APPENDIX

Notes for FOMC Meeting
May 20, 1986
Sam Y. Cross

The dollar has declined further since your April 1 meeting, dropping on balance about 6-7 percent against the major foreign currencies. In all, dollar exchange rates against those currencies have now fallen about 35 percent from their peaks of early 1985.

During the period since you last met, the market has continued to pay close attention to official attitudes toward the dollar's fall. There was not enough evidence of benefits to the U.S. economy and trade balance from the dollar's depreciation--as well as from lower interest rates and oil prices--to allay fears that U.S. authorities would wish to guide the dollar lower. At the same time, participants are well aware of pressures on foreign governments to ease the pain for their own industries of too-rapid a fall of the dollar, and of reservations about the potential inflationary effects in the United States. Thus, the dollar paused in its decline just before the summit meetings in Tokyo as traders anticipated the possibility of some agreement to support it. When the Summit passed with no such announcement, the dollar resumed its fall, reaching a new postwar low against the Japanese yen. During the last week, the dollar firmed somewhat, partly in response to a number of statements by monetary officials in the United States, Japan and Germany which were seen as indicating a desire for the dollar to stabilize, at least for the time being. This morning the dollar rose 1 percent on the GNP release.

During the first weeks after your April 1 meeting, further declines of U.S. interest rates were only partly matched abroad and long-term differentials between U.S. Government securities as compared with those of Japan and Germany narrowed at one point to within 200 basis points. The continuing moderation of global inflation expectations, in part a response to lower oil prices, provided impetus to the lowering of interest rates around the world which culminated at about the time of the Federal Reserve and Bank of Japan discount rate reductions announced April 18 and 19.

Since then, the momentum for a generalized fall of interest rates internationally has faded. Market participants noted that the Bundesbank, feeling constrained by the weakness of the Deutsche mark in the EMS, did not join in the mid April round of rate cuts, and recent statements by Poehl and other Bundesbank officials give little hope for rate reductions in the near future. Above-target monetary growth in several countries, as well as signs that the long-standing weakness of oil and other commodity prices may have ended, have been noted. The dollar's fall itself has been cited as one reason for the market's revised assessment of the scope for lower U.S. interest rates. In fact, as rates in the U.S. have backed up more than elsewhere in recent weeks, interest differentials have widened again to end the period slightly more in the dollar's favor than they were at the beginning of April. At the same time, some other countries which had previously kept interest rates high to shore up their currencies have continued to lower interest rates. This is true for the U.K. and Canada, as well as for several countries whose currencies were devalued in the April 6 EMS realignment. But exchange market expectations for further rounds of coordinated discount rate cuts by the major countries have faded.

The dollar also received some support from the Chernobyl disaster. That accident raised expectations of increased purchases of U.S. agricultural products. It has also eroded popular support for incumbent conservative governments in election campaigns in both

Germany and Holland, a political trend that lowers the attraction of some of the dollar's principal rivals as an investment currency.

Nevertheless, sentiment towards the dollar remains fragile. Some market observers expect the dollar to decline further and have called attention to the combination in recent weeks of a declining dollar and a widening of interest rate differentials favoring the dollar which they see as reflecting an underlying weakness of the dollar.

Notes for FOMC Meeting
May 20, 1986
Peter D. Sternlight

Domestic Desk operations since the last meeting were directed at maintaining an approximately steady degree of reserve pressure, with the reserve path allowance for adjustment and seasonal borrowing remaining at $300 million. This was done against a background of increasing growth in monetary aggregates (especially M1), mixed but mainly sluggish indicators on the economy, a declining dollar through much of the period, and subdued inflation data (though the recent upturn in wholesale oil prices is expected to show up in forthcoming statistics). Interest rates pushed downward early in the period, continuing the first quarter decline, but once the Federal Reserve's mid-April discount rate cut to 6-1/2 percent was out of the way, rates steadied or worked higher to end the period with mixed changes at the short end and somewhat higher for longer maturities.

All three money measures outpaced the Committee's anticipated March-June pace in April and early May. This brought M1 appreciably above its annual growth cone and even above the more accommodative parallel bands, but M2, after its slow first quarter, was still low in its annual range and M3 near the middle of its range.

While focusing on reserve paths that maintained a steady allowance for $300 million of borrowing, the Desk sought to be cautious and sometimes a bit sluggish in providing for indicated reserve needs. This was especially so around the time of the discount rate reduction when there seemed to be particular risk of excessively buoyant financial market sentiment and concern about a gathering momentum toward dollar weakness. Close attention to the dollar continued even after the frothy bond market sentiment had cooled off.

