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

Once again it is my unpleasant task to report to you of a further decline in the dollar, of the reasons for that decline, and of fairly sizable intervention on our part. The dollar was under almost continuing selling pressure during the period against the German mark, dropping a little bit further virtually every day, for a decline of 7 percent for the period. Against the Swiss franc, it had fallen by 8 percent until the National Bank entered into a program of heavy intervention, pushing the rate back by 10 percent only to have renewed slippage of 4 percent. Both the mark and the Swiss franc reached new highs against the dollar, as have the Dutch guilder and Belgian franc. The yen held reasonably for most of the period without much need for intervention by the Bank of Japan but on recent days has also advanced back to record high levels against the dollar.

The atmosphere has not been one of near panic, as developed in mid-August, so this cannot be classified as a run on the dollar. But the implications are just as serious. Corporate treasurers, investment managers, central bankers, and other holders of dollars around the world are simply walking away from the dollar. Whereas Alan and I have been reporting to you of the market's mood over the past year and a half as increasingly bearish or pessimistic, and then skeptical, I think the more appropriate term is now cynical. Even some of the staunchest dollar supporters in our banks and corporations have decided that they have to join in on the selling of dollars simply as a matter of self protection. For too many evenings they have gone home long of dollars, only to find themselves with a half percent or more loss in the morning.

The other side of the exodus from dollars is an insatiable demand for German marks

and Swiss francs, and a further bidding up of the price of gold, and ominously, other commodities as well. To be sure, there are special circumstances in each case which help explain the demand for other currencies. For the mark, there has been massive speculation over the possibility of a reevaluation of the mark within the EC snake. Within the period, the Bundesbank supplied equivalent of marks to the market to maintain the limits of the snake. This speculation was triggered by the market's reaction to the discussions of a new European Monetary System, which have been going on for some time and will continue at least into December and probably into next year. Market participants expect a substantial realignment of currencies, with a sharp revaluation of the mark, as one of the conditions of establishing the new arrangements. U.S. policy makers have been cautious in their characterization of the EMS negotiation, but the market's view is that it arises out of the European official frustrations over the dollar's weakness. Consequently, whereas speculation between snake currencies could in theory be neutral in terms of its effect on the dollar, with the dollar itself under generalized selling pressure, the tensions within the snake have generated additional flows of funds out of dollars. Indeed, to the extent that it has become expensive to borrow other snake currencies, such as the Dutch guilder, to short them against the mark—call-money in the Amsterdam money market has been allowed to rise temporarily to as high as 22 percent per annum—operators borrow dollars which are readily available and short dollars against the mark, either directly or through the snake currencies.

The Bundesbank, caught in the middle of all this, has been understandably concerned that it has already far exceeded its targets for monetary creation in 1978 and could face the same kind of delayed inflationary effects as occurred following the big interventions in the early 1970s. Since it has created so many marks in an open-ended commitment to the snake, the

Bundesbank has been reluctant to intervene very much in dollars or to have us intervene very much either. The market has sensed this reluctance and has tested both the Bundesbank and ourselves on each occasion in which the dollar has come under selling pressure.

The revaluation of the mark in the snake this past weekend—of 4 percent against the Danish and Norwegian kroner and 2 percent against the Dutch guilder and Belgian franc—was smaller than the market [unintelligible] and simply whetted the appetites of the speculators. The dollar was hit with a new bout of selling pressure yesterday, even after the latest hike in the Federal Reserve's discount rate, the passage of the energy bill, and the passage of the tax bill.

In the face of this pressure, since the last meeting, we have been in the market on ten days, although not in a big way on any occasion. At least we have avoided the kind of panicky selling of dollars which has erupted in the past when people suddenly feared that we were walking away from the dollar as well. During the period we sold a total of $519 million marks, of which $292 million was for the System account. Net of repayments our swap debt in marks increased by $120 million to $813 million. The Treasury's swap debt rose by a net of $114 million to $436 million.

The strength of the Swiss franc is also a special case, but the market sees it as directly related to the generalized weakness of the dollar. Real growth in Switzerland may be on the order of 2-3 percent this year, if that, and the inflation rate many actually come out flat or even negative. And yet M1 growth is currently running in excess of 15 percent—a classic Keynesian liquidity trap. That is, for speculative or precautionary reasons Swiss firms, foreign firms, banks around the world all want to buy and hold Swiss francs, which have been an incredibly appreciating asset. The franc has also appreciated against the mark and other European currencies, but again the dollar is the vehicle. To deal with the rise of their currency, the Swiss

National Bank had tried every technique in the book in terms of intervention in the spot and forward market and various forms of exchange and capital controls, and nothing worked.

By late September the rate had reached such ridiculous levels against both the dollar and the mark that the National Bank embarked on a program of what it called energetic intervention, which was really an effort to push the franc down far enough to force some of the bulls to cover their long positions on francs. This was fully discussed with senior officials of the Federal Reserve and the Treasury, and we followed up the National Bank's operations in Zurich with intervention in New York, again taking only half of the amount we did for our own account. But the fully effective coordination we have had in the past, between the Swiss, Germans, and ourselves, was not there since the Bundesbank was caught up in its own problems. As a result the market has been flooded with Swiss francs and marks, but the bulls are still looking for more. In all, the Swiss bought during the period including what we did for them in New York. Our sales for our own account amounted to $210 million, all drawn on the swap line, raising outstanding drawings to $306 million.

Mr. Chairman, I have spoken longer than I normally do, but the situation has become critical. Actions which are being taken by dollar holders today, and attitudes they are developing, will not be easily reversed. Fortunately, the economic indicators suggest that some of the fundamentals are beginning to turn in our favor. These include the relative trade and current account positions, and the underlying growth rates. Nevertheless, market participants stress that we have shown scant improvement on the inflation front, and that is their prime concern.

Notes for FOMC Meeting
October 17, 1978
Alan R. Holmes

As far as routine recommendations are concerned, the System as of Friday had nine swap drawings of German marks totaling $307 million and seven drawings of Swiss francs totaling $64 million maturing on or before December 1. All of these are first renewals except one drawing of marks equivalent to $43.5 million maturing on December 1 which would be a third renewal. I recommend that the Committee approve rolling over, if necessary, the drawings for a further three months as they mature. We will make a special effort to repay the mark swap drawing maturing on December 1, in order to avoid a third renewal. In fact, we will be paying down about [unintelligible]. We will, of course repay others if market conditions permit.

On September 29, we transmitted to the Committee a memorandum on Dr. Gleske's proposals for revisions of our swap arrangement with the Bundesbank which, along with other swap agreements, will be up for renewal in December. I have nothing to add to that memorandum, unless there are questions.

I would propose that we accept the proposal that the current exchange rate be applied to swap renewals and the proposal for certain clarification of the language of the existing swap agreement. Any language change would be cleared with the Foreign Exchange Subcommittee. I should like to proceed with negotiations with the Bundesbank and our other swap partners along these lines and ask for Committee concurrence.

As for the more substantive proposals made by Dr. Gleske for the elimination of the 50-50 profit or loss sharing on our swap drawings, and a revision of the interest rate

to be paid on the counterpart of our drawings, I suggest that we accept the Treasury's view that in light of current market conditions we defer action on these proposals. I would, however, like to get the Committee's opinion on the general nature of these proposals and ask for approval to negotiate them with the Bundesbank and our other swap partners when and if we and the Treasury agree that market conditions permit.

James L. Kichline
October 17, 1978

INTRODUCTION -- FOMC CHART SHOW

In our presentations this morning we will be referring to the package of chart materials distributed to you. The principal policy assumptions that underlie the staff's forecast are displayed in the first chart of the package. The interest rates assumed are those tied to the low end of the Federal funds rate range shown under longer-run Alternative B in the Bluebook; in short-term markets these rates are about 1/4 percentage point more than assumed in the forecast a month ago. Growth of M-1 consistent with these rates is assumed to be near the top of the current longer-run range, not allowing for the possible impact of automatic transfers.

On the fiscal side our assumptions are little changed from a month ago. The tax cut assumed is close to that contained in the bill now before the President. Federal outlays for fiscal 1979 are a bit larger than in the Congressional budget resolution, mainly because of higher interest payments. The assumption of a crude oil equalization tax has been dropped in view of Congressional actions.

Current economic indicators, shown on the next chart, suggest the economy has been expanding at a moderate rate in recent months. Total industrial production has continued to rise, but the gains have been smaller than during the spring. Output of consumer goods, in particular, has been sluggish since April. Total nonfarm employment also portrays a slower pace of activity recently following exceptional increases during the first half of the year. In manufacturing,

employment actually declined slightly during the third quarter. Retail sales, in the bottom left panel, perked up in September, according to advance data, and gains in August were revised upward. Residential construction outlays, in contrast, remain high but appear to have peaked out. In the aggregate, it seems likely that real GNP grew at about a 3 per cent annual rate last quarter and is expected to be around that rate or a little stronger in the current quarter.

Mr. Zeisel will now review the staff's domestic nonfinancial forecast, focusing on the principal forces expected to influence the course of economic activity and prices next year.

CONFIDENTIAL (FR) CLASS II-FOMC

Material for

Staff Presentation to the Federal Open Market Committee

October 17, 1978

PRINCIPAL ASSUMPTIONS

MONETARY POLICY

- Interest rates at the low end of ranges for Alternative B in the Bluebook
- Growth of M-1 at 6¼ per cent, around top end of range for Alternative B (abstracting from impact of automatic transfers)

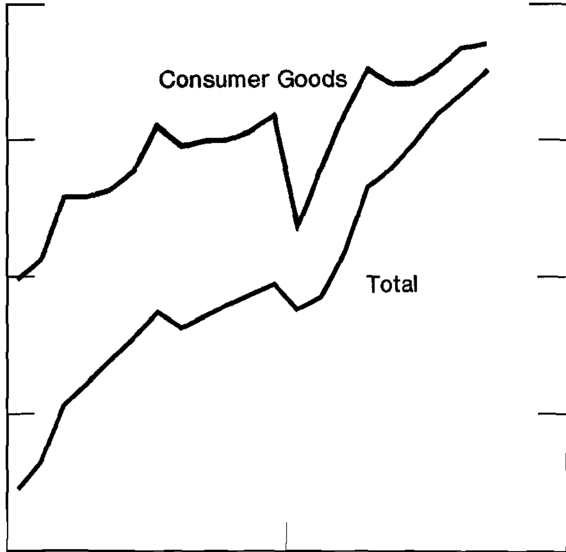
FISCAL POLICY

- Tax cut of $20 billion beginning 1979
- Unified budget expenditures of $491 billion in FY 1979

