FEDERAL R SERVE

press release

For Use at 4:00 p.m. August 18, 1978

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee today released the attached record of policy actions taken by the Federal Open Market Committee at its meeting on July 18, 1978.

Such records for each meeting of the Committee are made available a few days after the next regularly scheduled meeting and are published in the Federal Reserve Bulletin and the Board's Annual Report. The summary description of economic and financial conditions they contain are based solely on the information that was available to the Committee at the time of the meeting.

Attachment

RECORD OF POLICY ACTIONS
OF THE FEDERAL OPEN MARKET COMMITTEE

Meeting held on July 18, 1978

1. Domestic policy directive

The information reviewed at this meeting suggested that growth in economic activity had slowed in recent months. From the first to the second quarter, however, real output of goods and services appeared to have expanded sharply, reflecting the rebound in activity from the adverse effects of the severe winter and the lengthy coal strike. The rise in average prices--as measured by the fixed-weighted price index for gross domestic business product--accelerated markedly in the second quarter, largely because of substantial increases in food prices.

The staff continued to project moderate expansion in output from the second quarter of 1978 through the second quarter of 1979. The staff projections also suggested that the price advance would remain rapid, although not so rapid as in the second quarter of 1978, and that the unemployment rate would change little from its current level.

In June the index of industrial production rose an estimated 0.3 per cent, down from 0.6 per cent in May and much below the substantial gains in March and April. Total nonfarm payroll employment rose considerably in June, but the advance, like May's, was well below the increases in March and April. In manufacturing, employment and the average workweek were about unchanged in June. The over-all unemployment rate fell 0.4 of a percentage point to 5.7 per cent, its lowest level in nearly 4 years.

Total retail sales changed little in June for the second consecutive month, following 3 months of exceptionally large gains. Unit sales of new automobiles remained at a high level.

The advance in the index of average hourly earnings for private nonfarm production workers moderated in May and June, but it was somewhat faster over the first half of 1978 than during 1977. Average prices of producer goods rose less rapidly in May and June than earlier in the year, but their increase over the first half was considerably faster than the pace during 1977. In May the consumer price index for all urban consumers rose sharply further, led by rises in food, housing, and energy; over the first 5 months of the year the annual rate of increase averaged slightly above 10 per cent.

In foreign exchange markets the trade-weighted value of the dollar against major foreign currencies declined about 2 per cent further from mid-June to the date of this meeting, reaching its lowest point so far in 1978. The downward pressure on the dollar in recent weeks appeared to reflect heightened market concern about the high rate of inflation in the United States relative to rates abroad and about the persistence of extremely large current-account surpluses in Japan and Germany and a large deficit in the United States. In May the U.S. trade deficit was somewhat lower than its very high average rate in the first 4 months of the year.

The expansion in total credit at U.S. commercial banks slowed substantially in June from the unusually rapid rates in the preceding 2 months, as growth of business loans decelerated sharply after a surge in May. Growth of other types of loans moderated as well, but bank holdings of Treasury securities increased. Outstanding commercial paper of nonfinancial businesses increased substantially in June. Nevertheless, expansion of total short-term credit to nonfinancial businesses by banks and through the paper market was well below the exceptionally rapid pace earlier in the second quarter.

Growth of the narrowly defined money supply (M-1) moderated in May and June from the extraordinarily rapid pace in April, but growth from the first to the second quarter was at an annual rate of 9-1/2 per cent. Growth in M-2 and M-3 had been moderate over recent months. In June inflows of small-denomination time deposits to banks and to nonbank thrift institutions picked up, following introduction on the first of the month of a short-term money market certificate with a ceiling interest rate for new deposits that changes weekly with the average discount rate on new issues of 6-month Treasury bills. Preliminary reports indicated relatively strong investor interest in these certificates.

Over the year from the second quarter of 1977 to the second quarter of 1978, growth in M-1 was about 8 per cent--above the 4 to 6-1/2 per cent range for that period adopted by the Committee in July 1977. However, growth in M-2 and in M-3 over the period was within the ranges for those aggregates adopted at that time: M-2 expanded by about 8-1/2 per cent, compared with its range of 6-1/2 to 9 per cent; M-3 grew about 10 per cent, compared with its range of 8 to 10-1/2 per cent.

