APPENDIX

NOTES FOR F.O.M.C.
December 22, 1981

Sam Y. Cross

Mr. Chairman:

Since the November 17 meeting of the Committee, the dollar exchange rate has been subject to two main influences—interest rates and Poland. Although there were sharp and frequent exchange rate changes during the period, the rates today are not greatly different from those five weeks ago—the dollar is one or two percent higher against the European currencies, and about two percent lower against the Japanese yen, which has strengthened a bit relative to all currencies.

Through late November, as U.S. interest rates declined, and interest differentials favoring the dollar narrowed substantially, the dollar showed much resiliency in the exchange markets. Support for the dollar emerged at key points--such as DM 2.20 against the mark—as commercial interests and smaller central banks bought dollars at what they regarded as favorable rates. Partly this resiliency reflected the market's assessment that the Germans were comfortable with a trading range for the dollar of DM 2.20 to 2.25 or so. Also, the bond rally in the United States was attracting foreign investors.

Subsequently, beginning about the end of November, there was a reappraisal of the view that the weakening economy would lead to further marked declines in U.S. interest rates in the near future. The Federal Reserve was perceived as moving cautiously in its steps to reduce the discount rate and to supply bank liquidity. At the same time, it was noted that corporate financing needs remained large, the Federal government's borrowing requirement was revised upward, and that the monetary aggregates had registered several large increases. As short-term and long-term U.S. interest rates turned slightly higher during December and, in fact, interest rate differentials moved more favorably for the dollar, the dollar advanced in the exchange markets.

But these exchange rate movements were relatively modest in comparison to those that occurred after the declaration of martial law in Poland. Last Monday, beginning in Hong Kong, intense bidding pushed the dollar up to ¥ 224.50 and DM 2.36-1/2, a rise of 2 percent against the yen and 4 percent against the mark from the previous trading day. But then the dollar turned around abruptly, in response to prompt and sizable intervention by foreign central banks in their markets, and profit-taking by market participants. Thus, the dollar had already moved substantially off its peaks as the New York Monday trading session began. By mid-morning here, the dollar was back down to DM 2.28, close to the level prevailing before the Polish action. The Federal Reserve did not intervene during that period. We were authorized to intervene if necessary, but with the pressures subsiding and the market coming back into better balance, no action was taken. It was however a day of extraordinary volatility in the exchange market, with the dollar moving over a range of nearly 1000 points. Since last Monday, trading conditions have remained unsettled, as participants continued to be concerned about Poland and other political uncertainties, at a time when markets are especially thin because of the year end and the desire of corporations as well as banks to square their books.

I should also inform the Committee that the renewal of our reciprocal swap network is proceeding and will be completed before the end of the month.

REPORT ON OPEN
MARKET OPERATIONS

Mr. Sternlight made the following statement:

Trading Desk operations since the November meeting have been conducted against a background of increased monetary growth, a moderate upturn in interest rates after the earlier sharp declines, and a large seasonal need for reserves. While money growth somewhat exceeded path growth rates, this was reflected only to a modest extent in an enlarged borrowing gap to be met at the discount window. This was consistent with the Committee's reluctance to see borrowing move much above the initially preferred $400 million level. Thus, in reviewing the paths from week to week, allowance was made for the lower-than-expected borrowing of around $200 million in the first two weeks of the period. And just last Friday, when a strict arithmetical working through of the reserve data would have produced a nonborrowed reserve target for this week implying borrowing of more than $700 million, the nonborrowed target was set at a level associated with about $500 million of borrowing--roughly the same level as anticipated the previous week.

For the full five-week period, the slightly stronger than path M1B, and more considerably stronger M2, have led to a demand for total reserves roughly $100 million above path. In the ideal scheme of things, this should have led to average borrowing of about $500 million for the period, but as noted borrowing was lower than expected, especially in the first couple of weeks and at this point it looks like it could average about $350 million for the five weeks. Thus while in one sense, it could be said that we overprovided nonborrowed reserves by some $150 million, if one measures results against objectives as modified over the course of the interval then nonborrowed reserves are turning out close to path.

