Notes for FOMC Meeting
June 20, 1978
Scott E. Pardee

Since the last FOMC meeting, dollar rates have fluctuated widely in line with changing market sentiment. Following the dollar's rebound in April and early May, during which the dollar rose by 7 percent against the mark, 5 percent against the yen, and 12 percent against the Swiss franc, the market began to look for signals from the authorities on how far the rates might be permitted to go. By then the market was aware of the sizable amounts of marks being pulled out of the market by the Bundesbank, through the capital export conversion program, and, by inference, by ourselves as our swap repayments showed up as decreases in German reserves. Just after the FOMC, remarks by Dr. Emminger of the Bundesbank were misinterpretated as suggesting that the Bundesbank viewed the dollar's rise as threatening to be excessive. At the same time interest rates in the United States leveled off.

In this more tentative atmosphere, a spate of bad news in late May tipped the balance of the market against the dollar. These included the release of another large trade deficit for the United States in April, compared with continuing large trade surpluses for Japan and Germany, along with several indicators confirming the worsening of the price picture here as against trends elsewhere. Market participants were also treated to some grim forecasts by the OECD on relative rates of growth, price inflation, and trade balances. Moreover, several economists from the U.S. private sector made headlines in speeches in Europe, arguing that there should be a big cut in dollar exchanges rates or that the United States should impose controls on capital flows.

By early June, the dollar had dropped off 3 percent against the mark, 5 percent against the Swiss franc, and began to slip back against the yen. Nevertheless, except for a few days, the dollar's retreat was generally orderly, and the Desk intervened on only two occasions, in the amount of $74 million, out of balances, split with the Treasury. Otherwise, the dollar's generally firmer undertone has remained in evidence, and rates against European currencies are hovering somewhat above their recent lows. The Japanese yen has continued its recent rise, not only against the dollar with an 8 percent jump since late May, but against other major currencies as well. This unilateral strength of the yen is a welcome development in view of the continuing worrisome Japanese surplus even as their economy shows signs of more rapid growth. But the sharpness of the rise raises risks of triggering generalized selling pressure on the dollar such as happened last fall.

No one in the market is very optimistic about the outlook for the U.S. payments accounts or for inflation. Many market participants nevertheless believe that the dollar's technical position remains strong and that we have only seen the beginning of the process of covering short dollar positions and of unwinding the unfavorable leads and lags against European currencies which had built up during the six months in which the dollar was under virtually continuous selling pressure. Consequently, there is considerable disagreement on whether the dollar is likely to rise or fall, which provides for a two-way market for the time being. But the downside risk is great and further action is needed in the U.S. on inflation and other economic fundamentals to ensure the dollar's stability over the longer term.

Throughout the period, the Desk sought to obtain as many marks as possible to repay debt without triggering a market reversal. In all, we purchased a total of $879 million, of which about one-half came from the Bundesbank under capital export conversions, a quarter came from correspondents, and a quarter from the market either directly or through agents. On the 60-40 split with the Treasury, this enabled the Federal Reserve to repay a further $494 million equivalent of swap debt, clearing up all drawings incurred through December of last year, and leaving $1,044 million outstanding. Since the dollar has been lower than at the last meeting, our loss so far has increased to $19 million, but if we were to liquidate the remainder at current rates, our total loss would not be much bigger than the present amount. The Treasury has repaid a further $334 million, leaving $466 million outstanding, and at current rates stands to make a small profit. From the peak amount of $2.8 billion in mid-April the System and the Treasury have repaid $1.3 billion, or 47 percent.

Looking ahead, as long as the dollar does not encounter another sinking spell, we can continue to make progress in repaying debt through the various channels we have open. The German authorities halted non-resident issues in their capital market for a few weeks and will now resume them at a slower pace, so our acquisition of marks from their capital export conversions will be smaller than before. Nevertheless, we are now in the position of being able to buy marks from the Bundesbank in connection with German government payments to the United States and from the Bank of France in connection with that Bank's occasional intervention purchases of marks. I might add that during the period we reached several of the limits set forth in the authorization and procedural

instructions. Since we were heading in the right direction, both the Subcommittee and the FOMC readily approved our requests to exceed the intermeeting limits.

