

Notes for FOMC Meeting
July 18, 1978
Scott E. Pardee

Since the last meeting of the FOMC, the dollar has come under several bouts of selling pressure in response to a variety of uncertainties. The underlying concerns, of course, remain the same. On the U.S. side, the market remains pessimistic about the outlook for our trade and current account deficits and about our inflation rate. Most market participants are willing to accept that, in contrast to a year ago, U.S. officials are now making sincere efforts to deal with inflation and to shore up the dollar in the exchanges. Nevertheless, considerable skepticism remains over how successful these efforts will be and it won't be erased until clear progress shows through in the numbers. That skepticism applies to other countries' efforts as well—on Japan's resolve to reduce its trade and current account surplus and on Germany's ability to generate more growth—and these considerations also tend to weigh adversely on market sentiment toward the dollar.

New indicators on economic fundamentals during the past month have been mixed, but the market's attention has been on other matters. First, the further sharp run-up in the Japanese yen eventually unsettled other markets, leading to broader selling pressure on the dollar by late June.

The focus of attention then shifted to the series of high level meetings, within the EEC in Bremen on July 6-7, and the Seven Nation Summit in Bonn this past weekend. Before the meetings, the newspapers and tickers were flooded with reports and commentary on the points of possible controversy. In this atmosphere market participants took little heart in what they heard, expecting that at best the meetings would lead to no meaningful policy changes and at worse they could be a fiasco.

For many dealers the safest bet was to be flat or moderately short of dollars. This added to the general softening of dollar rates. The Bremen meeting resulted in an agreement among the EEC heads of state to seek what they call a wider zone of monetary stability, within Europe. The scheme, which will still require intensive negotiation both of important conceptual points and of technical details at first envisages drawing the wayward currencies such as the pound sterling, the French franc, and the Italian lira back into a closer relationship with the current snake. At a later stage, a new parity system would be developed, around central rates based on a basket of currencies called the Foreign Unit of Account, the FCU. A pooling of gold and exchange reserves, of 20 percent of each member's current holdings of each is also envisaged. The announcement set a target of early December for completion of the plan, for introduction next year. Along with some shifting of relative values of some of the EEC currencies—the French franc in particular strengthened—the immediate reaction in the market was to sell dollars, on the view that the agreement was in some way anti-dollar. To some degree this is true, but the implications are mixed and only time will tell whether final agreement can be reached on the particulars and then whether the agreement will stick. In any event, as traders had second thoughts, the dollar began to firm early last week as the Bonn Summit approached. The results of the Summit were not very specific but that the U.S. promised to act by year-end to reduce oil imports and promised to act by the end of August on growth.

So far the market reaction has been positive for the dollar, which has firmed somewhat further. On balance, however, the dollar is lower than it was at the time of the last FOMC, by about 1 percent against the mark and 4 percent against the yen.

The market may now settle down to focus on more normal considerations. This includes, I'm afraid, the course of monetary policy and interest rates in the United States. In that

connection, many market participants and some central banks ascribed the dollar's decline in early July in part to the reaction to the split vote of the Board of Governors on the quarter-point discount rate increase on June 30. I might add, however, that I believe that the sizable interest arbitrage differentials in favor of the dollar have been a major reason for our not having to intervene very much over this past month.

In all, we intervened on three occasions in marks, for \$91.7 million, of which, under the 60-40 split, \$55 million was for the System. These were all out of balances on hand. We also sold _____ of Swiss francs, at times when the rise of that currency was unsettling the markets generally, of which half was for the account of the Swiss National Bank, as their agent, and half for System account, financed by drawings under the swap line. As you recall, we conducted similar modest operations in Swiss francs early this year, based on swap drawings which were subsequently repaid at a profit.

On repayments of mark indebtedness, the Desk acquired a total of \$491 million of marks from the Bundesbank in connection with capital export conversions and German government payments to the United States, from other correspondents, and a small amount in the market. In view of the dollar's weakness over recent weeks, we have not been aggressive in trying to buy marks in the market but with the positive reaction to the Bonn Summit, we have resumed our program of overnight orders. In all, we repaid a further \$219.4 million of swap drawings for the System, reducing the total to \$824.3 million, or some 45 percent of the \$1,844 million peak. Similarly, we repaid \$150.7 million of the Treasury's swap drawings, reducing that total to \$315.7 million. On the 60-40 basis, when the Treasury swaps are completely liquidated, the System will still owe \$350 million. In any event, while we continue to make progress, the System's loss continues to creep up, now to \$22 million on a realized basis.

Recommendations

In August, we have coming up for maturity 10 swap drawings in the amount of \$315.2 million equivalent of German marks. All will be for second renewal, which is agreeable to the Bundesbank. I recommend that we renew them.

James L. Kichline
July 18, 1978

FOMC CHART SHOW -- INTRODUCTION

In our briefings this morning we will be referring to the package of chart materials distributed to you. The first chart indicates the principal assumptions which underlie the staff's economic and financial forecast--a forecast that has been extended two quarters to encompass all of 1979. For monetary policy, we have continued to assume interest rates at the low end of the ranges for Alternative B in the Bluebook--and these rates are only somewhat lower than those assumed a month ago. Growth rates of monetary aggregates believed consistent with the interest rates are also portrayed in Alternative B, with M-1 assumed to grow at an average 6-1/4 per cent rate, 1 percentage point more than was assumed last month. For fiscal policy, we have maintained the assumption of a \$19 billion income tax cut next year, two-thirds going to individuals and the remainder to businesses. The level of unified budget expenditures indicated for fiscal years 1978 and 1979 is a couple of billion dollars less than reported in the Administration's recent mid-year review; it seems likely to us that spending shortfalls and Congressional restraint on outlays will more than offset higher interest payments than forecasted in the budget documents. Finally, we have shifted the effective date of the assumed energy program from the fourth quarter to the beginning of 1979.

The next chart displays several key indicators of recent economic developments. Retail sales in June were about unchanged from their level in May and domestic auto sales also were little changed,

remaining around the exceptionally high pace of 10 million units annual rate. Industrial production last month increased only 0.3 per cent, half the pace of the preceding month. Total nonfarm employment too shows some signs of slower rates of increase than earlier this year, although employment gains generally remain surprisingly strong. The incoming information pointing to moderation of activity throughout the second quarter was anticipated in earlier staff forecasts, and thus we have maintained the estimate of real GNP growth of around 8-3/4 per cent annual rate in the second quarter.

Mr. Zeisel will continue the presentation with a discussion of the domestic nonfinancial situation and outlook.

CONFIDENTIAL (FR) CLASS II-FOMC

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

July 18, 1978

PRINCIPAL ASSUMPTIONS

MONETARY POLICY

- Interest rates at the low end of the ranges for Alternative B in the Bluebook
- Growth of monetary aggregates consistent with Alternative B in the Bluebook

FISCAL POLICY

- Tax cut of \$19 billion beginning 1979
- Unified budget expenditures of \$450 billion in FY 1978 and \$495 billion in FY 1979

