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SUPPLEMENT
CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

By the Staff
Board of Governors
of the Federal Reserve System

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SUPPLEMENTAL NOTES

THE DOMESTIC NONFINANCIAL ECONOMY

Unemployment claims

Recent data on insured unemployment suggest that labor market conditions continued to deteriorate through mid-September. Initial claims for unemployment insurance rose to 709,000 in the week ended September 18; this followed a somewhat reduced volume during the week of the Labor Day holiday. The average for new claims during the first three weeks of September was about 665,000--somewhat higher than the peak flow of new claimants during mid-May 1980. The level of insured unemployment under all regular programs averaged 4.4 million in the first two weeks of September--up more than 240,000 from the mid-August reference week for the BLS labor market surveys. The reference week for September was the week ended the 18th.

New house sales

New house sales have remained quite weak since midyear. The number of units sold rose 2 percent in August to a seasonally adjusted annual rate of 359,000 units; however, taken together new house sales in July and August averaged 3 percent below the pace in the second quarter which had been the recent cyclical low. The average sales price of new houses in August was \$92,300--6 percent above a year earlier. The preliminary average sales price of new houses in July--which originally showed a year-over-year increase of 10 percent--was revised down to \$87,700, now also 6 percent higher than a year earlier. The median sales price of new houses was \$73,200 in August.

Unsold inventories do not seem to be a serious problem nationwide. The stock of unsold new houses declined in August for the seventh consecutive month to a seasonally adjusted 247,000 total--the lowest since mid-1971. The slightly higher sales rate in August pushed inventories measured in terms of sales down to 7.9 months' supply. The median length of time that unsold new units have been on the market fell to 3.9 months in August; this period is considerably shorter than the average of 6 months at year-end 1981.

Construction expenditures

The total value of construction put-in-place rose 2 percent in August to a seasonally adjusted annual rate of \$232.3 billion. Expenditures in August were 2 percent below the level of a year earlier. In real terms, total construction expenditures also rose 2 percent in August, but remained slightly (2 percent) below August 1981.

Outlays for private residential and nonresidential construction each rose about 1 percent in August. The value of state and local construction expenditures increased by 4 percent, but remained somewhat smaller than a year earlier.

PRIVATE HOUSING ACTIVITY
(Seasonally adjusted annual rates, millions of units)

	1981		1982				
	Annual	Q4	Q1	Q2	June	July	Aug. ¹
All units							
Permits	.99	.76	.82	.92	.93	1.15	.89
Starts	1.08	.87	.92	.95	.91	1.20	1.00
Single-family units							
Permits	.56	.42	.45	.49	.52	.50	.49
Starts	.71	.54	.59	.61	.62	.63	.61
Sales							
New homes	.44	.40	.39	.37	.37	.35	.36
Existing homes	2.35	1.92	1.93	1.93	1.98	1.89	1.79
Multifamily units							
Permits	.42	.34	.37	.43	.41	.56	.39
Starts	.38	.33	.33	.35	.29	.57	.40
Mobile home shipments	.24	.21	.24	.25	.26	.26	n.a.

1. Preliminary estimates.
n.a.--Not available.

NEW CONSTRUCTION PUT IN PLACE
(Seasonally adjusted annual rates, in billions of dollars)

	1982					Percent change in Aug. from	
	QI	QII ¹	June ¹	July ¹	Aug. ²	July 1982	Aug. 1981
	Total - Current dollars	224.1	228.8	231.6	228.7	232.3	+2
Private	174.0	179.2	182.7	180.3	182.1	+1	-2
Residential	71.0	74.3	75.3	76.2	77.3	+1	-8
Nonresidential	103.1	104.9	107.4	104.1	104.8	+1	+4
Public	50.1	49.6	48.9	48.4	50.2	+4	-1
State & local	40.5	39.9	39.4	39.0	40.5	+4	-2
Federal	9.6	9.7	9.5	9.4	9.7	+2	+5
Total (1977 dollars)	143.4	147.2	149.8	147.2	150.1	+2	-2

