

## APPENDIX

Notes for the FOMC Meeting of  
March 31, 1981  
Margaret L. Greene

The exchange markets have been through a watershed, of sorts, since the February 3 meeting of the FOMC. The sharp advance of dollar rates under way at that time accelerated through mid-February, partly in response to the continuing pattern of interest rate relationships that attracted funds into dollar investments and to a positive attitude towards the economic policy initiatives of the new Administration. But in addition, the dollar's strength reflected the weakness of the German mark. As capital flowed out of Germany at an increasingly heavy pace, in spite of the gentleman's agreement and other actions to curb these flows, the dollar was bid up more than 6 percent from the levels of the last FOMC meeting to a three-year high of DM 2.2550. With pressures building up against the mark, the Bundesbank became increasingly fearful that a full-fledged run against the mark would develop. Accordingly, on February 19 the Bundesbank acted to raise short-term interest rates sharply in order to support the mark. By closing its regular Lombard window and opening a special overnight Lombard facility, the German central bank in effect pushed the day-to-day money rates up 3 percentage points to 12 percent, adopted a procedure which provides the central bank far more flexibility than it had before in adjusting money market conditions, and imparted a sense of uncertainty about the outlook for German interest rates that did not exist before.

In the exchange market, the Bundesbank's actions, together with an easing of U.S. short-term interest rates during late February and March, blunted the dollar's rise. Another implication of the Bundesbank's measures was that the rise in German interest rates left other currencies closely associated with the mark all the more vulnerable to the same kinds of capital outflows and selling pressures that had previously fallen so heavily on the mark. As a result, most of the continental European central banks have, with varying degrees of enthusiasm, seen fit to have interest rates in their countries move up--even though economic activity throughout the industrialized countries abroad is, at best, sluggish. Most of the increases have been less than in Germany but then both Italy and today Belgium have hiked their discount rates by 3 points. Only in the United Kingdom, Canada, and Japan have interest rates eased since early February. Even here, the interest rate declines were limited. The two percentage point cut in the Bank of England's Minimum Lending Rate (MLR) that was announced as part of Chancellor Howe's March 10 budget was only half what the market had come to expect. The Bank of Japan, although it did lower its discount rate a full percentage point as expected, signaled its intention to adopt a "special Lombard" type of facility to force banks to borrow at temporarily higher rates if capital outflow from Japan should become important.

As a result of these developments, the interest rate differentials that had previously favored the dollar have now been cut by one-half or, in the case of the mark, by three-quarters. In addition, an unwinding of commercial leads and lags has pushed the German mark from the bottom to the top of the EMS band, thereby permitting the Bundesbank to cover a substantial amount of Germany's indebtedness under the EC joint float arrangements. But despite these

substantial adjustments in exchange-rate and interest-rate relationships, the dollar has proven remarkably resilient. Yesterday it was trading around the same levels as in early February against the Continental currencies. Against the Japanese yen and sterling it was up 4 to 5 percent. Although yesterday it dropped 2-1/2 percent, this morning it recovered most of yesterday's drop.

Why was the dollar so resilient? First, the market for the most part had not expected U.S. interest rates to tumble very fast or very far. The relative firmness of long-term U.S. interest rates dampened any undue optimism which the several percentage point drop in short-term rates might otherwise have generated. Second, little happened during the past two months to change market participants' basic view about the economic policy initiatives of the new Administration. Third, our current account position was still relatively strong. Even if the surplus is rapidly eroding during the current quarter, an outcome of near balance is better than the large deficits that are continuing particularly in Europe. Fourth, the situation in Poland continued to cast uncertainties from time to time over the outlook for European currencies.

In the early part of the period since your last meeting when the dollar was rising, the Desk continued to buy German marks, but not so vigorously as when we were covering debt. In all, the Desk acquired \$670 million equivalent of marks outright in the market and from correspondents, split evenly between the System and the Treasury. In addition, the Desk acquired a net \$55 million equivalent of marks as the result of the "two-way price" operations, which the Desk did to settle the markets on days in February when trading conditions were especially disorderly. These net purchases were also added to System and Treasury balances equally. As a result, the System's holdings of marks are just under \$2.6 billion, within the \$2-3/4 billion limit established at your last meeting.