James L. Kichline
June 20, 1978

FOMC Briefing

Indicators of developments in the economy continue to point to substantial strength in real activity during the current quarter. However, much of the strength represents transitory impacts of a rebound from a severe winter and a lengthy coal strike. Those impacts now seem to be largely behind us and there is widespread evidence that the pace of economic activity moderated appreciably last month.

A slowing in the pace of activity recently is illustrated dramatically in the information on developments in the labor market. In May nonfarm employment is reported to have increased by 175,000, less than one-half the average gain in the first 4 months of the year, even after adjusting for the return of striking miners. Moreover, growth of manufacturing employment was relatively small and the average length of the factory workweek declined. The labor force grew at a sizable rate and the unemployment rate edged up a tenth to 6.1 per cent.

The reduction of demands for labor in manufacturing showed up in production, where industrial production rose by an estimated .6 per cent rate last month. Although this is still a healthy rate of increase, it nevertheless is one-half the pace recorded in the 2 preceding months. The slowing was accounted for importantly by declines in production of automotive products, but production of other final products and of materials also exhibited less rapid gains.

The dollar value of retail sales also has shown less strength recently. Sales of nondurable goods have been sluggish for the past 2 months, rising less than 1 per cent for April and May combined. Auto sales, however, have continued very high with total sales in May running

at over a 12 million unit annual rate. Domestic sales in May were just over a 10 million annual rate and that sales pace continued into early June. The disparity in sales of nondurable goods and autos as well as other durables is consistent with consumer attempts to beat anticipated price increases and substitute durable for nondurable goods. The current auto sales pace is clearly inconsistent with recent and prospective income gains, replacement demands, and high consumer debt burdens. Thus, we believe auto sales will soon slow, and the over-all disparity in performance of durable and nondurable goods sales should disappear.

Despite the sizable gyrations in sales and production so far this year inventories seem to have been kept under fairly good control. Reports of goods shortages or excesses are not widespread and generally have changed little in recent months. Although the book value of inventories in March and April rose substantially, food stocks valued at sharply higher prices were a key factor.

In real estate markets, activity reportedly has continued rather brisk amidst a much tighter mortgage market than prevailed early this year. Housing starts in May declined 5 per cent to under a 2.1 million unit annual rate. This was a bit stronger performance than we had expected and our forecast of starts for this quarter is probably somewhat low. Nevertheless, the general pattern of slowdown following a makeup for the severe winter seems on track.

Over-all, real growth of GNP this quarter still seems likely to be around a 9 per cent annual rate, or around 4-1/2 per cent annual rate over the first half of the year--taking account of the first quarter GNP revision released this morning which shows real GNP of no change versus a 1/2 per cent decline. Over the next 4 quarters real growth is forecasted around 3-3/4 per cent, about one-half percentage point less than a month ago.

There are 3 principal factors that account for the downward revision of expected real activity; these are the incorporation of the Administration's changed tax reduction proposal, a somewhat weaker outlook for business fixed investment and the impact of a deteriorating inflation outlook. The Administration's requested delay and scaling down of its proposed tax cut became known after the May forecast was prepared. This month we have incorporated a cut of around $19 billion beginning January 1979. The effect of the changed assumption on real growth is most apparent in the fourth quarter of this year and for the upcoming 4 quarters together is estimated to reduce real GNP growth by about 1/4 per cent. Whether or not Congress enacts a tax reduction comparable to our current assumption remains an open question, and in fact the Administration still has not detailed the make-up of its revised proposal.

The second significant adjustment to the forecast has been in the area of investment spending. The May Commerce survey of plant and equipment spending intentions was revised up only marginally to 11-1/4 per cent, considerably less than we had hoped to see. This survey has a fairly good track record and we adjusted downward somewhat forecasted growth of business investment spending while still expecting larger gains than reported in the survey. On average, new orders, capital appropriations figures, and construction contract awards provide a basis for expecting stronger performance than in the survey. However, recent corporate financial developments are a cause of some concern about the outlook for business spending; revised data indicate corporate holdings of liquid assets are appreciably lower than reported earlier and reliance

on short-term debt has been very heavy. Financial constraints in the corporate sector may have an adverse impact on willingness to invest.

