APPENDIX

Notes for FOMC Meeting
December 17, 1984

Sam Y. Cross

Since your last meeting the dollar has again climbed higher in the exchange markets, gaining more than 6 percent against the European currencies and 3 percent against the Japanese yen. Following President Reagan's reelection the dollar rose strongly throughout November, and eased only slightly and temporarily after the Federal Reserve announced a 1/2 percent cut in the discount rate. Since early December, the dollar, while still at high levels, has fluctuated without any clear trend.

During this period the dollar has once again approached the highs against the mark reached in late-September and in mid-October. On both of those earlier occasions, the Bundesbank, picking times when the dollar seemed vulnerable to a downward move, intervened to help knock the dollar down. The Bundesbank receives a steady stream of dollars from U.S. troop expenditures and from interest on its dollar reserves, and to prevent its foreign exchange reserves from rising at a time when the mark is weak, sells those dollars at times when it believes the impact on the exchange market will be largest. That was clearly the case when the

Bundesbank intervened on September 21 and the dollar fell nearly 4 percent in a couple of hours. During the latest intermeeting period, the Bundesbank has sold dollars on a number of occasions, a total of $1.2 billion, but with much less market effect than in September and October. Also, Bundesbank total sales of dollars were more than offset by purchases of dollars by other central banks.

The dollar's resiliency in November reflected the continued attractiveness of the investment climate in the United States despite the declines in U.S. interest rates. It was noted that interest rate differentials, though much narrower, still favored the dollar over other major currencies, and also that inflation expectations in the U.S. appeared to be moderating. Also, the dollar has gained some support from currency conversions into dollars of borrowings in other currencies by the debt-troubled countries. In particular there were reports of conversions of the foreign-currency portion of bank loans to Mexico taken down at the end of November.

The recent support for the dollar seems to reflect forces that have dominated the markets for most of 1984. The attraction of a brisk U.S. economic expansion, lower inflation, relatively high interest rates and a good environment for business has been sufficient not only to finance the large U.S. current account deficit, but also to exert upward pressure on the dollar.

The dollar also continues to look attractive because European alternatives have lost their luster, with sluggish economies, increased political uncertainties, and in some cases vulnerability to labor unrest. Thus far in 1984 the currencies of continental Europe have lost 14 percent against the dollar. The yen has lost 7 percent, and now stands near its all-time high against the German mark.

With the dollar now close to its historic highs for the third time, the exchange markets appear to be adjusting to the higher level. While most market observers acknowledge that the dollar's 4-year rise will reverse at some point, few entertain the likelihood of any significant drop in the near future. Most participants expect continued wide fluctuations, but generally around a steady or still rising trend.

Recommendation

As discussed at the last meeting, we have negotiated the extension of all of the Federal Reserve System's regular swap arrangements with foreign central banks and the B.I.S., which have come up for renewal in December. Only two minor technical changes were required. One, which was approved by the Committee at its last meeting, makes the applicable exchange rate in the agreement with Japan that of two days' prior to the value date of the drawing, rather than one day, to reflect a recent change in Japanese market practice. The second change is in the agreement with the National Bank of Denmark. That agreement referred to a specific Danish Treasury security issue as the basis for setting the interest rate on drawings in Danish krone, and that security is no longer being issued. Since changes may occur again, we have agreed that the rate applied will be the rate on a Danish Treasury security comparable to the U.S. Treasury bills, as agreed between the two parties at the time of any drawing.

I recommend that the Committee should authorize renewal of all the agreements for another year.

PETER D. STERNLIGHT
NOTES FOR FOMC MEETING
DECEMBER 17-18, 1984

Against a background of lagging growth in narrow money supply, sluggish growth in the economy, subdued inflation, and a strong dollar, Desk operations since the last meeting have sought to fill reserve needs promptly and fully, while aiming at a gradual reduction in pressures on bank reserve availability. Although broader aggregates grew robustly, exceeding the September-December growth rates indicated by the Committee, greater significance was attached to the sub-par performance of M1, which appeared to be falling short of the Committee's specified 3 percent September-December pace--a pace that in a sense was considered minimal and that the Committee would have found it acceptable to exceed. Moreover, the slow pace of M1 seemed more consistent with the signs of laggard growth in the economy than did the larger expansion of broader money measures. These broader measures may have benefited from the greater attractiveness of money market deposit accounts and money market mutual fund accounts as the yield declines on these accounts lagged the rate decreases on marketable money market instruments.

