APPENDIX

Notes for F.O.M.C. Meeting
August 21, 1984

Sam Y. Cross

The dollar on average is trading at about the same level as the time of your last meeting but it has shown a fair amount of movement in the interim. Earlier this month it touched new records for the 11 year floating rate period against the mark and pound and other European currencies, and then it edged back in markets that were thin and at times volatile. Even so, the dollar is still up some 11 percent in trade-weighted terms from its 1984 low which was reached in March.

In the first few weeks of the period the dollar benefited from a number of factors. Newly released economic statistics reinforced the view that the U.S. economy was continuing to expand at a brisk pace and considerably more strongly than the economies of our major trading partners. With better than expected U.S. price figures, inflationary expectations tended to moderate, and this was seen in the exchange market as adding to the attractiveness of dollar investments even as U.S. long-term interest rates declined. As the U.S. stock and bond markets rallied, there were reports in the exchange markets of increasing foreign interest in U.S. investments. Further, the repeal of U.S.

withholding tax on interest paid to foreigners was seen as stimulating such investment. But while there has probably been some increase in foreign investment in the United States, it is hard to say how much.

In the last couple of weeks, the rise of the dollar seemed to lose its momentum. With the prospect of our economic expansion moderating, market participants started to question whether the dollar could hold on to its current levels, which are around the highest of the year, in the absence of a continuing stream of positive news about the U.S. economy or improved yields on dollar assets. Exchange traders have been shying away from taking bold positions in foreign exchange--something that is perhaps easier to do when many of their customers are on vacation.

Foreign central banks have scaled back intervention to support their currencies. In fact, since your last meeting there were net purchases of dollars, of about 1/2 billion. In some cases, foreign central banks became resigned to the dollar's strength, and their concern over the impact on domestic prices of a continued rise in the dollar was tempered by falling commodity prices. As the dollar eased back, several countries took the opportunity to reduce domestic interest rates. In particular, the United Kingdom, which had, just before your last meeting, pushed up its interest rates by over 3 percentage points, led rates down by 1 1/2 percentage points.

Mr. Chairman, there were no intervention transactions under taken by the U.S. during this period.

In other operations, last week our Bank transferred $125 million from Argentina's account with us to the banks on Argentina's Advisory Committee. This was to repay one of the bridge loans the banks made to Argentina, and in accordance with the agreements we were to make the transfer if Argentina had not agreed on an IMF letter of intent by August 15. Argentina and the IMF are still in discussion over an adjustment program and the terms of an IMF letter of intent.

NOTES FOR FOMC MEETING

AUGUST 21, 1984

PETER D. STERNLIGHT

Desk operations since the last meeting have sought to maintain about the prevailing degree of pressure on bank reserve positions, as indicated by adjustment and seasonal borrowing at the discount window or net borrowed reserve positions. Monetary growth was slower than envisaged a month ago, especially for M1, but on balance the aggregates remained about in line with Committee objectives for the year. Short-term rates, notably the Federal funds rate, edged higher during the interval, while intermediate and longer rates declined in response to scattered signs of slower economic growth, continued subdued inflation, and lessened concern that monetary policy might take a firmer turn. Apprehension about the stability of the financial system, which had mounted visibly in May and June, had already abated considerably by the time of the mid-July meeting. The calming trend continued through July and early August although most recently there have been some new or renewed concerns, highlighted by last week's headlines about Financial Corporation of America.

The upward creep in the Federal funds rate, from weekly averages around 11 to 11 1/4 percent through most of July to around 11 1/2 to 11 3/4 percent in recent weeks (and 11.78 percent so far this statement period) has been something of a puzzle, occurring against a background of average adjustment and seasonal borrowing at the discount window that remained fairly consistently around the $1 billion level. Indeed, going back earlier in the year, the funds rate was more like 10 1/2 percent in association with borrowing around the $1 billion level. Part, and perhaps much of the explanation, I believe, has been a greater reluctance, particularly by larger banks, to use the window lest they be tarred with the same brush as Continental, or in order to preserve their access for a later time. This did not cause total seasonal and adjustment borrowing to decline because that level is essentially determined by the gap left between the System's provision of nonborrowed reserves and the bank's demands for reserves. But it did mean that individual banks facing reserve needs have preferred to pay up more in the funds market before turning to the window. Interestingly, borrowing by the large banks has declined from about half of total seasonal and adjustment borrowing before Continental's problems emerged to about one-third more recently, while the seasonal component of borrowing has risen appreciably.

