

E.M. Truman  
FOMC Briefing  
1/17/78

As a prelude to Mr. Pardee's report on recent exchange market developments, I would like to offer a brief report covering a longer time period.

Since the end of 1976 the trade-weighted average of the dollar against the G-10 currencies has declined by over 7 per cent; virtually all of this decline has occurred since the end of last September when substantial concern about our trade deficit intensified. Since December 1976, the Swiss franc and the yen have appreciated by over 20 per cent against the dollar; the pound sterling, the German mark, the Belgian franc and the guilder have appreciated 10 to 15 per cent; and the French franc rose about 6 per cent. Over the same period, the Canadian dollar and Swedish krona have depreciated against the dollar by 7 and 11 per cent, respectively.

These substantial exchange-rate changes have been accompanied by almost \$36 billion in net purchases of dollars by the major foreign central banks since the end of 1976, almost twice the size of our current-account deficit last year. The Bank of England purchased

of the \$27 billion in net dollar purchases in the first 10 months of last year. Since the end of October,

have accounted for almost all of the \$9 billion in net dollar purchases. How much lower the dollar would be today if it had not received such massive official support we do not know.

We have estimated that since the end of 1976 the price-adjusted depreciation of the dollar has been 7-1/2 to 10 per cent; that is, the nominal depreciation of the dollar plus our slightly better than average inflation performance have improved our price competitiveness by 7-1/2 to 10 per cent. These calculations suggest to some observers that the dollar is currently undervalued and will recover. On the other hand, the staff expects a continuation over the next six quarters of a U.S. trade deficit of around \$30 billion and a current-account deficit of close to \$20 billion. These projections suggest to some that downward pressure on the dollar will continue.

Notes for FOMC Meeting  
January 17, 1978  
Scott E. Pardee

Mr. Chairman:

The current phase of our intervention operation dates back to late September. Between late September and the last FOMC meeting, the dollar had declined by 8 percent against the mark, and our swap debt in marks had swelled to \$630 million equivalent.

From the December 20 FOMC meeting through January 2, the dollar declined by a further 4 percent against the mark, and we had increased our mark indebtedness by a further \$214 million. If anything, trading conditions were more disorderly than before. The market was simply ignoring anything positive and reacting only to news or rumors that reinforced its concerns toward the dollar.

Our inability to restore order rested on three problems. First, although most market participants and government officials here and abroad believed the dollar to be unrealistically low, many market participants feared that the dollar would eventually go lower in view of the continuing large U.S. trade deficit. This prognosis was, and is, open to debate but it was so widely held that the dollar had little resiliency when it came on offer.

Secondly, following the earlier efforts by the U.S. Treasury to encourage an appreciation of the yen and the mark, Administration officials had little credibility when they shifted ground and said they were really in favor of a strong dollar. In the absence of concrete measures to bolster these statements as through an energy policy, market skepticism had progressively deepened. Indeed, the statements themselves often backfired because they carried the wrong code words. In efforts to explain policy, U.S.

officials had fallen into the habit of saying that we were intervening only to counter disorderly conditions. To floating rate purists the only is a badge of honor suggesting a clean float. To the dealer in the market, seeing the dollar drop in disorderly trading every day, the only became pejorative. It reinforces the belief that the U.S. authorities were engaging in benign neglect--or worse, the new term malign neglect, a euphemism for competitive devaluation. The debate over U.S. intentions further eroded the dollar's resiliency.

Thirdly, in the confused and highly speculative atmosphere which developed, our usual covert techniques became of limited effectiveness. The desk's continuation of these techniques in the face of increasing market disorder was taken as further evidence of a lack of resolve by the U.S. authorities.

Under the more active intervention approach adopted on January 4, in which the Federal Reserve and the Treasury shared jointly, the Desk's objective has been to reestablish a sense of two-way risk to the market. On several occasions, we operated forcibly to encourage a rise of dollar rates. This was not done with a rate objective in mind. Rather the effort was to demonstrate to market professionals, and to the world at large, that dollar rates can move up as well as down--that selling dollars short is not as sure a bet as it was.

Our shift of tactics has been broadly welcomed by the international financial community, not to mention central bankers. Nevertheless, many people in and out of government question what we are doing. Some want us to do more and express disappointment that we aren't being forceful enough. Others want us to do less and express disappointment that we have engaged in what they consider an exercise in

futility. The daily press and the wire services which feed into trading rooms featured these critical comments, giving heart to the bears on the dollar and scaring the very few bulls who may be around. Nevertheless, we are more interested in regaining the respect of the market than of entering into a last ditch battle with the bears.

To indicate our intentions, we reverted to a technique used sparingly before, that of making a two-way price--placing a simultaneous bid and offer for marks--when we approach banks either directly or in the brokers' market. By this approach we not only work toward re-establishing two-way trading in the market at times when bid-asked spreads are unusually wide but we have occasionally bought marks which served as additional ammunition later on. We have no intention of making a market permanently; it is not the central bank's function. But during this period of extreme uncertainty, thoughtful people in the market are pleased to see that someone is making an effort to reduce exchange rate volatility and make the market function more efficiently.

So far, the dollar has recovered by a net 4 percent and on recent days trading conditions have settled significantly. The Federal Reserve's debt in marks has risen by a further \$381 million, which corresponds to the amount done by the Treasury. As the operations mounted during the period, our total debt in marks amounts to \$1.225 billion, a record. The Desk requested and received FOMC authorization to increase the limit on the overall open position from \$1 billion to \$1.5 billion. We also received approvals as needed both by the full Committee and by the Subcommittee on exceeding intermeeting limits specified in the procedural instructions. Again, I would defer changes in those instructions until the experience has been carefully reviewed by the staff and the Subcommittee as decided last month. I might note that we have some \$275 million

leeway left under the \$1.5 billion net open position authorized by the Committee. I would hope we could keep within that limit.

#### Recommendation

Between now and shortly after the next FOMC meeting, some four swap drawings on the Bundesbank, in the amount of \$123 million equivalent of marks, are up for renewal. These are first renewals and need only be noted to the Committee.

James L. Kichline  
January 17, 1978

Introduction -- FOMC Chart Show

The staff's forecast of likely economic and financial developments prepared for this meeting of the Committee has been updated for 1978 and extended to include the first half of 1979. As part of the forecasting exercise we altered several of the underlying monetary and fiscal assumptions. The monetary assumptions were changed to correspond with usual practice while the fiscal assumptions were changed mainly to incorporate a tax package expected to be announced later this month by the Administration.

The principal policy assumptions are displayed in the first chart of the materials distributed this morning. For monetary policy, we have assumed growth of  $M_1$  at a 5-1/4 per cent annual rate, the midpoint of the existing longer-run range, but have shifted forward the base level to QIV/1977. We have also assumed growth of  $M_2$  will average 8-1/4 per cent at an annual rate over the forecasting horizon. These assumptions are consistent with longer-run Alternative B in the Bluebook which includes an increase of 1/2 percentage point in deposit ceiling rates during the first half of this year. On the fiscal side we have included a \$25 billion tax cut--2/3 going to individuals and 1/3 to businesses--mainly effective in October, the beginning of the next fiscal year. Unified budget outlays of \$457 billion in fiscal year 1978 remain unchanged in our forecast and are about \$3 billion less than Administration estimates. Outlays in fiscal year 1979 are assumed to be in the neighborhood of \$500 billion. Delay in achieving passage of an energy

program has led us to postpone implementation of a wellhead tax from early this year to mid-1978.

Mr. Zeisel will now review recent and prospective economic developments.

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*Material for  
Staff Presentation to the  
Federal Open Market Committee*

*January 17, 1978*

## **PRINCIPAL ASSUMPTIONS**

### **MONETARY POLICY**

- Growth of  $M_1$  averaging  $5\frac{1}{4}\%$  annual rate from QIV 1977 base
- Growth of  $M_2$  averaging  $8\frac{1}{4}\%$  annual rate from QIV 1977 base

### **FISCAL POLICY**

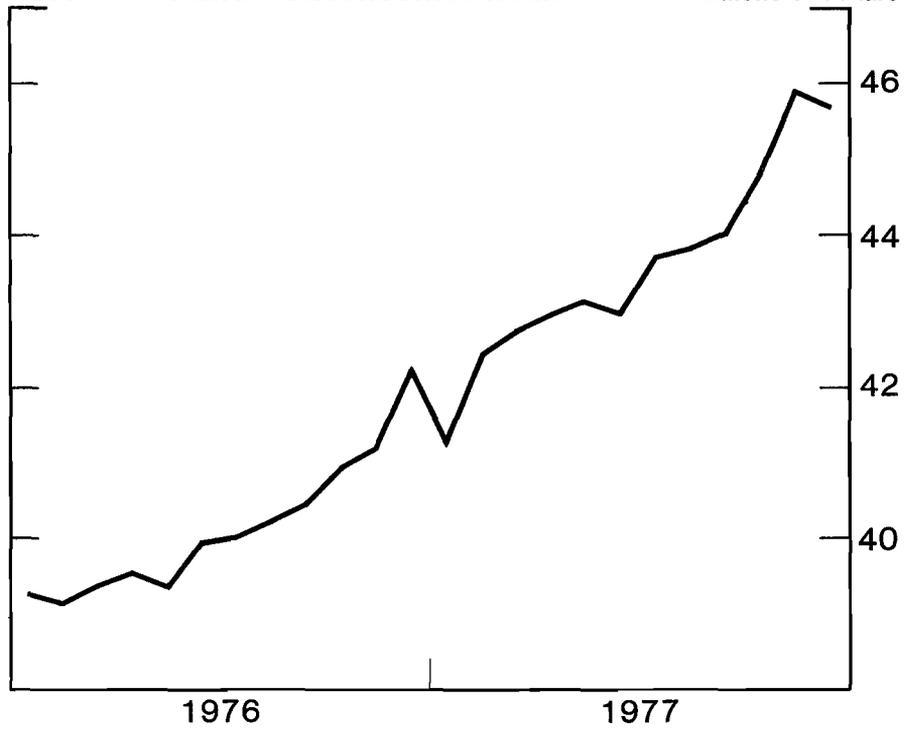
- Tax cut of \$25 billion in FY 1979
- Unified budget expenditures of \$457 billion in FY 1978 and \$500 billion in FY 1979

