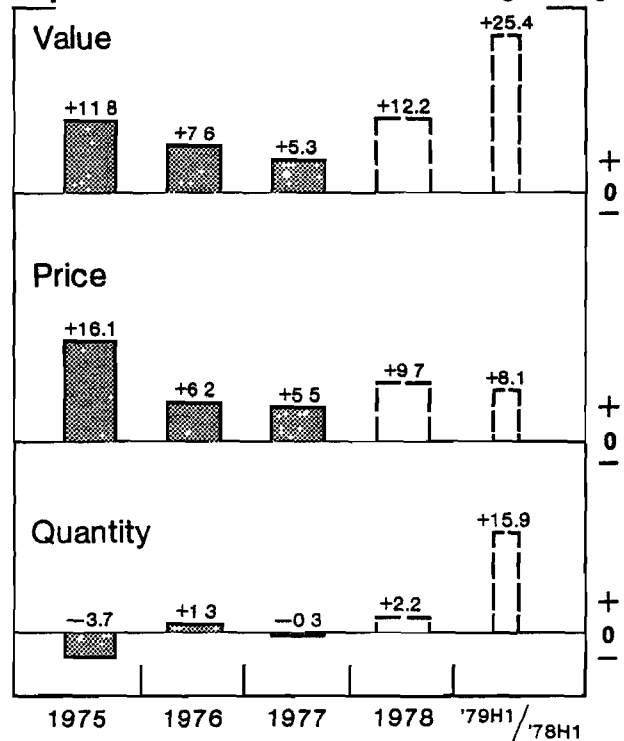
## Non-Oil Imports



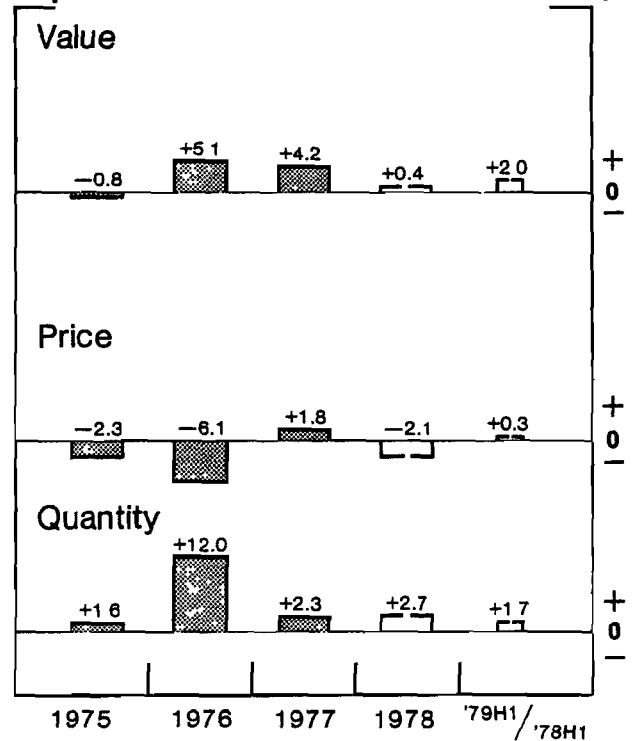
## Oil Imports



## Non-Agricultural Exports

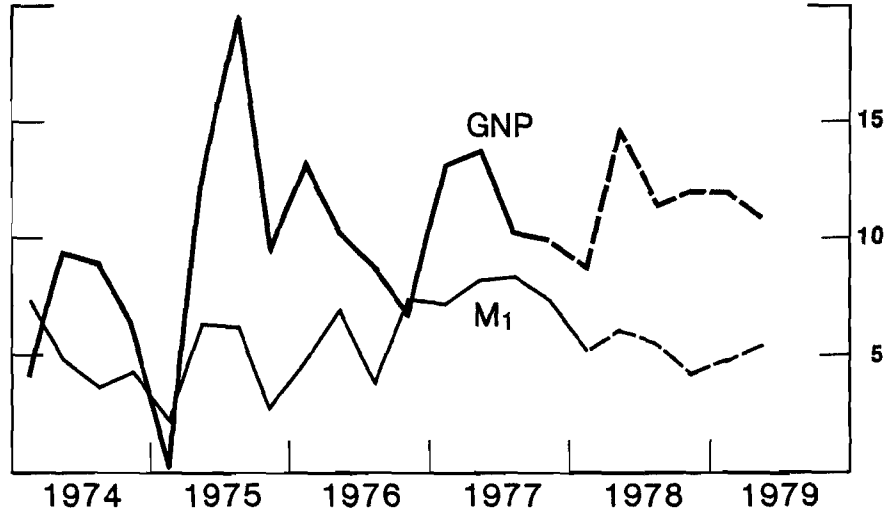


