APPENDIX

Notes for FOMC Meeting
February 6, 1979
Scott E. Pardee

As Alan Holmes reported during the telephone meeting on January 12, the dollar had come under heavy selling pressure in late December. Our intervention numbers had swelled, by a further $1.2 billion of sales of German marks and $104 million of Swiss francs. By year-end, some $8.2 billion of the facilities available to the U.S. authorities had been used, including $6.6 billion of the $30 billion November 1 package. At the peak in early January the Federal Reserve swap debt amounted to $5.5 billion of German marks, Swiss francs and Japanese yen. In marks, we had committed some $4.6 billion of the $6 billion line and were beginning to become concerned over our availabilities should heavy intervention continue to be necessary. As it turned out it wasn't, and today I can report a picture of considerable progress in repaying swap debt.

This of course is based on the rather impressive recovery of the dollar from the year-end depths. Dollar rates are currently 2-4 percent above year-end lows. At first, the recovery was a surprise to most market participants, who had been so bearish that they forgot just how oversold, in a technical sense, the dollar had become during the last months of 1978. Leads and lags were a major adverse factor. In effect, almost everyone who was going to sell dollars in early 1979 had sold them in late 1978. Thus dollar rates stabilized in the first weeks of January more on the lack of new selling pressure than as a result of buying.

Taking advantage of the dollar's better tone, on January 18 the Bundesbank took steps to absorb some of the excess liquidity in the German banking system through a tightening of reserve requirements and a hike in the Lombard rate. The Swiss and Japanese authorities also relaxed some of the more onerous barriers to inflows of funds which they had imposed last year. The German monetary policy step in particular gave us all a real scare, but the dollar's resiliency in the face of such action began to impress the market.

The next hurdle for the market was the President's State of the Union address and budget presentation, with follow-up testimony by senior officials, including Chairman Miller and Secretary Blumenthal. At first, the market remained skeptical about the message coming out of Washington of austerity in fiscal policy and restraint in monetary policy. But reports that Congress was perhaps in a receptive mood added to the credibility of that message. Moreover, to many market participants here and abroad the fact that the Federal funds rate remained steady even after some weeks of weak monetary aggregates was seen as tangible evidence of the determination of the U.S. authorities to deal with the inflation and dollar problems.

At the same time, the prolonged political upheaval in Iran began to raise serious economic questions, stemming from the halt of the oil exports from that country on one hand, and the potential cancellation of major import contracts by the Iranian government and Iranian firms on the other. Moreover, there was the immediate problem of how Iran was to pay its current bills. The market gradually came to the view, as Governor Partee suggested in the December meeting, that the Iranian situation was potentially more dangerous to Japan and Western Europe than the U.S. Consequently, the Iranian development led to some large shifts of funds into dollars. In part, this was attributed to exporters in Germany and Japan who had already sold dollars forward against their own currencies and now reversed themselves on the possibility that they would not be receiving dollars after all. In part, it was by some portfolio managers, who saw the Iranian situation as being a major uncertainty for those currencies for several months if not longer. The rush was not all into dollars; the gold price and other commodity prices have been strong.

As the balance of exchange market forces began to tip in favor of the dollar in late January the interest rate differential suddenly began to bite, with the three-month Euro-dollar rate more than 6 percent above that for

Euro-marks, more than 8 percent over the rate for Euro-yen, and 10 percent over three-months for Euro-Swiss francs.

The movement into dollars on the last days of January and the first days of February was in very substantial volume and would have led to a sharp rally for the dollar except for the massive intervention of central banks. Last week, we and the German, Swiss, and Japanese central banks sold a total of $1.8 billion into the market. This was partly to avoid the outbreak of disorderly conditions on the upside for the dollar and partly to enable us to repay swap debt. The dollar settled back somewhat yesterday and today. In all, from the early January peak of $5.5 billion, we have repaid a total of $1.5 billion. The Swiss franc debt has been halved, the Japanese yen debt cleared away completely, and the mark debt has been reduced by $1.1 billion to $3.5 billion.

I must stress, however, that what we saw last week was a shift of perception of risk on the part of market participants and not a change in the market's evaluation of fundamentals. Significant improvement in the U.S. trade deficit is still a forecast rather than an actuality. And expectations about the near-term outlook for inflation in the U.S. are as gloomy in the exchange market as before. It's just that the market's attention was diverted to other concerns for a while, and bearish psychology could resurface very quickly.

F.O.M.C. MEETING
FEBRUARY 6, 1979

REPORT OF OPEN
MARKET OPERATIONS

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

During the seven weeks since the December 19 Committee meeting, the Account Management has aimed for conditions of reserve availability consistent with Federal funds trading at or slightly above 10 percent. This represented a slightly firmer stance than was sought just prior to the December meeting. Despite a progressive weakening in estimated growth of the aggregates, the System's funds rate objective was maintained--in response to supplementary instructions from the Committee. Thus in late December, when the aggregates, taken together, were estimated to be slightly to the soft side of the specified ranges, the Desk was directed to hold its objective steady pending a further review at the Committee's telephone conference call on January 12. At that time, growth was estimated to be even a bit weaker but after reviewing broader factors such as the state of the economy, price behavior and the international position of the dollar, the Committee left the objective unchanged. Significant further weakening for M_1 and M_2 in the two months ending in January showed up in the data becoming available late last week, but with today's meeting so close, the Account Management continued its approach unchanged.

As it worked out, the funds rate was in fact at or slightly above 10 percent on most days. The exceptions were several days around year-end when the combination of large dollar flows and cautious bank reserve management produced unusual demands for excess reserves which the Desk could not fully meet, leaving the funds rate higher than desired, and a few Wednesday afternoon occasions of undesired ease or tightness. The average rate over the whole period was about 10.15 percent. Discount window borrowing averaged a little over $1 billion for the period--up several hundred million from the previous intermeeting period.

To achieve reserve objectives, the System Account was a very substantial outright seller of securities over the past seven weeks--to an extent that required two increases in the leeway to change outright System holdings between Committee meetings. Sales were nearly continuous through the period, except for the several days of tightness around year-end, and again yesterday, when the Desk provided temporary reserves through repurchase agreements. Total sales and redemptions came to nearly $5.7 billion. This included sales of about $1.6 billion of bills and $360 million of agency issues in the market, about $2,750 million of bills sold to foreign accounts, and $900 million of bills redeemed at maturity. The first of the large sales of bills in the market caused some temporary uncertainty among the legions of Fed watchers, largely because of the infrequency of such sales, but the second sale of bills and the sale of agencies went off with barely a ripple.

Several factors combined to produce the abundance of reserves, including declines in Treasury balances, high float, seasonal return flows of currency after the year-end, and later in the period reductions in required reserves and warehousing of foreign currency for the Treasury. Reserves are expected to be abundant through the next statement week, but after that we expect to supply reserves for some weeks. Right now it appears that a return to the usual $3 billion of leeway to change outright holdings between Committee meetings--down from the temporary $6 billion level--should provide sufficient operational flexibility. At some time though, the Committee may wish to consider enlarging the normal leeway limitation given the prospect of longer intervals between Committee meetings and the growth in the size of factors affecting reserves.

Despite the steady Federal funds rate, most market interest rates declined during the period since the last meeting, especially in the latter part of the interval. At first, yields on a number of instruments moved higher, partly in reaction to the System's slight firming at the December meeting, as well as to indications of strength in the economy and persistence of inflation. After about mid-January the trend in rates was downward as the market became more impressed with the lack of growth in the aggregates, the improvement in the dollar overseas, and the prospect of more moderate credit demands from the Treasury and other borrowers than had been anticipated earlier.

Most Treasury issues maturing in 1 to 5 years declined about 25 to 50 basis points in yield over the period. Longer Treasury issues were down about 10 to 30 basis points. In the short-term area, there has been an especially marked decline in rates on bank CD's which had been bid up aggressively in the final months of 1978 but came down by 50 to 100 basis points since mid-December. Part of the rise and subsequent decline was probably seasonal, but also banks apparently over-prepared for anticipated credit demand and rate pressures which failed to develop as expected. On the other hand, Treasury bill rates came down a more moderate 25 basis points or so for longer bills and there was little net change in rates on 3-month bills, where supplies were enlarged by System sales and a switch from foreign official account purchases to sales as the dollar improved. Yesterday, 3- and 6-month bills were auctioned at average rates of about 9.19 and 9.31 percent, compared with 9.24 and 9.52 percent the day before the December meeting.

Today the market is bidding on $2.25 billion of 8-year Treasury notes, the first part of the February refunding operation to replace $3 billion maturing notes held by the public and raise about $1 1/4 billion. The second part of the operation will be the sale tomorrow of $2 billion additional 8 3/4 percent bonds of 2008. We expect to roll over the System's $1.7 billion holding of maturing notes, divided between the two issues in about the proportions they are offered to the public.

There is currently a diversity of view in the markets about rate prospects. Few participants are convinced that we have already seen the peaks in the current cycle, but a number seem to feel that rates are close enough to their highs that some moderate moves to get invested are appropriate. Others believe that significant further increases could lie ahead--to be approached when monetary aggregates resume their growth and the monetary authorities continue their anti-inflationary efforts.

James L. Kichline
February 6, 1979

INTRODUCTION -- FOMC CHART SHOW

For this meeting of the Committee the staff has reassessed the forecast of economic and financial developments in 1979 and extended the forecast through 1980. This represents an unusually long period for the judgmental forecast, but we felt it would be helpful to take an early look at all of 1980, particularly in light of the Humphrey-Hawkins Act. The forecast has been prepared in an environment of more than usual uncertainty regarding the interpretation and implication of recent economic and financial developments. Thus a good deal of risk attaches to the forecast we will be presenting today.

The first chart in the materials distributed to you displays the principal policy assumptions that underlie the forecast. Interest rates are assumed to remain near current levels in the first half of 1979 and to move moderately lower thereafter. This assumption is consistent with the midpoints of the longer-run interest rate ranges for 1979 presented as Alternative B in the Bluebook. M-1 growth is assumed to average 6-1/4 per cent over the next two years, after adjusting for the effect of ATS shifts on M-1 growth. In addition, some further downward shift of money demand is assumed as discussed in the Bluebook. For fiscal policy we have assumed outlays of $493 billion in the current fiscal year and $538 billion in FY 1980.

The differences between the staff's Federal budget outlook and that of the Administration are shown in the next chart. Our estimate of outlays in 1979 is similar to that of the Administration but we anticipate larger outlays in 1980 reflecting our somewhat higher interest rates and level of unemployment, as well as an assumption that certain cost limiting measures will not be accepted by the Congress. On the receipts side, the difference in 1980 is accounted for mainly by our exclusion of the costs of a real wage insurance program--which presently does not appear to have much support in the Congress. The resulting budget deficit is shown in the bottom panel. Even though the projected deficit in 1980 is about $4 billion larger than the Administration plan, we would view our fiscal assumptions generally as being restrictive.

The next chart displays selected indicators of recent economic activity. Production, employment, and retail sales all rose strongly in the final quarter of 1978. Over-all, real GNP reportedly rose at a surprisingly strong 6 per cent annual rate. Thus we apparently entered this year with a good deal of momentum. The limited information available for activity in January, notably the employment situation, suggests appreciable strength.

Mr. Zeisel will continue the presentation with a discussion of the staff's domestic nonfinancial forecast.

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Joseph S. Zeisel
February 6, 1979

FOMC CHART SHOW

Although the economy apparently entered this year with a good deal of momentum, fundamental forces still appear to suggest a distinct slowing of activity by spring. The first chart of the nonfinancial section presents the average annual rates of growth of real GNP and its major sectors over the past two years, and our projections for the next two. As is evident, we are forecasting a significantly weaker rate of real growth in each of the key income generating sectors--housing, business fixed investment, and government--and an associated softening of consumer demand. Over the next two years, real GNP is projected to expand at less than a 2 per cent annual rate. While a slowing to such a pace increases the economy's vulnerability to shocks, we are not forecasting a recession, given the policy assumptions, and the apparent absence of substantial distortions in the economy at the present time.

A major factor retarding growth in our forecast is the weakening of housing. Activity in this sector has so far remained surprisingly strong, reflecting in no small measure the support to deposit growth at thrift institutions provided by the money market certificates introduced last June. But, as is illustrated in the top panel of the next chart, growth of savings inflows has slowed in recent months. As indicated in the middle panel, outstanding mortgage commitments may have topped out, and this month's Redbook confirms other reports of tightening mortgage markets. Moreover, it is our judgment that despite the attractiveness of homeownership as a hedge against inflation, the substantially increased costs of taking on larger mortgages at higher interest rates will increasingly put a damper on housing demand this year. As the bottom panel dramatically portrays, the monthly carrying cost for an average new conventional mortgage rose to $500 by the end of 1978--a 50 per cent increase over the past 3 years.

The next chart presents in the top panel our projection of housing starts. We now anticipate that starts will bottom out at about 1,650,000, annual rate at the end of this year and then edge up during 1980 as somewhat easier financial conditions permits a reemergence of the strong underlying demand associated with a high rate of family formation.

The key point made in the bottom panel is that while housing starts remained at a high level for much of 1978, real housing expenditures were no longer contributing to economic growth. And residential construction is expected to be a noticeable drag on real activity through most of this year.

Turning to the business sector, the top two panels of the next chart indicate recent trends in real orders for capital equipment and construction contracts. They suggest substantial upward momentum for capital spending in the short term. However, there are indications that this may be temporary ; both series appear to be either leveling off or turning down. In addition, a slower pace of capital spending over the balance of 1979 is indicated by the latest Commerce Department survey of plant and equipment outlays, illustrated in the bottom panel.

The outlook for capital spending in 1980 is obviously more speculative. As indicated in the next chart, our projections of over-all activity are consistent with a decline in capacity utilization rates in manufacturing from the present 86 per cent to about 83 per cent toward the end of 1980. In this environment there should be less pressure for expansion of capital stock, and given an expected weakening of profits, we are forecasting a virtual leveling out of these outlays in real terms over the course of 1980.

The next chart illustrates the diminished contribution to over-all expansion expected from government spending during the next two years. As the top panel shows, the annual growth of total government purchases--Federal, State and local--in real terms is expected to average little above 1 per cent during 1979 and 1980; this reflects an actual decline of such Federal financing programs as countercyclical revenue sharing and public service employment, and a more moderate rise in outlays for a wide range of other governmental programs. As the bottom panel shows, the Federal Government high employment budget surplus is projected to show only a modest change between 1978 and 1979 since personal and business tax cuts are about offset by mandated payroll tax increases and the impact of inflation in raising income tax receipts. However, with no new tax cut initiatives in 1980--but with the effects of inflation and the scheduled payroll tax increases--the high employment budget moves further into surplus next year.

Our projections of investment and government activity are reflected in a substantial further moderation of disposable income growth, as shown in the top panel of the next chart. This slowing does not bode well for consumer spending prospects. Growth of consumer outlays was also sustained in the recent past by a substantial rise in consumer credit. As indicated in the second panel, the ratio of total household debt to disposable income has reached record levels, increasing the vulnerability of consumer outlays, particularly for durables, to any weakening in the rise of disposable income. Furthermore, with the savings rate already at the lower end of historical experience--the third panel--it seems unlikely that growth of real consumer outlays will outpace income. Consequently, as the bottom panel shows, we have projected a rise in real consumer spending of only about 2 per cent, annual rate, over the next two years--about in line with the rise of real disposable income.

We do expect a further improvement in the trade deficit during the projection period which will help to sustain over-all economic activity. But on balance, as shown in the next chart, we anticipate real GNP growth to moderate during this year, averaging about a 2 per cent annual rate of growth over the four quarters, and then to level off at about a 1-1/2 per cent rate in 1980.

Consistent with the slower pace of over-all activity, we anticipate smaller employment gains over the projection period--as shown in the top panel of the next chart. Although we are also projecting slower labor force growth than in the past few years, reflecting both poorer job prospects and smaller population gains, the unemployment rate--shown in the bottom panel--is projected to move up steadily beginning this spring, reaching a level of about 7 per cent toward the end of 1980.

Despite growing labor market slack, inflation is expected to continue to be a critical problem for the economy. In the next chart are portrayed the core elements of the persistent inflation problem--the continuing rise in wages and the poor productivity performance of the economy. As the top panel shows, we expect that hourly compensation will rise about as rapidly on average in 1979 as in 1978, reflecting the lagged influence of recent cost of living increases, the results of the heavy round of contract negotiations and the hikes in minimum wage and in social security taxes that went into effect on January 1. Some modest easing of compensation increases is expected in 1980, in response to smaller payroll tax increases, the continued slackening of labor market pressures and some impact of the guidelines program.

As the middle panel indicates, we expect little help from improved productivity performance in damping the impact of rising wages on labor costs and prices. The continued abysmal performance of productivity remains baffling. But in any event, only modest productivity growth is to be expected in an environment of such small gains in over-all output. As a result, we are projecting continued rapid increases in unit labor costs, totaling about 8-1/2 per cent during 1979 and 7-1/2 per cent in 1980, paralleling the pattern of wage movements.

