

Notes for FOMC Meeting  
May 16, 1978  
Scott E. Pardee

Since the last meeting of the FOMC, the dollar has continued the recovery which began in late March-early April. As I noticed last time, this reflects more an improvement in market psychology toward the dollar than in economic fundamentals. But since the market's previous pessimism had pushed dollar rates to unrealistically low levels, the return to more normal two-way dealing set the stage for a net demand for dollars. Short positions and leads and lags against the dollar are still being unwound, and further such unwinding is likely should market psychology continue to improve.

The further rise in U.S. short-term interest rates has proved to be an even more immediate spur to many dealers. Money market rates in the United States are now running some 4 percent above day-to-day money rates in Germany and as much as 5 percent above rates one can receive on Japanese yen, making short positions in dollars extremely expensive. With such interest differentials, it is only the market's continued extreme caution over the outlook for the dollar that has averted an even larger shift into dollars. At the same time, however, inflows of foreign funds into the U.S. stock market have contributed to the recent rally in that market.

There is even some reason for hope in the fundamentals. Part of the sharp rise in the U.S. trade deficit, and in the trade surpluses of countries such as Japan and Germany earlier this year, reflected leads and lags of physical shipments of goods on the expectation of a further fall of the dollar against those and other currencies. To the extent that dollar rates have since stabilized, and even firmed somewhat, the reversal of those leads and lags of physical shipments may begin to show through, as may the favorable

effects of the J-curve which have been so long in coming. Japan has already reported a smaller trade surplus in April than in March, and the Germans also expect a narrowing of their trade surplus as their economy recovers from the depressing effects of the metal workers' strike in February and March.

Tangible evidence of progress in alleviating market concerns has come from our side as well. Some of the major roadblocks to the energy legislation stalled in Congress these many months seem to have been removed. Moreover, the Treasury's announcement of a program of modest sales of gold in the open market over the next six months was welcomed by dealers, particularly in Europe, as another expression of U.S. official concern for the dollar. The amounts involved are not large--some \$315 million worth at current market prices set to be sold over the next six months--but people are still so gold-minded that even the smallest gesture seems to take on magnified importance. The President's action to scale back and delay the tax cut was also well received.

On balance since the last meeting, the dollar has risen by 3 percent against the German mark, 2 percent against the Japanese yen, and 4 percent against the Swiss franc. This has left sterling vulnerable, and the pound came under selling pressure in April on pessimism over the outlook for U.K. trade and inflation. But the Bank of England intervened forcefully, using some of the hoard of reserves it piled up last year, and it tightened up the London money market; the minimum lending rate alone has advanced by 2-1/2 percent over the past five weeks. As a result, the sterling market has settled down. The Canadian dollar is also faring better, following the announcement of substantial new credits by the Canadian government. In recent months the Canadian government has negotiated some \$7 billion of international credits to offset the current

account deficit and bolster the Canadian currency. For all the effort, the Bank of Canada's market people believe that the turn in sentiment toward the U.S. dollar was an important factor in relieving selling pressure on their currency as well.

For our part, we intervened as a net seller of marks on only one occasion during the period, in an amount of less than \$4 million taken from System and Treasury balances. Instead, we have begun to acquire currencies to repay swap debt, using a variety of techniques. Of the \$561 million of marks we acquired during the period for the System and Treasury, \$265 million were from the Bundesbank in direct deals related to their own capital export conversions, \$229 million were from our own correspondents, and \$68 million were from the New York market on days when the dollar had risen sharply. We are still cautious about buying marks very openly in the market, in view of the dealers' sensitivity that the U.S. authorities may wish to sit on the rate. Indeed, to avoid that impression, we have even fed into the market some of the marks coming into our hands from correspondents. In addition, to the extent that some of these transactions by our correspondents represent fundamental decisions by other central banks to convert marks to dollars, we believe that some of the effects should show through in the market. In all, the System reduced its swap drawings in marks by \$306 million, to \$1,538 million. The Treasury's swap debt was reduced by \$200 million to \$800 million. We have taken an interim loss of some \$15 million, but if the remaining debt were settled at current rates, we would incur no further loss. The Treasury also has a modest interim loss but stands to make a profit on the full operation if the dollar holds at current levels.

In addition, we arranged with the Swiss National Bank to buy sufficient Swiss francs to repay the \$69 million of swap debt from operations in that currency in January and February. We managed a modest profit on that one.

