

APPENDIX

Notes for FOMC Meeting
October 5, 1982

Sam Y. Cross

Mr. Chairman:

The dollar has moved sharply higher against the currencies of Europe and Japan since the Committee's last meeting in an environment of increased anxiety -- anxiety over military conflicts and governmental changes in foreign countries, over the deepening world economic recession, and over the sovereign debt problems and widespread liquidity strains that have disturbed financial markets. The dollar now stands almost 5 percent higher in terms of the German mark and more than 7 percent higher in terms of the Swiss franc and the Japanese yen than on August 24, and against many currencies except the mark is at peak levels not seen for years.

Interest-rate incentives to invest in dollar assets increased over the period. Most short-term U.S. interest rates backed up somewhat while those in the major European centers dropped as central banks eased domestic credit conditions. Also, present market expectations are that dollar interest rates are not likely to decline while those in Germany and other European countries will.

More than interest-rate considerations, continuing concern about credit exposures and potential liquidity strains encouraged investors to prefer dollar-denominated assets and bid up the dollar. With so much of the questionable exposure made up of dollar-denominated claims, dollar-based United States institutions as a group were thought to be in

a better position than others to deal with a liquidity shortage. Moreover, the United States was also preferred as a safe haven at a time of continuing conflicts in the Middle East and elsewhere.

At the same time, the dollar benefited from perceptions that the U.S. economy being less dependent on international trade than some others is perhaps more immune from the effects of slumping worldwide demand. In addition, heightened political divisions in several foreign countries over economic policies and, in some cases, difficulties in forming workable coalition governments affected exchange market psychology. The mark in particular was caught up in the crosscurrents of political events leading to the replacement of the Schmidt government by a more conservative one. At first the prospect of more cautious economic policies and more pro-Western foreign policy buoyed the mark. But then the continuing disagreement about ways to contain Germany's rising budget deficit, and the prospect that a new center-right coalition may face serious difficulties in winning a majority at upcoming federal elections next spring provided a more hesitant tone.

The EMS has also been strained at times by bouts of heavy selling pressure against the French and Danish currencies, reflecting market doubts that those countries' governments would be able to keep their economies' competitiveness from deteriorating further. These

pressures have subsided in the last week or so as traders became more convinced that a realignment is not imminent. However, the Scandinavian currencies -- particularly the Swedish krone in the last few days -- have come on offer at times as the market puzzled over the probable implications of the return to power by Olaf Palme's socialist government.

Central bank intervention has been a relatively minor factor in the markets during the last six weeks, with dollar sales totaling about \$1.5 billion. Sales of dollars by the Japanese and Swedish central banks have been the largest, on the order of _____ each. Total dollar intervention reported by the Japanese thus far in 1982 is

Yesterday, however, after the dollar had been bid up in reaction to publication of larger-than-anticipated money supply figures, the central banks of Japan and Germany both intervened in their market in an effort to curb the dollar's rise. Then in New York, the Desk bought \$20 million of yen and \$30 million of marks.

The price of gold, which had surged past \$500 in early September in response to worries over LDC debt problems and Middle East conflicts, has now fallen to below \$400, with firm U.S. interest rates and the strength of the dollar contributing to the decline.

Agreement was reached on August 28 for new temporary credit facilities for the Bank of Mexico

totaling \$1.85 billion -- the Federal Reserve providing \$325 million, the U.S. Treasury \$600 million, and the Bank for International Settlements \$925 million. So far the Mexican central bank has used \$263 million on these credit lines -- \$46 million on the Federal Reserve swap and \$86 million on the Treasury swap line, and \$132 million from the BIS credit line -- leaving nearly \$1.6 billion still available in the entire facility. The Bank of Mexico also made one drawing on the combined credit facilities of \$250.0 million which was repaid partly the same day and the remainder the following day.

The earlier \$700 million drawing of the Bank of Mexico under its regular swap arrangement with the Federal Reserve will mature on November 4. Negotiations are in progress between Mexico and the IMF looking toward a Fund program, and if agreement is reached, that would be a centerpiece of a Mexican proposal for a more fundamental restructuring of Mexico's public sector debt to the commercial banks expected later this year. Realistically we should expect that a renewal of the Federal Reserve swap will be requested, and at this time I see no reason not to approve a renewal for the normal three months.

NOTES FOR FOMC MEETING
OCTOBER 5, 1982
PETER D. STERNLIGHT

Desk operations since the last meeting were conducted against a background of above-path growth in monetary aggregates and reserves. While this showed through to some extent in an enlarged demand for borrowing and associated reserve pressures, the System's response was tempered in light of evidence of continued sluggishness in the economy and fragile financial markets. Thus to a considerable degree the stronger-than-path money growth was considered acceptable and was accommodated. For the three months from June to September, M1 growth at an 8 percent rate compared with a path rate of 5 percent, while M2 growth at about a 10 percent rate modestly exceeded the 9 percent path.

