APPENDIX

Notes for FOMC Meeting
July 11, 1979

Scott E. Pardee

Since the last meeting of the FOMC we have had yet another reversal of market sentiment toward the dollar, which has over the past four weeks come under heavy selling pressure. Through most of early 1979, the dollar had been buoyed by a sustained reflux of funds from last year but by late May-early June this reflux tapered off, leaving the dollar increasingly vulnerable in the downward direction. Most market participants and officials here and abroad had come to expect that sooner or later there would be renewed pressure on the dollar in view of our continuing very high rate of inflation, our large trade deficit, and the many uncertainties around the world which could spark a burst of dollar selling.

As it turned out, the trigger mechanism for the shift in market sentiment was interest rates. Over the course of the spring interest rates had been raised in most industrialized countries in response to rapidly expanding aggregates and to sharp hikes in producer and consumer prices--in excess of one percent per month, even in countries such as Germany, Switzerland and Japan. The Federal Reserve had also moved on the funds rate in April, but by early June many market rates in the United States began to back off, and exchange traders took note of the fact that the Federal Reserve was holding steady on the funds rate even though the growth of the monetary aggregates remained strong. Meanwhile, interest rates elsewhere continued to rise, punctuated by a 2 percentage point jump in the Bank of England's minimum lending rate, to 14 percent, as part of the Thatcher Government's first budget proposal. The prospects were for more hikes in rates abroad, particularly for Germany. Officials of the Bundesbank were making no secret of their eagerness to tighten monetary policy further, and indeed of their view that the D-mark should sooner or later appreciate against the dollar and the EMS partner currencies.

A further element in the adverse swing in market sentiment reflected changing attitudes toward the relative ability of countries to cope with the higher oil prices and the tightening of oil supplies and with the energy problem generally. By early June the scramble for spot oil by other countries had slowed and spot prices had peaked, but there were reports that U. S. oil firms had for the first time begun to shop in those very expensive markets to meet U. S. needs. The growing gasoline shortages in the United States were taken as further evidence of the lack of an effective energy policy in this country. The shortages not only generated an immense amount of bad publicity for us abroad but also affected many foreign exchange traders and their corporate customers personally, as they also had to wait in line for gas. The very sour attitude this created toward the Administration and anyone else who might conceivably be blamed for the situation carried over to attitudes toward the dollar. It was not merely a matter of psychology. People were beginning to recognize that the sharp increase in oil prices--both the rise that had already occurred and that expected from an OPEC meeting in Geneva in late June--was going to add substantially to our oil import bill and thereby hamper our efforts to further reduce our trade deficit. Poor price and trade figures for the United States reinforced market pessimism.

On intervention, the Treasury--facing both the OPEC meeting in Geneva and the seven-nation summit in Tokyo during the last week of June--decided that it was an inopportune time to have a sharply declining dollar. So when pressure on the dollar erupted beginning on Friday June 15 the Desk went into the market forcefully to maintain a sense of two-way risk in the market and to halt the dollar decline. At first we were only using Treasury marks but later the intervention was split, as before, between the Federal Reserve and the Treasury. The pressure became very heavy, however, and although the Swiss National Bank quickly joined in with heavy intervention on its own account, the Bundesbank was not prepared to mount a major effort to hold the dollar-mark rate at the then prevailing levels. The market sensed this, and the apparent lack of coordination added to the tension in the market. Elsewhere, the British authorities were letting sterling rise very sharply, and it was beginning to pull other currencies up against the dollar.

By the week of June 25-29, which included the OPEC meeting and the Tokyo summit, with the dollar already down by about 3 percent, the Bundesbank had agreed to dig in should further pressure develop. During that week the Desk had people [on duty] each night--an officer and a trader--to monitor markets in Hong Kong and Singapore to intervene there if necessary. This was for two reasons. First, we had the unusual situation in which the summit was taking place in the Far Eastern time zones, with ample press coverage, and anything that came from the meetings of the individual delegations, or even press speculation, could have an exaggerated effect on exchange dealings in those hours. Second, we were still not sure that the Bundesbank would step in and push the rate back up if it found the dollar lower at the opening as a result of such exaggerated dealings. Thus, we made sure we handed over to the Bundesbank a steady market with a reasonably firm dollar rate. As it turned out, when the rate dipped to DM 1.83 on June 28 the Bundesbank picked up from us at 7:30 in the morning Frankfurt time, dealing in Singapore and Hong Kong, and hammered the rate back up with some of open intervention. That action, and follow-up intervention since, has erased many questions about the Bundesbank's intentions.

So far in July trading has continued to be exceedingly erratic, with the dollar at or near its recent lows. Sterling provided some fireworks, rocketing up to $2.25 before receding to the $2.23 level, bolstered by the high interest rates there and by North Sea oil. The market has become thin as traders await the President's message in his upcoming address. Traders are so jumpy that last Friday there was even a flurry of activity on a rumor that the President was canceling because he had had a nervous breakdown. Reports that the President will not [unintelligible] oil prices reversed dollar selling today. In this atmosphere, we have continued to intervene to maintain orderly trading conditions but have not dug in.

On balance, since the last FOMC meeting the dollar has declined by 4½ percent against the German mark and the Swiss franc and by ½ percent against the Japanese yen, which has not been caught up in the latest pressures in the markets. Sterling, on the other hand, is up by a net 8 percent.

The Desk's purchases of marks during the period amounted to $849 million, mostly early in the period and mostly for the Treasury, with $306 million of the marks for System account. Our sales of marks for Treasury and System account amounted to $2.7 billion. These compare with dollar intervention purchases by the Bundesbank of
during the same period. The System's share of U. S. mark sales was $1.2 billion, financed mainly by swap drawings, which right now amount to $905 million. In the hectic trading following the release of our trade figures in late June we also sold $69 million of Swiss francs for System account, which entailed drawing $36 million on the swap line with the Swiss National Bank. That drawing has been repaid at a modest profit. We did not operate in Japanese yen during the period.

The immediate outlook remains highly uncertain. The market is concerned about interest rates. Market participants have noted that the yield in dollar asset markets is [unintelligible] it has been since December 1977. The Bundesbank has given signals that it is likely to raise its discount rate tomorrow. Energy policy in the United States, in terms of President Carter's next initiatives and the response of Congress and the public, will still be on the minds of many market participants. We have shown, I think, that intervention can contain some of the pressure on the dollar for a time, but we already have had to dig fairly deep into our mark resources. The $2.8 billion of intervention over the past month is on the same scale as we had last November and December--after the November 1 program--and we cannot sustain a pace like that for very long without help in other policy areas. Some good news on fundamentals would, of course, help.

FOMC MEETING

JULY 11, 1979

REPORT OF OPEN
MARKET OPERATIONS

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

Since the May 22 meeting the Account Management has aimed steadily for reserve conditions consistent with a Federal funds rate remaining around 10 1/4 percent--the objective first adopted in late April. For about the first two weeks of the period the aggregates were tracking well within their ranges, but by early June growth seemed to be well up in the ranges--and by mid-June the estimates for May-June growth pushed through the upper ends of the tolerance ranges. This degree of strength would have called for a firmer stance by the Desk, but the Chairman recommended in view of recent signs of weakness in the economy and uncertainties in the outlook that the System's 10 1/4 percent objective remain unchanged, and a majority of the Committee concurred. Later in June, estimated growth increased slightly further, but the Committee, in the course of a telephone discussion on June 27, left unchanged the June 15 decision to retain a 10 1/4 percent funds rate objective. The latest aggregate data, available in early July, showed May-June growth lightly below where it appeared in late June--but still well above the Committee's ranges.

For the most part, the funds rate held quite close to 10 1/4, though it sank well below that the day after the last meeting, and pushed above in late May as banks tried to sort out the confusion of differing Memorial Day holidays. Again, in late

June and early July the rate pushed up for a few days because of cautious bank reserve management in the week that included the end-of-June statement date and the July 4 holiday. For the whole period, the funds rate averaged 10.30 percent--up 10 basis points from the preceding five weeks' average.

Early in the period, operations were directed mainly at absorbing reserves, and included the redemption of $200 million of bills and sales of $547 million of bills to foreign accounts. From about mid-June, the emphasis changed to one of predominantly supplying reserves, and outright activity included the purchase of $371 million of Federal agency issues and $693 million of Treasury coupon issues in the market, as well as the net purchase of $822 million of bills and $42 million of coupon issues from foreign accounts. The market purchase of agency issues was the first in about a year, while the purchase of Treasury coupon issues was the first since February. Outright operations were supplemented, as usual, by frequent and sizable short-term reserve adjustments through repurchase agreements and matched sale purchase transactions.

While the funds rate was essentially steady, most market interest rates registered a substantial decline for the period. Market participants continued to regard the System's interest rate objective as holding unchanged, but sentiment was buoyed repeatedly by signs of a slowing economy and this was regarded as evidence that a cyclical peak in rates was near at hand or had been passed. The softer economy was seen as virtually ruling out any significant further firming of monetary policy, despite the continuing signs of inflation and the evidence in June of rapid growth in the aggregates. The large rise in oil prices--ordinarily a factor that might have led to higher rates--was seen by some as an event that could reinforce recessionary tendencies, and hence be a neutral or even downward influence on rates. In the last few days, rates have backed up and reversed part of the earlier declines, as participants began to focus more on the vulnerability of the dollar, and the possible budget impact of new energy initiatives or anti-recession measures.

Treasury bills fell a net of roughly 50 basis points over the interval, and part way through the interval, in late June, some shorter maturity bills were down around 100 basis points from the level just before the last meeting. That steep decline partly reflected seasonal demands, exacerbated by the maturing of a large block of cash management bills after the June tax date. Strong speculative demand in the bill futures market, and the resumption of foreign account buying, in the wake of renewed dollar support activities, added to demands that temporarily pulled 3-month bills down to around 8.80 percent. The more recent back-up in rates emerged after dealers had stocked up in anticipation of demands that failed to materialize, and after financing costs rose abruptly. In last Monday's bill auctions, 3- and 6-month issues went at about 9.27 and 9.16 percent--down from 9.74 and 9.60 the day before the last Committee meeting.

Yields declined about 40-75 basis points on most intermediate term Treasury issues and some 30-40 basis points on longer issues, although the Treasury raised nearly $4 billion through sales of coupon issues over the period. An issue of $1.5 billion 15-year bonds was auctioned on June 27, when rates were near their low for the period. Sold at an average rate of 8.81 percent, the bonds ended the period at a discount from issue price, to yield about 8.93 percent, with dealers still holding some of their purchases in inventory. For the most part, dealers held low inventories or net short positions in over-one-year maturities, although holdings temporarily bulged just after fresh supplies were auctioned. Typically, the big price gains occurred against a background of declining inventories, as customer demand pressed on dealer supplies.

In the coming month, Treasury demands are expected to be moderate. There will be the usual 2-year month-end note, and the quarterly refunding of August 15 maturities, in which the market expects that the Treasury may raise perhaps $2 billion on top of the nearly $5 billion amount held by the public. The System holds nearly $1.6 billion of the August 15 maturities, and we would plan to exchange these for new issues--leaning somewhat, as in May, toward the shorter options offered by the Treasury.

Finally, I'd like to call to the Committee's attention that legislation was signed in early June extending the Treasury's authority to borrow up to $5 billion directly from the Federal Reserve but also modifying that authority in ways that have made obsolete paragraph 2 of the authorization for domestic open market operations. We have been discussing with Treasury the implications of those modifications and should have a revision to propose in the authorization for the next meeting.

James L. Kichline
July 11, 1979

INTRODUCTION -- FOMC CHART SHOW

For our presentation this morning we will be referring to the package of charts distributed to you. The first chart in the package displays the principal assumptions that underlie the forecast. M-1 growth is assumed to average 6 percent in 1979 and 1980, measured in the absence of shifts to ATS accounts. This assumption is unchanged from that used in recent projections and is consistent with the midpoint of the longer-run range presented as Alternative B in the Bluebook. The fiscal policy assumptions are also little changed from those we have been using since early this year. However, recent developments in world oil markets have led to a substantial change in the oil price assumption. The recent OPEC decision is estimated to result in an average contract sales price of $21.00 per barrel, or more than 60 percent higher than the price in December 1978. During 1980, a further rise of $2.00 per barrel has been assumed. Thus for the two years combined oil prices are assumed to rise close to 80 percent compared with the assumption of a little over 20 percent when the Committee discussed its longer-run ranges in February. We have assumed that oil price supplies will be tight but adequate at these higher prices and that retail fuel disruptions will disappear by the fall of this year.

The next chart depicts movements in the federal budget. In the current fiscal year we anticipate a deficit of $28-1/2 billion, a shade less than the administration will announce this Friday in its midyear update. For 1980 there also are only small differences between the staff and administration expectations, as shown in the table. Even though the budget deficit is expected by the staff to grow somewhat next year, this is attributable to weaker economic activity, and the budget posture in our judgment is still one of restraint.

As displayed in the next chart, indicators of economic activity in recent months have shown weakness. Growth of nonfarm employment slowed considerably in the second quarter, and manufacturing employment actually declined. Industrial production in May only recovered strike-related losses of the previous month, and preliminary information for June suggests a slight decline in output. Total retail sales in real terms have declined a substantial 6-1/2 percent from the peak in December. In June--not shown on the chart--we estimate that sales in real terms dropped 2 percent, led by a sharp fall in auto sales; sales of domestic makes were at a 7.2 million unit annual rate, the slowest monthly pace in four years. Housing market activity, as measured by starts, changed little in April and May, and remains well below levels in 1978. Given the information now available the staff estimates that real GNP declined at a 1-1/2 percent annual rate during the second quarter.

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

Joseph S. Zeisel
July 11, 1979

FOMC CHART SHOW

The evidence seems quite persuasive that the economy turned down in the second quarter, and thus, as indicated in the next chart, real GNP suffered a slight drop over the first half of this year. We are now forecasting that the decline will continue in the latter half of 1979, at about a 2-1/4 per cent annual rate. For the year as a whole this results in a reduction in real GNP of about 1-1/4 per cent. Our projections call for a fractional upturn early next year, with only a slightly stronger second half. For 1980 as a whole, real GNP is expected to increase by only about 3/4 per cent.

The key element in both the recent and prospective deterioration of activity is the weakness of personal consumption expenditures. The next chart addresses some of the major factors underlying the poorer performance of consumer markets recently. The top panel shows the sharp decline of after-tax real weekly earnings since the end of 1977. While these data are an imperfect measure of family income, they do dramatically reflect the erosion of real earnings by the latest round of accelerating inflation.

The concurrent deterioration of consumer attitudes is illustrated in the middle panel. Recent Michigan Survey reports show consumers' expectations of price inflation at a record high and indicate that buying conditions for cars were rated more unfavorable than at any time in the past three years.

The willingness of consumers to increase their use of credit played a significant part in sustaining growth of retail sales for much of this expansion. However, as shown in the bottom panel, by late last year, consumers' debt burdens had reached historically high rates. In such circumstances, consumer spending propensities become vulnerable to any weakening of income growth.

And as the top panel of the next chart shows, slower employment growth, a shorter workweek and accelerating inflation cut the gain in real income sharply in the first half of this year. This played a key role in the recent decline in real retail sales described earlier by Mr. Kichline. In regards to the future, we are forecasting an actual drop in real income in the second half of 1979 and only a sluggish recovery during 1980.

Recently, consumer spending has been further undermined by the sharp runup in petroleum product prices and gasoline shortages. Increased uncertainties regarding supplies have apparently damped retail sales, affected vacation plans and cut into a wide range of other household activities. One especially notable impact has been the reduced demand for larger, less fuel-efficient cars; as a result, total auto sales have plummeted.

We expect shortages of fuels to diminish later this year, but price increases already announced imply--as the middle panel shows--that the share of disposable income going to energy products will be rising precipitously. Some $20 billion that would otherwise be available for purchase of discretionary goods such as consumer durables will instead be flowing overseas in 1979 to pay for the added cost of imported oil. As the bottom panel indicates, these various factors have led us to expect a very sluggish outlook for real consumer demand--a decline for 1979 as a whole, and only a limited rise in 1980.

Many of the forces which have been affecting consumer attitudes are likely to be undermining business confidence as well. As the top panel of the next chart shows, new capital goods orders appear to have already topped out in real terms. As indicated in the middle panel, the pressures on capacity should be diminishing as markets weaken, and past performance suggests that this will lead to cutbacks in capital spending, as shown in the bottom panel.

But from an historical point of view, the contraction in capital outlays is relatively mild, reflecting the moderate overall decline in noninvestment demand, the lack of significant financing problems and needs to adjust to changes in the cost and availability of energy.

The rate of inventory investment is likely to mirror developments in fixed capital spending and other final demands. As the top panels of the next chart show, there are indications of a backup in stocks recently, reflecting the downturn in consumer demand, particularly for large cars. But businesses are likely to adjust output rather promptly--as they have in recent years--and, as shown in the middle panel, we expect the rate of inventory accumulation to decline through the remainder of 1979 and remain minimal in 1980. However, as is evident in the bottom panel, we are not anticipating a substantial inventory adjustment. Indeed, our expectation is that business will be keeping stocks about in line with growth of final sales.

