APPENDIX

NOTES FOR FOMC MEETING
March 30, 1982

Sam Y. Cross

Since your last meeting in February, the dollar has risen by 1-2 percent against the Swiss franc and the German mark, by 6 percent against the yen, and by even more against some other European currencies. The dollar is now trading above year-end levels by about 7 percent against the Swiss franc and German mark and as much as 13 percent against the Japanese yen.

The dollar's most recent advance, triggered initially by interest-rate developments early in the year, has by now been reinforced by an improving swing in market sentiment. The market is no longer talking about the dollar being undermined by a recession-induced drop in U.S. interest rates and a deterioration of our balance of payments. Instead, the market was impressed during February by the repeated expressions of Federal Reserve resolve to continue to address the need for curbing inflationary pressures, and to adhere to its monetary policy appoach even in the face of recession. Meanwhile, business credit demands remained strong, efforts to find ways to reduce the government deficit appeared to bear little fruit, and concern developed in the market that there might be a bulge in the money supply in April that would be resisted by the Federal Reserve. As a result, the view developed that U.S. interest rates might remain relatively high for longer than normal in a recession period. Other factors favorable to the dollar included a continuing winding down of inflation, announcement of moderate wage settlements in several key industries, and reduced concern that our current account would move into sizable deficit.

The dollar also benefited from a perception that the worldwide recession and a shrinking OPEC surplus may be adding to the strains already inflicting Europe and Japan. Their exports seem less likely to increase sufficiently to provide the boost needed to combat the sluggishness of demand and unemployment problems at home. Already, figures for Japan and Germany for the early months of 1982 suggest that the export performance of those two countries is failing to live up to expectations. Moreover, the decline of OPEC's investible surplus has generated concern that, at current interest rates and spreads, it may be more difficult than before for countries to attract capital inflows.

The changing international environment is seen in the market as increasing trade frictions and competitive pressures generally, and having an adverse effect on some currencies. With respect to Japan, the EC announced it is preparing to take initiatives against that country under GATT, and legislation requiring "reciprocity" in trade has been proposed in our Congress. These developments have had a depressing effect on the yen, which has weakened more against the dollar than have most European currencies. Within Europe, the market senses that these developments have increased countries' desires to protect or improve their competitive positions in world markets. In this context, a renewed speculative attack developed within the EMS against the French franc and, to a lesser extent, the Belgian franc and Italian lira. These pressures, which were intense for about two weeks in mid-March, have now been blunted by the French taking monetary and exchange-control measures and sizable intervention--but not without dragging even the strongest currencies within the EMS, the mark and guilder, down against the dollar.

The more pessimistic outlook for the international economy also implies that the major countries abroad must look even more to internal rather than external means for stimulating their economies. Already, a generalized lowering of European interest rates late in January had left the market with the impression that the central banks at home were prepared to see their interest rates continue to decline even if U.S. interest rates did not. Talk spread in the market of capital or exchange controls that would permit central banks to cut interest rates. Then, about the time U.S. interest rates eased in late February, the authorities in a number of countries also moved to allow their domestic interest rates to decline by at least as much. And, on March 18 central banks of three countries--Germany, Switzerland, and the Netherlands--dropped their official lending rates by a further 1/2 percentage point. Thus, by the end of the period, interest rate differentials favoring the dollar had not narrowed, but in most cases had widened.

The economic problems are being seen against the background of continuing political uncertainties in a number of countries in Europe. These concerns became more immediate with the approach of regional elections in Germany and France in mid-March, elections which in the event neither government did very well.

In view of the strength of sentiment for the dollar, some central banks appear to have scaled back their own intervention activity. Officials in major countries abroad seem to feel that without any indication that the U.S. might be willing to intervene to sell dollars, which they feel might have an important effect on market psychology, acting on their own they can achieve little through intervention to influence the trend of their exchange rate against the strong dollar. They tend to operate, if at all, simply to try and keep the movements orderly. The central banks of Germany, Switzerland, and the Netherlands are now also constrained by the pressures any action they take to sell dollars might impose on the exchange rate relationships within Europe. Thus, most of the $11 billion G-10 official intervention during the intermeeting period was EMS related. Apart from these transactions, the Bundesbank has pretty much limited its activity to operating at the Frankfurt fixing simply to facilitate the fixing process. The Bank of Japan sold about

with sizable operations being done through the U.S. in New York. But they, too, have been reluctant to try to dig in to stop the yen from dropping any further. The Bank of Canada has also been a substantial seller of dollars.