### **ENERGY PROGRAM**

- Wellhead tax of \$3.50 per barrel on domestically produced "old" oil beginning mid-1978

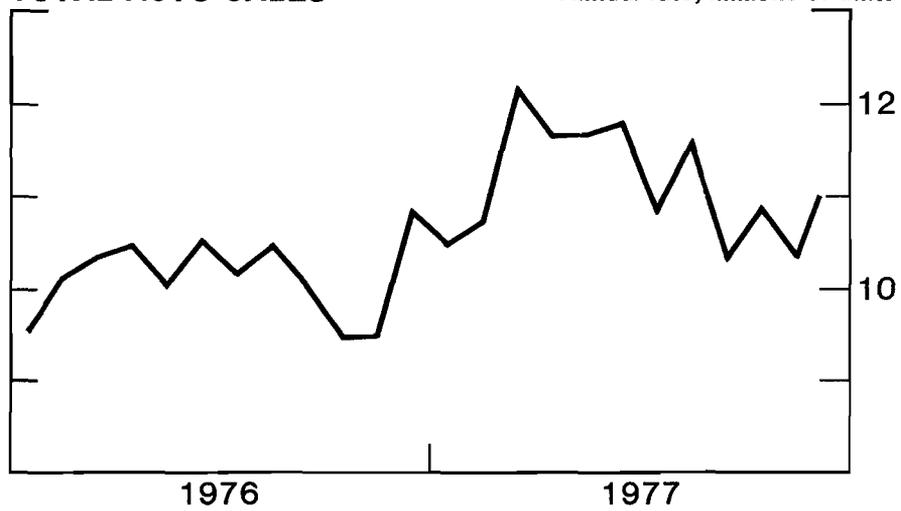
**RETAIL SALES**  
**Less Autos and Nonconsumer Items**