As the period began, reserve paths incorporated $575 million of adjustment and seasonal borrowing, down from the $700 million level used just before the November 7 meeting. Two weeks later, the borrowing assumption was pared to $500 million, and two weeks after that to $400 million. Given these reductions in intended pressure, further punctuated by the 1/2 percent reduction in the discount rate announced November 21, the federal funds rate worked down from 9.80 percent in the two weeks ended November 7 to 8.70 in the week ended December 12, and an average of about 8.30 percent in the first few days of the current week. Today it is around 8 percent and that will pull the averages down further, although a firming is likely before this reserve period ends on Wednesday.

Actual borrowing levels did not always behave quite as intended, with aberrations mainly on the high side because of unexpected reserve shortfalls, unusually heavy demands for excess reserves, or post-period upward revisions to required reserves. The day of the last meeting in fact saw particularly high borrowing due to a combination of reserve shortfall and heavy repurchase agreement withdrawals, boosting average borrowing in the two-week period ending that day to nearly $1.2 billion. In the first two-week period of the new intermeeting interval, borrowing averaged a close-to-path $588 million, although this was higher than intended since an effort had been made in the final days of that period to provide reserves relatively generously against indicated path levels to guard against unwanted firming. In the second maintenance period, borrowing averaged $763 million, well above the level assumed in the path, partly because of heavy borrowing on Thanksgiving Day which really was carried over from the end of the previous period and partly because of reserve shortfalls and high demand for excess reserves that led to a taut money market at the end of the period. In contrast, the current reserve maintenance period has seen relatively light borrowing so far --about $250 in the first 11 days. At this point, to achieve a $400 million average, borrowing for the current two weeks could imply an appreciable firming in the next couple of days.

For the two full maintenance periods since the last meeting, nonborrowed reserve levels somewhat exceeded the path levels as of the day the reserve period was ending, although in the case of the November 21 period there was a subsequent upward revision to required reserves and a nonborrowed objective based on that revised level was not quite met.

The Desk provided reserves in large size over the period, meeting seasonal needs for currency and required reserves, as well as offsetting a decline in extended credit borrowing. Net intermeeting outright purchases totaled a record $7.4 billion, requiring two temporary increases in the normal leeway to cover intermeeting changes. Purchases included $5.6 billion in three market operations --two in bills for about $4.1 billion and one in notes and bonds for $1.5 billion. The System also bought $1.7 billion in bills and notes from foreign accounts. System and customer-related repurchase agreements were used on a dozen occasions, while a temporary reserve glut was absorbed through matched-sale purchase transactions in the market on one occasion.

It may be of interest to note that so far this year, the System's outright holdings of Treasury and agency securities are up by a net of $6.4 billion, about evenly divided between bills and coupon issues with a small decline in agency securities. This year's increase is substantially smaller than the record $16 billion rise during all of 1983, although when account is taken of the $3.5 billion FDIC note and the rise of about $3 billion in extended credit, both essentially stemming from the Continental Illinois situation, the annual changes are fairly similar. The further reason for the bigger rise in 1983 was the $3 billion larger increase in currency in circulation in that year.

While federal funds worked fairly steadily lower in rate over the period, other market interest rates followed a somewhat erratic course, generally ending up lower for shorter maturities but little changed at the longer end. The System's accommodative stance provided encouragement through the lessening of reserve pressures and the decline in the discount rate midway in the period, but day-to-day news on the economy and monetary growth was considered a mixed bag and the market alternately blew hot and cold on whether there was further easing to come. The net result was a steeper yield curve as the lower funds rate and related dealer financing costs pulled short rates down while longer rates responded more to the shifting day-to-day psychology on bits of business news and money growth reports. Expectations of rate declines were already built into the longer end as the period began, in anticipation of a sluggish economy and System moves to pep up M1 growth, so the easing of reserve pressures and mixture of sluggish and not-so-sluggish news produced about a stand-off.