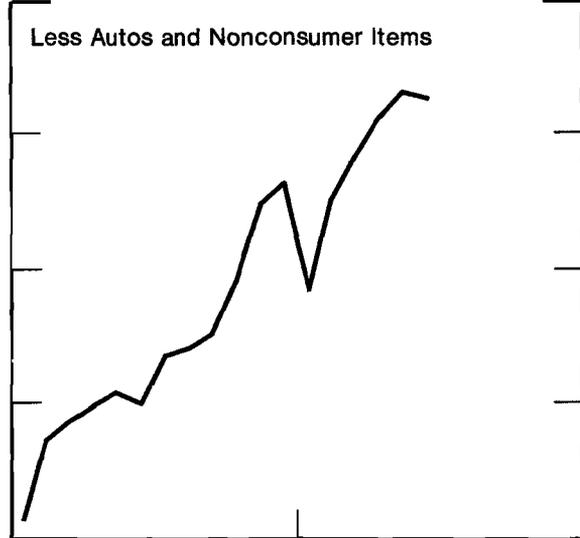
ENERGY PROGRAM

- Effective January 1979, including crude oil equalization tax

CURRENT ECONOMIC INDICATORS

Retail Sales

Billions of dollars

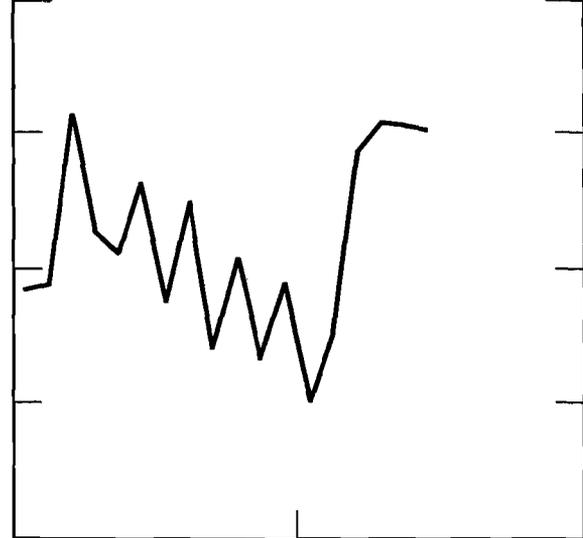


1977

1978

Domestic Auto Sales

Annual rate, millions of units

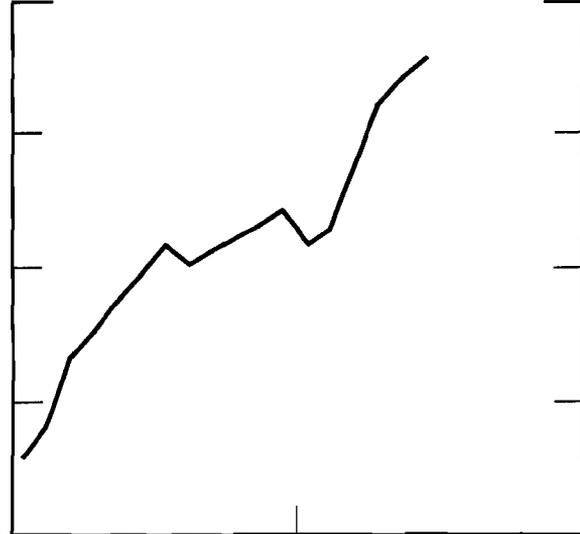


1977

1978

Industrial Production

Index, 1967 = 100

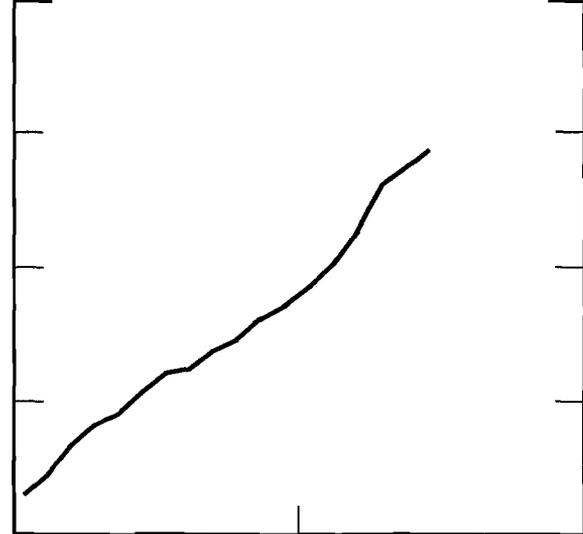


1977

1978

Nonfarm Employment

Millions



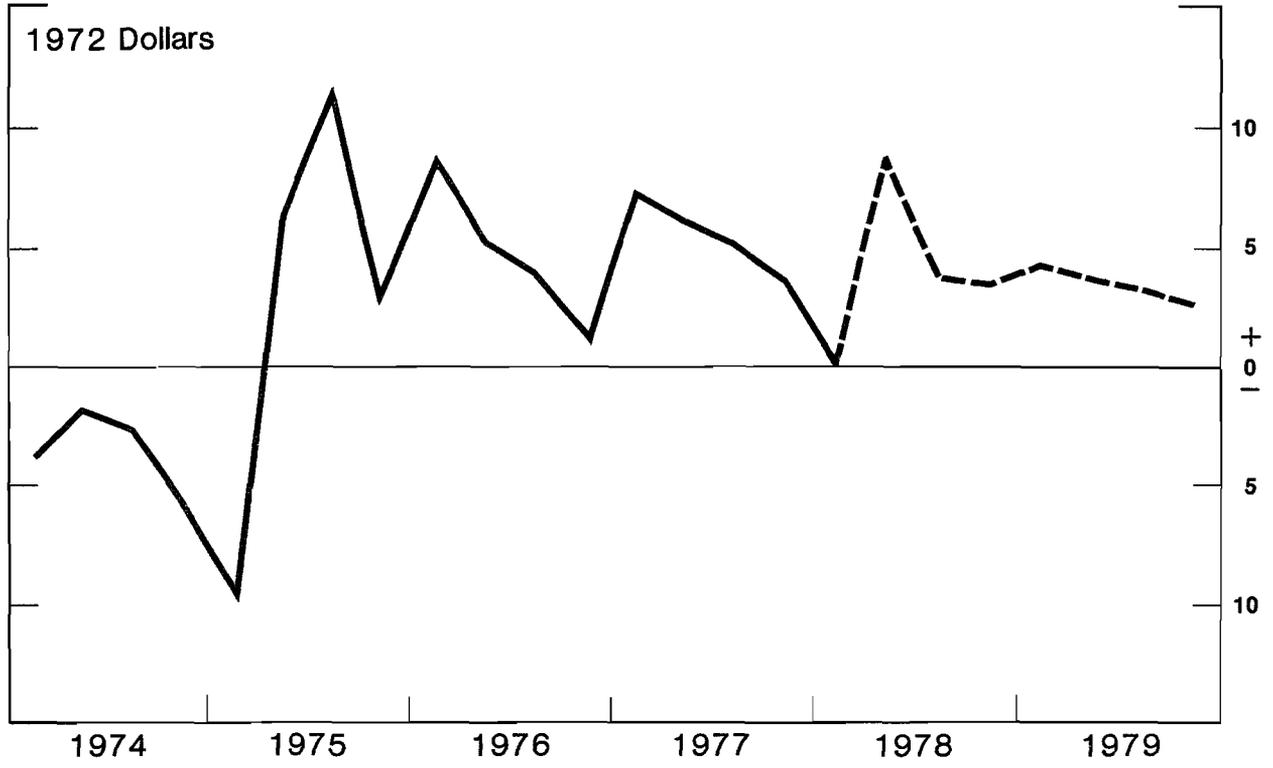
1977

1978

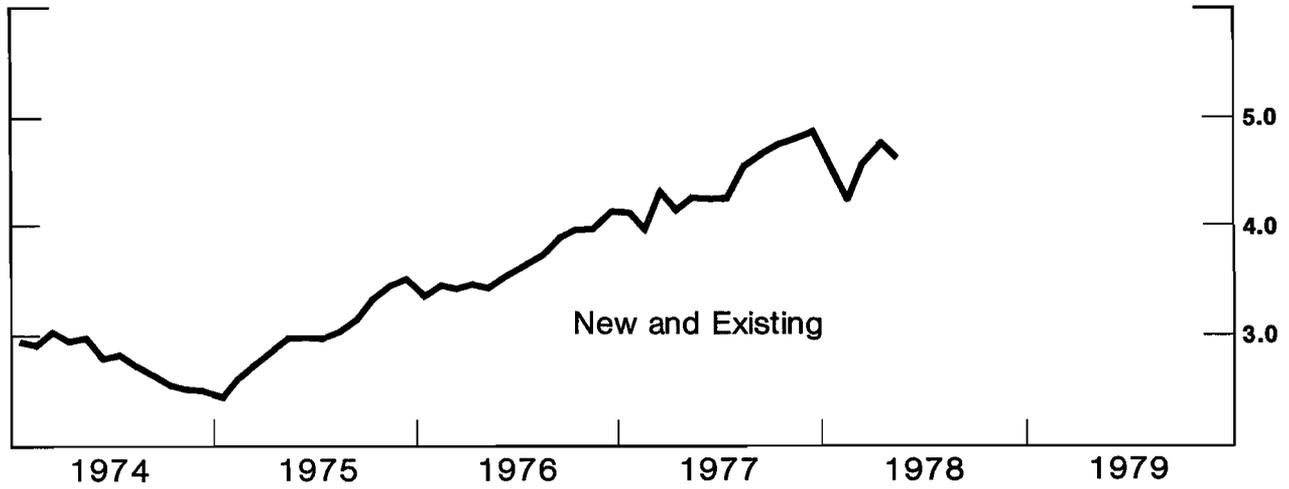
REAL GNP

1972 Dollars

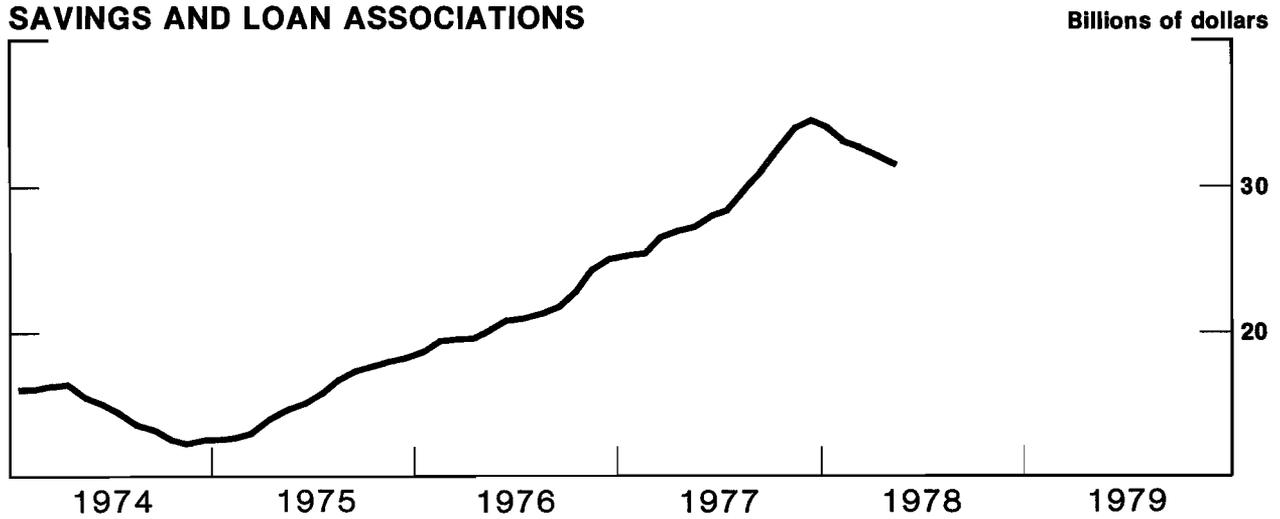
**Change from previous quarter,
annual rate, per cent**



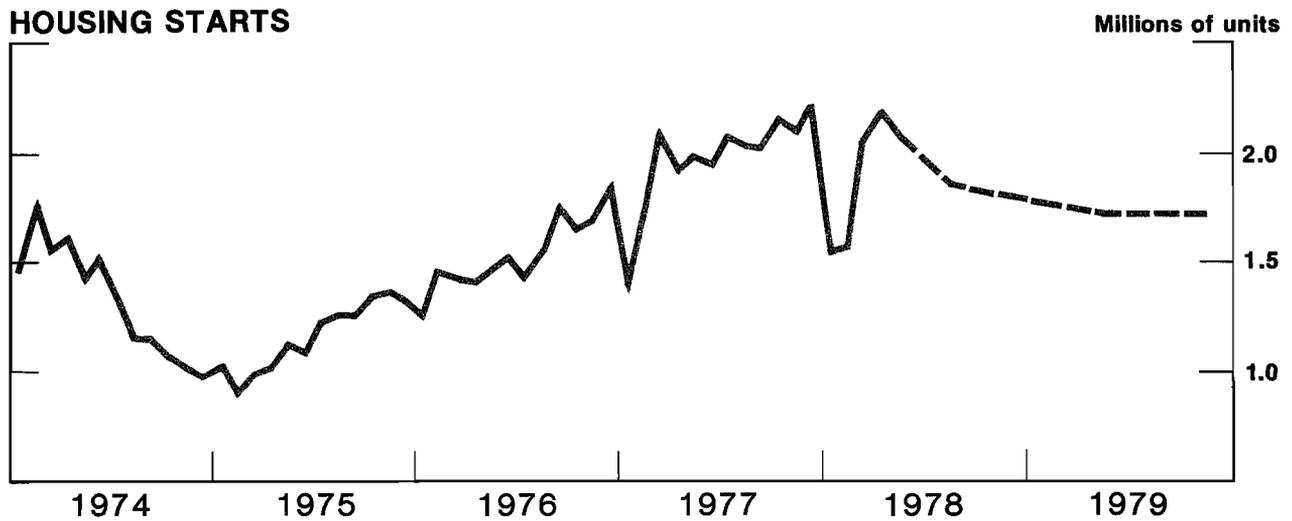
HOMES SOLD



OUTSTANDING COMMITMENTS AT SAVINGS AND LOAN ASSOCIATIONS

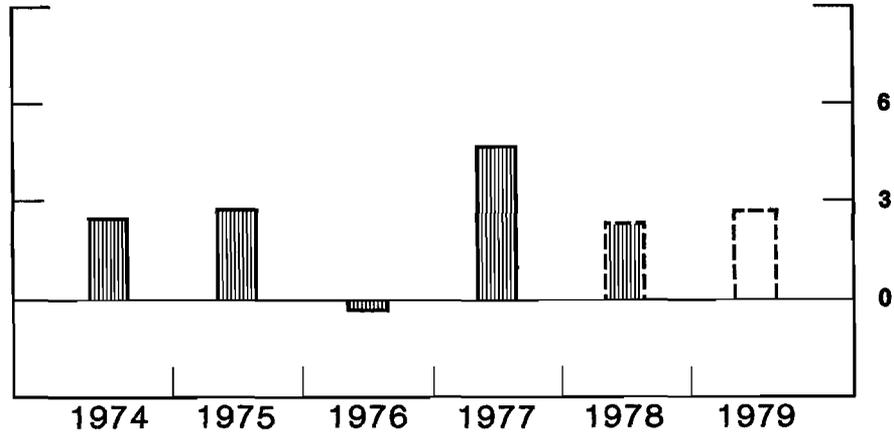


HOUSING STARTS



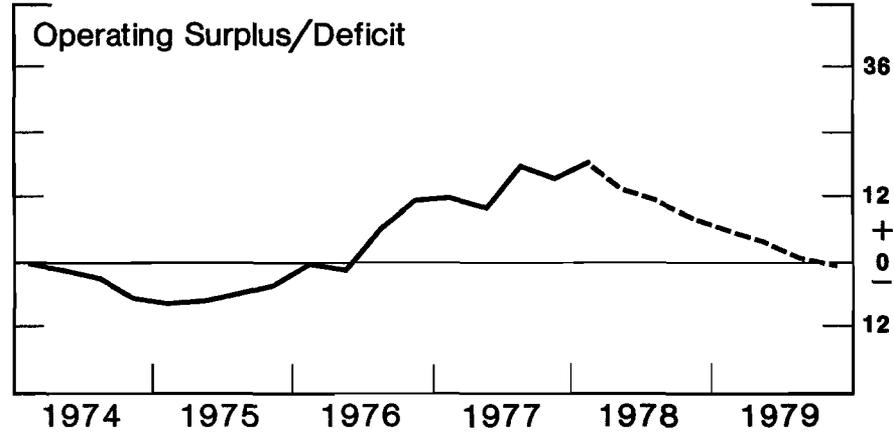
**REAL GOVERNMENT *PURCHASES
OF GOODS AND SERVICES**

