APPENDIX

FOMC PRESENTATION
E.M. Truman
February 4, 1980

Introduction

Mr. Chairman, we have prepared for the Committee a background presentation on "international financial trends." U.S. monetary policy decisions affect such trends and, to some extent, may be affected by them. With that in mind, and using the package of materials before you, Jeff Shafer and George Henry will review some of the economic and financial factors influencing exchange market developments and some of the international financial implications of the oil situation. When they have finished, I will offer a few concluding comments.

Mr. Shafer.

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FOMC PRESENTATION
Jeff Shafer
February 4, 1980

The red line in the top panel of Chart 1 shows the weighted-average foreign exchange value of the dollar since 1973 -- the begininning of the floating exchange rate period. The black line shows the ratio of foreign to U.S. consumer prices.

From March 1973 to 1976 the trend of the dollar, although obscured by sizable fluctuations, appears to follow the rising path of foreign prices relative to U.S. prices. The decline of the dollar since then has been associated with a downward movement of prices abroad relative to prices here. But the slide of the dollar has been much steeper than the trend in relative prices. The bottom panel shows the resulting drop in one measure of the price-adjusted average value of the dollar--or what is often referred to as the real exchange rate.

Chart 2 plots bilateral movements of the dollar against the currencies of Germany, Japan, Switzerland and the United Kingdom, together with the ratio of the price level in each of these economies to the U.S. price level. The chart indicates a general correspondence between price trends and exchange rate trends. Since March 1973, the dollar has depreciated against the currencies of the top three countries, where prices have risen more slowly than in the United States. It rose against the U.K. pound through 1976, in line with the more rapid rate of price increase in the United Kingdom. But since then, the dollar exchange rate against the pound has fallen below the trend of relative prices, as factors such as North Sea oil contributed to a strengthening of pound.

Relative price movements are clearly an important element in accounting for trends in the dollar. In 1980, the staff expects prices abroad to rise more slowly than U.S. prices, but probably by only one or two percent. Price increases in Germany and Switzerland, however, are expected to be substantially less than in the United States.

Several factors have operated since March 1973 to cause dollar exchange rates to deviate from the path of relative prices. Chart 3 provides a perspective on the relationship between interest rate developments and the exchange market performance of the dollar. The weighted-average exchange rate for the dollar is shown again in the top panel.

The middle panel shows the 90 day interest rate on U.S. CDs in red and a weighted-average of 3-month foreign interest rates in black. As can be seen from the Chart, U.S. and foreign interest rate movements have been broadly parallel. The red line in the bottom panel shows the movements in the differential between U.S. and average foreign interest rates that have occurred. For comparison, the black line presents the differential between the U.S. inflation rate and the average foreign inflation rate over the previous 12 months. Longer-term movements in the interest rate differential have tended to follow the inflation differential.

One episode in which short-run interest rate developments deviated from inflation developments and had a significant short-run impact on the dollar occurred from late 1974 to late 1975. During this period the drop in U.S. interest rates relative to foreign interest rates and the subsequent reversal were paralleled by a decline in the dollar and then a recovery. In contrast with this episode, the dollar remained firm in 1976 even though U.S. interest rates fell behind rising foreign interest rates while the inflation differential was stable. This pattern reflects the behavior of several foreign central banks which raised interest rates sharply to moderate depreciations of their currencies.

The three panels in Chart 4 repeat for the German mark and the dollar the same comparisons made in Chart 3. The bottom panel shows that from March 1973 through 1975 sizable fluctuations in relative interest rates corresponded reasonably well with short-run fluctuations in the mark-dollar exchange rate. But from late 1975 through late 1978 the interest differential and inflation differential between the two countries tracked rather closely. Over this period the dollar followed a weakening trend against the mark, but short-run fluctuations

about this trend were small. Despite a narrowing of the differential between U.S. and German interest rates in 1979, with no reduction in the inflation differential, the dollar declined only moderately against the mark.

For the record, in 1980, we expect interest rates abroad to remain in their recent range on average, including in Germany.

Shifting demands for assets denominated in dollars, for reasons other than movements of relative price levels or rates of return, also influence dollar exchange rates. For example, it has been argued that the advent of floating exchange rates has provided an incentive for official holders of dollars to diversify into other currencies in order to reduce the variability in the value of their reserves. Chart 5 summarizes some evidence concerning diversification. The top panel shows the evolution of the composition of the foreign exchange reserves of a sample of 76 countries.

The chart suggests that since 1973 there has been no secular trend of diversification out of dollars. Rather, the share of sterling has declined markedly while the shares of marks and other currencies have risen. The dollar share of reserves rose from 1973 to 1976 and has declined moderately since 1977. It was still well above its 1973 low in September 1979. The decline in the dollar's share since 1977 is largely attributable to the effects of exchange rate changes on the valuation of reserves rather than to sales of dollars for other currencies or major shifts in the currency distribution of additions to reserves.

More recently there have been reports of some OPEC diversification; but we have no evidence that, aside from Iran, large shifts have occurred. Looking ahead, if the dollar weakens for other reasons, official diversification, or fear of it in the aftermath of the Iranian asset freeze, may add to the downward pressures on the dollar. But the evidence suggests that if other factors become favorable for the dollar, official reserve management might not be a negative factor and indeed might over time even have a positive effect.

The lower panel on the Chart shows the currency composition of Euro-currency liabilities. This Chart is presented to give a rough indication of trends in private as well as official use of the dollar. The movements of currency shares here roughly parallel those for official reserves.

Chart 6 presents data on official exchange market intervention in dollars by major countries. The middle panel shows net official dollar purchases by foreign central banks and by the United States. It indicates that the scale of net dollar intervention increased sharply in 1977 and has remained greater than in the earlier part of the floating rate period. Until 1978 most of the net intervention was undertaken by foreign central banks. In 1978 and 1979 the United States took a larger share.

In general, intervention purchases of dollars have occurred when the dollar has been weak, thereby moderating its decline, and sales have occurred when it has been strong, or to unwind previous intervention when the dollar has been at least stable. In 1974, however, net dollar sales occurred even though the dollar declined over the year. And in the second half of 1979 U.S. purchases of dollars to counter downward pressure in exchange markets were offset by the net official sales of foreign central banks. Intervention that runs counter to the trend of the dollar's value, or that is offsetting among countries, reflects the reserve and intervention currency roles of the dollar. Some of the differences in intervention by individual central banks can be seen in the bottom panel where net dollar purchases by Germany, Japan, and other countries are shown. Years in which intervention by the three have been in opposite directions have been common.

Assessment of the effects of intervention on exchange rates is difficult, since a judgment as to how much further a currency might have moved in the absence of intervention is required. Moreover, in most episodes of dramatic success, intervention has been initiated in conjunction with new monetary or other policy actions. The principal effect of intervention under such

circumstances may be to underscore the importance authorities attach to the exchange rate in setting and executing their overall economic policies.

George Henry will continue our presentation.

FOMC PRESENTATION
George B. Henry
February 4, 1980

Complementing the factors that Mr. Shafer has reviewed, especially the influence of relative price levels, the behavior of the U.S. current-account position in 1977 and 1978 helps to explain the decline in the value of the dollar in those years. Perhaps the most important channel through which current-account developments affect exchange rates is by influencing expectations concerning rate adjustments that may be required to achieve sustainable external positions over time. How current-account developments affect expectations will depend on the market's view of the underlying factors at work. As can be seen from a comparison of the panels in Chart 7, the declining U.S. current-account position in 1976, attributed at the time to temporary cyclical factors, was associated with an appreciating dollar. The cyclical character of these developments was called into question by the further sharp decline in our balance in 1977 and substantial downward pressure on the dollar emerged.

Recently, the U.S. current account has improved notably. Substantial growth in net service receipts has contributed importantly to this favorable swing. As shown in the top panel of Chart 8, growing income on net investment abroad has recently been a dynamic factor. Net investment-income receipts now exceed $30 billion, of which approximately half is reinvested abroad.

Our trade position also has exhibited large shifts in recent years. The balance excluding agricultural exports and oil imports is shown in the second panel of the chart; it declined steadily and sharply from the recession-induced surplus of 1975 through the beginning of 1978. It has shown an equally dramatic improvement over the past two years and is now nearing surplus. As can be seen from the final two panels, this improvement has reflected substantial growth in the volume of our non-agricultural exports and stable non-oil imports -- both largely attributable to the earlier depreciation of the dollar.

Our projections suggest that the current account is not likely to be a bearish factor for the dollar at least after the first half of this year. These projections fold in the huge increases in our bill for imported oil (depicted in Chart 9) that have occurred and are expected to continue. Similar increases, of course, have affected every oil-importing country and they have affected as well the external position of OPEC.

As can be seen in Table 1, line 3, the initially huge OPEC current-account surplus in 1974 had virtually disappeared by 1978. The deficits of the non-oil developing countries, which peaked in 1975, had been worked down to more reasonable levels by 1977. The big oil-price increases of 1979 have taken us back to square one if not beyond; we project an OPEC surplus of $100 billion or more in 1980 and a very substantial widening in the deficits of non-oil developing countries. These prospects raise anew the so-called "recycling question," that is, the capacity of the international financial system to handle OPEC's surplus and to channel funds to countries in deficit, in particular to developing countries.

Chart 10 provides some historical perspective on this question. As can be seen in the top panel, official flows to non-oil developing countries increased rather rapidly during the period of large and rising deficits in 1974-75; since 1975 official flows have risen more modestly. The middle panel shows that banking flows also rose sharply in 1974 and 1975, and then leveled off. But they have expanded again recently. As indicated in the final panel, developing countries as a group added substantial amounts to their gross reserves in every year after 1975.

Table 2 provides some detail on the recent behavior of bank claims on non-oil developing countries. Debts to banks rose as a share of total debt of

these countries from about 25 percent in December 1973 to almost 45 percent at the end of 1979. Initially in 1973, and for several years thereafter, U.S. banks held more than half the claims, but since 1976 U.S. bank credits have risen much more slowly than have those of foreign banks -- and the U.S. share of the total has consequently fallen substantially.

The upper panel of Chart 11 plots total claims of U.S. banks on non-oil developing countries. Growth of these claims slowed over the past four years as international lending became a significant part of total portfolios. As is shown in the bottom panel of the chart, claims relative to bank capital and assets have remained essentially unchanged for about two years -- after having risen sharply earlier. One factor in the slower recent pace of lending to developing countries by U.S. banks may have been the low spreads that have recently prevailed on syndicated Eurocurrency credits. Moreover, some U.S. banks may have reached levels of exposure to certain major borrowing countries beyond which they would not have felt comfortable. Such a situation does not imply a cessation of increases in U.S. banks' lending to developing countries -- particularly if spreads were to rise; it more likely suggests a continuation of the moderate pace of lending of recent years.

At first blush, growth in bank credit to non-oil developing countries no faster than that of recent years would appear to suggest a distinct financing problem, since the deficits of these countries, shown in the upper panel of the final chart, are expected to be substantially enlarged in 1980 and 1981. I noted earlier, however, that borrowing in recent years has exceeded these countries' immediate financing requirements -- in fact, by about $10 billion per year on average over the past four years. Simply eliminating reserve increases by non-oil developing countries would thus significantly reduce borrowing requirements.

Moreover, as can be seen in the middle panel, increases in IMF quotas and the establishment of special facilities have substantially increased the availability of Fund resources. Some net use of reserves by non-oil developing countries may be called for in the future and, given the relatively high level of their reserves, this would not in itself be cause for alarm.

On balance, the prospective stresses in international financial markets, generated in large part by sharply rising energy prices, appear to be basically manageable -- but there are some potentially serious risks. These include: (1) the possibility of further large oil disruptions; (2) the possibility that developing countries may fail to take prompt steps that would reduce their deficits over time and, consequently, that severe economic adjustment on the part of a number of those countries will ultimately be required in order for them to service their debts; or (3) the possibility that countries, developed as well as developing, will impose trade restrictions in an effort to ameliorate their own difficulties.

Ted Truman will now conclude our presentation.

Concluding Comments

One aspect of international developments that is of major concern to the Federal Reserve is the foreign exchange value of the dollar. For that reason, Mr. Shafer and Mr. Henry have reviewed the economic and financial factors that are commonly regarded as influencing the dollar's value.

No one factor should be regarded as dominating the determination of the dollar's foreign exchange value over all time periods. Nevertheless, over the longer run--measured in years--a central role must be assigned to monetary policy. But the long run often is not the focus of immediate concern. And it is much more difficult to sort out the direct influence of various factors in the short run--measured in months.

One way to summarize the short-run influences on the dollar is to think in terms of the demand for dollar-denominated assets. That demand can be viewed as being determined in the short run by two factors: the nominal interest-rate differential and the expected exchange-rate change. If U.S. interest rates decline relative to foreign interest rates, everything else being equal, the quantity of dollar-denominated assets demanded and, hence, the exchange value of the dollar would be expected to decline.

But everything else may not be equal. Specifically, the complex of factors that bear on the expected exchange-rate change may not remain constant. These include the other factors Jeff and George reviewed: relative inflation rates, diversification practices, intervention activity, and current account developments. In particular, the exchange rate is

strongly influenced by what is expected to happen to economic variables and to policies affecting those variables. The market may react sharply based on its perception of changes in policies, especially those affecting inflation rates.

A broader area of Federal Reserve concern is the smooth functioning of the international financial system. As Mr. Henry has outlined, we believe that the overall situation with regard to current account surpluses and deficits, and their financing, in 1980 and 1981, is basically manageable. However, many countries face serious difficulties, and the capacity of developing countries to cope with their prospective, larger deficits without excessive reliance on new bank financing will depend to a considerable extent on whether the demand for their exports is reasonably well maintained.

Thus, there are risks, and they have increased significantly in recent months with the further rise in oil prices on top of an expected slowdown in global economic activity. These risks will be present even in a relatively stable international political environment, which may be an optimistic assumption. Disruptions in the international financial system would almost certainly spill over into exchange markets, although the implications for the foreign exchange value of the dollar might be either positive or negative. Perhaps more importantly, many such disruptions would have serious, adverse implications for inflation, for the health of the U.S. banking system, and for prospects for economic growth in the near and long term.

That concludes our presentation, Mr. Chairman.

CONFIDENTIAL (FR) CLASS II-FOMC

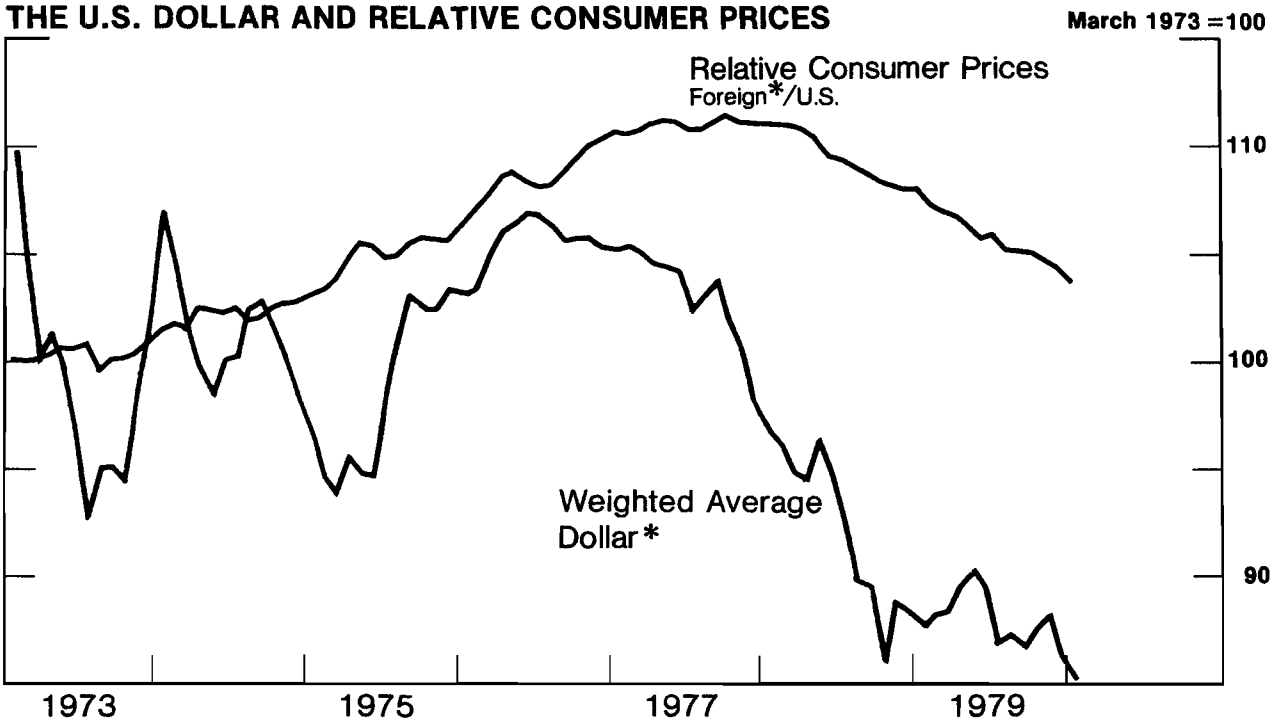
Material for
Staff Presentation to the
Federal Open Market Committee

"International Financial Trends"

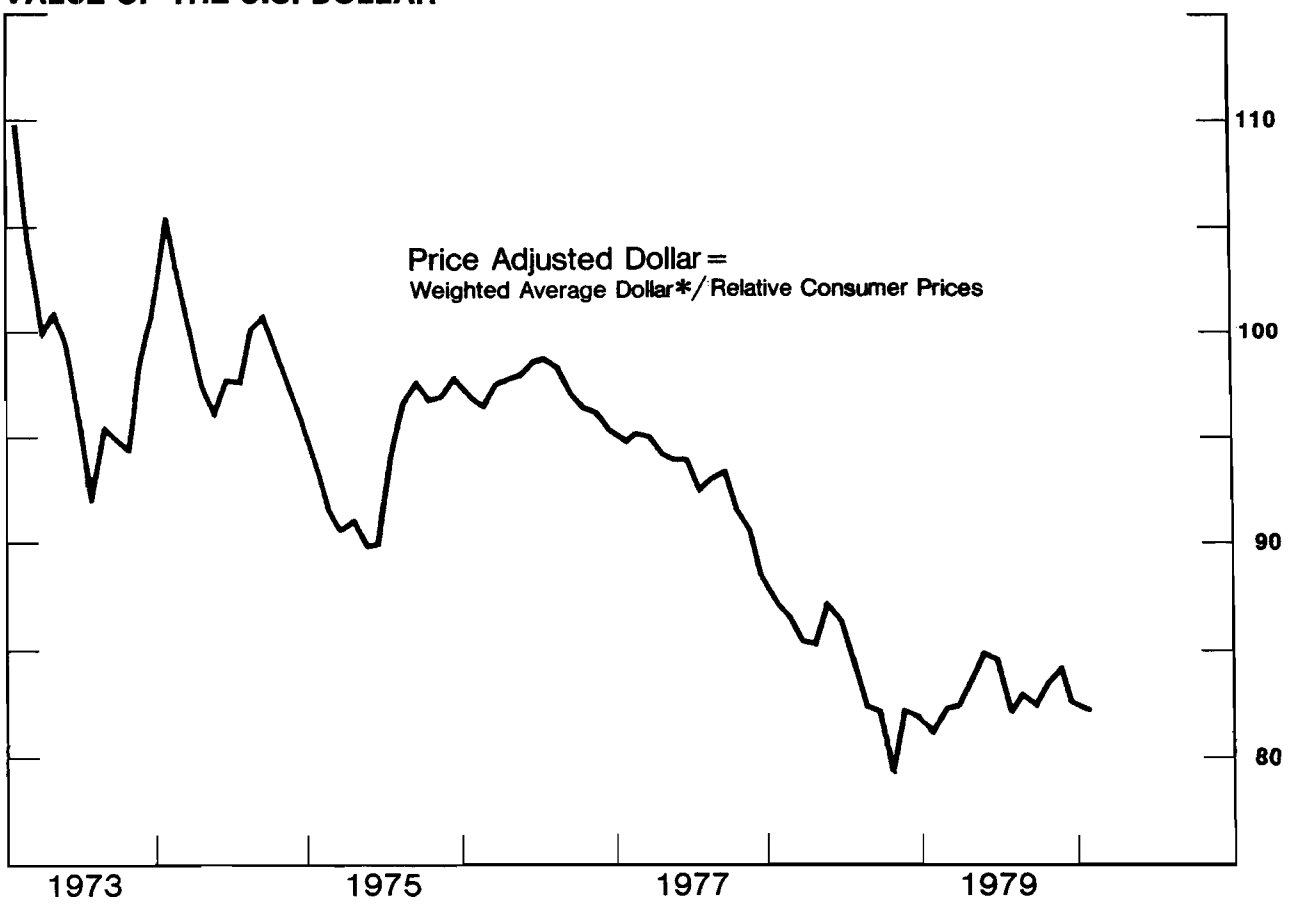
February 4, 1980

Chart 1

WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR AND RELATIVE CONSUMER PRICES



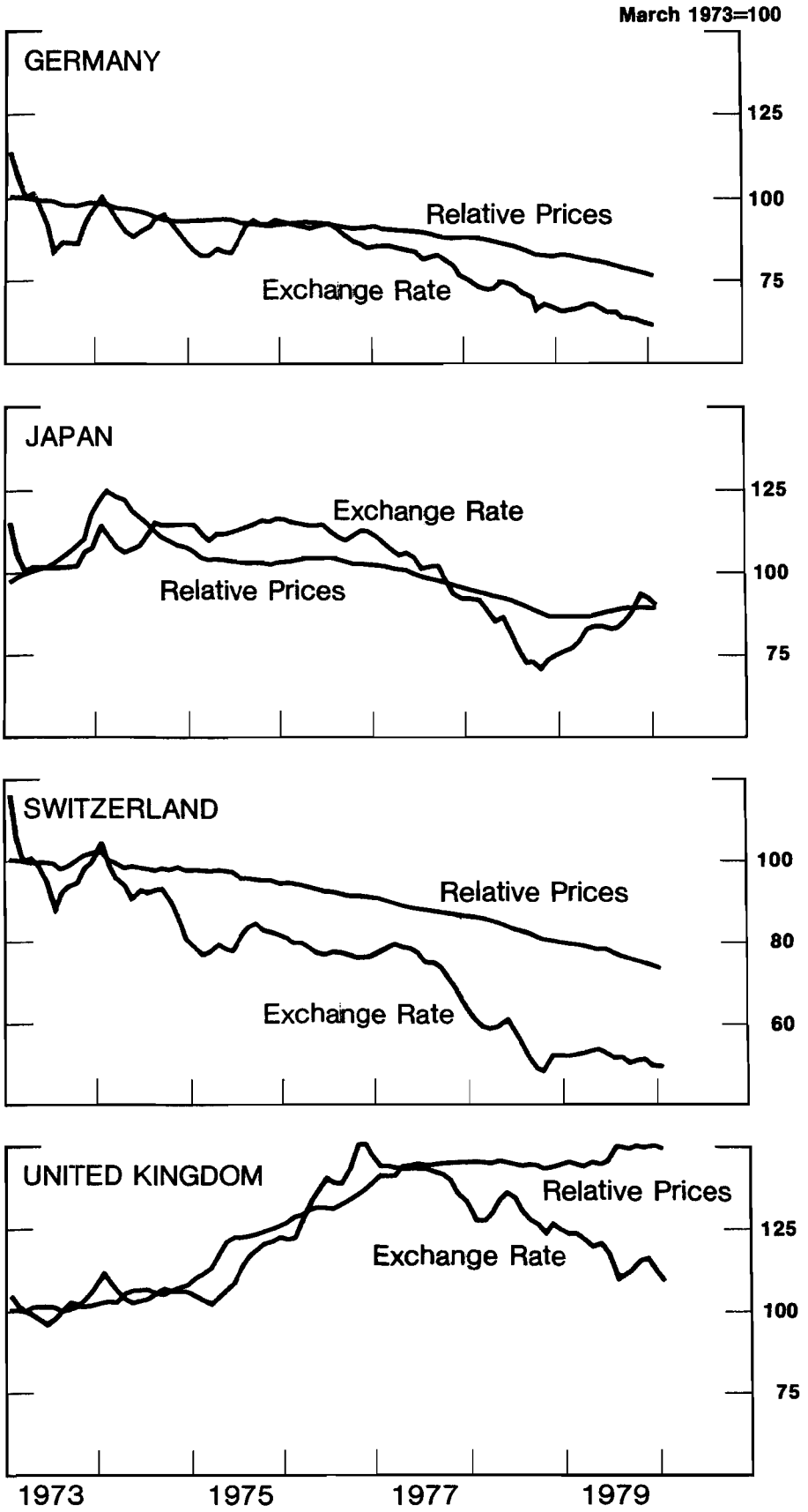
PRICE ADJUSTED WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR*



*Weighted average against G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

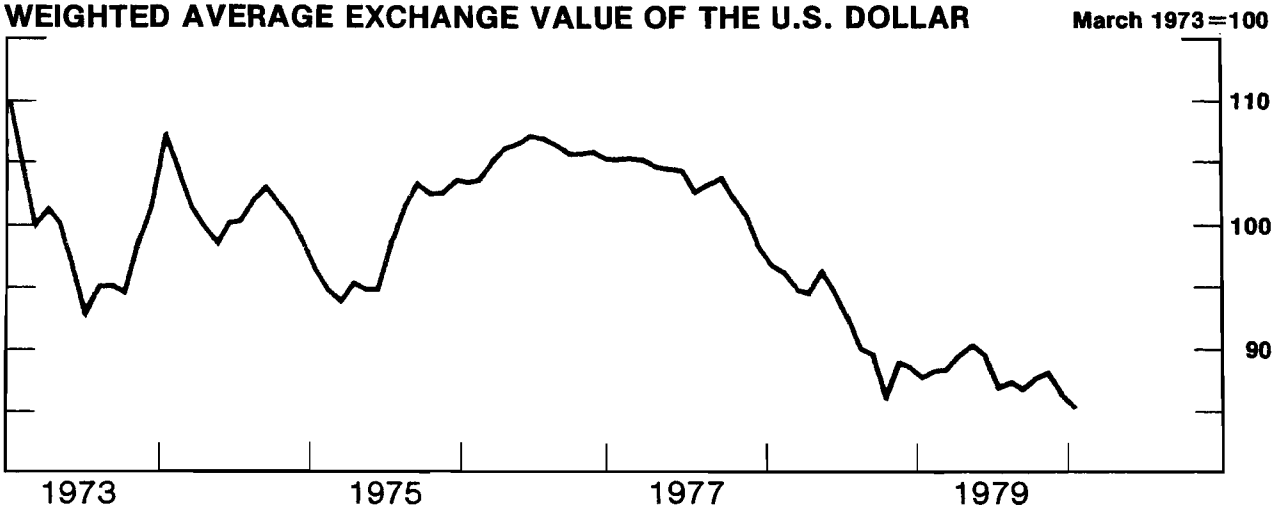
Chart 2

BILATERAL EXCHANGE RATES AND RELATIVE PRICE LEVELS*

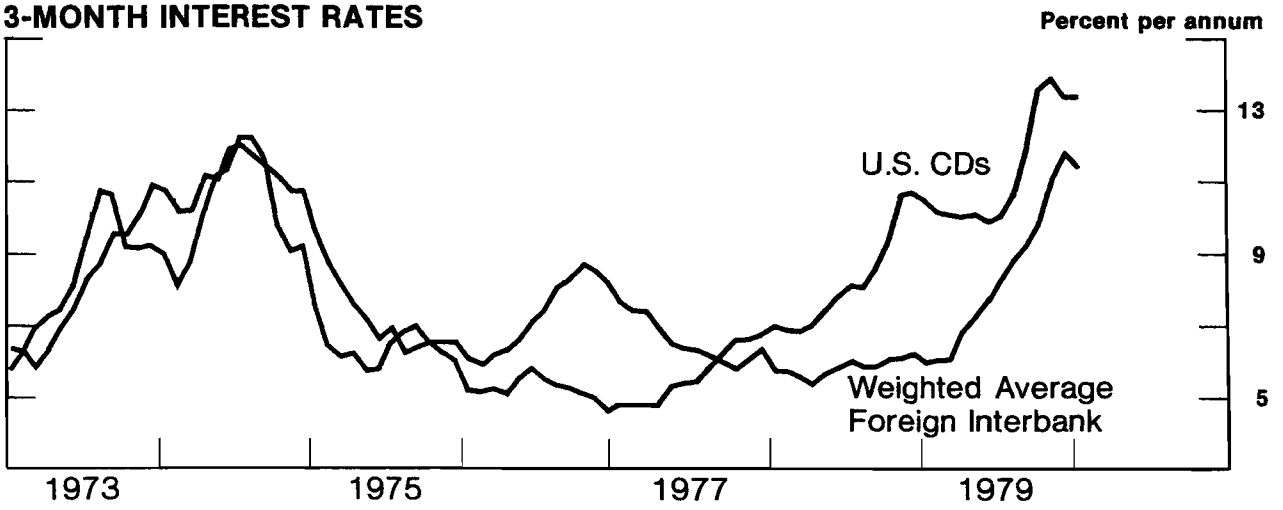


*Consumer prices, except for Japan where wholesale prices are used for Japan and the United States.