There have been a number of additional explanations of the borrowing-funds rate relationship with varying degrees of plausibility, ranging from a tightening of administrative standards at the window to a switching from longer to shorter term liability management by banks. Some explanations center on the large and growing borrowing by Continental, suggesting in some cases that the System's offsetting actions were somehow more potent than the reserve dollars borrowed by that bank, or that the substantial rechanneling of reserve flows in the wake of that borrowing somehow had to be done at higher rates.

Certainly, from a mechanical standpoint, Continental's rising use of the window was a major force shaping actual Desk operations during the past month. Continental's borrowing has increased from about $5 billion in mid-July to around $7 to $7 1/2 billion recently--failing to stabilize even after the massive official aid package was announced in early August. Largely to counteract this injection of reserves, the System reduced its outright portfolio by about $3.6 billion, including $2.2 billion of bill sales to foreign accounts and $1.4 billion of bill run-offs in weekly auctions. (That includes $500 million run off in yesterday's auction, for effect this Thursday.) Repurchase agreements were employed only once, at the very start of the period, while market matched sale-purchase transactions were used several times to absorb reserves temporarily.

Underlying the roughly 50-60 basis point decline for intermediate and longer term Treasury issues were the scattered indications of slowing growth in the economy, the continued signs of restrained inflation, moderating money growth, and official comments that were interpreted to mean that no near-term policy tightening was likely. The market also drew encouragement from reports of large equity-to-debt swaps by corporate pension funds and from the repeal of the withholding tax on foreign holders of U.S. issues, especially after the Treasury began to outline plans for issues targeted for the foreign market. Sales abroad of zero coupon instruments backed by U.S. issues also encouraged the market, offering the prospect of a lessened supply to be placed at home. This factor gave a particular lift to the Treasury's recent 30-year bond sale, as part of its generally successful $16 3/4 billion August coupon financing. The persistently firm money market dampened the spirits of the longer term market on occasion, but for the most part the long-market participants tended to look past the high funds rate and regard it as largely technical and perhaps temporary. In the overall improved atmosphere the Treasury coupon market fairly readily absorbed some $13 billion of net new cash borrowing, most of it in the August refunding.

The better atmosphere in intermediate and longer Treasury issues also extended to the corporate and tax-exempt markets, where new issuance was sizable and receptions mostly good.

At the short end, rate trends were mixed. Three-month Treasury bills rose over the period, affected by higher financing costs, increased Treasury supplies and an abatement, through part of the period, in flight-to-quality demand. Some of that latter type of demand re-emerged in recent days as concerns arose about foreign debt exposure and repercussions of Financial Corporation's problems. Longer bills showed little net change or modest declines in rate. Three- and six-month bills were auctioned yesterday at average rates of 10.40 and 10.59 percent, compared with 10.17 and 10.60 percent on July 16. Net cash raised in the bill sector was about $7 billion.

Market rates on large bank CDs showed little net change over the period for shorter maturities and modest declines for longer maturities. This resulted in some narrowing of the spreads of CD yields over bills. Spreads reached a recent low point in early August, with a little widening again in recent days.

As usual, sentiment is mixed as to where the markets may go from here. The intermediate and longer markets have fluctuated without trend most recently, apparently having spent the momentum that brought a vigorous rally into early August. Many participants feel that further significant rate declines are not likely unless short rates recede. Further down the road, some see upward rate pressures resuming for intermediate and longer issues if a fairly strong recovery and large budget deficit continue. A big uncertainty is the extent to which foreign demand might develop out of the withholding tax repeal and the structuring of issues to appeal to foreign buyers.

At the short end, while many feel the funds rate is somewhat artificially high just now, there is no widespread expectation of a significant early decline. Some observers expect that there could be a small decline, but possibly followed by more upward pressure later.

