Notes for FOMC Meeting
September 19, 1978
Scott E. Pardee

Since the time of the last FOMC meeting, the U.S. authorities have embarked on a multifaceted effort to address both the fundamental problems affecting the dollar and the immediate psychological concerns of the marketplace. This of course was kicked off by President Carter's August 16 statement of deep concern over the disorder in the markets and decline of the dollar, and his request to the Treasury and the Federal Reserve to see what steps could be taken. Everyone who lists the elements in the effort would include different items, but all lists would feature the actions by the Federal Reserve—the firming of the federal funds rate, the hike in the discount rate, and the reduction to zero in the reserve requirement on borrowings through foreign branches. For its part, the Treasury announced an increase in the amounts of gold it will be auctioning over the four months beginning November and has hinted that it is thinking of drawing foreign currencies from the IMF. More broadly, the administration—with considerable prodding from Federal Reserve and Treasury officials—has pressed ahead on the energy legislation, on an export expansion program, on a variety of fiscal policy improvements, and on establishing workable wage-price guidelines. Efforts for cooperation by other governments elicited a statement by Saudi Arabia that it does not favor an oil price increase this year and prefers to retain the dollar as the currency in which oil is valued rather than shift to a currency basket. The Japanese were also pressed to take additional stimulative measures, which they have, but they did not go as far as the U.S. side wanted. In concluding my list of steps to support the dollar, I was personally pleased to find that Federal Reserve and Treasury officials managed even to persuade Representative Reuss to say publicly that some central bank intervention is appropriate under the current circumstances. That's the first good word he has put

in for us yet.

What has been the effect on the market of all this? I'm afraid not much so far. Following President Carter's original statement of concern and each time individual elements of the package have been unveiled dollar rates were in the first instance bid up, but the demand for dollars on no occasion was sustained long enough to break through the entrenched short positions and general pessimism toward the dollar. Once the dollar began to rise, bearish professionals stepped in and pushed it back down again, on some occasions when there has been no adverse news. The poor trade figures for the United States in July, a deficit of $2.99 billion announced on August 30, took the heart out of the few bulls that may have been around. The market followed the Camp David summit with great interest, but last Sunday night's surprise announcement of an agreement on a framework for peace in the Middle East gave the dollar only a momentary boost. Against its mid-August lows, the dollar is only higher by 2-1/2 percent against the German mark, 1-1/2 percent against the Swiss franc and 4 percent against the Japanese yen.

I should add one more element in the panorama. On September 1, the foreign exchange dealing rooms of many U.S. banks were linked into international brokers, and U.S. brokers themselves went international. This included a formal shift over to European terms of quoting foreign exchange (so many marks per dollar) from what had been called U.S. terms (so many cents per mark). These changes, plus the adoption of direct dealing by many U.S. banks (that is, dealing directly with one another in addition to using brokers) followed lengthy and heated discussions among market participants. So far the transition has been smooth, and trading volume has increased substantially. The changes may eventually be helpful in providing greater depth, breadth and resiliency to the market. But under current conditions in which

markets are frequently one-way, it means that the stakes have been raised for anyone who wishes to be in the market for any reason. For example, whereas it had been customary to deal in round amounts of 3-5 million marks, we find many banks quoting round amounts of 3-5 million dollars worth of marks, twice as much. To be at all effective when we are in the market, we now have to be prepared to deal in the same lots.

Against this background of uncertainties over the fundamentals, over policy, and over evolving market practices, the Desk has had to tread extremely cautiously. During the period we intervened eight occasions, for a total of $348 million, of which half was for the Federal Reserve and half for the Treasury. On each occasion we backed away rather quickly, allowing a greater degree of rate variability than would otherwise be desirable. The market has sensed this caution, and some professionals have perhaps exploited it. Nevertheless, until the market is better persuaded that our economic policies are on the right track and our economic indicators and the trade balance show clear improvement, it would be difficult to justify a much more aggressive approach by the Desk, which would imply a much greater commitment of resources by the Federal Reserve and the Treasury.

During the period, the System drew a further $166 million under the swap line to finance intervention, but was able to acquire additional marks in direct deals from the Bundesbank and repaid $140 million of earlier drawings. On balance, therefore, our drawings increased by $26 million, to $693 million. In corresponding operations, the Treasury's indebtedness under its swap arrangement with the Bundesbank rose by a net $72 million to $322 million. We also continued to operate in Swiss francs, selling in the market and drawing from the National Bank an additional $51 million equivalent, raising total drawings in the latest sequence of operations to $92 million. As indicated earlier, in the absence of [unintelligible]

agreement between the U.S. and Japanese authorities, we have not intervened in Japanese yen for our own account. But we have had further discussions at a technical level on the conditions under which we would operate should there be agreement on the policy level to do so.