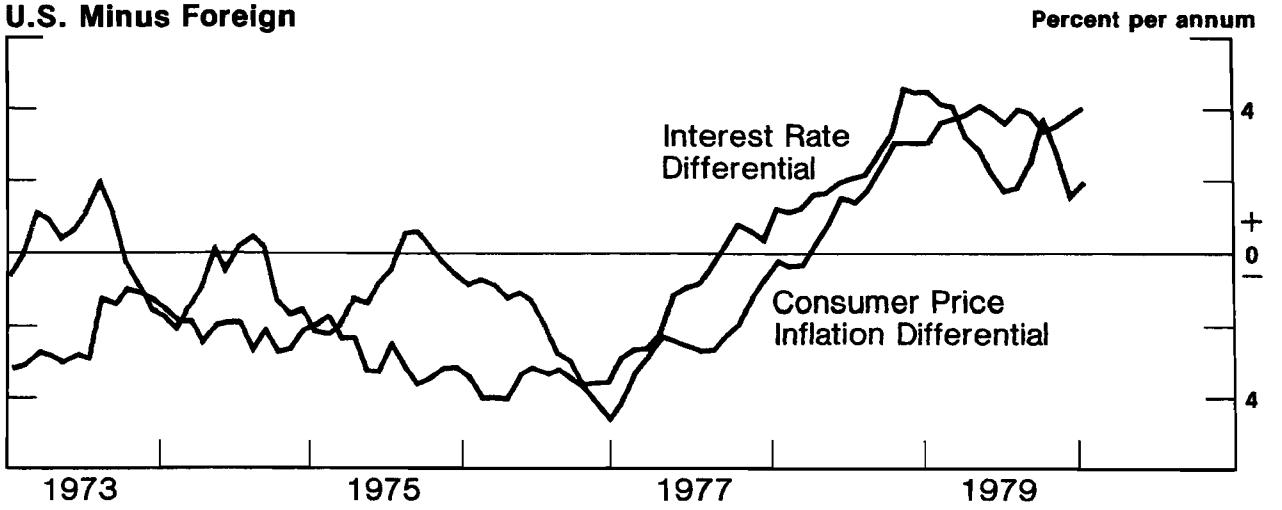
WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR



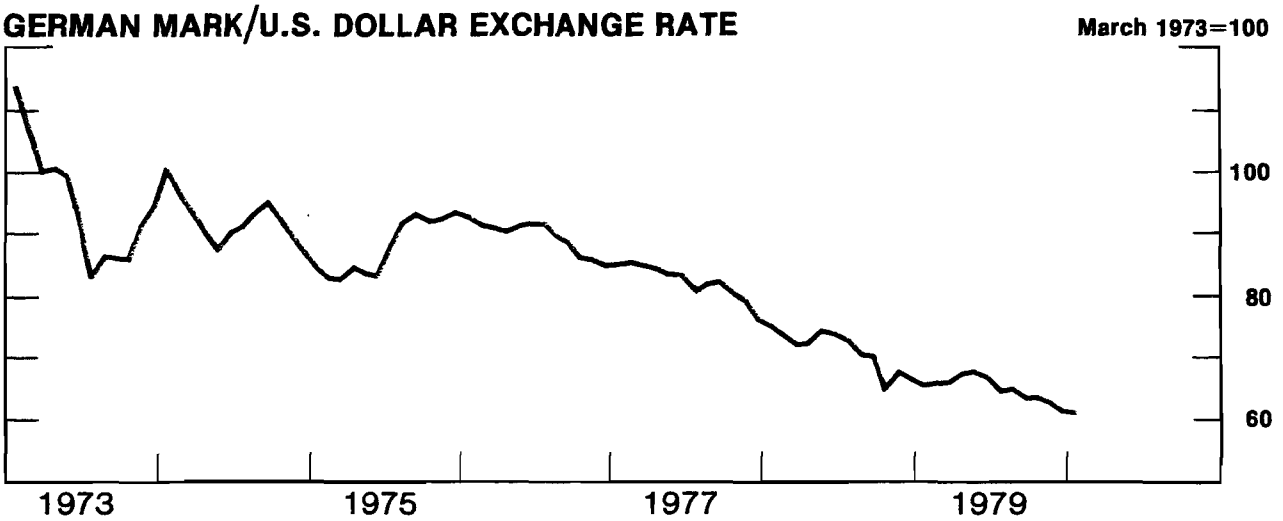
3-MONTH INTEREST RATES



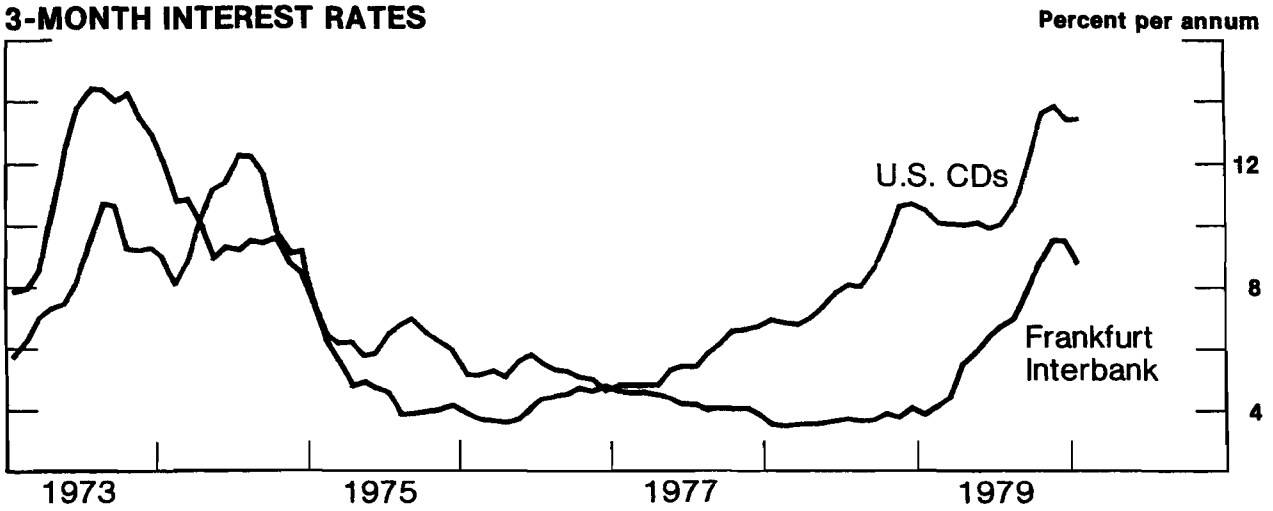
INTEREST RATE AND INFLATION DIFFERENTIALS
U.S. Minus Foreign



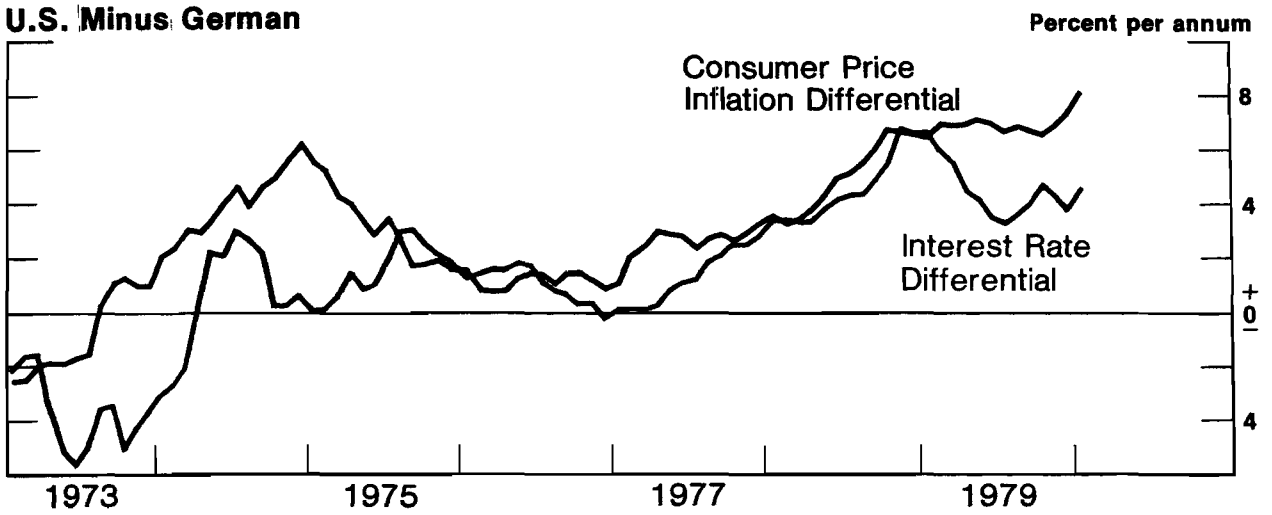
GERMAN MARK/U.S. DOLLAR EXCHANGE RATE



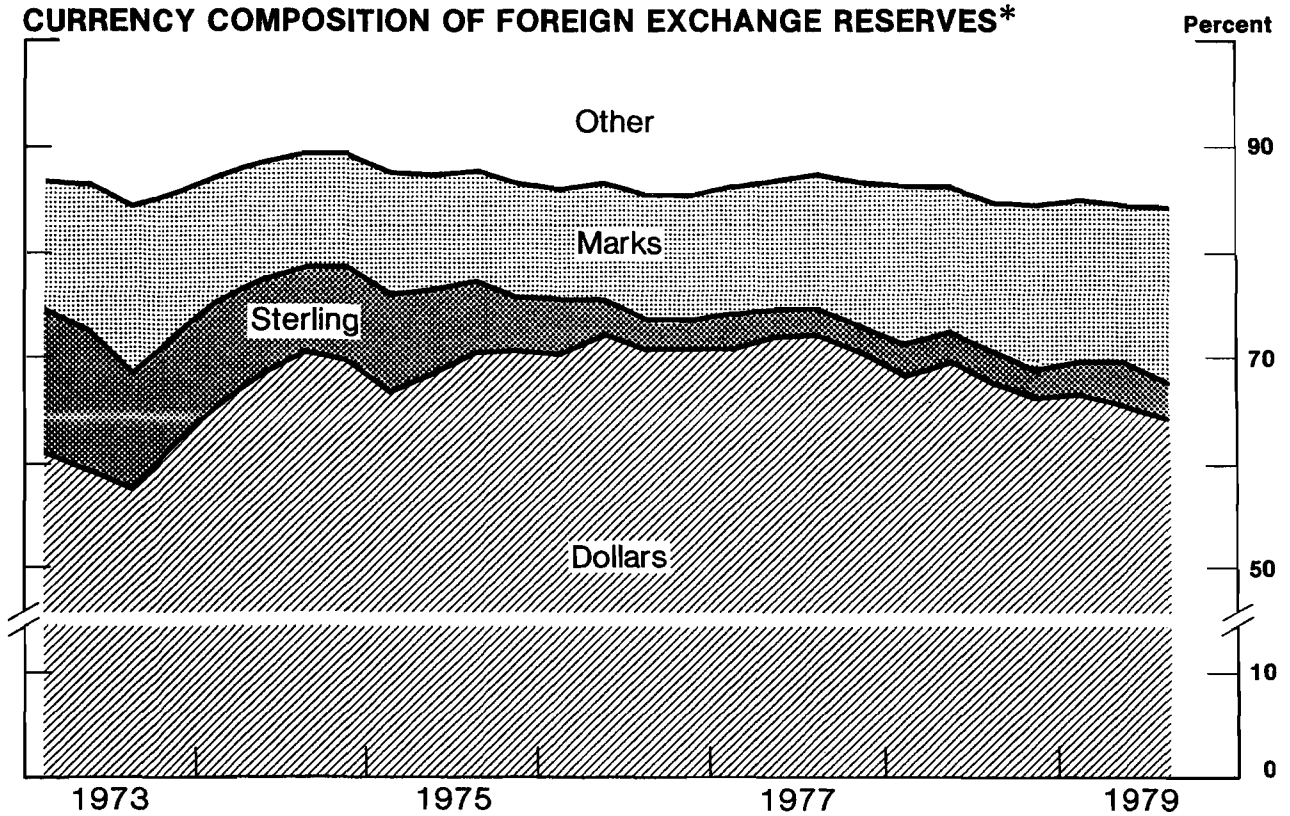
3-MONTH INTEREST RATES



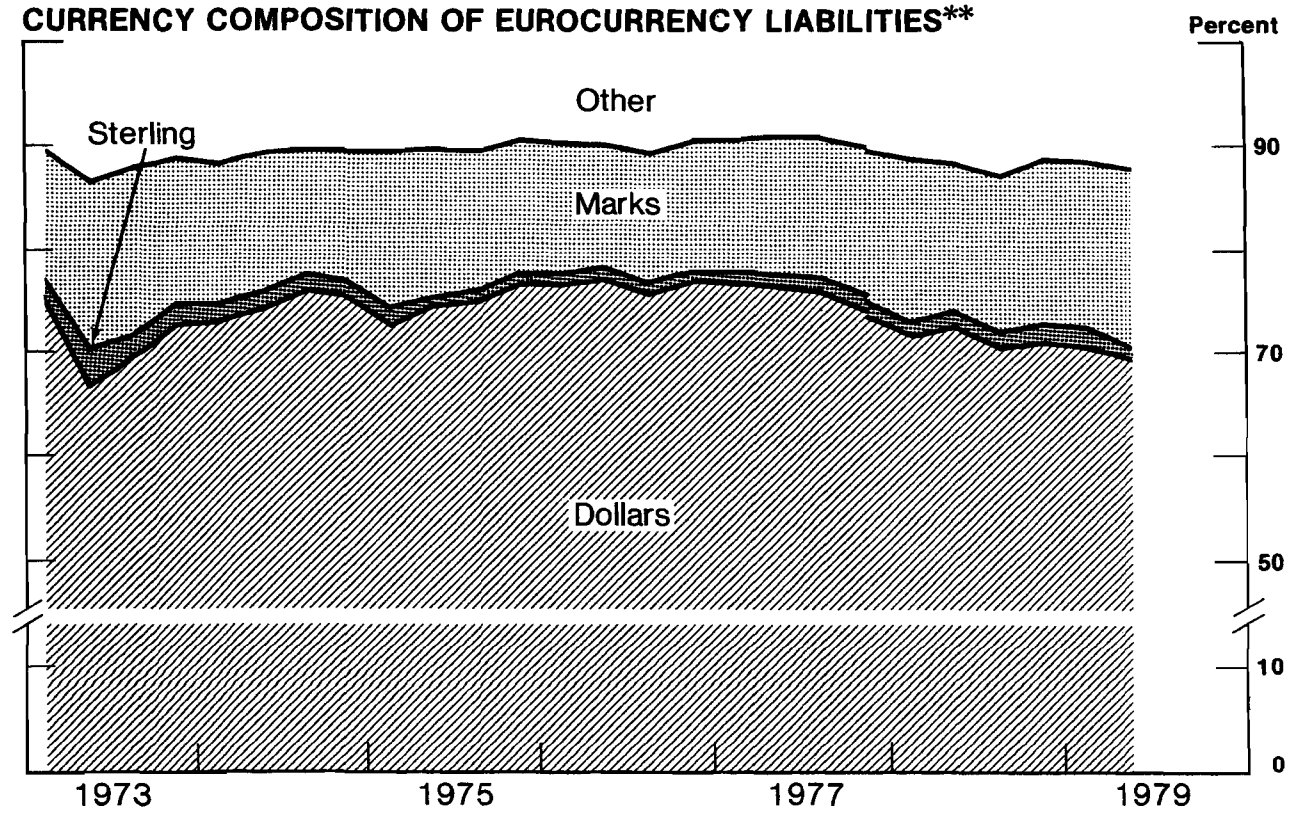
INTEREST RATE AND INFLATION DIFFERENTIALS
U.S. Minus German



CURRENCY COMPOSITION OF FOREIGN EXCHANGE RESERVES*



CURRENCY COMPOSITION OF EUROCURRENCY LIABILITIES**

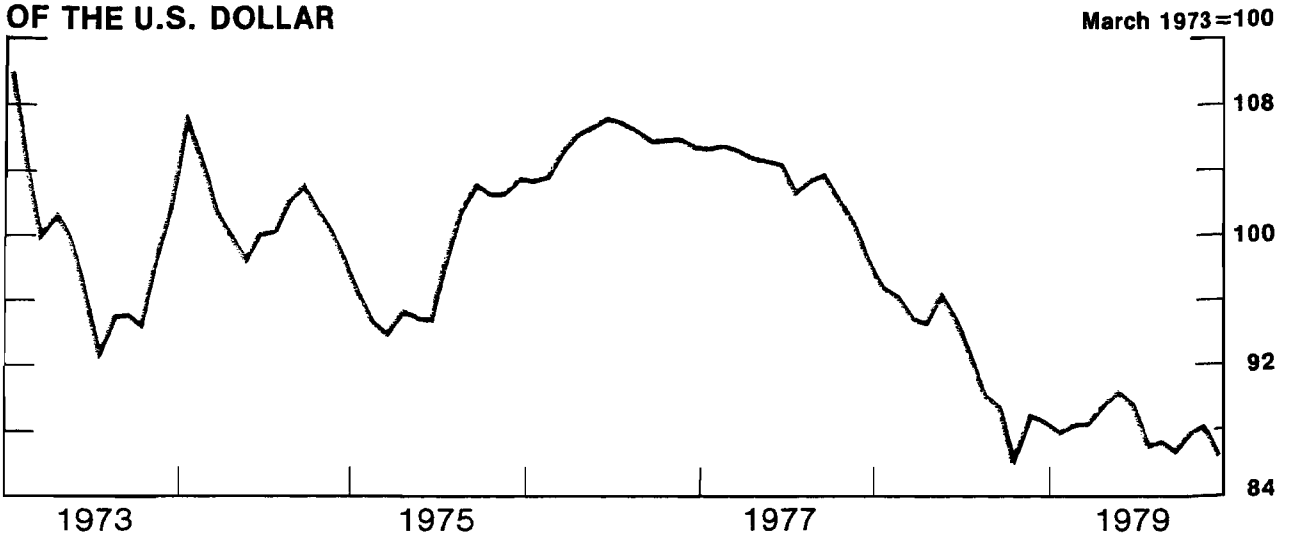


* Reserves of 76 countries, excluding reserve centers and countries that have not reported regularly to the IMF

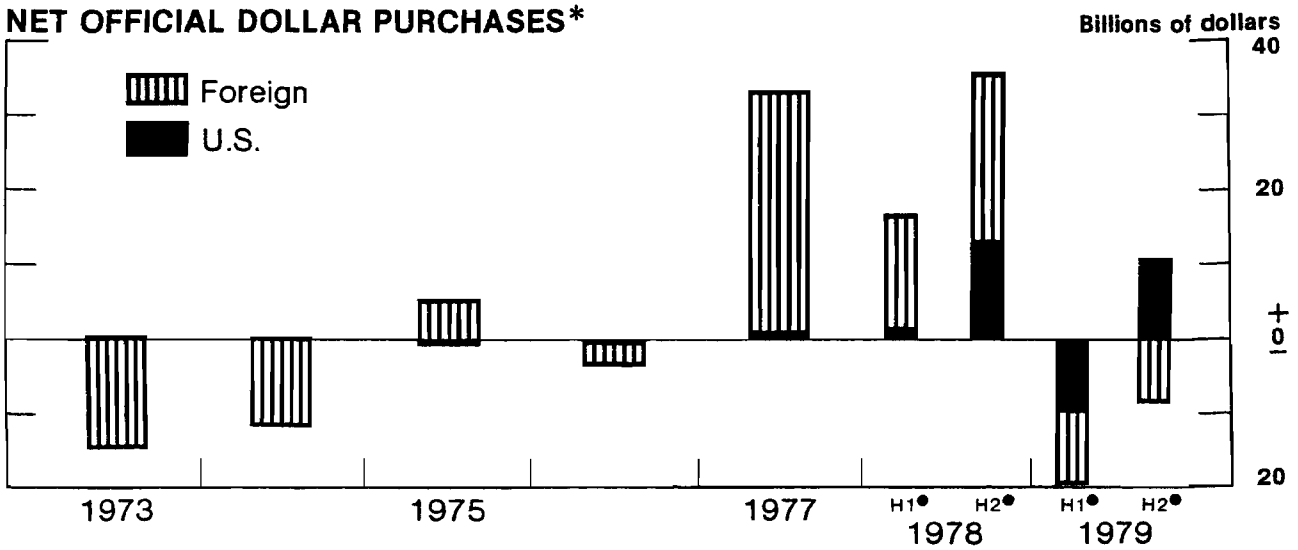
** Excluding liabilities in offshore banking centers

Chart 6

WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR



NET OFFICIAL DOLLAR PURCHASES*



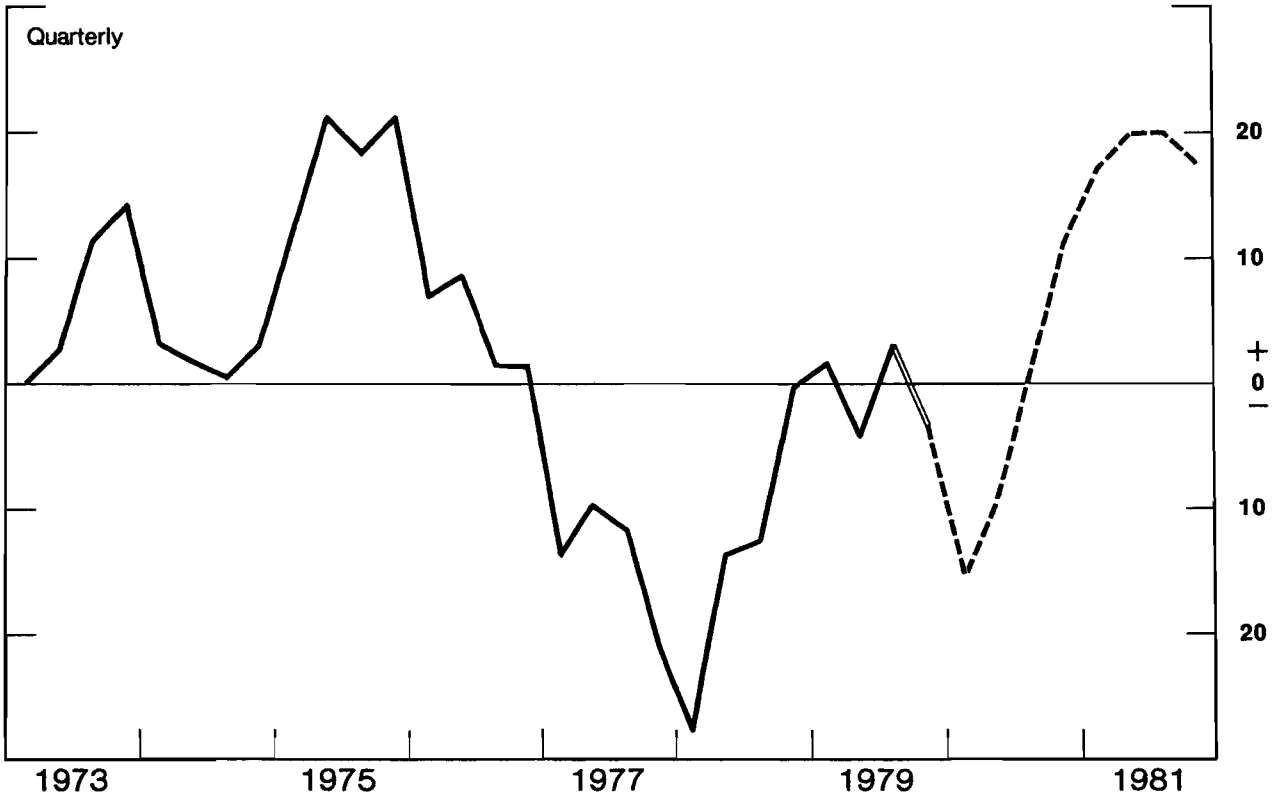
NET FOREIGN OFFICIAL DOLLAR PURCHASES*

* G-10 countries plus Switzerland
● Annual rate

Chart 7

U.S. CURRENT ACCOUNT BALANCE

Seasonally adjusted, annual rate, billions of dollars



WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.U.S. DOLLAR

March 1973=100

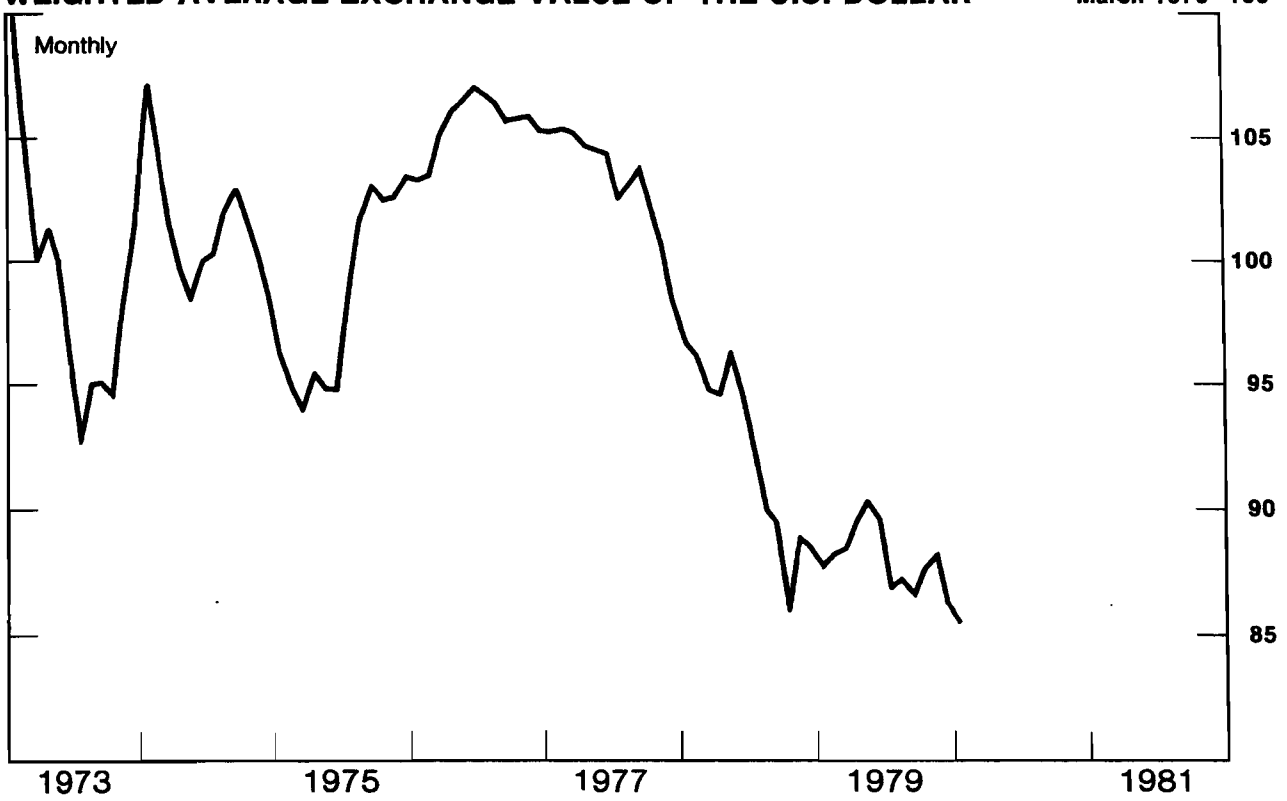


Chart 8

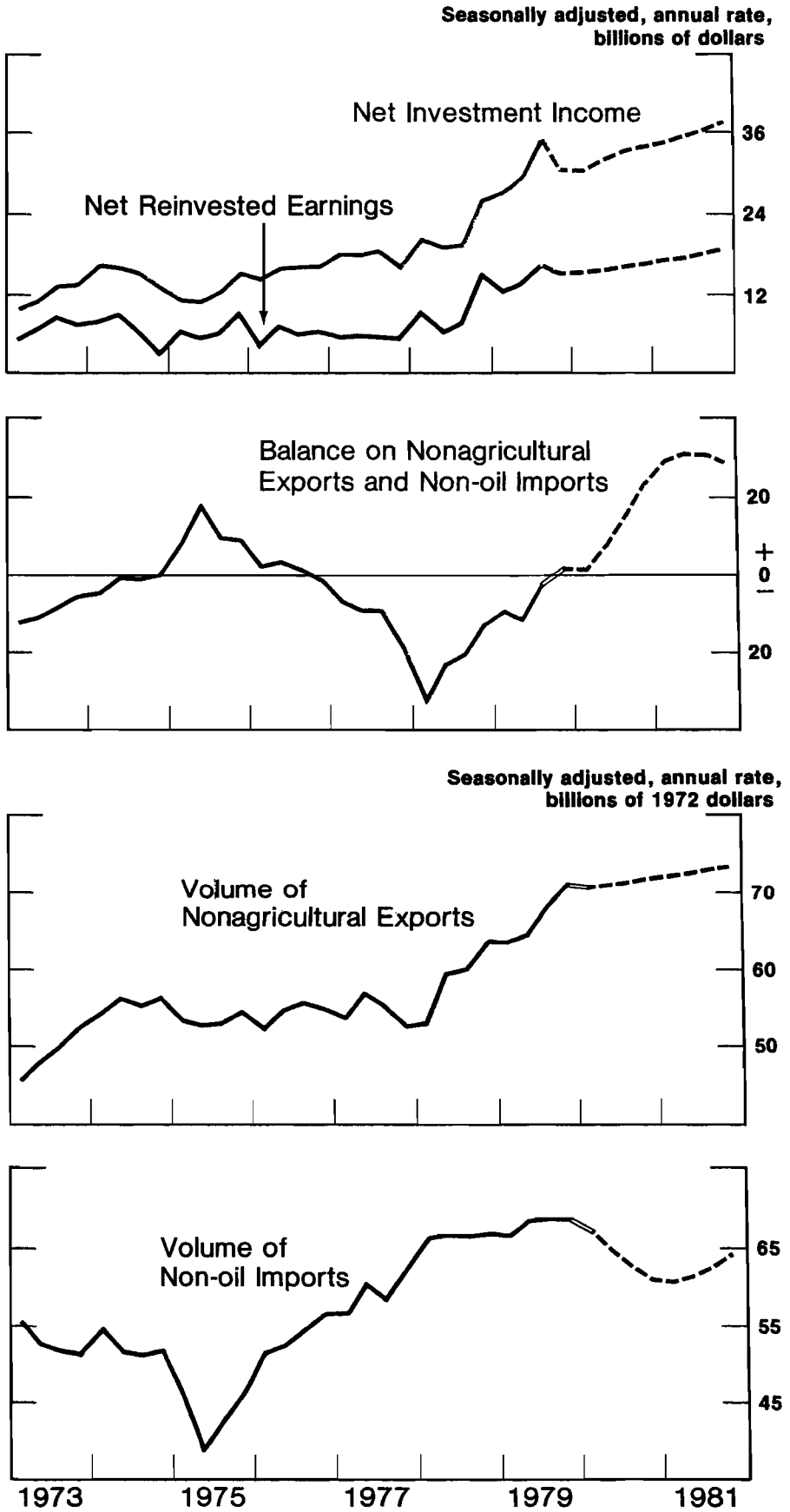

Seasonally adjusted, annual rate, billions of dollars
Net Investment Income
Net Reinvested Earnings
36
24
12
Balance on Nonagricultural Exports and Non-oil Imports
20
+
0
−
20
Seasonally adjusted, annual rate, billions of 1972 dollars
Volume of Nonagricultural Exports
70
60
50
Volume of Non-oil Imports
65
55
45
1973
1975
1977
1979
1981