Bill rates fell by about 70 to 85 basis points over the period while the Treasury tapped this market for roughly $15 billion of new funds. Three- and six-month bills were auctioned today at about 7.97 and 8.15 percent compared with 8.82 and 9.07 percent just before the last meeting. Similarly, CD rates came down 80-95 basis points, and most banks cut their prime rate in two or three steps by 75 basis points to 11-1/4 percent. The gap between the prime rate and bank funding costs remains fairly wide.

Rates on Treasury notes and bonds were down about 30-45 basis points for 2-5 year issues, little changed in the 10-year area, and up a few basis points for the longest maturities. Counting the whole November refunding, which was partly auctioned just before the last meeting date, the Treasury raised $19 million in coupon issues over the period. The offering included the Treasury's second foreign-targeted issue, a $1 billion add-on to the 5-year note. This issue attracted much less aggressive bidding than the similar 4-year note sold in October, saving the Treasury just 7 basis points as against 32 in the 4-year note. In the secondary market trading of both targeted issues, the rate spread between the foreign and domestic versions entirely eroded, or even turned to show a slightly higher return on the foreign issue--prompting some holders of the 4-year note to convert to the companion domestic issue. While a viable long-run market in the target issues does not seem to be developing, the attention surrounding their issuance may be said to serve a purpose in quickening foreign appetite for U.S. Treasury issues in general.

Rates on longer corporate issues moved in roughly similar fashion to longer Treasurys. New issuance was light to moderate until late November when there was a burst of supply to take advantage of lower rates--but this clogged the market for a time and backed rates up to about the same level as several weeks earlier. Tax-exempts fared better, somewhat out-performing the taxable market for the first time in several months as dealers and investors began to see an end to the heavy new supplies being brought to beat year-end deadlines for certain types of issues.

It seems harder than usual to summarize the state of market opinion on the rate outlook at this point. There are not even well-defined "schools of fish" swimming this way and then that as another crust of information is tossed in the water. In some average sense, I think the market is about adjusted to a funds rate centering around 8-1/2 to 8-3/4 percent, maybe leaning to 8-1/2. The strength of the economy is seen as the main influence on rates but there is a wide and shifting range of views about whether the recent lull is giving way to renewed vigor, recession, or just more lull. Few expect significant inflationary pressures near term, unless the dollar should weaken appreciably and this does not seem to be widely expected. Most participants expect little near-term progress on reducing the budget deficit, although this is not seen as having a big rate impact except by those--and there are some--who expect a fairly vigorous expansion to resume.

Request for Leeway

Current projections suggest a need to drain on the order of \$4 to \$6 billion of reserves in the weeks through the end of January, due chiefly to a seasonal return flow of currency and declines in required reserves. I would suggest a temporary increase in the standing \$4 billion leeway to \$6 billion until the next meeting date, although I can't rule out the possibility that even more might be needed, particularly with persisting uncertainties about what might happen to extended credit.

James L. Kichline
December 17, 1984

FOMC BRIEFING

Economic activity appears to be expanding at a sluggish pace this quarter. Domestic sales on average seem to be growing rather slowly, production has been weak, and inventories have backed up somewhat. Compared with the forecast presented at the last meeting of the Committee, the current staff forecast entails a little lower growth in real GNP this quarter and next, but it is not fundamentally different. We still believe the economy is on a track that will provide moderate expansion in 1985, that is real growth of around 3 percent. For inflation we expect the GNP deflator to rise about 4 percent next year, the same as anticipated in 1984.

This is the season to discuss consumer spending, and consumer behavior in recent months has been an area of concern and confusion. Major retailers generally have been describing sales in November and early December as disappointing, with heavy promotions required to elicit much consumer interest. The statistical evidence on consumer spending outside of autos is that sales dropped in October and recorded a huge advance in November. Total auto sales were at a 10 million unit rate in October and November, down a little from that in September and the third quarter as a whole; sales of domestic units reportedly are still constrained by shortages of the more popular models.

