

APPENDIX

Notes for FOMC Meeting
December 16, 1986

Sam Y. Cross

During the past several weeks, indeed since late September, dollar exchange rates have tended to steady. The momentum for a continuous dollar decline, a trend that was evident during most of 1985 and 1986, appears to have faded, at least for the moment, and market participants show little conviction about the probable course for exchange rates in the immediate future. Although underlying negative sentiment has led many to maintain short dollar positions, few feel a need to sell dollars aggressively in the near term. To the contrary, in recent weeks as corporate customers have purchased dollars for end-year needs, dealers have moved quickly and defensively to pass those purchases into the market at least in part to avoid expanding their own short positions ahead of the year end reporting date. On balance, the dollar is now about 2-1/2 percent lower against the German mark and 1/2 percent lower against the yen than it was on November 5, the date of your last meeting.

The greater stability of dollar exchange rates is most clearly illustrated by the narrow trading range for the dollar/yen during the intermeeting period. The late October Baker/Miyazawa agreement was seen as official acceptance that the yen/dollar rate was satisfactory under present circumstances, and as demonstrating a commitment to seek other policy measures, not just exchange rates, to help equilibrate global imbalances.

The market has not yet seen great progress with respect to reducing these imbalances, but there are a few signs of hope. The U.S. trade deficit seems to have stopped growing, and preliminary reports show a modest increase in U.S. exports during October.

Abroad, the picture is mixed. Domestic demand in Japan grew at a relatively rapid pace in the most recent quarter, but in Germany it grew only modestly.

There is certainly no assurance that the relatively quiescent markets of late 1986 will extend into 1987. Indeed, there are several factors that could introduce further tensions into the exchange markets and put downward pressure on dollar exchange rates.

One important issue is whether there will be a less confrontational international economic environment. Market participants are focusing closely on Secretary Baker's discussions with the Europeans, and whether those discussions will in time lead to cooperative action on interest rates and possible understandings with respect to present exchange rates, or whether, in the absence of progress soon after the German elections, there will be renewed pressures by the U.S. Administration.

Market perceptions about the economic fundamentals in the major industrial countries could also be an important factor. Doubts exist as to whether the U.S. economic recovery, already four years old, can continue into 1987, and accordingly, expectations for U.S. monetary policy remain unclear. Some market participants forecast that U.S. interest rates may trend lower, with or without further discount rate cuts by the Federal Reserve. In this environment, dollar-denominated assets could lose some of their appeal if interest rates abroad did not ease down in tandem with dollar rates.

In recent months, German monetary policy has shown no signs of easing. In fact, German interest rates have firmed a bit during the past few weeks. Although the effect on the dollar/mark exchange rate has been limited so far, the higher German interest rates have contributed to increased tensions within the EMS, leading at times to

substantial sales of German marks and increases in interest rates by other EMS central banks. For the French, exchange market pressures were further intensified by student disturbances. It is likely that tensions within the EMS will persist into 1987, and many market participants expect another realignment soon after the German elections. These developments could put downward pressure on the dollar. Moreover, if the dollar/yen exchange rate continues to be stabilized by the Baker/Miyazawa accord, a rising mark could also put downward pressure on the yen cross rate with the mark. During the past year, the depreciation of that yen cross rate has led to higher Japanese exports to the European Community, leading to some concern in Europe and a lot of complaints.

Pressures could also derive from political uncertainties. Market participants are concerned that the Iranian matter could unfold in a way which might weaken the Administration's ability to show needed initiative in economic policy issues.

These issues may move to center stage after the first of the year when the markets resume trading without the year-end corporate demand for dollars. In the meantime, they have had limited impact on dollar rates and markets have remained quiet.

