

## APPENDIX

Notes for FOMC Meeting  
March 20, 1979

Scott E. Pardee

In the six-week period since the last FOMC meeting on February 6, the dollar has held its own in the exchange markets for European currencies and even strengthened some 4 percent against the Japanese yen. As before, this has not reflected a sense that the United States has been doing better in reducing inflation at home or cutting into its massive trade and current account deficits. If anything, the numbers which have emerged continue to confirm the market's generally pessimistic appraisal of fundamentals. For the moment, at least, the market is prepared to take bad news in its stride.

There are many reasons for this respite in selling pressure, but I will cite three. First, exchange market participants around the world are impressed with the speed and forcefulness with which central banks are prepared to intervene. The current cliché among traders is that if the dollar goes down, the Fed steps in and if the dollar goes up, the Bundesbank steps in. The Swiss and Japanese central banks have also been quick to intervene in size on both sides of the market. The French, British, and Italian central banks have also operated on a big scale in a day-to-day effort to avoid sharp movements in their rates against either the dollar or the mark. The European Monetary System of course has been launched, also with the presumption of a fairly firm intervention approach. Dealers remain extremely nervous over a variety of concerns but large volumes are going through in good two-way trading. In this environment, the dollar has been much more resilient to shocks.

A second factor has been the market's perception of U. S. policy. Market participants still express considerable skepticism about the potential effectiveness of the broader anti-inflation program. But most would by now admit that the November 1 package, and the follow-through since then, generally has helped re-establish the credibility of the U. S. authorities in the marketplace. The fact that interest rates have not been allowed to ease in the face of the extended period of weak aggregates has impressed many dealers. In effect, the November 1 package and the current stance of monetary policy restraint are seen to have bought some time--now measured in weeks and months rather than days--but the market is still waiting for clear improvement in the fundamentals.

Third, adverse events abroad have on balance helped the dollar. In particular, nearly all major countries have reported monthly jumps of 1 percent or more in wholesale or retail prices--even the Swiss, Germans, and Japanese. Such poor results are not expected to persist in all countries, but dealers recall the generalized inflation that broke out in 1973-74, when oil and other commodity price increases contributed to worldwide inflation. This is not especially to our credit, but in contrast with 1978, the United States is no longer the only country in which inflationary pressures have been accelerating.

The conjunction of these various factors has led to a substantial reflow of funds, through unwinding of leads and lags, covering of speculative positions, and running off of deposits entered into when portfolio diversification against the dollar was at a fever pitch. Not all of this is seen in the market since it often shows up as an absence of dollar sales rather than actual purchases of foreign currency, but it is there. Here again, the interest rate differential has had an important bearing. If the dollar is steady or rising, the rolling over of short dollar positions on a day-to-day basis, as in the Euro-dollar market, becomes increasingly expensive. And we have heard of many time deposits or CDs in Euro-marks, Swiss francs, and yen, which were not renewed at maturity, since the investor felt he was giving away too much interest as against returning to dollars. Some portfolio diversification by central banks has been reversed. Not all of the flow has been into dollars. Big amounts have gone into sterling, where interest rates are even higher.

The reflux into dollars has given us an opportunity to repay swap debt. In marks, on a net basis, we repaid a further \$182 million equivalent, reducing the swap debt to \$3.3 billion. During the period we completed repayment of the remaining \$335 million of drawings in Swiss francs. We even accelerated our schedule for liquidating 1971 debt, and repaid \$109 million. If market conditions continue as they have, by the next FOMC meeting the Federal Reserve will be free of all debt in Swiss francs for the first time since 1970. The yen has weakened quite sharply, and the Bank of Japan has stepped up the volume of its dollar sales to support its currency. We have joined in some of these operations to a limited extent in New York and have bought \$170 million of yen, raising balances to about \$180 million.

[If] the United States does not show some improvement in its inflation performance soon, we will surely need those balances, and more, since pessimism [regarding] the longer-term prospects for the dollar remains widespread.

REPORT ON OPEN  
MARKET OPERATIONS

Mr. Sternlight made the following statement:

Throughout the period since the February 6 meeting, the Account Management continued to seek reserve conditions consistent with a Federal funds rate of 10 percent or slightly higher. Initially, the projected growth rates of  $M_1$  and  $M_2$  were within the tolerance ranges set by the Committee, but the estimates were revised progressively lower as new data came along and by the beginning of March it appeared that growth would be well below the selected range for  $M_1$  and slightly below for  $M_2$ . In a telephone meeting on March 2, the Desk was instructed to maintain an unchanged approach to the funds rate, in view of mixed evidence on the economy--including indications that the weakness in the aggregates might reflect changing preferences as to how liquidity is held. Subsequent data on the aggregates tended to confirm the picture about as projected at the beginning of March--with a resumption of growth in March leaving  $M_1$  growth quite weak for the two months, while  $M_2$  growth was seen as turning out a bit weaker than anticipated as the month began.

