APPENDIX

Notes for FOMC Meeting
September 23, 1986

Sam Y. Cross

Dollar exchange rates now show very little net change from levels at the time of your last meeting, although there have been shifts of market psychology in both directions. These changes occurred in the wake of actual and anticipated intervention by the Europeans, and conflicting comments by European and U.S. Administration officials about the possible need for further rate movements, and a changing outlook for the U.S. and global economy.

Looking back to your last meeting, the market response to the August 20 cut in the Federal Reserve discount rate was muted. In fact, there was initially a slight rise in the dollar. The dollar's resilience at that time was largely due to market expectations that Japan and Germany might soon follow with similar cuts in their official interest rates.

Throughout late August and early September, it appeared that changes in the global economic environment were favoring some stabilization of dollar exchange rates. Despite the large trade imbalances announced at that time, market participants began to feel that there were some signs of economic adjustment on the horizon. Statistics on U.S. employment and business activity suggested that the economy was beginning to revive. Moreover, evidence of economic growth in Germany and Japan was viewed as favorable to the dollar since growth abroad would help reduce the trade imbalances and alleviate pressures for protectionism. Thus many in the market felt that we had entered a period of consolidation, where exchange rates might tend to stabilize while economies adjusted to the new economic environment without further interest rate cuts.

Against this background, market professionals anticipated there might be short-term bidding for dollars, in part for technical reasons. The dollar rose in early September, and hit its high for the period in European trading on September 12, when it reached 2.10 DM--about 3 percent above the levels of the beginning of the period. At that time, the Bundesbank intervened openly in the market to sell dollars and the dollar fell to 2.06 DM.

Market participants were caught totally by surprise by the Bundesbank intervention and abruptly shifted their perception of the near-term outlook for the dollar. Only a few days earlier, many had talked about the prospects that the Bundesbank might intervene to buy dollars to slow the mark's rise. The market quickly decided that the dollar would not be allowed to rise very far. This view was reinforced by subsequent remarks by Bundesbank President Poehl indicating that, given the strength of the domestic economy, the Bundesbank would not cut its interest rates soon, and suggesting that Germany was prepared to accept a stronger mark as its contribution to international adjustment.

A subsequent interview with Secretary Baker, in which he stated that without additional measures to promote higher growth abroad there would need to be further exchange rate changes to reduce trade imbalances, then helped push the dollar below the 2.00 mark level.

The mark rose strongly not only against the dollar but against all currencies and brought the EMS under considerable pressure. After the Bundesbank intervention and the Poehl statement, other EMS central banks intervened heavily to limit the decline of their currencies against the mark, and in the last 3 days of last week sold   billion of Deutsche marks. These pressures led to an EC understanding reported over the weekend on joint European intervention as they put it, "to halt the slide of the dollar against the mark." In Asia-Pacific markets, there was a scramble to cover short positions and the dollar shot up from around 1.99 DM to 2.07 DM, before easing back to trade in Europe and the U.S. around 2.03 DM. (The dollar is trading above 2.04 DM this morning.) At present, the market remains extremely sensitive to further official discussion of exchange rates and economic policy which might be expected to come out of IMF and other meetings over the next week.

Peter D. Sternlight
Notes for FOMC Meeting
September 23, 1986

Domestic Desk operations during the five-week intermeeting period have been directed at maintaining the slightly easier conditions of reserve availability agreed on at the August meeting, and embodied in the 1/2 percentage point discount rate cut shortly after that meeting. Both before and after the discount rate change, the reserve path continued to allow for $300 million of adjustment and seasonal borrowing. While making no formal change in this allowance, the Desk was a touch more cautious in providing reserves in the latter part of the period, seeking to guard against inadvertent over-abundance of reserves that might fuel unwarranted market expectations of still further accommodation. This was in a context of strong growth in the broad aggregates and mixed evidence on the economy that at least did not suggest greater weakness.

In the August 27 reserve period, borrowing was just under $400 million, but after allowing for "special situation" borrowing in the earlier part of that period which was not formally classified as extended credit, the borrowing could be regarded as very close to the $300 million path level. In the September 10 period, borrowing was averaging slightly under $300 million until the final day, when a large bulge pulled the average up to about $520 million. It was only on that final day that we learned about a $400 million upward revision in required reserves, and hence in the reserve path, so that while in the several preceding days we perceived only a slight reserve need, we suddenly faced a large projected need on that final day. Curiously, the money market did not reflect that need during our normal operating time--conditions did not tighten until very late in the day when there was no other source but the window. So far in the current period--through Sunday--borrowing has averaged about $365 million.

