APPENDIX

Notes for FOMC Meeting

September 16, 1980

Scott E. Pardee

Dollar exchange rates have moved narrowly against major currencies since the August 12 FOMC meeting. Early in the period the dollar advanced by 1 to 2 percent virtually across the board, as U.S. interest rates firmed. At the time, market participants expected that interest rates abroad, and particularly in Germany, would be reduced in view of slower economic growth if not recessions developing in most industrial countries. But those interest rate expectations were not realized. Instead of cutting rates, the Bundesbank increased rediscount quotas, simply placing on a more permanent basis liquidity that had already been there. With the Bundesbank staying put, other EMS central banks also did not move down on interest rates. The British authorities, with a huge bulge in the growth of sterling M3, also remained firm on interest rates. Only the Bank of Japan cut its discount rate--by 3/4 percentage point, but that was less than the market expected.

With the thrust of monetary policy abroad thus remaining restrictive, market participants reviewed the latest data from the United States with caution. Indications that the recession here was beginning to bottom out, that the monetary aggregates were growing strongly once again, and that the producer price index was rising sharply as a result of the jump in food prices all contributed to heightened concerns about the outlook for inflation in the United States--at a time when other countries seem to be making clear progress in reducing their rates of inflation. The exchange market remains skeptical over the tax cut proposals that are coming forth from political candidates, for fear that the budget deficit will be very difficult to contain. In addition, the exchange market has been alive with reports of heavy OPEC diversification out of dollars and into other currencies. Much of this flow was diverted into sterling and the Japanese yen--which has risen sharply during the period--but substantial amounts have also moved into German marks and other continental currencies as well. The upsurge in gold and silver prices is also largely attributed to demand from Middle East interests, although again market participants believe that an intensification of inflationary expectations in the United States is part of the cause.

The upshot is that even though interest rates in the United States continued to climb in late August and early September, the dollar on balance slipped back in the exchange market, in most cases to around the levels prevailing at the time of the last FOMC meeting. The very fact that the dollar did not rise at a time of rising interest rates has been taken bearishly. At least the selling pressure has not been heavy. We intervened on only three occasions when the dollar came on offer, for a modest total of $33 million from balances. Otherwise, the Desk continued to accumulate marks to repay Federal Reserve swap debt and rebuild Treasury balances. Total purchases by the Desk amounted to $580 million. The System's swap indebtedness was reduced by $320 million to $363 million. The Treasury's short position in marks under the Carter notes was reduced by some $220 million, to $2.8 billion. We also found opportunities to acquire French francs, mainly through correspondent transactions, and we reduced the System's swap debt to the Bank of France by $55 million to $111 million.

FOMC MEETING
SEPTEMBER 16, 1980

REPORT ON OPEN
MARKET OPERATIONS

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

A record bulge in monetary aggregates in the week of August 6 cast a long shadow over the conduct of open market operations and the behavior of financial markets since the last meeting of the Committee. While some of the bulge washed out in subsequent weeks, this did not proceed to the extent expected initially, so that estimates of August growth worked higher over the month. The reserve paths were drawn to accommodate a moderate bulge in the early part of the period but events quickly out-ran that element of accommodation.

As early as August 15, when we had just learned of the August 6 bulge, it was estimated that demand for total reserves would be about $125 million above path, so that adjustment borrowing was expected to average around $200 million rather than the $75 million initial level indicated at the August meeting. As the period progressed, the expected excess of total reserves above path worked higher, to about $380 million most recently. Meantime, the path for nonborrowed reserves was reduced by $150 million relative to the total reserve path in view of the persisting expected excess of total reserves, and largely reflecting these developments it was anticipated by last Friday that adjustment borrowing at the discount window would average about $600 million for the five-week period ending tomorrow, including some $750 million in the current week. Because of a bulge in borrowing this past Friday, the current week is more likely to turn out around $1 billion or so and this could lift the 5-week average to more like $650 million.

Along with the greater pressure on reserve positions, the Federal funds rate also moved higher over the period, from around 9 percent early in the interval to the area of 10 1/2 - 11 percent in the last few days. While permitting the rate to rise, the Desk took care, particularly in light of Committee members' comments during a conference call on August 22, to avoid actions that might be read as aggressive moves to push rates higher--in order to avoid or minimize the market overreactions that have tended to follow Desk operations on several recent occasions.

