# APPENDIX

JLKichline
12/19/83

FOMC BRIEFING

Economic activity has been expanding at a strong rate in the fourth quarter, with real GNP estimated to be rising somewhat more than 6 percent at an annual rate. That rate of growth is, of course, less than the exceptionally rapid expansion during the spring and summer, and our interpretation of recent developments and the outlook continues to point to further deceleration early in 1984. Overall, the forecast prepared for this meeting of the Committee does not differ significantly from that presented at the last meeting.

In the current quarter, activity has been fueled by strong consumer and business spending. The dollar value of total retail sales advanced nearly 2 percent in November. Auto sales remained at the advanced level of the month earlier owing to continued very strong demand for imported models. Sales other than autos picked up in November, and given the abundance of reports that this is the best Christmas season for retailers in years, we have assumed a substantial further rise of sales during December.

Early next year, however, the forecast calls for a slackening in growth of consumer spending, consistent with a weakening of forces that presumably acted to boost spending this year--these would include the sharp rise in the stock market and the decline in interest rates in late 1982 and the first part of

this year, the mid-year tax cut, and the improved economic outlook that helped unleash pent up demands. We expect consumer income growth next year to be supportive of moderate gains in consumption, although employment growth seems likely to slow from the fast pace this year. In this connection, I might note that the November labor market surveys again reported sizable growth of employment, and with no expansion of the labor force the unemployment rate registered its second consecutive large decline. We expect the labor force to begin expanding, and with slower growth of employment, the unemployment rate is projected to move down slowly next year, but reach a bit lower level than previously projected.

On business spending, the indicators of current and future outlays have moved erratically, but on the whole they point to further appreciable growth this quarter and into 1984. Much of the strength of business fixed investment spending is focused on equipment and this component of industrial production has been rising briskly; in each of the past two months the total industrial production index rose 3/4 percent while output of business equipment averaged increases of nearly 1-1/2 percent per month. Business inventory investment has been on the uptrend and is projected to contribute to growth of activity early

next year as well; despite the turnaround in inventory investment this spring, inventory-sales ratios are still flat or declining given the surge in final sales.

Two areas of the economy acting to damp growth of activity are exports and residential construction. The persistent high foreign exchange value of the dollar and sluggish recovery abroad suggest exports will remain weak well into next year. Residential construction spending has slowed considerably and may well decline this quarter on the basis of developments through October, even assuming some uptick in housing starts during November and December; housing starts data for November will be available tomorrow morning. Around current interest rates it appears that housing market activity has about levelled out, and in fact issuance of building permits has stabilized recently. There has been an ample supply of mortgage money available and that supply has been enlarged by the recent flood of mortgage revenue bonds to beat the year-end cutoff on such financing. Overall, however, we don't expect to see much change in housing activity over the forecast period.

On the wage and price side of the forecast there have not been any significant changes. If anything the most recent news on prices has been a shade better than we might have expected. In particular, energy prices have been coming in a

little lower than projected and food prices have been rising about in line with expectations but the outlook for 1984--at least in terms of risks--seems to be improving a bit. For the four quarters of 1984 we have held to the forecast of the GNP deflator increasing 4-1/2 percent, up about 1/2 percent from the rate expected this year.

Notes for F.O.M.C. Meeting
December 20, 1983

Sam Y. Cross

The dollar has climbed steadily higher in the exchange markets, rising over the last five weeks by 2 to 4 percent against the European currencies, and posting its first significant gain against the Canadian dollar this year. Only the yen held firmly against the dollar. After the parliamentary elections the yen did fall temporarily by 1/2 to 3/4 of a percent, but it quickly recovered. Even news of a record trade deficit for October, at an annual rate of $95 billion, only temporarily slowed the appreciation of the dollar at the end of November.

On a trade-weighted average, the dollar is now at an all-time peak, and stands 56 percent above the low point reached in July 1980.

During the recent weeks, the major factor fueling the rise of the dollar was new evidence of the strong expansion in the United States economy and the implications of that for interest rates, particularly with large Treasury financing coming soon.

