



FEDERAL RESERVE

press release

For Use at 4:00 p.m.

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The Board of Governors of the Federal Reserve System and the Federal Open Market Committee today released the attached record of policy actions taken by the Federal Open Market Committee at its meeting on May 16, 1978.

Such records for each meeting of the Committee are made available a few days after the next regularly scheduled meeting and are published in the Federal Reserve Bulletin and the Board's Annual Report. The summary descriptions of economic and financial conditions they contain are based solely on the information that was available to the Committee at the time of the meeting.

Attachment

RECORD OF POLICY ACTIONS  
OF THE FEDERAL OPEN MARKET COMMITTEE

Meeting held on May 16, 1978

1. Domestic policy directive

The information reviewed at this meeting suggested that real output of goods and services was growing at a rapid rate in the current quarter, after having declined somewhat in the first quarter when activity was adversely affected by the unusually severe weather and the lengthy strike in coal mining. The rise in the fixed-weighted price index for gross domestic business product--which had stepped up in the first quarter to an annual rate of 6.6 per cent from 5.4 per cent in the fourth quarter of 1977--appeared to be still faster in the current quarter.

Staff projections continued to suggest that output would grow at a moderate pace over the year ahead, although the projected rate of growth was slightly less than that of a month earlier. It was expected that real consumption expenditures and business fixed investment would expand at moderate rates but that residential construction would decline throughout the period. The projections also suggested that the rate of increase in prices over the year ahead would be significantly below the rate in the current quarter but would remain somewhat above that in the first quarter. It was also anticipated, as it had been 4 weeks earlier, that the unemployment rate would decline gradually over the period.

In April the index of industrial production increased about 1 per cent to a level about 2-1/4 per cent above that in November, before activity was adversely affected by the weather and the coal strike. A significant part of the April increase in the index was attributable to recovery in output of coal and steel from reduced levels, but assemblies of autos rose further to an advanced level, in response to rising sales of domestic models, and production of business equipment continued to expand.

Nonfarm payroll employment continued to rise at a rapid pace in April, even after allowance for the return to work of large numbers of coal miners, and gains again were widespread among industry groups. The unemployment rate declined 0.2 of a percentage point to 6.0 per cent.

Total retail sales expanded substantially further in April to a level 3-3/4 per cent above the monthly average for the first quarter. Unit sales of new automobiles, already at an advanced rate in March, edged up further in April.

The index of average hourly earnings for private nonfarm production workers rose at an annual rate of about 9-1/2 per cent in April, little changed from the rapid rate of advance during the first quarter. The wholesale price index for

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all commodities continued its rapid rise in April, reflecting chiefly further large increases in prices of farm products and foods. In March the consumer price index for all urban consumers had continued to advance at a considerably faster pace than in the second half of 1977, owing not only to additional large increases in foods but also to sizable increases in the apparel and housing components.

In foreign exchange markets the trade-weighted value of the dollar rose about 1-3/4 per cent over the inter-meeting period, recovering to the level that had prevailed at the start of the year. While appreciating against all major currencies except the Canadian dollar, the dollar advanced most against the Swiss franc and the German mark.

The U.S. foreign trade deficit declined considerably in March, but because it had been at a record level in February, the deficit in the first quarter as a whole was greater than the large deficit incurred in the final quarter of 1977. In the first quarter the value of exports recovered from a fourth-quarter level that had been somewhat depressed by the dock strike. However, the value of imports expanded substantially, despite a decline in imports of petroleum.

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The rate of expansion in total bank credit accelerated sharply in April, reflecting an unusually large increase in security loans and sizable additions to bank holdings of both U.S. Government and other securities. Business and real estate loans grew at about the same pace as in March. Outstanding commercial paper of nonfinancial businesses rose substantially in April, although by much less than in March. The sum of business loans (net of bankers acceptances) and nonfinancial commercial paper grew at an annual rate of nearly 25 per cent, compared with about 28 per cent in March.

