APPENDIX

Notes For FOMC Meeting
May 21, 1985

Sam Y. Cross

In the last eight weeks the dollar has fluctuated widely. Against the mark, for example, it has ranged between DM2.95 and DM3.26. Over the period as a whole the dollar declined about 5 percent against most major currencies.

The exchange markets appear to have been reassessing the economic outlook both here and abroad. The strength of the U.S. economy and the outlook for U.S. interest rates has remained in question, and the expected strengthening abroad has been slow to materialize. Thus, the gap in economic performance that has been favoring the dollar may have narrowed but apparently has not been reversed. Moreover, market participants have expressed doubts about other countries' ability to sustain their expansion should U.S. growth remain subdued. Investment interest in the mark and the yen, the two currencies usually considered to be the alternatives to the dollar, appears to have been slack, even when the dollar has been declining. With economies abroad lackluster, the scope for a significant further narrowing of interest differentials is seen to be limited. Market participants anticipate that central banks abroad will take the opportunity to allow their interest rates to ease in response to convincing declines in the United States.

The dollar fell to its low point of the period in mid-April, when it was fully 20 percent below its late February peak relative to European currencies. The selling of dollars that precipitated this decline appears to have reflected largely professional positioning and hedging of portfolios. This selling was perhaps motivated by expectations that a more generalized sell-off of dollar assets would follow. But what is interesting is that many international portfolio managers appear not to have sold the dollar assets themselves, but rather to have hedged in forward markets and elsewhere. Indeed, the balance of payments statistics show that new foreign investment continued throughout the period at a healthy pace. When expectations of a larger sell-off did not materialize, the dollar subsequently stopped falling and recovered somewhat.

Foreign central banks responded in different ways to the dollar's decline. There has been little or no net dollar intervention since your last meeting. Some countries did allow a decline in their interest rates. Official rates were reduced by the U.K., France, and Belgium. Short-term market rates for sterling, French franc and Swiss franc assets fell almost as much as comparable dollar rates. However, short-term rates fell by a lesser amount in Germany and hardly at all in Japan.

Although exchange rates on balance have showed little trend during this period, they have exhibited considerable daily volatility. Since late February, the dollar/mark rate has fluctuated about 2 percent on average during each day. This means that, within an average day, a dealer with a $5 million position could experience a $100,000 loss. Over periods of days, exchange rate moves--and the consequent risks--have been even larger.

Many banks have responded to the growing risks of running foreign exchange positions by limiting exposures, and by limiting direct dealing with interbank counterparties. As a result, the exchange market has lost some resiliency and individual transactions can have greater influence than before. In this respect, foreign exchange dealers in commercial banks have been complaining to us for several months about the deteriorating market conditions.

More recently, corporate treasurers active in the exchange markets have also begun to express concern about the high degree of short-run exchange rate variability. They say they are able to get their required currency transactions completed, but that the recent day-to-day volatility has greatly hampered their financial operations and decision-making processes. Several corporate representatives hoped that the central banks could find a way to dampen this type of short-run volatility. They argued that it is necessary to bring greater stability to market conditions and deal with short-run volatility before judgments can be made about what is an appropriate medium-term exchange rate.

NOTES FOR FOMC MEETING
May 21, 1985
Peter D. Sternlight

Desk operations since the March 26 meeting sought to maintain approximately unchanged pressure on reserve positions against a background complicated by large and sometimes hard-to-predict moves in Treasury balances, and some distortions to borrowing numbers because of problems of non-federally insured thrifts. Mixed information on the economy netted out to a picture of continued modest growth, with contrasting elements of weakness and strength. Growth in M1 slowed from its very rapid rate in the opening months of the year and ran close to the Committee's preferred March-to-June pace in April, and just a little stronger in early May, although this meant remaining well above the annual growth cone and slightly above the parallel line growth channel. M2 and M3 were unexpectedly weak in April, leaving both these measures well within their annual growth cones in that month.

Reserve paths allowed initially for $400 million of borrowing--the center of the $350-$450 million range envisaged at the last meeting. At that time, special thrift borrowing in Ohio and Maryland was just under $50 million. By late April, special thrift borrowing had pushed somewhat over $100 million and the overall adjustment and seasonal borrowing number was raised to $450 million in the May 8 reserve period in partial recognition of this. In the current reserve period, developments in Maryland have raised the special thrift borrowing considerably further--over $450 million in recent days. In recognition of this, while not changing the formal borrowing allowance again, we have thought of the special situation borrowing as providing, on average in the current reserve period, an additional $250-$300 million or so of what can be regarded in effect as "nonborrowed reserves".