The staff's forecast projects consumer spending rising about 3 percent in real terms in the current quarter, a moderate expansion coming after the erratic pattern of the preceding two quarters. During the spring, real personal consumption expenditures rose at an unsustainable 8 percent annual rate followed by virtually no growth over the summer quarter. Most of the influences on consumer spending seem to be pointing in the direction of moderate expansion: for example, incomes and employment continue to exhibit growth, attitudes reportedly are still quite good, and consumers hold large amounts of liquid assets and don't seem to be averse to taking on debt. Thus, taking a middle ground on consumer spending has seemed the best bet to us.

But that moderate growth of consumer spending this quarter along with weak business fixed investment does not seem sufficient to clean up excess inventories. We expect that some final demands both this quarter and next will be satisfied out of inventories, which acts to damp growth of GNP in the forecast. Accumulation of inventories in the aggregate was still very large in October, the latest available data, even though production declined and imports were reduced. For November, industrial production increased 0.4 percent with most of the gain in the motor vehicle sector where output earlier was held down by strikes and other production difficulties. It appears that producers basically have been making fairly prompt adjustments to emerging trends of orders and inventories, and continued restraint on domestic production over the next few months is expected to alleviate lingering inventory difficulties.

In the business fixed investment sector, the quarter started off weak with sizable declines in domestic orders and shipments while imports of capital goods also fell. Some rebound in orders and shipments in later months of the quarter is assumed in the projection, but this would only provide very small growth of business capital spending for the quarter as a whole. On average, the staff believes business fixed investment will continue to be supportive of expansion in the overall economy in 1985, although growing at a much more moderate 6 percent pace in real terms. This rate of expansion takes account of the weaker trend of orders and contracts that has been developing and recognizes the reduced incentives to investment in an environment of slower growth of final sales and few upward pressures on capacity utilization rates.

In the housing sector, starts data for November will be available tomorrow morning. Nevertheless, the decline in mortgage interest rates is expected to provide a little lift to starts going into 1985, and indeed appeared to be affecting home sales in September and October. Mortgage rates are presumed to remain high enough to limit activity, however, and with rental vacancy rates on the rise and affecting multifamily starts, total housing starts averaging 1.8 million units next year would only match the performance in 1984.

On balance, the staff forecast of real activity is a bit weaker in the short run given the evidence on final sales and the apparent need to work down inventory accumulation. This is still a forecast nevertheless of an economy in transition to moderate expansion after a surprisingly strong first half of 1984. There is a bit more slack in labor markets and capacity utilization in the forecast and along with an upward revision to the projected value of the dollar, the projection of wage and price inflation was cut back a few tenths.

TO: Federal Open Market Committee DATE: December 11, 1984

FROM: S. H. Axilrod SUBJECT: Comments on operating procedures and certain monetary targeting issues

There are three interrelated issues that can be raised in connection with a general discussion by the Committee at this time of monetary policy formulation and implementation. One pertains mainly to implementation, and relates to questions about the most effective open market operating procedure in the context of a predominantly judgmental approach--a matter that was raised by President Morris at the last meeting in connection with the behavior of interest rates and borrowing over the summer and fall and has been discussed in one way or another by other Committee members in the course of the past year or more.

The other two issues have to do with the reliability of M1 as an intermediate objective for policy, particularly in light of its recent weakness, and the related question of whether its recent weakness should be taken specially into account when setting next year's ranges. A few comments can be offered on these two topics at this time partly as background for more formal consideration of specific ranges and their policy significance at the February meeting.

Operating procedures

Reserve paths for guiding open market operations have for some time now been based on an assumed level of adjustment plus seasonal borrowing at the discount window. This borrowing assumption is used to derive for each two-week reserve period a nonborrowed reserve path--which is what the Desk can really hit (aside from the unpredicted effects of market factors). That path is derived by subtracting assumed borrowing from the sum of estimated required reserves, updated in the course of a reserve period, and a projection of excess reserves.

