

APPENDIX

Notes for FOMC Meeting
April 17, 1979

Scott E. Pardee
(read by Alan Holmes)

Since the last FOMC meeting, the dollar has been in strong demand against the German mark, Swiss franc and Japanese yen. The heaviest selling pressure has been on the yen, which fell by 4 percent, even though the Bank of Japan sold a total of

in support of its own currency in Tokyo and through us in New York. The Swiss franc dropped by 2½ percent, with the BNS selling a total of again both in its own market and through us in New York. The mark declined by 2 percent and the combined intervention by the Bundesbank and U. S. authorities amounted to

In the three currencies intervention totaled \$9,425.3 million, one of the largest months on record. The flows of funds have not just been into dollars. Sterling has also been strong, and the Canadian dollar has been well bid, despite uncertainties over elections coming up in both of those countries in May. The comment of market participants is that, for the time being at least, the strong currencies are weak and the weak currencies are strong, even within the EMS.

For the dollar, we are clearly in the process of reflux--with massive reflows of interest sensitive funds and a substantial unwinding of the adverse leads and lags of last year. Corporate treasurers and money managers around the world do not perceive much of a downside risk for the dollar at the moment. Again, the improved attitude stems largely from the November 1 program and the policy follow-up, including monetary policy, by the U. S. authorities. In addition, we are beginning to hear some expression of belief that the fundamentals are improving, as viewed from the trade and current account figures released for February by the United States, with a smaller deficit and by Germany and Japan with smaller surpluses.

Inflation is still a major problem and for that reason many market participants consider the dollar a potentially weak currency. But we are not alone, since other countries have also had an outburst of inflation. The latest OPEC oil price hikes, with even higher prices in prospect, and the nuclear accident in Harrisburg, Pennsylvania, with serious implications for nuclear energy around the world, have been largely interpreted as worse news for others--for Japan and Continental Western Europe--than for us. The President's energy speech was well received in the exchange markets.

For the moment, we look good; but under circumstances of worldwide concern over inflation and energy supplies, market expectations can be highly volatile. We cannot count on the inflows into dollars to continue indefinitely.

For the German, Swiss and Japanese authorities, the heavy intervention has had four objectives, with varying degrees of emphasis in each case. First, they are hoping to moderate the rise of the dollar or the fall of their own currencies so that exchange rates

are not pushed to levels that overshoot and prove unsustainable later on. We share that objective.

Second, they have taken the opportunity to mop up the excess domestic liquidity from last year's intervention. In fact, in Germany and Switzerland the absorption process had gone so far that the central banks recently had to reverse gears and provide temporary injections of liquidity to their banking systems. I might note that interest rates have risen quite sharply in those countries, both in short- and long-term markets, closing somewhat the differential in favor of dollar placements.

Third, each of the central banks is concerned that the decline of their own currency will exacerbate domestic inflation. Last year they were protected from the full effects of external price developments by the appreciation of their currencies against the dollar. This year so far they have not had that luxury because the dollar itself has been rising.

Finally, the three central banks believe that we are at last seeing some of the real adjustments of trade and current account balances in response to the currency movements which have taken place since late 1976, to the net appreciation of their currencies and the depreciation of the dollar. This is particularly true of the Bank of Japan. They believe it would be unfortunate to slow or stop that process by starting a J-curve in reverse. The U. S. Treasury agrees, on the view that a sharply rising dollar would erode the competitive advantage we now have as a result of the net decline of the dollar over recent years.

At the Desk our reasons for operating heavily have been two--to repay debt and to avoid a sharp and unsustainable rise in dollar rates. In all during the period the Desk acquired for the U. S. authorities a total of \$3.0 billion of currencies. Of this, \$2.7 billion was in German marks. These were used to repay \$2,681.7 million of System swap debt with the Bundesbank and to clear away completely the remaining \$58.7 million under the Treasury's swap line in marks. As of this morning the Federal Reserve's indebtedness in marks amounts to \$556.9 million equivalent. In addition, we acquired enough Swiss francs to prepay the last \$300 million equivalent of 1971 debt by the System and the Treasury. Mr. Chairman, it is my great pleasure to report that for the first time since August 1970 the Federal Reserve is free and clear of swap debt to the Swiss National Bank. The books on the operations of the early 1970s are closed at last. Finally, we added some \$45 million to balances in Swiss francs and an additional \$10 million to our yen balances.

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

Retaining the stance adopted in late 1978, the Account Management continued through the period since the March 20 meeting to aim for a Federal funds rate around 10 percent or slightly higher. As in other recent intermeeting periods, estimated growth of the aggregates tended to weaken as the period progressed--especially in the case of M_1 . In early April, the weakness seemed pronounced enough to begin raising questions about the Desk's approach, but in the Chairman's view, confirmed by other Committee members, the weakness was not so marked as to call for a change in the System's funds rate objective, and none was made. The latest estimates by the Board staff placed M_1 growth at about the bottom of the Committee's two-month range of tolerance and M_2 at about the middle of its range.