The top panel of the next chart illustrates GNP prices excluding food and energy, which are projected to move generally in line with unit labor costs. We remain moderately optimistic in regard to food supplies and prices later this year and in 1980, reflecting prospects for good grain crops and some improvement in pork supplies. Our projections call for a 9-1/4 per cent food price increase this year as opposed to the 12-1/2 per cent rise during 1978. We are projecting an 8 per cent increase in 1980. Energy prices are projected to accelerate in response to the 14-1/2 per cent OPEC price increase during 1979; for 1980 we are assuming a rise in oil import prices of 7-1/2 per cent--about equal to average inflation. Over-all, we are projecting a modest deceleration in GNP price increases, from 8-3/4 per cent during 1978 to 8 per cent this year, and about 7-1/2 per cent in 1980.

Mr. Truman will now review the international situation.

FOMC PRESENTATION
E.M. Truman
February 6, 1979

The upper left-hand panel of the first international chart shows the decline in the weighted-average foreign exchange value of the dollar since the middle of 1976. The decline began to accelerate in the fourth quarter of 1977 and was only partially reversed following the November 1 initiatives. Over the past two months the dollar has been relatively stable. The foreign exchange value of the dollar, in nominal terms, is now about 17 per cent below its level in mid-1976 and about 15 per cent below its level in September 1977.

As is shown in the lower left-hand panel, in the first quarter of last year the average price level in foreign industrial countries began to fall relative to the U.S. price level. This deterioration in the relative price performance of the United States has offset some of the competitive advantage resulting from the decline in the dollar's nominal value. As is shown in the chart, we expect that, over the projection period, the U.S. inflation rate will remain relatively high, but the differential should narrow to about 1½ per cent per year--compared with almost 3 per cent over the past year.

The upper right-hand panel of the chart shows the staff's outlook for real economic activity abroad. Average growth in real GNP in foreign industrial countries picked up somewhat in 1978, and real growth is expected to continue at an average annual rate of about 3½ per cent over the projection period, while growth in the United

States slows. The expected relative rise in the level of economic activity abroad is summarized in the last panel.

The factors I have just reviewed are among the major determinants of the staff's outlook for U.S. international transactions that is presented in the next chart. As depicted in the upper left-hand panel, the value and volume of non-agricultural exports are expected to increase briskly over the next two years, though not as rapidly as in recent quarters. The volume of such exports is expected to increase at an annual rate of around 9 per cent and the value at a rate of about 18 per cent.

At the same time, as shown in the lower left-hand panel, the volume of non-oil imports is expected to expand relatively slowly reflecting the slower growth of the U.S. economy as well as the lagged effects of the dollar's depreciation. Even with substantial price increases, the value of these imports should increase over the next two years at an average rate of less than 9 per cent per year.

The upper right-hand panel illustrates the erratic upward trend of U.S. oil imports. In our forecast we have tried to take account of recently announced, and prospective, OPEC price increases and to make some guesses about the effects of the Iranian production situation--which we have assumed will mainly affect the time pattern of oil imports in 1979. On this basis, we expect that the U.S. oil import bill will rise $5-6 billion per year in both 1979 and 1980. Most of the increase will result from higher prices.

As shown in the final panel, the net effect of the components that I have just reviewed, together with little expected change in our agricultural exports, yields an improvement in the trade balance in 1979 and 1980. The top line in the chart depicts the gradual rise over the projection period in net exports of goods and services as measured in the GNP accounts.

The final international chart summarizes U.S. international transactions over the past three years. The left-hand column shows the current account balance for these years as well as the staff's projection for 1979 and 1980. You will note that we expect the United States will record its first current account surplus in 4 years in 1980. The middle column indicates that in 1977 and 1978 capital inflows in the form of increases in foreign official reserve assets held in the United States were about twice as large as our current account deficits. However, the pattern of these increases has been erratic; the largest inflows have roughly corresponded to periods of sharp downward pressure on the dollar in exchange markets during the last quarter of 1977 and the first and fourth quarters of 1978. The third column shows other transactions, derived essentially as a residual. These are mostly private capital transactions. Such transactions at times are a source of downward pressure on the dollar. However, the size of any actual net outflow is inversely related to the volume of official purchases of dollars.

Given the improved outlook for the U.S. current account that I have presented, the staff expects little further change in the average nominal foreign exchange value of the dollar over the projection period, although with the expected relatively high U.S. inflation rate this implies a small real appreciation of the dollar. I would draw two inferences from this outlook for a stable dollar and a declining U.S. current account deficit. First, foreign monetary authorities will have less inducement to purchase dollars to add to their holdings of reserve assets in the United States. Second, the lower current account deficit in 1979 should be accompanied by a substantially reduced net private capital outflow or, even, by a modest net inflow.

Mr. Kichline will now conclude our presentation.

James L. Kichline
February 6, 1979

CONCLUSION -- FOMC CHART SHOW

Total credit flows consistent with the staff's economic forecast are shown in the first chart of the last section of your packet. Funds raised by nonfinancial sectors in 1979 are projected to recede from the high levels of last year. The bulk of the decline is attributable to reduced demands by the Federal Government, which is expected to finance a portion of the deficit this year by drawing down its cash balances. Total borrowing by other sectors is not expected to grow in 1979 and 1980, reflecting the effects of financial restraints and decelerating growth of economic activity.

As shown in the bottom panel, commercial banks and thrift institutions are expected to supply a somewhat smaller volume of credit in the next two years than in 1978. These institutions will likely be less willing lenders this year in light of reduced liquidity positions and an expected further need to rely upon borrowed funds rather than deposit flows to meet credit demands. Other suppliers of credit, particularly insurance companies and pension funds, are expected to be in a more comfortable position to finance economic activity.

Total borrowing by nonfinancial corporations, shown in the next chart, is projected to rise appreciably in both 1979 and 1980 from the already high levels reached last year. Although the economic forecast projects a slowing of growth in capital expenditures, expansion of internally generated funds is also expected to moderate, thereby maintaining pressures on external financing. The increased volume of funds raised is expected to come from long-term sources, where funds should be available. Short-term markets seem likely to be relatively tighter, partly because of the pressures on banks. In addition, however, the bottom panel shows that heavy short-term borrowing in the past two years has pushed the ratio of short-term to total debt outstanding to fairly high levels. Later this year and in 1980 there probably will be strong pressures to begin funding such debt in long markets to relieve balance sheet distortions.

In contrast to the corporate sector, the next chart shows that household sector borrowing is projected to decline somewhat this year and next from the extraordinary level in 1978. Despite expected further rapid growth of house prices, mortgage borrowing in 1979 and 1980 is expected to remain around the level of the past two years, which reflects the effects of financial restraint. The sharp contraction of mortgage borrowing that has occurred during past periods of monetary restraint is projected to be avoided, as a result of both the partial insulation of the mortgage market from the direct effects of monetary restraint and sustained demands for housing. Consumer instalment and other borrowing is projected to diminish later this year and in 1980, given projected slower growth of durable goods purchases. Relative to income, however, consumer borrowing is projected to remain quite high.

The economic forecast and associated credit flows assume growth of M-1 averaging 6-1/4 per cent in 1979 and 1980. As shown in the next chart, nominal GNP expanded at a fast pace in the last quarter of 1978 while M-1 growth adjusted for the effects of ATS slowed. Thus the income velocity of money rose substantially and a strong velocity increase is also expected this quarter. Later this year and in 1980 the forecast assumes that stronger demands for money relative to GNP will be evident. In order to hold money growth to 6-1/4 per cent the 3-month bill rate is expected to decline only a little this year and next, shown in the bottom panel. The Administration in its forecast assumes 3-month bill rates about 1/2 percentage point lower on average this year than shown on the chart and more than a percentage point lower in 1980.

The economic forecast of the Administration and that of the staff also differ in a number of ways, as shown on the next chart. Growth of nominal GNP expected in 1979 is quite close, but in 1980 the staff forecast is significantly below that of the Administration. The difference is even greater for real GNP in 1980 when the Administration projects growth of 3-1/4 per cent, or more than twice the staff's forecasted rate of growth; business fixed investment, residential construction outlays and consumption expenditures are all growing at appreciably faster rates in 1980 than in our own forecast. The Administration also expects considerable improvement in inflation this year and next with the GNP implicit deflator in 1980 projected to rise about 6-1/2 per cent compared to 7-1/2 per cent in the staff forecast. Presumably the less rapid price increases stem from the assumed greater effectiveness of the wage-price restraint program, since the price deceleration occurs with little additional slack in resource utilization than now exists, as illustrated by maintenance of a 6-1/4 per cent unemployment rate in 1979 and 1980 in their projection.

M-1 growth assumed in the staff's forecast is 6-1/4 per cent adjusted to take account of the effects of ATS. Judging from the econometric exercises we have undertaken, nominal GNP growth as in the Administration forecast could also be financed by roughly similar monetary growth. The model simulations, however, suggest very low probabilities of jointly achieving the lower inflation and lower unemployment forecasts by the Administration.

The final chart in the package displays the results obtained from model simulations employing 1 percentage point slower and faster rates of M-1 growth than in the 6-1/4 per cent base forecast. Each of the forecasts presents a picture of slow or moderate economic growth accompanied by still high rates of inflation even into 1981. There seems to be little in the way of attractive options for monetary policy. Tightening further would bring on the likelihood of a recession later this year or next while an easier policy would probably produce higher rates of inflation over the longer run.

CONFIDENTIAL (FR) CLASS II-FOMC

Material for

Staff Presentation to the Federal Open Market Committee

February 6, 1979

PRINCIPAL ASSUMPTIONS

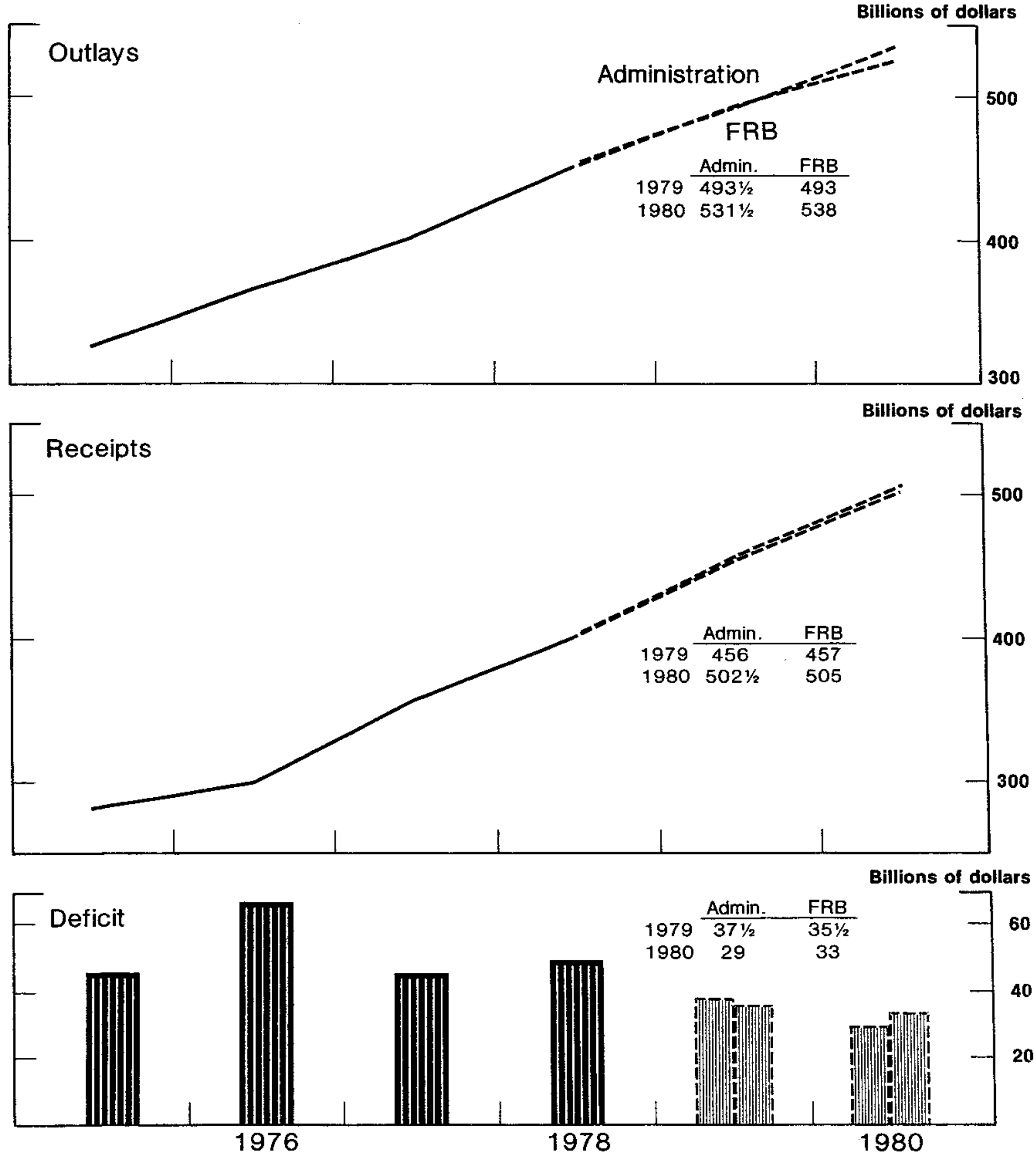
MONETARY POLICY

- Interest rates little changed in 1979H1; move lower through 1980
- Growth of M-1 averages 6¼ per cent (adjusting for impact of ATS) in 1979 and 1980

FISCAL POLICY

- Unified budget expenditures of $493 billion in FY 1979
- Unified budget expenditures of $538 billion in FY 1980