James L. Kichline

FOMC BRIEFING

September 19, 1978

Incoming data continue to suggest a moderation of economic activity in the current quarter. Our assessment of these data has led us to reduce slightly the forecast of real activity in the third quarter, with our expectations for real GNP growth now around 3 per cent at an annual rate. At the same time, however, the longer-run outlook for activity does not appear to have changed significantly from that of a month ago, and we have retained a forecast of real growth near 3-1/2 per cent through 1979. On the inflation side, an easing of the rapid pace of price increases had been anticipated this quarter, but that easing in the food sector now seems somewhat larger than expected. Thus, the current quarter forecast of the fixed weight deflator has been revised down more than a percentage point to 6-1/4 per cent annual rate increase. Here too, recent data have not led us to change the longer-run forecast, with inflation next year expected to run close to 7-1/2 per cent.

The slowing of economic activity in recent months is quite evident in labor market developments. Total nonfarm employment rose dramatically during the first half of the year, but in July and August on average the increase was less than one-half the earlier pace. Moreover, employment in manufacturing actually declined in August for the first time in a year, due to cutbacks at producers of nondurable goods. The unemployment rate has bounced around for the past several months, dropping .3 to 5.9 per cent in August, but has remained near the 6 per cent level since early in the year.

The slower growth in factory labor inputs reflects a moderation of industrial production, following strong increases in early spring when activity was rebounding from the winter and coal strike effects. In August the industrial production index rose .5 per cent, a couple of tenths less than the upward revised June-July pace, but still quite good.

The pattern of production gains among products appears consistent with other information available on short-run economic developments. In August, for example, business equipment output again rose strongly and was 9-1/2 per cent above the level of a year earlier, as was the case for construction supplies. In contrast, output of consumer goods increased only .1 per cent during the month and the level of output remained a little under that reached in April.

The weak pattern of consumer goods output since April has been necessary to avoid an excessive buildup of consumer goods inventories given sluggish retail sales. The dollar value of total retail sales in August was only 1/2 per cent above the second quarter average. Data on auto sales through early September generally point to a strong market, but are nevertheless consistent with our unchanged forecast of a decline of 3/4 million units annual rate from the exceptional sales pace in the second quarter. Although it is always difficult to interpret the performance of auto sales at the end of a model year, it may well be that the transitory effect of purchases in anticipation of price increases is weakening--the Michigan survey of consumer attitudes suggests the beginning of such a development. If this reasoning proves correct a slowing of durable goods purchases could also be accompanied by an increase in

funds available for other purchases, and hence larger gains in nondurable sales. Such sales have been particularly weak in recent months and account mainly for our downward revision of expected GNP growth this quarter. The pause in consumer spending growth this quarter is expected to result in a rise in the savings rate from the low level in the quarter earlier. Even so, the saving rate is projected to remain low through 1979 when compared with experience in the early half of this decade. To a large extent we are counting upon consumer spending preferences in an inflationary environment along with favorable demographic factors to bolster spending and keep saving relatively low.

In the residential construction sector the forecast has been strengthened. Housing starts in July remained near 2.1 million units annual rate and total home sales rose a little from the preceding month. Financial conditions in the mortgage market have eased a bit recently, attributable partly to the phenomenal success story of the money market certificate. The present housing forecast includes an upward revision to starts this quarter, and enlarged deposit flows projected at thrift institutions through 1979 have led us to raise starts somewhat for that period as well. Over-all, the housing market portrays a rather mild cyclical contraction, with starts dropping nearly one-fifth from the peak in the fourth quarter of last year to the end of 1979; by contrast, starts fell roughly three-fifths from the peak to trough in 1973-75.

Other major sectors of the economy appear to be behaving about as expected, including the key sector of business fixed investment. The latest Commerce survey of business investment spending indicated a 12-1/4 per cent increase for this year. Some of the revision was attributable

to stronger spending growth in the first half of the year rather than enlarged plans for gains in the current half year. Other information on new orders, capital appropriations, and construction contracts present a mixed picture, but one for which there remains a reasonable basis for achieving our forecast of nominal outlays increasing 13 per cent next year. Unfortunately, businesses still face a highly uncertain environment that is not particularly conducive to firming up long-term expenditure programs. Hopefully, some of the uncertainty will be reduced following resolution of the final energy and tax programs, as well as Phase 2 of the inflation program.

