APPENDIX

MARGARET L. GREENE
NOTES FOR FOMC MEETING
MARCH 26-27, 1984

Mr. Chairman, for much of the period since your last meeting, the dollar has declined. From end-January levels it dropped at one point in early March as much as 12 percent against the German mark and 7 percent against the Japanese yen. Even in trade-weighted terms the dollar fell at one point as much as 7 percent. Market observers had long been anticipating that sooner or later the dollar would give up much of its gains of last year. This expectation was based on the belief that U.S. interest rates would eventually ease and the weight of our current account deficit would then begin to show through in the exchange rate. Notwithstanding these expectations, the dollar's drop was surprising to the market because of its timing, because of its speed, and because of its circumstances. The drop was not associated with a decline in nominal U.S. interest rates. Instead, the dollar declined in the face of a modest uptrend of interest rates and a widening of interest differentials in favor of the dollar, as well as at a time of renewed strength in the economic recovery and heightened tensions abroad. You may remember that these factors, when they occurred last year, consistently buoyed the dollar. But during February and early March the release of each new statistic pointing to greater-than-expected buoyancy of the U.S. economy, became an excuse to push the dollar lower.

The question is: why was there this shift in market reaction? I think, Mr. Chairman, there is an answer, and that the answer is that

the market perceived the threat to a sustained world growth having changed. Last year inflation was subsiding and the risk was that economic recovery would peter out. By February, the market felt somewhat more hopeful about recovery abroad. The risk was that the U.S. economy might overheat. In the inevitable pressures of a presidential election year markets worried that the fiscal policy debate would become stalemated and that monetary policy would not succeed in containing renewed inflationary pressures. During the past two weeks the dollar staged a partial recovery--that is, until this morning--aided by the perception there might be more movement on the policy front than first supposed. But even so, the dollar is down on balance since end-January by about 8 percent against the mark and 4½ percent against the yen. The psychology of the market remains nervous. The preoccupation of the market last week, for example, that the Federal Reserve might raise the discount rate reflected a desire for a clear signal that the fears of February would soon be allayed.

Meanwhile, during the intermeeting period trading conditions in the foreign exchange market deteriorated substantially. The dollar/mark rate fluctuated as much as 400 to 500 points or 1½ to 2 percent on several days. Spreads widened, and traders withdrew from dealing for long periods during the day out of fear that they would not necessarily be able to unload an unwanted currency position without incurring substantial loss.

The U.S. authorities did not intervene, nor did the Desk recommend intervention, despite the deterioration in trading conditions. The Treasury recognized the potential that pressures against the dollar might cumulate, and expressed the desire to avoid having the situation get out of hand. At the same time, there was a reluctance to act and a reluctance to be perceived as acting to stand in the way of a downward adjustment. This reluctance reflected a feeling that some decline in the dollar was probably appropriate--certainly as the economic performance of other countries improved and our current account deficit worsened. It reflected an assessment that even at the lower levels of early March, the dollar was pretty firm anyway, and it reflected as well a desire to avoid getting entrapped in an extended intervention operation. In choosing not to recommend intervention, the Desk took these considerations into account. The Desk also concluded that the type of operation the Treasury has recently considered would not have a meaningful or constructive effect on market conditions.

As for the attitudes of other central banks to the dollar's decline, market participants assumed, so far, that the downward adjustment has been welcomed. There has been no particular effort by foreign central banks to resist their currency's rise against the dollar. In fact, foreign central banks sold in the market a net $1 billion or so during the past seven weeks. Nor has there been any request from other central banks that we intervene to cushion the dollar's decline. The attitude of the Bundesbank to these developments is undoubtedly ambivalent. On the one hand the

Bundesbank had been concerned that the effects of the mark's earlier depreciation on import prices introduced price pressures into the pipeline that would have to be carefully monitored. A gradual strengthening of the mark, particularly ahead of key spring wage negotiations, would help contain these influences. On the other hand, an important source of demand for Germany and for Germany's major export markets during the early stage of recovery is coming from the external side. As a result there might be come concern and sensitivity to the possibility that a further substantial drop in the dollar--particularly if it were to be precipitous--might put the tentative European recovery into jeopardy.