Housing is also likely to continue to be a negative factor in overall growth through the balance of 1979. As is shown in the top panels of the next chart, deposit growth at thrifts and the commitments of S&Ls have been on a general downtrend, following the surge associated with the introduction of MMCs. In the face of generally weak deposit growth and a relatively tight Federal Home Loan policy on advances, these lenders are likely to continue to reduce outstanding commitments. Given sluggish income growth and rapidly escalating homeownership costs--now aggravated by rising energy prices--we have assumed that housing activity will continue to slacken. As the bottom panel shows, we are now forecasting starts to bottom out at about a 1-1/2 million annual rate at the end of this year, and to edge up during 1980, largely in response to strong underlying demands.

As the next chart shows, we expect little contribution to growth from government spending through 1980. The total purchases of federal, state and local governments are projected to show no rise at all in real terms during 1979, assuming no new fiscal initiatives. Such programs as counter-cyclical revenue sharing and local public works grants have leveled out or are declining, and governments generally have curbed the growth of spending. The real increase in government purchases is projected at only a 1 per cent annual rate in 1980.

The next chart compares our projection of overall activity with previous postwar contractions. The absence of the serious distortions that precipitated the post-1973 recession is a key to the milder decline expected this time. The relative drop projected for real GNP is about equal to the average of the four preceding post-World War II recessions. However, the upturn projected to begin in 1980 is expected to lack the vigor of the earlier recoveries. This reflects in large measure the impact on consumer and business behavior of continued rapid inflation, the assumed lack of new fiscal policy initiatives and a policy of monetary restraint--associated with the effort to bring inflation under control. The modest recovery forecast for 1980 reflects a bottoming-out of housing activity, the small upturn anticipated in business fixed investment and an improvement in net exports.

Consistent with the weakness in overall activity, we are projecting substantially reduced growth in total employment this year--as shown in the next chart--and only a small increase in 1980. Nonfarm payroll employment is projected to decline by about half a million from peak to trough, as reductions in manufacturing employment--reflecting production cuts, particularly in consumer durables and capital related products--are partly offset by continued--albeit modest--growth in the service sectors.

While we are also projecting substantially slower labor force growth than in recent years, we anticipate that in addition to normal increases in the population of working age, a significant number of women will enter the labor market, particularly in an environment in which real family incomes are being reduced by both recession and rapidly rising prices. Thus, the unemployment rate is projected to rise quite rapidly, particularly later this year, and continue up during 1980, reaching about 8 per cent by year end.

However, we expect that rising unemployment will do little to damp inflation. The next chart illustrates a key aspect of this problem--that is, the prospect of a rapid increase in compensation in conjunction with poor performance of productivity. Continued upward pressure on wages, in response to past and prospective inflation is expected to offset the effects of labor market slack; compensation is projected to rise by close to 10 per cent in 1980, somewhat above this year's expected increase.

As the middle panel shows, we expect little help from improved productivity performance in damping the impact on labor costs, particularly in the near term. Some improvement in productivity growth is likely as overall output bottoms out--a typical cyclical performance--but gains will probably be modest, in line with the sluggish recovery projected.

As a result, while we are projecting some moderation in the rise of unit labor costs next year from the 1979 pace, these costs will still be putting considerable upward pressure on prices.

The next chart addresses the other major forces which have been fueling inflation recently--energy and food prices. The top panel presents our current forecast of overall energy price increases. The sharp rise to over a 40% rate at year-end reflects the adjustments for OPEC oil, as well as the impact of decontrol of domestic crude, and market forces which are putting upward pressure on energy prices. Our assumption of a 10 per cent further increase in OPEC oil prices in 1980 permits energy price increases to moderate substantially next year. Nonetheless, even with such a deceleration, energy prices are still expected to be rising at a 20 per cent annual rate toward year-end. And of course, the feedback effects of earlier energy price increases on wages and other costs will still be fueling inflation.

As the bottom panel shows, with some improvement in supplies, food price increases are projected to ease slightly in 1980 from the 11 per cent rate now forecast for this year. However, reports of poor grain harvests in the USSR and elsewhere in Eastern Europe have recently introduced uncertainties in regard to even this outlook for modest improvement.

The next chart shows our current view of the outlook for overall inflation. Prices excluding food and energy items--what has sometimes been called the underlying rate of inflation--are projected to be rising at about an 8 per cent rate in 1980, little different from the expected increase for this year. Less pressure from OPEC oil permits some easing of overall price increases during 1980, but we are forecasting prices to still be increasing at a rate in excess of 9 per cent at year end.

Mr. Truman will continue with a discussion of the international situation.

E.M. Truman
July 11, 1979

FOMC Chart Show Presentation

The first international chart summarizes the assumptions and projections underlying the staff's outlook for the external sector of the U.S. economy over the next six quarters. That outlook is dominated by recent and prospective oil price developments, which are depicted in the upper left-hand panel. As Mr. Kichline has indicated, we now expect that the average price of U.S. petroleum imports will rise by 60 percent during 1979 and have assumed that the price will rise by a further 10 percent during 1980.

Moving clockwise, the next panel shows the staff's projection for the average increase in consumer prices in foreign industrial countries. The average inflation rate abroad is expected to remain somewhat lower than in the United States. However, following the sharp improvement during 1978, inflation abroad is expected to average almost a double-digit rate during the four quarters of 1979 before subsiding somewhat in 1980. The increase this year will be strongly influenced by dramatically higher oil prices, by the absence of a further dollar depreciation, and, as always, by a number of special factors.

The deterioration in the oil and inflation situation abroad, along with actual and expected policy responses to it, have led us to mark down our forecast for real economic activity, as is illustrated in the next panel. The average growth of real GNP in foreign industrial countries is expected to slow from about 4 percent during 1978, to about 3-1/4 percent this year, and to about 2-1/2 percent next year.

The last panel shows the weighted-average foreign exchange value of the dollar. The dollar has declined somewhat since late May and early June; it is about 7 percent higher than at the end of last October but 15-1/2 percent lower than it was in September 1977. The staff expects that by the second half of 1980, the foreign exchange value of the dollar will be essentially unchanged from its average level in May and June of this year.

Turning to the upper left-hand panel of the next chart, the volume of U.S. non-agricultural exports, shown by the red line, has increased sharply since early last year in response to the dollar's depreciation during 1977 and 1978 and faster growth abroad. Although the volume of such exports appears to have declined last quarter, we expect a rebound in the second half of the year, followed by a slowing through the end of 1980 in line with the projected moderation of growth abroad.

Again moving clockwise, our agricultural exports have been on a plateau at an annual rate of around $30 billion for about a year. However, as a consequence of poor growing conditions in the U.S.S.R. and in Eastern Europe, the volume and value of such exports should pick up over the next several quarters.

Turning to the import side, the effects of the projected decline in U.S. economic activity should begin to show up in lower non-oil imports -- both value and volume -- toward the end of 1979. By the fourth quarter of 1980, the volume of non-oil imports is expected to be 2 percent lower than the estimated rate last quarter.

The last panel on this chart shows our oil imports. The volume of such imports is expected to average about 8-1/2 million barrels per day in 1979, slightly lower than the rate in 1978. However, the value of our oil imports is expected to rise by more than $20 billion dollars during 1979 to around $65 billion at an annual rate by the fourth quarter of this year. Because of higher oil prices and reduced aggregate demand, the volume of U.S. oil imports is expected to decline to less than 8 MMB/d in 1980. This would be comfortably within the U.S. commitment at the Tokyo Summit, which, on an equivalent basis, is to limit oil imports to less than 9.4 MMB/d.

The last international chart summarizes the staff's outlook for the external sector of the U.S. economy. As is shown in the upper panel, the trade deficit is expected to be somewhat larger over the remainder of this year than it has been in the last three quarters. The influence of higher prices for imported oil will offset higher exports and the effects on imports of reduced U.S. economic activity. However, the trade deficit is expected to decline to less than $20 billion in 1980 largely reflecting the continuing effects of reduced U.S. economic activity. Taking account of the Commerce Department's recent, sharp upward revision in U.S. net direct investment income, the U.S. current account deficit is expected to be sharply reduced to about $5 billion this year, compared with $14 billion last year. For 1980, we are projecting a current account surplus of around $14 billion.

The middle panel translates these developments into the GNP accounts. Real imports of goods and services are expected to decline through early 1980. Real exports of goods and services are expected to increase through the second quarter of 1980, cushioning the decline in U.S. economic activity, and then level off.

The bottom panel shows net exports of goods and services as measured in the GNP accounts in real terms (the red line) and in nominal terms (the black line). Note that between the first and third quarters of this year net exports are expected to be essentially unchanged in real terms but decrease sharply in nominal terms. This divergent movement reflects the terms-of-trade loss resulting from the sharp increase in the relative price of oil, a loss to the United States that has depressing effects on domestic economic activity.

Against the background of what I have presented this morning, the outlook for the foreign exchange value of the dollar is surrounded by even greater uncertainty than usual. Several conflicting influences are likely to be felt over the next 18 months: First, the differential between U.S. and the average foreign inflation rate has narrowed, but the U.S. rate will remain higher than the foreign rate. Second, the U.S. current account is expected to move into substantial surplus, but the improvement is not expected until early 1980 and may well be viewed as temporary when it comes. Third, while the staff has assumed that U.S. monetary conditions will be little changed in the second half of 1980 from what they are today, we expect over the projection period a further, general tightening of monetary conditions abroad, implying a narrowing of interest-rate differentials favoring dollar-denominated assets. In reaching a judgment on the net effect factors, the staff has projected, as I indicated earlier, that by the second half of 1980 the foreign exchange value of the dollar will be essentially unchanged from its average level in May and June of this year.

Mr. Kichline will now conclude our presentation.

James L. Kichline
July 11, 1979

CONCLUSION -- FOMC CHART SHOW

The first chart in the last section of your packet shows a projection of funds raised by domestic nonfinancial sectors developed along with the staff's economic forecast. Funds raised in 1979 are projected to recede from the peak level reached last year, and to fall further in 1980. The decline in total funds raised this year is attributable to reduced demands by the federal government, reflecting a smaller budget deficit and some drawing down of cash balances to meet financing demands. The emergence of a larger budget deficit next year will generate an increase in Treasury borrowing. In private sectors, funds raised are projected to increase a little this year compared with 1978, but heavy borrowing was already undertaken in the first half and borrowing is expected to drop over the remainder of the projection period. The reduction in total private borrowing is associated with the weakness of economic activity along with maintenance of a firm monetary policy.

The household sector, shown in the next chart, accounts for about two-thirds of the decline projected in total credit demands. The slower pace of housing activity in the GNP projection as well as sluggish markets for durable goods will generate reduced consumer credit demands. Total household borrowing is estimated to have peaked in the latter half of 1978 and by 1980 is projected to run around one-fifth below that level. But, as shown in the bottom panel, household liquidity--measured by the proportion of income not committed to debt service--is only expected to stop eroding instead of experiencing the usual cyclical increase; the expansion of disposable income is restrained while household borrowing remains quite high, partly reflecting some continued preference for goods and debt positions in a high inflation environment.

Corporate borrowing, shown in the top panel of the next chart, is projected to decline appreciably from the peak reached in the first half of this year. External financing needs are expected to fall as internally available funds continue to grow while expenditures on inventories and fixed capital moderate. Long-term financing is projected to rise over the projection period as firms fund part of the high volume of short-term debt taken on recently. That funding will lead to some improvement in balance sheet ratios, shown in the bottom panel. However, the strengthening of balance sheets is much less than that which occurred in 1975 and 1976, reflecting a variety of factors including the avoidance of sharp cutbacks in corporate spending that would accompany a deeper recession, and the absence of widespread financial difficulties that would generate pressures to liquify.

Firm financial conditions will tend to restrain improvement of balance sheet ratios of depositary institutions, shown in the next chart. At both commercial banks and savings and loan associations the erosion of selected balance sheet ratios is expected to moderate or halt, but a return to more usual ratios at a time of cyclical downturn seems unlikely. This result reflects the maintenance of fairly strong credit demands relative to inflows of traditional sources of funds. That is, interest rates remain well above fixed interest rate ceilings and under those conditions institutions are not flooded with relatively low cost funds.

The next chart shows interest rates thought to be consistent with the projection. In the latter half of this year and early next year the Treasury bill rate is expected to fall to around the 8-1/4 to 8-1/2 percent area, about a percentage point less than the average rate in the first half of 1979. Given a considerable pickup in growth of nominal GNP next year and attempts to hold M-1 growth to 6 percent, the bill rate is expected to rise later in 1980. In long-term markets, strong demands for funds, high inflation rates, and little change in short-term interest rates are expected to result in maintenance of bond rates near recent levels.

The last chart in the package displays the results obtained from model simulations employing 1 percentage point faster or slower M-1 growth than in the 6 percent base forecast. All of the alternatives presented provide a pattern of slow real growth after 1979, high rates of inflation, and rising unemployment. Developments so far this year--particularly energy price and supply disruptions and larger than anticipated food price inflation--have resulted in a considerable setback to achieving a path of moderate economic growth and substantially reduced rates of inflation. For monetary policy alone there seems to be little in the way of policy options which would yield substantially improved results during the next year or two. But possible outcomes for alternative monetary policies could well be altered in coming months; the response of the economy to uncertain energy developments is far from clear and the administration may well undertake initiatives that change the course of economic events.

To assist in the deliberations this morning your attention might be directed to the additional table distributed to you which compares the staff's forecast to revised administration forecasts. The administration figures are scheduled to be released on Friday and are confidential until that time. As can be seen, growth of nominal GNP in 1979 is a percentage point lower in the staff forecast due principally to weaker real GNP. The staff also forecasts a slower pace of expansion in real GNP in 1980 and appreciably higher inflation and unemployment.

CONFIDENTIAL (FR) CLASS II-FOMC

Material for

Staff Presentation to the Federal Open Market Committee

July 11, 1979

PRINCIPAL ASSUMPTIONS

MONETARY POLICY

- Growth of M-1 averages 6 percent (without ATS) in 1979 and 1980
- Interest rates move lower into early 1980 and rise over balance of forecast

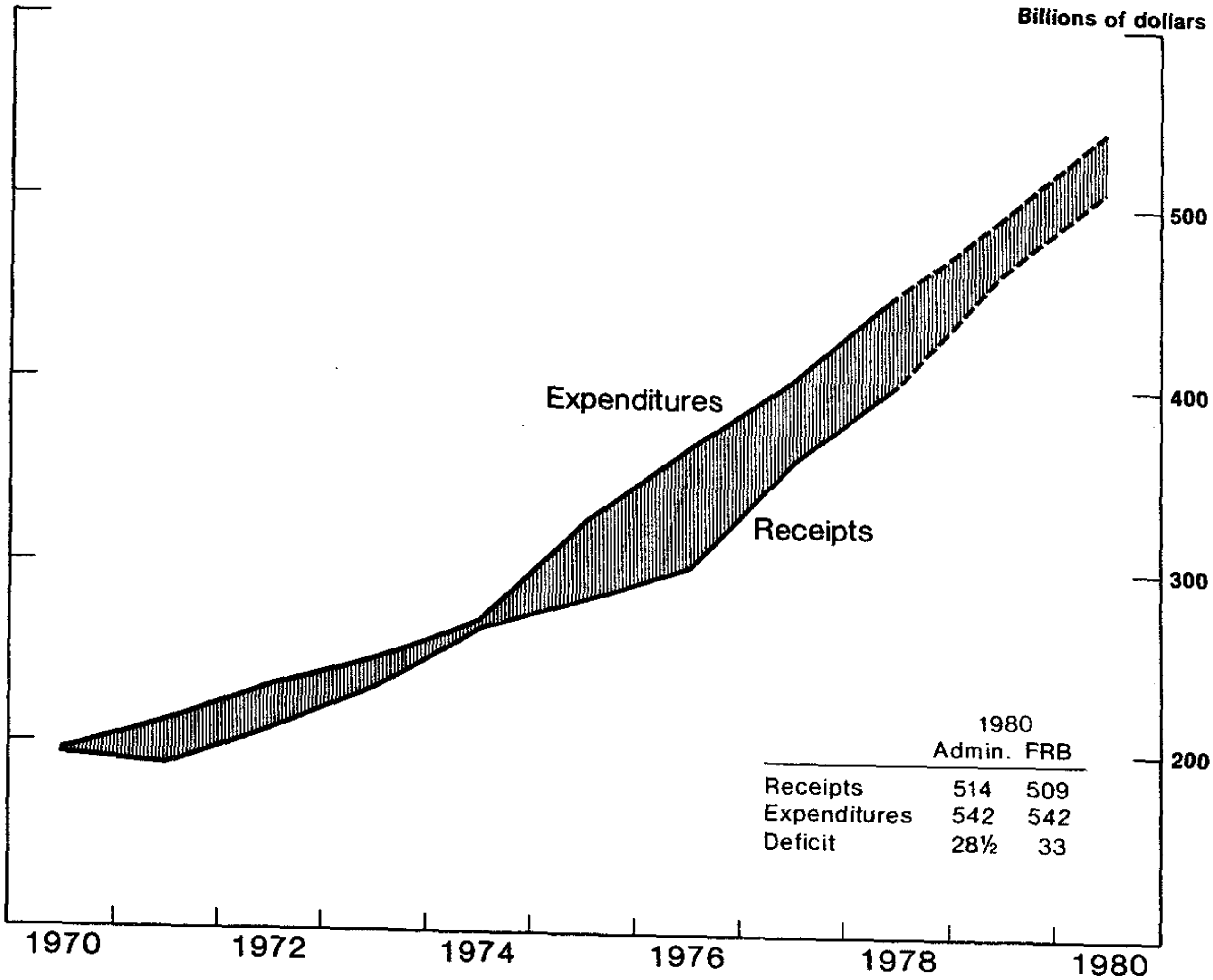
FISCAL POLICY

- Unified budget expenditures of $494 billion in FY 1979
- Unified budget expenditures of $542 billion in FY 1980

