

## APPENDIX

Notes for FOMC Meeting  
August 20, 1985

Sam Y. Cross

The dollar dropped further since your last meeting, falling about 6 percent against most Continental currencies and nearly 3 percent against the yen. It is now about 17-18 percent below the peaks of last February.

Ever since the release of June U.S. employment data just before your last meeting, market sentiment towards the dollar has become progressively more bearish. Economic statistics released since then have been seen as confirming the slow pace of U.S. growth. Most exchange market participants have thus ceased to expect a strong re-acceleration in the third quarter that might soon reverse the dollar's downward trend. In addition, the dollar's support from an image of strong U.S. leadership in economic policy has eroded, particularly after the failure to achieve a persuasive budget-reducing compromise before Congress adjourned in July. Public statements by Administration officials, saying that they would like to see the dollar fall more, may have contributed to the bearish tone of the dollar.

The view prevails that the Federal Reserve will avoid any significant tightening of its monetary policy stance so long as the U.S. economy looks so weak. Under these circumstances, the dollar did not rise in response to recent evidence of rapid growth in the monetary aggregates. Even last week's release of an oversized \$5.3 billion increase in M1 had virtually no effect on dollar exchange rates.

So far at least, there seem to be few signs that an early pickup in U.S. inflation is expected, with expectations influenced by oil and other world commodity prices.

The weakness of the dollar appears even more significant if one takes account of the fact that U.S. interest rates have been rising while interest rates in Germany and elsewhere have been declining. Interest rate differentials favoring the dollar over the mark have thereby widened during the period by about a percentage point. In response to the dollar's decline in the exchange market, there have been some feelings that foreign investors might become less willing to acquire more dollar-denominated securities, or that they would do so only on a hedged basis, and a concern that if foreign capital flows into the United States subsided U.S. interest rates would rise. But the substantial degree of foreign participation in the latest Treasury refunding has, at least for the time being, apparently mitigated fears of large-scale withdrawal of foreign investors, particularly Japanese investors, from U.S. securities markets.

A significant feature of the recent period has been the relative buoyancy of the German mark. The mark has risen against most

European currencies since the realignment of the EMS over the weekend of July 20-21. That realignment provided effectively for a 7.8 percent devaluation of the Italian lira relative to its EMS bilateral central rates, and roughly a 4 percent depreciation in terms of market rates with other EMS member currencies. The devaluation of the lira led to some fears of further EMS realignments and has generated the hedging of investments denominated in the French and Belgian francs-- currencies which have been attractive for investment because of their high interest rates, but which could be regarded as candidates for devaluation in a future realignment.

The German mark and the Dutch guilder have generally benefitted from these EMS hedging operations. This strength shows through as these two currencies tend to gain across the board even as interest rates are pushed steadily lower by their central banks. Last week's announcements that discount and Lombard rates in these two countries were lowered by 1/2 percentage point were thus taken in stride, with some market participants even viewing them as a sign of renewed confidence in the German mark's strength relative to the dollar.

The pace of foreign central banks' interventions to buy dollars has slowed since the Italian devaluation, as several EMS central banks have had to sell both dollars and marks to support their currencies within the joint float. Still, the dollar's fall has received cushioning over the period since your July meeting from central banks' net purchases of about \$1.6 billion in dollars to add to their reserves--and also from their net sales of \$3.8 billion equivalent of German marks.

Mr. Chairman, the only operation I have to report is the repayment by Argentina last Thursday of the first installment of its drawing on the \$483 million facility that was established with the support of twelve monetary authorities last June. The U.S. Treasury was repaid half of the \$142.9 million Argentina had drawn on its swap arrangement, leaving the other half to be repaid by September 30. The entire twelve-country facility now has \$230 million still outstanding, of \$460 million that was initially drawn. The Argentine repayment followed action by the IMF's Board approving a new Fund standby of SDR 1.18 billion.

PETER D. STERNLIGHT  
NOTES FOR FOMC MEETING  
AUGUST 20, 1985

Desk operations since the July meeting have been conducted against a background of initially moderate, but then sharply strengthening, growth in M1, appreciable strength in M2 and relative weakness in M3. News on the economy was mixed, suggesting some growth but not really much pick-up from the sluggish pace of the first half of the year. Signs of inflation remained subdued, although the further weakening of the dollar was a reminder that price pressures could re-emerge.

