



Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 17, 1979

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Midyear Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
G. William Miller, *Chairman*

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INTRODUCTION

The Problem Posed by Accelerated Inflation

The performance of the economy this year has been distinctly unsatisfactory. Starting from a base of rapid inflation and the lagged effects of the 1977-78 dollar depreciation, a series of unexpected events this year has disrupted economic activity and intensified inflationary pressures. These events have included labor disputes, severe weather, and adverse agricultural supply conditions, but the most disturbing development, in terms of its implications for future economic performance, has been an enormous increase in the price of imported oil. The adjustment to this oil price shock poses major problems for governmental policy and represents a serious setback to progress toward the longer-range goals enunciated by the Full Employment and Balanced Growth Act.

Increased energy costs have greatly aggravated our inflation problem. In February, when the Board submitted its first report to the Congress under the Humphrey-Hawkins Act, it was anticipated that oil prices would rise moderately this year, entailing some small upward pressure on the general level of prices. However, the developments since then--including the effects of the Iranian revolution and the latest OPEC decisions--are generating major increases in the prices of imported oil and, consequently, in the prices of other energy sources as well.

The inflationary effects of the energy price increases could, in principle, be offset if other prices on average declined or at least rose less than they otherwise would have. There will be some tendency

in this direction as the diversion of a larger share of spendable income to energy results in a reduction in demand for other goods and services. In recent years, however, nominal wages and prices have not generally exhibited much flexibility in a downward direction; rather, relative price adjustments typically have occurred in the context of an overall rise in the average level of prices as economic units attempted to avoid losses of real income.

It also must be recognized that the rise in the relative price of imported oil involves a transfer of real income and wealth from the U.S. public to foreign oil producers. This loss will, in turn, have at least temporarily depressing effects on domestic economic activity as the demand by foreign countries for U.S. exports expands only with a lag.

Thus, over the next year or two, it appears that exogenous forces will be causing both intensified inflationary pressures and downward adjustments in the demand for goods and services. Clearly, the problems confronting monetary policy, and macroeconomic policy generally, have been made much more difficult. If monetary policy encourages a more rapid expansion of money and credit in an attempt to strengthen aggregate demand, it risks building even greater inflation into the economic system through the aggravation of the price-wage-price spiral. On the other hand, if no account is taken of added upward price pressures in the formulation of policy, the risks are increased of deepening or lengthening the transitional downward adjustments in real economic activity that now appear in train.

The Federal Reserve remains firmly resolved to direct its policies toward a reduction in the rate of inflation. But in the current circumstances, a combination of added inflationary pressures, a slowing of economic activity, and a probable increase in unemployment may delay progress toward price stability. This problem highlights the need to solve some of the major structural defects in our economy. It is important that we begin to break down the barriers, both private and governmental, that inhibit innovation and competition and thereby contribute to the inflationary bias of the economy. We must ensure that our system of taxation does not discourage the saving and capital investment necessary to reverse the deterioration of productivity performance observed in recent years.

And it is absolutely essential that this nation develop an energy program that reduces its reliance on foreign sources of energy.

CHAPTER 1

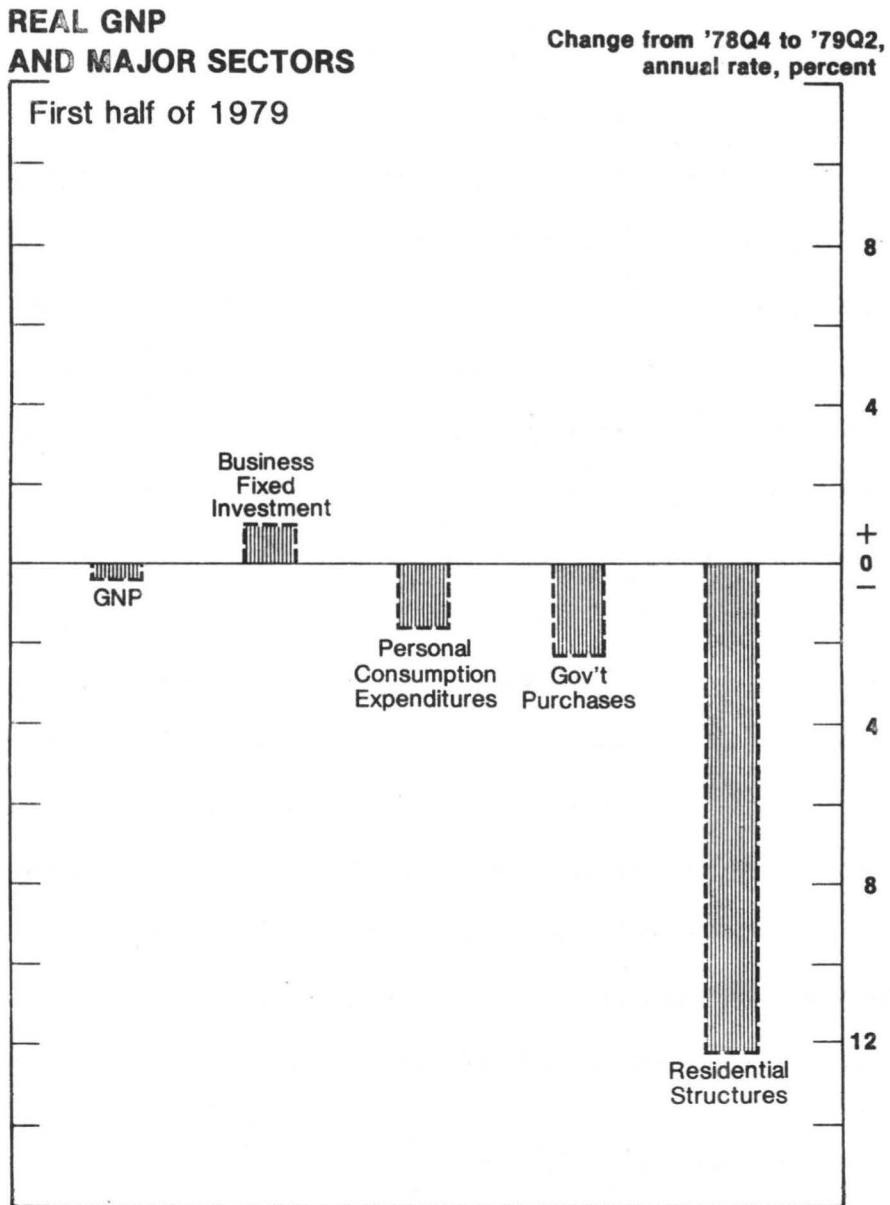
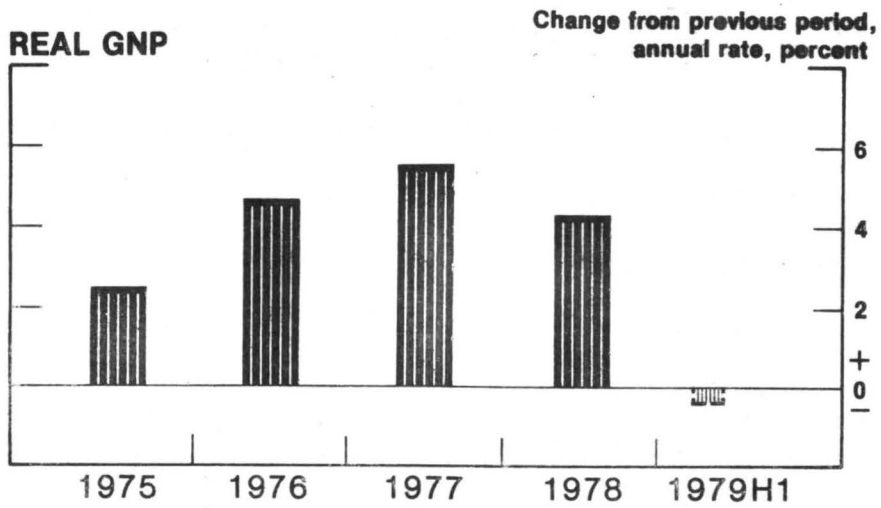
**"a review and analysis of recent developments
affecting economic trends in the nation"**

**Section 108(a) Full Employment and
Balanced Growth Act of 1978**

SECTION 1. ECONOMIC ACTIVITY DURING THE FIRST HALF OF 1979

Official Commerce Department data for the second quarter of this year have yet to become available, but it appears likely that they will indicate that real gross national product declined somewhat after advancing only marginally in the first quarter. The sluggishness of overall economic activity thus far in 1979 stands in marked contrast to the 4-1/4 percent gain in real GNP registered in 1978. Although the events of the first half do not in themselves compel a conclusion that the economy has entered a recession, the pause in growth does represent a significant interruption of the relatively long cyclical upswing that began early in 1975.

The sluggishness of economic activity since the beginning of the year is partly a consequence of the rising inflationary pressures of 1978 but is also traceable in considerable measure to special exogenous factors--as distinguished from such problems as widespread inventory overhangs or other fundamental imbalances or distortions, which have characterized the terminal stages of previous cyclical expansions. During January and February, production in many parts of the country was disrupted by unusually inclement weather; the construction industries were especially hard hit, but other sectors also were affected. In the early spring, labor contract disputes in the trucking, airline, and rubber industries interfered with activity in many areas of the economy. However, a more pervasive--and less transitory--influence on the course of the economy this year has been the sharp rise in energy and food prices. The resultant acceleration of inflation has had a serious impact on real disposable personal income and has had a broadly adverse effect on consumer spending attitudes.

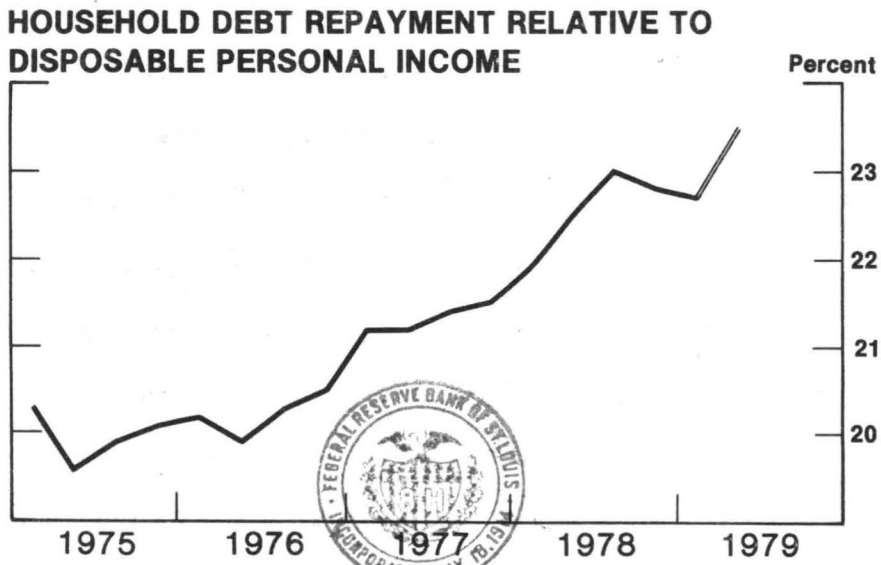
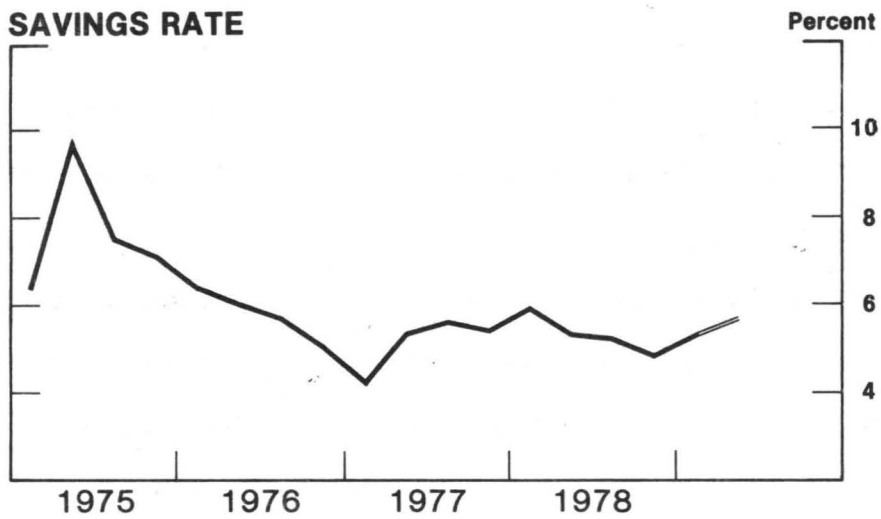
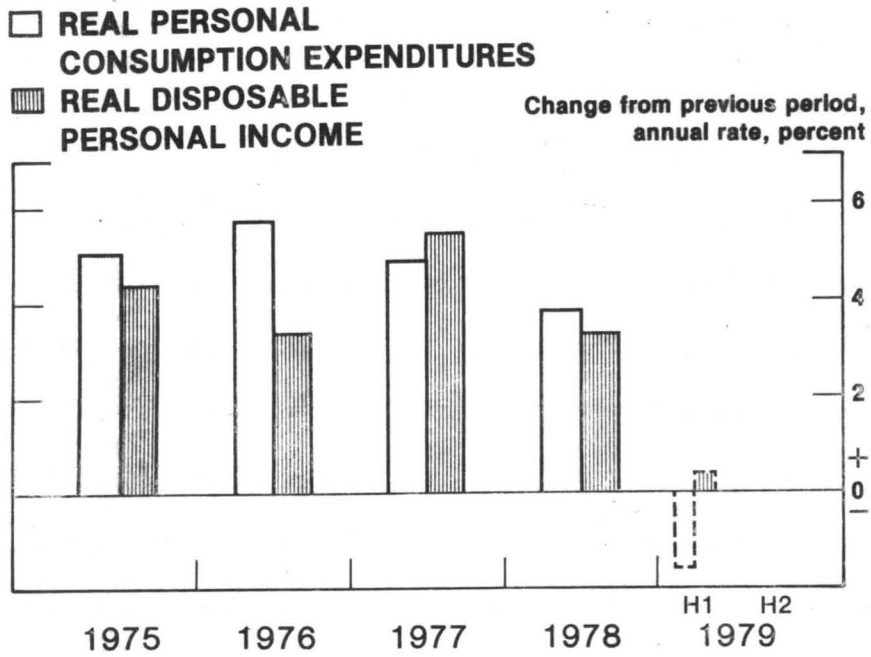


Data for the first half of 1979 are partially estimated.

Personal Consumption Expenditures

Personal consumption expenditures account for almost two-thirds of GNP, and their weakness during the past two quarters has been an important element in the flatness of overall economic activity. Some softness in consumer demand was not unexpected following the surge in spending during the final months of 1978. However, retail sales in real terms exhibited a clear downward trend through the first six months of this year, with the June level sharply depressed by a drop in auto sales. Rising gasoline prices and uncertainty about gas supplies initially had a mixed impact on auto sales: sales of large, fuel-inefficient cars plunged, while sales of smaller domestic and foreign cars recorded an offsetting increase. Most recently, however, the weakness in auto sales has broadened; this may in part reflect supply constraints as domestic makers shift facilities to the manufacture of small cars, but there appears to have been a general falloff in demand during June.

The weakness in consumer spending has extended beyond the market for motor vehicles, and it appears symptomatic of broader pressures on household finances. The personal savings rate reached historically low levels last year, so that a further rise in the spending propensities of households seemed unlikely. Moreover, the record indebtedness and debt repayment burdens of the household sector suggested that consumers might manifest, on the whole, a more cautious spending behavior. These influences have been substantially reinforced this year by the effects of accelerated inflation on the real disposable income of households. The budgets of many families have been squeezed by the upsurge in the prices of food, fuel, and other basic necessities. This has increased their uneasiness about their personal financial positions and contributed to a noticeable deterioration in consumer sentiment, as measured by most surveys.



Date for the first half of 1979 are partially estimated.

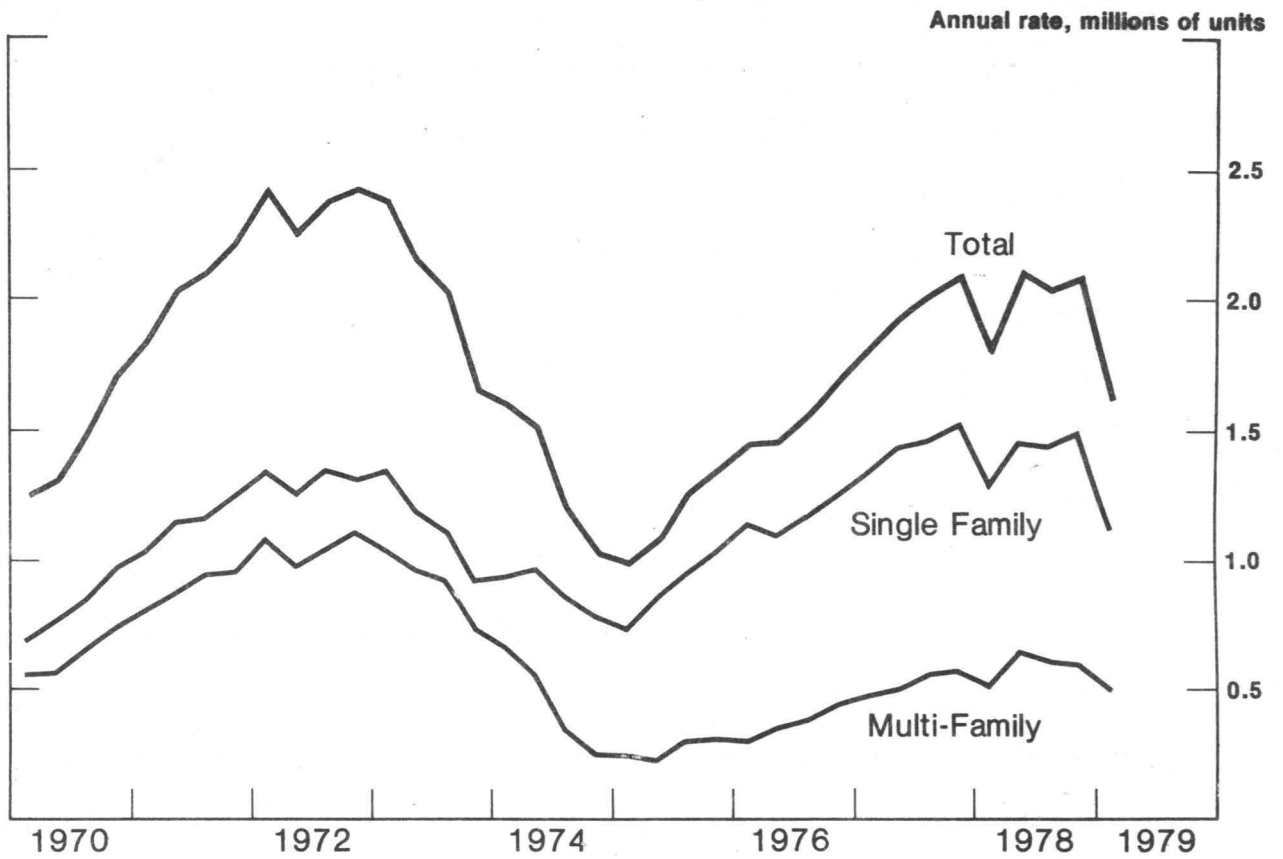
Residential Construction

As noted above, adverse weather depressed building activity during the opening months of 1979. Private housing starts, which had consistently run at an annual rate of just over 2 million units since a similar weather-related disruption the previous winter, fell to a 1-1/2 million rate in January and February. However, as construction picked up again in subsequent months, the rate of housing starts remained below the 1978 pace, averaging about 1-3/4 million units in the March-May period. Thus, there has been a moderate, but significant, downturn in residential building since the end of 1978.

