# APPENDIX

Notes for FOMC Meeting
September 18, 1979

Scott E. Pardee

For some two weeks after the August 14 FOMC meeting, the exchange markets were relatively quiet. The tone for the dollar was better, largely in response to the tightening actions by the Federal Reserve. News of a sharply reduced U. S. trade deficit in July also helped. Trading in dollar/mark remained balanced, with little intervention either by the Federal Reserve or the Bundesbank. But market sentiment was still so bearish toward the dollar--on relative inflation rates, energy policy, and the credibility of leadership in the United States--that most of those who sold dollars in June and July held back from covering short positions or otherwise shifting back into dollars. A few professional traders had gone long dollars in late July-early August on the expectation of a reflux of funds, which would bid up dollar rates. However, when that did not occur they wondered why and began to give credence to the many reports circulating in the market that the Bundesbank and other central banks were selling dollars to keep the dollar rates from rising. As for the Bundesbank, this was not the case; except for routine business, as far as we know it was on the sidelines. But the Swiss National Bank was a heavy seller of dollars in keeping the franc from falling against the mark. Also the Bank of Japan sold dollars to stem the decline of the yen. Many market participants took those sales as proof enough of central banks' intentions, including those of the Bundesbank. This view even made its way into the many market commentaries sent out to corporate treasures and other portfolio managers, giving then all the more reason to refrain from buying dollars. If the Bundesbank would not let the dollar go up, so the argument ran, the dollar could only go down.

Then, coming into late August, the Bundesbank, in its efforts to keep liquidity tight in the face of rising domestic loan demand, decided to cut back on what it considered excessive borrowing of German banks under the Lombard facility. It sought to shift the banks' demands for liquidity by offering a repurchase-agreement type of facility. As happens in the best of central banks, the Bundesbank miscalculated and found that it created substantially more liquidity under the repurchase agreement than it took away under the Lombard facility, and so it shifted to a third instrument, foreign exchange swaps, to mop up the excess. But this embarrassing incident for the Bundesbank was widely interpreted as a stratagem. The view in the market was that the Bundesbank was trying to keep up with or one step ahead of the Federal Reserve's efforts to firm up conditions in the United States. In fact, short-term interest rates in Germany did rise almost as much as U. S. rates did during the period.

These events occurred against the background of considerable press commentary about a possible interest rate war and Representative Reuss's letter complaining about Germany's interest rate policy. These charges have been countered by U. S. officials, but the feeling remained in the market that cooperation among central banks had somehow broken down. This not only applied to bilateral relations between the United States and Germany but also to relations within the European Community.

The Germans have a strong hand at the moment. Very few market participants question the determination of the Bundesbank to fight inflation in Germany, either through having the mark appreciate in the exchange market or through tightening domestic monetary policy. Many in the market are thus prepared to interpret about everything the Germans do as favoring the mark, and on that basis the mark is considered an attractive hedge. More generally, some investors consider gold to be an even surer bet, and the recent surge of demand in that market has pushed the price to $380 an ounce, nearly eleven times what we were defending ten years ago. The malaise in the international monetary system is not just over the dollar but over the outlook for currencies generally.

The upshot is that over the past three weeks the mark has been in heavy speculative demand, against dollars as well as against other European currencies. The demand has been particularly strong ahead of weekends, when realignments of European currencies generally occur. Intervention within the EMS has swelled to $2.8 billion equivalent, now increasingly in marks rather than dollars, which has helped relieve pressure on the dollar. Intervention in dollars by the German and U. S. authorities amounted to                    of which $1,580 million was by the United States. The immediate pressures in the EMS, mainly against the Danish, Belgian and French currencies, are likely to continue until one of these weekends a realignment is agreed upon or a successful bear squeeze is pulled off as a result of the very high interest rates now prevailing in those countries. Meanwhile, the Bundesbank has continued to use swaps against U. S. Treasury bills held in its own portfolio to mop up mark liquidity as fast as it is created.

Our intervention, while sizable, has been of a defensive nature. In the market we have shown ourselves as highly reluctant to give ground, particularly as the mark rate approaches the DM 1.80 level, which traders consider an important psychological benchmark. The U. S. authorities, of course, are not wedded to that rate. But in the current highly unstable exchange market environment, the more the Desk backs away, the bigger the outpouring of offers of dollars from speculators, corporate treasurers, and portfolio investors. Consequently, to keep some sense of two-way risk in the market, we have varied our tactics. The Treasury still has some $2.1 billion of its mark availabilities and has the possibility of acquiring more marks--as through the issuance of additional Carter notes--should the need arise. Overall, our swap drawings on the Bundesbank rose a net of $609 million and now total $2.7 billion. This leaves the System with $3.3 billion [available] under the swap lines.

