

## **APPENDIX**

James L. Kichline  
May 18, 1981

FOMC BRIEFING

The pace of economic activity in the aggregate appears to have slowed considerably over the past several months. Real GNP is projected to expand at a 1 percent annual rate this quarter following the strong 6½ percent gain reported for the first quarter--a figure that likely will be revised upward. The slower pace of activity recently to some extent reflects the restraining impact of monetary policy--particularly in the housing market. The monetary policy underlying the forecast we believe will constrain activity to a sluggish growth path through next year and will also help to produce an appreciable improvement of inflation in 1982.

Developments in both the labor market and in industrial production point to a loss of momentum in the economy. Payroll employment adjusted for strikes between February and April rose an average of 65 thousand per month, less than a third as much as the gains in the preceding three months. Although the household labor market survey has been showing large increases in employment recently, this measure lagged the strength of activity in the second half of last year and appears to be catching up now; in any event it is not a particularly good indicator of very short-run movements. Industrial production over the past three months has averaged increases of about .3 percent per month in contrast to average gains of more than 1 percent during the preceding three months. In April there were several areas

exhibiting considerable strength in output, notably business equipment and defense and space products. Output of construction supplies was once again little changed while the coal miners strike reduced growth of total production by several tenths. That strike is being reflected this quarter in a loss of exports and in a sizable runoff of previously stockpiled coal inventories.

In contrast, auto production was increased in April although assemblies have been outpacing sales in recent weeks by more than 1 million units at an annual rate. Some of the inventory buildup is voluntary, associated with output of new models, restocking of certain models depleted during the rebate period, and planning for the summer when plant shutdowns will be fairly lengthy. Even so, it seems production schedules will be trimmed from current plans given the continued sluggish sales in the post-rebate period and the additional increases in list prices. Our forecast entails some rise in domestic auto sales over the balance of the year, but to levels that historically are still low.

Total retail sales were about unchanged for the March-April period, reflecting the performance of autos and nonconsumer items. Excluding these categories, sales rose about 1 percent each month in nominal terms, recording further gains in real terms. The consumer on average continues to demonstrate rather strong spending preferences and we expect the saving rate will remain below 5 percent this quarter and next, before rising late in the year at the time of the assumed tax cut.

In the housing market, starts in February and March finally fell to the 1½ million unit annual rate area--after surprising strength earlier. Starts in this range or somewhat lower are expected over the balance of this year in light of tight conditions in mortgage markets. In fact, financing housing activity even at this lower level likely will entail a considerable volume of creative financing since the thrift industry undoubtedly will be rather cautious given high interest rates and their difficult financial prospects.

The business fixed investment sector has been quite strong in recent months and is hard to read in the current environment. Part of the fast growth of investment spending in the first quarter was attributable to outlays for autos and trucks at discounted prices, but other areas of spending for equipment and structures also rose briskly. Orders and contracts suggest that spending will advance somewhat further this quarter. However, the pattern of commitments does not seem strong enough to support continued significant advances in spending in real terms, and a slowing of spending is implied by surveys of planned business investment outlays as well. Overall, we have adjusted upward expected investment outlays for this year, but continue to forecast a weakening of spending given the cost of capital, poor profits, and sluggish sales growth.

The staff forecast in broad terms has been changed little over the projection period through next year. We continue to believe there are potentially very strong demands that are being held in check by monetary policy. Fiscal policy is

somewhat restraining this year, but is likely to be somewhat expansive next. The various conflicting forces at work seem most likely to be resolved in an environment of high interest rates, sluggish growth of economic activity, and an improvement of inflation.

To achieve a sustained reduction in inflation will require a slowing of wage increases, and this is in our forecast for next year. Persistent slack in labor and product markets should help achieve moderation in nominal wage gains, although there is not yet convincing evidence of general progress on the wage front. In addition, the value of the dollar in foreign exchange markets should be operating to reduce inflationary pressures over the forecast period. Both food and energy prices are projected to rise at or somewhat faster than the general rate of inflation, but we do not have an explosion of such prices in prospect, and the recent performance in these sectors has been better than we anticipated.