FEDERAL BUDGET*

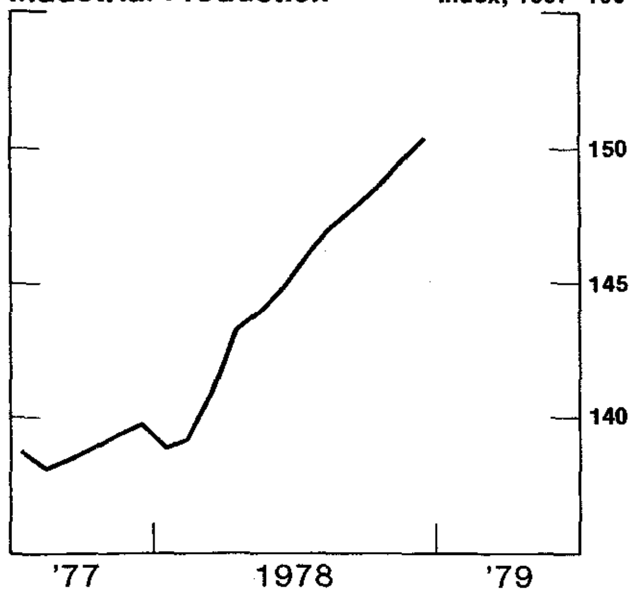


* Fiscal years

ECONOMIC ACTIVITY

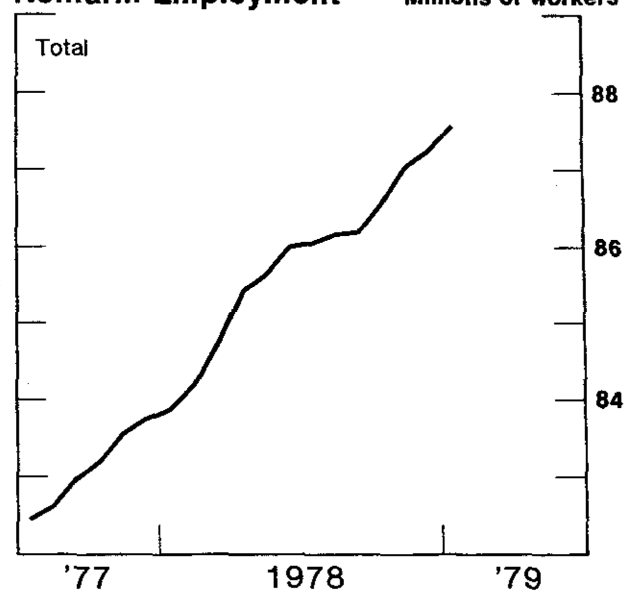
Industrial Production

Index, 1967=100



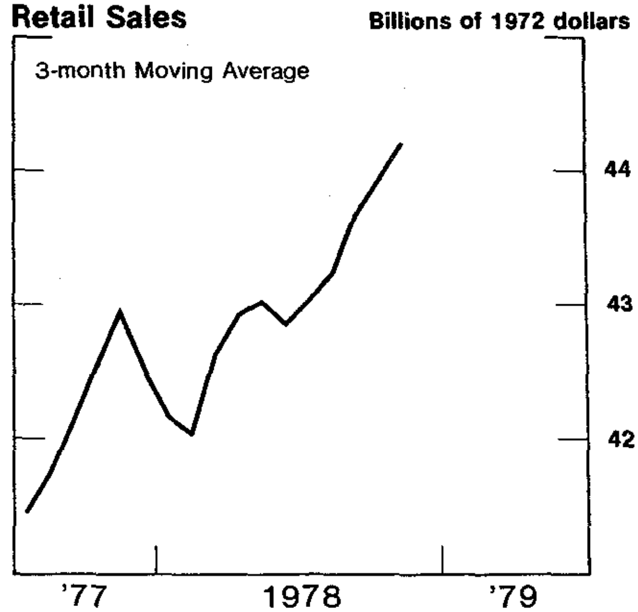
Nonfarm Employment

Millions of workers

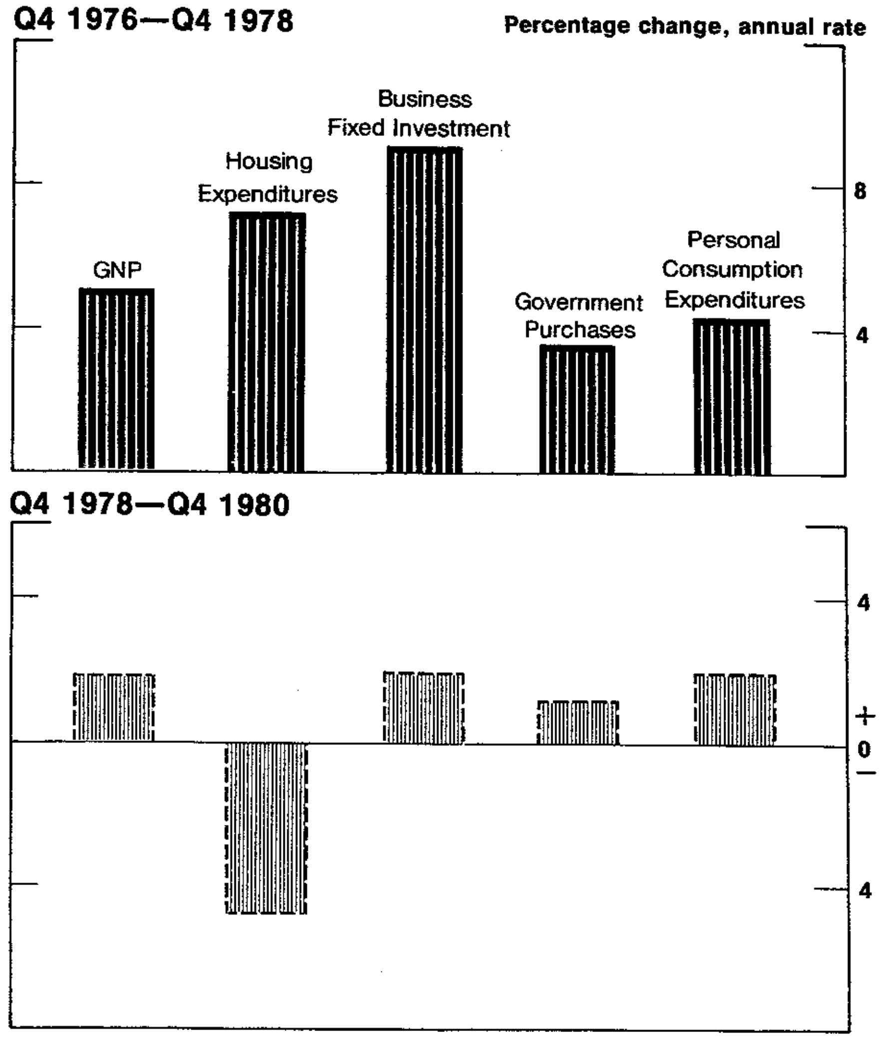


Retail Sales

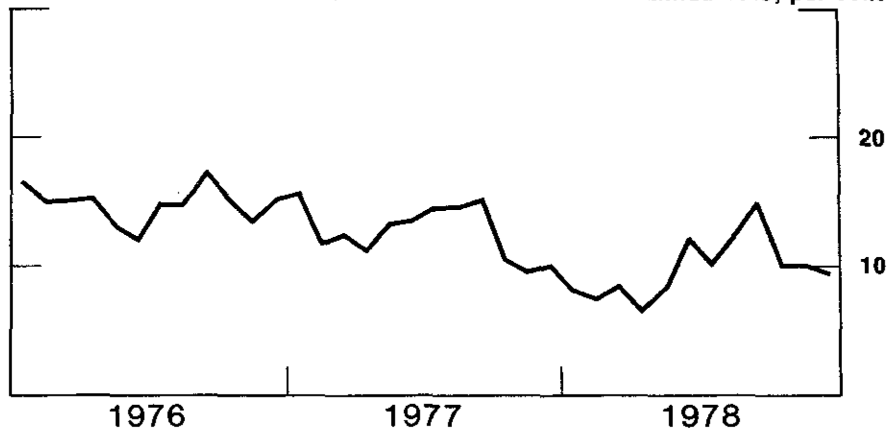
Billions of 1972 dollars



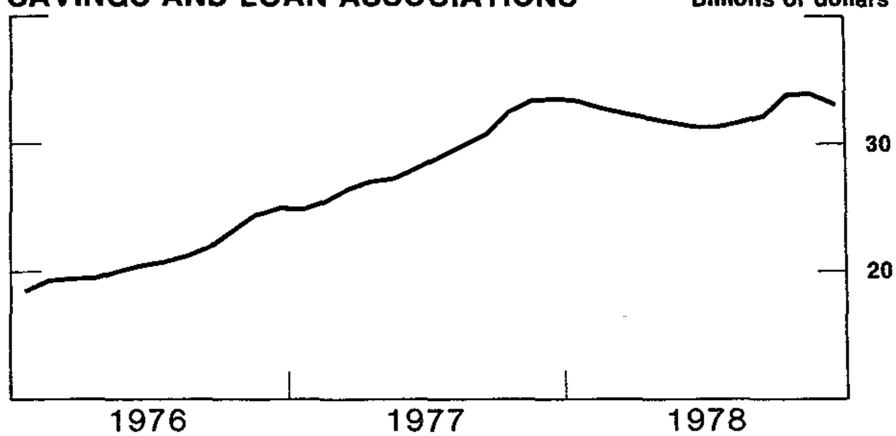
Real GNP and Major Sectors



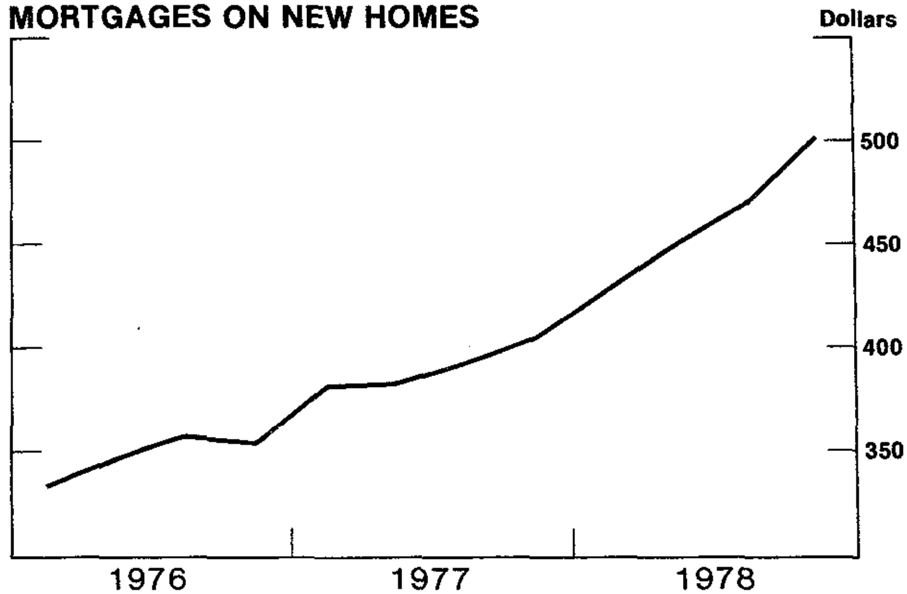
DEPOSIT GROWTH AT THRIFT INSTITUTIONS

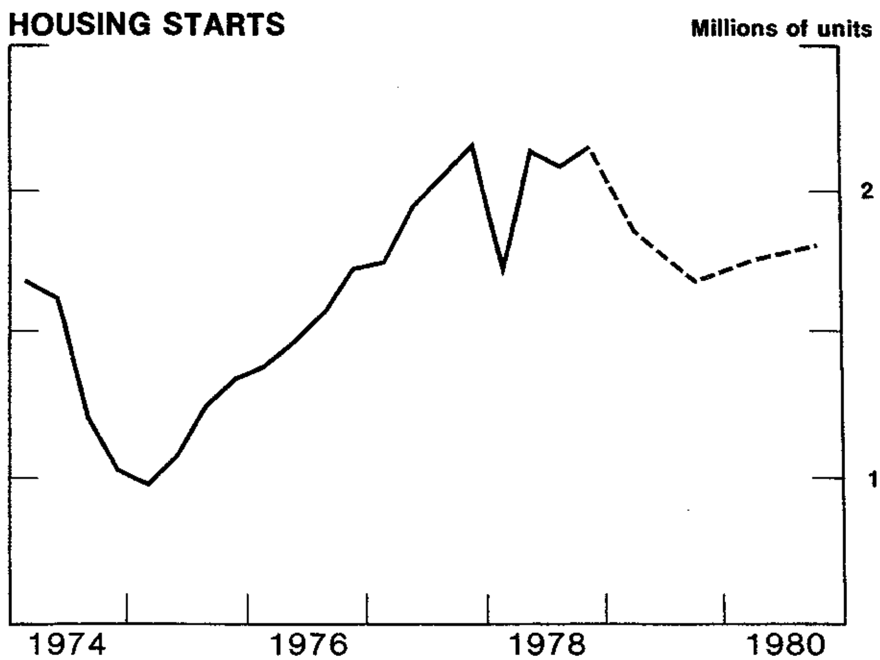


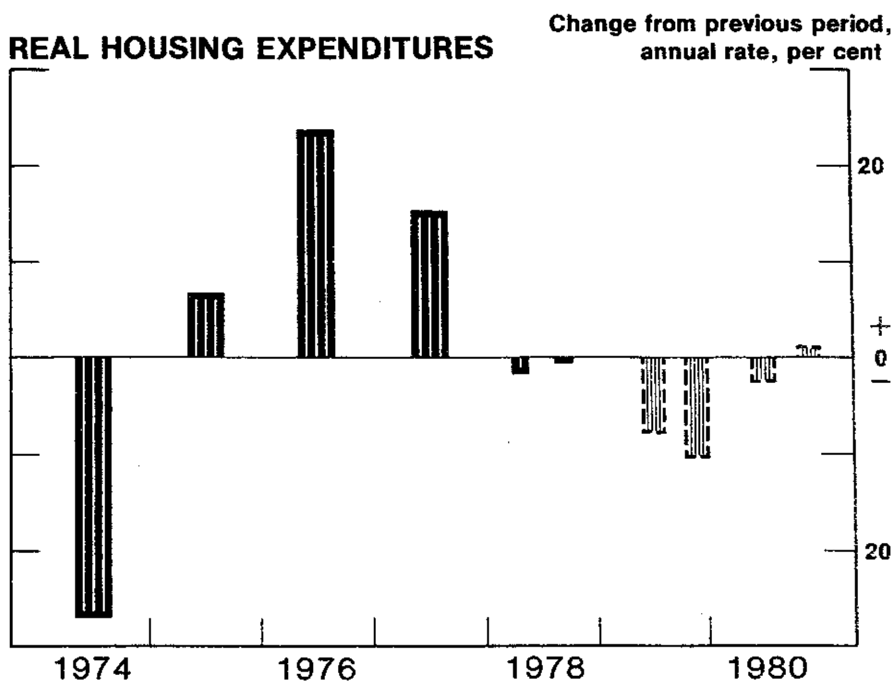
OUTSTANDING COMMITMENTS AT SAVINGS AND LOAN ASSOCIATIONS



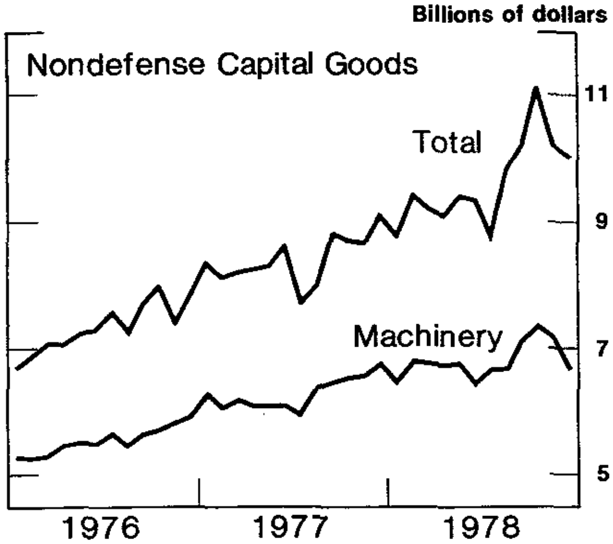
MONTHLY CARRYING COSTS, MORTGAGES ON NEW HOMES



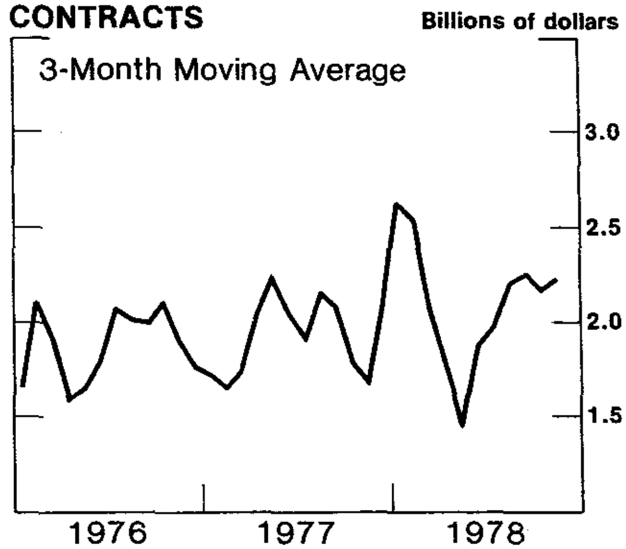

HOUSING STARTS
Millions of units
2
1
1974
1976
1978
1980


REAL HOUSING EXPENDITURES
Change from previous period, annual rate, per cent
20
+
0
−
20
1974
1976
1978
1980