OIL PRICES

- OPEC average price of about $21.00 per barrel effective Mid-1979; price increases in 1980 amounting to about $2.00 per barrel

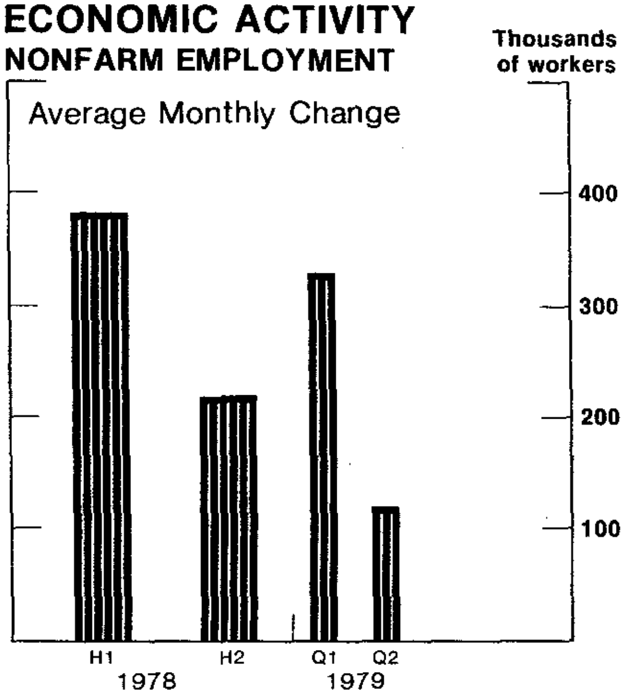
FEDERAL BUDGET *



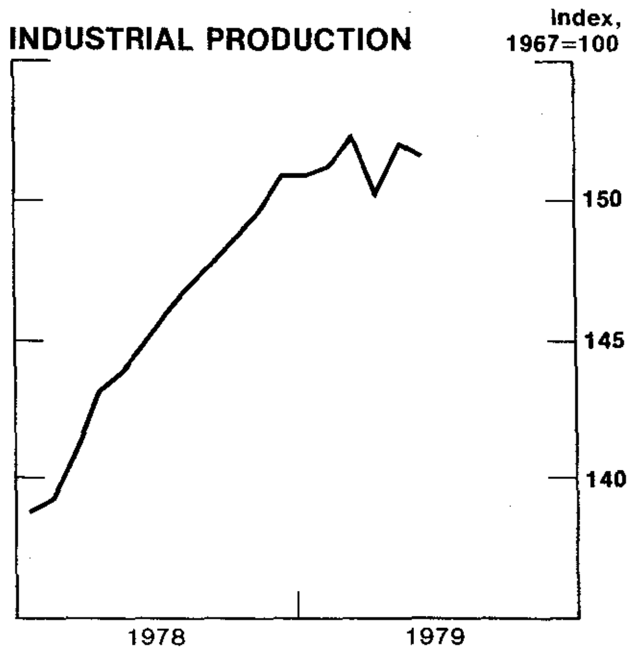
*Fiscal years

ECONOMIC ACTIVITY

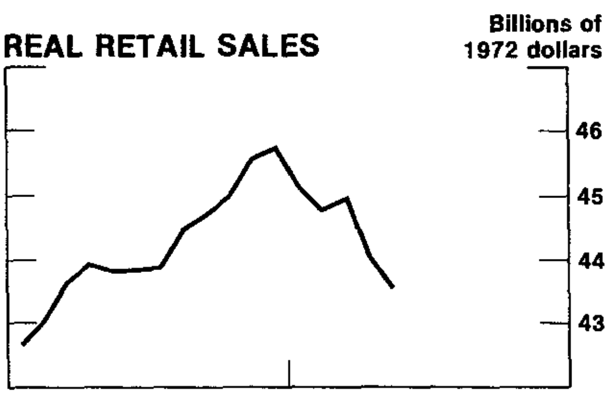
NONFARM EMPLOYMENT



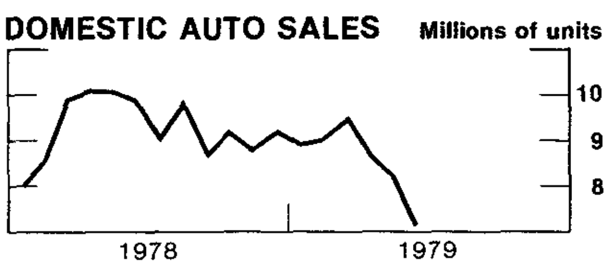
INDUSTRIAL PRODUCTION



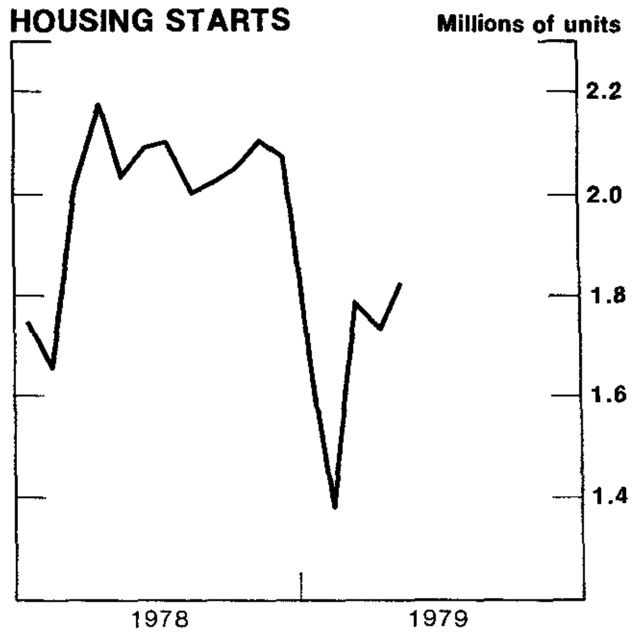
REAL RETAIL SALES

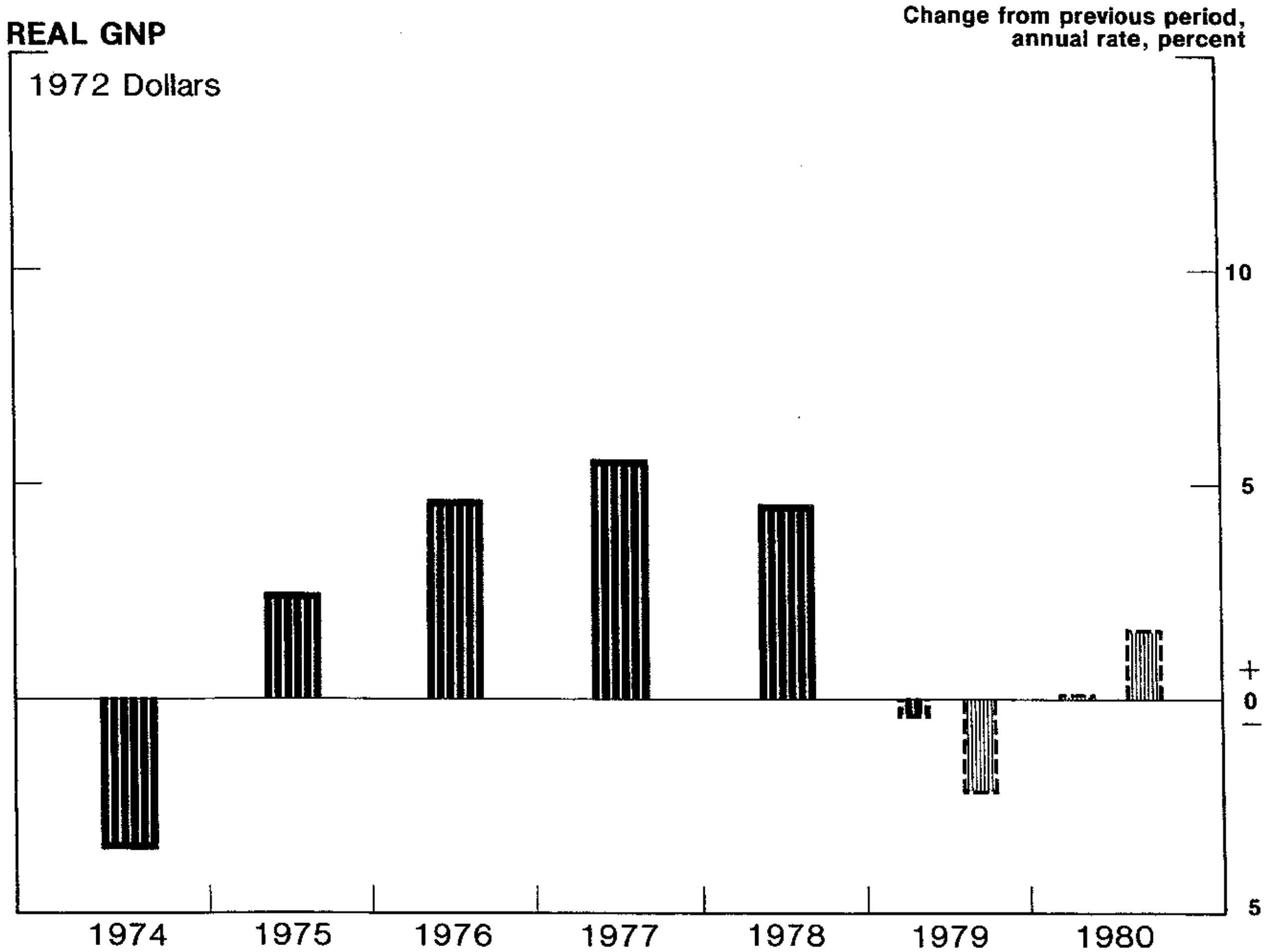


DOMESTIC AUTO SALES



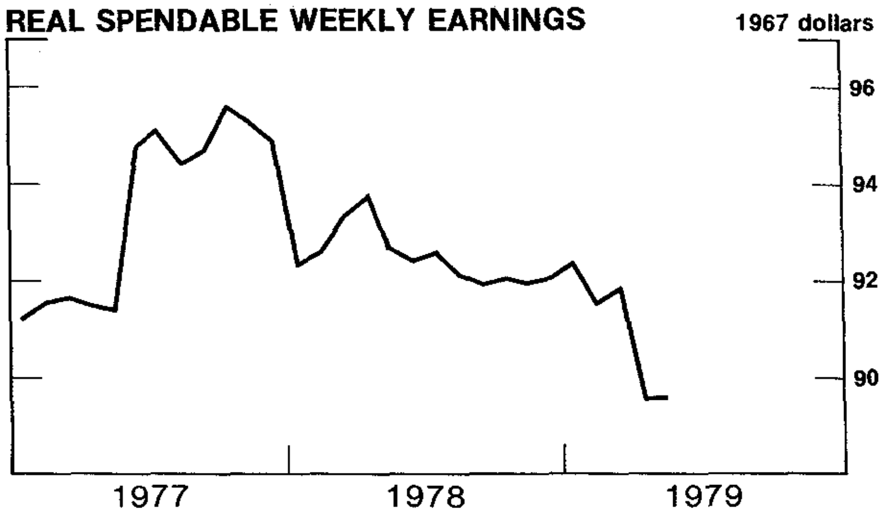
HOUSING STARTS



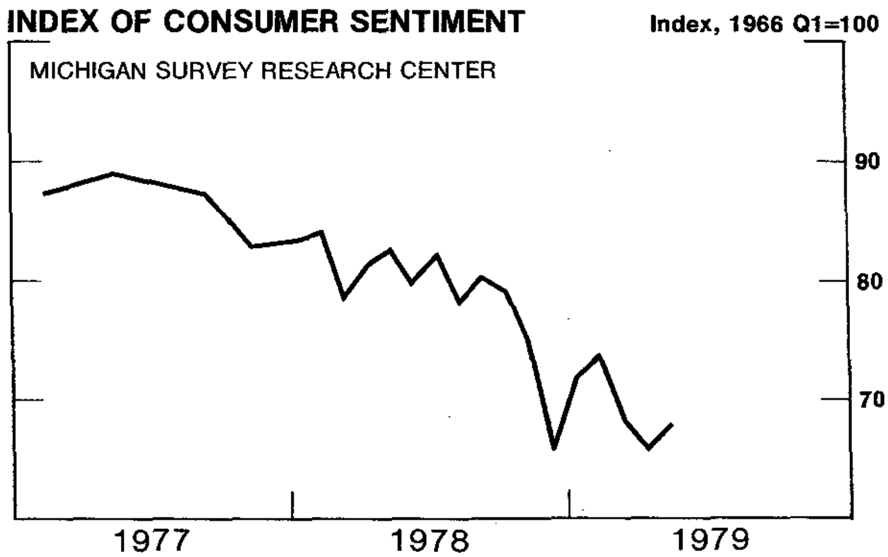


REAL GNP
Change from previous period, annual rate, percent
1972 Dollars
10
5
+
0
−
5
1974
1975
1976
1977
1978
1979
1980

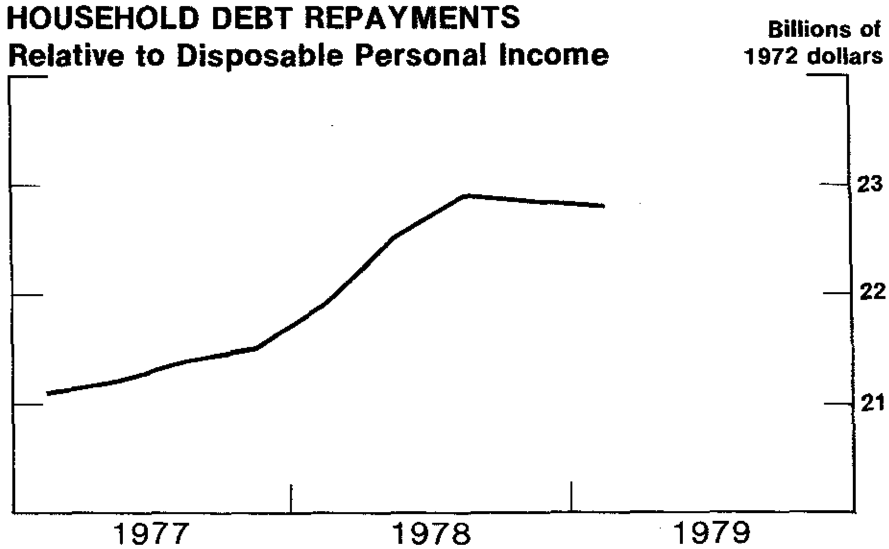
REAL SPENDABLE WEEKLY EARNINGS



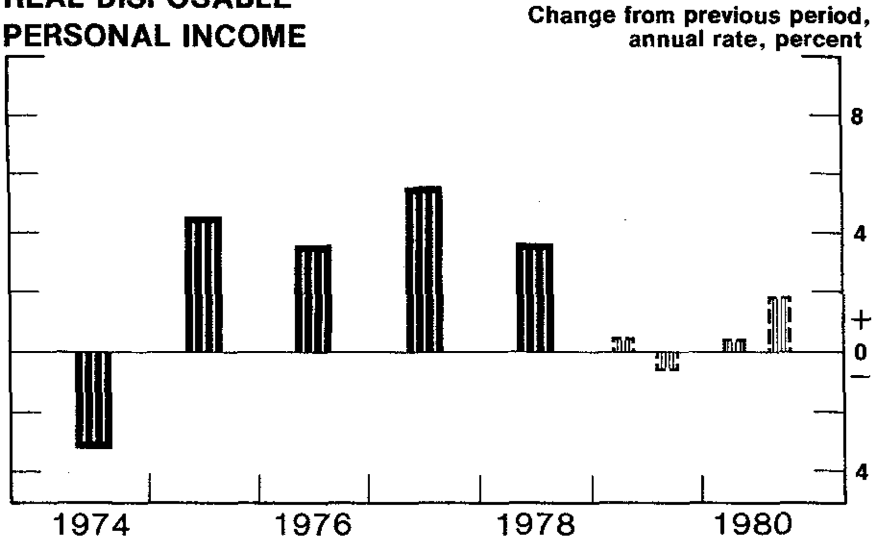
INDEX OF CONSUMER SENTIMENT



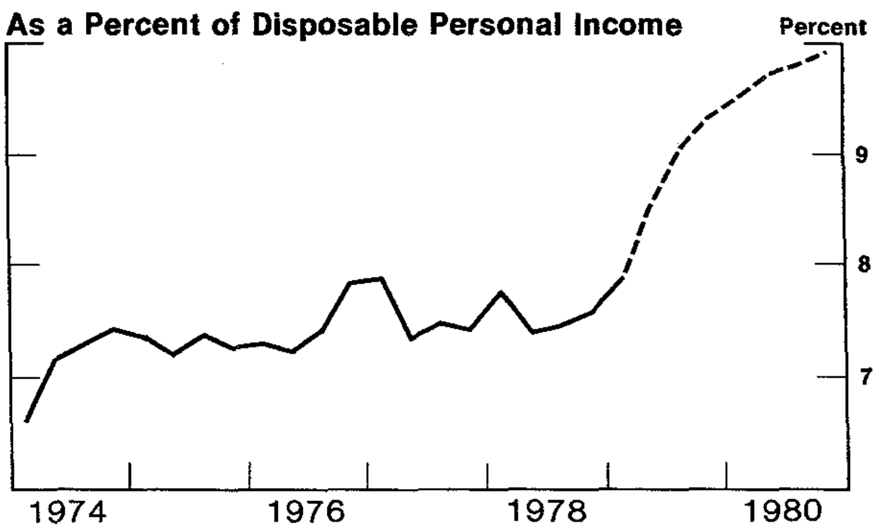
HOUSEHOLD DEBT REPAYMENTS
Relative to Disposable Personal Income