Desk operations were complicated during the period by exceptionally volatile and hard-to-predict levels of Federal Reserve float. Partly because of bad weather, check transportation was impeded and float soared to record high weekly average levels of around \$11 1/2 to \$12 billion in the latter half of February. On a couple of occasions, the unexpectedly high levels of float

caused the Desk to absorb reserves on such a large scale that System holdings of securities were insufficient to collateralize all the Federal Reserve currency considered as outstanding; thus steps were taken to return certain inventories of cash in Federal Reserve Banks to the custody of Federal Reserve agents so that the collateral requirement could be eased temporarily.

When float levels receded, this too was more abrupt than had been expected and this contributed to some temporary shortages of reserves in early March--and even to a brief flurry of speculation among market participants that the System was edging toward a firmer monetary policy. Subsequent aggressive action to provide reserves has subdued that speculation, although the funds rate remained higher than desired all of last week. For the whole period the funds rate averaged about 10.09 percent, slightly lower than in the previous intermeeting period which included some elevated rates around year-end.

Given the volatility of market factors affecting reserves, more than usual reliance was placed on adding or absorbing reserves on a temporary basis. Outright operations included purchases of \$700 million of Treasury coupon issues early in the period, sales of about \$450 million of Treasury bills to foreign accounts about midway through the period, and then purchases of about \$2 billion of bills, nearly all from foreign accounts, in the latter part of the period. Much of this foreign supply of bills reflected sales by Japan as it spent dollars to support the yen. The timing of those heavy sales meshed neatly with our need to provide reserves

as float contracted.

Most market yields moved somewhat higher on balance during the period. In the case of Treasury coupon issues, increases early in the interval were partly offset by subsequent declines. The increases were spurred by concern over inflation and a view that economic activity was holding strong for longer than expected. Disturbing international news from the mid-east and far east was also a negative factor. There was some partial price recovery later, amid better international news, mixed economic signals, and continued weak aggregates--but there was little investor enthusiasm to commit funds. An underlying market view seems to be that, primarily because of inflation, any near-term change in monetary policy is likely to be to the firmer side. This is probably why market analysts were so ready to jump to a wrong conclusion about a firming move being under way about ten days ago, when primarily technical factors pushed the funds rate higher for a time.

The net increase in rates for 1 - 5 year Treasury issues was about 25 - 40 basis points while for longer issues yields were up a more modest 10 - 20 basis points. Bill rates rose about 10 - 30 basis points over the period even though other short rates such as CDs and commercial paper changed little. Desk sales of bills for foreign accounts added to supplies, as did a Treasury sale of cash management bills. In yesterday's auction, 3- and 6-month bills sold at average rates of 9.50 and 9.48 percent, up from 9.19 and 9.31 percent the day before the last meeting.

The Treasury will have large cash needs in early April, and assuming that the Congress acts on the debt ceiling, the Treasury is likely to borrow perhaps \$1 1/2 billion in 15-year bonds and a very substantial amount through April and June cash management bills. A two-year note auction is scheduled for tomorrow, but this might very well be postponed because of the uncertainty about timely action on the debt ceiling before month-end.

James L. Kichline  
March 20, 1979

FOMC BRIEFING

Some observers of unfolding economic and financial developments interpret the current and near-term outlook as boomy, with perhaps a speculative bubble in process of developing. Whether or not such an interpretation of the current and prospective situation is appropriate represents a key issue at the present time. In the staff's judgment, economic activity has moderated this quarter and will continue to slow, and the boom scenario appears a very unlikely outcome. Even so, near-term inflation prospects are dismal and the Administration's wage-price restraint program is in a great deal of difficulty.

There still appears to be appreciable strength in the economy judging from the labor market situation. Nonfarm employment rose an average 1/4 million per month in January and February; although this was nearly 1/5 less than the average monthly increases in 1978, those gains were especially large. Employment gains last month were particularly notable in the durable manufacturing and trade sectors while construction and State and local sectors evidenced weakness. The unemployment rate was unchanged in February at 5-3/4 per cent.

The general strength of labor markets was not reflected in a large increase in production. Industrial production rose only 0.3 per cent in February and was unchanged in January. To some extent adverse weather acted to depress output in both months, but other forces were at work as well. Coal output declined in both months, partly related to weak demands, and auto assemblies were down in association with attempts to curtail rising inventories of certain models.

Retail sales in the aggregate continued to rise slightly over the past two months following sizable increases late in 1978. Auto sales in



particular have been running above an 11 million unit annual rate, somewhat faster than in the second half of 1978. The recent pick-up in auto sales has been in smaller, fuel-efficient cars which probably has been prompted by concerns over the price and future availability of gasoline. Other consumer sales have been expanding at a slower pace than we had anticipated earlier and we have reduced growth of personal consumption expenditures forecasted for the current quarter.