Meanwhile, I think that an increasing number of people in the market accept the more favorable medium-run scenario I laid out last month. Our trade and current accounts are adjusting and a further dramatic adjustment is expected if not over the next months at least over the next year. The Federal Reserve's tightening moves have been taken as a signal of the System's determination to fight inflation despite the action of the Bundesbank. And once the oil price increase works its way further through our price indexes, the U. S. inflation rate should begin to abate. But traders are still reluctant to bet on this scenario as long as more immediate uncertainties dominate market psychology.

FOMC MEETING
SEPTEMBER 18, 1979

REPORT ON OPEN
MARKET OPERATIONS

Mr. Sternlight made the following statement:

In response to decisions at the last Committee meeting, and strong aggregates in the intervening period, the Account Management aimed for a firming of money market conditions that contributed to higher interest rates across a broad front. Immediately following the August 14 meeting, the Desk began seeking a Federal funds rate around 11 percent, the midpoint of the new 10 3/4 - 11 1/4 percent range, and up from the previous objective of 10 5/8 percent or slightly higher. By August 23, the Board staff estimates of the aggregates appeared sufficiently strong--well above the range for $M_1$ and virtually at the top for $M_2$ --that the Desk's objective was raised to 11 1/4 percent. A week later, the aggregates appeared even a bit stronger and the Committee voted to provide an additional 1/4 percent leeway to raise the funds rate, though with the understanding that not all the leeway would be used immediately. Further adjustments were to be made in response to subsequent information on the aggregates and performance of the dollar in the foreign exchange market. In response, starting at the end of August the Desk aimed for a funds rate of about 11 3/8 percent, and that objective has continued up to now.

In implementing the moves to 11 1/4 and 11 3/8 percent the Desk moved in a gingerly fashion, taking care to avoid giving the market the impression that the objective might be even higher than it was. Partly because of this, and also due to some unexpected reserve bulges, the funds rate averaged somewhat under the Desk's objectives in late August and early September. Nevertheless, market participants came away with a pretty good idea of what we were shooting for, perhaps with a lag of a day or two at times. In the current week, funds are averaging very close to the 11 3/8 percent objective.

Outright operations were virtually all in bills during the period, though there were coupon purchases of nearly $1 billion just before the last meeting. Net purchases of bills from foreign accounts came to about $2 billion, partly offset by a redemption of $200 million in bills and a small redemption of agency issues. Repurchase agreements were used actively to provide reserves in the first half of the period, while matched-sale purchase transactions were employed to mop up reserves on several days toward the latter part of the interval, in addition to the execution of matched transactions with foreign accounts each day.

Largely in reaction to the higher funds rate, and anticipation of further firming to come, interest rates rose over a broad spectrum during the past five weeks. While the System's funds objective rose about 70 basis points, some other short rates pushed up by a full percentage point or more, spurred by enlarged credit demands and higher financing costs. Among the sharpest gains were those on bank CD's and commercial paper--about 1 3/8 percentage points. The banks' prime rate climbed 1 1/4 percent to a new high of 13 percent. Treasury bills were auctioned yesterday at about 10.35 and 10.32 percent for the 3- and 6-month issues, compared with 9.50 and 9.48 percent just before the last meeting. Yesterday's 6-month rate was a new record while the 3-month was down somewhat from the record of 10.53 percent a week earlier.

Short maturity Treasury coupon issues--out to about 20 months maturity--also rose by a full percentage point or more in yield, while intermediate issues in the 2 - 5 area were up about 50 - 85 basis points. For the longest maturities, yield increases tapered off to about 20 - 25 basis points--which is still quite substantial. Long term corporates and tax-exempts were also up by roughly that amount.

It will be recalled that on some other recent occasions, the longer market reacted to evidence of a firmer System policy by holding steady or even declining in yield as market participants took heart that sturdier action was being taken to deal with inflation. The different reaction this time may have come because of feelings that inflation is so deeply imbedded that it will take considerable time to root out, perhaps leaving that elusive peak in rates still some distance away. The recent rise, while setting new peaks for this year for short rates, and all-time peaks for Treasury bills, did not reach the highs of last spring for longer intermediate and long-term rates. Indicative of market psychology, dealer positions in Governments maturing in over a year have pushed to a near-record short. The dealers' net short position in over 1-year issues was about $500 million at the time of the last meeting, and most recently has been around $1.4 billion.

