

## APPENDIX

## Notes for FOMC Meeting

November 18, 1980

Scott E. Pardee

The exchange market tendencies I outlined to the Committee at the time of the October 21 FOMC meeting persisted through early November, with the dollar advancing virtually across the board. The dollar remained in particularly heavy demand against the German mark, rising a further 5 percent by November 7. This was mainly in response to a further rise in U.S. interest rates, which widened interest differentials in favor of the dollar over the mark by as much as 9 percent per annum. But the market also remained bearish toward the mark in view of the economic and political difficulties facing Germany, and funds flowed out of marks into other major currencies as well. In the EMS, with the mark on the bottom and the French franc, and occasionally the Dutch guilder, on the top, intervention mounted sharply, cumulating to some \$2.7 billion equivalent through the first week in November. The strains on the EMS had a classic pattern, with the difference being that roles were reversed. German officials were the ones who were vigorously denying rumors that their currency was about to be devaluated, and French officials were the ones who took action to curb the flow of funds into their currency in the name of defending the limits of the EMS band.

In Germany, with the expansion of the domestic economy having slowed and with the growth of central bank money coming in slightly below target, there were good reasons for the Bundesbank to ease monetary policy. Moreover, with the inflation rate trending downward, there was also some scope to cut the interest rates. Such a cut was widely expected, encouraged by numerous statements by German officials, including from the Bundesbank. But Germany has a huge current account deficit, with more in prospect next year. Interest rates are already lower than in most other countries, and the outflows of private funds have been so great that much of this year's deficit has mainly been financed out of official reserves. Consequently there were strong reasons, on international grounds, for the Bundesbank to hold firm on interest rates or if anything to raise them. Indeed, by early November, the outflows of funds had triggered a fall in bond prices--or a rise in bond yields--in Germany, prompting the Bundesbank to supply marks through domestic open market operations to support the bond market while it was simultaneously absorbing marks in support operations in the exchange

market. In the balance of its various operations, however, the Bundesbank gradually shifted to absorbing rather than providing liquidity with no overt move to raise or lower interest rates. Official talk of the need to cut German interest rates ceased for the time being.

The French authorities were caught in a somewhat different dilemma. Economic growth has also slowed in France and money growth has been exceeding the targets set by the Bank of France for this year. The intervention in response to the demand for francs within the EMS was adding to bank liquidity, which in turn was beginning to affect the monetary aggregates. For that reason the French actions announced on November 7 did not go very far. They made a modest reduction in the interest rates at which they intervene in the domestic money market and they introduced a marginal reserve requirement on non-resident holdings of francs to inhibit new inflows. But they also raised reserve requirements generally to absorb some of the liquidity created by the previous inflows. French officials argued, however, that much of the strain on the EMS reflected the rise of U.S. interest rates, to the extent that investors shifted out of marks, used the marks to buy francs at the EMS interruption limits, and then sold the francs against dollars. At least since the November 7 actions, the immediate strains on the EMS have eased. I could relate dilemma situations in other major countries which have been sharpened by the need once again to factor the rise of U.S. interest rates into their own foreign exchange and monetary policies.

The importance of interest rates in the dollar's advance was underscored beginning on Friday, November 7, when at the slightest sense that interest rates might be topping off in the United States, the dollar came under a sudden burst of selling pressure, particularly on Monday, November 10. The dollar dropped 3-½ percent in less than two days of trading. That episode had many of the characteristics of the dollar decline in the first week of April, when interest rates here began to turn down. This time U.S. interest rates did not continue to decline and were firming again when the Federal Reserve acted last Friday to boost the discount rate. The dollar thus came into demand again and has regained most of the ground it gave up early last week. On balance, since the last FOMC meeting, the dollar has advanced by a net of 3 percent against the German mark and the EMS currencies, 2 percent against the pound sterling, 2-½ percent against the Japanese yen, and 1-¾ percent against the Canadian dollar.

