APPENDIX

NOTES FOR F.O.M.C. MEETING
May 24, 1983

Sam Y. Cross

The dollar has been fairly stable and quite firm in the exchanges since your last meeting. It has risen by 2 to 3 percent against the German mark and the other EMS currencies, and has fallen by about 2 percent against the yen and 7 percent against sterling. The pound had been depressed by uncertainty over oil prices at the time of the last FOMC meeting, but it strengthened noticeably against all currencies early in April when fears of an oil price war dissipated.

Probably the most significant feature of the period was in fact what did not happen, that is, the failure of the dollar to trend lower, as many market participants had expected it to do and as public officials abroad had hoped it would do. For months forecasters have looked for large increases in the U.S. current account deficit during 1983, and for further sharp drops in our interest rates as the string of good U.S. inflation numbers lengthened. But the current account deficit in fact narrowed in the first quarter, and interest rates have not declined as many would have hoped. In the view of the market, with the U.S. economy apparently gathering momentum, the immediate outlook for interest rates is that these hopes may not be fulfilled. Meanwhile, investment in U.S. equities and fixed investments has become more attractive. Also, renewed talk of global debt problems probably emphasized "safe haven" considerations of the dollar for international investors as well.

The dollar's strength probably also springs from a general perception that conditions are improving more slowly abroad than in the U.S. In a number of countries, M_1 type monetary growth has accelerated, apparently more rapidly than any evidence of renewed economic activity would suggest, and in some cases these narrow monetary aggregates are above their target ranges, perhaps limiting the scope for further monetary stimulus. At the same time, the prospects for an export-led recovery seem limited by weak demand in most parts of the world. Indeed, with aggregate demand depressed, those countries with relatively weak currencies are not benefiting as expected from the terms-of-trade advantage that would normally result from a stronger dollar. By the same token, the firm dollar limits the potential domestic stimulative effects of lower dollar prices of commodities, especially energy. And concern is expressed that high U.S. interest rates bid away capital needed to finance investment and growth at home. These developments together seem to have simultaneously increased the need for, but narrowed the scope for, further interest rate reductions in many countries.

Against this background it is perhaps not surprising that market participants have focused on political considerations as the Williamsburg Summit approaches. The yen was bid up strongly in early May, largely because market participants thought the Bank of Japan, in order to defuse criticism at Williamsburg would defer the expected discount rate cut or take action to strengthen the yen. Also, some thought the U.S. would lower the discount rate or participate in coordinated central bank intervention to push the dollar lower ahead of the meeting. But none of these events materialized, and hopes for lower U.S. interest rates were dampened as well by a steady string of statistical releases showing increasing strength in the U.S. recovery. Also, Secretary Regan's reaffirmation of current policy as the intervention study was being released seemed to end speculation that had developed about coordinated intervention, and probably added to the market's view that the dollar might rise further.

Since the last FOMC meeting, the U.S. Treasury redeemed on May 13, German mark denominated securities in an amount of DM 1,197.2 million. After these redemptions, the Treasury had outstanding DM 1,050.5 million of notes, public series, which had been issued in the German market with the cooperation of the German authorities in connection with the dollar-support program of November 1978. The remaining notes are scheduled to mature on July 26, 1983.

FOMC RECOMMENDATIONS

Mr. Chairman, swap drawings totaling $197.7 million by Mexico under the Federal Reserve special swap arrangement will mature between now and July 23, 1983. Of these, eight drawings totaling $92.7 million will come up for their second renewal and eight drawings totaling $105.0 million for the third renewal. I would propose that all of these drawings be extended to August 23, 1983.

We understand that Mexico is to receive about $325 million from the IMF on May 31. It is expected that this money will be used to make a partial repayment on the combined $1.85 billion BIS-U.S. special credit facility. Thus, about $57 million should be repaid on the Federal Reserve special swap facility and about $105 million to the Treasury by the end of May. As you know, all drawings on the combined facility are to be liquidated on or before August 23, 1983.

PETER D. STERNLIGHT

NOTES FOR FOMC MEETING

MAY 24, 1983

Desk operations since the late March meeting of the Committee have been aimed at maintaining approximately steady restraint on bank reserve positions. Measured money growth was weaker than expected in April, possibly because of seasonal adjustment problems, with M1 actually registering a decline and M2 and M3 growth quite modest. M1 rebounded sharply in early May to levels above those consistent with Committee anticipations as of late March. Estimated growth of M2 and M3 in May has also picked up, but apparently only to levels a shade below the objectives indicated in late March. In terms of reserve targeting, week-to-week money growth was essentially "accommodated", in the sense that path revisions were made so as to leave the anticipated level of adjustment and seasonal borrowing in remaining weeks of the interval unchanged at $250 million.

