

APPENDIX

Notes for FOMC Meeting

March 18, 1980

Scott E. Pardee

Since the last meeting of the Federal Open Market Committee, the dollar has been in demand against all major currencies. For example, the dollar has advanced by some 7 percent against the German mark and other currencies linked to it within the EMS, 10 percent against the Swiss franc, and 3-½ percent against the Japanese yen. The major reason is the pull of substantially higher interest rates in the United States and in the Euro-dollar market. The differential between Euro-dollars and Euro-marks alone widened from 6 percent to 10 percent, a record.

The flow into dollars has been a combination of commercial leads and lags and other corporate funds, private portfolio shifts, and of placements in dollars by OPEC investors that had been channeling funds into other currencies. There have been some hefty transactions both ways, however, as some diversifiers have taken advantage of the lower rates for other currencies to switch out of dollars. With the dollar rising on balance, it is satisfying to think that those who for political reasons moved out of the dollar last fall and into other assets including gold are doubtlessly sitting on some very big losses. The gold price has tumbled some \$400 from the peak of \$875 in January to \$474 this morning.

While the dollar's advance has perhaps been a relief to us, the authorities of other countries have sought to resist the rise of the dollar lest the combination of a rising dollar and the higher oil price, denominated in dollars, exacerbates domestic inflationary pressures all the more. Most other major central banks also raised their official rates in recent weeks but market rates have not moved up so sharply in other countries as in the United States. Indeed, in most cases the central banks have been cautious about tightening further in view of the risk of triggering slowdowns in their economies. To the extent that the central banks are concerned about the weakening of their currencies against the dollar, however, they have resorted mainly to heavy intervention in the exchange market--in all during the period the G-10 central banks sold a net of \$10 billion. Some have also made adjustments in capital controls so as to encourage inflows. The German, Swiss and Japanese have actively solicited funds from the OPEC central banks.

So far, the U.S. program announced last Friday has been quite well received in the exchanges and the dollar has advanced further. Traders are quick to point out, however, that the positive reaction rests essentially on the expectation that interest rates will remain high here relative to the rates abroad. Economic fundamentals continue to be unfavorable for the dollar, in terms of the outlook for our trade and current account positions and our inflation rate.

With the Bundesbank selling dollars in such large quantities, we were able to share in the mark proceeds of that intervention. And we were able to acquire sizable amounts of marks from correspondents. As a result, last week we completed the repayment of \$2.7 billion of marks swap debt. The overall swap operation since last June netted the Federal Reserve a loss of some \$38 million. But experience has shown that to maintain the short-term nature of the swap arrangement it is best to clear the line quickly lest we have a new reversal of the dollar and need to start drawing again. The Treasury shared the mark sales with us on the way down but initially did not share in the mark purchases on the way up. All the marks we are purchasing now are for the Treasury, at profitable rates, [unintelligible] position under its Carter notes by \$260 million [unintelligible].

Beginning March 4, the Federal Reserve has also been participating in the intervention in support of the yen. From November 1978, when we intervened to correct an excessive decline of the dollar, the swing in Japan's payments account had been particularly drastic and the yen rate had fallen from around 180 to near the 250 level early this year, or by nearly 40 percent. The oil price has doubled in the interim, which means that Japan, as others, will have a substantial adjustment on its hands. Nevertheless, the decline of the yen against the dollar was clearly threatening to become excessive.

The Japanese authorities had been pressing for some time for us to help them stop the slide of the yen through purchases of yen for our own account. They also pressed others, including OPEC, members to buy and hold yen. The Desk had already been intervening in yen for the account of the Bank of Japan, and to have any effect on market psychology there would have to be an announcement that we would be participating more directly in the operation. Our concern was that announcing a purely bilateral operation in support of the yen could be misinterpreted in the market and trigger a rise not only of the yen but of other major currencies against the dollar as well. For that reason, we encouraged the Japanese to approach the Germans and Swiss to see if they might join in any announcement

and participate in the operation. After extensive consultations, those two central banks agreed to lend their names to a statement by the Japanese. The statement was released in Tokyo on March 3, accompanied by measures by the Japanese to encourage capital inflows. Over subsequent days, there was a period of testing in which the Bank of Japan intervened massively in Tokyo and New York, in the sum of We shared the New York operation by buying some \$147 million of yen for our own account. So far the Swiss have bought modest amounts of yen; the Germans have not bought any yen, but of course they have been very busy defending their own currency. We have indicated that we would be willing to take on some \$250 million at most in this operation and if the Japanese need more assistance from us that we would be prepared to activate the swap arrangements should they request drawings. Today the Bank of Japan raised its discount rate by $1\frac{3}{4}$ percentage points to 9 percent, and other measures are possible in the next weeks. Japanese exports are already beginning to pick up strongly, and I think it is only a matter of time before the yen begins to recover on its own.