- 1. revised
- 2. preliminary
- no change

MONETARY AGGREGATES
(Based on seasonally adjusted data unless otherwise noted)¹

	1982					QIV. '81 to Sept. '82P	
	Q1	Q2	Q3P	July	Aug.	Sept. ^P	Sept. '82P
--Percentage change at annual rates--							
<u>Money stock measures</u>							
1. M1	10.4	3.3	3.5	-0.3	10.4	14.0	6.5
2. (M1) ²	9.5	3.6	4.4	-4.0	13.9	17.4	7.0
3. M2	9.8	9.5	9.7	9.7	14.2	5.2	9.8
4. M3	8.7	10.7	12.0	12.6	18.4	3.5	10.6
<u>Selected components</u>							
5. Currency	7.9	9.3	6.9	3.7	6.5	10.2	8.4
6. Demand deposits	-0.5	-5.8	-1.4	-2.1	2.6	6.8	-1.8
7. Other checkable deposits	49.5	19.6	11.9	-1.4	38.4	39.9	30.3
8. M2 minus M1 (9+10+11+14)	9.5	11.5	11.7	12.9	15.4	2.6	10.8
9. Overnight RPs and Eurodollars, NSA ³	63.6	-8.4	19.0	8.4	35.9	-16.1	22.0
10. General purpose and broker/dealer money market mutual fund shares, NSA	33.8	20.9	31.0	19.2	60.9	12.7	31.1
11. Commercial banks	9.4	17.2	12.3	14.4	12.3	8.5	13.1
12. savings deposits	8.7	2.0	-9.7	-22.5	-8.4	4.6	0.2
13. small time deposits	9.7	23.8	21.6	29.1	20.3	10.0	18.8
14. Thrift institutions	1.6	6.0	6.1	11.0	4.8	-3.2	4.1
15. savings deposits	10.2	0.6	-8.0	-17.7	-5.8	-3.2	0.4
16. small time deposits	-1.5	8.1	11.4	21.7	8.6	-3.2	5.5
17. M3 minus M2 (18+21+22)	11.1	16.9	23.3	26.9	38.4	-5.0	14.5
18. Large time deposits	8.9	19.1	19.2	27.4	12.9	-3.5	14.9
19. at commercial banks, net ⁴	6.1	19.9	20.9	32.6	11.7	-8.2	14.4
20. at thrift institutions	21.6	15.5	11.5	4.0	18.1	17.8	17.2
21. Institutions-only money market mutual fund shares, NSA	-2.5	15.2	104.0	106.8	209.3	22.3	46.2
22. Term RPs, NSA	-29.9	6.2	-25.7	-69.2	122.4	-85.2	-16.2

--Average monthly change in billions of dollars--

MEMORANDA:

23. Managed liabilities at commercial banks ⁴ (24+25)	0.6	6.3	n.a.	6.1	5.2	n.a.	n.a.
24. Large time deposits, gross ⁵	2.7	5.8	5.5	10.6	6.8	-0.9	4.2
25. Nondeposit funds ⁵	-2.1	0.5	n.a.	-4.5	-1.6	n.a.	n.a.
26. Net due to related foreign institutions, NSA ⁵	-2.1	0.4	-4.8	-4.8	-4.1	-5.6	-2.1
27. Other ^{5,6}	0.0	0.1	n.a.	0.4	2.4	n.a.	n.a.
28. U.S. government deposits at commercial banks ⁷	1.9	-2.5	0.2	-1.5	0.8	1.4	-0.1

1. Quarterly growth rates are computed on a quarterly average basis. Dollar amounts shown under memoranda for quarterly changes are calculated on an end-month-of-quarter basis.

2. M1 seasonally adjusted using alternative model-based procedure applied to weekly data.

3. Overnight and continuing contract RPs issued to the nonbank public by commercial banks, net of amounts held by money market mutual funds, plus overnight Eurodollar deposits issued by Caribbean branches of U.S. member banks to U.S. nonbank customers. Excludes retail RPs, which are in the small time deposit components.

⁴ Net of large-denomination time deposits held by money market mutual funds and thrift institutions.

Adjusted for shifts of assets and liabilities to International Banking Facilities (IBFs) which affected us from December 1981 to June 1982.

⁵ Consists of borrowings from other than commercial banks in the form of federal funds purchased, securities sold under agreements to repurchase and other liabilities for borrowed money (including borrowings from the Federal Reserve and unaffiliated foreign banks), loans sold to affiliates, loan RPs and other minor items. Data are partially estimated.

7. Consists of Treasury demand deposits at commercial banks and Treasury note balances.

n.a. - Not available.

p - preliminary.