With healthy economic growth and restrained inflation, as well as high interest rates, the United States has remained very attractive to foreign investors. Once again demand for the dollar for investment purposes has been reinforced by concern about turbulence in the Middle East and by the malaise in Europe. Judging from market comments, there were sizable

portfolio shifts into dollars over the period. In addition, with year-end approaching and the dollar rising, many corporations that had been expecting a decline in the dollar, and consequently had delayed their dollar purchases, apparently felt they could postpone these purchases no longer.

With the dollar rising, to record levels, foreign central banks stepped up their spot and forward intervention sales of dollars. Net dollar sales by major foreign central banks, which amounted to $108 million during the second half of November, have surged to $3 billion thus far in December, more than half of it by the Bundesbank.

The mark in particular has been adversely affected by the implications of the bankruptcy of the IBH company, the difficulties of the Schroeder-Muenchmeyer Bank, and the bribery indictments against two highly-placed leaders. On December 5, as the dollar gapped higher in volatile trading, the U.S. authorities followed up Bundesbank intervention by purchasing $50 million-equivalent of marks to help restore more orderly trading conditions, which was divided equally between the Federal Reserve and the Treasury. Subsequently, the dollar continued to rise and in the last week the dollar reached a ten-year high of nearly DM2.78. The Bundesbank responded by intensifying its intervention operations, selling dollars heavily in both the spot and forward markets.

Looking back the past several quarters, the dollar has continued to strengthen even as the U.S. current account has deteriorated sharply. Thus far, capital inflows have been large enough not only to finance the burgeoning current account deficit, but also to exert upward pressure on the dollar. However, the factors generating these large capital inflows could change abruptly and the markets will be sensitive to any indications that they are changing, such as a resurgence of a high level of inflation.

Mr. Chairman, I recommend that the committee ratify the one intervention operation which was undertaken during the period--the purchase of $25 million of DM on December 5 on Federal Reserve account.

Notes for FOMC Meeting, Dec. 19-20, 1983

Peter D. Sternlight

Since the November 15 meeting, Desk operations have sought to maintain unchanged reserve pressure on the banking system, characterized by discount window borrowing of about $650 million. Incoming monetary data were mixed--holding quite close to the desired track for M2, on the high side for M3 and the low side for M1. While M1 and M3 pushed close to the lower and upper bounds of their longer-run ranges, monthly average levels remained within the specified limits, continuing the "good behavior" of other recent months. Moreover, early December data suggested a pick-up in M1 and slowing in M3 in the current month--setting the stage for a year-end result that would be within the Committee's bands for all three measures. Meantime, reports on the economy pointed to continuing strength, and this was a major factor underlying moderate increases in interest rates over the period.

While the Desk aimed steadily at reserve conditions consistent with $650 million of borrowing, actual recourse to the window varied both above and below that level--averaging fairly close to $700 million for the period as a whole. A bit curiously, borrowing was in the $800-$850 million area in the final weeks of November when the Federal funds rate softened to around 9 1/4 percent after several weeks hugging close to 9 3/8 percent, but in the first two weeks of December when borrowing fell off to about $450-$650 million, funds traded closer to 9 1/2 percent. The money market tightened appreciably at the end of the December 14 week,

partly because borrowing had run quite light early in that week, and tight conditions persisted into the current week, exacerbated by tax date pressures. So far this week, the funds rate averaged about 9 3/4 percent while borrowing has averaged over $1 billion, so at least in this week we seem to be getting a more expected combination of relatively high borrowing and firm funds, though by today funds have subsided to 9 1/2 percent. There is some anticipation in the market that the funds rate and day-to-day financing costs may tend a bit to the high side of recent experience in the period up to about year-end or a little beyond because of seasonal liquidity pressures.

Desk operations supplied a substantial amount of reserves over the period, meeting seasonal increases in required reserves and replacing the reserves absorbed by increases in currency in circulation. The System bought Treasury bills from foreign accounts on most days of the period, totaling about $2.2 billion, and about $2 billion of bills was bought in a market go-around on December 14, for total outright purchases of about $4.2 billion. The System had also bought nearly $ 1 1/2 billion of Treasury coupon issues the day of the last meeting, which counted against the intermeeting leeway for the period ended November 15. In the latest period there was a small offset to the rise in outright holdings through redemptions of about $85 million in maturing agency issues. Reserve supplies were augmented on most days by passing through to the market part of the foreign account repurchase orders, while System repurchase agreements were used on one occasion.