REPORT OF OPEN
MARKET OPERATIONS

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

Open market operations since the February meeting of the Committee were conducted against a background of strengthening monetary aggregates, deteriorating financial markets, and then widespread anticipations of new official initiatives to deal with burgeoning inflation. Initial market reaction to the array of new measures and proposals announced last Friday has been mixed--with verbal comments dominated by skepticism, and interest rates first a little higher yesterday but then lower by the day's end. Stocks were off sharply on the day, though.

Just after the early February meeting monetary growth seemed to be coming out quite close to the Committee's desires. By mid-February, however, it appeared that February growth was coming in stronger than desired and this impression was further confirmed as the month progressed. In response, the Desk aimed for lower levels of nonborrowed reserves than were contemplated in the original path specifications, so that a substantially increased need to borrow at the discount window was imposed on the banking system. In turn, this intensified reserve pressure helped to push the Federal funds rate and other short-term rates substantially higher. For the first half of the period since the last meeting--the 3-week subperiod ending February 27--total reserves turned out \$280 million above path, while nonborrowed reserves came in about \$230 million below their path (which had already been adjusted

downward modestly). Borrowing in those three weeks averaged about \$1.8 billion, compared with an initially contemplated level close to \$1.2 billion.

The excesses in total reserve growth above path were more pronounced in the second half of the period--the three weeks ending March 19--even though by early March the excessive growth in aggregates was beginning to abate. As noted in the Blue Book, December-March growth is currently estimated to be just modestly above target for the M_1 measures, though still considerably above for M_2 . For the three weeks ending tomorrow, it is estimated that total reserves could be about \$700 million above path. Non-borrowed reserves could come in several hundred million below their downward-revised path, with borrowing averaging close to \$3 billion. Part of this further rise in borrowing--up to about the \$2 1/4 billion level--was an intended result of the excessive growth in aggregates and hence demand for reserves, and was accompanied by further upward pressure on the funds rate and other short rates in early March. A further part of the rise in borrowing, however, reflected stepped-up bank initiatives to use the window, especially on the past two Fridays when borrowing bulged sharply, possibly stimulated to some degree by expectations of discount rate action. Once it occurs, a weekend borrowing bulge of this kind carries an implication for the appropriate level of nonborrowed reserves making it reasonable to have a lower level of nonborrowed than in the path, lest total reserves push even further above path.

Certainly, the level of borrowing remains one of the more difficult elements to cope with in our reserve targeting approach.

Possibly, the new surcharge announced last Friday will add in time to some greater predictability in use of the window, but at least initially the new procedure itself adds another element of uncertainty in devising the appropriate level of borrowing.

Indicative of the heightening pressures as the recent period proceeded, weekly average Federal funds rates, after working downward during January from around 14 percent to under 13 percent in early February, climbed to around 14 1/2 - 15 percent in late February. The Committee lifted the 15 1/2 percent upper bound on the weekly average rate to 16 1/2 percent on February 22. In early March, with somewhat greater reserve pressures applied, and a turbulent market atmosphere in which rate increases tended to reinforce one another, the funds rate rose still higher, to weekly averages in the area of 16 - 16 1/2 percent. The Committee raised the upper bound on the weekly average rate further to 18 percent on March 7, so that the presence of an upper limit has not constrained the Desk's pursuit of reserve objectives.

Outright purchase and sale or redemption activity was nearly a stand-off for the full period--amounting on each side to about \$1.8 billion. Sales and redemptions of bills were undertaken largely in late February, including a sizable market sale on February 22, in an unsettled atmosphere, when the Desk took the unusual step of telling the dealers how much we wanted to sell of short-maturity bills--thus relieving one element of market uncertainty. Outright purchases were concentrated at the end of the period and were chiefly for delivery in the current statement week. The purchases included about \$485 million of

Treasury coupon issues as well as large bill acquisitions. Repurchase agreements and matched sales were used flexibly as short-term needs arose to align reserve levels with path objectives.