In this setting, operations were first directed at maintaining about the same degree of pressure on bank reserve positions as was sought before the last meeting--characterized by a \$350 million level of seasonal and adjustment borrowing in constructing the reserve path. By the beginning of August, with M1 pushing well above its new range, M2 also fairly strong, a softish dollar and moderate economic growth, a very slightly less accommodative posture was adopted, with the path level of borrowing placed in a \$350-\$450 million range. A \$400 million level was used in path construction. At the same time, the path level for excess reserves was raised by \$50 million to \$700 million, making it closer to the higher levels that have prevailed on average this year. Using this more realistic level of excess reserves tends to reduce the need to allow informally at times for higher excess reserve demand. Taken together, the small path adjustments in borrowing and excess reserves imply a very slight, barely perceptible, lessening of reserve availability. Indeed, the net effect is probably just to place the intended degree of reserve pressure a bit closer to what most market observers seem to have had in mind right along for the past couple of months--that is, a borrowing level around \$400-\$500 million.

Borrowing averaged a relatively high \$800 million in the reserve maintenance period ended July 17, which included the last Committee meeting date. In part, that high level stemmed from the sharp borrowing surge on July 3 which automatically carried over to the start of the new period on Thursday, July 4. To some extent, the high borrowing in that period also reflected a bit of caution on the Desk's part in meeting reserve needs when more vigorous action might have fed unwarranted market anticipations of an easier policy tilt. This was right around the time of the Humphrey-Hawkins testimony. In the July 31 period, borrowing averaged a modestly-over-path \$411 million while nonborrowed reserves were even further above their objective as excess reserves ran quite high. The August 14 maintenance period saw borrowing average \$481 million, also a little above the path level which was now \$400 million. Nonborrowed reserves in that case ended up slightly below path, again partly because of relatively cautious reserve provision against a backdrop of accelerating M1 growth. So far in the current reserve period (through the past weekend) borrowing is averaging about \$565 million.

Federal funds averages for full two-week periods recently have been in a range of about 7-3/4 to 7-7/8 percent, with daily trading sometimes as low as around 7-1/2 or as high as 8-3/4 percent. Thus far in the current reserve period, which started on the heels of a fairly tight close-out to the previous period and also began on the day of a major Treasury financing settlement, funds have averaged about 8-1/4 percent, although trailing off to about 7-3/4 percent by late yesterday. It's probably fair to say that in the perception of market participants, the expected funds rate has firmed a shade in the past several weeks-- from about 7-5/8 to 7-3/4 in mid-July to more like 7-3/4 to 7-7/8 or even 7-3/4 to 8 percent more recently.

Desk activity was relatively light during the interval as reserve availability relative to path shifted between moderate shortages and excesses. Outright System holdings were increased by a modest \$328

million, reflecting purchases of about \$600 million of Treasury securities from foreign accounts partly offset by run-offs of Treasury bills and agency issues. The Desk arranged System repurchase agreements on only one occasion but passed through customer repos about a dozen times. Matched sale-purchase transactions in the market were done just once to drain temporarily redundant reserves.

Market yields rose moderately over the intermeeting period amid shifting assessments of the outlook for the economy and monetary policy. At the outset, there were narrowly divided views about the prospect for further policy moves toward the accommodative side, but some of the incoming news and reports on the Chairman's Humphrey-Hawkins testimony led observers to downgrade the likelihood of near-term easing. Disappointment with the budget process and the approach of the Treasury's August coupon financing augmented the market's uneasiness. Once rates had risen somewhat, the auctions went fairly well, aided partly by reports suggesting continued sluggishness in the economy rather than the second half pick-up anticipated by many observers.

While some commentators have expressed concern about money supply growth, a more prevalent view seems to be that we are experiencing more of the same kinds of developments that marked the first half of the year--calling for toleration rather than sharp reaction to the outsize money growth. Few observers are inclined to dismiss money growth entirely, though, and a number see its strength as at least a reason not to expect an easing.

The Treasury raised about \$15 billion of new cash over the period, including \$11.5 billion coupon bearing issues--with over \$10 billion of that in the record-sized August refunding. Coupon issues rose a net of about 20 to 35 basis points in yield. With the market tending to do a little better after the refunding auctions, all three new issues are currently at premiums over their issue prices.

Treasury bills meantime, rose about 20 to 35 basis points for key issues, while the Treasury raised about \$3-1/2 billion in the bill market. In yesterday's auctions, 3- and 6-month bills sold at average rates of 7.14 and 7.28 percent compared with 6.92 and 7.00 percent shortly before the last meeting. CD rates rose a bit more than bills despite light issuance, possibly reflecting a bit of increased quality or liquidity concerns. Those concerns have also arisen in the Federal agency market, where Farm Credit System paper has encountered somewhat increased spreads against Treasury issues following press reports of weakness in the Farm Credit System. And in recent days, concerns about a privately insured Maryland thrift and its mortgage marketing subsidiary were also a factor in the market.

