

APPENDIX

NOTES FOR F.O.M.C. MEETING
November 17, 1981

Sam Y. Cross

Mr. Chairman,

Since the Committee's last meeting the dollar has fluctuated rather widely. On balance, comparing today's exchange rates with those of six weeks ago, the dollar has declined by a significant amount against the Swiss franc, by a smaller amount against the yen and pound sterling, but only fractionally against the mark and related EMS currencies. Central banks were substantial net sellers of dollars. Interest rates in the U.S. declined much more sharply than in other countries. Thus, differentials narrowed noticeably since the last FOMC meeting. For example, interest rate differentials for three-month deposits in the Euro-market favorable to the dollar have declined by 2 1/2 to 3 percentage points against the mark and the yen. A question arises as to why, in the circumstances, the dollar has held up as well as it has.

One reason why the declining interest rate differentials have not had greater impact on the dollar-mark rate is that the market is expecting the Germans and most other Europeans to act soon to reduce their interest rates in line with U.S. reductions. In light of the criticism at the time of the Summit meeting, that rising U.S. interest rates compelled others to follow suit, the market might expect a prompt response

by the others to any U.S. interest rate reduction. The fact that they have not reduced their rates as much as the U.S. may in part reflect some uncertainty about how long the period of lower U.S. interest rates will last. But, in addition, concerns about persistent inflation and current account performance in their own economies may make some of these other countries reluctant to reduce their rates too far too fast, irrespective of the U.S. situation.

Moreover, the outlook for the German mark remains clouded by political uncertainties. Periodic episodes of heightened tensions overseas, especially in Poland and the Middle East, brought occasional upward pressure on the dollar and at times sharp increases in the exchange rate. Although these periods of tension had no lasting effect on the dollar-mark rate, they served to highlight the political divisions within Germany regarding security and economic policies. In this context, the market views the U.S. as having better prospects for domestic political stability than a number of other nations, and apparently continues to regard the U.S. as relatively immune from the consequences of any outbreak of hostilities in other parts of the world.

In the market, the dollar has been supported by substantial purchases from time to time by non-G-10 central banks converting their non-dollar reserves to pay for imports; by Russia, which may be accumulating U.S. and Canadian dollars to pay for wheat purchases, and by certain other central banks which appear to be making portfolio adjustments.

Aside from these official purchases, commercial demand for dollars for investment as well as current payments, has seemed to emerge in a number of centers when the dollar has reached certain levels--in terms of marks, around the DM2.20 or DM2.18 level. There seem to be those who think that at those levels the dollar is worth buying--or at least that being short is too risky or too expensive. After all, that level represents a substantial correction from the high dollar rates of mid-August, and the prospects for the U.S. current account next year look better now than they did a few weeks ago, given the decline in the exchange rate since mid-August and the weaker U.S. economic growth prospects. Thus, there seems to have been a rather solid commercial demand for dollars at a certain level which--thus far--has meant that the periodic selling pressures have not tended to snowball or get out of hand despite the narrowing of interest rate differentials.

Let me add a few words on recent developments in other currencies. The Swiss franc, as mentioned above has strengthened sharply against all currencies, partly as a reflection of the National Bank's tightened monetary policy designed to deal with inflation. The Swiss franc has even appreciated beyond the critically important .80 cross rate with the mark which had been regarded as an upper

limit since 1978. More recently the Swiss appear to have gotten concerned about the strength of the currency and have begun injecting liquidity. The EMS realignment is regarded as successful politically and technically. The French franc remains within the EMS arrangement, and is trading near the top of the band, supported by some capital reflow and by stringent exchange controls which have now been relaxed somewhat. The yen remains weaker than the Japanese authorities purport to want, and they attribute it to capital flows associated in part with low Japanese interest rates.

The Bundesbank operated, on both sides of the market at various times, to moderate fluctuations in the dollar-mark rate. On balance, the Bundesbank operated more aggressively to resist mark declines, selling slightly over net during the period.

The U.S. did not intervene on Federal Reserve or Treasury accounts during the period. On two occasions intervention was considered, once when the dollar rose after Sadat's assassination, and again on another occasion of rapid strengthening of the dollar. On both occasions the disturbances broke out before the U.S. market opened, and faded quickly, and no U.S. action was taken.