The bulk of the Desk's outright transactions came quite early in the pariod, on August 13, when the System bought about $1.2 billion of coupon issues of various maturities--including fair size at the longer end. It was fortuitous that we were in a position, looking at reserve needs, to make this purchase at a time when there was a sizable inventory available in the market. Without the System's purchases, the interest rate adjustments of the recent period might have been even more severe.

Later in the period the System sold $284 million of bills to foreign accounts while $91 million of an agency issue was redeemed without replacement. Temporary reserve transactions included the daily arrangement of matched sale-purchase transactions with foreign accounts and several instances of matched sales to absorb reserves in the market. System repurchase agreements were arranged only once in the market, an action that helped to spark a sharp price rally around Labor Day. On several other occasions the Desk passed through some of the foreign account repurchase orders to the market, but market analysts tend to place more weight on the System's own repurchase agreements even though the reserve effect is similar.

Market rates rose across a broad spectrum during the recent period. Major factors underlying the increase were the sharp rise in money supply and resultant concern that the System would foster greater restraint, the growing sense of emergent economic recovery, signs of continuing inflation and indications that demands on the credit markets from both the Government and private sectors will be large in months ahead. After a sharp slide in August, prices rallied for a few days around Labor Day, apparently in response to what we considered some routine repurchase agreements over the long weekend. The reaction probably came about because it looked to the market as though the System, up to then, had let rates push steadily higher without resistance, and the System RP's, which happened to be done when Federal funds moved up to 11 percent, were greeted like a cavalry charge coming to the rescue of a damsel in distress. Subsequently, the gains in the rally were approximately retraced.

Net over the period, bill rates rose roughly 150 to 190 basis points. Three- and six-month bills were auctioned yesterday at about 10.64 and 10.88 percent, compared with 8.72 and 8.89 percent just before the last meeting. The six-month rate is again in territory that causes the rate on related six-month money market certificates to be quite costly to financial institutions.

Intermediate-term coupon issues, up to about 5 years, have risen about 120 to 185 basis points in yield over the period, while long-term rates rose about 35 to 80 basis points. The Treasury will sell 2-year notes on Thursday this week and 4-year notes next Tuesday, possibly at rates approaching 12 percent. At the moment, dealer inventories of over-1-year Treasury issues are about $1 billion, rather moderate compared with about $3.6 billion at the time of the last Committee meeting which was in the midst of the August refunding. Ordinarily the next Treasury coupon issue would be some 15-year bonds in early October but at the moment this is still a question until the Congress acts to enlarge the leeway to sell bonds with coupons above 4 1/4 percent.

Finally, I should mention that we have recently trimmed our list of officially reporting dealers by three names to 34. The three names dropped are First Pennco, Nuveen, and Second District. Desk trading with the latter two had already been discontinued some months earlier, but they had remained for a while on the reporting list. The reasons for dropping these firms from the reporting list varied: First Pennco is being liquidated by its parent, the First Pennsylvania Bank; Nuveen changed the character of its business from being a dealer or market maker to being just an investment or trading account; and Second District's volume of customer activity had dwindled to a point that no longer met our standards for reporting dealers.

James L. Kichline
September 16, 1980

FOMC BRIEFING

Information available since the last meeting of the Committee suggests a further improvement of activity in a number of sectors of the economy. The staff has revised its forecast of real GNP to show a somewhat smaller rate of decline in the current quarter, and continues to expect the trough in activity will be reached soon, if it hasn't already occurred.

Consumer outlays are one important area where activity has picked up. Retail sales in August rose further, and the previously reported June and July increases were revised up appreciably. The August gain in sales was widespread, but not nearly so large as in July, owing to a leveling in auto sales. However, domestic auto sales in the first 10 days of September advanced. The retail sales data became available after the forecast was finalized, and they are considerably stronger than those implicit in the forecast for the current quarter.