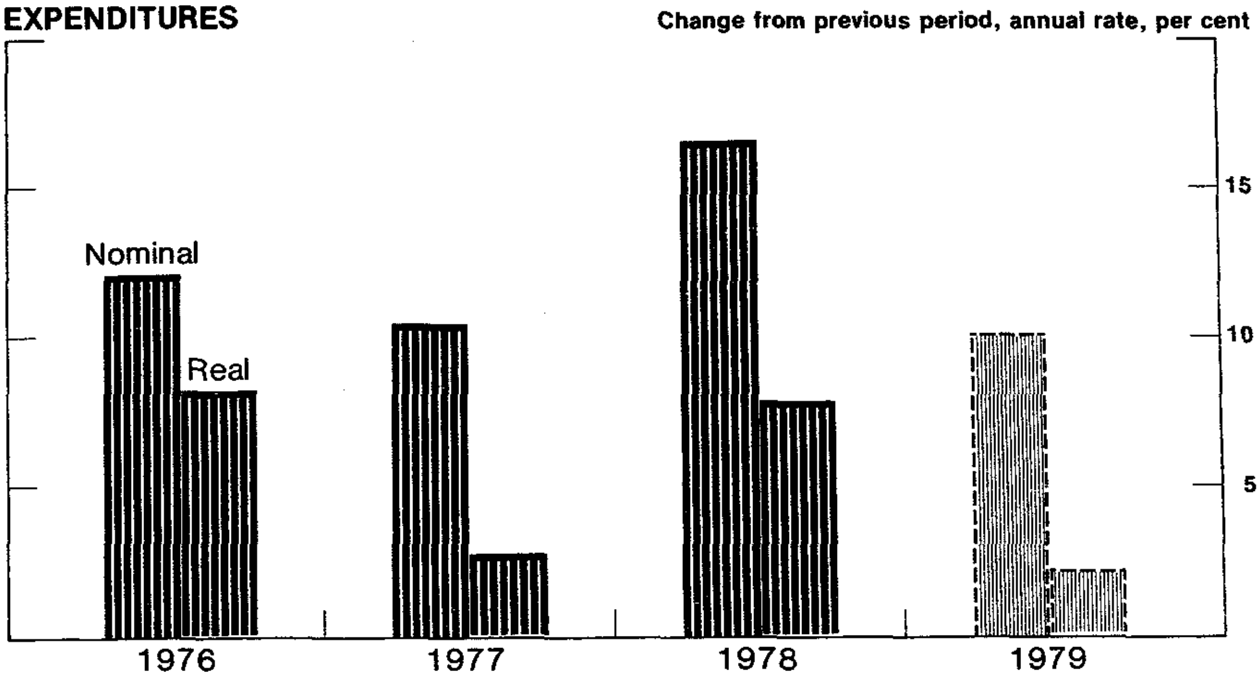
REAL NEW ORDERS



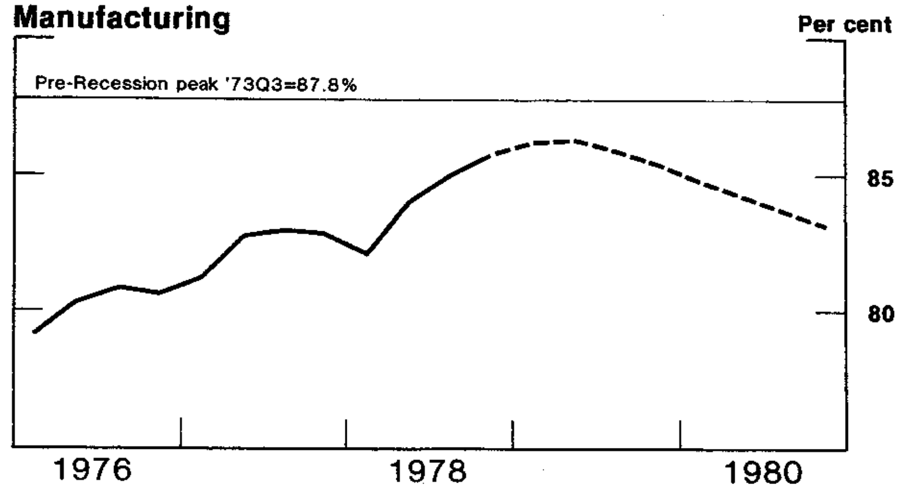
REAL CONSTRUCTION CONTRACTS



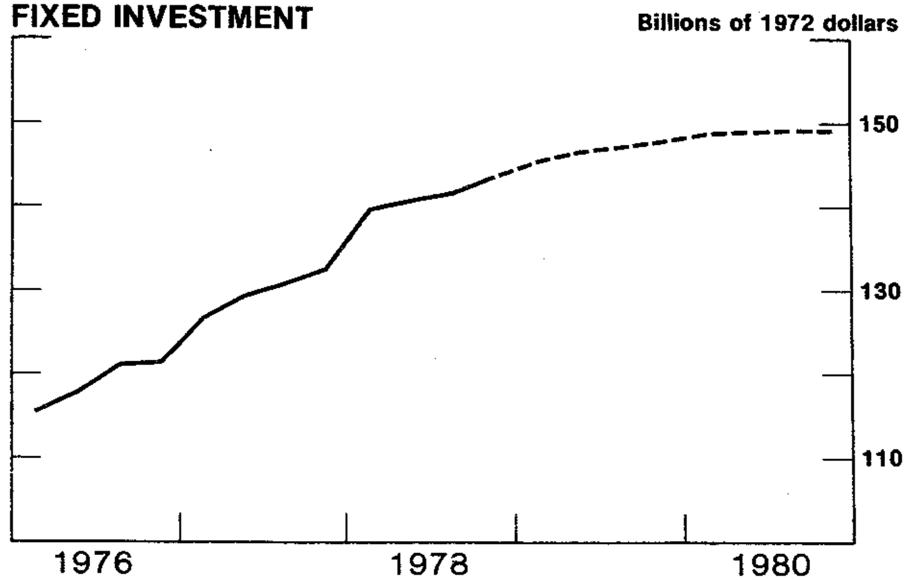
PLANT AND EQUIPMENT EXPENDITURES

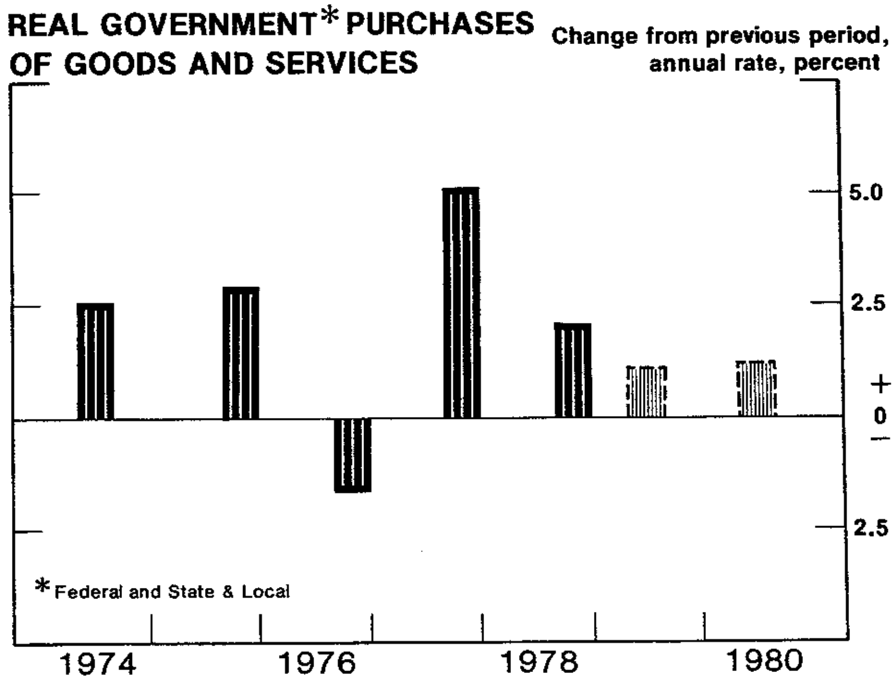


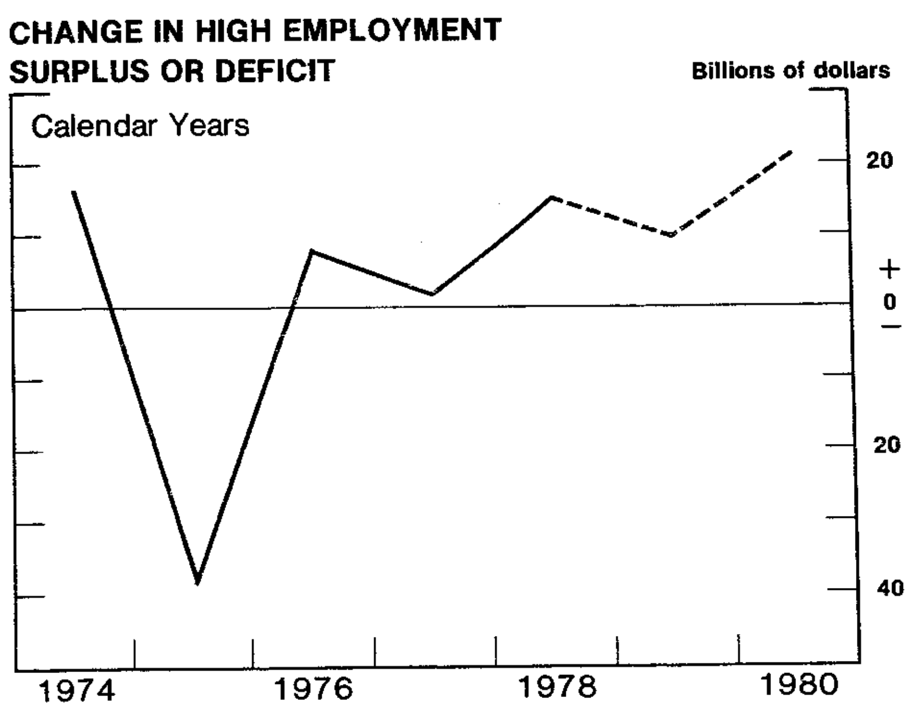
CAPACITY UTILIZATION
Manufacturing



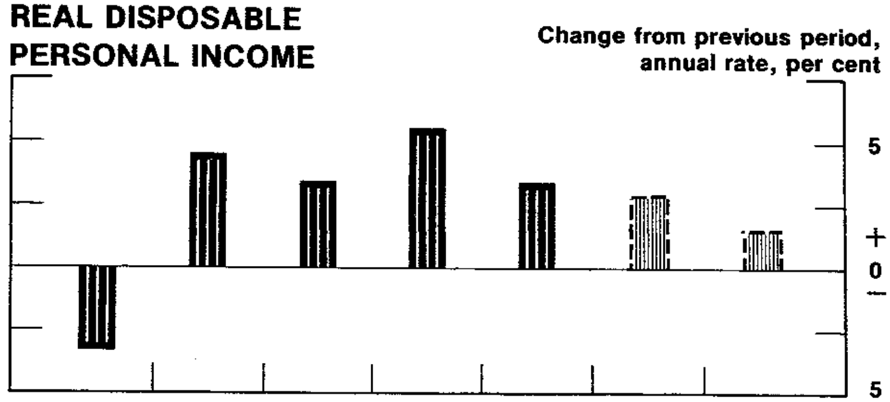
REAL BUSINESS
FIXED INVESTMENT



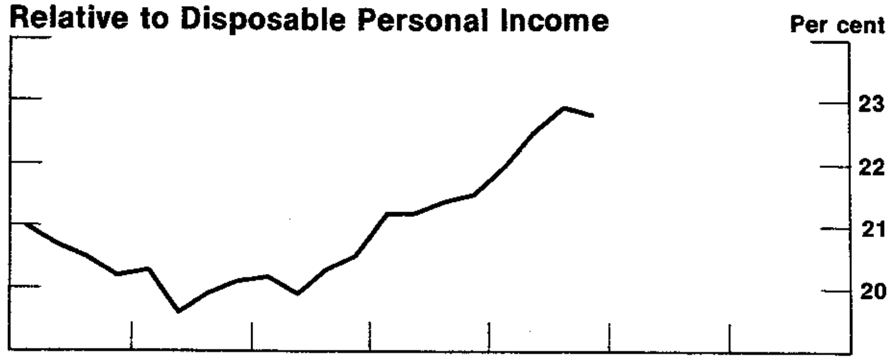

REAL GOVERNMENT* PURCHASES
OF GOODS AND SERVICES
Change from previous period,
annual rate, percent
5.0
2.5
+
0
−
2.5
*Federal and State & Local
1974
1976
1978
1980


CHANGE IN HIGH EMPLOYMENT
SURPLUS OR DEFICIT
Billions of dollars
Calendar Years
20
+
0
−
20
40
1974
1976
1978
1980

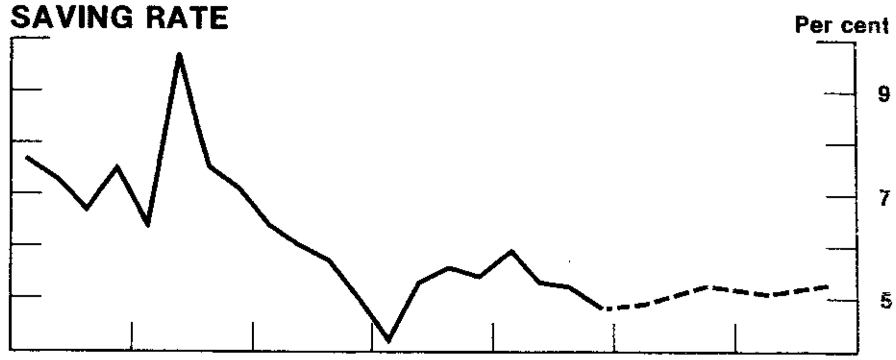
REAL DISPOSABLE PERSONAL INCOME



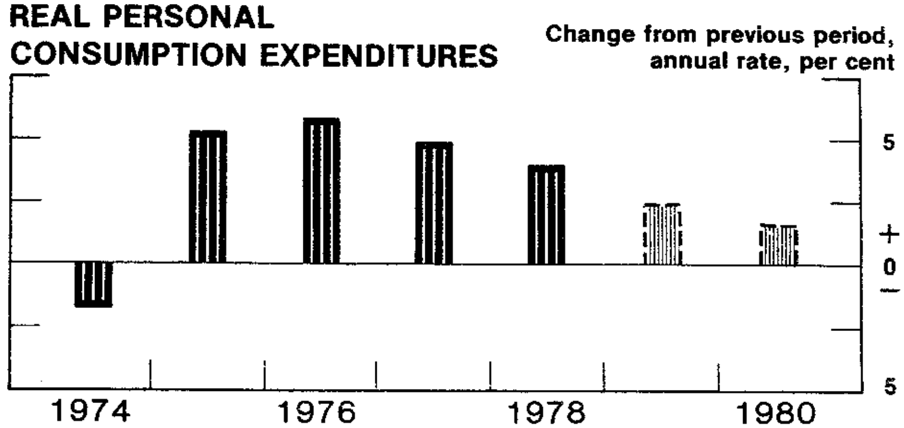
HOUSEHOLD DEBT REPAYMENTS Relative to Disposable Personal Income