In practice the actual level of borrowing can deviate from assumption even if the nonborrowed reserve path is hit perfectly and actual required reserves are as estimated. In this case, free reserves (the difference between nonborrowed and required) will turn out as expected, but borrowing may not since the composition of free reserves between excess reserves and borrowing is not within the System's control. However, as noted, we do attempt to estimate in advance the market's demand for excess reserves during any given reserve period in setting the nonborrowed reserve path. There are inevitably unexpected developments in that respect, but they tend to average out over time, and the actual level of borrowing will tend to vary around the assumed level within a reasonable range of tolerance. Over short periods, the market will often look to the level of free reserves as more indicative of System intentions when, for instance, both excess reserves and borrowings are relatively high or when both are relatively low.

An assessment of borrowing, or implied free reserves, as a guide for open market operations involves examination of two kinds of problems. One relates to conditions when money demand is proving to be stronger or weaker than anticipated. A borrowing guide would automatically accommodate such behavior, since open market operations would supply or absorb the unexpected shortfall or overshoot in required reserves. This is not a disadvantage to such a guide when the Committee does not wish to resist unanticipated behavior in money--either because a money demand shift may be under way or because more time may be required to assess the significance or durability of the change in money.

On the other hand, the accommodative characteristic of a borrowing guide is a drawback at times when the Committee wishes to achieve closer control of money, particularly M1 (the aggregate most directly related to reserves), as would be the case when unanticipated movements in money are more likely to be reflecting or foreshadowing undesired economic performance. In that case, adherence to a nonborrowed or total reserve aggregate guide would be more likely to achieve the desired outcome.

Our present procedures strike something of a compromise. The nonborrowed reserve paths are adjusted within a reserve operating period for unanticipated changes in money and required reserves, so as to maintain the initially implied borrowing level. Over a whole intermeeting period, though, the Committee specifically allows for judgmental adjustments in borrowing in an attempt to resist, at least in part, undesired movements of the aggregates. However, these adjustments are considered not only in the context of behavior of the monetary aggregates but also in relation to economic indicators and financial market conditions generally.

The second problem with borrowing (or free reserves) as a guide emerges in circumstances when money demand and the economy might be about as anticipated, given current interest rates, but when banks' attitudes toward borrowing, and free reserves, begin to shift. In that case adherence to a borrowing guide will cause actual money supply, as well as economic performance, to depart from anticipations. For example, money growth will fall short when banks' demand for borrowing declines (demand for free reserves rises) at given interest rates, because the System in its operations will force banks to be less liquid than they want (unless the borrowing target is changed), leading to interest rate increases, and, with some lag, to less money demand and actual money growth than anticipated and to weaker economic growth.

The behavior of M1 during the summer was to some extent an example of this problem with borrowing as a guide. Short-term interest rates rose from May through mid-summer, despite an unchanged level of borrowing, and money growth began to weaken. Based on results from our money market model, perhaps about 2 percentage points at annual rate of the M1 weakness over the summer might be attributed to a shift in borrowing demand.

However, the unanticipated weakness in money growth extending into the fall, as short-term rates began to drop substantially, more exemplifies the first problem noted above with a borrowing or free reserve guide. The extended weakness in M1 in good part was associated with diminishing transactions demand as economic growth decelerated sharply. In line with Committee decisions and operating procedures, successive reductions in borrowing targets, and increases in free reserves, were made beginning in late summer. Nonetheless, nonborrowed reserves and total reserves by November were still about at their July levels, as not enough reserves had been supplied both to satisfy banks' demands for liquidity and to attain M1 objectives.

While there are these problems with the current operating technique--as there would be problems, though perhaps different ones, in any procedure chosen--the procedure has worked reasonably well over a difficult period in which the Committee has not wanted to be tied as closely as earlier to an M1 aggregate that was subject to transitional uncertainties, and has wished to give more emphasis to over-all economic and financial considerations. In any event, economic performance has been reasonably satisfactory during the period in which these procedures have been in place, and financial conditions have been more stable than in the 1980-82 period. Since mid-1983 M1 and M2 have generally remained within their long-run ranges, in part because demand for these aggregates has been less variable than previously; recently, though, M1 has been in the lower portion of its range, an outcome that had not been expected earlier in the year.