In housing markets the latest hard information on activity is for July. In that month, home sales rose sharply and housing starts edged up to a 1.3 million unit annual rate. Scattered qualitative reports suggest that the rise of mortgage rates has begun to damp the rebound in housing market activity, with conventional mortgage commitment rates most recently averaging a little above 13 percent--up more than 3/4 percentage point since early August. The combination of somewhat higher mortgage interest rates over the forecast horizon and comparatively weak growth of real disposable income is expected to constrain the housing market recovery.

The labor market surveys for August also pointed impressively to a rise in activity. Nonfarm employment increased about 200,000, with half of that occurring in manufacturing--the first monthly gain since February. Moreover, the average length of the workweek in manufacturing rose ½ hour. The unemployment rate edged down 0.2 percentage point to 7.6 percent.

The gains in employment and hours worked were associated with a rise in industrial production in August, the first since January. The index will be released this morning and shows a gain of ½ percent, while revised information indicates smaller drops in output in both June and July than had been published earlier. Gains in output last month were fairly widespread, with notable increases in the production of durable home goods and construction products--areas that had been depressed sharply during the spring. The rise in the overall index was limited by the 12 percent drop in auto assemblies, a temporary factor reportedly accounted for by parts shortages for some models.

Running counter to the string of stronger business news is the information on business fixed investment. Shipments of capital goods and construction spending in July remained weak, and developments in orders and contracts suggest continued weakness in future months. Confirming evidence of the weak outlook became available with the Commerce Survey of anticipated plant and equipment spending which showed an increase of only 8-3/4 percent in nominal terms for 1980, all of which occurred in the first half of the year. The staff forecast of business fixed investment was not altered significantly, and it continues to portray declines in real outlays over the projection period.

Activity in the near term is also held down in the forecast by the projected liquidation of inventories. Inventory-sales ratios remain high, especially in manufacturing, even with the recent increases in sales. We have continued to assume that businesses will strive to obtain a leaner inventory posture than now exists, but admittedly forecasting inventory behavior is a chancy affair.

On the price front, the changes in the forecast this month have been small. The effects of adverse weather on food prices have continued to mount, and we added a bit more to expected inflation in that sector. Prices overall are projected to rise 10 to 10½ percent in 1980 and about 1 percentage point less next year.

In sum, the general contour of the staff's forecast remains the same as projected last month. Real GNP is expected to show a small decline in the current quarter, be about unchanged in the fourth quarter, and recover sluggishly next year. The recent stronger business news we interpret as a partial snapback from the severe drop in activity during the second quarter, particularly evident in the auto, housing, and durable home goods sectors. Those are the sectors that apparently bore the brunt of the credit restraints during the spring. The basis for a sustained, strong expansion of economic activity does not appear to be in place now or on the immediate horizon, given high rates of inflation and restraining monetary and discretionary fiscal policies.

FOMC Briefing
S. H. Axilrod
Sept. 16, 1980

The unusual burst of money growth in August is apparently being followed by a very modest expansion in September, but the rapid August growth was sufficient to make it likely that expansion for the third quarter (on a quarterly average basis) will be at a 9.8 percent annual rate for M-1A, a 12.3 percent rate for M-1B, and a 14.9 percent rate for M-2--all higher than the Committee had anticipated for that period, though M-2 apparently will be only slightly higher. With the August burst, M-1A and M-1B are now well within the Committee's longer-run target ranges for the year 1980, while M-2 is just above its longer-run range. Given the desirability of the Committee's not running over its longer-run monetary targets for this year if a credible anti-inflationary stance is to be sustained in face of stronger upward price pressures than had been expected and slippage in the Federal budget, the question naturally arises as to the practicability, in view of various economic lags, of limiting money growth sufficiently in the three and a half months between now and year-end to hit the longer-run targets.

This would probably be very difficult for M-2, and neither of the alternatives presented to the Committee in the blue book would bring M-2 back into target range. The yield on a significant and growing portion of the non-transactions assets in M-2 can be adjusted by institutions to changes in market rates, and so long as suitable investment outlets are available to the institutions, they can be expected to continue actively bidding for funds through instruments such as small-denomination time deposits even while restraint on reserve availability may be pushing up market rates. Thus, we may well see relatively strong M-2 growth over the next three months--though slower than in the summer--

under either alternative A or alternative B unless the economy in the fourth quarter turns out to be much weaker than expected and the flow of income and savings is thereby greatly reduced.