NOTES FOR FOMC MEETING
NOVEMBER 17, 1981
Peter D. Sternlight

Desk operations since the last meeting were shaped against the backdrop of weakening money supply growth, a softening economy, and resultant sharp declines in interest rates. These factors emerged clearly only in the second half of the period, however. Indeed, for the first few weeks money seemed to be growing about on track or even a shade above, while the securities markets continued on their up-and-down roller coaster course of recent months. By late October, though, the aggregates were repeatedly revised lower, the economy was sliding more visibly, and the fixed-income markets moved into one of their dramatic rallies.

For the first three-week subperiod, ended October 28, while aggregates ran fairly close to path, total reserves were roughly \$100 million below path, part of it due to lower-than-expected excess reserves. The shortfall was reflected in a level of borrowing that averaged about \$100 million below the Committee's initial \$850 million level--while nonborrowed reserves were just about on path.

In the second three-week subperiod, ending tomorrow, it looks as though demand for total reserves will be about \$150 million below path. A small upward adjustment was made in the nonborrowed reserve path to encourage slightly further the easing of reserve pressures already under way, and thus promote a little more robust money growth. As of this point, we expect to come fairly close to achieving the nonborrowed reserve path for the second subperiod as well. Weekly nonborrowed reserve levels in this second subperiod were set with an expectation that borrowing would work its way down to about \$700 million, \$500 million, and \$400 million in the three weeks--although actual borrowing turned out closer to about \$800 million in the first two weeks. In the current week, borrowing is lower, roughly \$300 million.

The funds rate moved only grudgingly and irregularly lower over most of the six-week period--fluctuating mainly in a 15 to 15-1/2 percent range through much of October, and slipping a little under by month-end. Then, after the basic discount rate was reduced, it gave ground more convincingly--sliding to 14 percent in the week of November 1, and averaging 13-1/4 percent so far this week.

The System's outright holdings of securities were reduced in the early part of the interval, but then increased by a more than offsetting amount toward the end of the interval as we began meeting large seasonal needs for reserves. Net holdings of bills increased by about \$400 million, including a \$1 billion purchase in the market on November 10. Active use was made of matched-sale purchase transactions to absorb reserves, especially in the early part of the period, while System repurchase agreements or the passing through of customer repurchase agreements were employed on several other occasions.

Interest rates fell across a broad front during the period, especially since late October. Short-term rates declined moderately in the first few weeks and then more steeply in the final weeks, spurred by a combination of lower funds rates and financing costs and then increasingly by expectational factors as the perception of a weakening economy gained momentum. Three- and six-month bills were auctioned yesterday at 10.69 and 10.97 percent, down from 14.21 and 14.22 on October 5. The latest auction rates were the lowest in over a year. Persistent buying by money market mutual funds helped the market to absorb some \$6-1/2 billion in additional supplies of bills over the period.

Other short-term rates also registered large declines—about 3 percentage points for commercial paper and 3 to 3-1/2 percentage points for bank CDs. The prevalent bank prime rate has come down from 19 to 16-1/2 percent but there is still a fair-sized gap between the prime rate and bank costs, and one large bank moved to 16 percent yesterday.

For longer maturities, most of October was a replay of experience over the summer—thin markets, violent moves up and down in rate, and lack of real conviction about trends. Concern about the Federal budget was a continuing adverse factor. Between early and late October, long-term rates had moved up to levels approaching the late-September records, as the market nervously awaited the Treasury's November refunding announcement and the accompanying estimates of the cash needs for the current and following quarters. Interestingly, the Treasury's announcements seemed to mark a turning point in underlying market sentiment, followed by a dramatic rally that has extended well into November. While the announced needs were large--about \$36 billion this quarter and some \$30 billion next quarter--they contained no unpleasant surprises for the market. They seemed to be large enough to be credible, compared to the market's own estimates, and not so large as to look unmanageable in the context of a weakening economy. Of course, the further unfolding news on the economy gave strong support to the rally in subsequent weeks, along with further confirmation of moderate money growth and signs of the Fed's willingness to see rates come down.

It is hard to disentangle clearly the impact of the October 30 announcement of a discount rate reduction, as it came in the midst of the rally and was by that point not really unexpected, though probably more people were looking just then for action on the surcharge rather than the basic rate. On the actual announcement day, the rate change seemed to have little impact, but viewed in a little longer context, the move was taken as indicative of System willingness to see some declines in market rates. Yesterday's announcement of a cut in the surcharge was followed by a modest rise in prices.

What has given staying power to this recent rally, in contrast to the volatile ups and downs earlier, was the broadened investor participation, and in turn that probably owes most to the perception of weakness in the economy and hence less concern about a large Treasury deficit this fiscal year. The market seems to be thinking mainly of a deficit on the order of \$70-\$80 billion, but even the occasional talk of \$100 billion has not caused the alarm it would have a month or two ago.