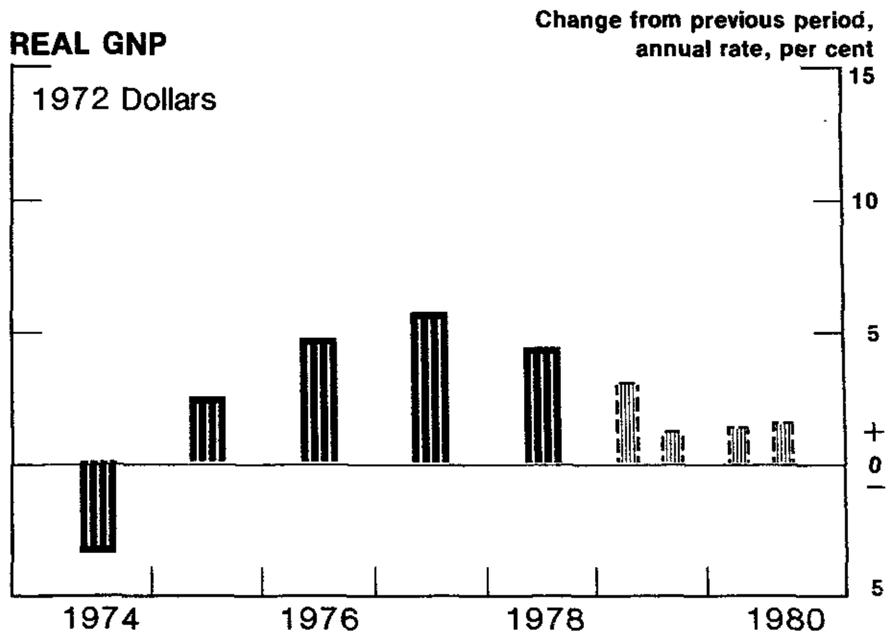


SAVING RATE

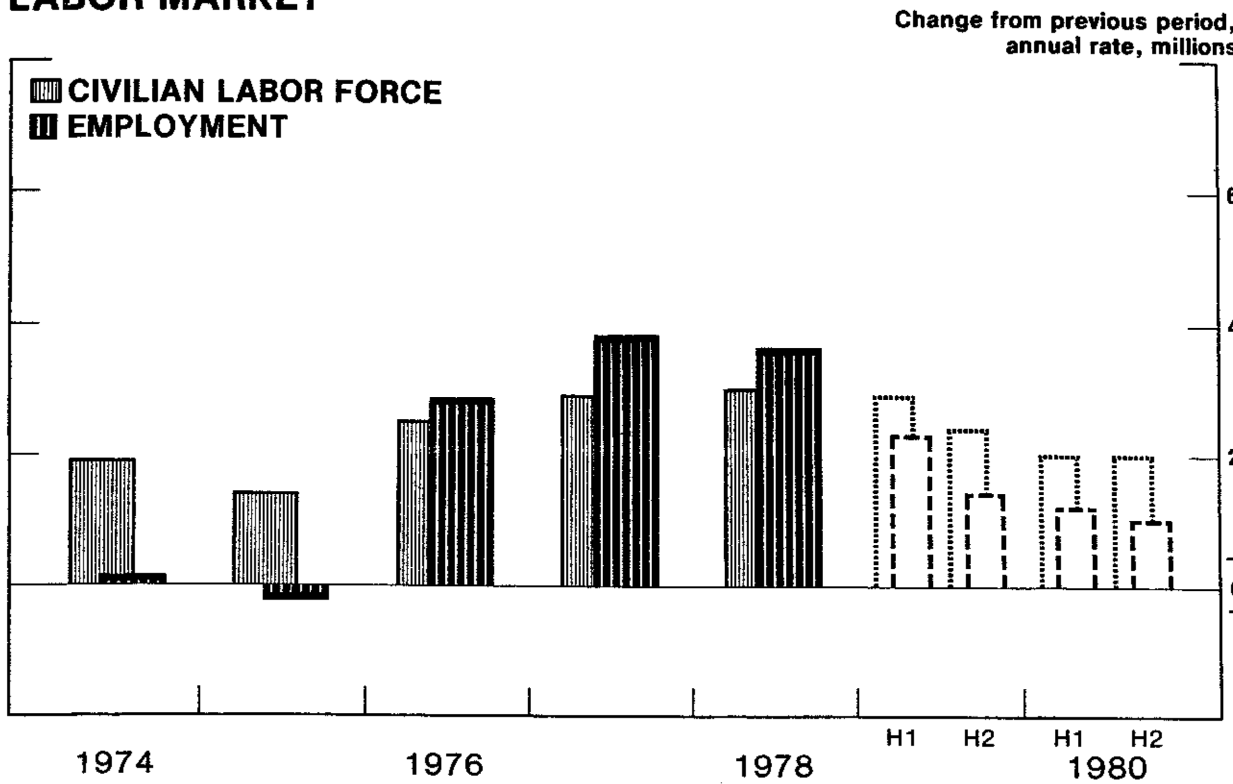


REAL PERSONAL CONSUMPTION EXPENDITURES

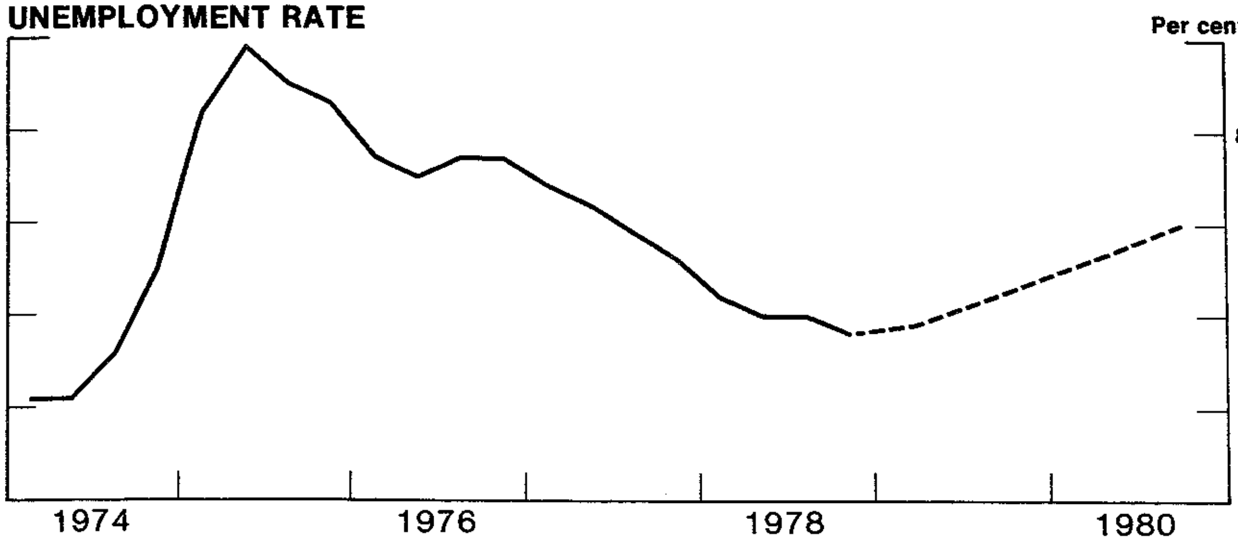



REAL GNP
Change from previous period, annual rate, per cent
1972 Dollars
15
10
5
+
0
−
5
1974
1976
1978
1980

LABOR MARKET

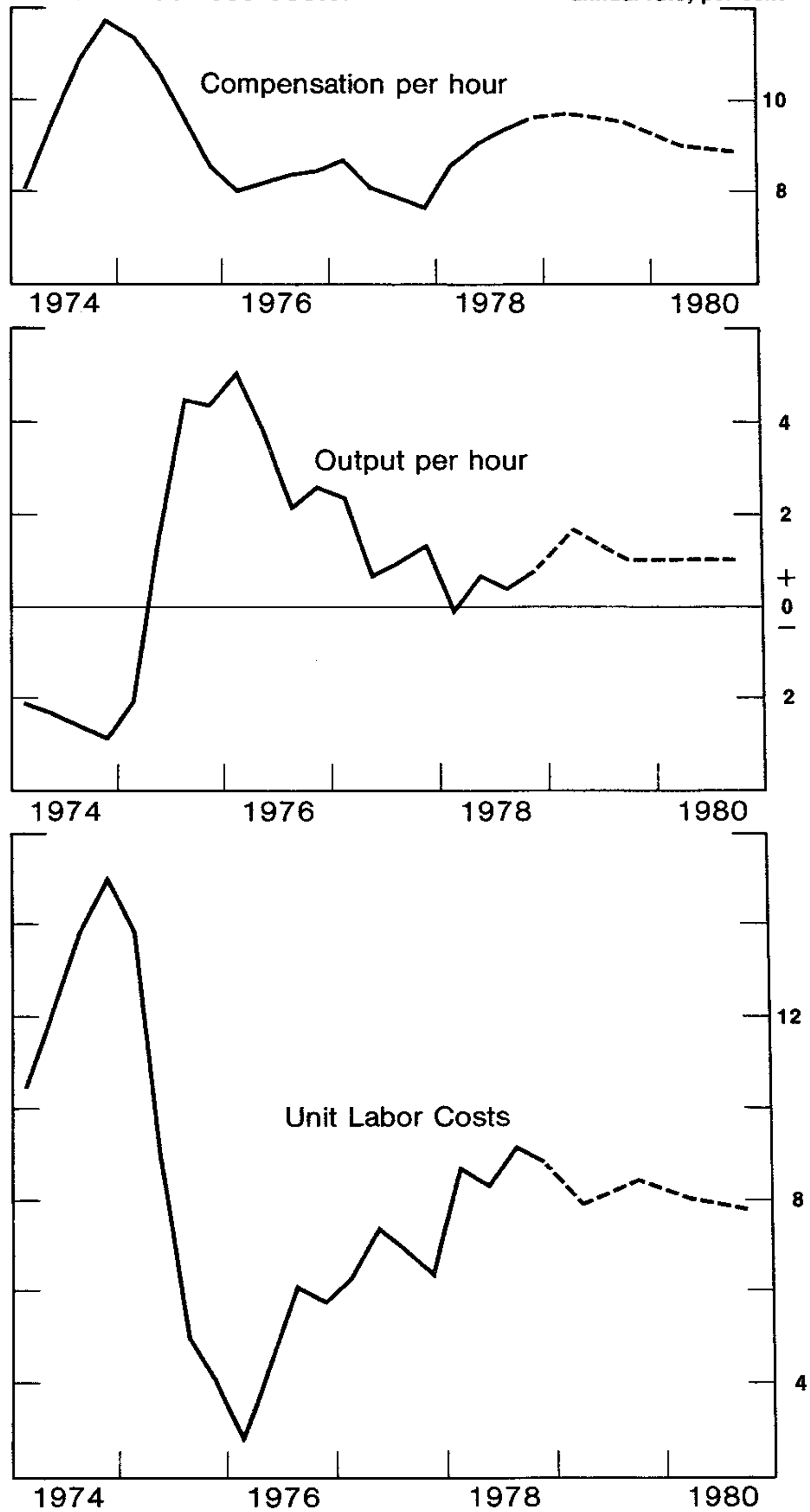


UNEMPLOYMENT RATE

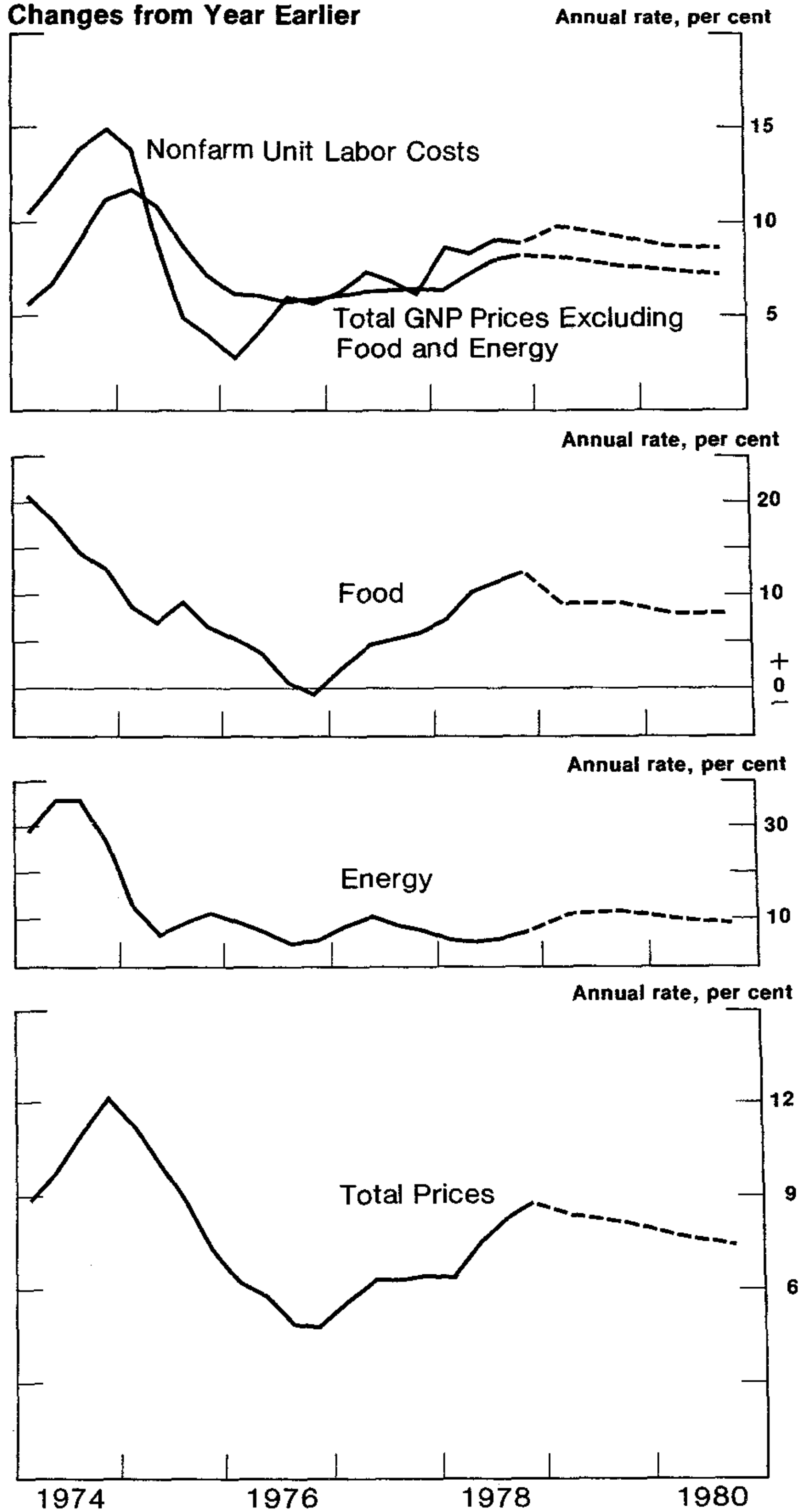


UNIT COST INDICATORS
Nonfarm Business Sector

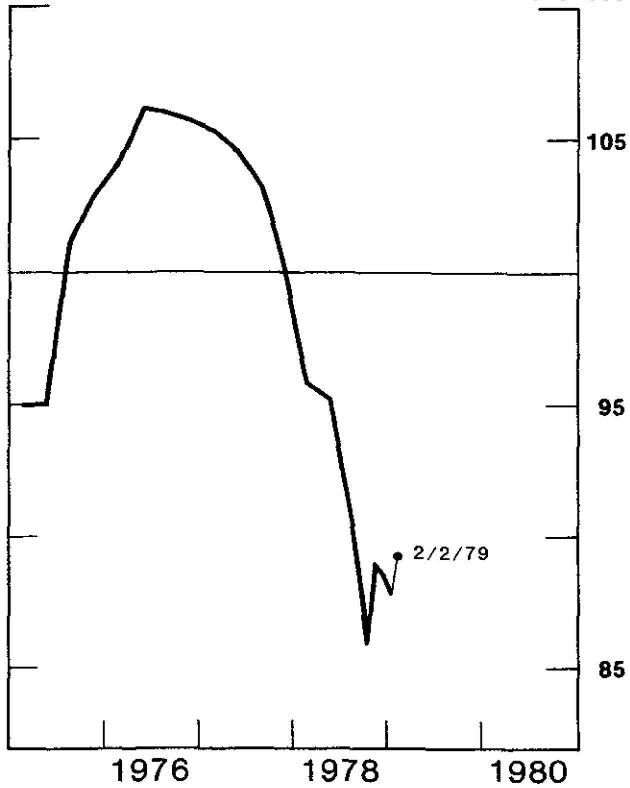
Change from year earlier, annual rate, per cent



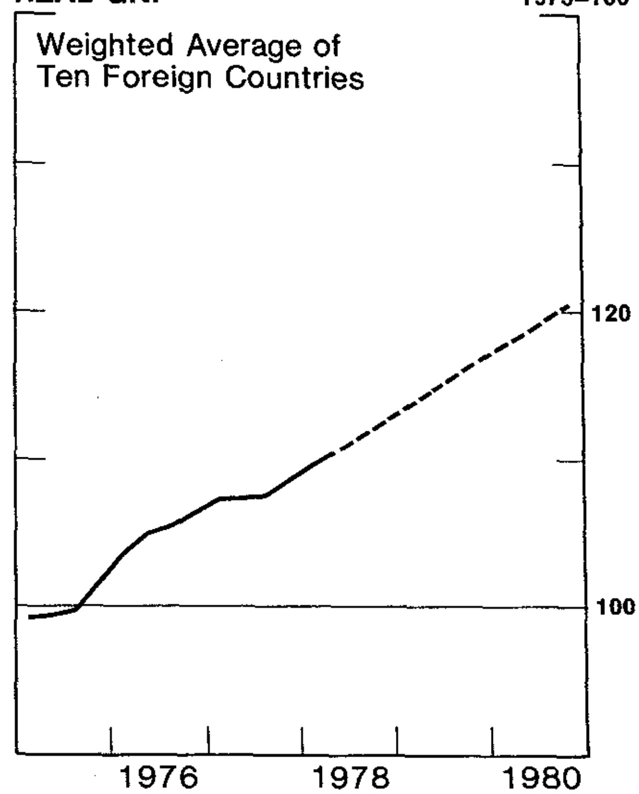
LABOR COSTS AND PRICES
Changes from Year Earlier



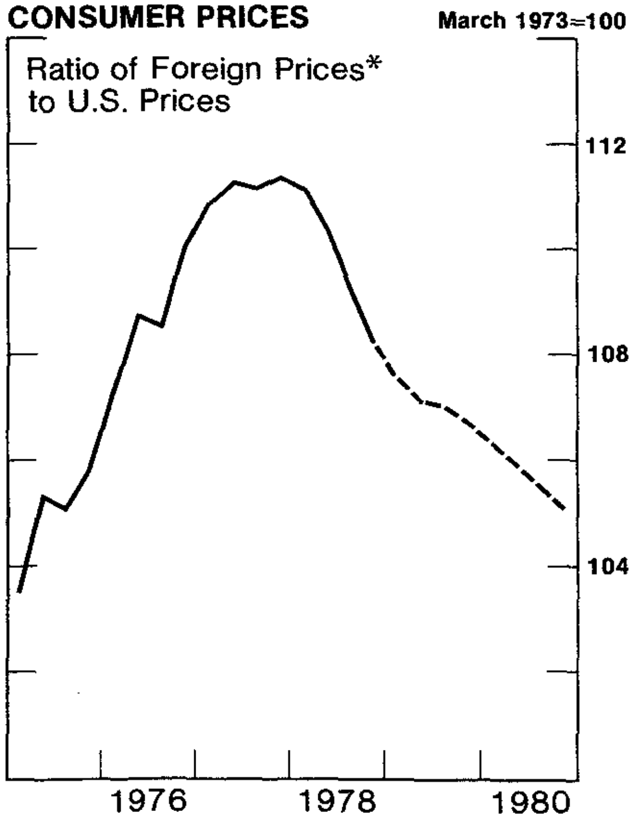
WEIGHTED AVG. EXCHANGE VALUE OF THE U.S. DOLLAR*