Billions of dollars



**TOTAL AUTO SALES**

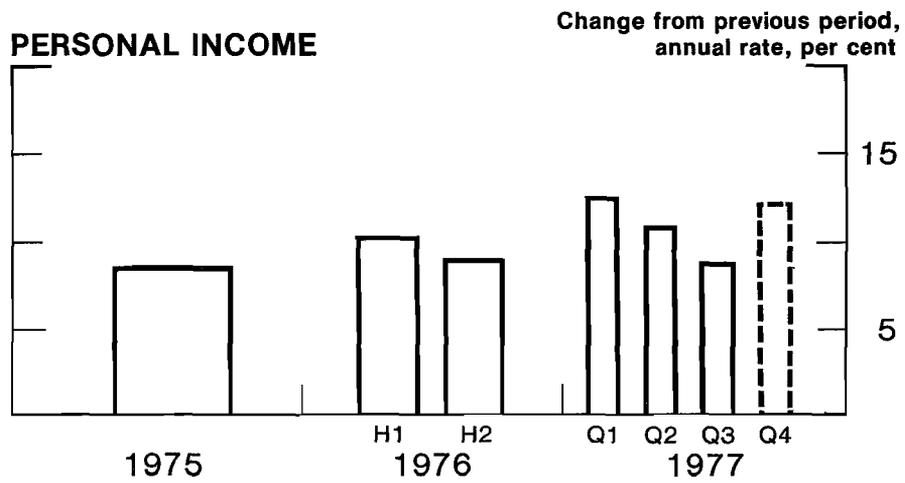
Annual rate, millions of units



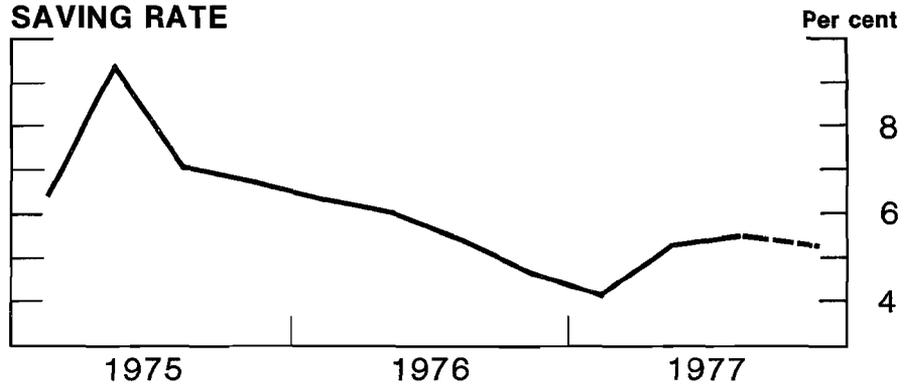
### TOTAL EMPLOYMENT



### PERSONAL INCOME



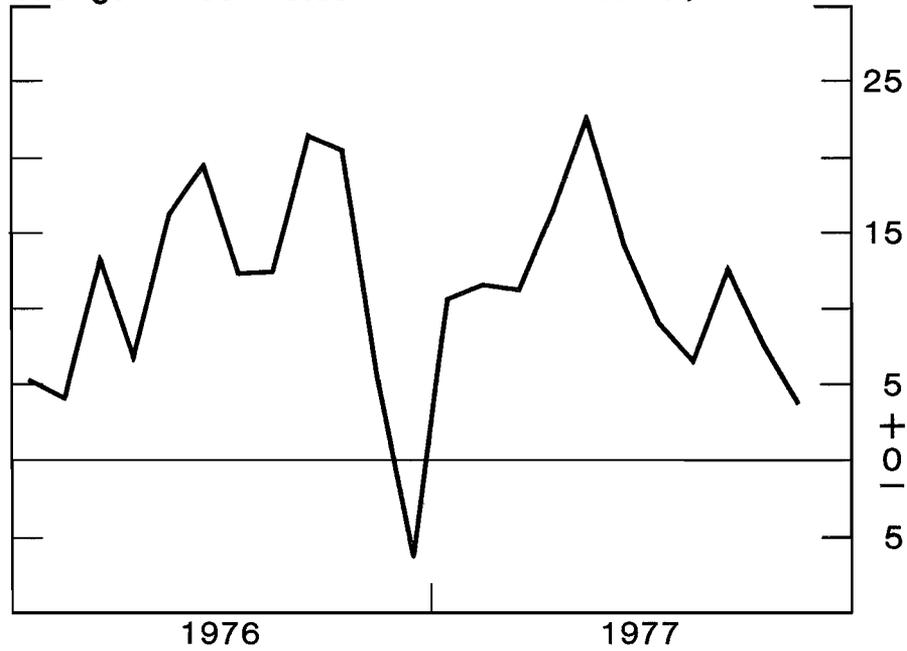
### SAVING RATE



### MANUFACTURERS' INVENTORIES

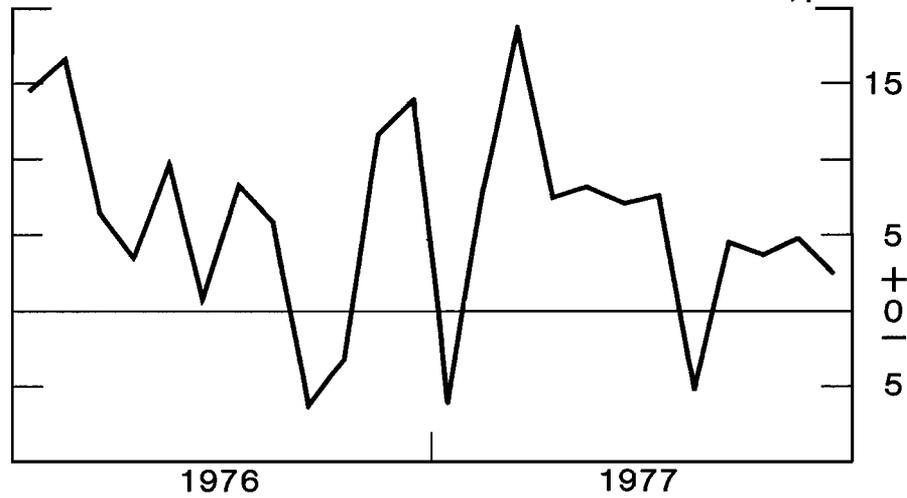
Change in Book Value

Annual rate, billions of dollars



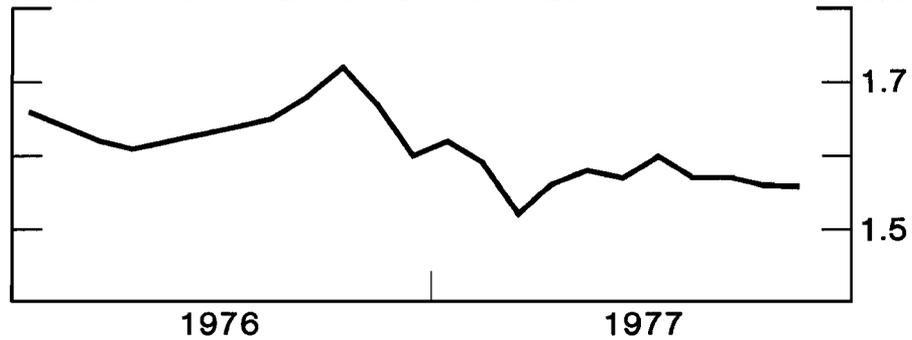
### INDUSTRIAL PRODUCTION

Change from previous month, annual rate, per cent

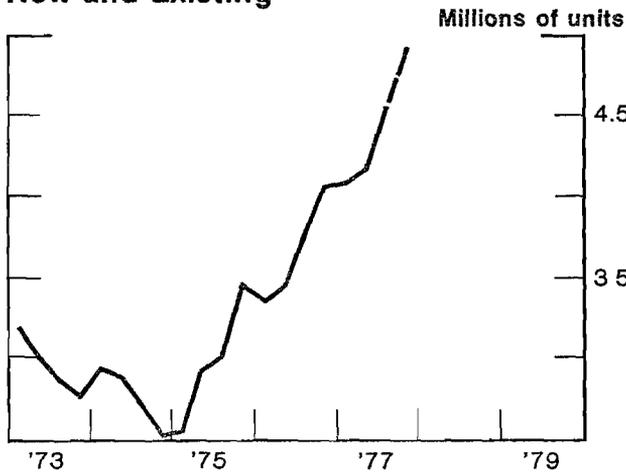


### RATIO: MFG. INVENTORIES TO SALES

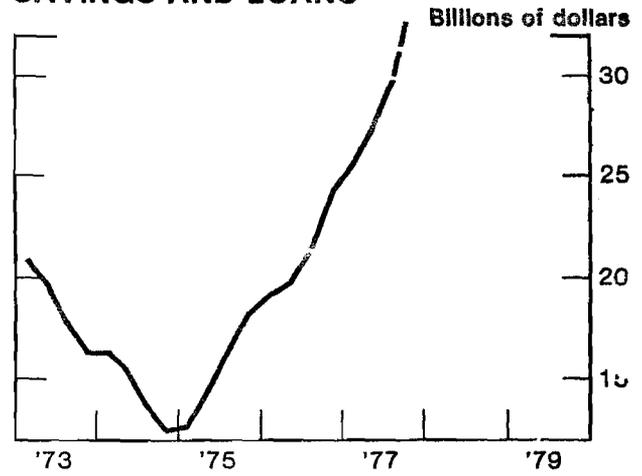