Almost all of these operations occurred before February 19. Since then the Desk has hardly been in the market even though the day-to-day volatility in the exchange markets has been as great as we have experienced. In view of the uncertainties generated by the Bundesbank's new approach and the continuing volatility of our own money markets, it would not have been practical for us to have operated to reduce the volatility in the exchange markets. But in addition, we scaled back operations while discussions were under way with the new Treasury about the intervention approach to be conducted. In the unusual events of yesterday, however, the Treasury felt it appropriate that we intervene to stabilize the exchange markets. The Desk sold \$244 million equivalent of DM, split 50/50 between the Treasury and the System. It was widely recognized that we were in the market and commentary in the press has praised the quick and forceful action of the Federal Reserve.

### Recommendation

The \$200 million drawing of the Swedish Riksbank comes due on April 23. This drawing served as bridge financing to a jumbo Euro-market loan which contains an SDR-denominated portion that was so well received that the overall amount of the loan was raised from \$1 billion to \$1.4 billion equivalent. In addition, following new monetary and budgetary actions and a favorable wage settlement in February, Sweden is experiencing a reversal of leads and lags and has been able to take in dollars rather consistently. As a result, I fully expect the Riksbank to repay this swap drawing in a timely fashion.

The timing of this repayment is, however, fortuitous for it draws attention to the fact that we are fast approaching the date--May 23--when the one-year \$200 million increase in the Riksbank's swap line is due to expire. Despite the progress the Swedish authorities have obviously made in dealing with the immediate exchange pressures against the krona, the Riksbank still expects the current account for 1981 to be in the same order of magnitude as last year's, or about \$5 billion. Moreover, a slowdown of the domestic economy is making it difficult for the government to achieve sizable cutbacks in Sweden's large fiscal deficit, even after the February measures. As a result, the government expects to continue to borrow abroad. If the Riksbank should wish to renew the \$200 million increase to maintain its short-term credit lines to back up these borrowings, the Manager expects to recommend FOMC approval to agree to such a renewal, which would be handled by wire to the Committee.

REPORT ON OPEN  
MARKET OPERATIONS

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

Monetary growth showed divergent trends in the period since the last meeting, with M1-B falling short of desired path levels while M-2 was about on or somewhat above path. Since reserve paths are largely geared to the narrow aggregates, as those components generate the bulk of required reserves, the shortfall in the narrow Ms led to declines in borrowings and sizable reductions in short-term interest rates as the Desk sought to provide nonborrowed reserves about in line with path. The overruns in M-2 had no comparable "automatic" effect, although the strength in M-2 was taken into account in a judgmental manner in two ways. First, it was a background factor, along with the considerable easing in money market rates, in the Committee's decision at the February 24 telephone meeting to accept some shortfall in the narrow Ms and temporarily adjust the nonborrowed reserve objective to reduce the likelihood of still further declines in short-term rates. Second, the strength in M-2 was a factor in the decision not to adjust the nonborrowed reserve path higher as the period progressed, despite the shortfall in total reserves.

The immediate prelude to the special February 24 meeting was a Federal funds rate that was tending to fall below

the Committee's 15 - 20 percent range. Indeed, earlier in that February 25 statement week, the Desk had drained reserves in good part because of funds trading below 15 percent. While this produced a reserve need, the need did not show up in the market until late Wednesday of that week, too late for the Desk to supply nonborrowed reserves. This led to a record one-day surge in borrowings to over \$5 billion, and average borrowing of \$1.7 billion in that February 25 week. Although path objectives had been modified after the February 24 meeting to provide somewhat more borrowing and less nonborrowed reserves than anticipated earlier, actual nonborrowed reserves in the February 25 week were substantially below path--by nearly \$1 billion. In turn, this result would have called for nonborrowed reserves in the March 4 week, the final week of the first four-week subperiod, that would have implied virtually no borrowings at all--an outcome deemed inconsistent with the Committee's February 24 discussion. Instead, the Desk aimed for, and achieved, nonborrowed reserves in the March 4 week consistent with the \$1 billion borrowing level that seemed to be emerging as the probable level in the second four-week subperiod.