## Recommendations

Alan Holmes has supplied members of the Committee with a brief memorandum reviewing the outcome of the discussions he and Governor Wallich had with the Bundesbank on means of repaying the debt. Our approach was also reviewed with the Treasury. The Bundesbank prefers to have each swap drawing repaid within 12 months of its inception--that is, with no more than three renewals. In addition to what we may be able to buy in the market, the Bundesbank has indicated that it is prepared to sell us marks which arise out of nonmarket transactions, as with its program of converting the proceeds of nonresident bond issues denominated in marks. As an ultimate recourse the Bundesbank is prepared to sell us the marks directly against dollars, which it would hold in reserves. Consequently, there is no need to consider longer-term financing or refunding. This is in line, we believe, with the thinking of the Committee. The only action needed by the Committee would be the renewals of swap drawings as they come due out to 12 months. So far, we have been able to repay the swaps that would run out in October and November, thus gaining two months. For today, we have 5 swap drawings, for the amount of \$257 million equivalent, coming up for the first maturity, and I recommend that they be renewed for a second three months.

On a final point, during the period we reduced our net open position by a little over \$300 million to just under \$1.5 billion. Indeed, last Friday we even had the satisfaction of having to request subcommittee approval, pursuant to the Procedural Instructions, to continue to buy marks as we approached the \$300 million limit on changes in the net open position between meetings. Late last year and early this year, as we moved more deeply into debt, the Committee provided additional leeway for

operations through increases in the net open position specified in the authorization. That limit now stands at \$2,250 million and gives us more leeway than we need. Therefore, I recommend that the Committee reduce the net open position limit to \$2 billion.

James L. Kichline  
May 16, 1978

FOMC BRIEFING

Since the last regular meeting of the Committee, the Commerce Department has released preliminary estimates of GNP for the first quarter. These figures indicate a somewhat smaller rise in prices than we had been forecasting and also weaker activity in real terms--that is, a slight decline of real GNP. While the data are still subject to considerable revision, it is clear nevertheless that the pace of activity for the quarter as a whole was poor. Much of the weakness was associated with the transitory effects of the weather and the lengthy coal strike, and to some extent special factors connected with the deterioration of the trade balance.

The limited data available for activity in the current quarter suggest a great deal of vigor in the economy. Outlays for consumer goods continued to rise in April following a strong rebound in February and March; total retail sales are reported to have increased 2 per cent last month. Growth of total sales has been influenced heavily by the surge in buying of autos. During the March-April period auto sales were running at over a 12 million unit annual rate, the highest pace in a year. It appears that the pick-up in auto sales reflects recovery from the earlier bad weather, the impact of incentive sales contests, and probably some acceleration of consumer buying plans to beat announced price increases. But even with some slowing of auto sales over the remainder of the quarter and little further growth in other sales, the strength so far insures a large increase of consumption expenditures for the quarter.

The employment situation also points to a strong performance this quarter. Nonfarm employment has grown at a phenomenal pace this year. For April, payroll employment grew by more than 450,000 after allowing for the effect of strikes; during the first four months of this year such employment has increased over 1-1/2 million, two-fifths faster than the rate of net hiring last year.

These employment gains suggest a step up in business production schedules. In fact, the industrial production index for April is estimated to have increased 1.1 per cent, only .2 percentage point less than the sharp rise recorded in March. Gains in output were widespread once again among industry groups.

In short, growth of activity this quarter is sure to be large. Our own forecast is for real growth in the neighborhood of 9 per cent at an annual rate. One needs to keep in mind the transitory elements influencing activity, however, and in perspective real growth over the first half of 1978 is likely to be about a 4 - 4-1/2 per cent annual rate or the same as that in the latter half of last year.

A key question for policy is where the economy may be headed after this quarter. As you know, the consumer has played a major role throughout this expansion in prompting good gains in real activity. Recent rapid gains in employment will bolster income growth in the short-run, consumer attitudes appear to be reasonably optimistic, and concerns about inflation may provide a near-term stimulus to sales of durable goods and houses. But debt burdens in the aggregate are now at/ or above the



highs registered earlier in the 1970's and will probably act as a constraint on purchases, and increased taxes as well as inflation will take their toll on growth of real disposable incomes--especially as the economy enters 1979. Thus, it seems likely the consumer will play a less active role than earlier in the expansion, but should still be supportive of moderate economic growth.

The residential construction sector, like consumption, has been a principal driving force during the first three years of this expansion. Here too we anticipate a change, with housing starts turning down after the current quarter. Financial conditions in mortgage markets continue to tighten and comments in the Redbook generally indicate increasing shortages of mortgage credit. The financial situation in prospect is more restrictive in the current forecast as a result of two factors, namely higher interest rates thought to be consistent with the M-1 assumption and the adoption of a change in ceiling rates believed to provide less support to depositary flows than assumed by the staff earlier this year. Thus, we have reduced the forecast of construction activity, with housing starts in the first half of 1979 100,000 less at an annual rate than in our last projection. The slower pace of construction activity implies weaker income generation and associated purchases of household durable goods also have been cut a bit.

Principal support to activity is expected to come from the business investment sector. Here the news is reasonably encouraging. New orders for nondefense capital goods and construction contract awards have continued on an irregular upward path. Order backlogs have been moving higher for a number of months. The recently available

Merrill Lynch and McGraw Hill surveys of investment spending reported an appreciable scaling up of business plans. When adjusted for their usual tendency to overstate spending, the surveys are roughly in line with staff forecasts. Over the next 4 quarters we continue to anticipate real growth of fixed investment spending to average about 6-1/4 per cent.