Chart 9

OIL IMPORT BILLS

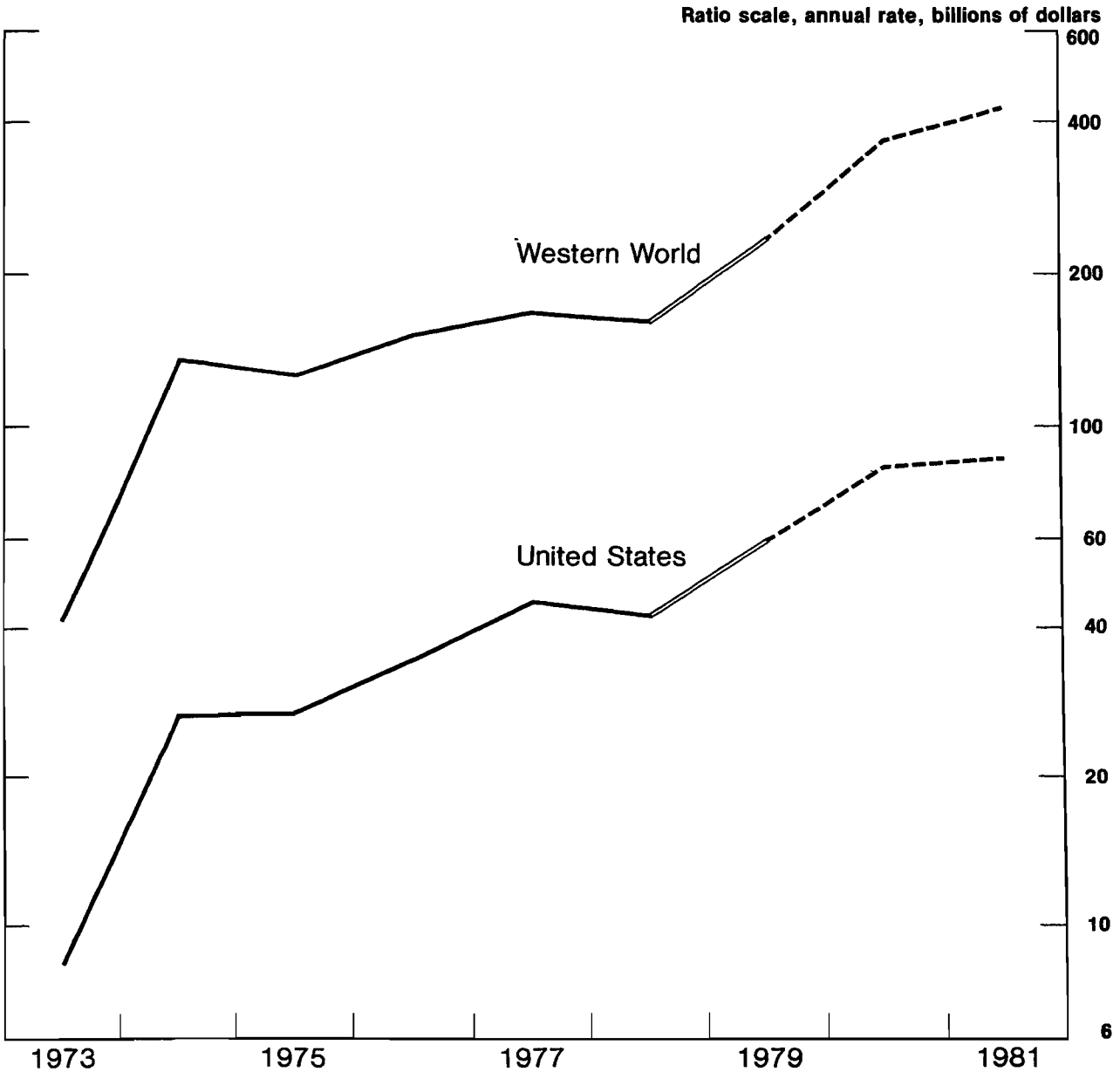


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Table I

GLOBAL CURRENT ACCOUNT BALANCES
Balances on Goods, Services, Private and Official Transfers; Billions of Dollars

								Staff Projection	
	1973	1974	1975	1976	1977	1978	1979[e]	1980	1981
1. United States	7.1	4.3	18.3	4.6	-14.1	-13.5	-1.0	-3½	18½
2. Other OECD	3.0	-31.4	-18.7	-22.8	-10.7	22.6	-32.5	-58½	-49
3. OPEC	8.0	70.0	31.0	37.0	30.0	7.0	65.0	113	91
4. Non-oil Developing Countries	-7.1	-24.2	-32.0	-20.2	-14.5	-25.7	-39.0	-58	-61
5. Other[1/]	-3.5	-9.5	-18.5	-13.0	-8.5	-9.5	11.0	-12	-13

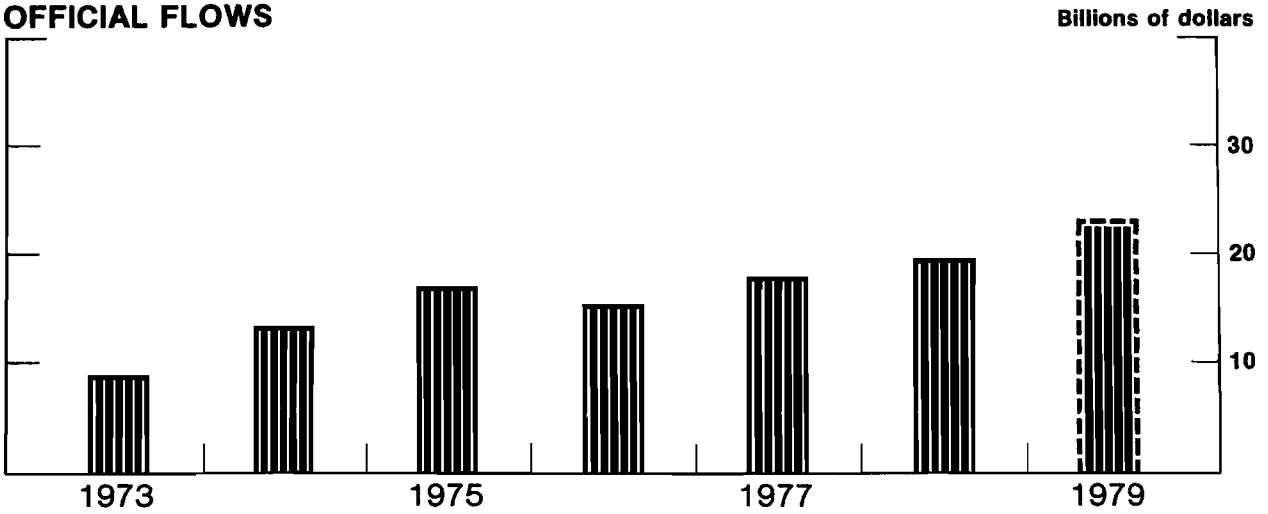
1/ Principally Sino-Soviet area and East European countries.

e = estimate

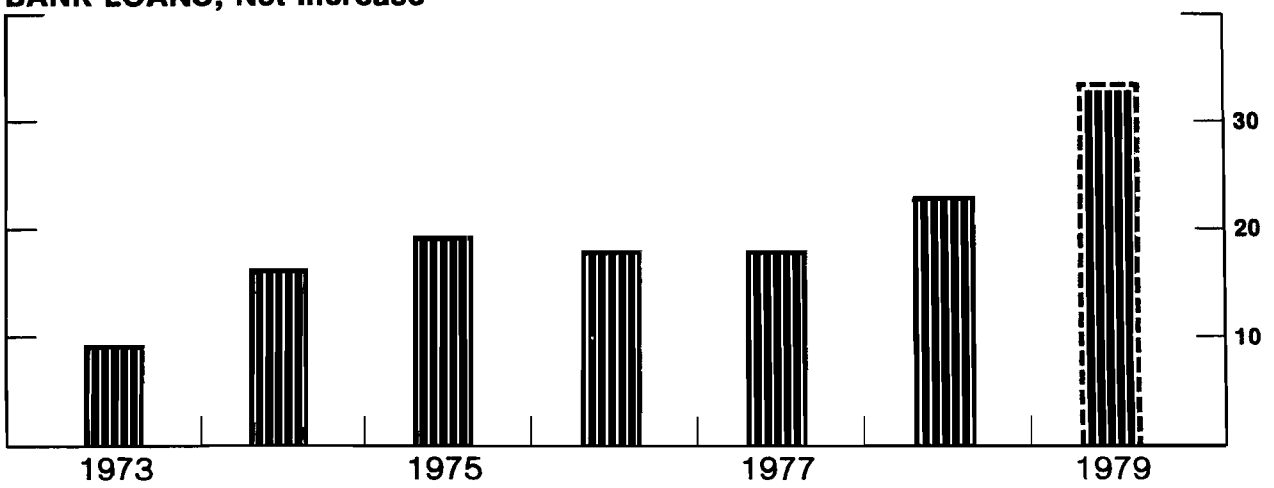
Chart 10

FINANCIAL FLOWS OF NON-OIL DEVELOPING COUNTRIES

OFFICIAL FLOWS



BANK LOANS, Net Increase



RESERVE CHANGES

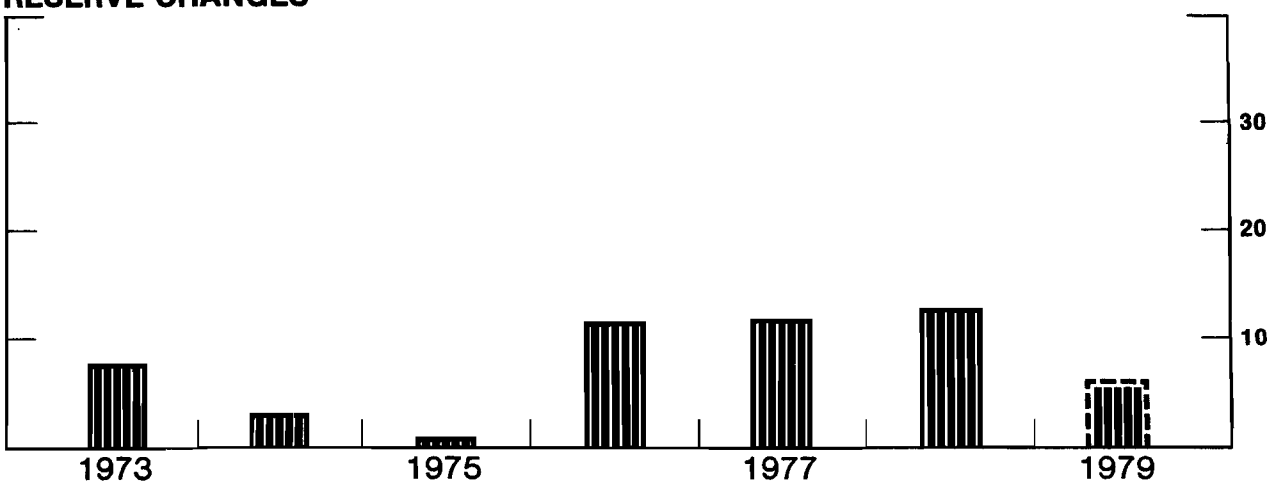


Table II

EXTERNAL DEBT OF NON-OIL DEVELOPING COUNTRIES
Billions of Dollars

	1973	1974	1975	1976	1977	1978	1979[e]
Total Debt[1/]	100	140	170	200	230	285	350
of which to banks[2/]	28	44	63	81	99	122	155
U. S. banks' share	54%	57%	54%	52%	48%	42%	39%
Foreign banks' share	46%	43%	46%	48%	52%	58%	61%

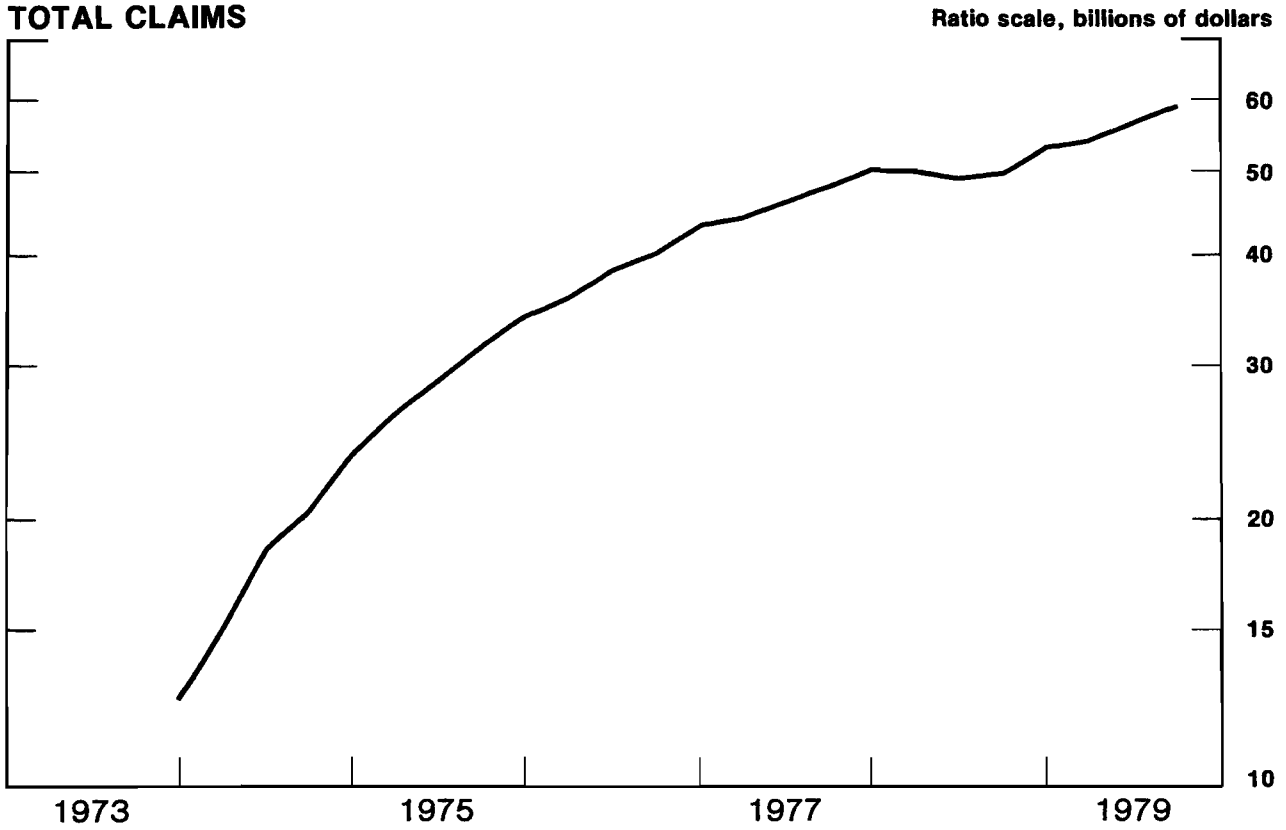
1/ Public long-term debt reported by the World Bank plus staff estimates of private long-term debt and short-term debt of developing countries other than offshore banking centers.

2/ Foreign claims of banking offices in major industrial countries and U. S. bank branches in offshore banking centers.

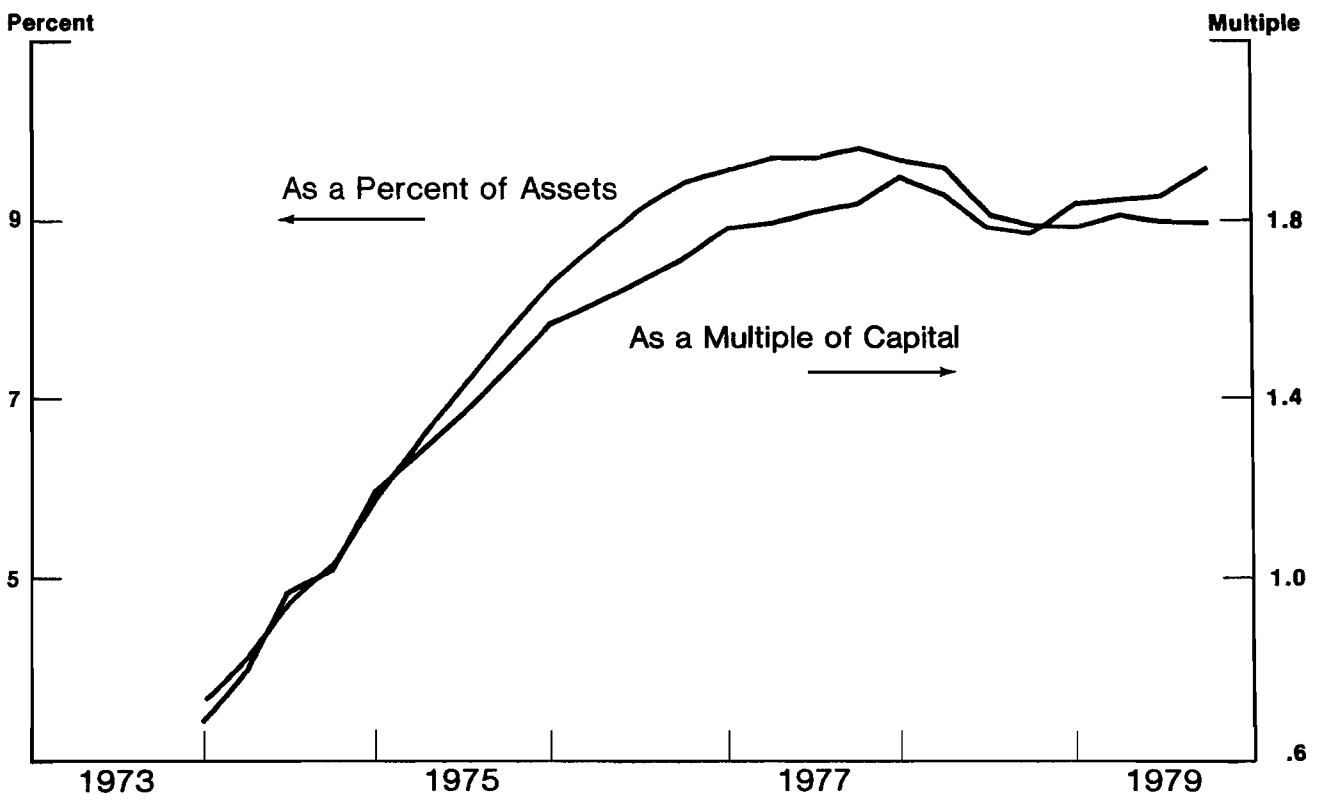
e = estimate

U.S. BANK CLAIMS ON NON-OIL DEVELOPING COUNTRIES

TOTAL CLAIMS

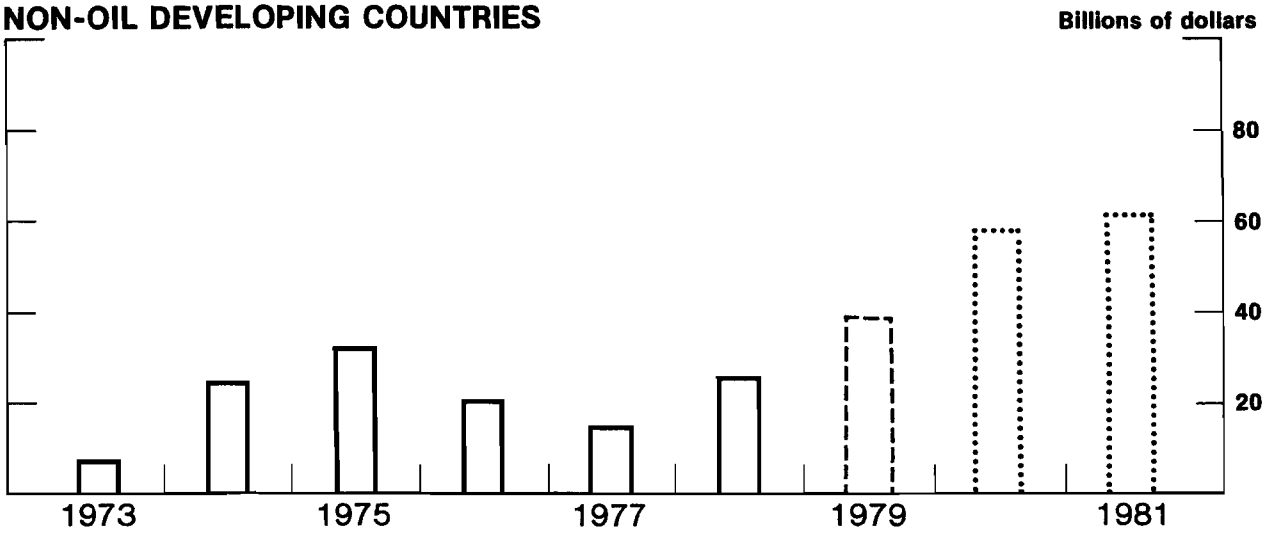


RELATIVE TO ASSETS AND CAPITAL*

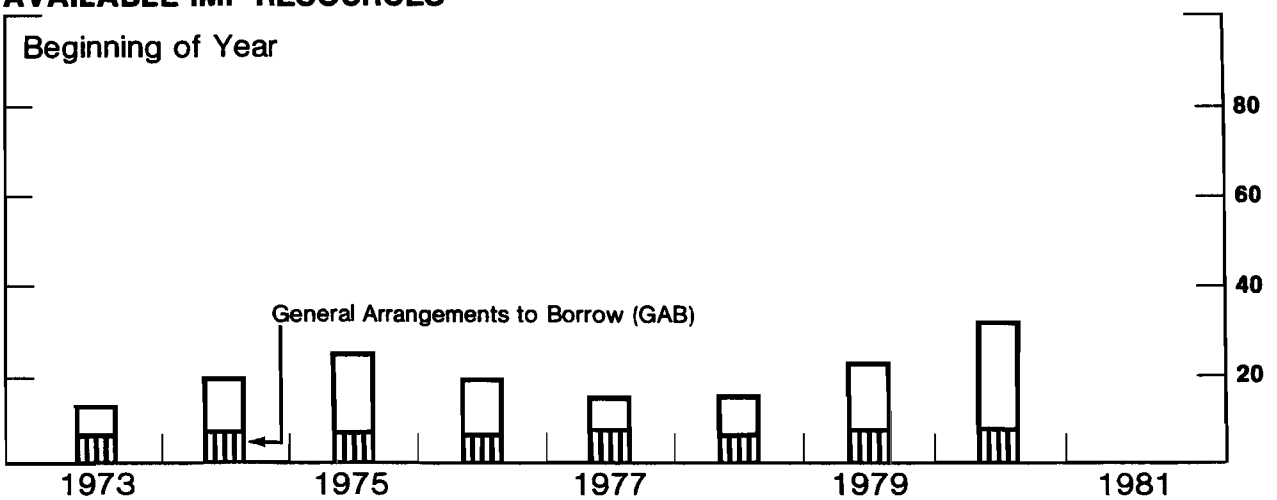


*Capital and assets data refer to 24 large banks that account for about five-sixths of U.S. bank lending to non-oil developing countries.