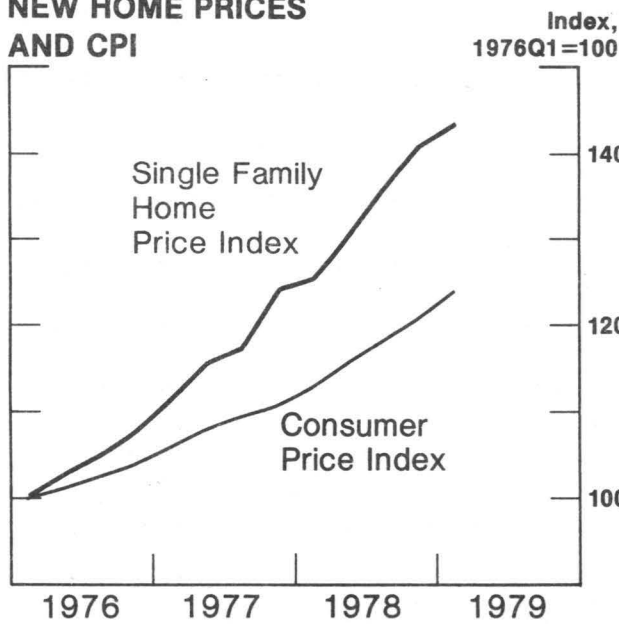
Several fundamental economic and demographic factors have continued to bolster the demand for housing--especially single-family dwellings and condominium apartments. One of these is the widespread view, based in large part on the actual experience of the past several years, that houses are a good hedge against inflation and therefore an attractive investment apart from the shelter services they provide. Another is the movement of a large portion of our population into the age group in which the rate of initial home purchases historically has been relatively high.

Nonetheless, other underlying supply and demand influences have acted to constrain the construction of new housing units. The rise in interest rates and the general tightening of credit markets over the past year have been particularly important factors. Homebuilders have found that lenders are charging substantially higher rates for land development and construction credit, and that they are showing greater selectivity in the projects they will finance. At the same time, potential builders and homebuyers have been affected by increasingly stringent terms on mortgage loans and, in some localities, by shortages of mortgage credit

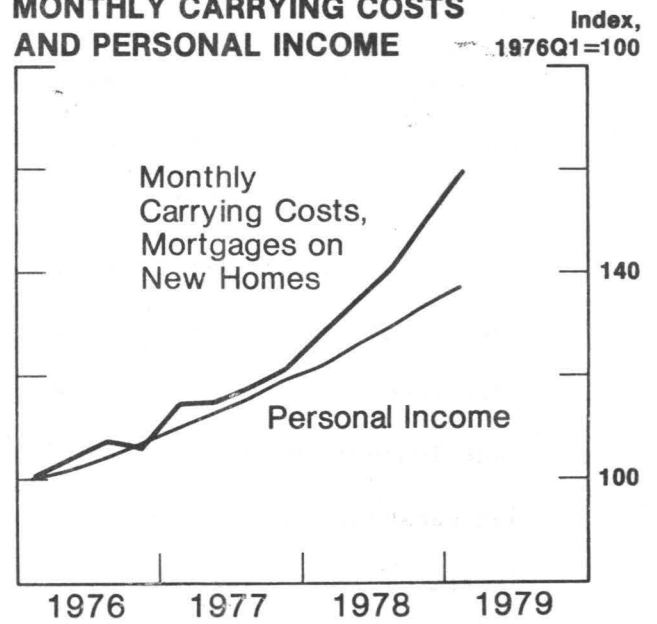
PRIVATE HOUSING STARTS



NEW HOME PRICES AND CPI



MONTHLY CARRYING COSTS AND PERSONAL INCOME



caused by usury ceilings. The combination of inflated house prices and record mortgage rates implies costs of homeownership that bulk large relative to the current incomes of many families. This fact has deterred some potential homebuyers and caused lending institutions to reject some credit applications. It also has given impetus to the development and use of graduated payment mortgages, which are designed to alleviate the cash-flow problems encountered in the early years of the traditional level payment loan in an inflationary environment; however, these instruments have not thus far attained an important role in the mortgage market.

In recent months, localized shortages of gasoline and generally uncertain prospects about future fuel prices and supplies likely have been another factor deterring home purchase and prompting a reassessment of building plans. Still, unit sales of new and existing single-family houses have declined only moderately this year from the record pace of 1978. Stocks of unsold single-family units, while perhaps less comfortable than a few months ago when demand was stronger, do not appear to be a significant depressant on new building activity. Nor, in major contrast to the last--and severe--housing cycle, is there a substantial overhang of multifamily rental and condominium units for rent or sale.

Business Investment

Business firms have continued to pursue generally cautious spending policies, but their investment in inventories and fixed capital nevertheless appears to have expanded significantly in real terms during the first half. Despite this further advance in business spending, there is little evidence to date of the development of broad imbalances between stocks or productive capacity and final sales that might seriously impede the resumption of economic expansion.

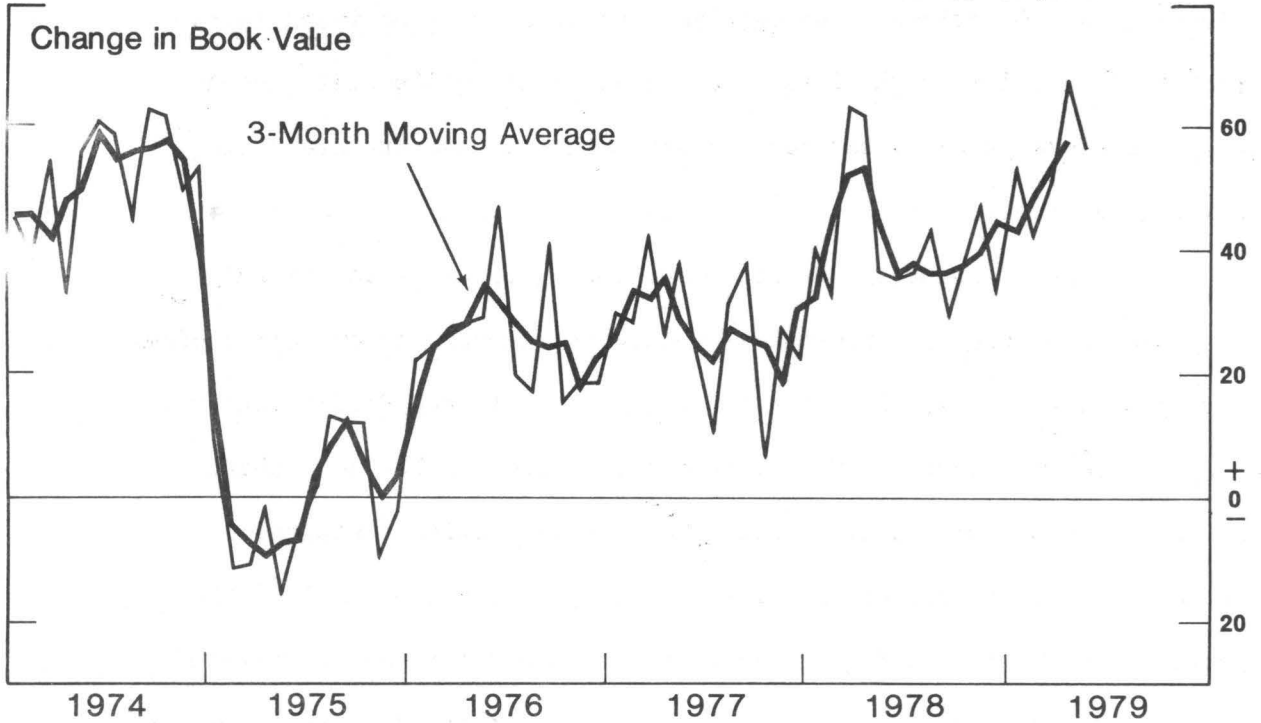
The surge in final sales in the last quarter of 1978 drew down stocks in many lines to the point where it seemed quite likely that some rebound in inventory investment would occur in ensuing months. However, the book value of business inventories increased very rapidly in the early part of 1979, causing some concern that the unexpected strength of demand at year-end and the acceleration of inflation might have prompted a speculative hoarding of commodities--perhaps reminiscent of 1973-74. These concerns abated as it became clear that the accumulation of inventories was relatively well balanced across sectors and across levels of processing and that much of the acceleration in the rise of book values reflected nothing more than the replacement of merchandise bought earlier at lower prices with stocks acquired at current, inflated prices. GNP accounts data for the first quarter in fact indicate that, while there was an appreciable pickup in real inventory investment, the rate of accumulation remained moderate.

Inventory data for the second quarter are fragmentary. Book-value figures showed exceptionally high rates of accumulation in April--especially at manufacturing concerns--but this evidently was attributable in part to delays in shipments caused by the labor dispute in the trucking industry. Inventory growth, again on a book-value basis, slowed in May; however, it appears likely that real inventory investment for the second quarter as a whole was considerably above the pace of the first quarter.

Nevertheless, inventories appear generally to have remained in reasonably comfortable alignment with sales. There are, of course, exceptions, the most notable being in the motor vehicle sector. With the drop in demand for large cars this spring, dealers' stocks became very sizable in relation to the current pace of sales. Stocks of smaller

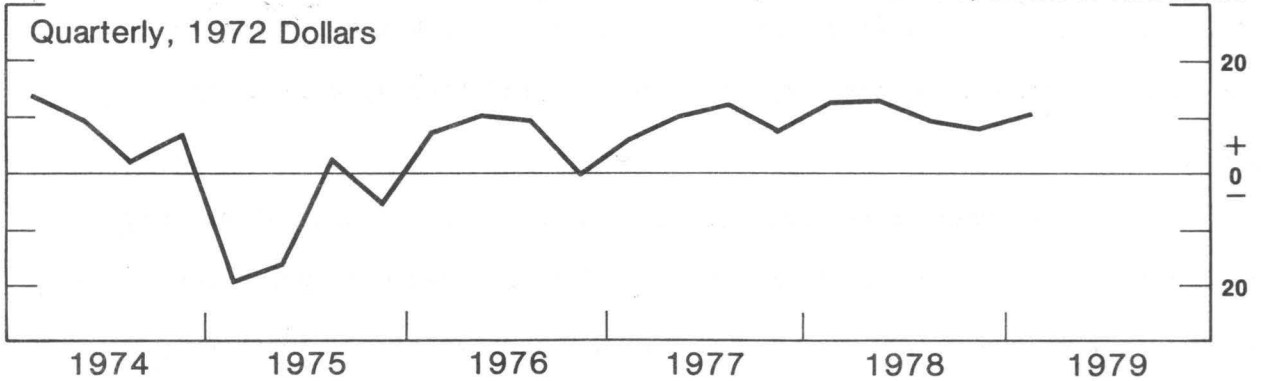
MANUFACTURING AND TRADE INVENTORIES

Annual rate, billions of dollars



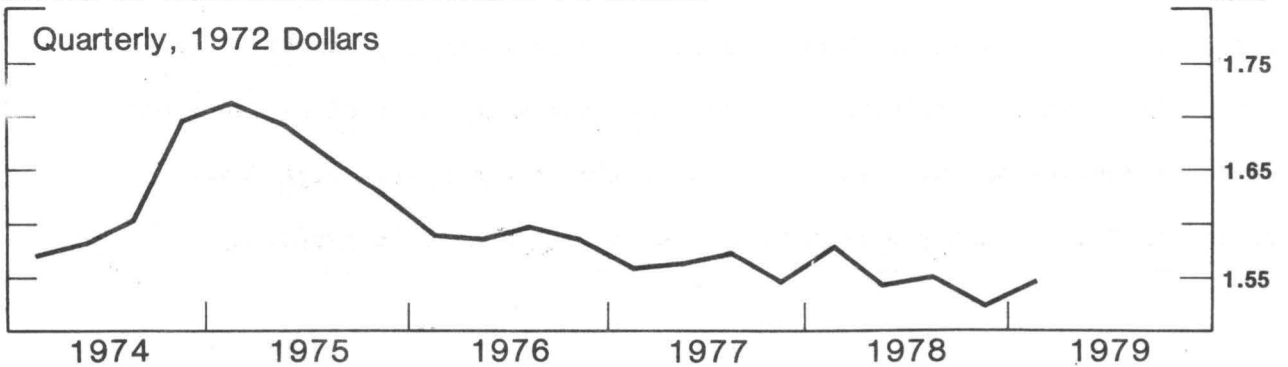
CHANGE IN BUSINESS INVENTORIES

Annual rate, billions of 1972 dollars



RATIO OF BUSINESS INVENTORIES TO SALES

Ratio



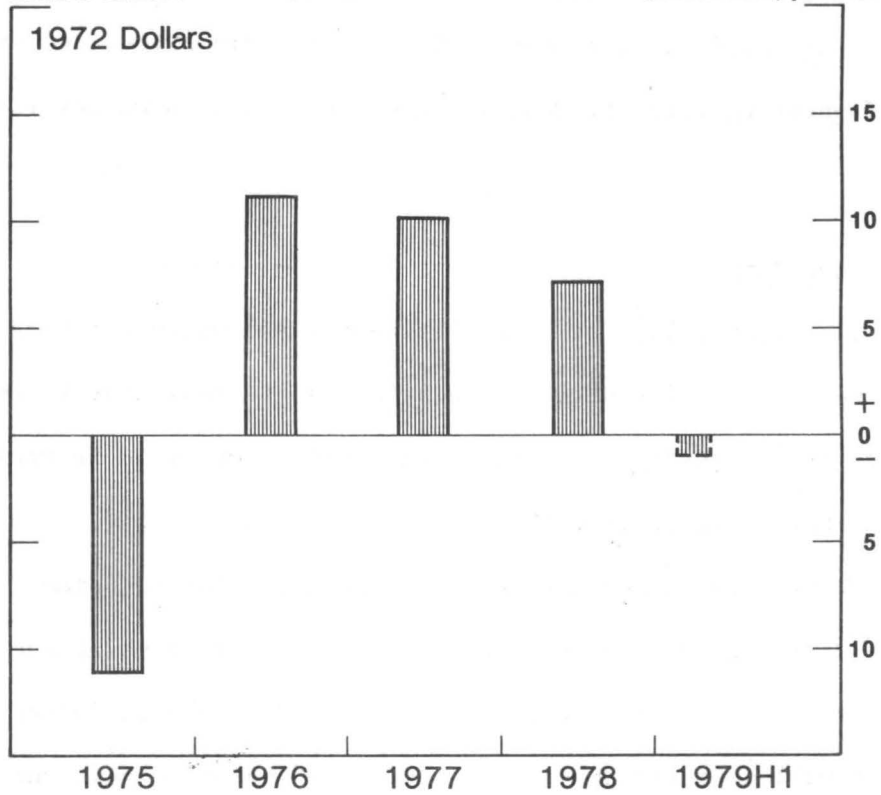
cars, in contrast, have been very lean in recent months, and customers desiring particular models and features sometimes have encountered long delivery lags. On balance, the aggregate ratio of real business inventories to real sales in the first quarter was well in line with recent norms, but there probably was some deterioration in the picture during the second quarter.

Business spending for new plant and equipment rose strongly during the first quarter, providing substantial impetus to overall economic activity; however, available evidence suggests that some decline occurred during the second quarter. The first quarter surge reflected a sharp rise in equipment purchases. Outlays for transportation equipment--especially airplanes and automobiles--accounted for a good deal of the strength. During the spring, outlays for equipment apparently retraced their earlier advance, owing in part to delays in shipments caused by the labor disputes in trucking. In contrast, spending on nonresidential structures lagged in the first quarter, as the adverse weather conditions interfered with building activity, but then snapped back smartly in the spring.

