WASHINGTON UNIVERSITY
Notes for Executive
MBA Class on 10/26/85

I. How does the market view the Fed?

A. When we talk about "the market," means U.S. Government securities market

1. By far most sophisticated in interpreting Fed activities; next in line would be the money markets and the foreign exchange markets

2. Largest and most liquid securities market in world

a) gross public debt of U.S. Treasury outstanding at 6/30/85 $1,774.6 billion

b) Average daily transactions of U.S. Government securities dealers during first half of 1985 approximately $75 billion

3. With some exceptions, because of size, liquidity, straight-forward terms and U.S. Government credit, directly reflects changing expectations about course of U.S. interest rates

B. Market participants don't think Fed sets interest rates

1. Rates a by-product of market interaction between buyers and sellers; Fed a major player whose actions need to be followed

2. To put into perspective, Fed holdings of U.S. Government securities at 6/30/85 $169.11 billion, or less than 10% of gross public holdings

3. Large outright purchase of securities would be on the order of $2-3 billion, less than 5% of average daily volume and a relatively infrequent occurrence in any event

4. Nevertheless, when Fed enters market can have significant technical impact

5. Accordingly, market participants "watch" Fed in order to anticipate these occurrences

6. Perhaps more importantly watch Fed for insight into how it views fundamentals--unanticipated action may evidence change in monetary policy and accordingly a change in outlook on fundamentals

7. However, misconception that Fed knows substantially more about what's happening in a fundamental sense in comparison to any other sophisticated observer

C. While easier to make money in periods of accommodation, market participants are not looking for hand-outs from the Fed

1. Tremendous respect for what Fed has done in coming to grips with inflation

2. While excessively easy policy might be good for awhile, in the long run renewed inflation would be bad for the business--1979-81 were tough years

D. "Fed watching" has gotten increased emphasis in recent years, although curiously present operating regime has made it potentially less productive than pre October 1979

1. Fed funds target - prior to October 1979

a) Relatively low volatility

b) Big positions, primarily in bills and short coupons

c) Big payoff if right on Fed easing - linkage between operating procedures and rates

d) Relatively few players--specialty firms (Lanston, Discount and Devine), money center banks (Morgan Guaranty, Citibank and Chase) and securities firms (Salomon and First Boston)

2. Non-borrowed reserves target - October 1979 through August 1982

   a) Much greater volatility

   b) Smaller positions; trading orientation

   c) More participants - beginning of trend in "street" toward bigger trading operations

3. Borrowings target - August 1982 through present

   a) Somewhere in between prior two regimes in terms of volatility

   b) Continued build-up of trading operations supported by strong profitability of 1982-84 period

   c) Development of interest rate risk transfer vehicles--futures, options, swaps

   d) Big increase in volume

   e) Foreign dimension; London (83-84) and Tokyo (84-85)

4. Despite reduced linkage between operating procedures and interest rates, increasing number of participants, derivative instruments and volume have led to strong demand for "Fed watchers."

E. What does a "Fed watcher" look at? (Wrightson letter)

1. Projection of open market operations (p.3)

a) RR + ER = NBR + B

NBR = RR + ER -B

b) Estimate RR, ER and B

c) Estimate how operating factors (float, currency in circulation, Treasury deposit at Fed, etc.) impact NBR

d) Project what open market operations are required

e) Operations different from what expected, either projections wrong or policy moving

2. Projection of funds rate (p.5)

a) Historical view of degree of reserve restraint, where funds have traded and short term credit demands--rough supply/demand relationship

b) Reserve projections viewed against this backdrop to estimate funds rate

c) Seasonal factors

3. Other fundamental and technical factors

a) Economic indicators (last page)

b) Money supply (p.6)

c) Treasury financing calendar (p.7)

d) Lacks any treatment of the dollar

F. What do market participants do with this information?

1. Not taken as gospel--another informed person's point of view

2. If policy apparently moving and other factors point in this direction as well, adjust positions accordingly; usually others will have been doing this and prices will reflect some, if not all, of appropriate adjustment

3. Role of market participant is to understand expectations, or what the market is discounting at any point in time--take advantage of extremes

4. Sometimes, what participant actually believes and positions will be contrary, e.g., short when fundamentally bullish.

5. This represents a major difference between position-taker and policy-maker; time-frame also major difference

II. What happens at an FOMC meeting?

A. Background

1. Comprised of seven Governors, 12 Presidents, five of whom are voting

2. Meets eight times per year

B. FOMC minutes (also known as Record of Policy Actions) represent an excellent summary--recommend regular reading for those interested in financial markets