For the first 3-week subperiod, ending September 15, the over-run in reserve demands was small, exceeding path by about \$115 million. Nonborrowed reserves were some \$65 million below path and borrowing about \$180 million above path. An upward adjustment was made in the initial \$350 million level of assumed adjustment borrowing to allow for borrowing situations that reflected limited money market access by certain institutions, rather than general pressures on reserve availability. With borrowing averaging about \$800 million for the three weeks, including some "special situation" borrowing, Federal funds moved up to trade on average slightly over 10 percent, compared with about 9 percent in the week of August 25.

For the second subperiod--the three weeks ending tomorrow--the stronger money growth produced a greater bulge of demand for reserves above path, roughly on the order of \$500 million. In line with discussion at a Committee consultation call on September 24, this bulge in demand was partly accommodated, in order to avoid a sharp rise in borrowing and associated reserve and rate pressures that seemed inappropriate in light of information on the economy and financial markets. Reserve paths were drawn in recent weeks with a view to holding seasonal and adjustment borrowing in the neighborhood of \$500-600 million. Actual borrowing slightly exceeded these levels, averaging around \$600-700 million. Federal funds continued to hover slightly above 10 percent in the last two full weeks of September, but have averaged a bit over 11 percent so far in the current week, partly reflecting pressures associated with the end of the calendar quarter and temporarily very high Treasury balances at Reserve Banks. Federal funds opened today at 10 1/4 percent.

As reserves ebbed and flowed from market factors, Desk operations were handled largely through temporary transactions. Outright holdings of securities declined about \$773 million, largely reflecting bill run-offs of \$400 million and \$792 million of bill sales to foreign accounts early in the period, partly offset by \$425 million in bill purchases

from such accounts later in the interval. There were numerous day-to-day reserve injections through System repurchase agreements or the passing through to the market of customer account repurchase transactions. On two occasions, reserves were withdrawn temporarily by matched sale purchase arrangements in the market.

Interest rates showed relatively moderate and mixed changes over the interval, following the sharp declines of the previous intermeeting period. Short-term rates registered a small net back up, responding to the firmer Federal funds rate compared with late August, and a market sense that renewed money growth seemed to preclude further easing of reserve conditions for the time being. The discount rate cut to 10 percent on August 26 was widely anticipated and quickly came to be regarded as the last reduction for a while. Rates on private short-term instruments such as CDs and commercial paper rose by roughly a percentage point or somewhat more, while bills were up more modestly, partly reflecting the preference for quality. Three- and six-month bills were auctioned yesterday at average rates of about 8.10 and 9.23 percent, compared with 7.75 and 8.99 percent just before the last meeting. Meantime, the Treasury raised about \$7 1/2 billion in bills over the period.

In the intermediate and longer term markets, rates generally tended lower over the period, though with some backing and filling. Underlying sentiment was affected substantially by the continuing evidence of weakness in the economy and fragility in the financial markets--elements that outweighed concern over budget deficits, strengthened money growth or higher short-term rates. The longer markets were also helped by the extent to which shorter rates had dropped earlier in the summer. The Treasury coupon market readily absorbed some \$20 million of new issues including a concentrated bloc of 4, 7 and 20-year issues on September 21-23. Over the interval, rates on Treasury coupon issues from 2 years on out declined by some 15-60 basis points. As part of last summer's tax legislation the Treasury got authority to reenter the long bond market, and they did so quite successfully with a \$2 3/4 billion sale of 20-year bonds.

Corporate and tax-exempt bond yields also declined over the period--about 3/4 percentage point for corporate and more like 1/4 to 1/2 percentage point for tax-exempts, with fairly sizable new issue flows for both sectors. In the corporate market, there was a revival in offerings of longer term issues which had dropped sharply early this year.

In appraising the current rate outlook, market participants are following Fed actions closely, seeking a

sense of how we may respond to recently strengthened money growth. My impression is that because of continuing disappointment in the performance of the real economy and apprehensions about the sturdiness of the financial system, market observers are prepared to be more tolerant of money growth over-runs than might have been the case a month or two ago.

As regards Government securities market surveillance, thankfully I have no new casualties to report. Our strengthened surveillance unit is now getting into operation under Ed Geng's direction. As of yesterday, all the primary dealers are supposed to be including accrued interest in their repo calculations with all customers, and we'll be checking to be sure they do this. We still have some fall-out from earlier casualties, however. The judge in the Lombard-Wall bankruptcy is inclined to view repurchase agreements as secured loans rather than purchases and sales transactions and in at least one case he refused to let the party liquidate the securities acquired from Lombard on repo. This type of interpretation could pose a considerable threat to the liquidity of the repurchase agreement market in Treasury issues, possibly causing a number of participants to withdraw from that market rather than risk having their funds tied up. An effort was made in the closing days of the just-adjourned Congressional

session to get some relief from this type of ruling but it did not get through--not because it lacked merit but because the bankruptcy legislation to which it was to be attached was side-lined for the time being. We expect to be watching the repo situation in the market closely.