It had been expected that this borrowing gap would be associated with Federal funds trading around the discount rate or a little above, and indeed most trading was in a range of 8 1/2-8 3/4 percent once we got past the April 6 week quarter-end and Easter holiday pressures. For a few days in early May the rate drifted below 8 1/2 percent, apparently due not so much to an abundance of reserves as to market anticipations of lower rates in the wake of slower money growth. More recently, reports of stronger money growth and a stronger economy discouraged the market's expectations of imminent rate declines and funds have returned to an 8 1/2-8 3/4 percent trading range.

Actual weekly borrowing levels more often exceeded than fell short of the $250 million norm, in good part because of special factors such as the quarter-end and Easter weekend pressures and occasional technical disruptions to money wire networks, either at Reserve Banks or major commercial banks. In addition, reserve levels more often seemed to fall short of projections than to exceed them, while demand for excess reserves tended to remain high, somewhat exceeding the allowances made in the weekly reserve paths.

Substantial reserve needs were met during the period, stemming chiefly from increased required reserves and currency in circulation. Outright System holdings of Treasury securities were increased by over $4.5 billion over the period, thus making use of a temporary increase in leeway for intermeeting changes approved by the Committee on May 10. Purchases included nearly $2 billion of Treasury bills bought in the market on April 12, a market purchase of $1.2 billion in Treasury coupon issues on May 10, and scattered purchases of bills from foreign accounts totaling about $1.5 billion. Temporary reserve needs were met by repurchase agreements, especially by passing through to the market some of the foreign official account day-to-day funds, while on one occasion temporarily excessive reserves were drained through matched sale-purchases with the market.

Interest rates declined through the early part of the intermeeting period as the end-of-quarter money market pressures subsided and concern about a firmer leaning of policy abated. As we moved through April, with visible weakening of money growth, continuing good news on inflation, and evidence of only modest economic recovery, the rate decline gathered some momentum, fed by renewed speculation that another discount rate cut might be imminent. Official comments about possibilities for further rate declines added to market optimism. In this atmosphere, the market gave a good initial reception to a record-size $15 billion quarterly Treasury financing. Yields on corporate and tax-exempt issues fell even more than on Treasuries, prompting a step-up in issuance in both sectors. Concern about budget deficits probably tempered the enthusiasm a bit, but mostly such concerns seemed to go underground for a while.

By the final days of April and continuing into May, the markets lost their buoyancy and retraced much or all of the rate declines since late March. The news on the economy was coming in stronger. Money supply weakness was suddenly replaced with unexpected strength, dashing expectations and then even faint hopes of an early discount rate cut. The heavy supplies of corporates and tax-exempt issues looked much more burdensome and large price concessions followed, with only partial success in reducing congestion. Budget concerns resurfaced as the Congress and Administration struggled to find an acceptable approach.

While market participants generally appreciate that money supply especially M1 is not being targeted in the sense that it was up to last fall, and therefore do not expect an imminent tightening of money market conditions, they also believe that the money numbers are not being wholly ignored either. At the very least, they see the fresh strengthening of M1 as an obstacle to any relaxation, and perhaps as a prelude to slightly firmer conditions.

Tracing the recent shifts in sentiment, the Treasury's actively traded 30-year bonds declined in yield from 10.67 percent on March 28 to a low of 10.25 in early May, but climbed back to 10.75 by yesterday for a small net rise in yield over the whole period. Shorter and intermediate-term Treasury coupon issues were about unchanged or slightly lower, net, over the period, with net Treasury borrowings of about $14 billion in this sector in the intermeeing period. (The figures would be a couple of billion higher except that bidding on a 2-year note has been delayed because of debt limit uncertainties.)