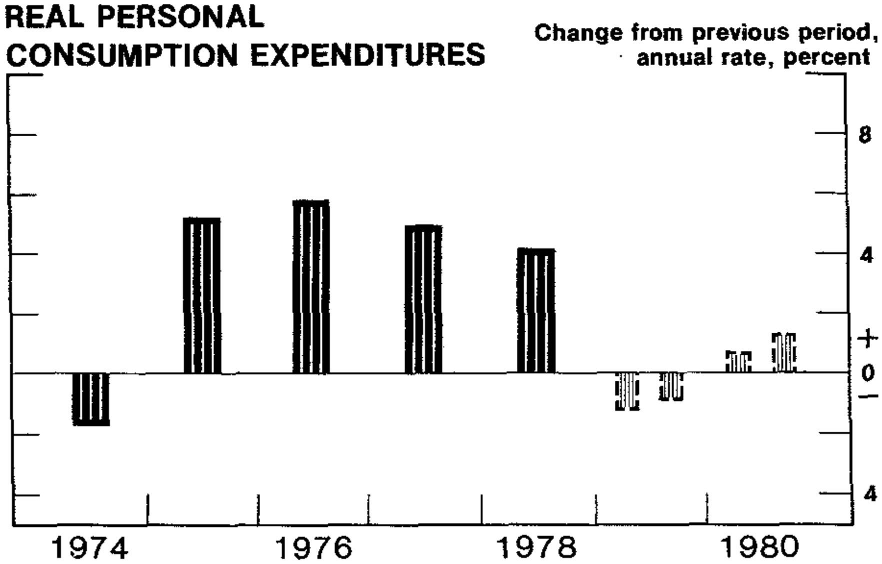
REAL DISPOSABLE PERSONAL INCOME



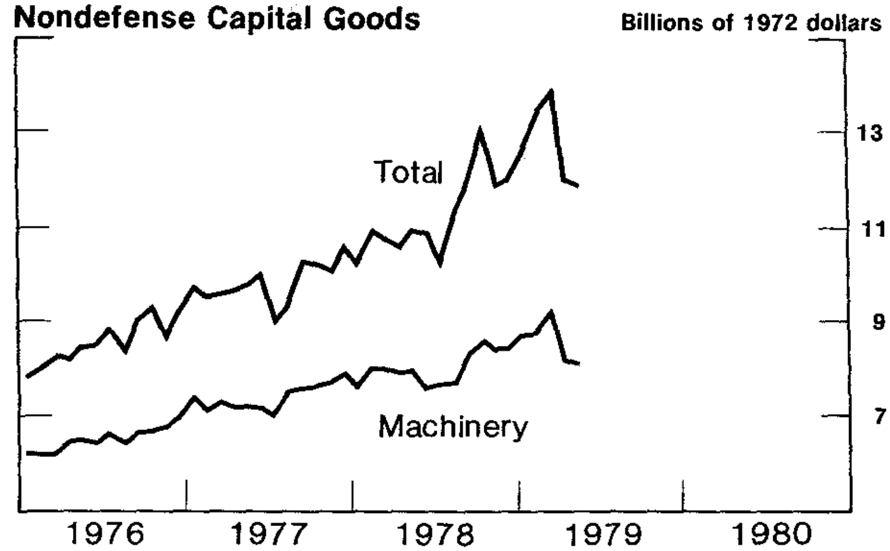
CONSUMER ENERGY OUTLAYS
As a Percent of Disposable Personal Income



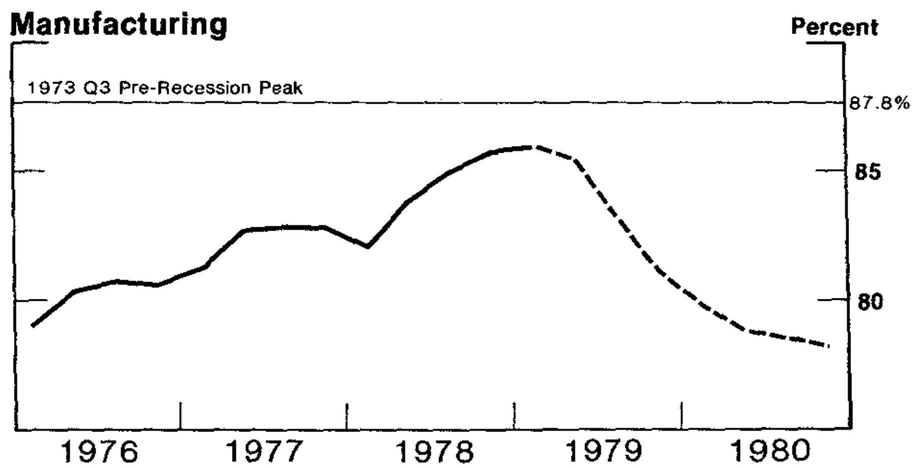
REAL PERSONAL CONSUMPTION EXPENDITURES



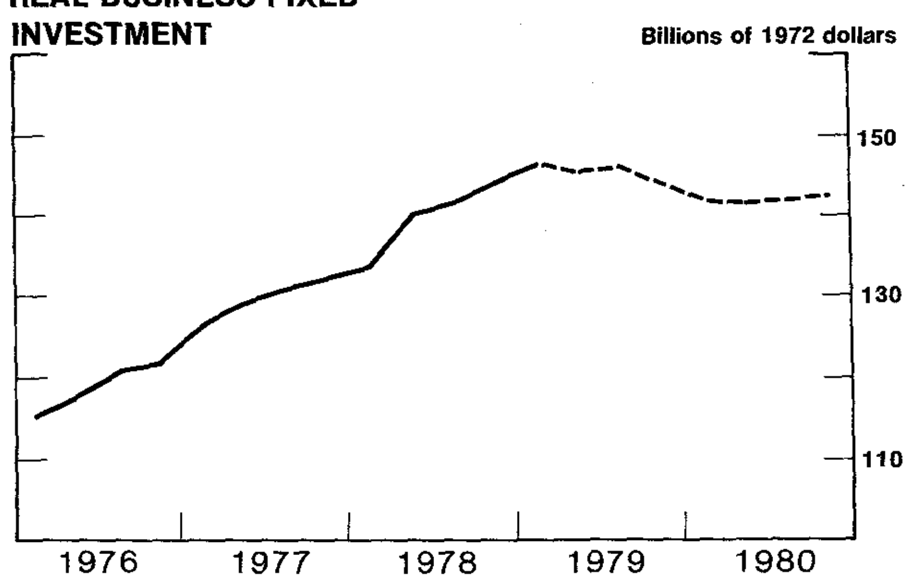
REAL NEW ORDERS
Nondefense Capital Goods