With M-2 quite likely to run high, it would seem to be even more urgent to keep growth in M-1A and M-1B within bounds. While that seems feasible at this point, I would not take much heart from the apparent weakness in M-1A and M-1B in September. At present levels of interest rates, that weakness will probably give way to considerable strength before the year is out, assuming that our projection of 11 percent in nominal GNP growth in the fourth quarter is near the mark. How strongly the Committee might wish to resist such a strengthening depends in part on interpretation of second and third quarter developments with respect to the narrow aggregates.

There is some question about whether the third quarter resurgence in M-1 growth should or should not be viewed as an offset to the second quarter weakness. Arithmetically, taking the two quarters together, M-1A grew at about a 3 percent annual rate and M-1B at a 5 percent rate, roughly paralleling expansion in nominal GNP at about a 3 percent annual rate. From that simple viewpoint, it would be tempting to say that the third quarter is best viewed as an offset to the second. But there is more to it than that.

There was a sharp drop of short-term interest rates after the first quarter. Given this drop in rates, and the GNP that we saw, a much more rapid growth in money than developed would have been expected on the basis of historical experience. The growth we didn't get represents the so-called demand drift. All of this drift occurred in the second quarter, when the actual level of money turned out to be a further 3-1/2 percentage points below the level predicted by our model. At the time, we thought his might mainly represent not a permanent demand shift, but a temporary downward blip related to, for example, use of cash to repay debts in consequence of the credit control programs. In the latter case, an at least partially offsetting greater than usual strength in money growth might have been expected in the third quarter. But strong as the third quarter is, the rapid growth in narrow money does not appear to represent, so far as our equations tell us, any significant compensation for the second quarter drift. Rather, given the lagged upward effect on money demanded from the second quarter drop in interest rates, the growth was about what the model would have predicted if the public had indeed decided to get along permanently with a lower stock of money and not make up for the second quarter shortfall.

Thus, the rapid growth of money in the third quarter does not appear to represent, to any significant extent, efforts by the public to make up for the second quarter weakness. Rather, we now do seem to be getting the rapid growth that might have been anticipated in any event and that appears consistent with the pull of inflationary pressures. And it would then seem probable that strong demands for money are likely to persist into the fourth quarter, particularly if nominal GNP is given an added fillip from improvement of the economy in real terms. Thus, even if September money growth is weak, the odds strongly favor rapid expansion on balance over the remainder of the year.

The following implications might be drawn for the Committee's policy decision as between alternatives A and B, or variants thereof.

First, under either alternative some further upward pressure on interest rates seems likely between now and year-end, with such pressures larger and sooner under B.

Second, if the 3-1/2 percentage point drop in money supply level below model expectations in the second quarter can be taken as the drift for the year, as seems to be the case in view of recent experience, then it might be taken as an argument for preferring the more restrictive alternative B--with its implied 4 percent M-1A growth for the year--to alternative A. When the FOMC reaffirmed its 1980 monetary targets in July our estimate of drift at that time was on the order of 2-3/4 percentage points. Now we seem to have 3/4 percentage point more drift--or technically speaking 3/4 of a point less money would be needed to finance the same GNP. In that case if the 4-3/4 percentage midpoint of a 3-1/2 to 6 percent range for 1980 was satisfactory in July, then 4 percent as implied by alternative B should be satisfactory now. This conclusion might be buttressed by the probability that M-1B would probably run high within its range and M-2 above its range even under the constraints of alternative B.

Third, and finally, it should be pointed out that, the relatively low growth in narrow money under alternative B between now and year-end--only 3-1/4 percent at an annual rate growth--runs a high risk, in my judgment, of quickly eroding the base for an economic recovery--largely, of course, because a recovery now appears to be occurring before there has been much, if any progress in containing inflation. The greater monetary expansion under alternative A than alternative B would run less risk of stymieing the recovery--though it is certainly not without risk in that respect, but it would run a little more risk of building in an inflationary momentum that would make the problem of monetary control even more difficult next year.