With respect to swap operations during the period, in November [and early December] the Bank of Mexico repaid a total of \$430.2 million of the multilateral official bridge facility extended in August. Of this amount, \$106.4 million was repaid to the Federal Reserve and \$106.8 million to the U.S. Treasury's Exchange Stabilization Fund. Subsequently, in early December, Mexico drew \$250 million from the official facility, along with \$500 million in bridge financing from banks. The Federal Reserve provided \$61.8 million and the ESF \$62 million of the more recent drawing. At the end of the

period, the Bank of Mexico had outstanding drawings of \$419.8 million on the entire official facility, of which \$98.9 million was provided by the Federal Reserve and \$99.2 million by the ESF and this is scheduled to be repaid in February. In another transaction, the Central Bank of Nigeria completely repaid its \$22.2 million swap drawing from the U.S. Treasury, under a facility which had been provided on October 29, 1986.

PETER D. STERNLIGHT
NOTES FOR FOMC MEETING
DECEMBER 15-16, 1986

The Domestic Trading desk conducted operations since the last meeting with a view to maintaining unchanged reserve pressures--characterized by a \$300 million level of adjustment and seasonal borrowing used in constructing reserve paths. The broader money aggregates were well behaved, both as compared to fourth quarter objectives and annual growth ranges, while M1 soared into ever-higher orbit. On average, discount window borrowing came out reasonably close to path--somewhat above in the first reserve period, a little below in the second, and well below in the first 11 days of the current period. Money market conditions were firmer than might have been expected, however, apparently reflecting a combination of factors that included some cautious attitudes toward use of the discount window, and seasonal pressures in a period of heavy reserve demands to meet rising requirements and large currency outflows. Possible additional factors include bigger demands for bank funding in the wake of post-Boesky troubles in the junk-bond market and heavier financial market activity to put through deals ahead of year-end tax law changes.

While the Desk sought to provide reserves forthcomingly, keeping abreast or ahead of needs, we encountered upward revised needs about as fast as we moved to meet them. Reserve paths incorporated an \$850 million allowance for excess reserves, but informal allowance was made for higher demands over much of the

period, so that nonborrowed reserves tended to exceed path levels.

Rather than the expected 5 7/8 percent Federal funds rate level that prevailed on average in the previous intermeeting period and was generally expected in the latest period, funds often traded at 6 percent or higher. The current reserve period saw a lessening of pressure after repeated sizable reserve injections, and funds averaged about 5.95 percent through the past weekend as compared with about 6.08 percent in the two full reserve periods since the last meeting. That abatement was short-lived, though, as renewed pressure showed up late Friday and today, apparently related to the mid-December tax date. All in all, it would not be surprising to see some firmness persisting up to and perhaps a little beyond year-end.

The Desk has met massive reserve needs since the last meeting through a combination of outright and temporary transactions. A market purchase of \$2.3 billion of bills the day of the last meeting, for delivery the next day, counted against the previous period's leeway. Then in the current period the Desk bought about \$6.9 billion of Treasury issues while permitting a \$125 million run-off in agency holdings. The purchases of Treasury issues, which used up all the normal \$6 billion intermeeting leeway and most of the \$1 billion additional leeway provided by the Committee, were needed to meet large seasonal currency outflows and increases in required reserves. The market purchases included nearly \$1.5 billion of coupon issues and close to \$4 billion of bills--a record market purchase--supplemented by almost \$1.5 billion of bills bought

from foreign accounts. Repurchase agreements were also arranged on most days, either for customer related account or the System directly.

With year-end approaching, I might note that the System's portfolio of securities has grown by a record \$19.2 billion so far in 1986, including \$18.1 billion in bills and \$1.5 billion in Treasury coupon issues, slightly offset by a \$400 million decline in agency holdings. The level is now \$209.2 billion. For all of 1985, the previous record year, the portfolio rise was \$18.6 billion. As usual, currency growth was the biggest factor absorbing reserves this year, but required reserves have also risen sharply.

Seasonal needs will require further reserve additions through year-end and into early January, but this should be followed by large return flows of currency from the public that will have us absorbing reserves, net, over the next intermeeting period. Possibly, the need to drain will exhaust the normal leeway but it's too early to say with any assurance.