CAPACITY UTILIZATION
Manufacturing

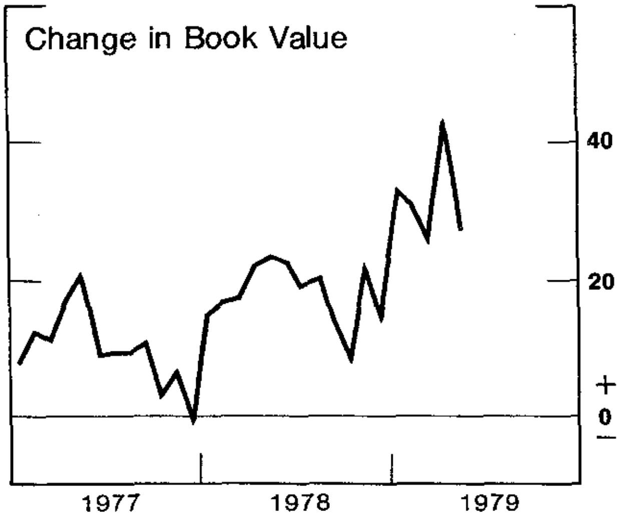


REAL BUSINESS FIXED INVESTMENT



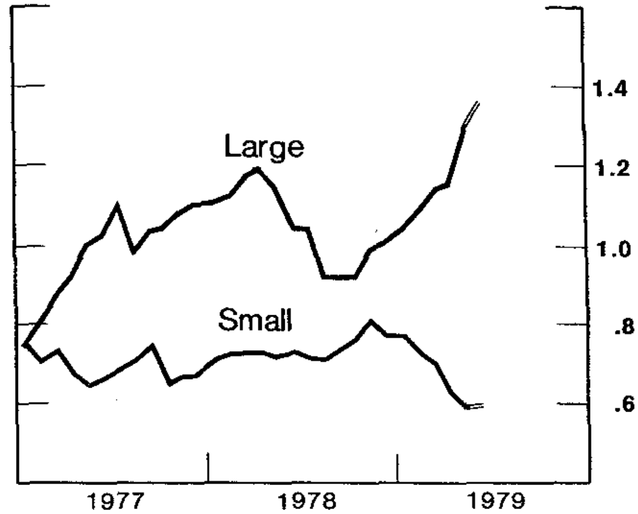
MANUFACTURES' INVENTORIES

Annual rate, billions of dollars



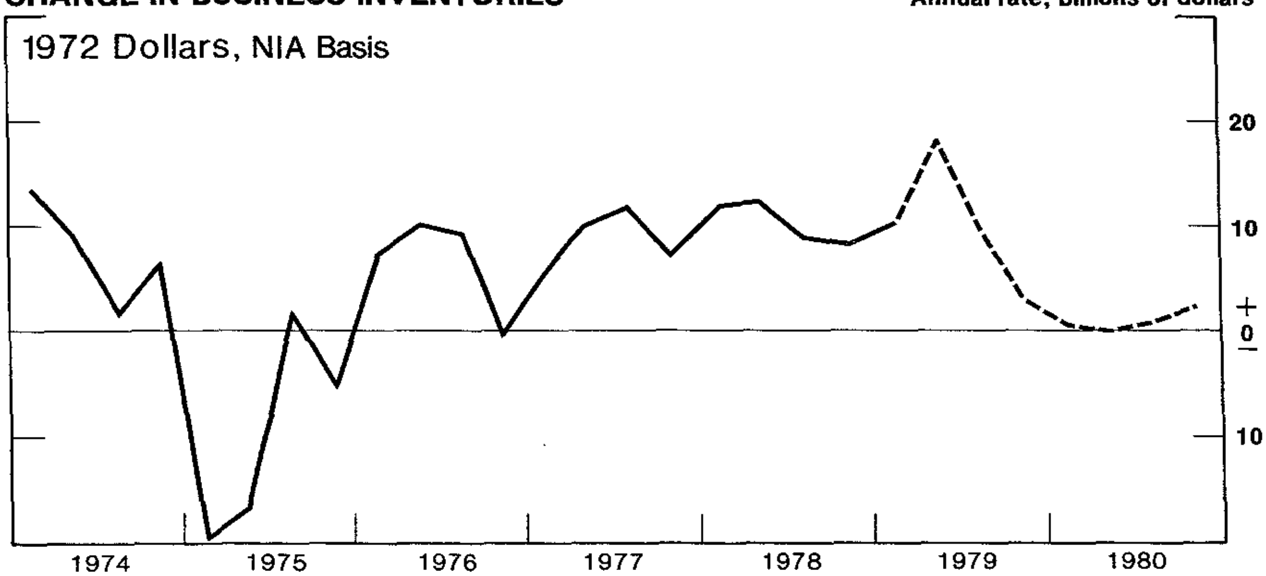
AUTO STOCKS

Millions of units



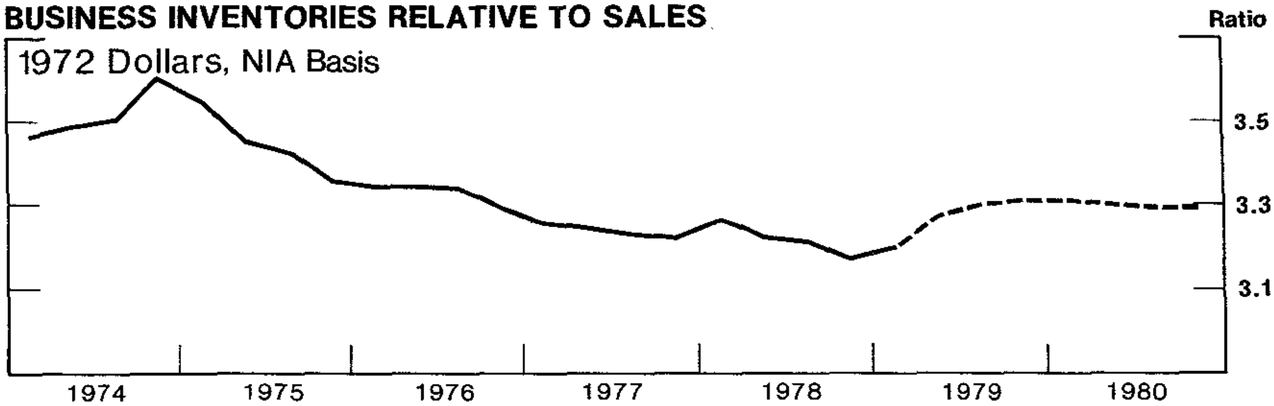
CHANGE IN BUSINESS INVENTORIES

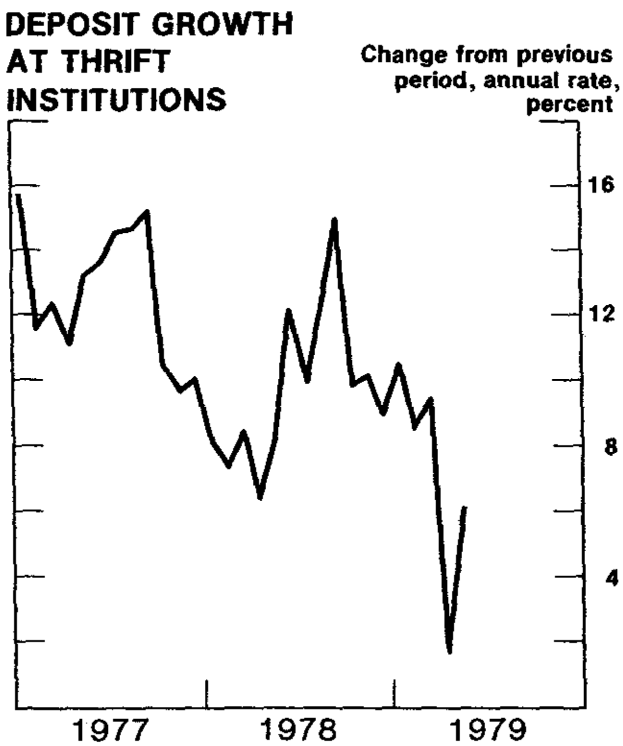
Annual rate, billions of dollars

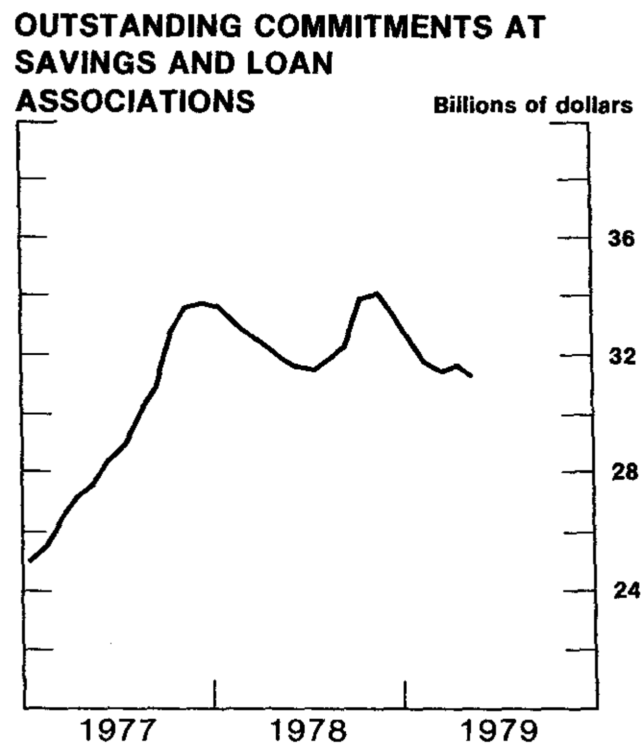


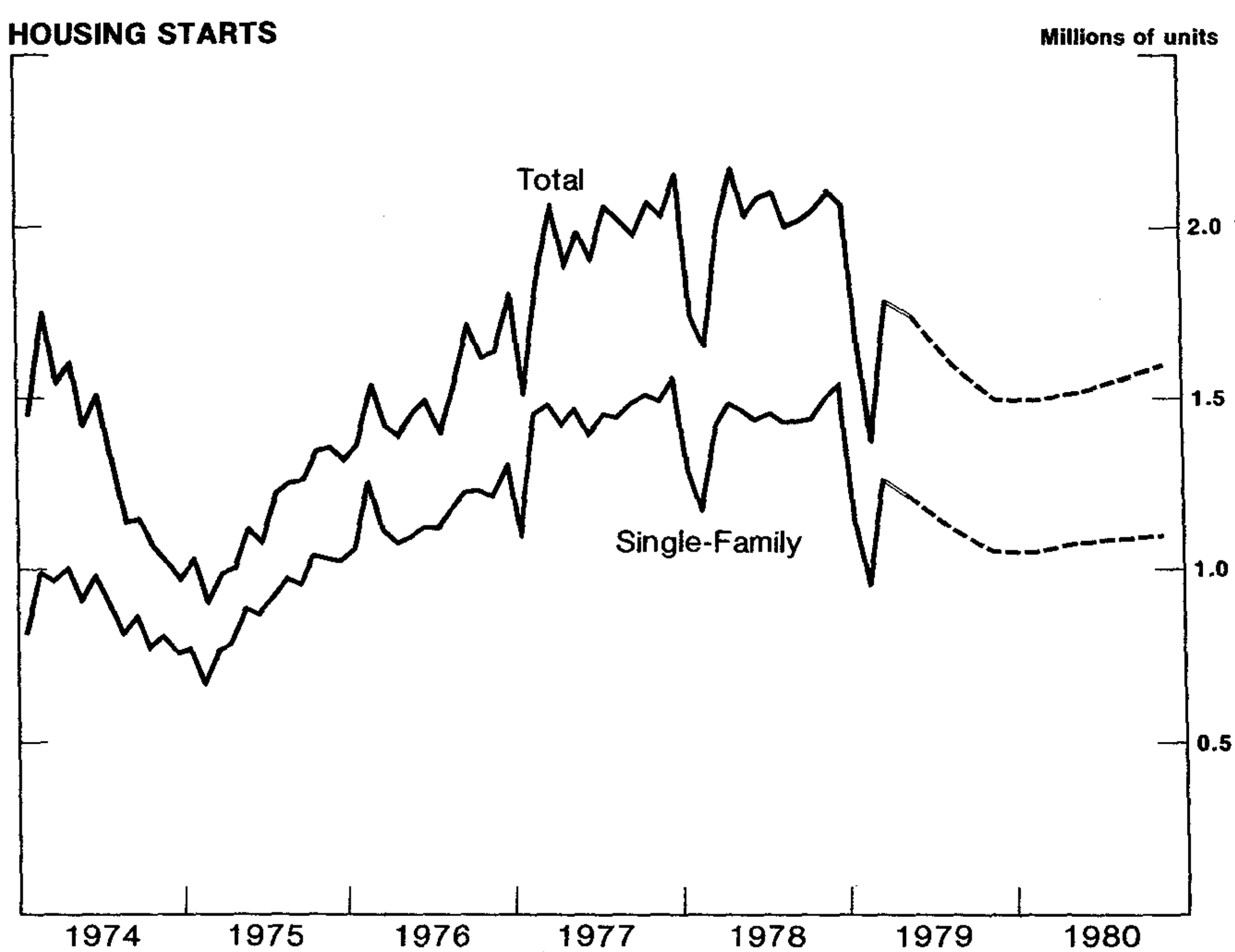
BUSINESS INVENTORIES RELATIVE TO SALES

Ratio

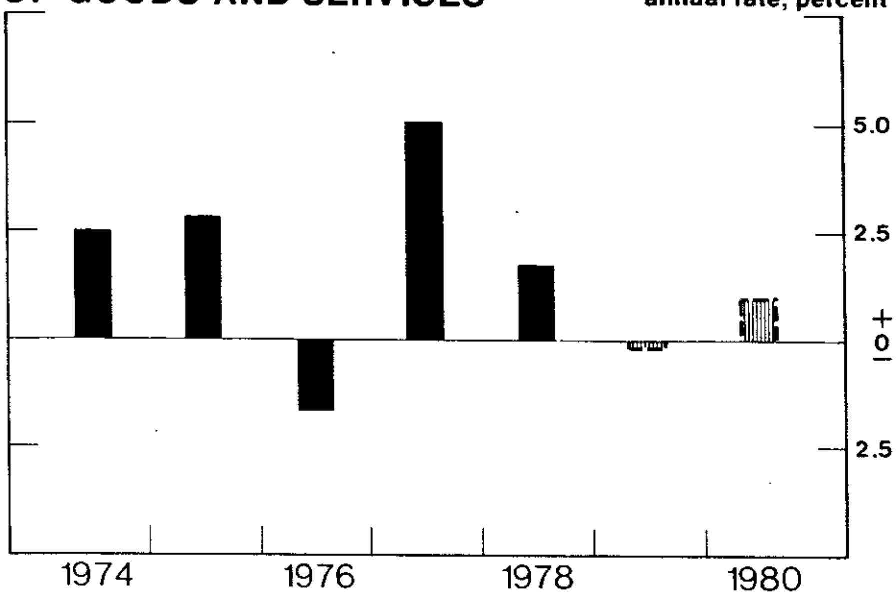



DEPOSIT GROWTH AT THRIFT INSTITUTIONS
Change from previous period, annual rate, percent
16
12
8
4
1977
1978
1979

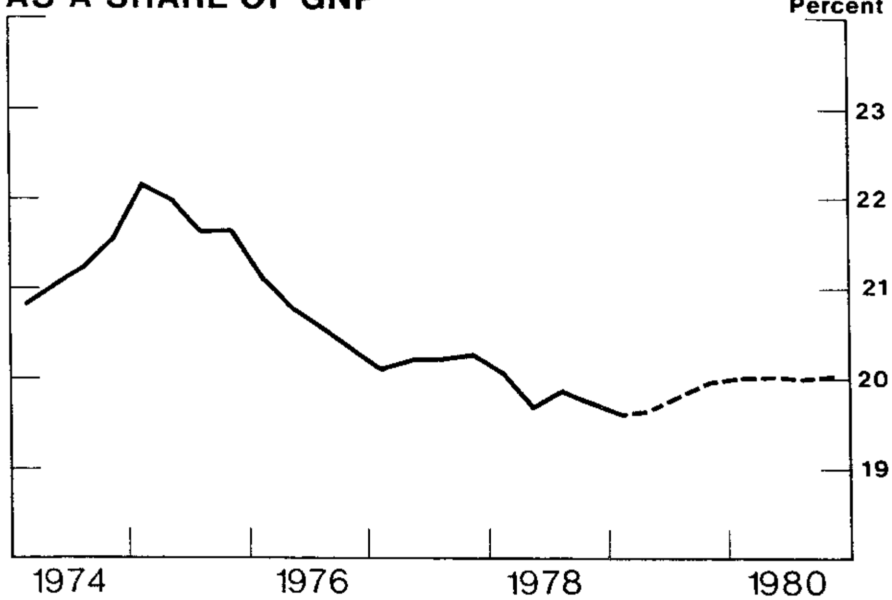

OUTSTANDING COMMITMENTS AT SAVINGS AND LOAN ASSOCIATIONS
Billions of dollars
36
32
28
24
1977
1978
1979


HOUSING STARTS
Millions of units
Total
Single-Family
2.0
1.5
1.0
0.5
1974
1975
1976
1977
1978
1979
1980

REAL GOV'T. * PURCHASES OF GOODS AND SERVICES

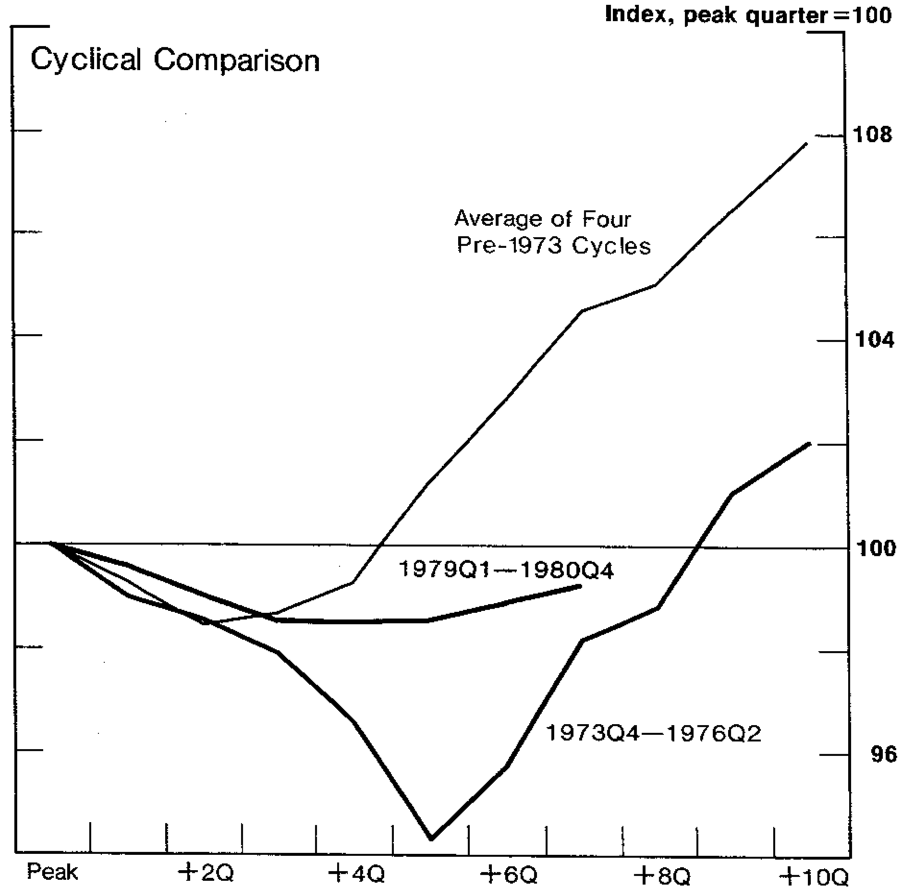


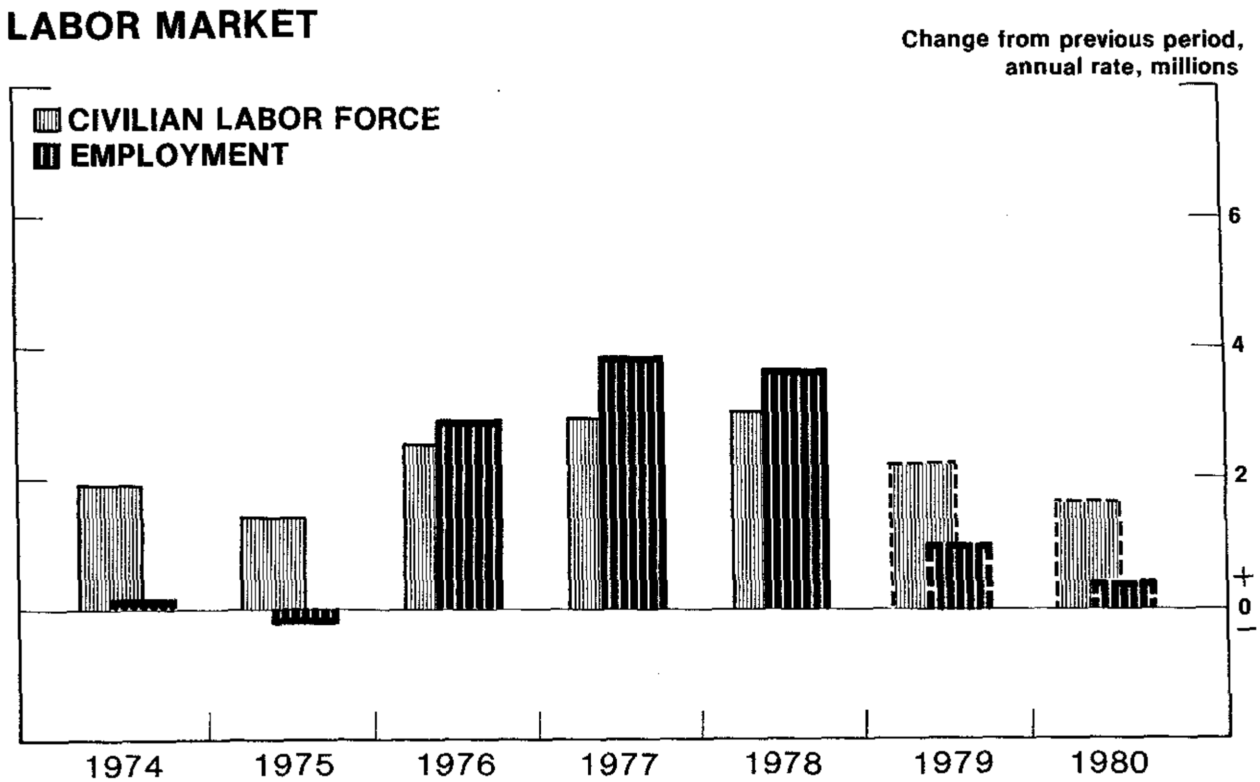
REAL GOV'T. * PURCHASES AS A SHARE OF GNP

