

Notes for FOMC Meeting  
November 21, 1978  
Scott E. Pardee

To us at the Foreign Exchange Trading Desk, the November 1 announcements by President Carter, the U.S. Treasury, and the Federal Reserve represented a different kind of mandate than we have had at any time in the era of floating exchange rates. We were to operate in such a way as to, in the President's words, "correct the excessive decline of the dollar" in the exchange markets. We were also given ample resources to work with and assurances, publicly and privately, that we would be backed fully if we found it necessary to intervene massively to achieve the broad objectives. We had a number of important advantages in the effort. The November 1 package followed a series of policy measures, such as the previous interest rate hikes by the Federal Reserve as well as actions by the rest of the government on the budget, tax policy, energy policy, and incomes policy. We also had the advantage of the gradual improvement of key economic fundamentals, including evidence of a convergence of economic activity here and abroad and of an improvement in our trade account, and, with the Administration anti-inflation program in place, some hope for progress on domestic inflation. Moreover, since the dollar was so heavily oversold, the technical conditions for a bear squeeze were ideal.

We also had serious disadvantages. As Alan and I related to you in the October meeting, we faced the serious loss of confidence in the dollar by market professionals and money managers around the world, including some central banks, with a flavor of cynicism in their attitudes toward the efforts of the U.S. and other major governments to eliminate economic imbalances. At least, the November 1 program was well-designed to convince the doubters. It included something for everyone—a rise in interest rates,

higher reserve requirements, increased gold sales, IMF drawings and SDR sales, foreign currency bonds and prospects of further action on the budget and on inflation. Few could say that the United States hadn't done what they thought we should do. They might wish we had done it sooner or had done more of one thing or another but they couldn't dismiss the program out of hand. But individuals in the market had been conditioned against buying dollars when they heard otherwise good news for the dollar—they had been burned too often.

The second disadvantage was the need to coordinate intervention policy with other central banks, each of which had a somewhat different approach in mind. In a 24-hour market, any difference in intervention approach from one country to another will be immediately noticed by traders and acted upon. Slippage in one market will be passed on to the next:

Consequently, as far as market participants were concerned, the November 1 actions turned the spotlight directly on the foreign exchange trading desks of the major central banks—on us, the Bundesbank, the Bank of Japan and the Swiss National Bank. The question was simple: would the central banks show sufficient resolve? We, of course, intervened rather aggressively on the first day and on subsequent days, resisting any serious slippage in dollar rates and pushing the dollar up when we found a chance. The Bank of Japan delivered a stunning blow to the Tokyo market on November 2 by buying \_\_\_\_\_ and neither we nor the Bank of Japan had serious difficulties thereafter in yen. Although we also intervened in Swiss francs, the heavy pressure on that market had already dissipated following the National Bank's massive intervention in late September-early October.

By contrast, the dollar remained under heavy testing in marks, and when the New York market was closed on Election Day the dollar rate began to fall away once again. This

caused some serious soul-searching in the Bundesbank, where many members of the directorate were becoming concerned over the magnitudes of intervention and the potential effects on the domestic money supply in Germany. The sudden drop in the rate came as a shock to the market, particularly at a time of political turmoil in Iran and talk of a possible breakdown in the Mid-East peace, talks. The Bundesbank did allow some slippage, but quickly resumed a more forceful stance for the time being. We continued to meet the remaining pressure head on in New York over subsequent days.

Early last week the heavy selling of dollars finally subsided, and over the past five trading days, the dollar has recovered on its own—in very heavy trading. Against the mark the dollar has risen by 3 percent from last week's lows and by 12 percent from the late October bottom.

Our problem was to persuade the various market participants that we meant business. Traders in U.S. banks were impressed very early, having seen a good bit of our intervention either as our agent when we asked them to help us out in the broker's market, or as our adversary when they sought to push us around. The high rollers in Europe and the Middle East were a bit harder to impress since they normally deal in big amounts and had been having a field day starting bandwagons against the dollar during the dollar's decline. But by being firm in our intervention approach and burning some fingers, we and the Bundesbank taught them to be much more careful. Some of those fellows have been seen as ardent buyers of dollars on recent days, as have other speculative elements, such as those on the IMM.