The third factor influencing the scaling down of expected real growth is inflation. In the current quarter we have revised up substantially the anticipated increase of the fixed weight deflator--to the neighborhood of 9-1/4 per cent annual rate. About one-half of the revision is attributable to another sizable increase of food price rises; in April alone food prices were 13-1/2 per cent annual rate above the first quarter average. Other changes reflect a variety of smaller adjustments. These higher prices are expected to have feedback effects on compensation and ultimately will be passed through in part to final product prices; in addition higher prices will tend to dampen real income growth, confidence, and spending. Over the 4 quarters ending in the second quarter of 1979 the forecast of the fixed weight deflator is 7-1/4 per cent, about 1/4 per cent more than a month ago. Included in the forecast is a substantial slowing in the rate of food price increases compared to recent experience.

Finally, I want to call your attention to the fact that the GNP forecast is based on the monetary assumption of interest rates at the low end of the range in the Bluebook, just as a month ago. If achieving 5-1/4 per cent growth of M-1 requires higher interest rates, the pace of economic activity would be expected to be weaker than that forecasted.

FOMC MEETING
June 20, 1978

REPORT OF OPEN
MARKET OPERATIONS

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

Desk operations since the last meeting of the Committee were directed first at moving up the Federal funds rate gradually to about 7 1/2 percent, and then at holding that level over the balance of the interval. The move from 7 1/4 percent or a shade higher to 7 1/2 percent developed a bit faster than the Desk intended, as market participants quickly anticipated the System's intentions--but there seemed no point in forcefully resisting this market tendency when the Committee's intent was to get there fairly soon anyway. On a few occasions, the funds rate softened somewhat below 7 1/2 percent, mostly notably over the confusing Memorial Day period when banks in different parts of the country were closed on different days, but market participants generally understood the System's objective to be steady at 7 1/2 percent.

Behavior of the monetary aggregates was well within the tolerance ranges through most of the period. Projected growth pushed fairly high in the ranges in the data reviewed late last week, raising some question as to whether the current objective should be modified, but the Committee instructed the Desk to hold steady for the time being given the proximity of today's meeting.

Early in the period, when reserves were being provided chiefly by a rundown in Treasury balances, the Desk was mainly engaged in absorbing reserves--through matched sale-purchase transactions, outright sales of over $700 million of bills to

foreign accounts and a run-off of $300 million in maturing bills. Mid-way through the period, as an enormous reserve provision job loomed ahead because of the mid-June tax date, the Desk began making outright purchases of securities--even while still draining reserves on a day-to-day basis. From June 6 through yesterday, the System bought over $1.2 billion of bills from foreign accounts, and $1.4 billion of bills in a market go-around. The System also bought somewhat over $1 billion of Treasury coupon issues in a market go-around. The net purchases over the period have nearly exhausted the standard $3 billion leeway for outright transactions between meetings.

A large reserve need still remains to be filled in the next week or so, although the Treasury is being quite helpful in scaling back the extent of calls on its tax and loan accounts in order to moderate the rise in its balances at the Reserve Banks. Much of the upcoming reserve need can be met with repurchase agreements but it seems appropriate to make some additional outright purchases, including agency issues which have not been purchased since last December. Agency market participants have begun to notice our absence, and this at a time when the Federally sponsored credit agencies are having to borrow heavily especially to assist mortgage credit.

Most market interest rates rose during the past month, particularly for shorter maturities. The moves were partly a response to the observed increase in the funds rate early in the period, and partly in anticipation of further firming as incoming information reinforced expectations of persistent inflation. The

strengthening of aggregates in recent weeks also led to higher rate expectations. Amond the larger rate increases were those on commercial paper and bank CDs, apparently reflecting active credit demands. The bank prime rate rose another 1/4 percent last Friday, with the posted rate change spreading through the banking industry very quickly.

Treasury bill rates rose about 20 to 50 basis points over the month, with the larger increases among shorter maturities. Three- and six-month issues were auctioned yesterday at about 6.67 and 7.23 percent compared with 6.32 and 7.01 percent the day before the last meeting. Supplies of very short maturities will diminish when $6 billion of cash management bills mature this Thursday but the Treasury will be adding to one-year bills in this week's auction and may add to other bills in coming months.