James L. Kichline
October 5, 1982

FOMC BRIEFING

Economic activity in the aggregate has remained sluggish in recent months, and as yet there aren't convincing signs of a recovery. The staff now estimates that real GNP was about unchanged in the third quarter, with a decline in final sales offset by an accumulation of inventories. We are forecasting a very small expansion in activity for the fourth quarter -- somewhat less than our previous forecast -- but essentially have not altered the projection of a slow recovery next year. The wage and price component of the forecast was not changed significantly, as developments in these areas have been on the expected track of continued progress in bringing down the rate of inflation.

Since the last meeting of the Committee, employment, production, and sales have performed about as expected or weaker. In labor markets there isn't any hint of a pickup in labor demands. The survey of labor markets in August showed another large drop in nonfarm employment at the same time that the average workweek in manufacturing declined. Moreover, initial claims for unemployment insurance since the mid-August survey have been surprisingly high, averaging about 660,000 during the first three weeks of September, a bit above the peak rates reached earlier in this recession and in the 1980

downturn. In the past, initial claims have been quite reliable as an indicator of developments in the economy, and their behavior in recent weeks is a source of concern.

The limited information now available for production in September generally is consistent with some further decline in output. During August the industrial production index fell 0.5 percent, with auto assemblies accounting for about one-half of the total decline. Output of business equipment continued downward, while the only persistent source of strength has been production of defense and space equipment.

A portion of the cutbacks in output can be traced to efforts designed to provide a better alignment of inventories to sales. A number of sectors still hold excess stocks -- such as autos, primary metals, and machinery -- but it seems that the inventory correction in the aggregate is nearing an end, assuming at least a small rise of final sales as in the staff projection.

The rise in final sales in the near term hinges importantly on the behavior of consumers. During the third quarter, consumer spending appears to have been appreciably weaker than we had projected at the last meeting of the Committee. In August, retail sales excluding autos and nonconsumption items rose only a couple of tenths while a drop in auto sales produced a decline of nearly 1 percent in total retail sales. For

September, the only hard data available are for auto sales, which averaged 6 million units annual rate for the first 20 days of the month; that sales rate is up considerably from July and August, helped by various sales incentive programs. Auto producers, however, generally remain bearish, having once again cut their production schedules.

The staff forecast entails some pickup in consumer spending during the fourth quarter, associated with continued expansion of disposable income and the lagged effects of the midyear tax cut. Clearly, projected short-run consumer spending behavior is debatable and we do not have evidence yet of a decided upturn in spending. The economic news coming out in the next month or two seems likely to continue negative, which carries a risk of damping spending attitudes. But our forecast doesn't call for a dramatic upturn in outlays, and given the income prospects the projected spending can be attained with only a small downward move in the saving rate from the higher level last quarter.

In the housing sector, a mild recovery has been underway since last winter and we are projecting a further small rise in housing starts in the next couple of quarters. Home sales this summer remained low, although recent declines in mortgage interest rates have led to a stirring of buyer interest, according to field reports. But those rates are still high, capital appreciation prospects have been damped, and overall the

forecast retains a pattern of very weak cyclical improvement in residential construction.

Business fixed investment prospects are rather gloomy, with orders, contracts, and qualitative reports pointing to further declines in real spending. The forecast of real fixed investment spending during 1982 entails a decline of 10 percent with little turnaround for 1983 as a whole. Although we have a sizable contraction of investment for this cycle, it still seems that the risks are on the down side, especially for the commercial and industrial construction sector where we have experienced relatively little decline in outlays so far.

For other sectors we anticipate small growth in government spending, and near-term weakness of exports in association with the high exchange value of the dollar, the Mexican situation and sluggish economic growth abroad. Taking these sectors and the outlook for private domestic sectors leads us to a forecast of little change in real GNP in the second half of this year and a poor cyclical recovery in 1983. The forecast seems consistent with an unemployment rate around the 10 percent area throughout next year.

The silver lining in all of this is on the wage-price side where there continues to be considerable progress. Given the substantial slack in labor and product markets, abundant harvests, and well behaved oil prices, the chances of seeing further progress in slowing inflation next year are very good.

