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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

December 13, 1978

MEMORANDUM FOR THE PRESIDENT

FROM: Charlie Schultze CLS

SUBJECT: Background for the Meeting of the Quadriad on December 14

Economic growth will be slowing next year, as it must to bring inflation under control. Achieving a "soft landing" and avoiding a recession will be difficult. It is therefore especially important to coordinate monetary and fiscal policies.

Chairman Miller is undoubtedly under substantial pressure from within the Fed to tighten monetary policy further in response to adverse news about current price developments, or to indicators of real growth that are continuing to show considerable near-term strength. It is important to impress upon him:

-- that the 1980 budget will indeed be tight, meaning that fiscal policy will be taking more of the burden of restraint.

-- that you are committed to the long pull in the battle against inflation and making good progress in implementing the voluntary program.

-- that too much monetary and fiscal restraint, and a recession next year, would make it politically difficult for you to persist with stringent budgetary policies.

It should be made clear that the Administration fully recognizes that the acceleration of inflation, and the depreciation of the dollar required rising interest rates during much of 1978 and that neither the domestic nor the

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international situation will permit them to decline in the near future. Nevertheless, adding further tightening to that which has already occurred, particularly since October 31, would threaten the "soft landing" we all want.

Attached is a proposed agenda for the meeting which I have circulated to Chairman Miller and the others who are attending. The following is an overview of economic developments and the outlook as background for this discussion.

I. Recent Economic Developments and the Outlook

A. Recent Developments -- An Overview

The revised estimates for real GNP growth in the third quarter show it to be 3.4 percent (annual rate). It now appears that the current quarter will be stronger -- possibly over 4 percent. Furthermore, current indicators suggest that this momentum will carry over into the early months of next year.

- In retail markets, a substantial upward revision in retail sales for October and a further large rise in November imply a resurgence in retail trade. New car sales remain fairly flat, but overall consumption spending is likely to show substantial strength in the fourth quarter.

- Housing starts are holding up well, remaining on a plateau of about 2 million units through October. Sales of new homes began to taper off very slightly during the third quarter.

- New capital goods orders, excluding defense, have risen strongly for the past three months and are now more than a third above a year ago. Construction contracts have also been decisively stronger in the three months ending in October. Consequently, the results of the Commerce Department's survey of spending plans, which show little or no real growth of capital spending early next year, are puzzling.

- Industrial production continues to rise more rapidly than GNP. Its rate of growth over the three months ending in October was 6.7 percent at an annual rate; in November, industrial production probably rose by 1 percent or perhaps more.

- Employment has increased remarkably in the past two months and, despite strong growth in the labor force, the unemployment rate dipped to 5.8 percent in October and remained there in November. The increase in total employment in nonagricultural establishments averaged over 400,000 persons per month during these two months. The opposite side of the coin, however, is the implication of relatively slow productivity growth in the fourth quarter.

B. The Outlook for Real Growth

The inter-agency forecast is currently in its final stage of development. It will probably show real growth over the four quarters of 1979 of a little over 2 percent, and positive in every quarter. Some modest strengthening in 1980 is likely if inflation moderates. Interest rates might then decline somewhat, and confidence would strengthen.

Our general outlook for 1979 is broadly consistent with the view of the Federal Reserve staff. However, the Congressional Budget Office staff is now tentatively forecasting a weaker economy, with slightly declining real output in the second half of the year. This view is shared by many private forecasters.

Thus, there is broad consensus that the pace of economic activity will slow next year; the question is how much. At the present time there is considerable momentum in the economy which is likely to carry over into the first part of next year. The areas clouded by uncertainty and the possibility of weakening later in the year are:

- business fixed investment, which we believe will slow somewhat but remain stronger than GNP as a whole. The signals are currently mixed.

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- consumption spending, which we believe will hold up reasonably well relative to income. However, in view of the current low level of the saving rate, the substantial debt burdens of households, and the possibility that more rapid inflation will create concern about the real value of savings, consumer spending could weaken more than we expect.

- housing is likely to taper off because of the substantial rise that has already occurred in mortgage interest rates. We believe the continuation of deposit inflows to thrift institutions and extensions of new mortgage loans will protect housing from the sharp drop that has occurred in past periods of tight money. But we are sailing in uncharted territory.

The task of slowing the economy gradually without tipping into recession is clearly delicate.

C. Price Developments

Price developments continue to be discouraging. Food prices at wholesale rose more slowly in November, but increases in the previous two months were very large. Meat supplies continue to be limited. We expect food prices at retail to rise about 8 percent next year.