## Agricultural Exports



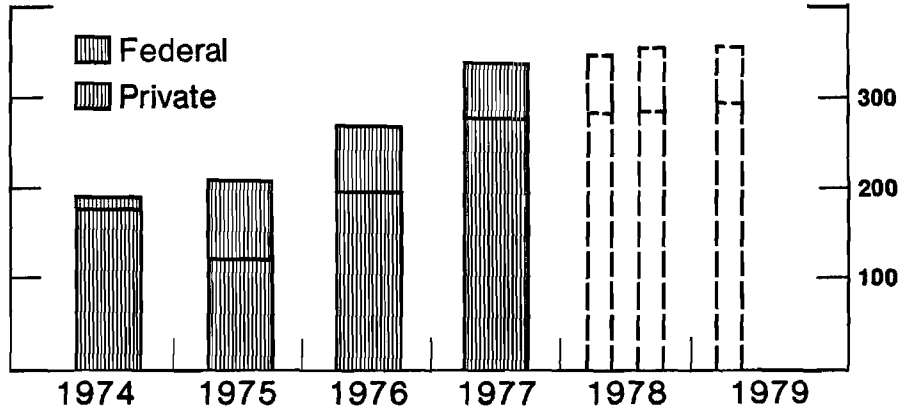
### GROWTH IN GNP AND MONEY

Change from previous quarter, annual rate, per cent