Total reserves averaged about \$380 million below path for the first four-week subperiod. Nonborrowed reserves could be said to have averaged right on path after allowing for the adjustment in the final week's nonborrowed objective just described, or could be said to have fallen short of path by

some \$215 million before making that adjustment.

In the second four-week subperiod, we returned to a nonborrowed path consistent with the initial monetary growth objectives and the initial borrowing assumption of \$1.3 billion. With the narrow aggregates remaining below path, it appeared as of last Friday that total reserves for the subperiod, which ends tomorrow, would fall about \$400 million below their path--about the same shortfall as in the first subperiod. As best we can tell now, nonborrowed reserves should come out close to their path in this subperiod.

Federal funds, after falling from a little over 17 percent in early February to just below 15 percent in late February, edged up in early March to the 15 1/2 percent area. As March progressed, the narrow aggregates began growing again but the level was still below path. Pursuit of reserve objectives led to reduced borrowing pressures and day-to-day funds rates temporarily as low as 13 percent--though the weekly average was no lower than about 13 1/2 percent. In the aftermath of the Committee's February 24 discussion, temporary deviations somewhat below 15 percent were not deemed unacceptable, particularly as it appeared that implicit needs for increased borrowed reserves in the wake of some strengthening of the aggregates in March would soon exert renewed upward pressure on the funds rate. And indeed in the current week the rate has returned to about 15 percent, although it seems to be starting out below that today.

The System's outright securities holdings were up a net of about \$1.2 billion, largely representing a market purchase of bills on March 11. There were also roughly offsetting purchases and sales from or to foreign accounts at various times in the period. Matched-sale purchase transactions were arranged several times in the market, and every day with foreign accounts, although on a number of occasions some of the temporary foreign account funds were passed through to the market. The System's own repurchase agreements were arranged just twice.

Short-term rates declined substantially, though irregularly, over the intermeeting interval, roughly paralleling the drop in the funds rate. In yesterday's bill auction, rates on the 3- and 6-month issues were 12.50 and 12.08 percent, down from about 14.66 and 13.74 on February 2. These declines occurred in the face of large additions to supply as the Treasury raised some \$20 billion in the bill market, including heavy seasonal issues of cash management bills. On the other side, money market funds were hungry buyers of bills. Rates on bank CDs and on commercial paper declined on the order of 2 - 3 percentage points, while the bank prime rate moved in steps from 19 1/2 - 20 to 17 - 17 1/2 percent.

Intermediate and longer maturities were a different story, however, with rates backing and filling under alternate



influences of slower money growth and some signs of a weaker economy, but also of large Treasury and corporate credit demands and continuing inflation. On balance, intermediate and long-term Treasury yields were up by roughly 50 basis points over the period--not unrelated to the Treasury's net cash raising of about \$13 billion through coupon issues. Corporate yields were up a more moderate 30 basis points or so. Sporadically, new corporate issuance picked up, but the much looked-for "window" still seems to be eluding many hopeful borrowers.

Subdued reaction to yesterday's shooting incident--no change in short rates, prices of intermediate and longer Treasury issues marked down, but no appreciable activity.

Sentiment on the rate outlook remains mixed, with few participants willing to stake much on their varying viewpoints. Some look forward to lower rates on the basis of weaker business or of the long-term beneficial effects of the Administration's economic program, while others are more impressed with the prospects for large Treasury deficits and an anticipation of a firm Fed resolve to dampen money growth. Investors continue to shy away from most long-term fixed interest issues, forcing many borrowers to restructure their offerings. Dealers seek to narrow their exposure by keeping only small positions or offsetting underwriting exposure with shorts in the futures market.

To close on a more cheerful note, most dealers seem to have weathered successfully the volatility and uncertainty of the past year. The reported profits of primary Government securities dealers set a record in 1980.

James L. Kichline  
March 31, 1981

FOMC BRIEFING

The economy showed surprising growth in the first quarter; it appears that real GNP may have risen between 5½ and 6 percent at an annual rate, following a 3-3/4 percent increase in the fourth quarter. Strength was evident in a wide range of activities. Consumer demand held up especially well and capital spending also has been quite robust, particularly in the area of nonresidential construction outlays.