An important factor bolstering demands for fixed capital has been the higher rates of industrial capacity utilization that have prevailed since the latter part of 1978. Slower growth of industrial production has resulted in a slight decline in utilization rates, but the rates have remained at levels that have been associated in the past with periods of strong investment demand. Despite deep cutbacks in auto production, capacity utilization in manufacturing last month averaged about 85 percent--only three percentage points below the peak of 1973 and a fairly high level historically. Capacity utilization rates in the materials producing

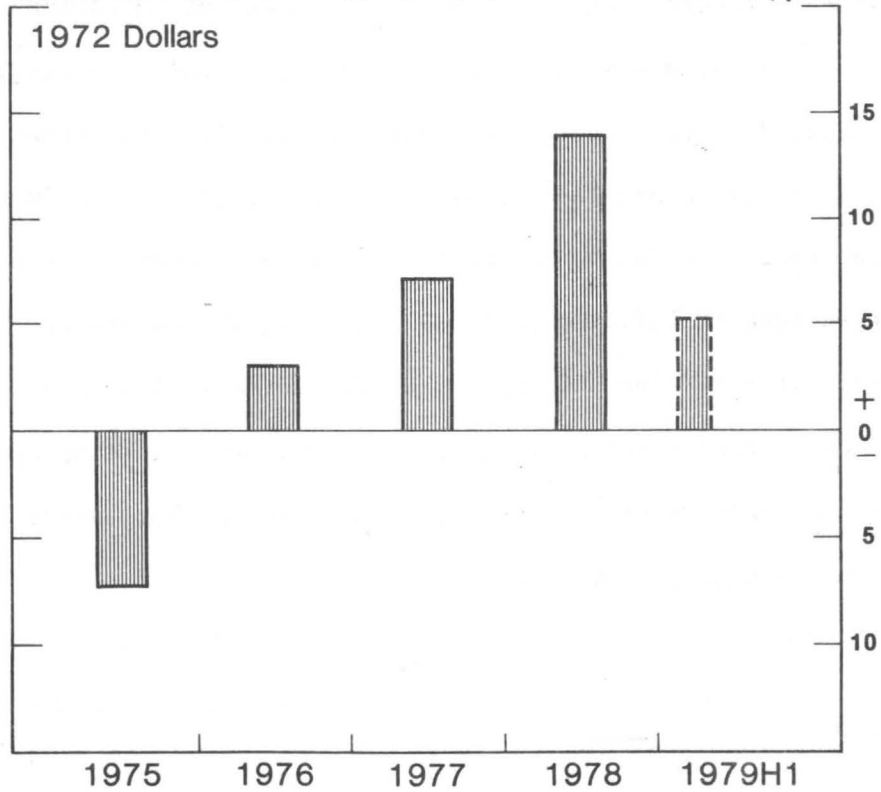
REAL BUSINESS FIXED INVESTMENT PRODUCERS' DURABLE EQUIPMENT

Change from previous period,
annual rate, percent



NONRESIDENTIAL STRUCTURES

Change from previous period,
annual rate, percent



Data for the first half of 1979 are partially estimated.

industries are not, on average, as close to the 1973 peaks. However, that period was marked by extraordinary pressures on production facilities caused by a worldwide boom in demand for basic commodities, and by normal standards operating rates currently are quite high in some materials sectors.

Government Spending

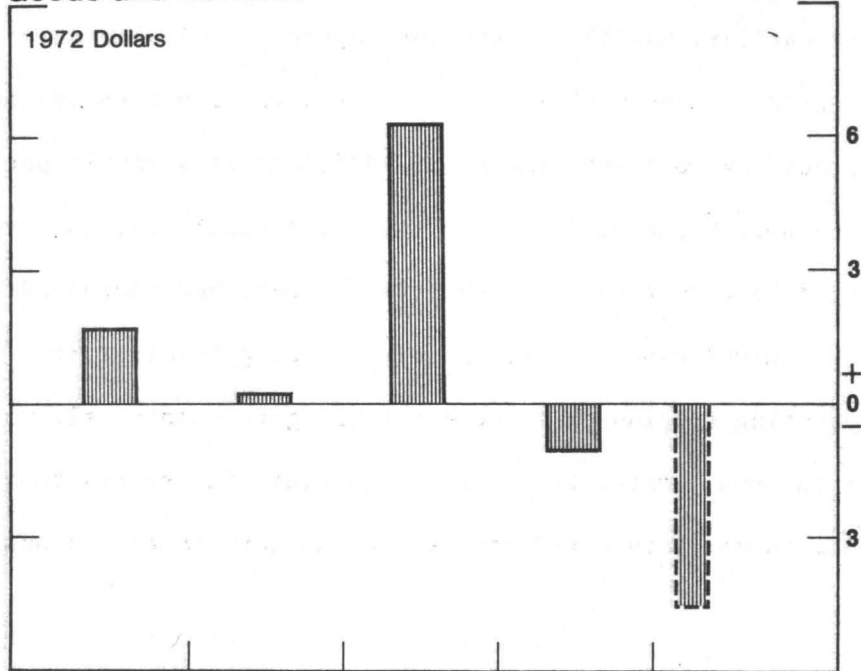
Budgetary policy at both the federal and state and local levels of government has continued to be characterized by restraint in spending. Indeed, government outlays for goods and services declined in real terms during the first half of 1979.

Federal purchases had fallen slightly, after adjustment for inflation, during 1978, and declines were recorded in each of the first two quarters of this year. Total federal expenditures--including transfer payments as well as outlays for goods and services--have been running just a bit higher in nominal terms than had been anticipated in the administration's budget plans. However, the impact of inflation on incomes has resulted in considerably stronger tax receipts than were projected, so that the budget deficit has been substantially smaller than expected.

At the state and local level, weather-related curtailments of construction reduced spending in the first quarter. However, the subsequent rebound in building activity was sluggish and may be indicative of a tendency to defer further capital expenditures following a surge last year. Moreover, states and localities also have been limiting spending by holding down employment: the number of workers on their payrolls in June was about the same as one year earlier.

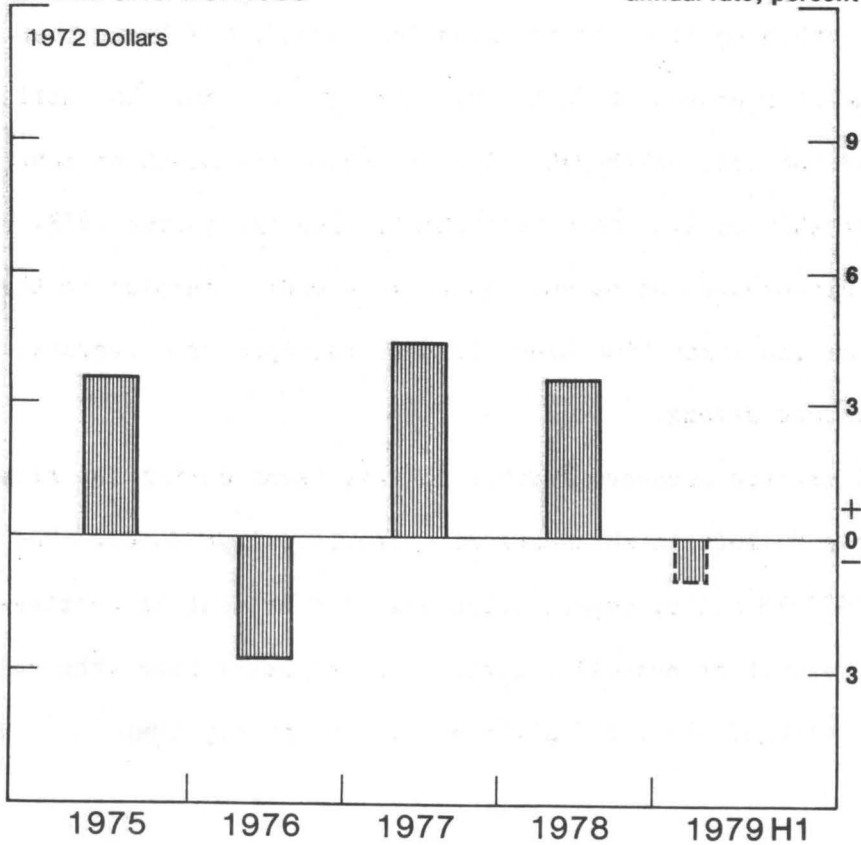
Federal Government Purchases of Goods and Services

Change from previous period,
annual rate, percent



State and Local Government Purchases of Goods and Services

Change from previous period,
annual rate, percent



Data for the first half of 1979 are partially estimated.

The growth of the economy after 1975, combined with tax rate increases enacted earlier, had led to the development of sizable surpluses in the budgets of many states. This pattern was reversed in the past year. Numerous tax cuts were passed in 1978, and as a result personal tax receipts were 5 percent lower in the first quarter of this year than in same period last year--even though the tax base had increased 16 percent. With nominal expenditures therefore rising relative to receipts, the operating surplus of state and local governments fell to \$3.8 billion, at an annual rate, in the first quarter; it appears that the operating budgets may have moved into slight deficit in the second quarter.

International Trade

The large decline in the exchange value of the dollar in 1977 and 1978 has enhanced foreign demands for U.S. exports. This, along with a relative strengthening of economic expansion abroad, has brought about a distinct trend of improvement in the U.S. trade position. The nation's merchandise trade deficit--although quite variable from month to month--has been considerably smaller this year than on average during 1978. Moreover, the current-account balance edged into modest surplus in the first quarter for the first time since 1976 as receipts from overseas investments remained strong.

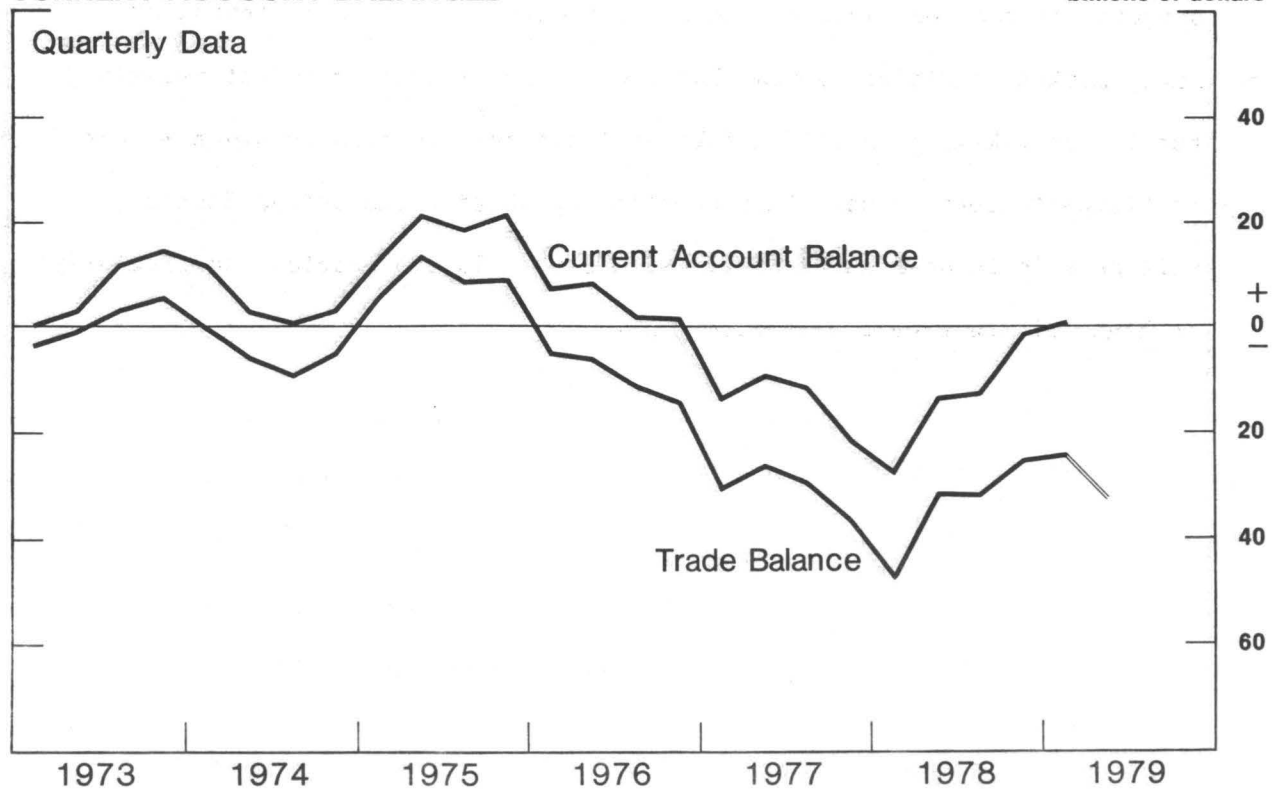
Total exports advanced further in real terms during the first quarter despite a falloff in shipments of agricultural products. The impact of the 1977-78 dollar depreciation was also evident in continued relatively slow growth of non-oil imports. On the other hand, the volume of oil imports averaged about 9.3 million barrels per day (MMB/d) during

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



U.S. MERCHANDISE TRADE AND CURRENT ACCOUNT BALANCES

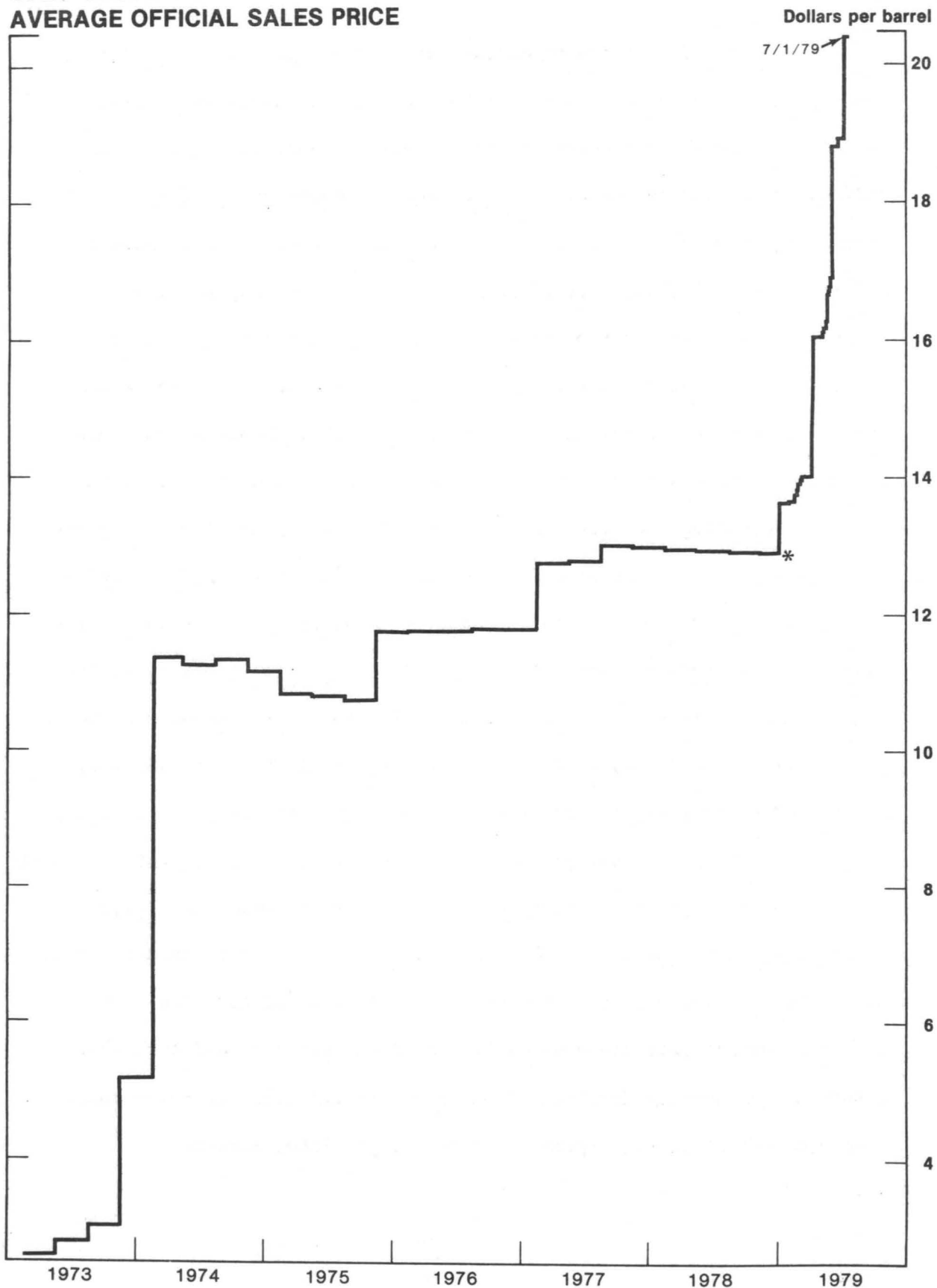
Seasonally adjusted, annual rate, billions of dollars



the first three months of the year as compared to an average of 8.7 MMB/d during 1978. In April and May the trade deficit widened as exports remained at about their first-quarter level while the value of both oil and non-oil imports advanced. A fall in the quantity of oil imported to 8.7 MMB/d in April and May was more than offset by price changes that began to reflect the OPEC price increases and surcharges. The unit value of imported oil in May was 22 percent above its level in the fourth quarter of 1978.

The improvement in the U.S. trade and current accounts this year has helped to bolster the private demand for dollars in foreign exchange markets. The dollar rose almost 5 percent, on a trade-weighted average against other major currencies, during the first five months of 1979--even while the United States and other governments unwound the heavy official intervention of late last year. Over the past month, however, the dollar has come under downward pressure; despite official support, it has lost much of the earlier gain. A relative firming of money market conditions abroad has been a factor in this recent weakness, but is not likely in itself a full explanation. Foreign exchange market participants seem to have been questioning whether the United States will be able to deal successfully with its inflation problem, particularly in light of the recent oil price jolt.

OPEC CRUDE OIL: AVERAGE OFFICIAL SALES PRICE



Note: Average price includes surcharges.