Outside of food, price increases at both the wholesale and consumer levels have been running in the last six months at an annual rate of 8 to 10 percent -- somewhat faster than the rate of rise over the past 12 months. This recent acceleration may reflect both the growth of unit labor costs and anticipatory or "front loading" price boosts induced by the announcement of the anti-inflation program.

Business response to the program appears to be quite positive and, on the basis of extensive contacts, we believe that most businesses will abide by the price standards. Compliance by labor will be made more difficult to achieve if consumer prices accelerate. Private conversations with Fitzsimmons give reason for some hope -- but no certainty -- that the Teamsters settlement may come at or very close to the pay standards. That would be a major achievement, and it would increase greatly the chances of securing compliance in other large collective bargaining contracts next year.

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Price Changes at Annual Rates

	Latest Month	Last 6 Months	Last 12 Months
Producer Prices			
All finished goods	9.4	7.4	8.7
Food	7.6	6.6	11.2
Other	10.4	7.8	7.8
Consumer Prices			
All items	9.4	9.3	8.9
Food	9.9	9.0	11.4
Other	9.6	9.4	8.3

Note: Latest month is November for producers' prices and October for consumer prices.

In view of the strong likelihood of (a) continued pressures on food prices through next spring, (b) increased energy prices due to the anticipated OPEC price increase and the implementation of our own energy policy and (c) continued poor productivity growth which will raise labor costs, it will be very difficult to reduce the inflation rate to 6-1/2 percent by year end. For the year as a whole, inflation is likely to be somewhat above 7 percent, even with widespread compliance with the pay and price standards. Such a performance would, of course, be a substantial improvement over 1978.

The outlook for prices next year, however, cannot be improved significantly by tightening monetary and fiscal policy still further. Moderation of demand growth will assist in achieving compliance with the pay and price standards. But it cannot do the job alone. An outright recession would contribute only marginally more to slowing inflation than a moderate slowdown in growth. And an outright recession would make it extremely difficult to maintain a political consensus that fighting inflation must be the top priority of economic policy.

II. Financial Markets

Interest rates have risen sharply since the dollar defense package was announced on October 31. At that time, the discount rate was raised a full percentage point from 8-1/2 percent to 9-1/2 percent. The target for the Federal funds rate was also raised, and that rate moved quickly from 9-1/4 to 9-3/4 percent. Most other short-term rates followed the funds rate up. Since the November 22 meeting of the FOMC, the Federal funds rate has moved somewhat erratically in a 9-3/4 to 10 percent range.

Concern had been raised earlier in the fall that despite increases in interest rates -- which, even before the October 31 move had risen by about 2 percentage points since the beginning of the year -- monetary restraint was not "biting." This concern was the result of continued strong growth of all of the monetary aggregates through the third quarter. Since the middle of October, however, growth of M_1 (the narrowly defined money supply) and of M_2 (which includes time and saving deposits) has slowed substantially (see charts).

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In addition to this recent slowing of growth of the monetary aggregates, there has been a significant slowing of credit growth. New extensions of consumer installment credit peaked in June and have tapered off somewhat since then. The net increase in home mortgage debt outstanding levelled out in the first half of the year even though the dollar value of residential construction kept rising. Business loans at commercial banks have continued to grow rapidly, however. This largely reflects the fact that business investment in both capital goods and inventories is outstripping growth of internal funds.

Consequently, there is reason to believe that monetary restraint is nibbling if not biting. The response is probably occurring more gradually and with a longer lag than in previous periods of restraint. A continuation of this gradual restraint will be an appropriate component of moderation in overall growth. Pressing yet harder on the monetary brakes could weaken the economy more than we want later in 1979.

Recent Dollar Developments

By November 30, one month after our October 31 actions, the dollar had risen on a weighted average basis by 10.3 percent from its October 30 low. About three-fourths of this appreciation occurred during the first week following the announcement.

During the month of November, U.S. intervention purchases of dollars totaled $3.2 billion. The Japanese bought $1.2 billion, the Germans and Swiss about a half billion each. Total intervention purchases thus amounted to $5.6 billion. (This is confidential information and will not be published for some time.)

The dollar weakened somewhat in early December, and by December 12, it had fallen 1 percent below its November 30 level. Intervention was light during the period December 1-7, but became heavy on Friday, December 8, and heavier on Monday and Tuesday mornings. Markets calmed later on Tuesday and continued calm today. Total dollar purchases during the period December 8-12 amounted to just over $3 billion ($1.1 billion by the United States, about $1 billion by the Swiss, the rest by Germany, the United Kingdom, and Italy; Japan also entered the market on Tuesday).