PETER D. STERNLIGHT
NOTES FOR FOMC MEETING
MARCH 26-27, 1984

Domestic Desk operations since the late January meeting were conducted against a background of reasonably on-track performance of monetary aggregates, with the M1 and M3 measures tending toward the high side of their growth ranges, while M2 ran a bit weaker than expected. The implementation of contemporaneous reserve requirements (CRR) accounting and the phasedown of reserve requirements at the start of the period were complicating factors, tending to inject greater uncertainty into day-to-day assessments of reserve needs. A further background factor was the increasing evidence of strong expansion in the economy, which cast a shadow over the markets and influenced expectations and interpretations of System actions.

Nonborrowed reserve paths consistently incorporated an allowance for $650 million of adjustment and seasonal borrowing, and for levels of excess reserves working down from $750 million in the first period (which saw the initiation of CRR) to $550 million in the latter part of the interval. It was anticipated early in the period that these reserve objectives would most likely be associated with federal funds trading continuing in the 9-1/2 percent or even 9-1/4 to 9-1/2 percent area that had prevailed on average for the several preceding months. As events worked out, the funds rate crept up to about 9-5/8 percent in the latter part of February, 9-3/4 percent in the first half of March, and a range of about 9-7/8 to 10-1/2 percent in the past 10 days or so. Today's rate came off to 10 percent or slightly over.

Several factors, probably interacting with one another, apparently contributed to the firming money market: One was the

market's own set of expectations, especially in the latter part of the interval, that stronger news on the economy was likely to prompt a less accommodative System stance toward reserve provision. Another may have been the implementation of CRR and its accompanying two-week reserve period, which not only boosted demand for excess reserves but also, at least in the first several weeks, may have reduced a bit the willingness of larger banks to use the discount window--thus tending to associate given borrowing levels with slightly higher funds rates. An allowance was made for additional demands for excess reserves, but actual demands ran even higher. Furthermore, while meeting nonborrowed reserve objectives, the Desk took a relatively cautious and gingerly approach, typically responding to needs only gradually. The rationale for such an approach early in the period was the very uncertainty of the reserve situation, affected as it was by CRR and the phasedown of reserve requirements. Later in the period, the reserve situation seemed less volatile but by then the increasing evidence of stronger business expansion made it seem appropriate to stay on the cautious side in meeting reserve needs. This approach was endorsed in the course of the March 20 Committee conference call. I would note, though, that even with a cautious approach to reserve provision, nonborrowed reserve objectives were met or more than met. Finally, an exacerbating factor at mid-March was the corporate tax date, and more recently possibly some anticipation of quarter-end pressures.

Over the first three maintenance periods since the last meeting, discount window borrowing averaged in a close-to-target $550-$670 million range. During the current period, which began in mid-March, borrowing has moved up to average somewhat over $1 billion,

partly reflecting sizable borrowing over the two weekends so far in this maintenance period.

At the start of the period, the System sold about $440 million of bills to foreign accounts, but beginning in late February the System has bought bills from foreign accounts nearly every day in a total amount approaching $2 billion. The net increase in outright holdings, taking account of two small agency issue redemptions, was about $1.5 billion. On most days, the Desk injected reserves by passing through to the market some of the foreign account repurchase orders, while on two occasions the Desk arranged System repurchase agreements. In the more recent instance of System RPs, the purpose was to meet perceived reserve needs against a background of some appreciable anxiety in a market that had seen the funds rate climb higher day by day. Midway through the interval, the Desk also arranged a sizable round of overnight matched-sale purchase transactions to absorb redundant reserves at the end of a maintenance period.