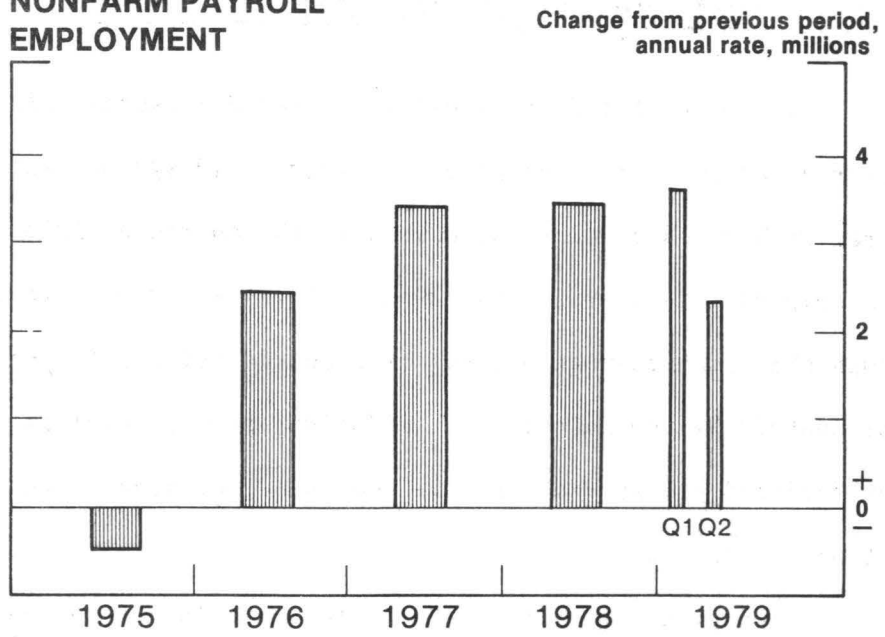
* Data are quarterly through 1978 and daily for selected dates thereafter.

SECTION 2. EMPLOYMENT AND UNEMPLOYMENT

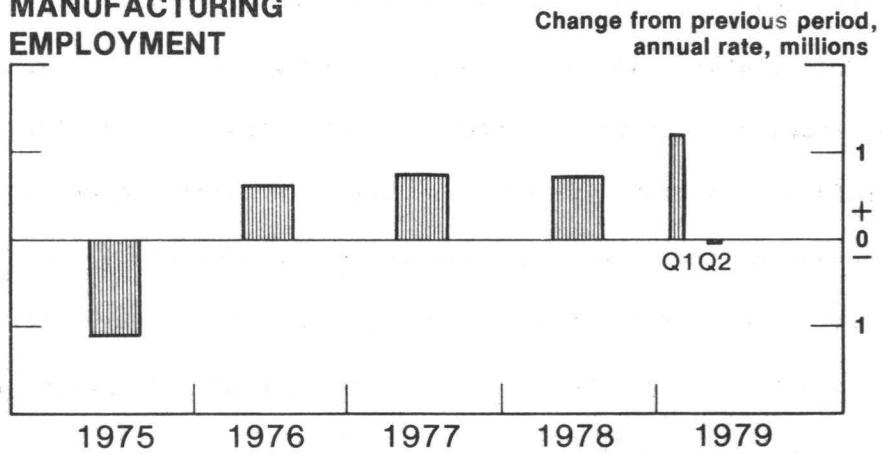
Almost four years of exceptionally rapid growth in employment had, by the end of 1978, given rise to considerable tautness in labor markets. Although businesses reportedly were encountering increasing difficulty in finding workers with the desired experience and skills at prevailing wage rates, the overall unemployment rate, at just under 6 percent, was well above past cyclical lows. This seeming paradox reflects in part longer-run changes in the composition of the labor force and in the output mix of the economy; in addition, the increased availability of unemployment compensation and other income maintenance programs may have altered the incentives to seek or accept employment.

Despite a leveling off in production during the first quarter of the year, monthly increases in payroll employment averaged 330,000--well above the 280,000 per month average gain during 1978. Gains in the manufacturing industry were quite large, and the average factory workweek remained at a high 40-3/4 hours. Some easing in labor demands has become perceptible since March, however, with employment gains averaging only one-third of their first quarter pace. Manufacturers have been reducing employment levels by about 35,000 per month--with the auto industry accounting for the bulk of the decline--and the average workweek has dropped to about 40 hours due to a cutback in overtime. Outside of manufacturing, hiring has continued in recent months, albeit at a reduced pace. Still, the unemployment rate has changed little since year-end, and such indicators as the average duration of unemployment and labor turnover rates have remained at levels typical of fairly tight labor markets.

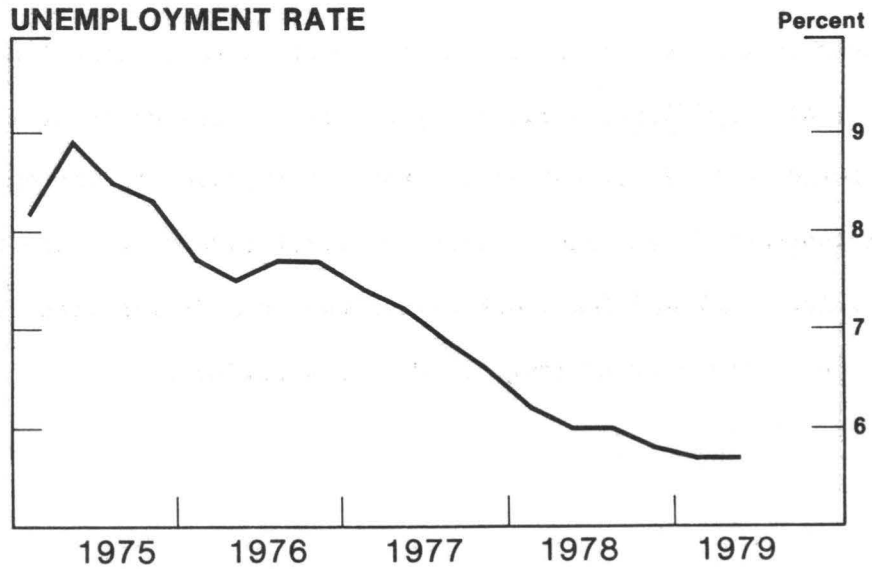
NONFARM PAYROLL EMPLOYMENT



MANUFACTURING EMPLOYMENT



UNEMPLOYMENT RATE



SECTION 3: WAGES, PRODUCTIVITY, AND PRICES

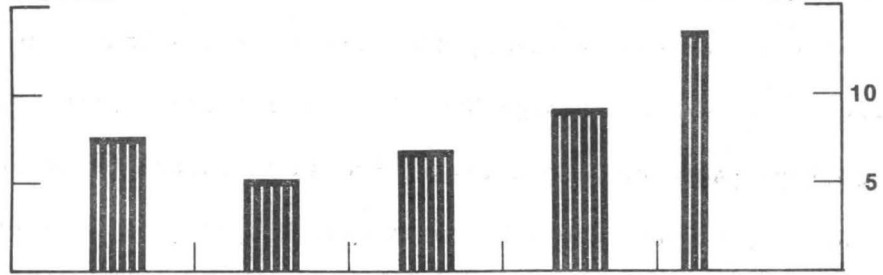
The pace of inflation has accelerated markedly this year. The Consumer Price Index rose at an annual rate of 13-1/2 percent through May compared with the 9 percent increase over the course of 1978. There has been a comparable stepup in the advance of prices at the producer level. Although the relatively high level of resource utilization has been a factor sustaining the momentum of inflation, supply developments specific to the food and energy sectors have accounted for much of the acceleration this year in inflation.

Food prices played a substantial role in the increase in inflation that occurred last year, and agricultural supply developments have continued to be unfavorable. In particular, beef production has remained on a downward trend, leading to sharp increases in meat prices. In addition, to rising farm prices, the rapid increase in costs of nonfarm inputs involved in processing and marketing has contributed to the acceleration of food price inflation. The further rise of the federal minimum wage, for example, was an important ingredient in the faster increase of prices for restaurant meals in the first half.

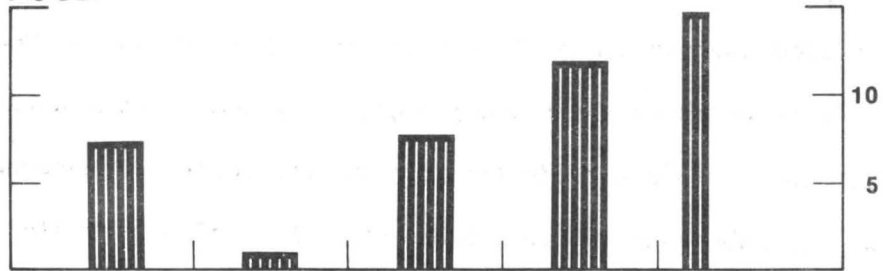
Energy prices have risen dramatically this year. Enormous increases in the prices charged by the OPEC cartel, occurring against a backdrop of significant worldwide pressures of demand on available supply, contributed to a 37 percent annual rate of increase in the energy component of the Consumer Price Index during the first five months of 1979. The rise in petroleum fuel and feedstock prices has in addition intensified cost pressures across a broad range of U.S. industries.

CONSUMER PRICES TOTAL

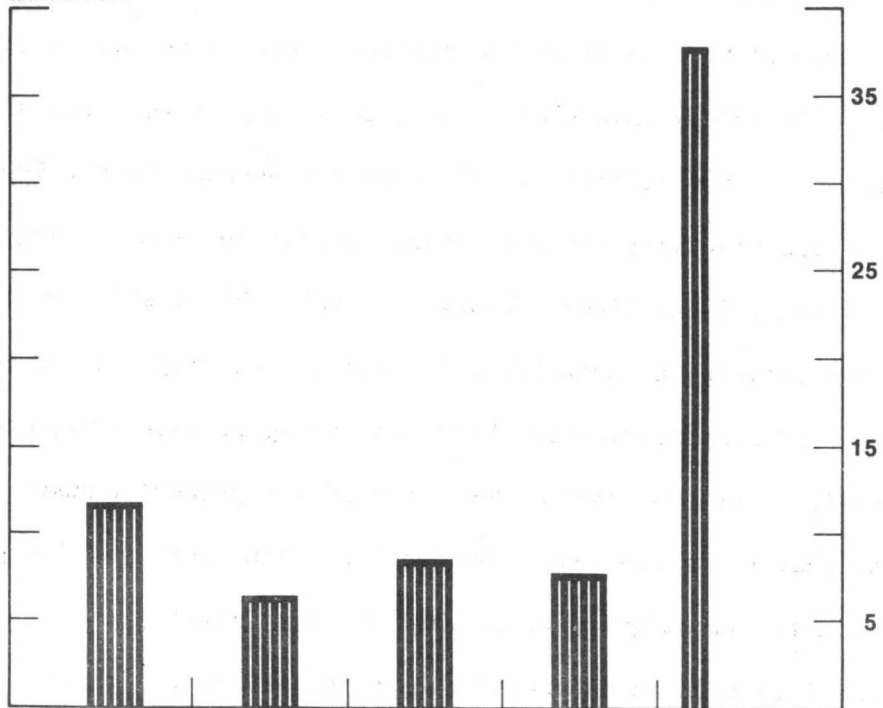
Change from previous period,
annual rate, percent



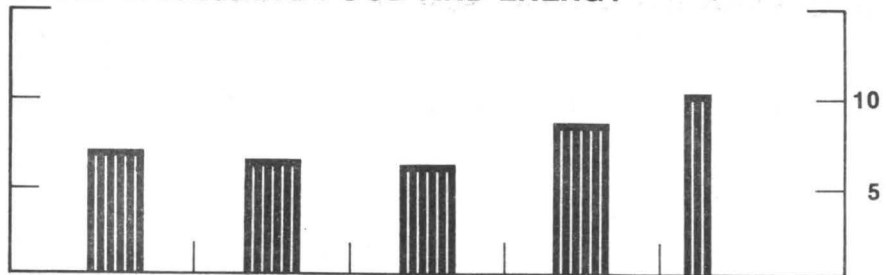
FOOD



ENERGY



TOTAL EXCLUDING FOOD AND ENERGY



1975

1976

1977

1978

Dec. 1978—
May 1979

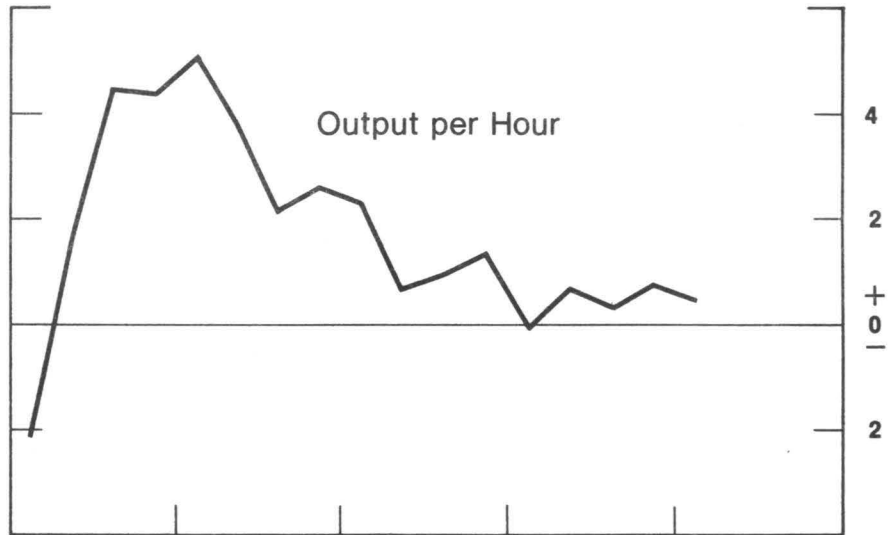
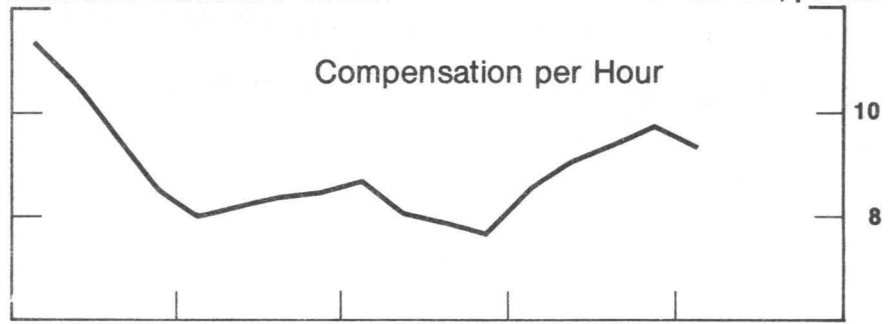
The acceleration in the rise of other prices has been less striking than that for food and energy, but it has been appreciable. Exclusive of food and energy items, the Consumer Price Index rose at an annual rate of 10 percent through May, 1-1/2 percentage points faster than the average pace throughout 1978. Pressures placed on prices of final products by rising materials costs have played some role in the broad pickup in inflation. Prices of nonferrous metals and of other actively traded nonfood commodities rose sharply early in the year when the year-end strength of the economy apparently led to some upward revision in expectations of future production levels and fears of consequent commodity shortages. In subsequent months, however, prices of many basic nonenergy commodities weakened as the slackening of economic activity became evident.

In addition to materials prices, labor costs have been a source of pressure on prices this year. The rise in wage rates generally does not appear to have accelerated, and surveys conducted by the Council on Wage and Price Stability indicate broad compliance with its wage standard, especially among large firms. However, total labor costs were boosted by enlarged employer contributions for social security and unemployment insurance, and compensation per hour (including private fringe benefits) in the nonfarm business sector rose at a 10-1/4 percent annual rate in the first quarter of the year. Meanwhile, output per hour dropped markedly in the first quarter, so that the unit labor costs of nonfarm businesses increased at an annual rate of more than 15 percent. Labor productivity apparently declined again in the second quarter, and while

UNIT COST INDICATORS

Nonfarm Business Sector

Change from year earlier,
annual rate, percent



the rise in unit labor costs likely was not quite so rapid as in the first three months of the year, it probably was fast enough to raise the first-half advance to a rate exceeded only in 1974.

SECTION 4: FINANCIAL DEVELOPMENTS

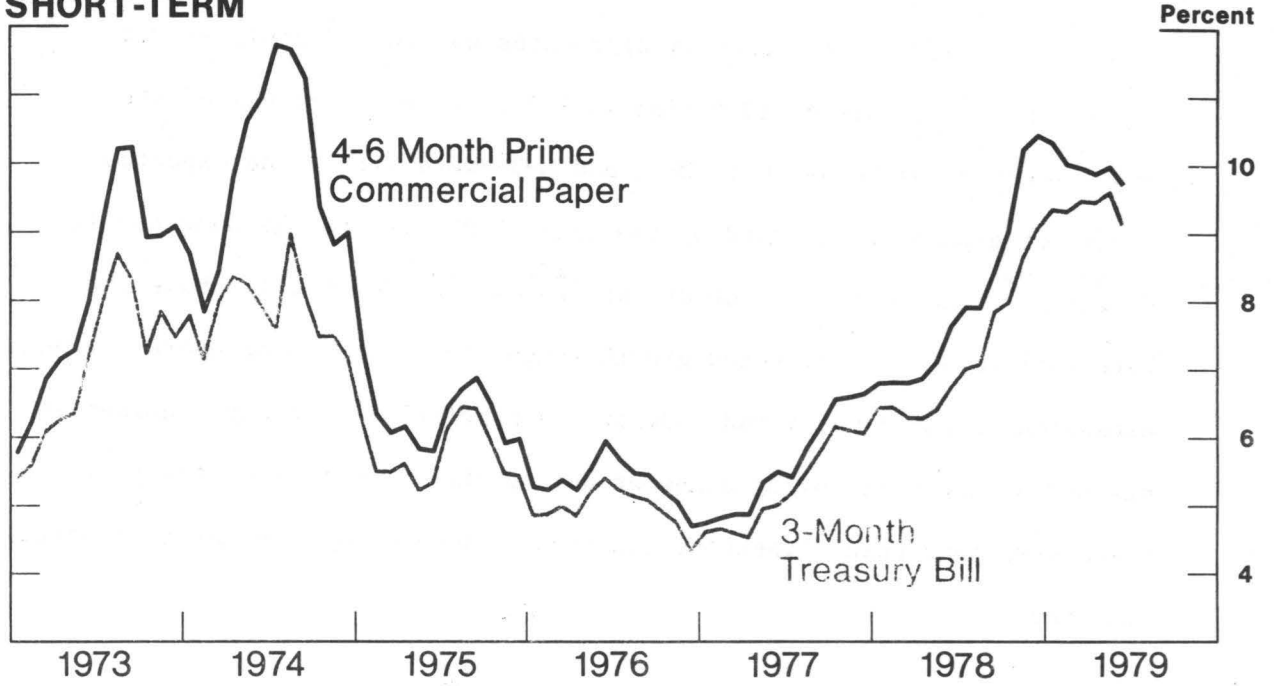
Growth of the monetary aggregates was considerably slower during the first half of 1979 than in 1978. At midyear, all of the major monetary measures--M-1, M-2, and M-3--were within the expected ranges of expansion reported by the Federal Reserve to the Congress in February. Commercial bank credit at midyear stood slightly above the path implied by its projected growth range, but the pace of overall credit expansion in the economy had moderated appreciably. Although businesses stepped up their borrowing somewhat during the first half of the year, there were more than offsetting declines in borrowing by other nonfinancial sectors.

