APPENDIX

Notes for FOMC Meeting
November 7, 1984

Sam Y. Cross

The dollar rose steadily for about two weeks after the Committee's last meeting. By mid-October it was approaching the highs against the German mark it had reached in mid-September before the Bundesbank's highly publicized intervention operation. But since then its trend has been downward and last week that decline accelerated.

The dollar has fallen in the last few weeks as exchange-market attention turned to the accelerating drop in U.S. interest rates. Market participants think recently published statistics point to further slowing in the U.S. economy and credit demands, and thus suggest that the Federal Reserve will find room to accommodate more interest rate declines in the near future. Some have speculated that additional interest rate cuts may follow the U.S. national elections--including a cut in the Federal Reserve's discount rate--and that this may extend the dollar's decline further.

Central bank intervention has been moderate in quantity since your last meeting, but the operations since mid-September appear to have imparted a more cautious attitude of speculators toward taking on long dollar

positions. On October 17, when the dollar/mark rose above DM 3.15 for the first time since September, the German Bundesbank again intervened in a highly visible operation. This operation was much smaller than the one of September--only $60 million--but it prompted a sharp fall at the time because the market had not expected it, judging the advance of the dollar this time to be far more orderly. The U.S. authorities followed up later that day when the dollar was again rising, selling $95 million against marks in New York, split equally between the Treasury and the Federal Reserve. The Desk's operations did not get much attention in the press. But they were seen in the market and reportedly influenced the attitude of professionals, who saw them as evidence that both German and U.S. authorities are prepared to resist a pronounced rise of the dollar.

Market participants expect most foreign officials to lag behind the U.S. in cutting their own interest rates. A sole exception is the Bank of England which has cut its dealing rates by 1/2 percent. In part, the central bank interventions since September have countered the impression that Continental authorities are willing to accept continuing currency depreciation. Dealers believe in particular that the Bundesbank's concern over imported inflation may have heightened. A mid-September hike in German gasoline prices was followed by publication of a jump in the monthly rate of consumer price inflation for October, although the year-on-year rate was still quite low. In fact, short-term interest rates have not dropped at all in

Germany or Japan. Where declines in major foreign centers have occurred, they lagged well behind those here, and interest differentials favoring the dollar have thus narrowed substantially since early September, in some cases by more than 2 percentage points.

Other Operations

On October 12 the U.S. Treasury Department concluded a swap agreement with the Central Bank of the Philippines to provide $45 million through the Exchange Stabilization Fund, in support of the economic adjustment program which the Republic of the Philippines had agreed upon with the management of the International Monetary Fund. The Treasury joined the Bank of Japan and the Bank of Korea in arrangements that total $80 million--including $30 million from the Bank of Japan and $5 million from the Bank of Korea. Last Friday the Treasury approved the Philippines' request to draw the entire $45 million, following confirmation by the Managing Director of the IMF that he was formally submitting the new standby arrangement to the Executive Board. This drawing, and those on the Japanese and Korean central banks, is for value today and is to be repaid when the Philippines draws on its standby arrangement with the IMF or by November 30, whichever is earlier.

Recommendation

Mr. Chairman, all of the Federal Reserve System's regular swap arrangements with foreign central banks and the BIS will come up for renewal in December. I recommend that all the swap arrangements be renewed. We propose no change in the terms of the agreements, except for a technical change to the swap with the Bank of Japan. That agreement stipulates that when the Bank of Japan initiates a drawing the spot exchange rate prevailing one business day before the value date of the drawing be applicable to the swap. At the beginning of last April, the Tokyo market began trading dollars against yen for two days' delivery, the same as is standard in other world markets, rather than for one day delivery as had been the Tokyo convention until then. As a consequence, the Bank of Japan has proposed that the applicable spot exchange rate on swaps initiated by the Bank of Japan be the one prevailing two days before the value of the drawing.