C. Briefings & discussion

1. Foreign currency operations

2. Domestic open market operations

3. Economic situation and outlook

4. Monetary (and financial) policy

5. Chairman encourages discussion; holds own comments until end; seeks consensus within acceptable bounds

D. Directive to FRB New York

1. Degree of reserve restraint (i.e., level of borrowings given assumed level of excess reserves)

2. Expected behavior of monetary aggregates for quarter (e.g., June-September or Q3)

3. Funds rate range; quite broad, although more precise expectation as to where funds will trade expressed verbally

III. Major current policy issues.

A. Economy

B. Inflation

C. Foreign exchange markets--relationship between trade deficit and budget deficit

D. Monetary growth rates--velocity

E. Domestic and international credit markets--LDC debt, farm problem, etc.

SELECTED ECONOMIC INDICATORS

	Released Prior to August 20	Released Subsequently		
	July	July Revision	August	Sept.
Industrial production (% change)	0.2	(0.2)	0.6	(0.1)
Capacity utilization (%)	80.8	80.2	80.5	80.2
Non-farm payrolls (000)	240	249	280	128
Retail sales (% change)	0.4	0.2	2.3	2.7
Housing starts (mm)	1.65	1.66	1.75	1.58
Housing permits (mm)	N/A	1.69	1.78	1.80
Durable goods orders (% change)	1.8/3.7 (1)	(2.3)	3.4	(1.1)
Non-defense capital goods (% change)	6.8/9.4 (1)	(4.6)	3.3	4.7
PPI	0.3	0.3	(0.3)	(0.6)
CPI	0.2/0.2	0.2	0.2	0.2
Avg. hourly earnings index	N/A	(0.1)	0.1	0.0
Trade-weighted value of $ (index)	138	N/A	N/A	130
Merchandise trade deficit ($mm)	134 (2)	N/A	126	119
GNP (3)	1.1	N/A	N/A	3.3

Notes:

(1) Figures shown are for June/June revision. July figures were not available at time of meeting.

(2) Merchandise trade deficit for second quarter at an annual rate.

(3) Figures represent annual growth rates for first half and third quarter GNP, respectively.

SHORT-RUN MONETARY
TARGETS AND GROWTH
RATES (ANNUALIZED)

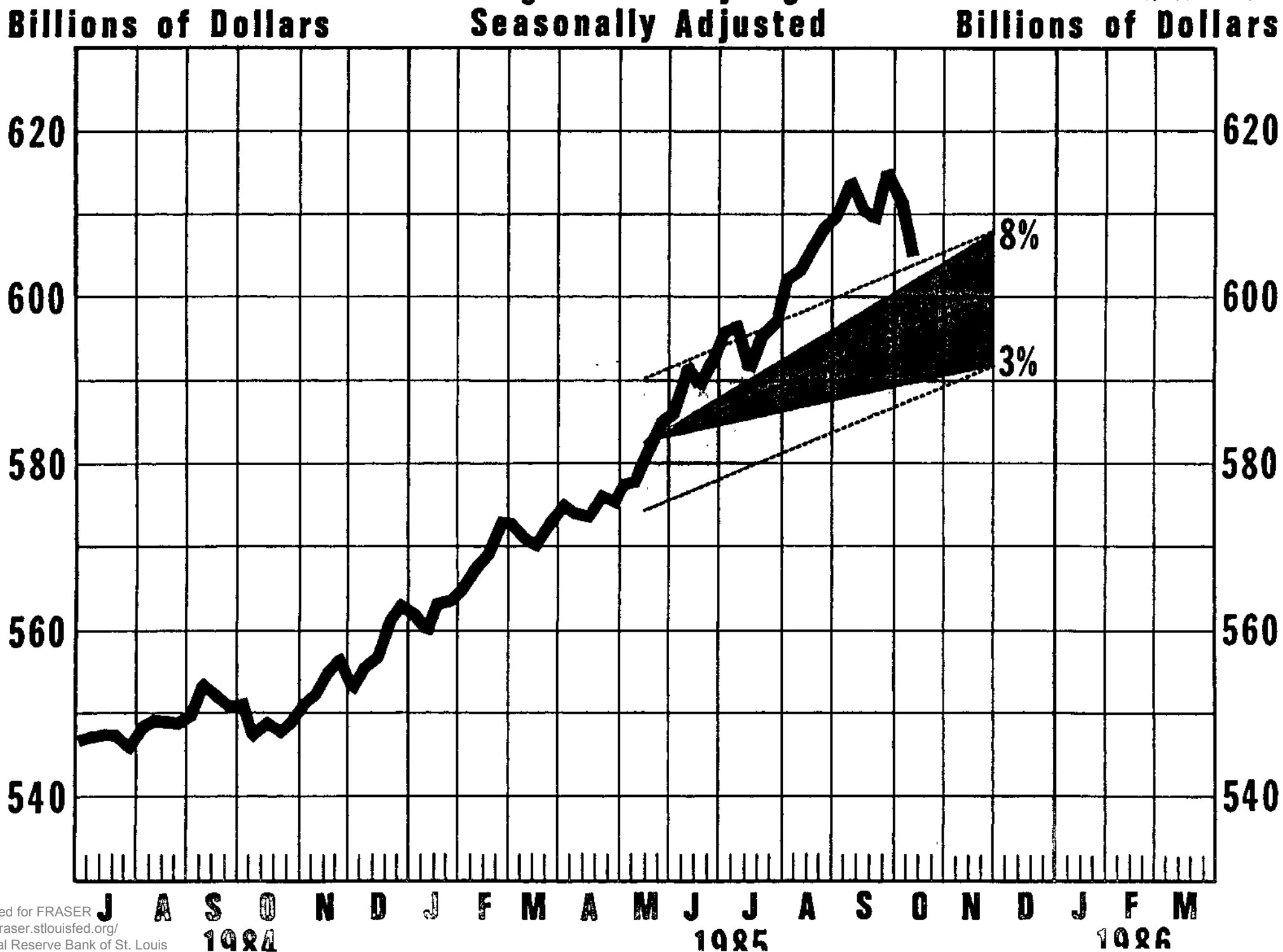
	August 20 Target	Actual June-Sept.
M1	8-9	14.7
M2	8-1/2	9.3
M3	6-1/2	8.0