Altogether the staff forecast is for a rate of real growth of about 4-1/4 per cent from the second quarter of 1978 to the second quarter of 1979, with growth slowing in the first half of next year. Employment growth is expected to moderate in coming quarters given the surge recently, and the unemployment rate therefore is likely to only edge down to 5-3/4 per cent from the 6 per cent prevailing in April. On the inflation side we continue to believe price increases will average about 7 per cent over the next 4 quarters. This pace is somewhat slower than that expected in the current quarter, and is based importantly on an anticipated moderation in food price increases.

The present forecast should be treated with a good deal of caution in view of the uncertainties and risks attaching to the current and expected environment. One major uncertainty relates to the proposed tax package; the Administration's willingness to defer the cut for one quarter and reduce the net size by \$5 billion came to light after the Greenbook was published. The details of the change are not yet clear, but we judge that real growth in the fourth quarter of this year would be roughly 1 percentage point or so at an annual rate lower than indicated and little changed in the first half of 1979. Another element

of uncertainty relates to social security tax increases scheduled for the beginning of 1979, which the House recently voted to scale back. Finally, there remains a substantial element of uncertainty about interest rate levels necessary to achieve 5-1/4 per cent real growth. For purposes of the projection we have assumed interest rates at the bottom end of the ranges shown in the Bluebook. If achieving 5-1/4 per cent M-1 required higher rates, then economic activity would be lower than indicated.

REPORT ON OPEN  
MARKET OPERATIONS

Mr. Sternlight made the following statement:

The Account Management sought firmer money market conditions during the period since the Committee's April meeting--initially moving to carry out the instructions for a modest immediate firming to a 7 percent funds rate and then going to a 7 1/4 funds rate in response to evidence of stronger than desired growth in the monetary aggregates. Still later in the period the aggregates appeared even stronger--suggesting that consideration be given to a further firming to the 7 1/2 percent top of the funds range adopted in April. However, in a special meeting on May 5, the Committee instructed the Desk to continue aiming for a funds rate around 7 1/4--though taking care to avoid slippage below that rate and resolving doubts on the side of permitting some upward variation. Under that approach, funds trading for about the past week has been mainly in the area of 7 5/16 to 7 3/8 percent.

The move from a 6 3/4 percent funds rate, prevailing since early this year, to around 7 1/4 percent was accomplished relatively smoothly--even though the timing of at least the first step took the market by surprise. By the time that the 10- and 22-year issues were being bid for in the Treasury's May refunding, market participants were generally aware of the System's 7 1/4 percent funds rate objective. The issues were well bid for, though at rates a little higher than would have occurred before the System's moves. The

higher funds rate in the closing days of the period appeared to be perceived by the market reasonably accurately as an objective of 7 1/4 percent or a little higher--though a number of participants expect a further edging up to 7 1/2 percent, especially in the wake of the large money supply increase published last week. Market anticipations of higher rates ahead are reflected in the dealers' sizable short positions.

In the course of meeting large reserve needs over the period, which stemmed from higher required reserves and bigger Treasury balances, the System bought about \$1.1 billion of Treasury bills outright from foreign accounts and about \$.5 billion of Treasury coupon issues in the market. These outright operations were supplemented as usual by heavy day-to-day reserve adjustments through repurchase agreements and matched sale purchase transactions. In executing daily operations, close account was taken of the upsurge in member bank borrowings, which became a significant source of reserves as the funds rate pushed well above the discount rate. In the few days since the discount rate was raised, the level of borrowing has receded, though not yet to the level prevailing before mid-April.

Market interest rates generally rose over the period, but by varying amounts, and in most cases by somewhat less than the 50-60 basis point rise in the funds rate. Three- and six-month bills were auctioned yesterday at average rates of about 6.32 and 7.01 percent, respectively, up about 18 and 45 basis points from the rates just before the April meeting. Bank CD's rose about 50 basis points

but commercial paper rates were up only about 15 to 25 basis points, and the prime bank lending rate rose 25 basis points. For Treasury issues due in up to two years, the rate rise was about 35-45 basis points. This brings the two-year rate to around 8 percent--a level that could have considerable appeal to a broad group of investors when the Treasury auctions two-year notes next week.

For intermediate Treasury issues the yield rise was about 25-35 basis points and for longer issues--10 years or more--the increases were mainly 15 to 25 basis points. Corporate yields were up somewhat less than Governments, but longer-term State and local issues rose more steeply as that market has had to digest large supplies.

Last month I reported a decline in the number of Government securities dealers because Merrill Lynch absorbed White Weld. Yesterday Weeden & Co. decided to discontinue its operations in Government securities, essentially because losses in other areas have eroded the firm's capital and it wished to use its remaining capital in activities with which top management was most familiar.