CURRENT ECONOMIC INDICATORS

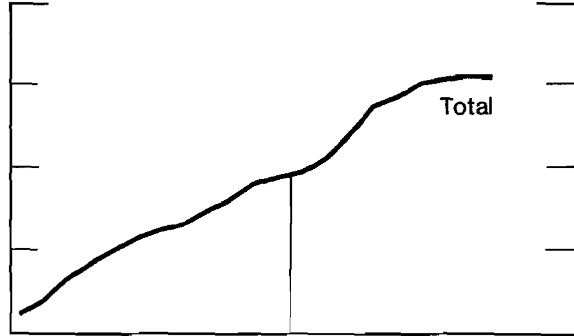
Industrial Production

Index, 1967=100



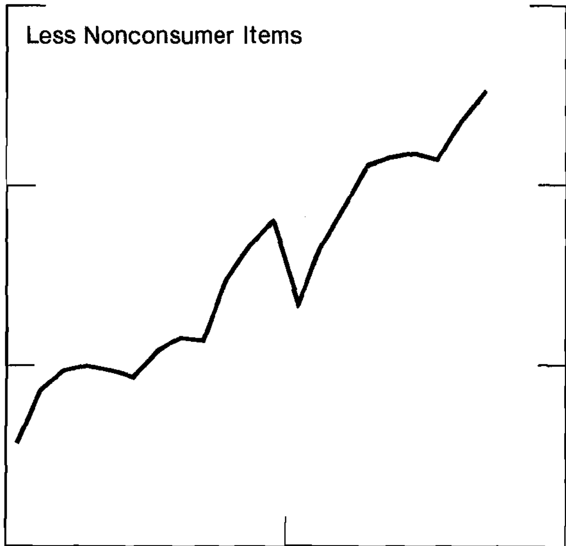
Nonfarm Employment

Millions



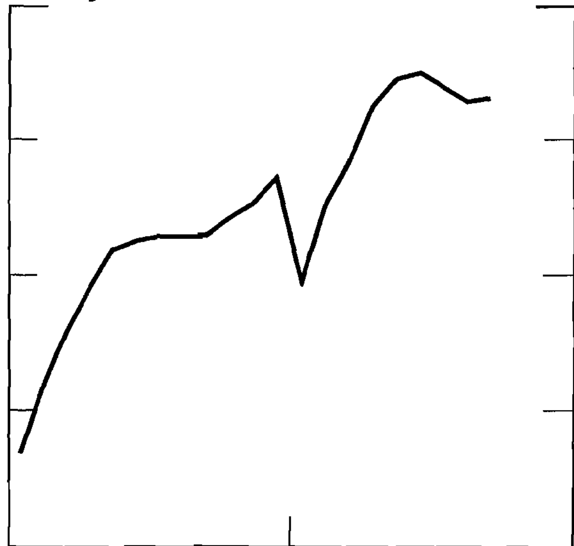
Retail Sales

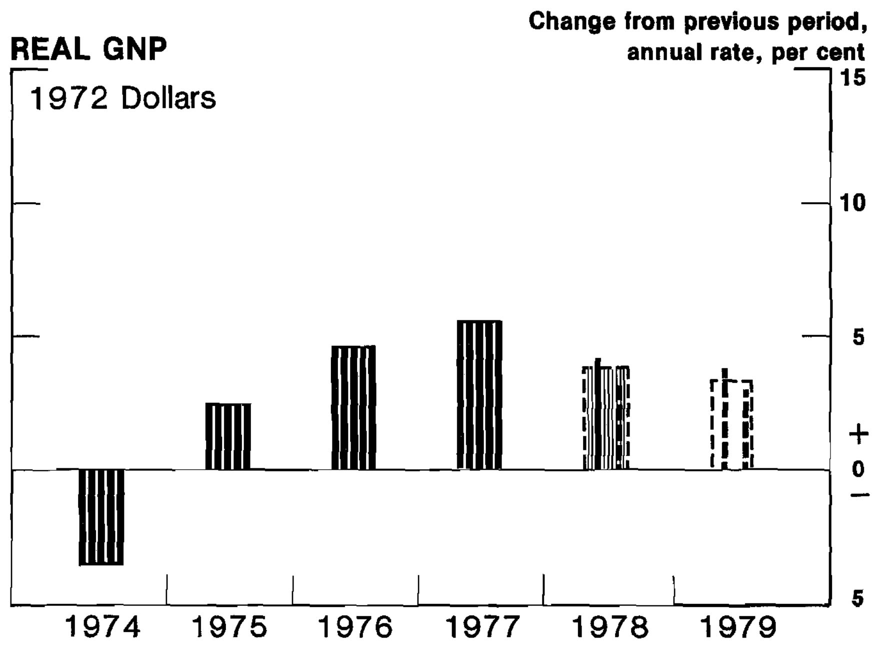
Billions of dollars



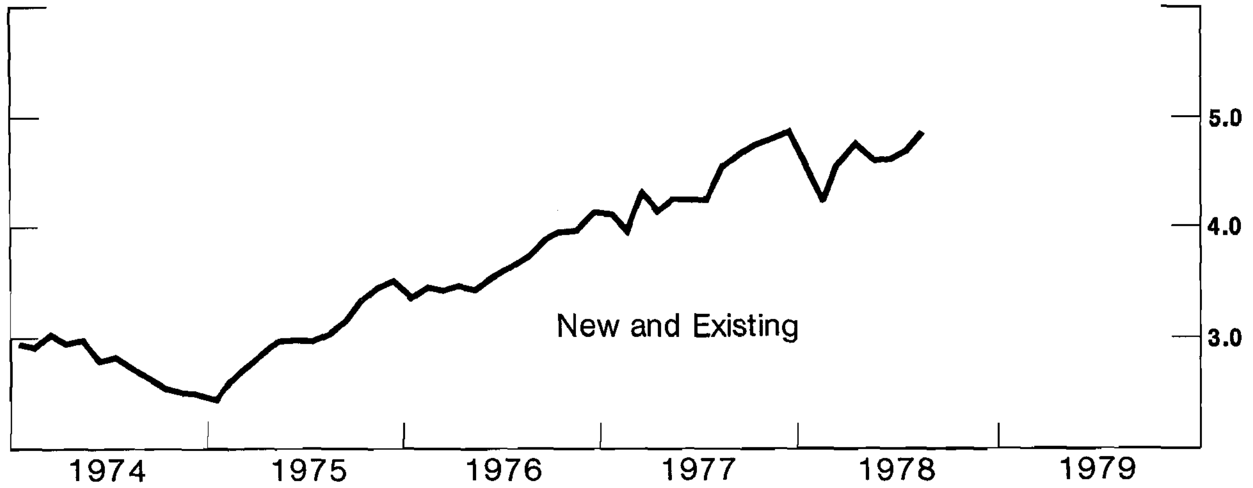
Residential Construction Outlays

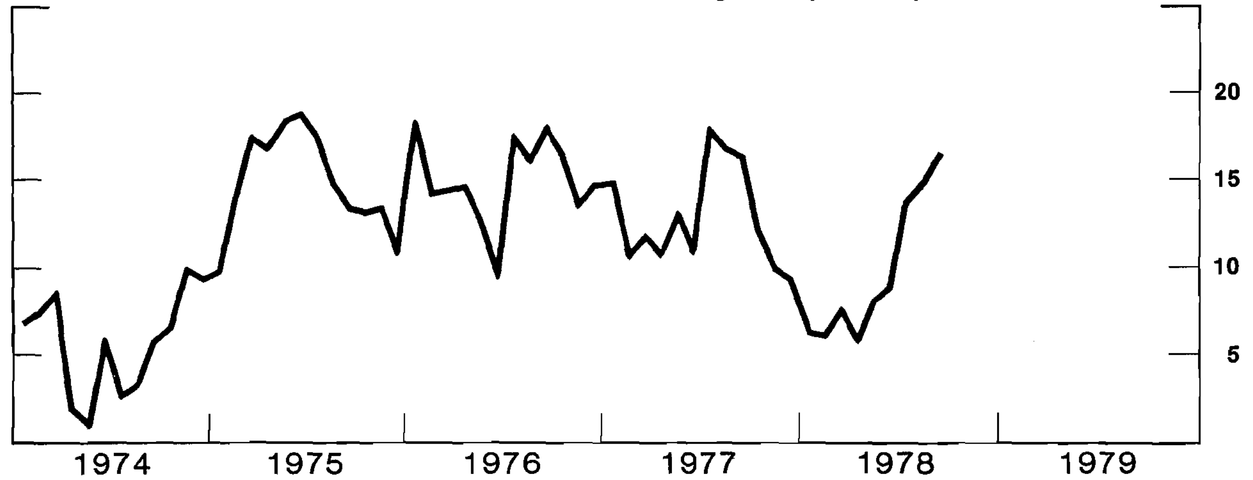
Billions of dollars

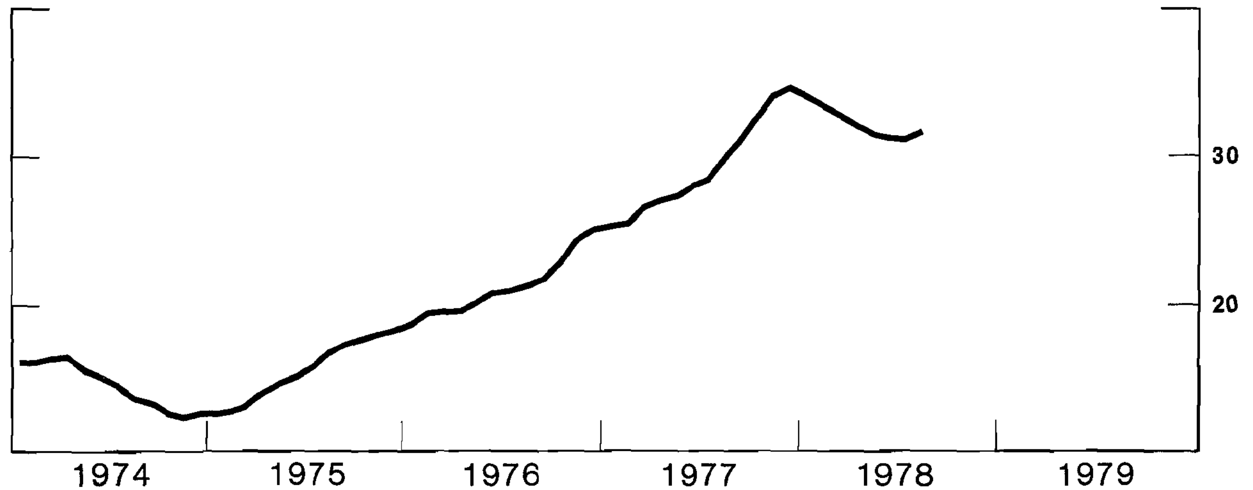


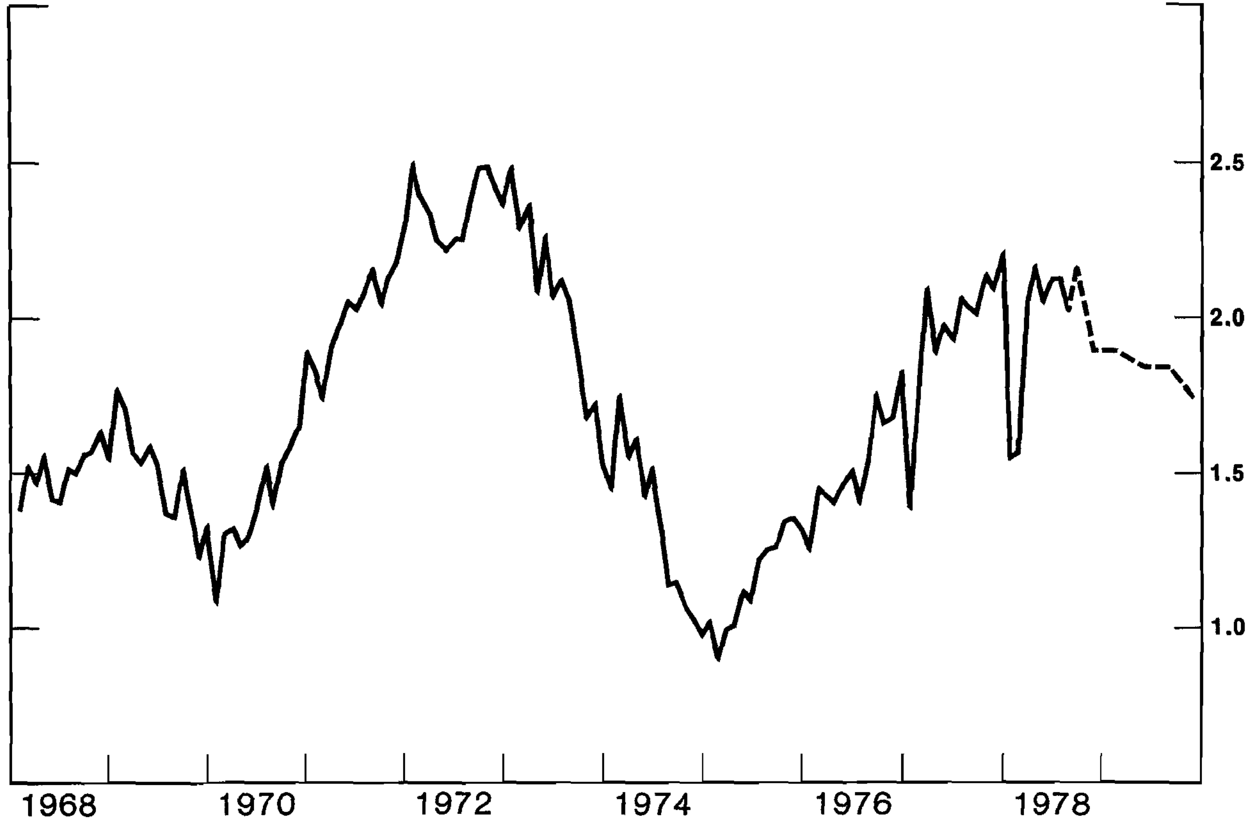


REAL GNP
Change from previous period,
annual rate, per cent
1972 Dollars
15
10
5
+
0
−
5
1974
1975
1976
1977
1978
1979


HOMES SOLD
Millions of units
5.0
4.0
3.0
New and Existing
1974
1975
1976
1977
1978
1979

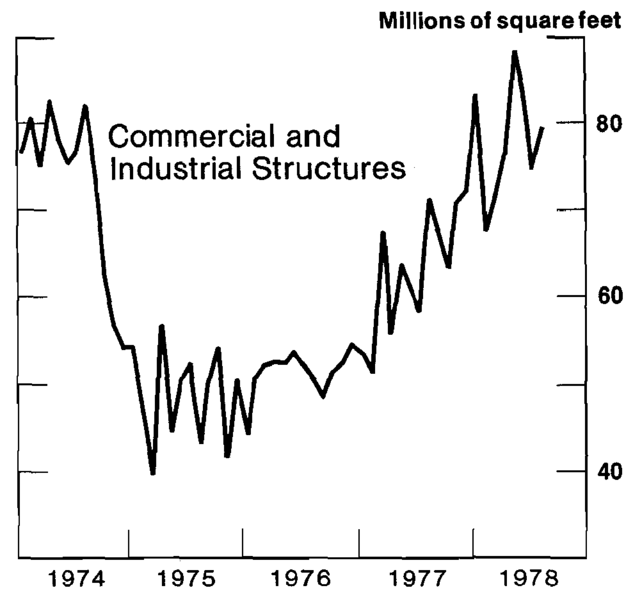

DEPOSIT GROWTH AT THRIFT INSTITUTIONS
Change from previous period, annual rate, per cent
20
15
10
5
1974
1975
1976
1977
1978
1979


OUTSTANDING COMMITMENTS AT SAVINGS AND LOAN ASSOCIATIONS
Billions of dollars
30
20
1974
1975
1976
1977
1978
1979