Interest rates responded to moderate crosscurrents during the period, resulting in a small net rise in short-term rates and a slight dip or no change in rates for most longer maturities. At the short end, rates were up about 15-45 basis points on various instruments, in many cases outpacing the rise in average Fed funds rates and suggesting that to some extent pressures may have moved from these instruments to funds as well as vice versa. Key Treasury bill rates rose about 15 to 30 basis points over the period. While the Treasury raised about \$9 billion in the bill market, the Federal Reserve's own seasonally heavy buying

absorbed over \$7 1/2 billion (including the bills bought the day of the last meeting). In today's 3- and 6-month auctions, average issuing rates were about 5.56 and 5.58 percent, respectively, up from 5.23 and 5.30 percent just before the last meeting.

The long term market for high grade debt moved in a narrow range, showing small mixed changes in yield over the period. The Treasury coupon market weakened at first as demand was initially disappointing just after November refunding auctions, and the report of fairly strong October employment gains, and publication of this Committee's September policy record, with its reference to possible firming, also had a sobering effect. Demand for the new issues soon improved against a background of some decline in precious metals prices, and a mixed bag of economic data that tended to be read as looking toward the sluggish side. A few market participants seemed concerned about the firmness in money market conditions, speculating in light of the September policy record that some slight firming was being sought or tolerated-- but most observers were inclined to dismiss the firmness as technical, particularly as they observed the Desk's active efforts to put in reserves, and as they noted the general economic trend, modest inflation and well-behaved broader aggregates. Later in the period, there was some setback again on publication of stronger-than-expected employment and sales data for November, pretty well dashing the already dwindling expectations that any policy easing could be expected before year-end. At the same time, while the prevalent expectation was for a reasonably good fourth quarter gain in the economy, there has been a fairly broad anticipation that growth will slow

appreciably after the turn of the year, setting the stage for further policy-easing steps, perhaps in coordination with other countries. Additional crosscurrents in the market related to the ebb and flow of the dollar, concerns about the implications of Iranian arms sales, and oil price movements.

Particular note should be made of the drop in junk-bond prices following the publicity given to Mr. Boesky and possible tie-ins to junk-bond financing of corporate takeovers. Prices of these bonds were marked down fairly sharply for a few days in light trading. There did not appear to be panic selling and a more stable climate soon emerged in which markets were being made and some price recovery occurred. Net over the period, the yield spread for below-investment-grade bonds over higher grade issues widened by perhaps half a percentage point, in what might be described as a "drift" if not a "flight" to quality.

Finally, I note for the record that our list of primary reporting dealers was increased by five a few days ago to 40. That change got sufficient publicity so as not to require further description here.

J. L. Kichline
December 15, 1986

FOMC BRIEFING

The staff's forecast of the economy has not been altered significantly since the last meeting of the Committee. That forecast shows real GNP growth at about a 3 percent annual rate in the current quarter, a bit less in the first half of next year but close to a 3 percent rate of growth during 1987 as a whole. Inflation this year, as measured by the GNP fixed-weighted price index, is projected to be around 2-1/4 percent and rise to 3 percent next year.

As a general matter, the information on economic activity that has become available over the past several weeks provides a sense of some improvement. However, it is difficult, if not impossible, to sort out and quantify a number of diverse and in a few cases transitory forces at work, such as the impending tax change and related possible effects on the timing of expenditures. Nevertheless, recent developments overall have not been out of line with our expectation that the economy is beginning to shift to slower but sustained growth of domestic demands while experiencing a strengthened performance of net exports. Ted Truman, in his presentation, will cover among other items recent and projected developments in the trade sector.

Information on labor markets have shown clear signs of strength in both October and November. Although the unemployment rate remained at 7.0 percent, nonfarm payroll employment rose 1/4 million in both October and November, appreciably more than the average monthly increases earlier this year. Hiring continued brisk in the service sector, but factory employment rose in both months as well. Gains in employment and hours worked showed up in a sizable increase in industrial output in November; after virtually no change from August through October, the industrial production index rose .6 percent in November. Increases in output were evident in most major sectors, although auto assemblies were about unchanged from the month earlier.