The crucial task was to impress the corporate treasurers and the other money managers around the world, including central bankers who had been diversifying out of dollars. Their confidence in the dollar had been badly eroded, and many were still engaged in programs of

dollar sales, decided on earlier, irrespective of the new U.S. policies. Several days of reasonable stability in dollar rates, as a result of stamina in intervention, seems finally to have turned some of them around. Skepticism remains, however. It is still too early to say that the dollar will stand on its own without further defense. We will be in for further serious testing, as long as we have a large current account deficit and an unsatisfactory rate of inflation.

Reviewing the numbers, during the period from the last FOMC, the Desk sold a total of \$4.6 billion of foreign currencies. Of this, \$2.9 billion was for the System, \$1.1 billion for the Treasury, and \$600 million for the accounts of the under joint intervention arrangements for operations in their currencies in the U.S. Of the \$4.6 billion total, \$1.1 billion was through October 31, and \$3.5 billion following the November 1 announcement. The System's swap debt in marks, net of \$219 million of repayments, rose by \$2,407 million, to \$2,871 million. In Swiss francs, net of \$9.8 million of repayments, the System drawings rose by \$353 million, to \$659.1 million. We drew \$135 million of yen under the swap line with the Bank of Japan. Using current rates, if the full \$3.665 billion of debt could be repaid at those rates the System would stand to make a profit of on the order of \$75 million, which would more than erase the losses we took earlier this year in repaying indebtedness incurred in German marks.

Notes for F.O.M.C. Meeting  
November 20, 1978

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Alan R. Holmes

Before turning to recommendations, Mr. Chairman, it might be useful to supplement Scott's remarks with a few general observations about our relationships with our swap partners since November 1. As far as the Japanese are concerned, they are, of course, delighted to see us use the swap arrangement. Our intervention in New York has been on a fifty-fifty basis with the Bank of Japan, with the U.S. share split again 60 percent for the System and 40 percent for the Treasury. There may be a few details still to be worked out about the appropriate role of the U.S. and Japan in deciding on intervention in the New York market and about techniques for acquiring yen for repayment of our swap drawings. So far, however, the arrangements have been very satisfactory.

There is no basic change in our relationship with the Swiss and Germans. New York intervention in Swiss francs is still on a fifty-fifty basis between the Federal Reserve and the Swiss National Bank. There of course cannot be Treasury operation in Swiss francs until the Treasury has acquired a supply either through the sale of Swiss-franc bonds or SDRs. The Swiss National Bank has, with respect to our acquisition of Swiss francs to repay debt, expressed a preference for direct purchases of Swiss francs from them rather than in the market. Should the dollar continue strong against the franc, as in the past few days, I would anticipate no problem in using both methods.

As far as the Bundesbank is concerned, New York intervention in marks is still for U.S. account, 60 percent for the Federal Reserve and 40 percent for the Treasury. I should note that since November 8 the Treasury has run out of mark availability under their swap line and has been using the proceeds of IMF mark drawings for intervention. There has, however, been some difference of opinion with the Bundesbank about the size of our intervention and the exchange rates at which purchases and sales of dollars against marks take place. As a lending country, concerned about the impact of our swap drawings on their domestic liquidity, they have at times proved to be a more reluctant dragon than we.

→ Scott referred to their reluctance to give much support to the dollar/mark rate on our election date. Last Thursday, and again yesterday, they were fairly substantial sellers of dollars even though the dollar had shown only marginal improvement in the exchange markets. Scott and I have referred to their action last Thursday as too much too soon, and too open, the latter since it was widely commented on in the market. Some difference of opinion with the Germans is not to be wondered at, and has not as yet presented a major problem, although it has required consultation on various levels.

Needless to say, the importance and magnitude of our activity in the exchange market in support of the dollar and, over time, repayment of debt will require the closest continuous consultation with the Treasury and with our central banking partners. I am confident that our joint efforts will prove successful.