Responding chiefly to the lower discount rate, federal funds fell off from around 6-3/8 percent in the first few weeks of August to around 5-7/8 percent or a shade lower in late August and much of September. So far in the current maintenance period, funds trading has averaged about 5.85 percent.

Reserve needs generated by currency increases, higher required reserves and larger Treasury balances were met through a combination of outright purchases and repurchase agreements. Outright buying of bills totaled nearly $3 billion, including about $2.1 billion bought in the market early in the period and the balance bought in small amounts from foreign accounts throughout the period. There was a modest agency issue redemption late in the period. Customer repurchase agreements were arranged nine times while six-day System repurchase transactions were used last Friday to cope with the reserve impact of swollen Treasury balances following the September tax date.

The yield curve steepened sharply during the recent period, reflecting a distinct change of mood among market participants. At the short end of the maturity scale, bill yields came down about 20 to 40 basis points, responding essentially to the discount rate and lower federal funds rate--which had already been anticipated and discounted to some extent. Three- and six-month bills were auctioned yesterday at about 5.25 and 5.39 percent compared with 5.64 and 5.65 percent just before the last meeting.

For intermediate- and longer-term issues, it was a different story as the market was affected by a mingling of many factors, most of which boiled down to concerns about future inflation. Some analysts cited recent evidence of actual spot and futures price increases of commodities. Early in the interval, note was taken of firming oil prices as OPEC production cuts took effect. Scattered signs of improvement in the economy also got attention, although the predominant view was still that the economy remained sluggish. Some participants saw reason for concern in the top-of-the-range performance of the broader money aggregates. In some cases this concerned them because they thought it kept the Fed from easing further, while others said this might _not_ keep the Fed from easing and that possibility bothered them even more about future inflation potential. Some similar thoughts were expressed about the possibility of a further discount rate cut. Mainly, the near-term prospects for such a cut were seen as fading, but a few worried that a further cut would be undertaken and would add to already ample liquidity. The budget deficit also attracted fresh concern after having receded from market participants' attention span. There has been a sense of frustration that the Gramm-Rudman disciplines are slipping away. Hopes that key foreign countries would cut their rates alternately waxed and waned, but they seem pretty dim at the moment and this was taken as discouraging. Late in the period, the weaker dollar was further cause for concern, being seen as a factor that would tend to inhibit further U.S. policy accommodation while also discouraging foreign investors from buying our securities. Although some of these factors are contradictory to one another, the market tended to focus on the negative elements of each. Even where no great resurgence of inflation was seen, there was a sense of distinctly limited possibilities for fresh declines in longer rates.

Altogether, the result was a notable lack of investor buying interest. Along with efforts to shorten up on existing holding, this produced yield increases in Treasury issues that ranged from about 1/8 percentage point in the 2-year area to about 1/2 or 5/8 percentage point at the longer end. New Treasury borrowing was about $20 billion over the five-week period, about equally divided between bills and coupon issues. Another $3 billion of new money from coupon issues will come from the 2-year note being auctioned today and 4-year note to be sold tomorrow. A 7-year issue was also announced, but it's being held in abeyance pending Congressional action on the debt ceiling.

I should note that the bearishness on interest rates is not universal, and it could be said that with the recent rise in longer rates, conditions are about in balance. Some observers, particularly the "economist" types rather than the "market" types, see little likelihood of inflation regaining a strong foothold any time soon. Given that view, and seeing a still soft economy, a few still expect another discount rate cut near term, especially if it can be coordinated with other countries--but most participants do not look for this, and some, as noted, even feel it could have an adverse market impact just now.

James L. Kichline
September 23, 1986

FOMC BRIEFING

Information that has become available since the last meeting of the Committee points to some pickup in the economy during the summer. At an aggregate level, the rise in activity is roughly consistent with the staff's expectations, and consequently changes to the forecast are of a minor nature. Real GNP is projected to grow at a 3 percent annual rate during the current quarter and is expected to rise to the 4 percent area in the fourth quarter before settling to around 3 percent next year. Wage and price inflation trends have remained moderate.

The labor market report for August was appreciably stronger than those in the preceding couple of months. Nonfarm employment gains were sizable and widespread, even including a small rise in manufacturing employment, while the unemployment rate edged down to 6.8 percent, nearly 1/2 percentage point below the second quarter average. Industrial output only rose .1 percent in August, but data for June and July were revised upward. We anticipate a further rise of output in September, helped partly by a rebound in truck and automobile production.