Change from year earlier,
per cent



STATE AND LOCAL GOVERNMENT

Billions of dollars

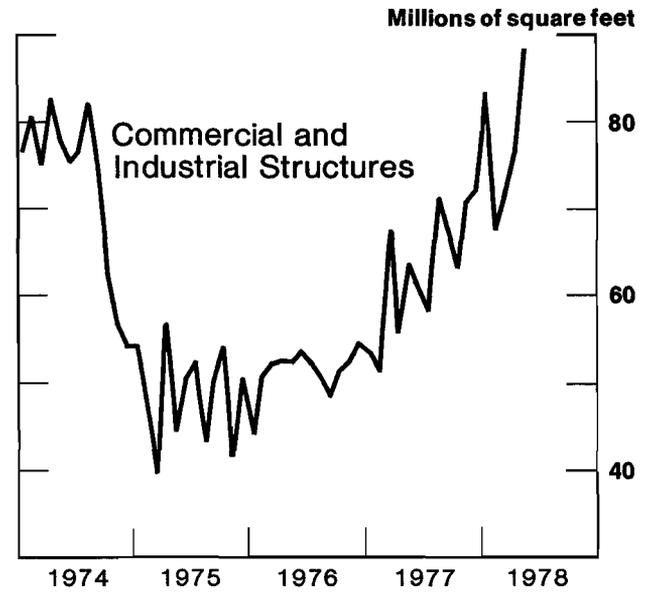


* Federal and State & Local

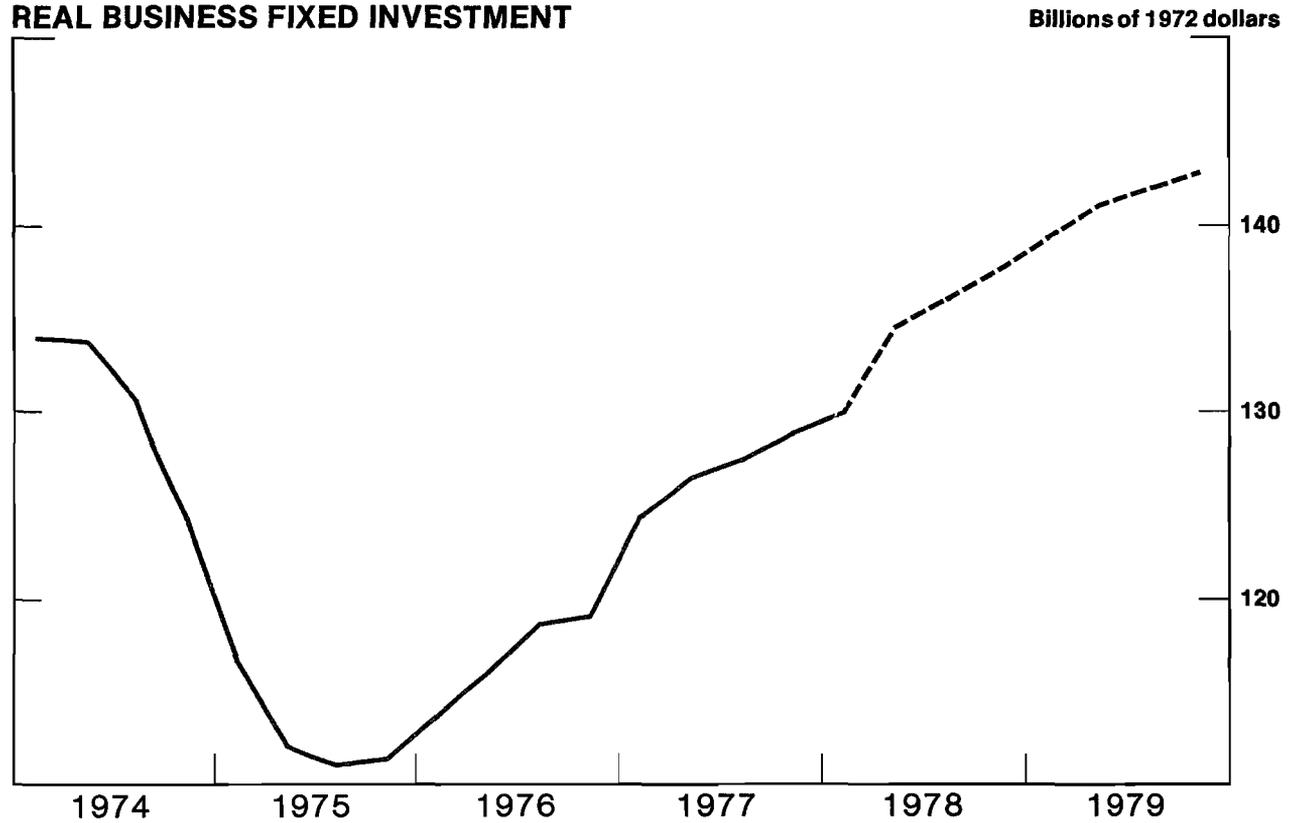
REAL NEW ORDERS



CONSTRUCTION CONTRACTS

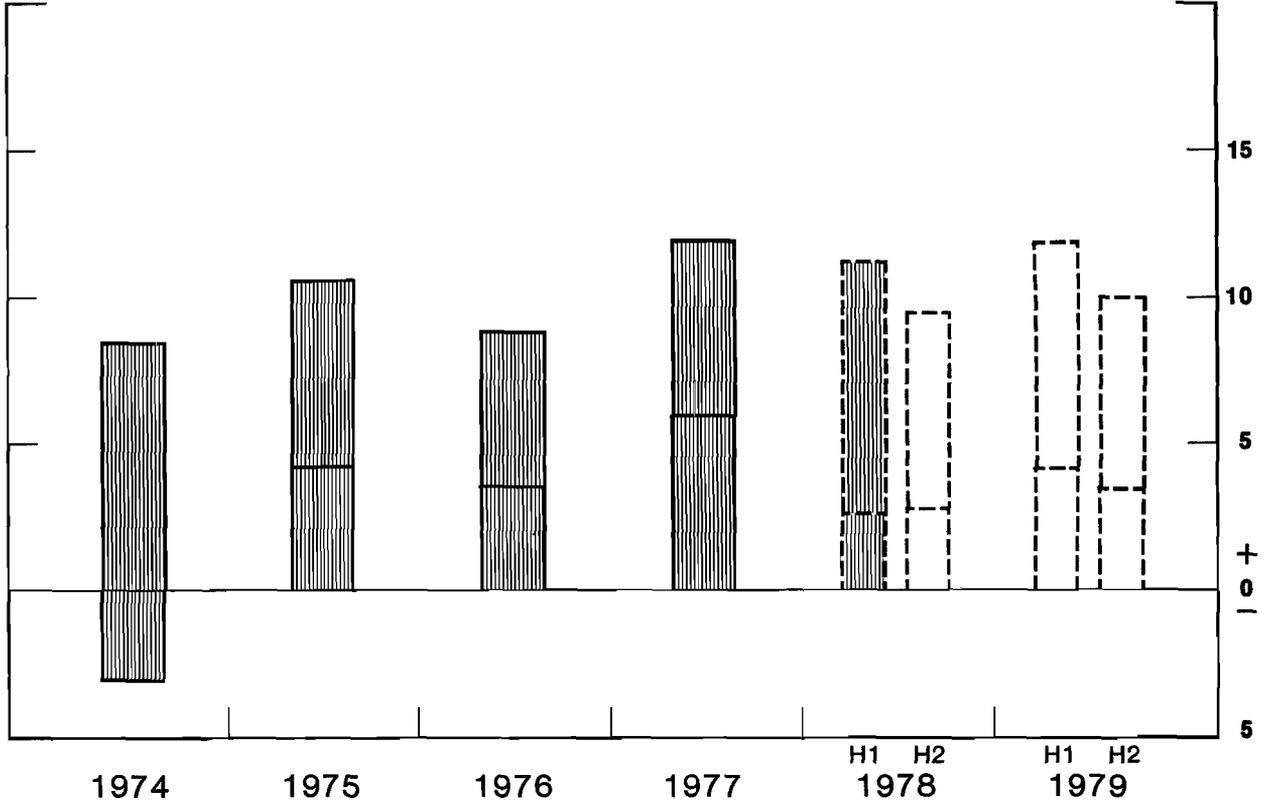


REAL BUSINESS FIXED INVESTMENT



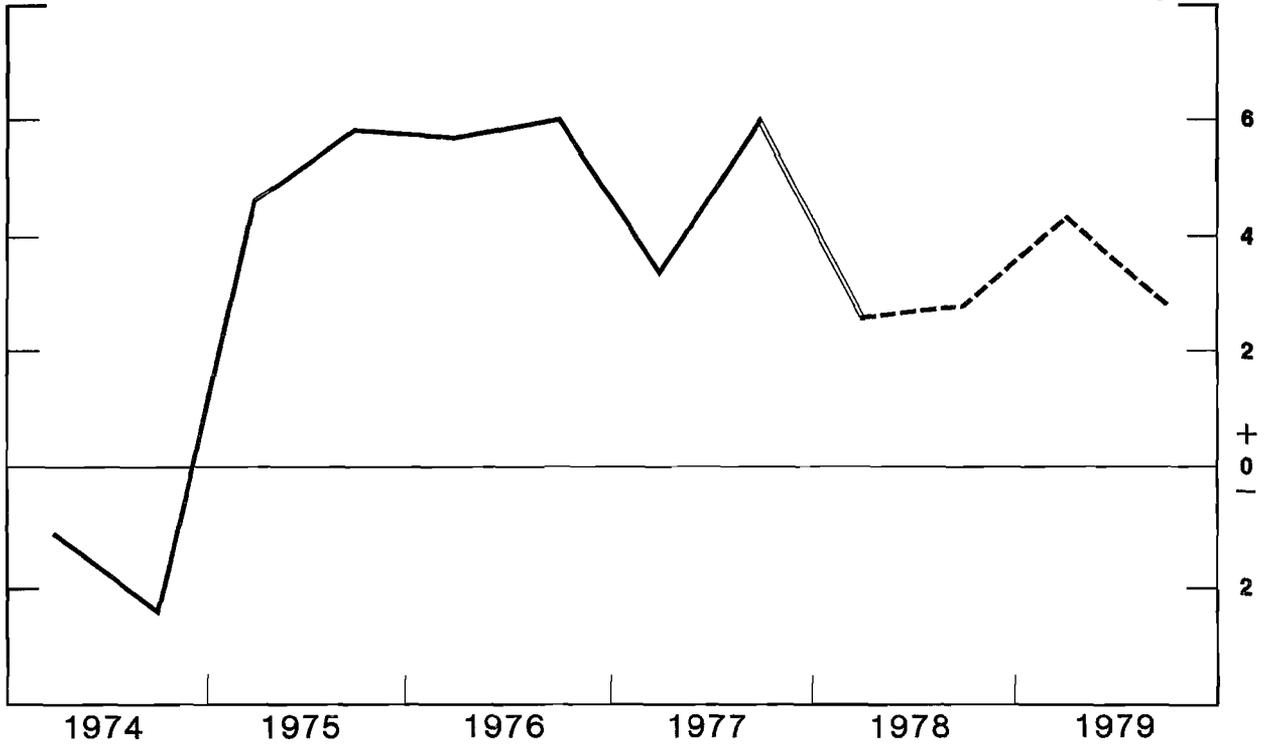
DISPOSABLE PERSONAL INCOME
 REAL DISPOSABLE PERSONAL INCOME

Change from previous period,
annual rate, per cent



REAL PERSONAL CONSUMPTION EXPENDITURES

Change from previous period,
annual rate, per cent



**IMPACT OF SCHEDULED AND
PROPOSED TAX CHANGES**

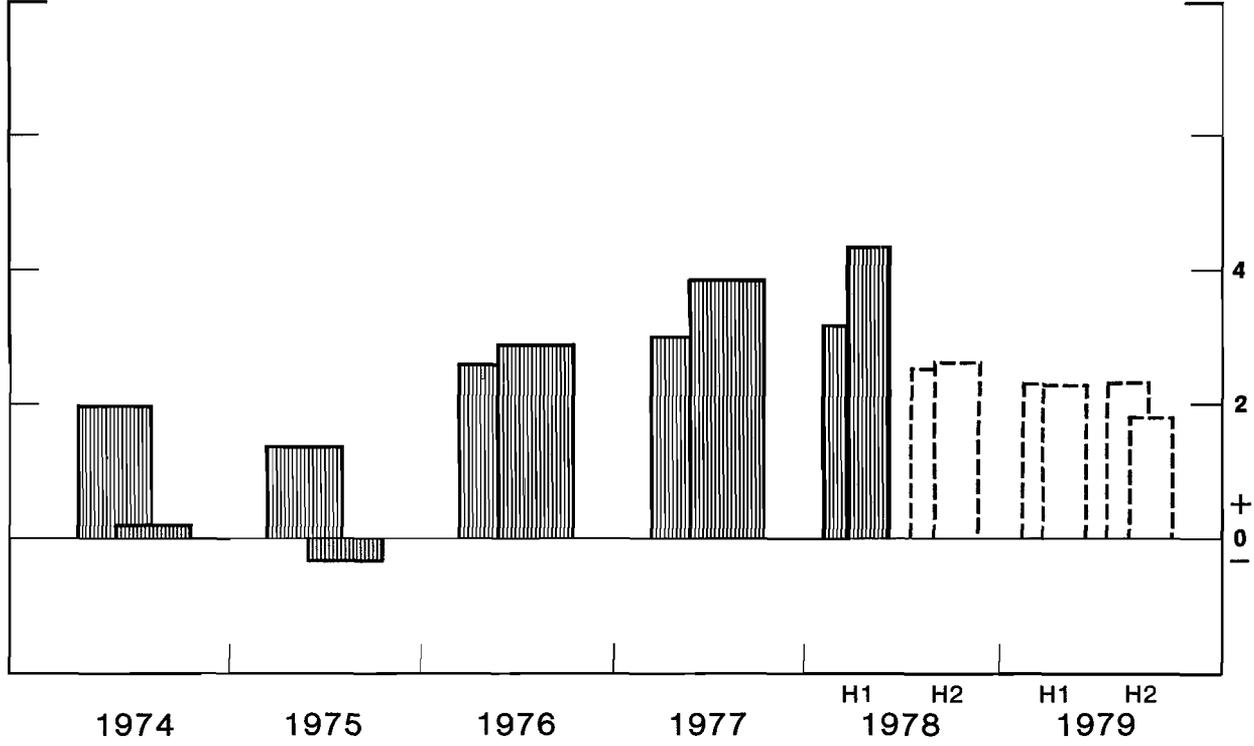
Calendar years, billions of dollars

| | Change in level relative to previous year | |
|--------------------------------|--|---------------|
| | 1978 | 1979 |
| SCHEDULED TAX INCREASES | \$14.0 | \$16.4 |
| Mandated Increases | | |
| Social Security Taxes | 3.8 | 7.9 |
| Unemployment Insurance | 2.2 | -- |
| Fiscal Drag ¹ | 8.0 | 8.5 |
| PROPOSED TAX REDUCTIONS | \$1.5 | \$17.5 |
| Assumed Changes | | |
| Personal Income | -- | 13.3 |
| Corporate (Net) | 1.5 | 3.2 |
| Unemployment and Excise | -- | 1.0 |
| NET TAX CHANGE | \$12.5 | \$-1.1 |

^{1/} Impact of inflation and progressivity on tax receipts.

