THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

February 21, 1978

MEMORANDUM FOR THE PRESIDENT

FROM: Charlie Schultze

SUBJECT: Meeting with Economic Advisers and Federal Reserve Board Chairman (Quadriad)

I am attaching to this memo a longer summary of recent developments in the economy that I would commend to your attention when your schedule permits. Portions of it which I have referenced in this cover note, may be useful to you in preparing for the Quadriad meeting tomorrow at noon. In this memo I will try to describe the issues worth discussing at tomorrow's luncheon.

As you know, Dr. Burns remains in the chairmanship of the Federal Reserve Board pending the confirmation of Mr. Miller. The meeting of the Federal Open Market Committee previously scheduled for today has been postponed until Tuesday, February 28 in the hope that Mr. Miller will be confirmed by that time and can chair the meeting. This remains uncertain. In any event, Dr. Burns will remain a member of the Board through that meeting and his general views and outlook will have much weight.

Discussion at the meeting on Wednesday, February 22 might center on the following areas:

1. implications of recent economic data;
2. the general outlook for monetary policy;
3. deposit flows at financial institutions and possible adjustments of regulatory ceilings on deposit interest rates.

1. The Outlook and Recent Economic Data

The attached memo provides a review of recent developments in the domestic economy. The first 4 pages, in particular, provide background on recent economic data relating to the outlook.

2. The General Outlook for Monetary Policy

The discussion commencing on page 6 of my review memorandum outlines Federal Reserve actions to raise interest rates

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early in January in a step publicly identified as intended to support the faltering international exchange value of the dollar. This resulted in 0.2 to 0.3 percentage point increases in interest rates across the board. Growth rates in the monetary aggregates have remained moderate and within target ranges as shown on the attached charts.

There are a number of uncertainties impinging on monetary developments at the current time:

(a) fluctuations in the foreign exchange value of the dollar which were substantial through mid-January and erupted again last week at the time of international meetings in Paris;

(b) the puzzling January statistics;

(c) fears of inflation, heightened by the increase in the minimum wage and payroll taxes which went into effect in January (see pages 5-6 of my review memorandum).

(d) developments pertaining to velocity of money, specifically:

- During the last three quarters of 1977 velocity growth appeared to be slowing, in contrast to the unusually rapid growth in the 1974-76 period.

- So far in the first quarter of this year, however, velocity growth appears to be somewhat on the high side once again, although it is very early to say.

Under the normal schedule the FOMC at next week's meeting would decide on new target ranges for growth in the monetary aggregates, extending from 1977-IV to 1978-IV, and those ranges would be announced to Congress shortly after the meeting. (The current ranges are shown in the heading of each of the attached charts.)

This could be a particularly difficult time to set the targets since the new Chairman may not yet be aboard when the decision is taken.

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Chairman Burns may argue that weakness in the dollar and fears of inflation require targets at least as tight or tighter than those announced last quarter. I think there are some counter-arguments suggesting either, (i) holding the ranges as they are, or (ii) widening them symmetrically;

- The volatility of the growth in velocity in recent quarters has made it difficult to predict what any given growth of M_1 or M_2 will do to credit conditions and interest rates. A wider band for the target ranges would give the Fed more flexibility and reduce speculative gyrations in interest rates, which can occur as M_1 or M_2 approach the upper and lower bounds.

- Tightening up on the monetary targets won't really help the dollar. There is already a wide interest rate differential in favor of holding dollars.

- Most of the factors bearing on inflation this year are institutional ones -- the higher minimum wage and payroll taxes -- which will not be significantly affected by overall monetary and fiscal policies. It would be most unfortunate to sacrifice real output objectives in the name of inflation control without giving your anti-inflation program a real test. Endorsement and support of that program by the Chairman would be very helpful.

3. Deposit Flows and the Availability of Mortgage Credit

Higher interest rates on marketable securities, such as Treasury securities, make these investments strong competitors for funds relative to deposits at banks and thrift institutions. As interest rates on these securities climb beyond a certain point, flows of funds into time and savings accounts shrink. In turn, the availability of morgage credit falls. The interest rates that can be offered on time and savings deposits are limited by two factors: (a) what these institutions can earn on their loans and other assets, and (b) regulatory ceilings on rates paid to depositors, which are set by the Federal Reserve, the Home Loan Bank Board and the FDIC. (In the case of the Federal Reserve, the ceiling-setting regulation is known as Regulation Q.) Different ceilings apply to different types of deposits and to different maturities and, by law, the interest ceilings applying to thrift institutions (institutions other than commercial banks) must be at least one quarter point higher than those for commercial banks.