PETER D. STERNLIGHT

NOTES FOR FOMC MEETING

MARCH 29-30, 1982

Monetary growth ran somewhat below path during much of the intermeeting period, though it tended to catch up to near-path levels by mid-March. As February progressed, with a moderate decline in M1 reversing some of the huge January bulge, and M2 also a little below path, pursuit of the path-related nonborrowed reserve levels permitted some decline in borrowings and easing of money market pressures, although the impact was delayed until late in the month. Borrowing tended to run above anticipated levels in mid-February, in the $1.6 - $1.7 billion area, while Federal funds moved up from about 14 percent in late February.

In March, while money growth resumed and offset part of the February decline, the below path level of demand for reserves permitted borrowing to stay below the $1.5 billion initial borrowing assumption--largely ranging around $1 1/4 billion. Federal funds remained about 14 percent in early March and then crept up to a 14 3/8 - 14 7/8 percent range later in the month. So far this week, through the weekend, the funds rate averaged 14.32 percent, although today's trading rose to the 15 - 15 1/2 percent area apparently because of quarter-end statement date pressures.

For the first four-week subperiod--ending March 3, total reserves ran about $70 million below path while non-borrowed reserves were about $20 million above their path. For the second subperiod--the four weeks ending March 31--it looks as though demand for total reserves is running about $150 million below path, although if all the potential technical reserve multiplier adjustments were taken the demand for total reserves would be quite close to path. However, given the tendency for borrowing to run below expectations in early March, the full use of the reserve multiplier adjustments would have imposed an increasing borrowing gap on the banking system--to well above the initial $1.5 billion level--which seemed inconsistent with the basically close-to-path, or even slightly below path, performance of the monetary aggregates. Hence, some discretion was exercised in applying these adjustments. In the current week, the anticipated borrowing level is about $1.4 billion.

Outright Desk activity was fairly moderate and largely offsetting during the period. There were purchases of about $1.5 billion of bills and a few coupon issues from foreign accounts, more than offset by sales of about $1.9 billion of bills, nearly all to foreign accounts, and redemptions of $600 million in bills and a small amount of agency issues. Net, outright holdings were down about $940 million. Sales and redemptions were concentrated in the early March period when reserves were being released by a rundown in Treasury deposits and a reduction in reserve requirements as part of the Monetary Control Act phase-in.

Short-term reserve adjustments were used actively to cope with temporary effects of market factors. A notable complication in this regard was the very high level of Treasury balances at the Federal Reserve in late February. Total Treasury cash outran the capacity of commercial bank depositories to hold note balances and their balance as the Fed ran several billions above the normal $3 billion level. (A similar situation could arise in late April, although efforts are under way to see if the holding capacity of the commercial banks can be enlarged to deal with future situations of this kind.)

Yields on fixed income securities fluctuated fairly widely over the February-March interval, ending up modestly lower on balance. Rates rose in early February in the wake of concerns about large budget deficits and the absence of a quick reversal of the early January money bulge--which observers could see was resulting in increased pressure on reserve positions. The Treasury's large February refunding was received unenthusiastically and the new issues weighed on the market for a time. Later in February, and into early

March, the market rallied briskly, responding to indications of some reversal of the January money bulge and a spate of statistics suggesting continued weakening of the economy. The market had also been encouraged earlier in February by Chairman Volcker's statement that the Federal Reserve would consider money supply in the high portion of the range, or even temporarily above the range, to be acceptable. An additional plus factor was the unexpectedly high level of Treasury cash balances in late February, leading to some scaling down of estimated near-term borrowing needs. The rally ran out of steam, though, as day-to-day money rates failed to decline as much as had been hoped, and even backed up somewhat as money growth resumed. Moreover, as March proceeded, some of the economic reports looked a bit stronger even though there was awareness that much of this represented a bounce back from the impact of especially severe weather in January.