Some modifications to current operating procedures could, nonetheless, be contemplated. While the problems caused by shifts in the borrowing function might be mitigated by aiming at a Federal funds rate, I would not suggest elevating the funds rate to a day-to-day target as before October 1979. In the first place, it would not help in the more fundamental case when money demand on the part of the public, and the economy, is weakening relative to expectations. Secondly, it would work to eliminate a very valuable degree of responsiveness of the funds rate, and short rates generally, to actual or anticipated changes in credit or money demand--a degree of responsiveness that often is in a direction consistent with, and helpful to, policy toward the aggregates and the economy, as was the case, for example, in early fall. With the funds rate as a target, by contrast, money market conditions will be much less responsive to factors other than the System's intention.

While the funds rate would not seem to be a desirable target, a reasonable argument can be made for evaluating movements in the funds rate and the money supply relative to borrowing levels, taking account of identifiable factors affecting changes in bank borrowing behavior, to determine whether there have been shifts in the borrowing function that may call for technical adjustment in reserve paths. This might tend to minimize problems associated with shifts in the borrowing function, but it would not address the first drawback with the current procedure noted earlier--that is, its tendency to accommodate, in part at least, undesired swings in money demand. That drawback may be best addressed by introducing some degree of automaticity in borrowing in response to deviations from the FOMC's path for M1 and related required reserves, if a reasonable degree of reliance can be placed on that monetary aggregate, a question to be discussed in the next section.

Because of remaining uncertainties under current circumstances about the significance of M1 movements, any automaticity should probably be relatively limited in its scope. For example, in any given reserve period, an automatic change in borrowing might be limited to about 25 to 50 percent of a deviation in required reserves associated with an unacceptable variation in M1 from path. If M1 were unacceptably low by an average of $2 billion, this would mean an automatic drop in borrowing of only $35 to $70 million, given the existing 7 percent average required reserve ratio on transactions deposits. One of the advantages to relatively small automatic borrowing changes--and the Committee could always indicate a dollar maximum--is that erratic movements in M1 will not lead to very significant volatility in money market conditions.

Judgmental adjustments would presumably remain as the principal source of sustained movements in borrowing over time in the context of something like the current directive structure, which conditions changes in borrowing on a variety of nonmonetary as well as monetary developments. In connection with factors influencing the judgmental setting of borrowing, it may well be that in current circumstances assessment of the real degree of financial restraint or ease—which has often been judged by interest rates, credit flows, and liquidity conditions—depends more than usual on indicators of price pressures and on the value of the dollar in exchange markets. Inflationary expectations are, and have been, in a state of flux, and obviously affect the real restraint implied by nominal interest rate levels. Price indicators in that situation would need to be evaluated more closely than usual not only for what they may suggest about aggregate demand but also for their impact on inflationary expectations. In addition, international forces today have become a significant factor affecting U.S. economic activity and prices, arguing for relatively more attention than usual to the dollar exchange rate, which has risen more or less persistently since early this year, in assessing the over-all degree of financial restraint or ease.

Reliability of M1

Even if operating procedures are essentially judgmental, the degree to which adjustments are made in borrowing will depend to a great extent on confidence in the reliability of the aggregates—particularly of M1 if some degree of automaticity were allowed in operations—as indicators of current and future economic activity and prices. Over the years, much research has been devoted to comparisons of M1 and other aggregates as they relate to GNP and prices. Our work has generally shown that, of the various aggregates, M1 has conveyed the most information about current and future GNP and has also had the most stable, or predictable, demand relationship to income. There have, however, been episodes when these relationships have broken down in one way or another—for example 1975-76 and most recently 1982-early 1983. Even apart from such periods, the relationship between money and GNP is subject to considerable noise and uncertainty, particularly the shorter the time period considered.

Because of the sharp, atypical drop in the velocity of M1 in 1982-early 1983, the Committee greatly reduced the weight on M1 for guiding day-to-day operations. In the latter part of 1983, the velocity of M1 began to behave more typically, given the stage of the business cycle, and after a time the Committee increased the weight on M1 in some degree. It was still not given the importance it had over the three years following October 1979, partly because of lingering uncertainties about the likely behavior of M1 under varying economic and financial circumstances, in light of the institutional changes of recent years.