The majority expectation in the market as of this point, in my view, is that there is still some further firming to come, to tame the aggregates and contain inflation. The view is not quite so predominant now as a few days ago, as some participants think that a more pronounced business softening is on the way and that this will preclude more rigorous restraint. But the more prevalent view is that some further restraining steps are likely. Certainly few, if any, observers have expressed optimism about the near-term prospects for curbing inflation.

Finally, I should call the Committee's attention to the possibility of some disruption to the financial markets as the Congress copes again with the debt ceiling. Congressional action must be taken before September 30, or the limit reverts to $400 billion. A Congressional recess is scheduled to begin September 28 so that is perhaps the more critical date--and indeed some problems would arise if there is no action by September 25 as that may be the date the Treasury would have to start postponing auctions of securities. Depending on the course of events, we may have to consider actions to help deal with special circumstances that emerge from a debt limit bind.

James L. Kichline
September 18, 1979

FOMC Briefing

Economic activity on average now appears likely to increase a bit in the current quarter from the level that prevailed in the second quarter. The staff's assessment of new information since the last meeting of the Committee has led us to revise upward expected final sales and inventory investment during the summer months. At the same time, however, additional evidence is available of a probable reduction in activity in the months ahead. Overall, the staff's forecast of a moderate cyclical decline in real GNP stretching into the first half of 1980 has not been altered appreciably by recent and prospective developments.

Much of the upward revision of final sales in the current quarter is attributable to higher personal consumption expenditures. Total retail sales in August were reported to have increased 3/4 percent, which undoubtedly amounted to little change in real terms. But sales for both June and July were revised upward. To some extent the recent halt in the series of declines in retail sales experienced during the spring is attributable to the direct and indirect effects of improved availability of gasoline. In addition, domestic auto sales in August and early September rose considerably in response to rebates and dealer incentives for overstocked '79 model cars. While dealers have pared auto inventories substantially, past experience suggests that a large proportion of such sales came at the expense of future sales rather than adding permanently to customer auto demands; thus our forecast contains a drop of around 8 percent in domestic auto sales in the fourth quarter.

The clean-up of excess auto inventories so far has required considerable adjustments in production along with increased sales. In August motor vehicles and parts accounted for two-thirds of the 1.1 percent drop in industrial production. Outside the motor vehicle sector, production declines generally were small although widespread among consumer and business products as well as materials.

Further downward adjustments in production will be necessary in order to achieve and maintain a desired level of inventories unless consumer and business sales were to pick up. Such a sustained rise of sales for consumer and investment goods does not seem probable. At the consumer level real disposable income has been on a downward path, savings rates are historically low, debt burdens are high and consumer attitudinal surveys point to concerns about current and future economic conditions. Attempts to maintain real standards of living should tend to provide some support to consumption, but are unlikely to outweigh fundamental negative forces at work.

In the investment sector housing starts in July were still fairly strong at 1.8 million units annual rate and home sales advanced. Since then, however, already high mortgage interest rates have risen further and nonprice terms have tightened. The financial evidence and damped demand forces suggest declining housing market activity this year and into early 1980. For plant and equipment spending, data for July suggest some rise in construction outlays and shipments of nondefense capital goods. However, indicators of future investment activity--including new orders, the recent Commerce survey of spending intentions, and contract awards--all point to a deceleration.

The staff's forecast has built into it a general weakening of consumer and business demands as well as a sizable drop in inventory investment from the pace of the second and third quarters. In July the rise in inventories on a book value basis was huge, even after allowing for rapid price increases.

Nearly one-fourth of the accumulation was in motor vehicles and parts where actual disinvestment occurred in August and so far this month. Another large chunk was in foods, presumably reflecting good crops, some strike effects, and temporary lags in exporting. But even so other inventories were rising rapidly--especially consumer goods at general merchandise stores--and the inventory situation is a cause of concern.

Forecasting the size and timing of an inventory adjustment is a hazardous affair. Our forecast of a smooth and fairly rapid balancing of desired and actual inventories relies heavily on the rather cautious behavior of businesses throughout the current cyclical expansion, and that caution is reinforced of course by the currently prevailing level of interest rates.

A further softening of labor markets would be consistent with the staff's forecast of economic activity. In August total nonfarm employment was unchanged, while the average length of the workweek declined, manufacturing employment was reduced for the fifth consecutive month, and the unemployment rate rose 0.3 percentage point. In light of current circumstances, increases in the unemployment rate averaging 0.3 percentage point per month over the balance of the year would not be surprising.