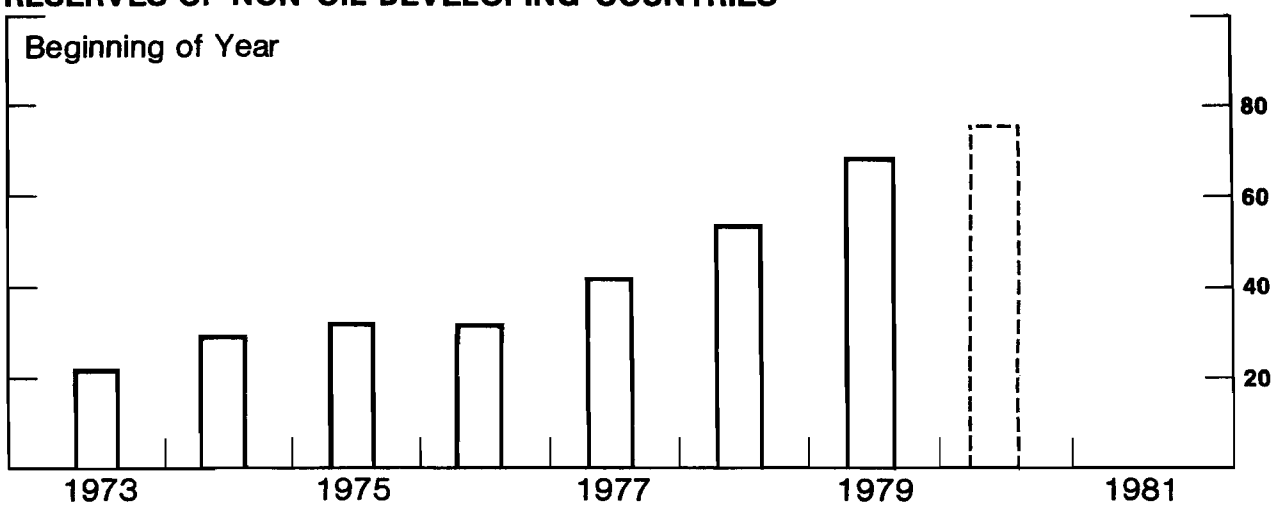
CURRENT ACCOUNT DEFICITS OF NON-OIL DEVELOPING COUNTRIES



AVAILABLE IMF RESOURCES



RESERVES OF NON-OIL DEVELOPING COUNTRIES



Notes for FOMC Meeting

February 4-5, 1980

Scott E. Pardee

Since the last meeting of the FOMC, the exchange markets for the dollar have been subject to several crosscurrents. For the United States, the economic fundamentals have, if anything, deteriorated. Our latest trade figures, a deficit of $3.1 billion for December, were a disappointment to the market. Earlier expectations of a swing into current account surplus in 1980 have pretty much been erased. A new round of oil price increases in currently under way, which will add further to our oil import bill. Also, many feel that the U.S. economy is likely to be more buoyant than previously expected. Exchange traders are particularly concerned that an increase in military expenditures in the United States, coupled with several types of election year budgetary largesse, will lead to much larger deficits this year and next than projected by the Administration.

Meanwhile, our inflation rate continues to be uncomfortably high, and hopes for early improvement have dimmed. So far the market's fears of a prolongation or intensification of inflation have not prompted renewed selling pressures on the dollar. Some market participants explain this in terms of the market's continuing positive reaction to the October 6 measures by the Federal Reserve and the System's follow-through on those measures. Interest rates have been high enough to protect the dollar from a build-up of speculative short positions, and coordinated intervention has spiked the few selling bouts which did occur.

At the same time, new interpretations of recent events have favored the dollar. Over the past three weeks, there have been no new surprises in Iran or new aggressive acts by the Soviet Union. The market's immediate concern over the implication of these problems for the dollar has begun to wane, and some traders are beginning to believe that the dollar will come out all right no matter what happens. A peaceful solution to Middle East tensions would favor the dollar. Intensification of the cold war would also help the dollar against the currencies of Western Europe and Japan. This concern has already prompted flows of funds out of Germany, out of marks, into the United States and into dollars. Whereas the mark had been bolstered in previous months by substantial

diversification out of dollars by Iranian and other OPEC interests, the net flow into marks from those sources seems to have dried up and in some cases we have heard of some return flow into dollars. The peaking out of the gold price has also helped to relax tensions in the exchange markets for the dollar. Finally, the fact that Germany has swung into current account deficit has at long last caught the attention of foreign exchange traders, and the prospect of a continuing current account deficit for Germany in 1980 is considered negative for the mark.

On balance, over the past weeks the dollar has tended to firm against most major currencies. Since the last meeting the dollar has risen a net of 1-½ percent against the German mark. This is only 2-½ percent above the record low reached earlier this year, and 3 percent below the level reached at the time of the October 6 package. The dollar has firmed against other currencies as well. An exception is sterling, which continues to be underpinned by high interest rates in London and by the market's positive attitude toward the United Kingdom's self-sufficiency in oil. The Canadian dollar also has advanced relative to all currencies, largely on energy-related considerations.

In view of the continuing concern over the economic fundamentals for the United States, the recent firming trend for the dollar is not viewed as a major turnaround. But the uptick has been a welcome respite from the recurrent selling pressures over the last half of 1979.

During this period we intervened on four occasions, selling some $114 million worth of marks out of System and Treasury balances. Otherwise, we are able to take advantage of the large calendar of international borrowings in German marks, the proceeds of which are converted by the Bundesbank through its capital export conversion program. With marks offered to us by the Bundesbank, coupled with our purchases from other correspondents we repaid a total of $494 million of swap drawings on the Bundesbank, reducing the outstanding debt to $2.6 billion. We also repaid the latest $22 million of swap debt in Swiss francs. During the period, the Treasury issued a new Carter note in the amount of 2 billion marks, thereby rebuilding its cash resources in marks.

With the dollar firming over the last few days the Bundesbank has begun to make modest sales of dollars. Since last fall the Bundesbank had accumulated a substantial sum of dollars, from the U.S. military and interest earnings, which it has held off the market

and it was only a matter of time before they began to release some of these dollars to the market. But Bundesbank officials are also candid in admitting that they do not want to see a sharp decline in the mark. These operations, while modest, risk the impression in the market that the authorities are trying to cap the exchange rate. The dollar's recovery still seems rather tenuous for us to enter a substantial program of mark purchases in the market, but we may share in some of the marks arising out of the Bundesbank's dollar sales.

REPORT OF OPEN
MARKET OPERATIONS

Reporting on open market operations, Mr. Sternlight made the following statement.

Desk operations since the last meeting have been directed at providing reserves consistent with the monetary growth rates specified by the Committee from December to March--4 to 5 percent for M_1 and about 7 percent for M_2. Reserve paths for the four weeks ending February 6 envisaged a 5 percent growth rate for M_1 in January and a borrowing level around $1 billion. As of this point, it is estimated that total reserves for the four weeks may average a little below the path--by about $85 million. Nonborrowed reserves will be more substantially below their path, perhaps by some $300-400 million, while borrowing may average around $1.2 - 1. billion.

The modest shortfall in total reserves may have been about consistent with the slower-than-expected money growth that developed in the latter part of January. January M_1 growth is currently estimated at about a 1 1/2 percent annual rate (although M_{1A}, with its somewhat different make-up and revised seasonals that should apply to the old M_1 as well, may have grown at something like a 4.8 percent rate). M_2, on the old definition, grew at about a 5 1/4 percent annual rate. Apart from slower money growth, the shortfall in total reserves could also be traced in some measure to the behavior of market factors--notably a particularly large shortfall in reserves on the last day of the January 30 statement week.

The higher-than-expected level of discount window borrowing seems to have reflected a greater-than-anticipated propensity to borrow rather than unwarranted firmness in monetary conditions. As we saw the higher borrowing emerge we sought to provide nonborrowed reserves more readily in the early parts of statement weeks, and thus relieve the need for borrowing--although we sometimes drained reserves late in the week once the high borrowing had already occurred, since otherwise it was expected that total reserves would come out well above path.

In this final week, borrowing is running a bit lighter than it did in earlier weeks of the interval, averaging about $960 million through Sunday compared with an average of $1.4 billion in the first three weeks since the last meeting. Meantime, the money market has eased off a bit as the intermeeting period progressed, with the average weekly funds rate working down from around 13 7/8 percent to about 13 3/8 or 13 1/2 percent in recent days.

In outright operations during the interval, the System sold or redeemed about $2.5 billion of Treasury bills--responding to the seasonal provision of reserves chiefly caused by the post-Christmas currency reflow. The total includes $200 million of bills scheduled to be redeemed next Thursday as a result of bids in yesterday's auction. Outright operations included the sale of about $900 million of bills in the market in mid-January. The need to absorb reserves might have been even greater but for some large declines in float in January, which may have reflected improved check transportation efforts as well as milder

weather. Matched sales purchase transactions were employed daily with foreign accounts and on a few occasions in the market, while System repurchase agreements were used on a few days in late January to make short-term reserve adjustments.

While speaking of Desk operations, I should mention, with an apology, that at the last meeting I understated the net increase in outright System holdings of Government and agency securities during the full year 1979. The increase was about $10.3 billion on a commitment basis, not $7.2 billion--the error reflecting a misunderstanding in the treatment of holdings reduced temporarily by matched-sale purchase transactions. The increase included $6.2 billion of bills, $3.7 billion in Treasury coupon issues and $.3 billion of agency issues.

In contrast to the slightly lower Federal funds rate, most market interest rates rose during the past month, with the larger increases occurring among longer maturities. This unusual pattern, which saw some long Treasury bond prices drop as much as 7 to 9 points and long yields rise as much as 90 to 110 basis points, reflected a shift in sentiment on the business outlook, and a weakening in confidence that the long-term inflation problem can be handled successfully. Not only were the late 1979 business data stronger than expected, but also the intensifying Middle East problem and related prospects for a stronger defense build-up lent credence to those who now see the widely anticipated recession as increasingly unlikely. Expectations of a heavier corporate financing calendar have added to market pressures. In the recent market mood, the President's Budget message was greeted with

skepticism in the financial community, as they expect larger Treasury demands on the market than the official numbers suggest. The rise in unemployment reported last Friday, while long-expected, was shrugged off. Nor did the market draw satisfaction from the recent money supply weakness, as there is concern that the newly defined money measures may tell a different story. There is also a feeling that the System has relaxed its firm resolve of last October to exercise restraint. Most of these factors would tend to raise yields in all maturities, but the particularly severe adjustment at the long end seems to reflect deep discouragement about prospects for dealing successfully with inflation. Time and again one hears from the market that many traditional long-term investors are reluctant to commit funds for an extended period.

For intermediate-term Treasury issues the yield increases in the past month have been about 65 to 90 basis points, and for shorter coupon issues the rise is about 20 - 60 basis points. Dealers have kept their inventories of coupon issues light except for underwriting new issues. The market will bid tomorrow for $3 1/4 billion of 3 1/2 year notes, with the rate expected to be around 11 1/2 percent. Wednesday is the auction of $2 billion 7 1/4 year notes and Thursday $2 billion of 30-year bonds, with yields well above 11 percent expected on both.

By comparison with the coupon area, most bill yields rose only moderately over the past month. Today's average 3- and 6-month rates of about 12.09 and 11.99 percent compared with about 11.94 and 11.85 percent just before the last meeting.

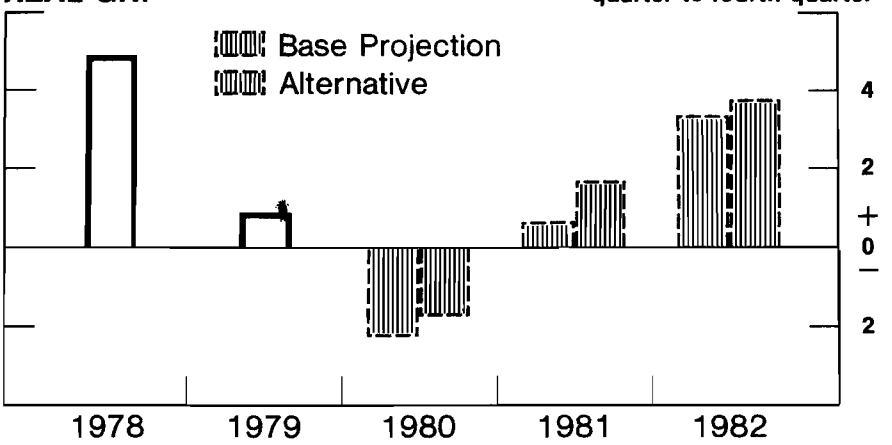
COMPARISON OF STAFF AND ADMINISTRATION ECONOMIC FORECASTS

	1980		1981	
	Staff	Administration	Staff	Administration
NOMINAL GNP	7.0	7.9	9.0	11.7
Percent change, Q4 to Q4				
REAL GNP	−2.2	−1.0	0.6	2.8
Percent change, Q4 to Q4				
GNP IMPLICIT DEFLATOR	9.3	9.0	8.4	8.6
Percent change, Q4 to Q4				
UNEMPLOYMENT RATE	7¾	7½	8¾	7¼
Q4 level, percent				

FISCAL ALTERNATIVE—TAX CUT*

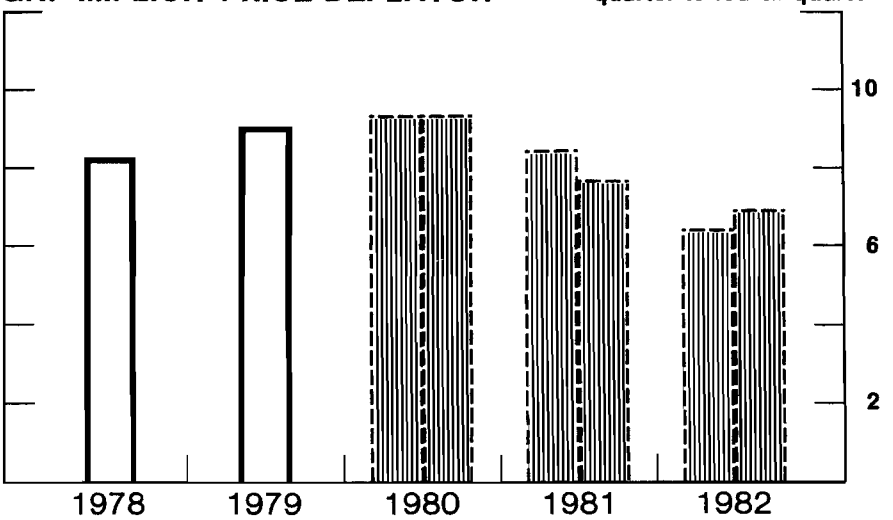
REAL GNP

Percent change, fourth quarter to fourth quarter



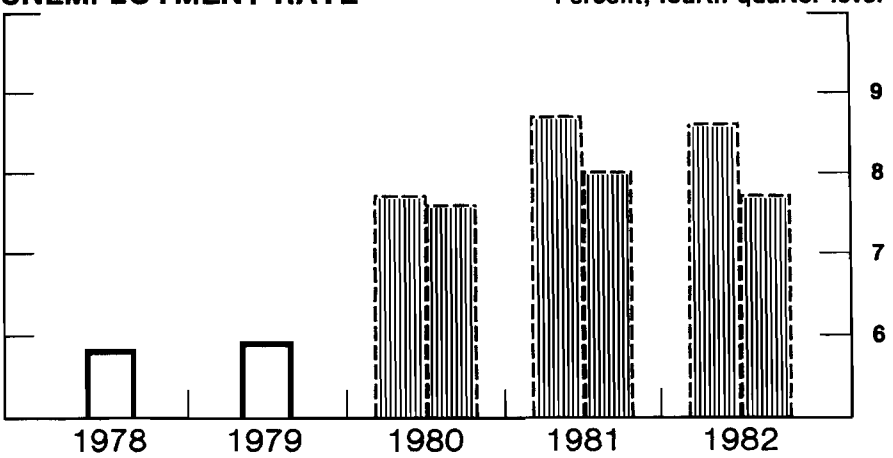
GNP IMPLICIT PRICE DEFLATOR

Percent change, fourth quarter to fourth quarter



UNEMPLOYMENT RATE

Percent, fourth quarter level

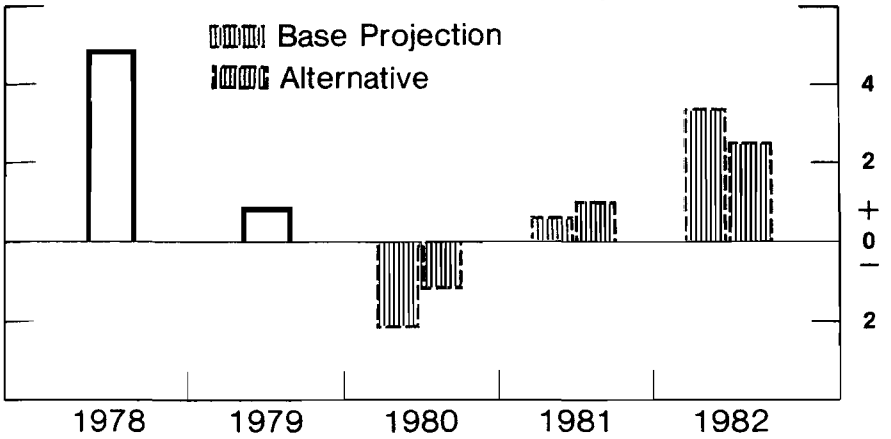


* Consists of:
- $10 billion cut in personal taxes mid-1980
- $10 billion cut in corporate taxes mid-1980
- Partial rollback of social security tax increases scheduled January 1981 ($13 billion)

FISCAL ALTERNATIVE—DEFENSE SPENDING*

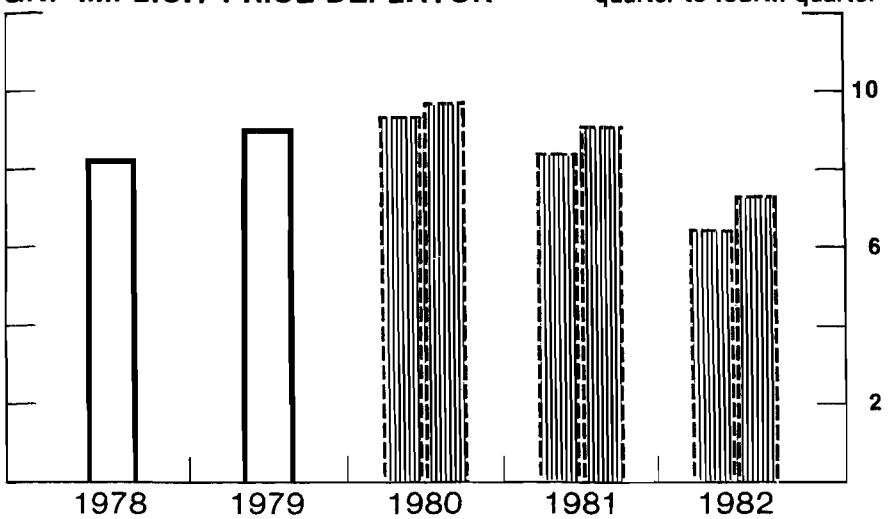
REAL GNP

Percent change, fourth quarter to fourth quarter



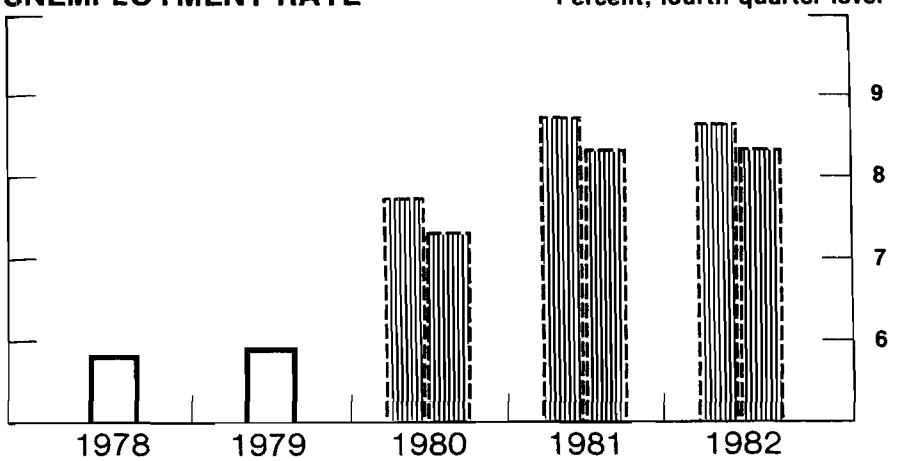
GNP IMPLICIT PRICE DEFLATOR

Percent change, fourth quarter to fourth quarter



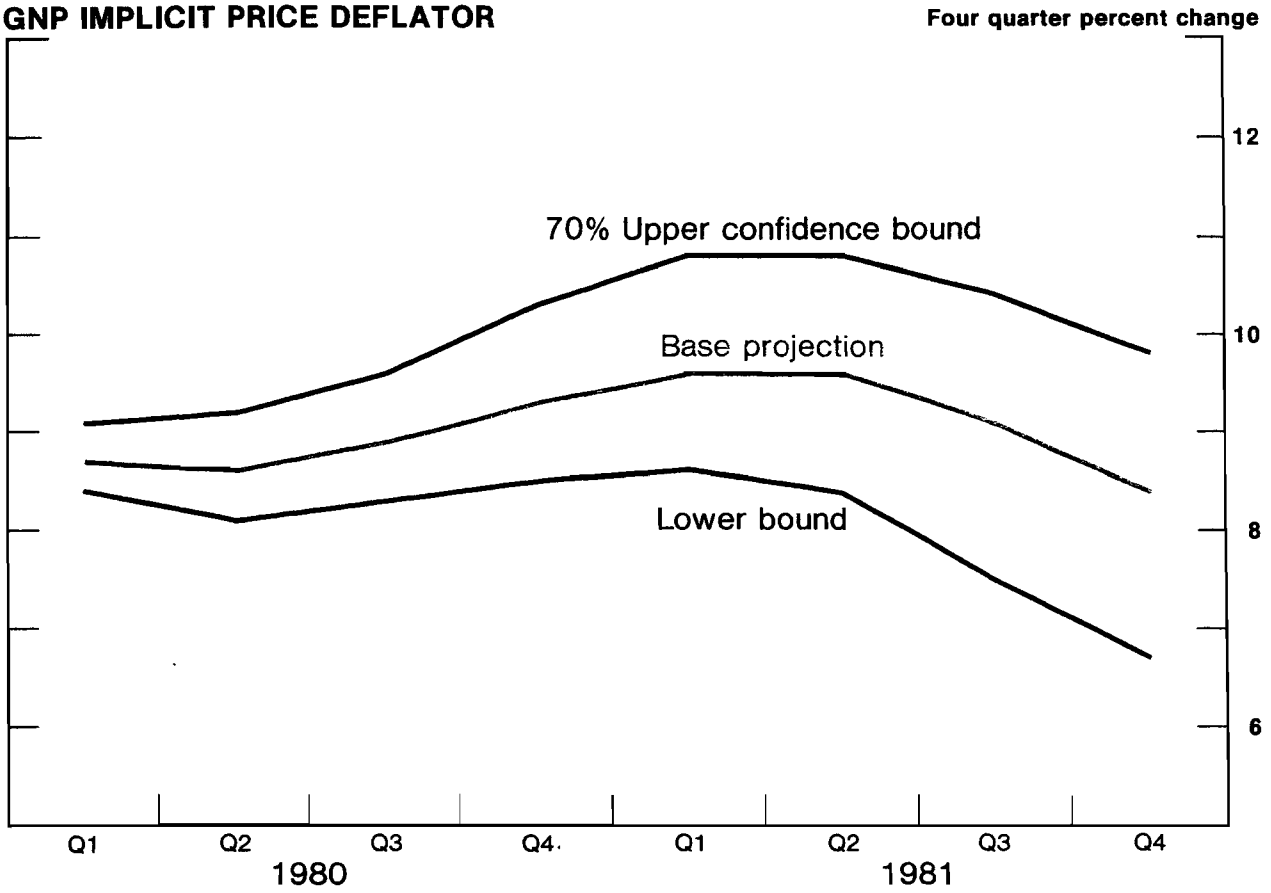
UNEMPLOYMENT RATE

Percent, fourth quarter level



*Defense purchases exceed those in the base projection by $10 billion during 1980, $20 billion in 1981, and $20 billion in 1982.

GNP IMPLICIT PRICE DEFLATOR



James L. Kichline
February 5, 1980

FOMC CHART SHOW -- INTRODUCTION

During our presentations this morning we will be referring to the package of charts distributed to you. The first chart in the package displays the principal policy assumptions underlying the staff forecast presented in detail in the Greenbook. For monetary policy, growth of M-1A is assumed at 5 percent in 1980 and 1981, around the preferences generally expressed at the Committee's January meeting, and less than had been assumed in earlier staff forecasts. For fiscal policy, we have made some adjustments in expenditures in response to newly available information, including the President's budget proposals. The forecast assumes no discretionary tax changes which is consistent with the current posture of the administration. Energy prices are assumed to continue rising rapidly, with oil import prices going up nearly one-third this year and further next year. Domestic crude oil prices will be rising faster than imported crude prices because of the decontrol program which will permit all domestic crude to move to world prices by the fourth quarter of 1981.

Both monetary and fiscal policy assumptions are interpreted as relatively restrictive over the forecast horizon in comparison with past cyclical experience. The top panel of the next chart shows the decelerating rate of growth of M-1A and M-1B built into the forecast; M-1A in fact understates growth of transactions balances in 1979 because of shifts into ATS and New York NOWs. Taking account of this, growth of M-1A slows from around 6-3/4 percent in 1979 to 5 percent. Consistent with the GNP outlook, holding M-1A to 5 percent is expected to result in a drifting down of interest rates--the lower panel--to around 11 percent for 3-month bills later this year, before moving up somewhat in 1981.

The top panel of the next chart compares the administration and staff federal budget outlooks. In fiscal 1980 outlays, receipts, and the deficit are not appreciably different in the aggregate, although we have assumed a somewhat different composition of expenditures--such as more spending for defense and less for the strategic petroleum reserve. For fiscal 1981, however, there are considerable differences related to the underlying economic outlook and other items which result in a staff budget deficit estimated at $39 billion, well above the administration's $16 billion figure. The widening deficit reflects the effects of automatic stabilizers; discretionary fiscal policy is continuing to move in a restraining fashion as illustrated in the bottom panel. On a high employment basis the budget moves toward restraint in 1980 and markedly so in 1981. Much of the growth in the high employment surplus in 1981 comes from social security tax increases, the windfall profits tax, and the impact of inflation on tax revenues.

The next chart shows several indicators of economic activity. Total industrial production--the top left panel--moved sideways throughout much of last year, as substantial declines in the output of motor vehicles and parts were offset by increases in production of business equipment, consumer nondurable goods, and defense items. Nonfarm employment continued to grow at a good clip in 1979, outpacing growth in economic activity. Employment growth last month--not shown on the chart--continued large but there were also signs of weakness as layoffs mounted and the unemployment rate rose 0.3 percentage point to 6.2 percent. Retail sales in real terms also have shown signs of weakening following a surge late in the summer--owing mainly to enlarged purchases of autos along with furniture and appliances. In the housing market, starts fell last quarter. All told, real GNP last quarter

is estimated to have increased at a 1-1/2 percent annual rate, with greater evidence of weakness in activity in several sectors.

Mr. Zeisel will continue the presentation with an analysis of domestic nonfinancial developments and prospects.

Joseph S. Ziesel

February 5, 1980

FOMC CHART SHOW

Recent developments continue to suggest to the staff that fundamental forces are moving us into recession. Given the momentum evident at year-end we expect at most only a modest contraction in the current quarter. But, as portrayed in the first chart, we do project a progressive weakening of activity later this year lasting into early '81. Recovery is projected to begin in the spring of '81, but for the year as a whole real GNP in expected to rise by only about ½ percent. From peak to trough, this projected contraction totals about 2 ½ percent; it falls in the middle of the range of postwar recessions in terms of severity--or about half the decline that occurred in 1974-75 when inventories were grossly out of line with sales--which is not the case today.

The consumer has played a key role in supporting activity recently, and, as is evident in the top panel of the next chart, this was accomplished in the face of virtual cessation of growth of real disposable personal income. The strength of consumer demand in the second half of 1979 appeared to represent spending to maintain normal growth of living standards in an inflationary environment and the purchase of durable goods in anticipation of continued rapid price increase. As may be seen in the middle and lower panels of the chart, this increased spending was associated with a sizable decline in the saving rate--one of the sharpest drops in the postwar years--while at the same time consumers took on historically large debt burdens.

While it has been extremely difficult to anticipate accurately consumer behavior recently, consumer spending propensities would appear to be vulnerable to any further weakening in real income growth, given debt burdens and low saving rates. And, as is evident in the top panel of the next chart, just such a decline in real income appears to be in prospect. Although employment gains have slowed this past year, the growth of jobs has been out-running production advances, and some downward employment adjustments are long overdue. If these occur, as we expect, in conjunction with continued sharply rising prices, it seems very likely that 1980 will witness a decline of real disposable income. After-tax income will be cut further by a large increase in social security taxes scheduled for the beginning of 1981.

While it is possible that consumers will continue to strive to maintain living standards, the Michigan survey suggests that the public has recently moved away somewhat from the buy-in-advance-of-inflation rationale that seemed to have bolstered durable goods purchases. And, as is evident in the middle panel, income otherwise available for the purchase of luxuries is increasingly being absorbed by skyrocketing energy prices. As the bottom panel indicates, these various factors have led us to expect a very sluggish outlook for real consumer demand--a decline in 1980 and very little change in 1981.