At its meeting on June 20 the Committee had decided on ranges of tolerance for the annual rates of growth in M-1 and M-2 during the June-July period of 5 to 10 per cent and 6 to 10 per cent, respectively. The Committee had agreed that during the coming inter-meeting period operations should be directed initially toward a Federal funds rate of 7-3/4 per cent, slightly above the prevailing level of 7-1/2 per cent. Subsequently, if the 2-month growth rates of M-1 and M-2 appeared to be significantly above or below the midpoints of the indicated ranges, the objective for the funds rate was to be raised or lowered in an orderly fashion within a range of 7-1/2 to 8 per cent.

In accordance with the Committee's decision, the Manager of the System Open Market Account began immediately after the June meeting to seek bank reserve conditions consistent with a firming of the Federal funds rate to a weekly average of around 7-3/4 per cent. Incoming data throughout the inter-meeting period suggested that growth in the monetary aggregates would be well within the ranges that had been specified by the Committee, and the Manager continued to seek reserve conditions consistent with a Federal funds rate averaging about 7-3/4 per cent. In the final days of the period the funds rate fluctuated around a level somewhat above 7-3/4 per cent.

Market interest rates on both long- and short-term securities had shown further increases since the June meeting of the Committee, ranging from about 1/8 to 3/8 of a percentage point. In addition, commercial banks raised the rate on loans to prime business borrowers from 8-3/4 to 9 per cent. Interest rates on new commitments for conventional mortgage loans at savings and loan associations had changed little during the inter-meeting period, while yields in the secondary market for home mortgages had risen somewhat further.

On June 30 an increase in Federal Reserve discount rates from 7 to 7-1/4 per cent was announced by the Board of Governors. The Board stated that the action was taken in recognition of increases that had already occurred in other short-term interest rates and that it would bring the discount rate into closer alignment with short-term rates generally.

In the Committee's discussion of the economic situation and outlook, there was general agreement among the members that over the year ending in the second quarter of 1979 output of goods and services was most likely to grow at about the moderate pace projected by the staff. However, a number of the members anticipated a little less growth and a few anticipated a little more.

Despite the consensus that continuing moderate growth in real GNP was still the most likely development, some members suggested that for a number of reasons--including the high rate of inflation and developing financial stringencies--the probabilities of such an outcome were lower than they had seemed to be earlier. A few members observed that the chances of a decline in output during the period had increased. In the opinion of one of these members, the prospects for a gradual slowing of growth in output toward a rate that might be sustainable for the longer term had been diminished by the recent rapid decline in the unemployment rate and by the development of some imbalances in the economy. Another member expected that consumer buying of houses and durable goods, which had been stimulated in recent months by anticipations of further increases in prices, would weaken in the period immediately ahead. He was concerned, moreover, that financial strains might develop to the point of bringing on a downturn in activity, although he did not regard such a development as inevitable.

Other members of the Committee felt more confident that a recession would not develop during the four quarters ahead and that output would grow moderately. One of these members thought that expectations of further price increases might well sustain consumer buying--and perhaps business buying, at least to some extent--during the second half of 1978 and that reductions in Federal taxes would strengthen demands in the first half of 1979. Similarly, another member believed that expansive elements in the economy were sufficient to sustain a moderate growth in output, and that distortions were not developing to the point that they would overcome those expansive influences. In his view, it remained possible to slow growth to a rate sustainable for the longer term. Another member agreed that there was still time to achieve such a slowing of growth, given appropriate government policies.

All members of the Committee expected a continuation of a rapid rate of inflation over the period to the second quarter of 1979--in the view of several members, even more rapid than the pace projected by the staff. It was observed that in 1979 strong pressures for large increases in wages would tend to spread throughout the economy from the many industries in which new contracts would be negotiated. It was also noted that minimum wage rates and social security taxes were scheduled to go up again at the beginning of the new year, exerting upward pressure on costs and prices.

Most members of the Committee thought that the unemployment rate a year ahead, in the second quarter of 1979, would be little changed from the average rate in recent months, which was well below the level that had been expected earlier. It was suggested that the rate of participation in the labor force would continue to rise, in part because of the pressure of inflation on family budgets.

