

APPENDIX

Notes for FOMC Meeting
November 5, 1986

Sam Y. Cross

The period since the last FOMC meeting was characterized, first, by three to four weeks of dollar weakness, followed by a period of dollar recovery. After these moves the dollar is now on average about 2 percent above the level of six weeks ago as measured by the Federal Reserve Board index.

During late September and the first half of October, pessimism toward the dollar deepened. The U.S. economy seemed to be going nowhere and there was little evidence of improvement in the current account. Dealers and investors saw little risk in maintaining short dollar positions. International discussions around the time of the IMF Annual Meeting had failed to produce any broad initiative for dollar support, and public calls by U.S. officials for more stimulative policies abroad were publicly rejected.

The deterioration of market sentiment was most evident in the downward movement of the dollar against the German mark and other continental currencies. The dollar traded as low as DM 1.97-1.98, both before and after public declarations by officials of EC countries in late September after the Gleneagles Conference of their intention to resist

a further slide in the dollar. Following those declarations, continental central banks, under the Bundesbank's lead, purchased on various occasions a total of more than half of this on a single day.

During that period, however, the dollar remained steady against the yen. Market participants perceived growing stagnation in the Japanese economy, and there were many reports that some export firms were finding it increasingly difficult to adjust to the yen's appreciation. These conditions, and disappointment that a Japanese discount rate cut had not taken place, reportedly led investors, particularly foreign investors, to sell their shares in Japanese companies, and to shift into dollar and other non-Japanese investments. Adding to the downward pressure on stock prices also was talk of probable changes in Japan's capital gains tax. Prices on the Tokyo equities markets fell by more than 10 percent in mid-October.

Another source of demand for dollars resulted from the fact that various large Japanese financial institutions apparently chose to repay dollar borrowings to offset the balance sheet losses in their stock portfolios resulting from the decline in Tokyo share prices. These Euromarket borrowings had been initiated when the dollar was at higher levels, as a hedge against the purchase of dollar-denominated securities, and the firms realized a profit by repaying them at prevailing exchange rates.

These dollar purchases by Japanese firms occurred at a time when business statistics were beginning to look somewhat more favorable for a revival of growth in the U.S. economy. Then, when the September U.S. merchandise trade figures came in much better than expected, many traders joined in with dollar purchases.

Against this background, the hints of a discount rate cut in Japan, subsequently announced last Friday, offered good support for the dollar. When Finance Minister Miyazawa announced the agreement with Secretary Baker, market participants scrambled to cover some of the short positions which had been built up during the earlier weeks of dollar pessimism, moving the dollar to higher levels. The dollar also moved higher against the European currencies, although the Treasury was at some pains to make clear that the agreement with the Japanese did not imply U.S. satisfaction with the performance of Germany and others. Although Miyazawa's suggestions that appreciation of the yen would be resisted by joint intervention were denied by the Treasury, dealers interpreted the agreement as, at a minimum, assurance that Secretary Baker was broadly satisfied with present exchange rate levels.

With the exchange markets impressed that international cooperation had been renewed, at least between Japan and the United States, and that officials on all sides seemed generally satisfied with present rates, the dollar continued to firm and by close of business Tuesday had eased slightly to trade just below DM 206 and ¥ 164, less than one percent higher against the mark and 6 1/2 percent higher against the yen than at your last meeting. Although traders remain uncertain about the exact implications of the agreement between the two ministers, they have for the present assumed a more relaxed attitude toward the dollar.

On swap operations during the period, the Bank of Mexico drew on its own reserves to repay \$270 million of the official bridge financing facility extended in August. Of this sum, \$133.8 million went to repay drawings from the Federal Reserve (\$66.8 million) and the U.S. Treasury (\$67 million). The remaining outstanding drawings on the official credit facility are scheduled to be paid in two tranches, with a payment of \$270 million due in late November and \$310 million in mid-February. Of these sums, a total of \$287.3 million is due to the Federal Reserve and U.S. Treasury. Efforts are still proceeding within the Bank Advisory Committee to arrange a "critical mass" of bank financing so that the Mexican financing package and IMF program can go forward.

