

APPENDIX

NOTES FOR F.O.M.C. MEETING
March 29, 1983

Sam Y. Cross

At the present time, the market has a positive attitude toward the dollar and it is showing a firm position in the exchanges.

Part of the dollar's present strength is technical, as there has been some added demand for dollar liquidity with the approach of the end of the calendar quarter and the end of the Japanese fiscal year.

The dollar also seems to be attractive as an investment instrument. During the latter part of February, the dollar reportedly benefitted from the rallies in the U.S. capital markets. More recently, expectations of some possible backing up of U.S. interest rates have also attracted funds into short-term dollar instruments. Market participants have noted the recent pace of money supply growth and other monetary conditions, and have wondered whether a tightening of Federal Reserve policy was or would be taking place. The continuing budget deficit and heavy Treasury financings--as recently as late March--heightened these concerns. In absolute terms dollar interest rates look high in light of our inflation progress. In relative terms they look high compared with other countries, where interest rates

have remained steady or trended lower.

Developments in the oil market have also buoyed the dollar. Partly this reflected an increase in demand for dollar liquidity generated by general uncertainty, and the possibility that a large, abrupt drop in oil prices would seriously erode the financial position of some countries and endanger the international banking system. Partly it was a recognition that a drop in oil prices would benefit the U.S. in terms of growth and inflation, and by reducing the U.S. trade and current account deficits, would lessen one of the major concerns about the prospects for the dollar. Curiously, it seemed that the dollar benefitted from the oil price developments relative to currencies of countries more dependent than the U.S. on imported oil--such as Japan. This may have reflected a view that an increase in Japan's expected large current account surplus is less credible than a decrease in the U.S. expected large current account deficit. Or it may have reflected a view that capital transactions would be more beneficial to the dollar--for example a view that OPEC members with payments problems may prefer to disinvest holdings of currencies like the yen and hold on to their dollars.

In addition to strengthening the dollar, the break in oil prices had a dramatic impact in the gold market. The deflationary effects of lower oil costs and anticipation of sales by major Middle East holders led to a \$100 drop in prices to less than \$400 an ounce

The EMS realignment which took place March 21, after protracted and difficult negotiations, led initially to some moderate strengthening of the dollar against all EMS currencies. The realignment itself was a constructive move, though there was a tendency to reserve judgment about the adequacy of the change and the durability of the new rates, until there is better evidence of how France and other deficit countries carry through with austerity programs. Technically the market rates of the EMS currencies moved in the way the realignment called for--that is, the mark moved to the bottom and the French franc to the top of the 2 1/4 percent band. But the market apparently saw no reason for the mark to rise against the dollar and other outside currencies--indeed as participants unwound the long mark/short dollar positions built up during the period of speculation before March 21, the mark weakened somewhat against the dollar.

Since the last FOMC meeting, there have been currency fluctuations and unsettled periods associated with these various factors. On balance the dollar ended up very little changed against the mark and the yen, but higher by about 5 percent against the French franc which was realigned, and against sterling, whose value declined to record lows amid concerns about the outlook for oil prices. There was no exchange market intervention on behalf of the U.S. during the period.

Since the last meeting of the Committee, the Bank of Mexico was granted its last drawings on the combined \$1.85 billion BIS-U.S. special credit facility, receiving \$25.75 million from the Federal Reserve and \$44.25 million from the U.S. Treasury. The Bank of Mexico repaid on February 28, 1983 all of the remaining \$373 million drawn on its regular Federal Reserve swap line.

FOMC Recommendations

Mr. Chairman, swap drawings totaling \$182.8 million by Mexico under the Federal Reserve special swap arrangement will mature between now and May 27, 1983. Of these, six drawings totaling \$57.3 million will come up for their first renewal and five drawings totaling \$125.5 million for the second renewal. I would propose that all of these drawings be extended for three more months. You will recall that all drawings on this facility are subject to three renewals of three months each and are to be liquidated by August 23, 1983.