Incidentally, you may find it noteworthy, even startling, that the System's outright securities holdings are up so far this

year by some $16 billion--a record by far. Chiefly, this was needed to offset the roughly $14 billion rise in currency in circulation.

Market interest rates generally rose in the interval since the last meeting, chiefly in the latter part of the period when sentiment seemed to be dominated by news of continuing strong growth in the economy, and conjecture that the System just had, or was just about to, firm up a bit on reserve conditions. Early in the period we were treated for a while to an array of market views that included both easing and tightening hypotheses as well as adherents to a no-change view. Those sensing an easing noted the lower Federal funds rate in the final weeks of November, and they also drew support from the reference in the last published policy record to the System having aimed for slightly less restraint before the October meeting. At the very same time, other observers noted a succession of a few weeks with relatively high borrowings and deep net borrowed reserve numbers and were inclined to conclude that some modest firming was intended. As the period progressed, the weight of opinion shifted more to a division between the no-change and slight firming schools, influenced by the rise in the funds rate and the continuation of strong numbers on the economy--notably the employment and retail trade data for November. The reduction in published levels of borrowing and net borrowed reserves in the last couple of weeks seemed to be pretty much shrugged off.

An additional factor weighing on the market was the press of Treasury offerings in late November, once the debt ceiling legislation was passed, and then the prospective schedule of fresh

Treasury supplies, with particular concern about the notes and bonds to be auctioned in the week between Christmas and New Year's Day. Dealers have tended to position themselves for the expected spate of offerings by lightening up and even establishing sizable short positions.

For the full intermeeting period, yields on intermediate to long-term Treasury issues rose about 20 to 30 basis points, with longer maturities approaching the highs of last August. As yields reached higher levels in the last few days, some investor demand began to emerge, and it may be that a rate level has been attained at which the market is prepared to take on the large supplies soon to come from the Treasury. Corporate and municipal yields rose about in line with Treasury issues, but with a relatively heavy atmosphere in the tax-exempt sector because of the large calendar of offerings and substantial inventories.

At the short-end, Treasury bill rates also rose about 20 to 35 basis points over the period. Three- and six-month bills were auctioned yesterday at 9.04 and 9.24 percent, up from 8.78 and 8.91 just before the last meeting. Rates on commercial paper and CDs rose about 55 to 75 basis points over the period, thus widening somewhat the yield spread of these instruments over bills. These spreads remain fairly narrow in the perspective of long-term experience, however.

Overall the current market mood might be described as guarded, and mildly apprehensive. A slight firming of policy--such as might be expected to carry Federal funds rates to the area of 9 1/2 percent or a shade higher--has probably been discounted.

Primary market focus is on the business situation, which most observers see as one of continuing strength for the time being. As horizons stretch into next year, opinions diverge as to whether one might expect further upward rate pressure because of a collision of private and public sector credit demands, or some abatment because a slowdown in private sector strength makes more room for the Treasury.

Request for continued enlarged leeway:

Mr. Chairman, looking ahead to prospective Desk operations in the next several weeks, I believe it would be advisable to retain the $5 billion intermeeting leeway for change in outright holdings adopted at the last meeting. This time the enlargement would be needed to cope with seasonal declines in currency and deposit levels. Also, if the intermeeting period extends into early February, we would come up to the final phase-down step of reserve requirement ratios for member banks stemming from the Monetary Control Act.