## Recommendations

As far as recommendations are concerned, taking the routine ones first, the System has four swap drawings on the Bundesbank maturing in December, totaling \$97.4 million equivalent. All of these represent first renewals and I recommend the Committee roll them over on maturity, if we have not acquired sufficient marks to pay them off. The System also had two drawings of \$30.6 million equivalent, maturing in December which would have represented third renewals. Both have already been paid off with marks purchased directly from the Bundesbank. The System, by the way, has only one swap drawing--totaling about \$26.5 million equivalent that was incurred prior to August 1978. This also should be repaid before maturity with marks acquired in the market or directly from the Bundesbank.

The System also has five swap drawings from the Swiss National Bank maturing totaling \$89 million equivalent, all of them first renewals. I recommend that the Committee roll these drawings over on maturity should we not be able to acquire sufficient Swiss francs to pay them off.

As Scott pointed out, we have outstanding indebtedness of \$2.9 billion in marks, \$668 million in Swiss francs and \$135 million in yen. We shall, of course, be alert to opportunities to acquire these currencies in the market or directly from the central bank involved. I would not advise, however, an aggressive approach to debt repayment at this time. The recovery in the dollar has been encouraging in the past few days, but is not yet fully established by any means. Any indication that the Federal Reserve was putting a cap on the

recovery of the dollar by acquiring currencies aggressively could be counter-productive in the longer run. Admittedly, we have some time to go before improvement in underlying conditions have a major impact on our trade and current account deficits and make an important contribution to a sustained recovery of the dollar. But we should remember that at the moment, the dollar is still not back even to where it was at the time of the IMF meetings in late September, when it was already generally considered to be undervalued.

In December, all of the System's basic swap agreements with foreign central banks and the BIS will be up for renewal, nine on December 4, one on December 20 and six on December 29. At its October meeting, the Committee agreed to minor changes in the German swap agreement suggested by the Bundesbank, subject to approval of final language by the Subcommittee on Foreign Exchange. We also agreed to discuss parallel changes with our other swap partners. Given recent events, there has not been much time, as you can imagine, for such discussions. I would, therefore, recommend that the Committee approve renewal of the basic swap agreements either in the revised form approved at the October meeting or in the old form, on the understanding that we will strive for uniformity as soon as individual central bank arrangements can be worked out. Exact language changes would be subject to Subcommittee approval.

In its special meeting on October 30, the Committee authorized the Chairman to raise the limit on the System's open position to \$5 billion and to suspend the \$500 million limit between Committee meetings for changes in that position. In

the event, the System's open position increased by about \$2.5 billion from the October meeting to date, with the total open position amounting to about \$3.7 billion as of Friday, November 17. In view of continuing uncertainties and the need to provide maximum flexibility to operations, I would recommend that the overall limit in the open position be continued at \$5 billion and the change in the intermeeting limit continue in suspension. I understand, however, that no formal action by the Committee is needed today since the earlier action remains in effect until a new decision is made.

I have also recommended to the Subcommittee--and it has approved--that its daily and intermeeting limits on changes in our open position/<sup>remain</sup> in suspension. Hopefully, we will be able to reduce our open position in the coming month but we must be prepared to meet any contingency. We shall, of course, keep the Subcommittee and the full Committee informed of developments as they take place.

Finally, Mr. Chairman, the Treasury is in the process of arranging borrowings of marks and Swiss francs; <sup>members of</sup> their fact-finding team, including a representative of the Board and the Federal Reserve Bank of New York, are currently in Europe on their second mission. While borrowing plans are not definite, it is quite likely that such borrowing will take place before the year-end. Should this be the case, and the foreign currencies not be needed for intervention, the Treasury will have to find means of financing the holdings. The ESF has limited resources and is in a rather poor financial position. For the Treasury to hold the currencies in the Treasurer's

General Account would mean giving up a dollar cash flow from the borrowing operation, which might be hard to justify. One possibility, of course, would be for the Treasury to utilize the warehousing of currency arrangement that the Committee reaffirmed at its annual meeting in March. Under that arrangement, the System could acquire up to \$1.5 billion equivalent in foreign currencies from the Treasury, with the Treasury assuming all exchange risk, half for up to six months and half for a year. The Treasury is considering the matter at the moment and may take a formal approach to the Committee at some time. The Committee should be aware, however, that warehousing may become an active subject in the near future.