Rates in the two-year area rose about 20 basis points in the past month. A $3 billion issue of two-year notes is being auctioned today, with early talk around 8.30 percent, compared with 8.09 percent a month earlier. That earlier auction drew substantial noncompetitive interest, as may this one. Dealers have a net short position in the two-year area, and apparently expect a firmer System policy in weeks to come, but they would probably be upset by a highly visible indication of firming immediately after today's meeting.

Rate increases for intermediate Treasury maturities were largely in the area of 15-20 basis points while most of the longest issues were up 1 to 5 basis points. Dealers hold a net short position in the intermediate and longer areas, too,

anticipating further upward pressure on rates. A 15-year Treasury bond is to be sold next week, to raise $1 3/4 billion, a bit more than most market participants expected.

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The policy alternatives presented to the Committee again suggest strong money growth over the next few weeks and, over time, further upward pressures on interest rates if growth in M-1 is to be constrained within the FOMC's longer-run range. So far as interest rates are concerned, this represents a continuation of trends of the past year, and it might be useful briefly to review those interest rate trends in relation to both credit and money demands.

Credit growth had strengthened considerably in the second half of last year, when net funds raised by nonfinancial sectors amounted to about $380 billion, up about $80 billion from the pace of the first half of 1977. However in the first half of this year credit growth fell off. Nonfinancial sectors are estimated to have raised about $345 billion, or $35 billion less than in the second half of 1977. About three-fourths of this decline represented a reduction in funds raised by the Federal and State and local governments. And by maturity distribution, virtually the whole decline took place in longer-term market sectors.

Despite this apparent slackening of credit growth in the first half of 1978, upward interest rate pressures have been every bit as strong thus far this year as in the second half of 1977--and in some areas noticeably stronger. Short-rates have risen a shade less so far this year--a one percentage point rise for the Federal funds and 3-month commercial paper rates, as compared with increases of about 120 basis points in the second half of last year. With business

loan demands on banks particularly strong in recent months, the bank prime rates rose a similar percentage point in both half years.

However, in long-term markets, interest rates have risen more in the first half of 1978, despite the drop in total funds raised in those market areas. Corporate and Treasury bonds rose about 60 basis points as compared with about 25 basis points in the second half of last year. And, in even more marked contrast, mortgage rates have risen about 75 basis points thus far this year after rising only 10 basis points in the second half of 1977.

There are two principal reasons, I believe, for the greater upward pressure on long rates this year than last. First, inflationary expectations have worsened. Second, there has been increasing pressure on the liquidity position of thrift institutions, and also banks, as shorter-term market rates rose further and further above ceiling rates on small-denomination interest-bearing deposits. This has had obvious implications for the mortgage markets as thrift institutions have been cutting back on commitments, and banks too have reduced their mortgage activity a little. The rise in mortgage rates led to a sympathetic reaction in other long-term markets. The upward rate pressures on longer-term markets have, in other words, reflected supply constraints--investors have demanded a larger inflationary premium (no evidence of accelerated borrowing) and depository institutions have become more reluctant to lend at pre-existing rates as a result of growing liquidity pressures.

The pressures on depository institutions have been reflected in the slowing of growth in M-2 and M-3 over the past half year. M-2 growth slowed from about a 9 per cent annual rate to 7¾ per cent, and M-3 from 11½ per cent to about 8 per cent. Thus, the behavior

of these broader aggregates gives a clearer indication of intensified monetary restraint over recent months than does the behavior of M-1--which has increased in a 7¾ to 8 per cent range in both the last half of 1977 and the first half of 1978.

Staff projections of GNP and evidence of a weakening in liquidity position of key economic sectors--such as corporations--suggest a continued strong need for money and liquidity over the months ahead if real activity is to be sustained. Our June-July projections for M-1 growth of around 9 per cent may exaggerate in some degree the underlying strength of demand for the money portion of liquidity--because of problems perhaps with the July seasonal factor. Nonetheless, it seems quite likely that as the year progresses, strong liquidity and money demands will exert further upward pressure on short- and also long-term interest rates, given System longer-run monetary aggregates targets, even without an acceleration in credit demands--unless, of course, the economy becomes much weaker than has been projected as the public attempts to attain liquidity by cutting back on spending and credit and money demands fall off dramatically.