Interest Rates

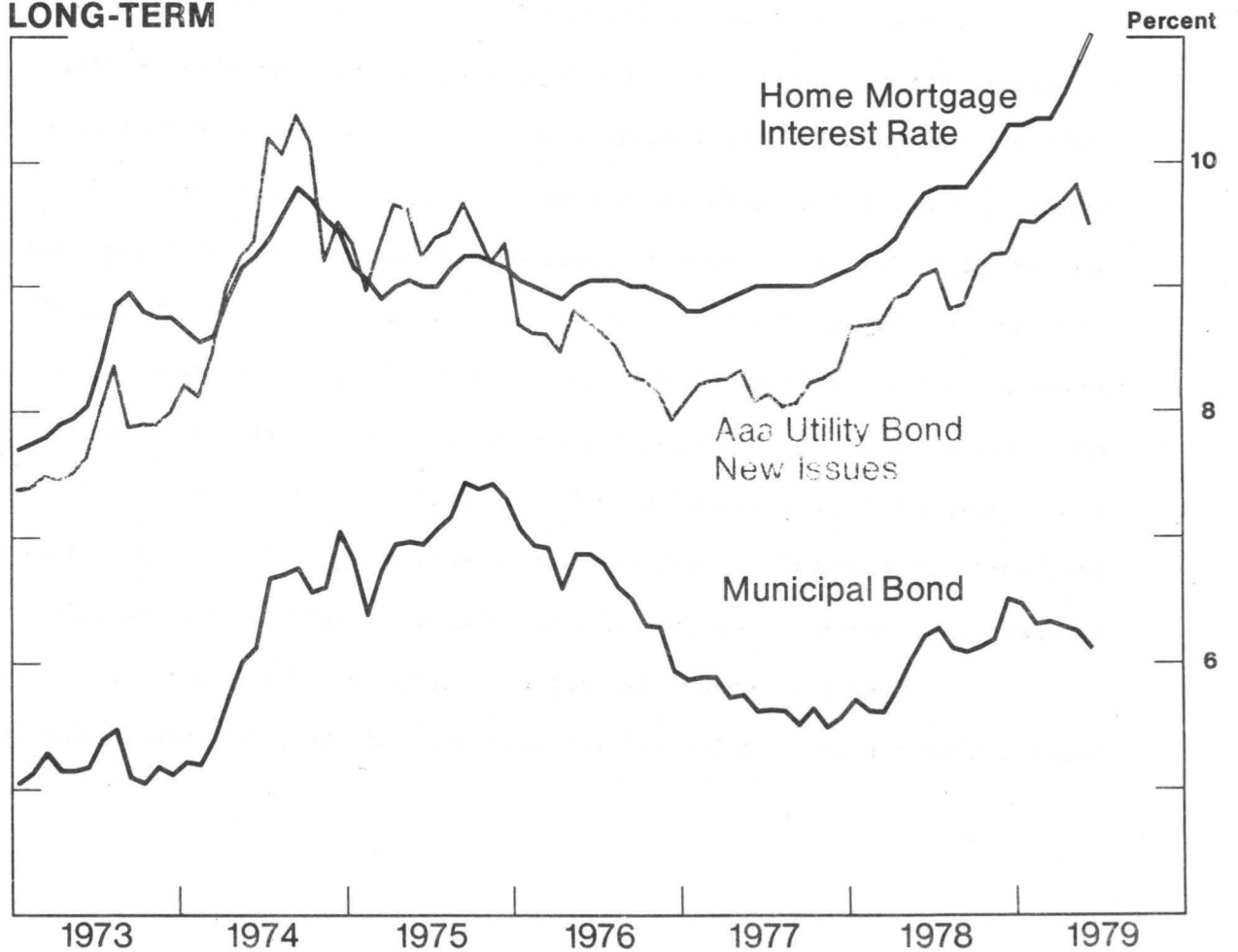
The general level of interest rates on market securities has changed relatively little since the beginning of the year after rising markedly during 1978. The federal funds rate--established in trading of immediately available funds on an overnight basis--remained around 10 percent until late April when it edged upward about one-quarter percentage point as the Federal Reserve moved to restrict bank reserve availability somewhat further in light of a surge in the monetary aggregates. Despite the small increase in the federal funds rate, other short-term market rates generally have declined somewhat on balance since December. This apparently is primarily a reflection of changing expectations about future interest rate movements as economic activity gave evidence of weakening.

In long-term securities markets, bond yields reached new cyclical highs during the first half, but retraced much of their advance in the latter

INTEREST RATES SHORT-TERM



LONG-TERM



part of the spring as many investors became convinced that the peak in money market rates had been reached. Mortgage interest rates have continued to rise, however, reaching record levels and prompting liberalization of usury ceilings in many states in order to sustain lending activity.

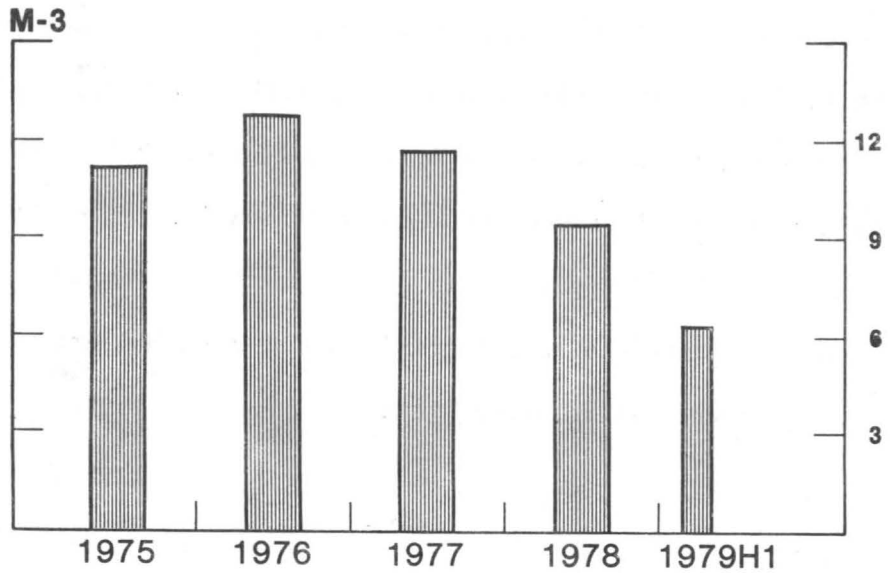
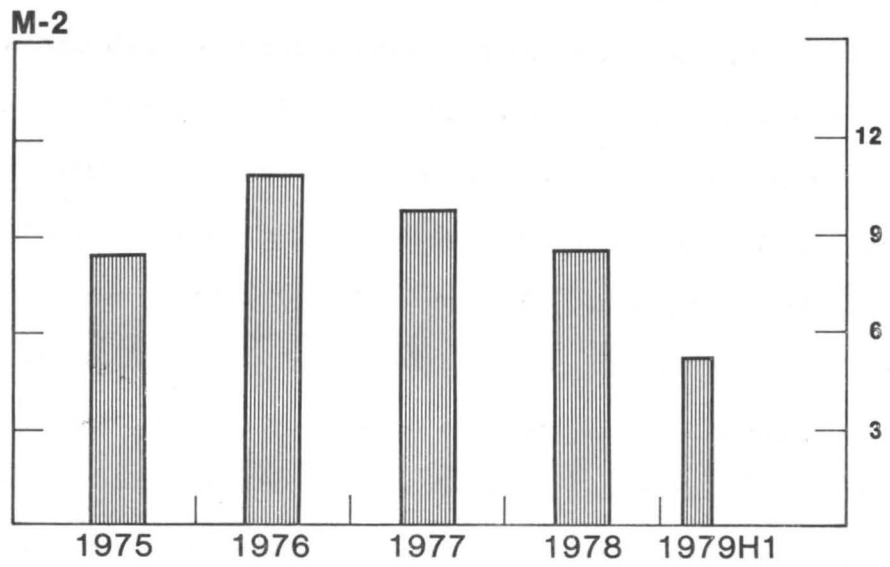
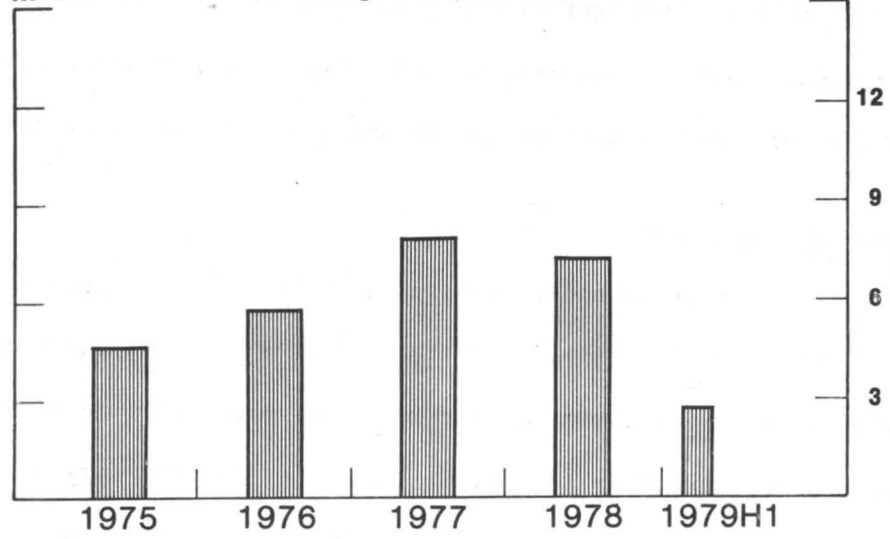
Monetary Aggregates

After expanding rapidly earlier in 1978, M-1--demand deposits and currency--leveled off in the fourth quarter and continued virtually flat through the first quarter of this year. Growth in this monetary aggregate resumed in the spring, but the rise over the first half of 1979 was at only a 2.7 percent annual rate--considerably slower than the 7.9 percent and 7.2 percent increases registered in 1977 and 1978, respectively. With nominal GNP increasing at about a 9 percent rate thus far this year, the very moderate expansion of M-1 represents a substantial shortfall from what might have been expected on the basis of historical relations among money, GNP, and interest rates.

As was noted in the Board's February report to the Congress, some weakness in the public's demand for M-1 was anticipated because of the introduction last November of automatic transfer services (ATS) nationwide and of NOW accounts in New York State. The Board staff had projected that transfers from demand deposits to savings accounts associated with these innovations might reduce M-1 growth by roughly 3 percentage points over the year ending in the fourth quarter of 1979. The impact of such transfers on M-1 growth was about that much early in the year, but it apparently has dropped off in recent months. Over the past two quarters it appears that the impact of ATS and NOWs on M-1 growth has been about 2-1/4 percent, at an annual rate.

MONEY SUPPLY GROWTH

M-1 Change from previous period, annual rate, percent



Even after taking account of ATS/NOW effects, the demand for M-1 was unusually weak in the past half year, especially in the first quarter. It appears that, again as suggested in the February report, the high level of interest rates reached in late 1978 prompted greater than normal efforts to economize on non-interest-earning cash balances. Individuals evidently have shifted demand balances into a variety of interest-bearing assets, including small denomination time deposits, Treasury securities, and shares in money market mutual funds. The growth of the money market funds this year has been quite striking: over the past six months, the total assets of these funds rose from less than \$11 billion to almost \$26 billion. While these funds are an imperfect substitute for checking accounts for transactional purposes, they have provided many individuals with a high-yielding liquid asset that may be purchased in small denominations.

The relatively high level of interest rates this year has also had an appreciable impact on the interest-bearing component of M-2--that is, commercial bank time and savings deposits other than large CDs. Deposits subject to fixed interest rate ceilings have been weak since last fall. Inflows to six-month money market certificates (MMCs) provided an offset to this weakness in the fall and winter. With a change in regulations in mid-March that eliminated the one-quarter percentage point differential between MMC ceilings at thrift institutions and commercial banks when the six-month Treasury bill rate exceeds 9 percent, MMC growth at banks accelerated and provided the impetus for a pickup in the expansion of the time and savings deposit component of M-2. Over the first half as a whole, this component expanded at a 7 percent annual rate

and brought M-2 growth to a 5.2 percent rate, substantially below the 8.4 percent average rate of 1978.

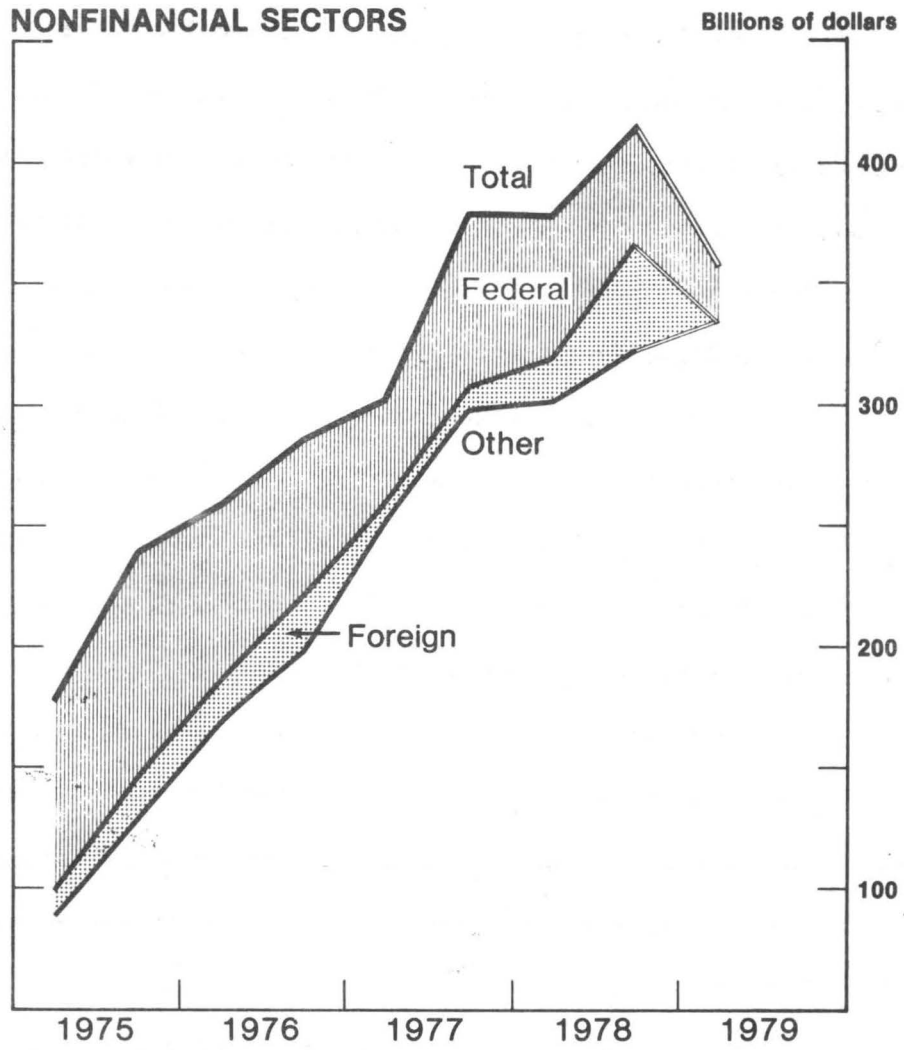
Growth of M-3 also has moderated in recent quarters, averaging 6-1/4 percent, at an annual rate, during the first half. This deceleration was partly a reflection of the slower growth of the narrower monetary aggregates, but reduced deposit inflows at nonbank thrift institutions also played a role. The slowing in thrift deposit growth was especially noticeable after mid-March when a share of the MMC market was lost to commercial banks, but inflows in the second quarter still exceeded the very low rates of past periods when high market interest rates caused serious disintermediation. Savings and loan associations made increased use of large-denomination time deposits, which are not subject to regulatory rate ceilings, to offset some of the weakness in other accounts.

Credit Flows

Net funds raised in credit markets by nonfinancial sectors of the economy during the first half totaled about \$355 billion, at an annual rate, according to preliminary estimates. This is well below the \$393 billion figure for 1978 and reflects the combined impacts of monetary restraint and a number of other factors.

One of these other factors was the diminished size of the federal budget deficit. With a very large year-end 1978 cash balance further reducing the Treasury's needs for new money during the first half, federal government borrowing fell off sharply from the 1978 pace. In contrast with the pattern in late 1978, when they effectively financed the Treasury's deficit with the proceeds of dollar-support operations, foreign central banks sold a large volume of Treasury securities in the first

FUNDS RAISED BY NONFINANCIAL SECTORS



Source: Federal Reserve Flow-of-Funds Accounts.

Data for the first half of 1979 are partially estimated.