Interest rates scaled new heights during the intermeeting period, in markets that functioned haltingly. Time and again, the market bid for new Treasury issues at record rates only to see the issues decline in price in subsequent trading. Understandably, this exercise was discouraging to dealers and investors, and perhaps the remarkable thing is that auctions were covered in more or less orderly fashion. Underlying the market's pessimism--which was already well entrenched with the sharp increases in intermediate and longer rates that took place in January--was the deep-seated view that inflation was worsening and the Administration was doing little about it. During February, a very steep rise began in shorter-term rates as well, partly responding to the increased reserve pressure exerted by open market operations, and partly a psychological reaction to the increases occurring across the maturity spectrum in very thin, almost nonfunctioning markets.

By the latter part of February, some sharp price rallies developed, still in very thin markets, amid rumors that official consideration was being given to new measures such as wage and price controls, selective credit controls, and budget cuts. These price gains reduced net losses for the period in intermediate and longer issues. Bill rates also came down the last few days, while rates on other short-term instruments such as CD's stayed very high.

The net rise in yields of intermediate maturity Treasury issues was roughly 1 to 3 1/2 percentage points over the period,

and for long-term issues about 1 percentage point. At their worst, though, near the end of February, yields were as much as 1 percent above the most recent levels. The highest auction yield for a Treasury coupon issue was the 14.39 percent average for 5-year notes on February 26. This issue closed the period bid to yield below 13 1/2 percent and it is currently the only Treasury coupon issue quoted at a premium price. There is to be an auction of 2-year notes this Thursday, and current guessing is for a yield around 15 percent. This would compare with about 14 percent on the 2-year notes a month ago and 11 1/2 percent two months ago.

Among shorter maturities, where rates had been fairly stable from the start of the year until early February, the increases over the past six weeks have ranged to several percentage points. The three- and six-month bills in yesterday's auction, at 15.05 and 14.95 percent, respectively, were up from around 12 percent in early February. Putting those latest rates of discount on a coupon equivalent basis produces yields of about 15 7/8 and 16.40 percent. At that, bills have benefitted somewhat in recent days from a flight to quality, while some other short rates have risen even more. Secondary market quotes on major bank CDs, for example, are up some 4 1/2 to 5 percentage points for the period, and prime commercial paper offered by dealers is up around 4 percentage points. The banks' predominant prime rate, 18 1/2 percent now, compares with 15 1/4 percent in early February.

What have these kinds of rate moves meant to the functioning of markets? Certainly the markets have been hobbled, and on some days close to non-functioning--but so far, at least, I have not had

a sense of permanent damage. In the Government market, Treasury auctions and Federal Reserve open market operations have been handled satisfactorily, though one sometimes had to reach for scaled out bids or offerings to accomplish sale and purchase objectives. In some private market sectors, some issuers have chosen to withdraw for a time, but to what degree this signifies real long-run restraint or just short-term rearrangements of demands is hard to assess.

Finally, on a local housekeeping note, the Committee should be advised that at the beginning of March the domestic trading desk suspended its trading relationship with Second District Securities Division of M.A. Schapiro and Co. This resulted from a long-term slippage in the firm's share of market trading activity and was in no way a result of recent market turbulence. By and large, the checking we have done suggests that primary dealers on the whole have not fared badly from a profit standpoint recently. Some have had losses, but they seem to have occurred in firms that can weather them, and more of the firms have actually had profitable months recently through keeping low profiles and exercising nimble footwork.

James L. Kichline
March 18, 1980

FOMC BRIEFING

Incoming information suggests that aggregate economic activity this quarter has continued to expand. The staff now expects real GNP to rise about 2 percent at an annual rate in the first quarter, the same as in the preceding quarter. Nevertheless, available information from a variety of areas also points to a weakening of activity and the staff forecasts that the economy probably will slip into recession beginning next quarter. The administration's new anti-inflation program has not been incorporated in the projections, but that would surely add somewhat to the forces acting to depress activity. The program in the short run also will add to inflation, mainly through higher gasoline prices.