Maturing swap arrangements:

	Amount ($ millions)	Term	Maturing Date
Austrian National Bank	250.0	12 months	12/3/84
Bank of England	3,000.0	"	12/3/84
Bank of Japan	5,000.0	"	12/3/84
Bank of Mexico	700.0	"	12/3/84
Bank of Norway	250.0	"	12/3/84
Bank of Sweden	300.0	"	12/3/84
Swiss National Bank	4,000.0	"	12/3/84

cont'd

Cont'd	Amount ($ millions)	Maturing Term	Date
Bank for International Settlements--			
Swiss francs	600.0	12 months	12/3/84
Other authorized European currencies	1,250.0	"	12/3/84
National Bank of Belgium	1,000.0	"	12/17/84
National Bank of Denmark	250.0	"	12/28/84
German Federal Bank	6,000.0	"	12/28/84
Bank of France	2,000.0	"	12/28/84
Netherlands Bank	500.0	"	12/28/84
Bank of Canada	2,000.0	"	12/28/84
Bank of Italy	3,000.0	"	12/28/84

NOTES FOR FOMC MEETING
NOVEMBER 7, 1984
PETER D. STERNLIGHT

During most of the period since the October 2 Committee meeting, the Desk's nonborrowed reserve objectives continued to incorporate the $750 million level of adjustment and seasonal borrowing that was adopted shortly before that meeting. In striking contrast to the previous intermeeting period--mid-August to early October--when money market conditions softened only slightly and grudgingly despite successive reductions in the planned borrowing gap from $1 billion to $750 million, conditions eased appreciably in the recent period. Notably, the Federal funds rate worked down, irregularly, from around 11 percent or a little over to the neighborhood of 10 percent or somewhat under. In the course of that irregular move, the rate spent a week in the vicinity of 9 1/2 percent, and the last couple of days have seen trading in that area also--or even lower. In fact, today's trading started out at 8 3/4 and 9 percent. In the last few days, our paths have been drawn to provide for a slight further reduction in the borrowing gap--to $700 million--a change made in recognition of the continuing weakness evident in M1 growth.

Why the contrast between the two periods? Of course, we've never pretended to have our finger on a close reliable fit between the intended borrowing gap and the funds rate--although I persist in the belief that there is a rough relationship lurking somewhere out there. In the late August-September period, the absence of more

"give" in the funds rate despite the decline in intended (and actual) borrowings appeared to reflect continuing cautious bank reserve management, including some reluctance, until the final days of September, to use the discount window. Approaching quarter-end pressures also tended to keep the funds rate up then. In the more recent period, the greater "give" in the funds rate appeared to reflect somewhat greater willingness to borrow at the discount window and, perhaps more important, the psychological impact of seeing a sustained period of weak growth in money and moderation in the economy. Also, at times, the day-to-day conduct of Desk reserve management contributed to the softening in rates as sizable excesses in the early and middle part of the period were withdrawn in a fairly gradual way, and most recently reserve needs have been met rather promptly. Even so, we ended up below the formal nonborrowed reserve objective in the October 24 reserve period, as substantial reserve excesses were carried into that period and a full meeting of the path would have produced a misleading overabundance of reserves. As it was, the money market ended that reserve period on a very comfortable note that carried over into the start of the current reserve period. So far in this period, which ends today, borrowing has averaged about $700 million and Federal funds roughly 9.85 percent--not too far from an expected relationship, although that's with the benefit of some averaging out over the period.

Over most of the period since the last meeting, the Desk withdrew reserves released by declines in Treasury balances and

transactions stemming from the Continental-Illinois aid package. Outright holdings were trimmed by a net of about $1.4 billion, accomplished through $1.3 billion of redemptions, over $600 million of bill sales to foreign accounts, and some $500 million of bill purchases from those accounts in the latter part of the interval. In addition to the daily matched-sale purchase transactions with foreign accounts, matched-sales were used several times in the market to absorb abundant reserves in generally comfortable money markets. As reserve needs developed in the final few days of the period, repurchase agreements were employed both as pass-throughs of customer transactions and on behalf of the System.

Most market rates declined substantially during the interval, especially in the latter half. Early in the interval, the Treasury note and bond market wavered uncertainly, pulled one way by the growing sense of a more accommodative approach toward reserve availability but pushed the other way by apprehension about the huge amount of Treasury debt to be sold and concern that the economy's summer pause might be followed by renewed acceleration in the closing months of the year. By about mid-October, the downward rate pressures began to pervail in the tug-of-war, bolstered by the continuing evidence of weakness in the money supply, sluggishness in the economy, and a sense that policy was in process of responding to these factors. Dealers and investors began to plow through the mountain of Treasury offerings, backed up and compressed in timing because of debt limit delays, with a fairly good appetite, even bordering on enthusiasm at times. Including the 10- and 30-year note and bond

issues to be auctioned today and tomorrow, the Treasury will have sold about $43 billion of coupon issues to the public since the last meeting, raising some $27 billion of new money.