In intervention, we continued to lean heavily against the wind as the dollar advanced, buying as many marks as we could. We are taking this opportunity to amass resources,

particularly to cover the Treasury's short position under the Carter notes. Our intervention is probably having another effect as well. By moderating the rise of the dollar and the pressures generally on the currencies of our trading partners as a result of the upsurge in U.S. interest rates, we have reduced the risk that other central banks will be forced to raise their interest rates to defend their own currencies at a time of slow or no growth in their domestic economies. Finally, although it is difficult to say whether current levels for the dollar are appropriate or not, if we had not intervened so heavily, dollar rates may very well have been pushed to levels that would have been widely recognized as unsustainable.

Our gross purchases of marks during the period amounted to \$2.1 billion equivalent. Last week, when the dollar did drop sharply, we sold a total of \$163 million on two days. Of the net acquisition of marks of nearly \$2 billion, System balances increased by \$619 million. As you know, the Committee agreed to increase the limit of our mark holdings to \$1.5 billion equivalent; we currently hold \$1.1 billion. The remaining marks went to the Treasury, reducing its short position under the Carter notes to just under \$1 billion. We also bought sufficient French francs to repay the remaining \$34 million of swap debt in that currency. And the Desk bought some \$90 million of Swiss francs, which we have split with the Treasury.

Looking ahead, we can expect some drop back in dollar exchange rates as soon as U.S. interest rates level off. But, for the time being, the dollar has also been bolstered by the fact that our current account is in near balance, with a surplus forecast for 1981, while the current accounts of most of our major trading partners are in substantial, if not massive, deficits. Slower economic growth is generally expected abroad so those deficits may well subside somewhat over the year ahead.

FOMC MEETING

NOVEMBER 18, 1980

OPEN MARKET  
OPERATIONS

Mr. Sternlight made the following statement:

For the fourth time in as many months, growth in monetary aggregates has exceeded the Committee's desired rates since the last FOMC meeting. Once again this has led to a marked firming in interest rates as the Desk sought to resist the overrun by providing nonborrowed reserves only in line with the Committee's modest growth objectives, thus forcing banks to borrow more heavily from the Reserve Banks. Moreover, as in other recent months, the force of this restraint was augmented by reducing the nonborrowed reserve path relative to the total reserve path, first by \$100 million and then by another \$50 million.

As of last Friday, it looked as though demand for total reserves would run about \$300 million above path for the four weeks ending November 19. Reflecting this, and the deliberate reduction in the nonborrowed reserve path by \$150 million, as noted, the implicit average borrowing for the full period works out to \$1,750 million rather than the \$1,300 million initially used in constructing the nonborrowed reserve path. Last Friday's announcement of a 1 percent rise in the basic discount rate and 2 percent surcharge for large banks that borrow frequently has further underlined the System's restraining posture.

Since borrowing in the middle weeks of the interval exceeded anticipated levels, especially in the November 12 week when it averaged somewhat over \$2 billion, the implicit borrowing level in this final

week is about \$1.6 billion. So far this week, through yesterday, actual borrowing has averaged about \$1.85 billion.

As the banks' enlarged reserve demands pressed against more limited supplies of nonborrowed reserves, the Federal funds rate rose sharply over the period, from roughly 12 1/2 percent in mid-October to an average of 14.65 in the reserve week ended November 12. For a few days around November 6-7, trading was largely at or somewhat above the 15 percent upper bound of the Committee's broad range, a level that seemed hard to explain just in terms of the volume of borrowing that the System was anticipating at the time. In part it may have developed from the strong upward momentum of various market rates, particularly including CD rates, as expectations of progressively increasing restraint gained force. A tendency of daily reserve levels to fall short of day-to-day estimates may also have contributed. In any event, by last Thursday and Friday some of that heightened momentum had abated and funds trading seemed to be settling closer to the area of 14 percent. Yesterday, however, the first trading day after announcement of the new discount and surcharge rates, the funds rate pushed higher again, to the area of 16-18 percent despite sizable Desk action to provide reserves.