COMMERCIAL BANK CREDIT AND SHORT- AND INTERMEDIATE-TERM BUSINESS CREDIT
(Percentage changes at annual rates, based on seasonally adjusted data)¹

	1981	1982				QIV '81 to Aug. '82	
	Q4	Q1	Q2	June	July	Aug.	Aug. '82
--Commercial Bank Credit--							
1. Total loans and investments at banks ^{2,3}	6.4	10.1	7.9	5.1	6.4	6.4	9.5
2. Investments	4.8	5.7	4.7	1.7	2.4	8.5	5.8
3. Treasury securities	-7.8	11.5	4.9	-5.2	7.3	13.4	8.5
4. Other securities	11.2	2.8	4.8	5.1	0.0	6.1	4.5
5. Total loans ^{2,3}	6.9	11.5	9.0	6.4	7.6	5.8	10.8
6. Business loans ^{2,3}	9.2	16.8	14.8	14.2	9.9	3.3	15.4
7. Security loans	58.6	-18.3	-26.8	-64.1	92.3	22.9	4.3
8. Real estate loans	7.3	7.8	6.6	7.3	0.8	4.4	7.4
9. Consumer loans	4.1	2.8	3.0	2.6	5.7	2.5	4.1
--Short- and Intermediate-Term Business Credit--							
10. Total short- and intermediate-term business credit (sum of lines 14, 15 and 16)	13.8	15.2	13.1	10.6	14.2	n.a.	n.a.
11. Business loans net of bankers acceptances ³	9.3	16.5	15.7	17.7	11.3	2.1	15.8
12. Commercial paper issued by non-financial firms ⁵	21.3	30.0	16.8	2.0	38.2	-1.9	27.4
13. Sum of line 11 & 12	10.8	18.2	15.9	15.6	14.9	1.8	17.3
14. Line 13 plus loans at foreign branches ⁶	14.0	18.4	15.7	13.6	15.2	5.3	18.2
15. Finance company loans to business ⁷	7.6	1.0	1.5	10.5	17.8	n.a.	n.a.
16. Total bankers acceptances outstanding ⁷	20.9	11.7	10.2	-6.6	0.0	n.a.	n.a.

1. Average of Wednesdays for domestically chartered banks and average of current and preceding ends of months for foreign-related institutions.

2. Loans include outstanding amounts of loans reported as sold outright to a bank's own foreign branches, unconsolidated nonbank affiliates of the bank, the bank's holding company (if not a bank), and unconsolidated nonbank subsidiaries of the holding company.

3. Adjusted for shifts of assets and liabilities to International Banking Facilities (IBFs) which affected flows from December 1981 to June 1982.

4. Growth of bank credit from the FOMC's December-January base through August 1982, not adjusted for shifts of assets from domestic offices to IBFs, was at an annual rate of 7.6 percent. Adjusted for such shifts after January, growth over this period was 8.4 percent.

5. Average of Wednesdays.

6. Loans at foreign branches are loans made to U.S. firms by foreign branches of domestically chartered banks.

7. Based on average of current and preceding ends of month.

n.a.--not available.

SELECTED FINANCIAL MARKET QUOTATIONS¹
(Percent)