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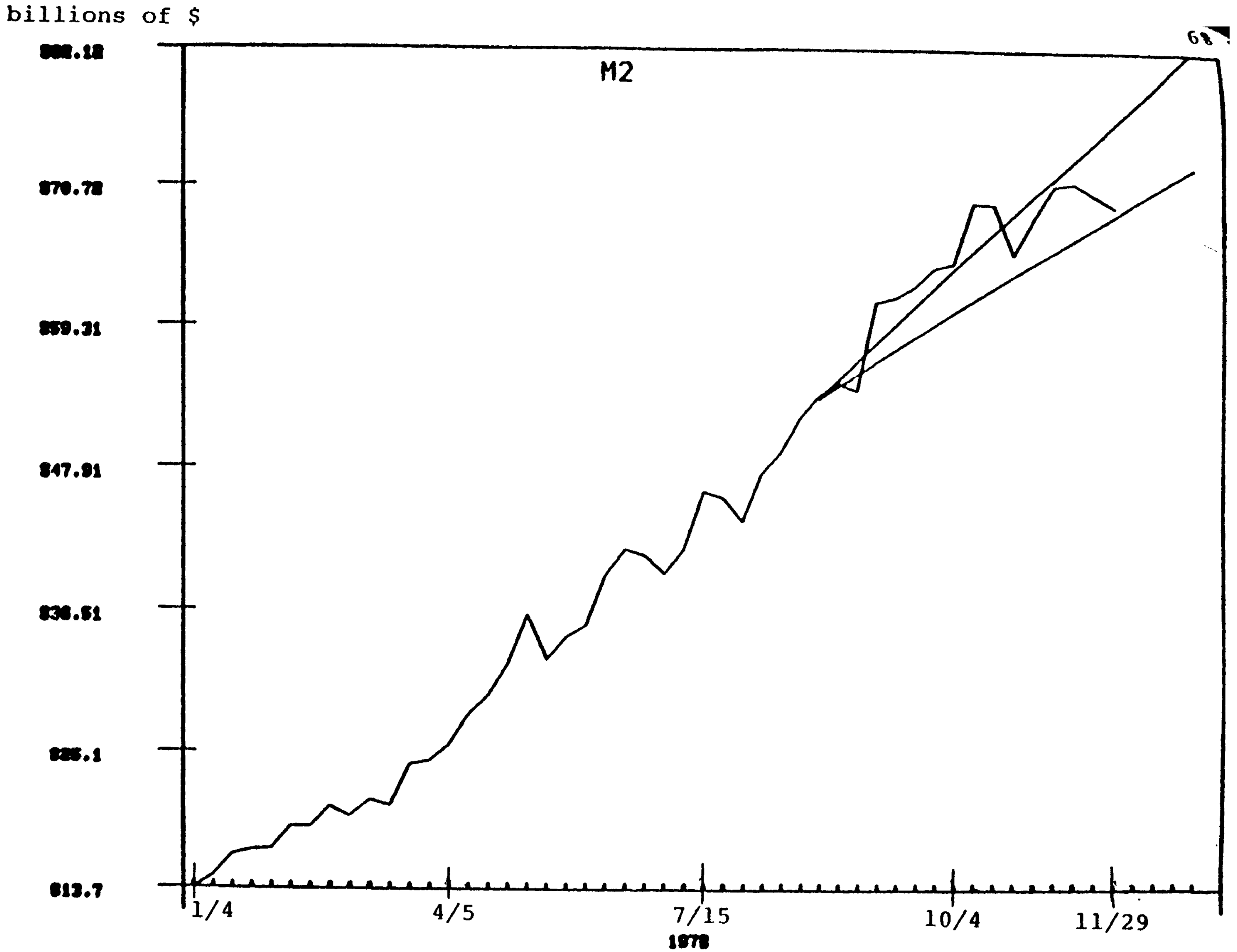
billions of $
M2
6%
870.72
859.31
847.91
836.51
825.1
813.7
1/4
4/5
7/15
10/4
11/29

We have no fully satisfactory explanation for the renewed downward pressure on the dollar. One hypothesis is that the appearance of data showing German reserve declines for November suggested to the market that German commitment to the dollar support program was half-hearted. More generally, the turbulence may reflect a "testing" of the commitment of the authorities to maintain support for the dollar.

