APPENDIX

James L. Kichline
June 29, 1982

CHART SHOW -- INTRODUCTION

During our presentations this afternoon we will be referring to the package of chart materials distributed to you. The first chart in the package displays the principal assumptions that underlie the staff forecast. For monetary policy, we have assumed M1 growth of 5 percent this year and 4½ percent in 1983, which is presented as long-run strategy 1 in the Bluebook. The fiscal policy assumptions include about $40 billion of expenditure cuts and tax increases for fiscal 1983, equal to roughly three-fifths of the actions contemplated in the first concurrent budget resolution. We also have assumed the multiyear personal tax rate reductions will be implemented as scheduled, consistent with the budget resolution.

The next page provides additional information on the federal budget outlook. The top panel shows the outlay, receipts, and deficit figures in the first resolution and the staff forecast. We do not yet have available administration estimates which are to be presented to the Congress in mid-July. For the current fiscal year the estimates are quite close, but they diverge considerably for 1983. Reconciliation of the deficits in 1983 is shown in the lower panel. The largest difference is accounted for by the underlying economic situation--higher unemployment and lower income--that influences both outlays and receipts. For example, the concurrent resolution has a projection of nominal GNP growth during 1983 of

11½ percent compared to 7½ percent in the staff forecast. The other major difference reflects our assessment that it is unlikely that all of the tax and expenditure changes envisaged in the resolution will be achieved. On balance, we still perceive the federal budget to be a stimulative force over the forecast period.

In contrast, we view monetary policy as a restraining force, as shown on the next chart. The implied M1 velocity growth this year and next does not appear unusual from the perspective of the last few years. But following the drop of velocity in the first half of 1982, we have built in an assumed willingness of the public to use existing balances more intensively to finance activity in the second half, as discussed in the Bluebook. During 1983, M1 growth of 4½ percent entails some downward shift of money demand given income and interest rates, according to the quarterly econometric model. As shown in the lower panel it seems to us that the monetary assumptions and economic environment imply continued high interest rates. To be sure, there is a great deal of uncertainty attaching to the interest rate outlook, but history doesn't seem to offer substantial encouragement for sizable rate declines in this forecast.

Mr. Zeisel will continue the presentation with a discussion of domestic nonfinancial developments.

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Joseph S. Zeisel
June 30, 1982

FOMC CHART SHOW

There have been some persuasive indications recently that the contraction is drawing to a close, although few signs as yet of significant recovery. Consumer demand has been lending the major support to final demands. As the upper left hand panel of the next chart indicates, total retail sales in real terms have been trending up since year-end, and in May were about 4-1/2 percent above the January level.

Auto demand, in particular, has strengthened, although the drop in sales in June following termination of most price incentives has caused some concern. Nevertheless, sales of domestic models have exceeded sharply reduced production levels for the past half year, laying the basis for a rise in auto production.

The improvement in auto output has been the major factor in the upturn in consumer durable goods production, shown in the lower left hand panel, and--along with expanding defense production--has helped stabilize overall industrial output. In contrast, output of business equipment and basic metals have continued to weaken.

As the lower right panel shows, both employment and the workweek have shown signs of leveling off, although the continued high flow of unemployment insurance claims suggests that employment and production adjustments have not been completed.

The next chart presents our view of the outlook for real GNP growth through the balance of this year and in 1983. The expected resumption of growth in the second half reflects in part the end of stock liquidation. But the major support for sustained growth should be provided by increases in personal consumption outlays in response to the tax cuts in mid-1982 and again in 1983. Nevertheless, the momentum of the recovery overall remains severely constrained as high interest rates inhibit business spending and housing activity, government continues to curb nondefense outlays, and exports are damped by the strength of the dollar. On balance, real GNP is expected to increase at under a 3 percent rate over the next 6 quarters, well short of a normal cyclical recovery.

As the bottom panel shows, this rate of rise is only a little more than the growth of economic potential, leaving the economy with a considerable degree of underutilized resources throughout the next year and a half.

The next chart portrays our view of the outlook for consumption. It is our judgment that consumers will respond in a traditional way to the increase in disposable income from the personal tax cut: we have assumed that they will spend some two-thirds of the extra income within half a year. But as a comparison of the two top panels indicates, absent sustained income gains generated in other sectors, growth of consumption will wane early next year and pick up again only after the next stage of the tax reduction in mid-1983. The expected increase in real consumer outlays averages about 3-1/2 percent over the next 6 quarters; although substantially faster than the pace of the last 3 years, it is not a particularly strong performance by past cyclical standards.

Recent tax reductions and incentives should result in some improvement in the volume of personal savings. But as the bottom panel indicates, these projections are consistent with a still moderately low saving rate, reflecting in part the less-than-outstanding growth in income.

The next chart addresses the outlook for residential construction. Housing starts have edged upward since their low in the fourth quarter, with a fairly substantial (although not necessarily sustainable) jump in multifamily starts in May. But as the right hand panel indicates, effective demand for new homes remains very weak, largely reflecting continued high mortgage interest rates. We anticipate that high interest rates will continue to be the dominant factor deterring a strong upturn in residential construction activity, although increased use of creative financing and adjustable rate instruments should permit a slightly improved level of activity. As shown in the bottom panel, we are projecting only 1-1/4 million starts for 1983, following a one million total in 1982.

The outlook for business fixed investment is presented in the next chart. Real new orders for nondefense capital goods have dropped sharply in recent months, as shown, and along with recent surveys and other indicators of prospective capital outlays, point to continued weakness in the near term.

We anticipate that capital spending will bottom out near year's end following a cyclical contraction about typical in size. As is evident in the upper right hand panel, new orders for defense capital goods, while erratic, have on average begun to grow in real terms and should be rising strongly as we move into 1983. In addition, the effects of liberalized depreciation should support stronger spending by business, particularly as the economic environment improves. But as shown in the bottom panel, we anticipate a relatively sluggish rebound in 1983--only about a 2 percent rise over the year. This would be well below average for cyclical recovery periods, but consistent with the continued high cost of capital and lack of pressure on available capacity.

The current inventory situation and outlook is portrayed in the next chart. Recent data suggest that a good deal of the inventory adjustment may well have been completed by now. As the top left panel shows, at auto dealers by the end of May inventories of domestic models were reduced to historically normal ranges as a result of drastic production cuts and some improvement in sales.

In manufacturing, shown in the right hand panel, the inventory total in real terms has been brought back down to about the late 1980 level. However, sales have declined as well, and stock-sales ratios remain high, particularly in primary metals and machinery. Overall stock-sales ratios should ease off gradually later this year as demand picks up as we anticipate.

Although we are projecting the end of liquidation later this year, little real inventory investment is expected in 1983 in light of the high cost of carrying stocks, relatively weak markets, and reduced inflation. As shown below, our projections involve a moderate further decline in the inventory-sales ratio.

The next chart presents the government components of spending. While reduced real government purchases have been a drag on activity this year, this should be less true in 1983. The rise in real defense outlays in 1982 lags the pace of the previous two years, but such spending is expected to accelerate again in 1983. Reflecting budget actions, nondefense purchases are projected to decline in both 1982 and 1983, although because of the timing of CCC outlays, the drop is expected to be smaller next year. Real state and local purchases are expected to continue contracting in response to reduced federal support and weak revenues but the drop in '83 should also be smaller than over the previous two years. In combination with the federal sector, this results in a rise in overall government purchases of about 1-1/2 percent in 1983, following a decline of about the same amount expected this year.

As the next chart shows, in line with the sluggish gains in output, we expect relatively weak employment growth over the balance of the projection period. In part, a pickup in demand for labor will likely be met through an increased workweek.

The paucity of job openings should continue to depress labor force growth, as has been the case in other recent periods of weak demands, and no increase is projected for the participation rate. Nevertheless, the rise in the working age population alone will support about a one percent growth in the labor force, close to the projected rise in employment; thus the unemployment rate is expected to edge off only slightly, remaining around 9 percent at the end of 1983.

As the next chart shows, the prolonged period of slack labor markets has paid handsome dividends in an easing of wage inflation. The moderation was first evident in the industrial sector where manufacturing wages dropped from an 11 percent rate of rise in late 1980 to about 8 percent in early 1982. A distinct slowing of the wage rise has been evident this year in the service sectors as well. We expect these trends to continue, given the general easing of price pressures, the environment of sustained high unemployment, and evidence of increased concessions on wages and fringe benefits. As shown in the bottom panel, we project the average hourly earnings index to be rising at about a 5-1/2 percent rate by the end of 1983 as compared to over 8 percent in 1981.

As the top panel of the next chart indicates, we also expect some help from productivity in reducing inflationary pressures. In light of the modest rise projected for production, we do not anticipate a strong cyclical productivity gain--about 1-1/2 percent in 1983. Nevertheless, such an improvement, when combined with the expected reduction in wage pressures, would result in a distinct deceleration of unit labor costs, which are expected to be rising at under a 4 percent rate in the latter half of 1983.

The outlook for inflation is presented in the next chart. The moderation of overall price increases last year owed much to food and energy as is clearly evident in the first two panels. Some resurgence of prices is currently underway in both sectors which is likely to last into early 1983. But fundamentally, the improvement in inflation has reflected reduced pressure from labor costs as well as prolonged slack in product markets. These forces are expected to damp the rise in food and energy sectors and foster improvement in price performance generally. The recent strong position of the dollar in international markets should also help. Overall, we are now projecting that prices will slow to about a 4-1/2 percent rate by late next year.

Mr. Truman will continue with a discussion of the international outlook.

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E.M. Truman
June 30, 1982

FOMC CHART SHOW PRESENTATION -- INTERNATIONAL

The top panel in the first international chart shows the new highs achieved by the foreign exchange value of the U.S. dollar in recent weeks. Although the dollar has declined from the point plotted for Monday, it is well above the peak reached last summer. Indeed, the dollar has recently traded at an average value it last attained prior to August 15, 1971.

As is shown in the lower panel, the differential between short-term dollar interest rates and rates on assets denominated in foreign currencies is somewhat narrower than it was a year ago, but the spread has widened over the past month. A further increase may be generally anticipated since interest rates abroad are expected to continue declining while short-term dollar rates remain high. The recent strengthening of the dollar has been aided also by the rise in international tensions and the problems of particular currencies such as the French franc and Canadian dollar.

While such special factors are important, the fundamental explanation of the dollar's current high value is probably the success of tight U.S. monetary policy in controlling inflation and the promised continuation of that policy in the face of large budget deficits.

The top panel of the next chart illustrates one measure of the relative success of U.S. monetary policy. From mid-1977 until last summer, U.S. consumer prices rose more rapidly than consumer prices on average abroad. Since last fall, prices abroad, while slowing, have risen more rapidly than U.S. prices. Thus, on a price-adjusted basis -- shown by the red line in the lower panel -- the dollar recently has just matched the peak it reached last summer, although on a nominal basis it has surpassed that earlier peak by 3½ percent.

As is shown in the upper left-hand panel of the next chart, consumer price inflation <u>has</u> been moderating on average in the major foreign industrial countries since the middle of 1980. This trend is expected to continue during the forecast period, as is shown in the lower left-hand panel, but will be less dramatic than the projected moderation in U.S. inflation.

The upper right-hand panel shows industrial production on average in the major foreign industrial countries. In mid-1980, production dipped below its level a year earlier. This recession in industrial production continued into late last year, and production dipped again below depressed year-earlier rates in the first four months of this year. Nevertheless, as is shown in the lower right panel, we are projecting a pickup in economic activity abroad for 1982 as a whole that will continue into 1983. But the recovery will be sluggish and unemployment is not likely to decline from its recent high rates.

Many foreign countries are counting on the United States to help pull them out of recession. To examine the strength of these effects we ran a simulation with our Multi-Country Model.

In this simulation, U.S. investment was lowered so as to cut U.S. growth over the next 6 quarters in half -- from an annual rate of about 3 percent to 1½ percent. The model results suggest only moderately lower growth abroad -- about one third of one percent, on average. We also examined the effects of a different mix of U.S. policies -- one producing the same path of U.S. real GNP with higher money growth and lower budget deficits. We found that under the assumption of unchanged policies abroad, growth would be weaker because the depreciation of the dollar that would be associated with the different mix of U.S. policies would reduce U.S. import demand. On the other hand, lower inflation abroad under such a scenario could lead to less contractionary policies.

As matters now stand, the projected pick up in growth abroad is expected to be insufficient to outweigh the continuing adverse effects of the dollar's appreciation on U.S. nonagricultural exports. Consequently, as is shown in the top panel of the next chart, such exports are expected to continue to decline in volume through the middle of next year, for a cumulative decline of more than 25 percent since mid-1980.

Meanwhile, agricultural exports -- the bottom panel -- are expected to show some growth in volume, but little growth in value before the end of this year, when prices may edge up a bit after the market has digested some of the large carryover stocks from the 1980/81 crop year.

