APPENDIX

NOTES FOR F.O.M.C. MEETING
November 16, 1982

Sam Y. Cross

Mr. Chairman:

The theme of the exchange market continues to be the unremitting strength of the dollar. The dollar has edged higher against most other currencies to levels not recorded since 1976 or earlier; in terms of trade-weighted averages of all major currencies, it has reached peaks never attained since these calculations began in 1970. While there have to be very serious doubts about our competitiveness at present exchange rates, particularly once the world economy starts growing, market psychology toward the dollar is nonetheless exceedingly bullish, in part because traders who bet against the dollar at times this year have been burned repeatedly and are wary of taking short positions.

In mid-October, when the announcement was made that less emphasis would be placed on M1 as an operating target of monetary policy, there were expectations of lower U.S. interest rates that would lead to a lower dollar. The failure of this to happen reflected several factors. First, the exchange market subsequently revised its view and decided that monetary policy had not been so fundamentally altered. Second, it was thought that foreign authorities, faced with weak economies and record unemployment, would move quickly to relax their own monetary conditions any time exchange rate constraints permitted. Third, with our progress on inflation, it was felt that real interest rates in the U.S. were still very high, both

absolutely and relative to other countries. Indeed, actual and expected declines in U.S. interest rates have fueled rallies in our financial markets that attract funds from foreign investors seeking capital appreciation.

The dollar's strength continues to have many foundations other than interest rates. Also, the dollar continues to be attractive as a safe haven currency, with concerns over the future leadership of Russia and the future sovereignty of Hong Kong being the most recent additions to the list of things for international investors to worry about.

The weaker than expected performance of our economy in the third quarter has, perhaps only temporarily but nonetheless effectively, upstaged concern about the fiscal deficit. The prospect that our economy may be closer than others to the forefront of recovery makes it attractive to investment. There is a continuing demand for dollar liquidity--indeed, there may be a build-up of dollar needs as those who postponed their dollar purchases on the expectation of lower exchange rates late in the year after interest rates fell are now confronted with a strong dollar and only a few weeks to meet their requirements before year-end.

There were some worries before the November elections that U.S. policy making could become stalemated by conflicts between the White House and the Congress, but these were dispelled when the results proved less a setback for the Administration than expected, and the exchange market's confidence in the cohesion of U.S. policy was confirmed.

The market's psychology is now such that almost any event can trigger dollar purchases. We had the experience last week when the playing of sad music on the Russian radio stations caused a rise in the dollar in the Far East, and the markets speculated for several hours on what was happening, until Brez hnev's death was subsequently announced.

At the time of the last FOMC meeting, when the dollar was bid up sharply, the Trading Desk intervened in New York, on 3 days, on behalf of the Federal Reserve and the Treasury to purchase modest amounts of German marks and Japanese yen. These operations helped to slow the dollar's rise at that time.

Since the Committee's last meeting, the Bank of Mexico drew $ 587 million on the combined U.S.-B.I.S. credit facility of $1.85 billion. In total, just over $1 billion has now been drawn, leaving nearly $850 million still available.

Also, since the last meeting, the Bank of Mexico has been granted a three-month renewal of a $700 million drawing on its regular Federal Reserve swap line, separate from the U.S.-B.I.S. facility.

Recommendations

All of the Federal Reserve System's regular swap arrangements with foreign central banks and the BIS will mature in December. I recommend. Mr. Chairman, that the following arrangements be renewed with no changes in their terms for one more year:

Maturing swap arrangements:

With	Amount ($ millions)	Term	Maturity Date
Austrian National Bank	250.0	12 mos.	12/ 3/82
Bank of England	3,000.0	"	12/ 3/82
Bank of Japan	5,000.0	"	12/ 3/82
Bank of Mexico	700.0	"	12/ 3/82
Bank of Norway	250.0	"	12/ 3/82
Bank of Sweden	300.0	"	12/ 3/82
Swiss National Bank	4,000.0	"	12/ 3/82
Bank for International Settlements --			
Swiss francs	600.0	"	12/ 3/82
Other authorized European currencies	1,250.0	"	12/ 3/82
National Bank of Belgium	1,000.0	"	12/17/82
National Bank of Denmark	250.0	"	12/29/82
German Federal Bank	6,000.0	"	12/29/82
Bank of France	2,000.0	"	12/29/82
Netherlands Bank	500.0	"	12/29/82
Bank of Canada	2,000.0	"	12/29/82
Bank of Italy	3,000.0	"	12/29/82