October 24, 1985

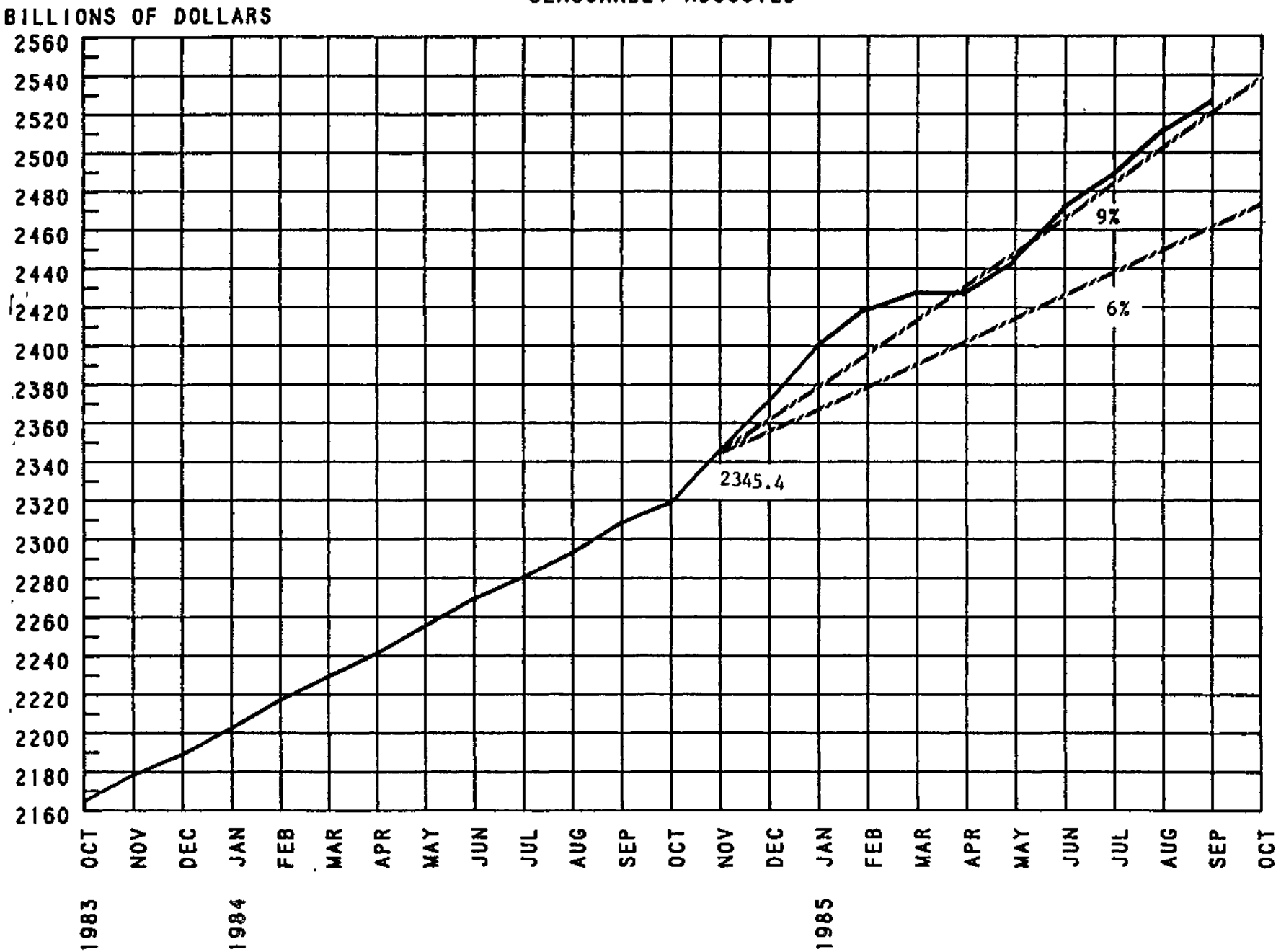
Money Stock (M1)

Averages of Daily Figures
Seasonally Adjusted

Current	--	10/14:	605.1
Previous	--	10/07:	611.9
Change		:	-6.8
Revision	--	10/07:	+0.4



MONEY STOCK (M2)
MONTHLY AVERAGES OF DAILY FIGURES
SEASONALLY ADJUSTED



August : 2513.7
September : 2528.4
Change : +14.7