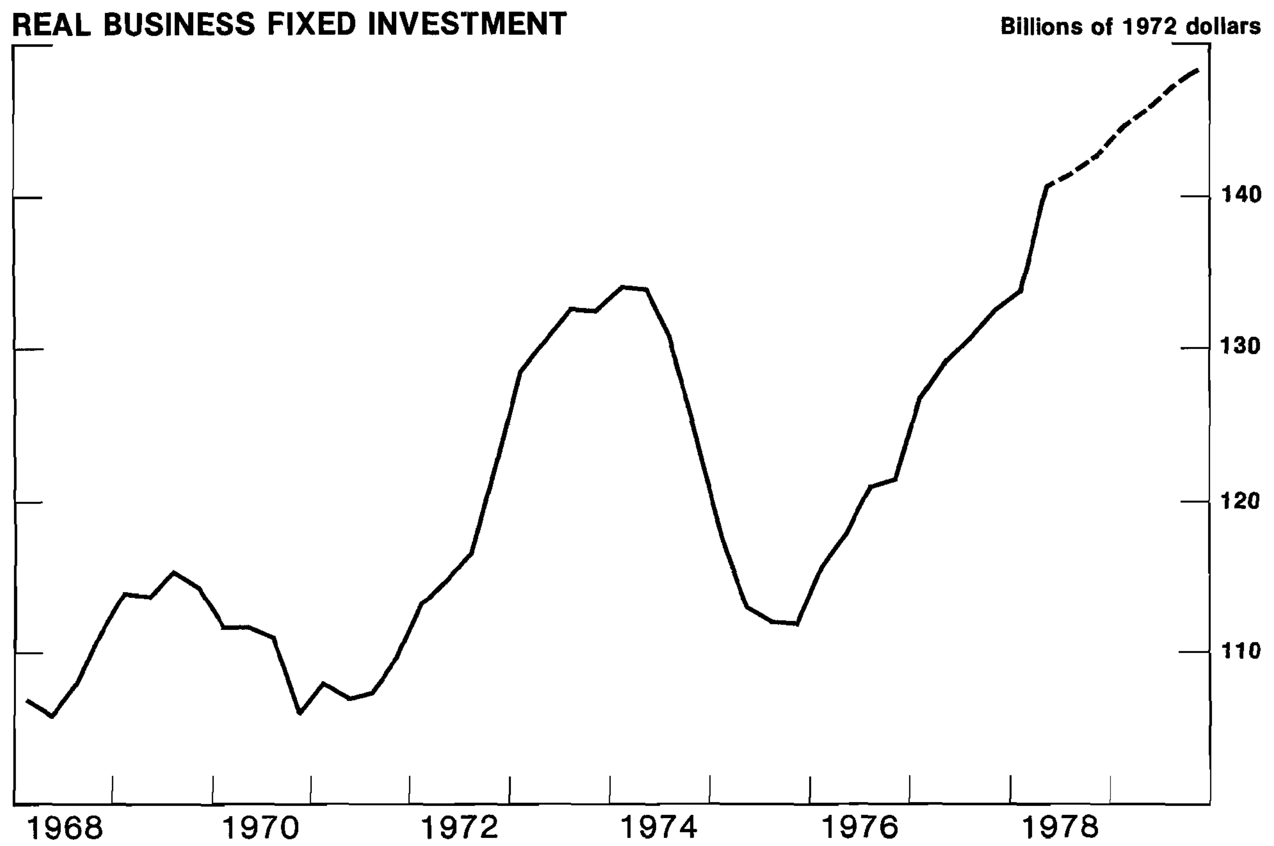

HOUSING STARTS
Millions of units
2.5
2.0
1.5
1.0
1968
1970
1972
1974
1976
1978

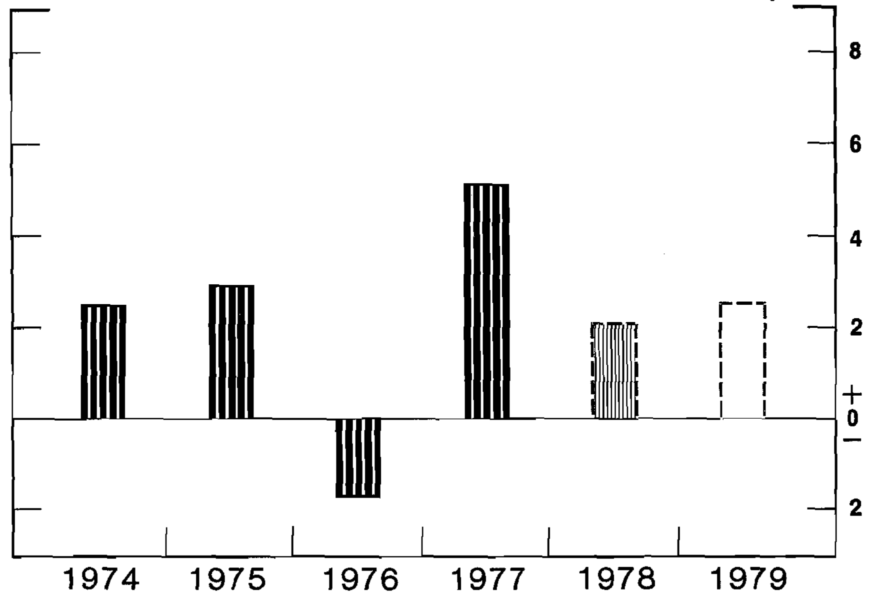
REAL NEW ORDERS

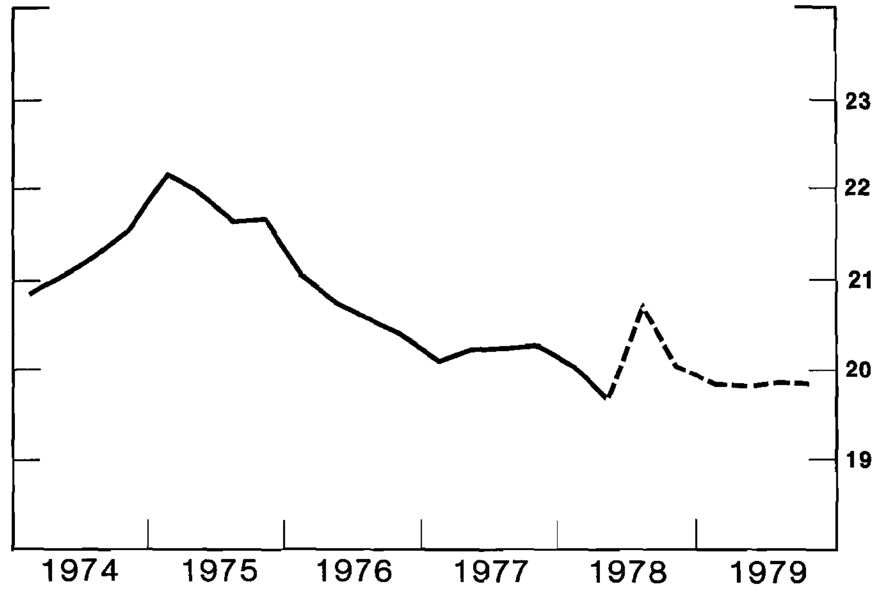
CONSTRUCTION CONTRACTS



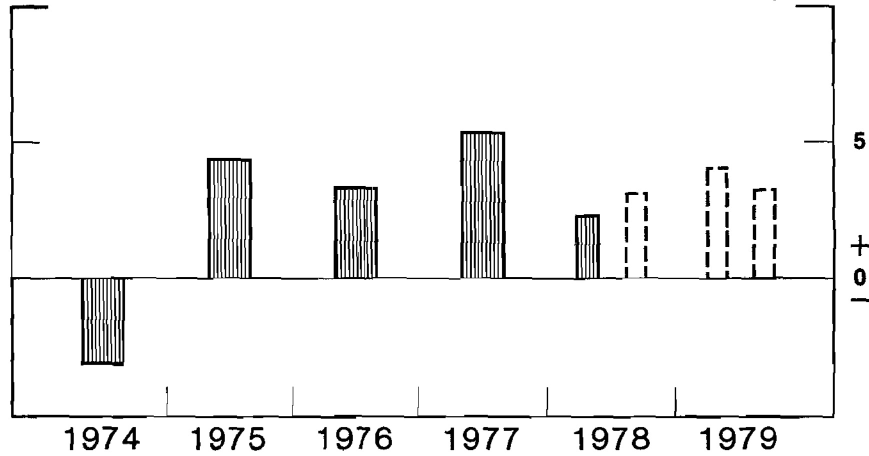
REAL BUSINESS FIXED INVESTMENT

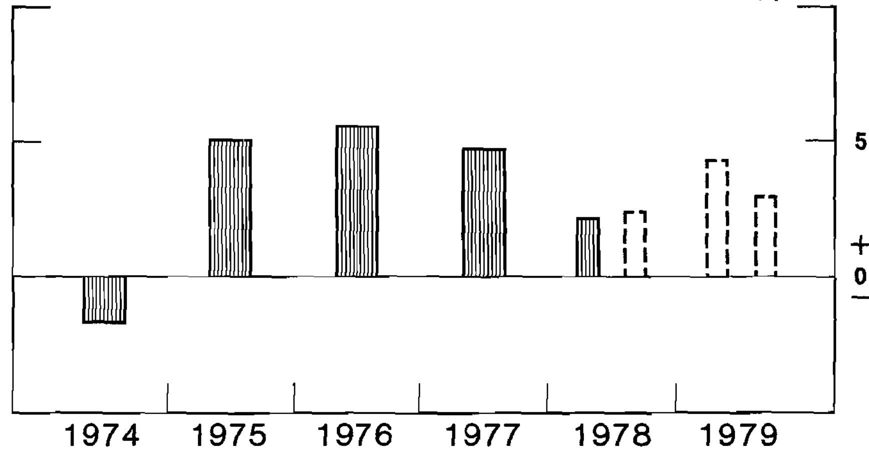


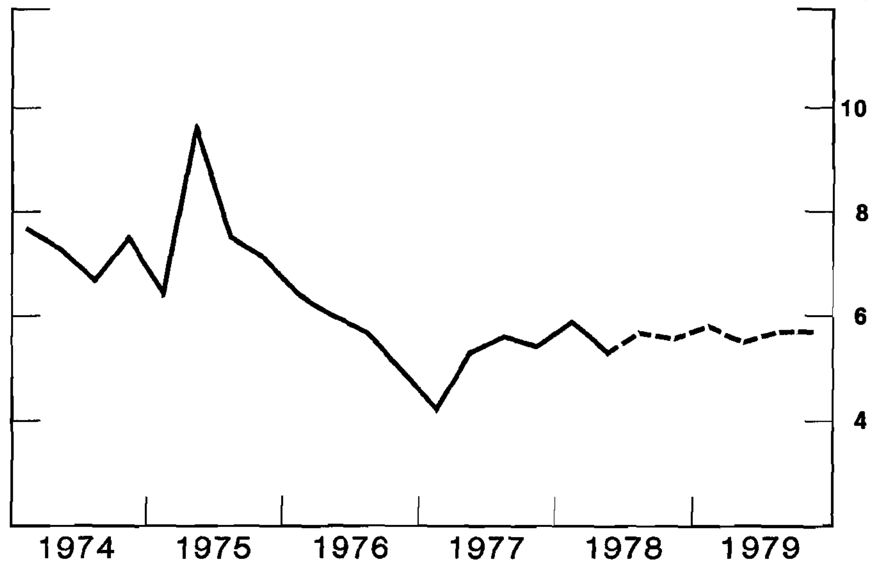


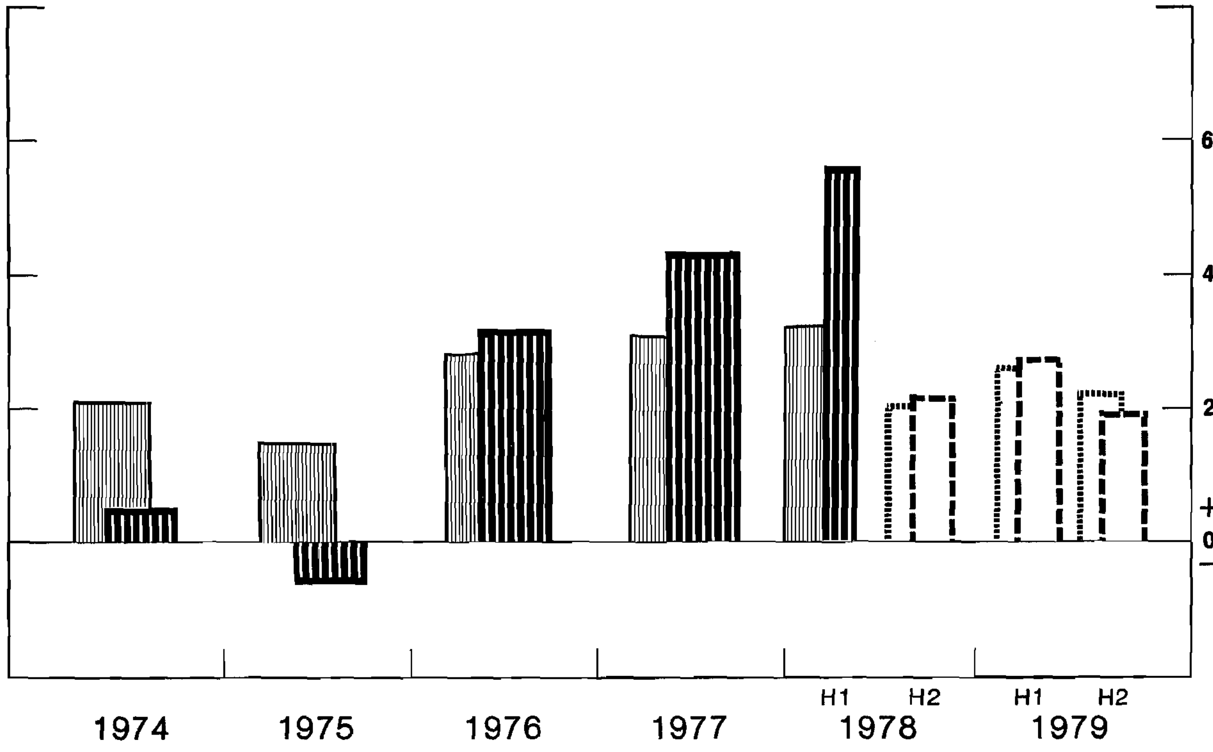


*Federal and State & Local

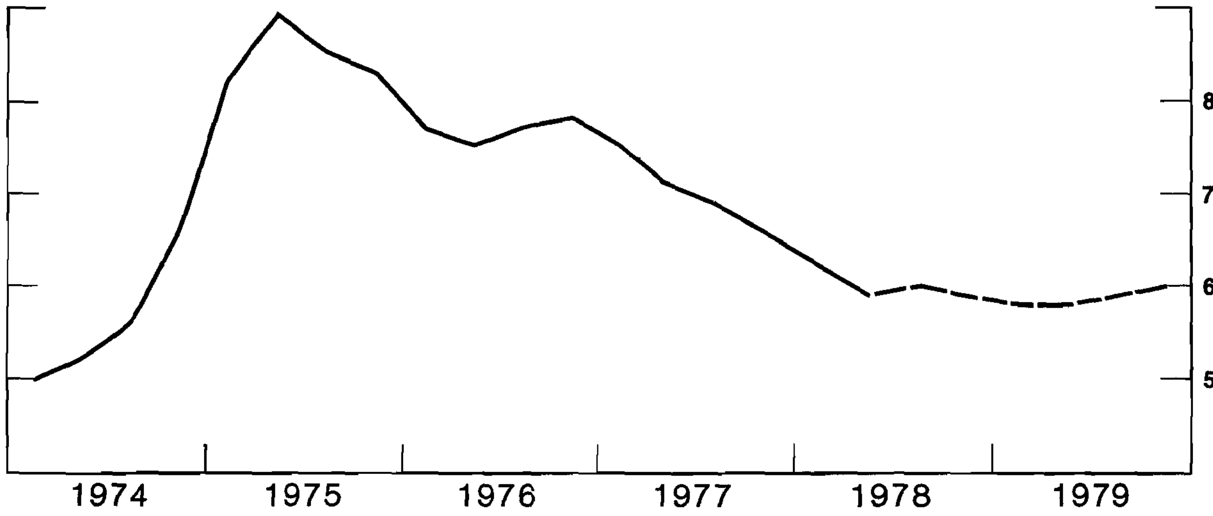

REAL DISPOSABLE PERSONAL INCOME
Change from previous period, annual rate, per cent
5
+
0
−
1974
1975
1976
1977
1978
1979


REAL PERSONAL CONSUMPTION EXPENDITURES
Change from previous period, annual rate, per cent
5
+
0
−
1974
1975
1976
1977
1978
1979


SAVING RATE
Per cent
10
8
6
4
1974
1975
1976
1977
1978
1979



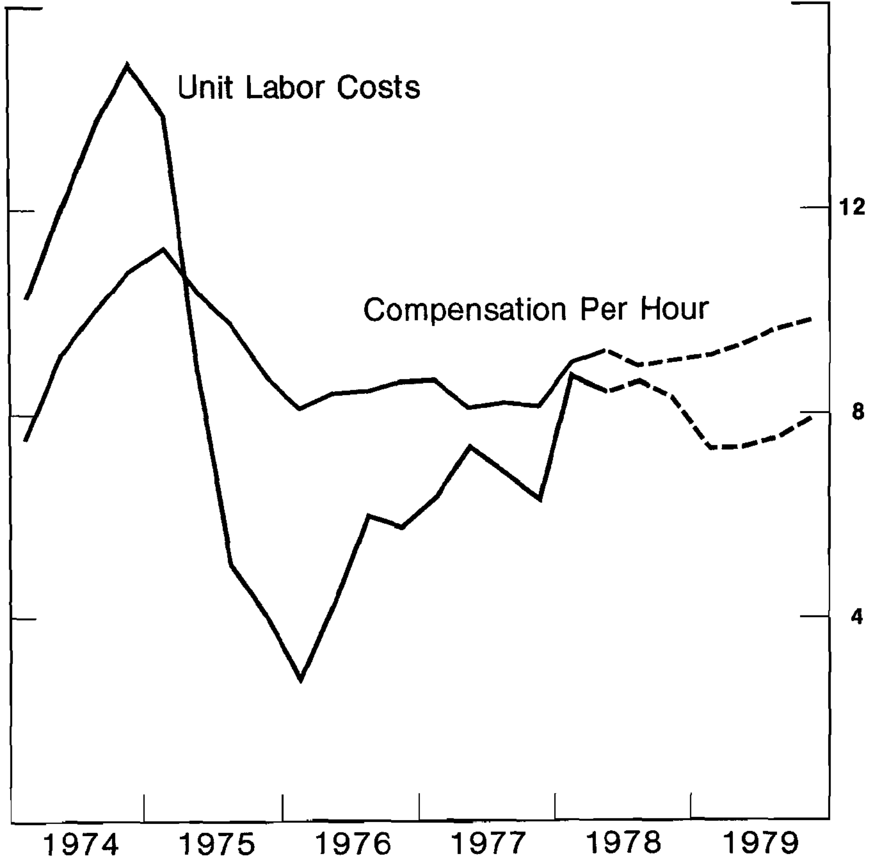
CIVILIAN LABOR FORCE
EMPLOYMENT
Change from previous period, annual rate, millions
6
4
2
+
0
−
H1
H2
H1
H2
1974
1975
1976
1977
1978
1979