PETER D. STERNLIGHT
NOTES FOR FOMC MEETING
MARCH 28-29, 1983

Desk operations since the last meeting of the Committee were aimed at maintaining an approximately steady measure of pressure on conditions of reserve availability. While money growth was more robust than had been anticipated at the time of the February meeting, there was much uncertainty as to the underlying significance of this growth, given the continuing impact of new deposit accounts and possibly other factors that have worked to reduce monetary velocity recently. As intended by the Committee, the stronger growth was in large measure accommodated through successive path revisions that left a \$200 million gap in remaining weeks of the period between total reserves demanded and targeted nonborrowed reserves. This steady intended gap, to be filled through discount window borrowings, was expected to be associated with Federal funds trading in the neighborhood of the 8 1/2 percent discount rate--about the same level that had prevailed since just after the turn of the year.

As it turned out, actual levels of adjustment and seasonal borrowing averaged above the anticipated \$200 million level--in fact around \$390 million--mainly reflecting factors such as end-of-week reserve shortfalls and unexpectedly high demands for excess reserves. Also contributing somewhat to this result, in the latter part of the period, was a tendency for the Desk

to move conservatively in meeting projected reserve needs--in effect resolving some day-to-day uncertainties on the side of providing less rather than more. Through the first five weeks of the interval, the weekly average Federal funds rate hewed closely to the discount rate level, within a band of about 10 basis points on either side. In the final full week and the current week thus far, Federal funds have edged up to about 8 3/4 percent. In part this reflected diminished market expectations, prevalent earlier in the interval, that there might be early further official moves to encourage lower rates. In part, too, the slightly higher rates appeared to reflect the Desk's cautious approach to meeting reserve needs, which in turn helped foster a belief that high money growth rates may have prompted a slightly less accommodative stance.

Desk operations were all on the reserve-supplying side, through a combination of outright and temporary transactions. Outright holdings of bills were increased by about \$2.5 billion, virtually all acquired from foreign accounts. In this connection, the unsettled foreign exchange markets generated sizable support operations which in turn led to foreign account sales orders that we were able to absorb. On many days we also executed repurchase agreements, either on behalf of the System or, more often, passing through part of the foreign account temporary investment orders to the market.

Interest rates followed a varied course over the period, generally declining through the first half, but turning upward again

in early March. The declines in mid and late February reflected market encouragement with oil price developments and interpretations of the Chairman's Humphrey-Hawkins testimony that seemed to leave ample room for monetary growth with little likelihood of any near-term firming of policy. Indeed, expectations of an imminent discount rate reduction, which had appeared on and off since the last cut in December, were rekindled for a time in late February. By early March, with no cut materializing, substantial continuing monetary growth observable, and comments by the Chairman and others indicating discomfort with recent money growth rates, rates began to turn up. Continued heavy Treasury borrowing and rising dealer financing costs were also factors in the rate upturn. Participants inferred that further near-term easing was unlikely, while renewed attention was paid to weekly money data and bank reserve statistics.

In the Treasury bill market, where the Treasury raised about \$22 billion in new funds over the period, including \$9 billion in very short-term cash management bills, rate increases in the latter part of the interval outweighed the initial declines, and rates rose by a net of 20 to 40 basis points. Three- and six-month issues were auctioned today at about 8.68 and 8.70 percent, compared with 8.25 and 8.34 just before the last meeting, and rates somewhat under 8 percent in late February.

Rates on commercial paper and CDs also registered net increases over the period--on the order of 20 to 35 basis points--quite similar to increases for bills, notwithstanding the relatively

heavy new supply in bills. Over most of the period, banks were light issuers of CDs, as needs were met or more than met with inflows to MMDA accounts. Some banks stepped up their CD issuance late in the period, in part because of a changing rate outlook.

Amidst the downward rate moves of late February, banks cut their prime rate from 11 to 10 1/2 percent. The subsequent climb in short-term market rates has reduced the spread against the prime rate to a relatively narrow margin compared with recent experience.

The Treasury was also a large borrower in intermediate and longer markets, taking a net of about \$24 billion in coupon issues. For maturities out to about three years there was little net change in yield over the interval, a decline up to early March followed by a comparable back up since then. For longer intermediate and long-term issues, there was an appreciable net decline in yield over the intermeeting period, as declines in the early part were only partly eroded. In the 10 to 30 year area, yields were down a net of about 30 to 40 basis points. Despite heavy issuance and concern over the budget outlook, the market remained impressed by the extent of progress on inflation, and viewed the recovery as moderate at most. Participants in the longer term markets also viewed the presentation of the System's 1983 targets quite constructively--leaving room for fairly sizable money growth in a context that could include further rate declines.