On the import side -- the next chart -- a decline in the value and volume of non-oil imports appears to have continued into the second quarter. The negative effects of the recession -- particularly as manifested in substantial inventory liquidation -- have been stronger than the positive influence of the dollar's appreciation, which sustained the volume growth of non-oil imports in 1981. With the resumption of U.S. economic growth, these two factors should be pulling for a while in the same direction, and non-oil imports are projected to expand rapidly.

Oil imports, shown in the lower panel, present a somewhat different picture. The price of imported oil declined to less than $30 per barrel in May -- more than $6 dollars less than a year earlier. As is shown in the box, we have assumed that the average price of imported oil will not reach the 1981 level in 1982 <u>or</u> 1983, although we expect the price to firm toward the official OPEC level of $34 per barrel. Meanwhile, the volume of U.S. oil imports should begin to recover with the rise in aggregate demand. However, the value of oil imports this year is expected to be more than $20 billion below last year, and the projected increase in 1983 is less than $10 billion.

The last international chart summarizes the projection for our international accounts. As is shown in the top panel, the trade deficit in 1982 is projected to be somewhat smaller than the deficit last year, but it is expected to widen to around $60 billion (at an annual rate) in the second half of 1983.

Consequently, the current account balance, shown in the middle panel, swings from a surplus of more than $10 billion at an annual rate in the first half of this year to a deficit of about $30 billion in the second half of next year. We expect that by 1983 the growing U.S. current account deficit should exert a substantial negative influence on the dollar's international value; our projection also is based on the expectation that the dollar will decline somewhat in the second half of this year from its recent very high levels.

In terms of the GNP accounts -- the bottom panel -- real exports of goods and services will continue to exert a negative influence on economic activity into early 1983, while imports should pick up next quarter.

Mr. Kichline will now complete our presentation.

James L. Kichline
June 29, 1982

CHART SHOW -- CONCLUSION

The first chart in the last section of your packet presents broad summary measures of the credit variables consistent with the staff's economic forecast. The top line of the chart shows that total funds raised by domestic nonfinancial sectors as a percent of GNP fell appreciably from the recent peak in 1978 through last year, a usual occurrence in periods of financial restraint. For this year and next we are expecting pressures on markets to keep the total near the level reached in 1981, which implies small expansion in the absolute dollar volume of funds raised--as shown in the box at the right. But there are marked changes projected in the composition of borrowing, with the Treasury commanding nearly one-half of the total in 1983. Even as a percent of GNP, the lower line in the chart, Treasury borrowing at over 6 percent next year would be at an unprecedented peacetime level.

The squeeze on markets from the Treasury we expect will be one of the important forces acting to damp the volume of funds raised by private sectors. The business sector, shown on the next chart, has cut back substantially on its investment expenditures in the first half of this year and the recovery in outlays projected next year still leaves the level below that in 1981. Profits, the top right panel, have been depressed by the recession, especially before taxes, although we anticipate expansion of profits later this year and next as sales pick up and businesses maintain tight control over costs.

The lower left panel displays the financing gap which plunged in the first half of this year as expenditures dropped more than cash flows; the forecast suggests little change in the gap through 1983. So far this year, however, corporate borrowing has been exceptionally strong relative to this measure of needs, and the sector in total apparently has piled up liquid assets. These developments are somewhat puzzling and may reflect, in part, a severe disparity of financing needs among individual corporations and perhaps weaker profits and cash flows than the available information suggests. In any event, we expect a moderation of borrowing and a halt in the rise of the ratio of short-term to total debt outstanding--the right panel. But with interest rates still high, and firms unable or unwilling to tap long markets in volume, we expect a degree of strain on balance sheets to persist.

In the household sector, the next chart, real disposable income has held up rather well during the recession, helped by the personal tax cuts last year. Household debt burdens, the right panel, eased over the past few years as consumers reduced their installment and mortgage borrowing. Over the next year and a half we expect debt burdens in the aggregate will remain quite manageable, given moderate borrowing expected in line with only limited improvement in the auto and housing markets.

An improved financial position of households is supported by the relatively low rate of short-term loan delinquencies, as indexed by auto loans in the lower left panel. Tightened lending standards and the high turnover of installment lending has led generally to a considerable improvement in short-term loan portfolios since 1980 despite the recession. But the same is not true in the mortgage area, shown in the right panel. There is reason for concern here, especially in view of the growth of various creative financing arrangements. It seems likely that disappointment will set in for those who undertook commitments with a view that in the near term they would be bailed out by large capital gains and sharply reduced mortgage interest rates.

In general, there are major downside risks to the economy stemming from the financial side of the outlook. Adjusting to a situation of declining inflation and high interest rates will continue to place strains on some households, businesses, and financial institutions.

The last chart in the package displays the forecasts of FOMC members for 1982 and 1983 along with the staff forecast. The figures generally are rather close, although for 1983 the staff's forecast of the deflator tends to be the most optimistic. At this time we only have tentative figures for the administration's forecast which is scheduled to be reported to the Congress in mid-July. Their forecast is within the range of FOMC members for 1982, but not for 1983. They now have nominal GNP projected at 10½ percent next year, with real growth of 4½ percent and a deflator of 5-3/4 percent; the unemployment rate at the end of 1983 is projected to be 8¼ percent.

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CONFIDENTIAL (FR) CLASS II-FOMC

Material for

Staff Presentation to the Federal Open Market Committee

June 30, 1982

Principal Assumptions

Monetary Policy

- Growth of M1 of 5 percent in 1982 and 4½ percent in 1983

Fiscal Policy

- Expenditure cuts and tax increases of about $40 billion in FY 1983
- Personal tax reductions scheduled for July 1982 and 1983 are implemented

Federal Budget

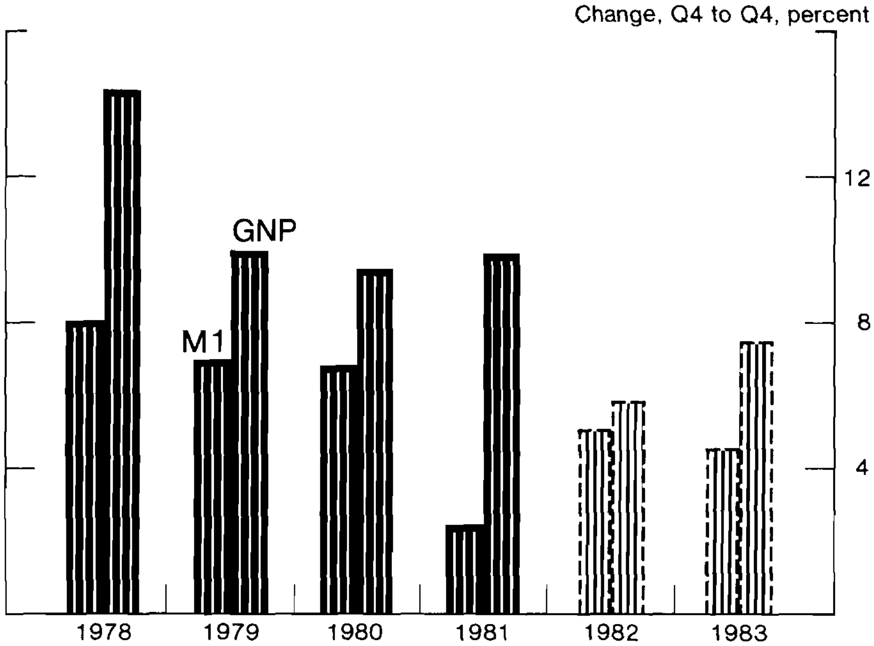
Fiscal Years, Unified Budget Basis, Billions of Dollars

	1981	1982		1983	
		1st Resolution	Staff	1st Resolution	Staff
Outlays	657	734	735	770	788
Receipts	599	629	622	666	622
Deficit	58	106	113	104	166

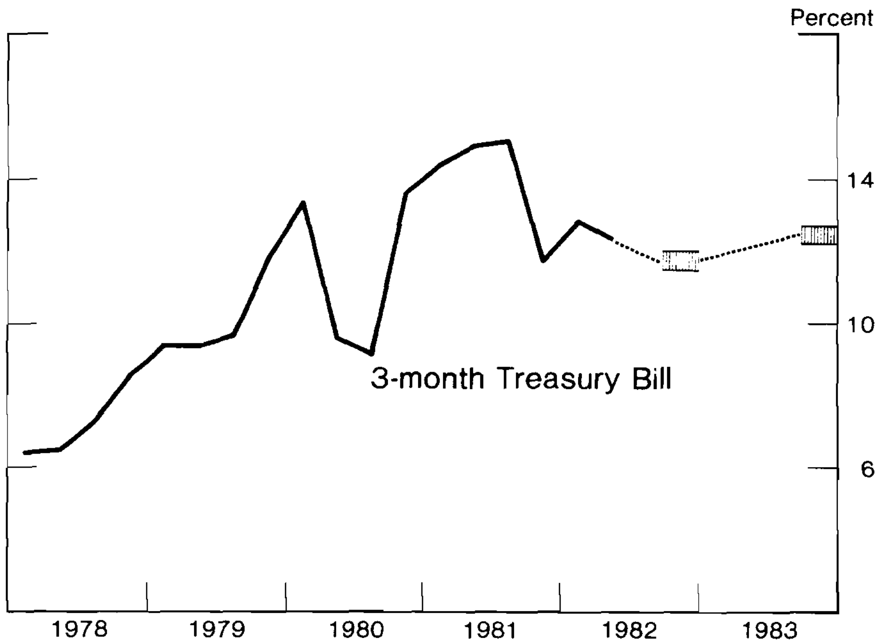
FY 1983 Deficit Comparison

1st Budget Resolution Deficit	104
Higher unemployment and lower income	41
Smaller deficit reducing actions	24
Other	−3
Staff Deficit	166

M1* and Nominal GNP

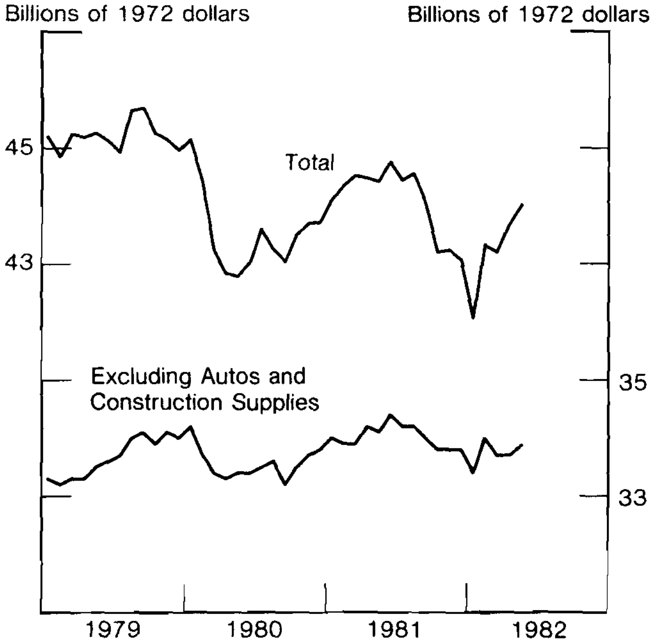


Interest Rate

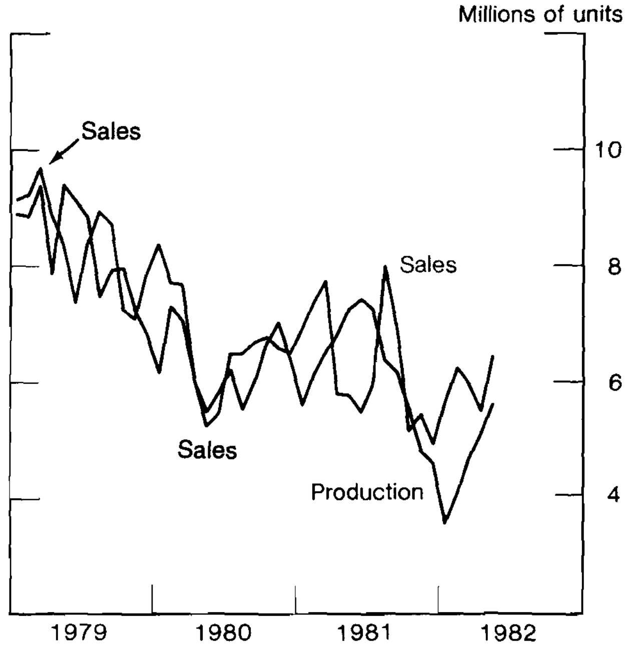


* Adjusted for shifts into ATS and NOW accounts.