The narrowly defined money supply (M-1), which had grown at an annual rate of 5 per cent in the first quarter on a quarterly-average basis, expanded at a rate of 19 per cent in April. The renewed strength in economic activity increased the demand for money, but the high rate of monetary growth in April was also influenced by the public's mobilization of cash for unusually large payments of Federal income taxes not withheld and by relatively slow processing of tax returns. The latest weekly data suggested that growth of M-1 would slow substantially in May.

Growth in M-2 and M-3 also accelerated in April but by much less than growth in M-1 because inflows of the interest-bearing deposits included in the broader aggregates remained slow. Thus, M-2 and M-3 grew in April at annual rates of about 11-1/4 and 10 per cent, respectively, compared with about 6-1/2 and 7-1/2 per cent in the first quarter.

At its meeting on April 18 the Committee had decided that during the April-May period growth in M-1 and M-2 within ranges of 4 to 8-1/2 and 5-1/2 to 9-1/2 per cent, respectively, would be appropriate, and it had judged that these growth rates were likely to be associated with a weekly-average Federal funds rate slightly above the level of 6-3/4 per cent prevailing at that time. The Committee had agreed that if growth rates in the aggregates over the 2-month period appeared to be deviating significantly from the midpoints of the indicated ranges, the operational objective for the weekly-average Federal funds rate should be modified in an orderly fashion within a range of 6-3/4 to 7-1/2 per cent. It was also agreed, however, that an increase in the rate above 7-1/4 per cent would not be sought until the Committee had had an opportunity for further consultation.

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In accordance with the Committee's decision, the Manager of the System Open Market Account began immediately after the April meeting to seek bank reserve conditions consistent with a firming of the Federal funds rate to around 7 per cent. As the inter-meeting period progressed, data becoming available suggested that over the April-May period M-1 would grow at a rate close to or above the upper limit of the range specified by the Committee and that M-2 would grow at a rate in the upper part of the range specified for that aggregate. Therefore, the Manager sought conditions consistent with a Federal funds rate of 7-1/4 per cent, and the rate rose to about that level in the statement week ending May 3.

In early May estimates indicated that M-1 had grown at a very rapid pace in April, and staff projections suggested that for the April-May period, growth in M-1 would be well above the upper limit of its range and growth in M-2 at about its upper limit. On May 5 the Committee voted to direct the Manager, until further instructed, to seek to maintain the weekly-average Federal funds rate at about 7-1/4 per cent, with any deviations tending to be in the direction of higher rather than lower funds rates. At the time of this meeting the funds rate was in the area of 7-1/4 to 7-3/8 per cent.

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The rise in the Federal funds rate was accompanied by upward pressures on interest rates in general. Increases in short-term market rates ranged from about 20 to 45 basis points and those in longer-term rates from about 10 to 35 basis points. In early May commercial banks raised the rate on loans to prime business borrowers from 8 to 8-1/4 per cent.

On May 11 the Board of Governors announced its approval of actions by directors of all 12 Federal Reserve Banks raising the discount rate from 6-1/2 to 7 per cent. In announcing the approval, the Board stated that the action had been taken in recognition of increases that had already occurred in other short-term interest rates and that it would bring the discount rate into closer alignment with short-term rates generally.

Mortgage lending in April apparently was at about the pace of the first quarter, which was below the peak reached in the fourth quarter of 1977. In March, the latest month for which data were available, mortgage commitments outstanding at savings and loan associations continued to decline, as new commitments remained near the reduced rate in February and takedowns of outstanding commitments picked up. During the inter-meeting

period, there was a further rise both in average interest rates on new commitments for conventional home loans at those associations and in yields in the secondary markets for mortgages.

In the Committee's discussion of the economic situation and outlook, the members generally agreed that real output of goods and services was growing rapidly in the current quarter, but they differed on the likely course of activity in succeeding quarters. Many members concurred with the staff's view that output would grow at a moderate pace over the year ahead, but some thought that the pace would be a little faster while others thought that it would be a little slower. A few members observed that the surge in the current quarter could generate forces that would sustain growth at a fairly rapid pace for a while but might then bring on a period of adjustment at some point in 1979. However, another member said he saw no evidence suggesting that such forces were likely to develop.