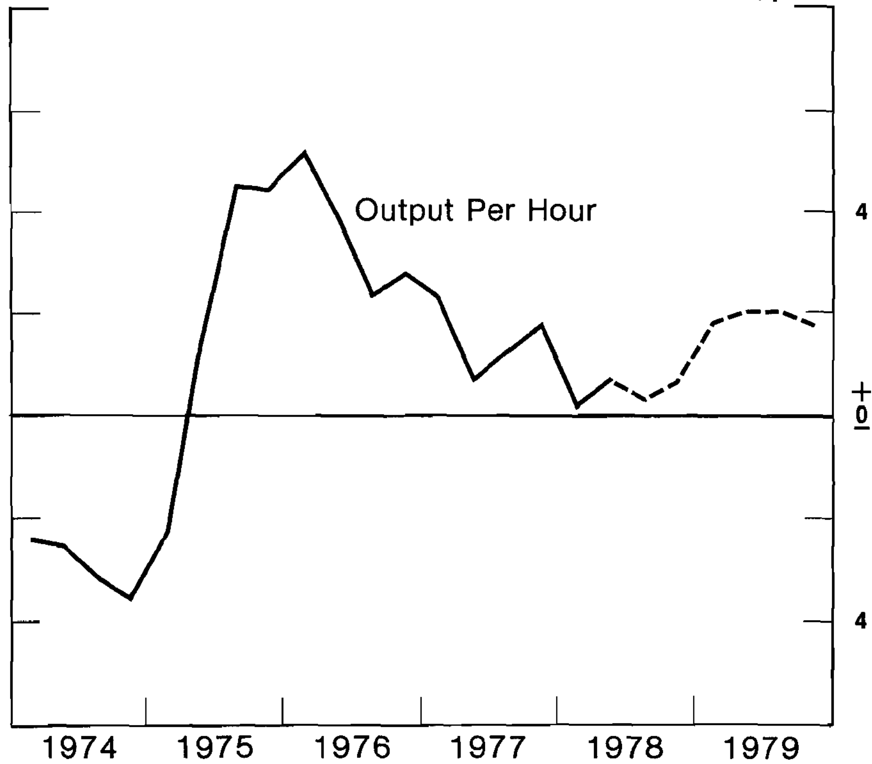
UNEMPLOYMENT RATE
Per cent
8
7
6
5
1974
1975
1976
1977
1978
1979

UNIT COST INDICATORS
Nonfarm Business Sector

Change from year earlier
annual rate, per cent

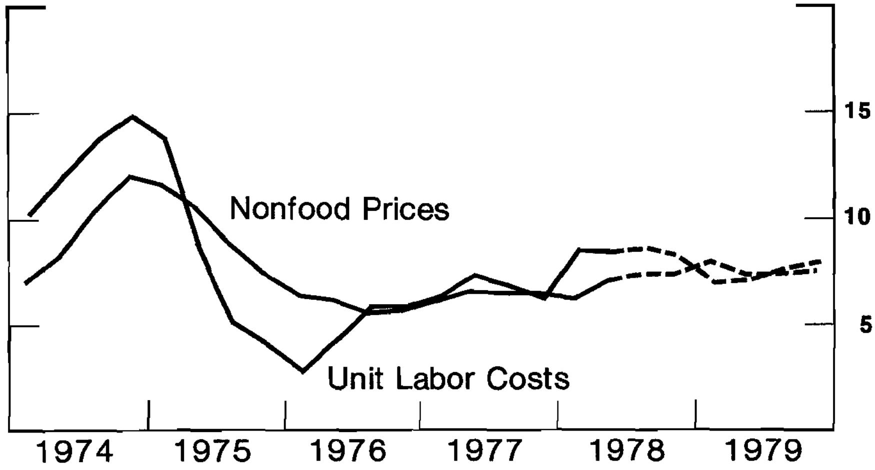


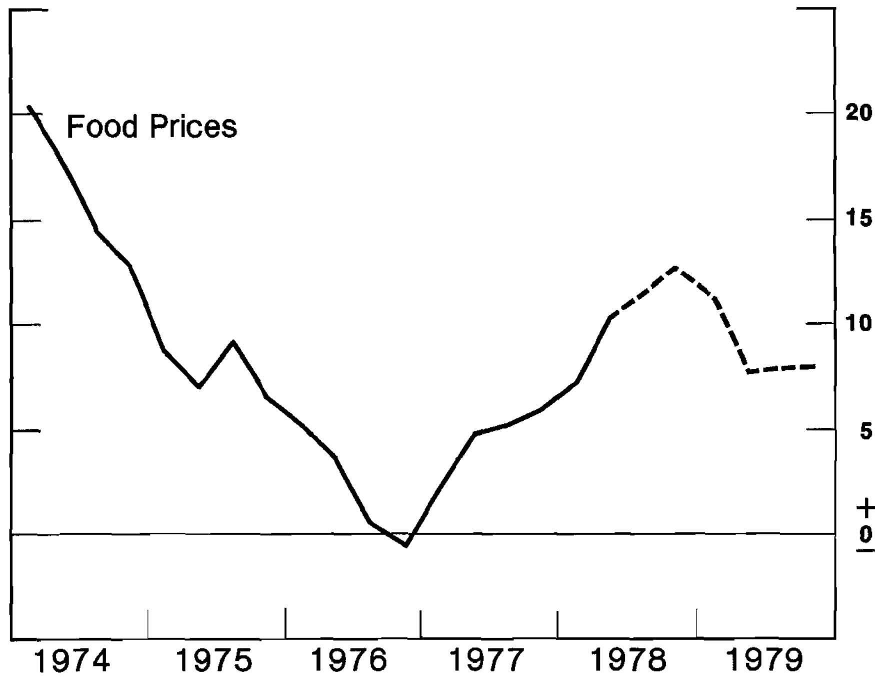
Change from year earlier
annual rate, per cent

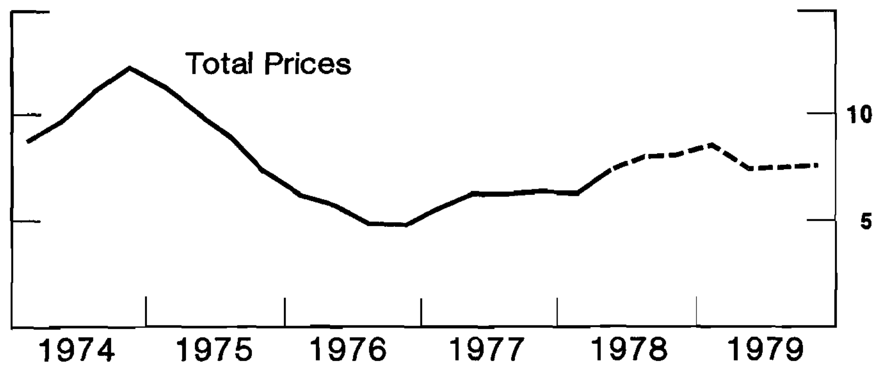


LABOR COSTS AND PRICES

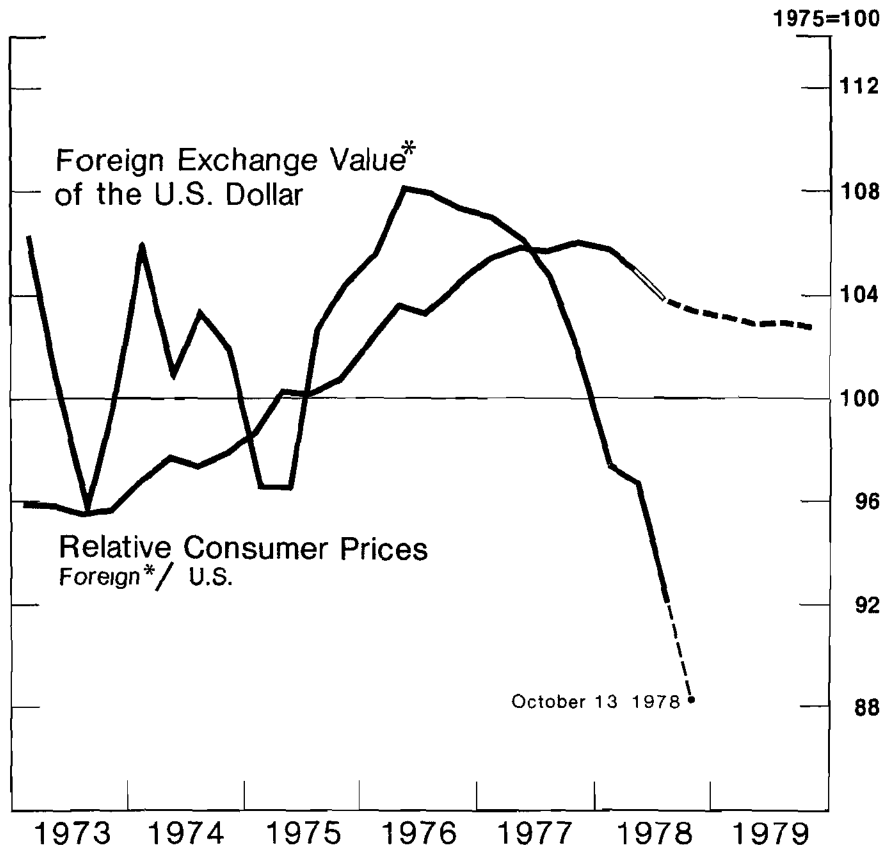
Change from year earlier, per cent



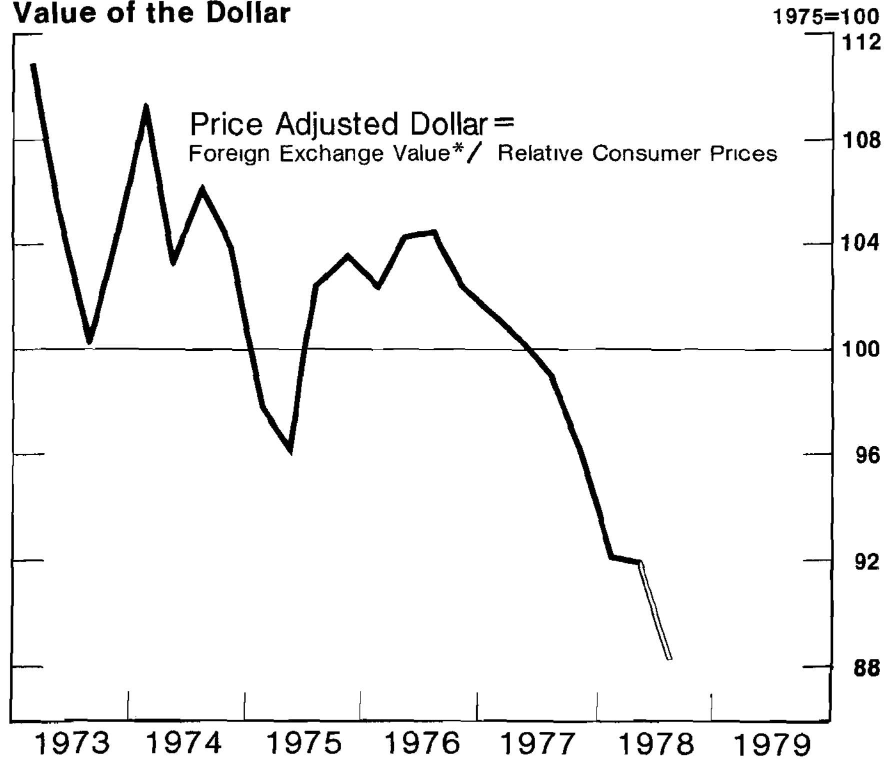




U. S. INTERNATIONAL PRICE COMPETITIVENESS

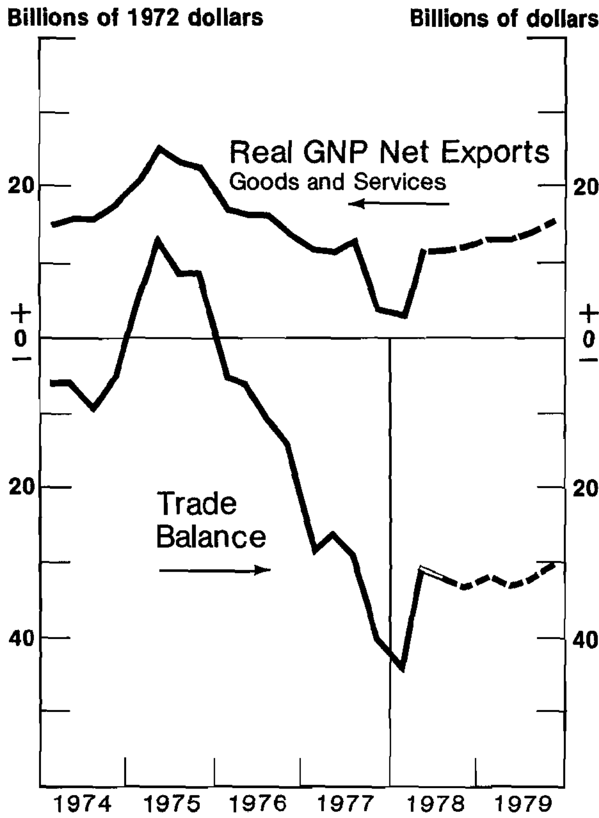


CPI Adjusted Foreign Exchange Value of the Dollar



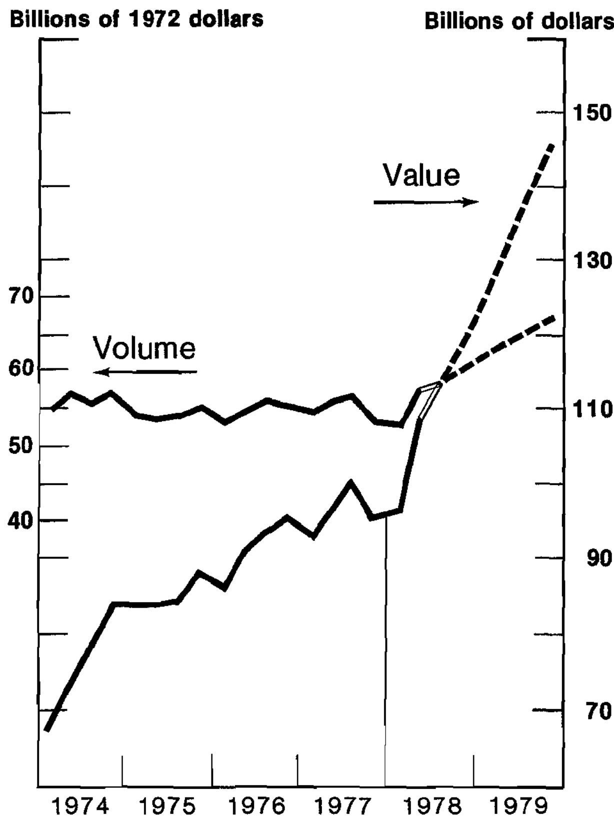
*Weighted average against G-10 countries plus Switzerland using total 1972-1976 average