Meantime, increasing concern developed over the budget outlook as participants looked past the currently flush Treasury position to the still very high--and even growing--estimates of deficits yet to come. There was discouragement about the lack of visible progress in efforts to contain the deficits. Only modest comfort was taken from the reports of substantial slowdowns in price increases, as there was concern that business recovery--even a weak one--along with outsize Federal deficits would bring an early resumption of upward price pressures. My impression is that most market participants believe the Fed will hold firm in its anti-inflationary stance but the conviction is not so universally or deeply held that signs suggesting relaxation of that stance would not be seized upon fairly quickly as evidence of a weakened resolve. Finally, a negative factor in the near-term rate outlook is the substantial concern over a big money supply bulge in April.

On balance over the period, bill rates were down about 25-50 basis points. Three- and six-month bills were auctioned today at about 13.40 and 13.25 percent, compared with 13.85 percent for each issue on February 1. At one point during the period, bill rates fell to about 12 percent. The Treasury raised about $5 billion in the bill market during the period, although because of their temporarily strong cash position they made a couple of reductions in the volume of 3- and 6-month issues being offered each week. No doubt, they'll have to return to higher amounts in another month or two.

Rates on other short paper--bank CD's and commercial paper--come down about similarly with bills, although some increased concern over quality has been voiced and at times there was evidence of widening spreads vs. Treasury bills. The prime rate was a somewhat different story. The day of the last Committee meeting, February 2, the prime rate was just in process of rising from 15 3/4 to 16 1/2 percent. It rose further to 17 percent later in February and then came off to 16 1/2 in March, and briefly was at 16 for several large banks.

For intermediate and longer Treasury maturities, net yield declines over the interval were on the order of 40 to 75 basis points. The Treasury raised about $15 billion through the coupon market, including around $1 1/2 billion directly from foreign accounts. Part of the yield decline in the long end may reflect the Treasury's present inability to sell bonds until the Congress grants further authority for issues with yields above 4 1/4 percent. The Congress seems to be in no hurry to do this. The Treasury has already cancelled the 20 year issue that would have been offered at this time, and there is increasing doubt about the ability to include a long bond in the quarterly refunding in May. Lacking such authority, the Treasury will have to press more into shorter coupon issues or bills.

Rates on corporate issues also declined over the interval. New issue volume picked up in late February and into March, after very low activity earlier in the year. More recently, new issue volume has faded again as rates backed up. A heavy pent-up demand for long-term funds remains.

Tax exempt yields showed a lesser yield decline for the period than Treasury or corporate issues. New issuance was not as variable as in the corporate market, but also showed a heavier March volume after a slow February.

James L. Kichline
March 29, 1982

FOMC BRIEFING

Economic activity in the first quarter is estimated to have declined at a 4½ percent annual rate, the same as in the preceding quarter. But final sales appear to have leveled off and the drop in real GNP this quarter is attributable to a substantial liquidation of inventories. The staff's forecast of the economy overall has not been altered in a major way since the last meeting of the Committee, although it has been tilted toward somewhat more real growth and less inflation, reflecting in particular a reassessment of fiscal stimulus and the recent and prospective developments in energy prices.

The severe winter weather distorted activity early this year, although it is clear that the rate of decline in the economy has slowed considerably in recent months. In labor markets, nonfarm payroll employment dropped 300,000 per month during the fourth quarter, but at one-third that rate between December and February. Initial claims for unemployment compensation since the February labor market survey have remained high and are consistent with further increases in the unemployment rate. However, developments in various sectors of the economy suggest that the bulk of the downward adjustment in labor demands is probably behind us, and we are projecting that the unemployment rate will peak around 9¼ percent this spring, up about 1/2 percentage point from the rate in February.

Industrial production continued to fall in the early months of this year, but nothing like the steep declines late in 1981; the industrial production index averaged 1/2 percent per month lower in January and February compared with 2 percent monthly declines in November and December when most sectors began to adjust to sharply rising inventories. The only major component of output that has shown persistent strength is defense.

Production adjustments have been particularly sharp in the auto industry, with output reduced to under half of capacity so far this year. While producers slashed output, auto sales picked up in the first quarter in response to various rebate and incentive programs, and roughly one-half of the estimated $30 billion runoff of inventories in the first quarter is in the auto area. At the present time it appears that the production adjustments have brought stocks into a reasonable alignment with sales, but it's a fragile situation and the near-term sales outlook remains poor given sluggish income growth, high interest rates, and high auto prices.