Looking at the most recent week or two, long-term market participants seem uncertain about how to react to the

possibility that short rates may back up for a time in resistance to outside money growth. Some longer investors are not disturbed at this prospect and even welcome the evidence that timely action to resist excessive money growth can better guard against a re-emergence of inflation. Others are not prepared to take so long term a view and are concerned that higher short rates could also impact the longer market adversely for a time.

In its sales of coupon issues, the Treasury continued to press gradually increasing amounts on the market, preferring for the time being to enlarge existing maturity cycles rather than add new ones. So far this approach seems to be working well. The market has a good idea of what is coming and it is standing up well to its distributive task. At the same time, it can be said that the dealers seem to be well compensated for performing their useful underwriting functions. Preliminary indications are that the primary dealers had, by far, record profits last year, and although much of this came during the summer months of sharply rising prices, the day-to-day underwriting and distributing process also seemed to be profitable on the whole.

Particular market attention in the recent period focused on the sales of 4, 7, and 20-year issues which were auctioned last week. These sales of about \$13.5 billion to the public raised some \$11 billion of new cash. The auctions were well bid and the issues moved to premiums in early secondary market trading, but the premiums faded or even turned negative in the last day or two as the market coped with fresh concerns about near-term rate prospects.

Yields on longer term corporate and municipal issues also ended the period lower on balance. New issues fared better in the tax-exempt market, supported by bond funds and demand from individuals. A near record \$900 million Intermountain Power Agency issue was a highlight of the period. Interest in corporate issues varied, but overall, supported sizable new issuance during the period while stock issuance was also substantial.

Joseph S. Zeisel
March 28, 1983

FOMC BRIEFING

The evidence is clear that an economic recovery is now well under way. Indeed, the staff is forecasting a somewhat stronger first-quarter increase in real GNP than previously--4.1 percent at an annual rate as opposed to the 3-1/2 percent rise estimated for the last FOMC meeting. A good deal of the turnaround from the one percent decline in GNP in the fourth quarter represents an expected sharp slowdown in inventory liquidation. But looking through the various transitory factors affecting the figures for these two quarters, it appears that real final demands picked up toward the end of last year and the rate of increase is holding up fairly well into the spring. Excluding the effects of huge swings in CCC payments, we expect that real final sales will rise at a 3 percent annual rate in Q1, little different from the pace in the fourth quarter of 1982.

Industrial production apparently reached its cyclical trough in November and has risen by 1-3/4 percent over the past three months. The monthly pace has been uneven, in part because of weather-related distortions in the data, but on balance the rate of recovery to date has been quite moderate when compared with the average of postwar cyclical rebounds. The composition of the recovery is not surprising--strength in consumer durables, particularly autos; in materials and construction supplies; and in defense products. In contrast, output of business equipment continued falling, with oil and gas well drilling particularly weak.

The continued decline in drilling activity is expected to damp the growth of production in March, and auto assemblies are scheduled to fall by about 10 percent. However, there should be a further moderate increase in overall output with gains in sectors such as steel, construction products, and defense.

The employment figures have moved pretty much in line with the moderate expansion in industrial output. Monthly employment figures also were distorted by unusual weather this winter, but over the December-to-February period nonfarm payroll jobs rose by 150,000, with manufacturing up by 90,000--largely in the auto and related metals industries. The civilian unemployment rate remained at 10.4 percent in January and February, down from its high of 10.8 percent in December. Recent unemployment insurance figures do not suggest any further unemployment declines in March, and in fact, since the labor force dropped sharply recently, some rebound in both unemployment and the labor force would not be surprising.

Consumer spending has continued to grow this quarter, although at a considerably slower rate than late last year when domestic car sales surged in initial response to interest rate subsidies. Although domestic auto sales have been flat at around a 6 million annual rate since December, outlays for other consumer goods continued to increase moderately in January and February. On balance, consumer demand has held up well, despite the relatively weak growth in disposable income; the saving rate appears to have dropped from 6 percent in the fourth quarter to about 5-3/4 percent in the first.

Growth in activity in the first quarter has benefited even more from the impressive rebound in housing, as starts moved from a 1.3 million unit annual rate in December to a 1-3/4 million rate in January and February. We expect starts to back off a bit in the near term, given the still very high real cost of borrowing, but housing outlays should remain a positive force for growth through 1984.