James L. Kichline  
November 21, 1978

FOMC Briefing

Incoming information suggests that economic activity this quarter is expanding at about the same rate as that reported for the third quarter. Growth of real GNP close to 3-1/2 per cent in the second half of this year would be roughly 1 percentage point less than in the first half. There seems to be sufficient momentum in the economy currently to carry over into the first quarter of the new year at around the current pace of expansion, but the prospects later on have weakened appreciably in light of developments during the past month.

For the short-run, economic indicators on balance have been quite good. Employment growth in October was surprisingly strong following small gains during the third quarter, and the unemployment rate declined .2 percentage point to 5.8 per cent. Increases in employment were widespread among manufacturing--which registered the largest gain in any month this year--construction, and service industries. The sizable increase in employment as well as earnings led to a considerable rise in personal income during October.

Industrial production registered a gain of 1/2 per cent in October, the same as the month earlier. A bit of that increase, however, reflected a make-up of output disrupted earlier by the rail strike. Moreover, a close reading of the available information on industrial output gives a hint of some further slowing of growth,

most notably in the business equipment area where expansion earlier in the year was exceptionally large.

In housing markets, financial conditions have tightened further, but starts in October remained at the upward revised pace of September--the seventh consecutive month of starts over a 2 million annual rate. Given the typical lags between tighter financial conditions and starts and expenditures, we have yet to see much impact of financial developments during the spring and summer. But we suspect the time has been reached where lower starts figures will soon appear.

On the weaker side, total retail sales in nominal terms are reported to have declined about 1/2 per cent in October. Unit auto sales picked up from the reduced pace in September when the new models were first introduced. But sales of other durable goods and nondurables both weakened, although these data are subject to substantial revision. Our forecast implies moderate growth of retail sales for the quarter as a whole and seems reasonable in light of income growth and reported consumer attitudes.

Recent information on price developments has been disappointing. Total producer finished goods prices rose .9 per cent in both September and October, with food price increases twice that amount. We are sure to be seeing rather poor consumer price indexes for the next few months given this and other information. Thus, the fixed weight deflator is now projected to rise about 7-1/4 per cent this quarter.

For the year ahead we have made considerable changes in the forecast. Growth of real GNP from the fourth quarter of 1978 to the fourth quarter of 1979 is projected to be 2 per cent, 1-1/4 percentage points less than a month ago. In light of weaker economic activity the unemployment rate is expected to be around 6-1/2 per cent late next year, about 1/2 percentage point higher than the previous forecast. Prices, however, are still expected to rise close to a 7-1/2 per cent annual rate.

There are three principal new elements incorporated in the forecast. First, financial conditions are assumed to be tighter; notably the Federal funds rate is assumed to stay around 9-3/4 per cent over the forecast period, compared with the peak rate of 9 per cent assumed for the Committee meeting in October. Second, new information has become available on business fixed investment that is not encouraging. Third, we incorporated expected impacts of the President's anti-inflation program.

The impact of tighter financial assumptions can be seen most readily in the housing market. The current forecast is for starts next year of 1.7 million, or 100,000 less than a month ago. We anticipate further tightening of price and nonprice mortgage terms, some retrenchment by builders facing 13 to 14 per cent construction loan rates and less readily available permanent financing, and reduced willingness and ability of consumers to purchase homes.

In the business fixed investment area growth of outlays in real terms is expected to total about 3-1/2 per cent in 1979, 1-1/2

percentage points less than last month. The McGraw Hill survey of spending plans--a fairly reliable indicator--reported anticipations of only a 2 per cent rise in real terms. Moreover, preliminary tabulations of capital appropriations figures show only a moderate rise in the third quarter following a steep decline in the second. In addition, the cost of capital has increased, general expectations of real growth next year appear to have deteriorated, and there is some talk of possible mandatory wage and price controls, none of which bode well for capital investment. However, the short-run indicators on equipment orders and construction contracts do not look bad and there seems to be enough work in the pipelines to provide some scaling up of business spending plans. Some upward revision of plans would be consistent with the present forecast.