Housing is also likely to continue to be a negative factor in overall growth, particularly during the next few quarters. As is evident in the top panel of the next chart, deposit growth at thrift institutions weakened further following the Fed's October 6 policy actions. In conjunction with high interest rates, this has led to a sharp reduction in outstanding mortgage lending commitments--the lower panel. While the supply of funds from sources such as housing bonds and mortgage passthroughs should cushion the housing decline, demand factors are also expected to be a major influence damping construction activity this year. The top panels of the next chart give dramatic evidence of the weakening of demand recently. Sales of new homes have fallen substantially since last fall and the average price of new homes has declined sharply; such a decline in prices, if sustained, could well blunt the investment motive for purchasing single-family homes and condos.

As indicated in the bottom panel, we are now forecasting housing starts to drop to a 1.4 million annual rate in the first half of this year. Starts are expected to turn up by the fall, as activity benefits from some easing in mortgage rates which will permit an emergence of underlying demand associated with population and migration trends.

Turning to the business sector, the top panel of the next chart indicates the recent trend in real orders for capital equipment. While new orders have edged up in the past few months, their level remains below that of the first quarter. These figures foretell weaker growth in business fixed investment. They are generally consistent with the results of the latest plant and equipment survey, which shows an increase of only about 1 percent in real terms for 1980 as a whole--and implies a downturn later this year.

The outlook for capital spending in 1981 is obviously more uncertain. But as indicated in the middle panel, we are projecting a further drop in capacity utilization rates in manufacturing as markets weaken, leading to reduced pressure for expansion of capital stock,

particularly given poorer profit performance and continued high normal interest rates. As the bottom panel shows, we thus foresee a continued, although far from precipitous, decline in real capital outlays through much of next year.

The rate of inventory investment over the next two years is expected to reflect largely developments in fixed capital spending and other final demands. As is indicated in the top panel of the next chart, the deterioration of auto demand in the spring of 1979 resulted in a backup of dealers' stocks of large, less fuel-efficient cars, but a combination of production adjustments and price-cutting eased that problem considerably. As shown in the middle panel, by the fall overall business inventory/sales ratios were almost back to levels of 1977 and 1978. We anticipate that businessmen will continue to keep stocks generally in line with sales. As is evident in the bottom panel, this implies some liquidation of stocks from mid-1980 through early 1981. A recovery in stock building should get under way later in 1981 as aggregate sales pick up. Throughout the forecast period we have allowed for some inventory accumulation in line with the rise in defense spending that now appears in process.

The pickup now scheduled in 1980 and 1981 for federal defense spending, other than personnel compensation, is portrayed in the top panel of the next chart. In real terms we now anticipate a rise in these defense purchases of about 7 percent in both the current and coming fiscal years--much more than in the last five years. All of the expected increase will be in procurement, operations, and research. Our figures are slightly larger than those in the Administration's budget and give additional upward thrust to total federal spending. But the overall rise in government purchases is projected to be blunted somewhat by continued restraint in nondefense outlays. Moreover, we anticipate that increases in federal spending will be offset by reduced real outlays at the state and local level as these jurisdictions respond to high interest rates and a squeeze on receipts. Thus, as is portrayed in the middle panel, in aggregate real government purchases of goods and services are expected to increase only a little faster in the next two years than last year. Nevertheless, as a share of GNP, these figures do rise in '80 and '81, reversing the downtrend in this ratio that has been evident for five years.

The top panel of the next chart portrays the projected contraction in real nonfarm output and the associated employment adjustment. As is evident, employment gains in 1979--while smaller than in previous years--were dramatically out of line with the fractional rise in nonfarm output. It seems reasonable to assume that some of this "hoarded" labor will be disgorged in

the near future as businessmen recognize that output is not rising rapidly enough to justify their retention. We are forecasting a decline of about 1-½ million nonfarm jobs from peak to trough, with the impact greatest in durables manufacturing.

We are also projecting a slower growth of the labor force--the middle panel--reflecting mainly poorer job prospects. But the unemployment rate--shown in the bottom panel--is projected to move up fairly sharply this year to about 7-¾ percent by the fourth quarter, and to drift up further during 1981, reaching 8-¾ percent by the end of the next year.

Rising unemployment can be expected to result in some damping of wage pressures, but labor costs nonetheless are likely to continue rising rapidly in the near term, for several reasons. First, as is evident in the top panel of the next chart, growth of compensation in 1979 fell sharply behind the rise in consumer prices. This should lead to attempts at wage catch-up in the latter half of 1981. And of course, the feedback effects of earlier energy price increases on wages and other costs will still be fueling inflation. We are assuming that food prices will move about in line with other prices over the next two years.

Finally, the next chart shows our current view of the outlook for overall inflation. On balance, we expect that the combination of a protracted period of slack markets, some improvement in productivity, and a moderation in the upward trend of energy prices will ease the inflation situation somewhat in late 1980 and in 1981. We are projecting overall prices to be rising at about an 8 percent rate by the end of 1981.

Mr. Truman will continue with a review of the international part of the projection.

CHART SHOW PRESENTATION
E.M. Truman
February 5, 1980

The upper left hand panel of the first international chart illustrates the dramatic shift over the past year in the cyclical situation of the United States relative to foreign industrial countries. The line shows the ratio of U.S. real GNP to the average of real GNP in other G-10 countries and Switzerland. Over the past four quarters, U.S. real GNP has expanded at about a 1 percent rate and foreign real GNP rose by about 3-1/2 percent. During 1980, while U.S. real GNP is expected to decline--as Mr. Zeisel has explained--foreign growth is expected only to moderate to about 1 percent. During 1981, foreign growth is expected to pick up and be about 2 percent faster than U.S. growth. These cyclical factors, along with oil, dominate our projection of U.S. international transactions.

As is shown in the upper right hand panel, the volume of non-oil imports is expected to decline this quarter. The decline continues through the first quarter of 1981 and then is reversed later next year. Because of rising import prices, the value of non-oil imports declines less in 1980 and later rises more rapidly.

The lower left hand panel indicates that the volume of non-agricultural exports is expected to expand much more moderately over the forecast period than has been the case for the past two years. Again, however, inflation imparts a big boost to the value of these exports.

The lower right hand panel presents our outlook for oil imports. Sharply higher oil prices--as described by Mr. Kichline--and weak U.S.

activity should produce a cutback in the volume of oil imports, but the higher prices will raise the value of oil imports to $90 billion, at an annual rate, by the end of 1981.

The second chart summarizes our external projection. The top panel shows that we expect a sharp increase in our trade and current account deficits this quarter as the result of lost grain and gold exports and because of higher oil prices. Thereafter, cyclical conditions predominate, pushing the current account into significant surplus by the fourth quarter of this year.

In terms of the GNP accounts, illustrated in the last two panels, real exports of goods and services are expected to decline slightly in 1980 reflecting lower agricultural exports and reduced service receipts. During 1981, we expect real exports of goods and services, on a GNP basis, to expand quite slowly, though somewhat faster than the rest of the economy. Thus, the rise in real GNP net exports of goods and services, depicted in the bottom panel by the red line, reflects mainly the cyclical decline in real imports of goods and services throughout most of the projection period.

Mr. Kichline will now complete our presentation.

James L. Kichline
February 5, 1980

FOMC CHART SHOW -- CONCLUSION

The first chart in the final section of your packet shows the volume of funds raised by nonfinancial sectors. Total funds raised declined last year from their peak in 1978 despite 10 percent growth of nominal GNP; the drop in the total reflected smaller federal government net financing while private borrowing was essentially unchanged for the year. Late in the year, however, private borrowing did drop off and we expect both demand and supply side constraints to result in a lower level of funds raised in 1980 than last year and little growth in 1981. Total funds raised relative to GNP, the lower panel, declined nearly 3 percentage points last year and is projected to decline further over the forecast horizon. A drop in this ratio is characteristic of recessionary periods.

The top panel of the next chart shows that reduced borrowing by households contributed appreciably to a recent reduction of private credit demands. Household borrowing declined in the second half of last year as both mortgage and other borrowing slackened--reflecting the reduced pace of spending on consumer durables and a slower pace of real estate activity. Household borrowing is projected to trend lower this year and to turn up a little in 1981 as activity recovers.

Total borrowing by nonfinancial corporations, the lower panel, also moved lower in the second half of last year and is expected to remain well below the early 1979 peak through 1981. External financing needs are projected to be held down by the sluggish growth of capital expenditures and little, if any, inventory accumulation. At the same time corporate financial

positions are likely to remain tight in the aggregate, with a need to fund some of the large volume of short-term debt taken on in the past few years. However, double-digit long-term rates may well act to restrain a major move into permanent financing.

The next table provides a comparison of the staff and administration economic forecasts. In 1980 the forecasts are not greatly different, and well within the range of uncertainty associated with point estimates. For 1981, however, the administration is forecasting considerably larger expansion of nominal GNP stemming from a faster economic recovery; prices are projected to rise about the same as in the staff forecast while the unemployment rate is 1-1/2 percentage points lower. The strong performance of real GNP seems to arise out of a higher pattern of consumer expenditures related in part to a savings rate that remains rather low. In addition, financial conditions implicitly are a good deal easier--the bill rate is assumed to fall more than 2 percentage points by the summer and by another 1 percentage point a year later. Irrespective of the monetary assumptions, however, experiments with the quarterly econometric model suggest there is a reasonable chance of hitting the administration inflation forecast, but a very low probability of obtaining or bettering both the inflation and the unemployment goals of the administration in 1981.

These experiments with the econometric model provide a formal way of assessing the uncertainty associated with a given forecast and are based upon errors in the equations of the model. But uncertainty may arise from the policy assumptions as well. In the current situation a good deal of uncertainty attaches to the fiscal assumptions. The next chart indicates the results derived from a fiscal alternative involving a tax cut. The tax

cut provides a spur to real GNP growth in 1980 through 1982 compared to the base projection, and carries with it a lower unemployment rate--the bottom panel. In 1981 the rate of increase of the deflator is also lower, reflecting the effects of the assumed partial rollback of social security tax increases, but prices in 1982 once again are rising faster owing to the higher level of activity. A cut in social security taxes alone would provide less impetus to real activity and employment growth but would carry with it a reduction in the price level from what would prevail otherwise.

The next chart shows the results of a different fiscal alternative involving appreciably more defense spending than in the base projection. The projected outcome involves more real GNP in 1980 and 1981 than in the base projection but more inflation as well. By 1982, however, real GNP expansion falls below that in the base projection as holding to a 5 percent money growth with accelerating inflation produces higher interest rates and begins choking off activity. Such an alternative is likely to have even larger effects than produced by the econometric model since rapid defense increases undoubtedly would affect business and consumer attitudes as well as result in bottlenecks that would intensify inflationary pressures.

None of these alternatives suggests an outcome that is particularly encouraging in the short- and medium-term. The last chart in the package indicates that the deeply ingrained inflation and inflationary expectations are the nub of the problem. Adapting the base projection to the econometric model provides an estimate of the range of uncertainty around the price forecast. As indicated, by the fourth quarter of 1981 there is a 70 percent probability that prices will be rising somewhere between 9-3/4 and 6-3/4 percent; alternatively expressed there is only a 15 percent chance

that inflation will be less than the 6-3/4 percent lower bound at that time. These probabilities of course would change to the extent that, for example, a mandatory wage-price control program is instituted or wage and price expectations are formed in ways different from past experience. But, judging from history, the likelihood of achieving both attractive inflation and unemployment outcomes in the shorter run does not seem high given the structure of the economy.

CONFIDENTIAL (FR) CLASS II-FOMC

Material for

Staff Presentation to the Federal Open Market Committee

February 5, 1980

PRINCIPAL ASSUMPTIONS

MONETARY POLICY

- Growth of M-1A averages 5 percent in 1980 and 1981

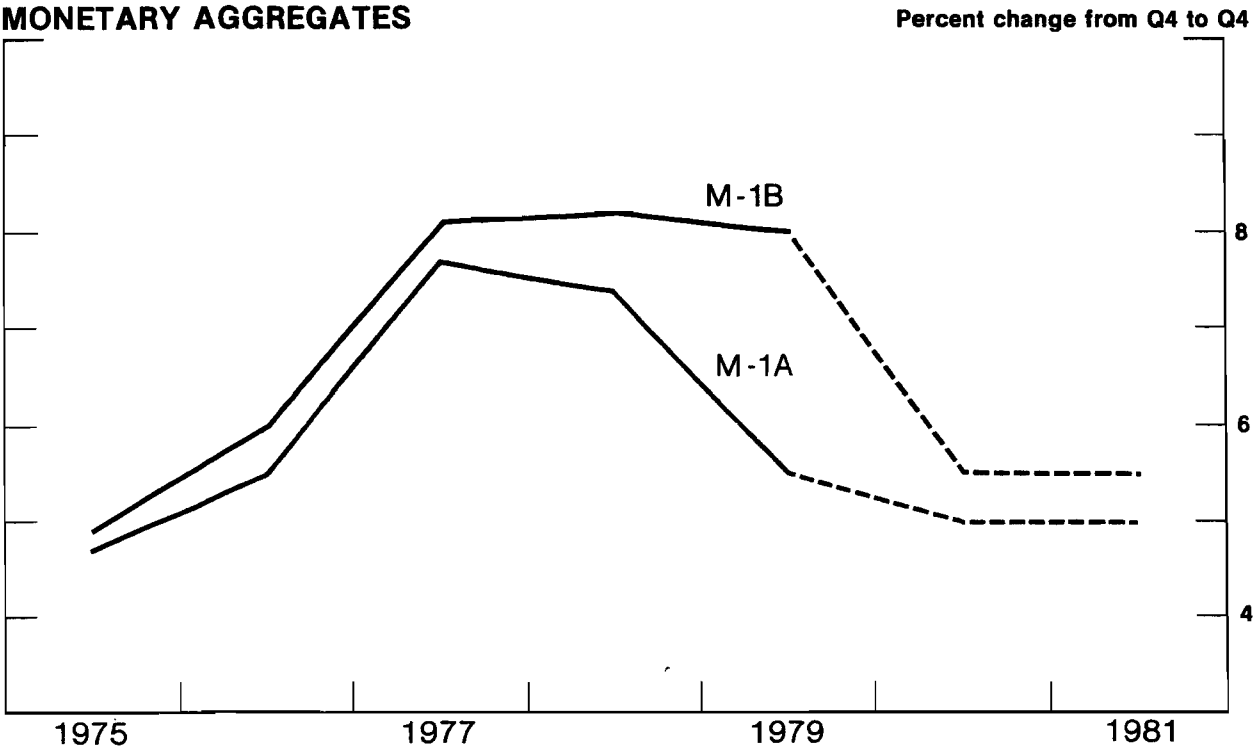
FISCAL POLICY

- Unified budget expenditures of $563 billion in FY 1980 and $623 billion in FY 1981
- No discretionary tax changes during forecast period

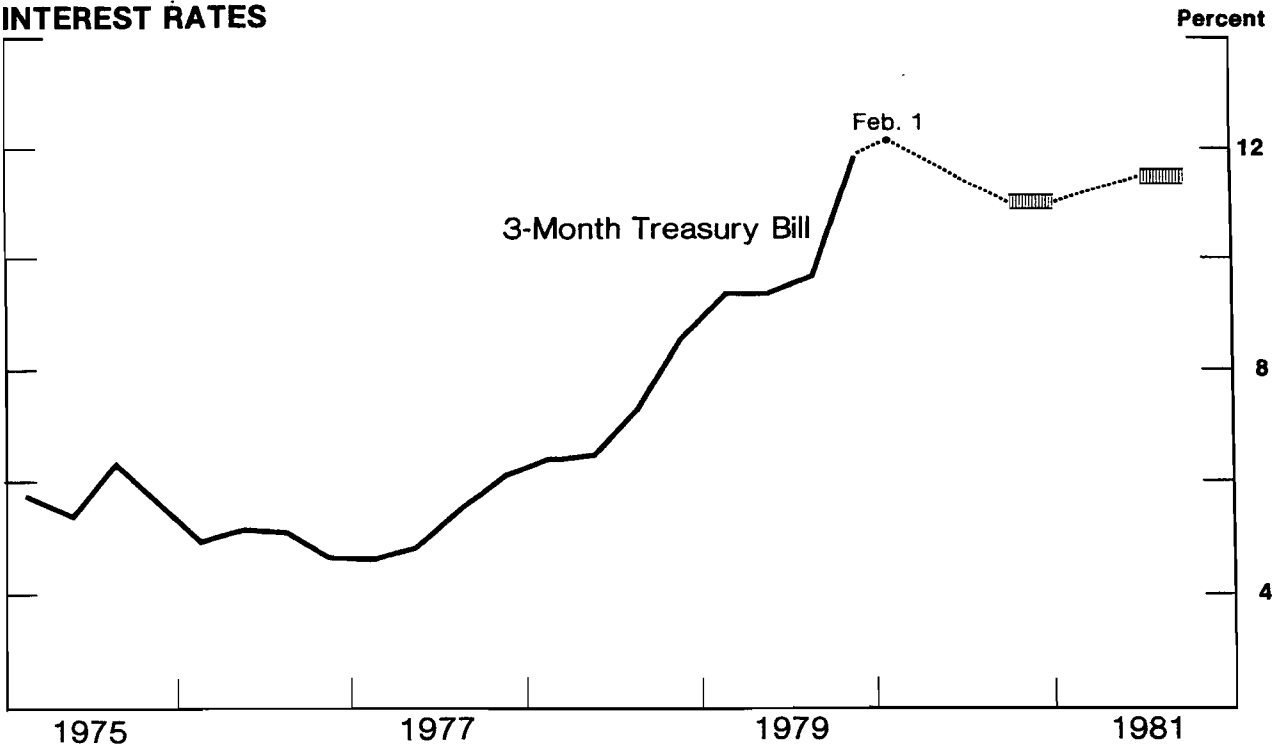
ENERGY PRICES

- Oil import prices rise 32 percent during 1980 and 13 percent during 1981
- Decontrol of domestic crude oil prices continues as scheduled

MONETARY AGGREGATES



INTEREST RATES



FEDERAL BUDGET

Billions of dollars

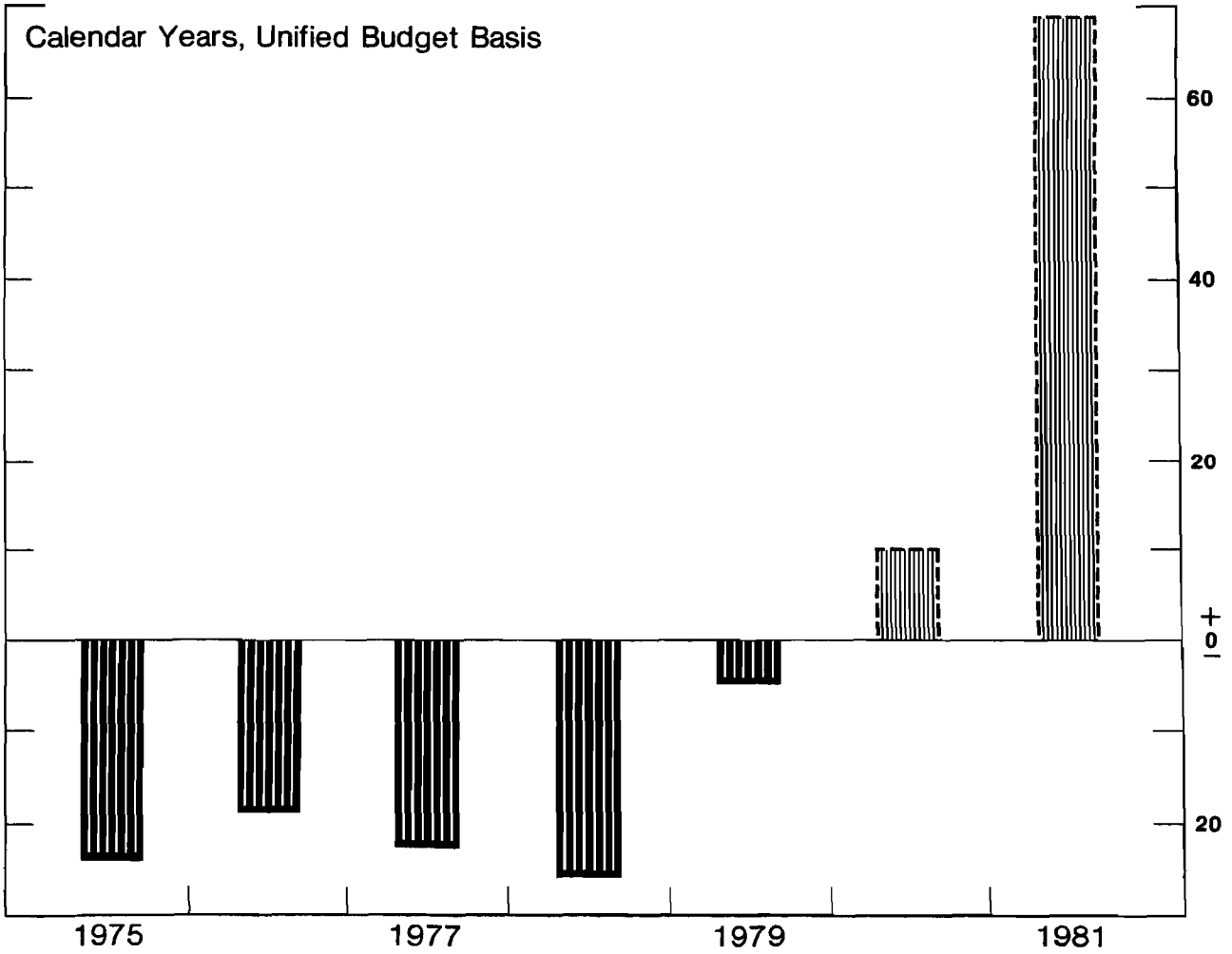
Fiscal Years, Unified Budget Basis

	1979	1980		1981	
	Actual	Admin.	FRB	Admin.	FRB
Outlays	494	564	563	616	623
Receipts	466	524	520	600	584
Deficit	28	40	43	16	39