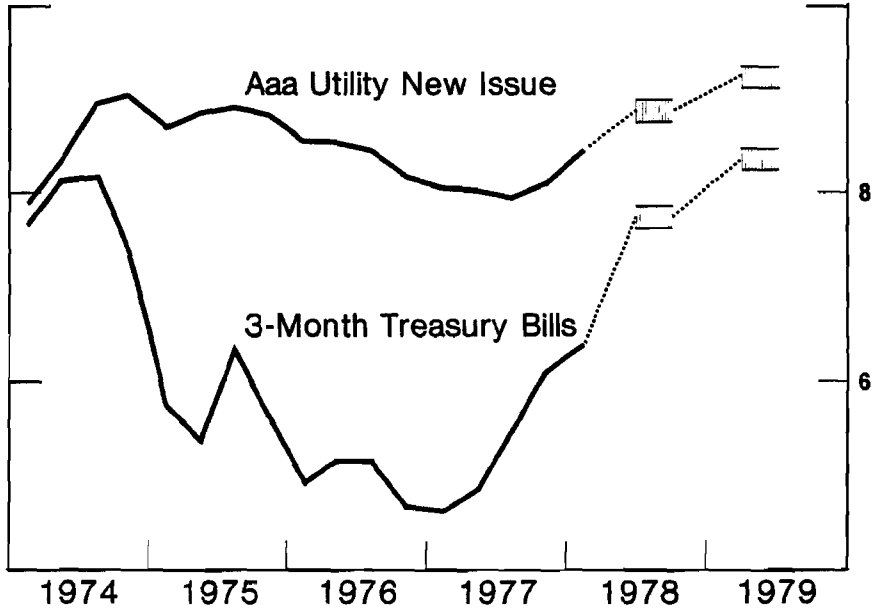
### FUNDS RAISED

Billions of dollars



### INTEREST RATES

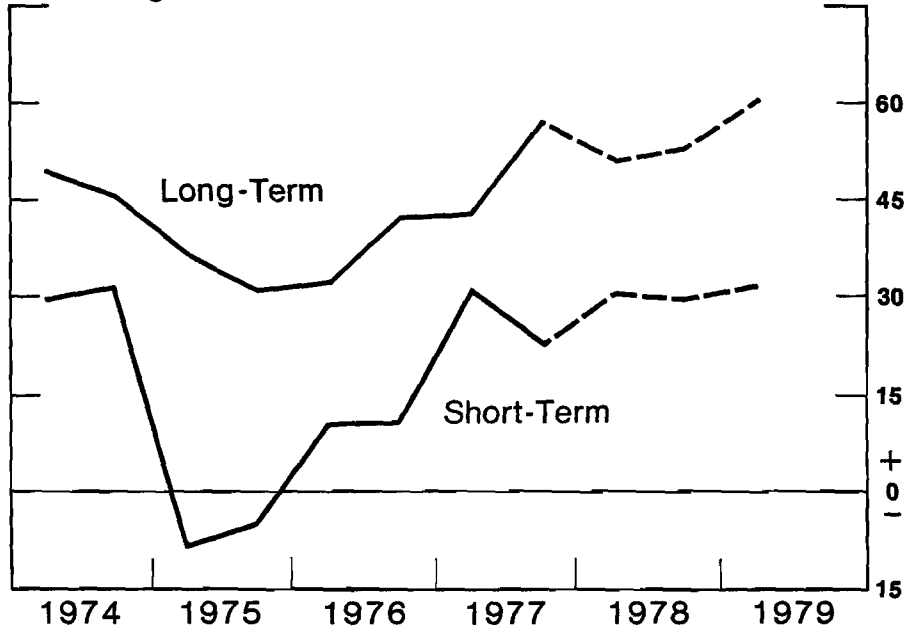
Per cent



