APPENDIX

Notes for FOMC Meeting

October 21, 1980

Scott E. Pardee

Since the last meeting of the FOMC, on September 16, the dollar has had to weather a number of potentially disturbing developments. The war between Iraq and Iran which broke out after mid-September has had momentous implications for the balance of power in the Middle East, for the continued flow of oil from the Persian Gulf to most industrial nations, and even for the future of OPEC. Reports on the conflict have been confusing. Traders' interpretations of the exchange market implications have also shifted back and forth, so it is difficult to say whether the net effect on the dollar has been positive or negative up to this point. The time of the IMF/World Bank meetings in late September-early October was also a period of tension, not so much for what happened but because traders recalled that events at previous meetings had triggered large flows of funds across the exchanges, including full scale runs on the dollar in several recent years. Fortunately, the meetings proved uneventful as far as the exchanges were concerned. The German election, on October 5, was the next possible disruptive event, since economic issues were being hotly debated. In the end, and despite some political mud slinging that made our own election campaign seem like a Sunday school picnic, the results of the German election were no surprise to the market. Another event at that time, President Carter's criticism of the Federal Reserve, followed by Chairman Volcker's response, did send a shiver through the exchanges. The fear was--and is--that the Fed would be forced to buckle under political pressure to ease up on monetary policy and thereby allow for a rekindling of inflationary expectations in the United States. But even this shiver passed as U.S. interest rates in fact held firm. Interest rates are not the only element bolstering the dollar in the exchanges; our relatively good current account performance so far this year and expected for next year has helped give the dollar a solid underpinning.

The dollar's advance has not been across the board. Other currencies that have been strong over the recent weeks have also benefited mainly from capital inflows. Sterling has risen to $2.42, on the attractiveness of continuing high interest rates in the U.K. as well as that country's self-sufficiency in oil. The Japanese yen has also advanced during the period of capital inflows, particularly into a booming stock market. Japan still has a large current account deficit, but the market believes that Japan has turned the corner and will be showing an improved trade and current account

performance. On the European continent, the French franc and the Dutch guilder are strong within the EMS, on capital inflows, and both currencies would have been higher against the dollar now except for the weakness of the German mark within the EMS.

Indeed, by last week's Bundesbank council meeting, the focus of attention turned to the monetary policy dilemma facing Bundesbank. Economic growth in Germany has virtually stalled, central bank money is coming in low relative to this year's target, and interest rates remain quite high relative to domestic inflation rates. Thus there is scope for easing policy. Nevertheless, Germany has a current account deficit running at an annual rate in excess of $15 billion and--partly because interest rates are low relative to those elsewhere--Germany has not had much success in financing that deficit on the basis of net capital inflows. Forecasters are quite bearish, thinking it will take some time for the current account deficit to be eliminated. The German mark, already low within the EMS band, was coming under more general selling pressure. In this dilemma situation, last Thursday, the Bundesbank decided to supply some additional liquidity to the market, but not to lower interest rates. Nevertheless, in the prevailing bearish atmosphere, the mark came under increased selling pressure, and outflows have continued yesterday and today. On balance, the mark has declined by 4-½ percent since the last FOMC meeting, to DM 1.86.

With the mark declining, we have seized the opportunity to buy as many marks as we could, to repay swap debt and rebuild balances. In total we acquired nearly $1.2 billion of marks during the period, from purchases in the market and from correspondents. With these marks we repaid the remaining $357 million of swap debt and built System balances by some $268 million equivalent. The Treasury reduced its net short position in marks by some $555 million equivalent to $2.1 billion. We also have bought sufficient French francs to reduce the System's swap debt in that currency to $34 million equivalent; and we have added some $35 million equivalent to our Swiss franc balances.

Although the dollar is firmly based for the moment, the picture is more one of weakness for the Deutsche mark than one of strength of the dollar. Market participants are far from bullish about the outlook for the dollar. We have our own election to go through and our inflation performance remains a major matter of concern. So having what resources we can for intervention will be helpful.

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

System open market operations since the last meeting of the Committee were pursued against a background of stronger than desired growth in the narrower targeted aggregates and consequent increases in interest rates, as the Desk sought to hold back the provision of reserves. As demand for reserves pushed up, while the Desk supplied nonborrowed reserves in line with the desired growth path, discount window borrowing expanded and the Federal funds rate rose. Midway in the period, the path for nonborrowed reserves was reduced by $200 million to encourage somewhat greater restraint on credit expansion and monetary growth. The message of restraint was further reinforced by the 1 percent boost in the discount rate effective September 26.