Ratio



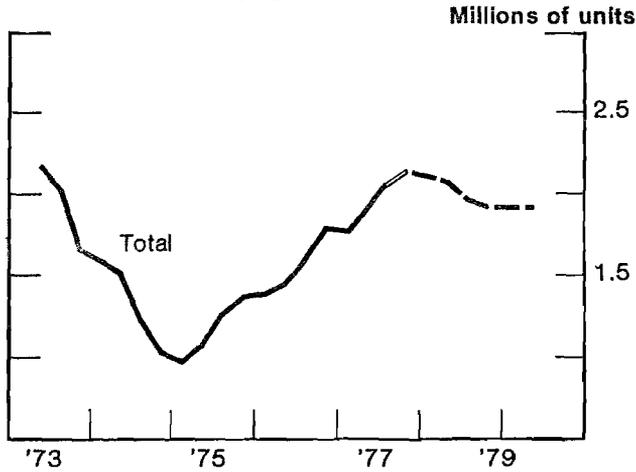
**HOMES SOLD**  
New and Existing



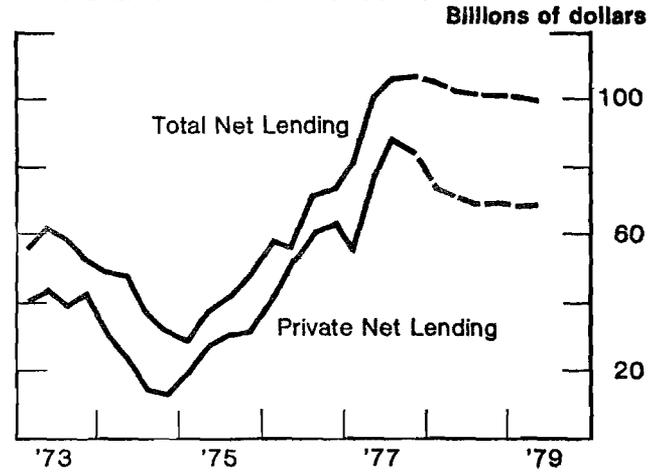
**OUTSTANDING MORTGAGE**  
COMMITMENTS AT  
SAVINGS AND LOANS



**HOUSING STARTS**

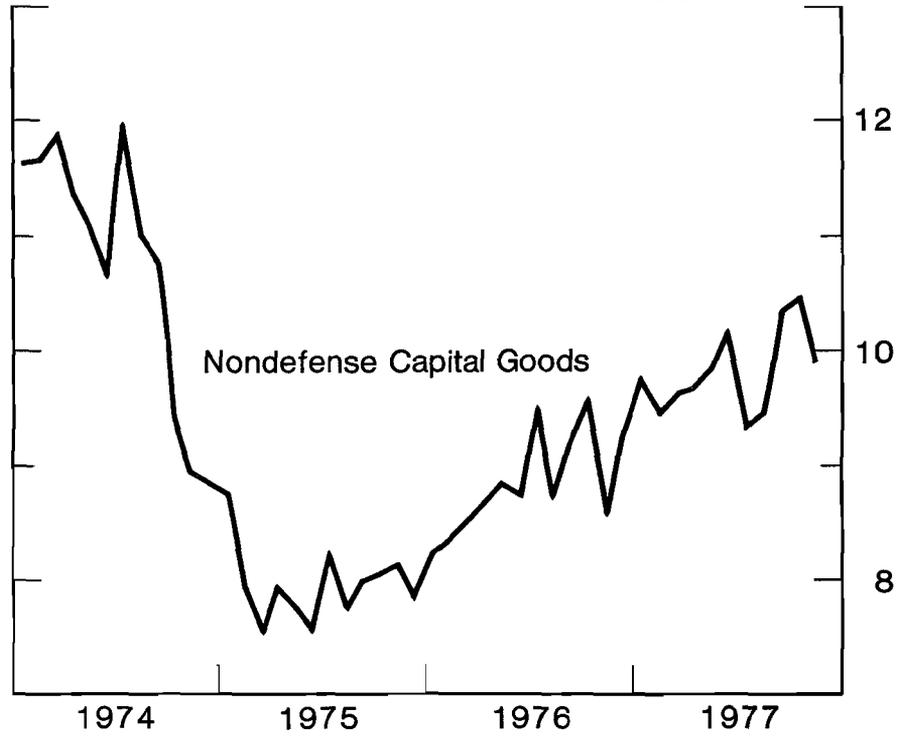


**RESIDENTIAL MORTGAGES**



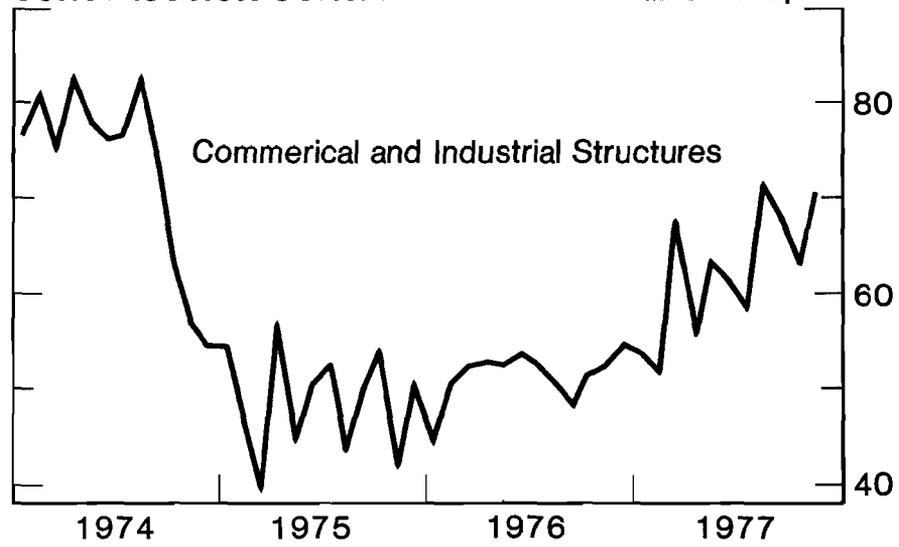
### REAL NEW ORDERS

Billions of 1972 dollars



### CONSTRUCTION CONTRACTS

Millions of square feet



**IMPACT OF SCHEDULED AND  
ASSUMED TAX CHANGES\***

Calendar years, billions of dollars

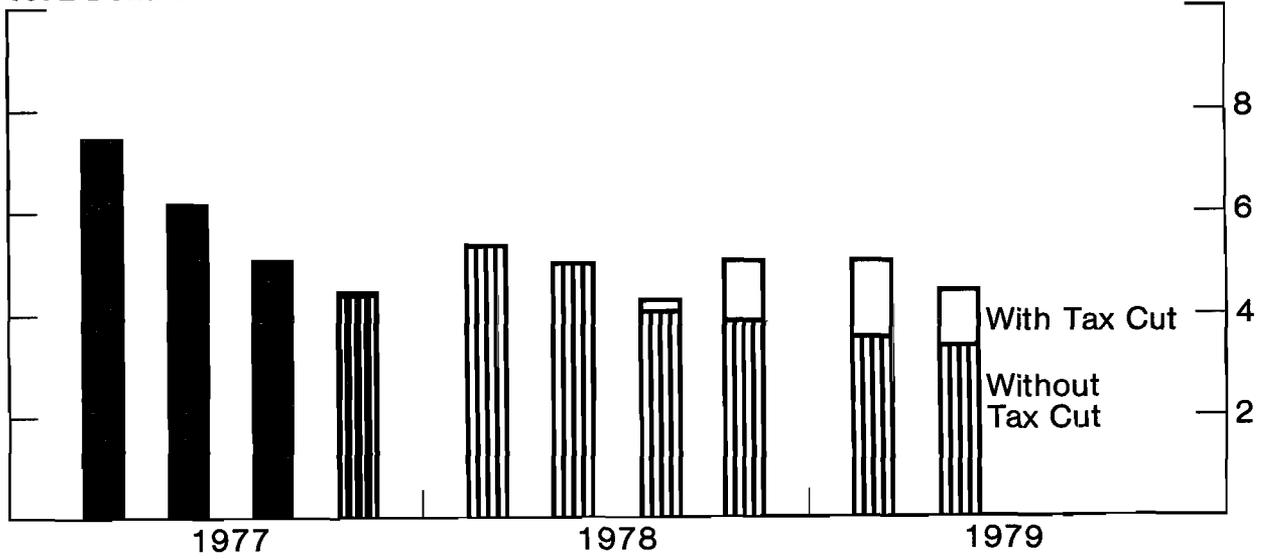
	1978	1979