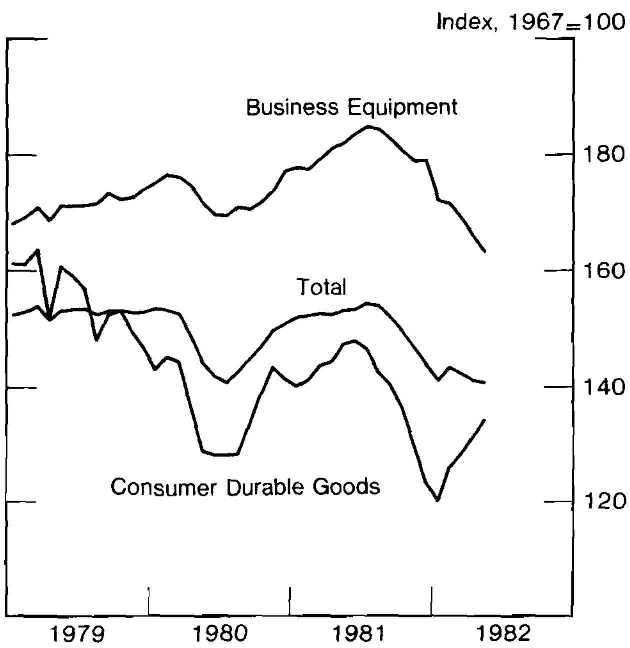
Real Retail Sales



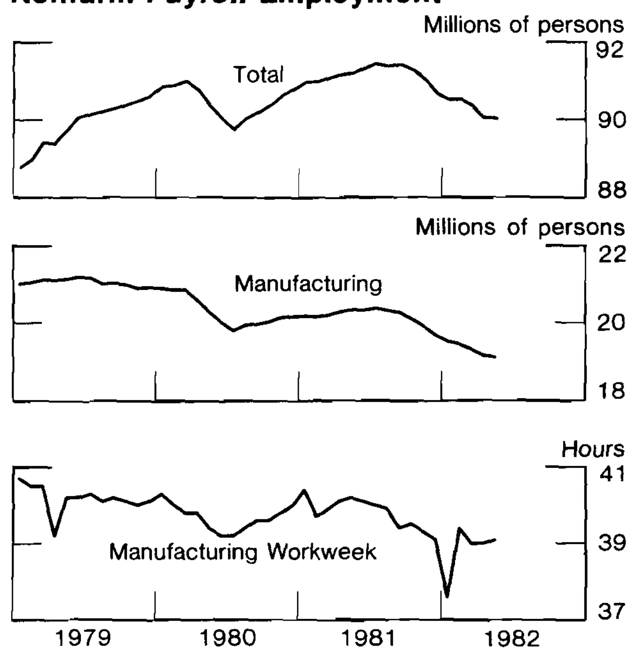
Domestic Auto Production and Sales



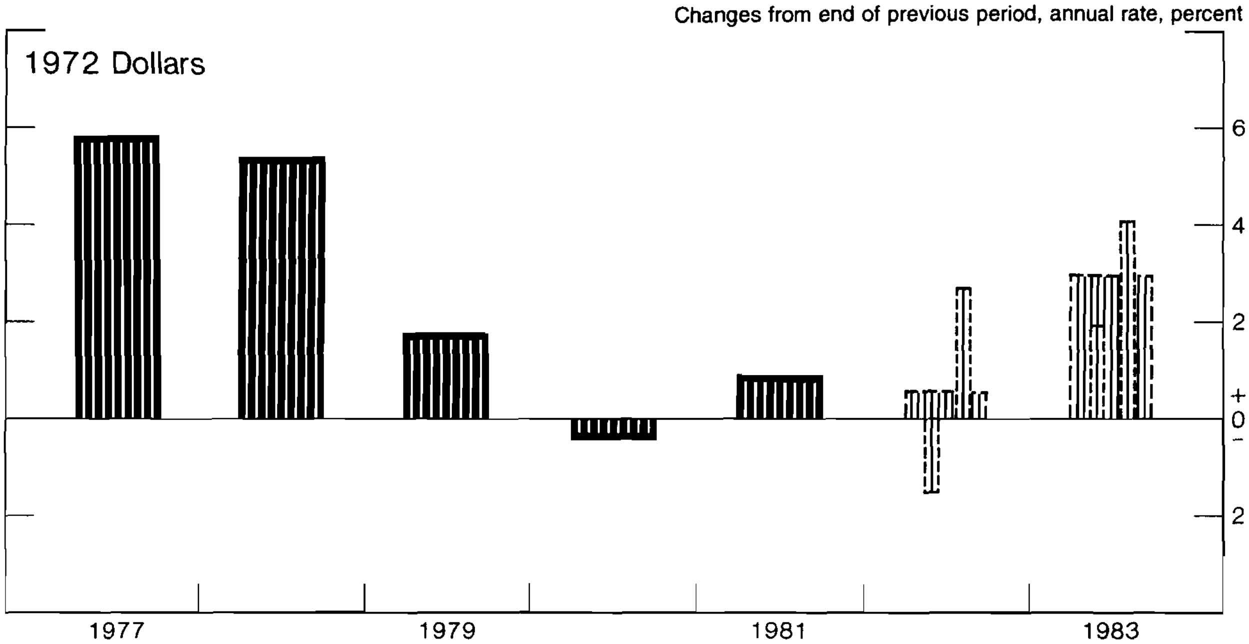
Industrial Production



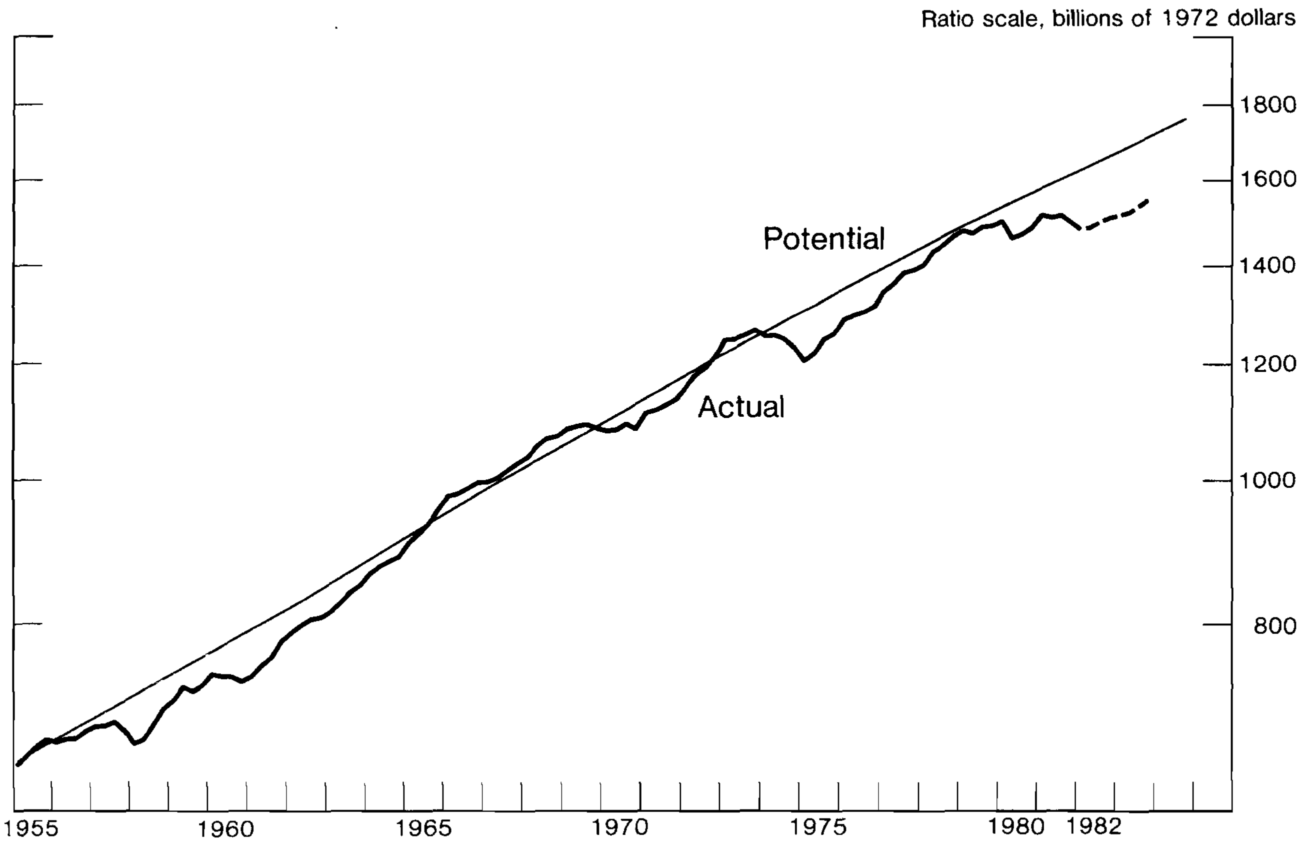
Nonfarm Payroll Employment



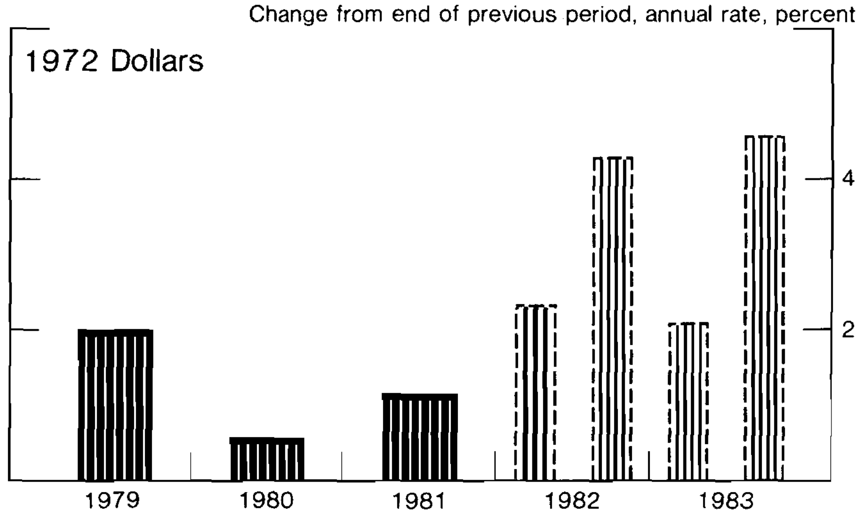
Real GNP



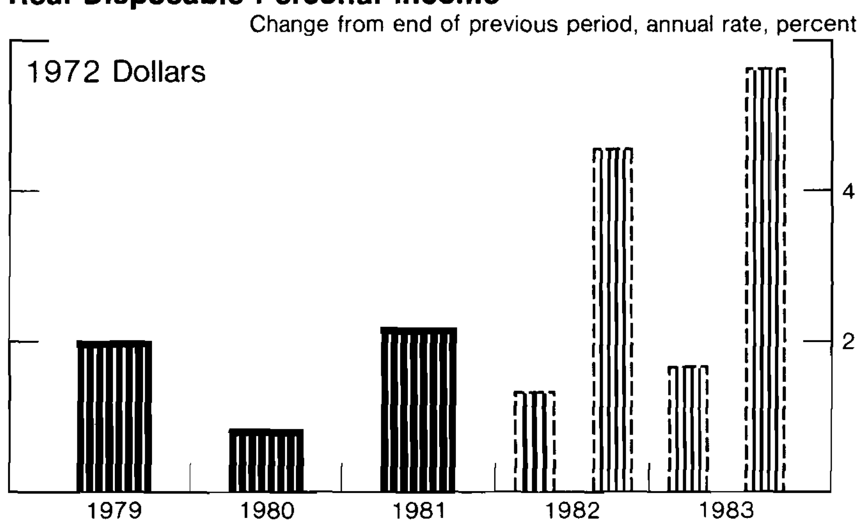
Real GNP and Potential



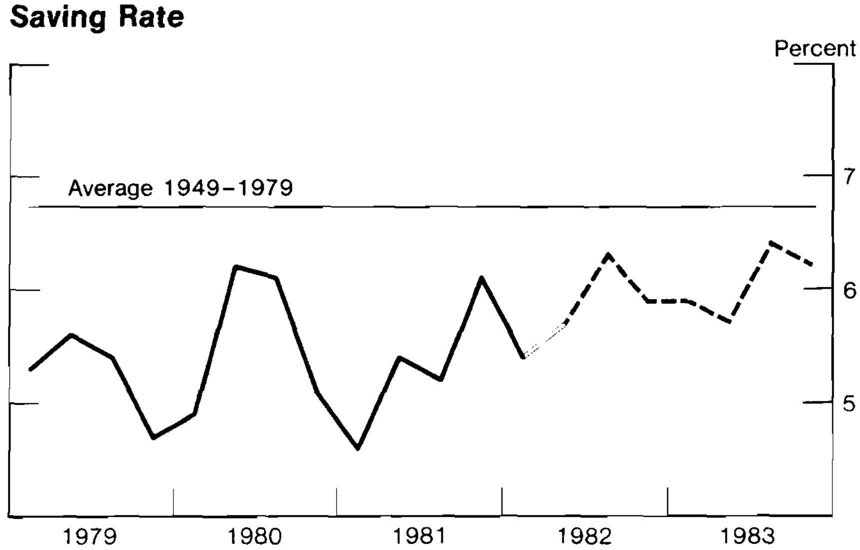
Real Personal Consumption Expenditures