Through Monday, rates on Treasury coupon issues were down about 105 to 115 basis points for issues due within five years and 75 to 95 basis points for longer maturities. This brought the longer coupon yields to their lows for this year. The tail end of the rate decline, it should be noted, seems to rest on a presumption that Federal funds will settle down soon at something like a 9 1/2 percent level or lower. I think that there could be some disappointment in coming days if funds tended to trade around 10 percent or higher. While most market participants' near-term outlook, say through year-end, is fairly buoyant, there is a considerable divergence of view about next year. Some see further rate declines based on progress against inflation and expected modest economic expansion. Many others, though, anticipate upward rate pressures as they look for a little stronger expansion--partly based on current rate declines--little progress on the budget deficit, and a possible weaker dollar.

Particular market attention in the recent period was focused on the Treasury's first "foreign-targeted" issue, a $1 billion 4-year offering sold alongside a like maturity of a $6 billion issue open to either domestic or foreign buyers. The foreign targeted issue could be sold only to foreign entities at auction, and traded offshore for its first 45 days. Its special appeal is that it offers a degree of anonymity to the final investors who purchase the issue from the

foreign institutions that buy it in the auction. With the advantage of vigorous Treasury promotion, the foreign targeted issue was auctioned at a yield some 32 basis points below that of the companion domestic issue. Secondary market trading has been light thus far, and it is not clear how much of the issue has been placed with final investors. The spread by which the secondary market yield on the foreign-targeted issue falls short of the "domestic" issue yield shrank just after the auction and then widened out again to near the auction average--but without much indication of really broad-based investor demand. The Treasury plans to come with other such issues before long and several Federal agencies are eager to tap this market as well. In fact, FNMA announced a 7-year, $300 million foreign-targeted issue yesterday.

Treasury bill yields also fell substantially over the period, by about 1 1/4 to 1 1/2 percentage points. Over the interval, the Treasury raised a modest $1 billion of new money in the bill market. In last Monday's auction, 3- and 6-month bills were sold at average rates of 8.82 and 9.07 percent, compared with 10.23 and 10.35 percent of October 1.

Rates on commercial paper declined nearly as much as Treasury bills, while CD rates fell about in line with bills over the whole period, though with some day-to-day variations that led to modest fluctuations in the spread of CD yields over bills. Essentially, those spreads remained fairly narrow for 3 to 6 month maturities, apparently reflecting a combination of reasonably subdued concern about bank vulnerability (though some market participants deny this)

and an absence of pressure on large banks to issue in size in the national market. In turn, the lessened cost of funds to banks and the fairly flat demand for loans paved the way for further declines in the posted prime rate from 12 3/4 to 12 percent. Current relationships suggest there is room for further cuts in the prime rate.

Corporate yields fell somewhat more moderately than those on Treasury issues, perhaps because of a greater impact from speculative buying in the Treasury sector as sentiment shifted to the buoyant side. Tax-exempt yields came down only slightly as that market continued to digest heavy new supplies.

J. L. KICHLINE
November 7, 1984

FOMC BRIEFING

At the time of the last Committee meeting, most of the recent information available on the economy related to the summer months, a very sluggish period. Since then information for September and October points to a pickup in activity. To be sure, there are conflicting signs on the course of the economy, we have relatively little data for October, and a good deal of uncertainty is attached to near-term developments. But on balance the staff believes the most likely path of real GNP is growth of about 3-1/2 percent this quarter and a bit less during 1985; this view is not significantly different from that presented a month ago.

The labor market reports for September and October indicated considerable growth of employment while the unemployment rate in each month was 7.4 percent, about the same rate that has prevailed since the spring. Nonfarm employment rose substantially in October and the average monthly increase for September and October was more than 300,000, not much below the sizable gains experienced during the first half of the year. Employment increases were notably large in the trade and services sectors, while manufacturing employment expanded somewhat in October, partly offsetting the drop in the preceding month.