Around the time of the last meeting, with the discount rate at 7 percent, federal funds tended to fluctuate largely in a range of 7-1/4 - 7-1/2 percent. In early April as market participants increasingly anticipated a cut in the discount rate, funds rates edged off, down to and then slightly below 7 percent. Following the mid-April discount rate move, funds have averaged close to 6-7/8 percent.

Borrowing levels for full maintenance periods have come in close to the $300 million level except for the April 23 period when exceptionally low borrowing--under $100 million--in the week preceding the discount rate cut led to a $190 million average for the two-week interval. Excess reserves have come in close to the recent path allowance of $900 million except in the April 9 period when excess was only about $600 million. Surprisingly, that was the reserve period that marked the formal start of a closer monitoring of daylight overdrafts.

To meet reserve needs over the period, the System bought about $3.1 billion of bills, nearly $2 billion in a market operation on April 2 and the rest from foreign accounts spread out over the period. There were numerous rounds of System or customer-related repurchase agreements, especially when the Treasury balance ran high after the mid-April tax date. On one occasion, early in the period, temporarily over-abundant reserves were drained through matched-sale purchase transactions in the market. The Treasury balance was particularly hard to predict from day-to-day, especially just after the tax date when some changes in IRS procedures apparently contributed to unusually large projection errors. One result was a brief inadvertent overdraft of the Treasury's account at the Federal Reserve, at a time when the Treasury actually had very large balances at their commercial bank depositories.

Lower interest rates early in the period reflected a continuation of the market forces that dominated the previous few months--chiefly sluggish economic news and low oil prices. A sense of accommodativeness at the central bank and strong foreign buying interest also bolstered sentiment that got to be a bit frenzied at times. The mid-April cut in the discount rate came to be widely anticipated, or even over-anticipated in the sense that some market rates had moved down to levels that could only be justified by a greater reduction than 1/2 percent--though few observers really seemed to expect that larger move in the immediate term.

Once the discount rate was cut, fed funds and some other short rates were more firmly anchored at a lower level but the discount rate was no longer there to anticipate as an immediate expectation, and the Board's announcement itself seemed to provide little encouragement of further moves to come.

Meantime, some of the earlier underlying factors shifted course. Oil prices levelled off and began backing up. Weakness in the dollar seemed to be causing increased official concern while strength in M1 began to gain attention, and these factors were seen as reducing the likelihood of further near-term central bank accommodation. Approaching, and then arriving, large supplies of new debt from the Treasury was also a factor, as was the huge supply of corporate issues induced by the rate declines in earlier months.

Just around the time of the discount rate cut, Treasury bills dropped below 6 percent on a discount basis and two-year Treasury notes were quoted in the 6.30's--a sharp contrast with their usual spread above the current funds rate and overnight financing rate. The yield on thirty-year Treasury bonds dropped as low as 7-1/8 percent, partly reflecting an unusual technical scarcity in that issue. By the end of the period, bills had backed up to around 6.20-6-3/8 percent--actually quite close to the quotes just before the last meeting. The two-year rate moved up to about 7.20 from 6.85 at the start, while a ten-year Treasury issue yielded around 8 percent compared with 7-3/8 when the period began. Thirty-year Treasury issues are something of a story unto themselves because of heavy Japanese purchases, but that sector showed a similar pattern with the Treasury's new 30-year bond ending the period around 7-3/4 compared with about 7.45 for what was the longest Treasury issue at the start of the period.

The Treasury raised about $16 billion in new money during the period, nearly all of it in coupon issues and the great bulk of that (some $13 billion) in the mid-May refunding. In that operation, they sold $9 billion each of 3, 10 and 30-year issues, particularly stepping up the amounts in 10 and 30 years, compared with past financings, in light of their decision to discontinue quarter-end offerings of 20-year bonds. Despite the huge size, the offerings went quite well, notably the 30-year of which around half went to Japanese buyers. The 10-year note in which the Japanese were a moderate factor, seems to be the least well distributed of the three, although all three issues are currently below issue price, and their yields are about 40-50 basis points above the auction averages.

As for the current state of market sentiment, one gets the feeling that the great rally momentum of the last several months has been spent. Some participants expect more easing "down the road" which could move rates back toward their recent lows, but then quite possibly followed by firmer rates in the context of a strengthening economy. Many others see a near balanced situation for the time being with the Fed content to sit back and weigh developments. Few would look for significant near-term firming efforts, though some would not rule out seeing the market firm on its own in response to stronger news on the economy, stronger money growth or stirrings on the price front.