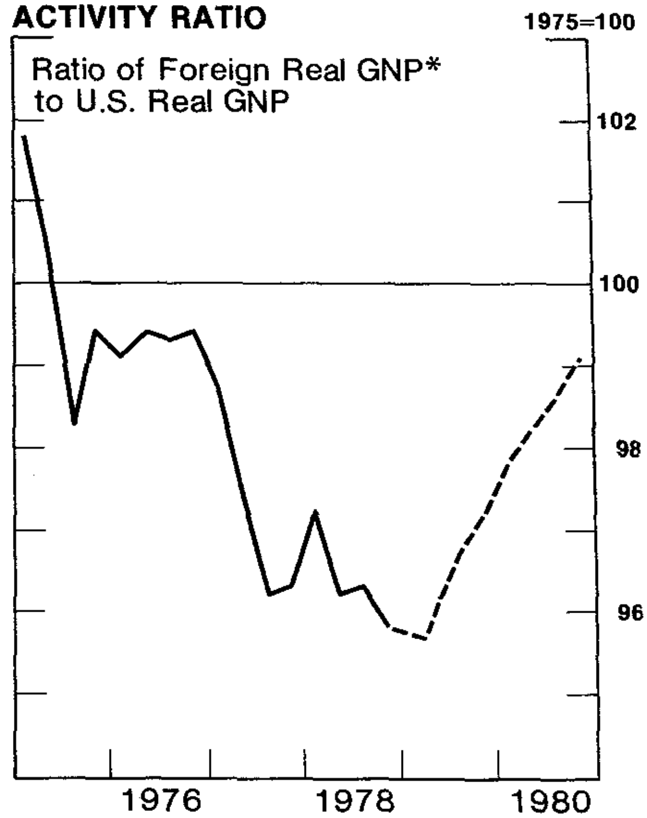
REAL GNP



CONSUMER PRICES

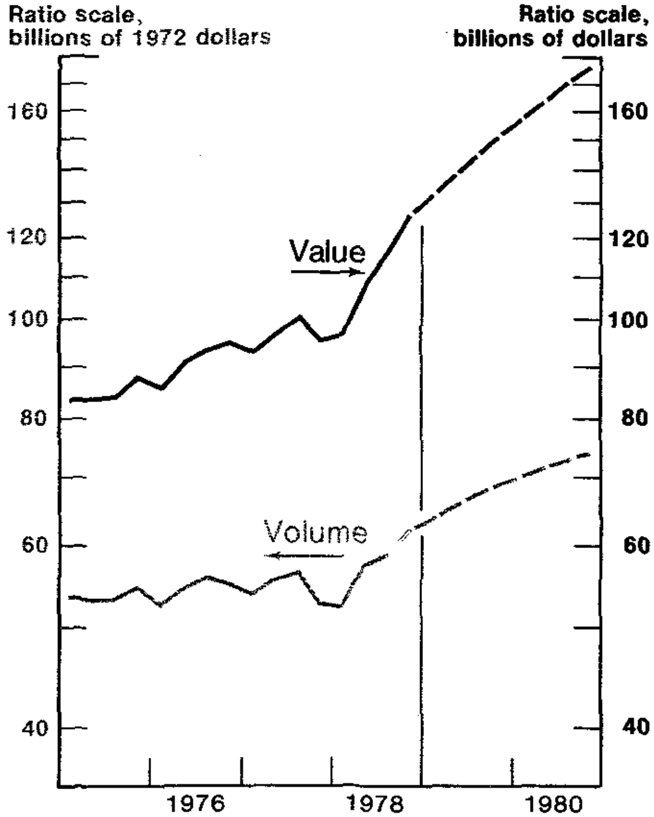


ACTIVITY RATIO

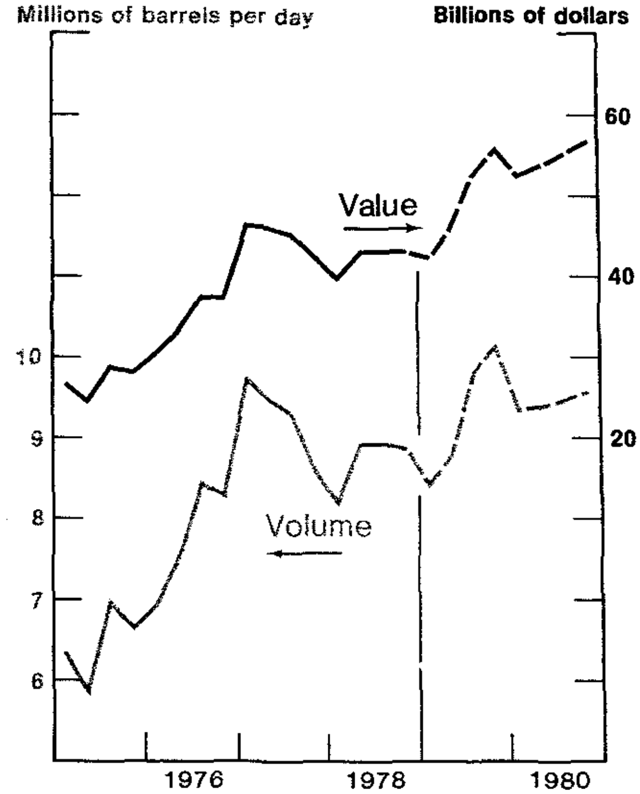


*Weighted average against G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

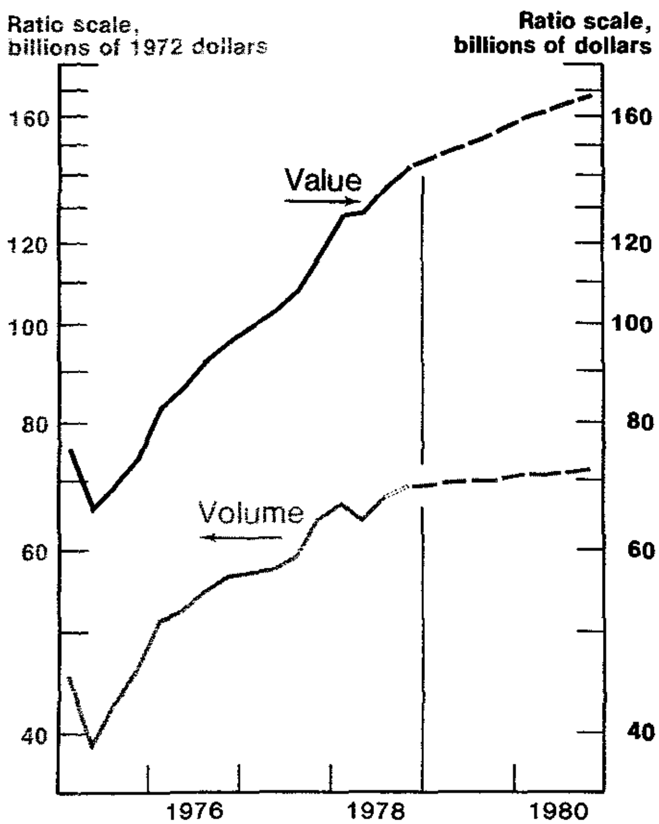
NON-AGRICULTURAL EXPORTS



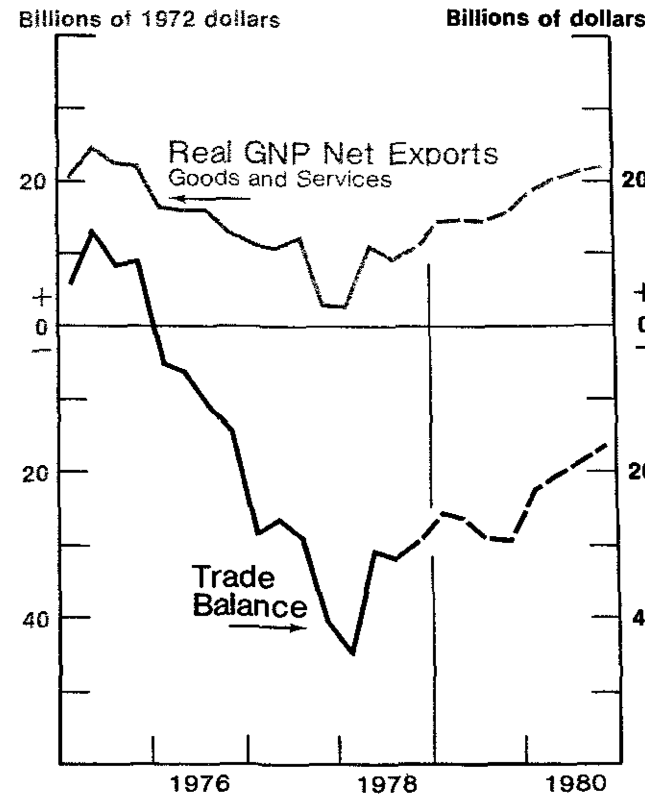
OIL IMPORTS



NON-OIL IMPORTS

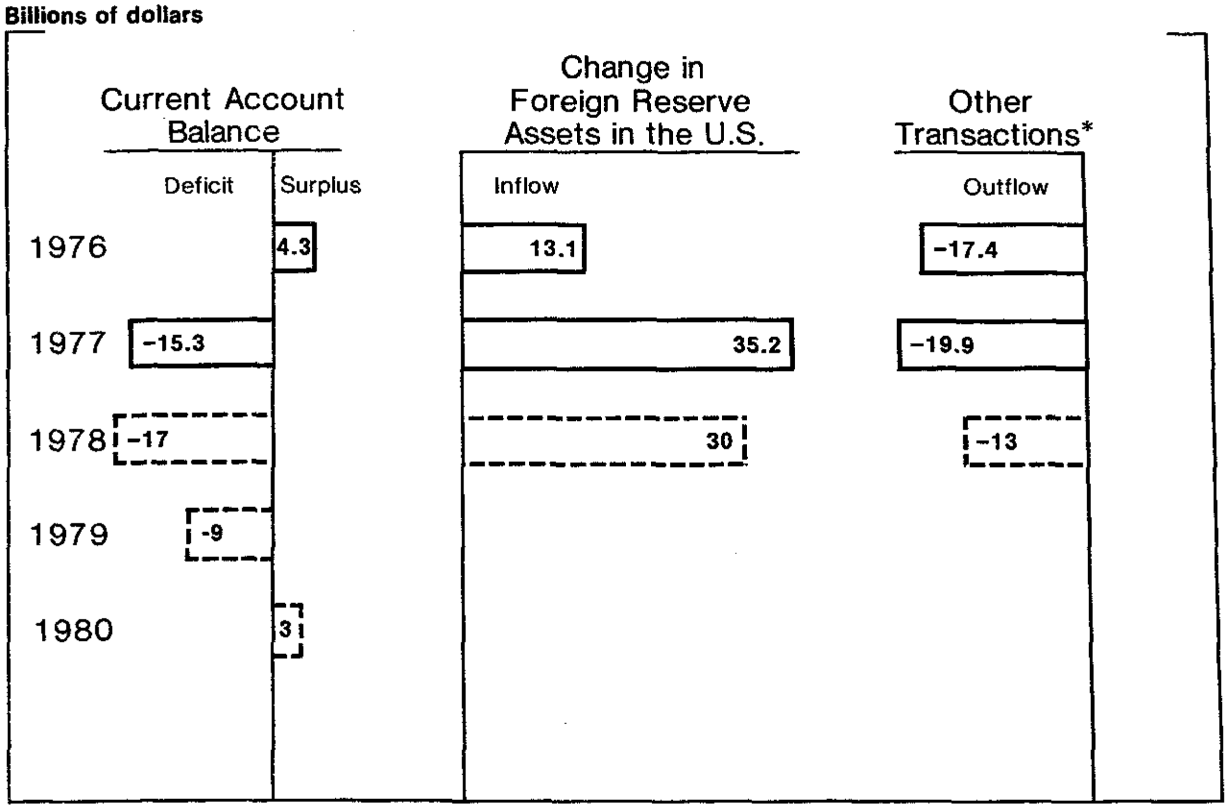


NET EXPORTS

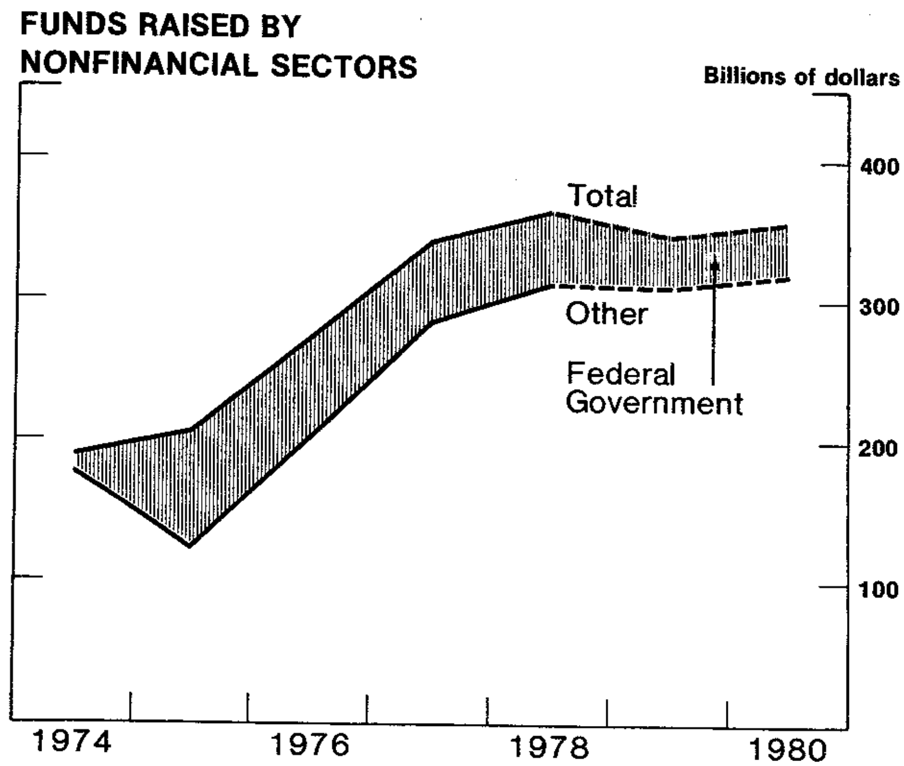


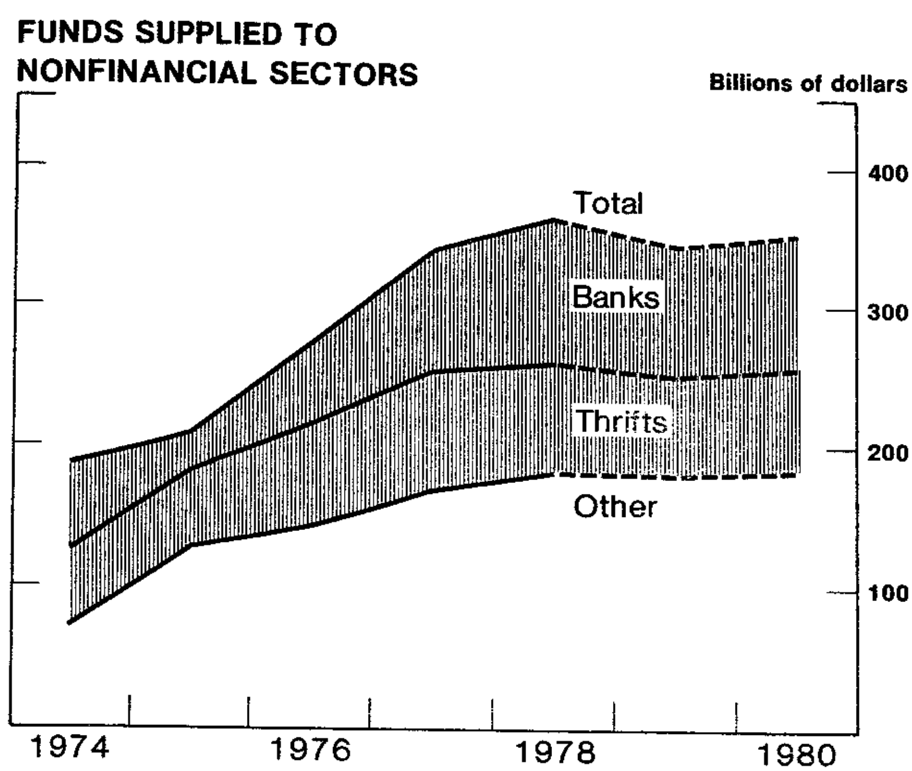
SUMMARY OF U.S. INTERNATIONAL TRANSACTIONS

Billions of dollars

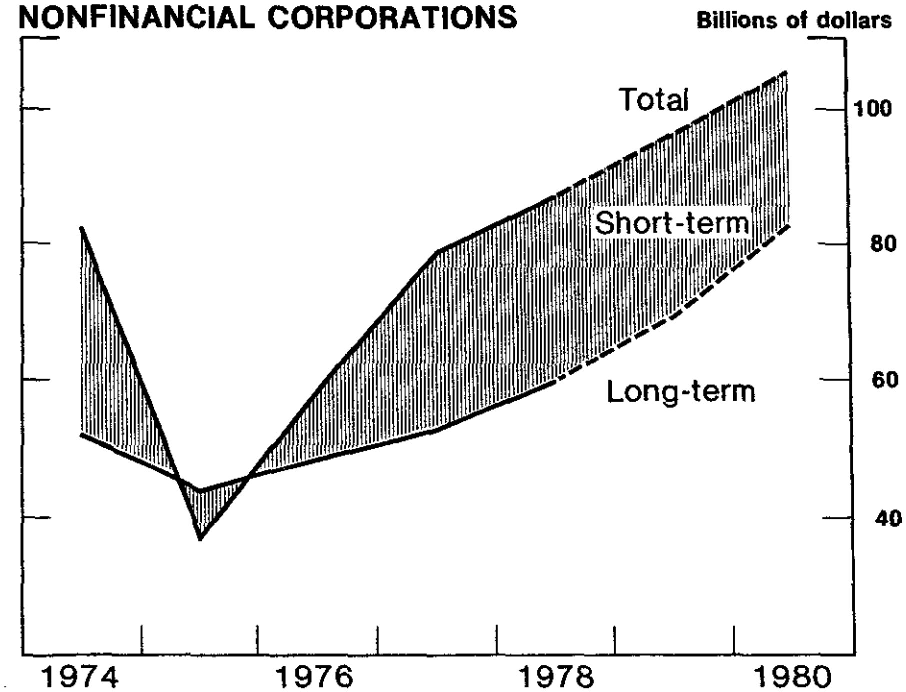


* Mostly net private capital transactions.