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Currently, most depository institutions are paying the legal ceiling rates. The earnings on their existing mortgage portfolios and other assets are probably such that they could pay somewhat higher deposit rates if permitted to do so. Yields on Government securities are now higher than the ceiling rates on most types of deposits; the exceptions are long-term deposits or certificates, particularly at thrift institutions.

In view of this adverse yield spread, which developed when interest rates rose last fall, it is not surprising that the growth of deposits has slowed. As noted in my review memorandum, deposit growth at mutual savings banks and savings and loan associations slowed from an exceptionally rapid 15 percent annual rate in the third quarter, to 11 percent in November, 9 percent in December and just under 7 percent in January. These are not strikingly slow rates, but a continuation of the January rate or lower would pose some threat to the availability of mortgage credit. More than half of all mortgage credit outstanding on 1-4 family homes is held by these institutions. In 1973-74 when market interest rates rose sharply, regulatory ceilings were eased somewhat but financial institutions earnings were not adequate to permit them to raise their deposit rates fast enough to keep up with market rates. Deposit growth at these institutions fell to 5-1/2 percent in 1974 and between 1972 and 1974 the amount of credit they extended dropped by more than 40 percent.

We do not anticipate a problem anywhere near this serious in the near future. In the absence of sharp further increases in interest rates, yield spreads will not be as adverse as in 1973-74 and the earnings of the thrifts are better. But the possibility exists that some adjustments of regulatory ceilings could become desirable in the near future in order to permit these institutions to compete for funds and in order to permit small savers, for whom time and saving deposits are the most accessible investment, to obtain returns more nearly equal to those available to the wealthy.

We might discuss with Chairman Burns the circumstances under which an adjustment of ceilings would be desirable and what kind of adjustments he thinks most appropriate. He may welcome your interest since it will be desirable for the three regulatory agencies (Fed, FHLBB and FDIC) to move together and the Administration could help to encourage such coordination. (Technically, FHLBB must move if the others are to do so since

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the ceilings pertaining to thrifts must be raised to preserve the one-quarter point differential in the event of higher ceilings for banks.)

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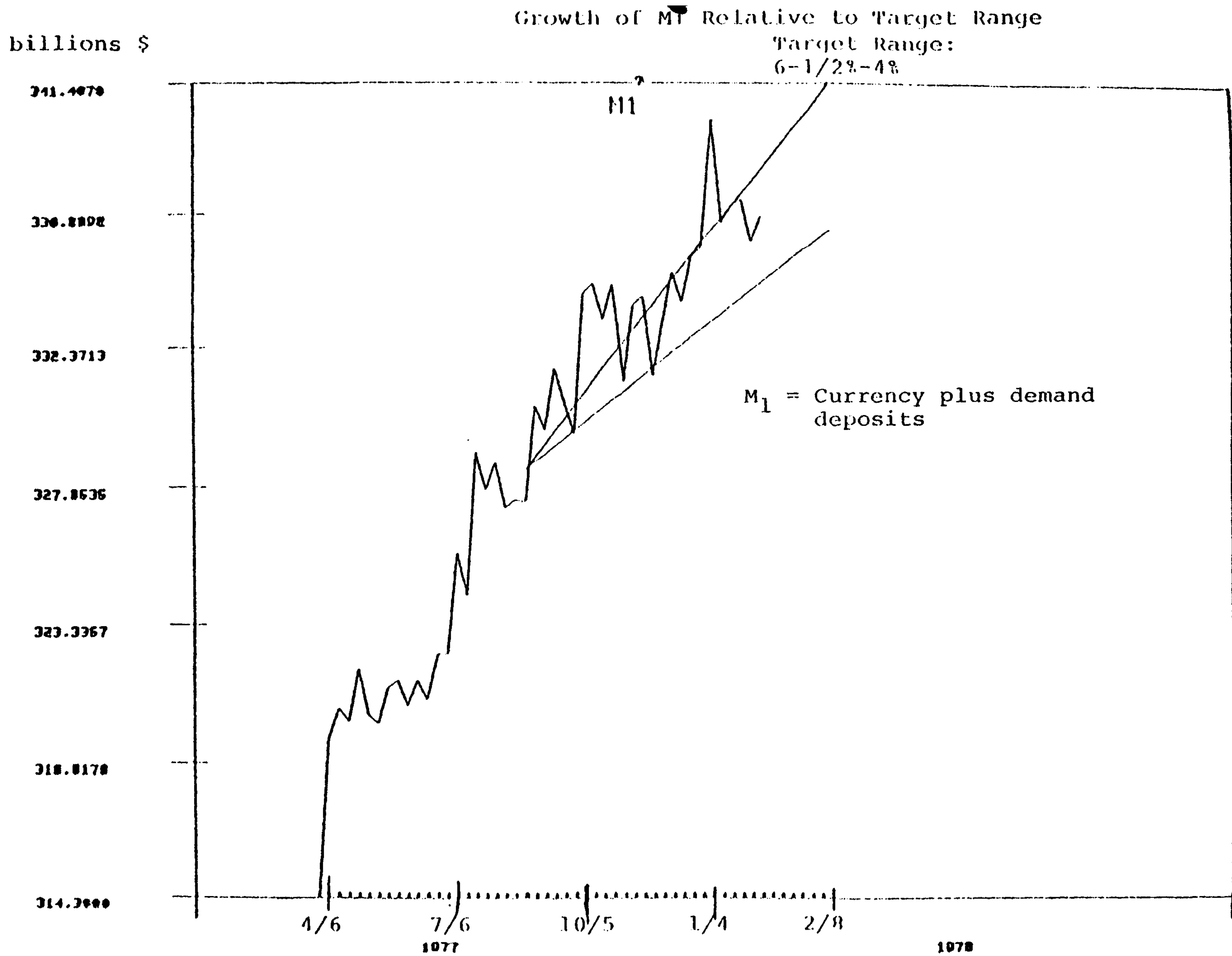
February 16,