Consumer spending has continued to post large gains. In the auto market, the latest round of sales incentives led to a skyrocketing of sales early in September and these programs seem to be a success in cleaning up excess stocks of 1986 models. Currently, domestic auto makers are scheduling a sharp increase in production for the fourth quarter; these plans seem unrealistic and we have assumed they will be scaled down as sales slump following this most recent round of incentives. Nonetheless, the auto sector is still expected to contribute about 3/4 percentage point to real GNP growth next quarter after depressing activity by almost 1/2 percentage point in the third quarter.

Outside of autos, consumer purchases of goods and services also have been strong. In fact, the personal expenditures data for August, released after we prepared the forecast, were somewhat higher than anticipated. Looking ahead, we still expect that slower growth of disposable income, waning wealth effects, and high debt burdens will combine to produce more moderate growth of consumption spending than experienced over the first three quarters of this year.

In the housing market, total starts in August remained at their relatively high July level. While the single-family market appears likely to continue rather strong in the present financial environment, high rental vacancy rates and tax reform are expected to produce further declines of starts in the multifamily market. Thus, beyond the third quarter residential construction in the forecast is not expected to contribute to growth of real GNP.

Indicators of business fixed investment have been mixed of late. Orders for nondefense capital goods rose considerably in July but the report for August--available this morning--showed a drop, leaving orders 1-1/2 percent above their second-quarter average. Current and prospective nonresidential structures activity is weak; while the drop in oil drilling activity seems to be bottoming out, the office building sector is in a major decline that we believe will continue through 1987. On balance, business fixed investment spending is not likely to provide much support to economic growth in coming quarters given ample capacity, sluggish corporate profits, and higher costs of capital stemming from tax reform.

Where all this leads to is an expectation that growth of domestic purchases will be slowing over the forecast period. Real GNP growth prospects continue to hinge importantly on an improvement in our external accounts, but given lags in data and in economic responses we do not yet have confirming evidence of such an improvement.

Wage and price inflation continues moderate and the forecast has not been changed in any material fashion. Wage rate increases continue to be somewhat less than last year and there aren't signs of any change in the pattern. Recent monthly measures of prices have been affected principally by food and energy developments, while other prices are rising at about the pace seen earlier in the year. The CPI for August, which was released this morning, continued the pattern. The CPI for all items rose 0.2 percent, with food prices up 0.9 percent and energy prices down 1.9 percent. One surprise in the report is the fall in gasoline prices that appeared in the PPI as well; information from spot markets and private retail surveys suggests that prices rose after July and we expect the CPI and PPI to show higher prices for September.

Finally, on the fiscal situation, the staff's forecast entails a shift in the federal budget toward restraint in fiscal year 1987 of $25 billion on a high employment basis. This is somewhat less than assumed previously, owing to a reduction in estimated receipts from tax reform and prospective higher outlays. The recent flurry of activity in the Congress to avoid sequestration under Gramm-Rudman undoubtedly will be successful on paper, but the bulk of the actions contemplated--such as asset sales--do little if anything to reduce deficits beyond the next year.

FOMC BRIEFING
Donald L. Kohn
September 23, 1986

The period since the last Committee meeting has been marked by a number of important developments in financial flows and markets--as well as in the real economy as reviewed by Mr. Kichline--that may have a bearing on the Committee's decision at this meeting. Growth in the broad monetary aggregates slowed in August and further moderation--at least in M2--appears in train in September. Nonetheless, both M2 and M3 appear to be running above the 7 to 9 percent short-run path set by the Committee, and are around the upper ends of their longer-run ranges. M1 actually accelerated in August; though its growth appears to have dropped off substantially in September, it seems to be increasing on average over the third quarter at close to the extraordinary pace of the second quarter. And debt has continued to expand very rapidly.

In financial markets, while short-term rates fell along with the cut in the discount rate, bond yields have risen appreciably and stock prices have fallen sharply. The behavior of long-term security markets reflects in part the perception that there was now some risk that short-term rates might move higher in the foreseeable future. Data over the intermeeting period suggested that the possibility of a stronger economy could not be ruled out. And this circumstance, along with the supply-side effects of the possible revival of the oil cartel, raised the specter of greater inflationary pressures. In addition, questions about the demand for dollar assets arose late last week when the foreign exchange value of the dollar dropped abruptly.