Retail sales other than autos were about flat in January and February and this is consistent with liquidation of inventories in the retail trade sector. The forecast does not envisage strength in consumer sales until after midyear when disposable incomes are boosted by the income tax cuts. In fact, in order to support consumption during the first quarter, consumers reduced their saving rate 1 percentage point to around 5 percent.

In the housing sector, starts and permits through February continued to edge up from the exceptionally low levels reached last fall. However, the tight conditions in mortgage markets currently and in prospect suggest housing market activity will grow little in coming quarters, but even so this implies some rise in expenditures for residential structures in real terms following a year of large declines.

Both exports and business fixed investment are areas where declines occurred in the first quarter and these sectors are projected to continue downward in the period ahead. Export markets have weakened in response to the high value of the dollar and poor economic activity abroad. Business fixed investment spending has deteriorated in response to declines in final sales, underutilization of capacity, sick profits and the high cost of capital. Orders and contracts are consistent with additional weakness in the investment sector. Nevertheless, there does not seem to be a major collapse of investment spending on the horizon, given survey evidence and qualitative reports, but this area of the economy has appreciable downside risks.

In the aggregate the staff forecast implies that the recession has neared the bottom and for 1982 as a whole real growth is projected at 1½ percent and nearly twice that in 1983. On the price side recent performance has been very good, helped along of course by weak markets and inventory liquidation. For 1982 we are projecting a rise in the business product fixed-weighted deflator of 6 percent--3 percentage points slower than last year--and for 1983 a further decline to 5 percent is expected. The price forecasts have been reduced largely in response to recent and prospective developments in energy markets. While we anticipate that world oil markets will firm up later this year as excess stocks are worked off and demands rise, nevertheless oil prices in 1982 are now projected to fall and in 1983 to rise less than the general rate of inflation.

Finally, I might note that what the Congress and the Administration may ultimately do with the fiscal 1983 budget remains totally unclear. We have maintained the assumption that roughly one-half of the President's spending cuts and revenue raising measures will be enacted. But an assessment of the Administration's budget details which became available after the last meeting of the Committee and other information has led us to revise federal spending levels upward. This has added some stimulus to demands in the forecast although it entails a deficit of nearly $160 billion for fiscal 1983. In an environment of monetary restraint, financing that deficit is expected to maintain interest rates at high levels and constrain interest-sensitive private sectors of the economy. It also means that there is considerable potential for financial disruptions given the weakened state of nonfinancial and financial businesses.

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S. H. Axilrod
March 30, 1982

FOMC BRIEFING

One of the principal issues before the Committee today is the question of whether, or how long, M1 should be permitted, or encouraged, to run above its current long-range target in view of the need to finance economic recovery. The response to this question depends in part on assessment of whether the recent apparent increase in liquidity preference (relative to income) will be long-lasting or whether it will be unwound over the next several months.

In a mechanical or arithmetic sense there is scope to finance the staff's projected nominal GNP expansion of about 7¼ percent for the year with growth of M1 in the upper half of the 2½ to 5½ percent annual range for M1. Those relationships imply a rise in the velocity of M1 for the year on the order of 2½ to 3 percent, well within the range of historical experience. In the first quarter the velocity of M1 actually declined at nearly a 10 percent annual rate. Arithmetically, this leaves room for a rise in velocity over the forthcoming three quarters averaging about 6½ to 7½ percent at an annual rate (with M1 growth on a quarterly basis averaging around 3 to 4 percent per annum).

Such a velocity increase is not particularly out of keeping with experience in the early stages of a recovery, especially the 1975 experience. But every economic cycle seems to have its own unique characteristics. And the economic question at issue is whether such a rise in velocity can take place without attendant upward interest rate pressures that might in practice restrain the pace of recovery below what the Committee views as acceptable.

If the recent increased preference for liquidity is not long-lasting, the odds are pretty good that a reasonable economic recovery can be financed within the Committee's present targets. For that to happen, it probably requires the build-up in liquidity of late last year and early this year to be at least partly unwound--with those funds willingly used to support a rebound in spending or invested in longer-term assets. Such a development, if it happens, would be reflected, most likely, in a marked further slowing in expansion of the NOW account component of M1 and, probably along with that, a return to a substantial rate of decline in outstanding savings deposits.