As it worked out, despite the unchanged objective, the funds rate averaged a bit under 10 percent for the period. Partly this was because unexpected aberrations, notably on Wednesday afternoons, tended to occur on the easier side. Also, with market factors tending to provide reserves over much of the period, the Desk was often in the posture of waiting to see some easing develop before moving to counter it. Further, a downward bias was imparted to the current week as the money market turned easier last Friday while the Desk's hands were tied because the Government securities market was essentially shut down for Good Friday. The market has not been misled by these variations, however; the System is still

seen as aiming at a funds rate of 10 percent or slightly higher.

Midway through the period, the delay in passage of debt ceiling legislation caused some extra complications in the Desk's reserve management, and in the arrangements for rolling over maturing Treasury issues. As part of its contingency planning when the old ceiling was running out at the end of March, the Treasury borrowed \$2.6 billion directly from the Federal Reserve. Half of this amount was repaid as of April 2 and the balance was repaid over the next two days once the Treasury was able to get back into the market. The Treasury's catch-up process had to be compressed within a very short period, with one \$6 billion issue of cash management bills requiring payment the same day it was auctioned. Because of that tight schedule, there was some concern that dealers might not be able to find initial financing for their takedowns of that bill. And after getting approval from this Committee, the Account Management told dealers that we would be prepared to finance the bill for that first day, at the rate of discount the dealer was earning, if there was unusual difficulty in getting financed elsewhere. With the help of that assurance, the dealers bid robustly for the bill, and since reserves were fairly plentiful that day the Desk was called on to finance only \$40 million through an overnight repurchase agreement.

Aside from the transactions in special certificates directly with the Treasury, the System's outright transactions were relatively modest during the period, and netted out to almost no change. Sales and redemptions of Treasury bills amounted to \$850 million, helping to absorb reserves during the period. In

the latter part of the interval the System bought \$715 million of bills from foreign accounts in preparation for anticipated reserve needs in coming weeks. Meantime, to deal with almost continual excesses of reserves, the System arranged matched sale purchase transactions daily with foreign accounts and quite frequently in the market as well.

In the Government securities market, most yields moved somewhat higher on balance over the period, as early declines based in part on the stability of monetary policy later gave way to increased yields as participants focused on inflation, signs of strength in the economy, and press speculation that the System might move to a firmer policy. Even with widespread speculation of that kind, however, a number of participants feel that a more restrictive stance would strengthen prospects for containing inflation so they would view a firming as beneficial to bond prices in the longer run. Illustrative of the market moves, a two-year note was sold in early April to yield 9.68 percent, down 17 basis points from the previous two-year auction--but by period's end the notes were bid at a discount to yield about 9.87 percent. A 15-year issue, which the Treasury reopened to raise \$1.5 billion of new cash, was up about 10 basis points in yield over the period and the longest Treasury issues rose about 5 - 8 basis points. Indicative of their cautious outlook, dealers typically maintained a net short position in coupon issues maturing in over one year, except when underwriting new supplies from the Treasury--and even then they sought to lighten up again quickly.

Most bill rates also rose over the past month, after first edging down toward the end of March when supplies were thinned out partly because of the delay in debt ceiling legislation. In early April, the Treasury sold no less than \$13 billion of short bills to raise new cash in a highly concentrated period. Meantime, the Desk was in the market almost daily to sell bills for foreign accounts as the dollar strengthened. Desk sales of bills for foreign accounts in the market came to a net of \$5.5 billion over the period. The market stood up well to this supply, but almost inevitably there was a rise in rates as earlier scarcities gave way to abundance and financing costs pushed higher. Indicative of the trend, 3- and 6-month bills were auctioned yesterday at 9.61 and 9.63 percent, compared with 9.50 and 9.48 percent the day before the last meeting. Dealers still hold a sizable chunk of the bills sold in early April, but some of these issues mature within a few days and this should relieve financing pressures.

Treasury financing operations in the next month will include the quarterly refunding to be announced a week from tomorrow. The public holds a relatively modest \$1.7 billion of issues maturing in mid-May, but the Treasury may take the opportunity to raise at least that much again in the market. The System Account holds \$550 million of the maturing notes, also relatively modest. In the recent past, we have exchanged our holdings for new issues in about the proportions those issues are offered to the public. Since the average maturity of the System's portfolio has increased faster than the average maturity of all Treasury debt in the past year, I would plan on this and subsequent quarterly rollovers to direct a somewhat greater than proportionate share of the System's subscription toward whatever shorter options are offered.