The bulge in demand for reserves was perceived quite shortly after the September 16 meeting, causing the Desk to aim for nonborrowed reserve levels in the early weeks such that borrowing would be about $1.1 or $1.2 billion, compared with the $750 million borrowing level agreed on by the Committee as appropriate in setting the nonborrowed reserve path. As it happened, borrowing rose even more sharply than intended in those opening two weeks, averaging about $1 3/4 billion. This reflected several factors including persisting shortfalls in reserves from day-to-day projected levels, some Reserve Bank computer problems, and pressures around the September 30 statement

date. The combined impact of these influences, coupled with the discount rate move in late September, resulted for a few days in a stubbornly tight money market and higher than expected funds rate that risked encouraging market over-reactions to ongoing developments. Accordingly the Desk took some care on a couple of occasions to reduce these risks by overproviding reserves early in the statement week, to be followed by reserve absorptions later on, if necessary to get back to path. For several days in late September-early October, funds traded predominantly at rates above 13 percent, although the weekly average did not exceed about 12 5/8 percent. This compared with around 10 - 10 1/2 percent earlier in September.

Because of the heavy borrowing early in the interval, there was not much rise in the implicit anticipated level of borrowing as the period proceeded, even though the aggregates strengthened somewhat further. In fact, the anticipated borrowing level slipped to just about $1.0 billion in the middle week before edging back up to about $1.2 billion and then $1.3 billion in this current week. Actual borrowing levels came fairly close to anticipated levels in the third and fourth week while in this final week it has been running lighter than expected so far. Federal funds continued to average around 12 5/8 percent in the latest full week and has run closer to 12 3/8 percent so far this week.

As of our latest review, last Friday, total reserves were expected to average about $440 million above the path level for the five weeks ending tomorrow, essentially reflecting the greater than desired strength in the aggregates. Nonborrowed reserves had fallen below path in early weeks of the period but should average close to the downward revised path for the full period.

Desk operations were mainly conducted through temporary additions and withdrawals of reserves. There were outright purchases of $200 million of bills from foreign accounts early in the period and purchases in mid-October of about $760 million of bills in the market and $165 million from foreign accounts. In between, we sold $102 million of bills to foreign accounts and ran off $300 million of bills at maturity. Most recently, yesterday, we have begun taking actions looking forward to the large release of reserves on November 13, by running off $400 million of bills in yesterday's auction and selling $100 million of bills. On a commitment basis, outright holdings are thus up a net of about $225 million for the period.

For about the first two weeks of the period, interest rates rose fairly sharply across a broad range of maturities and types of issues, propelled by the firming money market, strong monetary growth, signs of economic recovery and unyielding inflation, capped off by the late September discount rate rise.

Adverse market psychology was self-reinforcing, probably prompting some over-reaction to the daily flow of news. After early October, rates tended to stabilize or decline for a time with net declines for intermediate- and long-term Treasury issues that just about offset the earlier increases. Short-term rates still registered a net rise for the period--roughly 1 3/4 - 2 percentage points for Federal funds, and 1 - 1 3/8 percentage points for major bank CDs or commercial paper. The prime rate has risen 1 3/4 percentage points to 14. Treasury bills were up a more modest 5/8 - 3/4 percentage point for most maturities. Both three- and six-month bills were auctioned yesterday at average rates of about 11.41 percent compared with about 10.64 and 10.88 percent just before the last meeting.

The rate declines for intermediate- and longer-term issues after early October reflected a view that previous increases had been overdone, and Desk actions and official statements lent some support to this view. The view was bolstered further by reports of moderation in monetary growth, lessened inflationary pressure, and indications that business recovery was proceeding slowly. Bond market psychology weakened again in the past few days, however, with the rebound in money supply and stronger business news.

The Treasury continued to raise new funds during the period, including nearly $4 billion in coupon issues, as well as $2 1/2 billion in bills. New money in the coupon area included

$1.5 billion in 15-year bonds, which became feasible after the Congress acted at the eleventh hour to provide additional authority to sell bonds yielding above 4 1/4 percent. Substantial Treasury cash raising will continue during this quarter, including a quarterly refunding to be announced October 29 in which the Treasury may seek to raise about $3 billion from the public on top of about $5 billion publicly held maturing issues. The System holds a relatively moderate $880 million of the maturing issues which we expect to roll over as usual, leaning a bit toward the shorter maturities. There will be an auction of 2-year notes tomorrow, raising $1.1 billion for the Treasury, with early rate ideas around 12 percent or a little higher compared with 11.93 percent a month ago.

Dealers have continued to hold fairly moderate inventories of Treasury coupon issues in the recent period, in keeping with their cautious view of the market and volatility of rates. Holdings of over 1-year issues were last reported at about $1.1 billion, compared to $900 million just before the last Committee meeting.