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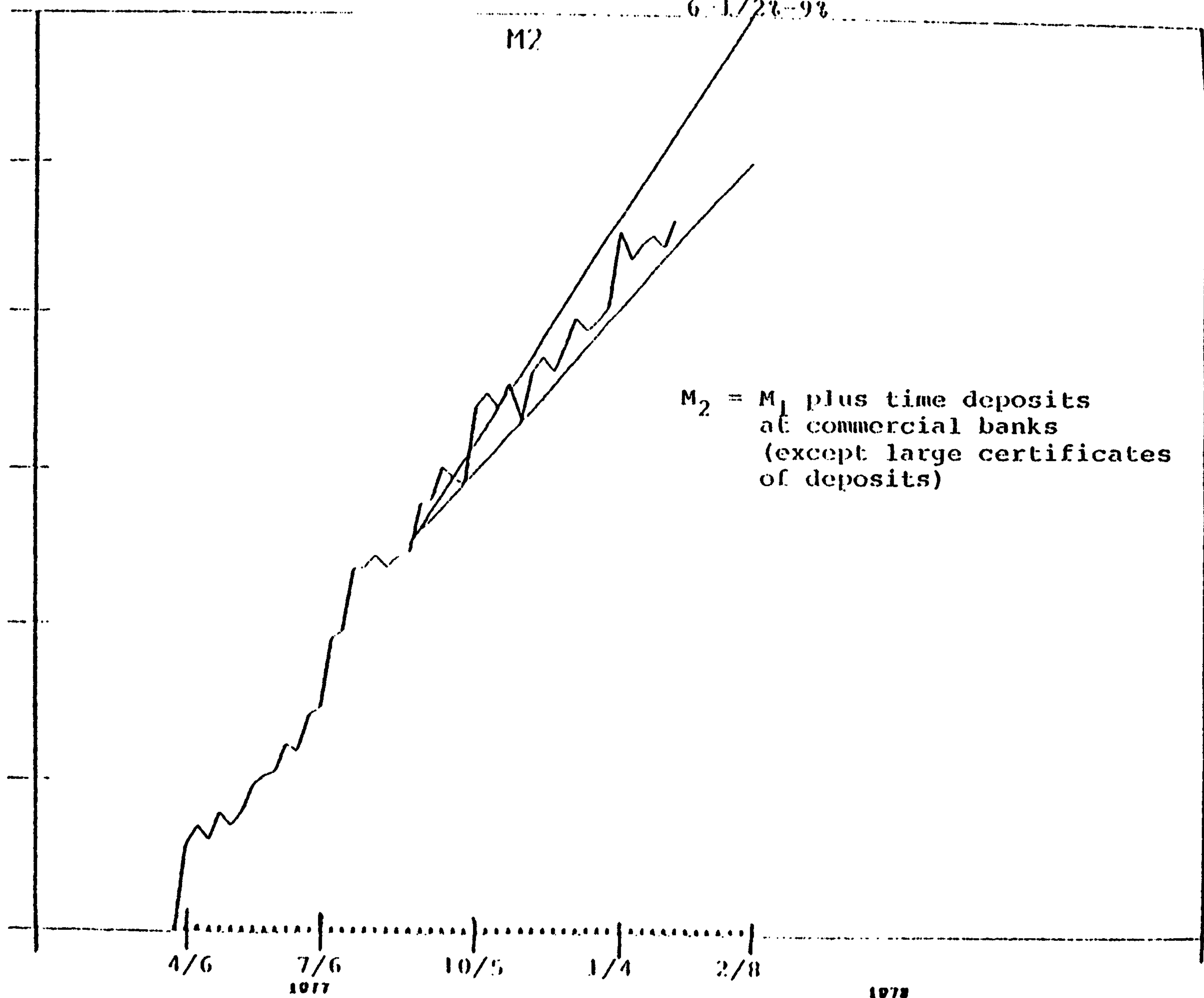
Growth of M2 Relative to Target Range