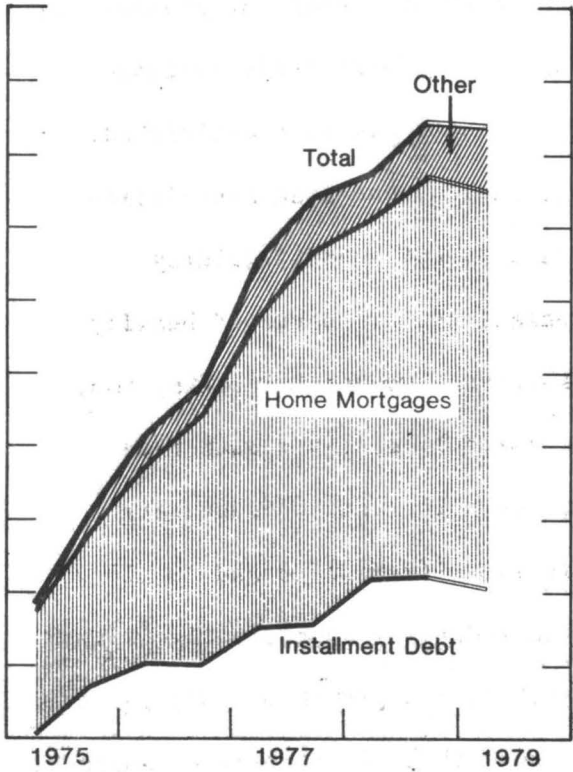
half. A part of the sizable private capital inflow to the United States during the first half was channeled through the Eurodollar market to the U.S. banking system, which acquired a substantial volume of Treasury securities. Households were important buyers of Treasury securities, as they responded to the enlarged gap between rates on such instruments and those available on deposits subject to regulatory ceilings.

State and local governments have borrowed at a reduced pace in 1979. This decline reflects the absence of advance refundings since last August when more restrictive regulations were promulgated by Internal Revenue Service. Tax-exempt bond issuance for new capital in first half was maintained at about the 1978 level, owing largely to a sharp increase in sales of revenue bonds for mortgage financing purposes; the pace of such housing-related financing slowed markedly in the second quarter, however, as a consequence of congressional proposals to curtail the use of tax-exempt bonds to fund low rate single-family mortgages. Casualty insurance companies and commercial banks have absorbed the bulk of tax-exempt bonds sold this year.

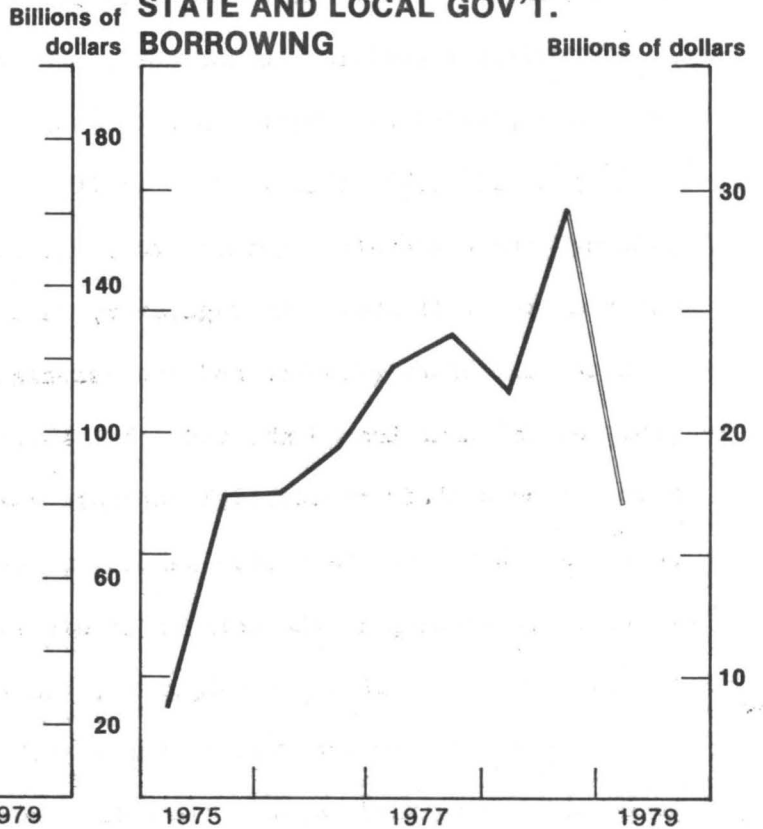
Household borrowing in the consumer installment and mortgage credit markets has leveled off this year. Although interest rates on consumer loans have risen during the past year, the moderation in growth of installment debt appears to be primarily a consequence of other factors tending to reduce consumer spending. The flattening in mortgage flows, on the other hand, does appear more directly a consequence of rising interest rates and the tightening of mortgage credit supplies.

On the demand side, households have deferred home purchase or scaled down expenditure or borrowing plans in light of the higher cost of mortgage credit. On the supply side, even where usury ceilings have

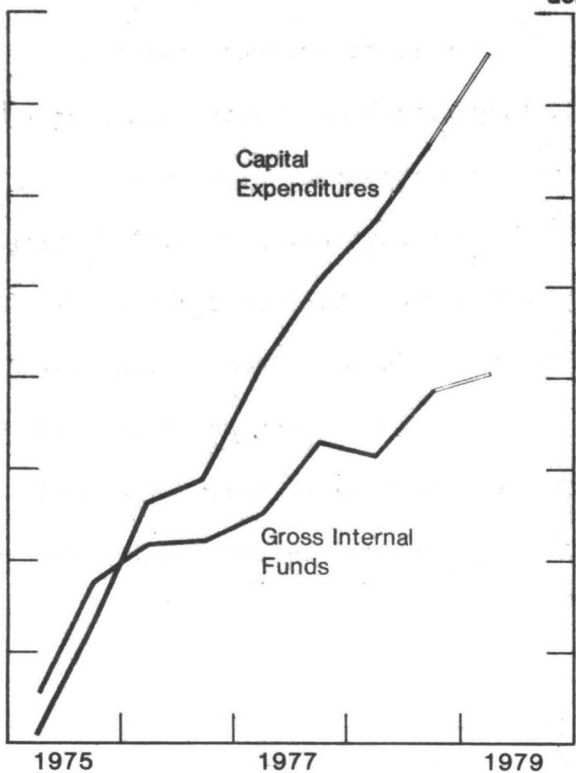
HOUSEHOLD BORROWING



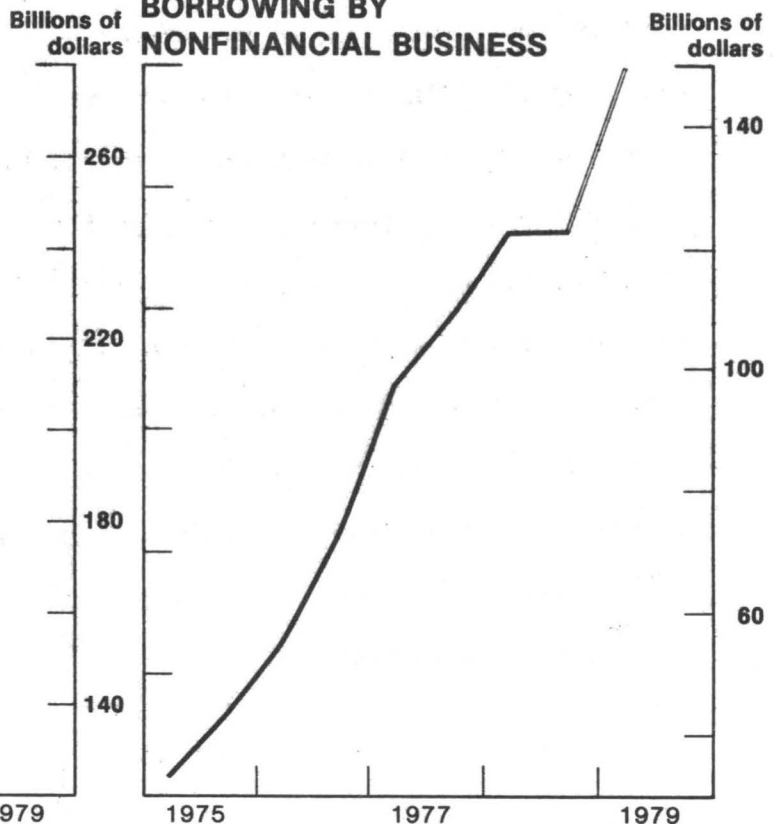
STATE AND LOCAL GOV'T. BORROWING



NONFINANCIAL BUSINESS



BORROWING BY NONFINANCIAL BUSINESS



Source: Federal Reserve Flow-of-Funds Accounts.

Data for the first half of 1979 are partially estimated.

not been a constraint, depository institutions have pursued more cautious loan commitment policies because of concerns about current or prospective liquidity pressures. Thrift institutions have reduced their mortgage lending considerably this year as their deposit flows have diminished; although the aggregate liquidity ratio of savings and loan associations has remained well above the regulatory requirement, that liquidity cushion has shrunk somewhat and the associations have borrowed heavily from Federal Home Loan Banks and other sources. Commercial banks, too, have expanded their residential mortgage portfolios at a slower pace this year, but there have been partial offsets to reduced depository institution lending in the form of credit flows from state and local governments, life insurance companies, and federally sponsored agencies.

In the nonfinancial business sector, the growth of outlays for inventories and fixed capital has outstripped that of internally generated funds, and firms have increased their borrowing substantially. An increased share of the credit flow to businesses has been accounted for by commercial banks, as many bigger firms have preferred--at current interest rates--short- or intermediate-term bank loans to long-term bond issues with lengthy call protection. Commercial mortgage flows have remained large, however, in reflection of the strength in nonresidential construction activity. Life insurance companies have provided a large portion of these mortgage loans and, with pension funds, absorbed the bulk of a reduced volume of bond issues. Commercial paper issuance was an increased source of short-term credit for businesses in the first half, and finance company business loans continued to grow rapidly, with much of the credit being extended to automobile dealers to finance inventories.

Foreigners, who had borrowed in U.S. credit markets when the dollar was weak in 1978, apparently did not expand their debt during the first half of 1979. This change was a significant element in the overall decline in funds raised by nonfinancial sectors.

Financial sectors increased their borrowing in credit markets during the first half. Government-sponsored credit agencies stepped up security issuance to finance assistance to the residential mortgage market. Commercial banking firms and finance companies sold substantial volumes of commercial paper and of bonds, including a number of floating rate issues that offered investors a hedge against future interest rate fluctuations. Savings and loan associations, after receiving approval from the Federal Home Loan Bank Board, issued commercial paper for the first time; toward midyear there were also a number of mortgage-backed bond issues by S&Ls.

CHAPTER 2

"the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or diminution of the monetary and credit aggregates for the calendar year during which the report is transmitted, taking account of past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade and payments, and prices"

Section 108(a) Full Employment and
Balanced Growth Act of 1978

SECTION 1. OUTLOOK FOR MONETARY GROWTH

In February the Federal Reserve reported to the Congress on the growth in the monetary aggregates that it expected would occur during the current calendar year. Expressed as ranges, and measured from the fourth quarter of 1978 to the fourth quarter of 1979, the increases indicated were: for M-1, 1-1/2 to 4-1/2 percent; for M-2, 5 to 8 percent; for M-3, 6 to 9 percent. The range for M-1 reflected an expectation that shifts of funds from demand deposits to newly authorized ATS and NOW accounts would reduce M-1 growth by about 3 percentage points. In addition, bank credit was projected to expand by between 7-1/2 and 10-1/2 percent.

At its most recent meeting, the Federal Open Market Committee reassessed the ranges for monetary expansion in 1979 and formulated preliminary monetary ranges for 1980. With respect to 1979, the Committee decided that it was appropriate to retain the previously established ranges for the aggregates. In reaching this decision, particular attention was focused on the uncertainties surrounding the behavior of M-1. As was noted in the preceding chapter, the estimated impact of ATS and NOW accounts on M-1 expansion has been somewhat smaller to date than had been expected when the range was initially adopted. However, the future extent of shifts to these accounts cannot be predicted with precision, especially in light of the April court decision barring ATS and certain other payments services as of January 1, 1980. Thus, while the Committee retained its original range for M-1, it expected growth to vary in relation to the range to the extent that the actual ATS/NOW impact deviates from the 3 percentage point figure projected earlier.

Even greater uncertainties faced the Committee in its consideration of monetary growth ranges for 1980. Apart from the question of possible judicial or legislative action that might affect the menu of transactions accounts available to the public, the economic circumstances and financial requirements of a period extending 18 months into the future obviously cannot be foreseen with much confidence. The Committee tentatively decided that the ranges for 1980 should be the same as those for 1979, with the understanding that adjustments might be necessary in response to legal or legislative developments affecting M-1 and, more generally, in light of emerging economic conditions. In any event, it was recognized that the current re-examination of the definitions of the monetary aggregates, which is being undertaken in light of the major institutional changes that have occurred in the payments system, might in the near future lead to a new and improved set of money stock measures.

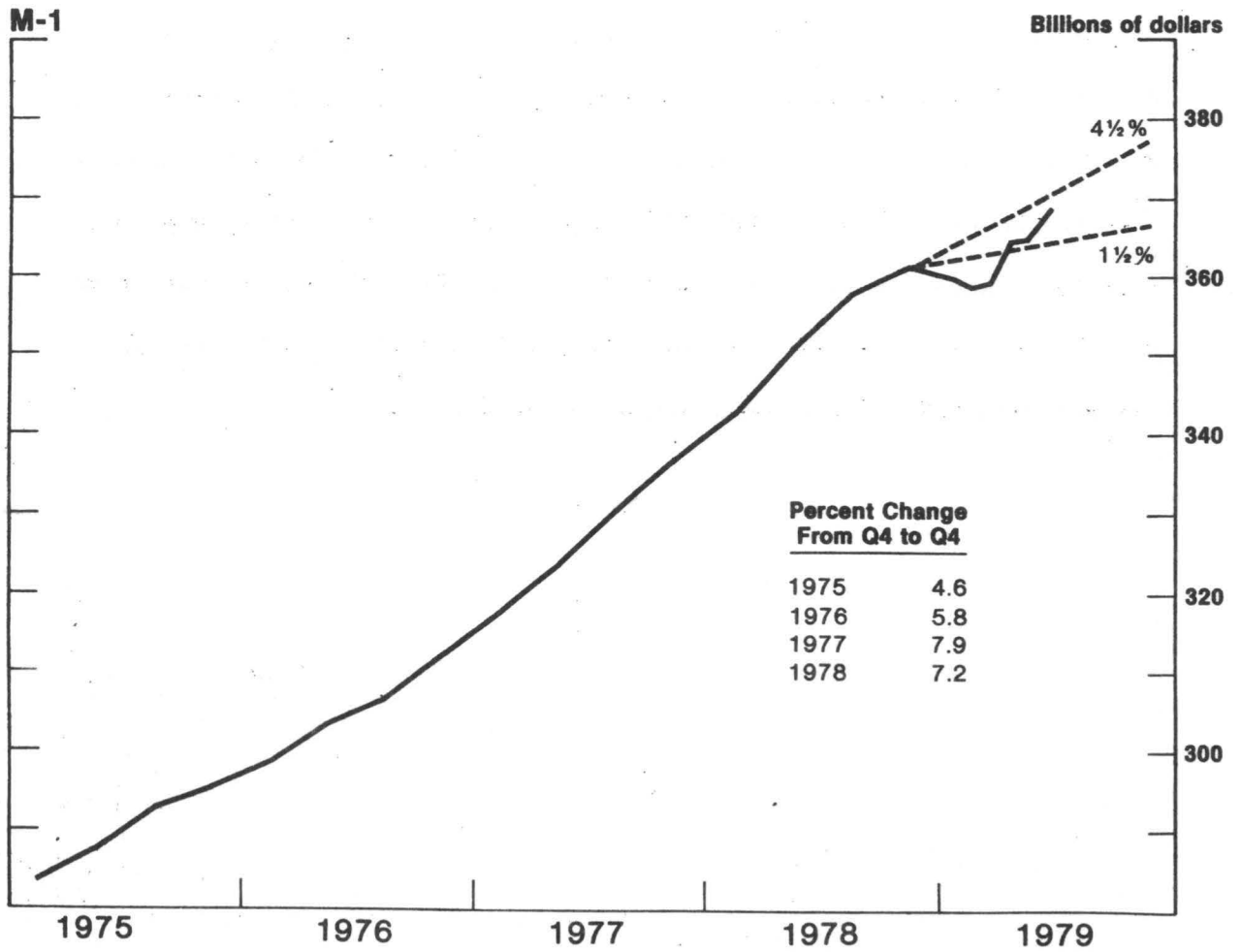
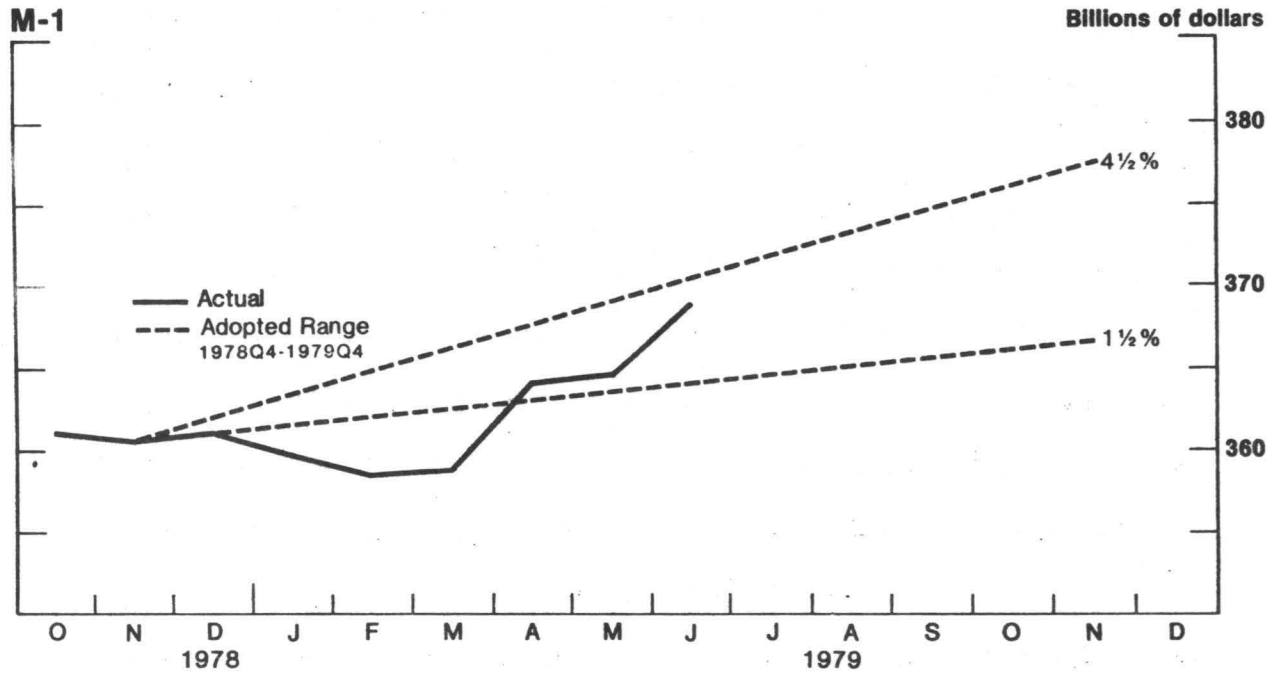
The ranges for the broader monetary aggregates, M-2 and M-3, allow for continued moderate growth of the interest-bearing components of those aggregates. In past periods of high market interest rates, inflows of deposits subject to regulatory interest rate ceilings weakened markedly. Investors "disintermediated," shifting their funds from banks and thrift institutions into higher yielding market securities. In the past year, however, inflows to such accounts--though smaller than in 1975-77--have been fairly well maintained. The six-month money market certificate, with a rate linked to Treasury bill yields, has permitted the depository institutions to compete successfully for savings against money market mutual funds and other instruments.