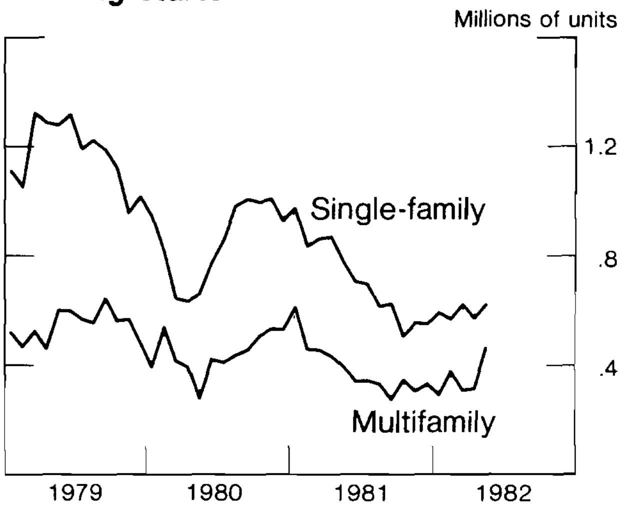
Real Disposable Personal Income



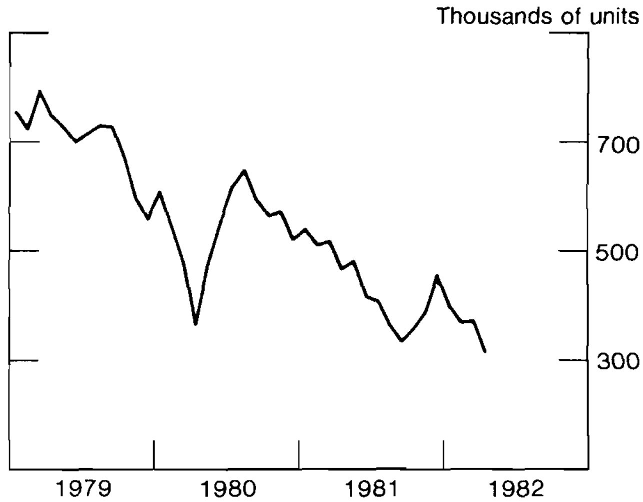
Saving Rate



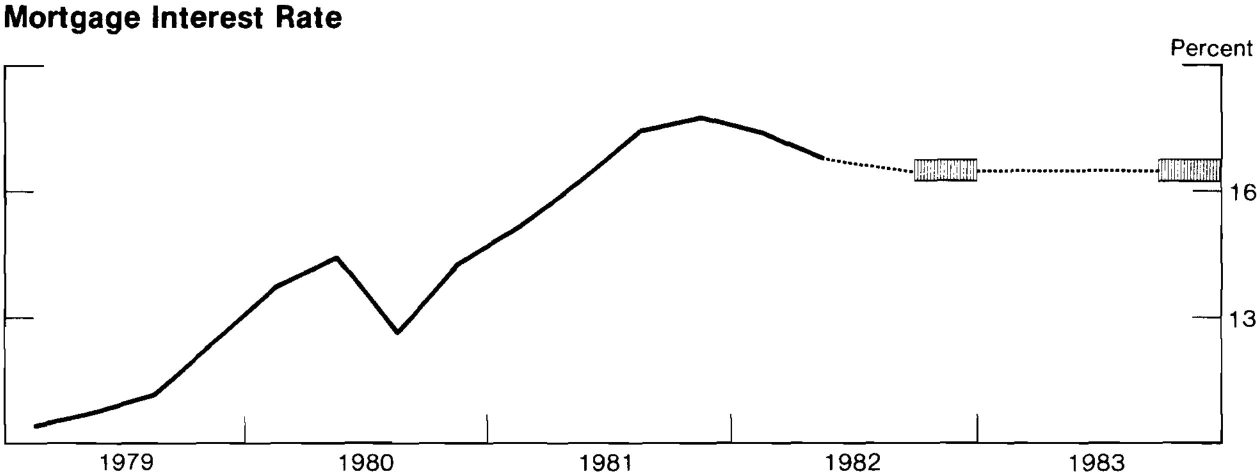
Housing Starts



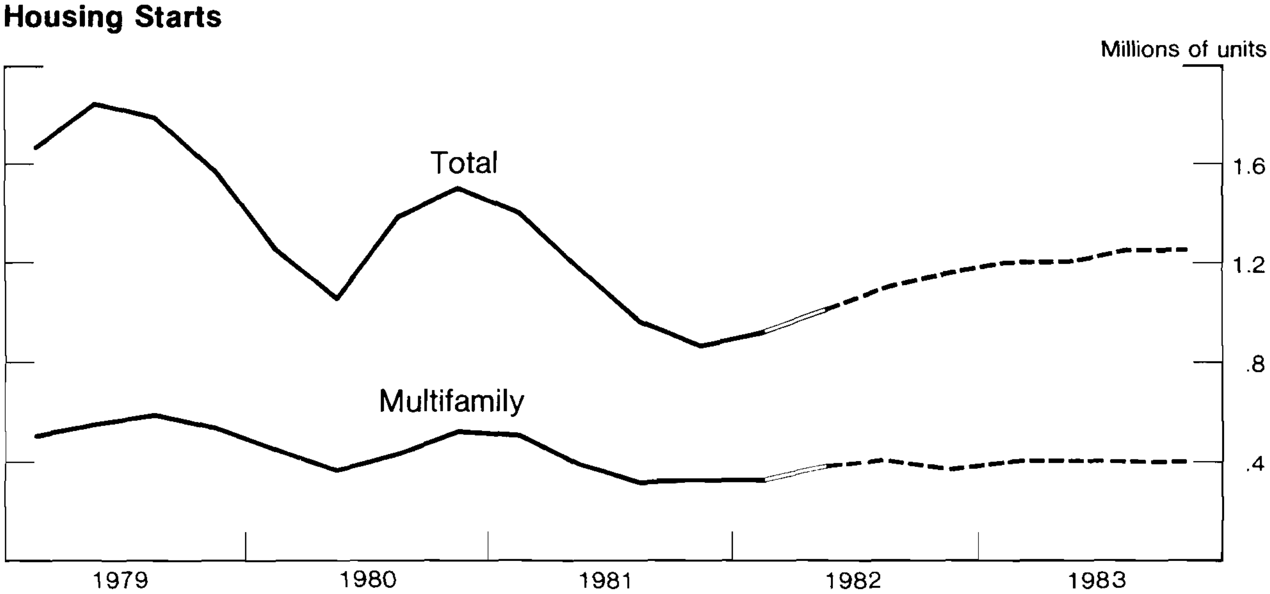
New Home Sales



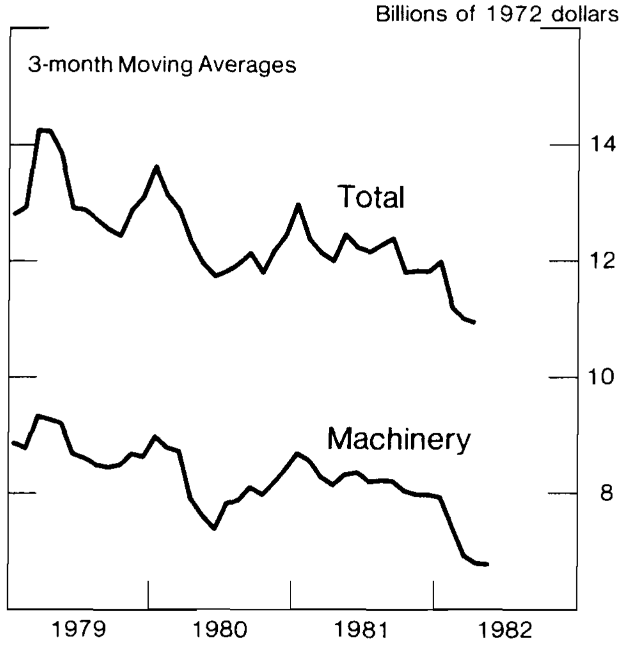
Mortgage Interest Rate



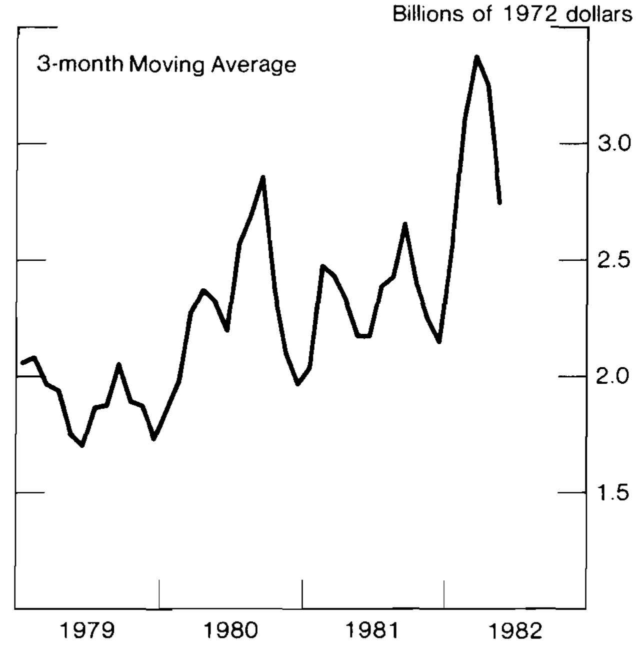
Housing Starts



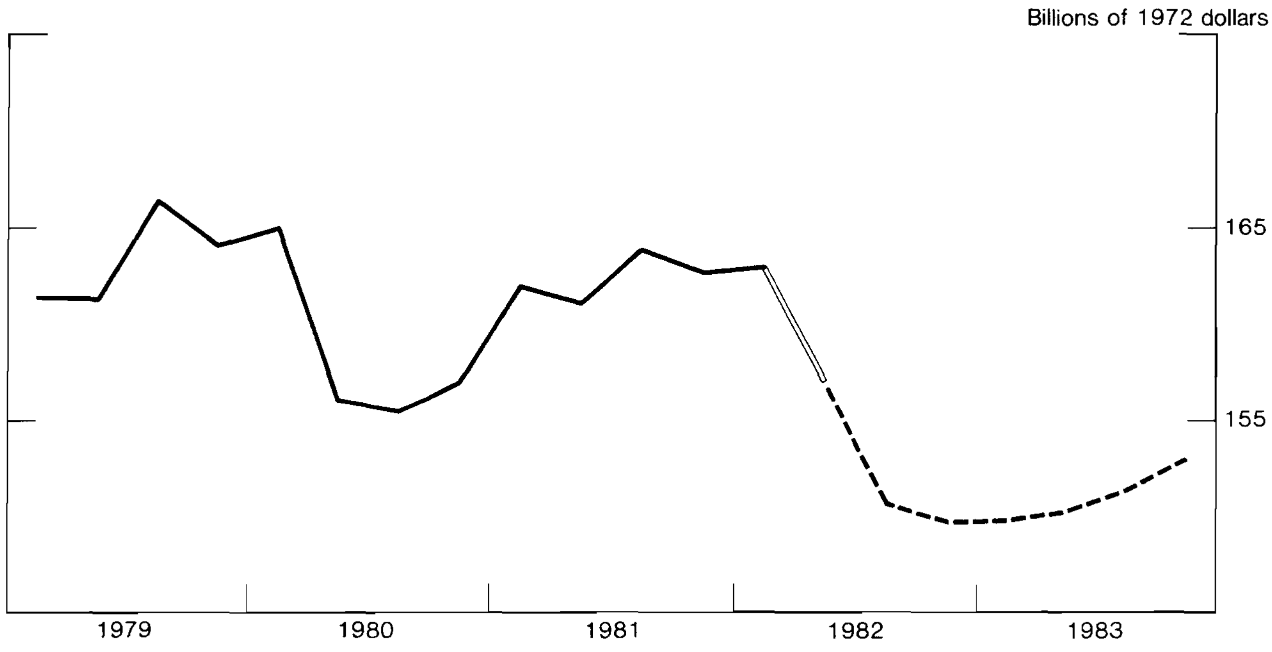
Real New Orders for Nondefense Capital Goods