In contrast, in the business sector, the near-term outlook remains fairly weak. Shipments of nondefense capital goods continued to fall in February and new orders dropped sharply after firming for several months. Outlays for nonresidential construction increased in January, but high and rising vacancy rates for office buildings continue to suggest growing weakness in this sector. In addition, with oil prices falling, petroleum drilling activity has dropped sharply and is likely to remain depressed.

On balance, we are now projecting a somewhat stronger rate of growth in real GNP for 1983 as a whole than last time--slightly over 4 percent. The inventory swing likely will become a less important factor in overall GNP growth by midyear; final demands in several sectors should then sustain the expansion at a moderate pace. Consumer spending will be bolstered by lower energy costs and by the effects of the final stage of the tax cut on July 1, and as noted, we expect housing to remain a positive force. In addition, two key sectors currently acting as a drag on activity are expected to show signs of recovery. As is typical, business spending on equipment should turn around shortly, following the recovery in production, and a pickup in

exports is likely late this year in response to an improvement in foreign economic activity. We expect GNP growth to strengthen slightly further in 1984 as the economic recovery becomes more broadly based; a projected decline in the exchange rate should also support stronger export volume next year. The unemployment rate is projected to remain near 10-1/2 percent through midyear and then to decline slowly, reaching 9-1/4 percent in the latter half of 1984.

The staff projection remains relatively moderate when compared with post-World War II recoveries--the first six quarters of growth in real GNP of 4-1/4 percent, annual rate, is about two-thirds the average rate of increase. A major constraint is, of course, our expectation that interest rates will edge off only a little from current, historically high, levels through the projection period. Given the financial and economic traumas of the past few years, we continue to believe that most businesses will remain quite cautious in their investment plans and inventory policies. And, in light of the moderate growth of income expected, and continued high unemployment, consumers' spending propensities are assumed to remain subdued, particularly for large ticket items such as autos.

On the inflation side, both wages and prices have been behaving even better than we had expected. Wages have increased at a 4-1/2 percent annual rate in the last three months, off from 6 percent last year, and in general union settlements continue to reflect the realities of the labor market, and apparently a decline in inflation

expectations. Price reports show very low or even negative inflation rates so far this year, largely reflecting sharp declines in energy prices, although food prices have also been a moderating force.

We expect some further downward pressure on wages and prices this year in an environment of considerable slack in both labor and product markets. In addition, we have incorporated a further one dollar reduction in the price of imported oil, consistent with the recent OPEC cut. However, it would be surprising if prices generally did not begin to firm somewhat with improving activity. Moreover, farm policies are aimed at raising food prices, and the anticipated depreciation of the dollar is likely to generate some upward pressure on domestic prices, particularly in 1984. On balance, the gross domestic business product fixed-weighted price index is now projected to rise at about a 3-3/4 percent rate in both 1983 and 1984, off about one percentage point from last year's pace.

FOMC Briefing
March 28, 1983
S. H. Axilrod

A major issue before the Committee today relates to whether recent performance of the aggregates suggests that they are far out of line with the longer-run monetary and credit ranges set for 1983 and/or with satisfactory behavior of basic economic objectives.

The broadest monetary aggregate targeted--M3--had been running in January and February at rates well in excess of its $6\frac{1}{2}$ to $9\frac{1}{2}$ percent longer-run range covering the period from QIV '82 to QIV '83. It is doubtful if much of that excess can be attributed directly to shifts in the public's asset preferences related to introduction of the new accounts. But there was probably some indirect effect temporarily increasing the supply of M3. That is, it seems likely that institutions willingly added substantial amounts to Government securities portfolios rather than let large CDs run off even more rapidly than they did, either as institutions lagged in adjustment of liability management policies to the new conditions or because of some increased preference for portfolio liquidity at a time when they might have been uncertain about how much of newly acquired funds might be retained on a permanent basis. But in any event by March--with expansion of MMDAs having slowed markedly--growth in M3 seems to have dropped off considerably, bringing the level of this aggregate back near to the upper limit of its longer-run range.

M2 is currently roughly consistent with its longer-run range more or less by definition, since the range of 7 to 10 percent is based on the February-March '83 average level rather than QIV '82. Actual growth of M2 in March--a month that by construction overlaps the long-run range--looks as if it will moderate enough from the February pace so that M2 will be positioned at the start only slightly above its long-run range.