Before closing, Mr. Chairman, I would like to seek the Committee's approval of the Federal Reserve swap agreements with other central banks and the BIS that come up for renewal in December. Aside from the swap drawings by Mexico, these facilities have not been drawn on for several years, either by the Federal Reserve or any of the counterparties and they cannot be drawn except by reciprocal agreement. However, it is important to keep these facilities in place and available in case of need. I recommend that the Committee authorize their extension for a further period of one year, without change.

Mr. Sternlight made the following statement:

Domestic Desk operations since the last meeting have been directed at maintaining unchanged conditions of reserve availability. The broader monetary aggregates, while hovering around the tops of their annual growth ranges, tracked within the Committee's preferred pace for August-to-December. Economic data remained mixed, but left most observers with a sense of modest growth over-all perhaps verging to the sluggish side.

Reserve objectives continued to allow for \$300 million of seasonal and adjustment borrowing. The provision for excess reserves initially remained at \$900 million, though informal allowance was made for the recent tendency for excess to fall short of this level. As the period progressed, the standard allowance for excess reserves was trimmed to \$850 million in recognition of the recent experience. Actual borrowing levels were close to path, averaging about \$325 million in the two full reserve maintenance periods since the last meeting, and about \$220 million in the first 12 days of the current period. Average Federal funds rates have remained close to the anticipated 5 7/8 percent area, ranging a little higher around the end of September when quarter-end pressures came into play, and a bit lower in early October as Treasury balances at the Fed came down swiftly and were redistributed to the banking system. The rate was a bit firmer again the last couple of days, possibly because of pressures stemming from payments

for new Treasury issues while reserves moved toward smaller banks in the wake of monthly social security payments.

Reserve needs were moderate for the period as a whole, and were met through a combination of outright purchases of about \$1.3 billion of bills from foreign accounts, and a succession of System and customer repurchase agreements on most days of the period. Incidentally, the outright purchases bring the total System portfolio to just over \$200 billion, including nearly \$100 billion in Treasury bills. I should note that we project quite heavy reserve drains in the upcoming intermeeting period, with seasonal increases of currency in circulation the major factor. At this point, it is not certain whether we will require an increase in the standard \$6 billion leeway for an intermeeting period, but that should be clarified as the period progresses, and we'll request additional leeway if we conclude that it's needed.

Interest rates through most of the maturity range moved moderately lower on balance during the past intermeeting period, essentially retaining the steeper yield curve that developed in September. There was very little net change in the bill area, however, where key rates were unchanged to down about 10 basis points. In the latest auctions, the 3- and 6-month bills were sold at average rates of 5.23 and 5.30 percent, down just slightly from 5.25 and 5.39 percent just before the last meeting. At times, bill supplies were curtailed because of Treasury debt ceiling constraints, but net

over the period the Treasury raised about \$8 billion in the bill market, about half of it through a \$4 billion cash management bill that just settled yesterday.

Yields on coupon issues of various maturity were down about 20-40 basis points, responding essentially to a sense that the economy's expansion remains on the moderate to sluggish side--even though some specific indicators looked stronger at times. Actual and anticipated strengthening of foreign demand for U.S. securities was also helpful to the coupon market, based in part on official statements looking forward to a steadier dollar and a few signs that the trade deficit might be starting to turn down. Given the lackluster view of the economy, and a subsidence of concerns about near-term inflation and growth in the broader money measures, there is some sense that monetary policy could turn a notch more accommodative, including another discount rate cut--but generally a move is not expected on the immediate horizon. Also, there is not much conviction that such a move would in itself bring lower long-term rates, although the anticipated softness in the economy could well have that effect. Let me add as a footnote that early indications suggest no big market reaction to yesterday's election results. There was a modest markdown of prices overseas, but it did not seem to be carrying through.

The Treasury has been raising substantial sums in the coupon market--about \$13 billion in the intermeeting period not

counting the quarterly refunding issues for which auctions began yesterday. These refunding issues which are also being auctioned today and tomorrow, will raise a further \$15 1/2 billion of net new money. In line with recent Committee discussion, the System's holdings of maturing issues in this refunding will be exchanged predominantly for the 3-year issue, with only quite modest amounts going into the 10- and 30-year options.