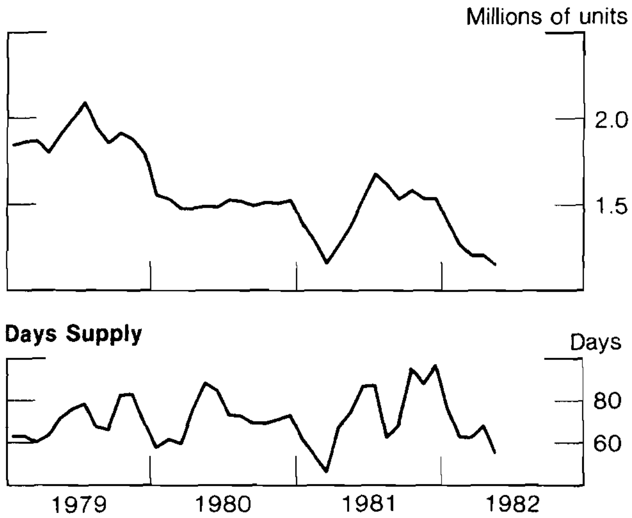
Real New Orders for Defense Capital Goods



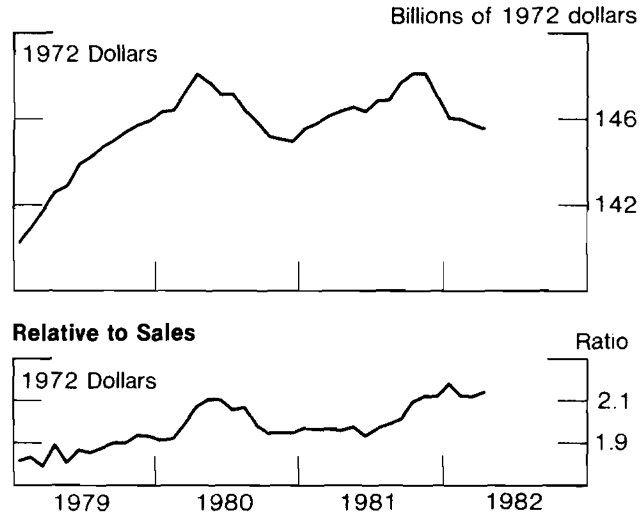
Real Business Fixed Investment



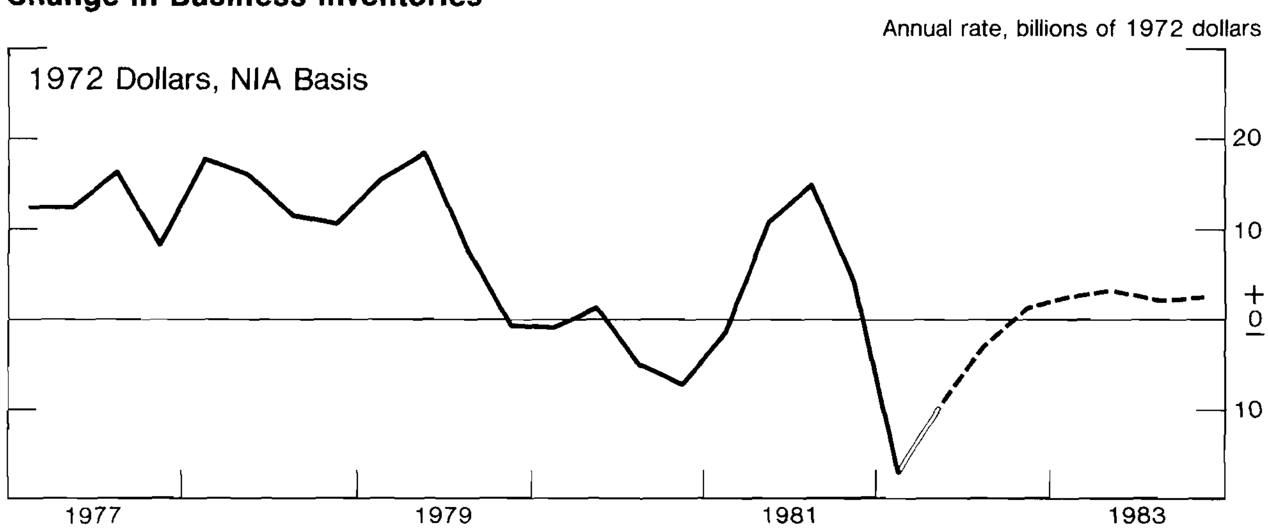
Domestic Auto Inventories



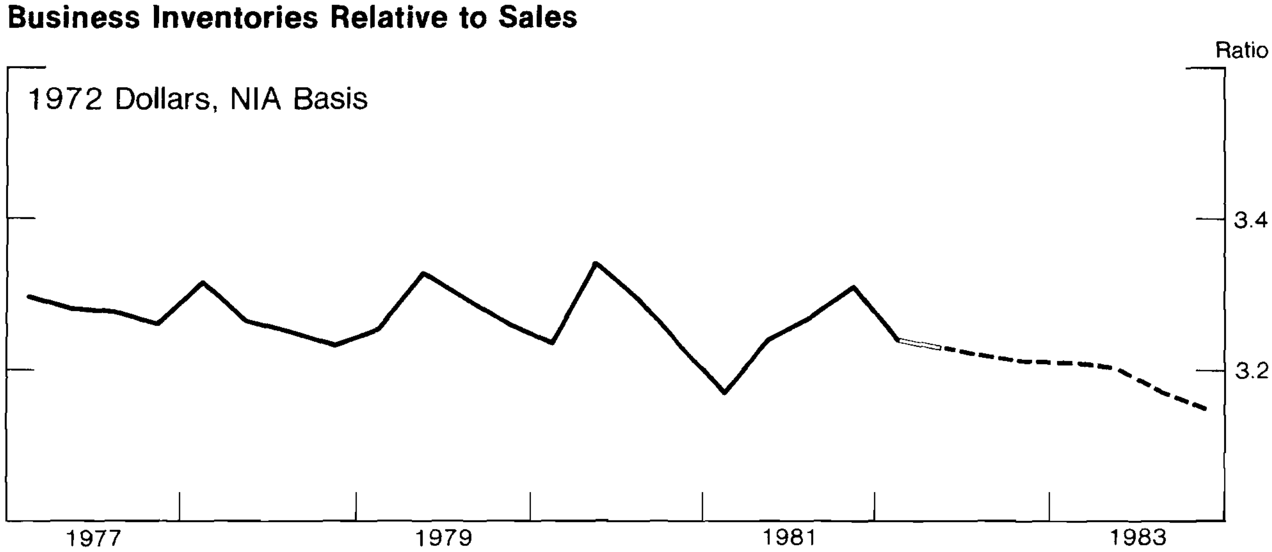
Manufacturing Inventories



Change in Business Inventories

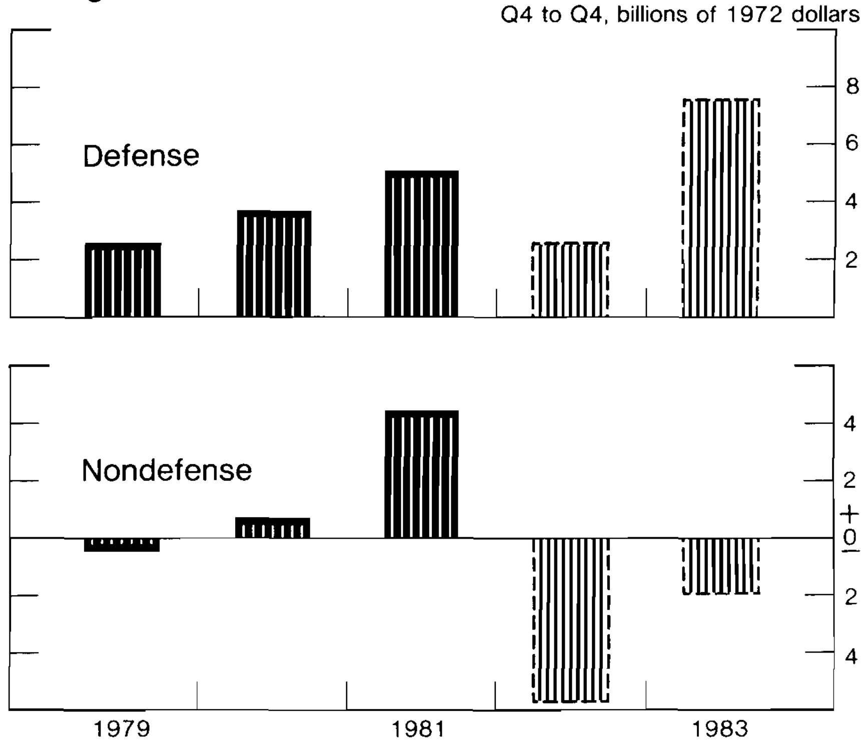


Business Inventories Relative to Sales



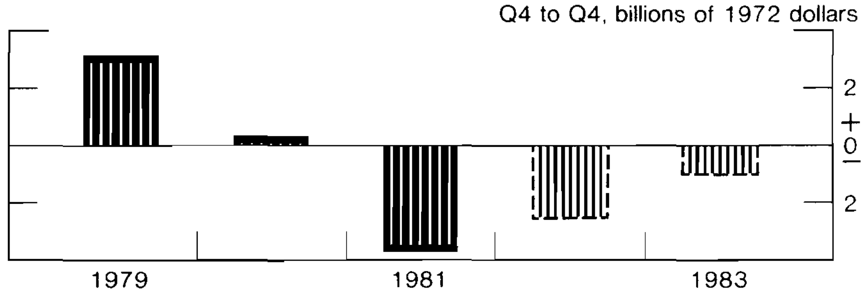
Change in Real Federal Government Purchases

Q4 to Q4, billions of 1972 dollars



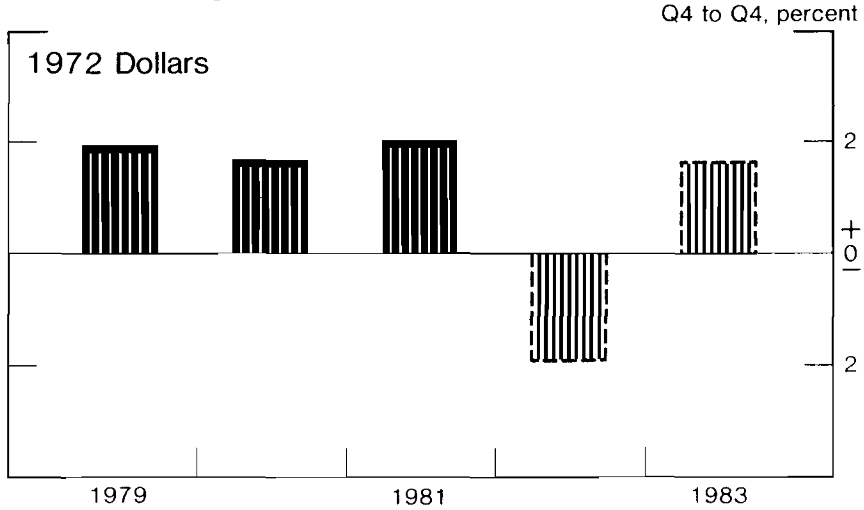
Change in Real State and Local Government Purchases