Income growth has been lowered as a result of reductions made to outlays for residential construction, business fixed investment, and inventories. Personal consumption expenditures therefore have been reduced as well. The tighter financial conditions and drop in wealth as a result of the recent stock market performance also will tend to limit consumer outlays and have further tempered our thinking on the consumer sector.

One area where we have revised up the forecast is net exports. Weaker domestic economic activity should tend to reduce import growth and the deficit on merchandise trade has been reduced \$3 billion for 1979.

On the price side, we have assumed only limited success of the President's program in holding wage and price increases below what

would have occurred otherwise. Such success would seem likely to come in the form of strengthening the hand of businesses in holding down wage increases. Given other changes, such as reduced productivity gains because of weaker activity, there has been little change of the price forecast from the 7-1/2 per cent increase expected last month.

The weakness of the staff's forecast, especially in the latter half of 1979, raises the issue of whether the economy might tip over the edge into recession. A recession forecast given the available information does not seem to be the best bet, however. Conditions typically preceding recessions are not apparent now; for example inventories generally seem in good shape and businesses are watching inventory positions with a cautious eye. Moreover, the housing sector remains comparatively strong, and structural as well as behavioral changes over the past few years suggest reduced sensitivity to a given degree of financial restraint. Nevertheless, the cyclical expansion in our view is becoming increasingly fragile.

REPORT OF OPEN  
MARKET OPERATIONS

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

While foreign exchange developments commanded the spotlight during the past month, domestic monetary developments also came in for a few thrills and spills. Following the October 17 meeting of the Committee, the Account Management began aiming for a 9 percent Federal funds rate, the center of the new  $8 \frac{3}{4}$  -  $9 \frac{1}{4}$  percent range, and up from the  $8 \frac{3}{4}$  percent objective prevailing earlier in October. Funds trading moved above the objective, however, as shortages of securities in the market hampered Desk efforts to meet reserve needs. In the closing days of October, with the dollar deteriorating seriously in the foreign exchange markets, and a growing sense developing that major moves were afoot to deal with this situation, the Desk became increasingly tolerant of funds trading somewhat above 9 percent.

A complicating factor at that time was the upcoming, and then ongoing, quarterly Treasury refunding operation. Ordinarily, care is taken to avoid significant monetary policy moves in the midst of a Treasury financing operation, but the march of events seemed to permit no decent separation this time. With the Treasury's 3 1/2 year note auction approaching on October 31, the Desk allowed increasing firmness to show through in the money market, so that bidders could get a sense of impending higher rates. Funds traded around  $9 \frac{1}{4}$  -  $1 \frac{1}{2}$  percent that day. The dramatic announcements on the morning of November 1 were followed by an immediate rise in funds

trading to the area of  $9 \frac{7}{8}$  - 10 percent--already above the newly agreed  $9 \frac{1}{2}$  -  $\frac{3}{4}$  percent Committee range. In order not to blunt the impact of the dollar defense program, the Desk avoided aggressive action to push the funds rate down to the new range, and trading hovered above  $9 \frac{3}{4}$  percent for several days. Once market factors began releasing reserves in size, funds eased down within the  $9 \frac{1}{2}$  -  $\frac{3}{4}$  percent range, but again in deference to the dollar defense program the Desk acted to keep trading largely in the upper portion of that range.

Market participants now are somewhat uncertain as to the System's funds rate objective. Many were convinced just after the November 1 moves that the current goal was  $9 \frac{7}{8}$  percent, headed toward 10. Later, as lower rates emerged, some took a view that a wider band of perhaps  $9 \frac{5}{8}$  -  $\frac{7}{8}$  percent was being fostered, while others have focussed on  $9 \frac{5}{8}$  -  $\frac{3}{4}$  percent as the presumed objective.

Behavior of the aggregates took a back seat during the period, as estimated growth rates consistently fell within specified bounds. Projected growth of  $M_1$  for October-November remained below the  $6 \frac{1}{2}$  percent upper limit indicated by the Committee.  $M_2$  growth at first appeared to be fairly high in its indicated  $5 \frac{1}{2}$  -  $9 \frac{1}{2}$  percent range, but later readings suggested growth close to the middle of the range.