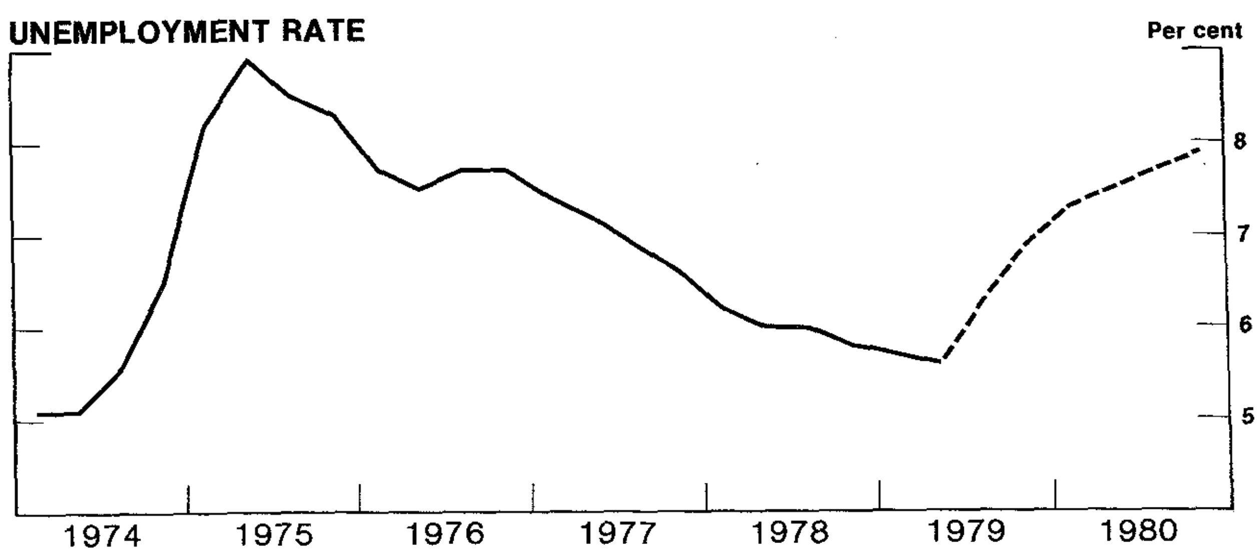


* Federal and State and Local

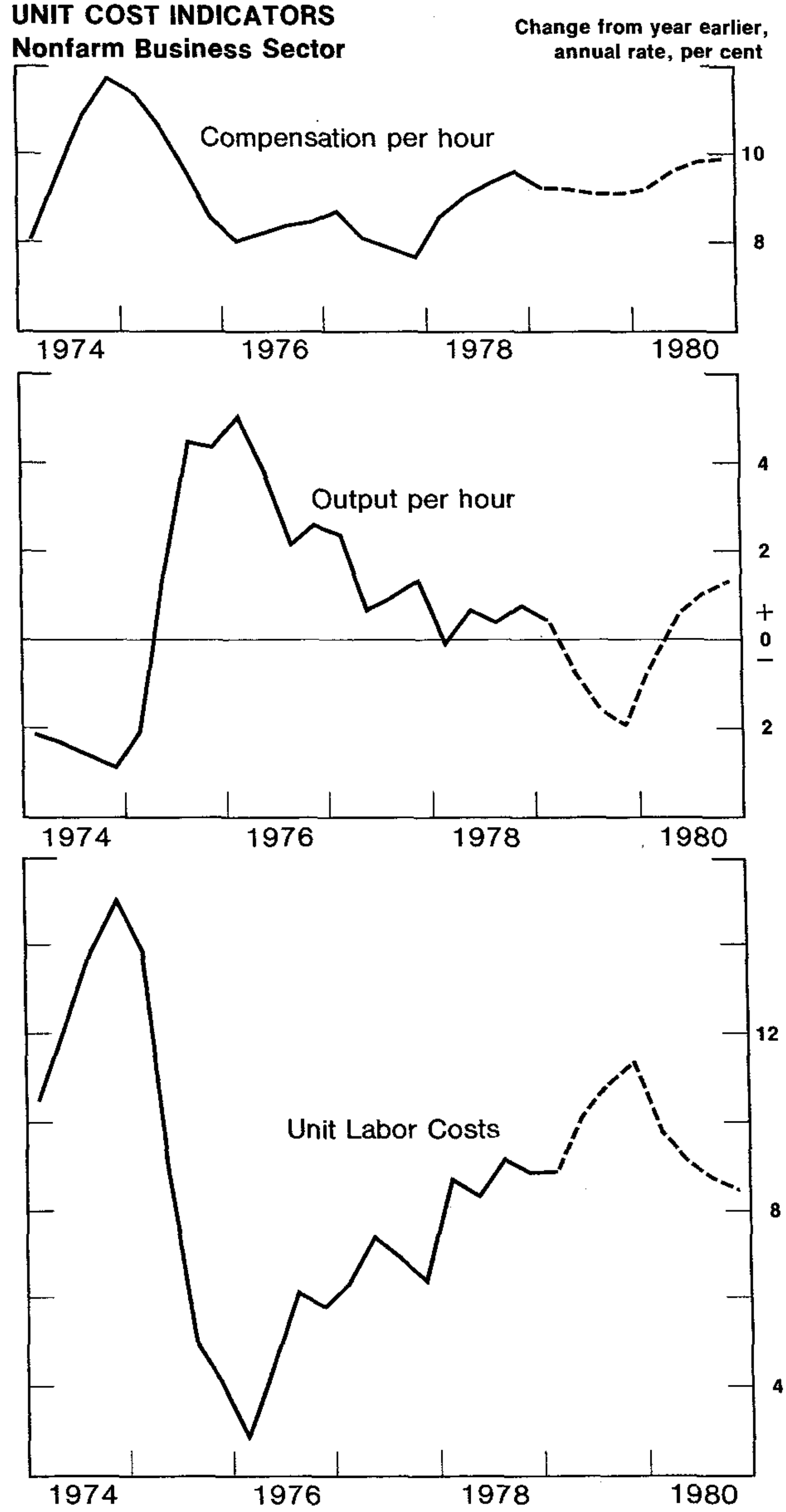
REAL GNP


Index, peak quarter=100
Cyclical Comparison
Average of Four
Pre-1973 Cycles
1979Q1—1980Q4
1973Q4—1976Q2
108
104
100
96
Peak
+2Q
+4Q
+6Q
+8Q
+10Q

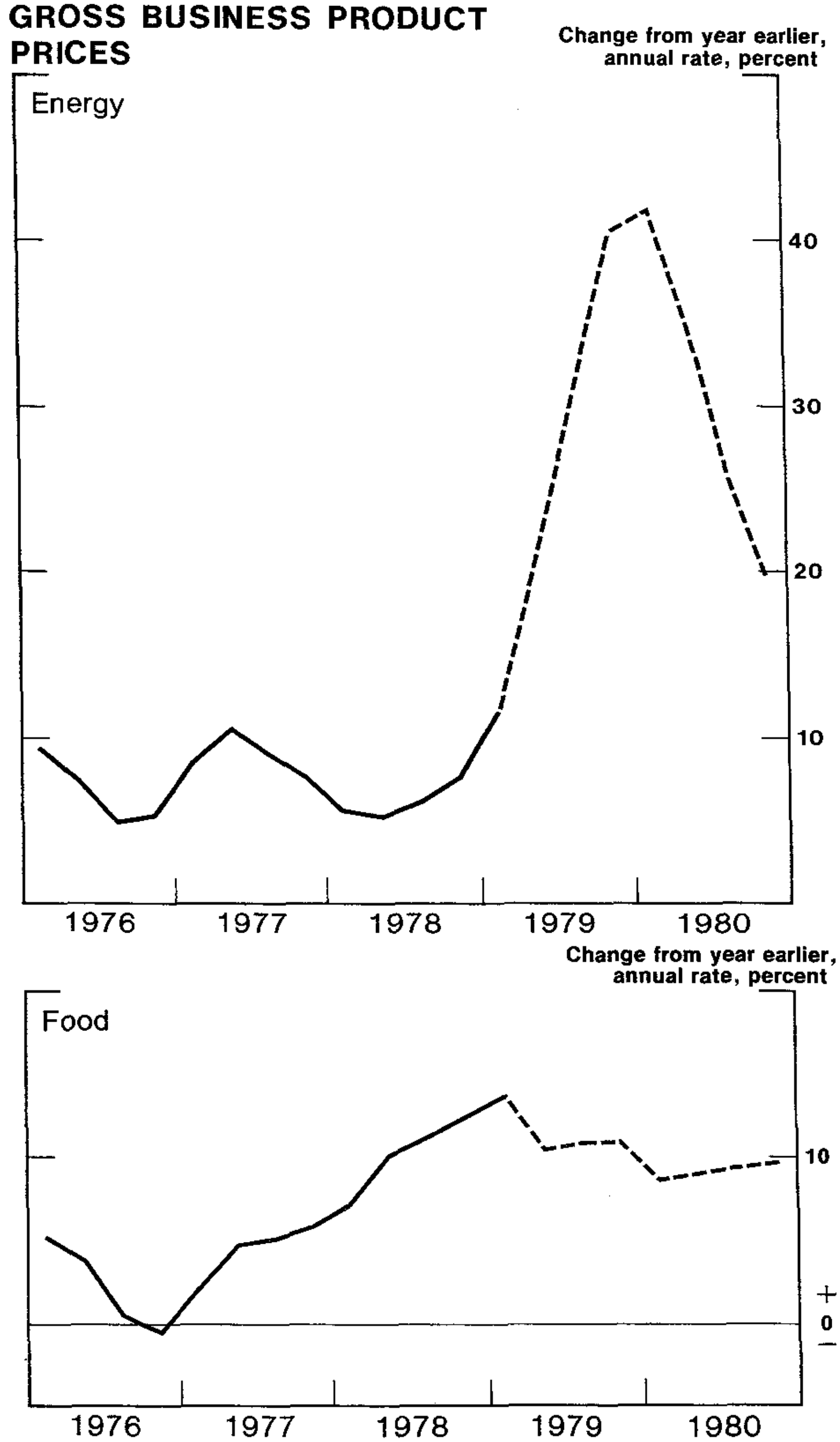

LABOR MARKET
Change from previous period, annual rate, millions
CIVILIAN LABOR FORCE
EMPLOYMENT
6
4
2
+
0
−
1974
1975
1976
1977
1978
1979
1980

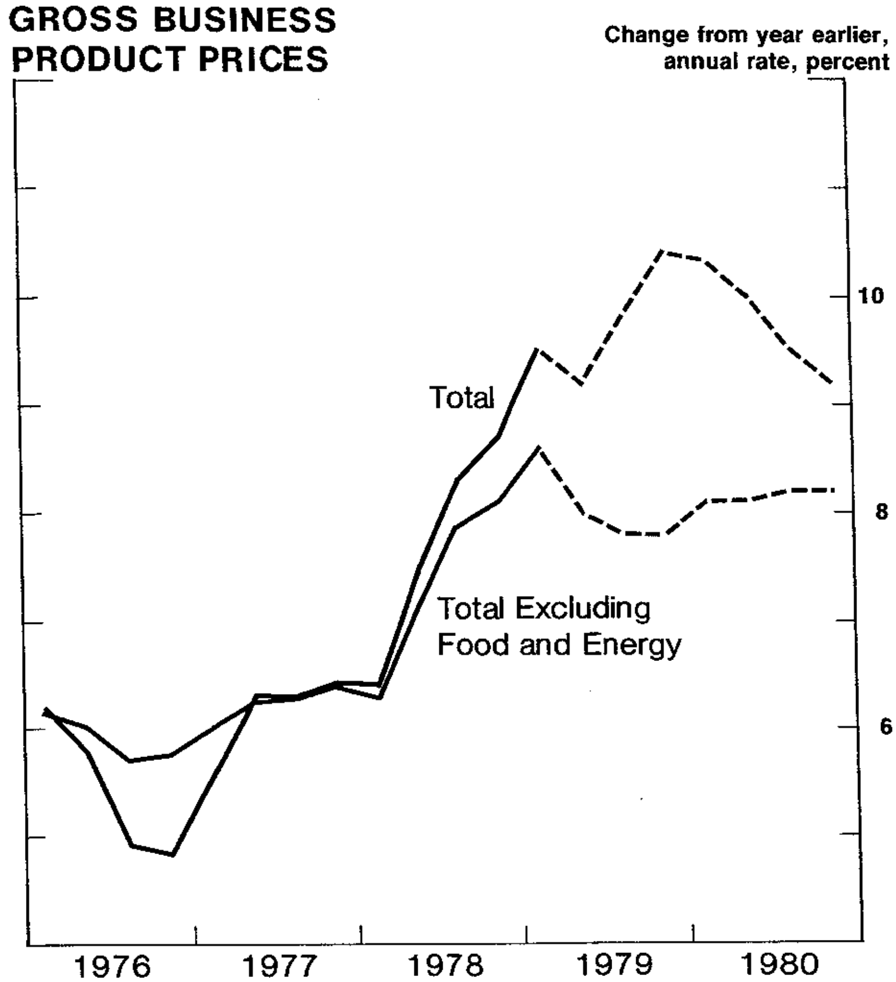

UNEMPLOYMENT RATE
Per cent
8
7
6
5
1974
1975
1976
1977
1978
1979
1980

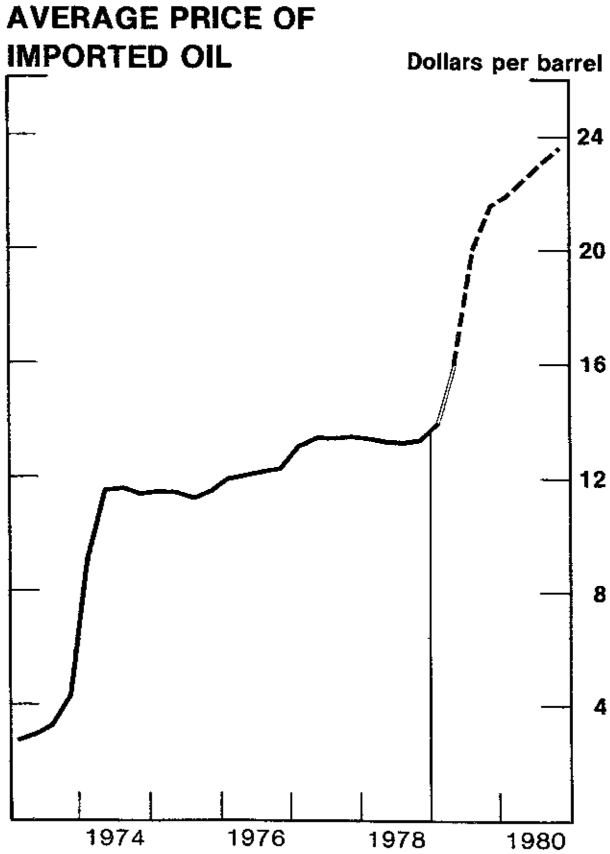
UNIT COST INDICATORS
Nonfarm Business Sector

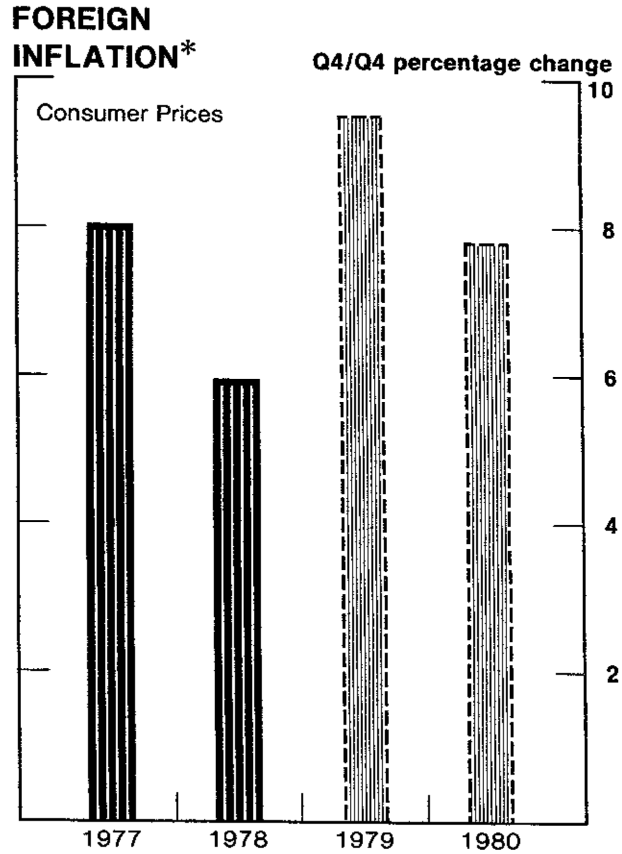


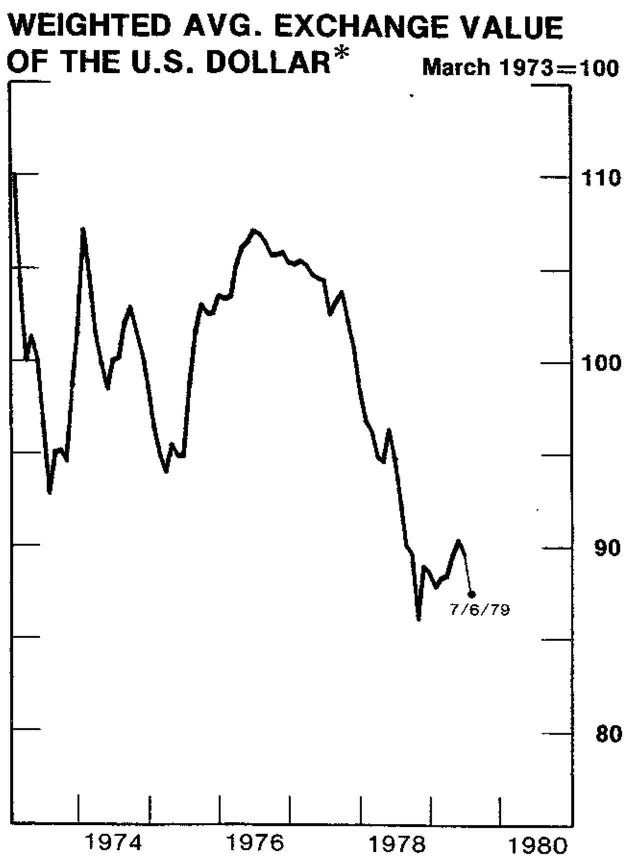
GROSS BUSINESS PRODUCT PRICES

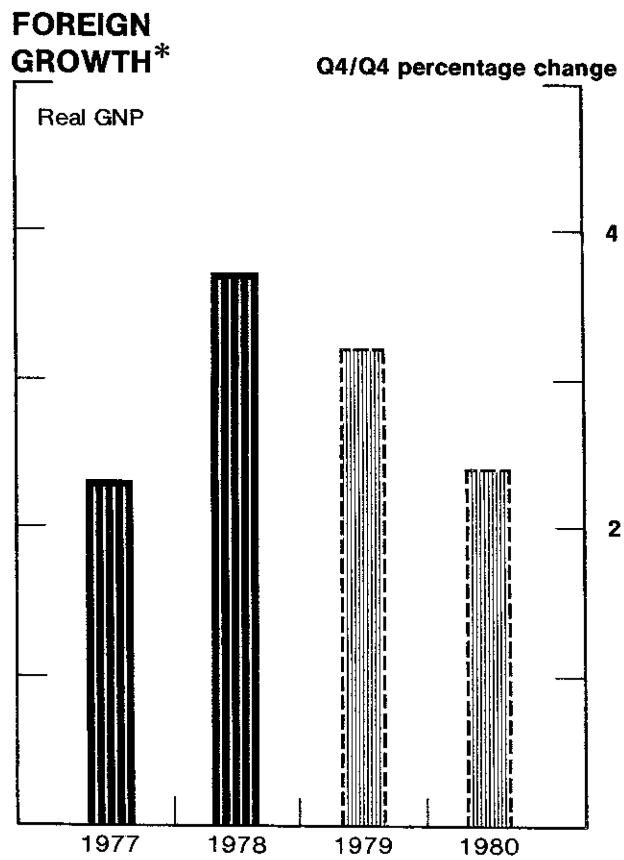



GROSS BUSINESS
PRODUCT PRICES
Change from year earlier,
annual rate, percent
10
8
6
Total
Total Excluding
Food and Energy
1976
1977
1978
1979
1980