Q4 to Q4, billions of 1972 dollars

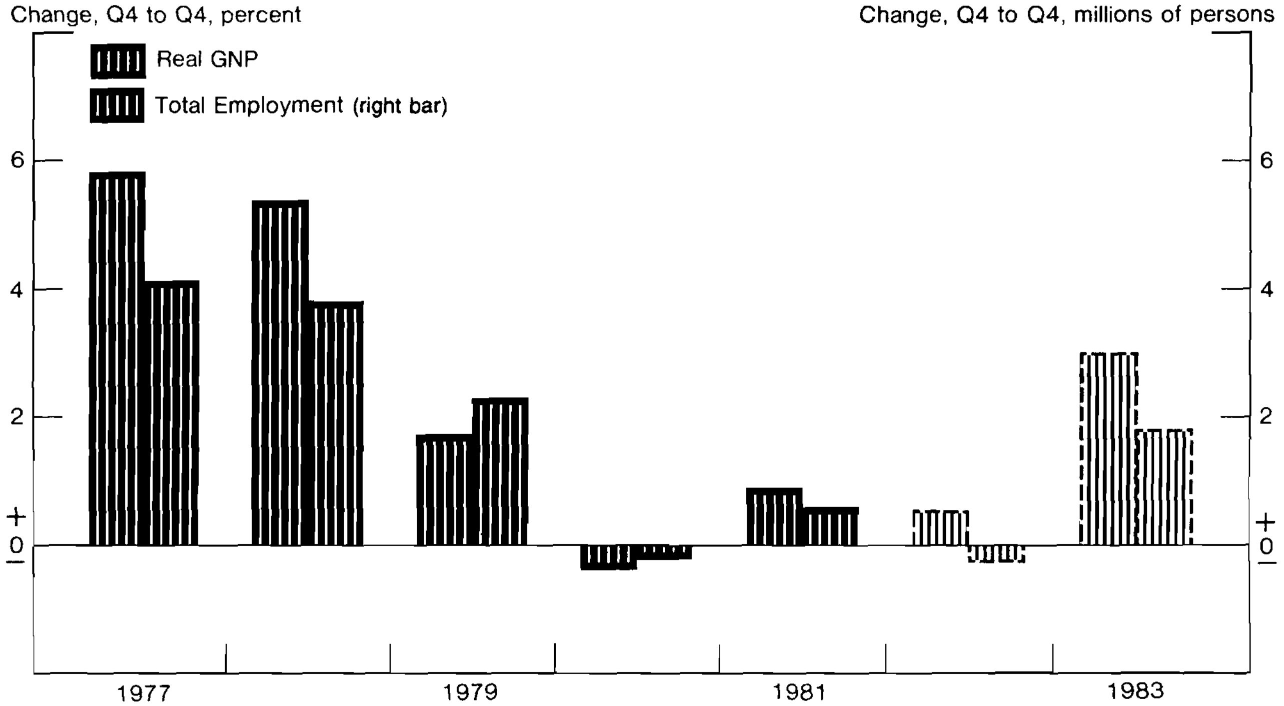


Percent Change in Real Total Government Purchases

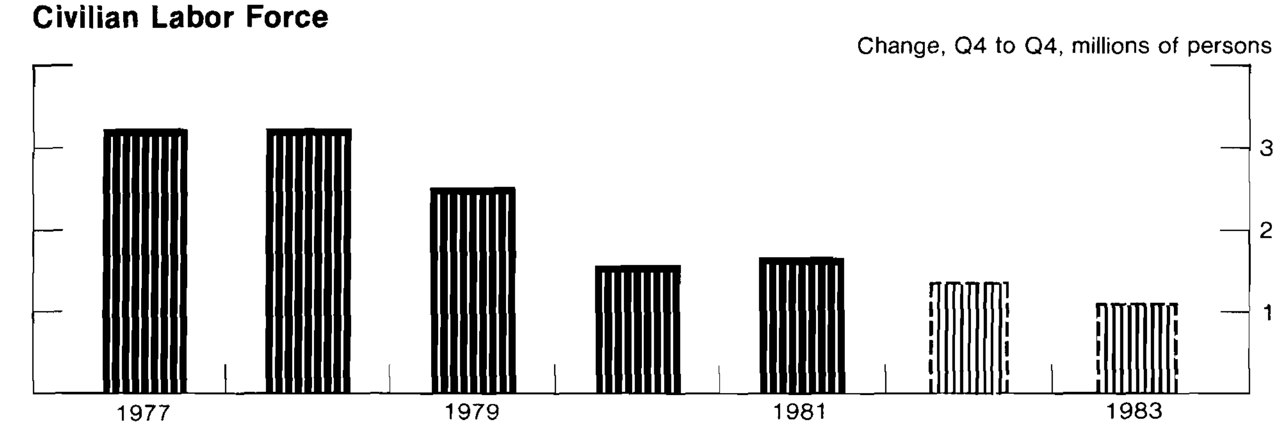
Q4 to Q4, percent



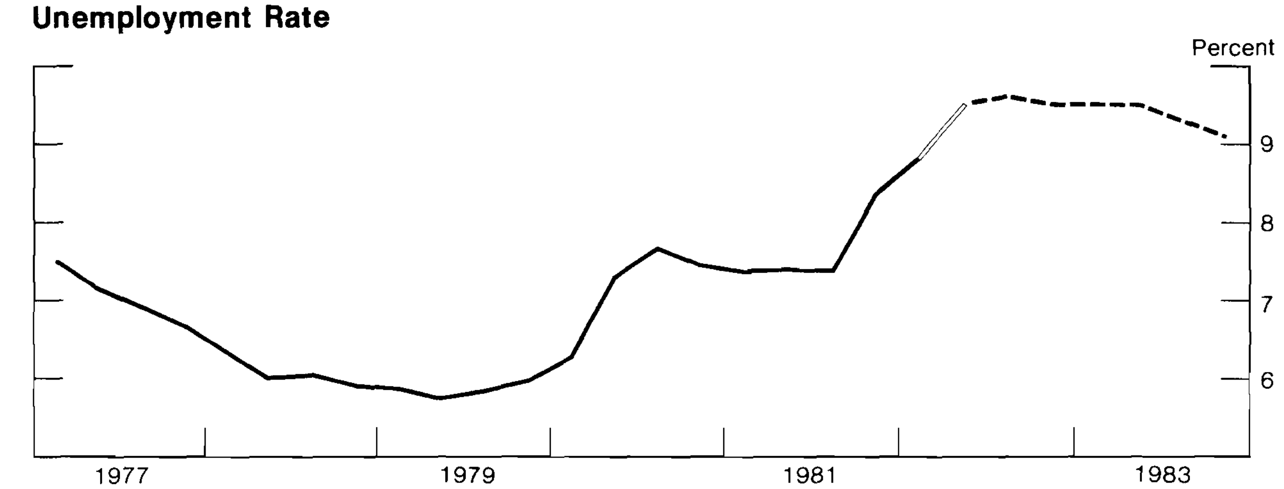
Total Employment and Real GNP



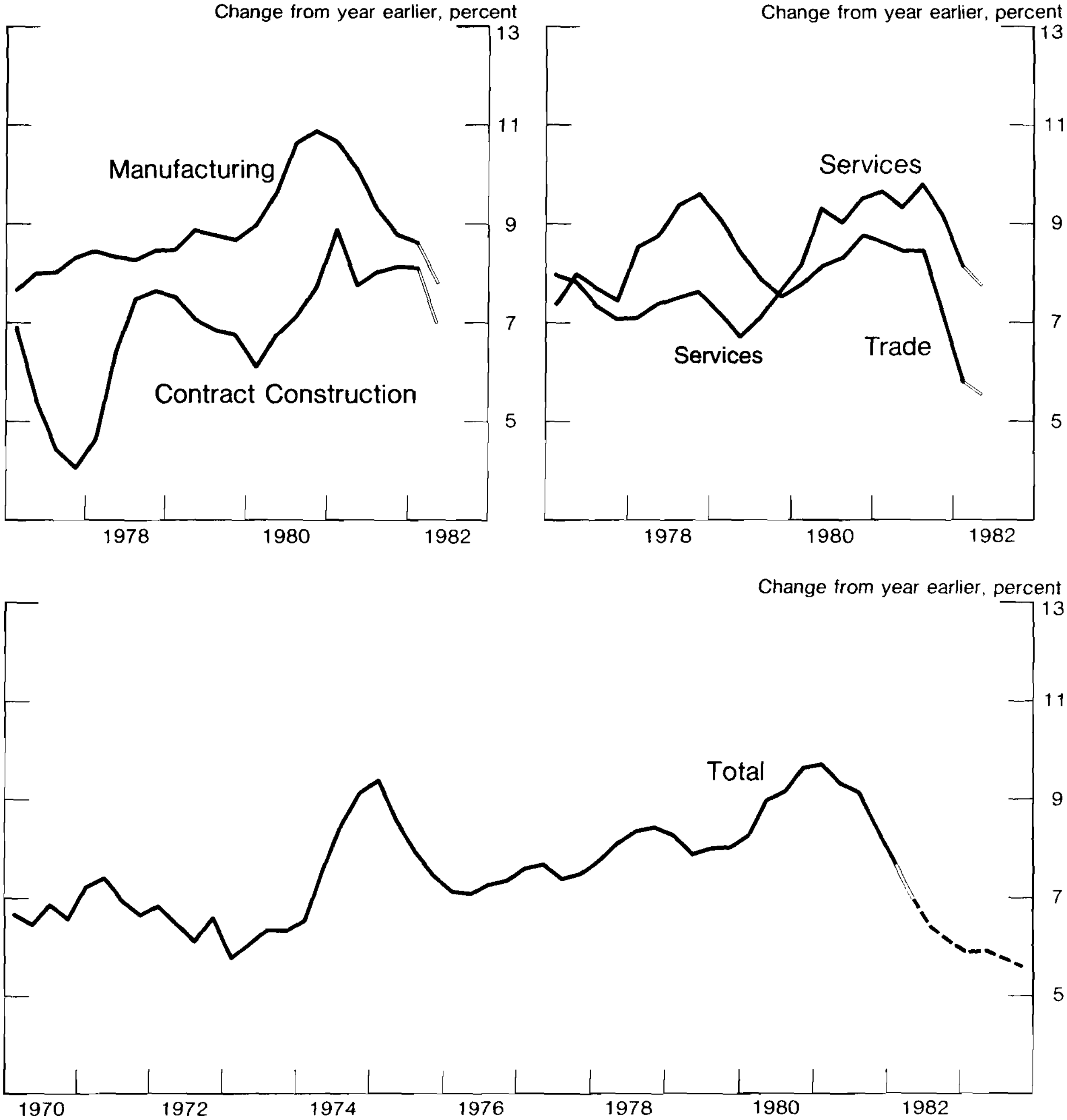
Civilian Labor Force



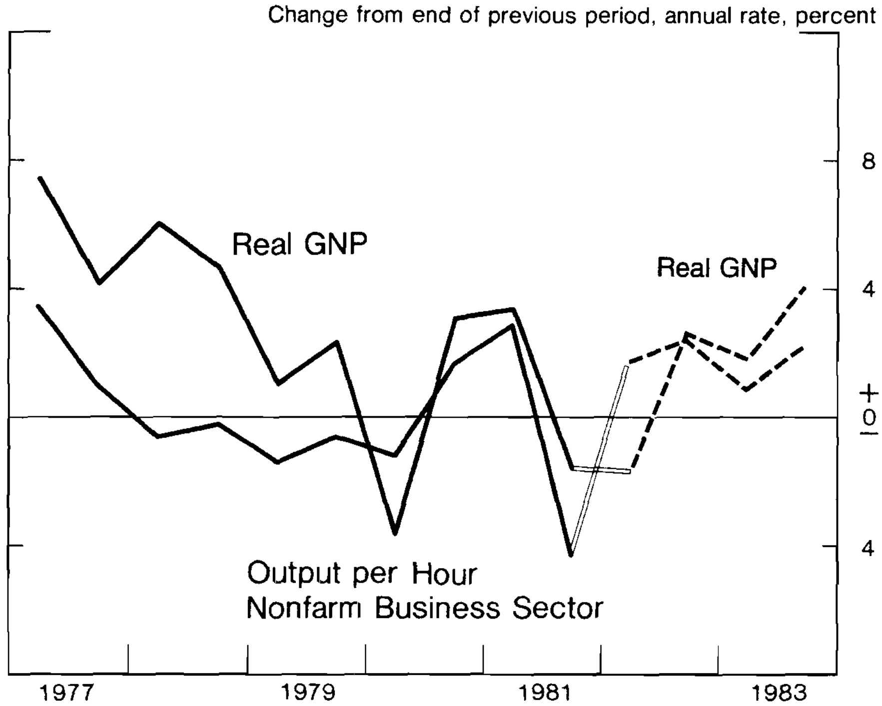
Unemployment Rate



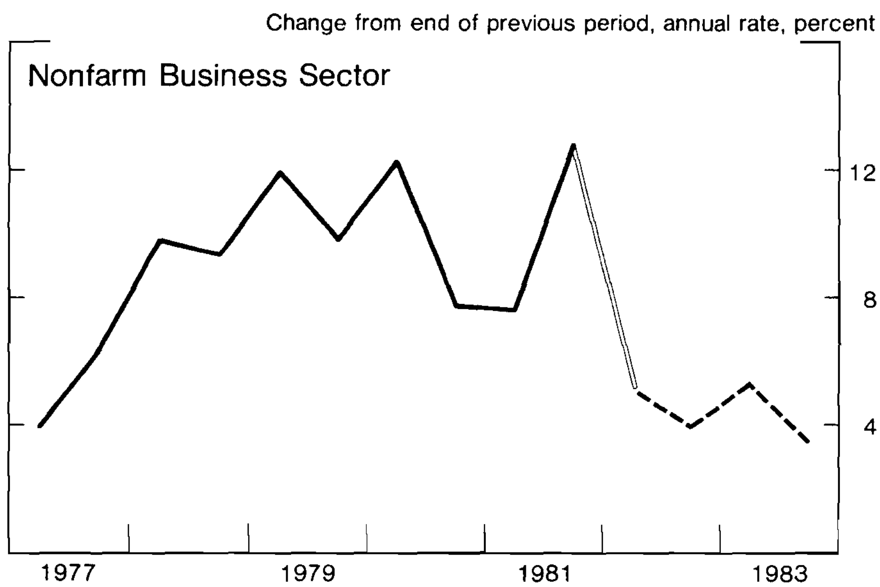
Average Hourly Earnings Index



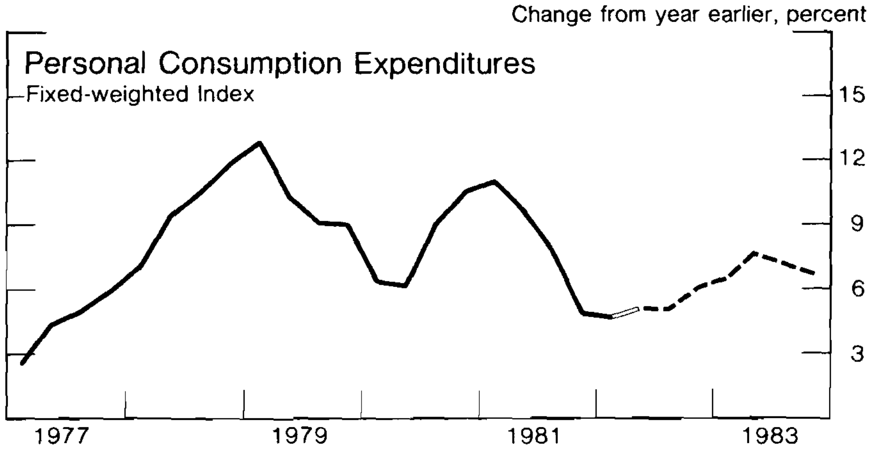