Interest rates pushed appreciably higher during the February-March period, spurred by news of a strengthening economy and speculation that the System might soon be turning more restrictive if indeed it had not done so already. Intermittently, a bit of encouragement was taken from signs of possible action to curb the Federal deficit, but these signs generally gave way quickly to renewed skepticism that any meaningful action would be taken soon. A negative mood was established early in the period with the release of the December FOMC minutes which referred to the possibility of a System tightening move. While market participants were aware the such a move had not occurred up to the time that policy record was released, they took careful note that the possibility had been contemplated

seriously. Another depressant was the upward revision to money growth data for the second half of 1983, which appeared to dash the faint lingering hopes of some market participants for a near-term policy easing and decline in rates. Subsequently, money growth data were taken fairly well in stride with only moderate reactions to weekly numbers that were at times a little stronger or weaker than expected. But the economic news was generally strong, the deficit overhang remained, and federal funds tended to firm, and those factors tended to push rates higher. Dealers bid well for the Treasury's mid-quarter coupon financing in early February, but those who did not get rid of their auction supplies quickly found themselves distributing at a loss. Moreover, investors pressed some of their holding back for sale to an unreceptive dealer market, causing further steep price erosion. Today, as the market is about to start bidding on a $15 billion package of 4-,7- and 20-year Treasury issues, intermediate and longer Treasury yields are about 75 to 90 basis points above those at the end of January. It remains to be seen whether yields, having climbed above those of last August to the highest levels since the summer and fall of 1982, will attract investors.

At the short end, yields are up similarly, by about 90 basis points for bills and in the area of 100 to 125 basis points for CDs--a move that prompted major banks to boost their prime lending rates 1/2 percentage point just a week ago. Weekly Treasury bills were auctioned yesterday at rates of about 9.78 and 9.90 for the 3- and 6-month issues, compared with auction averages of 8.87 and 8.97 percent just before the last meeting.

While it is hard to pin down the point with precision, my sense is that the market has priced itself to an expected federal funds trading range of about 10 to 10-1/4 percent, probably closer to

10-1/4. Temporary added pressures are anticipated later. There is an expectation that the discount rate will be raised soon, probably by 1/2 percent with some uncertainty about the consequences of such a rise. Certainly it would be seen as confirmation of some recent firming and it might tend to produce some further rate rise, particularly at the short end. But there are also some participants who say that at least regarding the longer-term maturities, a discount rate rise might be stabilizing or even beneficial, clearing the air and re-emphasizing the System's intention to resist an overheating of the economy.

PETER D. STERNLIGHT

RECOMMENDATION FOR INCREASED INTERMEETING LEEWAY

MARCH 26, 1984

Mr. Chairman, preliminary projections for the next intermeeting period suggest a very large reserve need in late April and early May to cope with the effects of a run-up in Treasury balances. Total Treasury balances could reach the $40 billion area, and this may force Treasury balances at the Fed up as high as $18 billion for a brief period.

While we should be able to meet much of the reserve need through repurchase agreements, which don't count against leeway, I think it would be prudent to allow $6 billion of leeway for outright purchases in place of the standard $4 billion intermeeting amount.

(If the Committee wished, it might also want to take this annual meeting occasion to raise the standard intermeeting leeway from $4 to $5 billion.)

James L. Kichline
March 26, 1984

FOMC BRIEFING

Economic activity during the first quarter has been growing at a surprisingly strong rate. The staff estimates real GNP growth at an 8 percent annual rate this quarter, a little above the Commerce Department's flash estimate, and appreciably higher than the 5 percent growth recorded in the last quarter of 1983.

Some of the monthly gyrations in incoming information around the turn of the year period were suspect, given the generally bad weather and possible seasonal adjustment difficulties. But additional data have helped clarify the picture and indeed most major sectors have been showing considerable strength. On the output side, industrial production rose 1-1/4 percent in both January and February, a substantial rebound from the pace in the fourth quarter. Increases in output were widespread among consumer goods, construction supplies, business equipment and defense. Auto production was little changed last month despite lean dealer stocks as the more popular larger-size car plants were already producing near capacity.

The labor market clearly has been reflecting the general strength of activity with growth of payroll employment in January and February picking up from the pace late last year.