At this meeting the Committee reviewed its 12-month ranges for growth in the monetary aggregates. At its meeting in April 1978 the Committee had specified the following ranges for the period from the first quarter of 1978 to the first quarter of 1979: M-1, 4 to 6-1/2 per cent; M-2, 6-1/2 to 9 per cent; and M-3, 7-1/2 to 10 per cent. The associated range for growth in commercial bank credit was 7-1/2 to 10-1/2 per cent. The ranges being considered at this meeting were for the period from the second quarter of 1978 to the second quarter of 1979.

The Committee members differed principally in their preferences for the 12-month range for M-1: A majority favored retention of the existing range, while a number favored an increase in its upper limit. In the case of the broader aggregates, most members expressed a preference for retaining the existing ranges; one member suggested that the lower limits be reduced by 1/2 of a percentage point, yielding ranges of 6 to 9 per cent for M-2 and 7 to 10 per cent for M-3.

An increase in the upper limit of the range for M-1 was advocated on the expectation that, over the coming year, growth of M-1 would have to exceed the 6-1/2 per cent upper limit of the existing range, as it had over the past year, if strains in the financial markets were not to be so severe as to threaten an economic downturn. That expectation was based on the probable rates of inflation and on the recent behavior of the income velocity of money. In this connection it was emphasized that the high rate of inflation in prospect for the quarters immediately ahead was attributable in part to governmental actions and to some strong forces in the private sector--including the effects of the depreciation of the dollar--that were not likely to be moderated appreciably by the stance of monetary policy. In these circumstances, it was argued, the Committee ought to raise the upper limit of the range for M-1 to allow for a growth rate that--given upward cost pressures on prices--was more nearly consistent with the generally anticipated rate of growth in real and nominal GNP for the year ahead and that, consequently, was more likely to be achieved.

Several arguments were advanced in favor of retaining the existing range of 4 to 6-1/2 per cent for M-1. First, M-1 growth in the second quarter--at an annual rate of 9-1/2 per cent, on a quarterly-average basis--had exceeded the upper limit of the Committee's range by a considerable margin, so that retention of the existing range for the year from the second quarter of 1978 to the second quarter of 1979 would allow for growth considerably faster than 6-1/2 per cent over the five-quarter period beginning the first quarter of 1978. Second, for a considerable period of time growth in M-1 on the average had exceeded the range adopted by the Committee and a reduction of growth to a rate within the existing range would be an important step toward moderating inflation. Also, such a reduction would have a positive effect on the economic outlook.

Moreover, any increase in the range could be misleading: Such an action, no matter what reasons might be offered for it, was likely to be interpreted both in this country and abroad as a signal of a shift in System policy toward less emphasis on fighting inflation. Since that was not the case, it would be consistent to retain the existing range, although the rate of growth over the period might be around the upper limit of the range. The members also noted that authorization for automatic transfers of funds into checking accounts from savings deposits at commercial banks was scheduled to become effective on November 1, 1978, and that during a transition period such transfers would tend to reduce the demand for M-1 and increase its income velocity.

With regard to M-2 and M-3, it was observed that growth over the year ending in the second quarter of 1978 had been within the Committee's longer-run ranges. One member proposed that in formulating policy for the period ahead the Committee begin to increase the emphasis given to M-2 and reduce that given to M-1. That proposal did not attract support from other members of the Committee.

At the conclusion of its discussion the Committee decided to retain the existing ranges for the monetary aggregates. Thus, the ranges for the period from the second quarter of 1978 to the second quarter of 1979 were 4 to 6-1/2 per cent for M-1, 6-1/2 to 9 per cent for M-2, and 7-1/2 to 10 per cent for M-3. The associated range for growth in commercial bank credit was raised to 8-1/2 to 11-1/2 per cent in recognition of the greater share of borrower demands being directed toward banks. It was agreed that the longer-run ranges, as well as the particular aggregates for which longer-run ranges were specified, would be subject to review and modification at subsequent meetings. It was also understood that short-run factors might cause growth rates from one month to the next to fall outside the ranges anticipated for the year ahead.