Over the interval, intermediate-term Treasury issues were down about 2 to 3-1/2 percentage points in yield, while long-term issues were down roughly 1-1/2 to 2 percentage points. Meantime, the Treasury was raising some \$7-1/2 billion from the public in the coupon market. Fortunately, the Treasury got the benefit of part of the rally in its sale of the November refunding issues. They came at yields about a full percentage point under those prevalent at the time the auctions were announced. Since the auctions, the yields on the new issues have dropped another 1 to 1-3/4 percentage points.

Roughly similar declines extended to the corporate market, notwithstanding some concern about the enormous potential backlog of issues held back earlier. As rates declined, the pace of new offerings has quickened noticeably, and it may even be approaching the flood proportions that some had feared. The tax-exempt market also saw substantial rate declines--on the order of 1 to 1-1/2 percentage points. The pace of offerings in this market had not slackened as much as for corporates, and its recent pickup was also more moderate.

Dealer profitability has improved with the recent rise in prices, following sizable losses by some dealers earlier in the year. Some dealers, though, had minimized losses or even made profits earlier in the year by avoiding or hedging exposed positions.

The primary dealers with which we trade Government securities have weathered the earlier turbulent period without too serious consequences. But one firm with which we were trading bankers' acceptances, Lombard-Wall, Inc. sustained significant capital impairment and we considered it prudent to suspend trading with them.

James L. Kichline
November 17, 1981

FOMC BRIEFING

Over the past month or so there has been a sizable and rather widespread deterioration of economic activity. Sales, production, and employment have all declined recently and it now appears to the staff that real GNP will fall at around a 4 percent annual rate in the current quarter. This is a somewhat larger decline than projected at the last meeting of the Committee, and given our reading of the available information it also appears probable that GNP will decline a little further in the first quarter of next year. The current forecast is more cyclical in character than the previous forecast, but not fundamentally different.

Final demands in the economy have weakened appreciably since the summer. In the consumer sector, the advance report on total retail sales for October shows a drop of $1\frac{1}{2}$ percent following an unchanged volume of sales in September. Excluding autos and nonconsumption items, retail sales rose a couple of tenths last month, which of course translates into declines in real terms. The retail sales data were obtained after the staff's forecast was prepared, but they are consistent with the consumer spending built into the projection for the current quarter. Auto sales plunged in October, reflecting principally the reduction of various purchase incentives. In early November sales picked up by about 1 million units annual rate, to around 6 million,

although this was still a very weak performance and one that we think generally will prevail over the next few months given the high cost of autos and poorer prospects for expansion of personal incomes.

In the investment sectors little has changed recently. The housing market remains in the doldrums; sales activity and starts are at low levels and could go somewhat lower in the near term. However, declines in mortgage rates assumed in the forecast should provide a little stimulus to activity and the forecast has housing starts bottoming out this winter. Business fixed investment outlays in real terms seem likely to take a while longer to turn up--not until the second half of next year when final sales are expected to be stimulated by the second and larger stage of personal income tax cuts. The near-term indicators of spending, namely shipments, orders, and contracts are suggestive of weakness which is not unexpected in view of the slower pace of sales and production, declining rates of capacity utilization and the financial pressures within the corporate sector.

Recent information available on inventories indicates a faster accumulation occurred in the third quarter than was estimated in the GNP accounts. It would appear that there indeed was some unintended accumulation and this seems to have fed quickly into reductions in orders, production and employment. Industrial production is now estimated to have declined $1\frac{1}{4}$ percent in September and $1\frac{1}{2}$ percent

further in October, with cutbacks widespread. In the staff forecast the production adjustments are thought to be fairly well along in the current quarter and inventories are expected to be brought back into line with sales in the next few months.

The reduction in output has entailed sizable declines in demands for labor, especially in the manufacturing sector, and the unemployment rate rose to 8 percent last month. Unemployment insurance claims indicate further large layoffs into early November, and the unemployment rate is expected to rise through the winter. We anticipate the unemployment rate will stabilize around 8-3/4 percent by next spring.