<b>TOTAL TAX INCREASES</b>	<b>\$ 16.1</b>	<b>\$ 31.1</b>
Mandated Increases		
Social Security Taxes	5.3	11.7
Unemployment Insurance	2.8	2.9
Revenue Drag <sup>1</sup>	8.0	16.5
<b>TOTAL TAX REDUCTIONS</b>	<b>\$ 6.0</b>	<b>\$ 25.0</b>
Assumed Changes		
Personal Income	4.0	16.0
Corporate (Net)	2.0	7.0
Unemployment and Excise		2.0
<b>NET ADDITIONAL TAX</b>	<b>\$ 10.1</b>	<b>\$ 6.1</b>

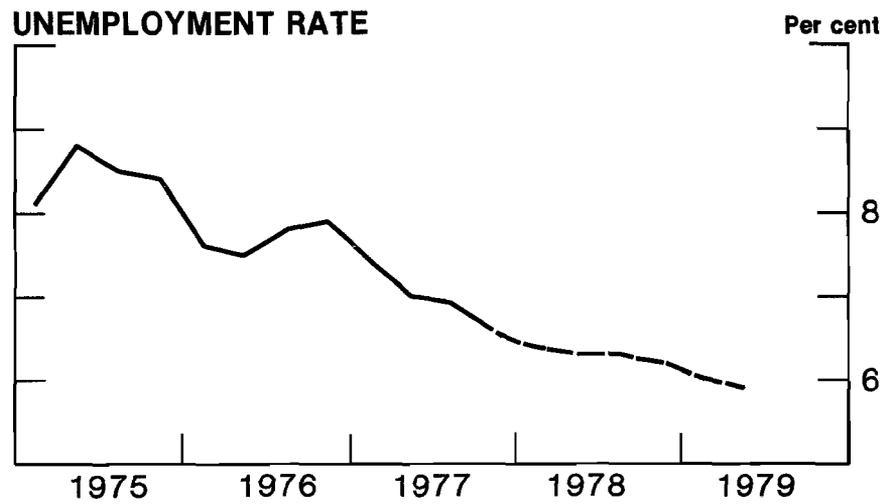
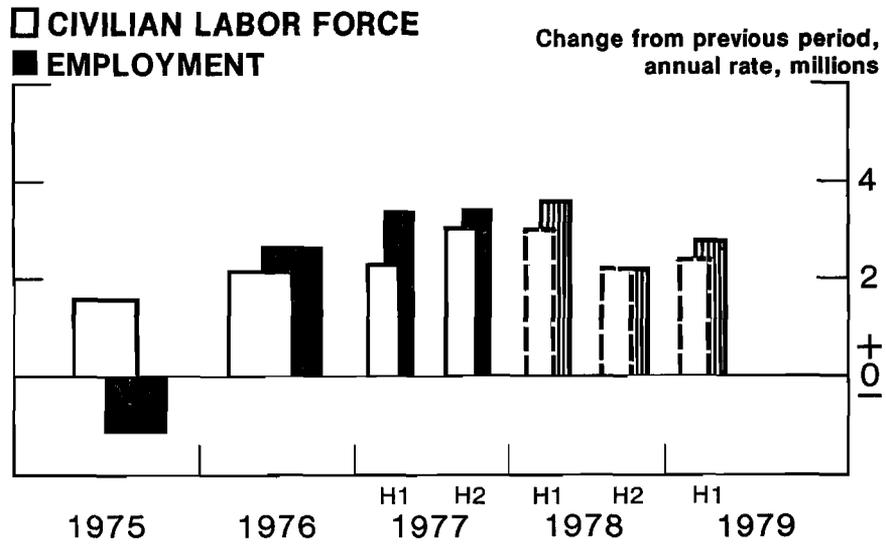
\* Relative to 1977 base

<sup>1</sup> Impact of inflation and progressivity on tax receipts

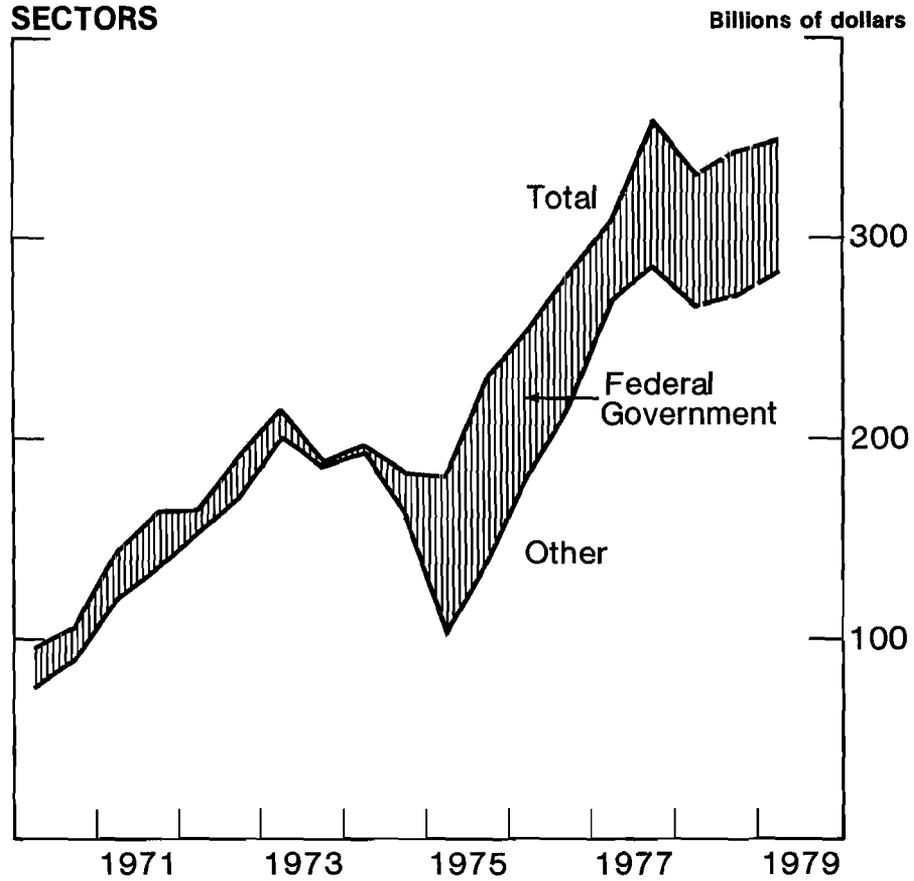
**GROWTH RATE REAL GNP**  
**1972 Dollars**