Actual borrowing levels have run fairly close to the path allowance over most of the intermeeting interval--averaging about $480 million and $390 million in the first two reserve periods, and then about $560 million in the two weeks ended May 8 when we had a particularly big job to keep up with the soaring Treasury balance and the thrift borrowing was a little higher. So far in the current reserve period borrowing has run considerably higher, averaging about $800 million for the first 11 days. This reflected not only the bulge in Maryland thrift borrowing but also a few instances of overnight borrowing by money center banks facing unexpected late shortages when federal funds were apparently not available in size. For the three full reserve periods since the last meeting, nonborrowed reserves averaged a little above path.

For the first few weeks of the period, the funds rate varied around the 8-1/2 percent level that characterized most of March. Then in the latter part of April the rate fell off, slipping below 8 percent for several days and then backing up to a range of 8 to 8-1/4 percent. The drop after mid-April may have reflected the Desk's vigorous efforts to offset rising Treasury balances; for a few days right after the tax date, those balances did not go up as fast as had been anticipated, so we were temporarily over-providing. Later, the rising balances caught up with and exceeded expectations, and the money market returned to rates somewhat over 8 percent. So far in the current reserve period, not counting yesterday when the lower discount rate took effect, funds averaged about 8-1/8 percent, notwithstanding the higher borrowing level mentioned earlier. Yesterday, with the new discount rate, funds traded largely around 7-5/8 - 7-3/4 percent, but firmed up late in the day apparently because of problems in the New York Fed computer that delayed funds and securities transfers until very late hours.

Desk operations added a net of nearly $6-1/2 billion to the System's outright securities holdings during the period. Midway through the period, with the Treasury balance on its steep rise, outright holdings were up nearly $7.7 billion, thus using an appreciable part of the temporarily enlarged $9 billion leeway. Later, as the balances declined, the portfolio was reduced somewhat through bill run-offs and sales to foreign accounts. The big rise in outright holdings was accomplished through two large bill purchases in the market totaling about $5.3 billion, a $1.3 billion purchase of coupon bearing issues in the market and about $1.1 billion of bill purchases from foreign accounts. In the second market purchase of bills, the System bought a record $3.7 billion. Substantial use was also made of repurchase agreements, particularly in coping with the final stages of the huge increase in Treasury balances. On May 2, the Desk arranged $11-3/4 billion of one- and four-day repurchase agreements. There was an ample $22 billion of offerings presented to the Desk that morning, probably because we had given the market notice of the operation the previous afternoon. Matched sales were used on two occasions to absorb reserves from the market, around mid-period, when our heavy preparations for the rising Treasury balances had produced a temporary overabundance of reserves.

Rates declined across a broad front over the period, including an extra kick at the end of the interval from the announcement of a discount rate reduction. Earlier, the rate decline was mainly influenced by a perception of sluggish economic growth (and indeed no growth in manufacturing activity), reasonably contained inflation, encouraging signs of progress in trimming the budget deficit, and a sense that the Fed was responding to these factors with a somewhat more accommodative stance toward reserve provision. Anticipations of a discount rate reduction alternately waxed and waned over the interval, but had become quite widespread by the time of last Friday's announcement--though many observers thought the word might come a few days later. Market commentators took note of the strong year-to-date performance of M1 and some found it troubling, but the more prevalent view was that the economy was sluggish despite the recent strong growth in M1 and that this seemed to be another of those periods when vigorous money growth was not all that clear a prelude to overheating in the economy or resurgent inflation. Sentiment was not all one way over the interval; at times the market was more impressed by signs of continuing gains in the economy, heavy supplies of new issues, or official comments that seemed to dampen near-term prospects for greater accommodation.

But overall, the rate trend was down. For Treasury coupon issues the yield declines ranged from about 160 or 170 basis points in the 2-3 year area to about 130 in the 10-year range and 95 or so at 30 years, including around 20-30 basis points in the wake of the discount rate cut. The Treasury raised a hefty $25 billion in the coupon market over the period, including $10 billion in the record mid-May financing. The market did back up a bit as this financing approached, but good bidding and follow-up interest developed, lifting the new issues to sizable premiums.