# CORPORATE FINANCE

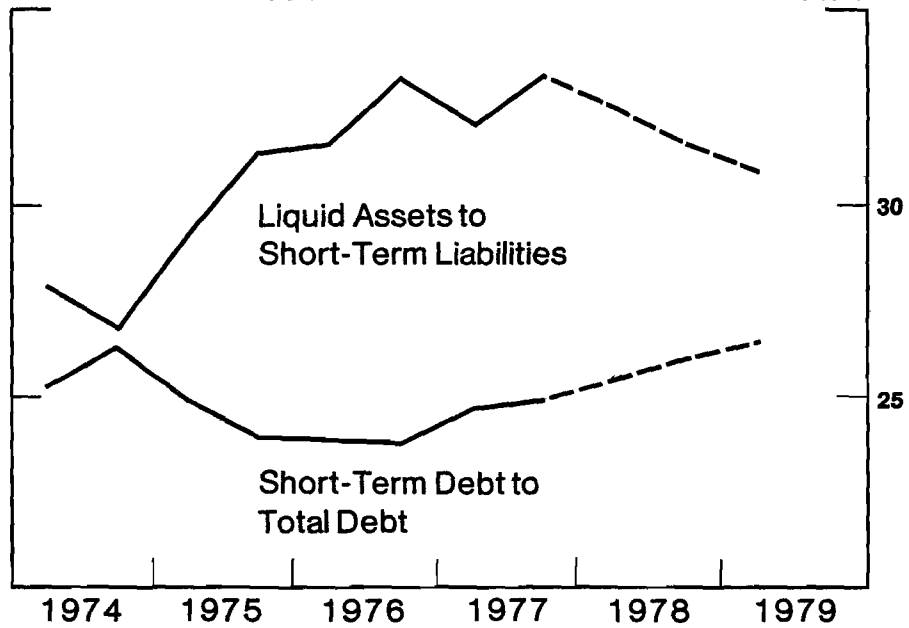
## Borrowing

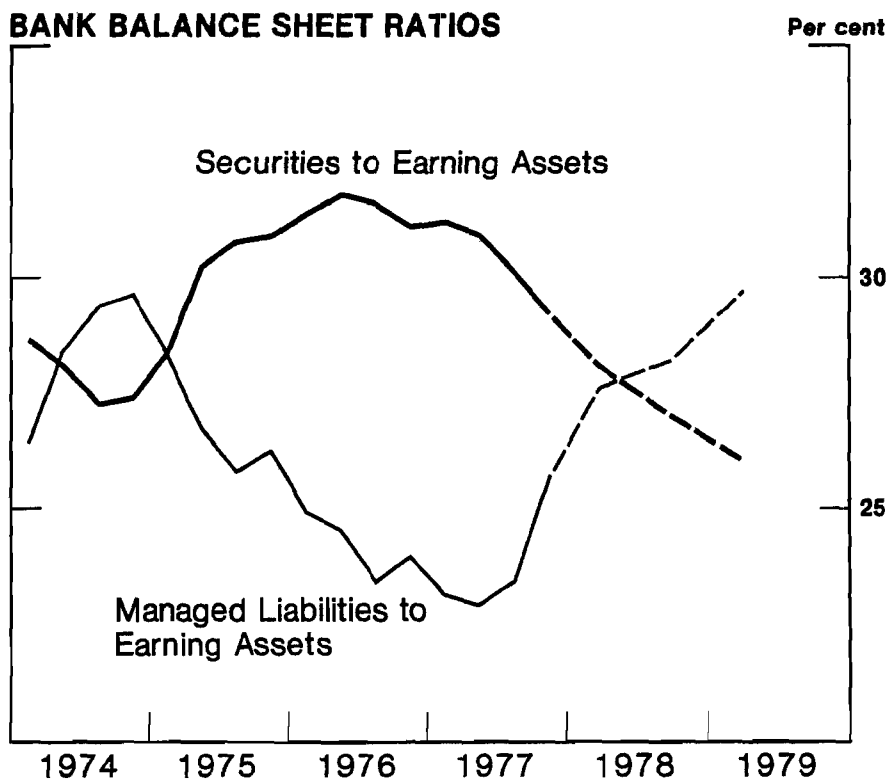
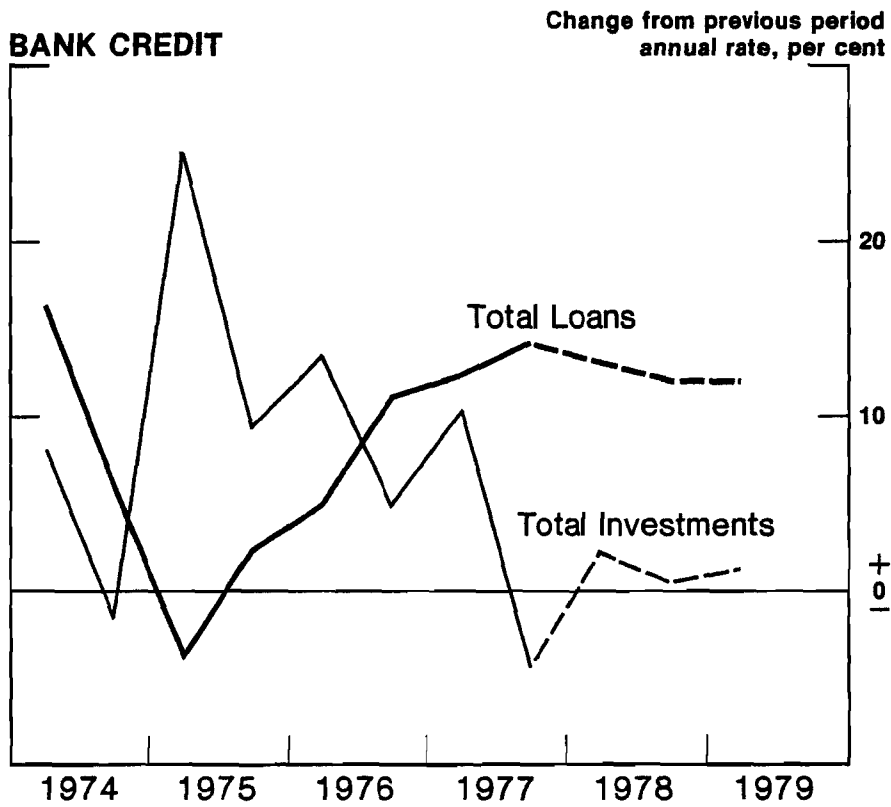
Billions of dollars