FOMC Briefing
SHAxilrod
Dec. 20, 1983

Mr. Chairman, my briefing will focus on M1, not because I want to overstress it, but because M1 is the aggregate recently showing the most variable behavior relative to norms, so to speak; thus it is most in need of analysis, particularly since in the past its variations over a period of months have at times provided a reasonably good signal for policy. As you can see from the alternatives presented in the blue book, we still believe that at something like present interest rates M1 growth will rebound from the sluggish pace shown over the 4 months ending in November, and we also believe that rebound will develop in the context of continued moderate growth in the broader aggregates. The growth in M1 of 6 percent at an annual rate that we are projecting over the first three months of 1984 under alternative B is in fact lower than the several models I have looked at would suggest, given a funds rate of around 9-1/2 percent and expansion in nominal GNP at the 10 percent annual rate projected for the coming quarter. Thus, at least as compared with these models, we have assumed that somewhat more of what might be termed an unwinding of the very large M1 build-up of 1982 through the first half '83 will continue into early next year.

One obvious near-term policy issue is how should the Committee react if M1 comes in significantly different from such expectations (assuming for the moment that those expectations are satisfactory). If relative weakness or strength in M1 corresponds also with weakness or strength in the broad aggregates and the economy, the answer would seem to be fairly clear. But the Committee has not for some time been in the relatively fortunate position where all of the aggregates and the economy have together given off unequivocal policy signals. Thus, if the past is

any guide, judgments may need to be made about the significance if any for policy of deviations in M1 from expectations in the context of reasonably acceptable behavior of the broader aggregates and probably uncertain signals from the real and price sides.

While statistical analysis has obvious deficiencies as an aid for making such judgments, it may make a marginal contribution. One might first note that over the four quarters ending with the third quarter of 1983, both our quarterly and monthly models underpredicted actual M1 growth in the range of 3 to 4 percent for that one-year period. If the excess of actual M1 relative to model predictions is taken, roughly, as a gauge of the amount of M1 that might eventually support additional spending as confidence is more fully restored--rather than retained as desired cash balances given the level of interest rates and income--then one might say that the shortfall in M1 growth during the fourth quarter would not itself be an event suggesting the need for an easing in policy. In an arithmetic sense, the fourth quarter of 1983 shortfall "makes up" for about 25 to 30 percent of the earlier noted 3 to 4 percent overshoot. A 6 percent actual growth in the first quarter of '84, given the expected GNP and unchanged interest rates, would make up for another 10 to 15 percent. All of this perhaps excessive statistical analysis tends to support a view that further shortfalls from expectations can be regarded with some equanimity, up to a point, in the context of reasonable behavior of the economy and other aggregates.

The arithmetic may well overstate, however, the potential for taking shortfalls in stride. Allowance should clearly be made for the inherent uncertainties of econometric analysis, particularly under conditions of institutional change. Some analysts for instance may contend

that virtually all of the earlier large M1 growth was predictable, given interest rate behavior. Others may assert that the M1 growth of 1982 and the first half of 1983 simply makes up for the undue weakness in 1981. Both groups would presumably contend that the recent slowdown in M1 would represent more of a worrisome new tendency rather than a desirable offset to earlier strength.

In general, under current circumstances assessment of the significance for policy of the recent slowdown in M1 growth seems inevitably ambiguous. If one views the recent slowdown in the context of rapid growth in M1 over the whole year 1983, a growth that follows relatively fast growth in 1982, one might not worry much about the potential for an undue deceleration in economic activity, and one might even be concerned about inflationary possibilities, particularly with fiscal policy remaining highly stimulative. On the other hand, if emphasis is instead placed only on the recent slowdown in M1 growth, recessionary concerns would become more prominent.

Those twin possibilities might argue for treating symmetrically the implications for bank reserve positions of overshoots or undershoots in M1 relative to path over the coming months, assuming there is going to be any response at all given behavior of the broader aggregates and the economy. However, it is plausible to me that there is still some room--in view of the sizable earlier growth in M1--for permitting at least some degree of relatively slow growth in M1 for a time, particularly if the economy continues reasonably strong. That reasoning would seem to suggest a degree of asymmetry in response to deviations in M1 from expectations such as those associated with alternative B--with undershoots being a bit less of concern than overshoots.

# APPENDIX

January 18, 1983

TO: Federal Open Market Committee

FROM: S. H. Axilrod

As mentioned by Chairman Volcker last Friday, a framework for specifying and explaining the operational meaning of longer-run monetary and credit targets for 1983 is attached for consideration. Such a framework provides a basis for construction of the directive to be adopted at the February meeting and for explanation in the semi-annual report to Congress. Specific numerical alternatives for the longer-term ranges for 1983 will be presented in the February blue book.