Should the public, on the other hand, want to continue saving in the highly liquid form of NOW accounts at something like the pace of the last month or two it greatly diminishes the odds on financing reasonable economic recovery within the constraints of the present monetary targets, especially the M1 target. For M1 growth to be within target under the circumstances, there would need to be offsetting shifts out of demand deposits or NOW accounts because of, say, increased use of sweep accounts or some new decision by DIDC creating a highly liquid short-term account that is not directly a transactions account. (Or, parenthetically, growth in NOW accounts could be relatively high but matched by a corresponding weakness in demand deposits if there were greater continuing shifts into NOW accounts out of existing assets than we have assumed; our assumption, of course, is that the remaining shift is quite modest).

Should the recent increase in liquidity preference not be unwound--or not be offset in measured M1 by adaptations to new financial innovations--the Committee might necessarily again be faced with the question of whether the base for the 1982 target should be the lower limit of last year's target band rather than the actual QIV '81 level. This would make a difference in allowable growth for the year 1982 of about one percentage point. Such a higher base, incidentally, would place the level of M1 in March within the 2½ to 5½ percent range. Growth by March '82 from the lower limit of the 1981 range is at just under a 5 percent annual rate.

Problems raised by the recent apparent changes in liquidity preference also raise questions for the interpretation of M2, whose velocity also declined sharply, by about a 9¼ percent annual rate in the first quarter. The M2 target for the year can be comfortably attained with economic recovery if such a decline is followed by an enhanced willingness to spend out of the assets built up in the first quarter; this seems to require not only that growth in its M1 component slows as income growth accelerates but also that growth in its nontransactions component slows somewhat from the first quarter pace. While similar issues in connection with liquidity preference behavior of the public can be raised for both M2 and M1, such preference changes may have a more diluted effect on M2 because some shifts toward and away from liquidity are more likely to represent internal shifts among the components of M2 whereas they may have a full effect on M1.

Of the alternatives presented to the Committee, alternative A is most consistent with a view that the public's shift toward liquidity late last year and early this year may be relatively long lasting--or at least it is most consistent with a view that more time is needed before coming to a determination that the accumulated liquidity is being unwound. Alternative B may be thought of as an intermediate course, moving back toward the current long-run range but not reaching even the upper limit before around mid-year. Alternative C would be consistent with a rapid unwinding of the recent liquidity build-up to finance a rebound in nominal GNP growth. But, given the projected GNP growth of the second quarter, this alternative would require a more rapid abatement in liquidity demand than we think likely and thus is the alternative that would most probably entail rising interest rates from current levels in the months ahead.

A word probably needs to be said, Mr. Chairman, about the very short-run problem of money growth in April. The problem with the seasonal for that month is explained in general terms in the bluebook. To provide some dimension to the question of how much of an understatement in April growth might be involved in the current seasonal, we looked at some alternatives to the current methodology and came up with an answer of 2 to 7 percentage points (annual rate). We have made an allowance for an error in that range in the proposed money paths. But there is also the chance that the present seasonal is right or that growth in April will be slowed below our path assumtions for other reasons--in connection perhaps with unpredictable behavior in the largest month by far for tax payments and refunds.

These uncertainties argue, I believe, for a certain flexibility in the setting of reserve paths over the next few weeks. For example, consideration might be given to tolerance for M1 growth at least in the 8 to 10 percent range that represents the range of April growth rates presented in the alternatives before the Committee--so long as M2 growth is not, say, staying above its current longer-run range. The Committee may also wish to accommodate to a certain amount of weakness in M1 growth should it develop in April because of the various uncertainties I've noted. However, if M2 were also running below the path set for the period ahead, there would be much less of an argument for accommodation to weakness since it would then be presumptive that money demand as a whole was running weak relative to the Committee's underlying money supply objective.

The optional language in the directive represents an effort to give some weight to M2 as a balance wheel in judging the influence on the composition and level of reserves of behavior in M1--in connection not only with April aberrations but also with longer-run asset shifts generated by liquidity preferences.