LEEWAY

While the situation is more than usually uncertain, I'd like to recommend an increase in the leeway for changes in the System's portfolio between meetings. Projected increases in required reserves and currency could nearly use up the usual $4 billion margin, while Treasury balances at the Fed may well rise in late September and enlarge the need further. Declines in extended credit could augment the need, while increases in such credit would reduce the need for additional leeway. To be reasonably safe, I suggest an increase in the standard leeway to $6 billion.

JLKichline
August 21, 1984

FOMC Briefing

Economic activity recently appears to be rising at a strong rate, but more moderate than the exceptional expansion during the first half of the year. The staff forecast of real GNP does not differ much from that presented at the last Committee meeting. For the current quarter we are anticipating real GNP growth of 5 percent annual rate and expect a further slowing to the area of 3 percent early in 1985. For price and wage inflation, the picture continues favorable and we've made some downward adjustments to the forecast.

Fundamental strength in the economy was revealed by the July labor market reports. Nonfarm payroll employment rose a substantial 300,000, not much different from the preceding few months although below the gains early in the year. The unemployment rate rose to 7.5 percent as the household survey reported a large drop in employment; that drop obviously was not confirmed by the payroll survey or initial claims for unemployment insurance, which have remained low. Thus, we have discounted the household survey as not representative of labor demands for the month and would expect declining unemployment rates to be reported in coming months.

About one-third of the rise in payroll employment in July was in the manufacturing sector and was associated with a 0.9 percent gain in industrial output, the same as the upward revised increase for the preceding month. Production of motor vehicles picked up in July and there were sizable further increases in output of business equipment and related materials.

Growth of business fixed investment has continued at a remarkable pace; in the second quarter it was 23 percent higher in real terms than the year earlier. The staff's forecast entails slower expansion during the projection period, with less growth coming from the motor vehicle and other equipment sectors. But the information on shipments, orders and contracts has induced us to raise somewhat future rates of growth compared to the last forecast. In this projection business investment continues to be a key source of strength in the economy.

Evidence of moderating growth in the economy comes mainly from the consumer and housing sectors. Domestic auto sales in July and the first 10 days of August averaged 8-1/4 million units annual rate, unchanged from earlier in the year. As domestic production rises there is the potential for some further gains in sales given the very short supply of popular models, but the surge in sales early this year is unlikely to be repeated. Retail sales other than autos and nonconsumer items are reported to have declined a little in July, while a broader measure of consumer outlays that includes expenditures for services shows a small rise. The forecast incorporates moderating growth of consumer spending, following the unusual buying spree during the spring.

In the housing sector, starts and building permits moved lower in July. This report became available after the projection was finalized, but it is consistent with our expectations. Most of the slowing in the housing area has been in the single family sector, but we expect that multi-units also will be edging lower as tighter mortgage rates and terms generally damp activity during the fall and winter.

On balance, the staff interprets incoming information as essentially consistent with a more moderate expansion of activity than we had been experiencing. Nevertheless, the evidence continues to indicate an economy with considerable potential for generating income.

For wages and prices the news has continued very favorable. Some of the wage information that has become available was below our expectations and there is not a hint of any significant upturn in rates of wage increase. For prices, too, the news has been good and we revised downward somewhat projected rates of inflation. In the very near term we should be seeing the impact of weaker energy prices;

gasoline prices actually have fallen this summer when seasonally they tend to rise. Food prices have been rising less than expected, and it appears harvests will be good and the long awaited sharp rise in meat prices has not materialized. Finally, the foreign exchange value of the dollar continues high and adverse price consequences of a fall in the dollar's value have been pushed farther into the future. In sum, we are projecting a rise in the GNP deflator of under 4 percent for 1984 and about 1 percentage point more in 1985.

FOMC Briefing
S. H. Axilrod
August 21, 1984

As indicated by the blue book, we believe that it is likely, in the limited time between now and the end of the quarter, that M1 will run below the short-run path for the June-to-September period adopted at the last Committee meeting even if reserve pressures were moderated somewhat. It seems possible that M2 also may run low. Of course, these aggregates are quite volatile, and our views do not assume growth in the double digits in either August or September, a possibility that quite obviously cannot be ruled out, given past experience. Meanwhile, M3 and credit growth remain relatively strong, though showing signs of moderating from their rapid first half paces.