> The Committee adopted the following ranges for rates of growth in monetary aggregates for the period from the second quarter of 1978 to the second quarter of 1979: M-1, 4 to 6-1/2 per cent; M-2, 6-1/2 to 9 per cent; and M-3, 7-1/2 to 10 per cent. The associated range for bank credit is 8-1/2 to 11-1/2 per cent.
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> > Votes for this action: Messrs. Miller, Volcker, Baughman, Coldwell, Eastburn, Wallich, Willes, and Winn. Votes against this action: Messrs. Jackson and Partee. Absent and not voting: Mr. Gardner.

Messrs. Jackson and Partee dissented from this action because they preferred to raise the upper limit of the range for M-1 to a level more nearly consistent with the anticipated growth in GNP--Mr. Jackson, to 7-1/2 per cent; Mr. Partee, to 8 per cent.

In the discussion of policy for the period immediately ahead, the members differed mainly in their views as to whether, and to what degree, additional firming in money market conditions should be sought during the next few weeks for the purpose of restraining monetary growth in coming months. No sentiment was expressed for easing money market conditions.

Several members proposed that for the time being operations be directed toward maintaining the money market conditions currently prevailing. It was argued that, in light of increased uncertainties in the economic outlook, such a "pause" would afford the Committee an opportunity to evaluate additional evidence on the current situation and outlook. It was suggested that, coming on top of the considerable firming in money market conditions over the past year or so, further significant firming would risk bringing on a recession. It was also observed that the restraining effects of the rise in interest rates over the past month had not yet been fully felt and that any additional firming that might be appropriate could be achieved at a later time.

On the other hand, a number of members favored a prompt further firming of money market conditions. Such a course was needed, it was suggested, to bring growth in M-1 within the Committee's longer-run range. Given the rate of inflation, it was argued, current levels of interest rates were relatively low and were much less restrictive in real terms than their nominal levels might suggest. And the point was made that failure to pursue additional firming at this time might well create a need for a greater degree of firming later.

In considering the ranges for the annual rates of growth in the monetary aggregates to be specified for the July-August period, the members took account of the indications that growth in M-1 might accelerate in July. Most members preferred ranges of tolerance for growth in M-1 over the 2-month period extending from a lower limit of 4 or 5 per cent to an upper limit of 8 or 9 per cent. One favored a higher range, from 5 to 10 per cent, and another a lower range, from 3 to 7 per cent. For M-2, most members favored ranges extending from 6 or 7 per cent to 10 or 11 per cent; one member preferred a range of 5 to 10 per cent.

With respect to the Federal funds rate, most members favored ranges centered either on 7-3/4 per cent, the midpoint of the 7-1/2 to 8 per cent range specified at the June meeting, or on the somewhat higher level that had developed in the most recent days; their proposals included ranges having a lower limit of 7-1/2 per cent or slightly above, and an upper limit of 8 per cent or slightly above. However, a number of members advocated a range centered on 8 per cent and extending from 7-3/4 to 8-1/4 per cent. A majority of the members favored giving greater weight than usual to money market conditions in the conduct of open market operations until the next meeting.

At the conclusion of the discussion the Committee decided that operations in the period immediately ahead should be directed toward maintaining the weekly-average Federal funds rate within a range of 7-3/4 to 8 per cent. The members agreed that, in deciding on the specific objective for the Federal funds rate, the Manager should be guided mainly by the relation between the latest estimates of annual rates of growth in M-1 and M-2 over the July-August period and the following ranges of tolerance: 4 to 8 per cent for M-1 and 6 to 10 per cent for M-2. It was also agreed that if, giving approximately equal weight to M-1 and M-2, their rates of growth appeared to be close to or beyond the limits of the indicated ranges, the Manager should raise or lower the objective for the funds rate in an orderly fashion within its range.

As is customary, it was understood that the Chairman might call upon the Committee to consider the need for supplementary instructions before the next scheduled meeting if significant inconsistencies appeared to be developing among the Committee's various objectives.