Residential construction outlays and the estimate of net exports also have been lowered in our forecast for the current quarter. Housing starts dropped in January and fell further to a 1.4 million unit annual rate in February. Even after allowing for a weather-related bounceback in March it now appears that residential construction outlays still will fall short of the Greenbook forecast for this quarter. For net exports, the trade figures in January were weaker than expected and technical data revisions as well have led us to reduce appreciably net exports for this quarter. In contrast to these downward revisions, business outlays for both inventories and fixed investment were raised in response to incoming data. On balance the staff's forecast indicates real GNP growth of 3 per cent annual rate this quarter, 1 percentage point less than our previous forecast.

Some of the concern over the possibility of an emerging boom emanates from a reading of business investment performance. Inventories, for example, rose markedly in January which could be interpreted as signaling a change in the generally conservative posture of businesses in this expansion. But it seems more likely that businesses desired to build stocks after a drawdown late last year because of strong sales. Moreover, the book value figures tend to overstate physical accumulation given rapid price increases, and adverse weather may have reduced shipments thereby adding temporarily to

inventories. In addition, materials continue to be in good balance relative to in-process and finished goods, which does not suggest increased hoarding for price or availability reasons. Our forecast assumes inventory accumulation will not be adding to economic growth after this quarter.

Business fixed investment outlays also appear fairly strong in the near term. New orders figures for January were up sharply and even little further growth over the balance of the quarter would place the average well above that of the fourth quarter. These orders along with qualitative reports of continuing strength in machinery and equipment industries have led us to raise our sights a bit on investment outlays this year. However, other evidence continues to temper our expectations, including survey data suggesting outlays for 1979 as a whole significantly less than last year, the downturn in construction contracts for the past three months, and the appropriations data which fail to suggest an acceleration of spending. Moreover, assuming our general outlook is correct, in coming months business tendencies to scale up investment programs should be inhibited by slower growth of sales and reduced pressures on capacity.

A major source of near-term slackening of over-all activity is the housing sector for which we have further reduced the forecast for this year. The recent Regulation Q change on money market certificates is assumed to reduce housing starts by about 50,000 at an annual rate. The evidence of a slowing in housing--perhaps larger than in our forecast--is beginning to pile up; new home sales have been declining for several months, building permits are running low, and mortgage commitments outstanding are turning down.

The net result of our revisions to construction, business investment, and other expenditures has been to reduce the forecast of real growth this year to about 1-3/4 per cent measured from fourth quarter to fourth quarter. In part the somewhat slower real growth now projected for 1979 is a fallout of the poorer price outlook, especially as higher prices impact

adversely on consumer real incomes and spending. Both producer and consumer price indexes have risen sharply this year. Although a great deal of the runup was in food and energy prices, an acceleration of other price rises was disturbingly widespread. To some extent it seems that producers may have been pushing through price increases over concerns of mandatory controls or perhaps other changes in the anti-inflation program. But much more has been occurring on prices than that alone. In reassessing the inflation outlook we have raised further expected food price increases during 1979--to 10-1/2 per cent. In addition we have incorporated higher OPEC oil price increases, now assumed to total 23 per cent this year instead of the previously scheduled 14-1/2 per cent. Taking these and other changes into account the gross business product deflator this year is projected to rise 8-3/4 per cent, showing no improvement in inflation from last year's experience.

It is clear that the general economic situation has deteriorated in recent weeks and is surrounded by increased uncertainty. It will take some time to obtain a good reading on the actual resolution of the unsettled oil price and availability situation and in the meantime the Administration may come forth with additional actions in the inflation and energy areas. Altogether events over the past several weeks seem to have reduced the chances of achieving sustained moderate economic growth along with a gradual unwinding of inflation.

Notes for FOMC Meeting

March 20, 1979

Alan R. Holmes

With yen and current Swiss franc debt paid off, my recommendations can be quiet brief. Incidentally, given the size of Swiss capital exports and their willingness to share the Swiss franc counterpart of them, I share Scott's expectation that the System and the Treasury can be out of our pre-August debt shortly, perhaps by the end of the month.

Through the 27<sup>th</sup> of April, the System has only four Deutsche mark swap drawings maturing, totaling \$189 million. These are all first renewals and we would plan to roll them on maturity. While the immediate schedule of maturities is light it becomes quite heavy in May, reflecting out stepped up intervention in marks after November 1. In fact, about half of our outstanding swap debt of roughly \$3.14 billion of DM Swap debt matures in May, \$1.6 billion of which will represent second renewals. In order to get a head start on this schedule we have already begun and will intensify discussions with Germans, exploring ways of speeding up direct acquisition of DM from the Bundesbank, and, to the extent we can do so without upsetting the recent stability of the dollar, to step up market acquisitions. Second renewals, as you may recall, require Federal Reserve-Bundesbank agreement and I believe it would be desirable to avoid that necessity if it is at all possible.

We had hoped to distribute to the Committee a memorandum or memoranda on the subject of eventual System acquisition of foreign currencies. It has not been possible to do so, but we expect to have papers from the Desk and the Board Staff available to the Committee before the April meeting. Meanwhile, the informal \$500 million dollar equivalent limit discussed at the last Committee meeting appears adequate.