HIGH-EMPLOYMENT BUDGET

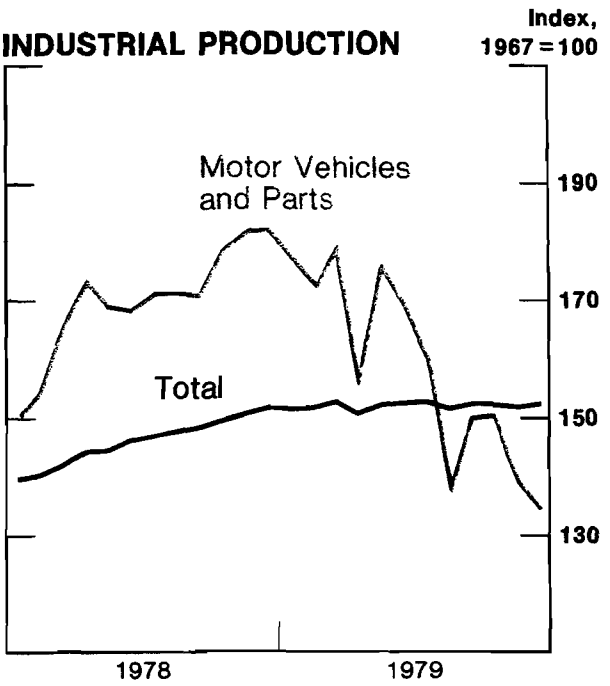
Billions of dollars

Calendar Years, Unified Budget Basis

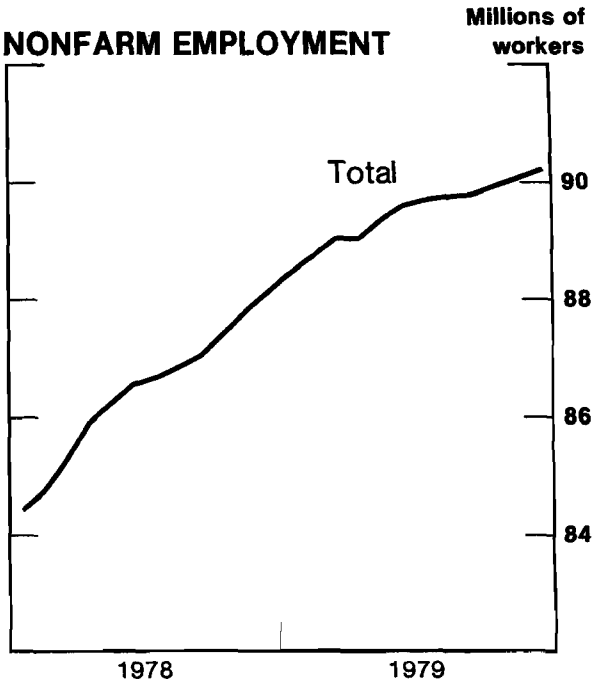


ECONOMIC ACTIVITY

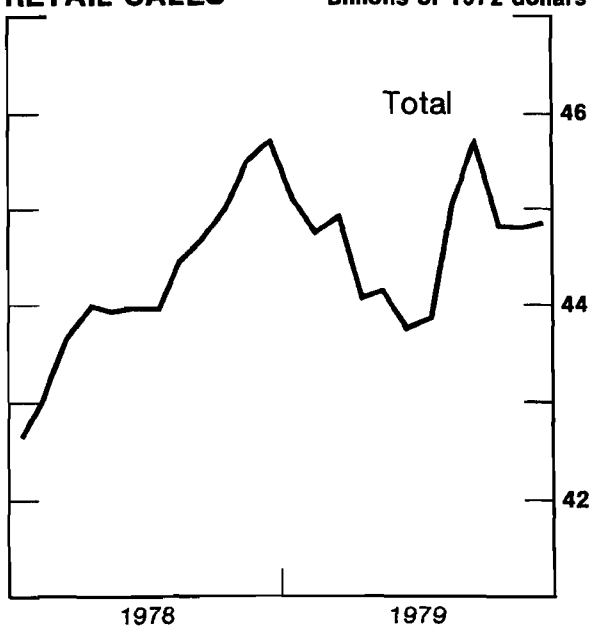
INDUSTRIAL PRODUCTION



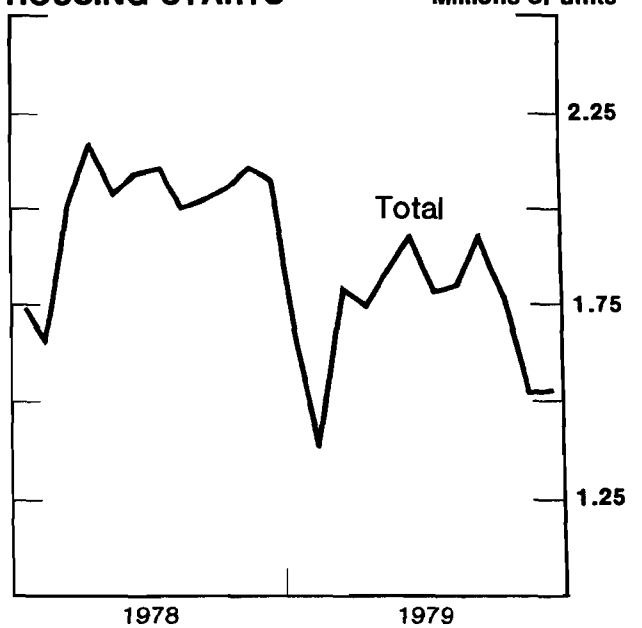
NONFARM EMPLOYMENT

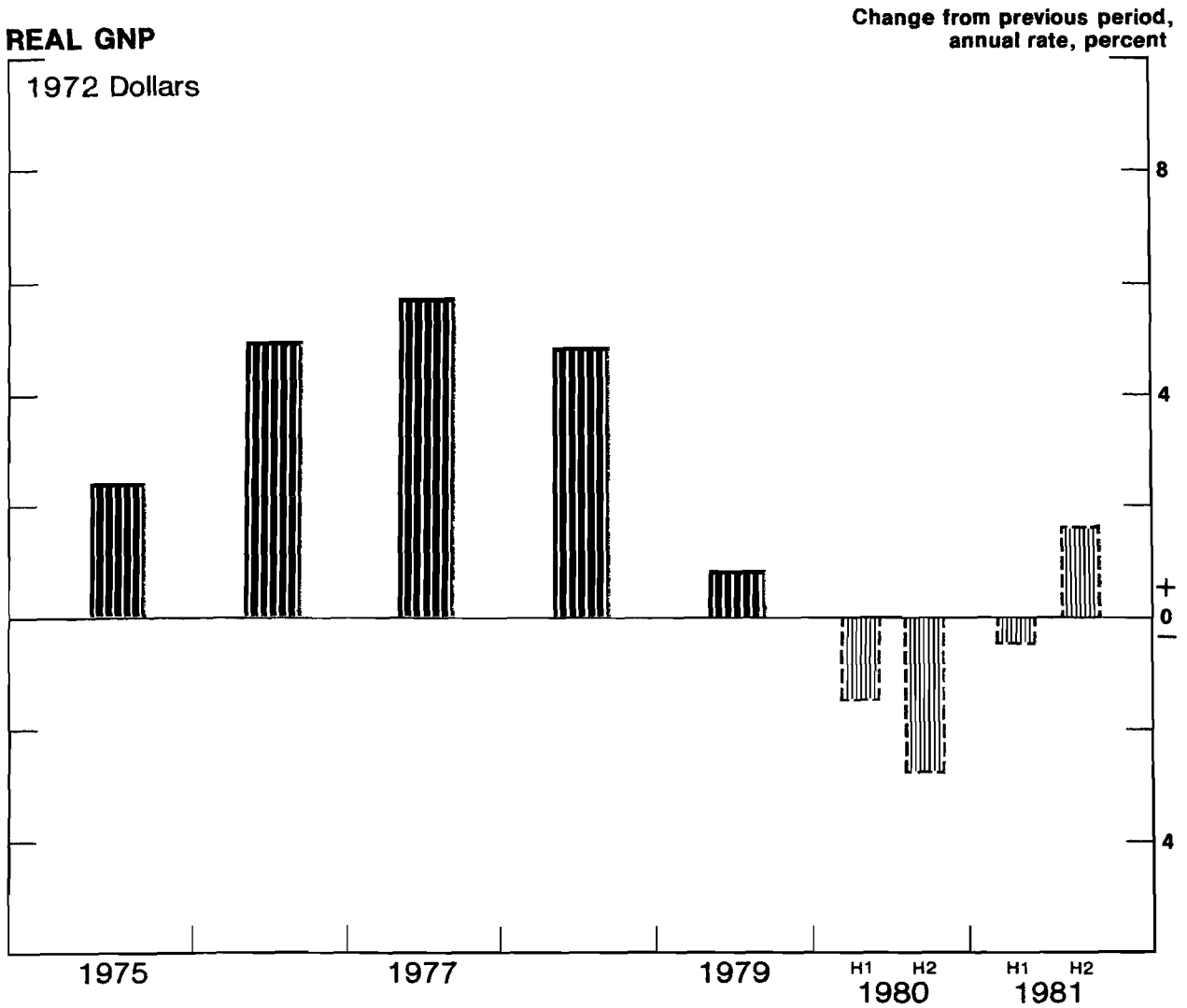


RETAIL SALES



HOUSING STARTS

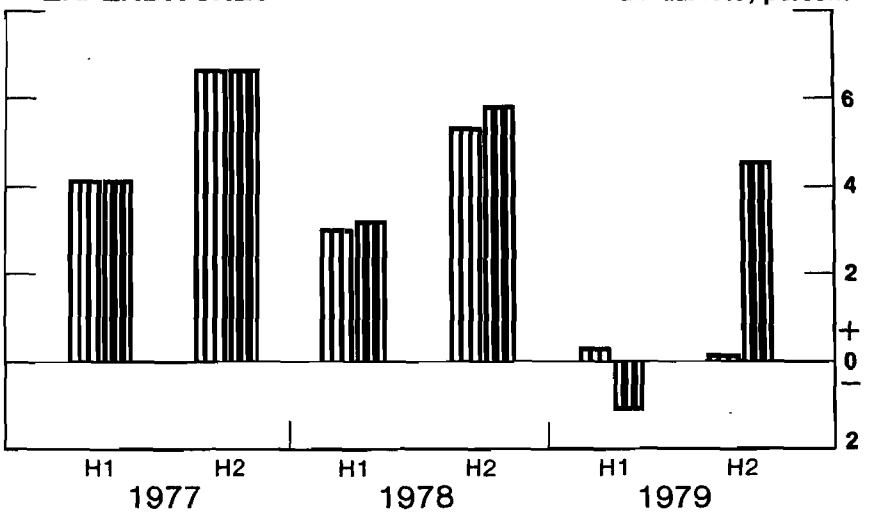



REAL GNP
1972 Dollars
Change from previous period, annual rate, percent
8
4
+
0
—
4
1975
1977
1979
H1
H2
1980
H1
H2
1981

DISPOSABLE PERSONAL INCOME

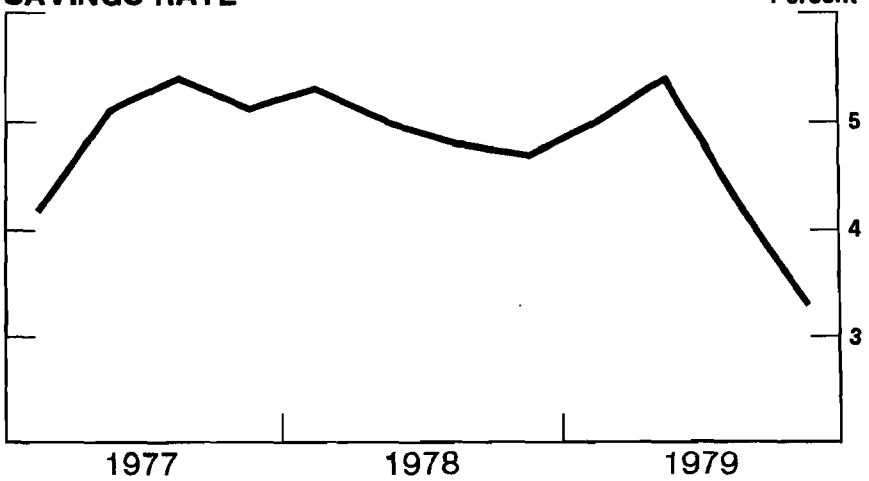
PERSONAL CONSUMPTION EXPENDITURES

Change from previous period, annual rate, percent



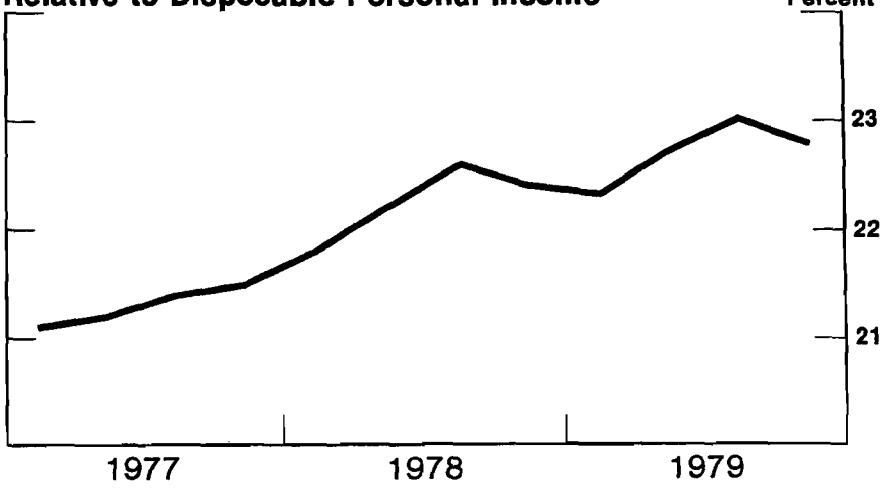
SAVINGS RATE

Percent

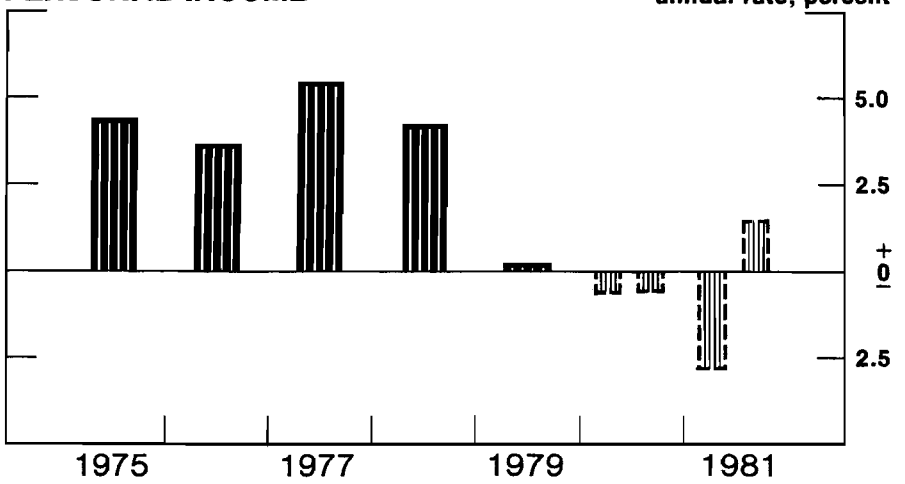


HOUSEHOLD DEBT REPAYMENT
Relative to Disposable Personal Income

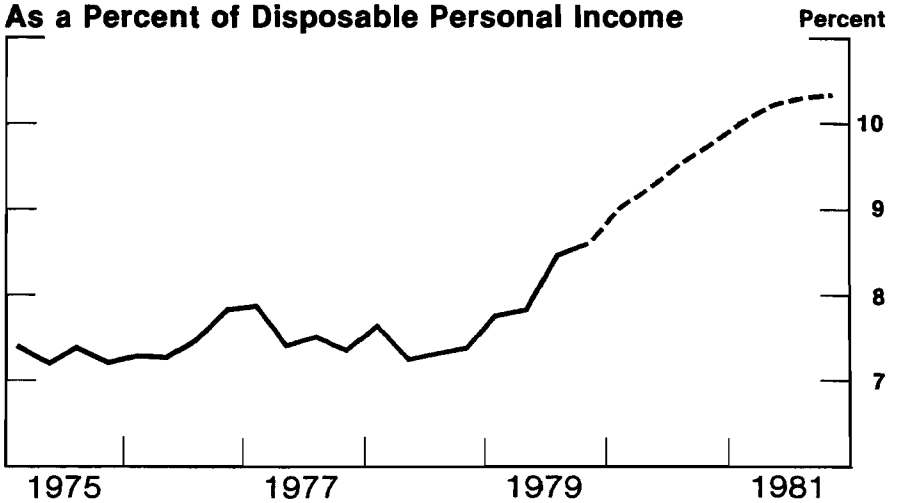
Percent



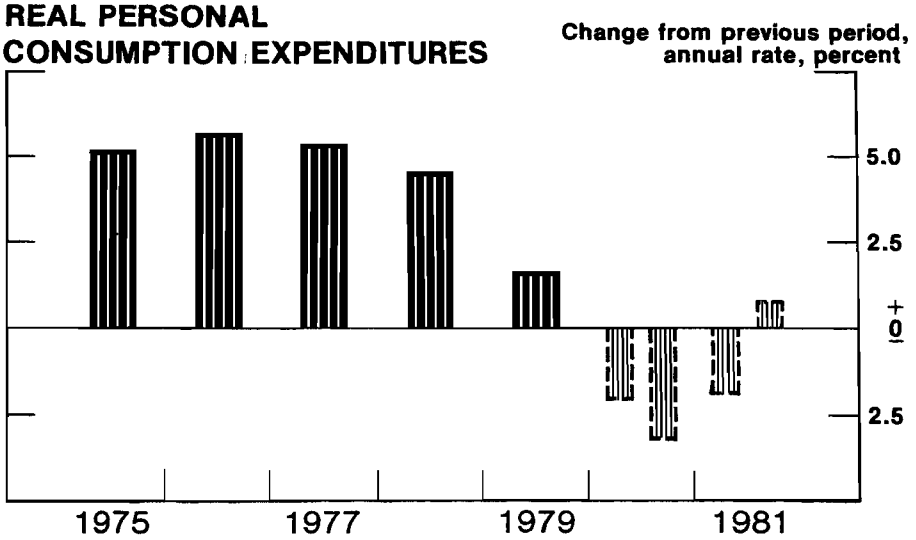
REAL DISPOSABLE PERSONAL INCOME



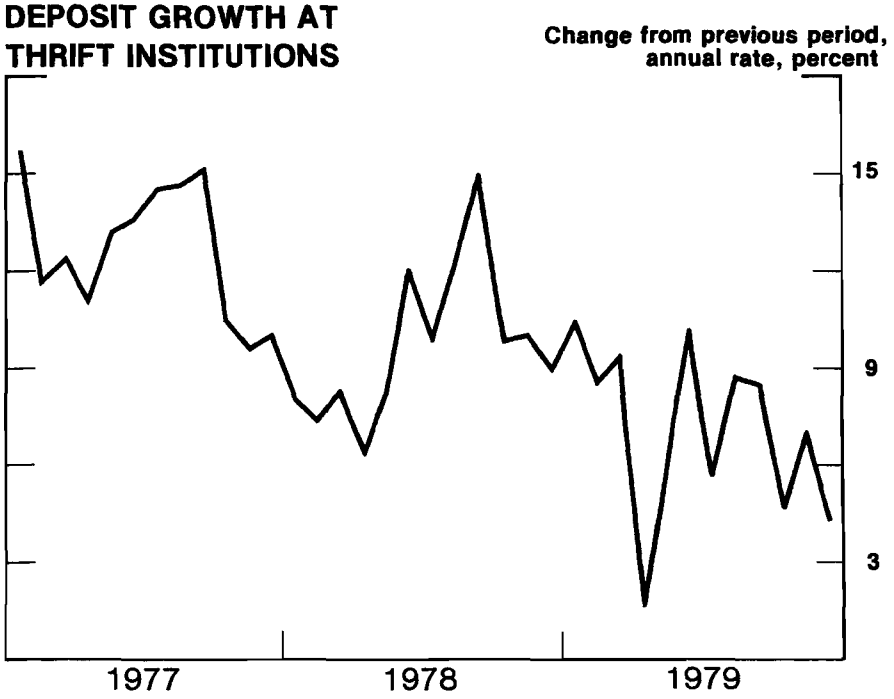
CONSUMER ENERGY OUTLAYS
As a Percent of Disposable Personal Income



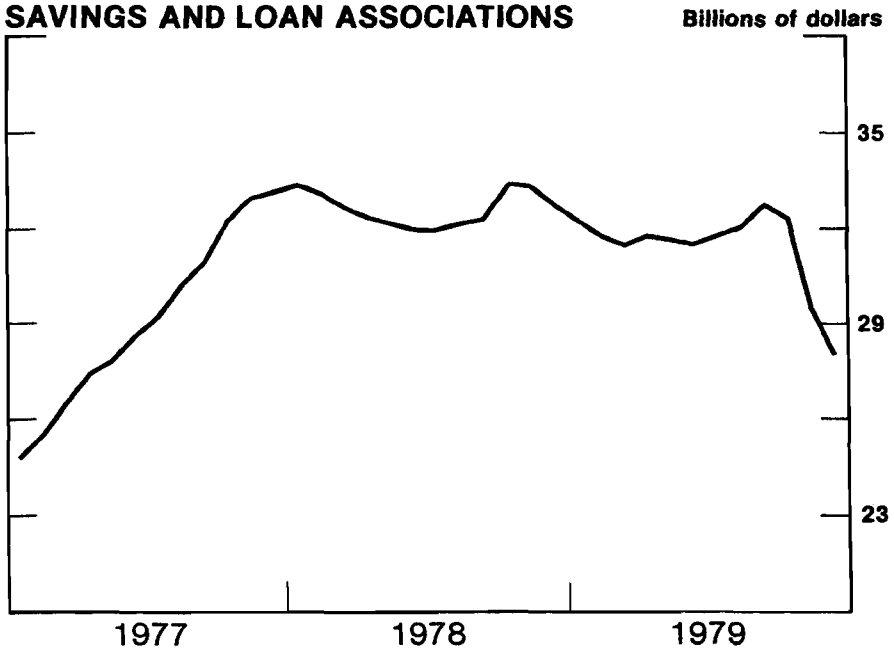
REAL PERSONAL CONSUMPTION EXPENDITURES



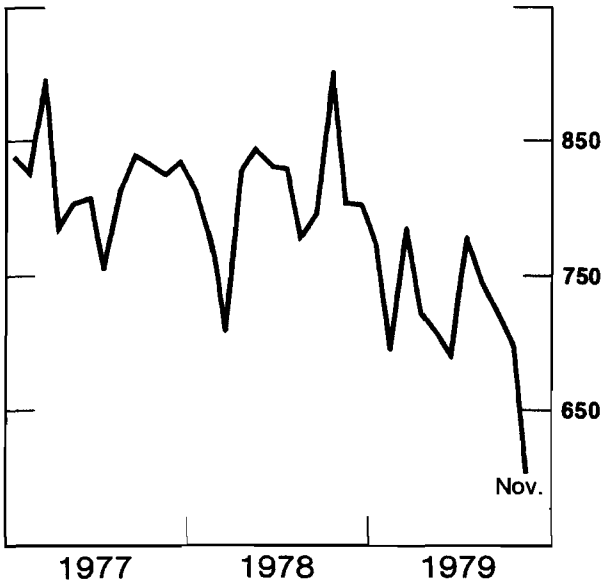
DEPOSIT GROWTH AT THRIFT INSTITUTIONS



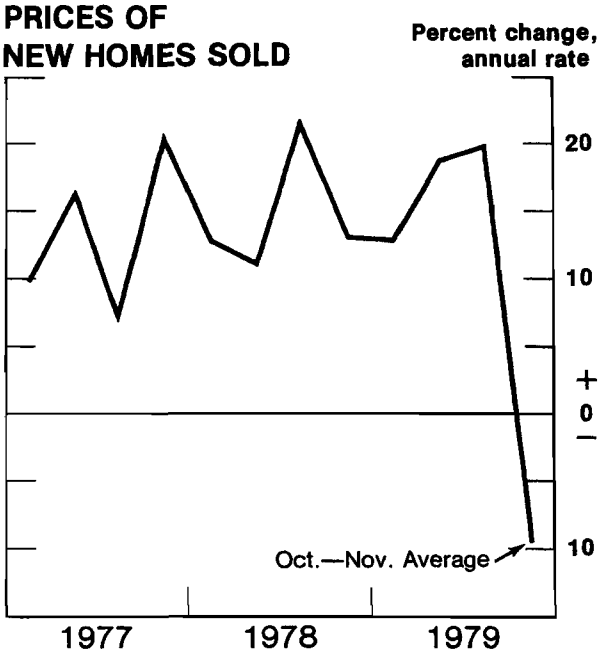
OUTSTANDING COMMITMENTS AT SAVINGS AND LOAN ASSOCIATIONS



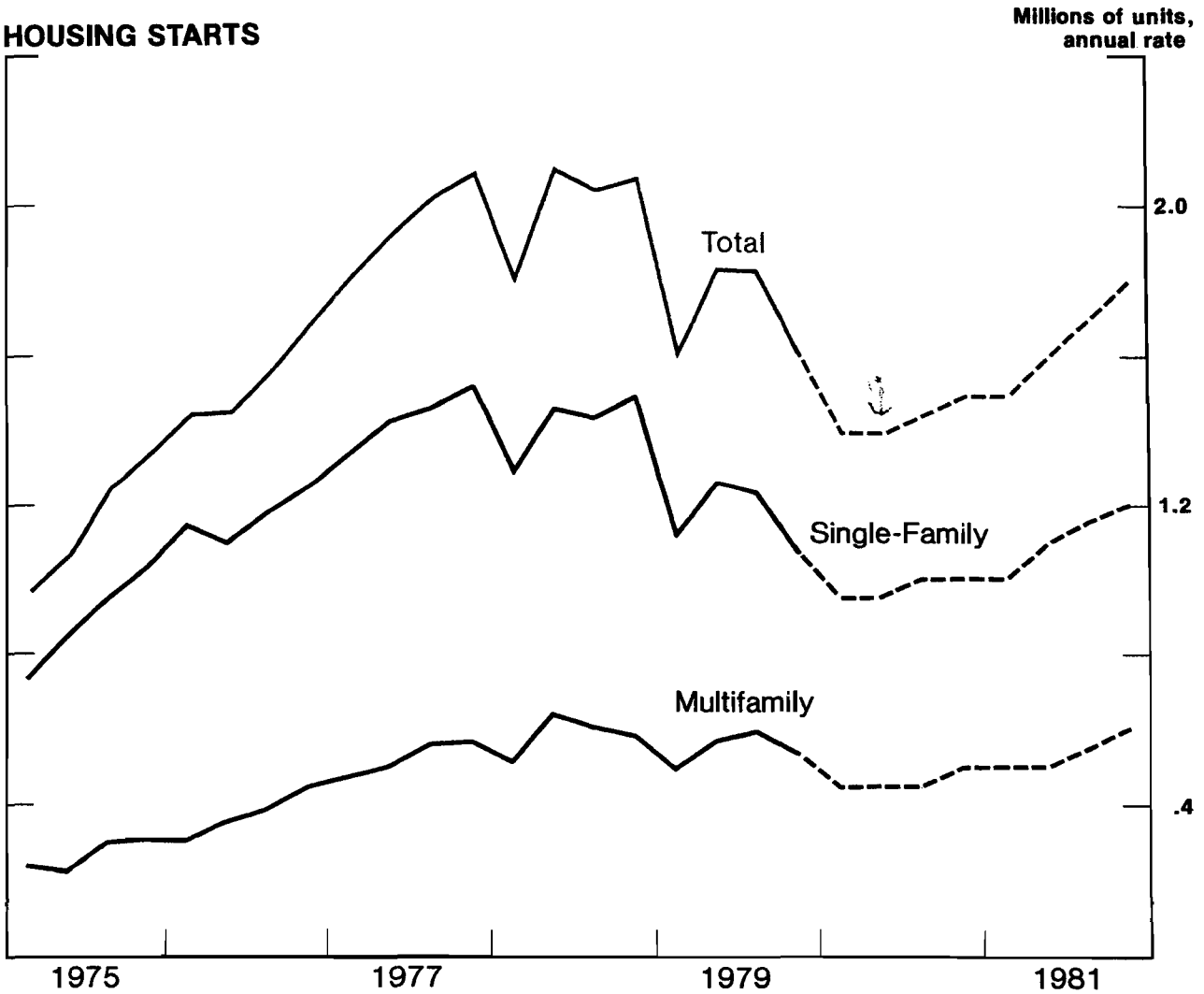
NEW HOMES SOLD



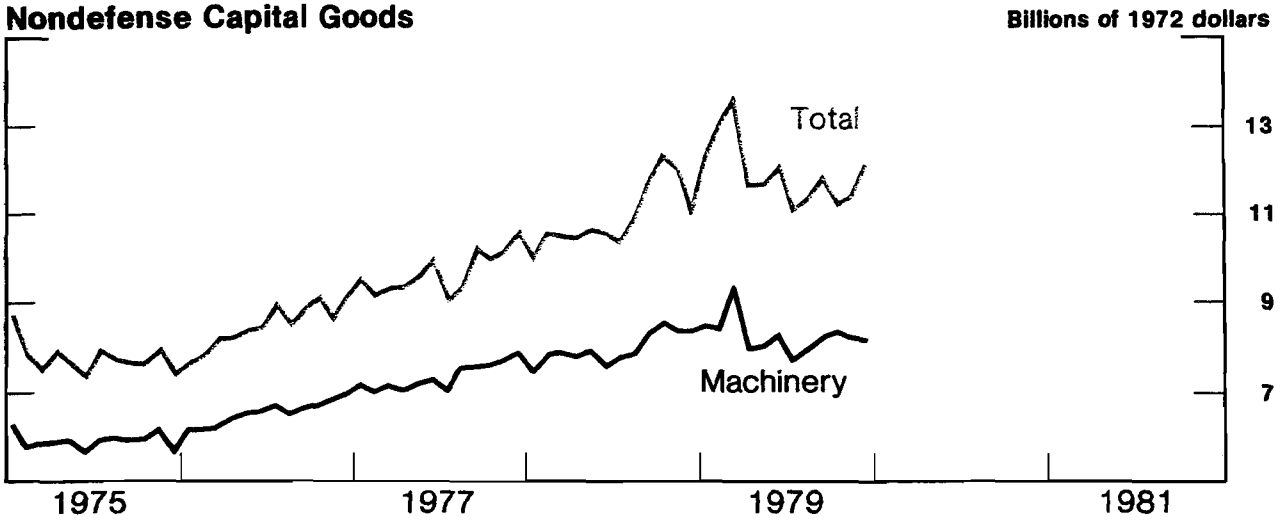
PRICES OF NEW HOMES SOLD



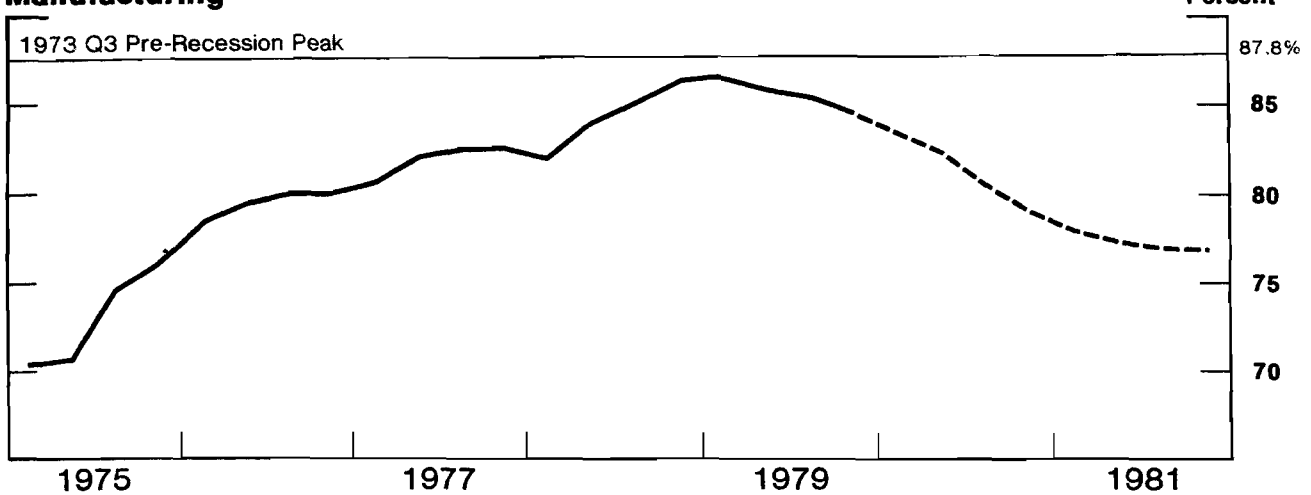
HOUSING STARTS



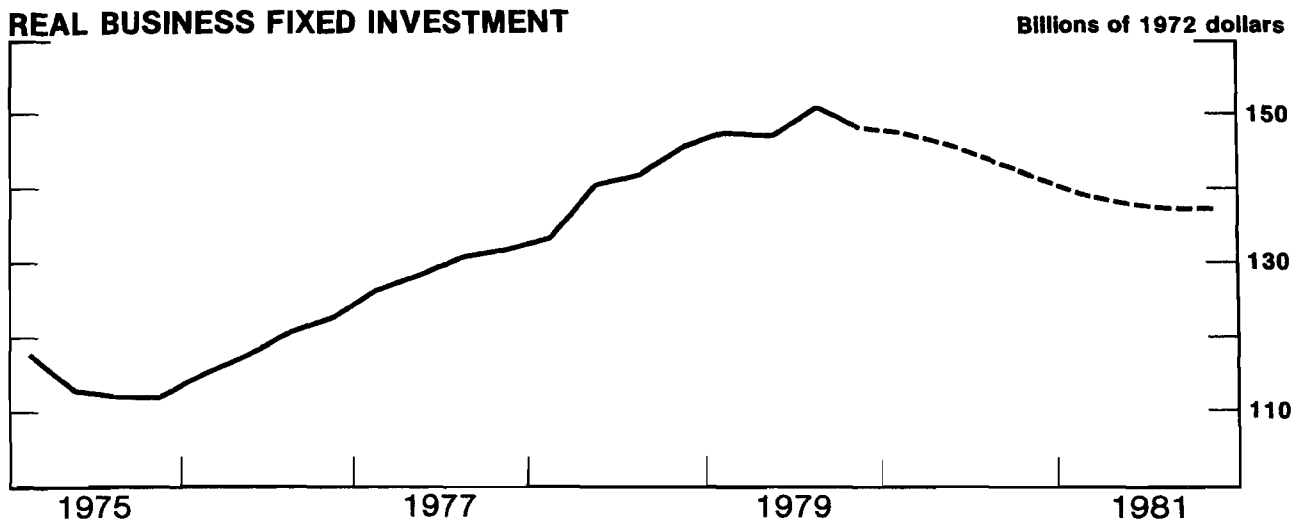
REAL NEW ORDERS
Nondefense Capital Goods