Industrial output during October is estimated to have increased only about 1/4 percent following a 0.6 percent decline in September. Motor vehicle production in both months was depressed owing to strikes, but outside the auto sector weakness in output appears to have been rather widespread. To some extent domestic production is being damped by the pervasive competition from imported products. It also seems that firms generally have been undertaking efforts to bring inventories into better alignment with sales. During the third quarter all of the growth in real GNP was attributable to inventory investment as final sales were flat, and those inventories were beginning to look uncomfortably high in a number of areas. With the pickup in demands and output curtailments, however, business adjustments likely are well along assuming that sales will continue to exhibit moderate growth. The latest hard data on inventories is for manufacturers in September, and there inventory growth was half that of the preceding few months. On balance, the staff forecast has the pace of inventory investment declining this quarter and not contributing to growth of real GNP over 1985 as well.

One key area of uncertainty has been--and continues to be--that of consumer behavior. In September personal consumption spending rose strongly after the weakness evident in the previous two months. For October we only have fragmentary

information; chain store sales appeared to be on the sluggish side but we have not been able to relate these sales in a consistent way to more aggregative measures of consumer spending. Foreign car sales rose substantially in October while domestic auto sales declined to a 7-1/4 million unit annual rate as supplies of the popular cars continued to be very tight, partly because of strike effects. Production of autos is scheduled for a healthy rise this month and we anticipate sales will improve as well, with a strong auto market projected into 1985. Other consumer spending is expected to rise at a moderate rate, reflecting continuing expansion of employment and incomes and positive spending attitudes.

In the residential construction sector, housing starts and new home sales rose in September after a poor performance in August. The declines in mortgage interest rates in recent months should be supportive of housing activity, although rates are expected to remain high enough over the forecast period to limit growth in this sector. Housing starts are projected to hover around 1-3/4 million units throughout the forecast which is a little above the level in the third quarter.

Business fixed investment spending picked up in September with shipments of equipment and construction spending both expanding. Investment spending slowed considerably during the third quarter as a whole, however, following exceptional

increases over the preceding year. Our reading of the forward looking indicators has induced us to reduce a bit projected outlays over the forecast period, but at a 7-1/2 percent real increase next year capital spending provides strong support to overall economic growth.

For price and wage behavior the news generally remains quite favorable. We have incorporated a somewhat lower oil price in this projection reflecting recent developments, but have assumed that OPEC will be able to constrain production so as to avoid a major price break. Food prices have risen less over the past few months than we had expected, and the forecast in the near term has been reduced a little. The aggregate forecast of both prices and wages shows an increase that is a couple of tenths lower than in the last projection, and the GNP deflator is expected to rise 4-1/4 percent next year, about 1/2 percentage point above the rate anticipated for this year.

FOMC Briefing
S.H. Axilrod
November 7, 1984

The recent substantial and unexpected weakness in M1 naturally raises the question whether it reflects or presages unexpected and substantial weakness in GNP. In part the answers depend on how long the weakness in M1 has lasted, and whether it reflects primarily changes in the supply of money or a shift in the demand for money.

In the first place, I would argue that any significant weakness in M1 is of quite recent vintage. The failure of money to grow in July and August seems to me to be best viewed as an offset to the rapid growth of late spring. Through August, M1 growth was just about at the midpoint of the 4 to 8 percent long-run range. However, the weak performance of M1 in late summer and early fall has brought this aggregate well into the lower half of the long-run range.

I would take the late summer-early fall behavior as the more troublesome to interpret. It will take a bit more time before one can be reasonably sure that it is part of a disturbingly weak trend. (Mention most recent data being weak.) But even if there is a rebound of growth in November and December to around the dimensions of alternative A or B, over the last four months of the year growth will have been only about 3 to 4 percent at an annual rate—still a fairly marked phase-down from the about 6 percent growth over the first eight months of the year.

The counterpart of such a phase-down would be the apparent substantial rise in velocity of M1 that appears in prospect for the fourth quarter. The rise in velocity is close to what we experienced during the first half of this year, but at that time interest rates were rising, money was becoming relatively more expensive to hold, and credit and GNP growth were very strong. Now rates are going down and money is becoming

less expensive to hold, so there should be more rather than less demand for it for that reason alone. Much of that effect occurs with a lag, but in any event our quarterly model suggests that M1 should grow some 4 percentage points more than we are expecting at an annual rate in the fourth quarter, given projected GNP and interest rates.