billions $



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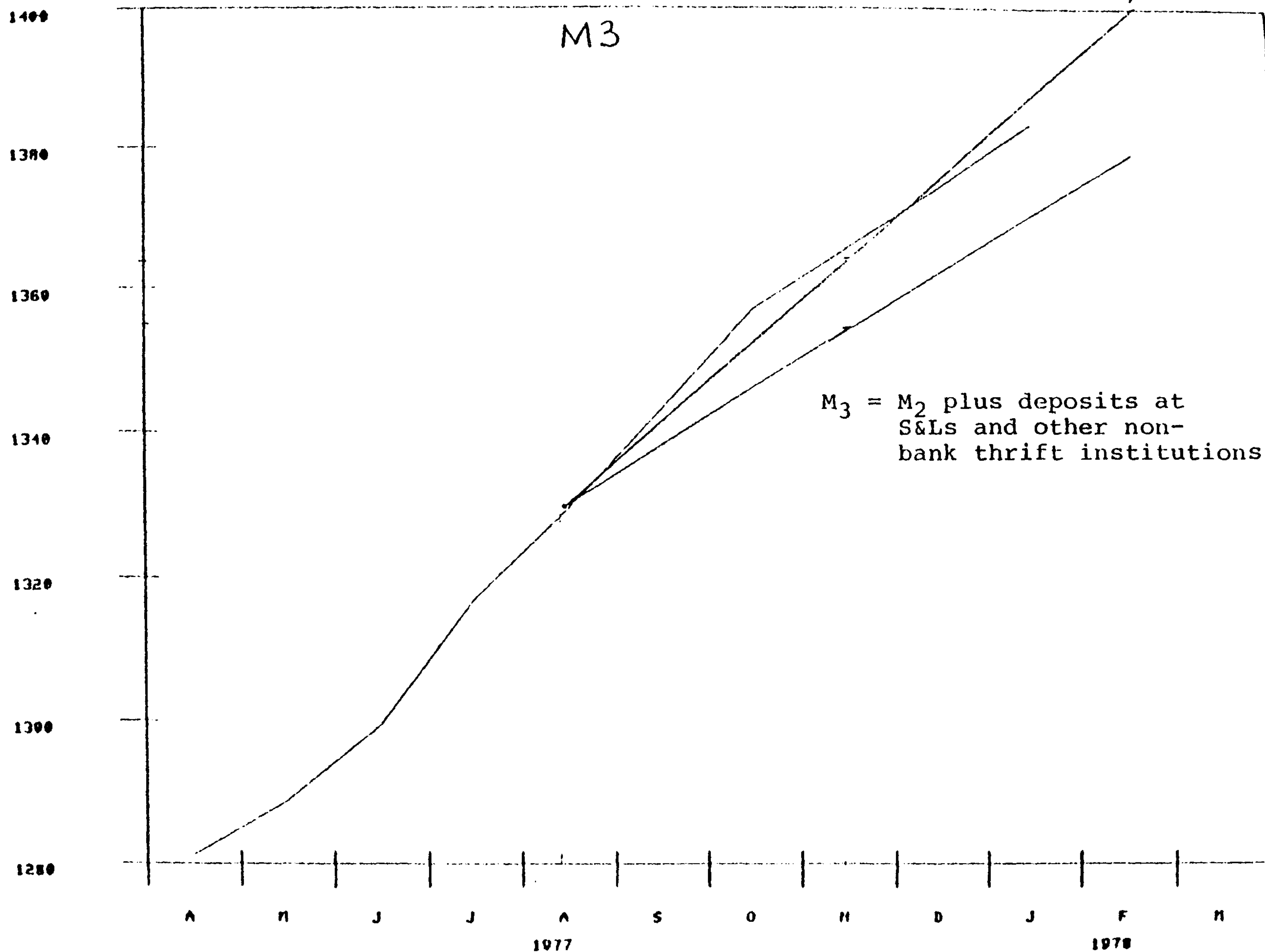

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