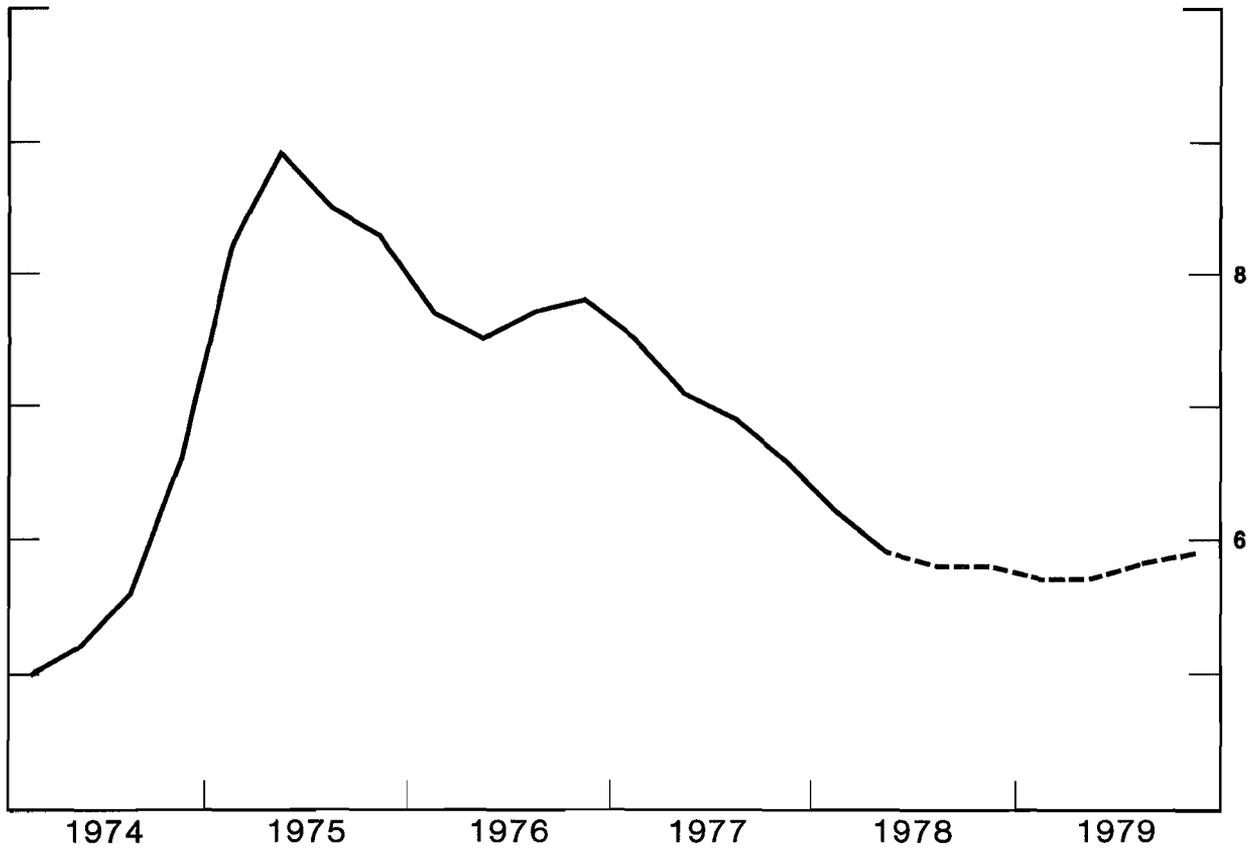
CIVILIAN LABOR FORCE
 EMPLOYMENT

Change from previous period,
annual rate, millions



UNEMPLOYMENT RATE

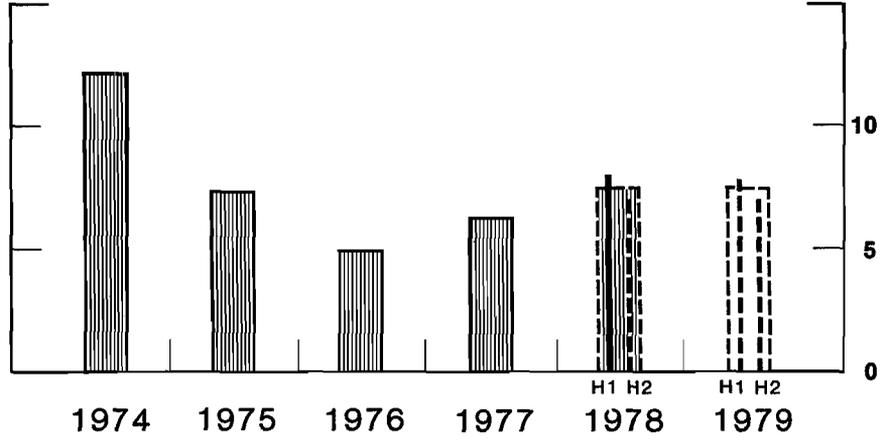
Per cent



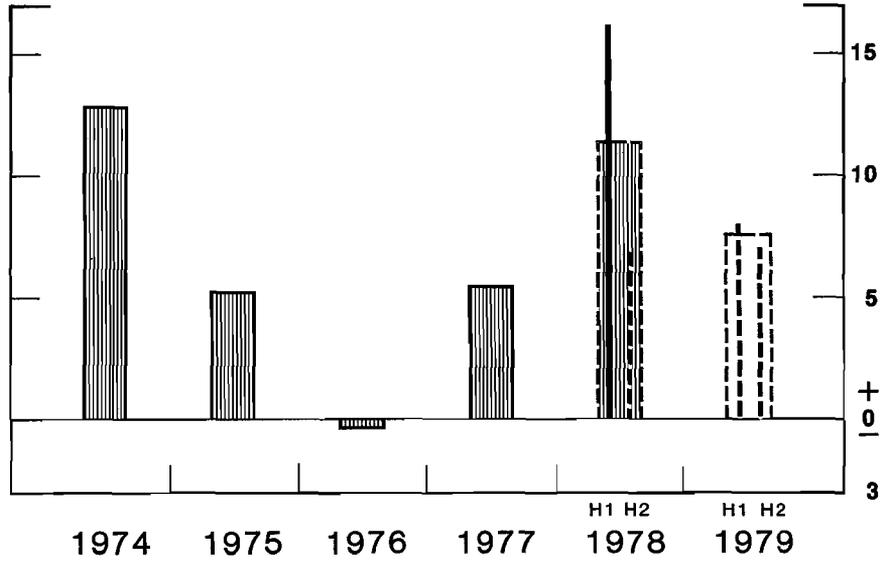
GNP PRICE INDEXES

Total

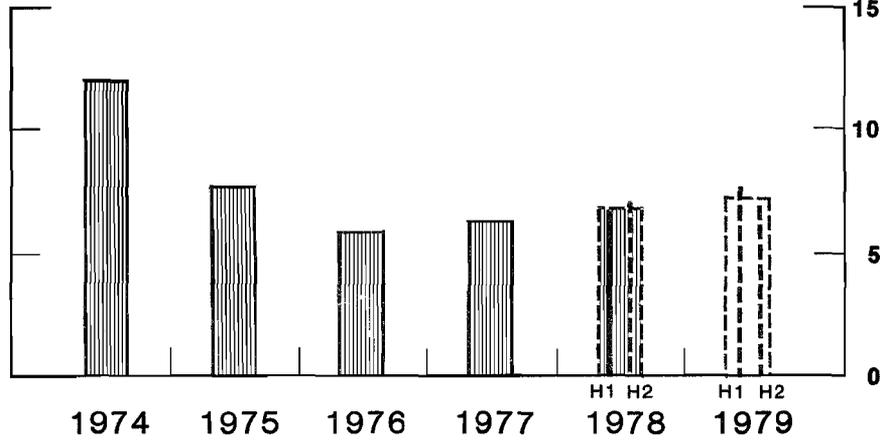
Change from previous period annual rate, per cent



Food

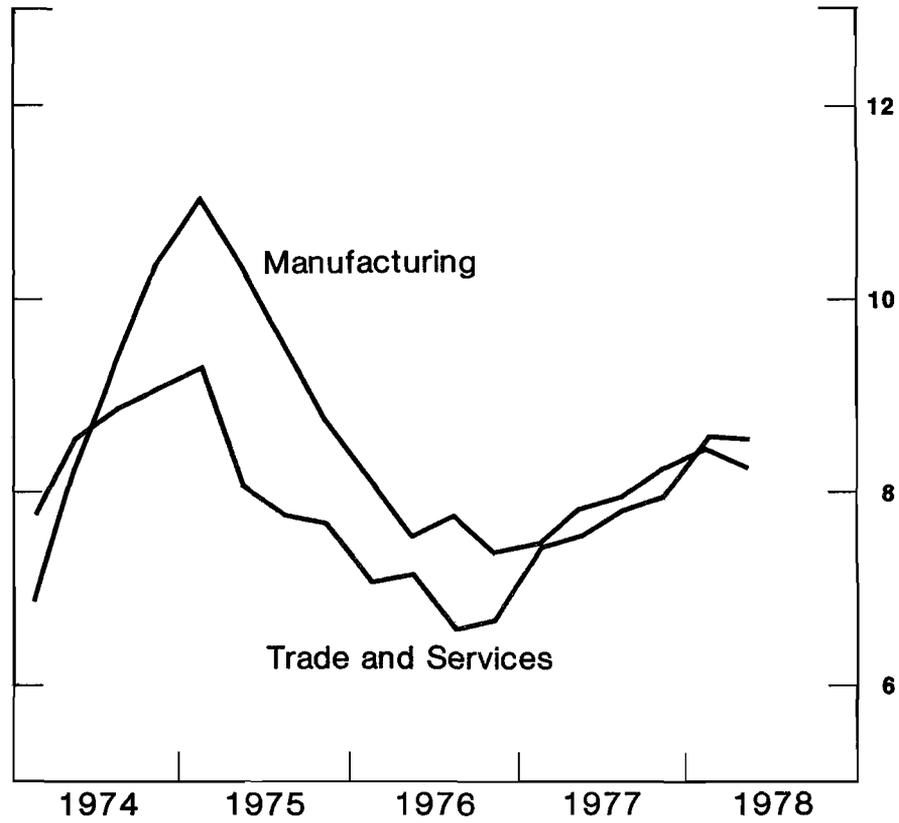
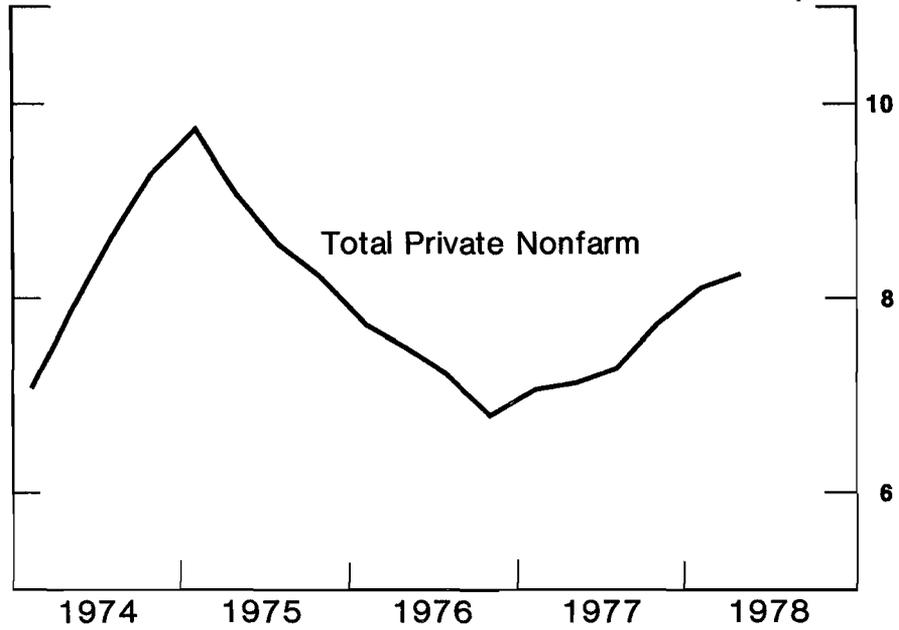