The tendency for borrowing to fall short of anticipated levels seemed to result partly from a view among market participants that the System expected only frictional levels of borrowing with Federal funds likely to trade, if anything, a little below the discount rate. Thus, there was reluctance to use the window or pay up much above the discount rate for funds. While one might have expected the accumulated reserve deficiencies to catch up with the banks as reserve weeks drew to a close, this did not always happen because of reserve misses late in the week. And even when settlement day borrowing did bulge, as on December 9, there was some tendency for market participants to regard this as an aberration.

Thus in the first two weeks of the period, funds traded around 12 1/2 percent, somewhat under the then 13 percent discount rate, and below the "13 plus" funds rate at the time of the November meeting. Following the December 3 cut in the discount rate to 12 percent, funds traded for several days a bit under 12, although the weekly average for the

December 9 week was a hair over 12 because of a firming on the final day. For the past week or so, funds have traded mainly a little over the 12 percent discount rate, as expectations about the rate were modified, although some participants still cling to the view that funds "ought to be" below the discount rate and are held up by temporary influences.

The System made substantial purchases of securities during the past five weeks, chiefly to offset the reserve absorption from seasonal increases in currency in circulation. Outright purchases since the last meeting total about $3.8 billion, using up most of the temporary enlargement in the usual leeway voted by the Committee. The purchases included about $2.6 billion in Treasury bills, about evenly divided between purchases in the market and from foreign accounts, some $700 million of Treasury coupon issues and about $500 million of Federal agency issues. As the reverse seasonal movement sets in during January, we expect to undertake substantial sales and/or redemptions.

Incidentally, for the full year that is now drawing to a close, the System's outright holdings are up about $8.3 billion, including $5.3 billion in bills, $2.6 billion in Treasury coupons and $400 million in agencies.

In supplementing outright purchases with temporary reserve adjustments during the recent period, the Desk frequently passed through a portion of the foreign account repurchase orders to the market on a day-by-day basis.

This was done in order to feel reserves out gradually, to avoid meeting needs too much ahead of time; we hoped in this way to encourage the expected amounts of discount window borrowing with somewhat mixed success.

At the time of the last Committee meeting, the securities markets were in the midst of a strong rally, based essentially on the evidence of a weakening economy and slow money growth. The rally continued for a few more days after the meeting but then gave way to a period of retrenchment as disappointment set in that day-to-day money rates did not drop still lower and even turned up, while more robust growth in money aggregates resumed. Estimates of larger Federal deficits were also a sobering influence. Although many market participants do not quite believe the huge deficit estimates that surfaced in Washington in early December, my impression at this time is that most analysts expect a fiscal 1982 deficit in the $80-90 billion range, while some are in the 90s and still fewer are in the $100 billion or more camp. The back-up in market rates proceeded unevenly, with sizable declines posted on occasion in response to the continuing flow of bearish news on the economy.

In the Treasury bill area, rates rose a net of about 40 to 95 basis points over the interval. The Treasury raised about $10 billion of new cash in this area, roughly half of it through cash management bills and half in regular weekly and monthly auctions. Three- and six-month bills were auctioned today at about 11.05 and 11.85 percent, compared with 10.69 and 10.97 percent just before the last meeting.

Meantime, the Treasury also raised nearly $5 billion in the coupon market. Rates on short and intermediate coupon issues were up about 3/4 to 1 1/4 percentage point while at the longer end the net rate rise was about 3/8 - 1/2 percentage point. This reversed only a modest fraction of the rate decline posted earlier in the autumn.

Corporate yields were also up over the recent interval as the market labored to digest a huge volume of new issues attracted by the earlier rate decline. New issuance has slowed now, both because of the rate back-up and the holidays, but a big backlog of desired medium and long-term offerings remains. Tax-exempt yields have also backed up in recent weeks, weighed down by heavy new issuance, and in fact current yields in this sector are not much below the earlier peaks.

The present atmosphere in the financial markets, it seems to me, is one of particular uncertainty and indecision. There is some feeling that continuing recession should be reflected in fresh rate declines with the recent back-up just a temporary hiatus. But the view is not strongly held, and there is at the same time a viewpoint that any further rally would be modest and short-lived, soon to be overcome by heavy Treasury demands, corporate debt restructuring demands, and later on by demands associated with a business upturn.