The growth ranges for the broader monetary aggregates imply that the depository institutions will experience adequate inflows of

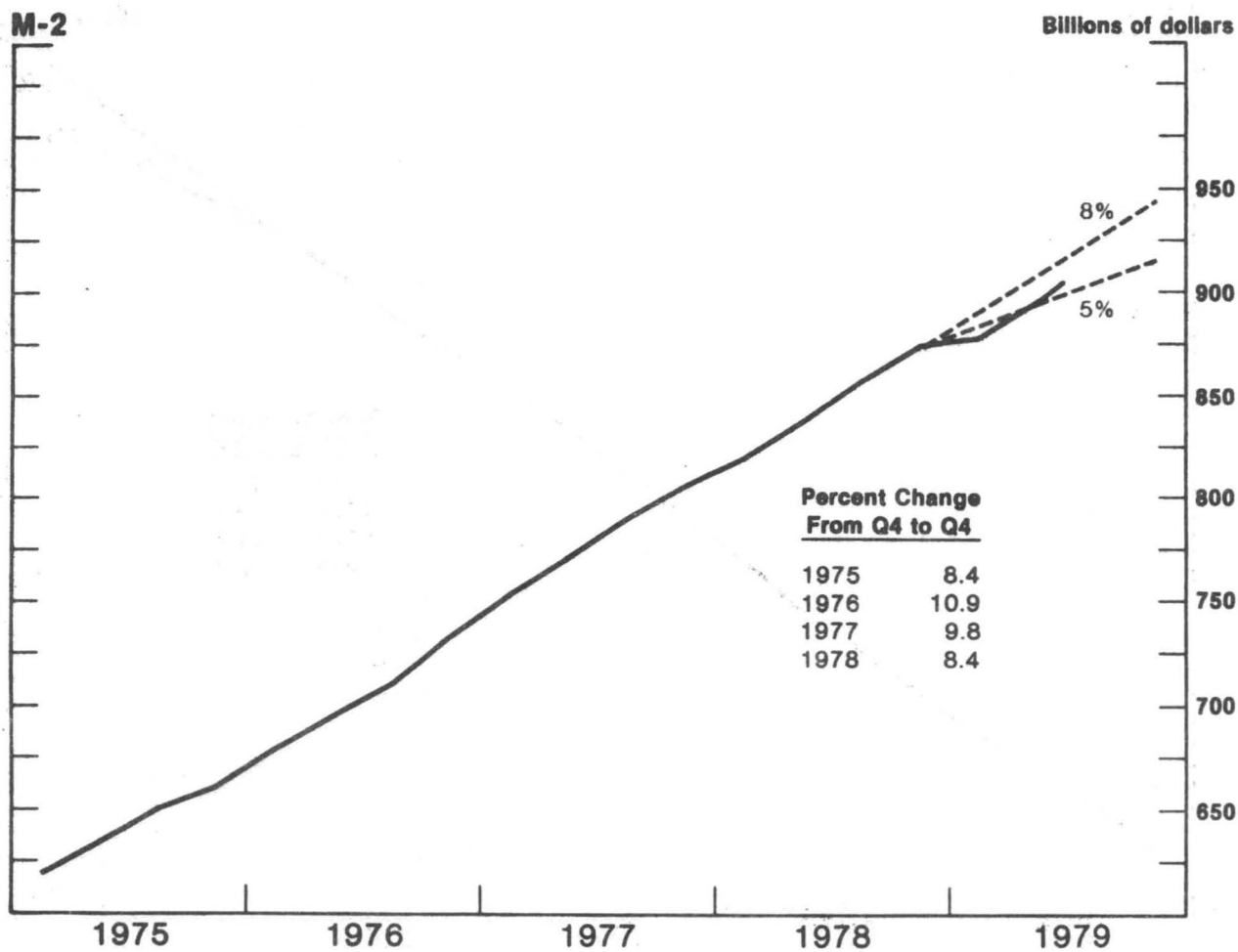
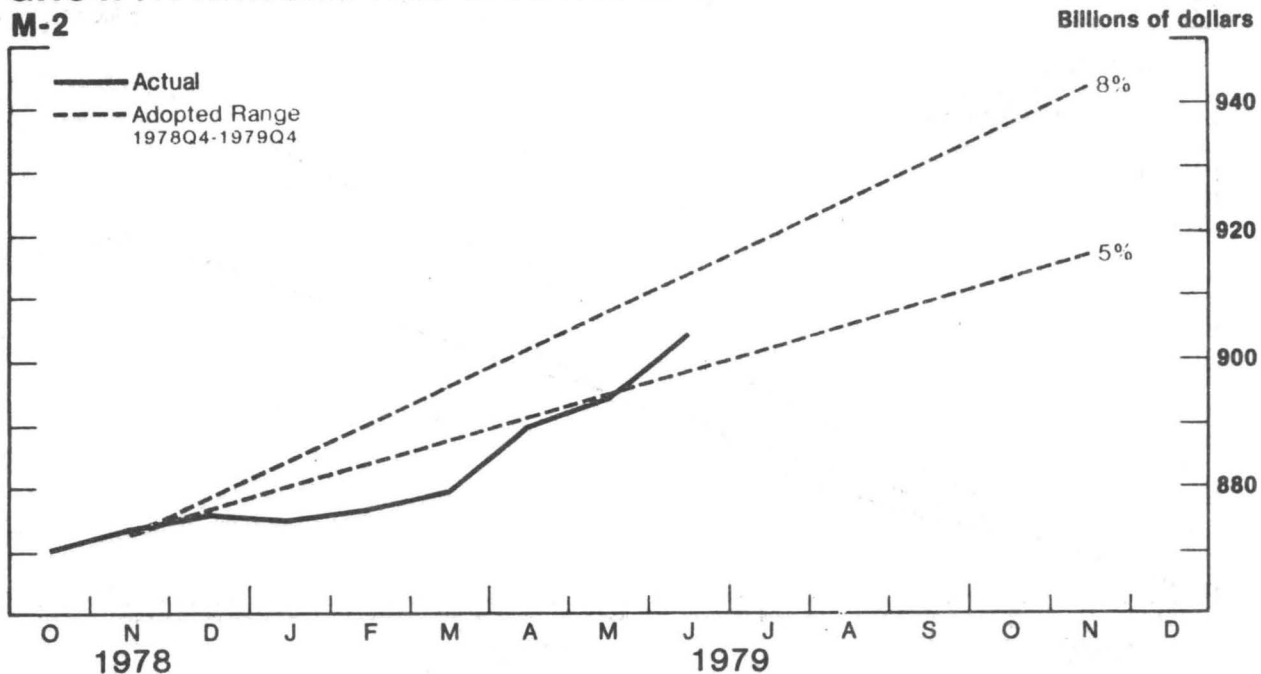
lendable funds over the remainder of 1979 and in 1980. The projections for bank credit reflect an expectation that loan demands at commercial banks will begin to moderate in the months ahead. Business loan demands, in particular, should diminish, with the corporate financing gap likely narrowing and firms probably desiring to fund short-term debts in longer-term credit markets.

The monetary ranges established by the FOMC are consistent with a policy of gradual reduction in rates of increase of the monetary aggregates in order to curb inflation. As shown in the charts on the following pages, growth in the aggregates slowed in 1978, and a further deceleration should occur this year. A further deceleration in M-1 is likely to develop even in the absence of any shifting of funds from demand deposits to ATS savings and NOW accounts. The ranges tentatively adopted for 1980 would permit continued slowing in monetary expansion. However, there is considerable variability over time in the behavior of the monetary aggregates, owing in part to financial innovations and to changes in the public's asset preferences. Since satisfactory economic performance remains the basic objective of the Federal Reserve, monetary policy, from time to time, may have to permit growth rates in the aggregates that temporarily interrupt the downward trend.

GROWTH RANGES AND ACTUAL M-1

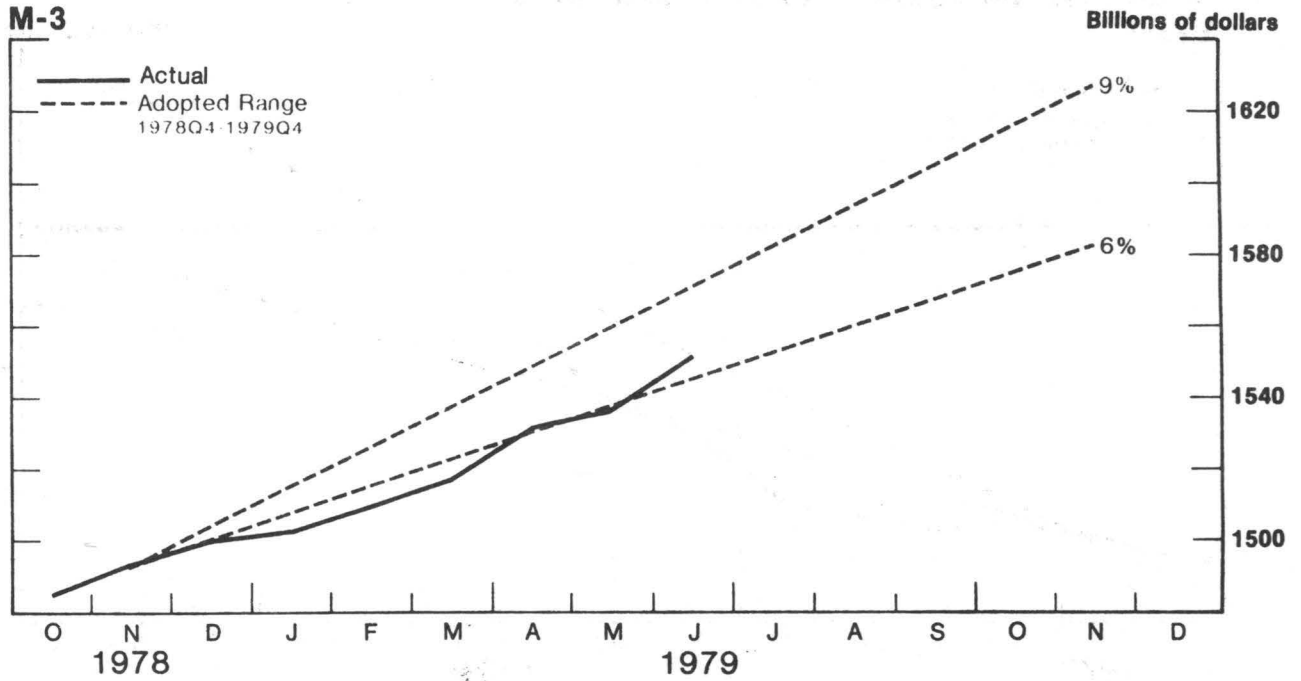


GROWTH RANGES AND ACTUAL M-2

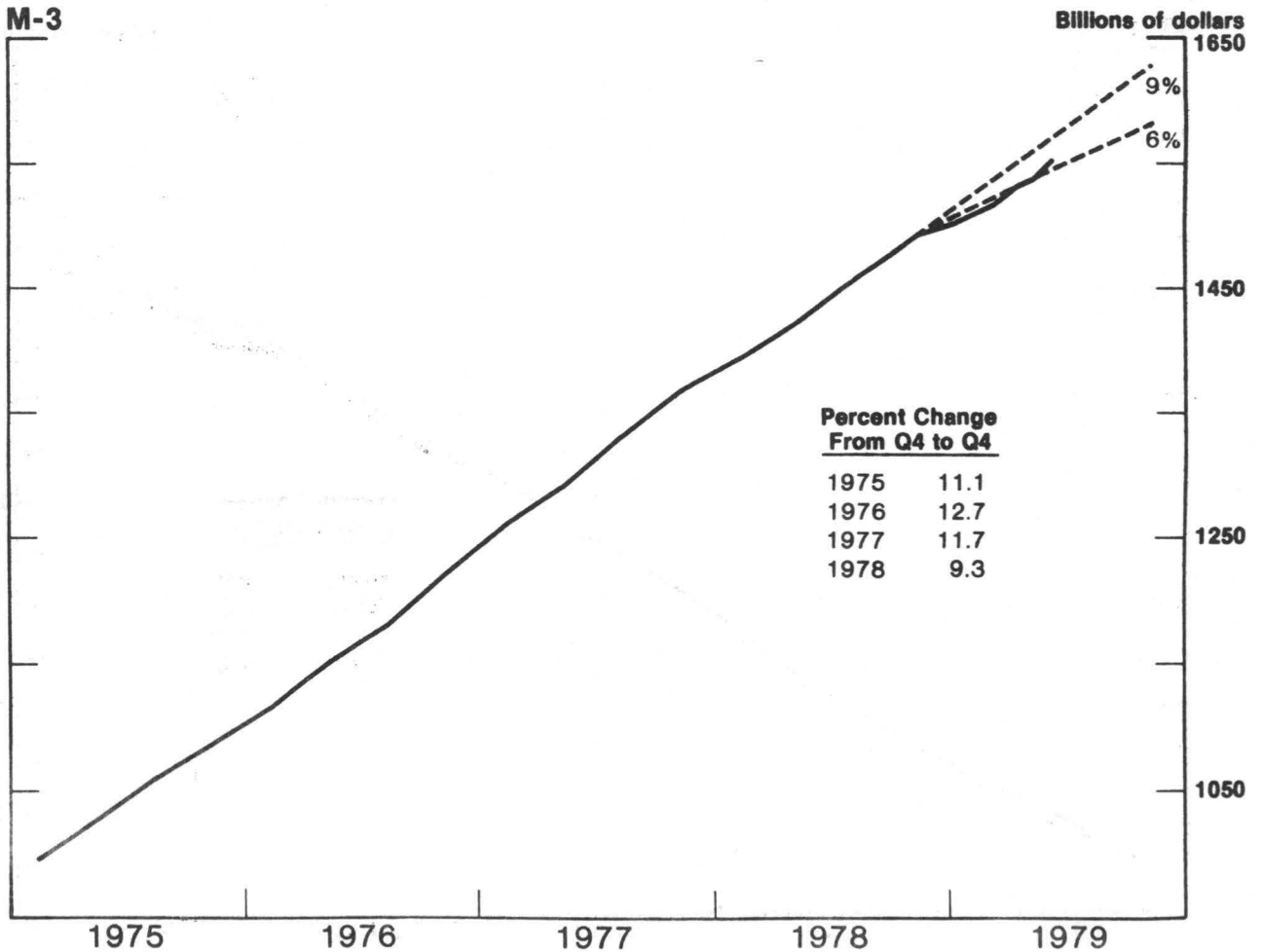


GROWTH RANGES AND ACTUAL M-3

M-3



M-3



SECTION 2. OUTLOOK FOR THE ECONOMY

As noted in the introduction, the economy faces a difficult adjustment to this year's oil price increases, which are aggravating inflationary pressures and intensifying forces likely to depress aggregate demand. It now appears that economic activity may well decline somewhat over the next few quarters, before turning upward in 1980.

In the near term, real disposable income is likely to show no more than modest gains, and consumers probably will spend cautiously. Business spending may decline in real terms, reflecting the correction of inventory imbalances--particularly in the auto industry--and a mild retrenchment in fixed investment occasioned by the sluggishness of consumer demand. Housing construction activity can be expected to decline somewhat further this year in response to the recent tightening of credit conditions and to the weakness in income flows. Export demand should, however, tend to support activity.

During this period, industrial production and employment are likely to edge downward. The resulting easing of demands on productive resources should help to contain inflation. Pressures on credit markets may abate and lay the groundwork for an upturn in homebuilding during 1980.