Change from previous quarter, annual rates, per cent

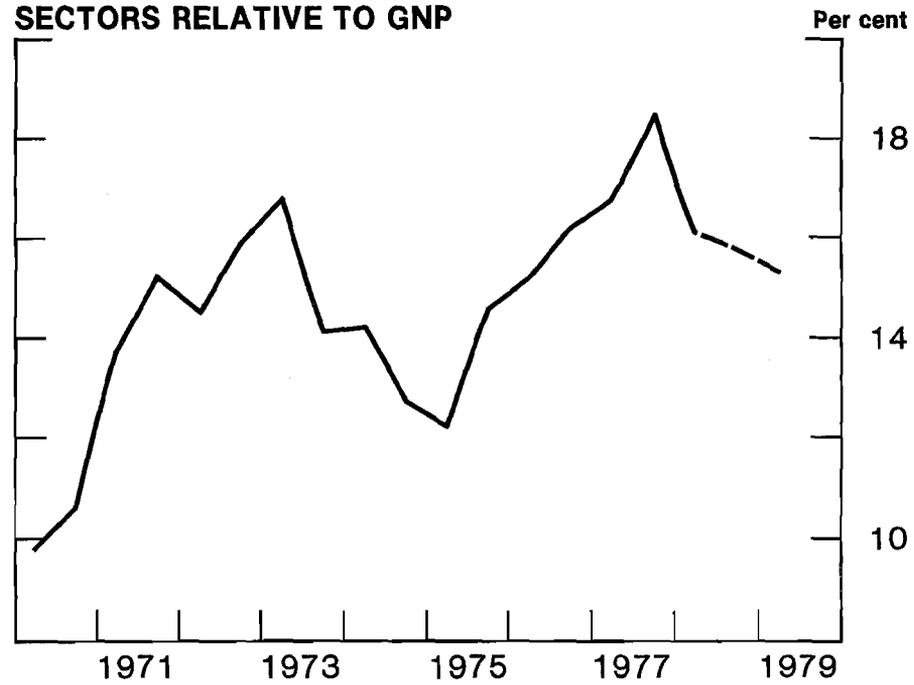




**FUNDS RAISED BY NONFINANCIAL SECTORS**

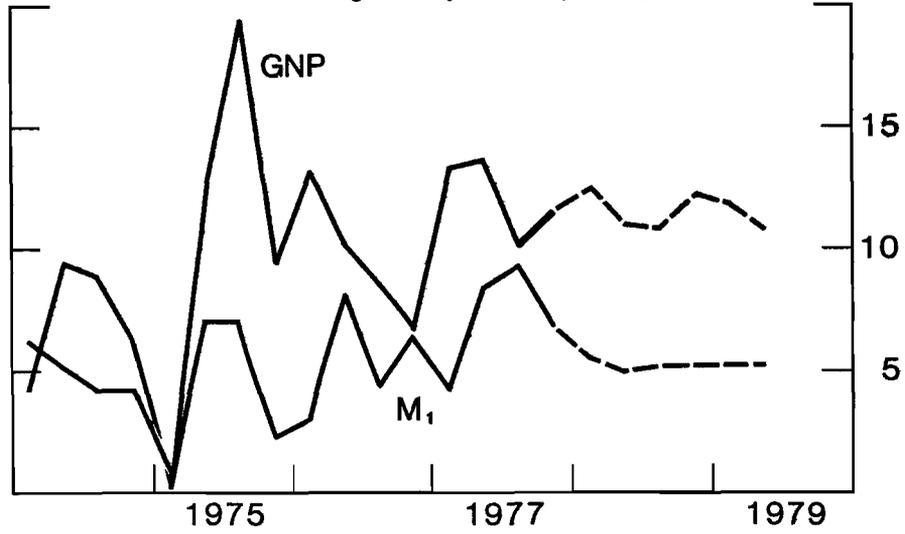


**FUNDS RAISED BY NONFINANCIAL SECTORS RELATIVE TO GNP**



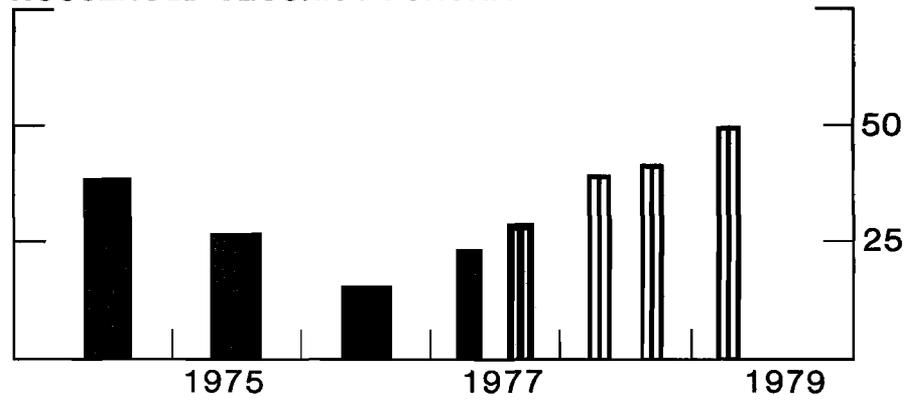
### GNP AND M1 GROWTH RATES

Change from previous quarter, annual rate, per cent



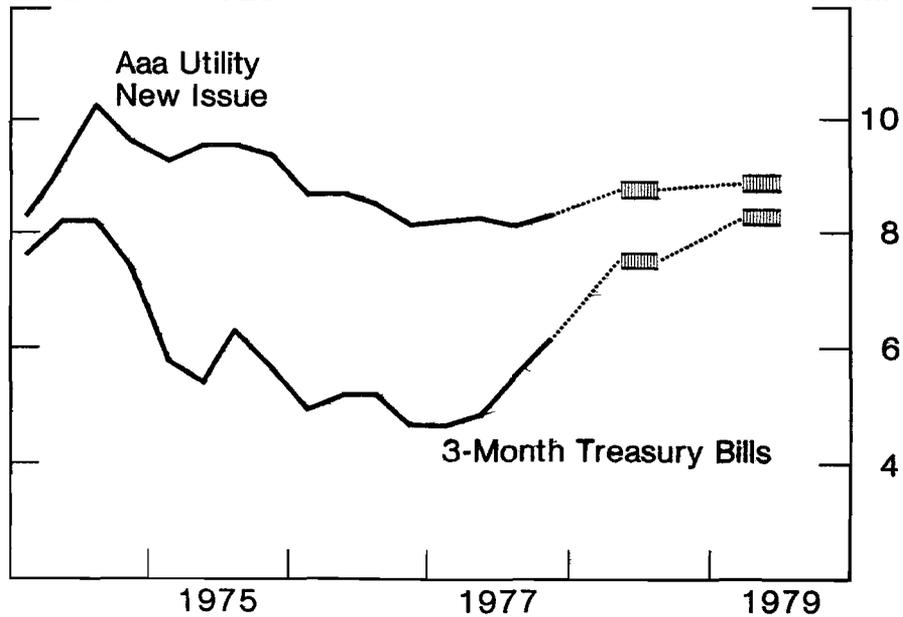
### HOUSEHOLD SECURITY PURCHASES

Billions of dollars

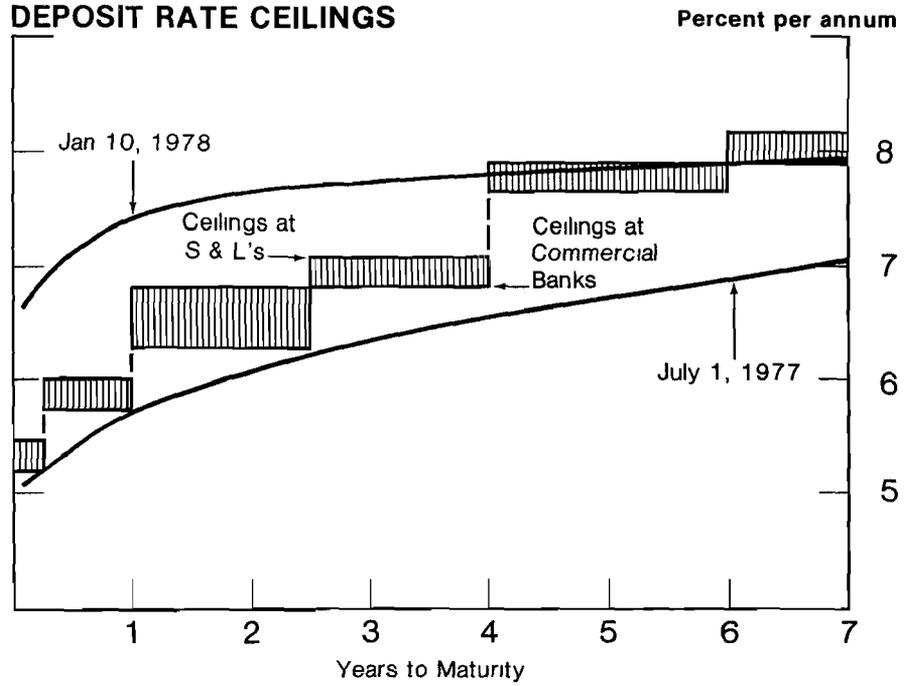


### INTEREST RATES

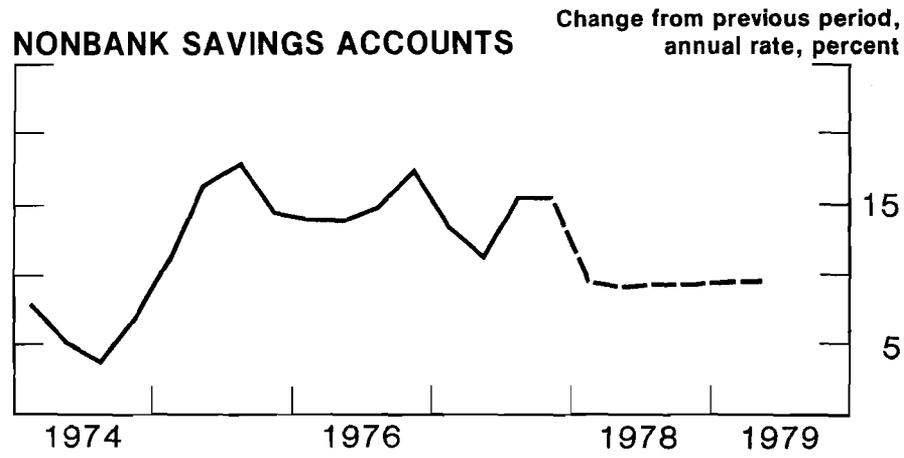
Per cent



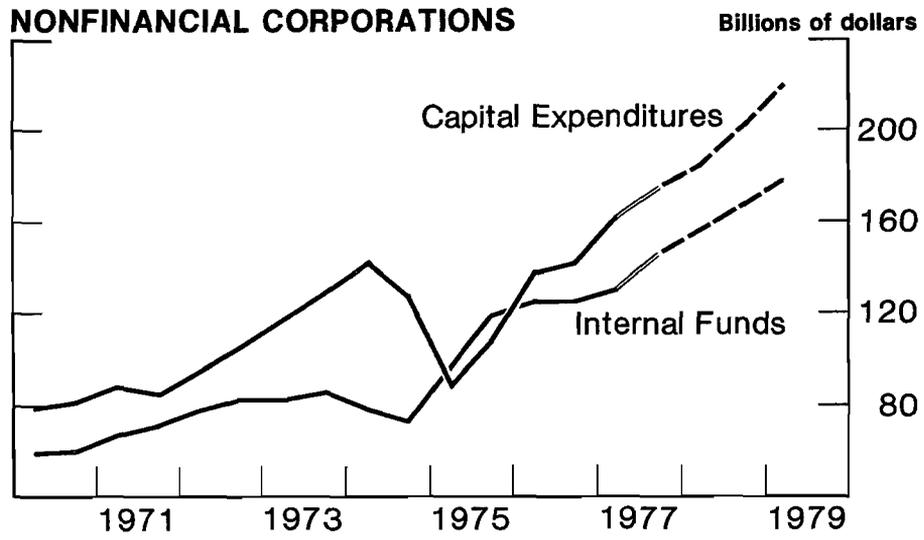
### TREASURY YIELD CURVES AND DEPOSIT RATE CEILINGS