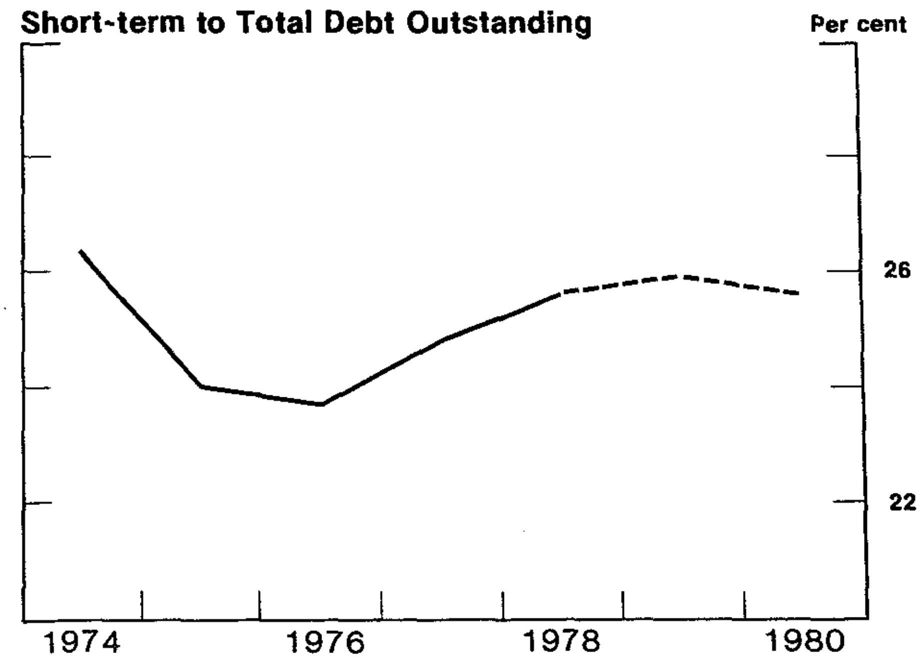

FUNDS RAISED BY
NONFINANCIAL SECTORS
Billions of dollars
400
300
200
100
Total
Other
Federal
Government
1974
1976
1978
1980

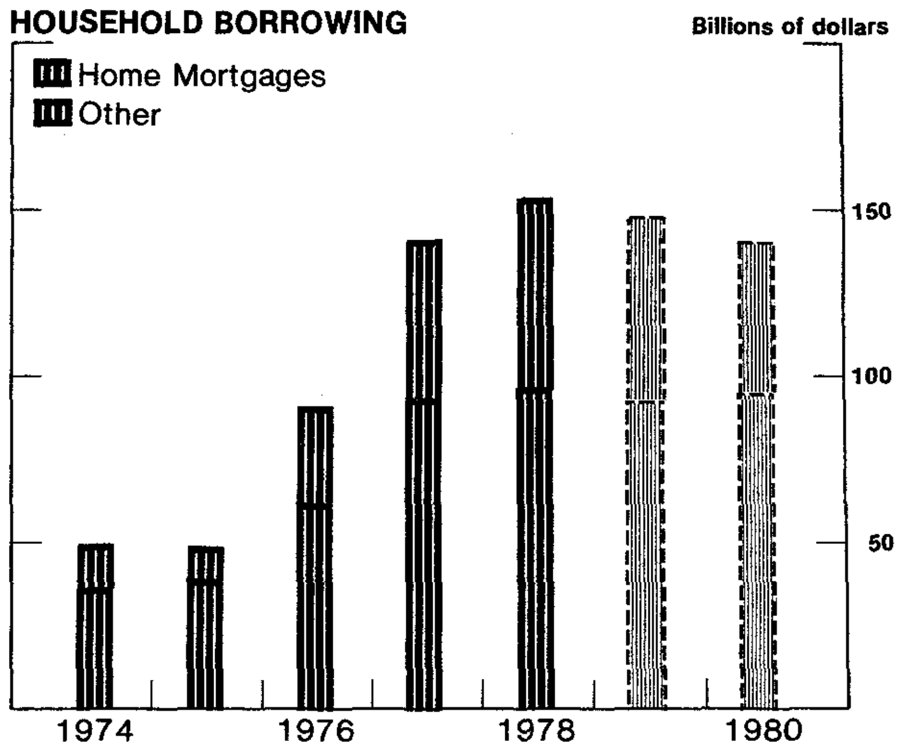

FUNDS SUPPLIED TO
NONFINANCIAL SECTORS
Billions of dollars
400
300
200
100
Total
Banks
Thrifts
Other
1974
1976
1978
1980

FUNDS RAISED BY NONFINANCIAL CORPORATIONS



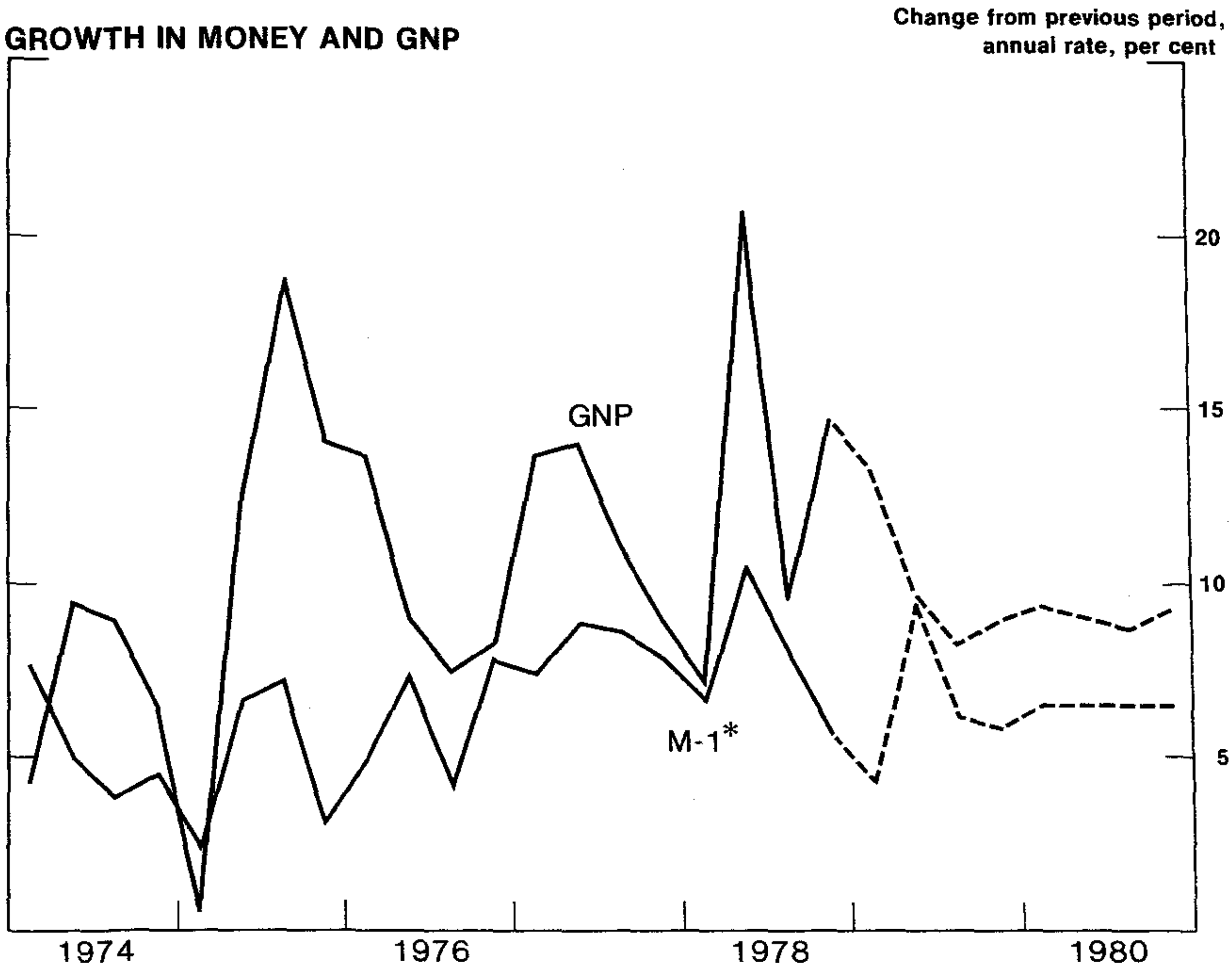
NONFINANCIAL CORPORATIONS
Short-term to Total Debt Outstanding



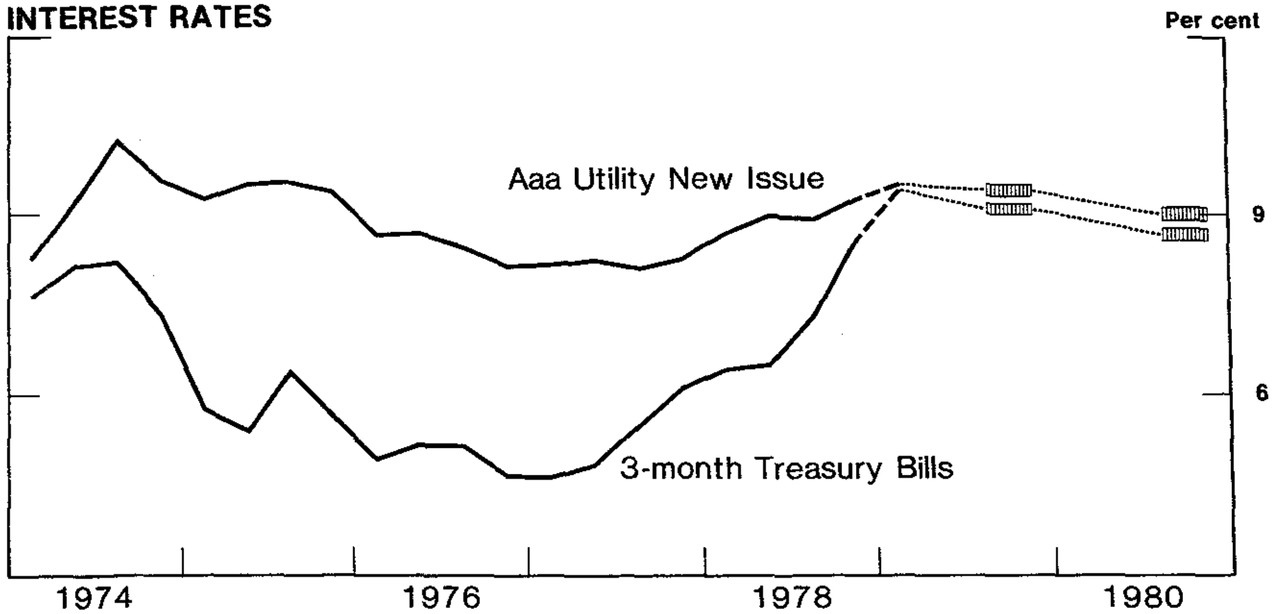


HOUSEHOLD BORROWING
Billions of dollars
Home Mortgages
Other
150
100
50
1974
1976
1978
1980

GROWTH IN MONEY AND GNP

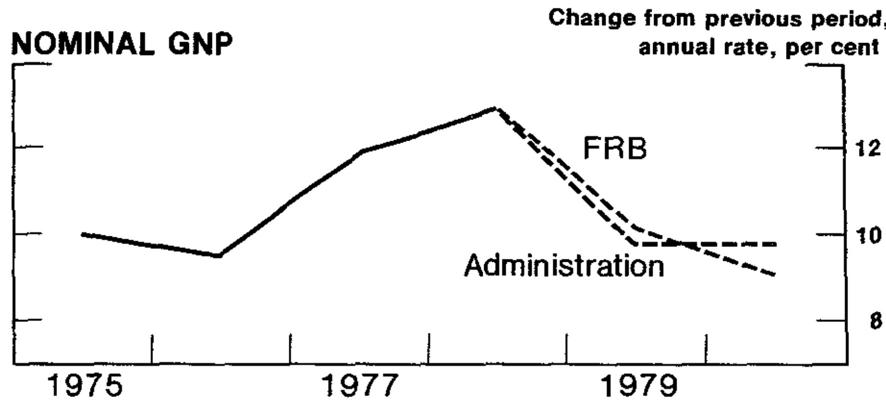


INTEREST RATES

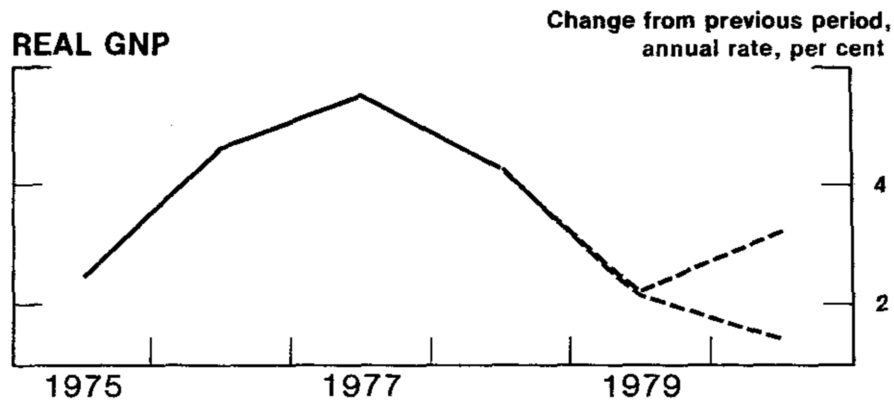


* Adjusted for A.T.S.

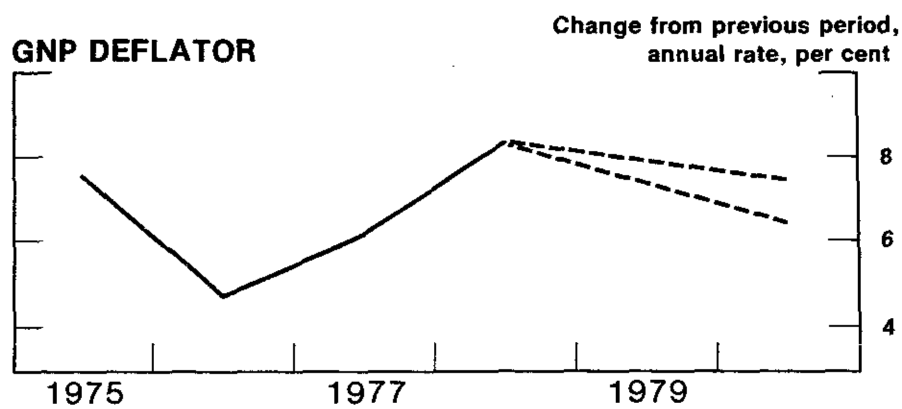
NOMINAL GNP



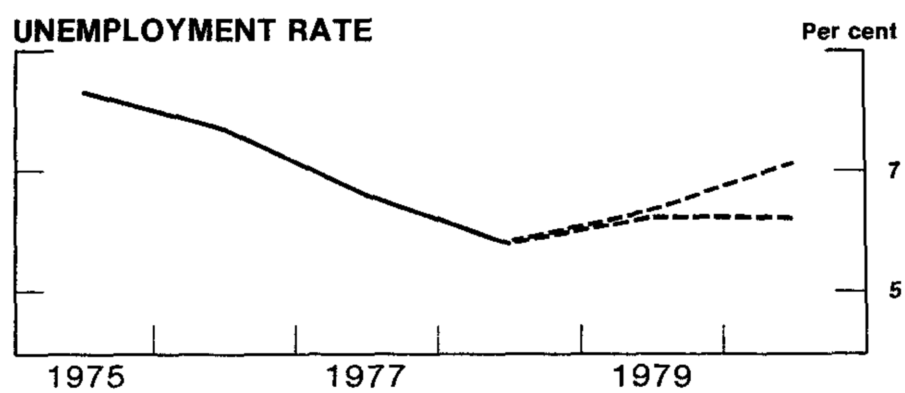
REAL GNP



GNP DEFLATOR



UNEMPLOYMENT RATE



MONETARY POLICY ALTERNATIVES [1]

REAL GNP (%) [2]	1979	1980	1981
5¼ per cent M-1	1.6	.4	.7
6¼ per cent M-1	2.1	1.4	1.4
7¼ per cent M-1	2.8	2.5	2.4
PRICES (%) [2]			
5¼ per cent M-1	8.0	7.1	6.6
6¼ per cent M-1	8.1	7.4	7.4
7¼ per cent M-1	8.1	8.0	8.3
UNEMPLOYMENT RATE (%) [3]			
5¼ per cent M-1	6.5	7.7	9.4
6¼ per cent M-1	6.3	7.1	8.2
7¼ per cent M-1	6.1	6.3	6.8
3 MONTH TREASURY BILL RATE (%) [3]			
5¼ per cent M-1	10¼	9¾	8¾
6¼ per cent M-1	9⅜	8¾	8
7¼ per cent M-1	8½	8⅛	7¾

[1] M1 growth rates equivalent to those in the absence of ATS.
[2] Measured from fourth quarter to fourth quarter.
[3] Level end quarter of each year.