NET EXPORTS

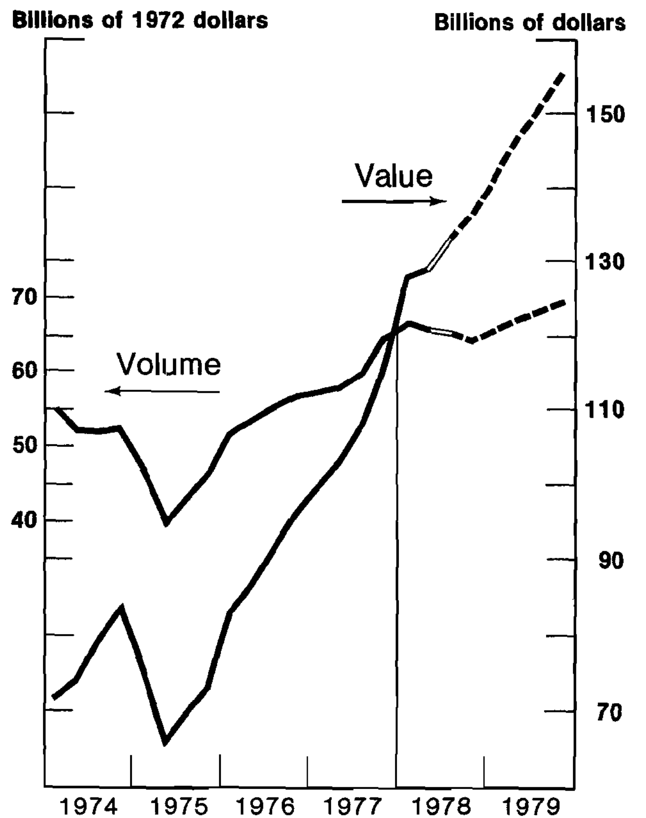


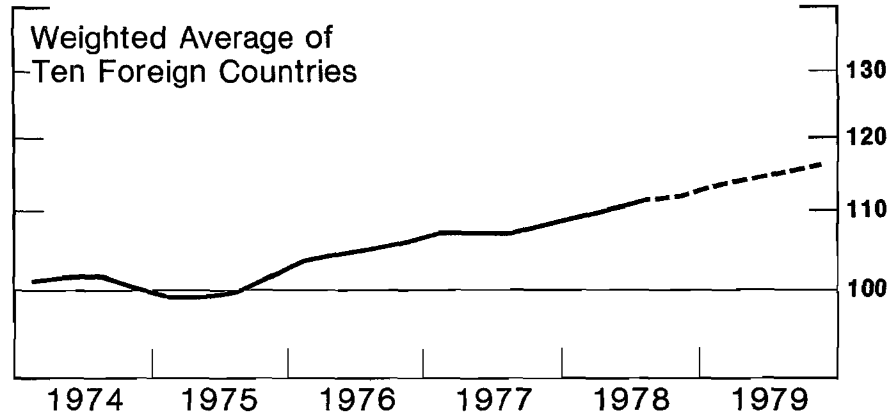
	Merchandise Trade Balance	Current Account Balance
	Billions of dollars	
1977	−31.1	−15.2
1978	−36	−18
1979	−32	−13

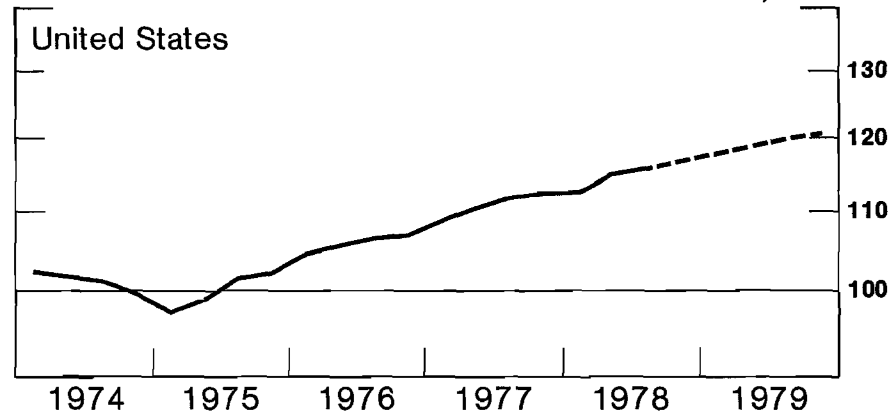
NON-AGRICULTURAL EXPORTS

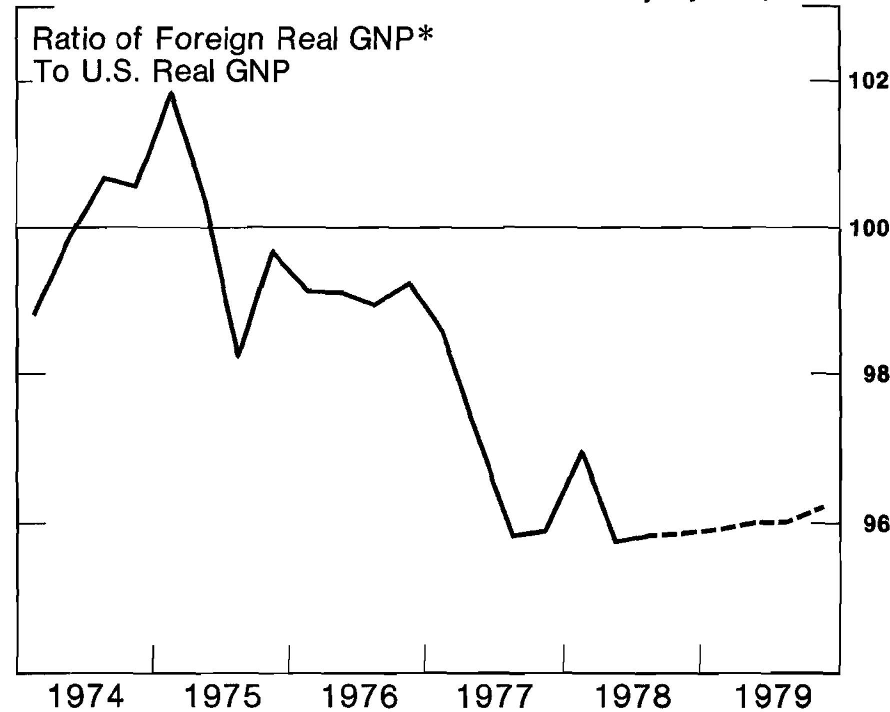


NON-OIL IMPORTS

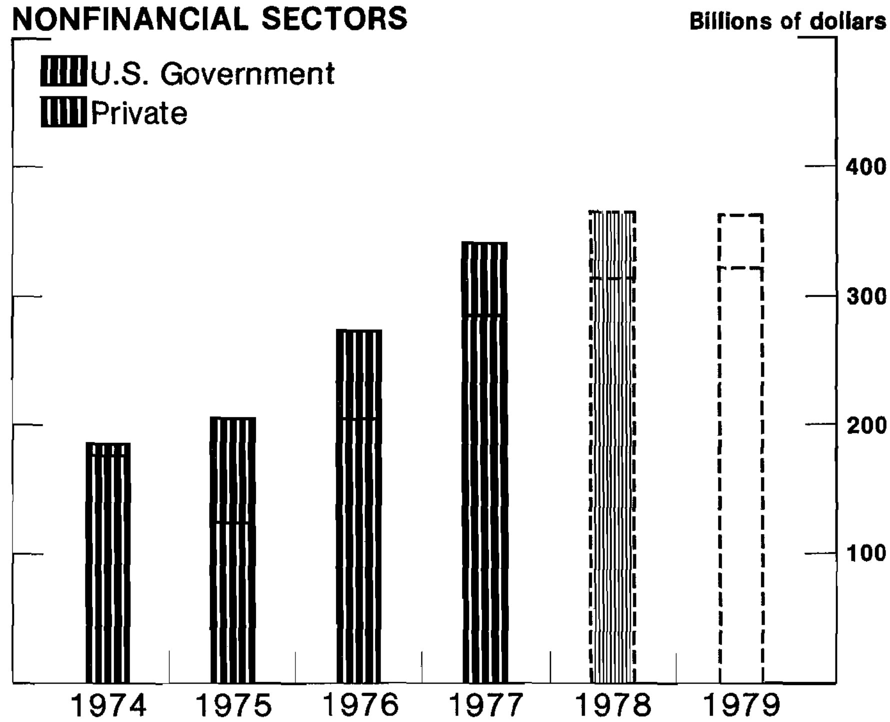


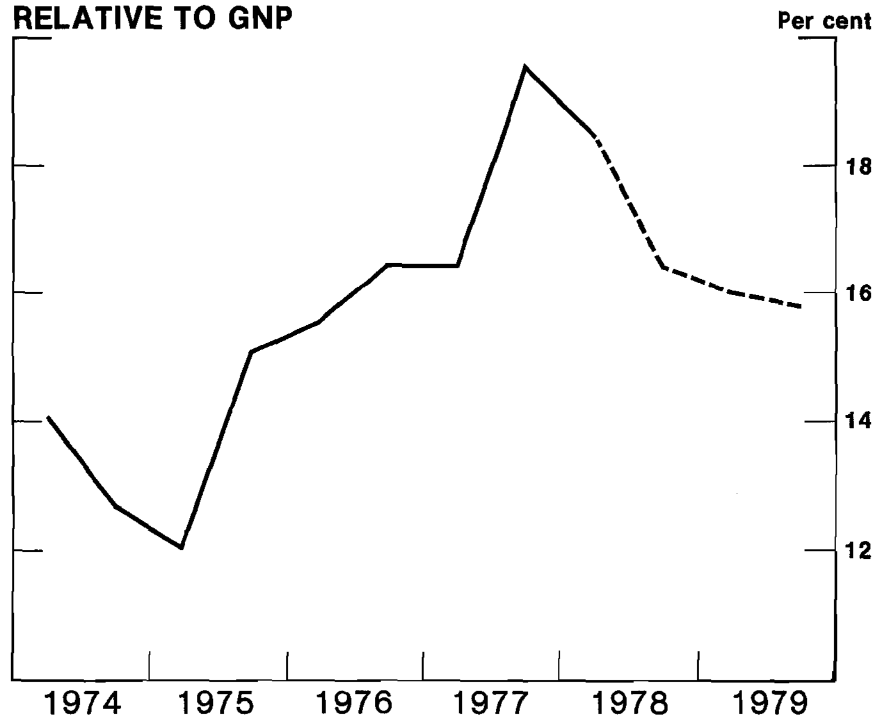




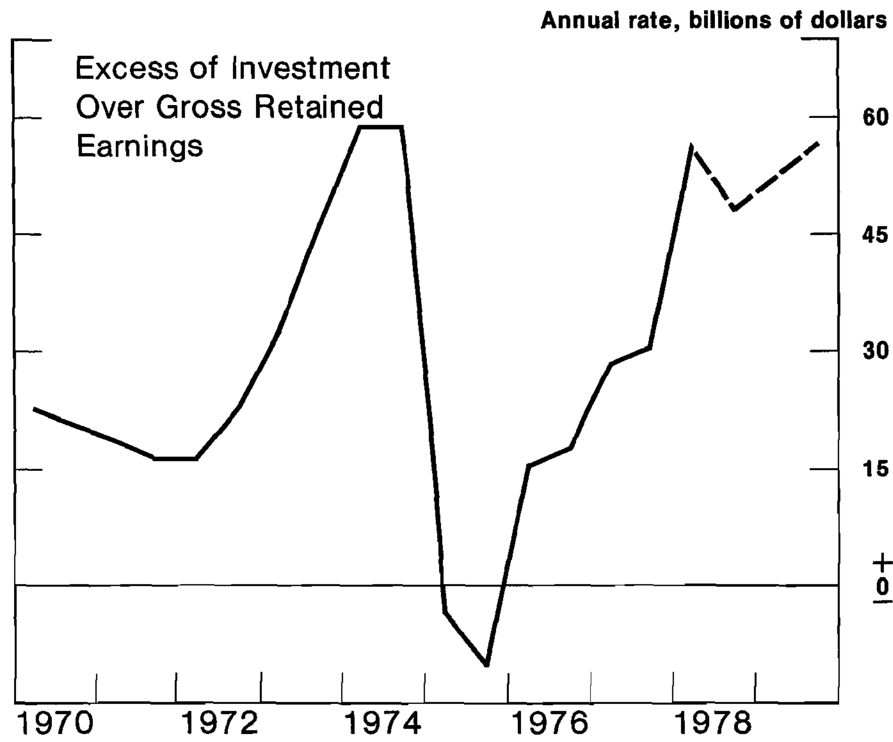


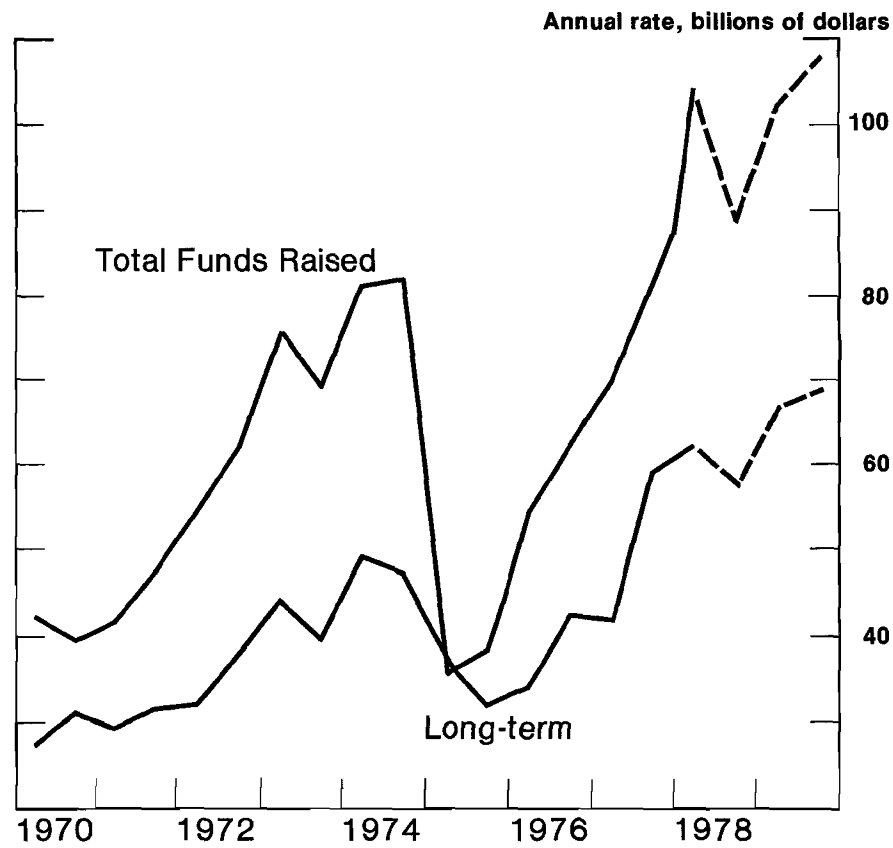
* Weighted average of G-10 countries plus Switzerland using 1972-1976 average trade of these countries


FUNDS RAISED BY
NONFINANCIAL SECTORS
Billions of dollars
U.S. Government
Private
400
300
200
100
1974
1975
1976
1977
1978
1979