The domestic automobile industry experienced a much reduced pace of sales in October and November after the end of the major sales incentive programs. During the first 10 days of this month domestic sales did pick up to a 7.7 million unit annual rate from the prevailing 7 million rate. In the GNP accounts for this quarter we anticipate the domestic auto sector will be a neutral force, as the drop in sales is about matched by the rebuilding of dealer stocks. While the forecast contains a moderate rise in domestic auto sales from the pace of the last couple of months, those sales are well below the current production plans of the industry and we anticipate additional cutbacks in planned output, especially by GM. Meanwhile, sales of foreign cars have remained strong.

Retail sales in November, excluding autos, gasoline, and nonconsumer items, reportedly were quite strong--rising 0.9 percent. Those data became available after the forecast was put together, and indeed are somewhat larger than we had allowed. Sales at general merchandisers were about flat in November, and the anecdotal evidence we've obtained from major retailers on sales so far in December is mixed although generally on the sluggish side. In any event, we have maintained the view that consumer spending in real terms will be trending up at a moderate pace next year. That growth it seems would be consistent with varying influences on consumer spending, including on one side high debt burdens and an already low saving rate, and on the other a tax reduction and high wealth levels.

Business fixed investment spending this quarter seems likely to decline a little, associated with a fall in purchases of autos and trucks. In other areas, shipments of producers equipment and construction outlays rose considerably in October, the latest available data. Some of the investment activity undertaken this quarter may reflect an acceleration of spending to take advantage of more favorable depreciation schedules before the new tax law takes effect next year. On the whole, the indicators of future investment spending are on the weak side, with orders down in October and private surveys of 1987 spending intentions pointing to little or no growth. The staff forecast for business fixed investment spending for next year is growth

in real terms only a bit over 1 percent; that is, however, an improvement from the nearly 5 percent drop expected in 1986 owing mainly to the earlier plunge in oil drilling.

In the housing sector, starts in October remained at the reduced September pace; data for November will be available tomorrow morning. During the summer and fall we have seen both starts and new home sales drift lower, with the weakness notable in the South and Southwest where overbuilding and weak regional economies are taking their toll. Total existing home sales have been brisk, however, and with mortgage rates having fallen considerably to the lowest in eight years, we anticipate the single-family market will strengthen gradually over the course of next year.

In the government sectors we had a burst of spending during the second and third quarters, but that seems unlikely to be repeated anytime soon. In particular, federal government purchases are being constrained by earlier legislative actions and in real terms are projected to decline slightly during 1987. The staff's projection currently provides for a deficit of \$180 billion in fiscal year 1987; by contrast, the Administration according to preliminary and unofficial estimates is dealing with a deficit in the area of \$160-\$165 billion, roughly \$15 to \$20 billion above the Gramm-Rudman target. Their deficit figures are higher than earlier in part because of reductions in their projected economic growth.

Finally, there is little new to report on wage and price developments. We still anticipate a somewhat higher rate of inflation next year in association with a drifting up of oil prices and a feeding through to prices of the effects of the lower foreign exchange value of the dollar.

Mr. Truman will continue the briefing.

* * * * *

E.M. Truman
December 15, 1986

FOMC Briefing on U.S. External Sector

Revised data on U.S. merchandise trade for the third quarter and preliminary data for October are, I believe, mildly encouraging, but it is premature to assert with much confidence that we have decisively turned the corner. Although the trade deficit for the third quarter as a whole, \$151 billion at a seasonally adjusted annual rate, was not significantly different from the deficits in the previous three quarters, that stability derives in large part from a \$25 billion reduction in payments for oil imports over that period.

On a GNP basis, real net exports of goods and services deteriorated further in the third quarter and, based on revised trade data and our own estimates for the service sector, we expect a somewhat larger deterioration will be shown in the revised GNP data that are to be released on Wednesday.

Nevertheless, our exports have begun to pick up; most of the increase in the third quarter was concentrated in aircraft and agriculture with a small boost in industrial supplies other than gold. Non-oil imports also rose, particularly imports of automotive products, consumer goods and capital goods, though the pace of increases in the last category has slowed markedly. Imports of oil in the third quarter surged but the offsetting impact on inventories appears not to have been picked up in the GNP accounts.