I referred earlier to the fact that we have started to sell and run off at maturity some securities in preparation for the large release of reserves scheduled for November 13. While we know there is a sizable reserve absorption job to be done, its precise magnitude is uncertain as we will to some degree be feeling our way, come mid-November, seeking to assess

how banks will utilize their newly released reserves and how various institutions newly required to keep reserve balances will tend to behave. In this connection, I would like to request a temporary increase to $4 billion in the normal $3 billion leeway to change System Account holdings between meetings of the Committee, contained in paragraph 1 (a) of the Authorization for Domestic Open Market Operations. We may not need this added leeway but it would be useful to have, given current uncertainties.

Joseph S. Zeisel
October 21, 1980

FOMC BRIEFING

Recent information has confirmed that the economy turned around convincingly over the past few months. Following the sharpest quarterly decline in the postwar period, the Commerce Department estimates that real GNP rose by 1 percent in the third quarter. The rebound came somewhat earlier and was stronger than had been anticipated; the increased strength in July and August was concentrated largely in housing and consumer outlays, and was clearly associated with the easing of credit conditions earlier this summer.

Activity continued to expand in September, although there were suggestions of some loss of momentum. Retail sales, excluding autos, rose in current dollar terms for the fourth month in a row, but spending for discretionary items such as furniture, appliances and general merchandise leveled off. Auto sales edged up further in September, probably partly in response to discounts and rebates on 1980 models. Price increases announced for the 1981s likely helped the sales of the previous year's models as well. It is too early to tell how well the new models are faring; overall sales picked up only slightly further in early October following introduction of the 1981 Chrysler and Ford models.

Housing activity also continued to expand in September, with starts exceeding a 1½ million annual rate. Most of the

gain was in the multifamily sector and apparently was associated with a fisal year-end bulge in federal subsidies. Field reports--including those in the Redbook--indicate that the rebound in mortgage rates to around 14 percent was increasingly curtailing housing as the month progressed.

The improvement in consumer demand and residential construction activity since May has been reflected in production and labor markets in the past two months. Industrial production rose 1 percent in September following a six-tenths percent gain in August, with much of the increase in motor vehicles, home goods and building materials. However, the level of output remains below that of the second quarter. Nonfarm jobs increased by nearly 200,000 in September, slightly less than in the previous month. Much of the rise over the two months was in trade and services, but employment picked up in manufacturing as well, particularly in the metals industries, and the factory workweek--generally a good lead indicator--has moved ½ hour above its July trough.

In contrast to the upturn in outlays for housing and consumption, spending for business fixed investment has continued to weaken, and data on orders suggest a further real reduction in equipment purchases over the near term. Contracts for commercial and industrial construction indicate no signs of strength for at least the next several quarters. Business investment in inventories also declined in the third quarter as the sharp contraction in industrial output from the second-quarter level contrasted with a strong upswing in real final demands.

On balance, therefore, we have seen in the third quarter a moderate expansion of GNP, reflecting a strong, credit-associated rebound in housing and consumer demand, offset in part by continued weakness in real business outlays.

In the fourth quarter, we are now projecting that real GNP will rise at about the same 1 percent pace as in the third, reflecting in part some carry-over of the resurgent strength in housing. But we expect that the support for the recent rebound in overall activity will be diminishing as a downturn in housing starts in response to higher interest rates combines with a further contraction in business fixed investment to damp growth of income and consumption. We expect a reduced rate of inventory liquidation to offset, temporarily, the loss of strength in final demands.

Given the restrictive nature of assumed monetary and fiscal policy, we anticipate little growth overall during 1981. Real GNP is now projected to rise by only about ½ percent over the four quarters. The monetary targets imply high interest rates throughout 1981. While it is possible, given recent experience, that mortgage rates in the current range may not appear as formidable to prospective house purchasers as they did formerly, it is our judgment that they will put a severe damper on home sales and construction activity, particularly in an environment of weak growth in real income. We therefore expect housing activity to slacken over the next few months, with starts remaining in the neighborhood of 1.1

to 1.2 million units at an annual rate throughout next year.

The outlook remains poor for capital spending as well. The combination of considerable slack in capacity, reduced profit margins and the high cost of funds suggests further decline in real investment outlays during 1981. At the same time, we expect government spending at all levels to continue to be restrained.

In sum, we foresee little strength in the income-generating sectors of the economy, and with the saving rate already low, and the proposed tax cut providing no net relief, this translates into poor prospects for consumer demand.

Little employment gain is likely to be associated with ½ percent real increase in GNP, and despite relatively slow growth in the labor force, the unemployment rate is projected to edge up to about 8-1/4 percent by the end of 1981.