U.S. intervention strategy has continued to be to resist downward dollar movements strongly and not resist upward movements -- though small sales of dollars on rising markets have occurred in order to acquire balances for swap repayments.

Attachments

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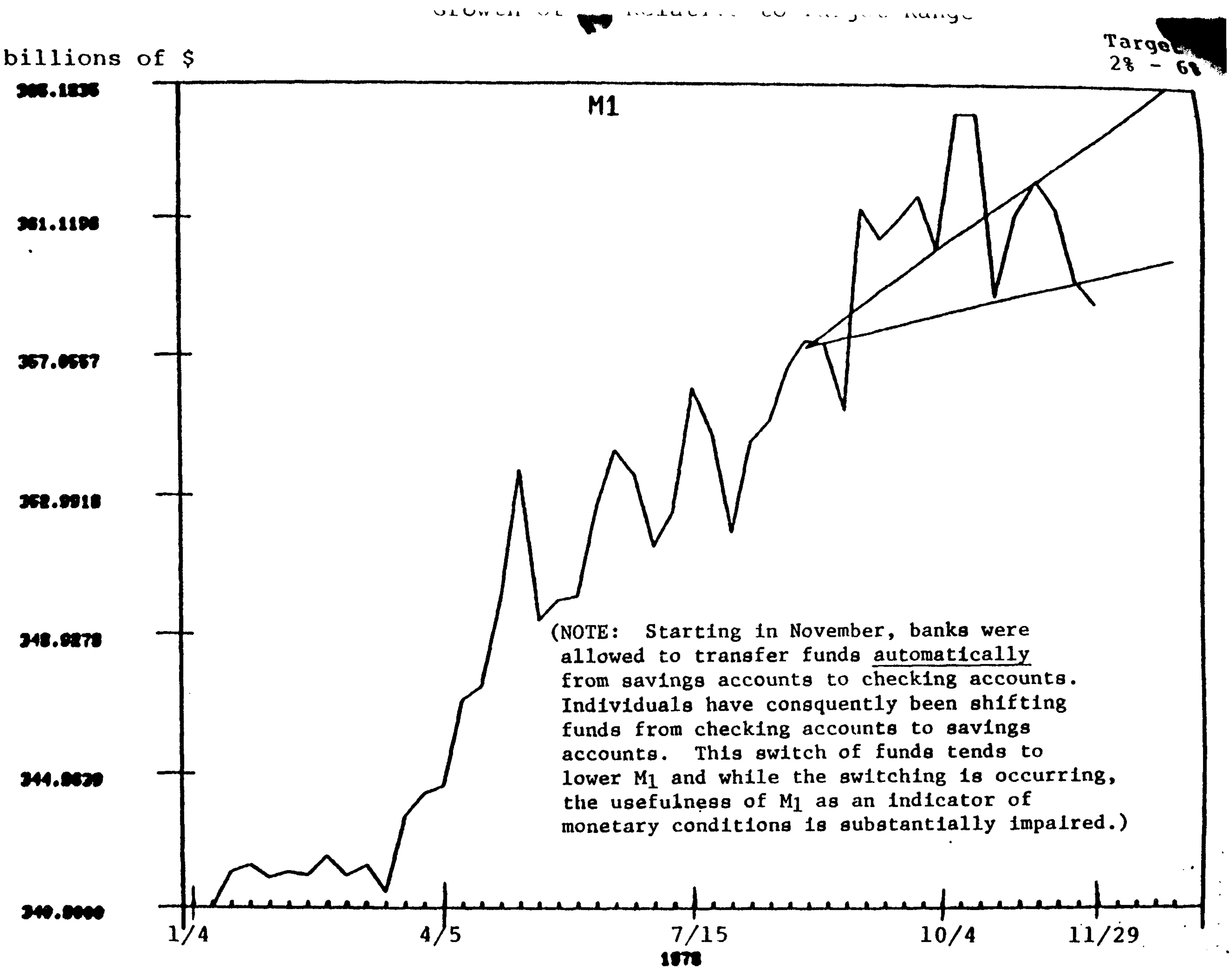
billions of $
M1
2% - 6%
365.1836
361.1196
357.0557
352.9918
348.9278
344.8639
340.8000
1/4
4/5
7/15
10/4
11/29
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(NOTE: Starting in November, banks were allowed to transfer funds automatically from savings accounts to checking accounts. Individuals have consquently been shifting funds from checking accounts to savings accounts. This switch of funds tends to lower M_1 and while the switching is occurring, the usefulness of M_1 as an indicator of monetary conditions is substantially impaired.)