The Desk's outright trading activity during the past four weeks was nearly all on the reserve-draining side, addressed to absorbing a net release of reserves on November 13, as the Monetary Control Act phase-ins began. A net of nearly \$900 million of Treasury bills was sold to foreign accounts while \$500 million of

bills was run off in auctions. At that, the net reduction in outright holdings was much less than we had anticipated a month ago and the temporary addition to leeway was not needed. As it turned out, market factors such as float either drained more or provided less reserves than had been expected earlier and this helped accomplish some needed absorption. Substantial day-to-day use was made of repurchase agreements, especially in early November, when outright holdings were being reduced in preparation for November 13 but reserves were still needed on a temporary basis. Matched sales to drain reserves from the market were arranged on only one occasion, but they were employed every day with foreign accounts.

The rise in yields extended across a broad front during the period--from Federal funds to the longest term bonds. It reflected a combination of factors including the heightened money market tautness as well as reaction to the continuing money growth, and concern over inflation. At the short end of the market, a key role seemed to be taken by CD rates, as some banks aggressively sought to issue new liabilities. In secondary market trading, 3-month CD rates were up roughly 300 basis points over the period. Commercial paper moved up about 250 basis points. The bank prime rate rose  $2\frac{1}{4}$  percentage points to  $16\frac{1}{4}$ , including yesterday's move of  $\frac{3}{4}$  percent by several large banks. Treasury bill rates were auctioned yesterday at rates of 14.31 and 13.92 percent for 3- and 6-month issues, compared with 11.41 for both issues the day before the last meeting.

For intermediate Treasury issues the net yield rise was on the order of 1 to 1 1/2 percentage points and somewhat under 1 percent for the longest issues. The Treasury continued to tap the intermediate and longer markets for new funds, including about \$3 billion raised in the refunding that settled yesterday. The Treasury paid record high rates for the respective maturities sold in the refunding. The market improved for several days after the refunding and this permitted some distribution to occur at premium prices but the premiums largely eroded in the closing days of the period. A temporary improvement about a week ago reflected some abatement in the pressures that were pushing short-term money rates higher each day as well as a feeling that recent economic news was more mixed in its implications for the sustainability of recovery and the strength of inflation. Prices had weakened last Friday in reaction to the large industrial production increase reported early in the day, and gave further ground when a large rise in bank loans was announced late in the day. Reaction to the discount rate was fairly mild in the intermediate and longer-term markets-- a modest price decline that still left a little premium on the new 10- and 30-year issues, though not on the 3 1/2- year note.

By last Friday, dealers' cash positions in over-1-year Treasury issues were about \$1.2 billion, well down from the \$2.1 billion post-refunding peak but above the \$700 million level on the day of the last meeting. Their net exposure is reduced by virtue

of positions in coupon futures--a net short of \$1.1 billion at the latest report, as of October 31.

Among short maturities the recent rise in rates has produced levels still considerably below the highs early this year--by some 2 - 2 1/2 percentage points in the case of bills, CD's or commercial paper. At the longer end, Treasury and corporate yields are quite close to their past peaks, while long-term tax exempts have broken through to new highs. This difference between the short and long ends of the maturity spectrum may reflect a view that inflation is now considered by investors to be an even longer-term, more intractable problem than was perceived earlier.

James L. Kichline  
November 18, 1980

FOMC BRIEFING

Economic activity in the aggregate continued to expand last month and this quarter as a whole will likely show a little larger growth than last quarter. But there are signs that the rebound of activity during the past few months is now waning. Overall, the staff's forecast of the economy for this meeting of the Committee is little different from that presented a month ago, even though we have modified the underlying fiscal assumptions; through 1981 we continue to forecast rapid inflation and slow real growth.

The continued upswing in economic activity last month was indicated by the strong reports on labor markets and industrial production. While the unemployment rate remained about  $7\frac{1}{2}$  percent in October, around the level that has prevailed since the spring, nonfarm employment increased about  $\frac{1}{4}$  million--bringing the level  $\frac{3}{4}$  million above the trough in July. The gains in employment were widespread, but were particularly notable for durable goods manufacturing and construction where earlier job losses were sizable. In addition to the increased employment, the average length of the workweek in manufacturing also rose for the third consecutive month.