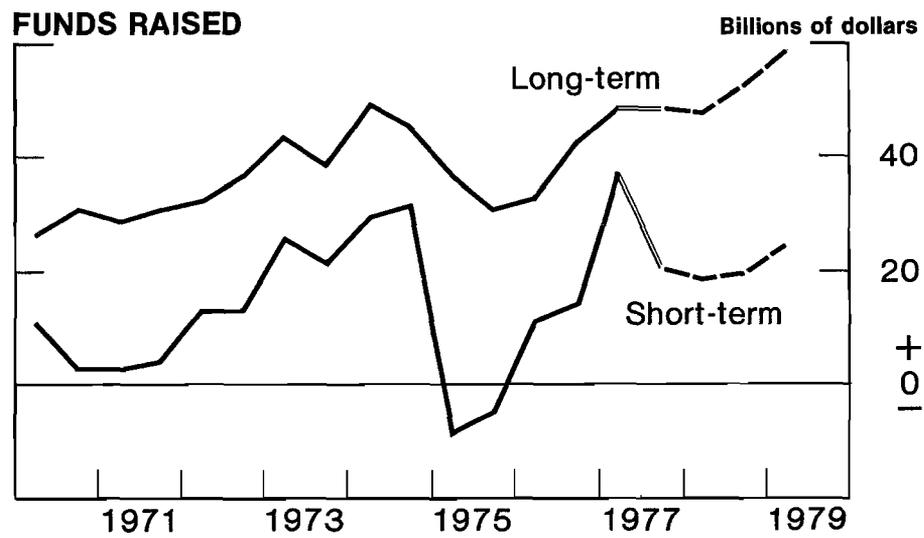
### NONBANK SAVINGS ACCOUNTS



### NONFINANCIAL CORPORATIONS

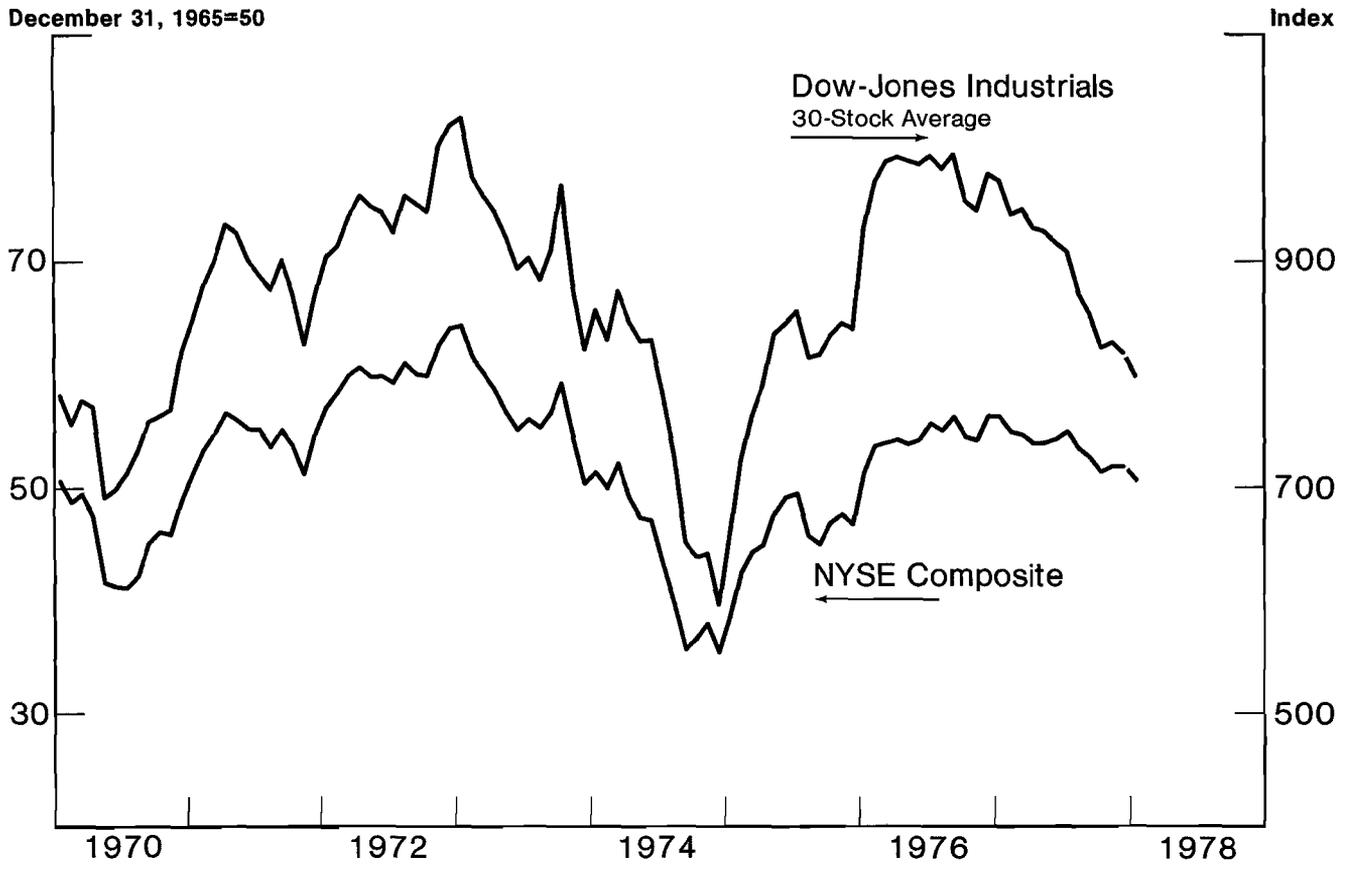


### FUNDS RAISED

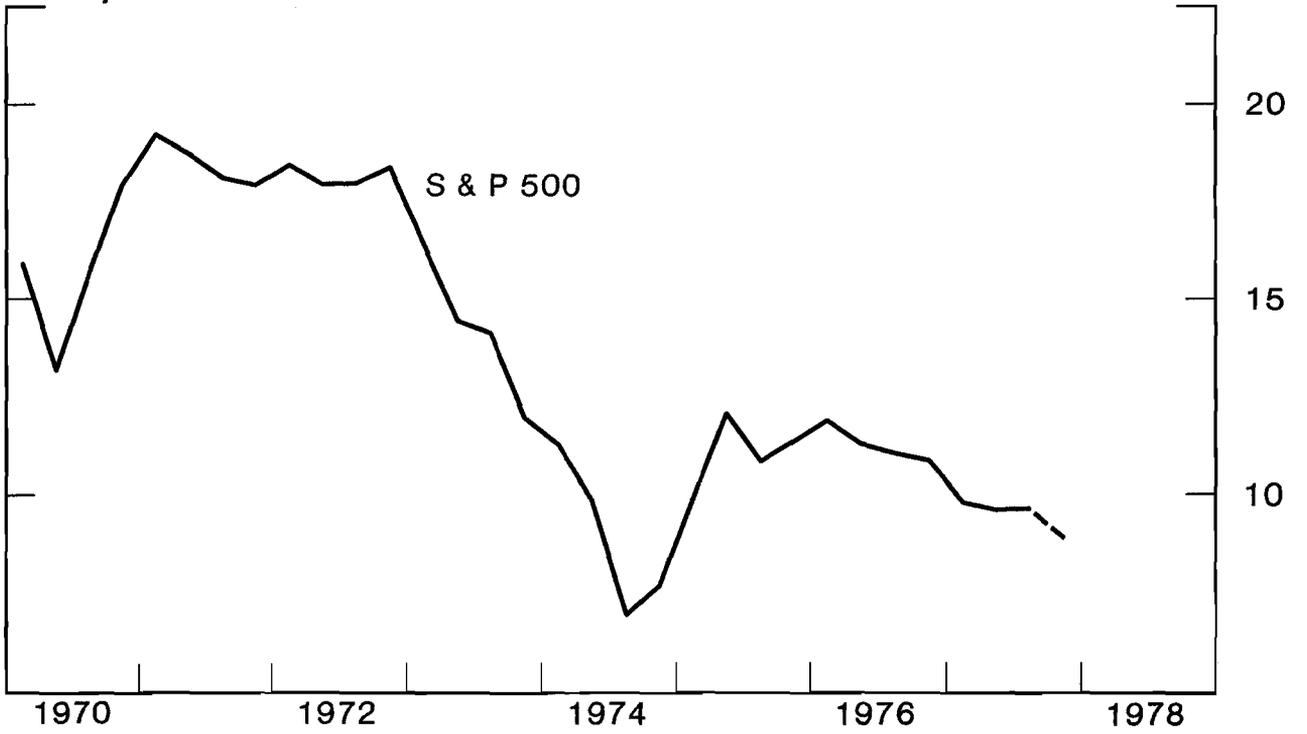


# STOCK PRICES

December 31, 1965=50



# PRICE / EARNINGS RATIO



Joseph S. Zeisel

FOMC BRIEFING  
January 17, 1978

The economy ended the year on a distinctly upbeat note. Growth of real final sales in the last quarter was apparently the strongest for any quarter in 1977. Housing outlays picked up vigorously, but the major source of increased buoyancy has been retail sales--portrayed in the top panel of the next chart. Despite a slight dip in December, retail sales excluding autos and nonconsumption items rose in the fourth quarter at the most rapid quarterly pace in over a decade.

Unit auto sales however--the bottom panel--have not shown the strength in recent months exhibited by overall consumer demand. Although sales picked up in December, the pace remains below that of early in the year and the industry has cut back on its production schedules somewhat. But basic underlying demographic and other determinants of demand continue to be favorable and the most recent slowing may reflect the tendency for auto sales to suffer somewhat when other retail sales are extremely strong.

The next chart pinpoints a major source of the recent strength in consumer demand--the substantial growth of employment, which rose by over a million in the fourth quarter. Gains in payroll employment have been more modest but still very substantial. And, as indicated in the middle panel, there has been a comparably vigorous rise in personal income. Thus--as the bottom panel shows--in contrast to last winter, the strength of consumer demand recently has not been at the expense of a sharp decline in the savings rate.

But the surge of consumer buying along with the increased strength in homebuilding recently, apparently caught producers by surprise. And, as is evident in the top panel of the next chart, inventory accumulation in manufacturing was at a sharply reduced rate in the past few months. As the second panel shows, gains in production have been modest recently, in response to the slower pace of demand that had prevailed through the summer. It is this combination of increased sales and reduced production which cut the rate of inventory accumulation sharply.

Thus, despite strong final demands, real GNP growth in the last quarter probably was held to about  $\frac{4}{4-1/2}$  per cent annual rate, somewhat less than we were estimating last month.

It is clear, however, that the ground has been laid for a substantial improvement in industrial activity over the next few months. Inventories are now quite lean relative to sales, as is evident in the bottom panel, and businessmen are bound to adjust production schedules upward, if only to keep stocks in line with  $\frac{\text{increased}}{\text{sales}}$  sales levels. This should contribute to the resumption of a more rapid rate of GNP growth in the first half.

But it also seems likely that once the impetus from this inventory adjustment fades, in the absence of a tax reduction  $\frac{\text{package,}}{\text{under-}}$  lying forces in the economy would tend to slow the pace of overall growth. Among these forces are first, a likely reduction in the contribution of residential construction during this coming year. Demand for housing remains strong, as is clearly evident in the top panels of the next chart, which show total home sales and outstanding mortgage commitments. But we expect that starts <sup>will</sup> soon begin to decline

in response to tighter mortgage market conditions, reflecting recent reductions in the flow of funds to thrift institutions. However, as noted, we have assumed that Regulation Q ceilings will be raised in the spring, and as is suggested in the last panel, we anticipate that government support programs will partly offset declines in private mortgage lending, helping to thereby/avoid any precipitous decline in construction activity.

Another source of potential drag later this year could be the performance of business fixed investment, which has remained a disappointment throughout this recovery. As is evident on the next chart, indicators of the near-term outlook for capital spending, such as new equipment orders and construction contracts, have continued to rise on average. But they have not shown the degree of expansion necessary to ensure a sustained rapid growth of capital spending. In fact, the rate of growth of orders has slowed recently. Moreover, the latest Commerce survey of capital spending plans showed an increase of only 10 per cent for 1978, as compared to the nearly 14 per cent realized in 1977, which suggests a reduced contribution of investment spending to overall growth as the year progresses.

Finally, and particularly important, is the burden on the economy-- as detailed in the next table-- of already mandated new taxes for social security and unemployment insurance, as well as the continuing revenue drag resulting from the interaction of inflation and a progressive income tax structure. Together, these various factors involve a drain on the income stream of about \$16 billion between 1977 and 1978. There is an impact of about the same magnitude in 1979.

As indicated in the lower section of the table, these fiscal restraints would by 1979 be offset in substantial measure by the \$25 billion tax cut which the Administration reportedly will present to Congress, and which we have incorporated as an assumption in our projection.

Without the proposed tax cut, we have projected that the rate of growth of real GNP would moderate throughout 1978--as indicated in the next chart--and average under a 4 per cent rate in the first half of 1979. However, with the tax cut, the staff now projects a rate of growth averaging about  $4\frac{3}{4}$  per cent for the next six quarters. Following the surge in activity expected early this year in association with inventory building, growth is expected to moderate somewhat until late in the year when consumers initially respond to the reduction in personal taxes. Investment spending is expected to react modestly somewhat earlier, to the liberalized investment tax credit, assumed to be retroactive to January 1st. By the first half of 1979, real GNP growth is projected to be over 1 per cent greater than in the absence of the tax cut.

The stronger activity projected under these assumptions should stimulate employment gains--the final chart. But even with a more moderate increase in the civilian labor force than we have recently experienced, the projected rate of real GNP growth of under 5 per cent is likely to have only a limited impact on unemployment. We now anticipate that the rate may drop to about 6 per cent by mid-1979 from last month's  $6\frac{1}{2}$  per cent level.

Mr. Kichline will complete the presentation.

James L. Kichline  
January 17, 1978

FOMC BRIEFING

The financial counterpart of our GNP projection is contained in the flow-of-funds forecast. The top panel of the first chart in the financial presentation shows the volume of funds raised by nonfinancial sectors. We expect most sectors to reduce their borrowing pace in the first half of this year compared to the record rates experienced in the second half of last year. Borrowing later this year and into 1979 is expected to rise somewhat reflecting the continued large requirements of the Federal Government and a pick up in business credit demands. But in the aggregate, total funds raised will likely decline relative to GNP, the bottom panel of the chart. Such a development is often associated with tightening credit markets and we believe that will be in store during the forecast period.

The top panel of the next chart indicates that nominal GNP is expected to expand quite rapidly relative to the assumed 5-1/4 per cent growth of  $M_1$ . To hold down  $M_1$  expansion will likely require appreciable further increases in the Federal funds rate, as discussed in the Bluebook, and will be associated with a large rise in velocity over the forecast period. The process of inducing economies in the holding of  $M_1$  balances will encourage purchases of securities by households, another way of looking at tightening financial markets. Interest rates on Treasury bills are expected to rise to around 7-1/2 per cent by mid-year and to move a little above 8 per cent in 1979. Bond rates are also expected to rise but comparatively little, reflecting the still wide

yield differentials and continuing strong demands for bonds on the part of institutional investors.