In addition, six swap drawings, totaling $46 million, by the Bank of Mexico under the $325 million special swap arrangement--extended as part of the $1.85 billion combined credit facility to Mexico--will mature between December 7, 1982 and December 21 1982. I recommend that these drawings, listed below, be extended for three more months.

Maturing swap commitments:

Line in continuous use since	Institution	Amount ($ millions)	Maturity	Current Term
9/7/82	Bank of Mexico	13.7 1st R.	12/ 7/82	3 mos.
		6.8 1st R.	12/15/82	"
		2.3 1st R.	12/16/82	"
		1.9 1st R.	12/17/82	"
		8.2 1st R.	12/20/82	"
		13.1 1st R.	12/21/82	"
	Total	46.0		

This will represent the first renewal of the drawings.

PETER D. STERNLIGHT
NOTES FOR FOMC MEETING
NOVEMBER 16, 1982

System open market operations since the last meeting of the Committee were conducted against a background of widespread market expectations of declining interest rates--but also of a strengthening in M2 growth which tended to limit the scope for accommodation of such declines. Growth in M1 was quite rapid over the period, reaching a 20 percent annual rate in October, much of it attributable to temporary holdings of transactions balances in the wake of heavy maturities of All-Savers Certificates. The rapid M1 growth was essentially accommodated through periodic adjustments of the reserve paths in line with the Committee's decisions at the last meeting.

As for M2, in the early part of the period, it looked as though growth was proceeding at or even slightly below the modest pace anticipated at the time of the October meeting. By late October, however, it became clear that the month's growth was pushing ahead more strongly than expected earlier. The October growth rate of about 8 percent was still in line with the Committee's desired quarterly growth rate of 8 1/2 to 9 1/2 percent, but the late October information suggested levels exceeding a path consistent with the preferred growth rate for the quarter. In line with the Committee's admonition for flexibility in assessing the implications of substantial monetary growth that might be an outcome of increased precautionary demands for liquidity, part of the M2 strength was accommodated, but a portion also tended

to show through as demand for reserves somewhat in excess of the desired path. Thus while reserves ran a shade below path in the first three-week subperiod, demand was perceived to be somewhat above path in the second three-week period. Consistent with this, adjustment and seasonal borrowing ran a little below the initial $300 million assumption in the first three weeks, but above in the second subperiod. In fact, because of a particular bulge in borrowing last Wednesday, November 10, which also carried over to the Veterans Day holiday on November 11, it looks as though borrowing in the second three-week subperiod could be on the order of $450 million or so. This margin above the initial $300 million borrowing level could be regarded as reflecting both a modest rise in demand for reserves above path, roughly on the order of $50 million, and the aforementioned November 10-11 bulge in borrowing. Because of the distortion to this current week's borrowing level due to the high figure on November 11, this week's assumed path level of borrowing is $550 million.

Federal funds typically traded close to the 9 1/2 percent discount rate made effective early in the interval, compared with rates somewhat over 10 percent through much of September. While one might have expected the pervailing borrowing levels to be associated with funds trading, if anything, a little above the discount rate, the widespread anticipation of an early further reduction in that rate often tended to bias the day-to-day funds rate a bit lower. In the current week, however, affected in part by the tightness that carried over from the end of the November 10 week, funds have averaged about 9 5/8 percent so far.