Mr. Chairman, I also have a recommendation to make--namely that the leeway to change holdings in the System Account be left at the $4 billion level up to the time of the next meeting, as our projections make it look as though we'll need to absorb roughly $3 billion of reserves during January.

James L. Kichline
December 21, 1981

FOMC BRIEFING

Since the last meeting of the Committee, information on economic activity has continued to indicate a broadly based contraction is in process. Much of the weakness has been in line with the staff's expectations, although there are a few areas--especially business fixed investment spending--which have deteriorated somewhat more than anticipated, and this has led us to revise downward projected real GNP for the current quarter to a drop of 5½ percent at an annual rate. Otherwise, there is relatively little change in the staff's forecast; we still anticipate a turnaround in activity early next year with financial constraints working to moderate the pace of the recovery later on in 1982. At the same time, a further deceleration in the rate of increase of wages and prices is expected.

Highly visible indications of the weakness in activity appear in the reports on labor markets and industrial output. The unemployment rate rose 0.4 percentage point further last month to 8.4 percent. Much of the rise in unemployment once again was accounted for by workers who lost their last job and surely these will rise further in the December labor market report given curtailed production schedules and plant closings.

Industrial production in November fell 2.1 percent, the third consecutive, sizable, monthly decline. All major categories of materials and products registered weakness except the defense and space products grouping. The recent drops in output have resulted in a decline in the manufacturing capacity utilization rate to about 75 percent, the low reached in the middle of last year.

The output reductions reflect efforts by manufacturers and retailers to cut back their inventories which had grown rapidly during the third quarter as final sales remained weak. In October, the latest data available, inventory accumulation slowed only a little, and the situation in the trade sectors--especially general merchandisers--appears to have deteriorated. For the retail trade group the Christmas sales experience obviously will be a key in determining their status, but it's too early to tell with any degree of certainty how they have been faring. Nevertheless, what we do know about final sales and production this quarter suggests a reduction in the rate of inventory accumulation and we expect the adjustment of inventories to continue next quarter. If final sales turned out to be appreciably weaker than forecasted, there of course would tend to be a deeper and perhaps more protracted drop of output in prospect to bring inventories down to levels businesses viewed as desirable. As of now, however, that does not seem the best bet.

In both the auto and housing sectors there are signs we are near or at the bottom of activity. Auto sales remain depressed, although they do not seem to be sinking further since sales for domestic producers have held at a rate somewhat above 5 million units annually from October through early December. Production is running below sales and first-quarter schedules show very little planned increases. In the housing sector starts last month didn't fall further and the reduction in mortgage commitment rates should at the margin provide a bit of an incentive to higher starts and sales volume. The forecast, however, maintains a meager recovery pattern, which is a reflection principally of the fairly high mortgage rates thought likely to prevail next year.

Consumer spending outside the auto sector rose a bit in November following a large drop in the preceding month. Consumers have been cautious in their borrowing and spending patterns, and the personal saving rate this quarter seems to be running around 6 percent--up nearly a percentage point from last quarter. We have assumed retail sales will show small increases in nominal terms this month and early next year, but this remains an area of uncertainty.

An area of greater uncertainty and one with clear downside risks is business fixed investment. In both September and October new orders for nondefense capital goods plunged and actual shipments in October were surprisingly weak. Nonresidential construction activity has shown no clear trend but if anything seems to be moving lower. As a result, we have revised business investment spending downward for the current and subsequent quarters, although the forecast still represents a mild cyclical performance compared with past recessions. The forecast attempts to allow for the fact that there already have been huge adjustments in transportation and farm equipment which is probably now largely behind us, and that the energy and defense sectors seem likely to be supportive of investment spending. Even so the recent information is disconcerting, and if we are seeing the effects of a major deterioration of business confidence then investment spending will probably move appreciably lower.

Finally, the available data on prices and wages seem to be coming in about as expected or perhaps a little better. In particular, food prices continue to rise less than we expected and goods prices on average have shown improved performance given weaker markets. Prices of services generally have continued to rise rapidly, although they typically lag and should prove responsive to smaller wage gains which are projected next year.