The following domestic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that growth in economic activity has slowed in recent months. Following substantial gains in March and April, increases in industrial production and nonfarm payroll employment moderated in May and June and retail sales changed little. In June, however, the unemployment rate dropped 0.4 of a percentage point to 5.7 per cent. Average producer prices rose somewhat less rapidly in May and June than earlier in 1978, but over the first half of this year prices increased at a considerably faster rate than they had on the average during 1977. The advance in the index of average hourly earnings also moderated in May and June but was at a somewhat faster pace over the first half of 1978 than during 1977.
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> Since mid-June the trade-weighted value of the dollar against major foreign currencies has declined further to its lowest level of the year. The U.S. trade deficit in May was lower than the very high rate of the first 4 months of the year.
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> Growth in M-1 moderated in May and June, but reflecting the extraordinarily rapid pace in April, growth from the first to the second quarter was relatively high. Growth in M-2 and M-3 has been moderate over recent months. In June inflows of small-denomination time deposits to commercial banks and other thrift institutions picked up, following introduction of the new 6-month certificate. Market interest rates have risen further in recent weeks. On June 30 an increase in Federal Reserve discount rates from 7 to 7-1/4 per cent was announced.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster monetary and financial conditions that will resist inflationary pressures while encouraging continued moderate economic expansion and contributing to a sustainable pattern of international transactions. The Committee agreed that these objectives would be furthered by growth of M-1, M-2, and M-3 from the second quarter of 1978 to the second quarter of 1979 at rates within ranges of 4 to 6-1/2 per cent, 6-1/2 to 9 per cent, and 7-1/2 to 10 per cent, respectively. The associated range for bank credit is 8-1/2 to 11-1/2 per cent. These ranges are subject to reconsideration at any time as conditions warrant.

In the short run, the Committee seeks to achieve bank reserve and money market conditions that are broadly consistent with the longer-run ranges for monetary aggregates cited above, while giving due regard to developing conditions in financial markets more generally. During the period until the next regular meeting, System open market operations shall be directed at maintaining the weekly-average Federal funds rate within the range of 7-3/4 to 8 per cent. In deciding on the specific objective for the Federal funds rate the Manager shall be guided mainly by the relationship between the latest estimates of annual rates of growth in the July-August period of M-1 and M-2 and the following ranges of tolerance: 4 to 8 per cent for M-1 and 6 to 10 per cent for M-2. If, giving approximately equal weight to M-1 and M-2, their rates of growth appear to be close to or beyond the upper or lower limits of the indicated ranges, the objective for the funds rate shall be raised or lowered in an orderly fashion within its range.

> If the rates of growth in the aggregates appear to be above the upper limit or below the lower limit of the indicated ranges at a time when the objective for the funds rate has already been moved to the corresponding limit of its range, the Manager is promptly to notify the Chairman who will then decide whether the situation calls for supplementary instructions from the Committee.

> Votes for this action: Messrs. Miller, Volcker, Coldwell, Eastburn, Jackson, Partee, and Wallich. Votes against this action: Messrs. Baughman, Willes, and Winn. Absent and not voting: Mr. Gardner.

Messrs. Baughman, Willes, and Winn dissented from this action because they favored more vigorous measures to curb the rates of growth in the monetary aggregates. All three preferred a directive that would have instructed the Manager to direct operations initially toward an increase in the Federal funds rate to 8 per cent and that would have provided for a further increase in the rate to a level of 8-1/4 per cent, if growth in the monetary aggregates over the July-August period appeared to be strong relative to the specified ranges. In addition, Mr. Willes favored specifying a 2-month range for M-1 of 3 to 7 per cent, somewhat lower than the range agreed upon by the majority.

2. Authorization for domestic open market operations

Paragraph 2 of the authorization for domestic open market operations authorizes the Federal Reserve Bank of New York (and, under certain circumstances, other Reserve Banks) to purchase short-term certificates of indebtedness directly from the Treasury, subject to certain conditions. This authorization is, in turn, based on a provision of Section 14 (b) of the Federal Reserve Act authorizing the Federal Reserve Banks to buy and sell obligations of specified types "directly from or to the United States," subject to certain conditions. It was noted at this meeting that, because the statutory authority in question had expired on April 30, 1978, paragraph 2 of the authorization had been in a state of *de facto* suspension since then, and that the paragraph would remain in suspension until the enactment of expected legislation extending the authority.