Turning to a concern regarding the Desk's relations with the Government securities market, I'd like to mention that we've been giving attention recently to the procedures by which dealers qualify to become, or remain, primary dealers. We have had standards for this, but we are planning some modifications. For one thing, we expect to clarify at what point we would be prepared to regard an aspiring primary dealer as a "serious prospect" from whom we would want to receive daily reports for closer monitoring purposes before designation as a primary dealer. Right now there are roughly a half dozen firms approaching that "serious prospect" stage. A couple of those firms, incidentally, are Japanese, and this is generating some discussion about comparability of access for foreign firms in the U.S. and Japanese markets. Our past approach has been one of national treatment--viewing foreign and domestic firms alike in applying our standards--and in fact, foreign firms have been so informed on various occasions. I should note, too, that several primary dealers already are foreign-owned, although these came about through foreign acquisition of on-going U.S. operations. In any event, as noted, there has recently been increased discussion of the subject, both in the market and on the official side.

J.L. KICHLINE  
August 20, 1985

FOMC BRIEFING

The staff forecast for this meeting of the Committee looks about the same as that presented in July. We still expect real GNP this quarter and next to rise at around a 3 percent annual rate. That moderate expansion occurs in the context of an expected slowing in growth of domestic final demands from the first half pace, but those demands show through to GNP as both the drag from reduced inventory investment and the deterioration in net exports come to a halt. Unfortunately, we have no statistical evidence on the behavior of inventories or the trade sector for the current quarter, and the limited data available for other sectors do not yet provide a clear picture of the course of the economy.

In the industrial sector there seems to be some firming of activity, with the index of industrial production rising .2 percent in July after an upward revised increase of .3 percent in June. Small production gains were reported across a variety of areas in both final products and materials, excluding the business equipment and energy sectors where weakness has been apparent. Moreover, there



also has been a noticeable slackening in the loss of manufacturing jobs during the past two months following quite sizable cutbacks earlier in the year. Outside of manufacturing, employment in other sectors picked up in July and total payroll employment rose nearly 1/4 million--a little larger than the average monthly gains during the first half of the year.

These employment gains are, of course, supportive of moderate growth in consumer spending. The forecast entails expansion in real personal consumption expenditures of only about 1-1/2 to 2 percent over the projection period which is expected roughly to track the path of disposable income; this is a marked departure from developments in the first half of this year when consumer spending rose at an unsustainable 5 percent annual rate.

The monthly data available on consumer spending generally point to sluggish behavior in recent months. For July, retail sales excluding autos and nonconsumer items rose 1/2 percent although this followed a drop in the preceding month. The auto sector, however, saw domestic sales of 7-1/2 million units annual rate in July--1 million below the level earlier in the year when foreign cars were in short supply--and sales slipped further in the first part of August. It's a bit difficult to sort out the impact of various influences on auto sales, such as the off again and

on again financing incentive programs and most recently the auto-haulers strike. Suffice it to say that the forecast includes some near-term rise in domestic car sales from recent levels along with continuing moderate gains in other consumer spending similar to that in July.

The housing sector has been weaker than we had thought would be the case. Housing starts dipped in July in association with a fall in multifamily starts. We have been expecting weakness in the multi area given very high rental vacancy rates, but the surprise has been in the virtual stability of single-family starts over the past several months. It still seems that single-family starts should respond soon to the earlier decline in mortgage interest rates, and the generally favorable market influences are thought to outweigh the negatives, such as the uncertainty about tax reform and tightened mortgage lending and insurance standards.

The business investment sector is an area where the latest data are for the month of June. In that month orders and shipments for nondefense capital goods bounced back while outlays for nonresidential structures weakened. These and other data are viewed as consistent with developments expected during the second half of the year, namely continued growth in equipment spending, primarily for replacement and modernization purposes, and a small decline in structures spending as the boom in office building fades.

In sum, expectations of real growth around 3 percent annual rate over the balance of the year still seem the best bet to us. However, if we are wrong, the signs now available suggest near-term growth likely would be less than expected rather than more. For wages and prices the forecast is unchanged, and recent information continues to suggest inflation rates this year will be close to those of a year ago with some uptick next year in response to a lower foreign exchange value of the dollar.

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FOMC Briefing  
SHAxilrod  
8/19/85

The conflict between signals for policy given off by the monetary aggregates and the economy has, unfortunately, not become less intense since the July meeting. Incoming economic data have not been as vigorous as might have been hoped. At the same time the M1 money supply has shown no real sign of slowing into the newly adopted 3 to 8 percent range for the second half of the year. M2 remains a little above the upper end of its long-run range for the year, while M3 is well in the middle of its range.