The price outlook does not appear promising, despite the continued slack forecast for industrial and labor markets. The recent easing of prices in energy, housing and food appears likely to be temporary. More fundamentally, while we still expect some moderation of the wage rise in an environment of sustained high unemployment, we anticipate that any improvement will be modest, given the continued pressures on living costs and the already protracted decline in real earnings. On balance, and barring severe supply shocks, we expect a little easing of overall inflation, to about a 9½ percent rate in 1981, down about 1 percent from this year.

FOMC Briefing
October 21, 1980
S. H.Axilrod

The rapid growth in narrowly defined money that it seemed reasonable to expect in one of the last few months of the year took place, unexpectedly, in September. With nonborrowed reserve growth set to accommodate the much slower monetary growth targeted at the last meeting, interest rates rose earlier than had been expected. The additional restraining effect on money demand from that rise of rates, and the larger-than-anticipated stock of money with which the economy enters the fourth quarter, provides some hope that growth in money demand will be quite moderate over the balance of the year--assuming that the economy is no stronger in the fourth quarter than currently projected by the staff. However, as the Bluebook indicates, money demand is not expected to be so weak over the balance of the year as to permit attainment of the August-to-December path for the narrow aggregates the Committee set at the last meeting without some further rise in interest rates--with a funds rate around 13 ½ percent not unlikely.

The policy dilemma before the Committee is no different from that evident at the last meeting, except that the spurt of money growth in September and the clearer signs of an early turnaround in economic activity before any noticeable progress has been made in restraining inflation make the dilemma more pointed and more immediate. The dilemma stems from the possible inconsistency between the monetary targets and the encouragement of economic recovery

It is probably necessary to attain the monetary targets for 1980 in a convincing fashion to maintain credibility of the System's anti-inflationary stance. To be convincing probably means at least that M-1A growth should be well within its longer-run range if M-1B and M2 are above theirs, as they may be, though by small margins apparently. That M3 and bank credit are likely to be well within their ranges will probably be widely ignored by markets, on the ground that they have not been key variables in the FOMC's operating directives to the Desk and are therefore not viewed as critical by the System. But if assuring M-1A growth well within its range, as with the Bluebook's alternative A path, brings a more significant rise of interest rates than the staff has projected or even such a rise, it seems increasingly likely that a second dip in economic activity will be in store, if one is not in store in any event.

The Committee may wish to consider therefore how much upward flexibility there might be in M1 growth rates between now and year-end without risking erosion of its credibility. The answer probably is, some but not a whole lot. While an M1 level in December at the 6 percent upper end of the Committee's M-1A growth range for 1980 could be hit even if growth were around 9 percent between now and year-end, this would drive M-1B growth further above the limit of its range. Moreover, clearly the successive double-digit growth rates of July, August, and September make much more modest growth rates of M-1A in succeeding months essential for market psychology and to avoid the risk of building so much inflationary momentum into the economy that today's policy dilemma becomes even worse in 1981.

to avoid the risk of building so much inflationary momentum into the economy that today's policy dilemma becomes even worse in 1981.

Finally, it should be pointed out that the widening differential between growth in M-1A and M-1B might be construed as effectively lowering the Committee's M-1A range, though raising the range a bit for M-1B. In February, the differential between M-1B and M-1A was expected to be ½ point. That differential was maintained when targets were reset in July. It now appears that M-1B growth will exceed that of M-1A by about 2 percentage points.

Based on earlier evidence that suggested dividing sources of new ATS/NOW accounts between demand deposits and other assets in about a 2-to-1 ratio, one might argue that M-1B growth at ½ point above the present upper limit is justified but that M-1A growth should be up to 1 point below its present upper limit if growth is not to be more expansive than presumably originally desired.

If the effective upper limit of M-1A is in that way considered to be 5 percent or so rather than 6 percent, this would imply an M-1A growth of around 4½ percent, annual rate, from September to December. Alternative B proposes a somewhat lower growth rate than that of 3½ percent--a growth rate that places M-1A at the midpoint of its present range and runs less chance than a higher growth rate of pushing M-1B substantially above its present longer-run range.

Assuming in current circumstances that very low money growth rates are less risk to the credibility of its targeting procedures than high growth rates, the Committee might wish to consider a tactical approach to reserve targeting that reverses the approach of June and July. At that time, the Committee authorized raising nonborrowed reserve paths, up to a point, to accommodate money growth above a minimum. In the period ahead, it might wish to consider setting a maximum money growth target and lowering nonborrowed reserve paths should money fall short, up to a point. With such an approach it would of course be particularly critical what level of borrowing the Committee wished the staff to assume initially in constructing the nonborrowed path.