The weakness of M1 in July followed a couple of strong months. Growth of that aggregate since the beginning of the year still leaves it somewhat above the midpoint of its long-run range. And it is not unreasonable to expect expansion in August and September to average in the 6 to 7 percent area, which would maintain M1 somewhat above the midpoint of its long-run range. One reason for anticipating at least that much expansion at around current interest rates is the apparent strength of nominal GNP growth in the third quarter and our thought, and also our quarterly model's implied prediction, that velocity growth should slow further from the pace of the first and second quarters, given our expectation that interest rates will not increase further over the near-term.

Strains on financial markets appear to have abated a little since the last Committee meeting. Quality spreads have narrowed; bond yields have declined; and the stock market has risen sharply. However, the Financial Corporation of America situation, which has been deteriorating in the past several days, carries with it the potential for heightening concerns about the underlying health of the financial system depending on how the situation is resolved. While perhaps the most likely outcome is that it would be viewed as an isolated event, the thrift industry as a whole is on the verge of negative earnings, and large depositors in thrifts—which have relied on large CDs to a great extent for funds over the past year—may as a result of Financial Corporation become more sensitized than they were in earlier high interest rate periods to reductions in thrift net worth. In addition, some little spillover on banks cannot be ruled out, and the spreads between large CDs and Treasury bills deteriorated slightly on the recent publicity.

One problem for monetary policy of the Financial Corporation or other developments (e.g. problems with Latin-American debt) contributing to financial strain is how they may affect bank reserve management attitudes. Since May we have already seen a rise in the federal funds rate on the order of a little over one percentage point without any change in the level of adjustment borrowing at the discount window. Some rise in rates could be expected under normal circumstances as a relatively high level of borrowing persists and banks rotate through the window.

In addition, the rate may have come under upward pressure over the past 2-1/2 months as other financing sources (like large CDs and Euro-dollars) have become less available or more expensive, thus diverting demand to the funds market, and as funds lenders may have sought more of a risk premium. But much of the rate rise we've seen reflects, I believe, what in technical jargon would be termed an increase in the demand for free reserves (manifested mainly by increased reluctance to borrow) in response to the perceived plight of certain major financial institutions. Such an increase in the demand for free reserves generally was observable in the mid-1974 when Franklin National was borrowing for emergency reasons what was then considered to be the large sum of on the order of $1-1/2 billion. As short-term rates rise for a given level of borrowing, that may indicate that the Federal Reserve is not accommodating to an increased demand for free reserves. The result can well be less growth in reserve and related money aggregates than desired. If money growth weakened enough, presumably policy would respond within the structure of the current directive in any event. But adjustment of the amount of borrowing to clearly perceived changes in bank attitudes toward the discount window reduces the odds on such weakness developing, or at least developing in the wake of unexpectedly high interest rates.

On the larger policy issue of the basic response of monetary policy to unsatisfactory developments in the aggregates and the economy, the proposed directive language suggests wording that would revert to a symmetrical response on the easing or tightening side, given recent developments in the aggregates and the economy, instead of a slight bias toward tightening. In practice, of course, there is very little room for tightening within the current 8 to 12 percent funds rate range, since I suspect any thought in the market that the System was seeking a sustained, higher level of borrowing above the area of $1 billion would, under current circumstances, quickly drive the funds rate to over 12 percent. But I do not mean to be implying any technical need to raise the limit at this time. Indeed, the limit could well serve the Committee's policy purposes should potential financial strains lead the FOMC to want to evaluate the situation before permitting strength in the aggregates or the economy to be reflected in tighter bank reserve positions.

Whether in any event the Committee would wish to adopt symmetric language to govern the response to deviations from expectations may depend on the exact specifications adopted for the aggregates. If, for example, the current 5-1/2 percent June-to-September specification for M1 is retained, it might be argued that no change should be made in the response language in the directive, since M1 is already so weak relative to path that further weakness would call for a response within the present directive structure. On the other hand, if the Committee were to make a downward adjustment in its June-to-September path for M1 to a growth rate of 4 to 4-1/2 percent, the response language could be asymmetric in the other direction--that is, a response could be more delayed for overshoots (given the recent weakness) than for further shortfalls. Probably the best case for symmetric response language would be if the Committee were to adopt a range for M1 growth--for example 4 to 6 percent--covering the June-to-September period.