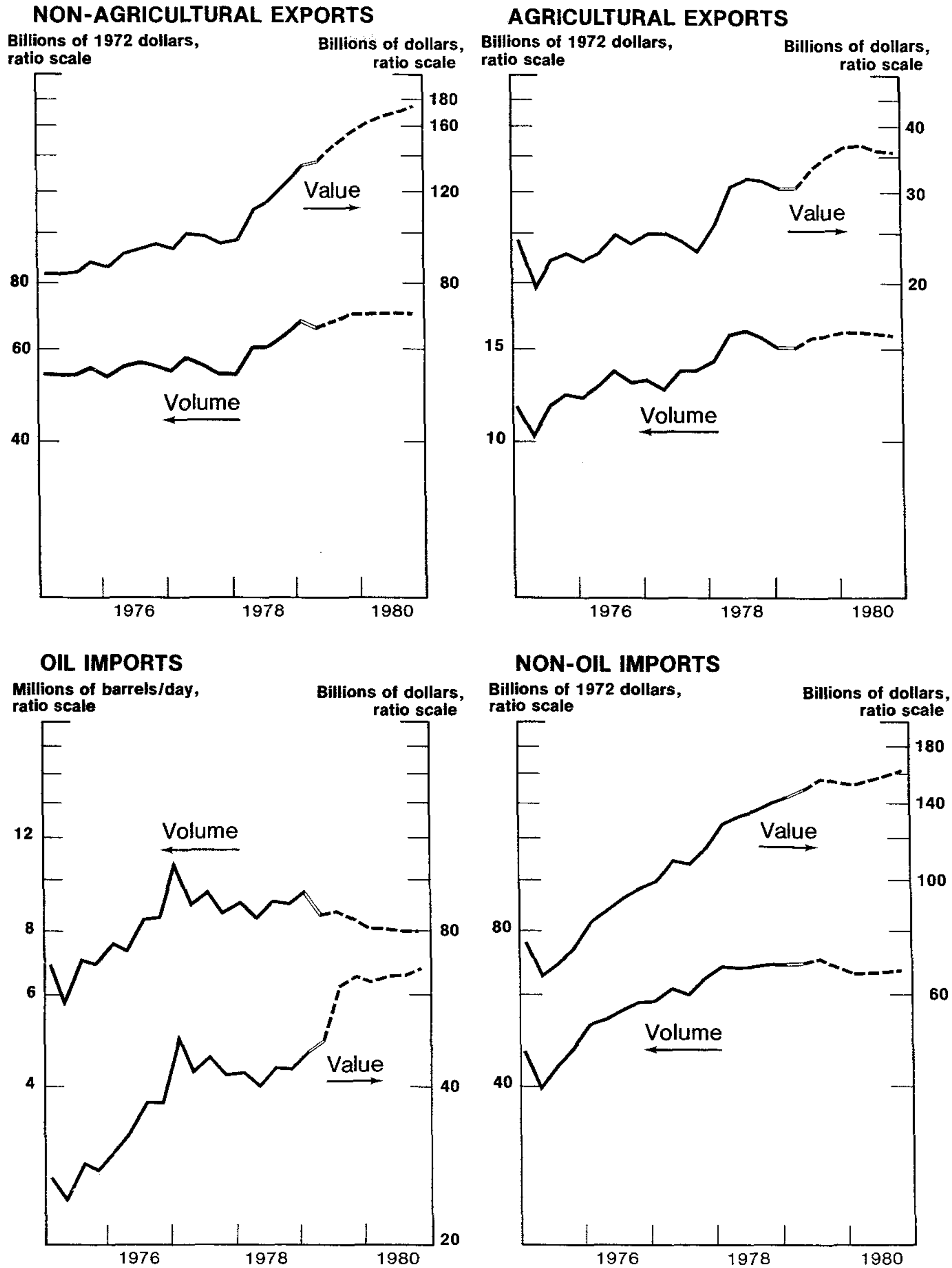




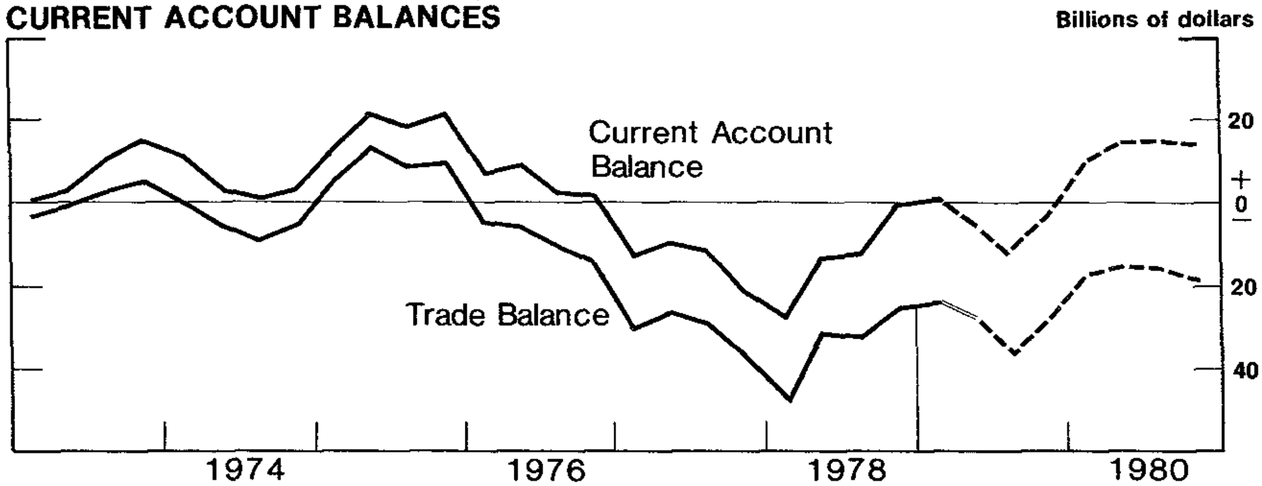


*Average of G-10 countries plus Switzerland using total 1972-1976 average trade.

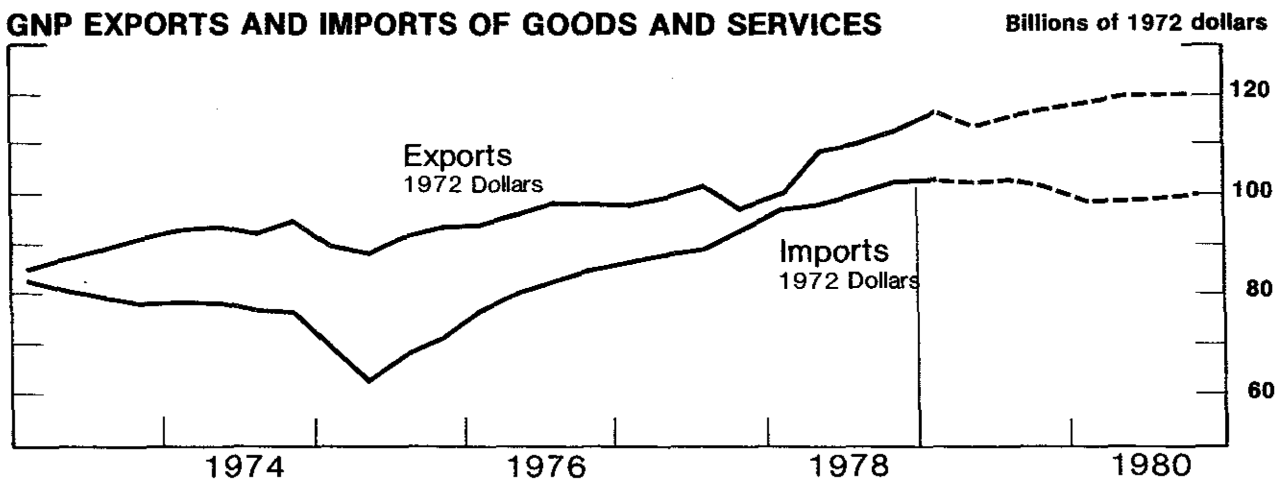
U.S. MERCHANDISE TRADE



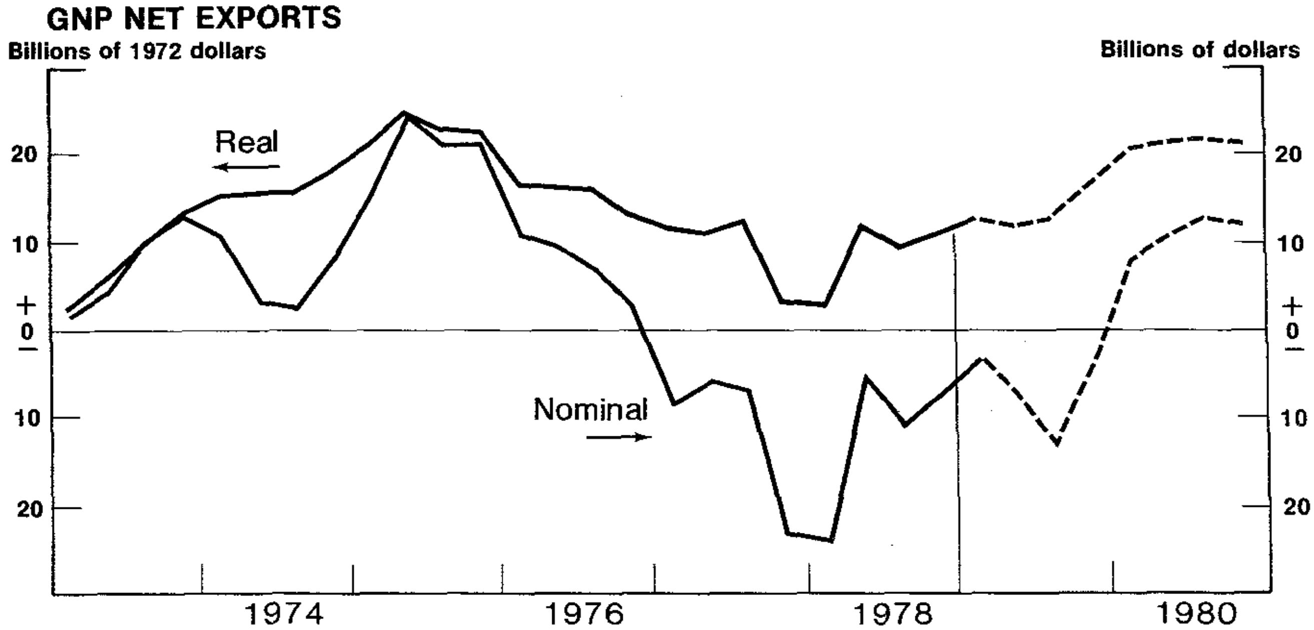
MERCHANDISE TRADE AND CURRENT ACCOUNT BALANCES



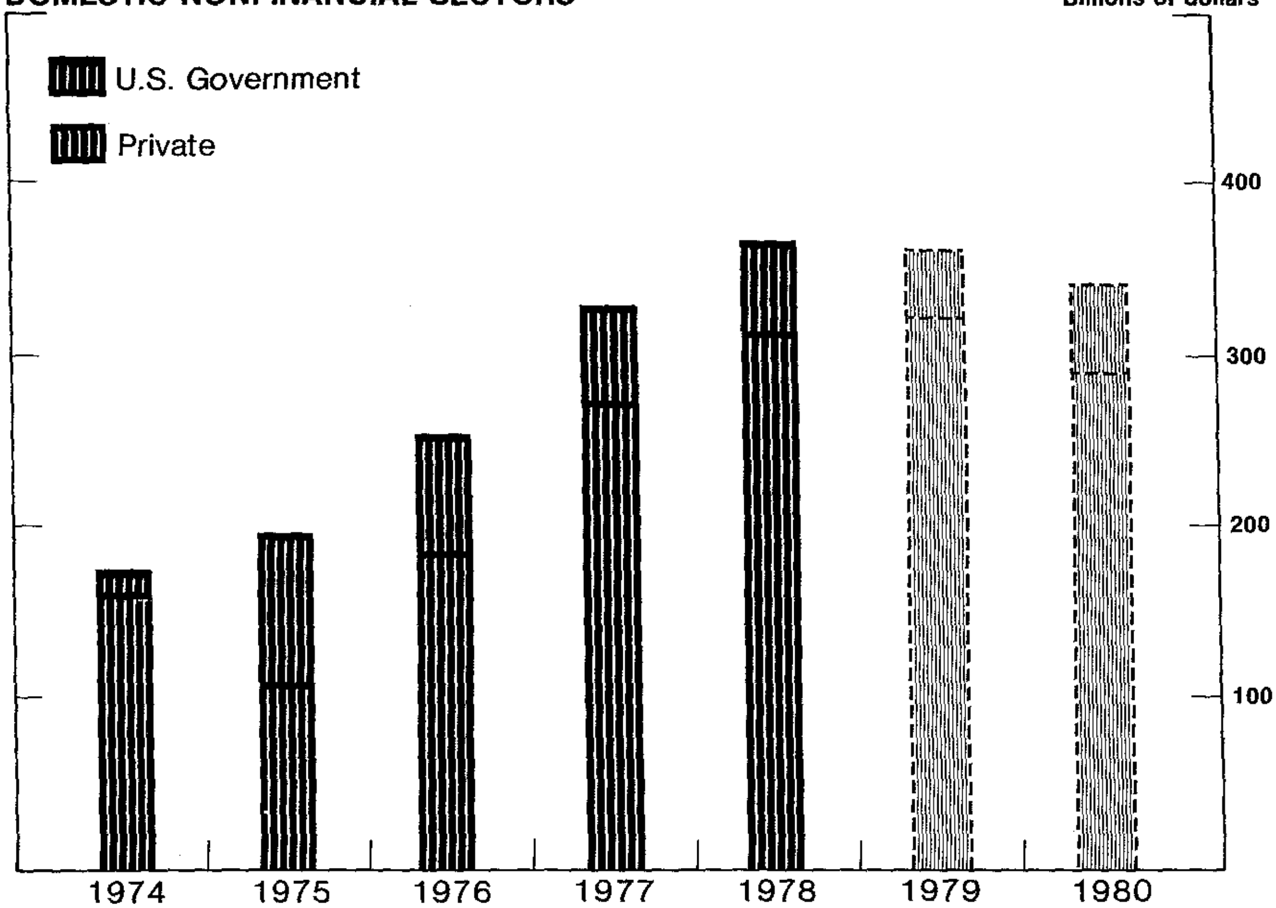
GNP EXPORTS AND IMPORTS OF GOODS AND SERVICES