Even so, there have been a number of fairly clear suggestions that the economy has been losing its upward momentum. Such a slowing in the economy is, we believe, consistent with existing fundamental monetary and fiscal policy constraints--constraints that imply a sluggish pace of growth overall through the projection period.

One area of weakening has been industrial output. Industrial production has shown successively smaller monthly increases since last fall, and activity in this sector declined by half a percent in February, with production cuts fairly widespread. The notable exception was auto assemblies, which picked up from a very low level. In line with the weaker performance of output, growth of manufacturing employment moderated and the workweek was cut back; in addition, sizable layoffs occurred in construction, all of which contributed to slower income growth.

In the housing sector, demand, construction activity and to some extent prices, now appear to be bending under the weight

of high interest rates. Sales and permits had begun edging off last fall, but it was not until February, when starts fell by 25 percent, that the picture really began to conform to general expectations. Anticipating that mortgage interest rates will remain high, we are forecasting housing starts around the 1½ million unit rate level through most of this year.

Although outlays in the business sector have been rather strong recently, information on new orders and contracts suggests that the first-quarter spending pace will not be sustained over the near term. The recent survey by the Commerce Department also indicates only a small increase in real terms for 1981 as a whole despite business expectations of what appear to be optimistic sales growth. The liberalized depreciation schedules proposed by the Administration and assumed in the forecast should provide some stimulus to spending, but any substantial response undoubtedly will take time to develop. For the balance of this year and into early 1982, it is still our judgment that real capital outlays will drift downward in an environment of continued underutilization of capacity, poor profits, and high cost of capital.

In the consumer markets spending has been strong, even aside from the impact of the rebates in the auto market. Excluding autos and nonconsumption items, nominal retail purchases reportedly grew over 2 percent in January and more than 1 percent in February. The gains in consumer spending have outpaced growth in disposable income in the past few months and the saving rate has dropped sharply, to an estimated 4½ percent in the first quarter. It's been difficult to predict consumer behavior, but with production,

employment and income growth slowing, and the already low saving rate, it seems most likely that consumer spending will weaken.

The auto market is of course a special case. The rate of domestic car sales, which had averaged about 6-3/4 million units since the model year began, rose to a 9 million unit pace in late February and the first 20 days of March in response to widespread rebates. Meanwhile, foreign car sales were at a near-record pace in February, perhaps partly in anticipation of restraint on imports and further price increases. Past experience indicates that a substantial portion of the rise in sales induced by rebates represents borrowing from the future--which suggests a period of several months of sluggish car sales in late spring and summer after the rebate programs end.

With the outlook for consumer demand likely to be dictated by growth of income, and growth of the private income generating sectors--mainly housing and business outlays--severely constrained, we foresee a general sluggish performance for the economy overall during the forecast period--likely, a rate of growth averaging under 1 percent. In that environment, there would be little or no employment gains and a rising rate of unemployment, reaching about 8½ percent in the second half of next year.

Additional slack in labor and product markets is a key element in our forecast of inflation, which by later next year is expected to fall below 8 percent. There are beginning to be some signs around now of selected easing of wage pressures, but these are appearing so far in distressed industries or in a limited fashion

in nonunionized sectors. But with sustained labor market slack a more generalized slowing of labor cost increases is expected next year and this should carry into price developments. For the near term, the inflation outlook appears a bit more favorable than it did a few months ago. In part this can be attributed to energy price developments where large stocks of oil and oil products along with further conservation efforts have helped limit price increases in the face of the OPEC price rise and decontrol. A bigger part of the improved performance has been in food prices, reflecting declines in meat prices as larger supplies of meat have reached market. This may well prove temporary given cost pressures and production cutbacks seemingly coming along. Even so, when looking at overall inflation, recent developments seem to provide greater hope that--absent any major new shocks--we should experience a noticeable deceleration of price increases over the next year or so.