Notes for FOMC Meeting  
May 18, 1981

Scott E. Pardue

In the 8-week period since the March 31 meeting of the FOMC the dollar has advanced sharply across the board. Using this morning's rates, the dollar has risen by a net of about 10 percent against the German mark, 12 percent against the French franc--which dropped from the top to the bottom within the EMS following the May 10 election in France--7 percent against the pound sterling, and 5 percent against the Japanese yen. Interest rates, of course, are the major factor cited in the market, as our rates have again climbed to very high levels. Several other major central banks have also moved up on interest rates in their markets, including some which are currently meeting their own monetary targets. But, with the exception of France, in no case did the rise of interest rates abroad match the rise of rates here.

The exchange markets continue to respond to factors other than interest rates. Some people are now forecasting a current account deficit for the United States this year and next, but the market is still focussing on the large current account deficits of Germany and other continental Western European countries. Poland is off the front pages for the time being, but concerns over the political and economic outlook for Western Europe continue to be a fact, while positive sentiment and [unintelligible] toward the Reagan Administration is helping to bolster the dollar.

The French presidential election was won by the socialist candidate Mitterand, and was a shock to the exchanges. His program includes a list of industries to be nationalized and a commitment to more expansionary economic policies; concerns over both of these commitments contribute to outflows of funds. Nervous sentiment in financial circles goes beyond the outlook for France, since it is just another element of concern for Western Europe at large--including Germany.

As a result, the mark and other Western European currencies have also been pulled down against the dollar. The Bundesbank is really on the spot, since the French have been [unintelligible]. The German economy is in recession and interest rates are already high. The main reason for tight money has been [unintelligible], to deal with the current account deficit and the weakness of the D-mark. Germany's trade and current account performance continues to be disappointing to them, adversely affected by the J-curve effects of the depreciation of the mark, which began last fall. The latest drop in the D-mark, should it be sustained, will add further to that problem in the short run. Over the longer haul, however, the latest rise of the dollar has an adverse effect on the competitiveness of U.S. goods compared with Germany as well as with other countries. By this time there is a widespread view in the market that it is the D-mark which is undervalued and that once the Germans begin to turn their current account around, or our interest rates drop back sharply, we could be in for a very sharp reversal of dollar exchange rates.

Beyond the heavy intervention to support the French franc within the EMS, foreign central banks sold a net of \$ 1-3/4 billion. We did not operate on behalf of the United States authorities. As one European central banker put it, U.S. intervention policy has been the talk of the town. Shortly after the last FOMC meeting, the U.S. Treasury team, led by Under Secretary Sprinkel announced what they call a minimalist approach to foreign exchange intervention on the part of the U.S. authorities. In prepared testimony, which was reviewed by Federal Reserve people, the Under Secretary couched this approach in terms of countering disorderly conditions--concepts we have been living with since international agreements reached in 1975. But in his own comments to the Congress and to the press, the Under Secretary has stated that we will intervene in extreme situations, such as we did on the day the President was shot. He also questioned the need for foreign currency balances if we were not going to intervene and has suggested that we sell them off. He has even wondered aloud about the need for Federal Reserve swap lines, musing that perhaps they should be scaled back or eliminated since we are not going to intervene.

The market's reactions to all this are along the following lines:

1. Most market people simply do not believe that a minimalist intervention policy will work. New Treasury teams have generally argued that they would prefer not to intervene but ultimately intervention is needed. Many market participants simply believe that sooner or later we will have to intervene again under this new team. The test will be when the dollar declines sharply.
2. The hint that we would consider selling our mark balances comes at a time when the mark has been weak and has been interpreted by non-believers in the market as an effort to talk the dollar up. That interpretation can readily be debunked. The new Administration [favors] free markets. But market participants easily understood the reasons why we took on the balances. Other countries, after all, hold reserves and [unintelligible] sold dollar reserves [unintelligible].
3. The hint that the United States might eliminate the swap lines has raised a broader question in the market, and with foreign officials, i.e. whether the United States is prepared to [unintelligible] on the whole network of cooperation with foreign governments and monetary authorities. We can give reassurances, and the Under Secretary has recently sought to do so. For our part, the Federal Reserve has continued to be cooperative, and foreign central banks continue to turn to us at the Desk to operate on their behalf. We have even conducted two operations in New York on behalf of the German Bundesbank after their market closed, using their reserves. [Unintelligible]

REPORT ON OPEN  
MARKET OPERATIONS

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

Desk operations since the March 31 meeting of the Committee were conditioned by excessively rapid growth in the narrow money supply, leading to a quick and forceful response in terms of heightened reserve pressures and increased interest rates. Monetary growth seemed to be reasonably on track in early April, at least for M1B, but by mid-month the April growth rate appeared to be far above the Committee's objective of 5 1/2 percent or somewhat less, while M2 at that point was also running high relative to its short-run path. Final figures for April, with the added benefit of revised seasonal adjustments, toned down the recent growth rates somewhat, leaving M1B growth still substantially above path and M2 somewhat above path. Early May data suggest more moderate growth rates but with M1B still above its short-term path level while M2 is expected to be a little under its short-run path but above the annual path range.