	1981	1982		Change from:		
	Highs	Early summer Highs	FOMC Aug. 24	Sept. 30	Early summer Highs	FOMC Aug. 24
<u>Short-term rates</u>						
Federal funds ²	20.06	14.81	9.04	10.12	-4.69	1.08
Treasury bills						
3-month	17.01	13.19	7.61	7.62	-5.57	.01
6-month	15.93	13.40	8.94	8.76	-4.64	-.18
1-year	15.21	13.12	9.52	9.46	-3.66	-.06
Commercial paper						
1-month	18.63	14.89	8.11	9.96	-4.93	1.85
3-month	18.29	15.00	9.00	10.19	-4.81	1.19
Large negotiable CDs ³						
1-month	18.90	14.99	8.95	10.15	-4.84	1.20
3-month	19.01	15.58	9.63	10.44	-5.14	.81
6-month	18.50	15.70	10.67	10.75	-4.95	.08
Eurodollar deposits ²						
1-month	19.80	15.66	9.76	11.18	-4.48	1.42
3-month	19.56	16.28	10.36	11.61	-4.67	1.25
Bank prime rate	21.50	16.50	13.50	13.50	-3.00	0
Treasury bill futures						
Dec. 1982 contract	14.20	13.69	10.09	8.63	-5.06	-1.46
June 1983 contract	14.07	13.67	11.18	10.37	-3.30	-.81
<u>Intermediate- and long-term rates</u>						
U.S. Treasury (constant maturity)						
3-year	16.59	14.98	11.81	11.52	-3.46	-.29
10-year	15.84	14.73	12.35	11.73	-3.00	-.62
30-year	15.20	14.26	12.16	11.79	-2.47	-.37
Municipal (Bond Buyer)	13.30	12.63	10.82 ⁴	10.48	-2.15	-.34
Corporate--Aaa utility Recently offered	17.72	16.19	13.70e	13.44p	-2.75	-.26
S&L fixed-rate mort- gage commitment	18.63	16.93	16.21 ⁵	15.19 ⁵	-1.74	-1.02
	1981	1982		Percent change from:		
	Highs	FOMC Aug. 24	Sept. 30	1981 Highs	FOMC Aug. 24	
<u>Stock Prices</u>						
Dow-Jones Industrial	1,024.05	874.90	896.25	-12.5	2.4	
NYSE Composite	79.14	66.10	69.18	-12.6	4.7	
EX Composite	380.36	265.28	283.18	-25.5	6.7	
SDAQ (OTC)	223.47	172.23	187.65	-16.0	9.0	

1. One-day quotes except as noted.

2. Averages for statement week closest to date shown.

3. Secondary market.

4. One-day quotes for preceding Thursday.

5. One-day quotes for preceding Friday.

p--preliminary. e--estimated.

APPENDIX*

COMPENSATING BALANCE ARRANGEMENTS AND DEMAND DEPOSIT BEHAVIOR

The expansion of demand deposits in August and September--which had been preceded by six months of contraction--may have been in part a reaction to the sharp fall in short-term interest rates since June. An inverse relation between demand deposits and interest rates is consistent with conventional economic modeling of the transactions demand for money. Moreover, for businesses, which account for well over half of all demand deposits in the money stock, compensating balance arrangements may reinforce the interest rate response of demand deposits. To update information on compensating balance practices, the staff at the Board and three District Banks earlier this month contacted nine large commercial banks.

Most of the banks contacted indicated that the vast bulk of their business demand deposits were linked to formal compensating balance agreements. Based on the responses of all the banks, compensating balances appear, on average, to be approximately equally split between those associated with operational services (including cash management services) and those connected with credit services (loan commitments and takedowns). These deposits of businesses are used actively for transaction purposes, and average daily (close of business) collected balances typically are used as the basis for determining compensation.

A corporate customer can pay for credit services either through fees or balances.¹ When balances are used, the required level of average balances is fixed for the term of the agreement and does not change in response to fluctuations in short-term interest rates. However, since balances can be averaged over periods such as a quarter or even a year, customers do have some scope to vary credit-related balances in response to interest rate movements and rate expectations. The balance requirements for loan commitments or takedowns reportedly have come down from a standard 10 percent a few years ago to around three to five percent.²

* Prepared by Fred Furlong, Economist, Banking Section, and Richard Porter, Chief, Econometrics and Computer Applications, Division of Research and Statistics.

1. There has been a pronounced trend toward the use of fees rather than balances to pay for credit services in recent years, particularly in the case of large firms. This may reflect in part the fact that funds linked to compensating balance arrangements generally are used actively for transaction purposes, and a business would have less need to hold transaction balances with a bank from which it receives only credit services compared to a bank that supplies operational services.

2. Fees on lines of credit reportedly are centered around 3/8 percent of the dollar value of the line, with higher credit quality customers in many cases paying 1/4 percent and lower rated customers paying 1/2 percent.