## Balance Sheet Ratios

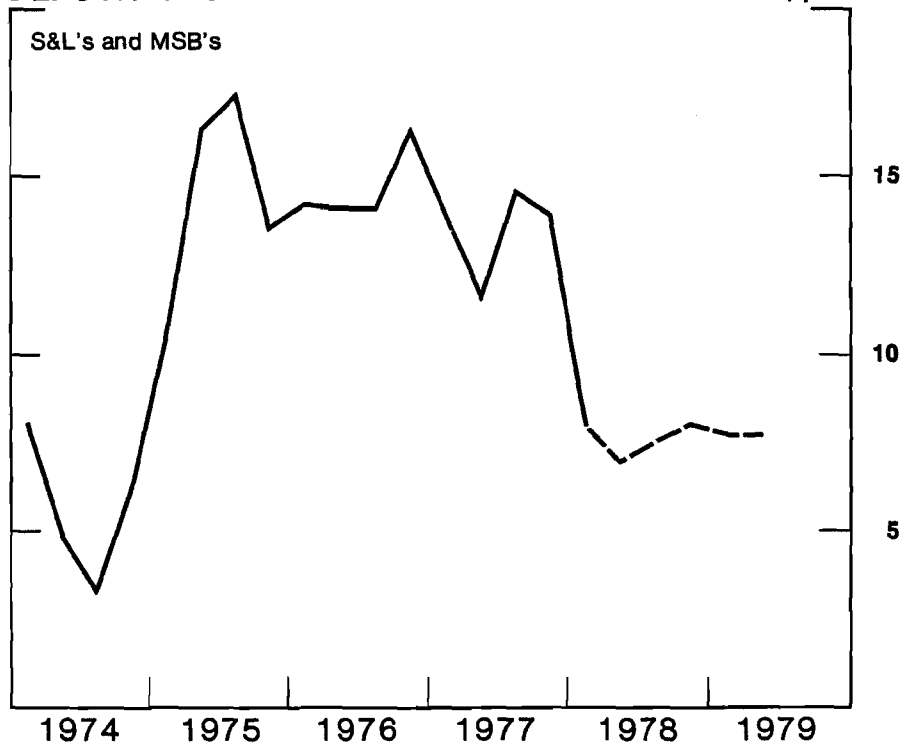
Per Cent





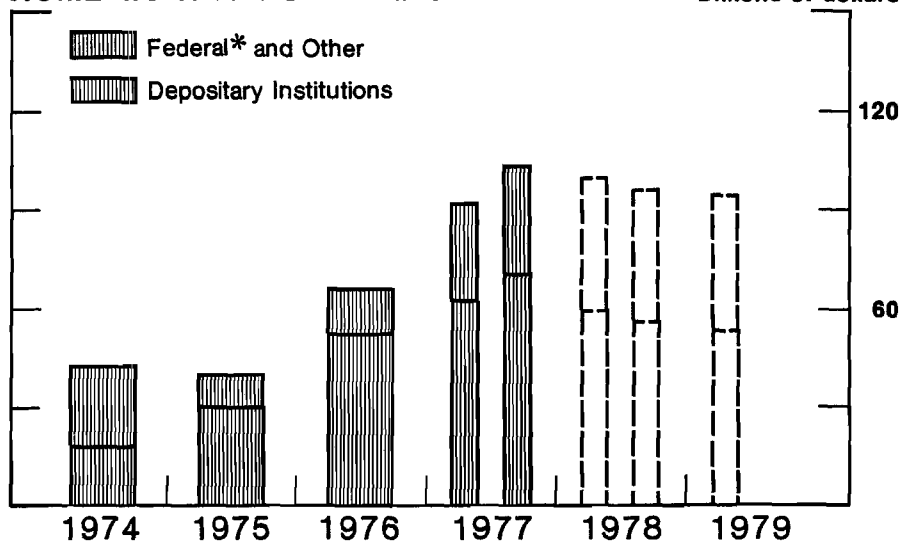
### DEPOSIT GROWTH

Change from previous quarter,  
annual rate, per cent



### HOME MORTGAGE LENDING

Billions of dollars



\* includes FHLBs Lending

Joseph S. Zeisel  
April 18, 1978

FOMC BRIEFING

Given the strength of the economic rebound in the past few months, we expect that by mid-year, activity will have recovered most of the first quarter shortfall. Consumer demand, supported by employment and income gains, should play a key role. The top panel of the first chart, beyond the yellow separating sheet, indicates the impressive gains in nonfarm payroll employment in the first quarter, in the face of the unusual winter weather and the coal strike. Moreover, as can be seen in the shaded section of the bars, a significant proportion of that growth has been in manufacturing employment, which had fared rather indifferently for much of last year. With the recovery of the workweek from reduced January-February levels, these employment gains are currently being reflected in stronger take-home pay.

Furthermore, there are indications of consumers willingness to spend. As the bottom panel shows, car purchases--a particularly

sensitive component of the consumer market--picked up strongly last month after sliding for almost a year, and the high sales rate continued in early April. The improved car sales may of course be transitory, reflecting better weather and sales-incentive contests, but as the next chart shows--consumer attitudes as measured by both the Conference Board and Michigan surveys have remained at comparatively high levels.

Another sector of demand which should be supportive of industrial activity in the short-run is business inventory accumulation--the next chart. Despite a drawdown of coal stocks, inventory investment picked up strongly in the first quarter, following a sharply reduced rate of growth late last year. Some rebound was expected since, as the bottom panel indicates, the inventory sales ratio had dropped substantially by late '77--to near the lower end of postwar experience. The latest reading for this ratio remains low, suggesting the need for further additions to stocks in coming months, even if only to maintain parity between inventories and recent increases in sales.



On the other hand, residential construction--shown in the next chart--appears on the verge of turning down, as we have been expecting. As the top panel shows, total home sales dropped significantly in both January and February. It is not clear how much of this may have been weather-related, but certainly the downturn in outstanding commitments at S&L's--portrayed in the middle panel--appears to foretell a weakening in starts. Given the less accommodative financial markets that appear in prospect, it looks as if housing starts--the bottom panel--will not reattain late '77 levels this year; we project starts to drop to about a 1.8 million rate by year-end, and then to level off, supported in large part by mortgage funds made available through Federal sources.