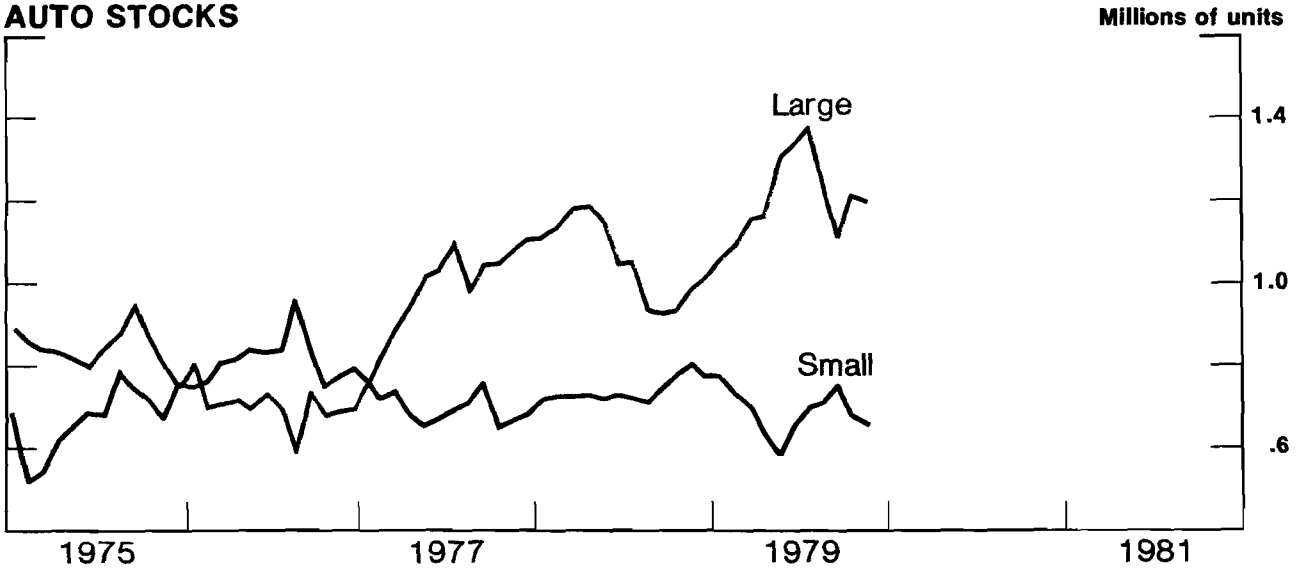
CAPACITY UTILIZATION
Manufacturing



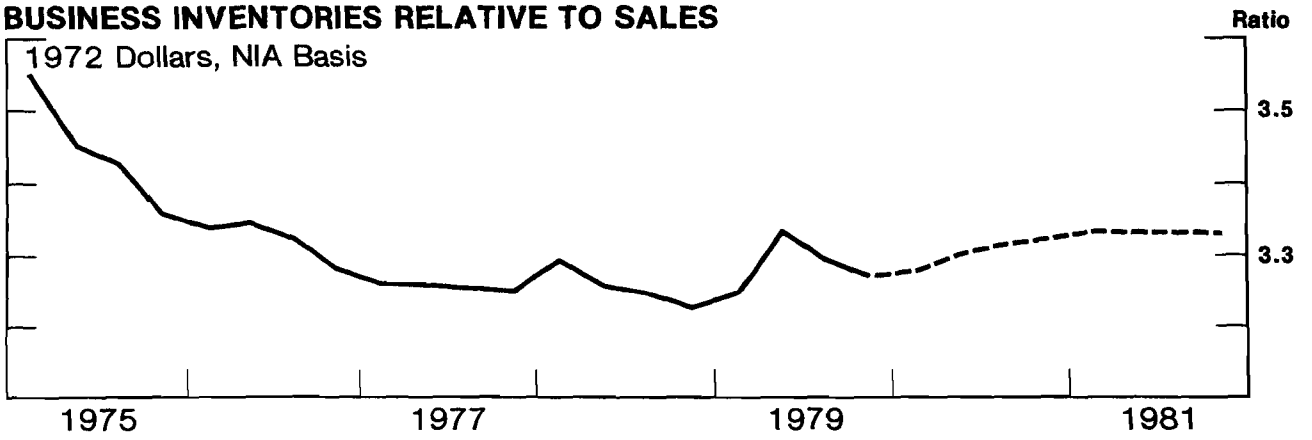
REAL BUSINESS FIXED INVESTMENT



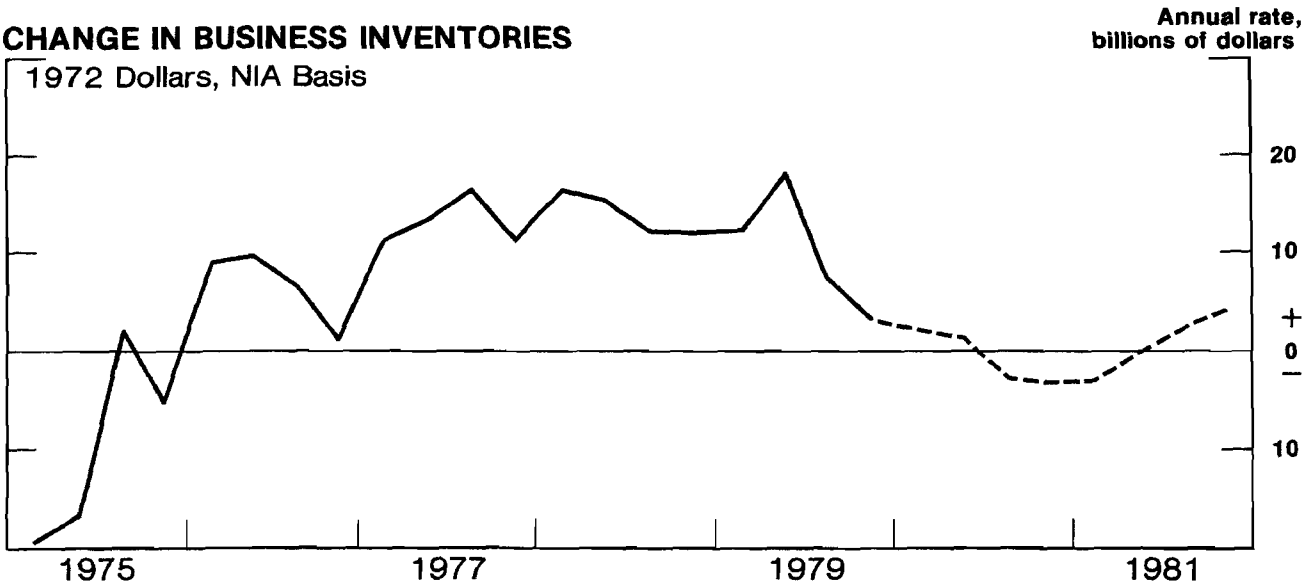
AUTO STOCKS



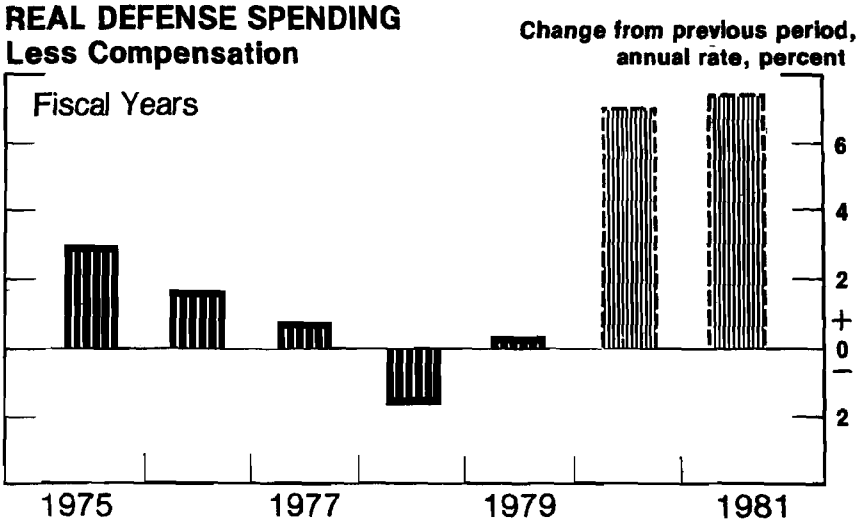
BUSINESS INVENTORIES RELATIVE TO SALES



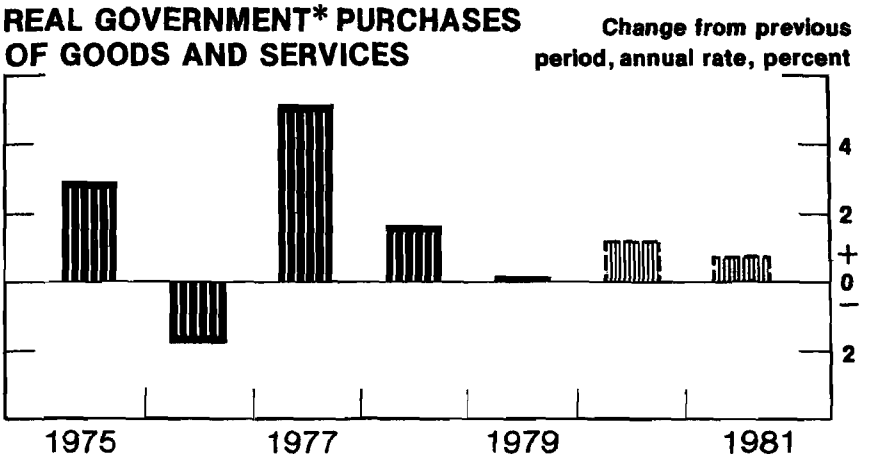
CHANGE IN BUSINESS INVENTORIES



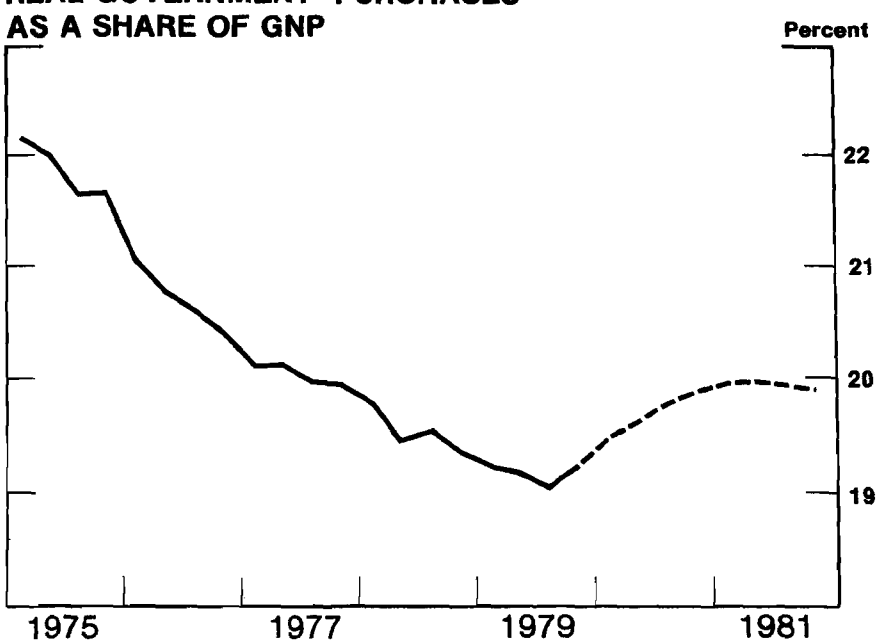
REAL DEFENSE SPENDING
Less Compensation



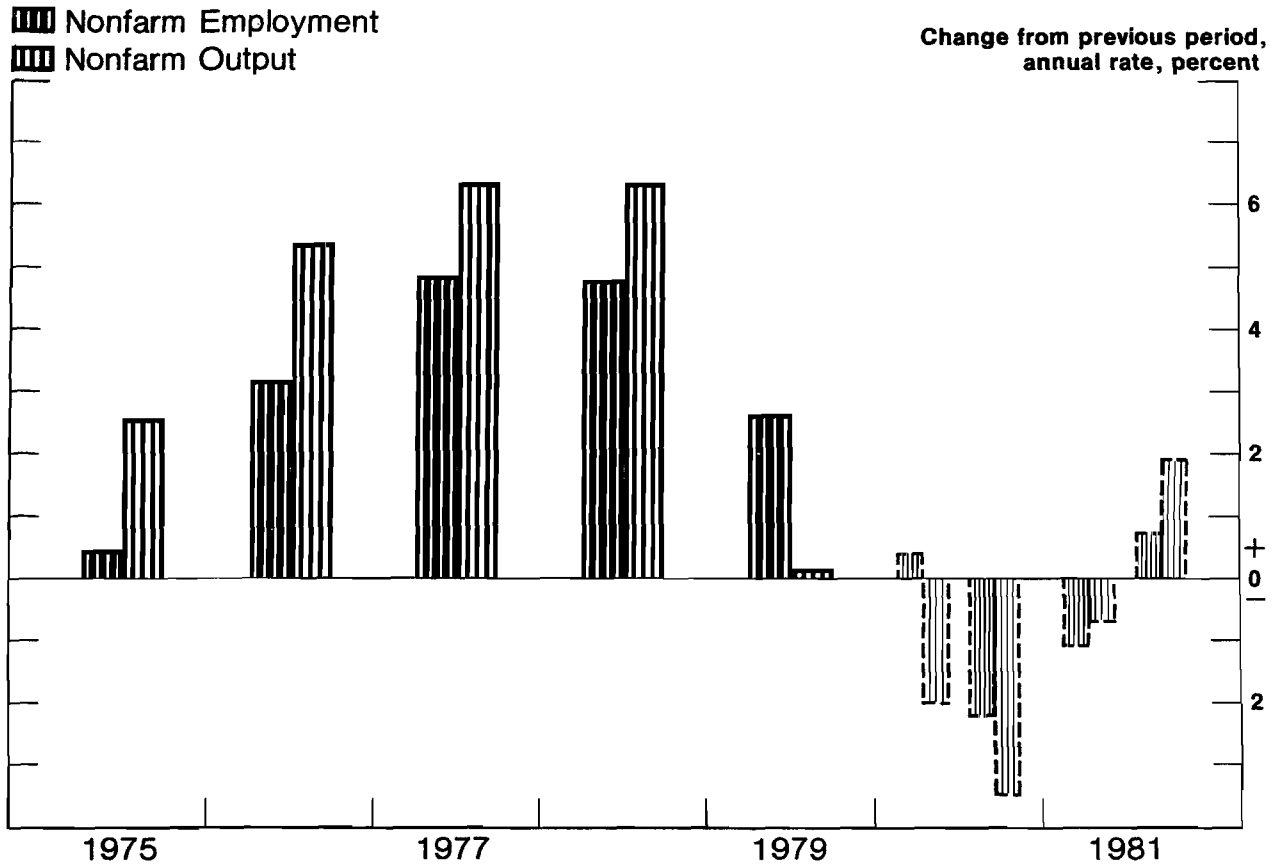
REAL GOVERNMENT* PURCHASES OF GOODS AND SERVICES

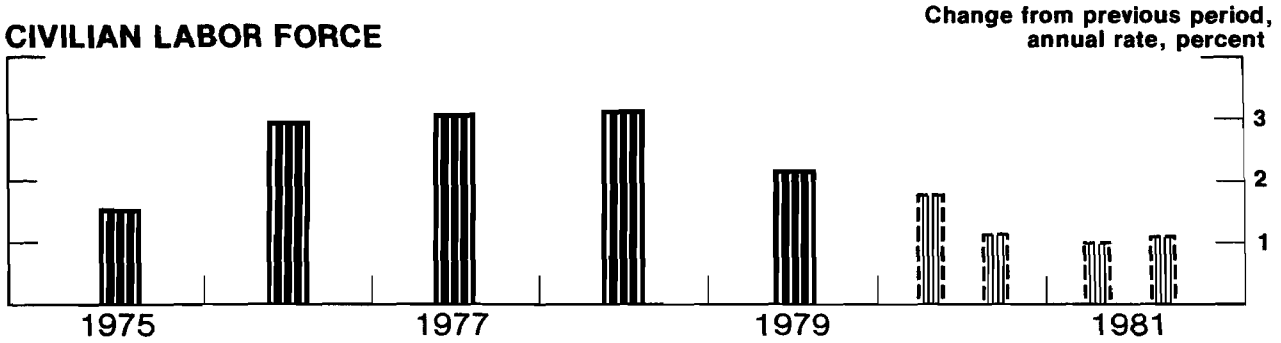


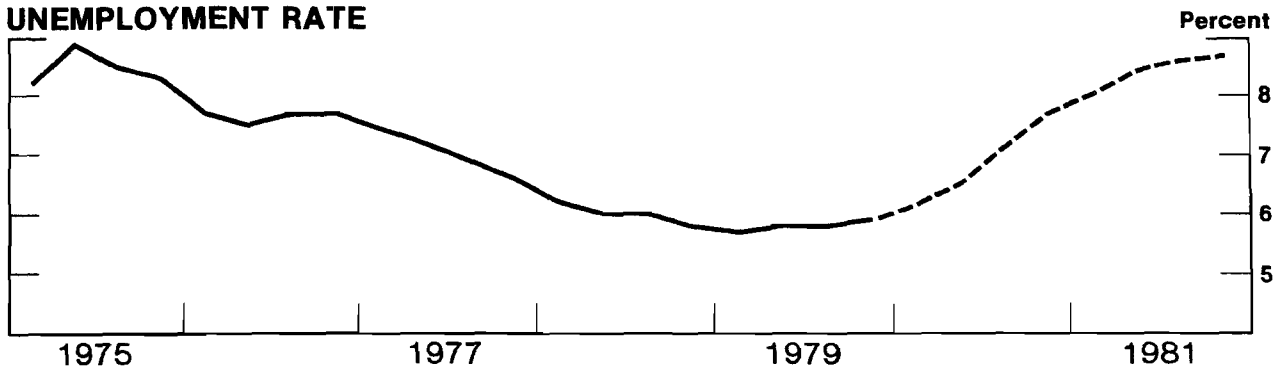
REAL GOVERNMENT* PURCHASES AS A SHARE OF GNP



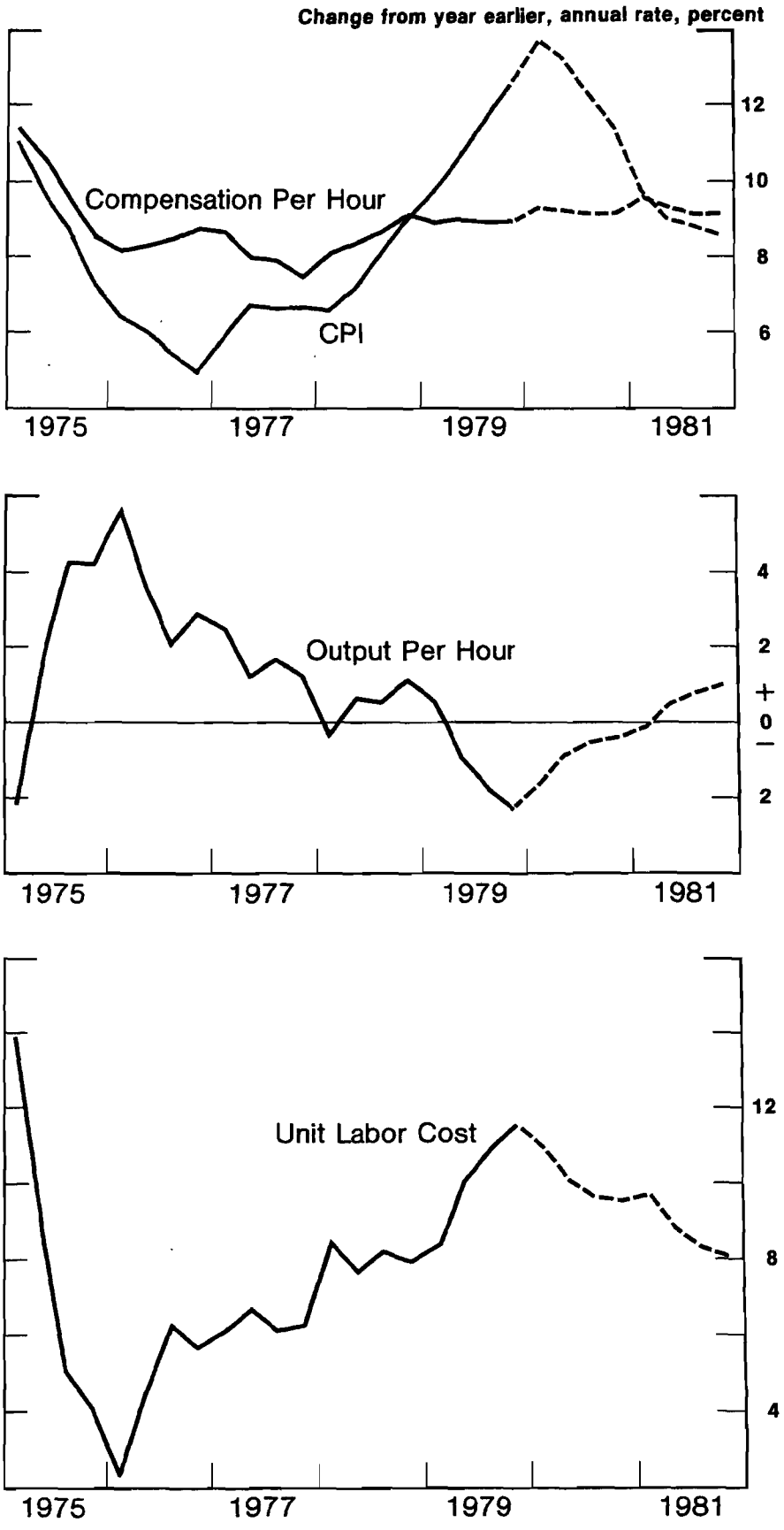
*Federal and State and local


Nonfarm Employment
Nonfarm Output
Change from previous period, annual rate, percent
6
4
2
+
0
−
2
1975
1977
1979
1981

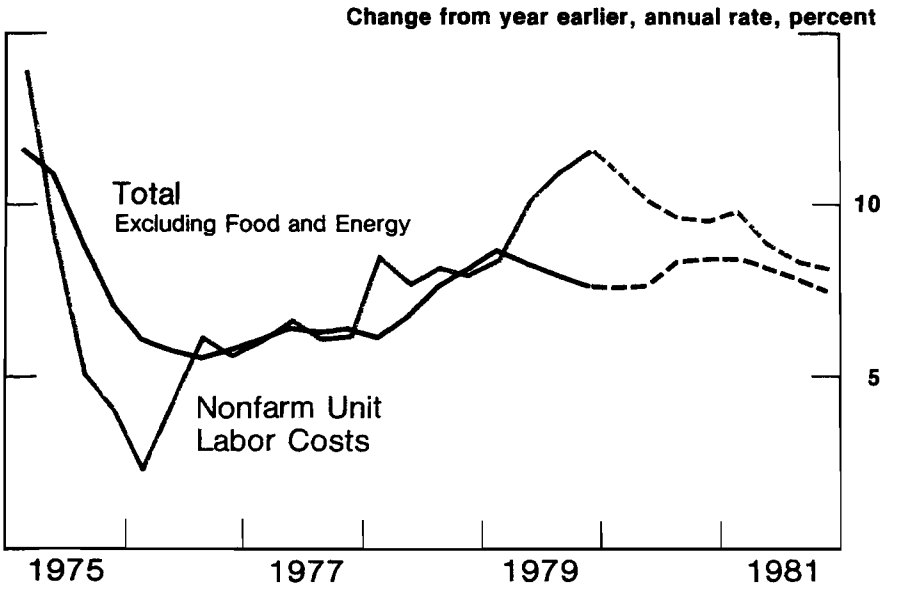

CIVILIAN LABOR FORCE
Change from previous period, annual rate, percent
3
2
1
1975
1977
1979
1981