Total Less Food

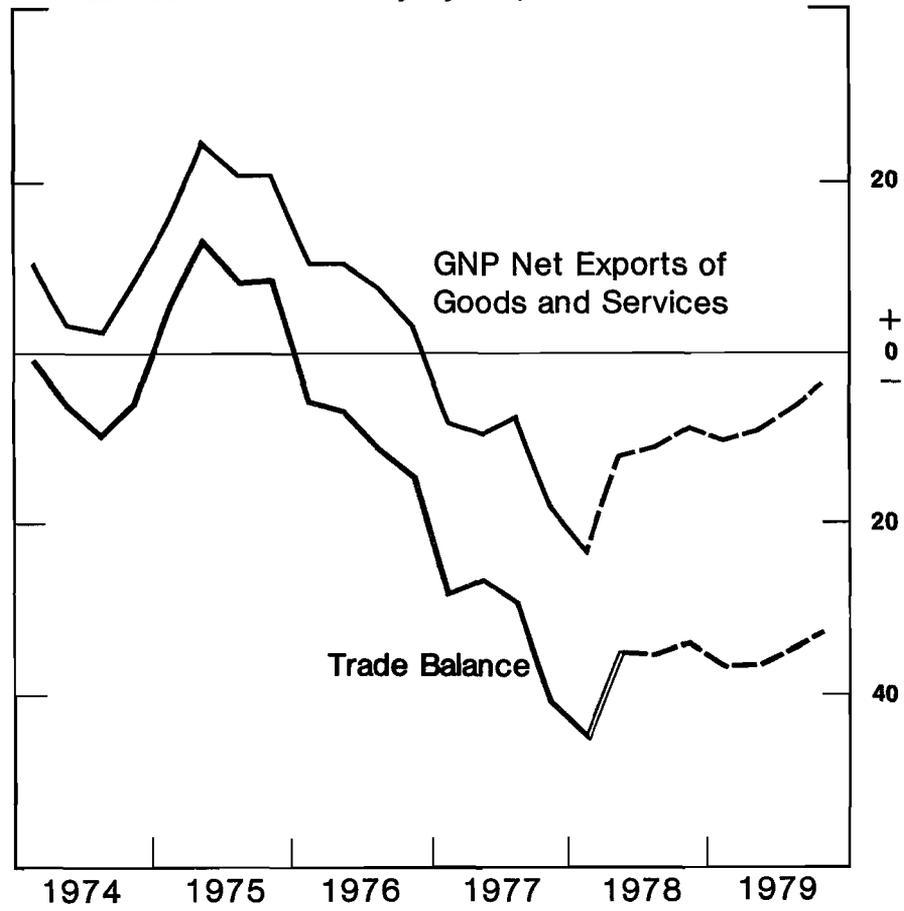


**AVERAGE
HOURLY EARNINGS INDEX**

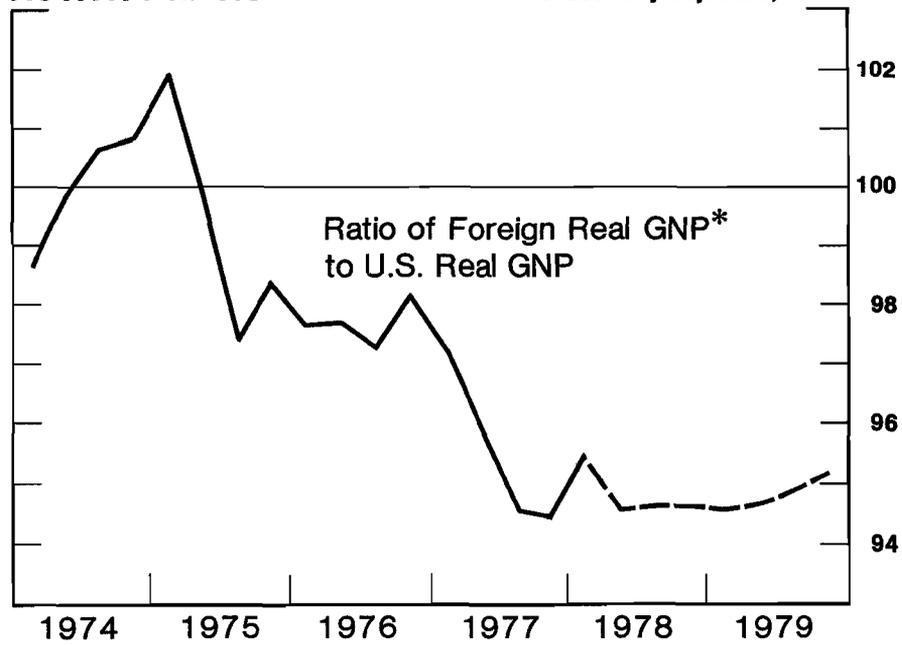
**Change from year earlier,
per cent**



NET EXPORTS Seasonally adjusted, annual rates, billions of dollars

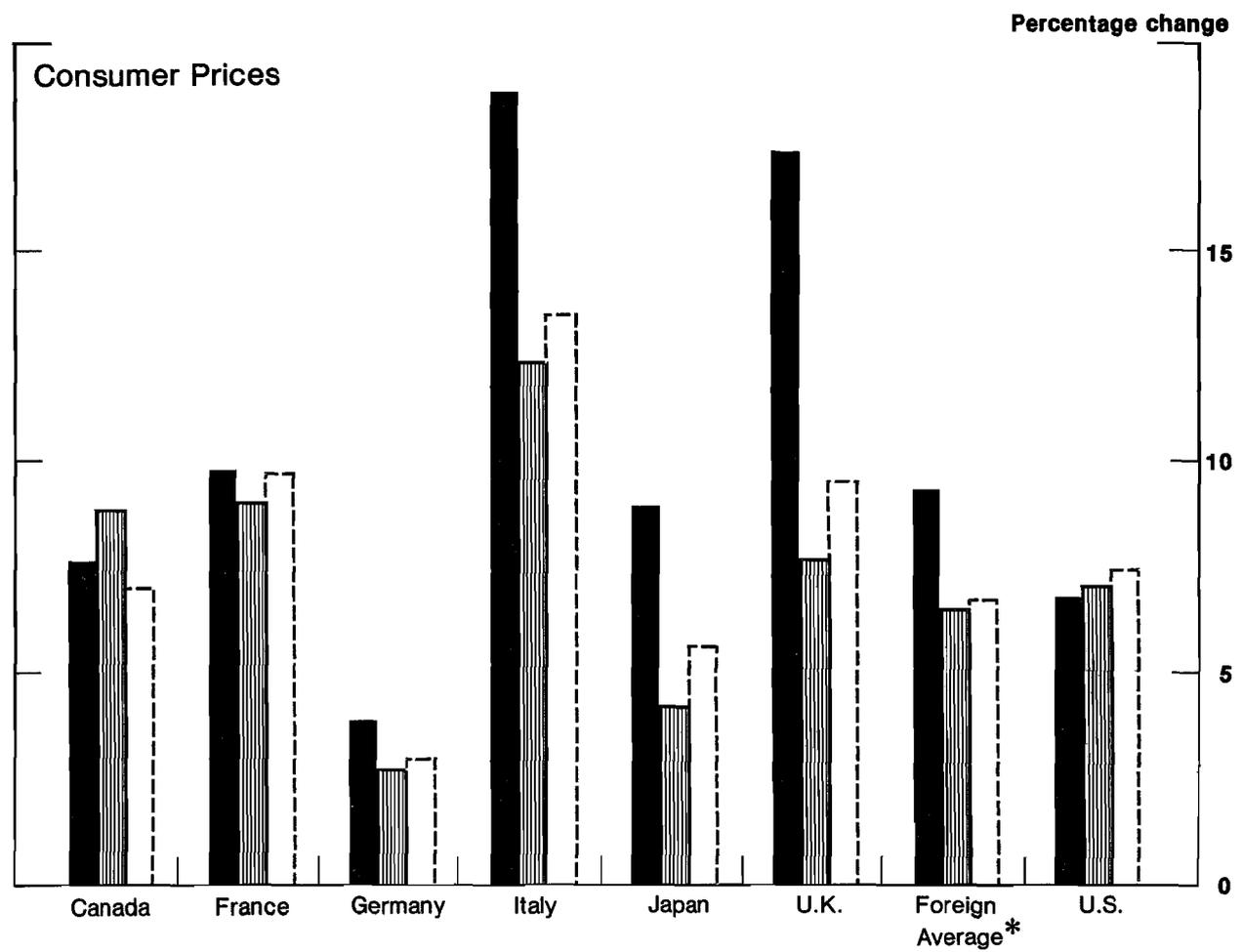
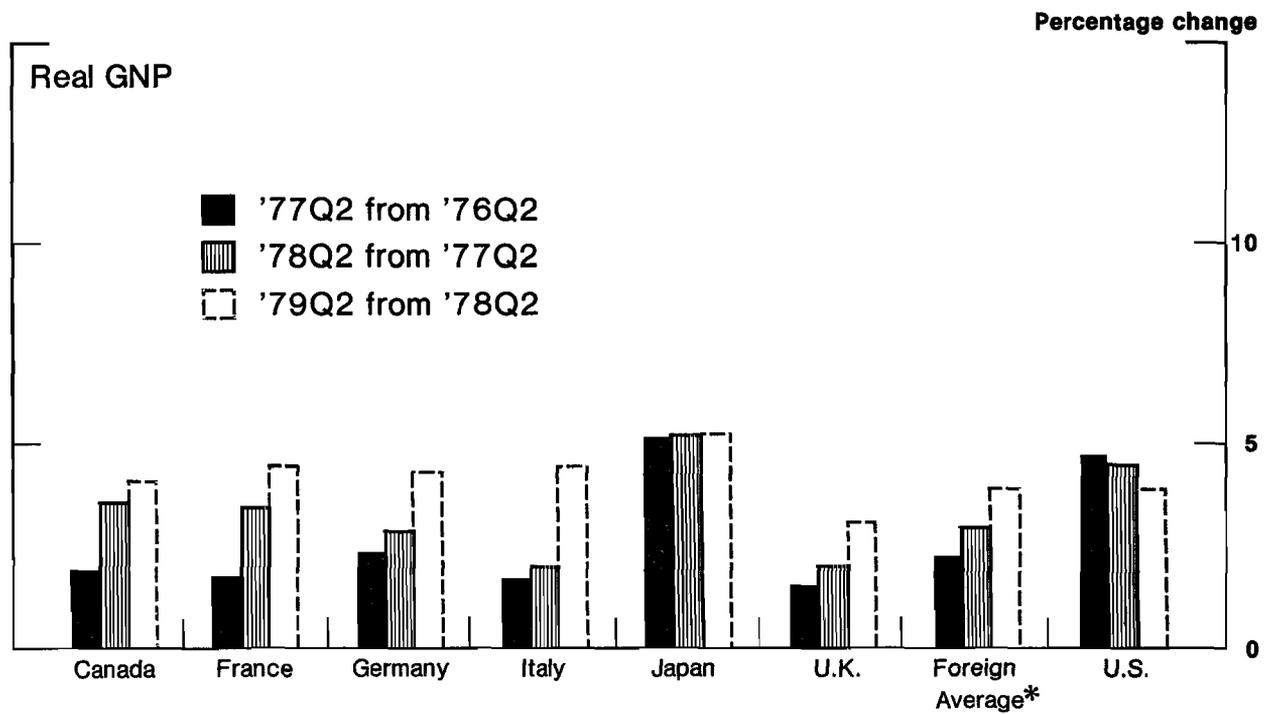


ACTIVITY RATIO Seasonally adjusted, 1974=100

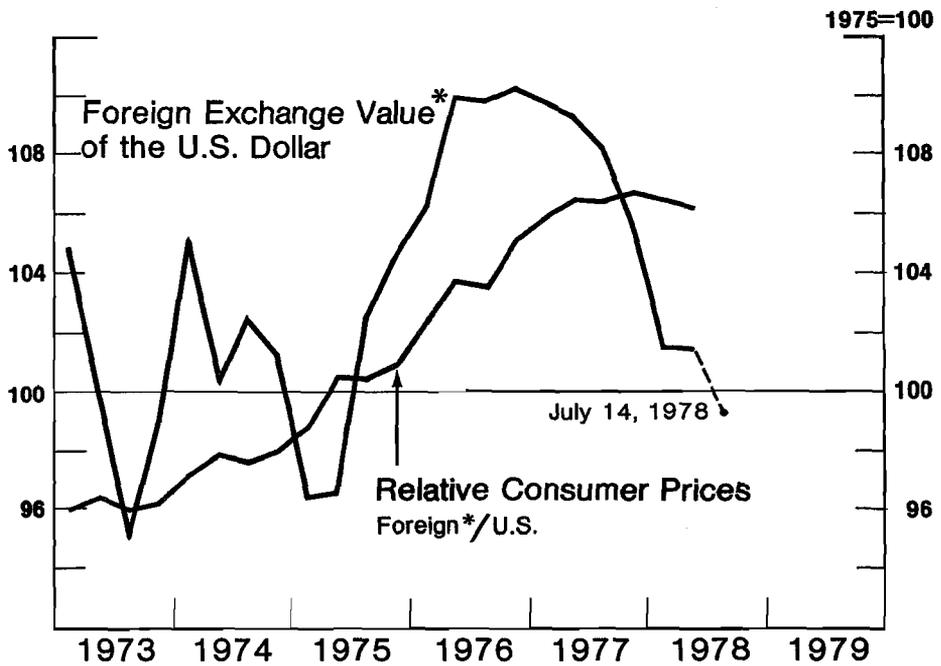
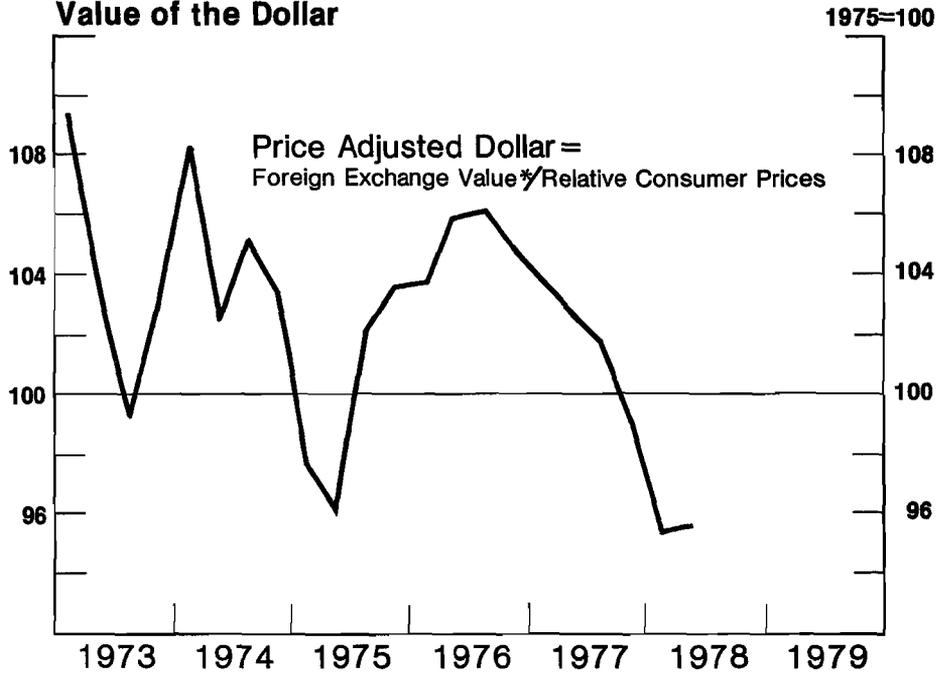


* Weighted average of G-10 countries plus Switzerland using total 1972 trade of these countries

GNP AND PRICES IN INDUSTRIAL COUNTRIES

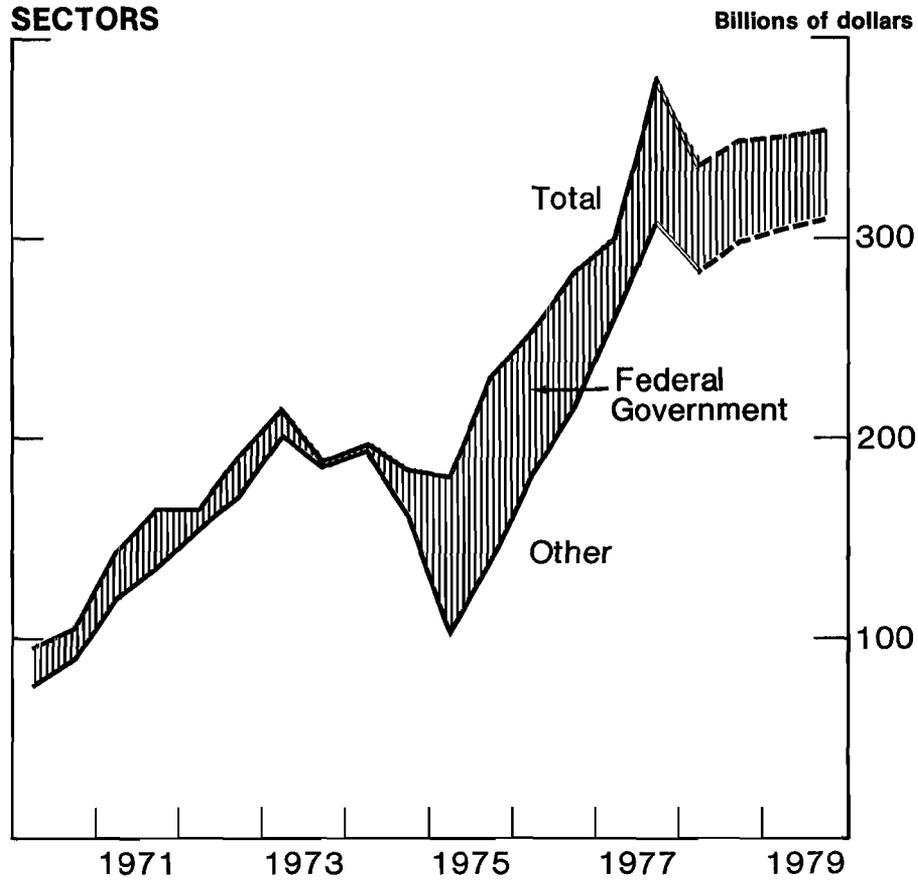


U.S. INTERNATIONAL PRICE COMPETITIVENESS
CPI Adjusted Foreign Exchange
Value of the Dollar