The next chart illustrates another sector where the contribution to over-all economic activity is expected to be diminishing. As the top panel indicates, the rate of real growth of government purchases--Federal, State and local--is projected to be somewhat more moderate in the next year or so. The sharp drop in the Federal component

this quarter represents a fall off in CCC payments, but the moderation in growth of government spending generally--particularly at the State and local level--reflects the smaller contribution of Federal counter-cyclical revenue sharing and public employment programs later this year. As is indicated in the bottom panel, total government purchases as a share of GNP are expected to drift down over the next year. While this would tend to have a salutary effect on the deficit, in the short-run, the result is to damp real GNP growth.

With less contribution from housing and government, our outlook thus critically depends on business fixed capital outlays to help sustain the momentum of the economy beyond mid-year. While not showing all the vigor one might desire, real gains in this sector still appear likely to provide continued substantial support.

As the top left panel in the next chart shows, real new orders for nondefense capital equipment have continued to trend upward, rising by close to 15 per cent since last year. Moreover, the recovery in building contracts over the past year suggests that we may finally get

some significant increases in plant construction later in '78. As the bottom panel shows, we are forecasting a sustained rate of real increase in business fixed investment averaging 6-1/2 per cent at annual rates through mid '79--considerably more than the rate of GNP growth.

On balance, as the next chart shows, following a strong rebound in real GNP growth of about 6-3/4 per cent in the second quarter, we are now projecting the gain in real GNP over the subsequent four quarters to average close to 4-1/2 per cent. This is slightly less than indicated by last month's projection--the result mainly of the damping effects of the greater foreign trade deficit now projected. In addition to the continued rise expected for fixed capital spending, we are projecting a better-than-average increase in personal consumption expenditures, representing in part the effects of the tax cut assumed for late this year.

But as is evident in the bottom panel, we expect only a modest further reduction in unemployment--to about a 5-3/4 per cent rate in mid '79 reflecting smaller employment gains. The labor

force is likely to continue up at a fairly rapid pace, since the rise in living costs will continue to influence secondary workers to seek work.

As is evident in the next chart, the acceleration in prices recently--to close to a 7-1/2 per cent rate in the first half of 1978--is largely a function of higher food prices, reflecting mainly reduced supplies of meat. This situation is now expected to affect food prices through the year. But our price projections also reflect the recent and anticipated weakening of the dollar, which is expected to put upward pressure on prices of imports and competitive domestic goods. With wage demands likely to respond to increased inflation, and little chance of an offsetting surge in productivity given the moderate pace of over-all growth, there appears no hope for an easing soon of the uptrend in unit labor costs. As a result, we project the rate of inflation to continue in the 7 per cent range over the next year, about half a per cent more than last month's forecast.

RESTRICTED

FOMC PRESENTATION  
E.M. Truman  
April 18, 1978

The top panel of the first international chart depicts the almost continuous decline of the U.S. trade balance from mid-1975 to date. The increase in the deficit has been particularly rapid in the past two quarters. Over the entire period, the decline in net exports of goods and services, as measured in the U.S. GNP accounts, has been somewhat smaller than the decline in the trade balance because of rising net investment income and other service receipts. Over the forecast period, we anticipate little change in the U.S. trade deficit from the range between the figure for the last quarter of 1977 and our estimate for the first quarter of 1978.

Turning to the basic considerations behind this projection, the lower panel of the first chart shows the ratio of real GNP in the six major foreign industrial countries to U.S. real GNP. Since early 1975, the pace of economic expansion has been faster in the United States than on average abroad. This has produced, in large part, our widening trade deficit. Moreover, since potential output has probably continued to expand more rapidly abroad than in this country, the line in the chart would normally have shown an upward trend. On this basis we have estimated that our trade deficit would be \$10-\$20 billion lower with more normal levels of capacity utilization abroad. As is shown by the dashed line in the chart, we expect over the forecast period that real GNP abroad will expand about as rapidly as in the United States. While the gap between U.S. and foreign growth that has opened up over the past several years will not be closed, the recent widening trend should be halted.

RESTRICTED

The other major determinant of aggregate U.S. trade flows is relative prices. The upper panel of the next chart presents one measure of U.S. international price competitiveness -- the so-called "real", or price-adjusted, exchange rate. A depreciation of the U.S. dollar in real terms has two effects on the U.S. economy. It helps over time to reduce our trade deficit, but it also contributes to domestic inflationary pressures.