In the current quarter, we expect to see a significant improvement in our trade position in real terms. The volume of oil

imports has dropped back substantially, and we expect some weakening of non-oil imports. We also know there has been a surge in grain and especially soybean export shipments, following earlier cuts in support prices and a poor soybean harvest in Brazil. These factors translate into our projection of a \$25-30 billion increase in real net exports in the current quarter--accounting for essentially all of the projected expansion of real GNP. Preliminary data for trade in October are consistent with this picture; they are consistent even with a somewhat stronger picture, but it would be unwise to rely much on such volatile data.

Turning to next year, and given the staff's forecast for the strength of demand in the United States, the outlook will depend importantly on foreign demand and on the timing and extent of responses to exchange rate changes.

Evidence on foreign growth presents a mixed picture. The pattern of demand abroad seems to be moving in the right direction, at least in Japan where total domestic demand increased very strongly in the third quarter, net exports made a substantial negative contribution to growth, and real GNP expanded about 2-1/2 percent. In Germany, the pattern is more difficult to ascertain because of sharp quarter-to-quarter volatility in the data; in the third quarter, total domestic demand increased only slightly (following a surge in the second quarter), and real GNP rose about 3 percent. In both of these countries, and elsewhere, growth of output has been disappointing.

We are projecting growth in 1987 for the industrial countries as a group to be only about 2-1/4 percent (Q4/Q4), somewhat slower than

this year and less than we are projecting for the United States. One uncertainty in the forecast involves the response of policymakers abroad to such sluggishness. Meanwhile, we do expect to see some pickup in growth in Mexico, but growth should slow in Brazil, and OPEC members will be cutting back.

We are projecting a continued, though more moderate, decline in the dollar against currencies of industrial countries over the year ahead, but on average little net change in real terms against the currencies of developing countries. We are assuming that OPEC will succeed to some extent in limiting its oil output, so that oil prices will firm to \$16 per barrel by the second quarter.

Given these factors, it would appear at this point that any improvement in our external accounts will have to rely predominantly on the effects of changes in U.S. competitiveness. We expect to see little change in imports of goods and services in real terms in 1987. The increase shown in the forecast is due to higher payments to service our external debt. For trade, a rise in the volume of oil imports is expected to be offset by a slight decline in non-oil imports. The volume of non-oil imports should respond to increases in the relative prices of these goods, as prices of non-oil imports advance at about a 10 percent annual rate next year. We believe that profit margins of foreign exporters in Japan and Europe have been squeezed significantly and that further declines in the dollar are likely to be passed through more fully and quickly.

On the export side, U.S. producers have already made substantial gains in price competitiveness vis-a-vis their major

competitors in industrial countries, and we expect exports of goods and services to increase substantially--more than 10 percent over the four quarters of 1987. Most of the growth is expected to be in capital goods and industrial supplies.

On balance, increases in real net exports are expected to contribute directly about one-third of GNP growth over the course of 1987. However, rising payments for oil and the relative increase in import prices will prevent most of the improvement in real net exports from showing through to our trade and current accounts during 1987. As a consequence, those balances are expected to remain in deficit at around \$150 billion.

That concludes our reports, Mr. Chairman.

Briefing on Long-run Policy Considerations

The velocities of all the monetary aggregates fell in 1986, registering even larger declines than in 1985 and deviating even more substantially from their previous trends. The paper by Mr. Simpson distributed to the Committee analyzed this behavior and its implications for the factors that might affect money and velocity in 1987. The major conclusion of that paper was that the strong growth in money and decreases in velocity appear to have been related primarily to a narrowing in the opportunity costs of holding money--especially in its more liquid forms--as the interest returns on market instruments and time deposits fell much more rapidly than those on these liquid components of the monetary aggregates. Generally the response of the aggregates to these declines in opportunity costs, however, was greater than might have been anticipated at the beginning of the year based on past experience. Opportunity costs had fallen to unprecedentedly low levels, and the public apparently reacted strongly to this development.