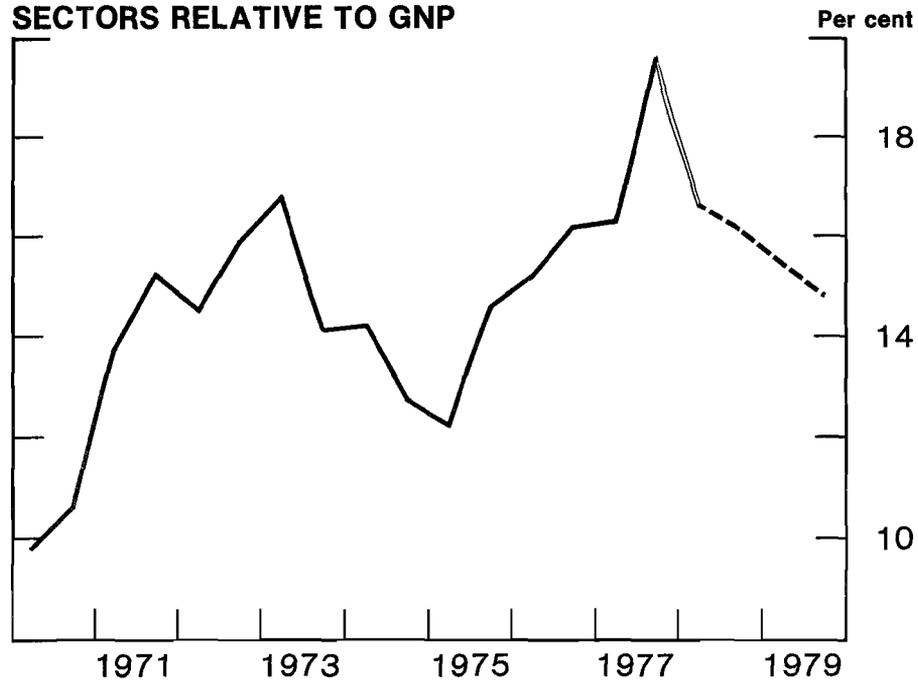


* Weighted average against G-10 countries plus Switzerland using total 1972 trade of these countries.

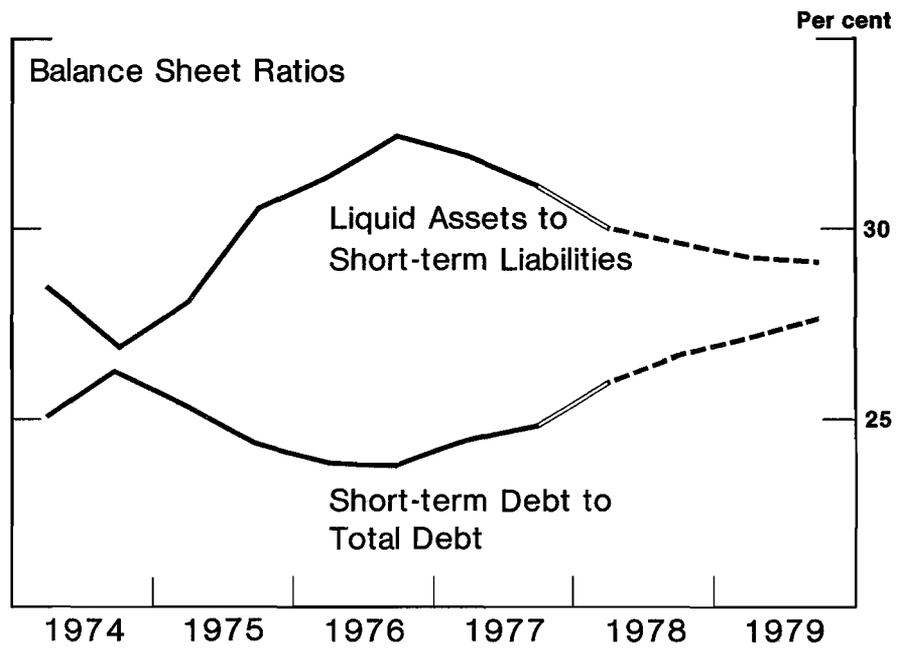
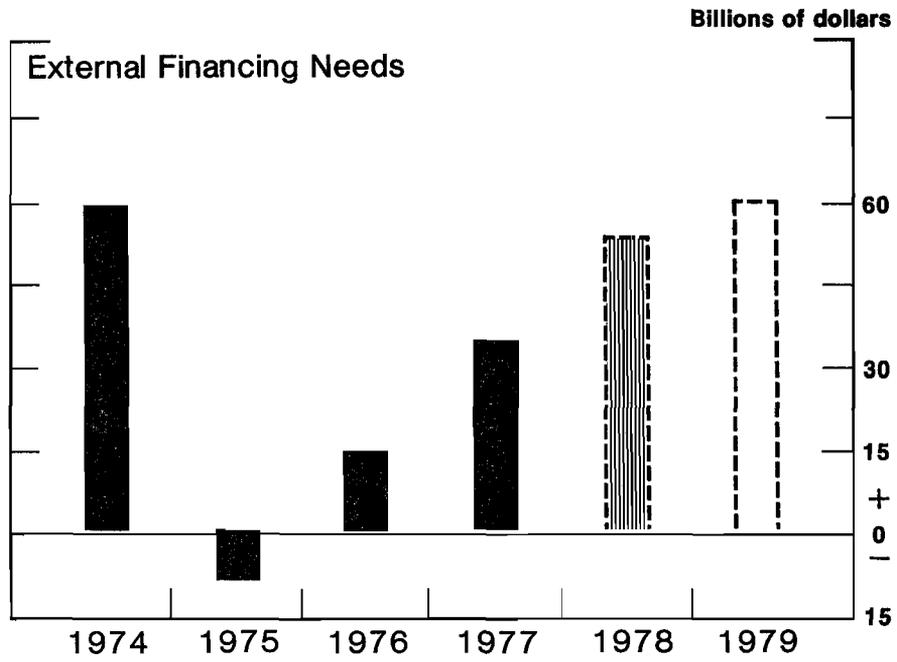
FUNDS RAISED BY NONFINANCIAL SECTORS

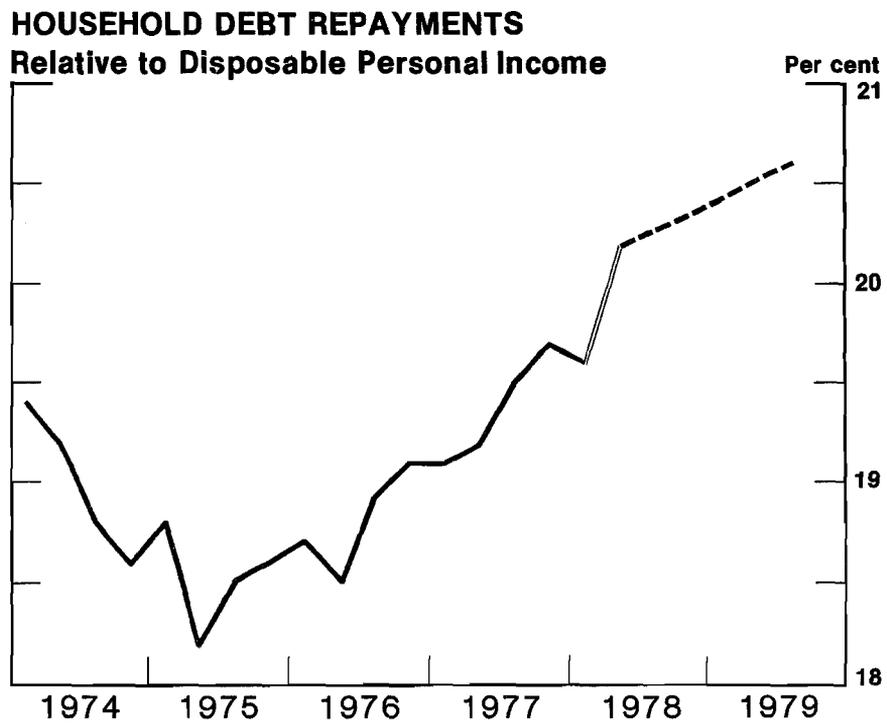
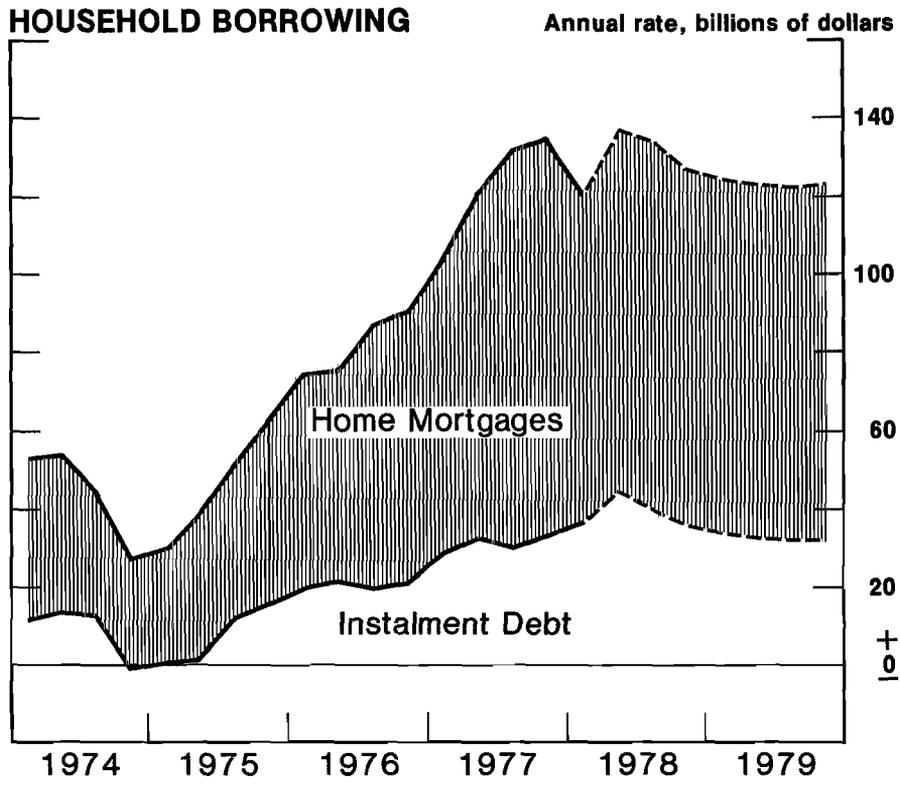