FUNDS RAISED BY
NONFINANCIAL SECTORS
RELATIVE TO GNP
Per cent
18
16
14
12
1974
1975
1976
1977
1978
1979

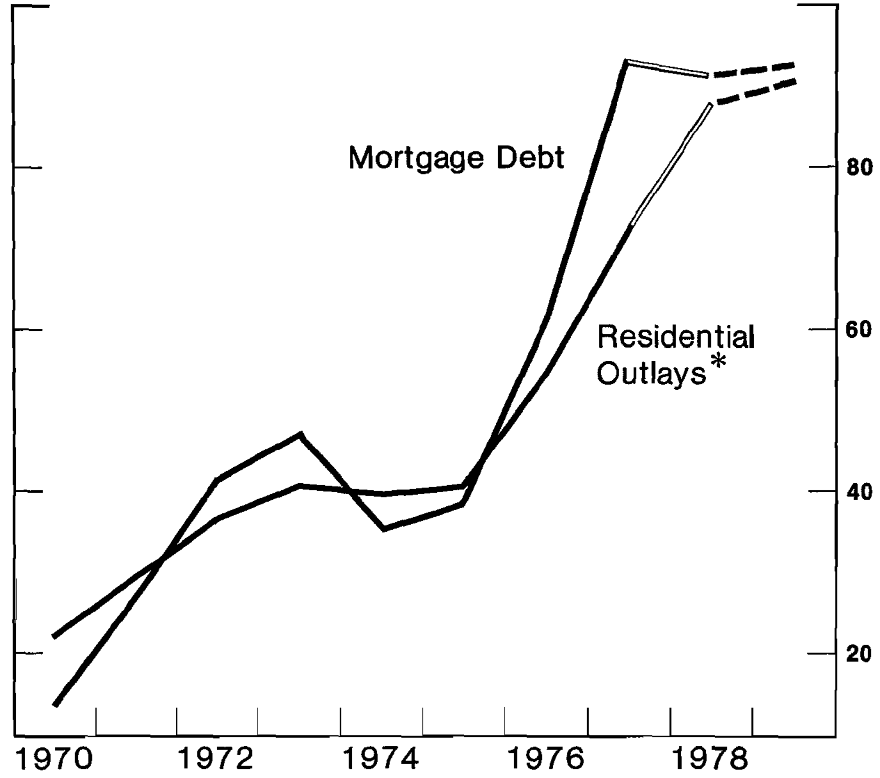
NONFINANCIAL CORPORATIONS





HOUSEHOLD RESIDENTIAL OUTLAYS AND NET MORTGAGE BORROWING

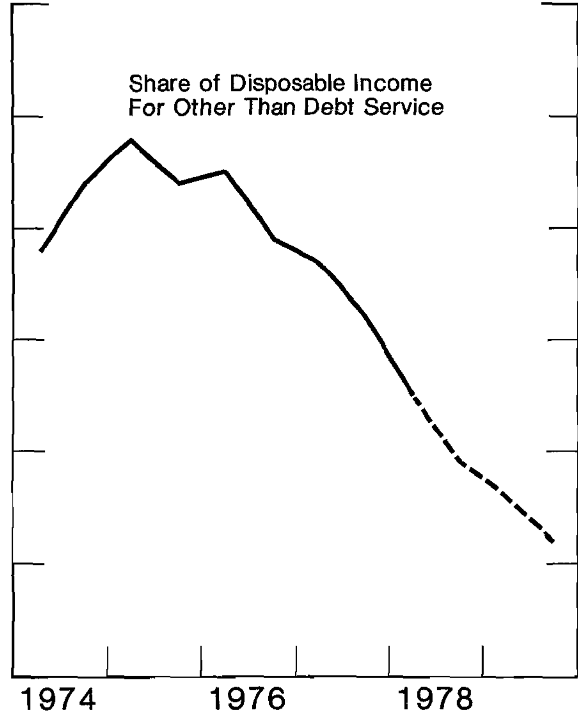
Change, billions of dollars



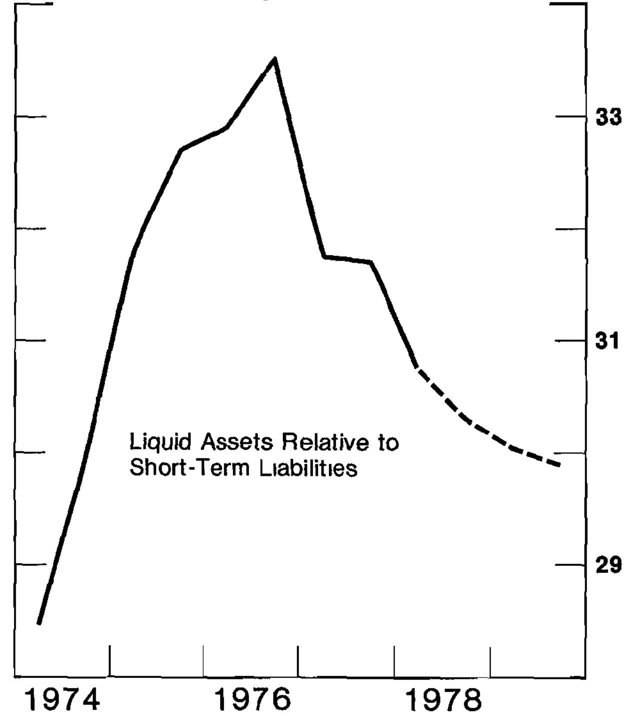
* Household purchases of new residential construction excluding mobile homes