The monetary aggregate with the most pronounced property as a leading indicator of GNP is M1. We have examined various lead times from 3 to 9 months using data for the past six years. In terms of simple correlations between the change in M1 and the change in GNP since 1979, a lead time of 6 months, or a bit less, seems to work best on average; longer lead times of up to 9 months also showed some positive relationships, particularly for predictions outside the period of the 1980 credit control program. All of the relationships were, of course, loose at best. But for what they were worth, they would suggest that GNP growth should be picking up markedly in the third quarter, and should also be strong in the fourth quarter, given the strength of M1 thus far this year.

However, as Jim as noted, we have no evidence so far for such a strong pick-up in GNP and are not projecting one. In the third quarter, indeed, it is probable that the drop in velocity of M1 will be even sharper than in the first and second quarters. Moreover, even on a two-quarter lagged basis--comparing M1 two quarters ago with GNP projected

for the third quarter--it appears that M1 velocity will now be negative, declining by about 4-1/2 percent at an annual rate.

We cannot explain this recent weakness in velocity as well as we could in the first half by standard estimates of the effects of interest rate declines. There probably is still some lagged impact of earlier rate declines at work, but the growth in M1 over the past four months has been significantly greater than our models would predict. Some explanations were offered in the blue book, including a brief summary of the rather diffuse results of a survey we made of 40 banks with exceptionally large demand deposit increases.

Since midyear, however, demand deposits have not been the cutting edge of M1 increases, though they have not yet shown a tendency to reverse some of the previous unusual surge. It is NOW accounts that have been the main propelling force, with the increase divided between regular and super NOW accounts about in proportion to their share in the total of NOW accounts. We are also observing a similar accelerated rise in straight savings accounts and MMDAs, while the outstanding amount of small time deposits has been declining since midyear. Yield spreads between time deposits and the other more liquid balances are narrower than they were this spring, though still noticeably favorable to time deposits and widening slightly in the past two months. Thus, the very recent rise in M1 appears to reflect a shift in the distribution of saving toward more liquid deposit balances, at least partly in response to the relatively less wide interest differential.

If M1 is responding to interest rate behavior, that should be picked up in the interest rate variable of our models. That the model is nonetheless underpredicting M1 recently would indicate that the rate

elasticity in the model may not be large enough in the current institutional environment. Or if one believes the model's interest responsiveness, one might conclude that recent growth of liquid balances reflects a shift in the demand schedule because of economic uncertainties or some fear of capital loss on alternative investments with a less favorable interest rate outlook in the future.

While the recent strength of M1 may be laid at the door of savings behavior, and even though the predictive power of M1 for GNP seems in abeyance so far this year, it may be difficult to downplay M1 more in terms of policy if and as it remains well outside the adopted range for the second half. The question at issue would be the credibility of the Fed's targeting procedure and whether inflationary expectations would worsen. In a clearly weak economy, there would probably be little chance of such an adverse expectational response if money were permitted to run very strong without resistance. Present economic circumstances are not so clear. The economy does not appear strong, but it is not clearly weak. The behavior of the dollar is also a complicating factor. It seems to be on a declining course, which would be welcome over the longer run, but combined with continued strong money growth could well give off inflationary signals--again unless the economy is clearly weak. Finally, whether the budget process will in the end yield as much restraint as promised is uncertain.

Against such a background, the staff has presented three alternatives. The one providing the greatest probability of moving within the M1 long-run range by the fourth quarter -- C -- calls for a distinct firming of money market conditions over the weeks ahead. It likely would weaken the economy further, though with potential long-run advantages for

making more progress in curbing inflation. At the opposite extreme, alternative A probably would just about assure growth of M1 well above the FOMC's target for the second half of the year. Pursuit of that alternative seems to us most consistent with a view that the economy is currently weak enough to require the support of distinctly lower market interest rates. The middle alternative B calls for essentially the same policy as over the past few weeks, capturing the slight degree of tightening that has developed. The odds on attaining the upper limit of the long-run range for M1 under that approach do not seem particularly high to me, though one might come reasonably close.

In general, Mr. Chairman, there is the real possibility that the Committee cannot both have a very satisfactory real economy over the near term and attain its M1 target. It is no doubt still too early to be reasonably sure about that. We could well experience extremely weak behavior of M1 in subsequent months, as has occurred in the past after large increases, or even over the balance of this month. Or monetarist-type predictions of strengthening GNP could be realized as we move into the fall. The need for such additional evidence tends to argue either for standing pat as of now or for making quite modest policy adjustments--e.g. not going to the extremes of A and C--with the direction depending on the Committee's judgment about whether the greater risk over time, looking ahead further than the immediate future, is on the side of inflation or of economic weakness.