Output per Hour and Real GNP



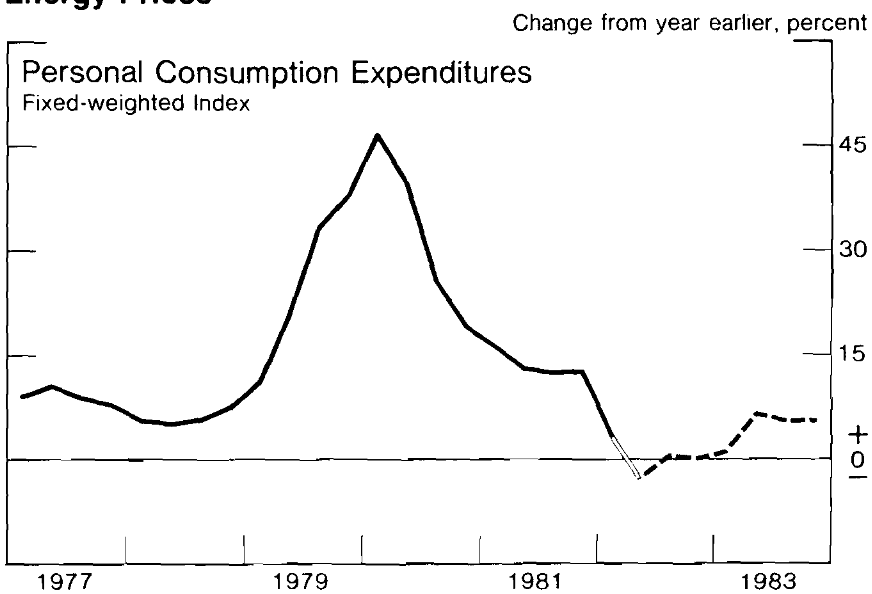
Unit Labor Costs



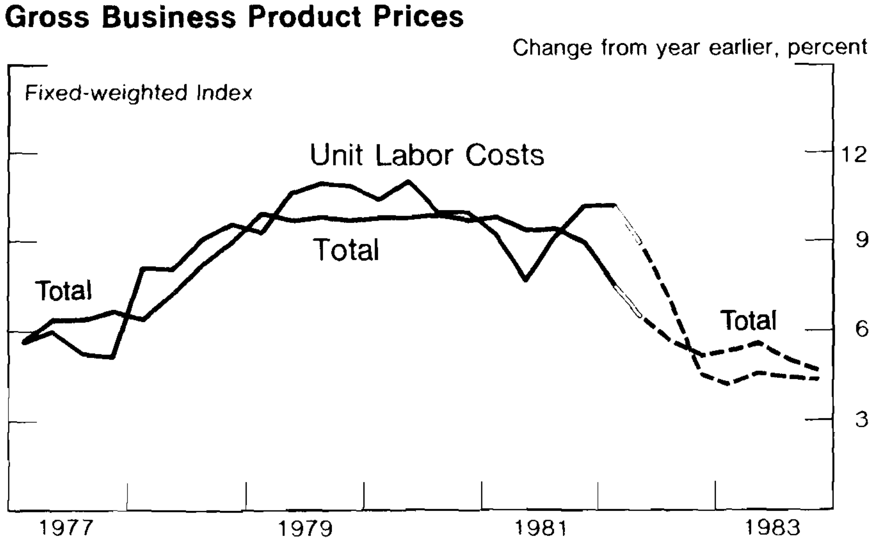
Food Prices



Energy Prices

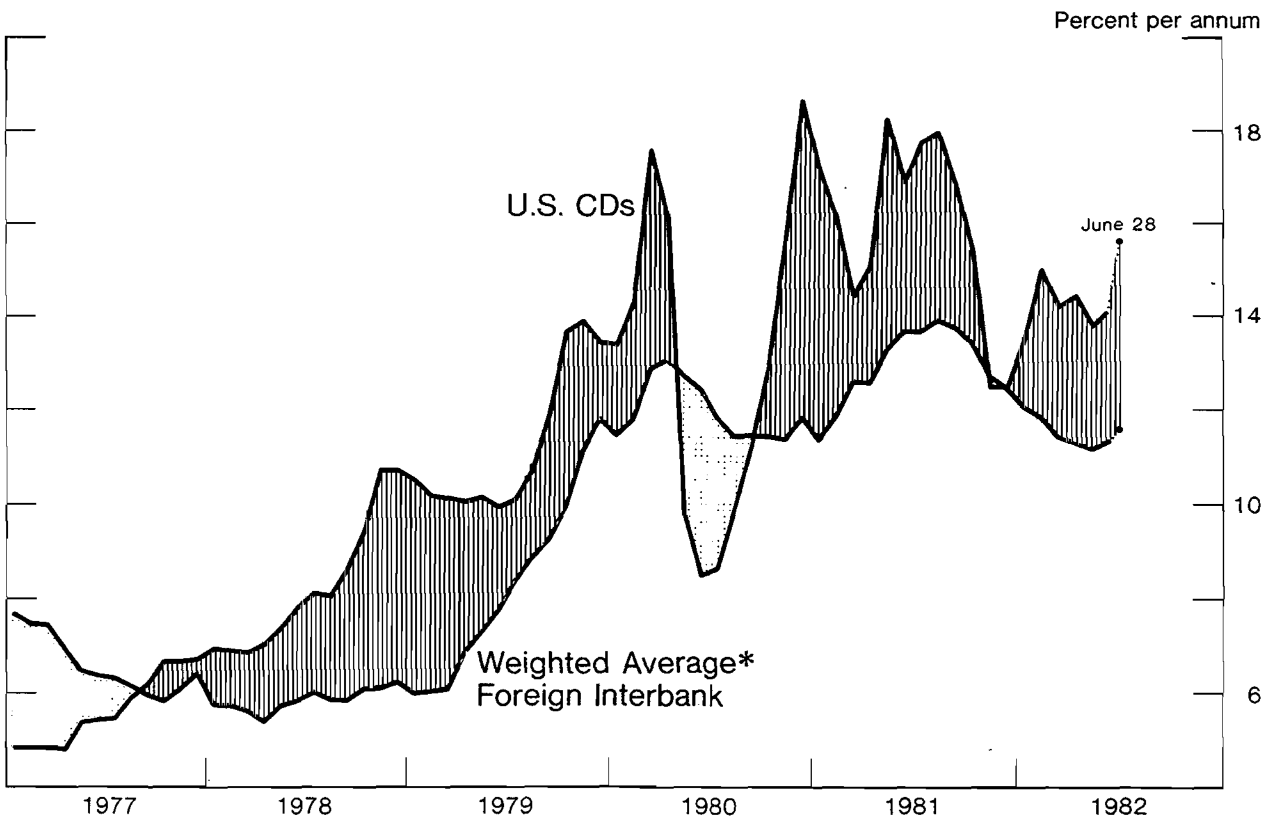


Gross Business Product Prices



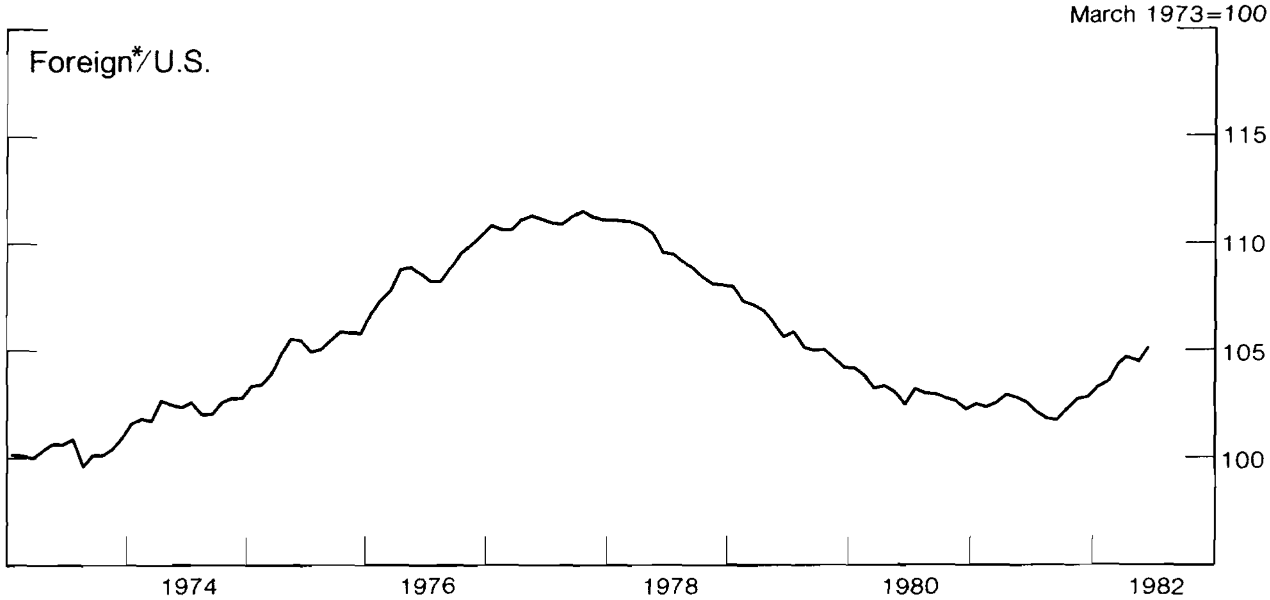
Foreign Exchange Value of the U.S. Dollar*

Short-term Interest Rates



*Weighted average against or of G-10 countries plus Switzerland using total 1972-1976 average trade of these countries.