FUNDS RAISED BY NONFINANCIAL SECTORS RELATIVE TO GNP

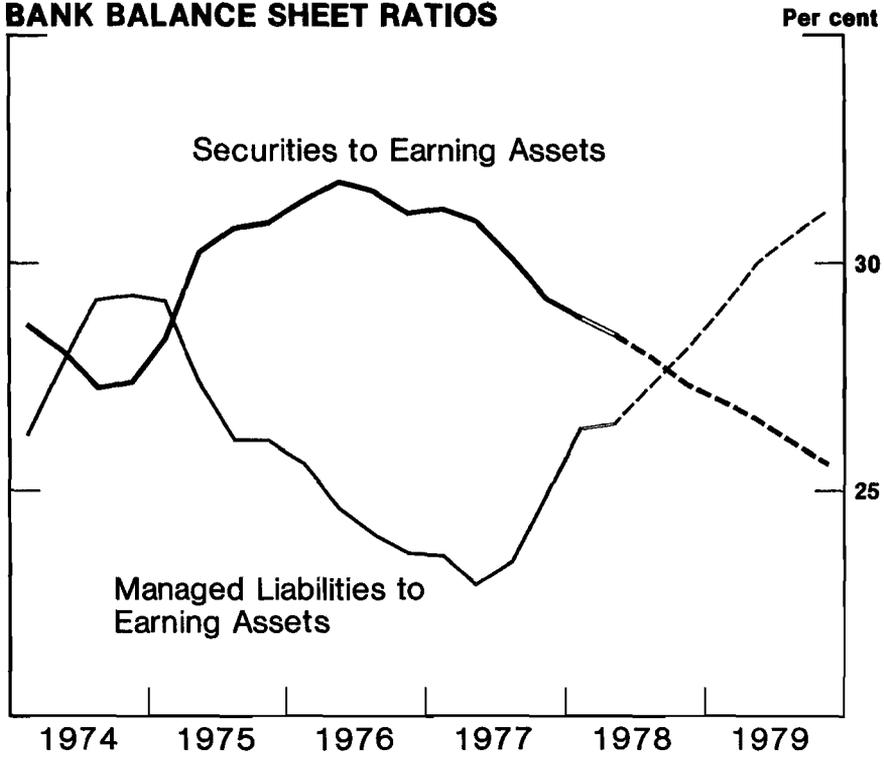


NONFINANCIAL CORPORATIONS

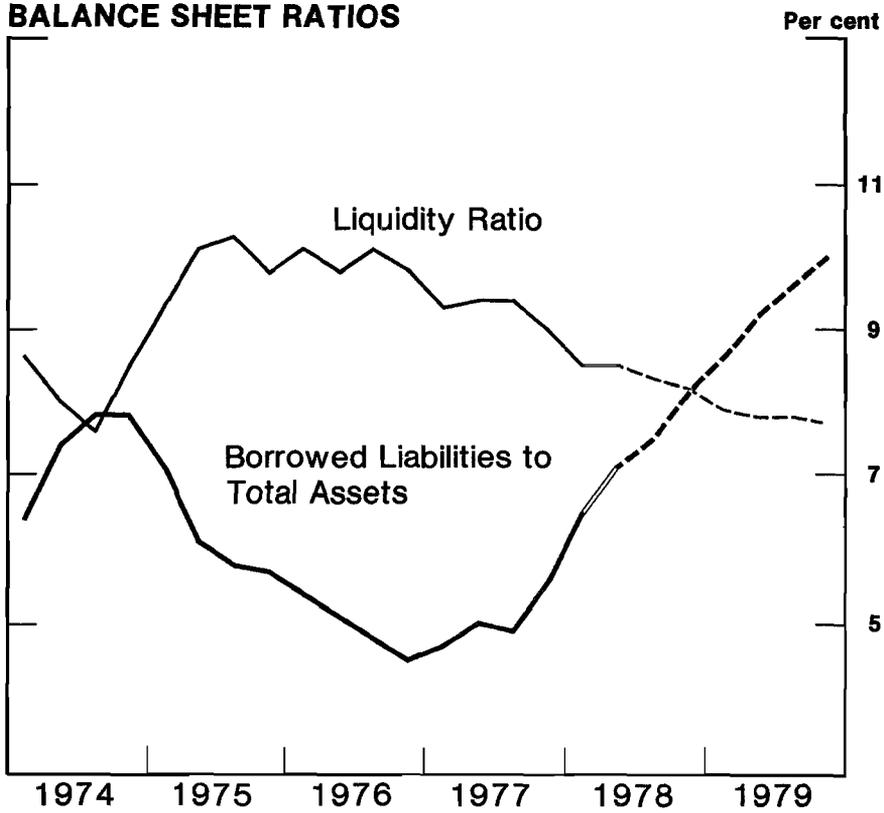




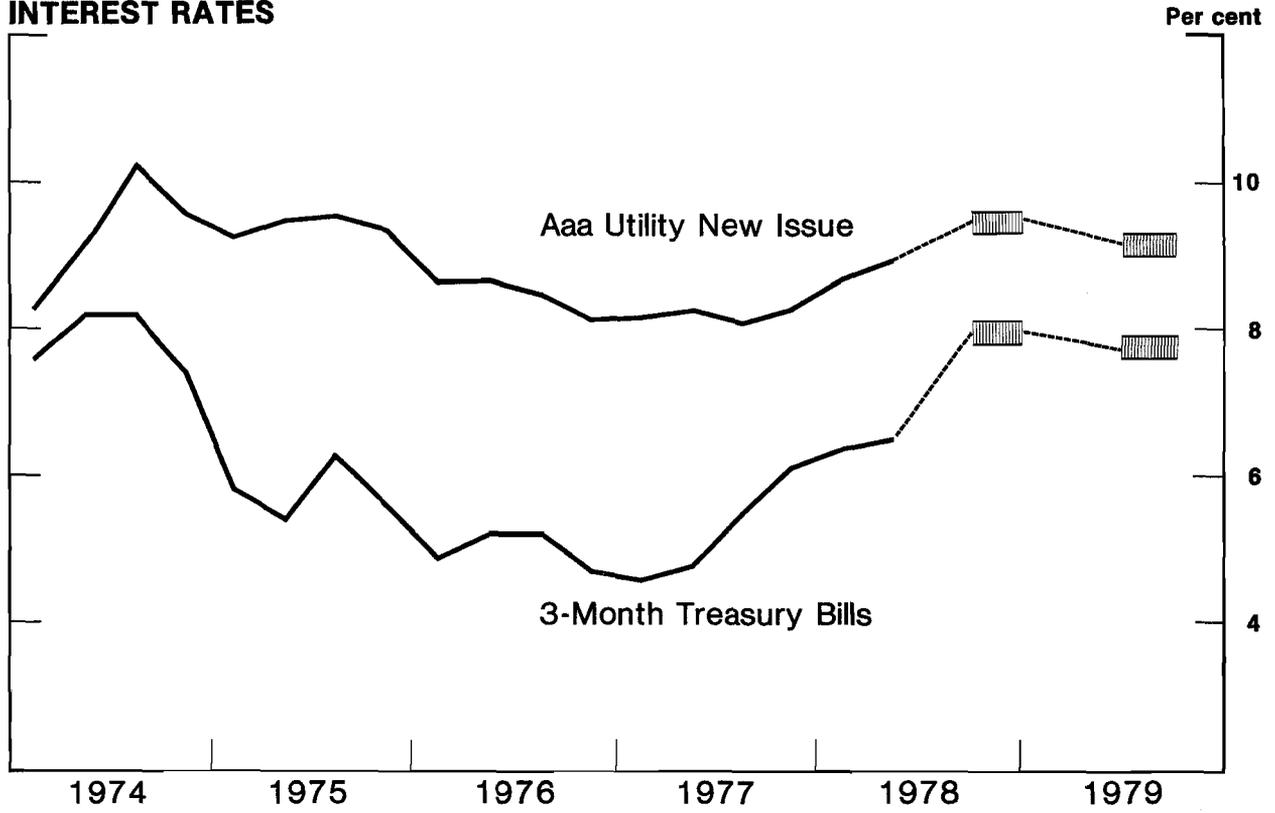
BANK BALANCE SHEET RATIOS



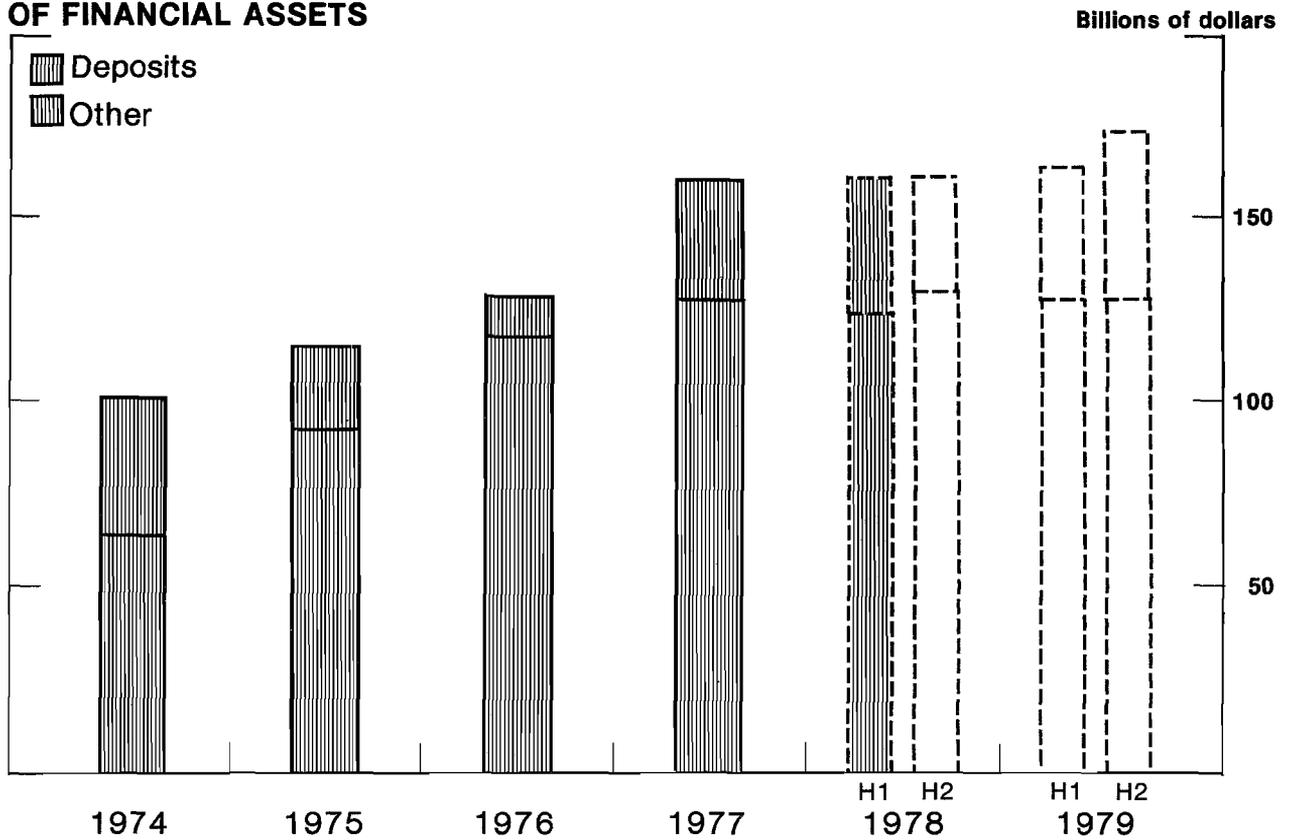
SAVINGS AND LOAN BALANCE SHEET RATIOS



INTEREST RATES



HOUSEHOLDS NET ACQUISITION OF FINANCIAL ASSETS



MONETARY POLICY ALTERNATIVES

| REAL GNP (%) | 1979 | 1980 | 1981 |
|--|-------------|-------------|-------------|
| 6¼ per cent M-1 | 3.5 | 2.5 | 1.8 |
| 5¼ per cent M-1 | 2.6 | 1.5 | 1.4 |
| 7¼ per cent M-1 | 4.5 | 3.4 | 2.1 |
| PRICES (%) | | | |
| Fixed Weight Index | | | |
| 6¼ per cent M-1 | 7.2 | 7.2 | 7.1 |
| 5¼ per cent M-1 | 7.0 | 6.5 | 6.2 |
| 7¼ per cent M-1 | 7.6 | 8.2 | 8.5 |
| UNEMPLOYMENT RATE (%) ^{1/} | | | |
| 6¼ per cent M-1 | 5.9 | 6.2 | 6.8 |
| 5¼ per cent M-1 | 6.2 | 6.9 | 7.8 |
| 7¼ per cent M-1 | 5.5 | 5.4 | 5.8 |

^{1/} Level end quarter of each year.

Joseph S. Zeisel
July 18, 1978

FOMC BRIEFING

Recent economic intelligence supports the likelihood of continued growth over the remainder of the year, but as Jim Kichline has noted, there are clear indications that the pace of expansion is moderating. Real GNP gains, portrayed in the first chart, have swung widely in the first two quarters of this year, reflecting mainly the impact of unusual weather and the coal strike. But on average, the increase in the past half year has been in the 4-1/2 per cent annual rate range, about the same as in the latter half of '77. We project that real growth will slow to about a 3-1/2 per cent rate in the second half of this year, and with the exception of a temporary fillip associated with the tax cut in early '79, to ease further over the balance of the projection period.

The major force retarding growth in our forecast is the expected decline in residential construction. As the top panel of the next chart shows, total home sales appear to have topped out around year-end, and--abstracting from weather-induced gyrations--have

moved down since then. While construction activity remains at a high level, the steady decline in commitments at S&Ls so far this year--shown in the middle panel--underlines the likelihood of a continued weakening in housing starts over coming months.

But we expect that starts--the bottom panel--will stabilize at around 1.7 million units in 1979, with mortgage markets supported in large part by funds made available through Federal programs. The success of the recently introduced savings instruments in sustaining the flow of deposits to thrift institutions should help to avoid a sharper decline in housing activity.

The next chart illustrates another sector--Government, whose contribution to over-all economic expansion appears likely to be moderating from the recent pace. As the top panel shows, real growth of total government purchases--Federal, State and local--is expected to be off significantly in 1978 and 1979 from the 1977 rate of increase.

real

At the Federal level, a relatively small/rise in purchases is projected for '79.

Growth in State and local spending is also expected to be quite moderate as the impact of Federal counter-cyclical grants programs trail off. Furthermore, the tendency for States and localities to pursue conservative spending practices undoubtedly has been reinforced by California's Proposition 13 and the likelihood of similar actions elsewhere. But as illustrated in the bottom chart, we also expect these jurisdictions in aggregate to draw down their operating budget surplus to avoid / drastic spending cuts in the coming period.

In the business sector, the outlook continues to appear promising for moderate growth of capital spending. As the top left panel of the next chart shows, real new orders for nondefense capital goods have been rising at a good pace -- an 8 per cent annual rate so far this year. Commercial and industrial construction (the right panel) has been showing even greater momentum--increasing in square feet terms, at a 50 per cent annual rate. However, survey results on anticipated capital spending plans for 1978 are less promising than these data, and we continue to take something of a

middle position--forecasting a rate of real growth for business fixed investment of slightly under 5 per cent over the next year, with some slowing in late '79. Thus, activity in this sector is expected to be providing continued, ^{albeit} / diminishing support to over-all economic growth.

On the positive side, the trade deficit is projected to stabilize over the next year, removing one significant drag on the economy. But in aggregate, the outlook for the key income-generating sectors suggests a loss of momentum over the next six quarters. As indicated in the next chart, this results in a damped rate of rise in disposable income, particularly in real terms--the lower, red section of the bars. As illustrated in the bottom panel of the chart, we anticipate a rather moderate rate of increase in real personal consumption expenditures to accompany the slowing in income growth. The transitory rise in spending in the first half of 1979 represents the initial response to the assumed tax cut next January 1st.

That tax cut operates to offset the potential for a further weakening of activity in early 1979. In addition to the other factors mentioned, growth of disposable income will be cut this year and next by increased taxes for social security and unemployment insurance, as well as by the continuing revenue drag resulting from the interaction of inflation and a progressive income tax.

The details of the tax increases are spelled out in the next table. Together they involve a drain on the income stream of about \$14 billion in 1978, and a slightly larger effect in 1979. But as is evident in the lower portion of the table, these fiscal restraints would be just about offset in '79 by the proposed \$19 billion tax cut--\$1-1/2 billion of which is retroactive to 1978. With the tax cut, real GNP growth is projected to ^{advance} / to a 4 per cent annual rate in the first half of next year. As the initial impact of the fiscal action diminishes, however, factors tending to retard growth again are likely to dominate, and real gains in GNP are projected to recede to about a 3 per cent rate in the second half of 1979.

Consistent with the projected moderate pace of activity is

a significant slowing in employment gains, as illustrated in the top panel of the next chart. While a moderation of labor force growth from the recent extraordinary pace is also expected, it is probable that unemployment-- shown in the bottom panel--will show little further decline from current levels, and will turn up somewhat toward the end of 1979.