Desk operations during the period featured an unusually heavy volume of outright sales of Treasury bills to foreign accounts. Net outright sales of bills over the period came to about  $\$3 \frac{1}{2}$

billion. These sales absorbed reserves released by the big drop in Treasury balances in early November, and also met foreign account demands for bills which otherwise would have been pressed on a thinly supplied bill market. Reserves were also absorbed (and market supplies of bills increased) by the run-off of \$550 million of maturing bills. At one point in the period, the Desk had used about \$4.3 billion of the temporarily enlarged \$5 billion leeway to reduce outright holdings of Treasury and agency securities between meetings of the Committee. Toward the end of the period, the Desk bought \$1,037 million of coupon issues to help meet reserve needs that emerged on November 16 when the reserve requirement increase took effect. For the whole period, outright holdings of securities were down \$3.1 billion.

On two occasions, the Treasury modified its cash management procedures to aid the Desk in meeting reserve objectives. In late October the Treasury made redeposits to its accounts in commercial banks to supplement the System's limited ability to arrange repurchase agreements. Again in mid-November the Treasury took steps to place funds in its new interest-bearing note accounts, at the Desk's request, to help meet large anticipated reserve needs.

The markets were buffeted by diverse influences during the past month. Early in the period, rates pressed higher across a broad front, responding to continuing evidence of inflation, gradual firming of System policy and serious deterioration of the dollar. The announcement of vigorous dollar defense measures on November 1 caused

the yield curve to pivot. Most short-term yields, out to about a year or two, rose sharply in response to the 1 percent rise in the discount rate and other evidence that the authorities were determined to pursue a more restrictive course. At the same time, intermediate and longer term yields fell--based on the view that effective action to deal with the dollar problem and inflation was finally being taken, which would be expected in time to produce lower rate levels. Subsequently, yields backed and filled as market participants continued to appraise the expected efficacy of the program and sought to assess the immediate outlook for System policy objectives.

As noted, the November 1 announcement came right in the middle of the Treasury's refunding auctions. The first auction, on October 31, saw a 3 1/2 year note sold at 9.36 percent--about 50 - 60 basis points higher than expected when the Treasury announced its refunding package. A large part of the issue went to non-competitive bidders, leaving little for professional participants. Against that background, the issue went to a large premium when the new program was announced the next morning. To allow the market time to digest news on November 1, the 10- and 30-year auctions were each postponed a day, to November 2 and 3. Perhaps because the market was reacting to its over-exuberance on November 1, bidding for the 10-year note on the 2nd was quite meager, and many dealers won securities for which they were putting in only underwriting bids. The average yield was 8.85 percent with some awards as high as 8.90 percent. The notes traded around issue price for some days

after the auction, but finally moved to a premium by mid-November. The 30-year bond auction, encountered widespread bidding interest, selling at an average yield of 8.86 percent and quickly moving to a premium in secondary market trading. By yesterday, the 3 1/2 year note was bid to yield 8.81 percent, the ten year was at 8.71 percent, and the 30-year at 8.69 percent.

For the whole period, yield increases on Treasury issues were as much as 90 basis points in the 1- to 2-year area, but only 15 - 25 basis points at 5 years and yields were virtually unchanged at the long end.

As for the Treasury bills, longer maturities were up as much as 65 basis points over the period. Three-month bills rose sharply through about the first week of November, but then fell as widespread demand--including Desk purchases for foreign accounts--pressed on limited supplies. Most recently, three month rates moved up again as the Desk was in a position to execute foreign sell orders in the market, while the Treasury changed its weekly mix to sell more three-month and fewer six-month bills than formerly. Yesterday, three- and six-month bills were auctioned at 8.70 and 9.00 percent, compared with 8.21 and 8.56 percent the day before the last meeting.

Treasury cash needs should not be great over the period to mid-December. Balances have been bolstered by special issues arising in connection with swap drawings. A moderate-sized sale of cash management bills is possible in early December. A two-year note is being sold today, raising no new money in the domestic

market--although there are some foreign official add-ons. It is also possible that the Treasury will sell one or more foreign currency denominated issues in December.