Attachment

January 18, 1983

The Federal Open Market Committee established growth ranges for M2 and M3 in 1983 of ___ to ___ and ___ to ___ percent, respectively. In association with these objectives, total credit was expected to expand in a ___ to ___ percent range. The Committee agreed that specification of a growth range for M1 was not feasible at this time because of distortions introduced by the transition to the money market deposit accounts (MMDAs) and super-NOW accounts that depository institutions have been able to offer at competitive market interest rates since mid-December and early January, respectively.

The super-NOWs are included in M1, but MMDAs, because of their more limited transactions features, are included only in the broader monetary aggregates. In the transition period, the nature and meaning of M1 may change substantially, as some investment-type funds shift into M1 through super-NOW accounts and some transactions funds shift out of M1 into MMDAs. Even after the bulk of shifts has been completed, the behavior of M1 will be difficult to evaluate before some experience is gained.

Nonetheless, the Committee intends to monitor developments with respect to M1 closely, in conjunction with the behavior of the broader monetary aggregates that will serve as the principal guides for monetary policy at least over the next several months. At the time of the mid-year report to Congress, the Committee will again assess the feasibility of providing a numerical specification for M1.

The behavior of the broader monetary aggregates will also be influenced in some degree by shifts of funds generated by the introduction of the new deposit accounts, with effects larger on M2 than on M3. Even

though the bulk of shifts is likely to be among components of these aggregates and thus will not affect the totals, shifts into MMDAs from market instruments, or from large time deposits currently included only in M3, will work to raise M2, especially early in the year when most of the adjustments are expected to take place. [Insert sentence about how ranges adopted for 1983, and possibly expected actual behavior relative to them, may be influenced by shifts.]

In assessing the performance of the aggregates over the year, and recognizing the inherent volatility of money and credit aggregates, the Committee will look not only to their growth from QIV '82 to QIV '83, but also will evaluate emerging trends on a year-over-year basis. Because growth of M2 and possibly also M3 may be higher relative to target early in the year, this would contribute to raising growth on a year-over-year basis. [The following language suggests an alternative method for basing the monetary aggregates in 1983: To reduce the distorting influence on growth ranges of the large-scale shifts of funds since the last half of December stemming from the public's initial adjustment to the newly available deposit accounts, the Committee's ranges for M2 and M3 represent annual rates of growth from the average levels of these aggregates outstanding in the three-month period from December '82 to February '83 (or two months from January '82 to February '83) to the average level in QIV '83.]

The associated range for total credit expansion provides a broader context for helping to interpret the behavior of the monetary aggregates over the course of the year as well as the thrust of monetary policy. This range represents the percentage increase in funds raised by domestic

nonfinancial sectors in the form of debt [and equity issues]. Such an aggregate is not likely to be much affected by shifting preferences by the public for various financial assets, including money and near-money assets, and by changes in the extent to which borrowers obtain the credit needed to finance economic recovery at depository institutions or in the open market.

Historical experience nonetheless suggests that the relationships to nominal GNP of credit aggregates, as well as of monetary aggregates, are relatively loose. On the credit side, spending can be financed out of internal cash flows or by drawing down existing assets, rather than by net additions to debt. On the side of money, existing cash balances can be employed more or less intensively in financing economic activity, as reflected in variations in the velocity of money. The broader aggregates, which are not closely related to the reserve base of depository institutions and which are largely composed of assets offering market interest rates, tend to fluctuate with credit demands, the aggressiveness with which institutions seek funds, and the public's savings propensities.

Thus, the implementation of monetary policy necessarily also involves evaluation of evolving market conditions, as typified by trends in domestic interest rates and the foreign exchange value of the dollar as well as by ongoing changes in the velocity of money or credit. They provide information about market expectations, demands for liquidity, attitudes toward inflation or disinflation, and the strength or weakness of credit demands that contributes to assessment of money and credit behavior in relation to the ranges set for them and the performance of the economy.