As the next chart illustrates, we anticipate no real improvement in the rate of inflation over the projected period, other than a slowing in food prices later this year. Spot prices for cattle have come down, and fruit and vegetable prices are projected to drop as new supplies hit the market. But as shown in the middle panel, food prices are still expected to continue up at a faster pace than in any year since 1974. As shown in the bottom panel of the chart, prices exclusive of foods, are projected to rise at a 7 per cent plus rate through 1979.

Continued cost pressures are the major factor driving these prices. As is evident in the top panel of the next chart, wage rates

have been moving up at an accelerated pace since the end of 1976, reflecting large negotiated union settlements as well as increases in the minimum wage. This acceleration also reflected a tendency for wage increases in the relatively lower paid, less unionized, sectors such as trade and service to move more closely in line with increases in the heavily unionized manufacturing industries-- as shown in the bottom panel. This is fairly characteristic of a firming labor market.

Recent large price increases are expected to continue to influence wage settlements in the heavy round of contract negotiations scheduled for next year. Moreover, further boosts in the minimum wage and in social security taxes are scheduled for the beginning of '79, and in fact, on into the early 1980's as well. Since little help is likely from improved productivity performance, unit labor costs are expected to continue rising at a rapid pace, suggesting no easing of the pressure on prices, despite the moderate pace of economic growth.

Ted Truman will now discuss the international sector.

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FOMC PRESENTATION

E.M. Truman

July 18, 1978

The upper panel of the first international chart shows a narrowing of the trade deficit in the second quarter of this year. However, much of this change reflects the influences of special factors. Coal exports increased in the second quarter after the end of the strike. The initial adverse effect of the sharp depreciation of the dollar in late 1977 and early 1978 on the value of imports is largely behind us. And we think we have seen the end of abnormal increases in imports associated with actual or expected commercial policy actions here and abroad. With these temporary influences having largely run their course, we expect the trade deficit to fluctuate around the \$35 billion annual rate estimated for the second quarter throughout the forecast period. Nevertheless, as shown in the top line of the chart, net exports of goods and services, as measured in the GNP accounts, should show a modest rising trend primarily, reflecting increases in net receipts on military transactions and in net investment income.

The lower panel of the first chart summarizes one important factor that is helping to arrest the increase in the trade deficit. The line shows the ratio of average real GNP in ten major foreign industrial countries to U.S. real GNP. After declining for almost three years, this ratio appears to have bottomed out. The slight

RESTRICTED

upward trend over the forecast period reflects the anticipated slower growth of real GNP in this country as well as a modest pick-up in growth abroad.

The upper panel of the next chart illustrates this pattern of convergence in somewhat greater detail. For each of the individual foreign countries in the chart, as well as for the average of ten foreign countries, the annual increase in real GNP in the year ending in the second quarter of 1978 was larger than that for the year ending in the second quarter of 1977. We expect this increasing trend to continue in coming quarters. Although the most recent data on industrial production suggest that economic activity abroad was disappointingly weak in May, data for the past several months taken together show a stronger picture -- except in Germany -- and are, we believe, consistent with this forecast.

The lower panel in the chart shows a more mixed picture with regard to consumer price inflation. For each of the individual foreign countries, except Canada, the rate of increase of consumer prices decelerated between the second quarter of 1977 and the second quarter of 1978. As a result, consumer price inflation for the average of the ten foreign countries is now running below that for the United States. This relationship is expected to continue over the forecast period, even though inflation rates abroad are expected to rise as real growth picks up and as the transitory dampening effects of recent currency appreciations wear off.

The next chart summarizes recent developments in our international price competitiveness as measured by the CPI-adjusted foreign exchange value of the dollar. The red line in the lower panel shows the deterioration of the U.S. relative price performance over the past year while the black line shows the much sharper depreciation of the dollar. Combining these two components, one can see that our international price competitiveness has increased by about 9 per cent over the past 18 months. By the end of the forecast period, this factor is expected to reduce our trade deficit by about \$7 billion at an annual rate from what it otherwise would be, i.e., from over \$40 billion to under \$35 billion.

Although the general international picture that I have outlined contains some grounds for optimism for the dollar, I would expect to see some further decline in the foreign exchange value of the dollar over the forecast period. This judgment is based on three factors. First, we are forecasting less of a turnaround in the U.S. trade deficit than appears to be expected by most market participants, in part because many market participants expect a sharper downturn in U.S. economic activity than is forecast by the staff. Second, we expect a continuation of large German and Japanese surpluses, which may contribute to upward pressure on their currencies. Third, the pattern of relative inflation rates is likely to exert a negative influence on the dollar.

Mr. Kichline will now conclude our presentation.

James L. Kichline
July 18, 1978

FOMC Chart Show -- Financial & Conclusions

The first chart in the final section of your packet shows the financial counterpart to GNP, that is the volume of funds raised by nonfinancial sectors. Total funds raised in the first half of this year are estimated to have declined appreciably from the record volume in the latter half of 1977, as borrowing by the Federal Government and other sectors both declined. Federal borrowing is projected to edge a little lower through 1979, but still remains large by historical standards. Net borrowing by other sectors is expected to rise from the level in the first half of this year, reaching its previous peak by the latter part of next year. Funds raised relative to GNP, shown in the bottom panel, is expected to move lower throughout the forecast period; such a development is consistent with tightening financial markets in which borrowers rely more heavily on current income flows or run down financial assets to finance their requirements.

The projected rise from recent levels in the dollar volume of funds raised is attributable to developments in the nonfinancial corporate sector, shown in the next chart. Corporate expenditures for fixed investment and inventories have been rising faster than internally generated funds, thereby leading to enlarged external financing needs--shown in the top panel--and such needs are expected to rise further next year. Although this financing gap in 1979 is expected to be around the very high level experienced in 1974, the needs are not so large when allowance is made for the impact of inflation over the intervening years.

Selected balance sheet ratios, however, portray a picture of considerable erosion of corporate financial strength through next year. The top line in the bottom panel indicates that corporate liquidity peaked in the latter half of 1976 and is expected to continue declining over the forecast period, principally reflecting sizable growth of short-term debt. The ratio of short-term to total debt, the bottom line, rose appreciably in the first half of this year and should soon surpass the peak level during the second half of 1974.

The next chart indicates that the household sector also has been experiencing a less comfortable financial situation. Growth of mortgage and instalment debt has been tremendous in the current economic expansion, in association with the rapid pace of consumer outlays. While growth of total household debt is projected to recede from the peak rate last quarter, debt repayments relative to income are expected to rise further from the current record high. To some extent, households probably are conscious of the advantage in buying now and paying later during periods of high inflation, and thus are less concerned with the debt burden than in, say, the 1950's or 1960's. In addition, demographic changes are probably accounting in part for the upward move of the ratio, as growth of households in their 20's and 30's has picked up in recent years and these groups are traditionally heavy debt users. Nevertheless, the household sector in the aggregate is now into an area where further expenditures are likely to be constrained somewhat by debt servicing requirements and where slower growth or declines in income could bring on a substantial rise of loan delinquencies.

At various financial institutions, the projection also calls for a further tightening of positions. The next chart shows selected balance sheet ratios at banks and S&L's. In the present and forecasted environment of strong credit demands relative to deposit inflows, banks are expected to reduce their holdings of securities relative to total earning assets and to rely heavily on managed liabilities as fund sources. At savings and loans similar developments are also underway and expected to continue. In particular, borrowings from Home Loan Banks are likely to remain a key support of S&L mortgage lending.

The projections of GNP and flows of funds are consistent with some further rise in interest rates, shown in the next chart. Treasury bill rates are assumed to rise into the area of 8 per cent or a little higher by late this year and early in 1979. Later on in 1979, interest rates are assumed to drift down given a continuation of 6-1/4 per cent growth of M-1 and some moderation in the expansion of nominal GNP. Given these interest rates, household net acquisitions of financial assets--shown in the bottom panel--are likely to change relatively little. Deposit flows in dollar terms are expected to be sustained by the recent liberalization of Regulation Q ceilings and by further income growth.

The final chart in the package presents selected information on key variables assuming 6-1/4 per cent growth of M-1 and 1 percentage point slower and faster growth. For 1979, policy indexed by 6-1/4 per cent expansion of M-1 along with the associated interest rate assumption

represents the staff's judgmental forecast in the Greenbook. Extensions of that forecast to 1981 and the projections for the alternatives are derived mainly from the econometric model. The judgmental forecast for 1979 shows real growth of 3-1/2 per cent, prices rising around 7-1/4 per cent, and unemployment close to current levels at the end of 1979. Continuation of 6-1/4 per cent M-1 growth into 1980 and 1981 shows real growth fading, inflation little changed and unemployment rising. For the alternatives, impacts on real growth compared to the base forecast appear mainly in 1979 and 1980 while by 1981 real growth rates are converging; the reverse is true of rates of inflation which are diverging in 1981.

Monetary policy, of course, is a flexible instrument that can be altered more or less aggressively over time. Hence, the exercise performed is quite constraining, but illustrative of the difficult nature of the present and prospective situation. In all the scenarios, the economy is showing financial strains often associated with a mature expansion. The key problem stems from continuing high rates of inflation next year despite a moderating pace of economic activity. In the absence of additional exogenous price shocks, emanating largely from governmental actions, both the model solutions and the judgmental forecast suggest some easing of inflationary pressures next year.

FOMC MEETING

JULY 18, 1978

REPORT OF OPEN
MARKET OPERATIONS

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

Desk operations since the last meeting of the Committee were directed initially at moving the Federal funds rate modestly higher--from 7 1/2 to 7 3/4 percent--and then at holding that higher level. Estimated growth of the aggregates for the June-July period remained reasonably well within the Committee's ranges--though the growth rates reviewed in early July were fairly substantial, pressing toward the outer edge of the typical zone of indifference observed by the Desk. By last Friday, new estimates of the growth rates incorporated a sharp bulge in the July 5 week, but also an estimated decline in the July 12 week, and the two-month rates were actually pared slightly from those of a week earlier.

In practice, the weekly average funds rate hewed quite close to the 7 3/4 percent objective, although there was intraweek variation. Thus, the rate pushed to around 8 percent or a little higher in the closing days of June, as banks sought to manage their reserve positions with extra caution around the end-of-quarter statement publishing date. Heavy System injections of reserves to combat that undesired firmness caused the money market to ease noticeably in early July, calling for comparably massive efforts to absorb reserves on a temporary basis. Considerable firmness also developed yesterday, with Federal funds pushing close to 8 percent despite repeated desk efforts to pump in reserves.

In meeting reserve needs since the last meeting, the System was a sizable outright buyer of securities early in the period, a moderate seller about midway through the interval, and a moderate buyer again in the closing days. Over the period, the Desk bought \$861 million of bills in the market and \$1,279 million of bills from foreign accounts, while sales of bills to foreign accounts totaled \$466 million. Also in the early part of the interval the Desk bought \$301 million of Federal agency issues in the market--a more modest purchase of agencies than on other recent occasions.

A few days after buying the agency issues, we began mentioning in routine conversations with dealers that the Desk would probably seek to undertake some modest sales of agency issues on occasion when it fit with reserve objectives, avoiding times when the market seemed especially vulnerable to upset. These conversations elicited mixed reactions--mostly mild, though a few dealers expressed concern despite our reassurances. In any event, the market is now on notice that such sales could be undertaken.

The Treasury was quite helpful to us in facilitating operations around the end of June, moderating their calls on tax and loan accounts and even making a billion dollar redeposit to hold down their Federal Reserve balance. The modifications made a difference of some \$4 billion in the average Treasury balance in the July 5 week.

Interest rates moved higher across a broad front during the past month, very roughly in line with the 1/4 percent rise

in the Federal funds rate. Bill rates rose somewhat more than the funds rate, with 3-month issues up around 40 basis points, possibly reflecting an abatement of foreign official purchases. In yesterday's auctions the 3- and 6-month bills yielded about 7.11 and 7.50 respectively, compared with 6.67 and 7.23 percent a month earlier.

The day of the last meeting, the Treasury sold a 2-year note to yield 8.32 percent. Although bidders appeared to be anticipating the higher funds rate that emerged a few days later, the issue sagged in price soon after the sale and it currently yields about 8.46 percent. Another 2-year note is to be auctioned later this week and the market expects a yield around 8.50 percent-- a level that could attract sizable disintermediation.

Among longer-term Treasury issues--5 years or longer-- yield increases were mainly 20-25 basis points, including sizable 20 basis point increases in some of the longest issues. One factor weighing on the longer end was the \$1 3/4 billion issue of 15-year bonds, which was well bid for on June 28 at an average yield of 8.63 percent, but which slipped in price to yield about 8.67 percent by the period's close. More fundamentally, though, the market's weakness was a response to continuing evidence of inflation, anticipation of firmer System policy sooner or later, and prospects of heavy Treasury and other credit demands in coming months. The 1/4 percent rise in the discount rate announced June 30 was fully expected and even "over-expected" in that many observers had looked for a larger rise. The small size of the change initially provided some relief and support to the

market, but a more sombre appraisal developed later along the line that the central bank and the financial markets will eventually have to face up to stronger medicine. Indicative of their sober view, Government securities dealers ended the period with a net short position of about \$1.3 billion in over-one-year coupon issues, a little deeper than the \$1 billion short position a month earlier.

In the month ahead, the Treasury will be raising additional funds in the market--\$300 million in one-year bills tomorrow, about \$750 million in 2-year notes to be auctioned Thursday, and perhaps about \$2 billion in the August financing to be announced a week from tomorrow. The System Account holds \$3.2 billion of the notes maturing August 15, and we would plan as usual to roll these over into new issues in about the proportions those issues are offered to the public.

Finally, I should mention that the Trading Desk began a few weeks ago to trade with another dealer in Government securities--Morgan Stanley and Company, which has long been a major underwriter of corporate issues and recently has developed a capability in Treasury issues.