On the price side, recent consumer and producer price indexes have evidenced a better performance than we had anticipated. A good deal of the favorable news relates to food prices which were unchanged in the July CPI and declined sharply at the producer level in August. After taking these prices into account and a technical adjustment in the international area, the fixed weighted deflator is expected to rise about 6-1/4 per cent this quarter. But food prices seem likely to rise a bit faster later this year--I might note, for example, that spot prices for live cattle have been rising over the past few weeks. In addition the outlook for increases in unit labor costs is not encouraging and we continue to expect prices to rise about 7-1/2 per cent next year.

Notes for FOMC Meeting
September 19, 1978
Paul Meek

The written reports detail the operations of the Trading Desk as the weekly federal funds rate objective rose in successive steps from 7-7/8 to 8-3/8 percent over the past five weeks. The move started as a complement to the rise in the Federal Reserve discount rate from 7-1/4 to 7-3/4 percent to underscore U.S. concern with the dollar's international position. It continued in response to evidence of overly rapid monetary growth.

The Desk fostered the 1/2 percentage point increase in the federal funds rate against a background that called first for adding substantially to reserves, as the Treasury's balance at the Reserve Banks rose, and then for reversing direction as it fell sharply to its monthly low point last week. We added a bit over $2 billion in permanent reserves through purchases of $947 million of Treasury coupon issues in the market on August 15 and $1,175 million of Treasury bills from foreign accounts at various times. We used repurchase agreements with dealers extensively to moderate reserve pressures through the statement date surrounding Labor Day, and then shifted to mopping up reserves temporarily through matched sale-purchase transactions with the market as well as those routinely done with foreign accounts.

Bearing in mind the sensitive state of the foreign exchange markets, the Desk sought to conduct operations in such a way that market participants would sense the System's resolve in moving up its operational federal funds rate objective but would also see the limited extent of each move as it took place. Thus, on the Friday after the Committee meeting, we resisted through market action the decline in the rate below 8 percent, and then made repurchase agreements in the market later on when the federal funds rate rose to 8-1/4percent. This was the first occasion on which we both absorbed and supplied reserves in the market with effect on the

same day. Again on September 8, we indicated by temporary market sales that the Committee no longer considered 8-1/4 percent an acceptable rate. Then, as the rate rose to the desired 8-3/8 percent, we passed through a portion of foreign account repurchase agreements to the market to indicate the acceptability of that rate. The quickness with which the new objective was established confirmed the usefulness of the flexibility given by the Committee in establishing the procedures used for handling temporary foreign investment orders.

We are confronting a very large reserve need for the coming period as corporate tax receipts swell the Treasury's balance and new tax and loan procedures are not yet in effect. Under the circumstances, I would like to recommend that the Committee increase temporarily the leeway for raising, or lowering, the System's portfolio between meetings to $4 billion from $3 billion.

Short-term interest rates adjusted markedly higher in the wake of the System's move to allow a higher federal funds rate. Rates rose by as much as 1 percent on short-dated Treasury bills and by about 3/8 percent on the one-year bill issues as market supplies expanded at a time that dealer financing costs were increasing. Foreign central banks sold $1.6 billion net of short-dated issues through the Desk, chiefly reflecting Canadian exchange operations and Japanese sales related to the placement of funds with their commercial banks and to their payment for new Treasury coupon issues. Such sales, following substantial purchases earlier when there was heavy Japanese intervention in the foreign exchange market, contributed to a sharp reversal of market attitudes. Adding to the upward pressure was the scramble to close out long positions established in the September 21 futures contract in 3-month Treasury bills on the Chicago Mercantile Exchange. In yesterday's auction, the rates established on 3-and 6-month bills were about 7.78 and 7.98 percent, up 100 and 72 basis points from those set in the August 14 auction.

During the period, the prime lending rate of most commercial banks rose by 1/2 percentage point to 9-1/2 percent. Rates on 6-month negotiable CDs rose by 70 basis points to about 8.95 percent, and rates on commercial paper and bankers' acceptances also advanced.

In contrast to these increases, yields on intermediate- and longer-term securities—and on corporate stocks—have continued to decline since reaching their highest levels in this cycle in mid-July. I for one am not sure I understand why the markets seem to be acting as though [unintelligible] the yield curve on Treasury securities now peaks around 8.60 percent within the one- to two-year area and slides gently to 8-3/8 percent on 30-year maturities. Corporate underwriters have enthusiastically pushed the offering rate on new 40-year telephone bonds down about 40 basis points to 8-5/8 percent since July, overreaching investor interest as it turned out. Municipal yields have declined further, now that the calendar has receded from August's record $5.9 billion of new issues.