The decline in the line from mid-1976 through the first quarter of 1978 shows a 10 per cent improvement in U.S. price competitiveness, as measured by relative consumer prices in U.S. dollars. The bottom panel of the chart shows the two components of this measure. Fluctuations in U.S. price competitiveness to date have been dominated by fluctuations in the weighted-average foreign exchange value of the dollar -- the black line -- superimposed on a trend of consumer prices that on average were rising faster abroad than in the United States -- the red line. The projected relative improvement in consumer-price inflation abroad -- shown by the dashed line -- suggests that this pattern may be coming to an end.

The effects of the improvement in U.S. price competitiveness since mid-1976, along with the influence of somewhat more rapid growth abroad than in 1977, are the main elements underlying the staff's projection that the widening of the U.S. trade deficit will be arrested over the forecast period. However, the trade balance deteriorated sharply in the first quarter, and we are not forecasting a significant improvement from this lower level. For these reasons, we expect that the

dollar will depreciate further, perhaps by as much as the 5 per cent (on a weighted-average basis) that is in our forecast. Such a depreciation would have only a marginal effect on the overall U.S. trade balance by mid-1979. Most of the impact would come in late 1979 and in 1980.

The third chart presents our outlook for the four basic components of the U.S. trade balance. The influence of the factors I have reviewed is greatest on our non-oil imports and non-agricultural exports shown in the left-hand side of the chart. The upper panel shows an expected slowdown in the expansion of non-oil imports. Under the influence of the decline in the dollar and a reduced rate of U.S. economic expansion, slower growth in the quantities of such imports is partly offset by higher prices. As is shown in the panel on the lower left, both the price and quantity of our non-agricultural exports are expected to pick up over the forecast period because of the dollar's decline and a somewhat faster pace of economic expansion abroad. On the basis of anticipated supply conditions, our agricultural exports, as shown on the lower right, are expected to show little change. Finally, we expect a temporary decline in oil imports in 1978 largely because of the availability of Alaskan oil. In 1979, however, we assume a 5 per cent OPEC price rise and increases in both consumption relative to domestic production and purchases for the Strategic Petroleum Reserve. These factors will boost our oil import bill.

Mr. Kichline will now conclude our presentation.

James L. Kichline  
4/18/78

Financial Presentation -- FOMC Chart Show

The top panel of the first chart in the financial presentation indicates the staff forecast of strong expansion in nominal GNP through mid-1979, driven by continued high rates of inflation. Given the assumed growth of M-1 at 5-1/4 per cent, the income velocity of money will have to rise rapidly throughout the forecast period. Such an increase in velocity is unlikely to occur without rising interest rates, which act to hold down demands for money. Thus, interest rates--shown in the bottom panel--are expected to begin rising this spring with bill rates reaching 8-1/4 to 8-1/2 per cent in the first half of 1979. Some further downward shift in the demand for money is also assumed in the forecast; if the shifting failed to materialize, 5-1/4 per cent M-1 growth would be consistent with even higher interest rates and a consequent slower growth of GNP.

As the middle panel of the chart shows we expect total funds raised will be very strong over the forecast period, with Federal borrowing likely to rise somewhat from that in 1977. In view of the restraints assumed on credit supplies, the volume of funds raised probably will be associated with significant changes in financial markets from that experienced earlier in this expansion.

For example, in the corporate sector, the next chart, we anticipate larger borrowing requirements as expansion of expenditures outstrips growth of internally generated funds. Demands for short-term credit to finance working capital needs are projected to match the high level in 1977. Because of the heavy reliance on shorter-term



credit, and tighter financial market conditions, corporations will acquire smaller amounts of liquid assets over the forecast period. Thus, as indicated in the bottom panel, corporate financial strength, which began to erode in 1977, is expected to deteriorate further.

As shown in the next chart, a good deal of the demands by businesses for short-term credit are likely to fall on banks. Total loan growth is projected to recede only a little from the high rate in the second half of 1977. To accommodate strong business borrowing, banks will find it necessary to make adjustments in their lending and investment policies and to supplement demand and small denomination deposits as a source of funds, even with an increase in Regulation Q ceiling rates. Acquisitions of investments likely will remain rather small and the increasing use of large denomination CD's and nondeposit sources of funds since the second half of 1977 probably will continue. As shown in the bottom panel, by 1979 banks will find themselves having exhausted much of the financial flexibility they acquired earlier in the expansion.

Deposit growth at thrift institutions, the top panel of the next chart, will also be constrained by the attractiveness of yields on market securities relative to returns available on deposit accounts. The slowdown in deposit growth that began in late 1977 along with reduced portfolio liquidity and increased borrowing by thrifts will be associated with a further tightening of mortgage markets. Mortgage lending by depository institutions is expected to slacken over the projection period and an increased share of lending will be provided through Federal sources.