J. L. KICHLINE
May 20, 1986

FOMC BRIEFING

The basic contour of the staff's forecast for the economy remains unchanged from that presented at the last meeting of the Committee. Real GNP is expected to rise at a 2 percent annual rate in the current quarter and to accelerate to a 4 percent plus rate in the second half of the year. However, there is as yet not much to show for the faster growth we believe to be in prospect, and we still need to rely mainly upon our assessment of the fundamental forces driving activity. On the inflation side, we have lowered projected inflation somewhat in both 1986 and 1987, but have maintained the pattern of rising inflation next year.

For the current quarter, the available information relates largely to developments in April, and the data present an uneven pattern. Employment rose moderately owing to gains in service, trade, and construction sectors while employment in manufacturing and mining continued to contract. Industrial production increased 0.2 percent after deep declines in the preceding two months; oil and gas drilling activity continued to plunge, but in a number of other areas output increases were suggestive of a somewhat improved situation.

In the consumer sector, total retail sales rose 1/2 percent in April. Unit car sales were up considerably given a return of financing incentives, and domestic model sales rose further early in May. Aside from autos, gasoline, and nonconsumer items, retail sales actually declined. The housing sector has responded strongly to the drop in mortgage interest rates and starts were at a high 2 million unit annual rate in April. At this point we do not have firm data on business fixed investment spending, but believe equipment spending will rise from the depressed first-quarter pace. The first quarter evidently was influenced by efforts to take delivery of equipment before year-end in light of possible tax reform.

The rate of growth of real GNP this quarter is being damped by two major forces. The domestic automobile sector is being hampered by excessive inventories and the staff forecast incorporates a sizable reduction in auto production this quarter. Developments in the auto sector are expected to cut about 1-1/2 percentage points off real GNP growth. We also have built in further reductions of structures spending in the energy industry which takes off roughly 1/2 percentage point of real GNP expansion.

Beyond the current quarter, these negative influences on activity are expected to wane, and the stimulative effects of the lower levels of interest rates, oil prices, and the foreign exchange value of the dollar are forecasted to show through in stronger economic growth. Unfortunately, the only clear evidence of strengthened performance to date is in the housing sector, and the generally high level of activity there is projected to persist. Consumer spending has been rising about 3 percent on average over the past year and is expected to increase at about the same rate in coming quarters.

Two key areas where major questions remain are business fixed investment and net exports. We are counting on both areas to contribute importantly to activity later this year and in 1987. The indicators of business investment generally remain weak and there are uncertainties as to the effects, if any, of prospective tax reform on business plans. For net exports, the available data do not yet provide evidence of substantial improvement. In any event, if we have correctly assessed the timing and magnitude of the projected pickup in growth of real GNP the evidence will need to emerge in the indicators over the next couple of months.

With regard to wage and price developments, incoming information has been about in line or better than anticipated. Wage and compensation growth still seems to be slowing a little and we have reduced somewhat expected future acceleration in labor costs. The monthly price indexes have been influenced heavily by declining energy prices, but also seem to be rising a little less rapidly overall than had been expected. The GNP fixed-weighted price index is projected to rise 2-1/2 percent in 1986--one-half percentage point less than in the previous forecast. For 1987, we project the inflation rate to move up close to 4 percent associated with ending of oil price declines, tighter labor markets, and especially the price effects of the lower value of the dollar.

FOMC BRIEFING
Donald L. Kohn
May 21, 1986

The period since the last meeting has been marked by a substantial surge in money--extending beyond M1 to the broader aggregates. The bluebook alternatives contemplate some moderation in money growth over the balance of the quarter, but given the growth thus far in the quarter, all three alternatives specify growth rates for all three measures of money that are above the short-run paths set by the Committee at its last meeting. The paths for M2 and M3 would leave these broader aggregates reasonably close to the midpoints of their respective ranges in June. Growth rates specified for M1, however, would all place this aggregate above its upper parallel line in June. In this situation, a key question before the Committee is how to react, if at all, to these growth prospects for money, especially M1. While the current decision involves only a mid-quarter review of growth paths, it could have implications for the situation facing the Committee when it reconsiders its longer-term objectives in July.

It seems clear that a major reason for the rapid money growth, and accompanying steep decline in velocity, is the downward movement in interest rates of recent months. With the yield curve flattening at the same time, the decrease in the opportunity costs of holding the most liquid monetary assets has been especially marked. Econometric model results suggest that up to 5 percentage points of growth of M1 expected in the second quarter can be attributed to the effects of lower interest rates.