Outright transactions to affect reserves over the period were virtually all on the buy side, including about $1.2 billion of bill purchases from foreign accounts, and $1.3 billion of bill purchases in the market. On other occasions, reserve adjustments were made with short-term repurchase agreements, either passing through part of foreign account repos to the market or arranging the System's own repurchase transactions in the market. On a few occasions reserves were withdrawn through short-term matched sale-purchase transactions in the market, in addition to such transactions arranged routinely each day with foreign accounts.

Most market interest rates declined since the early October meeting, especially in the days immediately after the meeting when the press focused on reports of Federal Reserve intentions to de-emphasize M1 for the time being and, by some accounts, to pursue a more accommodative course in view of the weak economy. Further along into the period, rates showed mixed movements, backing up on occasion in response to temporary indigestion and disappointment that a lower funds rate and further discount rate decline were not forthcoming more promptly, but also edging down further at other times in response to signs of weakness in the economy, moderation of inflation, and periodic renewal of hopes for an early discount rate cut. Those hopes are still there, although they have eroded in recent days, and yesterday's money numbers provided a further dampening.

Among the more significant rate reductions since early October were those for private short-term debt instruments such as commercial paper and bank CDs. These rates fell about 1 1/2 to 1 5/8 percentage points, considerably narrowing the spread against short-term Treasury issues. Indeed, Treasury bills in the 3-month area actually rose about 1/2 percentage point over the period while 6- and 12-month bills were down about 1/2 to 1 percentage point. These differing trends reflected a narrowing of the unusually wide rate spreads between Treasury and private issues that had developed late in the summer in a significant flight to quality. As some of the market apprehensions abated, the spreads have narrowed to about the normal range. Also helping to narrow spreads were the sizable net sales of Treasury bills (about $15 billion over the period) and modest issuance of CDs and commercial paper. In turn, part of the weakness in commercial paper issuance reflected corporate moves to fund previous short-term borrowings through sales of intermediate and longer issues. Another factor possibly retarding the decline in bill rates was the somewhat higher than usual cost of repo financing of Treasury issues in relation to the funds rate--which in turn may have stemmed in part from some narrowing in the repo market in the wake of concern over the legal status of repos. In yesterday's bill auctions, the 3- and 6-month issues went at about 8.45 and 8.54 percent, compared with about 8.10 and 9.23 percent just before the last meeting.

The Treasury was also active in the coupon market, raising a net of about $12 billion, including some $8.8 billion in the quarterly refunding settling yesterday. Over the period, rates on 2 to 5 year issues came down about 1 to 1 1/4 percentage points, while longer issues came down by less--a little under one percentage point for the longest maturities. With the rate decline concentrated early in the period, the Treasury's refunding issues got the benefit of the lower rates, but ended the period somewhat below issue price. Dealer's holdings of over one year Treasury issues were up only moderately over the interval, considering the dealers' sizable stake in underwriting the issues just paid for.

New issuance of both corporate and tax-exempt bonds was substantial over the period, with good receptions for the most part. Corporate yields came down about in parallel with Treasury issues, while the tax-exempt sector declined by less--apparently reflecting large recent and prospective supplies. There has been a particular push recently to issue tax-exempt securities in bearer form, as this won't be allowed after the turn of the year.

Finally, I'd like to mention that today is the most logical day, in my judgment, to make a purchase of coupon issues in the market to meet seasonal reserve needs in coming weeks. Because of our purchases of bills since the last meeting, there is only about $500 million of leeway left for such purchases,

and the new leeway following this meeting would not ordinarily take effect until tomorrow. I'd therefore like to request that the Committee enlarge the present leeway, running through today, by $1 billion.

James L. Kichline
November 16, 1982

FOMC BRIEFING

The available evidence indicates the recession still has not ended. There are a few sectors of the economy evidencing growth, but there are also areas in the midst of substantial contraction. On net, the staff has reduced its forecast of real GNP a little this quarter to show a small decline, and now expects that a recovery of activity will have to await the turn of the year. A delay in the expected recovery is about the only change in the forecast since the last meeting of the Committee. We have maintained the view that real GNP in 1983 will expand about 3 percent while additional progress will be experienced in bringing down the rate of inflation.