It's never possible to judge precisely how deep or how long a contraction might run, but it seems that the best bet at this time is that it won't ultimately prove worse than portrayed in the staff forecast. We did not enter this period with major imbalances in the economy, and as I noted, the recent emergence of some inventory overhang seems to be reasonably under control. Moreover, there are still a few sectors of strength, especially the defense and energy areas. In addition, the housing and auto markets have already undergone major adjustments, and it's hard to envisage much more of a decline there. To provide some perspective, the latest monthly figures on domestic auto sales and housing starts are a little below the depressed levels in the spring of 1980 at the time of the credit control

program, and 45 to 50 percent below the levels prevailing in the spring of 1979. The decline in interest rates of late should, with a lag, provide some support to these and other markets, and the fiscal side is providing support as well. But on balance, while we don't perceive the economy to be in a major contraction, we also don't believe there is a basis for a particularly brisk recovery in view of the assumed monetary restraints.

In conclusion, I might note that the staff's price forecast has not been changed significantly for this meeting of the Committee. It still seems that the outlook is for improved cost and price performance next year in association with slack labor and product markets.

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November 17, 1981

FOMC BRIEFING

Stephen H. Axilrod

By this time in the year, the outcome for the year for the aggregates is just about determined. Barring a very sharp upsurge in growth of narrow money, M1-B will end the year clearly below its longer-run for 1981 of 3-1/2 to 6 percent. (It would take growth at about a 15 percent annual rate over November and December to hit the bottom of the range by December.) At the same time growth of M2 will be at or, more likely, somewhat above its longer-run range of 6 to 9 percent. Thus, the Committee's decision today would seem to have more importance for its impact on the emerging pattern of credit market conditions and implications for the process of attaining next year's monetary targets. This is inevitably involved with assessment of the underlying resilience of the economy and with the likely effects of changing credit conditions on inflationary expectations.

Jim has already discussed the economic outlook. Given the monetary targets tentatively set for 1982, and the present fiscal outlook, the staff at this time would expect short-term interest rates to move above current levels in the course of next year, more probably by the second half of next year. In that kind of context--which assumes a certain resiliency in the economy--any substantial further drop of interest rates in the months immediately ahead may tend to exacerbate the dimension of, or accelerate the timing of, a prospective turn-around in rates as efforts are made to keep monetary aggregates reasonably close to the long-run target path in the early part of next year.

While such an outlook tends to argue against a policy toward the aggregates over the near-term that would encourage rapid further short-term interest rate declines, it is of course the case that interest rate declines would have an excessively expansionary effect only in the degree that they were larger than justified by basic emerging weakness in economic activity. In that respect, it should be observed that the sharp drop of rates in the spring of 1980 and the sharp rebound in the aftermath--while certainly containing lessons for the present--are not clearly analogous. The credit control program imposed at that time is one substantial difference. I would argue that the impact of the credit program masked the underlying degree of strength of the economy at the time, or at least made the economy seem a lot weaker than it was. As a result, the sharp drop in short-term rates turned out to be much greater than basic economic conditions warranted, and a large rebound necessarily ensued after the program was lifted.

In the current situation, we would seem to have more pervasive economic weakness both at home and in key industrial countries abroad, with weakness at home not attributable to the terms and psychological impact of a credit program but more to sustained reductions in demands for goods and services, partly in consequence of persistently taut financial conditions. While the current widespread economic weakness may provide some assurance that some further interest rate declines would not undo progress thus far made in curbing inflation, the Committee would still have to weigh carefully the impact of rate declines on the state of inflationary expectations. If rate declines were to be interpreted as indicating the Federal Reserve's resolve to curb inflation was weakening and the odds on prospective large budgetary deficits being financed by money creation were therefore increasing, that would probably work to discourage more moderate wage settlements

in the course of next year and to encourage a rebound in private credit demands and interest rates as, with inflationary expectations possibly strengthening, debt came to appear less burdensome in real terms.

7 But it is of course difficult to assess in advance the likely impact on attitudes of further interest rate declines. That would depend in part on behavior of the money supply at the time as well as on the extent to which businesses and consumers perceive that the economic outlook is for sustained weakness. The alternatives before the Committee suggest that a modest acceleration in M1 growth in November and December from its October pace--as in alternative C--might be associated with either no change or only a minor further decline in short-term rates, unless the economy is a lot weaker than we currently project. This alternative involves growth in M1 on a trajectory that is approximately consistent with next year's tentative target (with near the upper end of it to be more precise). Efforts to achieve more rapid growth rates over the last two months of this year, as in alternatives A and B, are more likely to involve rather substantial further drops in rates, and a more difficult task of phasing into next year's target. However the Committee balances its course for the aggregates against the potential for an easing in credit conditions and for its longer-run anti-inflationary strategy, it may also wish to consider whether or not, in the off chance money runs strong relative to the chosen course, it wishes to see any commensurate tightening in money market conditions.