The strength in manufacturing hours and employment is consistent with the large rise in industrial output last month. The total industrial production index is estimated to have increased 1.6 percent in October, and output for the preceding

two months was revised up as well. The rise in production of late has been broadly based, although the growth in output of materials--such as steel--construction supplies, and motor vehicles has been particularly strong. For a number of sectors it appears that inventories were drawn down substantially in the spring and summer so that a pick-up in orders would translate rather quickly into accelerated production. But growth of final demand seems to be weakening, and unless that situation changes, production schedules will have to be trimmed to avoid a pile up of inventories. In fact, the forecast implicitly contains an appreciable slowing of production increases in November and December along with a swing in inventories from liquidation last quarter to a small increase this quarter.

Developments in the auto market highlight the nature of the present situation. Auto sales and production rebounded in the third quarter from the severely depressed pace in the spring. But domestic auto sales in October and the first 10 days of November were at a 6-3/4 million unit annual rate, or only a little above the sales pace in the third quarter. Although sales of the highly touted new Chrysler and Ford models generally have been good, high prices, high nominal financing charges, and weak real income undoubtedly have damped overall auto demands. Even though producers in recent weeks have been trimming planned assembly schedules, scheduled production still exceeds current sales levels.

Retail sales other than autos and nonconsumer items also have fared relatively poorly in the past two months. The

information currently available indicates such sales declined in real terms in both September and October.

In the housing markets, tighter financial conditions apparently are taking their toll on activity. Conventional mortgage commitment rates are now averaging over 14 percent, and there are numerous reports in the Redbook and elsewhere of builders, potential buyers, and lenders backing away from the market. Although housing starts data for October are not yet available, partial data on building permits indicate a substantial drop from the month earlier. The staff forecast contains a decline in starts this quarter to  $1\frac{1}{2}$  million units at an annual rate and a slightly lower level on average for 1981.

Business fixed investment in the current quarter is expected to register its third consecutive decline and remain weak through most of next year. The volatile nondefense capital goods series on orders and shipments rose appreciably in September, but on average indicators of investment spending in real terms have tended down in recent months. Restraint on investment spending in the forecast stems from continued underutilization of capacity in an environment of sluggish output growth, poor profits, and high costs of capital.

The business sector also seems less likely now to receive as large a share of possible tax cuts next year. We have altered the fiscal assumptions in light of the election results and unfolding information on tax and spending intentions. The tax reduction is still assumed to take effect in April, retroactive

to the beginning of the year, but the size of the assumed package was increased \$7 billion to \$35 billion, and more of the cuts were shifted to individuals. At the same time, non-defense expenditures are assumed to be cut about 2 percent from what they would have been otherwise. On balance, the fiscal and monetary policies assumed still exert a restraining influence on activity over the projection period.

On the price side, it seems likely that the news will prove rather bearish in the period immediately ahead. Food prices in particular are rising rapidly and will probably continue to do so for several months to come, while energy price increases tend to accelerate after their tranquil behavior last quarter. But we continue to forecast some moderation of inflation later next year given continued appreciable slack in labor and product markets.

FOMC BRIEFING  
S.H. Axilrod  
November 18, 1980

As was explained in the Bluebook, the staff continues to expect a sharp decline in the rate of growth in narrow money. We expected that in September and also October, of course--although at an earlier meeting it was pointed out that large growth might very well occur in any one month. Nonetheless in the last couple of months an over-all marked slowing in growth was asserted to be in prospect, but accompanied by a modest further rise of interest rates. In the event, of course, money grew much more rapidly in September and October than anticipated, and interest rates rose much more quickly than earlier expected and to higher levels.

I don't believe there is any real mystery behind this deviation between expectations and outcome. The economy has been much, much stronger in recent months than commonly anticipated. On our own estimates, the third quarter growth in nominal GNP has been revised up by 5 percentage points (annual rate) since the September meeting and fourth quarter growth by 4 percentage points, mostly in real terms. Growth has apparently been particularly rapid in the past three months, when real growth in that sector of the economy measured by the industrial production index rose at a 4 percent rate, not annualized.