For the first four-week subperiod in the interval--the four weeks ended April 29--total reserves were nearly equal to path (a scant \$22 million below according to latest data). Reflecting the stronger aggregates, required reserves were \$220 million above their path, but this was offset by lower-than-expected excess reserves which averaged only about \$60 million. Nonborrowed reserves in those first four weeks averaged about \$165 million below path. Borrowing averaged

about \$1.3 billion in those weeks, some \$150 million above the Committee's initially indicated \$1,150 million. All of the heavier borrowing was concentrated in the fourth week, in a sense making up for lighter than expected borrowing in earlier weeks; and indeed in that final week borrowing was especially concentrated on the final day, April 29, when banks visited the window for a record \$8.6 billion.

In the second three-week subperiod--the three weeks ending May 20--it looks at this point as though total reserves may average some \$390 million above path, reflecting a similar overrun for required reserves. In turn, this stems essentially from the sustained above-path level of M1B. Given the continued overshoot in demand for total reserves, and the deliberate acceptance of somewhat lower-than-path nonborrowed reserves in the week of May 6, the three-week average path for nonborrowed reserves was reduced by about \$485 million relative to total reserves for this current subperiod, in order to apply greater pressure to return monetary growth to path more promptly. Reflecting the above-path demand for total reserves, and the reductions in the nonborrowed reserve path, anticipated average borrowing for this three-week period is about \$2 billion.

As the need to borrow from the discount window mounted, the Federal funds rate climbed. The rise was delayed for a time as banks chose to hold very low or even negative excess reserves. After ranging around 15 1/2 percent in the first few weeks of April, funds averaged above 16 percent in the April 29 week,

with considerable trading at rates of 20 percent or higher on the exceptionally tight final day of that week. Funds trading remained high in the next few days--around 19-21 percent--as the reserve stringency carried over. The rate seemed to be settling back to perhaps the 16-17 percent area when the discount and surcharge rates were raised and subsequent funds trading has been largely in the 18-19 percent range. This was consistent with the Committee's expectation indicated at a conference call in early May.

The System added about \$2.8 billion to outright holdings of Treasury securities during the interval, including the purchase of \$836 million in coupon issues early in the period. This was the first coupon purchase in the market since last August. The System also bought over \$800 million of bills in the market and \$1.1 billion of bills from foreign accounts. Additional reserve adjustments were accomplished through short-term self-reversing transactions.

Market yields moved irregularly higher over the inter-meeting interval, setting new records for most sectors beyond the very short maturities. Early in April yields pushed higher when the market was surprised to learn from the FOMC policy record published April 3 that the decline in funds rates in March to below 15 percent had been tolerated but not really sought by the System. This gave a different perspective to recent events, both underscoring the System's determination

to restrain money growth over the long pull and also indicating a different significance to the Committee's funds ranges than most market participants had envisioned. Stronger growth of the aggregates led to further yield increases as April progressed. While some encouragement was taken from Congressional action to restrain Federal spending, there was also much market concern about prospective deficits in light of tax cut plans, and concern as well that monetary restraint would remain in force or even intensify. Bearish sentiment reached a crescendo in the first few days of May when the report of a large and unexpected money supply increase was closely followed by the May 4 discount rate announcement--just as the market was getting ready to bid on the Treasury's quarterly refunding issues. Good bidding interest developed for these issues at the record high interest rates, including a lofty 15.81 percent three-year and 13.99 percent 30-year rate. Sizable premiums developed on the new issues shortly after their auctions. These faded briefly, but there was a fresh rally late last week that more than restored the earlier premiums. The late rally seemed to stem partly from a sense that the Administration might accept a scaled down tax cut, as well as views that money growth might be turning out less strong than some had feared. On balance over the intermeeting period, in which the Treasury raised a net of \$6 1/2 billion in coupon issues, yields on intermediate Treasury issues rose as much as 2 percentage points, and long-term issues about 3/4 point.