The growth of activity this quarter is indicated by developments in employment, production, and sales. But a careful reading of these and other statistics also provides evidence of weakening. In labor markets, total employment growth in February was still quite strong, although less than in January, and the unemployment rate edged down 0.2 percentage point to 6.0 percent. Most of the employment growth continued to be in trade, finance, and service industries while manufacturing was little changed. Average weekly hours worked--usually a fairly sensitive and early labor market indicator--declined in February for the second consecutive month, and, in fact, aggregate hours worked in February declined a bit. But the figures on initial claims for unemployment insurance have not yet shown a distinct rising tendency and while unemployment rates have risen for some groups over the past 6 months or so, this is associated mainly with developments in the auto and steel industries.

Industrial production in February edged up 0.2 percent on the strength of increased output of motor vehicles and parts from the low January levels. Aside from the motor vehicle and related sectors, output declined 1/4 percent. Production of durable home goods and materials dropped appreciably while business equipment output slowed further. Capacity utilization in manufacturing was unchanged at just over 84 percent, about 3 percentage points below the recent peak in March of last year.

Total retail sales in January rose briskly but the advance data indicate a decline during February. After adjusting for the rapid increase of prices, total retail sales in February appear to be about unchanged from the fourth-quarter average. The domestic automobile component of sales has held to about an 8 million unit annual rate--somewhat above that in the fourth quarter mainly as a result of a continuation and expansion of various rebate programs. Smaller, fuel efficient cars generally remain in strong demand, with imported models experiencing especially good sales.

On average we read consumer spending as being in the process of weakening and expect declines in real terms in coming quarters. Pressures on family budgets are mounting and will intensify in association with developments outside the consumer sector. Although tax refund checks might provide a small fillip to expenditures in the short term, declining real incomes and tight financial markets will show through as key forces depressing consumer outlays.

In the housing market conditions have tightened substantially further in recent weeks. Net deposit flows at thrift institutions have weakened considerably, earnings pressures have intensified, mortgage commitments

outstanding are on the decline, and interest rates have shot up in both primary and secondary markets. Both homebuyers and homebuilders are being influenced by these developments, as home sales and housing starts are trending down. Our current forecast places housing starts at a 1 million unit annual rate in the spring quarter, with only a moderate recovery later this year.

The general deterioration of long-term financial markets is likely also to affect business spending plans adversely, although it's too soon to have hard evidence of a downward revision of spending plans. For the current quarter, shipments of nondefense capital goods in January were quite strong and construction outlays continued at a high level. There are enough orders and contracts in the pipeline to sustain spending in the near term, but new orders and contracts in real terms appear to have peaked early last year. In general, the forecast contains a rather mild decline in business fixed investment outlays compared to past cycles. In this regard we have attempted to allow for special factors, such as the strength of outlays in the petroleum industry and auto industry outlays associated with the shift to smaller cars. However, the weight of the available evidence as well as likely responses to developments in financial markets and a downturn in sales suggest cutbacks in total investment outlays this year and next.

Overall, real GNP during this year is forecasted to decline 1-3/4 percent and to turn up in the latter half of next year. The decline in activity might be around 1/2 percent larger when taking account of the expected impact on activity of the administration's newly announced anti-inflation program. This would still imply a drop in activity from peak

to trough that would be appreciably less than that during 1974-75 although more than the average of other postwar recessions. The projected recovery of activity lacks vigor, however, principally as a result of continuing rapid inflation along with restraining monetary and fiscal policies.

On the inflation side, producer and consumer price indexes have increased rapidly in recent months and there likely will be continuing bad news for the next several months. The consumer price index in particular will be influenced not only by the impact of the oil import levy but also by the surge in mortgage interest rates. The oil import levy is not reflected in the forecast, but the direct impact is estimated to add about 1/2 percent to inflation this year. We still anticipate some easing of inflation later this year and in 1981 in response to a slowing of the extraordinary energy and mortgage rate increases and the growing slack in labor and product markets. In fact not all the news is bad; there is a hint of slackening in the rate of price rise, or actual declines of prices, in markets for some materials and supplies--including, for example, copper, steel scrap, rubber, lumber and plywood. These developments are too few as yet to have much significance in aggregate price measures, but they are suggestive of what is likely to become increasingly important as markets weaken further.