Briefing for Long-run
Aggregates FOMC meeting
of 2/6/79
S. H. Axilrod

As background to the discussion of the longer-run ranges, it might first be useful to review briefly recent trends in the aggregates and their relationship to the ranges the Committee has been setting: Ranges for the year just past--QIV '77-QIV '78--were 4 to 6-1/2 per cent for M-1, 6-1/2 to 9 per cent for M-2, and 7-1/2 to 10 per cent for M-3. These ranges were set last February and were held essentially unchanged in the course of the year--except for the adjustment made in October for the ATS effects on M-1. For that period, QIV '77-QIV '78, M-1 came in above the range again, but less so than it had in the previous year. It grew at a rate of 7.3 per cent; without ATS effects that rate would have been 7.5 per cent. M-2 and M-3 were well within the ranges set by the Committee, at 8.5 and 9.4 per cent, respectively.

The interesting development is that growth rates of all these aggregates have been veering sharply downwards in the last few months of 1978 and early 1979, and all the aggregates have been growing well below the long-run ranges set by the FOMC. In the 3 months ending January 1979 M-1 growth was -1.8 per cent (+0.5 per cent without ATS effects); M-2 growth was about 2 per cent and M-3 growth around 5.4 per cent. M-1+ declined 4.6 per cent--such a rapid rate of decline it sort of just drifted out of the blue book in the process.

Three reasons might be advanced for the sharp downward veer in these growth rates. The first and very usual reason is that the cumulative impact of the 2-1/2 percentage point rise in short rates since mid-year is affecting the aggregates with the usual lag. That would not, of course, cause the "veer" but it would cause some decline in growth from what it had been before. More particularly, I should point out that the strength in spending in the last few months has been reflected, I believe, in an increased willingness of the public temporarily to draw down their liquidity. Now this may sound somewhat hypothetical, but if one looks back over the past several years in the quarters in which there was sharp growth in real GNP--that is, a growth in real GNP sharper than the surrounding quarters, irrespective of trend (QIV '78, QII '78, QI '77, QI '76, and QIII '75)--velocity of M-1 was considerably higher than in the surrounding quarters. For example, in the third quarter of 1978 even though M-1 growth was sharp M-1 velocity was about 9.1 per cent. Finally, the reassessment by the public of portfolio positions, especially their transactions and precautionary balances following the ATS innovation, and the realization that interest rates and inflation may be at high levels for a sustained period, has undoubtedly caused people to shift money out of demand and savings deposits into instruments other than ATS accounts--including money market funds, which as noted in the blue book have grown very sharply in the past 2 months, and other similar instruments.

The staff expects growth in M-1 to resume over the year ahead as the usual lagged effects of interest rate increases wear out and as the public attempts to restore balances depleted by the recent surge in spending. The evidence I pointed out earlier shows that these velocity increases aren't sustained; velocity returns to more normal levels. The staff does expect the underlying growth rate of M-1--apart from ATS effects--to be slower in 1979 than over the past two years for two reasons: the slower nominal GNP growth, and our assumption of a downward shift in demand for M-1 of about two percentage points (again apart from ATS effects). Such a downward shift has been assumed to occur when interest rates moved to high ground, and that has been built into our forecast of the interest rate-money relationship for about the past year, and was essentially the reason why we did not forecast higher Federal funds rates other than the 9-1/2 to 10 per cent range at the Committee's target level. Whether our luck will continue in this, I don't know, but thus far it has.

If such a shift does not develop, higher interest rates would be needed to restrain M-1 growth if the Committee wanted to stay with that particular M-1 target rate. Or to put it the other way, more growth in M-1 would be needed, given current interest rates. On the other hand--and this is also a possibility--a greater shift may develop. In the first quarter we have evidence of a greater shift; we just don't believe that that will be sustained. If a greater downward shift develops the Committee would need to permit lower M-1 growth for any given interest rate level.

The staff also expects a pick-up in growth of M-2 and M-3 as the year progresses, as the shift out of time and savings deposits of highly interest-sensitive funds abates. But, still, recent experience suggests that the public is likely to remain quite interest sensitive. Thus, growth in broader aggregates, too, is likely to be much slower in 1979 than in the last two years. That is the reason for the lower ranges of broader aggregates in the blue book alternatives.

The Committee's decision today is probably essentially whether to lower the aggregates ranges or to leave them unchanged. There is some difference from recent Committee decisions in this regard in that account needs to be taken of the Administration's short-run goals and the relationship of the Committee's ranges for the aggregates to these goals--that is, under the procedures set forth in the Humphrey-Hawkins Act, that relationship has to be explained, at least.

There are some arguments, of course, for lowering the ranges and I would like to present a few to the Committee for consideration. First, a step needs to be taken that will move in the direction of reducing the rate of inflation over the long run. It has been a year, as I mentioned earlier, since any range has been lowered. Meanwhile, inflation and the public's perception of inflation have worsened. With regard to the broader aggregates, a lowering of the ranges would be consistent with the apparent recent downward shift in the demand for them, and if the ranges aren't lowered, there is a great danger that actual growth will be below the ranges set by the Committee. Finally, lower ranges may, over the near term, enhance confidence that the slowing of price inflation can be achieved in 1979 and thus will help increase the odds that the Administration's anti-inflationary program will succeed.

There are also, of course, reasons for not lowering the ranges, or for lowering them with caution. With regard to M-1, the earlier range had been unrealistic; events seem to be making it realistic, though barely so, and with the requirement that we continue to have considerable luck. So the Committee may achieve more credibility by leaving the range unchanged and letting actual growth come within it than by lowering the range and still missing actual growth. Secondly, the broader aggregates are highly sensitive to interest rate fluctuations, so that if there's any thought that interest rates might decline substantially over next year--say a couple of percentage points or so--the Committee might want to leave room for some greater growth in these aggregates than the staff has projected. And as a third point I should add that if sharp reductions are made in the M-2 and M-3 ranges even if they are correct, they might be perceived publicly as an advertisement of a crunch and have unfortunate psychological repercussions.

Balancing these various arguments I would make the following recommendations for Committee consideration: With regard to M-1, one might consider lowering the present 2 to 6 per cent range to 2 to 5 per cent, and construe the midpoint, rather than the upper point, as the basic assumption. I think this would get reporting under the Humphrey-Hawkins Act off on a more reasonable and less awkward basis. Such a range would leave ample room for changing economic circumstances within the year. It would be a range I believe that is more realistic and more likely to be hit. And finally, I would point out that this would narrow the width of the range from its present 4 points to 3, but the 3 is a little bit wider than usual. I believe, however, that the three points are needed because of the continuing uncertainty about ATS. Implicit in such a range would be a deceleration of M-1 associated with ATS of around 3 percentage points. Second, I would suggest lowering the ranges for M-2 and M-3 but not quite by the dimensions indicated in the blue book. The Committee may wish to leave room over the full year ahead for the possible effect of significant interest rate declines, should they develop, or for other adjustments such as Regulation Q ceiling rates. Moreover, the Committee might wish to avoid giving the impression of a potential credit crunch by publication of sharply lower ranges.

Thus, I would suggest for the Committee's consideration a range for M-2 of 6 to 8-1/2 per cent and for M-3, 7 to 9-1/2 per cent--1/2 point lower than at present on both ends. If a wider range were practical in terms of public relations, it would probably be desirable to put a 1/2 point further reduction on the bottom ends of those ranges--that is, 5-1/2 to 8-1/2 per cent for M-2 and 6-1/2 to 9-1/2 per cent for M-3. That would increase the odds that growth would be within those ranges; but I think in terms of public relations it might be best to stay with the somewhat narrower ranges suggested first.

Briefing for short-run operating decision FOMC of 2/6/79
S. H. Axilrod

Basic to the alternatives the staff has presented in the Bluebook is an expectation of a very considerable rebound of growth in the aggregates--particularly M-1 and thus reflected in M-2 and M-3--in February and March. Often at the time of the Committee meeting we have some data for the month in which the Committee meeting is held and have some statistical basis for speculation. We have none at this meeting, of course, with no evidence at all about February. Our expectation is based on the fact that if we don't have a very sizable rebound, we're not even going to have a positive rate of growth for M-1 for the first quarter on average, and we're going to have a velocity far larger than we think is explainable, or sustainable--given the projection of about a 13 per cent increase in nominal GNP. Thus we really do believe that we will have a rebound in February and March; a 7 per cent rate of growth, which is the center of the various alternatives, is what we projected. If you put the ATS effects back in, in effect that's a 10 per cent rate of growth on average for the 2 months which means we're going to have to have a very big month--that one of those months is probably going to be very large.

Now I would like to call the Committee's attention again to the table on page 14 which we put in the Bluebook in response to the discussion of the subcommittee report last time and also in response to other requests that we relate the short-run alternatives more specifically to the long-run alternatives. Based on the midpoint of the 1-1/2 to 4-1/2 per cent range for M-1 shown under alternative B, that table shows that from January you would have to have growth in M-1 of 5.3 per cent and in M-2 of 7.8 per cent, to reach the low end of the range by March. And the range is defined as the cone based on the fourth quarter of 1978. So a sharp rebound in the coming 2 months would be consistent with moving back into the range that the Committee has just adopted in view of the shortfalls that have been experienced already.

It's of course quite possible that the aggregates will remain unexpectedly weak in the first quarter if the shift out of money into other competing assets is even stronger than we have allowed for. In the first quarter, we've allowed for a shift not of 2 per cent but of 3-1/2 per cent in addition to the ATS. So our first-quarter allowance is much larger than we're expecting for the year as a whole. At the same time, of course, you could get even more strength than we've projected if the economy is quite a lot stronger than the staff projection or if this shift doesn't develop.

I think the Committee may wish to consider whether it's more important at this particular time--in the 6 weeks ahead--to guard against an excessive rebound in the aggregates or against continued weakness. The inflation problem would tend to argue for guarding against an excessive rebound and permitting some continued weakness in the aggregates for a little while more or at least until signs of weakness in economic activity are much clearer.

We have proposed an optional directive paragraph structured with a proviso clause that would stress money market conditions and suggest no easing at all. It provides an option for tightening if the aggregates are running high, but no option for easing if the aggregates are running weak. You could have the same effect without using that optional paragraph by using the language adopted at the last meeting which would permit some tightening if the aggregates were running strong but would limit the easing to the point where the aggregates are running very weak--that is, the tightening would occur if you're moving above the midpoint of whatever ranges are adopted by the Committee but the easing would not occur until you reach the bottom of the ranges. That may be a more preferable approach at this time since the Committee has already had 3 months of weakness and it may not wish to have 2 more months without taking any action. Thus, the operational point becomes what ranges should be adopted both for the money market conditions and the aggregates if you want to have such an asymmetrical approach.

Therefore, Mr. Chairman, I would say that the Committee probably might want to consider permitting a pretty sharp increase in M-2 in view of the weakness that we've had and the strains that's putting on credit conditions at banks and at thrifts. From that point of view, the alternative 2 range of 5 to 9 per cent for M-2 may be quite desirable. An M-1 range somewhat lower than the associated 4-1/2 to 9-1/2 per cent might be considered if the Committee wants to respond more promptly to a rise in the monetary aggregates. As for the Federal funds rate, since there has been no change in that rate since the last meeting, a range such as that in alternative 2 still permits the degree of tightening or easing that the Committee was willing to contemplate at the last meeting and I don't think conditions have changed such as to require an adjustment in that range.

Alan R. Holmes
Notes For Meeting Of
FOMC February 6, 1979

Scott has already reported on our substantial progress in repaying swap debt. Since year-end, we have paid off Net no less than $ 1.1 billion of our Deutsche mark debt, bringing it $ 591 million below the level outstanding at the December Committee meeting. We have made steady progress on our repayment of current Swiss franc swap debt bringing the total outstanding down to the equivalent of $ 423 million a reduction of $ 344 million from the level outstanding at the last Committee meeting. And, of course, we have completely paid off our Japanese yen swap debt. I should note that repayment of yen debt resulted in a profit of $8.5 million, of which the System gets half. To date, repayment of current Swiss franc swap debt has resulted in a profit of $36million, shared equally with the Swiss National Bank. We have of course suffered substantial losses in our operation in Deutsch marks. As of today, our losses total $ 71 million, equally shared with the Bundesbank. Should we able to acquire DM at current rates to repay our outstanding debt of $ 3.4 billion, we would cut those losses by almost $ 27 million.

As for our current situation, the System has about 41.7 billion in DM swaps maturing before the end of March that are not covered by previous committee decisions. All of these are fist renewals and I recommend that they be rolled over on maturity, if that should prove necessary.

As far as out Swiss franc position is concerned, we have ten swaps totaling about $350 million maturing before the end of March that are not already covered by a Committee decision. I recommend that, if necessary, these swaps be renewed. They are all first renewals. I should note that we acquired this morning $107 million in Swiss Planes directly from the Swiss National Bank for debt repayment.

As already noted, we have repaid our yen swap debt, and have accumulated about $50 million in yen over the past few days as the dollar appreciated sharply against the yen. That acquisition was in the New York market.

This acquisition, together with possibility that intervention in the market may from time to time be required to prevent too rapid appreciation of the dollar, raises the question of the System's position with respect to the acquisition of foreign exchange assets. In my view the System would be wise to acquire a substantial amount of foreign currency under appropriate market conditions, giving us ammunition to defend the dollar later on if necessary and avoiding exclusive reliance on the swap network. This is a matter that needs solid study of the exchange risks involved, the appropriate size and composition of a foreign currency asset portfolio, and of Federal Reserve – Treasury relations in this area. We are preparing a memorandum on this subject. We plan to have it ready in time for Board staff review and submission to the Committee well before the next meeting.

Meantime, however, I believe the System should be prepared to acquire yen and Swiss francs should we be able to pay off our current Swiss franc swap debt before the next Committee meeting. Acquisitions would be made only if market conditions so dictate and with the full concurrence of the Treasury and the foreign central banks concerned. I would suggest that we not exceed $500 million, with the probability that the amount may be substantially less. Acquisition of Deutsche marks—except temporarily pending repayment of swap debt—would not seem likely for some time to come.

As I understand, the Committee has not established a formal limit on the amount of foreign exchange that can be acquired or held. Hood lings would be subject to the general limitations of the Committee's limit on the System's overall open position, but that is not much of a limitation at the moment. At the Desk, however, we have always felt constrained by the Committee discussions of foreign exchange holdings way back at its December 1975 meeting. At that meeting, I proposed, and the Committee concurred, that we try to build up our foreign exchange holdings to $150 million, with the expectation that the Committee would review the situation should we reach that amount. In the event we never reached even that modest target, given the general pressure on the dollar that existed over much of the period.

Last week, however, as we began to acquire yen—acquisition that seemed reasonable and desirable, and informally assented to by members of the System's foreign exchange subcommittee and the Treasury—it appeared that we might approach the $150 million figure by the time of this meeting. He we done so, I would have felt obliged to put the matter before the Committee. On Friday, however the Bank of Japan decided to take all of our yen purchases in New York for their own account, so that our yen holdings held steady at just under $50 million. Other holdings, apart from Deutsche marks and Swiss francs which are earmarked to repay debt, amount to only $13million equivalent at the moment.

It is my understanding that no formal vote is needed on the suggestions that the informal limit on the foreign currency acquisition be raised from $150 million to $500 million if the Committee is in general agreement. I would, however, like to have the Committee's views. The larger amount may be needed to meet System commitments in the foreign exchange market and, I hope, can be reviewed in depth at the next Committee meeting.