Much has been made in the Treasury market about continuing investor interest, which has pushed yields down 10 to 15 basis points on issues maturing beyond six years. Market participants are also impressed by the reduction in prospective sales of marketable securities, as a result of heavy sales of Treasury issues to state and local governments and to foreign governments. Market observers are now projecting fourth-quarter sales of $14 to $17 billion of marketable Treasury issues rather than the $22.5 billion estimated by the Treasury in late July. Market people also are encouraged by press reports that the Administration is trying to reduce the FY 1980 budget deficit to $30 billion or less. In the short run dealers are also expecting the Trading Desk to supply a large volume of reserves over the next month.

At this point, most Government securities dealers worry that inflation remains the principal problem of the country, but their positions tend to err on the long, rather than the short,

side for the time being. Of course, the events of the last two months remind us how quickly investor perceptions can change, and yesterday the Southern Bell Telephone issue adjusted upward by 15 basis points to 8.78 percent in secondary market trading.

FOMC Briefing
S. H. Axilrod
9/19/78

As indicated in the blue book, the staff expects that growth in M-1--as well as M-2 and M-3--will continue to be relatively rapid in the September-October period. We believe M-1 will grow around 8 to 8½ per cent at an annual rate from August to October--which would be about the same rate of growth as over the past year and only slightly below growth during the past six months. In large part, we have projected so high a growth rate for the two month period because of the 10½ to 11 per cent expansion (annual rate) that appears to be in train for September, given data available through September 13. However, some moderation of M-1 growth is expected in the fall, even abstracting from the impact of the automatic transfer service from savings to demand deposits, for two reasons: first, because of the lagged effect of the about 1½ percentage point rise in short-rates since April and second, because transactions demands for cash will be held down by a probable slowing in nominal GNP growth, with growth for the second half of this year projected to be about 3 percentage points lower than actual growth in the first half on average.

The prospective slowing of money grwoth at current interest rate levels would probably bring M-1 growth to around 7 per cent, or maybe a little more, over the one year period ending in the second quarter of 1979, again abstracting from automatic transfers. This would, of course, be more rapid than the upper limit of the Committee's longer-run range, though noticeably slower than over the past year. In any event, such a rate of money growth is indicative

of the underlying strnegth of money demand, given built-in inflationary forces in the economy.

Another way of putting the same point is that the degree of restraint embedded in the current interest rate structure would not appear to be sufficient to reduce the rate of nominal GNP growth, and the associated transactions demand for cash, to a pace consistent with the Committee's longer-run target for M-1. One reason of course, is that inflationary expectations are strong enough so that borrowers do not feel very constrained by current interest rate levels. Another is that the degree of non-price rationing by lenders has been lessened by the increasing "perfection" of the markets for finance, particularly housing finance, over recent years.

The 6-month money market certificate, for instance, has enabled thrift institutions to compete very successfully for deposits. In August--with the conventional mortgage rate close to 9¾ per cent--the percentage of S&L's reporting mortgage funds in short supply was down 10 percentage points from the May report, down to 57 from 67 per cent. (By way of comparison, in the late summer and early fall of 1974 about 90 per cent of S&L's reported a short supply of funds, and the average mortgage rate was only about 20 basis points higher than now). I do not mean to be saying that the money market certificate has made monetary policy less effective--only that it, and other similar market adaptations, such as increased willingness of Home Loan Banks to lend to S&L's, mean that more reliance needs to be placed on interest rates in achieving a given degree of monetary restraint.

While the staff is forecasting higher short-term rates, given the Committee's longer-run monetary targets, these rates are not sharply above current levels--about ½ to ¾ of a percentage point as indexed by the Federal funds rate. If our analysis that prospective rate increases are of relatively small dimensions is correct, it suggests that not a great deal may be risked, in terms of control over the aggregates, should the Committee wish to hold the money market steady while awaiting further evidence about the underlying strength of the economy or about other anti-inflationary measures that may be in process. On the other hand, the modest size of the prospective rate increase, viewed against the ability of financial markets and the economy to adjust rather easily thus far to recent rate increases, also suggests that there may not be severe financial market repercussions should the Committee in the current inflationary environment wish to minimize any risk of unduly rapid growth in the aggregates.