SELECTED LIQUIDITY MEASURES

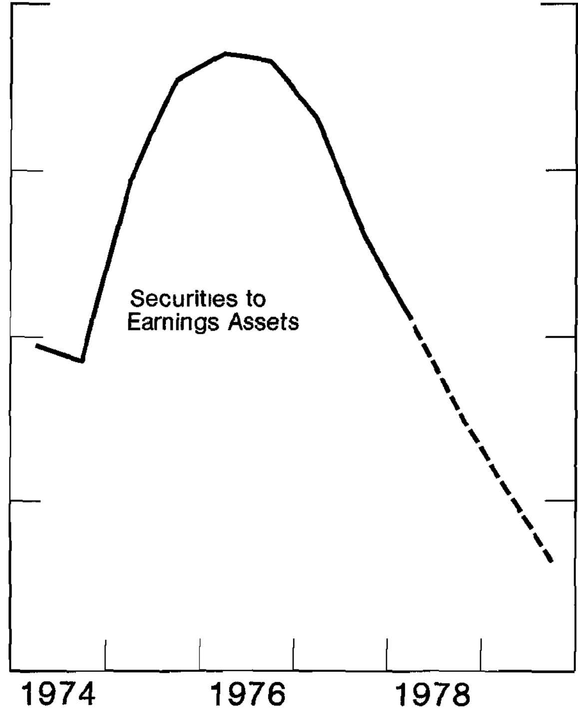
Households



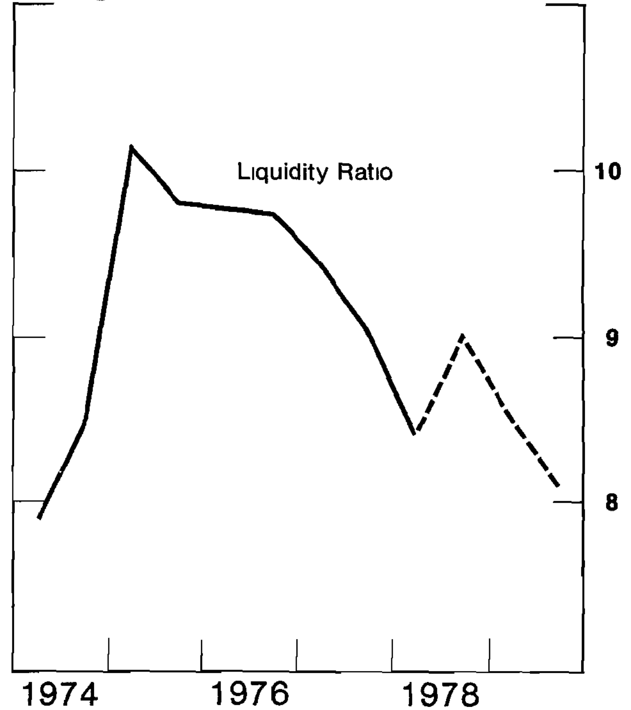
Nonfinancial Corporations

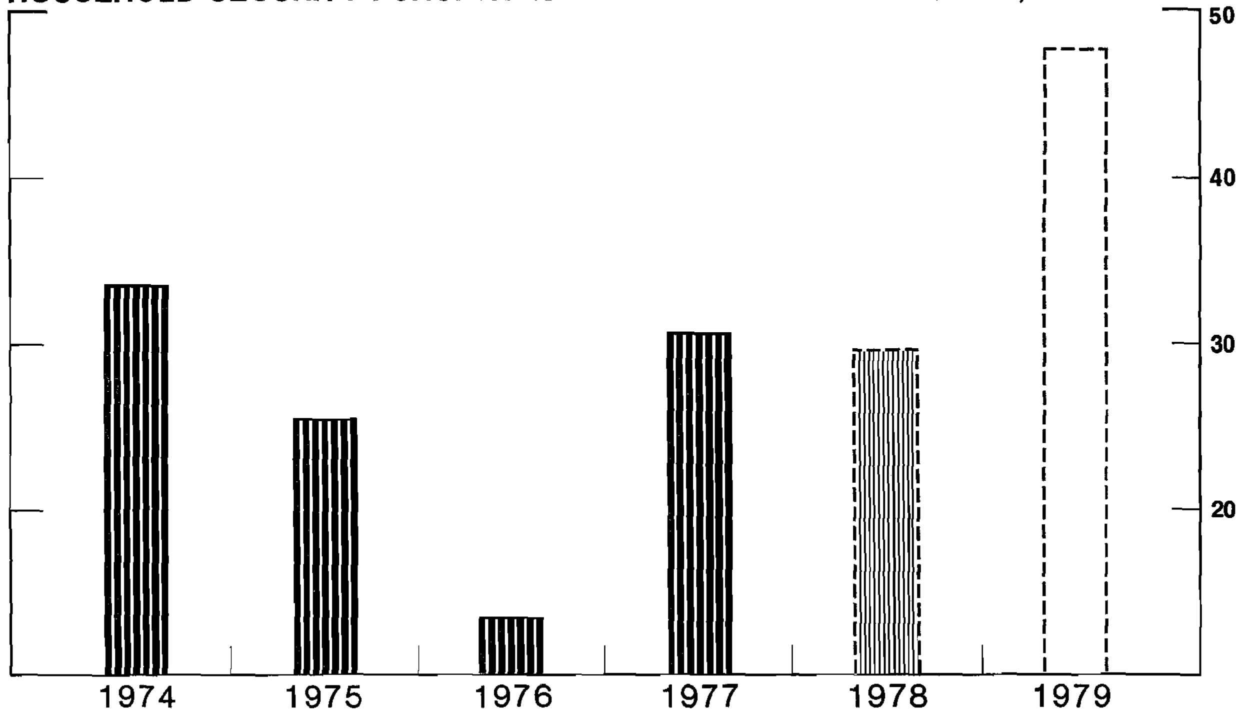


Commercial Banks

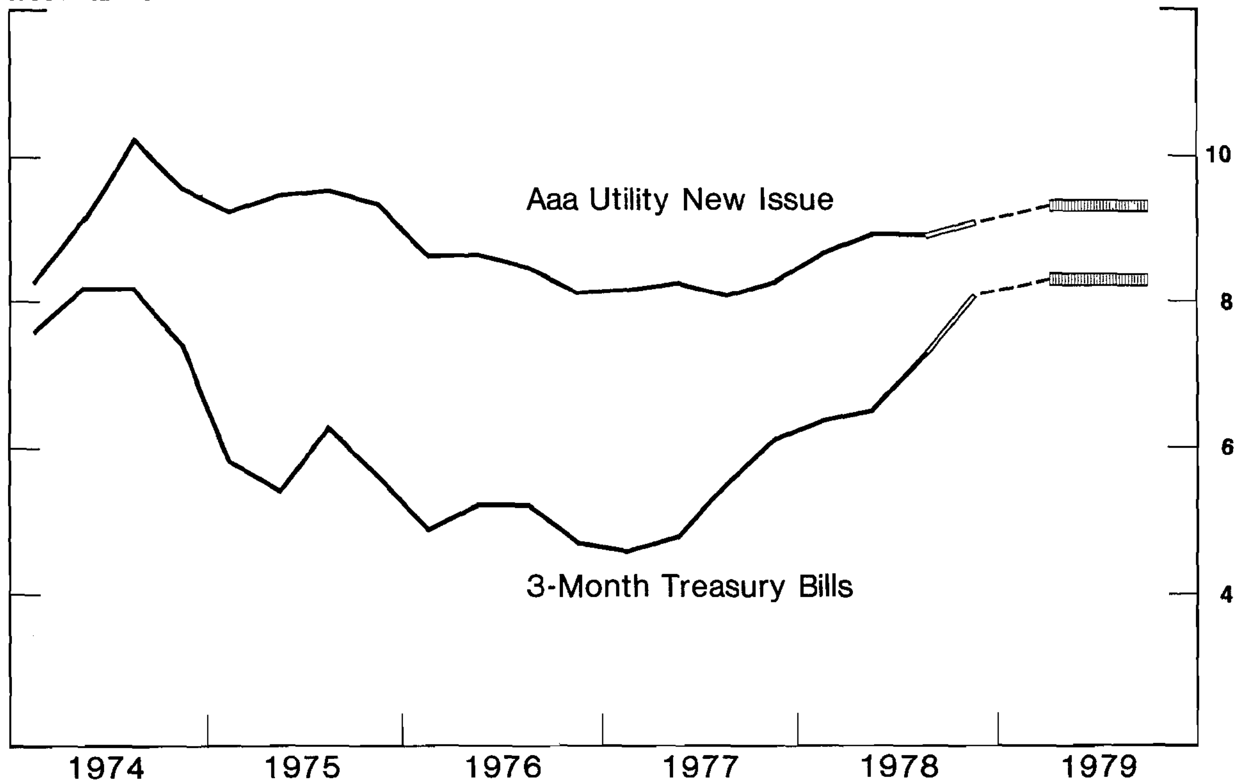


Savings & Loan Associations

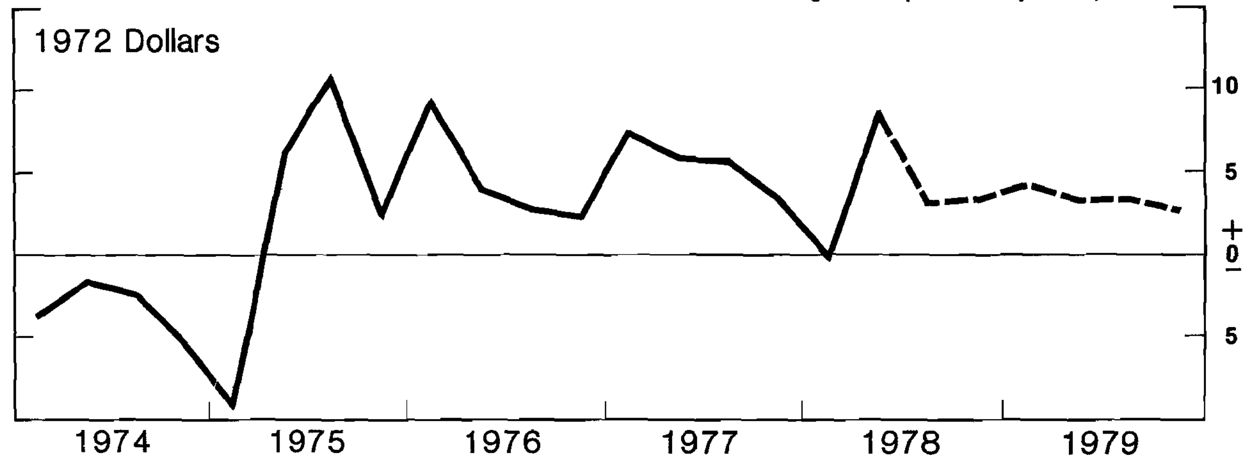


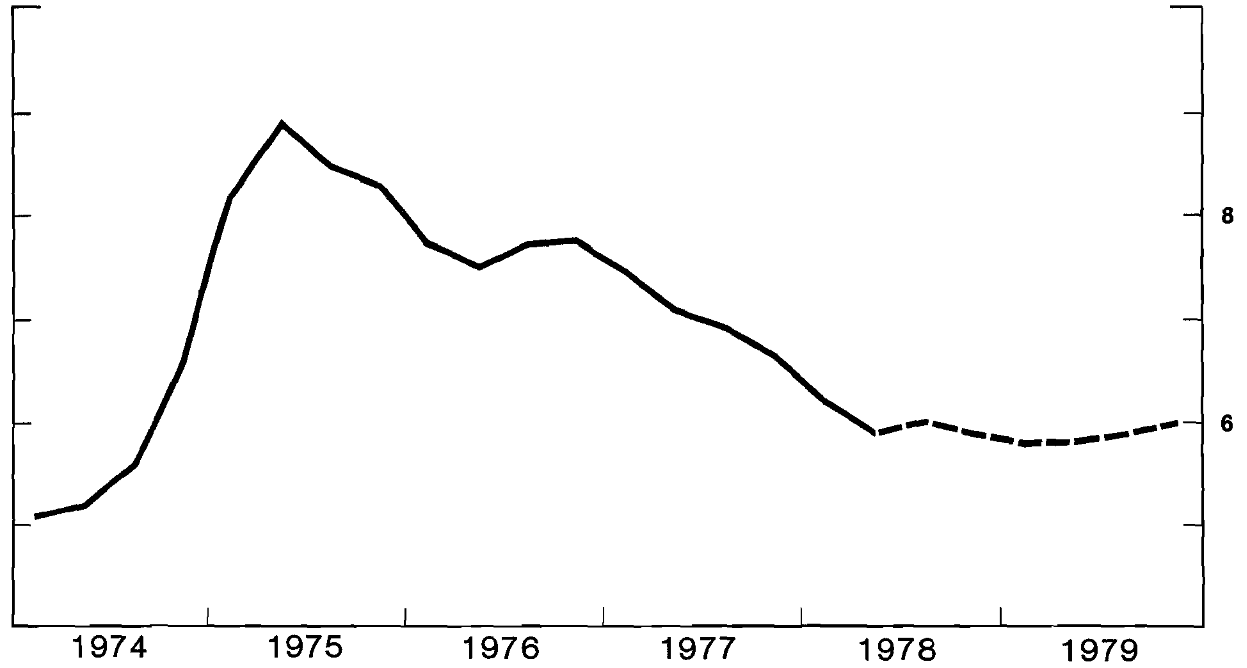


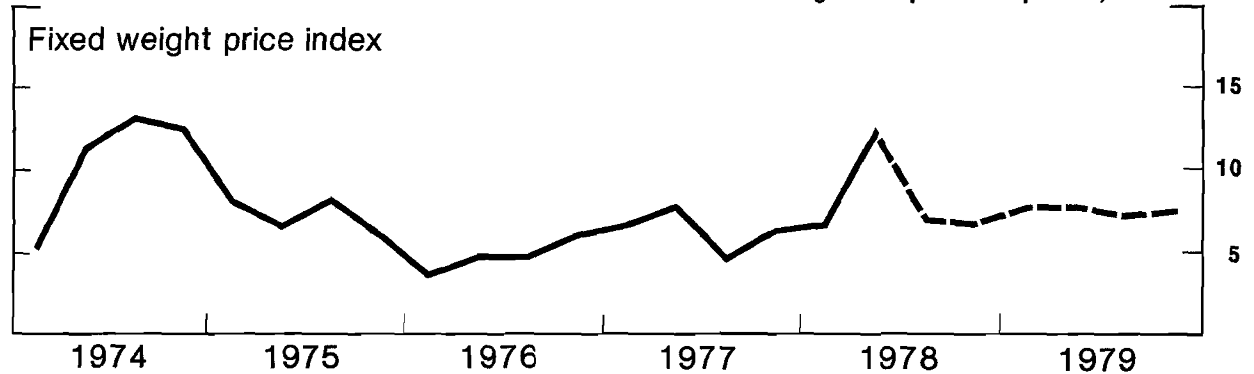
HOUSEHOLD SECURITY PURCHASES
Annual rate, billions of dollars
50
40
30
20
1974
1975
1976
1977
1978
1979



INTEREST RATES
Per cent
Aaa Utility New Issue
3-Month Treasury Bills
10
8
6
4
1974
1975
1976
1977
1978
1979


REAL GNP
Per cent change from previous quarter, annual rate
1972 Dollars
10
5
+
0
−
5
1974
1975
1976
1977
1978
1979


UNEMPLOYMENT RATE
Per cent
8
6
1974
1975
1976
1977
1978
1979


GROSS BUSINESS PRODUCT
Per cent change from previous quarter, annual rate
Fixed weight price index
15
10
5
1974
1975
1976
1977
1978
1979

COMPARISON OF SELECTED UNEMPLOYMENT AND CAPACITY UTILIZATION RATES

UNEMPLOYMENT (%)	1972	1973	1978: QIII
Total	5.6	4.9	6.0
Men, 25-54	3.1	2.5	3.4
Fulltime workers	5.1	4.3	5.6
White collar	3.4	2.9	3.6
Craft & kindred	4.3	3.7	4.4
Manufacturing	5.6	4.3	5.6

CAPACITY UTILIZATION (%)	1973: PEAK	1978: Aug.
Manufacturing, Total	88.0	84.8
Materials, Total	93.1	85.6
Durable goods	92.5	84.6
Nondurable goods	94.6	87.5

MONETARY POLICY ALTERNATIVES

REAL GNP (%)	1979	1980	1981
6¼ per cent M-1	3.3	2.6	1.9
5¼ per cent M-1	2.5	1.5	1.2
7¼ per cent M-1	4.1	3.5	2.5
PRICES (%) Fixed Weight Index			
6¼ per cent M-1	7.6	7.3	7.6
5¼ per cent M-1	7.5	7.0	7.0
7¼ per cent M-1	7.8	7.6	8.3
UNEMPLOYMENT RATE (%) 1/			
6¼ per cent M-1	6.0	6.3	6.8
5¼ per cent M-1	6.2	6.9	7.6
7¼ per cent M-1	5.8	5.8	6.1

1/ Level end quarter of each year.

Joseph S. Zeisel
October 17, 1978

FOMC BRIEFING

As Mr. Kichline has pointed out, the economy now appears to be on a more moderate growth path than earlier this year. As shown in the next chart, the pace of activity is expected to pick up somewhat in early 1979 as a result of the assumed tax cut, but then to drift moderately lower during the balance of the year, averaging about 3-1/4 per cent over the next five quarters.

We believe there are significant downside risks in this outlook. As the economy slows down, there is always the possibility of a cumulating weakness eventuating in recession. And yet, despite the signs of slowing in key sectors, there are also indications of continued vitality, and apparently sufficient momentum to sustain a moderate rate of over-all expansion through the forecast period.

An important plus at the moment is the behavior of residential construction. As the top panel of the next chart indicates, housing demand remains strong. Although sales of new homes have been edging down

sinc May, sales of existing homes rose to an all time high in August. In addition to fundamental demographic and income factors supporting demand, this strength apparently reflects a widespread perception of home ownership as a major hedge against inflation. The fact that mortgage funds remain in relatively good supply has been a key factor supporting housing activity. As is evident in the middle panel, deposit growth at thrift institutions has rebounded strongly from its spring low, reflecting largely the remarkable success of the new money market certificates. S&L's acquired about $18 billion in such accounts by the end of September--and a significant proportion represented new money. As a result, outstanding commitments at savings and loan institutions--the bottom panel--have held at high levels.

As is indicated in the next chart, we still expect that starts will be moving down from their current 2 million annual rate. But--as is clearly evident--we anticipate a rather modest decline in activity by comparison with past periods of cyclically high interest rates--to about a 1-3/4 million starts rate by the end of 1979.

Prospects for business capital spending remain a relatively positive feature of the outlook. As the top left panel of the next chart shows, real new orders for nondefense capital equipment have been moving generally upward--increasing at about a 10 per cent annual rate so far this year. The growth path has been uneven and there have been signs of recent flattening of demand, particularly in the important machinery component. But commercial and industrial construction contracts measured in square feet terms--the right hand upper panel--have been on a strong, albeit irregular, upward trend. On balance, we feel that the growth of real business fixed investment--the bottom panel--will moderate somewhat over the next year, but at about a 4-1/2 per cent annual rate of rise, will continue to be a force sustaining over-all expansion.

The next chart illustrates that the contribution of Government spending to over-all economic expansion seems likely to be rather limited through the end of 1979. As the top panel shows, real annual growth of total Government purchases--Federal, State, and local--is expected to be

in the range of 2 to 2-1/2 per cent, reflecting the leveling-off of several large spending programs and generally conservative fiscal policies at all levels. The bottom panel illustrates the relative stability of total Government purchases as a share of GNP in the projected period.

The aggregate effect of the projected slowdown in the fixed investment sectors--with no offset from Government--is a moderation in the rise of real disposable income to about 3-1/2 per cent rate. This is illustrated in the top panel of the next chart. We have estimated that gains in disposable income resulting from the assumed tax cut would be about offset by increased taxes for social security and by the revenue drag resulting from the interaction of inflation and tax progressivity.

As illustrated in the bottom two panels, we are projecting an increase in real personal consumption expenditures roughly comparable to the rise in income over the next year, and therefore a fairly stable savings rate. The continued relatively low savings rate reflects in part our judgment of likely consumer response to sustained high inflationary expectations.

Consistent with the more moderate pace of over-all growth, employment expansion is expected to slow, as illustrated in the top panel of the next chart. Employment gains have already eased substantially from the unusually rapid pace earlier this year. We are projecting a more moderate growth in the labor force as well, in response to reduced employment opportunities. But it seems likely that unemployment--shown in the bottom panel--will stabilize at about the current rate, and probably turn up somewhat in the latter half of 1979.

The next chart addresses a major force driving inflation--the increase in wages and labor costs. As the top panel shows, hourly compensation costs have continued rising rapidly over the past several years, reflecting large negotiated wage settlements, as well as legislated increases in the minimum wage and social security taxes. Recent rapid price rises are expected to continue the upward pressure on wage settlements in the heavy round of contract negotiations scheduled for next year. Moreover, with further hikes in the minimum wage and in social security taxes scheduled for the beginning of 1979, no relief is in sight; we are

projecting a rise of over 9-1/2 per cent in compensation costs in 1979.

Certainly recent productivity performance--the bottom panel--has been no help in damping the impact of wage increases on unit labor costs and prices. We have no definitive explanation for the abysmal growth in output per worker in the past several quarters. We do feel, however, that some rebound is likely. Indeed, the recent slowdown in job growth suggests that employers are beginning to match their workforces with output more realistically than earlier this year. Nevertheless, in 1979 we expect productivity growth to remain historically fairly weak, averaging under 2 per cent.

The top panel of the next chart illustrates the implications of these figures for prices. As is evident, our projections of nonfood prices continue to move generally in line with unit labor costs. For a few months recently, an easing of food prices moderated the over-all inflation rate, but these prices have started accelerating again. We have assumed some slowing of food price increases again next year.

But over-all, we project a rise in the GNP fixed-weighted price index of slightly over 7-1/2 per cent during 1979. These projections do not take into consideration any possible effects of the Administration's forthcoming anti-inflation program.

Mr. Truman will now review the international situation.

CONFIDENTIAL (F.R.)
CLASS II FOMC

FOMC PRESENTATION
E.M. Truman
October 17, 1978

The upper panel of the first international chart shows in the black line the steady decline in the weighted-average foreign exchange value of the dollar which began in the middle of 1976. Since then the value of the dollar in nominal terms has declined more than 15 per cent with most of it occurring over the past year. The decline in the dollar's international value has reflected a number of developments concerning the U.S. trade and current accounts and, during 1978, increasing concern about the U.S. relative performance on inflation.

As shown by the red line, a lower rate of consumer price inflation in the United States than was recorded on average in foreign industrial countries made a positive contribution to U.S. international price competitiveness through the fourth quarter of last year. In 1978 the rate of inflation has been somewhat higher in the United States than abroad, and it is expected to remain so, though by a smaller margin, throughout the projection period.

The lower panel shows the net decline in the CPI-adjusted foreign exchange value of the dollar. The gain from our better relative inflation performance from the middle of 1976 through the end of 1977 has now been dissipated. Consequently, this measure of the dollar's average real exchange rate also shows a 15 per cent depreciation since the middle of 1976, about the same as the nominal depreciation of the dollar over the same period.

Turning to the next chart, one can see that considerable change in the trade balance has already occurred. As shown by the black line in the upper left-hand panel of the chart, the deficit was reduced from an unusually large annual rate of over $40 billion in the fourth quarter of 1977 and the first quarter of 1978 to about $32 billion last quarter. This development was due to two major factors.

First, as shown in the lower left-hand panel, the volume of U.S. non-agricultural exports has begun to increase after four years of stagnation. Given our outlook for a continued moderate pace of economic expansion abroad, and given the likely effects in the future of the depreciation of the dollar that has already occurred, the recent positive trend in U.S. non-agricultural exports should continue. The volume of such exports is expected to increase at about a 12 per cent annual rate over the projection period.

Second, as shown in the lower right-hand panel, the volume of U.S. non-oil imports has leveled off recently, following three years of rapid expansion. The recent slowdown reflects the reversal of temporary factors that boosted imports in the first quarter, as well as the initial influence of the improvement in U.S. international price competitiveness. Over the projection period, the volume of U.S. non-oil imports is expected to rise again, but at a 5 per cent annual rate -- well below the rate experienced earlier.

The table in the upper right-hand panel summarizes the staff's outlook for the U.S. trade and current accounts. It indicates

for 1978 a net deterioration, all of which is behind us, and a slight improvement in 1979. As shown by the red line in the upper left-hand panel, over the projection period net exports of goods and services should make a modest positive contribution to U.S. economic expansion, as measured in the GNP accounts.

The upper panel of the next chart shows the staff's outlook for growth abroad over the projection period. Over the past four quarters real GNP abroad has expanded at an average annual rate of about 3-3/4 per cent compared with about two per cent over the previous four quarters. Encouraged by recent data showing somewhat faster growth abroad, and by recent stimulative policy actions by a few foreign governments, we expect that over the projection period real GNP in the foreign industrial countries will continue to increase at an average annual rate of around 3-3/4 per cent. In contrast, as is shown in the middle panel, U.S. growth is expected to slow somewhat. This pattern of relative growth rates is summarized in the bottom panel, which depicts the ratio of foreign to U.S. real GNP.

In summary, the overall international outlook I have presented is consistent with a gradual convergence in economic conditions here and abroad which, in turn, should contribute to greater stability in the exchange value of the dollar. Indeed, some analysts believe that the dollar's decline has been overdone. The staff's best judgment is that, over the year ahead, we will see little net change in the exchange value of the dollar from the average of the past couple of

months. However, exchange market participants are likely to remain nervous and suspicious for some time, and the dollar could well be subject to periods of further buffeting.

Mr. Kichline will now conclude our presentation.

James L. Kichline
October 17, 1978

CONCLUSION -- FOMC CHART SHOW

The first chart in the final section of your materials shows the total volume of funds raised by nonfinancial sectors. Given the principal policy assumptions and the staff's GNP forecast, total funds raised next year are expected to be little changed from the high nominal level in prospect this year. Borrowing by the Federal Government is expected to edge down a little further in 1979, but remain large by historical standards. Funds raised by private sectors are expected to increase slightly in 1979 from the high levels likely this year. Total funds raised relative to GNP, shown in the bottom panel, are expected to continue moving down from the peak in the current expansion which was reached in the latter half of 1977. This development in a growing economy is consistent with tighter financial markets that act to discourage some borrowing.