In the short end, despite a recent back-up, Treasury bill yields are still below those of late March, though not by much. Three- and six-month bills were auctioned yesterday at 8.46 and 8.47 percent, compared with 8.68 and 8.71 just before the last meeting, and a recent auction low of about 8.04 - 8.05 in early May. In part, the net decline in bill yields may reflect the different supply situation there compared with coupon issues. Bill supplies have contracted seasonally with the big paydowns of cash management bills and also some paydown because of debt limit constraints. If the Congress finishes action on the debt ceiling by the end of this week, as seems likely, this should permit a replenishment of fast-diminishing Treasury coffers by early next week--but there may be a bit of scramble to do with this with compressed auction and payment schedules. The Treasury had scheduled a 2-year note auction for today, but yesterday afternoon they announced a postponement as they lacked sufficient assurance that an adequate debt ceiling would be in place. A 5-year note auction, tentatively scheduled for tomorrow, is also in jeopardy.

Looking at other short-term rates, as with Treasury bills, the level now is somewhat lower than in late March, notwithstanding a recent rise. Three- and six-month CDs are trading about 25 basis points lower, and commercial paper rates are down by a similar margin. Banks have been under little pressure to issue CDs given the inflow of MMDA money and slack loan demand, while good corporate cash flows and debt restructuring have lessened the needs of commercial paper issuers.

In the intermediate and longer-term corporate market, yields are about unchanged to slightly lower than before the last meeting. At first these yields fell more than on comparable Treasury issues, as investors reached for yield against a background of declining rates. A better feeling about solvency prospects also seemed to underly this narrowing of spreads, although this may be just a rationalization for what observers uncharitably called a "flight to junk." In any event, after a barrage of new issues, corporate yields backed up somewhat more than Treasuries, reversing part of the narrowing in yield spreads.

Tax-exempt bond yields also fell more than Treasury yields in the early part of the period, but a large volume of new offerings caused congestion and a back-up that has more than erased the earlier declines. Part of the heavy issuance reflects an effort to sell bonds in definitive form before a June 30 deadline, after which all issues must be in registered form. Another depressant on at least some segments of the tax-exempt market is the uncertainty hanging over the Washington Public Power Supply System bonds. We seem to be only days away from a technical state of default on the $2 1/4 billion of bonds associated with projects 4 and 5 of the Power System, and it's uncertain how this may affect the $6 billion of bonds behind projects 1, 2 and 3, despite what is deemed to be Bonneville Power Administration backing of the 1, 2 and 3 bonds. Ratings of these bonds have been lowered or suspended and their prices plummetted enough to raise yields as much as 2 1/2 percentage points.

Joseph S. Zeisel
May 24, 1983

FOMC BRIEFING

Recent economic data have largely erased lingering doubts about the vitality of the recovery. Although the Commerce Department scaled back the first-quarter real GNP increase from 3.1 to 2-1/2 percent, this revision reflected entirely evidence of a greater rate of inventory liquidation. Indeed, book value manufacturing and trade stocks were reduced in March at a $63 billion annual rate. This brought inventory/sales ratios close to prerecession levels, paving the way for a stronger rebound in activity in the current quarter.

Such a resurgence in activity was clearly evident in industrial production figures for April. The production index posted a gain of 2.1 percent, the largest rise since the summer of 1975. Moreover, the strength was evident in a wide variety of industries. Earlier this year, the recovery in production had been associated largely with autos and homebuilding; last month business equipment output and a wide range of consumer goods were showing stronger gains as well.

The employment surveys for April also reflected increased demand for labor. Nonfarm payroll jobs rose 260,000 with a gain of 100,000 in manufacturing. Moreover, this was accompanied by a sharp further expansion of overtime hours. There has been only modest improvement in unemployment as yet however. The civilian jobless rate edged down one tenth to 10.2 percent in April and new claims for unemployment benefits continue to hang rather high.

For the current quarter, the staff is forecasting an increase in real GNP of 5-1/2 percent. Much of the rise reflects the apparent ending of the inventory liquidation phase of the cycle, while real final sales are projected to increase at a rather modest rate--under 2 percent. However, a good deal of the sluggishness in final demands is the result of the decline in net exports. At the same time, there have been signs of improved performance in some key sectors of the economy, probably most importantly, in consumer demand.

Retail sales were generally disappointing early this year, but revised data now show a gain of over 1-1/2 percent in March, and there was an equal rise in April. Demand for domestically produced cars in particular has firmed. Sales of these models, which had been running at slightly over a 6 million annual rate from December to March, improved to a 6.4 million rate in April and edged higher in early May. As a result, production schedules were raised for coming months. Aside from autos, the improvement in consumer demand was more modest, with furniture and appliances leading the way.