On the price side we have not altered the forecast significantly. The gross business product fixed weight deflator is expected to be rising at around 8-1/2 percent annual rate late next year compared to the recent 10 percent rate. The sluggish economy in prospect, along with a slowing in the rapid increase of energy prices, is expected to contribute importantly to reduced, although still high, rates of inflation. We have not assumed much success by the Administration in holding down wages and prices during the second year of its restraint program beginning October 1. The details of the revised guidelines will not be available until later this month, although it appears that the program will tend to be relaxed, at least on the wage side.

FOMC Briefing
S. H. Axilrod
Sept. 18, 1979

Following 5 months of weak growth beginning in November 1978, both M-1 and M-2 have been expanding very rapidly over the 5½ month period from March as a base through the first two weeks of September--with M-1 expanding at about an 11 percent annual rate and M-2 at a 12½ percent rate. I would interpret this accelerated growth for the most part as a return to the relationships between money, nominal GNP, and interest rates that might be expected on the basis of past history. There is some evidence for this since the acceleration reflects mainly resumed growth of demand deposits and savings deposits--accounts from which businesses and consumers began shifting funds last November when they started re-evaluating money positions following the introduction of ATS accounts and the simultaneous abrupt and seemingly more permanent rise in market interest rates associated with the dollar support program. This stock adjustment in retrospect appears to have ended in the spring.

Most recently, money appears to be growing a bit more rapidly than historical relationships would suggest. There would appear to be at least three plausible explanations, with differing implications for spending or interest rates. First, it might be assumed that earlier this year the public drew down cash balances more than they found desirable, and recently they have been re-adjusting to some extent. This assumption would not have any particular implications for spending or interest rates in the future, since the public would simply wish to hold the cash.

A second possibility would be that the public is now adding to cash, as well as to other liquid assets, for precautionary reasons in view of the uncertain economic outlook. Such behavior is typically not long lasting, and thus this added cash is likely to be spent or invested in other financial assets. Or, third, it may also be that M-1 is rising because the Federal Reserve is attempting to mute upward interest rate pressures in a period of relatively strong, perhaps strengthened short-term credit demands. Cash so supplied would also be quite likely to be spent or invested fairly soon, rather than be held for a longish period.

Our projections of a slowing in money growth over the months ahead assume, essentially, that precautionary additions to cash will abate and that short-term credit demands will slack off later in the year in line with weakening business activity. Our projections do not assume that recent additions to cash will be spent in sufficient volume to sustain business activity and thereby generate either a renewed need for cash for transactions purposes or a sharp rise in velocity occasioned by spending out of pre-existing balances. Rather, they assume that any surplus cash will, mainly, be invested, thereby putting some downward pressure on interest rates and/ or leading to slower growth in money over the next few months.

Jim has discussed the factors leading to the staff projection of a weakening GNP in the fourth quarter. Such a weakening appears to depend to a great extent on elements endogenous to the nonfinancial economy--such as declines in real personal income and inventory imbalances. From a financial perspective, we have not been able to detect the kinds of conditions that have in past cycles been associated with clear constraints on credit availability--such as, widening yield spreads between low and high-grade market instruments, or a considerable worsening in indexes representing changing bank attitudes toward lending. There is surely some restraint in the housing market, but the willingness of S&L's to make mortgage commitments appears to have held up a little better than in previous periods of restraint.

Financial restraint under current conditions would, of course, need to come mostly from the impact of interest rate levels on the willingness to borrow. Here, the prime rate at 13 percent might be considered restrictive, and would encourage inventory liquidation, given the relatively weak sales outlook and especially if any signs develop of softness in prices of goods held in inventories.

With regard to the decision before the Committees today, a few considerations may be raised, based in part on the preceding analysis. Strategy toward the Federal funds rate in the weeks ahead involves balancing efforts to reduce growth in the aggregates and curb inflation against an apparently weakening economy. One obvious approach at this time would be to stand pat in terms of the Federal funds rate, while assessing whether endogenous forces in the nonfinancial sectors of the economy--as well as the lagged effects of recent tightening actions--will in fact weaken the economy enough to bring money growth down to more acceptable levels. On the other hand, the Committee might consider some little further tightening of the funds rate on the grounds that more insurance is needed--in the form, for example, of encouraging more restraint on credit availability--if the process of moving toward significantly slower money growth is to be more certain.

Finally, it might be noted that weakness in economic activity may argue for a policy of easing the funds rate. However, under existing circumstances, such an argument needs to be weighed against the absence of any clear and lasting sign of a slowing in money growth, the absence of evident constraints on credit availability, and the desirability of avoiding signals that markets might interpret as a weakening in the resolve to combat inflation.