FOMC Briefing
S. H. Axilrod
December 22, 1981

As the Committee well knows, setting longer-run monetary targets is particularly difficult in a period, such as the present, during which innovations and regulatory changes are altering financial technology, services, and markets and leading to changes in the way the public manages its money and other assets. Many of the issues raised were discussed, perhaps in an all too compressed fashion, in the blue book section presenting considerations germaine to the Committee's preliminary review today of next year's longer-run targets. The sense of uncertainty in that discussion might be said to reflect the apparent at least partial breakdown of historical relationships between money and other key economic variables during this transition period to new financial services. From the viewpoint of the Committee, this uncertainty tends to argue, among other things, for maintaining the width of ranges at the three points that had already been tentatively decided. While a case in the abstract might even be made for a slight widening would indeed tend to reduce the credibility of the ranges as an indication of System intentions. Credibility is a critical point since a large part of the effectiveness of the present policy approach in curbing inflation depends on its effect on the public's attitude toward inflation.

The continuing strength of inflationary psychology, though showing some signs of letting up, together with the related worry about whether or not the upcoming enlarged budgetary deficit will be financed out of newly created money are factors that suggest the need to avoid indications of a weakening in the System's resolve to curb inflation over time and thus argue against upward adjustments in the monetary ranges next year from those set in 1981. And if a sense of progress in controlling inflation is to be retained, there would also be an argument for a lower M1 range, as was in fact tentatively set for 1982 by the Committee last July.

The tentative M1 range does, of course, call for more rapid money growth in 1982 than actually developed in 1981 on a QIV to QIV basis (though I might add, not necessarily a more rapid growth on a year-over-year basis). Some acceleration should be understood by the market as representing a return to somewhat more normal conditions, following the large downward shift in demand for narrow money this year. A basic problem, however, is that the public's demand for narrow money (given the Committee may view as a desirable economic performance) could, not implausibly, be either greater than the upper end of the range or even below the lower end of the tentative range for 1981. It could be above the upper end if demands for goods and services were so weak that it took substantially lower interest rates than the staff is projecting to encourage economic recovery and if these lower rates were associated with a stronger performance of NOW accounts or by a return to historical relationships among money, income, and interest rates. On the other hand, it could be below the lower end if the shift away from narrow money were as great as it apparently was in 1981. We are not assuming that it will be so great in our economic projections; nor is that result suggested by econometric methods that were reasonably successful, it turns out, in suggesting the dimensions of this year's shift.

The $2\frac{1}{2}$ to $5\frac{1}{2}$ percent range does allow some scope for both the low and high risks. A decision to alter the range would depend in part on whether the Committee judges the balance of risk to be adequately allowed for, given the need not only to continue a process that curbs inflation but also to encourage economic recovery.

The broader aggregates from one perspective provide a hedge against unanticipated behavior of M1. But they are also subject to their own uncertainties. There may be increased demand for assets included in them relative to market instruments in response to regulatory changes and financial innovations. This would tend to make broader Ms run higher than anticipated, as was the case last year.

At the same time it needs to be recognized that the behavior of the broader assets is affected by the ability of depository instititions now and of money market funds to offer returns that keep pace with market rates. This means that achieving a broad money target in the face of shifts in demands for goods and services will evoke relatively prompt interest rate responses. That is an advantage for attaining an income goal if the economy can otherwise stand the interest rate variations. However, it also means that if the wrong broad money target is chosen relative to desired income, the interest rate movements will be more destabilizing than they otherwise would be.

The FOMC's tentative ranges for 1982 for the broad Ms are unchanged from this year. On balance, our projections would suggest little scope for reducing these ranges. If the projections are right, there is a reasonable chance of actual growth in the broad Ms being within the ranges next year, though in the upper part at best. Still, this would mean that actual growth would decelerate next year from this. If that happened, it would represent a turn-around from the tendency in recent years for measured growth to accelerate or remain strong--a development probably greatly affected by the impact of financial innovation and regulatory changes on demand for broad money, given interest rates.