The business sector is likely to be a source of strong credit demands as shown in the next chart. The top panel displays the excess of capital and inventory expenditures over internally generated funds, and this gap is expected to remain substantial next year. To finance their needs, the bottom panel shows that businesses likely will increase their borrowing next year from the lower pace being experienced in the last half of this year. In view of the heavy reliance already placed on short-term fund sources, it seems likely that firms will be induced to borrow somewhat more in capital markets, where funds should be in adequate supply.

In the household sector demands for funds are also expected to be sizable, but expand little from the level of borrowings in 1978. The next chart shows the relationship of residential outlays and household net mortgage borrowing. In 1978 and 1979 the rise in net mortgage borrowing is expected to about equal the large volume during 1977, despite substantial further increases in the nominal value of residential outlays. Thus, the large excess of borrowings relative to new construction that emerged in 1977 is now in process of being squeezed out given the tighter financial conditions that have developed since then and that are projected to continue next year.

The general movement toward a tighter financial environment appears in various liquidity measures shown in the next chart. Households--the top left panel--in the aggregate have been experiencing a decline in their financial flexibility as debt service burdens have risen and the share of disposable income for other than debt service consequently has moved lower. At nonfinancial corporations liquid assets relative to short-term liabilities have been trending down since the latter part of 1976. Depositary institutions also have experienced an appreciable decline in their liquidity positions from earlier in the expansion. At savings and loans it appears that liquidity is increasing currently given huge deposit flows, but we view this as a temporary development.

The surge in deposit inflows associated with 6-month certificates accounts partly for the small change in household security purchases in 1978, shown in the next chart. Slower expansion of deposit inflows is expected next year as households probably will be induced to acquire

a larger volume of market securities. Such a development would be consistent with some further upward movement of interest rates from current levels, shown in the bottom panel.

The next chart shows the staff's projection of GNP, unemployment, and prices. Over-all, underlying forces on the nonfinancial side of the economy, the anticipated international outlook, and the financial environment suggest to us that real GNP next year is likely to expand around a 3 to 3-1/2 per cent rate and unemployment is likely to remain close to 6 per cent. Inflationary pressures unfortunately are expected to remain strong with the gross business product index projected to rise about 7-1/2 per cent.

It is apparent that the staff's projection does not imply a significant further tightening of labor markets nor does it present unusual strains on capacity utilization. The next table compares selected unemployment rates in 1972 and 1973 with those prevailing last quarter. As you know, there is considerable difficulty in interpreting the degree of tightness or ease in labor markets by looking at the aggregate unemployment rate. Looking at key disaggregated unemployment rates is more instructive in this regard and these show there is considerable distance between such rates currently and those prevailing in the very tight labor market in 1973. But most of the rates listed are at or close to those in 1972 which was a fairly tight year. The present situation in capacity utilization is significantly more favorable than that in 1973, especially for materials industries where bottlenecks were particularly serious.

It is our judgment that the current and projected state of slack in labor markets and in capacity utilization is rather small. At the same time it also seems that the risks of the forecast if we are wrong are weighted toward more slack rather than less.

The same cannot be said with regard to inflation. Here there are a number of upside risks. The final chart presents selected information on key variables assuming 6-1/4 per cent growth of M-1 in the base forecast and 1 percentage point slower and faster growth. The 6-1/4 per cent extension to 1981 and the alternatives are derived mainly from the econometric model. The set of inflation rates associated with the base forecast and the alternatives are all disappointing. Even with decelerating rates of real growth for 3 years, the 6-1/4 and 5-1/4 per cent forecasts suggest little relief in sight. In part this stems from the apparently slow responsiveness of prices to economic slack. But it importantly also reflects the adverse impact on costs and prices of exogenous price shocks at the beginning of each of the next three years, namely large scheduled increases in minimum wages and social security taxes.

OCTOBER 17, 1978

F.O.M.C. MEETING

REPORT OF OPEN
MARKET OPERATIONS

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

Soon after the September Committee meeting, incoming data suggested strong monetary growth--around the upper bounds of the tolerance ranges--so that the Account Management sought a firming of the Federal funds rate from 8 3/8 percent in mid-September to 8 3/4 percent by the end of that month. The 8 3/4 percent objective, the top of the Committee's funds range, was retained through the first half of October, as new data continued to suggest aggregate growth around the upper ends of the Committee ranges.

Through the first half of the period, actual market rates tended to exceed the Desk's objective, as it was difficult to keep pace with reserve needs, particularly around the quarter-end statement date. In early October the funds rate held close to the objective, or even a little below, although rates averaged slightly above 8 3/4 percent yesterday.

The System acquired an unusually large volume of securities during the period--a net of about $4.8 billion on an outright basis. Thus the Desk used not only the additional $1 billion of leeway voted at the September meeting but also a sizable part of the further $1 billion approved on October 10. (The $4.8 billion total includes about $300 million purchased on the day of the last meeting which counted against the leeway provided in the previous period.)

The purchases for the period included $1,558 million of Treasury coupon issues bought in the market on two occasions, about $1,750 million of bills bought in the market in a record one-day purchase, and about $1,500 million of bills bought from foreign accounts on several occasions.

The exceptionally large reserve need stemmed initially from a build-up in Treasury deposits after the September tax date. That build-up, was very large even though the Treasury was helpful in moderating their tax and loan account calls and made a temporary re-deposit to the commercial banks on one occasion. We had expected the Treasury balance to be declining seasonally by early October, but investments in special issues by foreign holders--largely the backwash of the weak dollar internationally--kept the Treasury balance high while other factors such as increased currency in circulation absorbed additional reserves and necessitated our request for additional leeway. The large outright operations were supplemented frequently by heavy day-to-day reserve injections through repurchase agreements, and occasional use of matched-sale purchase transactions in the market when reserves were temporarily over-abundant.

In early November, we expect to begin getting some relief from the reserve swings caused by movements in the Treasury balance, as the Treasury plans to implement the new arrangements for leaving balances in commercial banks in the form of interest-bearing notes, and calling funds in to their account at the Fed more or less as needed to maintain working balances. The

changeover is to be phased in gradually, and some variation in Treasury balances at the Fed is likely to remain, but it should be significantly reduced from the pattern of the past two years or so.

Most interest rates rose during the past intermeeting period, though by varying amounts in different sectors. Federal funds, as noted, worked up from around 8 3/8 percent at the time of the last meeting to around 8 3/4 percent recently. In the wake of the latest discount rate rise most market participants seem to expect a funds rate close to 9 percent. Three- and six-month bills were auctioned yesterday at about 8.21 and 8.56 percent, up from 7.88 and 7.98 percent the day before the last meeting. Through much of the period, though, three-month and shorter issues were under downward pressure, trading below their auction rates as demand from foreign accounts and other investors pressed against limited market supplies.

Rates on many short-term private sector instruments, such as bank CDs and acceptances, rose somewhat more than bill rates--in the area of 40-60 basis points before the latest discount rate hike and another 10-15 basis points yesterday. Large commercial banks raised their prime rate 1/4 percent early in the period, and another 1/4 percent, to 10 percent, toward the end of the period, just before the 1/2 percent discount rate increase. The discount rate had also been raised 1/4 percent near the start of the interval.

Yields on most Treasury coupon issues rose about 20 to 50 basis points over the period, including some 5 to 10 basis points yesterday. The largest increases were in one-year and shorter area, though some longer issues--over ten years--were up a substantial 20 to 25 basis points. The market reacted to signs of higher System rate objectives as well as to evidence of speedy monetary growth, persistent inflation, and indications that an economic slowdown might not be as imminent as some had expected earlier.

Dealers have held lean positions, tending to the net short side except when temporarily taking on new supply from fresh Treasury offerings. Most participants seem to anticipate higher rates ahead, though they are wary of taking very large short positions after experiencing the sharp price rally last summer, when a scramble to cover shorts proved costly. Caution is heightened as participants seek to factor in potential reaction to the next stage of the Administration's anti-inflation program. Analysts in the private sector are skeptical about the prospects for success of such a program, but dealers and investors also seem reluctant to bet heavily against its success.

Market attention is now beginning to turn to the Treasury's November financing, in which the Treasury may seek to raise about $2 billion of new money in addition to rolling over $4.6 billion of privately held maturing debt. Market participants expect a conventional three-pronged offering, perhaps with maturities in three, ten and thirty years. Given

the high level of Treasury cash balances, bolstered by the big influx of funds from foreign accounts, other Treasury cash needs over the next month should be small. In the November refunding, we would expect, as usual, to roll over the System's $2.5 billion holding of maturing November 15 notes into new issues in about the proportions offered to the public.

Statement by Lawrence K. Roos to FOMC - October 17, 1978

At the September 19th meeting of the FOMC, Chairman Miller invited comments on the question: "Can reduction in growth of the monetary aggregates be achieved without causing a recession." I believe that this can be accomplished and I offer the following rationale for my point of view:

1. Every demand-induced recession (recession as defined by NBER) in the U.S. since World War II has been preceded by a pattern of money growth having two characteristics:
   a. The money growth has dropped below the 20 quarter trend rate of money growth by at least 2 percent.
   b. This reduction below trend has lasted for at least 2 quarters.
2. There is not one instance in post-World War II history where smaller and/or shorter deviations below the trend have caused recessions (see Attachment I).
3. There is no evidence that a reduction of money growth to its 20 quarter trend rate (currently 6 percent) or slightly below that trend rate would cause a recession.
4. No major econometric model predicts negative output growth (recession) with 6 percent money growth. (For FRB staff projection, see Attachment II, Kichline memo of October 13, 1978, Table I.)

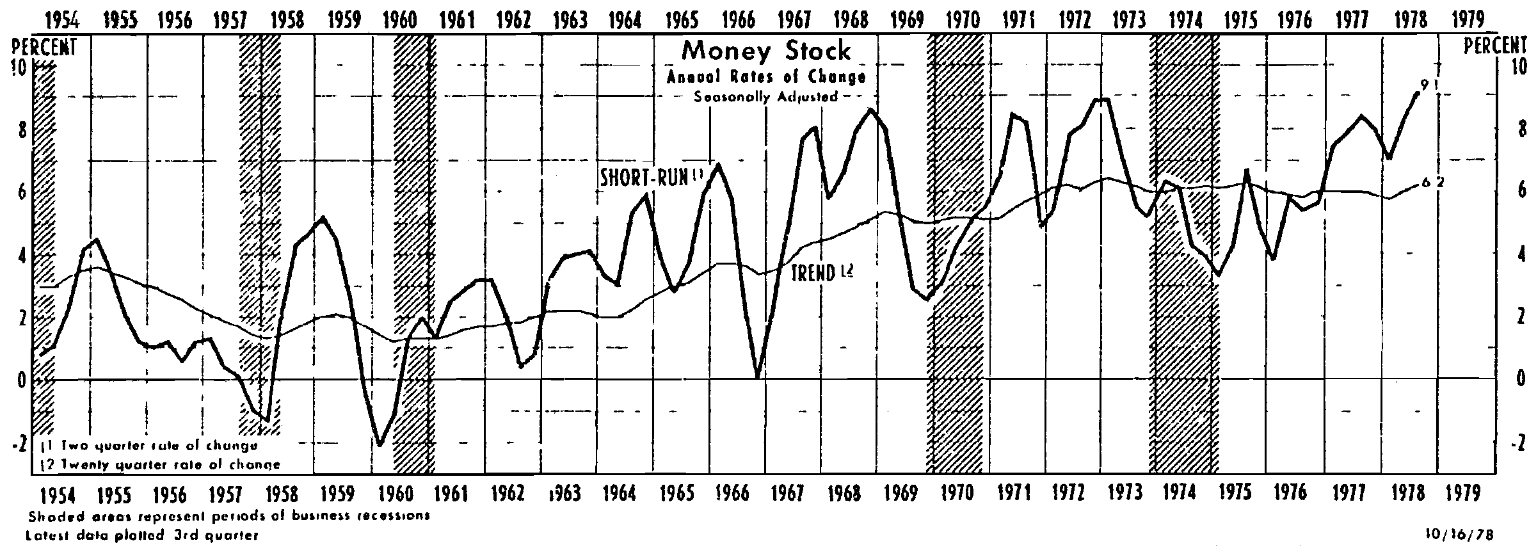
A Proposal

The FOMC can reduce the growth of the monetary aggregates and thereby reduce inflation without causing a recession by doing the following:

1. Limit money growth to six percent for the IV quarter of 1978 and maintain that rate of growth through III quarter of 1979.
2. To avoid base drift, state this money growth in terms of money supply level in the III quarter of 1979.
3. Announce this policy action as the first step in a longer-term program to further reduce the growth rate of monetary aggregates.
4. The following supplemental actions would facilitate accomplishment of the above program:
   a. Significantly widen the federal funds target ranges.
   b. Place increased emphasis on the growth of a reserve aggregate in the short-run implementation of policy.
   c. Reestablish contemporaneous reserve requirements.
   d. To the extent possible, attempt to keep the spread between the federal funds rate and discount rate at a minimum.

A well publicized firm commitment to such program would reduce inflation with no risk of recession. It would reduce inflationary expectations and lead to a moderation of wage demands, an increase in the international value of the dollar, and a reduction in long-term interest rates.

ATTACHMENT I



Projection of Selected Economic and Financial Variables Assuming
Alternative Money Growth Rates

	1978	1979				1980		1981		1982	
	Q4	Q1	Q2	Q3	Q4	Q2	Q4	Q2	Q4	Q2	Q4
Real GNP Growth (per cent, annual rate)											
1) 5-1/4% M-1 Growth	3.1	3.6	2.5	2.3	1.6	1.6	1.1	1.1	1.1	1.4	1.3
2) 6-1/4% M-1 Growth	3.3	4.1	3.3	3.3	2.7	2.8	2.1	1.9	1.6	1.9	1.7
3) 7-1/4% M-1 Growth	3.4	4.5	3.9	4.1	3.7	3.8	3.0	2.6	2.1	2.4	2.4
Unemployment Rate (per cent)											
1) 5-1/4% M-1 Growth	5.9	5.9	5.9	6.1	6.2	6.5	6.9	7.3	7.6	8.0	8.3
2) 6-1/4% M-1 Growth	5.9	5.8	5.8	5.9	6.0	6.1	6.3	6.6	6.8	7.1	7.3
3) 7-1/4% M-1 Growth	5.9	5.8	5.8	5.8	5.8	5.8	5.8	5.9	6.1	6.3	6.4
Fixed Weight Deflator (per cent change, annual rate)											
1) 5-1/4% M-1 Growth	6.9	7.8	7.8	7.1	7.2	7.0	6.9	7.1	6.5	6.5	6.0
2) 6-1/4% M-1 Growth	6.9	7.9	7.9	7.2	7.4	7.3	7.1	7.7	7.1	7.1	6.7
3) 7-1/4% M-1 Growth	7.0	8.0	9.0	7.3	7.5	7.7	7.7	8.5	7.9	7.9	7.6
Three-month Treasury Bill Rate (per cent)											
1) 5-1/4% M-1 Growth	8 1/2	9	9	9	9	9 1/8	9	9	8 3/4	8 1/2	8 1/4
2) 6-1/4% M-1 Growth	8 1/4	8 1/4	8 1/4	8 1/4	8 1/4	8 3/8	8 1/4	8 1/4	8	7 3/4	7 3/8
3) 7-1/4% M-1 Growth	8	7 3/4	7 3/4	7 3/4	7 3/4	7 3/4	7 1/2	7 1/2	7 3/8	7 1/8	7