However, interest rate effects alone do not seem to be able to explain all of the 13 percent money growth and 9 percent velocity decline, at least based on historic relationships. In part, the models may not be capturing the full interest sensitivity of money demand at the historically low opportunity costs that have come to be associated with holding NOW accounts. And in this regard, very rapid growth of OCD, such as the 30 percent pace recorded in April may not be all that surprising. But the degree of strength in demand deposits through early May is somewhat puzzling. It could be that business cash management is being pursued less aggressively--in light of E.F. Hutton and other uncertainties as well as lower opportunity costs--or that these deposits are being boosted by a large volume of purely financial transactions, or that interest-sensitive compensating balances have come to represent a higher proportion of demand deposits as households shift to NOW accounts and businesses pare excess cash holdings. In any event, the extraordinary growth of demand deposits, as well as the size of the decline in M1 velocity more generally in the current quarter, raise questions as to whether some of this surge might not be reversed, or at least whether a period of considerably more restrained M1 expansion might be in the offing. The bluebook alternatives assume no reversal over the balance of the quarter, but they do presume an abatement of unusually strong growth--especially in demand deposits.

Even if the expansion of M1 is seen to be primarily interest rate related, that does not go far in telling us the degree to which the rapid money growth may be providing stimulus to the economy. To the extent that interest rate declines have primarily been associated with sluggish investment demand or reduced inflation expectations, the surge in money may have served primarily to keep real interest rates sufficiently low to sustain economic expansion. On the other hand, a simultaneous increase in money and reduction in interest rates obviously may be largely a result of a more stimulative policy of reserve provision by the Federal Reserve, which in time will boost economic activity.

Alternative A would seem most consistent with the view that the expansion of M1 has primarily reflected relatively permanent additions to highly liquid balances as nominal interst rates decline in response to lower inflation and weaker final demands. In this context, the more moderate growth in M2, at least for the year-to-date, could be seen as reinforcing the notion that M1 growth represents more a shift in the location of savings than a general build-up of liquidity that is likely to spur future spending. Indeed choice of alternative A would seem to imply a judgment that there is a risk that underlying demands in the economy remain relatively weak, and monetary expansion has not been sufficient to reduce real interest rates to levels that will assure a stronger economic performance in the second half of this year and next.

However, the specifications of alternative A put M1 in June at a very high level, and the delayed effects of still lower interest rates on money demand in the second half of the year would seem to imply a substantial probability of growth for the year in excess of the long-run range. The possibility of such an outcome would be less of a concern to the extent the decline in rates was seen as leading only to moderate economic expansion and the heightened interest sensitivity of money demand resulted in a further weakness in velocity in the second half.

Alternative C is more consistent with a view that money growth has been--or is quickly becoming--excessive, increasing the risk of a very sharp snap back in the economy later in the year with potentially adverse effects on underlying inflation pressures. In this view, the elements for such a substantial strengthening of the economy are in place, stemming in large measure from factors that traditionally have suggested an expansive monetary policy--lower interest rates, higher stock prices and a declining dollar.

The firming in interest rates implied by the reserve specifications of this alternative could be viewed as a step toward restraining M1 to the Committee's current 3 to 8 percent long-run range. This might be considered particularly appropriate if an especially vigorous economic expansion were expected in the second half; under those conditions velocity might very well rebound.

Alternative B might be characterized as consistent with the view that accommodation of recent money growth has been appropriate and necessary to assure a stronger economy in the second half, but further very rapid money growth may prove to be excessive. Given the huge build-up in liquidity, a substantial slowing of M1 growth would be welcomed and accommodated under this alternative by holding reserve conditions unchanged. The staff has projected such a slowing, based in part, as I have already noted, on expectations that the unusual surge in the volatile demand deposit component will not continue and some gradual moderation in OCD growth as both depositors and depositories adapt to the lower level of market rates. A moderation of M2 growth from its recent rapid pace also would seem appropriate, and has been built into the alternative B path. Although this aggregate is now in the lower portion of its range, continued strong growth at the same time that M1 was running above its range might suggest more cause for concern. With regard to yearly growth paths, alternative B could be considered as something of a holding action. M1 would be above the upper parallel line associated with its annual range in June under this alternative, and a considerable slowing of its growth and moderate rise in velocity would be required for the second half to achieve its annual objective. Yet, particularly if the expected slowing materialized over coming weeks, such an outcome would still be a possibility, although it could require some upward movement of interest rates as the economy strengthened in the second half.

Finally, Mr. Chairman, I would like to draw the Committee's attention to the directive language suggested for Committee consideration. Variants II and III of the directive acknowledge and react to the recent overage in money growth relative to the Committee's short-run path. Both emphasize the expected slowing in money growth over the balance of the quarter. With respect to policy implementation over the coming intermeeting period, variant II retains the current laundry list of criteria for tightening reserve availability, while spelling out a little more explicitly the circumstances under which availability could be eased. Variant III carries over much of the easing criteria from II, but clarifies that a tightening of reserve conditions could be acceptable if the expected slowing of money growth does not materialize.