M. J. Prell
November 5, 1986

FOMC Briefing
Economic Situation and Outlook

The forecast we've provided for this meeting is broadly similar to those presented at previous meetings. We are looking for the economy to grow a bit faster in the coming year or so, and for inflation to pick up a little because of developments in the oil and foreign exchange markets. In the anticipated policy environment, including the moderate shift in the direction of fiscal policy, growth in domestic demand should be restrained while resources are shifted at the margin toward the tradeable goods sector.

Unfortunately, there is not yet much evidence with which to confirm that these trends are indeed emerging in the current quarter. Few of the data now in hand go beyond September, and some don't go that far. Our forecast of 3 percent real GNP for this quarter thus depends on inferences drawn from a very small pool of information on production, spending, and prices.

On the production side, three pieces of information stand out. First, the employment report for September showed a relatively small increase in payrolls, a further decline in manufacturing jobs, and a flat total for production worker hours. This, coupled with other indicators and anecdotes, has led us to expect a rather moderate increase on average in labor inputs in the current quarter. Second, however, even allowing for a trimming of assembly plants, it appears that auto output in this quarter will exceed that in the third quarter by enough to give a slight boost to GNP. And, finally, the indications of a bottoming out in the rig count suggest that drilling activity, which has been a considerable drag on GNP thus far this year, should be a neutral element in the fourth quarter.

On the expenditure side of the equation, we find ourselves in the midst of some complicated special stories. As a consequence, the composition of spending in the forecast undergoes some rather exotic gyrations. In the current quarter, for example, increases in inventories and net exports more than account for the growth in real GNP. Two unusual factors are at work here. One is the payback in auto sales after the recent promotions. Domestic car sales have averaged only 6-1/4 million units at an annual rate in the two ten-day selling periods since the incentives were dropped, and although some pickup is expected before yearend, we anticipate that an appreciable share of this quarter's higher auto production will end up in dealer inventories. The other unusual factor is the surge in oil imports that occurred in the third quarter and that seems likely to reverse at least in part in the current period, thereby boosting growth in net exports beyond what we believe to be the emerging favorable trend.

In terms of the underlying trends, we are projecting only a moderate expansion in consumer spending over the forecast period. Even if, as expected, the personal saving rate does bounce back in the current quarter from the extraordinarily low level reached during the September auto buying binge, the presumably waning influence of the earlier surge in stock and bond market wealth and signs of debt servicing difficulties among households suggest that we shouldn't look for spending to outstrip income growth in 1987.

In the business sector, near-term expenditures may be buffeted by the cross-currents associated with, on the one hand, a small payback after the recent runup in auto and truck purchases and, on the other, efforts to acquire capital goods before less generous depreciation rules take effect.

The September jump in orders for nondefense capital goods was, we think, influenced by such tax considerations. But we also believe that there is a hint of a more fundamental firming in the orders for equipment, and we are looking for moderate gains in producers' durables spending as 1987 progresses. Those gains should be sufficient to offset the decreases that we expect to occur in nonresidential structures outlays. Construction put-in-place was unchanged in September, and up slightly in the third quarter as a whole, but the data on contracts and vacancies point to a strong enough downtrend in office building, in particular, to pull down total structures outlays substantially in the months ahead.

In the residential construction sector, we are projecting only minor variations in the level of activity, in an environment in which financing costs do not change substantially. Housing starts have been trending gradually lower since the first quarter, dropping below the 1.7 million unit annual rate mark in September. Recent figures on sales of single-family units indicate that a rebound may be in store for that segment of the market, but, in light of still rising vacancy rates and adverse tax law changes, we expect multifamily building to sag further.

One surprise in the recent data has been the strength of state and local spending. Public construction outlays have skyrocketed in the past two quarters, as governmental units appear to have stepped up infrastructure outlays with the grants and borrowed funds they had been accumulating. Remarkably, in the Commerce Department's preliminary figures, state and local purchases accounted for more than half of the growth in real GNP over the second and third quarters combined. Regional differences obviously are significant,

but our reading of the state and local budgetary situation suggests to us that increases in this sector's spending are likely to be more moderate in the future.