James L. Kichline
April 17, 1979

FOMC BRIEFING

Economic activity was maintained at a high level in the first quarter but apparently grew relatively little following year-end. To some extent, slower expansion of activity was attributable to weather effects, which will tend to boost activity in the current quarter. However, our reading of the available evidence still suggests a considerable moderation of real growth of GNP is in store for the first half of this year.

In general incoming information on the real economy since the last meeting of the Committee has been in line with our expectations, or weaker. One exception has been the labor market report for March which indicated surprisingly large growth of employment. Nonfarm employment rose 325,000 with gains widespread among industries, and the unemployment rate remained at 5-3/4 per cent. On average, payroll employment in the first quarter increased at about the same strong pace as over the past two years. In the manufacturing sector employment increases were especially sizable and by far outran increases in production--which suggests a large drop in productivity for the first quarter.

Industrial production in March picked up, following two months of little change. Growth of production was influenced importantly by expansion of output in the auto, steel, and coal industries, areas where output had declined earlier in the year. For the first quarter as a whole industrial production rose about 4-1/2 per cent at an annual rate or little more than half the pace in the second half of last year. The rebound of output in March led to an increase in the manufacturing capacity utilization rate, which reattained the level prevailing in December. In the next couple of months it seems likely that capacity utilization rates could rise

slightly further, but we anticipate the current quarter will be the high water mark given projected weaker output growth over the balance of the forecast period.

Final sales in the first quarter are estimated to have declined following exceptional growth in the fourth quarter. In particular, personal consumption expenditures have been weak so far this year. Total retail sales in nominal terms rose 1 per cent in March, but in real terms probably were little changed after considerable declines in both January and February. Although sales in a number of areas rebounded in March, auto sales were notably strong with gains for both imports and fuel-efficient small cars. Our forecast of activity in the second quarter has built in an expectation of sizable monthly retail sales gains, financed partly by a reduction in the already low savings rate.

With final sales estimated to have declined in the first quarter, all of the growth in GNP was attributable to inventory investment. Additional information on inventories since the last meeting of the Committee has tended to dampen--although not eliminate--concerns that business attitudes had changed and perhaps inventory stockpiling reminiscent of 1973-74 was under way. Inventory investment figures for January and February have tended to be lowered a bit in revised data, and retail trade inventories are reported to have dropped appreciably in February--information available since the forecast was prepared. Moreover, a broad range of factors is likely to have much more explanatory power than speculative stockpiling; these factors include desired restocking following inventory drawdowns in the fourth quarter, weather effects which temporarily added to inventories, involuntary accumulation in some auto models, hedging against Teamsters and rubber worker strikes, and growth of inventories related to GM X body cars. Given the

transitory nature of most of these factors, we believe that inventory accumulation will not be adding to growth of economic activity this quarter.

In the construction and business capital investment area the forecast incorporates a stronger pattern of spending in the second quarter than in the first. Housing starts data for March will be available later today, but we have assumed a strong pickup from the weather-depressed February pace. However, there are numerous quantitative and qualitative reports available that suggest residential construction is basically on a downward path. Business fixed investment is still expected to provide major support to activity in the near term, but here too our interpretation of the available evidence has not caused us to change significantly the forecast of slower growth in the second half of the year and into 1980.

On average, real growth in the first half of this year is now expected to increase roughly 2 per cent at an annual rate, about 1/2 percentage point less than a month ago. Beyond the current quarter little change was made in the forecast, which shows sluggish real growth and an easing of pressures on capital and labor resources.

On the inflation side the outlook has deteriorated and we have made further upward adjustments to the forecast. The inflation picture is influenced importantly, although not entirely, by developments in the food and energy sectors. Expected food price increases in the first half of 1979 were raised once again, mainly because of the beef situation. While cattle prices have continued to increase over the past few weeks, there is nonetheless emerging evidence of some possible slackening in total food price inflation given recent declines in prices of hogs, broilers, and some fruits and vegetables. We are counting on such developments to give us some price relief later this year. As it now stands the staff's forecast of food prices entails a 12 per cent increase from the fourth quarter of 1978 to the

fourth quarter of 1979, or about 2 percentage points higher than the top end of the Department of Agriculture's recent forecast. If our forecast for this year is realized, total food prices in 1978 and 1979 together will have increased about one-fourth, a budget-wrenching performance.

In the energy area, this month we have incorporated the assumption of phased decontrol of domestic crude oil prices, as announced by the Administration's plan. The direct and indirect effects of decontrol are estimated to increase the gross business product deflator by about one-half per cent over the next six quarters, a little more than that estimated by the Administration. The impact of decontrol along with actual and assumed OPEC prices, earlier natural gas decontrol actions and other factors has led us to forecast an increase of total energy prices this year of about 18 per cent.