In addition, the manufacturing workweek--which was already high but jumped 1/2 hour in January--held at that level last month. The civilian unemployment rate continued on its downward path, reaching 7.8 percent in February, or 1 percentage below the rate in October of last year.

The gains in activity recently have been fueled by both consumer and business spending. Retail sales were little changed in February following a huge increase in the month earlier, and the average level of sales is well above that in the fourth quarter. The auto market has been especially strong with the annual rate of 8-1/2 million domestic model sales in January and February up over a million from the pace during the fourth quarter. For the first 20 days of March domestic sales were nearly 8 million units annual rate. In short, consumers seem to be in the mood to spend, their incomes are rising, and they are willing to take on debt in volume.

In the housing market there have been dramatic increases in activity. Housing starts soared in January and February, reaching a 2.2 million unit annual rate--the highest in six years. Permits and sales have risen as well. There has been a base of demand for housing given rising incomes and some purchases that had been deferred during earlier periods of higher interest rates. But this base appears to have been augmented by the ready availability of mortgage funds and a

willingness to take on adjustable rate mortgages--often at rates that have been discounted for at least the first year.

In the business sector, capital outlays are continuing to grow, although at rates less than the unusual pace late last year. Shipments of nondefense capital goods weakened in the first two months of this year but remain at high levels. Further expansion of outlays is suggested by the rising trend of orders, upward revisions to business spending plans as reported in surveys, and by the strength of profits and high capacity utilization rates. In contrast business inventory investment has been lagging, particularly in manufacturing, with inventory-sales ratios actually declining. Demand simply has been outpacing production recently, and building of stocks in coming months should be a source of support for activity.

In view of the strong growth in the first quarter, the key issue is where is the economy headed. The staff is forecasting real GNP growth of 6 percent in the second quarter, compared to 4-1/2 percent at the time of the last Greenbook, and expects real growth to settle down to the 3 percent area late this year and in 1985. That forecast hinges critically on the monetary assumptions of growth of M1 and M2 at, or not much above the midpoints of their target ranges, which we believe will entail further increases in interest rates to levels somewhat higher than in the last forecast. It is the rising

interest rates that we expect will act to damp growth in the housing and other interest sensitive sectors. Even with higher interest rates, moderate growth next year is projected to be sustained through increases in capital outlays, fiscal stimulus, and improved exports following an expected further decline in the foreign exchange value of the dollar.

The higher level of activity in the staff's current forecast carries with it significantly less slack in labor and product markets than we had been projecting earlier. By late this year we anticipate the unemployment rate will be a bit below 7 percent and capacity utilization will be in the mid-80s. Although recent wage and price increases generally have been moderate and not out of line with our expectations, the projected tighter markets ahead have increased the likelihood of higher inflation. We now expect that inflation will pick up next year to the neighborhood of 5-1/2 to 6 percent, 1/2 percentage point higher than we had projected previously.

FOMC Briefing
Stephen H. Axilrod
March 26, 1984

Of the various financial aggregates on which the Committee focuses, total credit is the one most evidently reflecting the unanticipated strength of the economy. It is growing above its 8 to 11 percent long-run path even after allowance for merger-related credit. That result is not too surprising since credit often reflects ongoing economic activity, while not necessarily anticipating future activity. As noted in the Bluebook, we would expect credit growth just above path to continue into the second quarter, before falling back toward the upper end of the path later in the year.

While not perhaps as self-evident, the behavior of M1 also seems to me to be consistent with developments in the economy. A substantial rise of economic activity is often first reflected in a concurrent rise in the velocity of M1. That happened in the first quarter. Growth of M1 on average during the quarter was about as anticipated at the January meeting, but at that meeting we had also assumed that the relatively moderate rise in M1 velocity of the latter part of 1983 would continue into 1984. In the event, economic expansion was about 3 percentage points stronger and M1 velocity growth also about that much faster than anticipated. There is little evidence that this velocity behavior is unusual, given what happened to GNP and interest rates; indeed our quarterly econometric model correctly predicted M1 growth, given GNP and interest rates, in the first quarter, and other models were not far off.