Over-all, the financial environment associated with the staff's GNP forecast is one of considerable restraint in evidence by late this year and on into 1979 which, of course, raises concerns about economic performance beyond the projection period. A good deal of the problem for financial markets and economic activity stems from the inflationary pressures we are now experiencing and anticipate. If the Administration's anti-inflation program begins to make some progress in coming quarters, it would be easier to be more sanguine about the economic and financial outlook.

April 18, 1978

REPORT OF OPEN  
MARKET OPERATIONS

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

Since the last meeting, the Account Management has continued to seek reserve conditions consistent with a Federal funds rate around 6 3/4 percent--extending further the same rate objective that has been sought since the opening days of this year. A few days after the March meeting, it looked as though two-month growth would be fairly high relative to the Committee's short-term ranges for the aggregates. Since the data represented only a week of new information and the strength was concentrated in the projected rather than the past portion of the period, the Desk's approach was held unchanged. Later information suggested more moderate growth, with the estimates last Friday indicating growth rates in both aggregates well within the Committee's short-term ranges.

For a time in late March and around the first weekend in April the funds rate pushed above the desired 6 3/4 percent rate, with substantial trading in the area of 6 7/8 to 7 percent despite vigorous efforts at the Desk to put in additional reserves. Reserve needs were fairly sizable at the time, and were especially insistent on the days surrounding the March 31 quarterly statement date. At the same time, there was a shortage of suitable securities available in the market either for outright purchase or acquisition under repurchase agreements. Dealers' own holdings of securities were light, in keeping with their bearish rate outlook, and heavy foreign account purchases of bills had also caused supplies

to be limited. The picture changed after the opening days of April as a rundown of Treasury cash put reserves into the banking system and a \$6 billion Treasury sale of cash management bills relieved the scarcity of securities. The funds rate quickly returned to around 6 3/4 percent, having averaged as high as 6.86 percent in the week ended April 5.

To meet both current reserve needs and the substantially larger projected needs at the end of April--when collateral is likely to be scarce again--the Desk made large outright purchases of securities during the past month. Treasury coupon issues were bought on two occasions in the market, in the total amount of \$1,265 million. The System also bought about \$1,320 million of Treasury bills, some \$900 million from foreign accounts, and the rest in the market. The combined bill and coupon purchases used up a substantial portion of the \$3 billion leeway for changes in outright holdings between meetings. Repurchase agreements were executed nearly every day from March 23 through April 3, the interval when funds traded above the desired level. Matched sale-purchase transactions were arranged each day with foreign accounts, and on several days in the market when an easier money market developed after early April.

Even after the recent large outright purchases, a big reserve need is still projected for late April - early May. If collateral proves to be scarce, as we anticipate it will, we will need to ask for Treasury cooperation by foregoing some calls on tax and loan accounts and perhaps even redepositing funds with the banks.

Yields on Treasury coupon issues rose about 10 to 20 basis points over the period, chiefly reflecting a cautious market attitude in the wake of revised money supply growth data published in late March, apprehension that monetary growth would soon accelerate, and signs of continuing inflation. Money market firmness in late March had little impact on other rates at first, as market participants could see that the Desk was striving to combat that firmness, but after a time the high funds rate began to augment market concerns about an imminent firming in policy. The market recovered somewhat after funds eased early in April, and made further gains in the final two days of the period, after the latest week's money supply data failed to show the large rise that some had feared.

While a number of market participants recently have set back their timetable for an anticipated firming of monetary policy, the prevalent market view is still that rates are likely to rise in coming months, as the economy regains momentum, inflation persists, and aggregates press higher. The market is now preparing to bid on about \$2.2 billion of 2-year notes tomorrow, and also is awaiting the Treasury's refunding terms for the mid-May maturity which should be announced on April 26. Incidentally, the System Account holds about \$2.5 billion of the maturing May issues, which we expect to exchange for new issues in about the proportions offered to the public.

Bill rates also rose through much of the period, but declined near the end to register little net change for the interval.

The back-up in rates early in the period stemmed in part from a moderation in the pace of foreign account purchases, and the Treasury's issuance of \$6 billion in cash management bills, as well as the firmer money market. Late in the interval rates came down again, especially in the shorter bills, as the money market was more comfortable and dealers began to anticipate a more intense shortage of supplies in coming weeks. Bills were auctioned yesterday at average rates of about 6.14 and 6.56 percent for the three- and six-month issues, compared with 6.21 and 6.55 percent the day before the last meeting.

Finally, I should note that we now are trading with one less dealer (now trade with 34) than earlier, as Merrill Lynch has taken over White Weld.