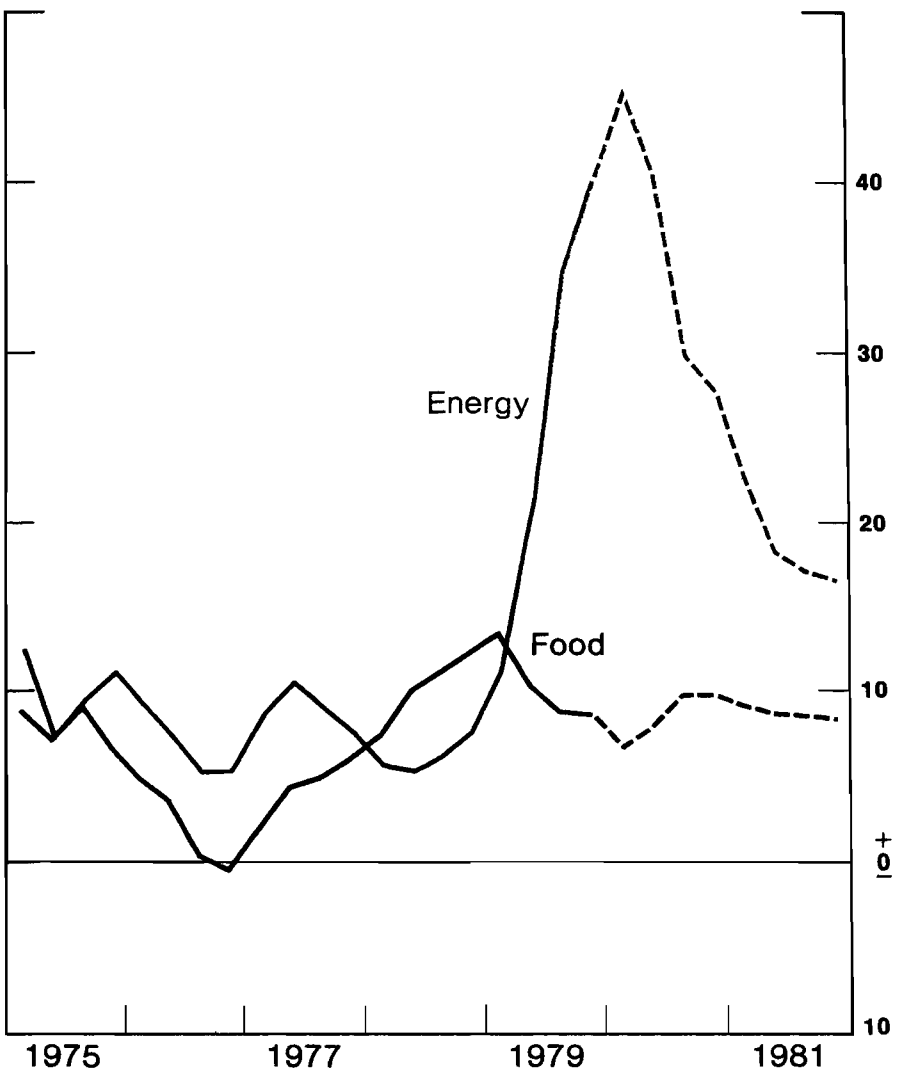

UNEMPLOYMENT RATE
Percent
8
7
6
5
1975
1977
1979
1981

UNIT COST INDICATORS
Nonfarm Business Sector

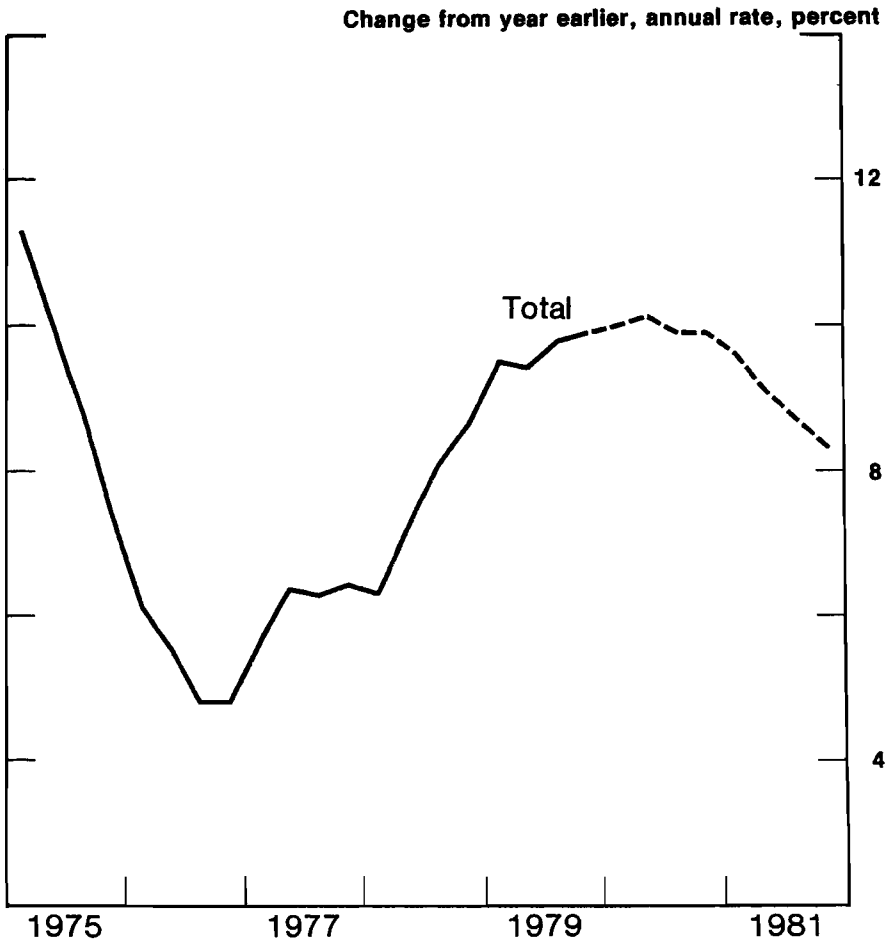


PRICES
Gross Domestic Business Product

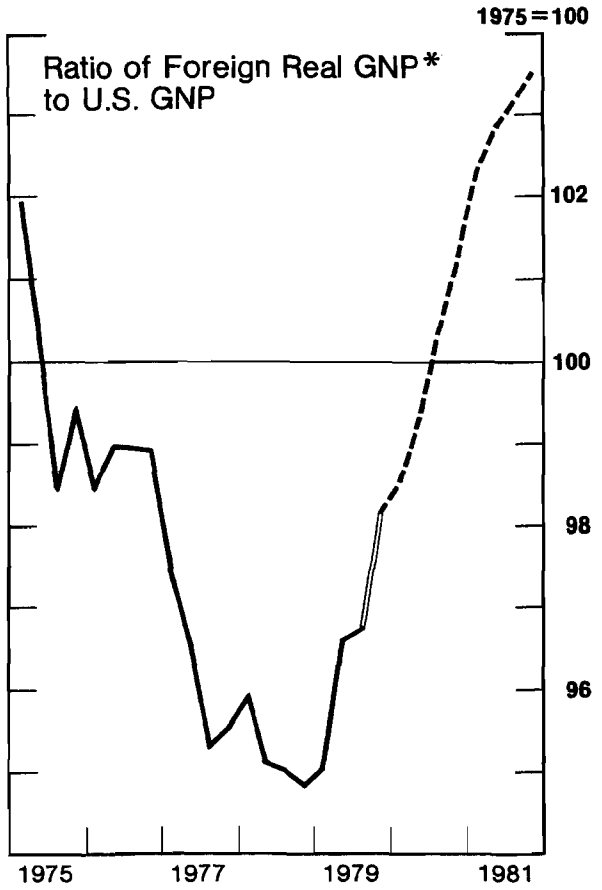




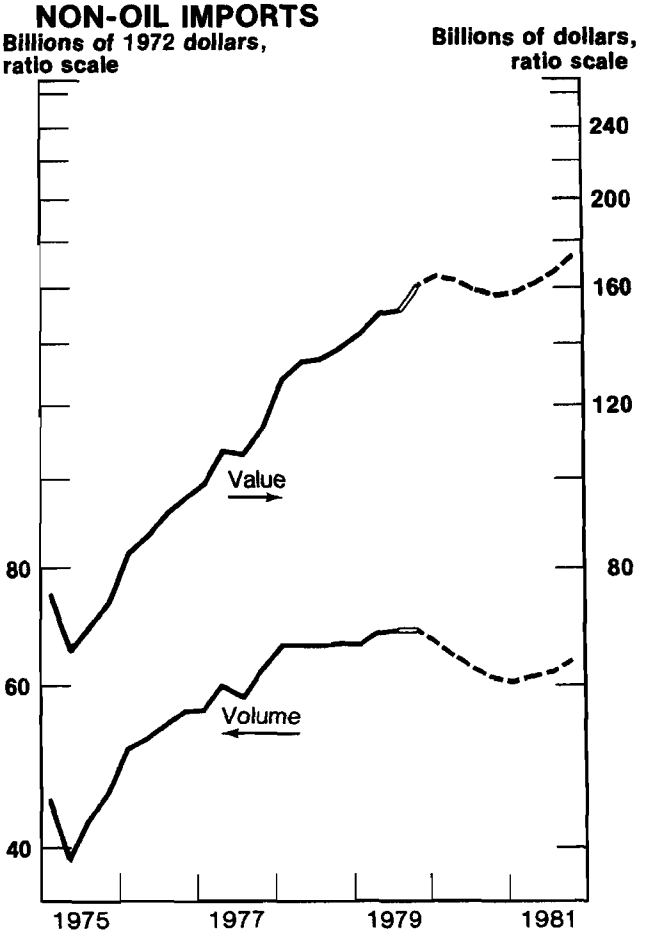
PRICES
Gross Domestic Business Product



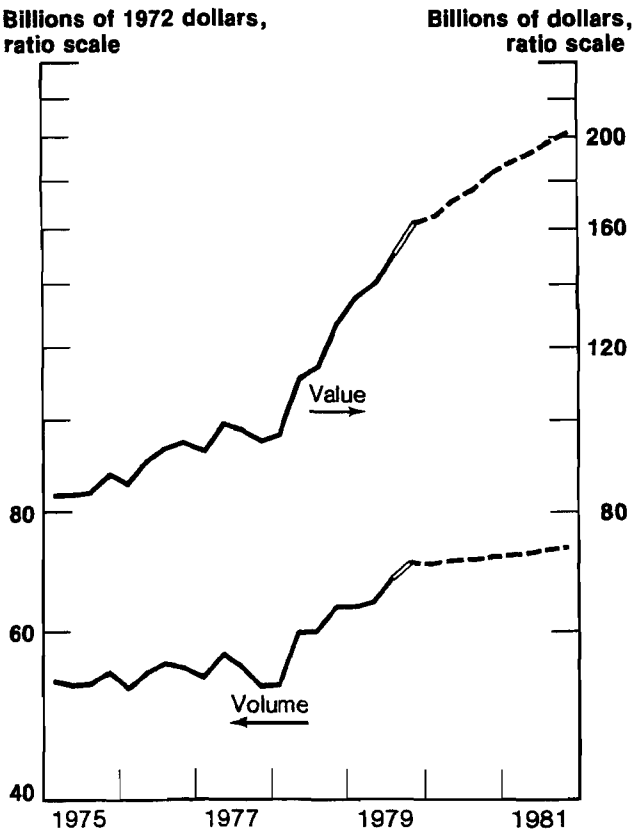
ACTIVITY RATIO



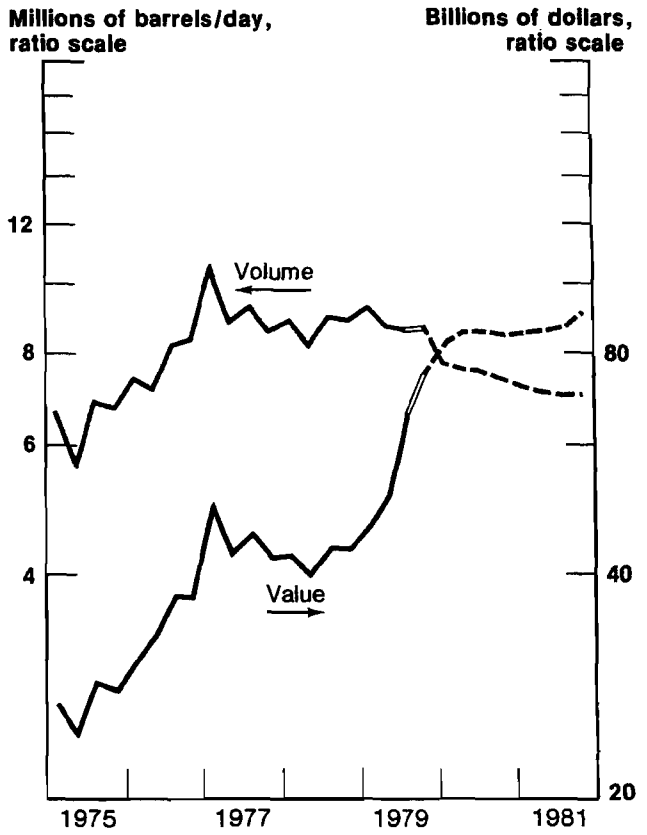
NON-OIL IMPORTS



NONAGRICULTURAL EXPORTS

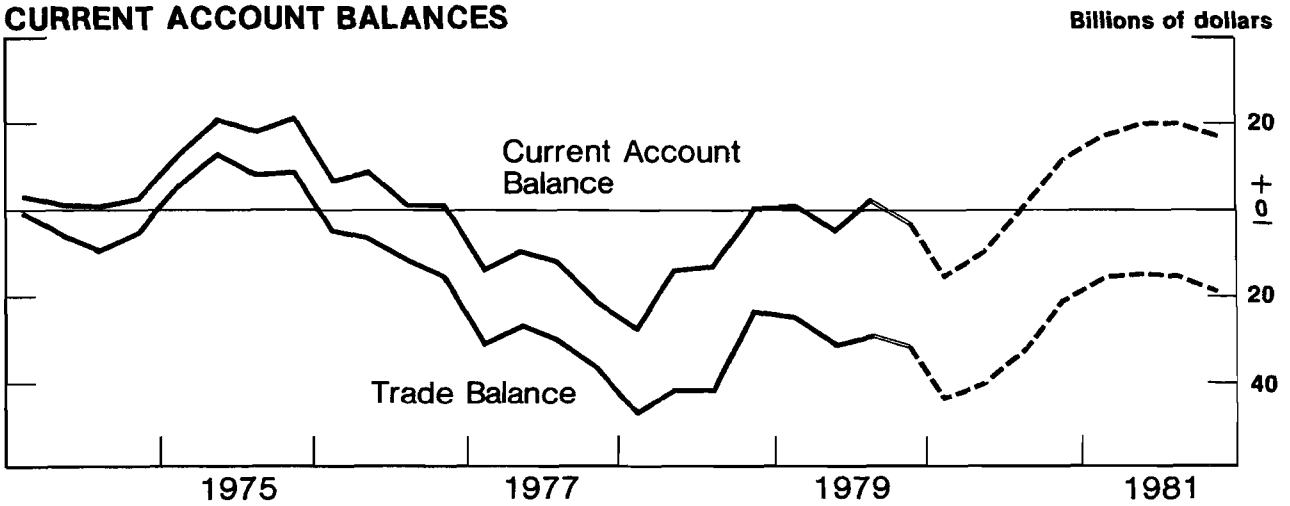


OIL IMPORTS



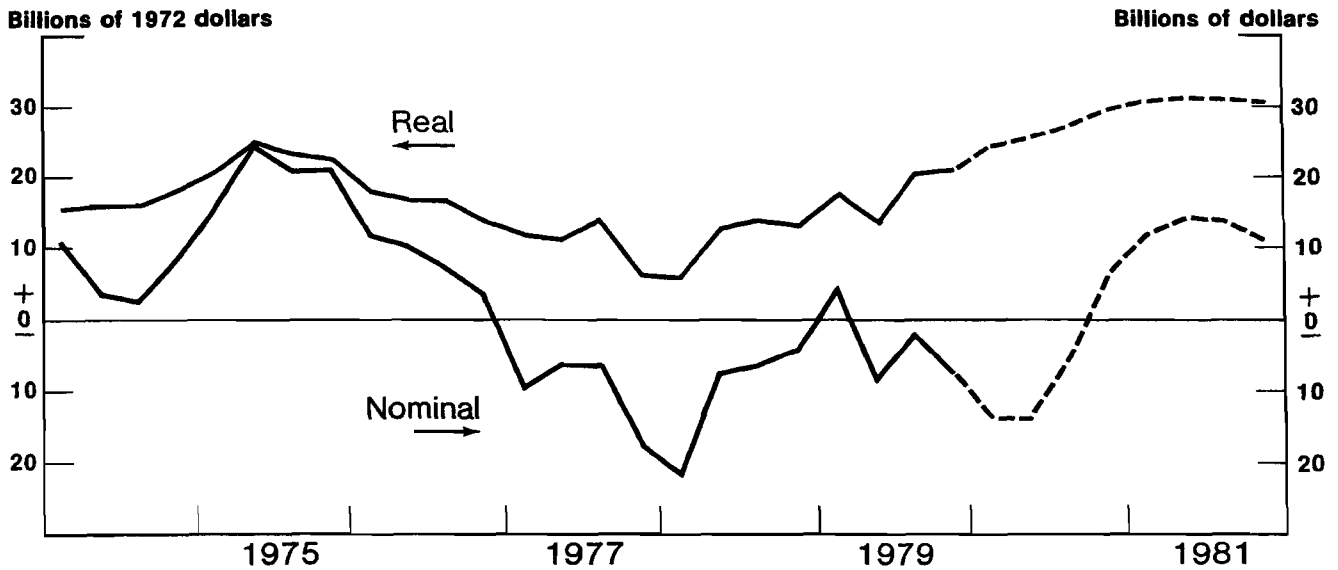
* Weighted average against G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

MERCHANDISE TRADE AND CURRENT ACCOUNT BALANCES

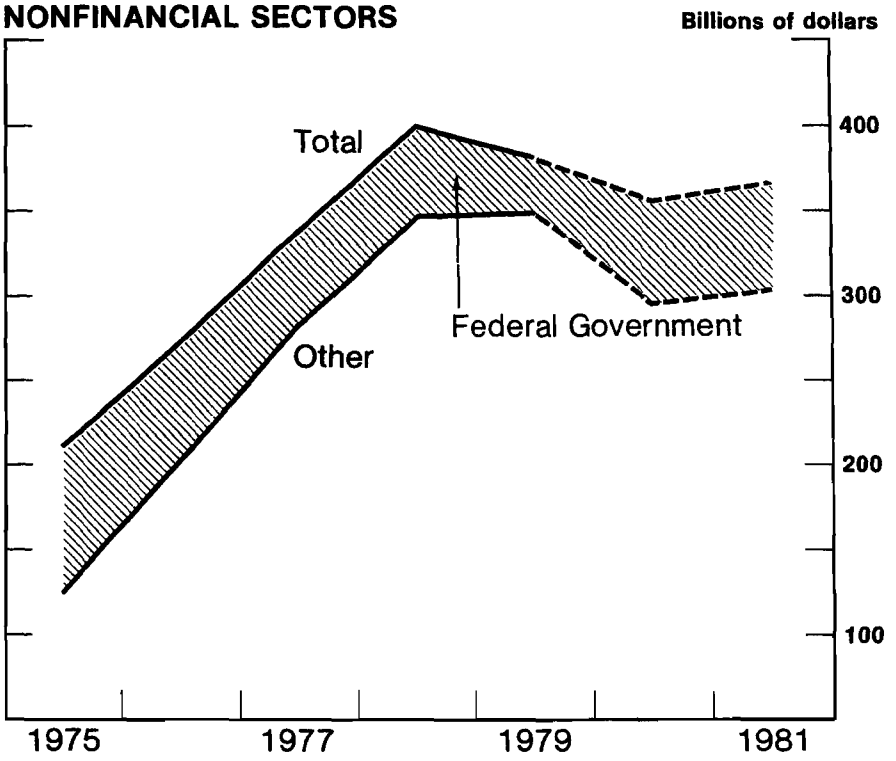


GNP EXPORTS AND IMPORTS OF GOODS AND SERVICES

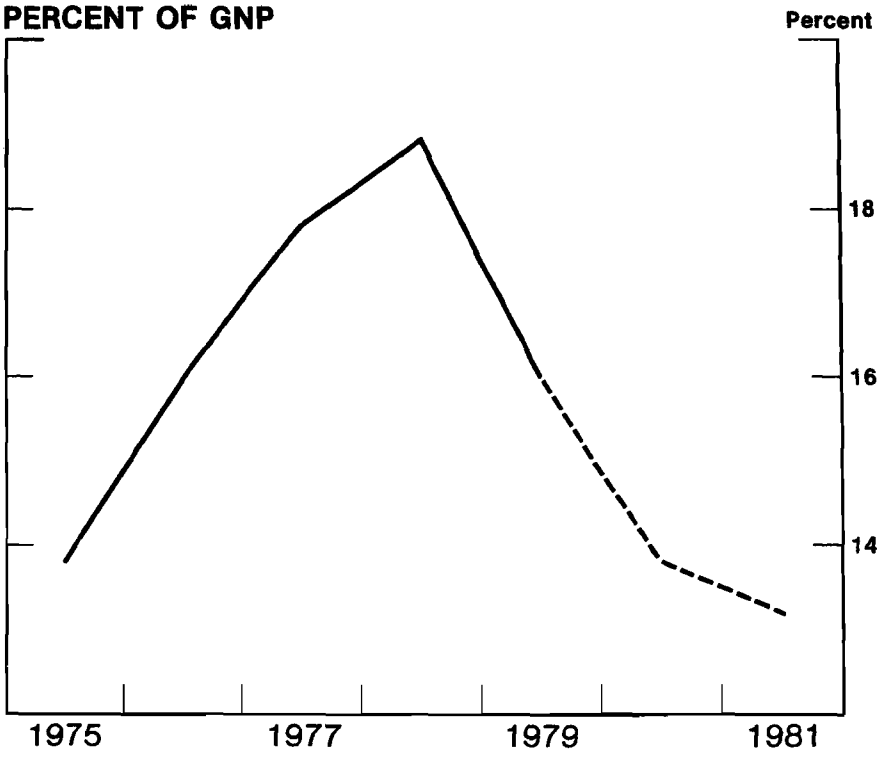
GNP NET EXPORTS



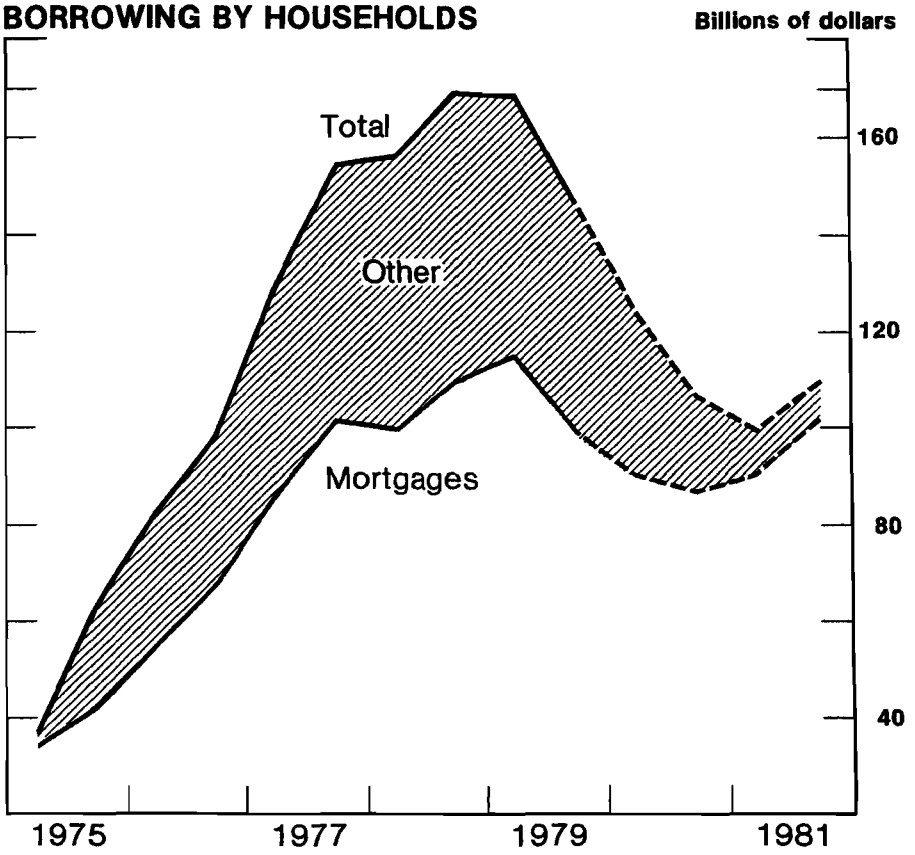
FUNDS RAISED BY NONFINANCIAL SECTORS



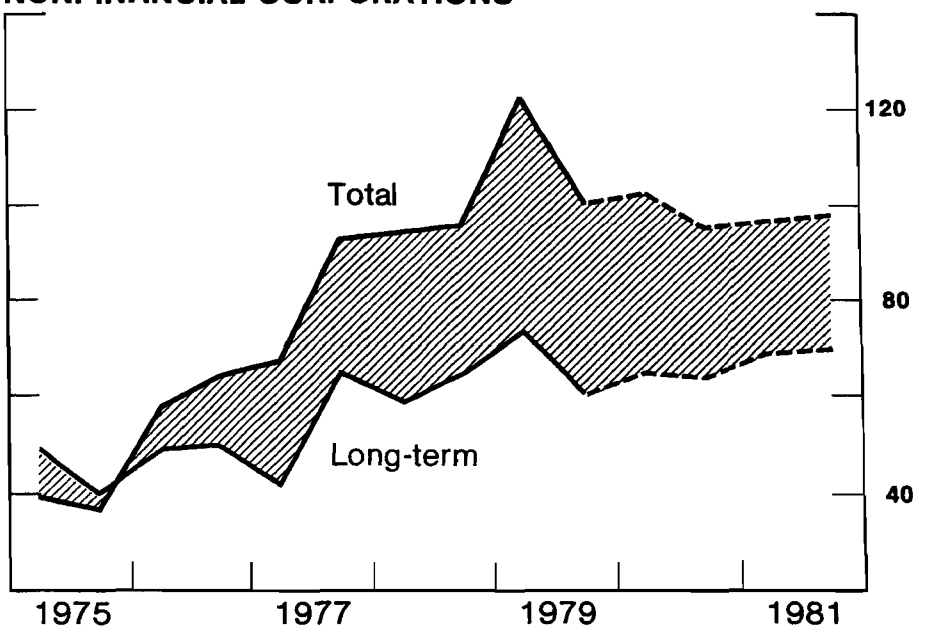
FUNDS RAISED AS A PERCENT OF GNP



BORROWING BY HOUSEHOLDS



BORROWING BY NONFINANCIAL CORPORATIONS



FOMC Briefing
SHA: 2/5/80

Thus far--and in large part thanks to the miracle of major seasonal and definitional revisions in the money supply--money growth, measured by narrow definitions, appears on track with the target for December to March set by the Committee at its last meeting. But such a course now looks as if it will be associated with less ease in credit conditions than might have been expected at that time. Money demands are likely to be stronger in reflection of a revised and less weak staff GNP projection for the first quarter. As a result, should that projection be accurate, the quite moderate increase in money supply targeted by the Committee may entail little, if any, decline in the Federal funds rate over the weeks immediately ahead. But, with economic activity projected to be weaker in the second quarter, some further decline in the funds rate is more likely to occur in early spring, particularly if the Committee were to encourage a bit more rapid expansion in M-1A or M-1B in the second quarter than in the first, as suggested by alternative B.

But there may also be some question about whether it will in fact be possible to keep money growth to modest proportions over the coming months without exerting upward pressure on the funds rate. Such upward pressure would be most likely to arise, of course, if the economy strengthens relative to the staff forecast. In that case upward rate pressure would appear consistent with the cyclical situation.

On the other hand, there are two possible developments that could tend to lead to the seeming anomaly of upward short-term interest rate pressures in a weakening economy, given money growth over the next few months

along the alternative B path. One would be emergence of greater demand for money relative to income than the staff is projecting. We have assumed that money demand will be weak enough to permit a bit stronger behavior in velocity of M-1A and M-1B over this and the next quarter than has usually been the case in post-war cyclical peak-to-trough periods. In the present inflationary environment the public in fact may be content to let the real value of cash balances decline sharply and attempt to maintain the real value of wealth--to the extent they can--by, say, acquiring other physical and financial assets that are more hedged against price rises. But if the public should turn out not to be willing to let cash balances decline relative to income, interest rates would come under upward pressure and/or nominal GNP under downward pressure as the public adjusts to the constrained supply of money.

The second development that could generate upward rate pressures over the next few months has somewhat greater odds of occurring. This would be the impact on money growth of the considerable bulge, relative to earlier years, in individual income tax refunds that is expected to begin sometime in late winter. While we are reasonably confident about our estimate of the amount of these refunds, we are quite uncertain about the exact timing--which depends on the speed with which the public files tax forms and the speed with which the IRS processes them. We are also uncertain about the exact response of the public to refunds received--whether placed initially in demand accounts or immediately in other assets, and if in demand accounts, whether they stay only one day or more. As noted in the bluebook, we would expect any upward impact of the refunds on money to be temporary--that is, it would not reflect a more permanent shift in money demand but would be followed in late spring and early summer by a tendency for money to grow slower.

Because of all the uncertainties involved no advance special allowance was made in the proposed monetary targets for the impact of tax refunds. Therefore, if the refunds do in fact tend to raise growth in the monetary aggregates beyond the proposed targets, short-term interest rates would temporarily come under upward pressure--a pressure that would be reversed later in the spring and summer as the flow were in effect reversed. However, the Committee may not wish to see interest rates rising over the months ahead for such a reason, especially if in fact the economy is weakening.

So far as I can see there is no easy practical solution to the dilemma posed by tax refunds. Deciding to adjust reserve paths to permit more money growth to the extent such growth can be identified as related to tax rebates has an appeal, but it is difficult to be certain that a higher money growth in any month is in fact temporary and related to the rebates. We have had experience in the past under a funds rate target--a target that makes it easy to accommodate to temporary bulges in money growth--where the bulge in growth has not been reversed, or fully reversed, and money over time ran higher than desired. Moreover, in deciding on whether to make any special allowance the Committee would probably also want to take account of the public impact of upward adjustments in targets--even by no more than the 1 or 2 percentage points that we now estimate to be the special effect of tax refunds--at a time when many in the market have been questioning the resolve of policy, though doing so for misguided reasons.

One approach would be to ignore the question on the ground that impacts on money now seem relatively minor, or it might be ignored on the ground that the risk of permitting higher growth in money can't be taken in the present environment. On the other hand, if the Committee wished to allow for some temporary increase in money growth, it might do so by recognizing--either in the directive or in the policy record--the possibility that money growth might deviate temporarily from target in case of unusually large individual income tax refunds.

If the Committee desired to make such an allowance, there are a number of ways to do so. One way would be to indicate that the Manager need not lower the nonborrowed reserve path over the next few months if total reserves are running persistently strong. In that case, interest rates would probably rise as borrowing rose but not by as much as if nonborrowed reserves were lowered. A much more accommodative approach would be to raise the nonborrowed reserve path to the extent that any bulge in money appeared to reflect the rebates, as determined by, say, analysis of the actual bulge in money compared with the actual timing of rebates. But such an interpretation leaves the staff with a very difficult and ticklish analytic problem. A third less rigid interpretation would be to permit the Manager to be tolerant of a little more money growth than formally targeted should that emerge, and there was reason to think it was related to refunds, without straining for precision in hitting total and nonborrowed reserves targets.

A final, brief word Mr. Chairman on another practical problem--the problem of which of the proposed aggregates should be given most weight in adjustments, if any, to the reserve path. On that issue, at present, I would suggest roughly equal weight to M-1A and M-1B, so as to minimize the risk that we are not overlooking significant growth in transactions balances. In any event, as a practical matter, M-1A and M-1B ought

to move closely together under current circumstances. I would suggest giving M-2 a more subsidiary role until we have more experience with it and with assessing the significance for policy of changing behavior of money market funds and overnight RP's relative to uncertain staff projections.