Thus, I would like to stress--as was indicated in the current Bluebook--that our projection for the slowing of money growth over the balance of the year depends not only on the usual lagged response to increases in interest rates over the balance of the year but also on the assumption that economic activity is now in process of weakening markedly.

To the degree that economic activity is not weakening, money demand can be expected to be stronger than projected, and upward pressures on interest rates over the balance of the year could then be quite intense.

Uncertainties in forecasting GNP and money demand, particularly in an unstable inflationary period, were of course one of the main reasons for the Committee's shift to reserve targeting, and away from reliance on money demand relationships, in setting operating guides for the Account Manager. The lags inherent in the economic process can easily cause money growth to diverge from Committee targets in the short-run, but over the longer run a divergence is more likely to be interpreted as reflecting Committee assessment that the monetary targets should not be met, or should be permitted to be high or low in the range, for one reason or another.

The question of whether a longer-run target should be met obviously involves fundamental economic issues, but when there are only about six weeks to go in the targeting period--as is the case now--it also involves technical issues. At this point, with so little time left, there is not much within reason that can be done to change the outcome for the year 1980 significantly.

Thus, the Committee's decision at this meeting might well involve the degree of resistance it wishes to put up to developing behavior of the aggregates in light of, among other things, assessment of the likely impact of emerging interest rate levels on future economic activity and money demand, and on prospects for next year's target. For example, if the Committee believes that the pace of economic activity will in fact slow considerably in the next few months--whether in response to recent credit

tightening or for other reasons--then it might wish to consider putting up less resistance to emerging growth in the aggregates assuming such growth is reasonably low, than it would if it believed that economic activity would remain strong and inflationary pressures would intensify. At the same time, if the Committee takes the view that inflationary pressures remain strong even if economic activity is weakening, and that interest rates therefore may have to be relatively high next year, it may not wish to resist relatively weak aggregates over the balance of the year, particularly in view of the strength in the aggregates to date.

But the Committee would need also to take account of response by the market to the behavior of money itself and to the short-run targets the Committee sets for itself. Alternative B in the Bluebook maintains the September-to-December target set by the Committee at the last meeting. But that was an upward revision of the implied target for the same period set at the previous meeting, and it implied growth above the target range for the year for M-1B and M-2. If the Committee at this meeting were to opt for the higher aggregates of say alternative A, that would represent yet another upward revision of the September-December target, and may be construed by markets as a weakening of the FOMC's anti-inflationary resolve, particularly if actual results come in even higher.

Two not necessarily mutually exclusive approaches come to mind under present circumstances. One is to narrow the funds rate range a bit so that the Committee has an opportunity to review any changes in prospect for the economy and money demand over the months ahead before acquiescing in substantial interest rate movements if the aggregates come in substantially

different from path. In such a context the Committee's placement of the upper and lower limits of the range would depend in part on whether the Committee views a substantial drop in rates in the short run as potentially more counter-productive than a substantial rise in rates. A second approach is for the Committee to decide on the maximum growth in money that it finds tolerable without letting resistance develop, and at the same time--in view of recent overshoots--accepting sizable shortfalls from that growth rate without a concomitant easing of bank reserve positions. Such an approach, if adopted, would appear at least implicitly to imply that a short-run drop in rates runs more economic risk than a rise.

Finally, I should also point out that as explained in the Blue-book, there is more doubt than usual about banks' demand for borrowing, since the limited time and special conditions under which the surcharge on the basic discount rate was in effect earlier provides only an uncertain basis for estimating current reactions. Thus, a certain flexibility may be needed in judging the behavior of nonborrowed reserves relative to path, and indeed in constructing the path itself. I am not sure how to quantify such flexibility, but in principle the emerging level of borrowing would have to be judged against growth in the monetary aggregates and other indicators of pressure on bank reserve positions.