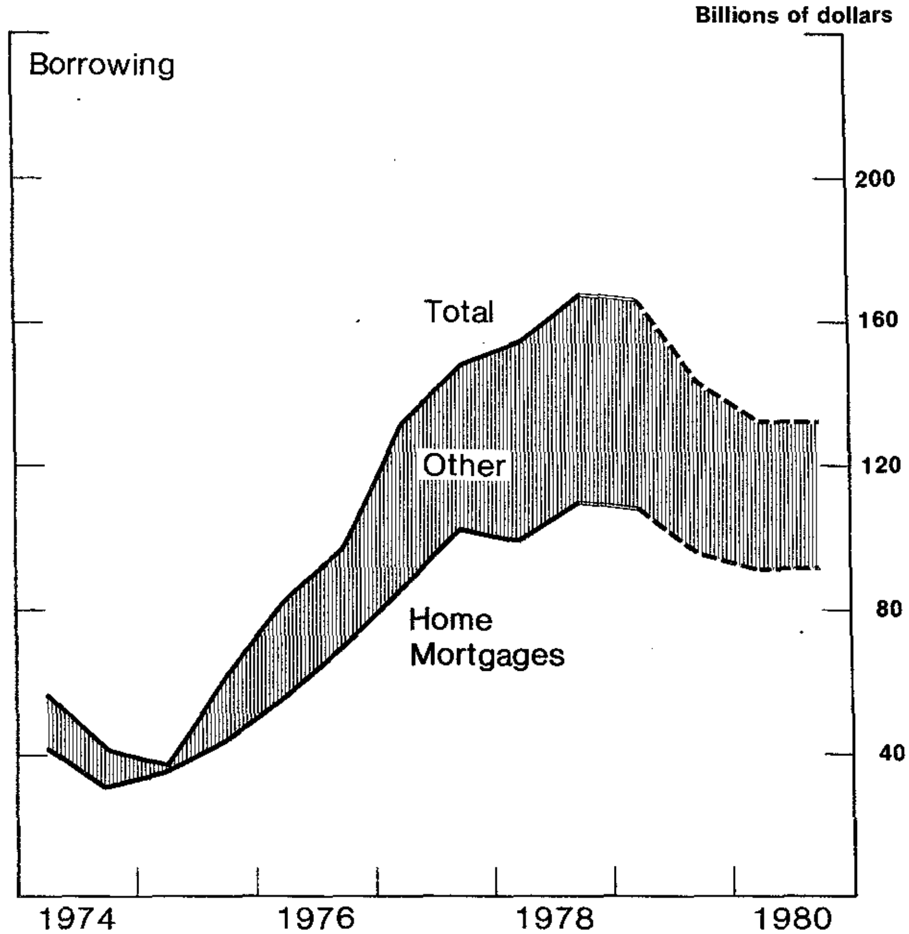
GNP NET EXPORTS



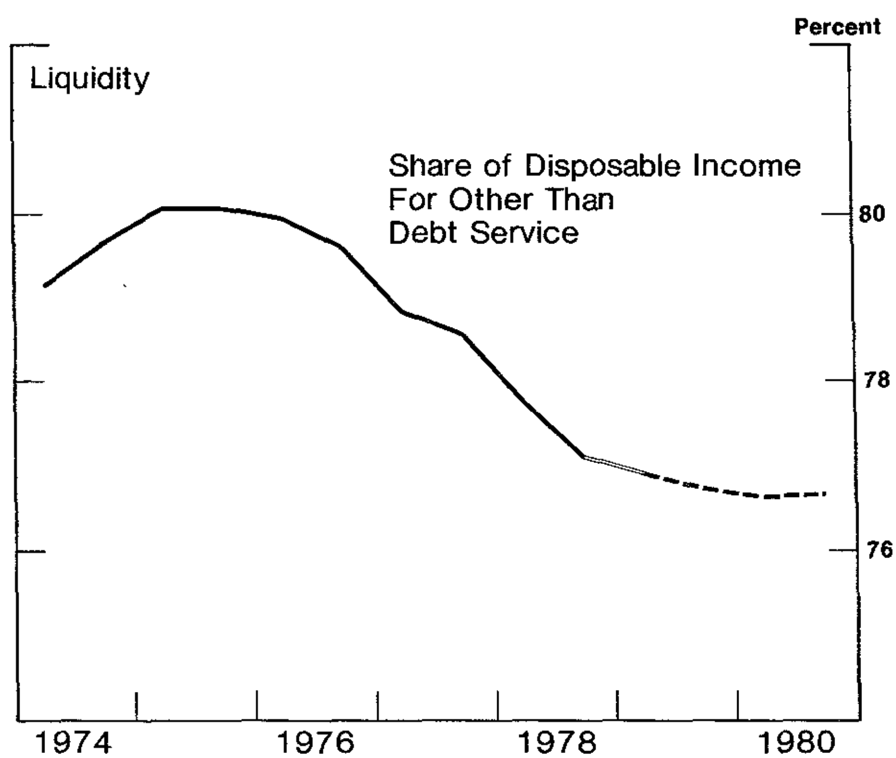
FUNDS RAISED BY
DOMESTIC NONFINANCIAL SECTORS



HOUSEHOLDS

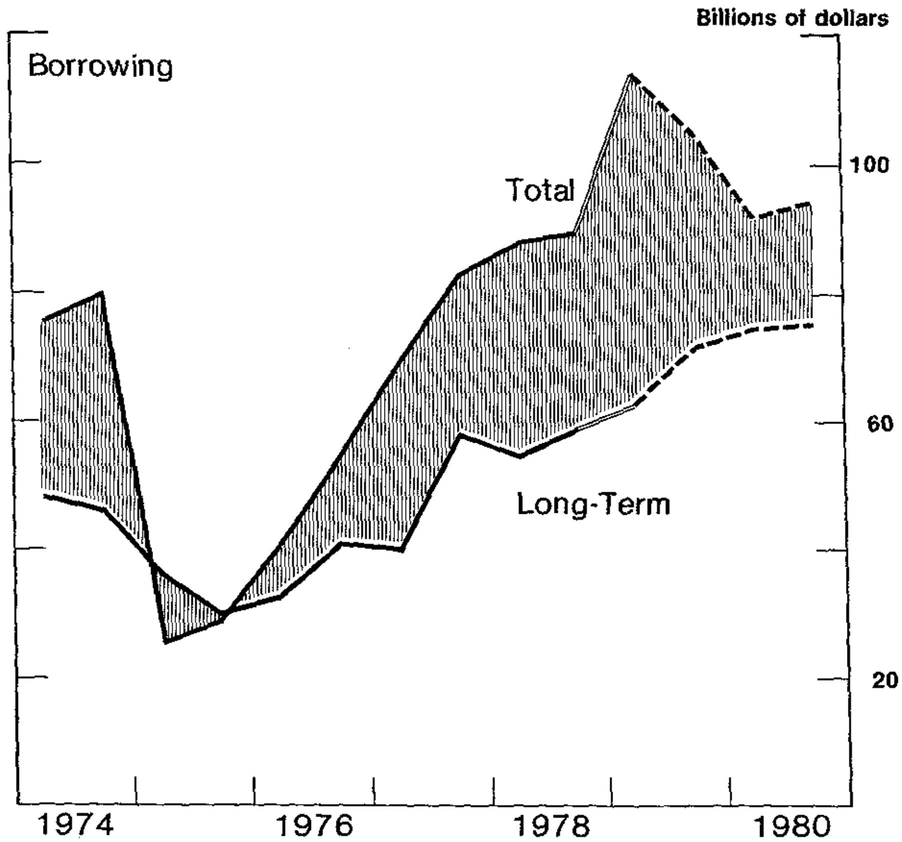


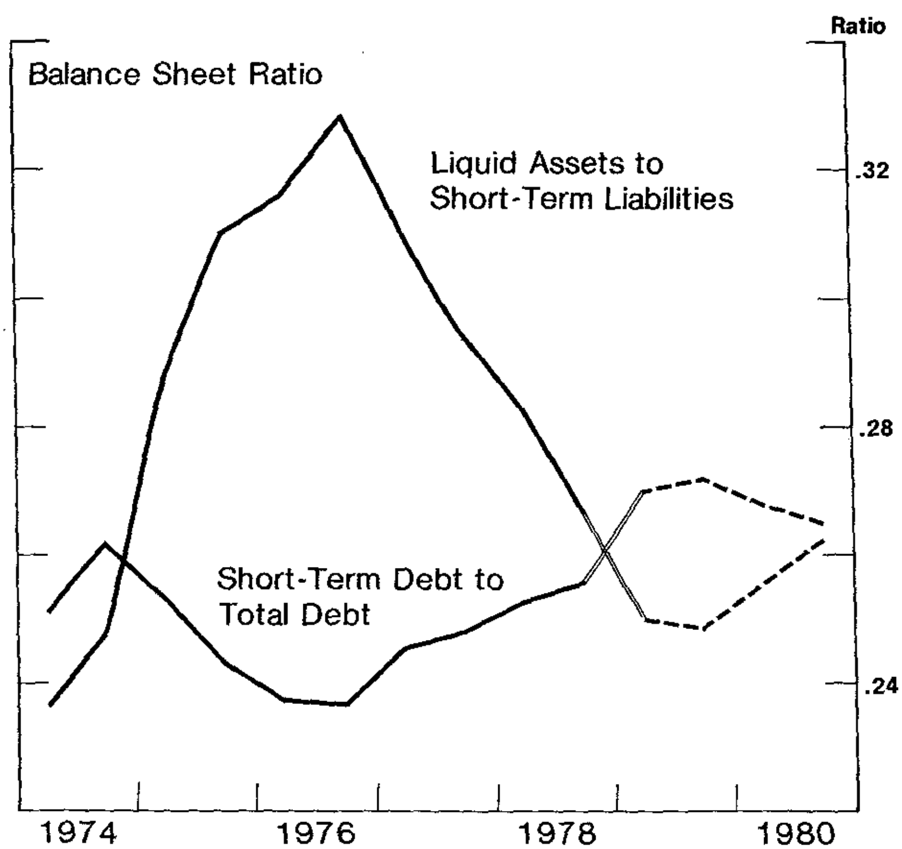
Billions of dollars
Borrowing
Total
Other
Home
Mortgages
200
160
120
80
40
1974
1976
1978
1980



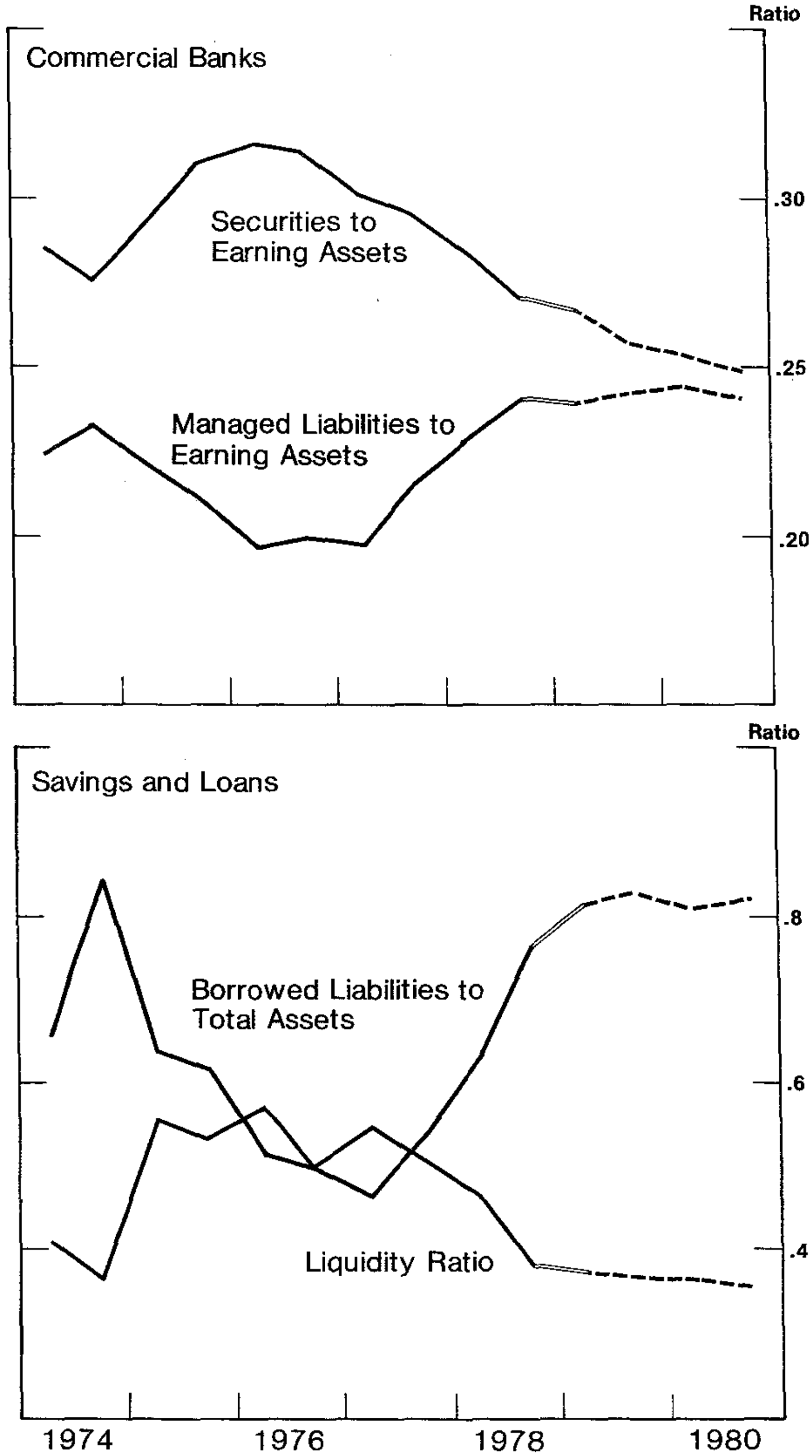
Percent
Liquidity
Share of Disposable Income
For Other Than
Debt Service
80
78
76
1974
1976
1978
1980

CORPORATE FINANCE

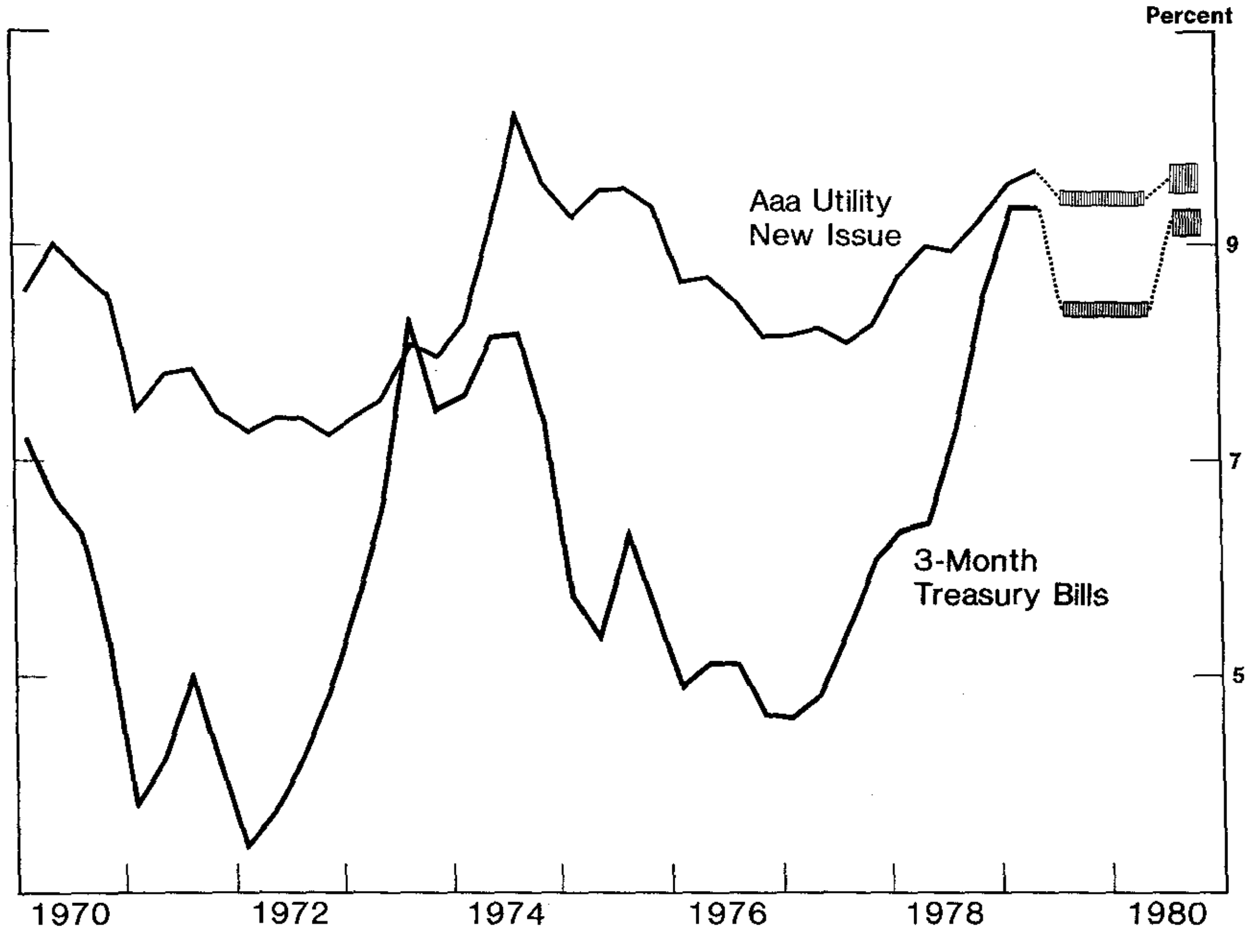




BALANCE SHEET RATIOS



INTEREST RATES



MONETARY POLICY ALTERNATIVES [1]

REAL GNP (%) [2]	1979	1980	1981
5 per cent M-1	−1.5	0	0.5
6 per cent M-1	−1.3	0.8	1.4
7 per cent M-1	−1.1	1.3	2.5
PRICES (%) [2]			
5 per cent M-1	9.5	8.8	8.7
6 per cent M-1	9.6	9.0	9.1
7 per cent M-1	9.6	9.1	9.5
UNEMPLOYMENT RATE (%) [3]			
5 per cent M-1	6.9	8.3	9.6
6 per cent M-1	6.9	7.9	8.7
7 per cent M-1	6.8	7.6	8.0
3 MONTH TREASURY BILL RATE (%) [3]			
5 per cent M-1	9½	10½	10¾
6 per cent M-1	8½	9½	9¾
7 per cent M-1	7¾	8½	8¾

[1] M1 growth rates equivalent to those in the absence of ATS.

[2] GNP implicit deflator measured from fourth quarter to fourth quarter.

[3] Level end quarter of each year.

Comparison of Staff and Administration
Economic Forecasts

	1979		1980	
	Staff	Administration	Staff	Administration
Nominal GNP (percent change QIV to QIV)	8.2	9.2	9.8	10.3
Real GNP (percent change QIV to QIV)	-1.3	-0.5	0.8	2.0
GNP Implicit Deflator (percent change QIV to QIV)	9.6	9.8	9.0	8.1
Unemployment Rate (QIV, in percent)	6.9	6.6	7.9	6.9