FOMC Briefing
S. H. Axilrod
March 18, 1980

Of the policy alternatives presented in the bluebook, alternative B continues throughout the first half of the year the $4\frac{1}{2}$ percent annual rate of growth in M-1A and 5 percent for M-1B that the Committee decided on for the first quarter. But it involves a somewhat more rapid growth in M-2 than the Committee had targeted for the first quarter. This more rapid growth recognizes the greater than expected willingness of the public to expand holdings of the interest-bearing components of M-2, particularly in the form of money market funds in the first two months of the year, at today's very high interest rate levels. Still, this stronger growth would leave M-2 expansion well within the FOMC's 6 to 9 percent longer-run range for that aggregate.

Continuation throughout the whole first half of this year of the Committee's first-quarter objectives for the aggregates would appear consistent with the new anti-inflation program announced on Friday. For that program to be seen as effective in terms of at least adding a psychological impetus to lowering inflationary expectations--not to mention producing a real reduction in spending--it should probably not be followed by any very rapid growth in either the monetary aggregates or bank credit. A tendency toward slower growth in money might develop over the months ahead if and as the rate of expansion in nominal GNP and transactions demand for cash slows in line with staff projections. But the tendency would be buttressed by continuation for a while of some degree of tension in credit markets. And such tension might be needed to insure slower growth in bank credit in line with the special credit restraint program, given our forecast of relatively strong credit demands over the next few months.

The restraint on reserve growth implicit in the alternative B targets is likely to maintain pressure on interest rates and credit conditions over the weeks ahead--always barring a sudden, sharp weakening of the economy. If the Committee wished to be more certain of continuing pressure on credit markets as the anti-inflation program takes effect, it might want to consider something like the specifications of alternative C--which call for lower money growth targets over the next few months, to be compensated for by a bit more rapid growth in the second half of the year when the economy is expected to be weakest. The relatively more rapid growth in the aggregates of alternative A--though still representing rather modest growth rates in an absolute sense--would appear least consistent with the spirit of the anti-inflation program since they are most likely to tend to encourage an immediate, noticeable easing of interest rate pressures and thereby tend to weaken market incentives for institutions to adhere to, for example, the special credit restraint program.

Because growth in the aggregates was relatively rapid in January-February, all of the monetary alternatives presented to the Committee in fact call for a considerable slowing in growth of the aggregates over the four months between February and June. Data thus far available in March indicate that very low, if any, growth is likely in M-1A for that month on average. But given the relatively low level of M-1A in early March, attainment of even a zero rate of growth on average for the month will require a substantial rebound in the latter part of March. If that develops, it would imply a relatively high level of M-1A at the beginning of April and would lay the basis for a sizable rate of growth in the month of April on average even if there was little further expansion in the course of that month. That does in fact seem the most likely pattern to us, and

is the pattern we have built into the proposed target paths for the aggregates over the period from February to June shown in the bluebook.

Should the Committee wish to tilt the odds toward minimizing the risk that another month of relatively large money growth may unduly encourage inflationary expectations and work against the spirit of the anti-inflation program, it might want to consider the desirability of aiming at relatively low money growth in April. This would tend to assure relatively large member bank borrowing and tight money market conditions if money does indeed grow rapidly. However, it would also lead to a rather prompt ensuing easing of conditions if we are correct in our assessment that any more rapid money growth might unwind rather quickly.

What the staff has proposed, instead, is to permit a relatively rapid growth of money--8½ percent for M-1A under alternative B--but to base it on a reserve path that initially assumes a relatively high level of member bank borrowing. Thus, under alternative B, money market conditions would not ease unless money growth slows. There are more uncertainties than usual, however, in the relationships among money supply, borrowing, and interest rates. Banks' attitudes toward the discount window have been volatile in recent months, and their reactions to the new surcharge on the basic discount rate cannot easily be predicted. Thus, for example, even a \$2½ billion level of borrowing--as assumed in alternative B--may be too low for the money supply targets and/or maintenance of taut money market conditions if the \$3½ billion borrowing levels of the past week and a half signal greater willingness to borrow by banks and if the new surcharge somehow encourages banks to take more advantage of the lower basic rate. On the other hand, the surcharge could cause banks to conserve their

borrowing until needs become pressing so as to be more sure to avoid the higher rate. Member bank borrowing yesterday dropped to \$1.9 billion. Thus, under the circumstances, the Manager may need to be more flexible than usual in adjusting nonborrowed reserves in light of perceived variations in banks' willingness to obtain reserves from the discount window.