The impact has been greatest for M1, where rates on NOW accounts have moved very sluggishly, creating a situation in which relatively little yield is sacrificed for considerable additional liquidity. But it has also affected M2, whose velocity has fallen to its lowest level in many years, and perhaps M3 as well. Moreover, various alternative measures of money have not been immune. The velocities of Mq, Ms, and Mla also have dropped relative to trend and by more than might have been expected from historical relationships. Using St. Louis type reduced form equations, the various measures of money--including these alternatives--over predict average nominal GNP growth through the first three quarters of this year by anywhere from 5 percentage points for M2 and L to 10 percentage points for M1.

To some extent, this behavior of money and velocity is "explained" by models of money demand refitted to encompass the 1986 experience and a heightened interest sensitivity. The results of such exercises are the kinds of interest elasticities reported in the second part of the paper distributed to the Committee. In the context of such interest sensitivity, the view that the extraordinary growth in M1 and expansion of the broader aggregates near the upper ends of their ranges does not represent an overly expansive monetary policy rests in part on the interpretation of the decline in interest rates. To the extent that such a decline was associated with falling inflation expectations in late 1985 and 1986, and with decreasing real rates resulting from weakness in underlying demands for domestic production, the resulting money growth has been needed to keep income growth from falling short even of the moderate track it appears to be taking.

While this interest sensitivity may be helpful for rationalizing past behavior of the aggregates, it has some disquieting implications for the future. An interest sensitive monetary or credit aggregate may not be a very good guide for policy. Under such conditions, whether a given rate of money growth will yield a particular outcome for the expansion of income depends very much on the behavior of interest rates associated with that income path. This year, moderate economic expansion was associated with rapid money growth as interest rates fell, but at some point in the future, especially if inflation or its expectations strengthen, much slower money growth and an increase in velocity may be needed to restrain income growth to a satisfactory path. The problem of course is knowing what particular situation you may be facing at the time. Tendencies for the aggregates to run above or below target

ranges may indicate an unintended or undesired deviation of the economy, or only a desirable accommodation of policy to changes in underlying economic conditions.

The staff's best guess right now is that its forecast of GNP for 1987 will entail very little net movement of interest rates. In this situation, we would expect velocities to move more in line with their long-run trends, at least for the broader aggregates, which we have assumed to be expanding well within their tentative ranges for next year. This implies as well no reversal of the velocity decline of recent years; at least for a time, the higher level of money relative to income would persist, a by-product of the transformation from a high inflation to a low inflation economy with associated interest rate adjustment. But this expectation could be way off if interest rates do need to move very much to achieve reasonable economic growth, or if the pattern of response by depository institutions in their offering rates deviates greatly from recent trends. Clearly these institutions are continuing to adapt to the changed regulatory and economic situation and their behavior adds an additional element of uncertainty in evaluating evolving money-income relationships.

With respect to the broad aggregates these uncertainties might become encompassed in a reasonable range for rapid growth. To a considerable extent the shifts of funds into M1 have been from other elements in the broader aggregates. The effects of lags in the adjustments of offering rates on some elements of the broader aggregates have been muted, given relatively prompt adjustment on other elements. While the velocities of these aggregates have registered sizable declines this year, their overall interest sensitivity seems considerably less than for M1, and not sufficiently large to impair

their usefulness as longer run guides to policy. Moreover, they seem to be coming into better alignment with income in recent months, giving some additional confidence about the coming year. These aggregates have never tracked GNP very closely over the short or intermediate runs, and as a result their movements need to be interpreted in light of other information indicating the effect of monetary policy on the economy. Even so, their long-run character probably has been altered relatively little by innovation. Thus, these aggregates would seem to contain useful information about the longer-term thrust of monetary policy and its eventual impact on the economy--information not readily discernable in the other financial indicators of policy, such as reserve conditions, interest or exchange rates, that tend to be the short-term focus of policy.

These problems and uncertainties in assessing the likely course of money and velocity seem more acute for M1, complicating the difficulties of establishing a range for this aggregate. M1 appears to be extremely sensitive to changes in various rates on NOW and other deposits, as well as to returns available in the market. Moreover, institutions may be having particular problems determining their offering rates and marketing strategies for NOW accounts, given the competitive pressures, high servicing costs of these accounts and their recent regulatory history. Using the elasticities in the paper calculated assuming a slow adjustment pattern, a one percentage point change in interest rates from current levels, would by itself, cause M1 growth to deviate by about 4 percentage points from the path it would otherwise take. While these elasticities may be overstated, they do suggest that a relatively wide range for M1 growth would be needed to encompass possible outcomes and the velocity of this aggregate could remain difficult to assess for some time.