All of this continues to be suggestive that M1 may now be on a somewhat more predictable course. If that is so, the strength in the economy, if and as it continues, would probably soon be associated with more M1 growth than might be desirable--as the public seeks to maintain cash balances in line with transaction needs--or associated with higher interest rates. To a degree, the recent rise of interest rates will have lagged effects into the second quarter, working to hold down M1 growth, given GNP. But it remains possible that some further interest rate increases might develop in holding M1 growth to something like, say, an alternative B path, and particularly so if nominal GNP were to run a bit stronger than our current second quarter projection of about 10-1/4 percent.

While M1 appears to be on more of an explainable track recently, M2 growth in the first quarter was surprisingly weak, as its nontransaction component grew relatively slowly. A number of explanations can be offered. One would be bad seasonals. Our ability to estimate seasonal movements was complicated by the shift into MMDAs at the beginning of last year and by enlarged IRA-Keogh transfers; however, we believe growth could be understated by no more than about 1/4 or 1/2 percent at an annual rate over the quarter. Another explanation would be that the very strong rise in spending on consumer durables in the first quarter was financed in part by the public's drawing on the liquid portion of savings. A third explanation should also be advanced. Some of our econometric work suggests that behavior of the nontransactions component of M2 responds directly to changes in wealth, so that the recent decline in stock and bond prices would on that view have caused the public to

want to hold less liquid balances, presumably shifting funds to higher yielding bonds and equities.

With funds available to institutions through M2-type balances somewhat restrained, banks and others have aggressively marketed managed liabilities to support sizable credit expansion. As a result, M3 growth has remained near the upper end of the Committee's long-run range, and we would expect it to stay around there, given the continued relatively strong credit demands anticipated for the second quarter. In particular, the financing gap of businesses (the excess of investment outlays over internal funds)--which had been non-existent during the past two years--became noticeably positive in the first quarter and is expected to be enlarged in the second and subsequent quarters, reflecting a marked slowing in profit growth in face of sustained expansion in outlays. Much of the growth in business net credit demands is expected to fall on banks or on short-term open markets.

In general it seems to me that the aggregates as a group and the economy have pretty much been in synch recently--not giving off such conflicting signals as in 1982 and early 1983. Thus, the Committee might in that context want to consider whether reserve conditions should become a bit more responsive to money supply behavior, particularly to M1. The bracketed language in the proposed operating paragraph of the directive provides for what might be interpreted as more of a symmetrical approach to the aggregates--with strength or weakness equally likely to lead to ease or tightening, but with the still important caveat that they would need to be interpreted in the context of ongoing economic developments. There is still reason in my view to be a bit uncertain about underlying velocity trends, and the Committee would still need to evaluate whether

changes in money and velocity might be reflecting changing attitudes toward money for given income and interest rates. For example, while the cumulative impact of recent strength in the economy should, as I have noted, increase the demand for cash balances, a downward shift in money demand relative to income cannot be ruled out, particularly if inflationary expectations were to strengthen--in which case slow growth in M1 would itself be an unsatisfactory indicator for monetary action, just as rapid growth was in 1982 and early 1983.

But with such a caveat, a little more "automaticity" in open market operations--permitting the actual level of borrowing to respond, up to some point, to movements in required reserves that reflect undue strength or weakness of money relative to path--might begin to be considered as being consistent with the continued rather more predictable behavior of the aggregates, particularly M1, and an associated willingness to place more emphasis on them. Modest deviations of $50 to $100 million of borrowing in any one reserve period in response to required reserves would not in and of themselves necessarily spark significant changes in credit market conditions, given the amount of variation that develops naturally out of misses in reserve factors and changes in market psychology and bank behavior--so that there is something of a safety factor should weakness or strength in money be transitory. Sustained or cumulative changes in borrowing would develop only in face of persistent weakness or strength.

Any such approach would not be inconsistent with the present structure of the directive. Rather, it could be construed as a means of implementing the language in the directive written to permit changes in reserve pressure if money growth is excessive or insufficient in the context of economic behavior.