Over the balance of the year, the staff is projecting that, if current money market conditions are maintained, the broad monetary aggregates will remain right around the upper bounds of their longer-run ranges. The risk of exceeding the ranges is obviously greater under the easier conditions of alternative A and less under the tighter conditions of alternative C, although the differences in the QIV-to-QIV growth rates are not very large, since any change in reserve conditions would not have much time to affect the fourth-quarter average level of the aggregates. The bluebook paths for the rest of the year incorporate some slowing in growth of the broad aggregates relative to July and August--especially under alternatives B and C. This is based on the usual presumption that at least some of the flows this summer represented one-time portfolio adjustments in response to previous rate decreases, and that the attractiveness of M2 components will erode as offering rates on liquid deposits are reduced, albeit at a sluggish pace. In addition, we do not expect bank credit growth to be sustained at the unusually rapid pace of the past few months, when there were large net additions to securities portfolios, and that should help to restrain issuance of managed liabilities in the broader aggregates even as core deposit flows moderate.

These projections of monetary growth are subject to more than the usual substantial uncertainties, however, owing to questions about the effect of developments in financial markets on the behavior of depositories and depositors in two particular areas. One, stressed in the bluebook, involves deposit rates, especially on NOW and savings accounts, which will be under pressure over coming months to be reduced to below their previous regulatory ceilings. The bluebook paths assumed that this adjustment will continue to be gradual, but once the competitive log jam around these seemingly sensitive levels is broken, deposit rates could fall appreciably and significantly retard M2 growth. The other area of uncertainty, potentially working in the opposite direction, involves the public's portfolio preferences in the wake of recent price movements in capital markets. Strong demands for bond and stock mutual funds in 1985 and thus far in 1986 probably have restrained M2 growth. However there were reports associated with the drop in stock and bond prices, that shifts out of such funds were occurring or anticipated. The most recent data on money market funds do show an unusually large increase, perhaps reflecting shifts within families of mutual funds. This could be a one-time phenomenon, or the recent performance of longer-term markets could cause a more fundamental reappraisal of their prospects, boosting demands for more liquid assets in M2 by the money-holding public.

In any case, growth in the broader aggregates is expected to exceed the expansion of income again in the fourth quarter, contributing to a further decline in velocity this year--of nearly 4 percent--following decreases in 1985 as well. Two years of falling velocity is less unusual for M3, whose velocity has been on a long downward trend, than for M2, whose velocity has changed little on balance over long periods. Although there is much uncertainty about the determinants of M2 demand, especially in light of the deregulation of deposit offering rates, it seems likely that the declines in M2 velocity both this year and last are primarily attributable to the effects of decreases in market interest rates on the opportunity costs of holding this aggregate.

This interpretation of money and velocity again underscores the need to look at interest rates as well as money growth in assessing the thrust of policy. Certainly one interpretation of the behavior of bond markets recently is that market participants believe that policy has reduced short-term rates sufficiently to spark a reasonably robust expansion of economic activity, with some risk that inflation could be rekindled. The staff greenbook forecast was based on an analysis that demands on the U.S. economy would be sufficiently strong to support 3 percent output growth at around the current level of interest rates in the near term, and with short-term rates a bit more likely to rise than to fall over the coming year. Consistent with this forecast is the notion that real interest rates are not unusually high by historic standards. Certainly at the shorter end of the maturity spectrum real rates have dropped somewhat recently as nominal short-term rates declined while inflation expectations likely have risen a little. Based on survey results, expectations of inflation over the next year seem to be in a range around 4 percent. On this basis, real, before tax, one-year Treasury bill rates are in the neighborhood of 2 percent, above the negative values of realized real rates in the late 1970's, but close to those of the 1960's.

Finally, I might note that the directive language suggested for Committee consideration in the bluebook simply would follow the current structure closely. It would omit a numerical specification for M1, and intermeeting changes in the stance of reserve provision would be keyed to the usual list of factors including the behavior of the monetary aggregates, the economy, etc. In this regard, the Committee might want to pay particular attention to how it wished Desk operations to be influenced by any tendency for M2 and M3 to run above their paths--especially if it were to choose something like alternative B with essentially unchanged reserve conditions and expectations that the broad aggregates would run along the top of their ranges. Of course, any reaction to an unexpected surge in money growth would need to be considered in the context of incoming data on the economy and prices and developments in foreign exchange markets. However, the failure to respond noticeably to an overage in M2 and M3 might raise additional questions about the operational significance of the money growth ranges and, if the economy and prices were also showing some strength, possibly about the Federal Reserve's commitment to its anti-inflation objectives.