To some extent differences of opinion concerning developments in the period ahead reflected varying assessments of the likely behavior of consumers. A number of members anticipated relatively strong consumer demand. One observed that the demand for new domestic autos would be sustained at fairly

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high levels by various new features, including greater fuel efficiency. On the other hand, one member expressed the view that demands by consumers would be weakened in the second half of the year by their accumulation of debt.

It was stressed that consumer spending was particularly difficult to forecast because of uncertainty concerning consumers' responses to inflation. One member observed that, in contrast with other recent episodes of inflation in this country, consumers now appeared to be more inclined to buy in anticipation of price increases. A second member suggested that consumers might respond to the current inflation by expanding credit-financed expenditures for durable goods while economizing on expenditures for non-durable goods and services. Another member believed that inflation at the rates generally expected would have an adverse impact on confidence sooner or later, causing consumers and others to retrench.

Some differences of opinion were expressed concerning other sectors as well. Thus, one member thought that housing activity would be stronger over the year ahead than the staff projections suggested, but another believed that it would be

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weaker. The view was expressed that business fixed investment currently was gaining strength, but it was also observed that increases in interest rates might dampen such investment in 1979. With respect to business inventories, it was suggested that an excessive build-up could develop in the near future, setting the stage for a subsequent correction.

Committee members were deeply concerned about the recent acceleration of inflation and about prospects for prices. Several expressed the view that the rise was likely to be more rapid than projected by the staff. Thus, it was suggested that the supply-related increase in prices of foods over the remainder of 1978 would exceed the staff projection and that the effect on the over-all price level this year would influence the outcome of labor contract negotiations in 1979. It was also suggested that pressures had begun to develop on labor resources, particularly skilled labor, and on some types of capacity. A few members observed that in these circumstances it would be desirable for growth in real output to diminish in the second half of this year toward a rate that could be sustained for the longer term.

At its meeting in April the Committee had agreed that from the first quarter of 1978 to the first quarter of 1979 average rates of growth in the monetary aggregates within the following ranges appeared to be consistent with broad economic aims: M-1, 4 to 6-1/2 per cent, M-2, 6-1/2 to 9 per cent; and M-3, 7-1/2 to 10 per cent. The associated range for the rate of growth in commercial bank credit was 7-1/2 to 10-1/2 per cent. It had also been agreed that the longer-run ranges, as well as the particular aggregates for which such ranges were specified, would be subject to review and modification at subsequent meetings.

Committee members differed somewhat in their judgments concerning the course of policy for the period immediately ahead, in part because of varying views about the current and prospective economic situation and in part because of differing judgments about the appropriate response to the surge of M-1 in April. The differences essentially concerned the degree of any further firming of money market conditions that might be pursued during the next few weeks. No member advocated an easing of money market conditions.

Several reasons were advanced for pursuing a very cautious approach to any further firming at this time, including the fact that transitory influences had contributed to the April surge in M-1. It was observed that, despite the surge, the annual rate of growth of M-1, and also of M-2, over the 3, 6, and 12 months ending in April had been lower than growth over the four quarters of 1977. It was also noted that a significant degree of firming of money market conditions had been achieved since the April meeting of the Committee. Moreover, it was pointed out, the administration's new tax proposals--which had just been announced--were considerably less stimulative than the earlier ones, particularly as they affected the fourth quarter of 1978. It was suggested that further significant monetary firming at this time might risk provoking dislocations in financial markets that would contribute eventually to the onset of a downturn in economic activity. Finally, it was argued, a very cautious approach would give the Committee time to evaluate incoming evidence concerning both the underlying strength of economic activity and the consequences of the firming that had already been achieved.