FOMC Briefing
S. H. Axilrod
October 5, 1982

Mr. Chairman, it is no longer clear--and it has not been so for some time--that the behavior of the aggregates and the behavior of the economy are consonant with what might have been earlier expected, or hoped, for economic activity. One of the prime virtues of a monetary aggregate target, it has been frequently noted, is that adherence to it would reduce the risk that monetary policy would be pro-cyclical. If money growth were kept from falling off significantly in a recession, conventional analysis tells us that interest rates would tend to fall sharply enough to encourage an early resumption of real economic growth. But under current circumstances, there appear to be difficulties with that simple, straightforward analysis--though the analysis, I hasten to add, has enough historical verification behind it that exceptions which may appear to arise have to be judged with considerable care.

The chief problem under current circumstances is illustrated by the fact that maintenance of money growth through the recent period has not led to an early economic recovery, but has been accompanied by consistent downward adjustments to estimates of the strength of recovery and by delays in its expected timing. The sustained strength of money growth is illustrated, I believe, by successive annual growth rates over a 3-month period beginning in the last three months of 1981 and going through the summer of this year for M1 of 9, 6-3/4, 2-3/4, and 8 percent; for M2 of 9 to 10 percent in each period; and for M3 of growth rates that rose from about 9 percent to about 11-1/2 percent in the most recent 3 months. At the same time the weakness of the accompanying economy is seen in the decline in velocity of money. Looking at velocity behavior since the beginning of this year, the decline has been particularly sharp for M2 and

M3--5½ to 6½ percent at an annual rate--but even M1 velocity has dropped over the past three quarters by about 1½ percent at an annual rate.

Of course, interest rates have declined since the fourth quarter of last year, but the declines did not show any substantial downward momentum until the last couple of months. The funds rate and other short-term rates are now about 2 to 3 percentage points below levels in December of last year (and a little further below fourth quarter '81 averages) and long-term rates are down close to 2 percentage points.

Assessment of the meaning of rate declines of this magnitude depends in part on how much of a drop in inflationary expectations one believes has occurred. Obviously if the drop in inflation expectations is on the order of 2 points or so since the end of last year (or say 3 points since the fourth quarter on average) no decline in real market rates has occurred. In that case, little progress may have been made in stimulating recovery despite relatively substantial money growth, though progress would have been made in curbing inflation. Progress in stimulating recovery could be even less than expected, it should be added, if essential constancy in real market rates has been accompanied by declining expectations of real rates of return on investment, as may well have been the case recently, given the deepening gloom in the outlook for business spending on plant and equipment.

What could be happening in part is that the demand for liquidity may be increasing relative to GNP--and with it not being fully accommodated, short-term interest rates in real terms have remained high. An increase in liquidity demand seemed to have affected M1 in late '81 and early '82, and has probably affected M2 and M3 demand throughout the year. It could also be a factor in the recent strong behavior of M1, although other alternative

explanations certainly should not be quickly or entirely rejected--that is, recent growth may be in lagged response to earlier interest rate declines, as our models would suggest (implying also rapid growth in the months ahead), or growth may reflect temporary increases in deposits in response to the tax cut, with these funds perhaps soon to be spent or invested.

Liquidity demands have not been manifested only by declines in the velocity of money measures. They have also been reflected in institutional behavior. Thrifts have been building up liquid assets rather than taking an aggressive stance toward the mortgage market. And I would not doubt that banks, or at least some key banks, have become more cautious in their approach to lending--and less willing or even able to add to short-term indebtedness--in view of the well-known financial problems that have affected them.

It is not really possible to foretell how long unusual liquidity demands will last, but so long as they do and to the degree they are not accommodated, short-term interest rates should remain relatively high and economic activity relatively low. Assessing the interaction of liquidity demands and the behavior of various measures of money which have both liquidity and transactions characteristics is difficult enough under the best of circumstances, but it will be made even more difficult when the public can place funds in the new instrument that DIDC is required to authorize to make depository institutions competitive with money market funds. That instrument or instruments--which must be available in early December at the latest but conceivably earlier--will almost certainly play havoc with M1 at least for a transition period. Thus, even apart from questions about how strong (or weak) an M1 expansion the Committee may wish to tolerate between now and year-end under existing circumstances, M1 will

be subject to large shifts of funds, either in or out, depending on the exact characteristics of the instruments authorized by DIDC and their inclusion or exclusion in the definition of M1.

I would suggest that the Committee today would need to come to some judgment about whether there should be somewhat more flexibility than usual in its specification of growth in the monetary aggregates over the next three months. Prospective regulatory changes cast doubt on the usefulness of a rigid, if any, M1 specification unless we are prepared with "shift adjustments." In that context, the Committee may also want to consider--for an interim period while regulatory changes, liquidity demands, and financial market problems sort themselves out--whether a relatively wide range of tolerance for behavior of the monetary aggregates, narrow or broad, might not be in order and whether credit market conditions and the economic need to assure a stable flow of funds in financial markets under current circumstances should not be given some added weight in setting the near-term policy course.