The model, therefore, suggests that there has been a downward shift for money, evidenced by the willingness of the public to hold less cash than the model predicts. One might then feel some confidence in a judgment that spending will not be adversely affected by recent money behavior.

There is of course something to be said for such an analysis of money demand. But it carries most conviction when the model has been consistently overpredicting money for sizable amounts for some period. It then becomes clearer that something fundamental affecting attitudes toward cash may be in train. We have in fact been running with less M1 growth than our quarterly model predicts for four straight quarters now, but the amounts have been very small. This quarter would be, on current assumptions, by far the largest miss yet. However, it occurs at a time when there are very few special factors on the demand side that appear to explain the weakness in M1. It is possible that MMDAs, which have again begun growing relatively rapidly, may have displaced NOW accounts as an outlet for highly liquid savings funds in an environment of falling interest rates. But it is difficult to account for more than a few percentage points of the recent restraint on M1 from such a factor.

The demand for money, given income and interest rates, may have weakened, but it is also plausible that a sharp rise in velocity this quarter, if it occurs, should be interpreted as instead reflecting mainly curtailment

in the supply of money. In that case, a contemporaneous increase in velocity can be expected--both for arithmetic reasons and behaviorally in view of the lags in the system--but after a period of time GNP growth may also be expected to weaken so as to bring GNP growth more in line with money. Still, M1 has not proved to be a very reliable predictor of GNP over the past few years. Thus, while it is plausible that GNP could be weaker than we have projected, such a result does not necessarily follow from the recent behavior of M1. Moreover, we are not seeing confirming weakness in other aggregates. M2 growth over the past two months has held up remarkably well, averaging close to 7 percent, about the same as earlier in the year. And M3 growth has recently picked up again after a lull in late summer when banks and thrifts held back on issuance of managed liabilities. However, the behavior of M1, particularly if not much more than a moderate rebound is ahead of us, is certainly not inconsistent with a weaker GNP.

Interpretation of the significance of recent money behavior depends in part on assessment of interest rate trends--in particular, whether or to what extent declines in nominal rates also involve drops in real rates. Such an assessment is particularly difficult at the present time because we seem to be passing through a period in which inflationary expectations are in process of change--in this case lowered--partly in response to OPEC's well-publicized problems in holding up the oil price. Three-month Treasury bill and CD rates have dropped about 1-1/2 percentage points since the last FOMC meeting, and the funds rate by about the same amount. As a result the constellation of short market rates is not far from where it was last winter. With the short-run outlook for inflation probably little different,

real short-term rates have probably also returned to levels of that period, and are substantially lower than in summer.

However, the story is somewhat more complicated for longer-term rates. As with nominal short rates, nominal longer-term market rates are close to, and some cases a little below, last winter's levels, after falling substantially from early summer peaks. But in contrast to the probable stability of the short-term inflation outlook, longer-term inflationary expectations have probably improved--according to one poll by 1 to 1-1/4 percentage points since last winter. Thus, real longer-term rates have not declined as much as nominal rates; real long-term rates are probably now below their early summer peaks but they may well still be above levels of last winter.

Whether nominal rates should be even lower in an effort to press real rates down further depends obviously on assessment of the strength of demands for goods and services. When interest rates fall while money is weak and bank reserves are dropping, one is tempted to conclude that underlying demands for goods are weak and interest rates could appropriately fall further. This argument is not quite foolproof, however, particularly if credence is given to M2 and M3 behavior as representing monetary policy or if there is belief that we are experiencing yet another demand shift for M1.

Of the alternatives before you, A would be most appropriate on the view that underlying demands for goods and services have weakened significantly or that inflationary expectations will continue to abate. In that case, the risk of an unduly sharp re-expansion of M1 early next year from additional money market ease in the weeks ahead would not be particularly large. Alternative B, which initially keeps bank reserve

positions about unchanged from recent levels, would be consistent with a view that the economy may be moving forward satisfactorily after the summer lull and given the recent declines in rates. I should note, however, that under this alternative at least some of the recent rate declines are likely to be reversed since the market appears to have anticipated some further easing of bank reserve positions.