Moderate growth in real GNP should resume next year as the initial effects of the oil shock abate and consumers begin to expand their spending. The completion of the inventory correction should lead to a resumption in the growth of orders and production. Employment growth would pick up in this environment, but it seems probable

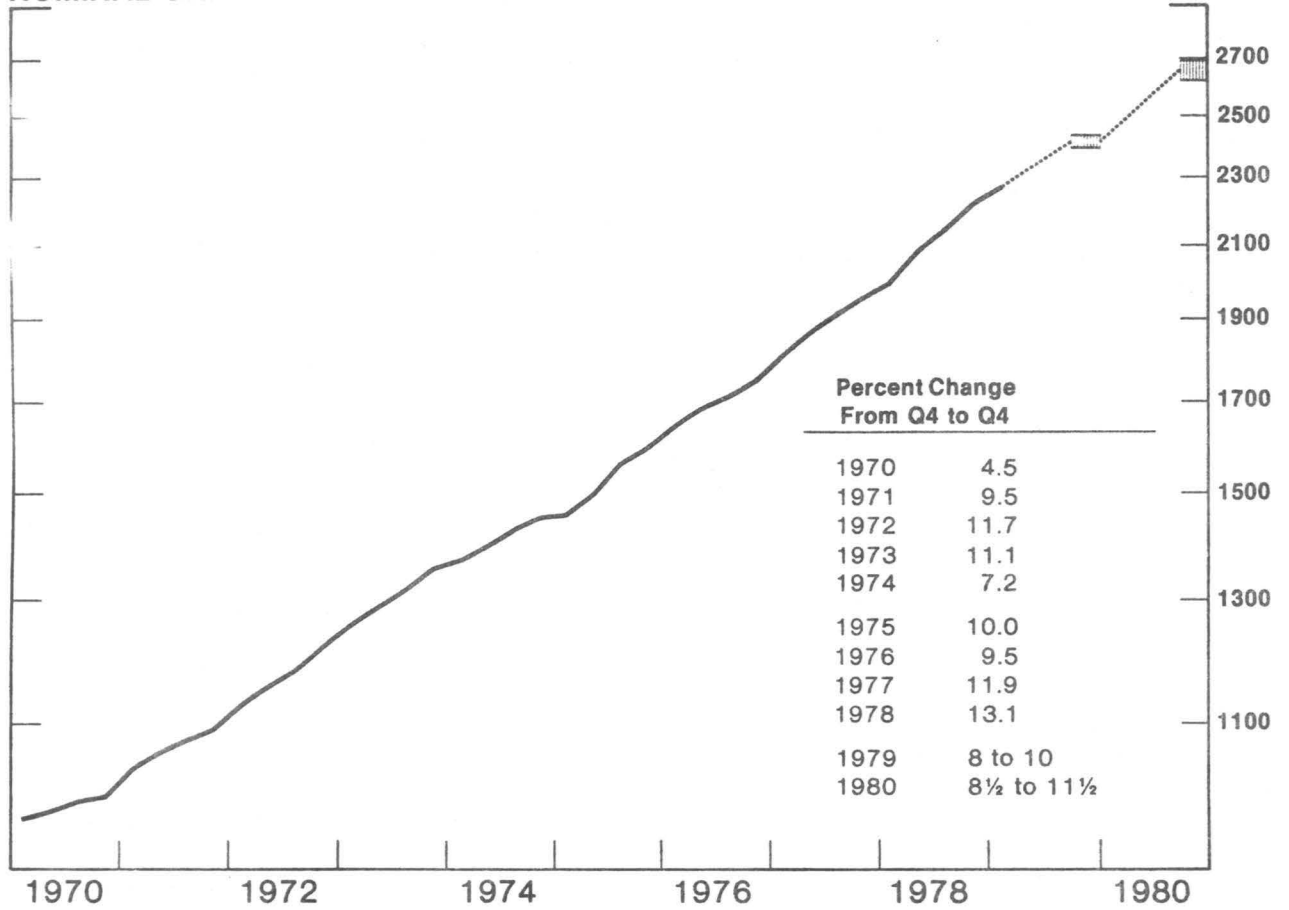
that the pace of hiring will not be strong enough to cut into unemployment. Inflation should edge lower, though progress may be quite gradual owing to the strong upward momentum of unit labor costs, the continuing relatively tight supplies of some agricultural commodities, and the further adjustment of the system to higher energy costs.

The economic outlook currently is obscured by exceptional uncertainties, and the range of possible outcomes appears quite wide. However, in order to improve understanding of the monetary objectives, an economic projection representing the consensus of the Board members at this time has been summarized in the table below and in a series of charts on the next several pages.

	Actual	Projections	
	1978	1979	1980
Change from fourth quarter to fourth quarter, percent			
Nominal GNP	13.1	8 to 10	8-1/2 to 11-1/2
Real GNP	4.4	-2 to -1/2	-1/2 to 2
Implicit price deflator	8.3	9-1/2 to 11	8-1/2 to 10-1/2
Average level in fourth quarter, percent			
Unemployment rate	5.8	6-1/4 to 7	6-3/4 to 8-1/4

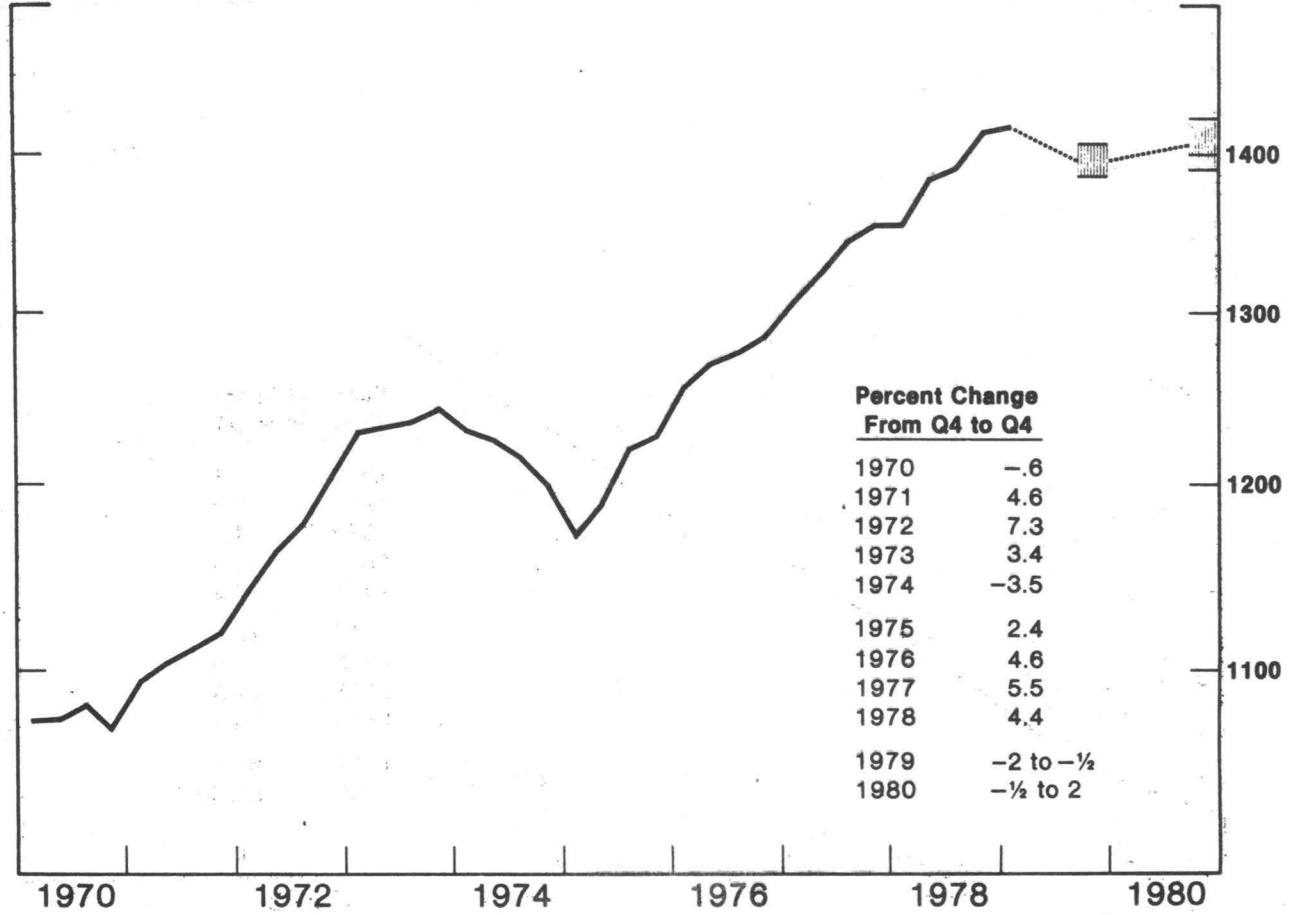
NOMINAL GNP

Ratio scale, billions of dollars



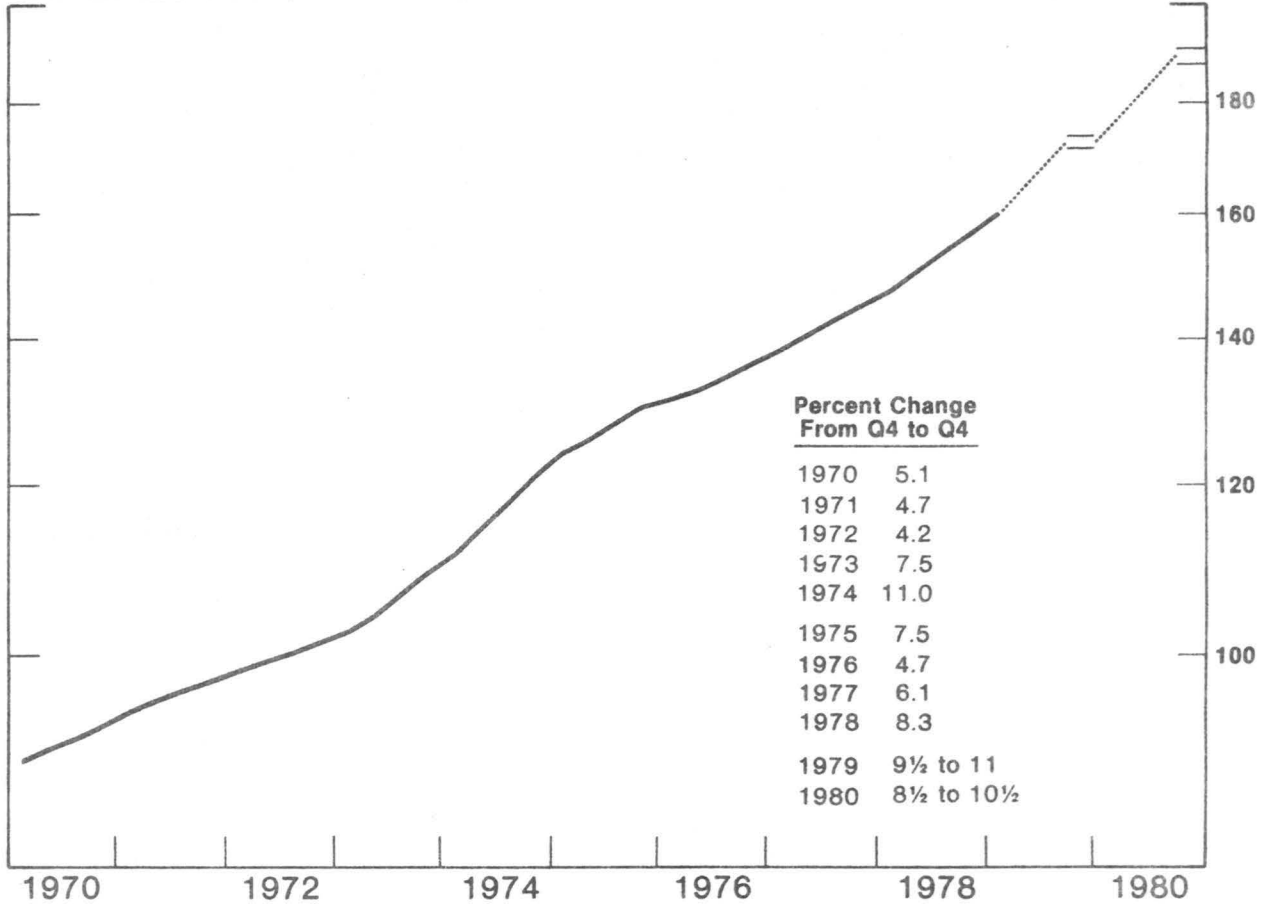
REAL GNP

Ratio scale, billions of 1972 dollars

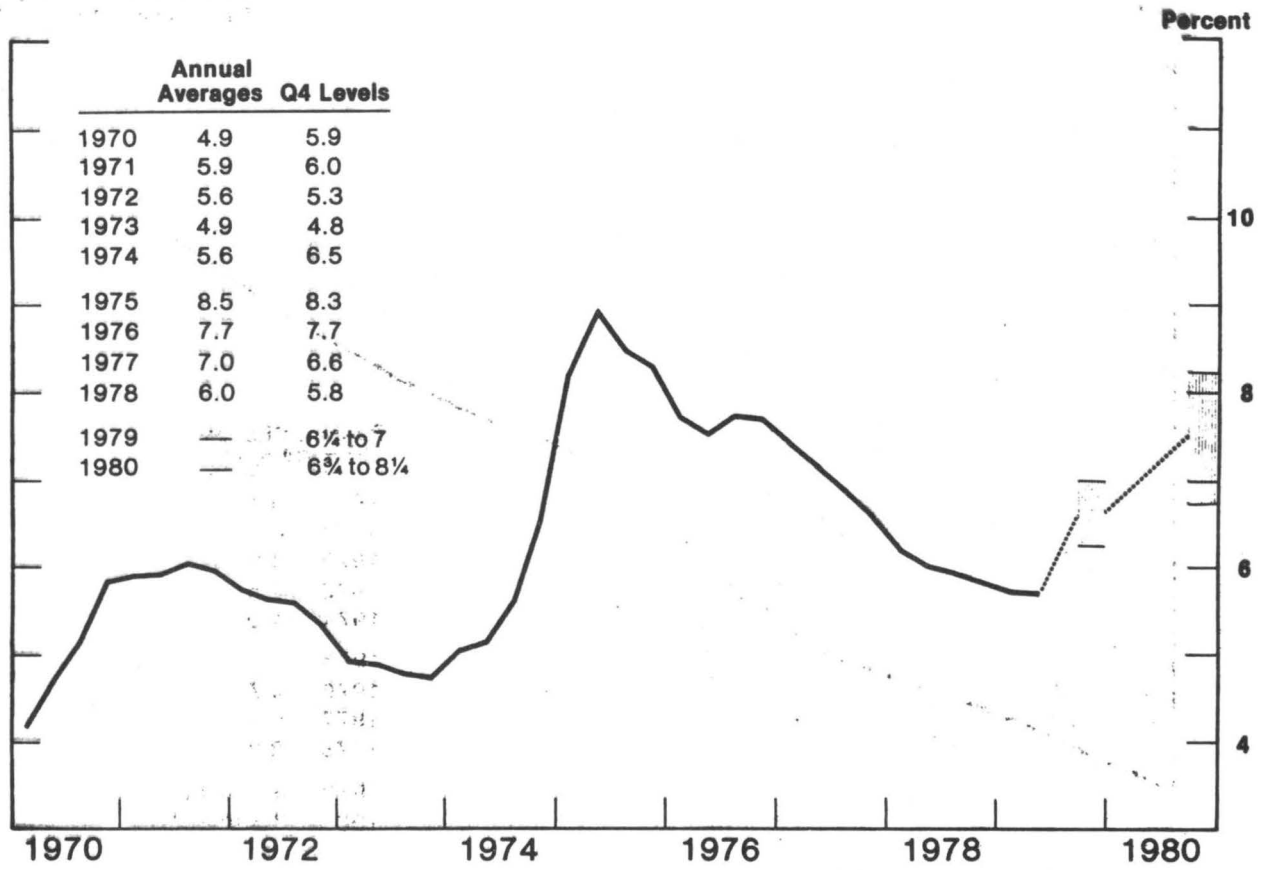


GNP IMPLICIT PRICE DEFLATOR

Ratio scale, index, 1972=100



UNEMPLOYMENT RATE



CHAPTER 3

"the relationship of the [Federal Reserve's] objectives and plans to the short-term goals set forth in the most recent Economic Report of the President"

Section 108(a) Full Employment and
Balanced Growth Act of 1978

SECTION 1: THE ADMINISTRATION'S SHORT-TERM GOALS

The administration has recently announced its forecast^{1/} of key economic variables in association with the midyear budget update. This forecast, which assumes no major new fiscal initiatives, contains some significant changes from the figures contained in the January Economic Report of the President. In particular, real economic growth through 1980 has been reduced and inflation has been raised.

The Administration's Forecast

	<u>1979</u>	<u>1980</u>
Change from fourth quarter to fourth quarter, percent		
Nominal GNP	9.2	10.3
Real GNP	-0.5	2.0
Implicit price deflator	9.8	8.1
Average level in fourth quarter, percent		
Unemployment rate	6.6	6.9

^{1/} The January Economic Report equated the 1979-1980 forecast with short-run goals.

SECTION 2. THE ADMINISTRATION'S GOALS AND THE FEDERAL RESERVE'S PLANS FOR
MONETARY GROWTH

The monetary ranges set by the Federal Reserve should be adequate to finance the amount of spending in current dollars projected by the administration. However, the administration's forecast does seem to envision a somewhat more favorable combination of real output and inflation than that suggested by the Board's consensus projection. The actual price-output mix will be determined primarily by supply conditions and by other structural or behavioral characteristics of the economy. These relationships are not known with certainty, of course, and thus many different price-output combinations must be viewed as possible for given rates of monetary growth.

Monetary growth rates are much more closely related in the short run to nominal GNP than they are to the division of nominal GNP between output and prices. The tradeoff between output and price might be improved, however, through the use of other policy tools. Governmental action to eliminate regulatory or market impediments to price competition could be helpful in tempering inflationary pressures. So, too, could a continuing program of voluntary wage-price guidelines, which may help in restraining the anticipatory actions that have made the wage-price spiral so intractable. The nation's ability to avoid an escalation of inflation over the next year or so--without serious recession--will depend in considerable degree on whether a means is found to overcome the tendency for workers and businesses to seek higher wages and prices in an effort to offset the effects of the income transfer associated with the rise in oil prices. Over the longer run, the ability of the nation to achieve sustained growth of real income will depend importantly on whether it can solve its energy problem.