As I noted earlier, the external sector remains a key element in the pattern of activity we have forecast. Real exports posted a sizable gain in the third quarter and we are projecting solid gains throughout the forecast period. Agricultural exports appear to be moving up now that support price levels have dropped, and some non-ag industries--led by aircraft--have posted healthy orders and sales abroad. On the import side, noticeable price increases have become somewhat more widespread, and should increasingly damp the flow of goods into this country.

Finally, on the wage-price front, the recent news has, on the whole, been quite favorable. Consumer and producer price index increases have been enlarged of late by what ought to be some transitory spikes in food prices and by what may well be more lasting increases in gasoline and fuel oil prices. Outside of food and energy, the trends of price increase have not changed materially in recent months. As we move on into 1987, however, the firming of energy prices and the rise in import prices are likely to leave a clearer imprint on overall inflation rates, especially at the consumer level.

On the labor cost side, recent data measuring compensation trends have been very encouraging. It is clear that a combination of slack demand in some sectors of the labor market and the first-half halt in consumer price inflation have produced an appreciable moderation of compensation growth from the pace of the preceding year or two. That moderation is evident across the full range of private industries, among union and non-union, white and

blue collar workers. But it appears to us, too, that people are viewing the benefits of the drop in oil prices as a one-time bonus and are not building it fully into their inflation expectations. Moreover, in coming months the firming of energy and import prices will be feeding into formal and informal COLAs. Under the circumstances, while we do not see labor markets tightening enough to create general pressures on wages, we believe it most likely that compensation increases will become somewhat bigger as time passes. Even so, hourly compensation rises only 3-1/4 percent next year, in our forecast--still considerably below the 4 percent 1985 pace—and unit labor costs go up only about 2-1/2 percent in the nonfarm business sector.

Donald L. Kohn
FOMC BRIEFING
November 4, 1986

Developments in financial markets since the last FOMC meeting have--for a change--turned out very close to expectations. In credit markets, as Mr. Sternlight has reported, the federal funds rate remained in the 5-7/8 percent area prevailing at the time of the last meeting, while other rates have tended to decline a bit, especially at the long end of the maturity spectrum. M2 growth slowed in September and M3 in October, leaving both within the short-run 7 to 9 percent paths the Committee specified for August to December, and right at the tops of their longer-run ranges. M1 growth slowed even more substantially in September relative to its pace over the previous several months, and while it accelerated in October, the two months combined are well below the extraordinary growth rates over the summer.

One does not want to make too much of the last two months of data, but it could be that we are seeing the beginnings of a return toward somewhat more moderate money numbers, and at least smaller declines in velocity. For M2, after stripping away the RP and Eurodollar components, which are driven by bank funding needs, the rest of this aggregate has been slowing since late spring. This has occurred despite further declines in short-term rates in July and August. It may be that the declines in rates earlier this year had more of an effect in part because long-term rates were also falling. It probably was not only the lag in the adjustment of M2 rates but also the flattening of the yield curve earlier in the year that helped attract funds from outside this aggregate in the second and third quarters. The yield curve has steepened a little since the spring, and, with intermediate-term

rates essentially unchanged on balance over recent months, offering yields on a portion of M2 time deposits have had a chance to come into better alignment with market rates. Overall growth of liquid assets has remained quite high--estimated at 9-1/2 percent in September--but M2 seems to be capturing a slightly smaller share.

The alternative B path in the bluebook envisions a continuation of this trend of decelerating M2 growth, assuming unchanged reserve conditions and about the current level of market interest rates, as depositor portfolios become more fully adjusted to the previous declines in opportunity costs and as depository institutions allow offering yields on the more liquid components of M2 to edge lower. M3 growth over the balance of the year also is considered likely to remain at a reduced pace, given expectations of relatively slow growth of credit at banks and thrifts--and thus of managed liabilities to fund that growth.