The slowing in MMDA growth over the past few weeks--to \$8 billion in the most recent week for which we have data--has been about in line with staff projections at the time of the previous FOMC meeting and gives some hope that our current projections for further slowing are reasonable. Those projections would call for additional growth in M2 from MMDA-related shifts over the second quarter of 1 percentage point or so at an annual rate and of even less over the balance of the year.

Whether such shifts can be accommodated within the 7 to 10 percent long-run range depends on the "underlying" strength of M2 demand. Underlying M2 growth--abstracting from shifts--seems to have been very strong in February (so strong indeed as to make one doubt the estimate), but by March seems to have returned to around an 8 to 9 percent annual rate pace. Should it remain there--and our monthly model says it should be lower and the quarterly model higher--growth of M2 within its long-run range can be expected over the balance of the year, given something like current interest rates and the staff's economic outlook, though over the next three months there is a higher risk of M2 expansion near, or even a bit above, the upper end of the range.

Thus, it is not apparent that the broader monetary aggregates have been behaving in such a way as to cast significant doubt on the realism_ of their longer-run ranges. This seems to be the case also for the domestic nonfinancial debt aggregate. Judging from the first quarter flow of funds projections and from estimates of our experimental monthly debt proxy for January and February debt growth may be well down in its $8\frac{1}{2}$ to $11\frac{1}{2}$ percent range.

M1 thus appears to be the only aggregate to date whose behavior seems sharply at variance with its longer-run range. Whether its behavior

is also at variance with expected economic performance--suggesting either a stronger economic recovery than we are projecting or more upward price pressures, if not this year then next--is the more critical issue.

As we model money demand, either from our standard quarterly M1 equations or new equations (still in the developmental stage) fit through 1981, the first quarter behavior of M1 seems to represent--as noted in the blue book--a continuation of last year's upward demand shift for M1. That is, the equations are underpredicting M1 by a sizable amount, given actual income and interest rates--in the first quarter of 1983 by 4 to 6½ percentage points at an annual rate.

In my view, the econometric results probably reflect our inability to date to find a good way to model that element of M1 performance which represents savings behavior--now that NOW accounts are so important a component--rather than transactions demand. One might conclude therefore that last year and early this year the "unpredicted" M1 growth reflected at least in part shifts toward savings in the form of NOW accounts as market rates declined relative to the ceiling rates on these accounts as well as reflecting enhanced precautionary demands for cash.

Such conclusions do not necessarily mean that the funds embodied in M1 will not be spent by more than we currently anticipate if the economic environment improves, but they would seem to suggest that very high odds should not be placed on the possibility. But there are some odds, and they may be enhanced a bit by the fact that money balances as a whole have probably become more liquid. That is, M2 now includes a very sizable amount of highly liquid MMDA funds that have substituted for the somewhat less liquid money market certificates, large CDs, and market instruments.

Still, in evaluating whether a marked accumulation of liquid balances will lead, with some lag, to greater-than-expected spending, one should take account of the level of real interest rates. In that context, the present monetary situation looks relatively restrictive. In real terms the 3-month Treasury bill rate can be estimated to have been around a positive $3\frac{1}{4}$ percent in December 1982, presumably near the bottom of the recession, basing price expectations on behavior of the deflator over the past 12 months; the real rate so measured is somewhat higher at present. By contrast at recession troughs in March 1975 and July 1980, this real rate measure was a negative 2 to 3 percent. In three earlier troughs in the years 1958, 1961, and 1970--when inflation was much less of a problem--the measure was roughly between 1 percent positive and 1 percent negative, still well below current levels.

I am afraid, Mr. Chairman, that, as has been usual in recent months, the policy implications of the recent monetary, credit, and other data are simply not unequivocal. To attempt a brief summary, the broad aggregates and credit flows do not appear to suggest a need for tighter markets, but they also do not clearly point to ease. Narrow money more probably suggests a need for tightening to raise the odds in hitting the 4 to 8 percent range, or if the Committee takes the view that the growth in narrow money presages a much stronger, more inflationary economy than is being projected or is acceptable. On the other hand, the present level of real interest rates seems relatively high for this stage of the cycle, and could even suggest the need for lower nominal rate levels if a satisfactory recovery is to be sustained, always assuming that we have not underestimated prospective upward price pressures.