FOMC Briefing  
Stephen H. Axilrod  
March 30, 1981

Since the last meeting of the Committee, the principal monetary aggregates have shown divergent behavior. M-1B has run low relative to the short-run path adopted by the FOMC while M-2 has run high. On a quarterly average basis M-1B grew less than  $\frac{1}{2}$  percent at an annual rate in the first quarter, well below its long-run range of  $3\frac{1}{2}$  to 6 percent, and yielding a post-Korean war record increase in velocity. Meanwhile M-2 expanded at about a 7 percent annual rate, well within its 6 to 9 percent range. However, growth of M-2 was very rapid late in the quarter, as the public placed enormous amounts of funds in money market funds. By the month of March, M-2 was at the upper limit of its range, and we expect it to move above the range in the months ahead. In terms of the monetary aggregates, probably the main policy issues facing the Committee today are the interrelated ones of how much weight to place on M-2 and how rapidly should M-1B be brought back to within its long-run range.

Without attempting to resolve the ongoing dispute about whether M-1 or M-2 is more closely related to GNP in some causative sense, the inexplicable behavior of M-1 recently may be one reason for giving some weight to M-2, although M-2 also has not been behaving with great predictability and the increase in its velocity in the first quarter was unusually rapid. Another reason for giving added weight to M-2 would be the possibility that there may have been some shifts between M-1B deposits and MMF assets that might artificially have lowered adjusted M-1B growth in the first quarter. It is most difficult, of course, to isolate the source of flows into MMFs. Some may have come from non-M-2 interest-bearing assets, like large CDs or Treasury bills. But it is not likely that such flows were unusually large in the first quarter, since MMFs

that accept deposits only from institutional investors increased about in line with their share in MMF assets.

It would appear that the great bulk of the increase in MMF assets probably came from non-transactions deposits in M-2, whose rate of growth dropped sharply from the fourth to the first quarter. But it may be that some portion shifted out of M-1B as the public re-assessed their cash management practices in the wake of the introduction of nationwide NOW accounts. To the degree that occurred, the strength of M-2 would serve as a proxy for what is very likely a more rapid first-quarter growth in M-1B in an economic sense than is indicated by the measured  $\frac{1}{2}$  percent expansion in adjusted M-1B.

I suspect, though, that transfers to MMF's out of M-1B deposits could serve to explain only a relatively small portion of the unexplained M-1B weakness in the first quarter. The unexplained weakness amounts to about 6 percentage points at annual rate. That is to say, our quarterly model would have predicted M-1B growth in the first quarter of about  $6\frac{1}{2}$  percent at an annual rate, given GNP and interest rates, instead of the  $\frac{1}{2}$  percent we got.

Whether because of shifts from M-1B into MMF's, or because of shifts into other assets, including goods, the large size of the apparent downward shift in demand for adjusted M-1B relative to the Committee's target in the first quarter suggests the possibility that an even greater shift than had been assumed in staff GNP projections when the target was set could develop for the year as a whole. And that would suggest actual growth would need to be in the lower half of the M-1B range to have the same degree of restrictiveness as had been originally assumed for the midpoint of the range.

However that eventually works out, the Committee may also wish to consider the other advantages and disadvantages to an effort to bring

M-1B back to the middle of its target range relatively rapidly, say by midyear, as in alternative A. The principal advantage, of course, is that it would reduce the odds on prolonging a decline in economic activity, should one develop in the months ahead. It would also tend to show an even-handed monetarist approach by attempting to get back on path rather promptly.

On the other hand, such an approach would, by the arithmetic of it, require a quite rapid growth of adjusted M-1B over the next few months, almost 9 percent at an annual rate. And, unless the economy is stronger than currently projected, and perhaps even if it were about as strong, this could risk a further drop of short-term interest rates, followed by a sharp rebound, replicating something like last year's pattern. In addition, monthly growth rates of adjusted M-1B in the 9 percent annual rate range for several months could well be misunderstood by the market as signaling a weakening of anti-inflationary resolve by the Federal Reserve.

The slower M-1B growth paths of alternatives B and C would avoid many of the risks in alternative A. Which of the former two is more appealing depends essentially, in my view, on how the Committee assesses the need to take the present opportunity to maintain, or push, short-term rates above the currently expected rate of inflation and thereby perhaps encouraging resumption of downward pressures on commodity prices and maintaining downward pressures on the housing market and house prices--actions that might build up a little momentum toward deceleration of price increases in general (though, of course, not without some pain and stress). It also depends on how much weight the Committee wishes to give to keeping M-2 within its long-run target band, the chances of which are greater under alternative C than under alternative B.