Our most recent examination of M1 behavior in relation to other aggregates and GNP from a variety of statistical perspectives suggests that on balance M1 is still the most reliable of the aggregates as a policy guide and that, following the 1982-early 1983 deterioration, its reliability since around mid-1983 seems to have been improving. As noted, its velocity has begun to behave more typically in recent quarters. It has also shown less unreliability than in 1982-early 1983 as a predictor of GNP behavior in monetarist-type models.

In addition, a recent regression analysis that compares the indicator properties of M1, M2, and M3 relative to each other shows that M1 still bears the preponderant weight in conveying information, with comparatively little additional information imparted by M2 and M3. However, the regression work also suggests that, while the average performance of M1 as an indicator of GNP remains high relative to the other monetary aggregates, the precise weight that one would attach to M1 has become more uncertain in recent years, as is also the case for M2.[1/] This perhaps reflects institutional changes of recent years that also may have contributed to some decreased reliability of the aggregates as a group as indicators of GNP.

Thus, examination of recent data provides some assurance that M1 is a noticeably more reliable guide than broader aggregates, but it is still far too soon to be reasonably confident about the underlying trend of its velocity, and its cyclical responsiveness to income and interest rates. In large part, this reflects the need for more experience with the public's financial asset behavior in light of the changed composition of M1 itself as well as the new deposits and fund outlets (such as money market deposit accounts and money market funds) in other, higher-order aggregates that also serve to one degree or another as both as means of payment and a repository for savings. For instance, the weak behavior of M1 thus far in the fourth quarter could be attributable in part to the public's placing funds in MMDA's that in prior years might otherwise have been deposited in M1-type accounts—given present interest rate incentives favoring MMDAs and increased familiarity with such accounts.

Base for the M1 target next year

The specific longer-run ranges for 1985 will be considered by the FOMC at its February meeting, against the background of a broad review of the economic outlook in the chart show and analysis of policy options. It may be useful at this time to raise an issue about the base for the targets, in particular for M1 in light of evidence that, of all

1/ Preliminary memorandum by Messrs. Porter and Swartz, "Relative Indicator Properties of M1, M2, and M3: Regressions of GNP Growth on Distributed Lags of Weighted Averages of the M's."

the aggregates, it may still be a relatively more reliable guide for policy. As will be recalled, the tentative ranges for next year adopted in July entail reductions for M1 and M2, to 4 to 7 percent and 6 to 8-1/2 percent, respectively. Ranges for M3 and total debt were left unchanged. The table below compares these tentative ranges with the ranges and estimated outcomes for 1984 (all data measured from QIV to QIV).

	Ranges for 1984	Actual	Tentative Ranges for 1985
M1	4 to 8	5	4 to 7
M2	6 to 9	7-1/2	6 to 8-1/2
M3	6 to 9	10	6 to 9
Debt	8 to 11	13-1/4	8 to 11

The Committee early this year had indicated an expectation that M1 growth over 1984 would appropriately be in the middle of the range, assuming normal velocity behavior. The velocity of M1 this year looks as if it will grow by about 4 percent, somewhat above previous experience in the second year of expansion. But this velocity outcome has been accompanied by noticeably slower nominal GNP growth (currently estimated at 9.1 percent from QIV '83 to QIV '84) than anticipated by the Committee at midyear, and at the low end of the FOMC's central tendency indicated in February. Real GNP growth was also slower than expected at midyear, but was above the central tendency expectation of early this year. Price behavior has been better than anticipated early in the year and at the low end of the midyear central tendency.

With the over-all economic outcome for the year somewhat worse than anticipated at midyear, and with M1 growth for the year in the lower part of the range, it can be questioned whether the range for 1985 should be based on the actual outcome for the fourth quarter, or instead should be based on the midpoint for that quarter of the 1984 target range. This type of question has, of course, arisen often in the past when the Committee has discussed questions of "base drift."