In the Treasury bill market, where net new issuance was a modest $2 billion over the period--and the Federal Reserve was a sizable net buyer--the rate declines were actually somewhat less than for shorter coupon issues, though still an appreciable 120 to 145 basis points for key issues. Three- and six-month bills were auctioned yesterday at about 7.28 and 7.43 percent, down from 8.41 and 8.86 percent just before the last meeting. Other money market rates declined by roughly similar magnitudes, in the area of 1-1/4 percentage points for commercial paper and acceptances and 1 to 1-5/8 percentage points for CDs. One large money center bank cut its prime rate 1/2 percent to 10 percent shortly before the discount rate cut, and most others followed suit afterward.

By and large, the Government securities market has continued to function pretty normally despite the failures of several nonprimary dealer firms in recent months. Anecdotally, we get the impression of some dealers and customers becoming more selective about their trading partners--and indeed some of these upgradings may have played a role in uncovering some of the additional problems that emerged after the ESM collapse--but it's hard to put one's finger on specific measurable effects. Indirectly, the fall-out of ESM and other dealer failures caused some anxious moments last week with respect to the monthly settlement for mortgage-backed securities. Growing out of the dealer failures and the disposition of securities involved in certain repurchase agreements, a number of adverse action claims were filed where ownership of mortgage-backed securities was in dispute. These claims could have the effect of stopping the transfer of particular certificates if they turned up in the general monthly settlement. In turn, this threatened the orderly conduct of the settlement, as well as ordinary day-to-day repo financing of mortgage-backed securities, and in effect the overall liquidity of the mortgage-backed securities market. As it turned out, the settlement process and repo financing proceeded smoothly after tense meetings with market representatives and the Federal mortgage guaranteeing agencies, pointing toward some longer-run relief measures, and also with the help of the fact that few, if any, of the tainted securities showed up in the settlement process. The longer-run measures are still being pursued. In the meantime, we were prepared at the Desk in case of a serious threat to the liquidity of the financial markets, to make repurchase agreements against mortgage-backed securities. Fortunately, we didn't have to--just mechanics alone would be quite cumbersome, never mind the policy implications of stepping in seemingly to aid a particular sector. Finally, I'd like to mention that the New York Fed has now published its guidelines for capital adequacy of government securities dealers. It is designed for a voluntary framework but could also fit into one or another of the mandatory reforms now under discussion.

Michael J. Prell
May 21, 1985

FOMC Economic Briefing

Incoming data since the last meeting suggest that the economy is expanding, but not very rapidly. The Commerce Department released revised first-quarter GNP data this morning, and they showed a 0.7 percent rate of growth in real GNP, about 1/2 point less than the preliminary estimate. The revision reflected the netting of small changes in all the major components. Our best guess is that real GNP is rising at something over a 2 percent annual rate in the current quarter. Beyond the current quarter, the projected pace of expansion is the same as we previously forecast, but the recent shortfall in the level of output is not made up and this prevents the unemployment rate from moving below 7 percent.

The unemployment rate stayed at 7.3 percent last month. Nonfarm payrolls rose about 215,000--an appreciable gain, but considerably smaller than the average in prior months. Manufacturing employment fell for the third straight month, and this was reflected in a decline of 0.2 percent in industrial production.

Although the less robust growth in employment limited wage and salary growth in April, total personal income was reported to be up 0.6 percent. Moreover, disposable income rose strongly because of the tax refund catchup. It is our assessment that the drop in disposable income in the first quarter that resulted from delays in refunds cut primarily into saving rather than spending and that a good share of the refunds now being received will be used to repay debt or otherwise boost measured saving. The few data we have on second-quarter spending appear consistent with this thesis. The level of overall consumption expenditures in April, though up 0.7 percent after a slight March dip, was only moderately above the first-quarter average. And car sales--which rose appreciably in the first part of the year--have shown no signs of rising further. On the whole, personal outlays probably are now on a less vigorous growth track, with a lessening impetus from pent-up demands for durables.

On the investment front, residential construction appears to be a particular source of strength at present. Housing starts rose to a 1.9 million unit rate in March and April. Although we expect that mortgage rates will decline somewhat further, slower income and employment growth are likely to temper expansion in housing demand over the projection period; moreover, the recent pace of multifamily building seems unsustainable, given rental vacancy rates.