In contrast, arrangements involving operational services provide more room for movements in short-term interest rates to influence balances.¹ Banks have formulas for calculating an implicit interest rate that will be applied to deposit balances, the so-called "earnings credit rate" (ECR). This rate is based on one or more short-term interest rates.² It generally is adjusted downward for reserve requirements against demand deposits, which ordinarily means that the ECR is below open market rates. The ECR can be an average rate for the month in question, the average rate in the previous month, or a moving average over, say, a three-month period. The average collected balance that would be sufficient to compensate the bank for operational services is determined by dividing the ECR into the dollar value of the services obtained in a given month.³

Given the sharp drop in interest rates in recent months, the formula that was just mentioned would call for a substantial increase in compensating balances if utilization of services remained unchanged.⁴ However, based on the responses of the nine large banks contacted, the actual enforcement of the arrangements leads to a much smaller adjustment in balances than that implied by the formula. An important reason for this is that businesses--especially larger ones--generally are able to pay for operational services through a combination of fees and balances. Although balances may account for a high proportion of the total payment for services, fees often are used to make adjustments when the ECR changes. A trend toward the use of fees has been particularly evident in the past two years or so. Banks generally prefer balances to fees, and one of the banks contacted emphasized that it requests additional deposits to make up shortfalls in compensating balances. However, because the ECR typically is below other market rates banks have found it difficult to persuade some of their customers--especially large firms--to raise deposit balances beyond what they normally wish to maintain for transaction purposes.

1. Operational services connected with cash management include such things as lock boxes, wire transfers, account reconciliation, and instantaneous deposit balance information. Other operational services cover payroll processing, foreign exchange transactions, stock transfers, etc.
2. The banks contacted most frequently used the 91-day Treasury yield. Otherwise they used the three-month CD rate or an average of a pool of short-term interest rates.
3. The dollar value of the services is determined by an explicit pricing formula for each type of operational service.
4. Based on the formula, required compensating balances in the long run would increase one percent for every one percent drop in short-term interest rates. Since June, the three-month Treasury bill rate has declined about 37-1/2 percent. This would imply roughly a \$25 billion increase in required compensating balances--37-1/2 percent of something on the order of \$60 billion to \$70 billion in deposits apparently held as compensation for operational services.

Aside from the use of fees to cover shortfalls, there are other reasons for there to be a loose relation between changes in the ECR and movements in corporate demand deposits. Accounts are evaluated on a case-by-case basis. Banks consider the overall profitability of an account before deciding whether more balances (or a higher fee) are required. Previous surpluses in deposit balances or even the return on the customer's loans are taken into account. A shortfall in demand deposit balances may be permitted to persist for a number of months if the seasonal pattern in the cash flow of the corporate customer is such that the firm would be able to make up the deficit more easily in the future. In addition, some businesses have balances beyond those used to meet formal compensating balance requirements.¹ These deposits absorb some of the change in "required" compensating balances. Overall, the banks contacted indicated that when balances are adjusted to interest rate changes lags can range from a few months to a year or more.

As noted earlier, the ECR tends to be lower than market rates. However, because of the method used to calculate the ECR at many banks, this implicit rate of return can lag other market rates. As such, if short-term interest rates fall sharply enough to offset the adjustment for reserve requirements, the ECR for a given month can exceed rates available on market instruments. Corporate depositors would have an incentive to increase their demand deposit holdings to take advantage of the higher yield.² This would allow a business to reduce its fee payments for services, make up for previous shortfalls in compensating balances, or build up surplus balances that can be applied to services obtained in the future. Any such buildup in demand deposits would be temporary, since the increase would be reversed when the ECR came back into line as market rates stopped falling.

In summary, there appears to be ample scope for compensating balance arrangements, particularly those involving operational services, to have affected the behavior of demand deposits as interest rates have fallen sharply. The ECR at a number of banks has lagged the drop in market rates, and, thus, the implicit return on compensating balances may have exceeded market rates in recent months. This would have created an incentive for some businesses to temporarily increase their demand deposit holdings. In the longer run, the flexibility afforded depositors by using fees instead of balances and the fact that the ECR ordinarily is below open market rates will affect the extent to which businesses

1. Some of these free balances are active transaction deposits of smaller businesses, and some are funds that are maintained by businesses that want certain services that are not priced explicitly by banks, such as access to the bank's chairman or financial analysts.
2. The intra-monthly pattern of interest rates also can affect the relative attractiveness of the ECR, even in the cases where the ECR is not lagged. Since the ECR represents a daily average, if rates fall sharply early in the month, a business may be able to profit by holding larger balances in the latter part of the month when the ECR exceeds prevailing market rates.

increase their demand balances beyond what they normally wish to hold for transaction purposes. Finally, given the variation in methods used to enforce compensating balance arrangements, some portion of the adjustment in balances that does occur could be spread over a long and indefinite period.