If the Committee retained the present 4 to 7 percent M1 range for 1985, aimed at its 5-1/2 percent midpoint, and based the range on the fourth quarter midpoint of the 1984 range, actual growth for 1985 would be 6-1/2 percent--making up for the one percent point shortfall relative to this year's midpoint. Such an approach, whatever its economic merits, is awkward presentationally since it would be difficult to avoid public confusion between actual growth expected and the somewhat artificial specification of the target growth range. In addition, there is always the question of why rebasing was undertaken this year, after many years of not formally offsetting overshoots and undershoots--which to a degree have averaged out over time, depending on the starting point.

Moreover, it may be difficult, though perhaps not overridingly so, to explain why the range for one aggregate is based on the midpoint of a previous year's range, whereas others are based on the actual outcome for a previous year. For M2, which looks as if it may end the year near the current midpoint, there is no meaningful problem. But for M3 and credit, which are above current ranges, in part because of special factors, a rebasing to the fourth quarter midpoints of their 1984 ranges would seem to imply much too limited growth relative to M1 and GNP should their tentative growth ranges for 1985 be retained. However, reference to the special factors affecting M3 and credit--for example, merger activity--does provide a rationale for different treatment relative to M1.

If the Committee wished to foster somewhat more rapid growth of M1 next year in light of the shortfall for this year that developed in the second half,[1/] it could do so more consistently with past targeting practice by continuing to base on the actual fourth quarter outcome and by simply indicating that actual growth is expected to be toward the upper end of the 4 to 7 percent range for 1985.[2/] But the more fundamental question, of course, is whether it would be desirable policy to compensate for the somewhat slower than expected M1 growth in 1984. The economic issue revolves in part around the question of whether the shortfall represents a "permanent" downward shift in demand for money, which need not be offset later, or whether it reflects a degree of restraint on money supply that will eventually unduly constrain demands for goods and services. In the latter case, the lower money growth would need to be subsequently offset.

Our quarterly model does suggest the possibility of a downward shift in money demand since, given estimated income and interest rates, the model forecasts stronger money growth in 1984, by about 1-1/2 percentage points, than actually is occurring. However, most of this "shift" took place in the fourth quarter, when actual income and to a lesser degree money (on a quarterly average basis) are still uncertain. Moreover, the model's forecast error this year differs little from what would be encompassed by

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1/ The concurrent seasonal adjustment procedure (as of now and before benchmark adjustments to the underlying data) would raise second half growth (QII to QIV) by 1/2 percentage point to about 3-1/2 percent at an annual rate and lower the first half by the same amount, which would moderate but not significantly change the pattern of steady deceleration in M1 growth quarter by quarter.

2/ Although this procedure would produce the same growth for the year as rebasing the current range and aiming at its midpoint, a rebased range would imply scope for more rapid growth early next year. This occurs because a rebased range starts at a higher level, thus arithmetically leading to relatively high actual growth early in the year if money is to move promptly to the midpoint of the new cone.

its normal range of uncertainty. Thus, model evidence about a downward demand shift is ambiguous. It is also difficult to point to institutional developments that clearly would lead to a lasting downward shift in M1 demand this year, though the recent popularity of MMDAs could be contributing to such a development.

Whether or not there have been demand shifts for money, practical, presentational considerations tend to argue against rebasing M1 at the fourth quarter midpoint of its 1984 range. In addition, the degree of looseness in the M1 to GNP relationship is such that the impact of only one percentage point of slower or faster money growth may readily be absorbed, or offset, by compensating unexpected movements in velocity. This looseness has led the Committee to express its annual growth targets for the aggregates as relatively wide ranges. But the Committee has often expressed its view about whether an aggregate can be expected to be high or low in, or at the middle of, its target range. If there is a desire to compensate for this year's relatively slow growth of M1, the size of the year's shortfall is small enough for that objective to be accomplished by growth in the upper part of the range for 1985 without altering past practice. The issue of what particular actual M1 growth would be desirable in 1985 can be more readily addressed in February, when the Committee will have more evidence about the basic strength of demands for goods and services and perhaps about the underlying behavior of M1 velocity.