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In support of a somewhat more restrictive posture, it was suggested that the relatively low rate of growth of M-1 in the first quarter of 1978 represented an aberration related to the temporary weakening in the pace of economic activity and that, abstracting from that aberration, the trend of monetary expansion had accelerated. Views were expressed to the effect that further significant firming of money market conditions in the coming period in order to moderate growth of the monetary aggregates would have a beneficial effect on public confidence, that partly for that reason, such firming would reduce the chances of a further build-up of inflationary forces; and that it would increase the chances of achieving a rate of growth in real output that could be sustained for the longer term. In this connection, it was suggested that at times in the past when high levels of resource use had been approached, lags in the application of monetary restraint had contributed to bringing on a downturn in economic activity and to increasing the depth and duration of the downturn. The comment was made that if further significant action were not taken in the present circumstances, current monetary policy might be found in retrospect to have been pro-cyclical.

With respect to operating specifications for the period ahead, most members preferred ranges of tolerance for the annual rate of growth in M-1 over the May-June period that more or less encompassed the Committee's longer-run range of 4 to 6-1/2 per cent; the preferences centered on 3 to 8 per cent. However, some members preferred to widen the range by reducing the lower limit, on the ground that, given the April surge, growth somewhat slower than 3 per cent could be tolerated for a time and should not form the basis for an easing of money market conditions. One member, believing that the upper limit of the 2-month range should not be above 6-1/2 per cent in view of the April surge, favored a range of 2-1/2 to 6-1/2 per cent. For M-2 most members advocated a range of 4 to 9 per cent, but there was some sentiment for ranges of both 5 to 9 and 4 to 8 per cent.

All of the members favored directing operations during the coming inter-meeting period initially toward a Federal funds rate slightly above the current rate, which was in the area of 7-1/4 to 7-3/8 per cent. Views differed somewhat with respect to the degree of leeway for operations during the inter-meeting period in the event that growth in the monetary aggregates appeared to be deviating significantly from the midpoints of the specified ranges. Most members favored a range for the weekly-

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average Federal funds rate extending from 7-1/4 to 7-3/4 per cent, but there was some sentiment for an upper limit of 8 per cent.

At the conclusion of the discussion the Committee decided that the ranges of tolerance for the annual rates of growth in M-1 and M-2 over the May-June period should be 3 to 8 and 4 to 9 per cent, respectively. It was understood that in assessing the behavior of these aggregates the Manager should continue to give approximately equal weight to the behavior of M-1 and M-2.

In the judgment of the Committee such growth rates were likely to be associated with a weekly-average Federal funds rate slightly above the current level of 7-1/4 to 7-3/8 per cent. The members agreed that if growth rates of the aggregates over the 2-month period appeared to be deviating significantly from the midpoints of the indicated ranges, the operational objective for the weekly-average Federal funds rate should be modified in an orderly fashion within a range of 7-1/4 to 7-3/4 per cent.

As is customary, it was understood that the Chairman might call upon the Committee to consider the need for supplementary instructions before the next scheduled meeting if significant inconsistencies appeared to be developing among the Committee's various objectives. The members also agreed that in the conduct of day-to-day operations, account should be taken of emerging financial market conditions.

The following domestic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests that real output of goods and services is growing at a rapid rate in the current quarter, after having declined somewhat in the first quarter when activity was adversely affected by the unusually severe weather and the lengthy strike in coal mining. In April retail sales, industrial production, and nonfarm payroll employment increased substantially further and the unemployment rate declined from 6.2 to 6.0 per cent. The pace of the rise in wholesale prices remained rapid, reflecting mainly further large increases in farm products and processed foods. The index of average hourly earnings continued to advance at about the fast pace that it had on the average during the first quarter.

The trade-weighted value of the dollar against major foreign currencies has risen over the past 4 weeks to the level prevailing at the beginning of the year. The trade deficit in the first quarter widened substantially from the already large deficit recorded in the final quarter of 1977.

M-1, which had grown moderately in the first quarter, rose sharply in April. Growth in M-2 and M-3 also stepped up but much less than growth in M-1, because inflows of the interest-bearing deposits included in these aggregates

remained slow. Market interest rates have increased in recent weeks. On May 11 an increase in Federal Reserve discount rates from 6-1/2 to 7 per cent was announced.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster bank reserve and other financial conditions that will resist inflationary pressures while encouraging continued moderate economic expansion and contributing to a sustainable pattern of international transactions.