Increased housing activity is also currently lending strong support to overall growth. Although starts edged down during the past two months, residential construction continues to benefit significantly from the strong gains in activity that followed the drop in mortgage interest rates late last year and in early 1983. Overall spending in the second quarter should also be supported by increased outlays for defense, which have been lagging in recent months.

We have also revised up somewhat our projection of real GNP growth in the second half of this year to about a 5 percent rate, reflecting the evidence of greater strength in production and income. Surveys recently have suggested substantially improved consumer attitudes, and enhanced purchasing power associated with rising employment should support an increased pace of spending. In addition, we are still assuming a $30 billion cut in personal income taxes on July 1.

The investment sector should also be contributing to the recovery, albeit by somewhat less than the usual amount. Business spending on equipment has shown signs of turning up--a typical response to an increase in overall output--but outlays for nonresidential construction have begun to fall and, as suggested by the special Redbook survey, they appear likely to continue to weaken over the next year or so. In the housing market, we expect starts to post only modest gains from the pace of the past couple of months, and thus the growth of residential construction activity will be moderating as the year progresses.

In 1984, our expectation that interest rates will continue close to current high levels remains a major constraint on growth in private demand, affecting particularly business outlays, housing activity, and sales of big ticket consumer items such as autos. But we expect a further improvement in foreign demand, and assume a relatively sharp decline in the value of the dollar beginning later this year, which will significantly boost export volume and add to economic growth in 1984.

Overall, our projections involve an increase in real GNP during the two years, 1983-84, totaling slightly over 9 percent--a little under the median recovery in other postwar cycles. But given the intensity and duration of the current contraction, this would leave the economy with considerable slack in both physical capacity and in the labor markets--unemployment would be just below 9 percent at the end of 1984, and capacity utilization in manufacturing would still be under 80 percent.

In such an environment, there is a reasonable prospect that inflation will be kept in check. We do not expect a continuation of the remarkable price performance of recent months--that is, actual stability or even declines at both the consumer and producer level. In fact, there are currently signs of a surge in some sectors this quarter. Prices of petroleum products, which had been dropping sharply, have recently stabilized, and gasoline prices at retail have jumped in conjunction with some firming of demand and the introduction on April 1 of the 5 cent per gallon tax. Moreover, food prices at the producer level have moved up in response to new government farm programs and weather-induced crop damage. But to a large extent, these effects are expected to be temporary, and price increases for other goods and services have continued to moderate. We anticipate continuing efforts on the part of business to improve productivity and reduce costs, and given the projected degree of slack, we are forecasting a reasonable rate of success in that direction. Thus, we are projecting the gross domestic business product fixed-weighted price index to continue to moderate somewhat, increasing 3-3/4 percent both this year and next, off about one percent from 1982.

FOMC Briefing
Short-run Outlook
SHAxilrod/pjd
May 24, 1983

The various monetary aggregates appear to be giving conflicting signals about the course of monetary policy. Or rather, a more accurate statement would be that except for M1, all of the aggregates of concern to the Committee seem to be on the course earlier set by the Committee. Some perspective can be provided by looking at growth of the aggregates since the end of the summer of 1982, after interest rates had started downward cyclically and following a bulge in growth of narrow and broad money over that summer.

From September to December of last year M2 and M3 expanded at annual rates of just 8¾ and 7½ percent, respectively. Bracketing and setting aside January and February as reflecting a massive stock adjustment to the new money market deposit accounts, growth in M2 and M3 over the past three months, including an estimate for May, has remained quite moderate--close to 8 percent for M2 and around 6½ percent for M3. And growth of domestic nonfinancial debt seems to have for the moment settled in the lower part of the FOMC's range. At the same time, of course, M1 growth has been unusually rapid. Since September of last year M1 has expanded at around a 14 percent annual rate (including growth in January and February).

It seems probable to me that the expansiveness of monetary policy may at least in some degree be understated by behavior of the broader aggregates since the end of last summer while it is overstated by the behavior of M1. M2 growth probably has been held down--with the slowing in its nontransactions component providing a particularly noticeable contrast to the strength of M1 in the period--by shifts of funds into bonds and equities as it became more and more likely that the value of longer-term financial assets would rise, indeed were rising, as prospects became better that inflation would come under control. The restrained growth of M3 reflected the slowing of M2 as well as less active issuance of large CDs as businesses attempted to improve their balance sheet positions by shifting away from short- toward longer-term debt. At the same time M1 growth has accelerated sharply in large part because of the heightened interest-sensitivity of that aggregate as fixed ceiling rate NOW accounts became a more and more important component. Thus, structural changes in the composition of the aggregates in conjunction with adaptations in liquidity positions and investment portfolios to the prospects of lower inflation and market rates have probably contributed to a strengthening of narrow money and some weakening of broader money.