Higher market interest rates will take their toll on deposit flows to banks and thrift institutions. In the next chart, the top panel indicates that effective rate ceilings on savings and time deposits at banks and S&L's were above yields available on Treasury securities in all maturity ranges as of July 1, 1977. By early this year, however, only the longer-term deposits at S&L's were marginally attractive.

Recent evidence indicates interest bearing deposit flows at banks and thrift institutions have decelerated and we anticipate continued moderation. The growth of deposits at nonbank institutions projected in the bottom panel allows for an increase in time deposit interest rate ceilings of 1/2 percentage point during the first half of this year. With slower deposit inflows, of course, depository institutions will need to rely on other sources of funds, including borrowings, run-down liquid assets, and tighten lending terms and conditions. These developments are likely to impact importantly on the mortgage market.

The nonfinancial corporate sector remains a key element in both the economic and financial outlook. The top panel of the next chart indicates that the forecast incorporates substantial growth in nominal capital expenditures (including inventory investment) by non-financial corporations. Internal funds are also expected to be rising considerably--partly because of corporate tax reductions. The resulting external financing gap (the difference between the two lines) thus remains manageable; the gap is projected below that in 1974 and corporations now are in much better financial shape than at that time.

We expect that corporations will rely quite heavily on long-term sources of funds--the bottom panel--given the expected availability and cost of funds in the bond market as well as their desires to limit erosion of liquidity positions.

Our projection, however, incorporates a sharp decline in equity issues in 1978 and 1979 reflecting the disappointing performance of equity prices--the next chart. The decline of the Dow Jones Industrial Index has been especially large and highly visible during the past few weeks. Moreover, the Dow Jones Index performed poorly throughout 1977 and the more broadly based NYSE index has also been trending lower although it has held up better than the Dow Jones. In view of the sizable gains in corporate profits in the past two years, the price earnings ratio has moved lower and indicates the high cost of capital. The performance of equity prices remains an element of concern in the outlook in regard to business spending, potential adverse impacts on consumer spending, and the general state of confidence.

REPORT ON OPEN  
MARKET OPERATIONS

Mr. Sternlight made the following statement:

Desk operations for about the first two thirds of the period since the December meeting of the Committee were aimed at achieving a Federal funds rate around 6 1/2 percent--the center of the 6 1/4 - 6 3/4 percent range adopted in December. In the final third of the interval, following the January 6 announcement of a 1/2 percent increase in the discount rate and the Committee's adoption of a 6 1/2 - 7 percent funds range, both essentially because of the weak dollar and disorderly conditions in the foreign exchange market, the Desk pursued the Committee's related instruction to raise the funds rate to around 6 3/4 percent over the next few days.

Behavior of the monetary aggregates, taken together, was reasonably well within the Committee's ranges and provided no reason to modify the Desk's approach. Estimates of  $M_1$  growth for the two months ending in January gradually strengthened over the period, ending the interval in the upper part of the range but still well within it. On the other hand,  $M_2$  estimates tended lower over the period, and most recently were well down in the indicated range.

Through the first half of the period, the funds rate exceeded the Desk's 6 1/2 percent objective, owing to reserve shortages in the holiday-shortened weeks, and particular pressures around the year-end statement date. The Desk had some difficulty in supplying needed reserves, even after getting good cooperation from the Treasury in reducing their balances. Troubles in projecting reserve availability compounded the problem. The market appeared to understand these difficulties, however, and remained confident through

early January that the System's objective was still 6 1/2 percent even after some days of trading closer to 6 3/4 and even 7 percent. Very briefly, January 5 and 6, the funds rate did return to around 6 1/2 percent, but starting January 9 the Desk began to push the rate higher, reaching about 6 3/4 percent by January 12. The funds rate pushed higher yesterday--to about 6 7/8 - 7 percent--despite strenuous Desk efforts to provide reserves, but came down this morning. The market perceived the Desk's intent to raise the rate beginning January 9, and this together with the higher discount rate produced higher interest rates across a broad front. While market participants initially were uncertain of the extent of the Desk's firming move, with some expecting a quick move to 7 percent, the predominant view now is that the System is seeking a rate around 6 3/4 percent. Still some uncertainty lingers, particularly as the market seeks to factor in the heightened official concern over the international position of the dollar.

Early in the period, the Desk sought to fill enormous reserve needs produced largely as a result of higher Treasury balances. The System made outright purchases of \$707 million of Federal agency issues and net purchases of about \$1 1/4 billion of bills in the market, as well as some \$200 million of bills from foreign accounts. Substantial repurchase agreements were made in the market almost every day from December 20 to January 5, with especially heavy activity around the year-end days. Reserves were absorbed from January 9 to 11 through matched sale-purchase transactions in the market and outright sales of about \$350 million bills to foreign accounts. Most recently, the Desk provided reserves again, buying nearly \$700 million of bills in the market last Friday, and arranging

repurchase agreements yesterday. Each day, matched sale-purchase transactions were arranged with foreign accounts.

Interest rates moved a little higher over the first two thirds of the period and then jumped sharply on January 9 following the discount rate rise and the Desk's perceived move towards a higher Federal funds rate. The moderate rise early in the period reflected the market views that expanding credit demands were likely to result in higher rates as the new year unfolded. In the last few days, rates have come down a bit as the market gained some confidence that the System was not pushing toward additional firming in the money market. Treasury bills were auctioned yesterday at about 6.54 and 6.76 percent for the 3- and 6-month issues, up from 5.99 and 6.34 percent just before the last meeting, but off from 6.68 and 6.85 percent on January 9.

For intermediate term Treasury issues, 1 - 5 years, yields rose about 35 to 50 basis points for the period. The two-year note to be auctioned tomorrow is expected to go around 7.55 - 7.60 percent, compared with 7.20 percent a month earlier. For longer Treasury issues, yield increases were about 25 to 35 basis points. While the yield moves caused dealer losses, these were not extreme as inventories were moderate.

In the Treasury 2-year note auction tomorrow, \$1 billion of new money is to be raised. Another \$2 billion or so may be raised in coupon issues in the quarterly refunding to be announced a week from tomorrow. Maturing issues in the hands of the public come to \$5 billion in that refunding. The System Account holds \$2.6 billion of those February 15 notes and we would plan as usual to roll these over into new issues in about the proportions offered to the public.

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Since the last Committee meeting, growth in M-1 has shown somewhat more strength than projected, while growth in M-2 has displayed somewhat less. Partly in consequence, the 2-month ranges presented for consideration at this meeting encompass somewhat slower growth in M-2 relative to M-1 as compared with ranges adopted at the previous meeting. For instance, alternative B specifies the same 2-1/2 to 8-1/2 percent annual rate for M-1 adopted by the Committee at its last meeting, but for M-2 the staff now expects growth to be in a 5 to 9 percent range--about a percentage point lower than projected at the last meeting. Sizable shortfalls in the time and savings deposit component of M-2 relative to earlier expectations, as well as recent upward market rate adjustments, account for this change.

Interest rates on intermediate-term U.S. Government securities--which had risen 20 to 30 basis points during December--rose another 15 to 25 basis points following the discount rate action and are now above effective ceiling rates on small-denomination time deposits at banks in all maturity categories. Thus, flows of funds into deposits subject to ceilings at banks and thrift institutions are likely to continue at a reduced pace, and could come under further downward pressure depending in part on the attractiveness to individuals of the terms set by the Treasury on new issues to be offered in the sizeable refunding operation to be announced a week from Wednesday. The ability of thrift institutions to attract funds through deposits has also become more restricted.

While the potential diversion of funds from interest-bearing deposits to market instruments further complicates the interpretation of M-2 and M-3 as over-all indicators

for monetary policy, reduced deposit inflows to thrift institutions do suggest developing pressures on mortgage terms and on the considerable willingness (evident in the latest data available through November) of institutions to commit funds to housing. Recent mortgage rate increases have been most pronounced in the secondary market--where yields have risen 25 to 35 basis points since the end of November--but primary market rates have edged up in the past few weeks.

I would expect any upward pressures on the money stock that may develop in the period ahead to continue to focus mainly on M-1, though there could be some spillover effects on M-2. The recent upward adjustments in short-term rates following the rise in the discount rate and the funds rate may exert only a relatively minor restraint in growth in M-1. Short-term rates have increased 20-35 basis points on balance since the discount rate action. I doubt that these rate increases will lead to very substantial adjustments in banking lending or portfolio policies. Indeed, unless the commercial paper rate rises further from its current level, bank loan rates to businesses are not likely to adjust upward from the levels to which they had tended -- as indexed by the 8 percent prime loan rate -- just prior to the discount rate increase. Thus, there may not be strong additional restraint on banks' willingness to supply credit and in the process create money as a result of recent policy moves.

At the same time, the economy's need for demand deposits for transactions purposes should be quite sizeable. Nominal GNP is projected to increase at about a 12-1/2 percent annual rate in the first quarter, up about 1-1/4 percentage points from last month's projection for the period. The associated transactions demands for money could exert a strong pull on demand deposits at current market rates. If short-term rates do not

rise over the next few weeks as a result of efforts to restrain actual M-1 growth, the staff would expect such rates to have to begin rising shortly thereafter.