In October both employment and production declined further. The midmonth labor market surveys showed a drop of ¼ million in payroll employment from the month earlier and a rise in the unemployment rate to 10.4 percent. Moreover, initial claims for unemployment insurance in the latter part of October remained in the 650 to 700 thousand area, indicating that employment was still being cut in the nonfarm sector. The industrial production index, which was released this morning, dropped 0.8 percent in October, a tenth more than during the preceding month. Production of autos was cut back once again, output of business equipment fell substantially further, and the only

major area of final products showing strength was defense and space equipment. These latest production numbers will result in capacity utilization rates in manufacturing a bit below 69 percent which will be a new postwar low; at materials producers new lows began being set during the summer.

The general declines of employment and production have been associated with a weak pattern of sales and orders, along with lingering inventory problems in certain areas. Job losses of course have been taking their toll on personal incomes, a key element in the performance of consumer spending. Retail sales excluding autos and nonconsumer items were flat in October, the third consecutive month of virtually no change or small declines in nominal terms. I might note that these data became available after the staff prepared its forecast, and although the October sales were only a little weaker than we expected, downward revisions to the level of sales in September suggest our current quarter forecast of consumption may be somewhat high.

In the auto market sales have been moving irregularly reflecting the impact of various sales incentive programs; sales dropped in October following the end of incentives but rose smartly in early November as new programs were introduced to clean up 1982 models. On balance, there haven't been any signs yet of a fundamental strengthening of demands for autos. The recent decline of interest rates for consumer credit should, how-

ever, be helpful in stimulating some pickup of buyer interest for autos and other durable goods in coming months.

The rate decline in mortgage markets has led to rising loan applications and commitment activity. New home sales rose appreciably in September, the latest month for which we have data, and starts and permits were up as well. The cyclical recovery of residential construction seems quite well established, although mortgage rate levels are expected to remain high enough to hold the housing upturn to moderate proportions.

In contrast to housing, there are two principal areas of the economy now in the midst of a major contraction, namely fixed investment and exports, with little prospect for a turnaround until the second half of next year. Ted Truman will be discussing international economic conditions in his briefing. Indicators of business capital spending have been very weak in recent months, and we have revised down further the projection for this sector. Declines in long rates and higher stock prices are providing an opportunity for restructuring of corporate balance sheets, and this should be helpful over the longer run. But it will take time for financial and real side forces to exert appreciable positive influences on investment.

For the near term the staff forecast of real GNP provides for a small upturn early next year following an essentially flat second half of 1982. If our judgment is correct, we should begin to see an improvement in production, employment and sales

within the next few months. However, given the fairly strong drag on activity from the investment and export sectors, both of which have downside potential, it would appear that the short-run risks for aggregate activity are weighted toward greater weakness than in the staff forecast.

Finally, we have not changed in any significant way the wage/price portion of the forecast. Incoming information and the outlook still point to further progress on the inflation front. This morning the producer price index for October was released. It shows [an increase at an annual rate of 5-1/2 percent.]

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FOMC Briefing
E.M. Truman
November 16, 1982

International and Economic Financial Conditions

International economic and financial developments continue to be a cause for concern, and the outlook is subject to substantial uncertainty.

One bright spot that may be losing some of its shine is the external strength of the dollar. Combined with the generally bleak picture for world economic activity, the dollar's current high level means that U.S. exports are projected to continue to decline in real terms for most of the forecast period.

The weakness in external demand is illustrated by the fact that September industrial production in foreign industrial countries averaged 3½ percent below the rate a year ago and 7 percent below the peak in early 1980. These countries are completing their third year in a row with real GNP, on average, inching up at less than one half of one percent. The recovery, which still appears to lie in the future, is expected to be very moderate. The current staff forecast is for real growth to average somewhat less than two percent during 1983. As a consequence, unemployment rates will continue to rise from current record levels.

On the brighter side, inflation in the foreign industrial countries has declined by about two percentage points on average during the past year. The continued slowing of inflation may lead to somewhat lower savings rates and to some stimulus to consumption, in the context of slow growth in real disposable incomes.