Putting all the pieces of the price situation together we anticipate an increase of the gross business product fixed weight deflator of about 9-1/4 per cent this year, 1/2 per cent more than a month ago. This forecast is consistent with some visible relief from the current pace of double-digit inflation, but probably not until at least into the summer months.

FOMC Briefing
S. H. Axilrod
4/17/79

The monetary aggregates are continuing to behave quite sluggishly, and are running below the FOMC's long-run targets, but our estimate of the first quarter rate of inflation, not to mention projections of future inflation rates, continues to be revised upwards. Meanwhile, real economic activity is projected to be quite weak.

Thus, there are conflicting tendencies in the behavior of money, prices, and output that make the Committee's decision-making this morning especially difficult. The sluggish monetary growth seems to be quite consistent with the staff's projection of a marked slowing in the demand for goods and services over the balance of the year. On the other hand, the recent slow money growth rates have been quite sufficient to finance a rising rate of inflation and sizable expansion in nominal GNP. This might suggest that the Committee's targets for the aggregates do not adequately reflect changes that have been occurring in the public's attitudes towards cash and liquidity. In other words, the Committee's targets may underestimate the downward shift in money demand that is in train.

These issues have been discussed with the Committee for some time now, and I will not try your patience by repeating all of the arguments. However a few observations may be useful.

The income velocity of M-1 rose unusually rapidly in the fourth quarter of 1978 and the first quarter of 1979--at annual rates of 10 and 13 per cent, respectively. And our projections suggest a further $7\frac{1}{2}$ per cent rise in the second quarter. Even after subtracting ATS effects, these numbers are far above trend. Moreover, since interest rates have not risen

since December, there is little reason to believe that the rise in velocity represents--as it often has in the past--an effort by the public to adjust to an increasingly restrictive monetary situation.

Thus, the balance of evidence suggests that there has been a shift in money demand--with the public simply becoming less willing than they used to be to hold money balances--including demand deposits, savings deposits, and other deposits subject to rate ceilings--relative to income and interest rates. This is, of course, rational behavior in an inflationary situation. The tax on money as prices rise becomes oppressive and holders shift to other assets, including physical assets.

Interest rates as conventionally measured should also rise in the process if all financial assets--not merely cash--lose value relative to physical assets. This has not occurred yet this year, although cash holders have been able to secure a higher effective interest rate on their portfolio by shifting to money market certificates, money market funds, and other assets.

A rise in over-all market rates may not have occurred this year for any of three reasons--(a) the market as a whole still believes the rate of inflation will decelerate, (b) the market believes the real return on capital goods is declining, or (c) shifts out of cash are occurring so rapidly that they are offsetting any tendency for rates on market instruments to rise.

If interest rates were being held down only because of shifts out of cash, then monetary policy might be overly stimulative at the moment. This would be the case if the market did not believe the real return on capital was declining and did believe the rate of inflation was accelerating.

In that case the expected nominal return on capital would be rising while nominal market rates were unchanged. Such a situation would tend to stimulate demand for plant and equipment, housing, and other durable goods. It would imply the need for a further rise in market rates if the rate of inflation is to be contained, and would be consistent with the view that the Committee's longer-run monetary targets are too high under current institutional circumstances.

However, interpretation of the restrictiveness of current market interest rate levels clearly depends importantly on an assessment of the present state of expectations of businesses and consumers. Surveys of spending intentions and other anticipatory data are one source of evidence for attitudes about the future. Based in part on such data, our staff projections suggest a significant slowing in the demands for durable goods at current market interest rate levels. Such a slowing, if it develops, would be consistent with a view that the expected real return on capital may be declining in this advanced stage of the cyclical expansion and thus that the current level of nominal market rates may be reasonably restrictive --even if expectations of inflation are being revised up somewhat.

One would need to believe that the expected real return on capital is dropping sharply to argue for an easing of money market conditions under present circumstances, or would need to take the view that longer-run monetary targets, once set, should be the dominant force in guiding policy decisions--regardless of incoming evidence about money demand in relation to economic activity.

All of these various considerations suggest the lack of clear-cut signals for policy under present circumstances. The acceleration of information, in combination with the possibility that the real return on capital may

not have declined very much, could argue for a policy of tightening at this time. But the very marked weakness in the aggregates relative to longer-run targets tends to weigh against such a move.

A policy of easing money market conditions would go in the direction of bringing aggregate growth back toward target, but the staff still believes a rebound in growth of the aggregates will occur, at present interest rate levels, in the months ahead. And, in any event, there appears to be some reasonable possibility that the downward shift in money demand may be greater than had been estimated when the longer-run targets were originally set in February, and that, therefore, present targets may be a bit high.

Thus, almost by elimination, a continued policy of unchanged money market conditions, at least for a while, may represent the best compromise in face of uncertainties inherent in the combination of rapid inflation, of indications of a considerable weakening in economic activity, and of special factors affecting the behavior of the aggregates.