Yield increases were even greater at the short end. Treasury bills were auctioned last Monday at average rates of 16.43 and 15.33 percent for the 3- and 6-month issues, respectively, up from 12.50 and 12.08 percent just before the last meeting. The bill rate increases of some 3 to 4 percentage points are the more noteworthy in that the Treasury paid down nearly \$17 billion of bills--chiefly the seasonal maturity of cash management bills. CD rates, meantime, have risen by some 4-5 percentage points, with fairly aggressive issuance reported at times. The banks' posted prime rate was up a more moderate net of 2 percentage points to 19 1/2 percent.

Given the large recent rate moves, we've been alert to reports of possible loss experience in the dealer market. Up to this point we have not heard of disastrous losses among the primary dealers although there have been reports of some smaller fringe operations that have had to curtail activity or even go out of business.

Since the latter part of March, when short-term market interest rates were around their lows for the year, 3-month rates have risen 4 to 5½ percentage points--with the largest increases in private market rates such as for CDs and commercial paper. The federal funds rate has also risen about 5 percentage points or so from its low for the year of 13½ percent in the last statement week of March to the 18 to 19 percent range most recently.

The rise in rates does not seem to have been accompanied by any strong resurgence in short-term credit demands by businesses, or at least there is not enough evidence to say that it has. But it should be noted that business credit demands in fact remained fairly strong through the first quarter, though edging off a bit as the quarter progressed. Demands were quite weak at banks, as the decline in the prime rate from its high around year-end lagged considerably behind the drop during the winter in private short-term rates. More recently, the rise in the prime has lagged the rise in market rates, and partly for this reason there has been a sizable increase in business loans at large banks in late April and early May. As I noted, there is not enough evidence to say whether this recent spurt in business loans, in addition to reflecting a shift, also marks a further basic strengthening in credit demands and perhaps more sustained pressures on interest rates from the credit side.

What the rise in short-term rates can most clearly be attributed to, of course, is the restraint placed on reserves to contain the resurgence in money growth.

After rising at a 6 percent annual rate from December to March, nonborrowed reserves declined by a 12 percent annual rate last month--and another drop is probably in store for May, assuming borrowing at the discount window remains at least around current levels. This drop in nonborrowed reserves occurred in face of an increased demand for reserves on the part of depository institutions to accommodate the expansion in required reserves that accompanied the resurgence in money growth. Some of that demand, it might be noted, was not reflected in a rise of member bank borrowing, but was met by a drop in the level of excess reserves last month to an unusually low level of about \$95 million.

None of the alternatives before the Committee assume a drop in the level of short-term rates from current levels, despite a considerable weakening in the growth of economic activity and nominal GNP from the first-quarter pace. And a literal reading of our models suggests that the near-term federal funds rate range proposed as consultation points in the blue book may be conservative. It would seem to require a much weaker real GNP and/or much less upward price pressures than we have projected to lead to both lower interest rates and success in hitting the midpoint of the Committee's M-1B target.

With that in mind, one might think that 3-month private short-term rates in the 18 to 19 percent area, their present level, would be highly restrictive on the economy if maintained for some time. They imply a very high real interest rate if you believe the expected rate of inflation over the near-term is in the 9-10 percent area. We have not, I believe, had a practical test yet of just how restrictive such rates might be if they were sustained. When similar rate levels were reached in March of 1980,

they were not long sustained because the economy very quickly showed great weakness, largely I believe in consequence of the credit control program. Similar rate levels reached around the turn of this year were also quite transitory--not because the economy turned very weak, of course, but only because the measured money supply did, despite continued relatively strong credit demands and a quite strong economy.

The tendency for short rates over the past year or more to move back up toward the 17 to 20 percent area once they have declined suggests that restraint on inflation in the economy under current conditions tends to involve that rate level--that declines from that level seem to produce an easing in downward price pressures on, for example, the commodity and housing markets. Thus, it would seem that the Committee could well consider the extent to which it might be willing to aim at, or permit, very low M-1B growth for a while in the interest of maintaining quite high real rates of interest for longer than has been the experience of the past year or more.