The indicators of near-term nonresidential investment are quite ambiguous at this point. Construction activity was up strongly on average in the first quarter, especially in the commercial area, but there are some hints of a flattening in new contracts. We expect the glut of office space in many cities to produce a downturn in the commercial building cycle before long, and we are projecting a leveling out of overall nonresidential construction in coming quarters.

With regard to equipment spending, trends in orders placed with domestic producers have been obscured in recent months by wild gyrations in the computer category. Big increases in capital goods shipments in February and March have, however, set the stage arithmetically for a considerable rise in the average level of outlays in the current quarter. Thereafter, we expect that desires to adopt up-to-date technologies will still be strong enough to support continuing appreciable growth in equipment spending through 1986--albeit at a rate far below that of 1983-84, and with imports absorbing a sizable share of the outlays.

In the government sector, a spurt in defense spending is expected in the current quarter--a catchup after a fluky drop in the January-to-March period, but over the next year and a half the picture is one of slowing growth in federal and state and local purchases.

Focusing on the near term, while real domestic final demand appears to be growing at a fairly good clip, the projection for GNP growth hinges importantly on assessments of inventory behavior and of tendencies in the external sector. We are anticipating continued caution toward stock accumulation, but the key factor in the current quarter is a probable swing in auto dealers' stocks associated with model changeovers. Whether it is in fact reflected in reduced stocks or instead in weaker sales, the lower auto assembly schedules imply a 1-1/2 percent drag on GNP growth in this quarter.

On the external side, there have been wide quarterly fluctuations in net exports over the past year, and the first quarter saw another big negative swing. Real GNP less net exports (that is, domestic purchases) actually rose at a 4 percent annual rate. There was a massive increase in nonoil imports--indeed, one so large that we think it likely that there will be a small drop-back in the current quarter. The effects of the projected dollar depreciation will not really begin to leave their mark until the end of this year; consequently, the external sector does not become a consistent contributor to GNP growth until 1986.

Similarly, the domestic price impact of a declining dollar is not expected to be appreciable until next year, when it will be the major force behind the projected acceleration of inflation from the 3-1/2 percent area to around 4 percent. The inflation forecast is essentially unchanged from March's, as the effects of a lower dollar are offset by the somewhat greater degree of slack in the domestic economy.

I should say, though, that incoming data have led us to lower the probability of price developments turning out more favorably than we have projected. The 6 percent first-quarter increase in hourly compensation was exaggerated by payroll tax increases and perhaps by other special factors; the series also is susceptible to substantial revision. However, the faster growth of manufacturing production worker wages in the hourly earnings index and the pickup in nonunionized manufacturing wages in the employment cost index at least suggest that wage deceleration may have run its course for the time being. Moreover, recent productivity performance has been no better than expected, and with a lessened offset to wage increases, the pressures of labor costs on profit margins are likely to be more substantial. Finally, recent producer and consumer price increases--including the 0.4 percent April CPI rise announced the morning--have tended to run above the trends the past couple of years. Some transitory influences have been involved--especially a spike in gasoline and fuel oil prices--and the markets for basic commodities have remained soft. Nonetheless, we are hesitant to discount entirely the overall firmness displayed of late by final goods prices.

FOMC Presentation
S.H. Axilrod
5/20/85

The alternatives presented to the Committee all specify growth in the broader aggregates--M2 and M3--well within their long-run growth cones, largely the result of the unexpected weakness of these aggregates last month. Growth of M1, on the other hand, is expected to remain somewhat above the upper limit of its parallel band. Indeed it appears likely that growth of M1 over the three-month period from March through June will be somewhat higher than the 6 percent growth path adopted by the Committee at its last meeting, assuming pressures on bank reserve positions--as gauged by the level of adjustment plus seasonal borrowing are about unchanged from those prevailing over recent weeks.

The strength of M1 has been accompanied by declines in its income velocity. In the first quarter the drop was at about a 4 percent annual rate. In the second quarter a decline of close to 2 percent annual rate can be expected based on current estimates of growth in nominal GNP and M1. Thus, there will have been two consecutive quarters of negative velocity following its rebound in growth at a relatively rapid pace since late 1983.