At its meeting on April 18, 1978, the Committee agreed that growth of M-1, M-2, and M-3 within ranges of 4 to 6-1/2 per cent, 6-1/2 to 9 per cent, and 7-1/2 to 10 per cent, respectively, from the first quarter of 1978 to the first quarter of 1979 appears to be consistent with these objectives. The associated range for bank credit is 7-1/2 to 10-1/2 per cent. These ranges are subject to reconsideration at any time as conditions warrant.

The Committee seeks to encourage near-term rates of growth in M-1 and M-2 on a path believed to be reasonably consistent with the longer-run ranges for monetary aggregates cited in the preceding paragraph. Specifically, at present, the ranges of tolerance for the annual growth rates over the May-June period will be 3 to 8 per cent for M-1 and 4 to 9 per cent for M-2. In the judgment of the Committee such growth rates are likely to be associated with a weekly-average Federal funds rate slightly above the current level. If, giving approximately equal weight to M-1 and M-2, it appears that growth rates over the 2-month period will deviate significantly from the mid-points of the indicated ranges, the operational objective for the Federal funds rate shall be modified in an orderly fashion within a range of 7-1/4 to 7-3/4 per cent. In the conduct of day-to-day operations, account shall be taken of emerging financial market conditions.

If it appears during the period before the next meeting that the operating constraints specified above are proving to be significantly inconsistent, the Manager is promptly to notify the Chairman who will then decide whether the situation calls for supplementary instructions from the Committee.

Votes for this action: Messrs. Miller, Volcker, Baughman, Coldwell, Eastburn, Gardner, Jackson, Partee, Wallich, and Winn. Vote against this action: Mr. Willes.

Mr. Willes dissented from this action because he favored more vigorous measures to reduce the rate of monetary growth, given the acceleration of the rate of inflation and its adverse effect on consumer and business confidence and spending plans. Specifically, he preferred a range of 2-1/2 to 6-1/2 per cent for the annual rate of growth in M-1 over the May-June period and an inter-meeting range of 7-1/4 to 8 per cent for the Federal funds rate.

Subsequent to the meeting, on June 15, revised projections based on newly available data suggested that M-1 would grow in the May-June period at an annual rate of about 7-1/2 per cent, near the upper limit of the range of tolerance of 3 to 8 per cent specified in the Committee's directive. M-2 also was projected to grow in the 2-month period at a 7-1/2 per cent annual rate, but this was well within the range of 4 to 9 per cent specified for that aggregate.

In general, the strength of the aggregates suggested a need for Committee consultation, looking toward further instruction to the Desk. In view of the proximity of the Committee meeting scheduled for June 20, Chairman Miller recommended that the Desk be instructed to continue aiming for a Federal funds rate of 7-1/2 per cent at this time.

On June 16, 1978, the Committee modified the domestic policy directive adopted at its meeting on May 16, 1978, to instruct the Desk to continue aiming for a weekly-average Federal funds rate of 7-1/2 per cent at this time.

Votes for this action: Messrs. Miller, Baughman, Coldwell, Eastburn, Gardner, Partee, Wallich, Willes, Winn, and Timlen. Votes against this action: None. Absent and not voting: Messrs. Volcker and Jackson. (Mr. Timlen voted as alternate for Mr. Volcker.)

2. Authorization for foreign currency operations

Paragraph 1D of the Committee's authorization for foreign currency operations authorizes the Federal Reserve Bank of New York, for the System Open Market Account, to maintain an over-all open position in all foreign currencies not to exceed \$1.0 billion, unless a larger position is expressly authorized by the Committee. On March 21, 1978, the Committee had authorized an open position of \$2.25 billion in view of the scale of recent and

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potential Federal Reserve operations in the foreign exchange markets undertaken pursuant to the Committee's foreign currency directive.

At this meeting the Committee voted to reduce the authorized open position to \$2 billion. This action was taken in view of the decrease in the open position that had occurred in recent weeks.

Votes for this action: Messrs. Miller, Volcker, Baughman, Coldwell, Eastburn, Gardner, Jackson, Partee, Wallich, Willes, and Winn. Votes against this action: None.