Briefing on Short-run Policy Options

There are three elements to the staff's thinking behind alternative B in the bluebook that I thought might be useful to discuss as background for the Committee's consideration of its short-run policy options.

The first pertains to interest rates. Alternative B presumes roughly unchanged interest rates; this alternative is consistent with the thinking underlying the staff's GNP forecast, which does not anticipate a major move in rates in the months ahead. While many in the market seem to be expecting an easing of policy in the first half of next year, this conviction does not appear to be very strongly held, and the pattern of data that would emerge under the staff forecast seems unlikely to produce a clear signal to the market.

Within this picture of little net rate movement, we are expecting that maintenance of seasonal and adjustment borrowing at the discount window at the \$300 million level would be consistent with federal funds returning to trade more evenly around 5-7/8 percent in January once year-end pressures dissipate, and consequently with some edging down of other money market rates. However, I think there is some chance that the funds rate could persist a little to the tight side of 5-7/8 percent. One characteristic of the recent period has been an unusually low level of borrowing by smaller banks, which apparently are flush with liquidity in the absence of loan demand. This can be seen in the extremely low borrowing totals for the first week of the recent maintenance period--the \$78 million total published last week was the lowest since 1980 when the funds rate was below the discount rate--and has the effect of forcing more borrowing by larger banks within an overall borrowing objective. Some firmness--albeit considerably less than recently--may persist

if smaller banks remain out of the window, so the larger banks continue to do a disproportionate share of the borrowing and become concerned about wearing out their welcome.

The second area concerns the behavior of M2 and M3. Data becoming available since the last meeting show relatively moderate growth in November, and suggest a further deceleration may be in train this month. December is largely projected, but the two-month slowdown seems a little greater than expected, and has brought these aggregates in below the upper ends of their long-term ranges--noticeably so in the case of M3. The reasons for the degree of moderation are not entirely clear; while the November deceleration in M2 was accounted for in part by the weakness of the overnight RP and Eurodollar components, December behavior, as it looks early in the month, largely reflects a further slowing in the total of deposits and money funds.

Under alternative B, and also under A, M2 and M3 growth would pick up a little in the early months of next year as nominal GNP strengthened, leaving M2 in the middle of its tentative range, and M3 in the lower half of its tentative range. But even this minor acceleration would be around a basic trend of moderating money growth and smaller decreases in velocity as interest rate effects abate. On a quarterly average basis M2 growth would drop from 8-1/2 percent in the fourth quarter to 7 percent in the first under alternative B and M3 from 7 to 5-1/2 percent. The decrease in M2 velocity would go from 4-1/2 percent in the fourth quarter to only 1-1/2 percent in the first, and M3 velocity in the first quarter would be declining at about its long-run trend of 1 percent.

The third and final area is the subject of M1 growth. Given the narrow opportunity costs, OCDs have continued to expand at around 30 percent annual rates, and demand deposits surged in November and early December following two months of relatively subdued growth. As a consequence it appears that M1 growth from September to December will be close to the extraordinary pace registered over the summer. However, the staff--courageously or foolishly--continues to believe, for all the usual reasons enumerated in the bluebook, that the underlying forces point to a slowing of M1 growth over the months ahead at unchanged market interest rates. Even so, M1 would continue to expand at historically rapid rates, well in excess of its very tentative 3 to 8 percent range and of income growth.

Given the uncertainties, however, the Committee may not wish even to express the general expectations of a slowing in M1 growth that it has included in the directive for the past several months. The draft directive on page 14 of the bluebook includes both the current language and an alternative wording that would acknowledge the uncertainties while avoiding any reference to expected growth; it would retain the notion that M1 would continue to be evaluated in light of the behavior of the other aggregates.