The M1 picture, as usual, is more uncertain. The recent slowing has been accounted for primarily by a sharp reduction in demand deposit growth. It is difficult to account for a deceleration of demand deposits of this dimension, and some strengthening in this component over coming months seems likely, in part reflecting the effects of declines in short-term rates over the summer in raising compensating balance requirements for businesses. At the same time, with the spread between rates on NOW accounts and on other savings vehicles still extremely narrow, the OCD component of M1 has continued to expand at close to the pace of the spring and summer, and is expected to moderate only slowly. On balance, M1 under alternative B is not expected to slow much further over the near term, expanding over November and December at about its average pace of the last two months.

Even with the recent moderation of money growth, expansion of all the aggregates continues to outstrip increases in income by a wide margin, but velocities do seem to be dropping in the fourth quarter less rapidly than in the third. And, we expect this trend toward smaller decreases in velocity to be extended into the first quarter as well. Of course the Committee's decision today will have an important effect in the growth of the aggregates early next year. At that time, there will be several conflicting forces affecting money growth. On the one hand, should interest rates remain near current levels, the effects of previous rate declines would continue to wear off, helping to moderate money growth. On the other, the expansion of nominal income and spending is expected to pick up early next year. On balance, and recognizing the precarious nature of money predictions extending as many as 5 months into the future, there would seem to be reasonable odds that money growth would slow a little further from the fourth quarter, with the broad aggregates expanding a little below the upper ends of their tentative 1987 ranges and M1 somewhat more slowly than the 14 percent rate anticipated for 1986.

These expectations are based on essentially unchanged money market rates over the balance of the year as in alternative B, and into next year as well. This pattern is consistent with the staff GNP forecast, which assumed that rates would remain near current levels over the forecast horizon. Real interest rates, at least in the shorter maturity range seem to be around 2 percent, given nominal yields on a one-year bill of around 5-3/4 percent and inflation expectations of around 3-3/4 percent. This level of real rates is not high by historic standards, and is considered to be consistent with a modest expansion in domestic demand, with, as Mr. Prell

reported, much of the boost to GNP arising from the turnaround in the foreign sector.

Should the Committee choose the reserve conditions of alternative A, the chances are greater that money growth could accelerate a bit towards year end and into the first quarter, possibly bringing the aggregates above the upper ends of their growth cones early in the year; but even this alternative would not be expected to induce expansion outside the parallel bands in the first quarter. The effects of such an easing in reserve markets on long-term rates is difficult to gauge. The yield curve retains a significant upward slope, likely reflecting expectations of an emergence of more rapid inflation, skepticism about the sustainability of the trend toward smaller budget deficits, and concern about the implications of possible weakness in the dollar for inflation, monetary policy, and foreign demands for dollar assets. The slight flattening of the yield curve that has occurred recently seems to have been associated with some reduced anxiety about the dollar, and perhaps about inflation prospects as well. Longer-term rates could work their way lower without much additional encouragement from monetary policy if incoming data and market developments induced further downward revisions in expectations about the economy and price pressures. In these circumstances, more substantial declines in long-term rates would be possible if policy were also eased. In the absence of signs of weakness though, easing actions may have only limited near-term effects on long-term rates, especially if the easing put substantial downward pressure on the dollar.

The tightening conditions of alternative C probably would have a substantial impact raising bond yields, at least initially. This alternative might be considered most appropriate if the outlook for the economy seemed

favorable and there were concerns about the broad aggregates exceeding their ranges in late 1986 and early 1987, and the implications of continued rapid money growth for potential price pressures in 1987 and beyond.

In this regard, especially should the Committee choose to keep reserve conditions unchanged, it might want to consider how to respond to the possibility of an overshoot in the ranges for the broad aggregates over the balance of 1986. While actions taken over November and early December are unlikely to affect to any appreciable extent the actual growth of the aggregates for 1986, the Committee might want to be seen as reacting to such a development, at least if the overage seemed likely to be appreciable and other factors also appeared to support a firming move. The draft directive in the bluebook retained the language adopted at the September meeting regarding the factors to be weighed in making intermeeting adjustments to reserve conditions; this structure may be interpreted as putting a little more emphasis on growth of the aggregates in making such adjustments than did the language used over the previous year.