But I should quickly add that the impact of M2 of shifts into stocks and bonds may not be large. If it were, M2 velocity might tend to rise, but we have not yet seen any substantial rebound in M2 velocity. In the second quarter of this year M2 velocity may be close to flat, perhaps returning to something like normal, in contrast to continued sizable declines in the latter part of 1982. M1 velocity looks as if it might continue to decline a little this quarter, though at a slower pace than in the previous three quarters. But more significantly the velocity of M1 either contemporaneously or lagged one or two quarters has not yet shown anything like its normal cyclical rebound. I would conclude that at present the behavior of M1 velocity is more at variance with historical patterns than is M2 velocity.

We have looked carefully at the very recent behavior of M1 in an effort to determine what, if any, unusual influences may be at work and to see what might be said about the underlying trend. In brief, seasonal factors may be distorting the two months of April and May by 2 to 5 percentage points--i.e. growth could be about that much higher in April and lower in May--judging from the behavior of our experimental series and tests of our current seasonal method made by rerunning the series through May. That would not change the April-May pattern significantly. The May changes, particularly for the week of the 11th, look very large seasonally unadjusted, compared with similar periods of earlier years; they are well distributed geographically and by size of bank; and we have checked carefully for possible reporting errors at large banks and have found none. It is possible that April growth was held down by tax payments as demand deposits dropped several billion dollars around mid-month and NOW accounts did not grow, while growth has been accelerated in May in part by a rebuilding of those accounts as well as by an unusually sharp \$7½ billion seasonally adjusted (\$17½ billion not adjusted) drop in Treasury balances over the last three weeks (including a projection for the current week) as sizable delayed tax refund payments were made and debt ceiling problems caused a large net repayment of Treasury debt.

Thus, even though the seasonals seem to be only a moderately distorting factor, I would still think the April-May average is, obviously, much more reflective of underlying M1 growth than either month alone. But the April-May average itself--if it is as high as the currently estimated 10½ percent annual rate--may be an overstatement if there are indeed special factors affecting May alone (independently of April). Our models, as noted in the blue book, would suggest growth over the balance of the year in the 6 to 7 percent annual rate range, and we would hold out some hope for somewhat slower growth in June.

The disparate behavior of the aggregates--and remaining uncertainties about their interpretation--clearly make the FOMC's policy decision today that much harder since it tends to elevate assessment of the likely strength of the economy over the months ahead in relation to prevailing interest rates to an even more crucial element in policy judgments. The present level of interest rates has for some time seemed high in real terms, and it has not been clear--given the current and prospective fiscal stimulus--whether or how much of a reduction in nominal interest rates would be needed to sustain a non-inflationary economic recovery. While very recent strength of the economy may be exaggerated somewhat by a developing inventory turn-around, private final demands have held up rather well over the past two or three quarters. There is a risk, though, that some weakening in the pace of activity may develop from a sustained relatively high level of real rates that works to restrain purchases of durables and housing and retards an inventory build-up. On the other hand, we have been surprised in the past by the resilience of the economy; we have not generally been confronted with such a rising fiscal stimulus as is projected well into a period of recovery; and it is always possible that greater price increases than are now forecast for the quarters ahead could develop and bring real rates down without any action to affect nominal rates.

With regard to the directives, alternative I retains the present directive structure. It seems outdated by recent behavior of the aggregates, however. Nonetheless, because it may be awkward to alter the specifications for the second quarter this late in the period, given the uncertainties surrounding them, the Committee could if it wished retain that directive structure without changing the specifications. It might do so on the implicit, if not explicit, assumption that strength of M1 could or should be interpreted as offsetting weakness of M2 and M3 relative to expectations--or on the assumption consistent with the present directive that continued weakness in M2 and M3, or disappointments about the economy, would lead to some easing of bank reserve positions if the recent bulge in M1 unwound quickly. The alternative directive structure in alternative II rather less convolutedly could embody a Committee decision about whether it wishes to retain, add to, or diminish current pressures on interest rates over the next several weeks, given an expectation about the behavior of the aggregates over that period and without particular regard to a specific second-quarter growth path.