The easing of interest rates may also help to stimulate demand. In a few countries, residential construction has picked up and inventory decumulation has stopped. On the external side, current account positions -- with the important exception of France -- have moved this year toward surplus. We expect some further move in the same direction next year; however, the external sector is not likely to provide a significant net stimulus to real economic activity abroad.

On the whole, the foreign industrial countries appear to be looking to the United States for lower real interest rates and for more real growth, setting the tone for a general expansion in the world economy. Indeed, the staff forecast is that U.S. economic activity will be expanding more rapidly next year than activity abroad. However, the staff forecast also implies a significantly less robust and more delayed U.S. recovery than appears to be embedded in forecasts of other countries, suggesting the risk that the forecasts may be too optimistic.

Turning to the developing countries, it is apparent that many of these countries are facing severe adjustment problems. The sources of these problems include economic mismanagement, dramatic terms-of-trade deterioration caused by the global recession, high real interest rates and pure miscalculation. Regardless of the source of their economic problems, these countries' short-run prospects are constrained by their sharply reduced access to external financing. A few observations may provide some perspective on the current situation.

-- The current staff forecast is that in an environment of forced adjustment the current account deficit of the non-OPEC developing countries will be about $45 billion next year -- a significant reduction from $75 billion in 1981.

-- The 1983 deficit will be more than accounted for by interest payments on external debt; in 1980, the interest contribution was less than 50 percent. A rule of thumb is that each percentage point change in the level of world interest rates implies a corresponding change of at least $2 billion in interest payments by these countries.

-- Net new borrowing from international banks by the non-OPEC developing countries was more than $40 billion in 1981. A reduction in the flow to less than $20 billion would be consistent with our current account estimates for next year. However, those estimates also assume a replacement, in 1983, of about $150 billion in maturing bank claims.

-- Next year these countries as a group will experience a third consecutive year of slow growth--- about 1½ percent or three percentage points less than the average for the 1973-1980 period. Real GNP will probably decline on average in Latin America.

-- We are forecasting that the volume of imports by the non-OPEC developing countries will decline again next

year following a substantial decline this year. (This general pattern contrasts with the 1974-75 experience when these countries generally cushioned the recession in the industrial world.)

Again, there are some bright spots. Lower interest rates already have eased the financing burden somewhat. It is encouraging that Mexico and Argentina -- two of the top three developing countries in terms of international bank claims -- have reached agreement with the IMF on stabilization programs. The prospect that the second largest borrower -- Brazil -- will soon follow suit should also contribute to international financial stability. However, adjustment measures put in place by individual countries are unlikely to yield a complete solution to their problems, especially in a stagnant world economy. Such measures are necessary but they do not remove all the economic and financial risks for the countries or for the rest of the world. The ability of Mexico, Brazil, Argentina, and countries in similar circumstances to follow through successfully on their IMF-approved, stabilization programs depends on some recovery in the industrial countries, adequate resources for the IMF to finance a part of these countries' needs, and continued lending by commercial banks to most of them -- albeit at a reduced pace.

In the best of circumstances, significant real and financial adjustments will be required by all. On the real side, we have roughly calculated that the external component of the expected adjustment by developing countries next year will reduce U.S.

exports by at least five percent and lower U.S. real GNP by about 1/3 of a percentage point. These impacts could easily be larger. The financial implications are more difficult to quantify. But the real and financial risks could be significant especially if we have underestimated the negative real interactions among countries or miscalculated the capacity of the international financial system to bridge over recent and potential disturbances.

FOMC Briefing
S. H. Axilrod
November 16, 1982

Behavior of the monetary aggregates in October and early November suggests that growth will again be on the strong side for the quarter as a whole, despite comparatively slow growth in nominal GNP. M1 growth was particularly large in October. It does not seem unreasonable--based on bits and pieces of evidence we have about behavior at banks--to attribute about half of the M1 expansion to maturing ASCs, but that would still leave a very substantial growth apart from ASCs. As you have seen from the blue book, we have assumed a deceleration of growth in narrow money over the balance of the year, but with the pace of advance still fairly strong in view of the evident sizable demands for liquidity relative to GNP. These demands have fallen as much, or more, on M2, and we have assumed that growth in M2 would accelerate somewhat from the measured October pace over the remainder of the year, given something like current levels of interest rates.