The recent velocity experience resembles on a much more limited scale the sustained weakness in M1 velocity during 1982 and early 1983. What they have in common is an apparent increase in the amount of money demanded in lagged response to a substantial decline in short-term interest rates. From mid-summer of 1984 to early 1985 the 3-month bill rate had dropped close to 3 percentage points, or about 30 percent. That is why both our monthly and quarterly models were predicting sizable growth of M1 in the first half of this year despite quite moderate growth in nominal GNP.

There are of course substantial differences between this year and 1982-early 1983. The main difference stems from an economy that is operating now at a much higher level of activity. Most of the earlier drop in velocity occurred during the recession, when there appeared to be a considerable reduction of inflationary expectations that was reflected in a sustained lower level of nominal interest rates. Lower interest rates appeared to induce a relatively "permanent" downward shift in the level of velocity--corresponding to an upward shift in the demand for money--that needed to be accommodated.

It seems possible that further downward shifts in velocity may become evident at some point as interest rates drop because more progress toward price stability is in fact made, or because real rates need in any event to decline from current relatively high levels to support satisfactory real economic growth. If and as rates phase down, velocity could be expected to grow less than its trend annual rate of expansion--which we tentatively place at 1 to 2 percent--and probably to decline at times. But to decide whether weakness in velocity over any relatively short period, like the last two quarters, reflects a "permanent" upward adjustment in the amount of money demanded or a transitory effect of a burst in money growth or a temporary dip in GNP is a difficult judgment. If there is no lasting upward adjustment in money demanded, the decline in nominal and real rates associated with expanding money supply may in time trigger a greater than desired expansion of demand for goods and services, a resurgence of inflationary pressures, and a sharp turnaround to expansion in velocity.

The incoming economic evidence at present suggests, however, that the present seemingly large gap between actual and potential real

GNP will not be narrowing over the period immediately ahead--not a condition that normally would accelerate inflationary pressures. On the other hand, there can be doubt about what is the economy's potential and also about the size of the gap. Skepticism about the prospects for improvement in productivity performance would tend to lower the potential for growth, and there is also uncertainty about the unemployment rate that can with reasonable certainty be characterized as the natural rate--that is, the rate below which inflation will tend to accelerate. If that rate is higher than most now suppose and the potential growth rate of GNP is lower, it would not take particularly strong demands for goods and services at this point to generate untoward upward price pressures. But, with respect to the underlying strength of demand, it must be noted that if the House goes along with something like the Senate's budget cuts, there will be no further increase in fiscal stimulus over the next several quarters, leaving even more scope for the negative impact on economic activity from the high real exchange rate and any continuing associated rise in the trade deficit to work through the economy.

Many of these issues about the relationship of money growth to velocity trends, inflationary expectations, and the economy's growth potential will be particularly relevant at the July meeting when the Committee reconsiders its long-run targets for 1985 and establishes tentative ranges for 1986. At present, as I noted at the beginning, we expect maintenance of existing, in the sense of prevailing over recent weeks, reserve pressures to lead to slightly faster M1 growth than adopted at the previous FOMC meeting. If our projection is correct, that would put M1 only about 0.3 of a percent above the upper parallel line of the band by June. That means, arithmetically speaking, that 5-1/2 percent growth from then on would yield 7.3 percent for the year. Such growth over the balance of the year, or even somewhat lower, cannot be said to be unmanageable if something like more usual tendencies in velocity were to emerge, though that might entail an edging up of interest rates at some point in the context of a reasonably strong economy.

A word, if I may Mr. Chairman, about why we believe the $300 to $350 million borrowing level of alternative B does characterize existing or recent reserve pressures. At the last FOMC meeting, the Committee indicated that the reserve path should be initially set on the basis of adjustment plus seasonal borrowing of $350 to $450 million. At the time special situation thrift borrowing amounted to around $50 million. Thus, excluding that borrowing, the range could be construed as $300 to $400 million. Actual borrowing other than for special situations over the three complete reserve maintenance periods since then averaged $380 million, reasonably close to 300 to 350 given the vagaries in excess reserves and seasonal borrowing under the more liberalized program, and has run around $300 million over the past few days. I would expect the federal funds rate under those conditions to be somewhere between the old discount rate of 8 percent and the new rate of 7-1/2 percent, [probably more often closer to the latter than the former.]