For the year, growth rates for the monetary aggregates look as if they will be above the Committee's targets. Accompanying this above target growth for the year will be a substantial contraction in the income velocity of M1 and the broader aggregates over the four quarters of the year--about 3 percent for V1 and 5 percent for V2. (Velocity of the broader aggregates would decline even if these aggregates fell within their ranges).

With regard to the velocity of M1, prior to this year there was only one other four quarter decline of any significance since 1960, and that was a 1 percent drop in the four quarters ending in the first quarter of 1961. More spectacularly, perhaps, V1 will also decline by

about 3 percent at an annual rate for the <u>five</u> quarters ending in the fourth quarter, the only five quarter decline of significance prior to this year in the period since 1960.

We have, of course, had substantial five quarter declines in the income velocity of M2 since 1960, given distortions generated by movements of market rates relative to fixed Regulation Q ceilings for the bulk of the period. But the five quarter decline ending with this quarter is the largest, even though M2 in the recent period was presumably less affected than in earlier years by the ceiling rate distortions, since key components of the M2 aggregate in this latest period bear a market-related interest rate.

From all this I would draw the conclusion that demands for liquidity have been unusually strong. The econometric evidence is not totally clear for M1, though not in my view inconsistent. Our standard money demand equation has <u>underpredicted</u> M1 growth--given income and interest rates--over the past four quarters by about 1¾ percentage points, though by considerably less over the past five quarters. Buttressing the idea of an upward shift in money demand, though, the modified version of the standard model--modified to allow for so-called ratchet effects on money demand of significant new highs in interest rates--has underpredicted money growth by 2¼ to 2½ percentage points over the past 4 or 5 quarters.

These strengthened money demands have been accommodated to a considerable extent by Federal Reserve policy, at least as might be judged from declines in short-term interest rates. The relative decline in the 3-month bill rate over the past five quarters--close to a 40 percent decline at an annual rate--would by a small margin be the largest in the whole period since 1960, assuming about the current rate level. Of course,

it is difficult to evaluate how the decline stacks up in real terms, given difficulties in measuring inflationary expectations. The relative decline in inflation over the past five quarters varies with the measure of inflation that is used; the CPI has declined relatively more than the bill rate over the past five quarters but the GNP deflator has declined relatively less. It would not be far afield to think that the relative decline in short-term real interest rates has probably been about as much as the relative decline in nominal rates.

Whether the relative drop in rates in nominal or real terms is sufficient to achieve the kind of economic performance satisfactory to the Committee is another matter. That depends in part on the confidence of business and consumers in face of current rate levels. While rates may have dropped, the resulting levels could still be restrictive if there were a substantial deterioration in confidence since last year--with confidence affecting the willingness to borrow and also to spend out of accumulated liquidity.

Another way of putting it is that the demand for goods and services at any given level of real interest rates may have declined over the past year or so as confidence has waned. In other words, the drop in the income velocity of money over the past several quarters may reflect not only an outward shift in the money demand schedule but also what could be a fairly substantial backward shift in the demand schedule for goods and services of the private sector. An outward shift in the money demand schedule would mean that measured money is overstating the expansionary effect of monetary policy. At the same time a backward shift in the goods and services demand schedule would tend to imply the need for even more

money and lower interest rates than might have otherwise been thought necessary to achieve any given level of GNP. There would be a double bind.

The alternatives before the Committee might all be construed as accommodating stronger liquidity demands this year than were consistent with the Committee's original targets. Only alternative A calls for a further lowering of interest rates. The desirability of that alternative depends in part, given the preceding analysis, on assessment of the underlying strength of business and consumer confidence at this point.