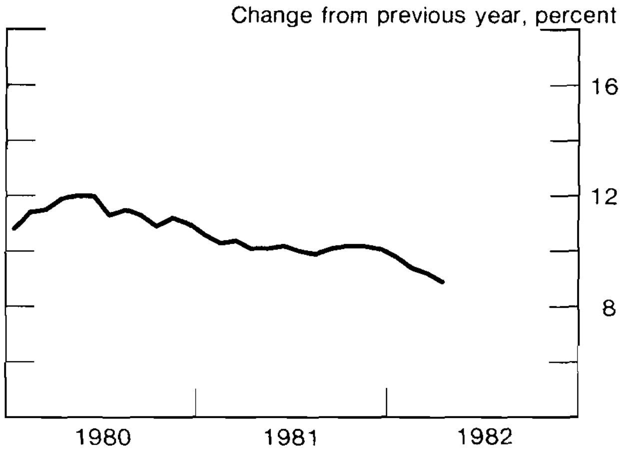
Relative Consumer Prices



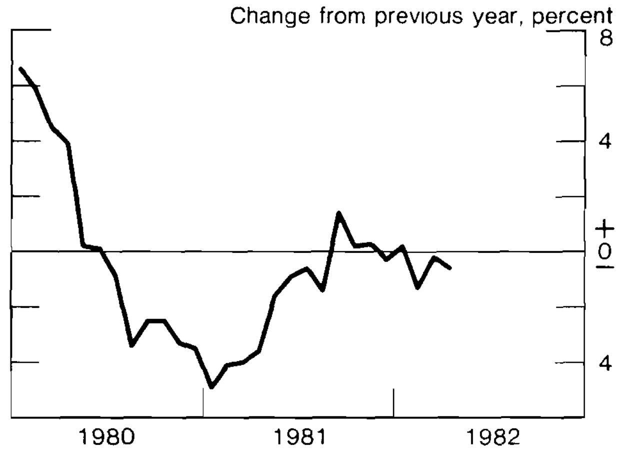
Nominal and Real Exchange Rates

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

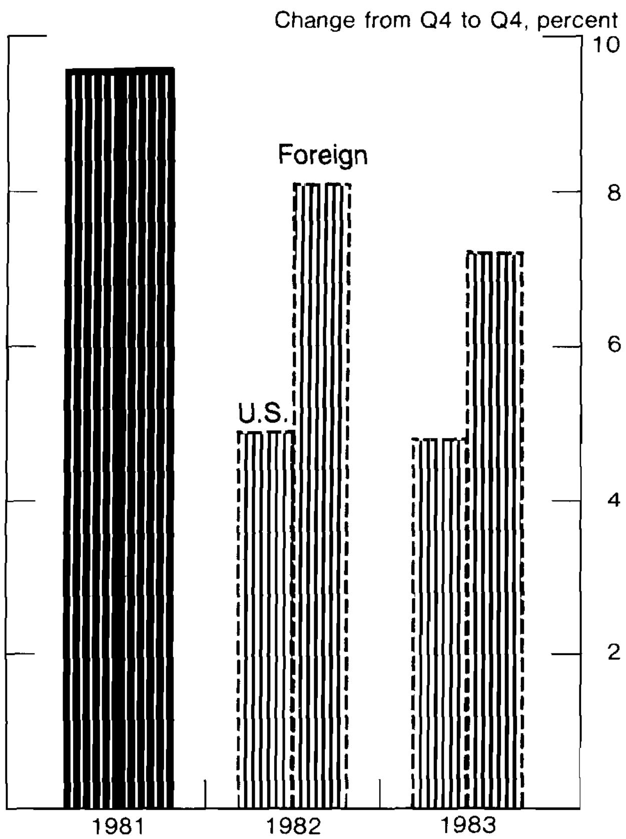
Foreign* Consumer Prices



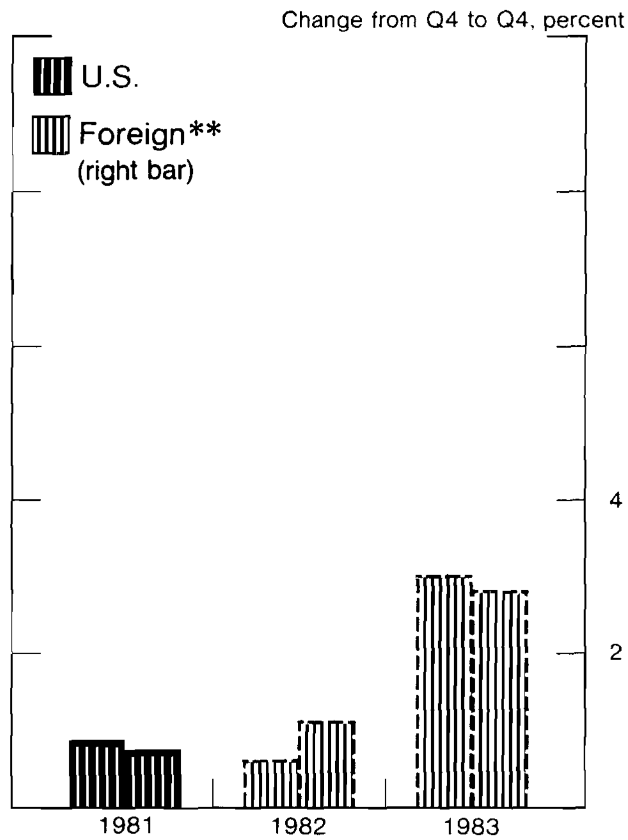
Foreign* Industrial Production



Consumer Prices



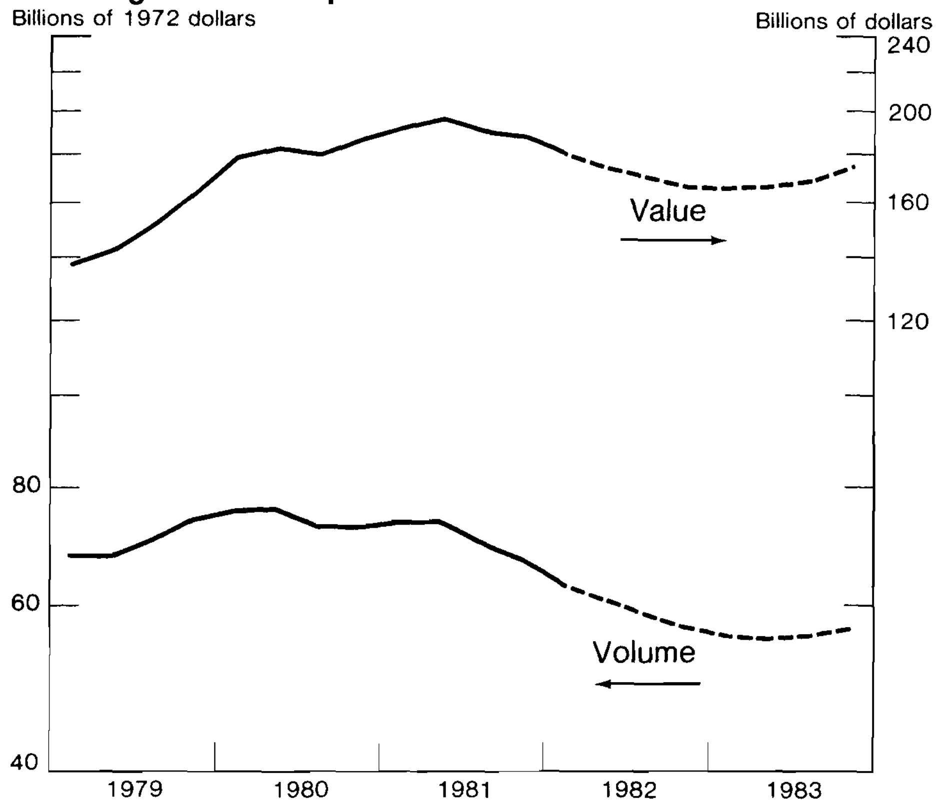
Gross National Product



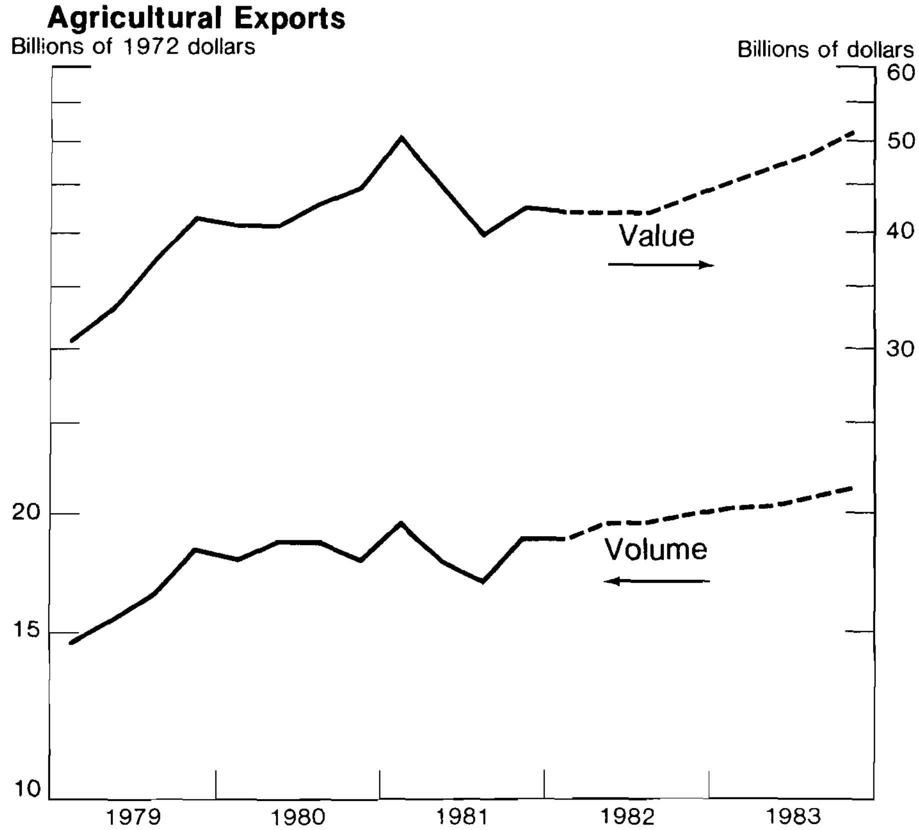
*Weighted average of six major foreign countries using total 1972-76 average trade of these countries

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

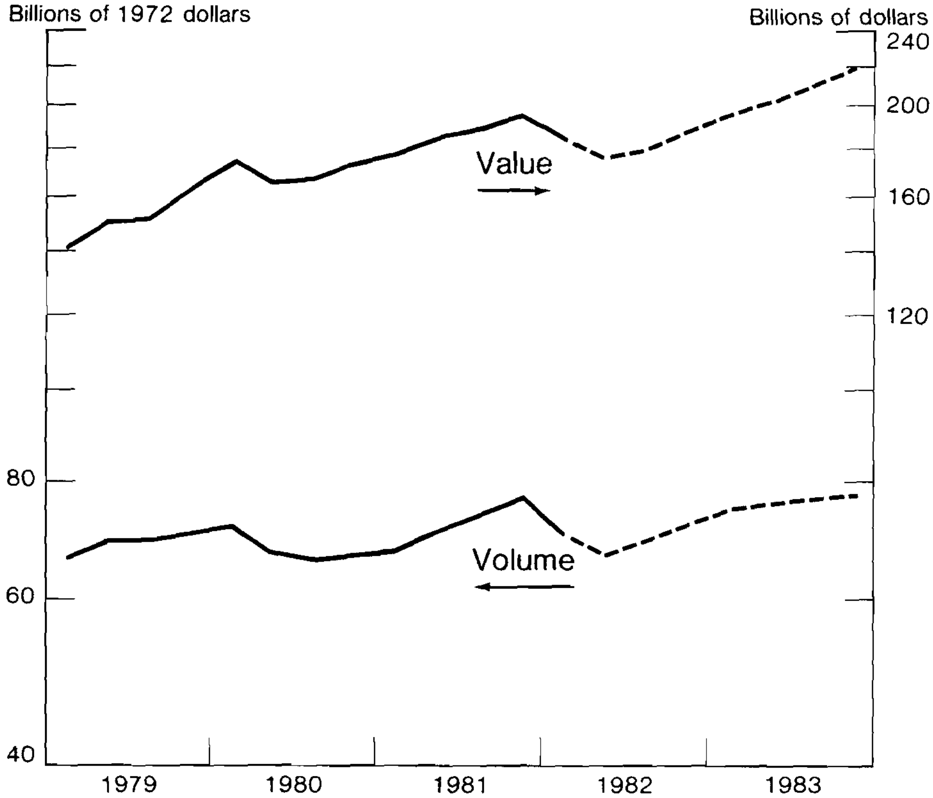
Nonagricultural Exports



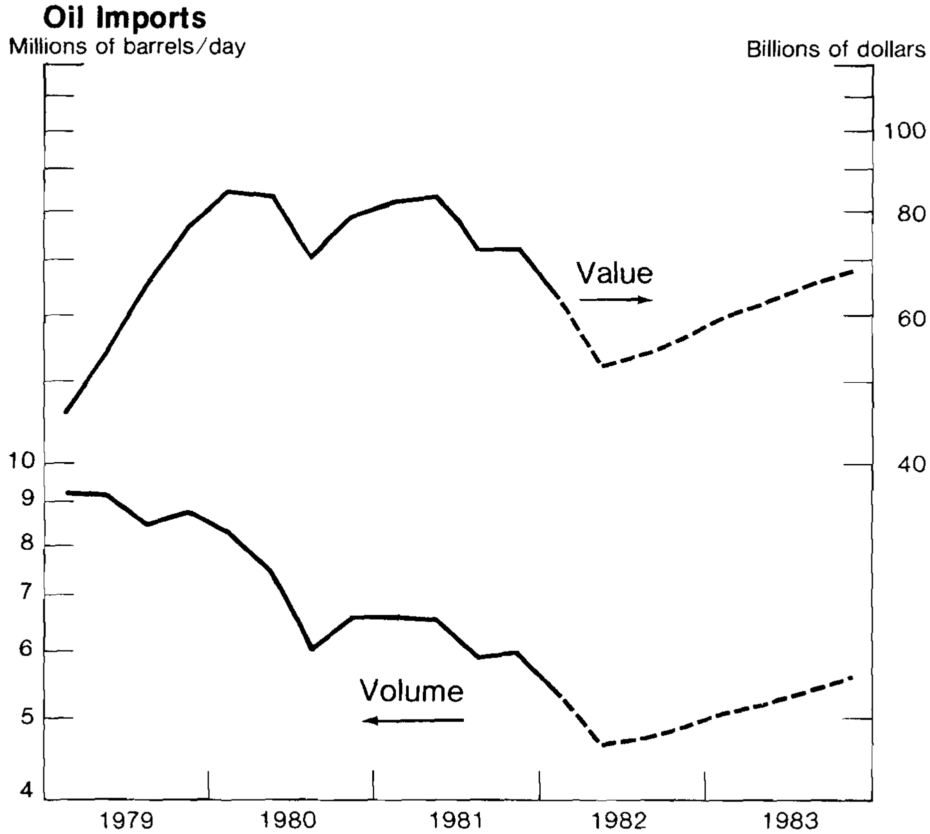
Agricultural Exports



Non-Oil Imports



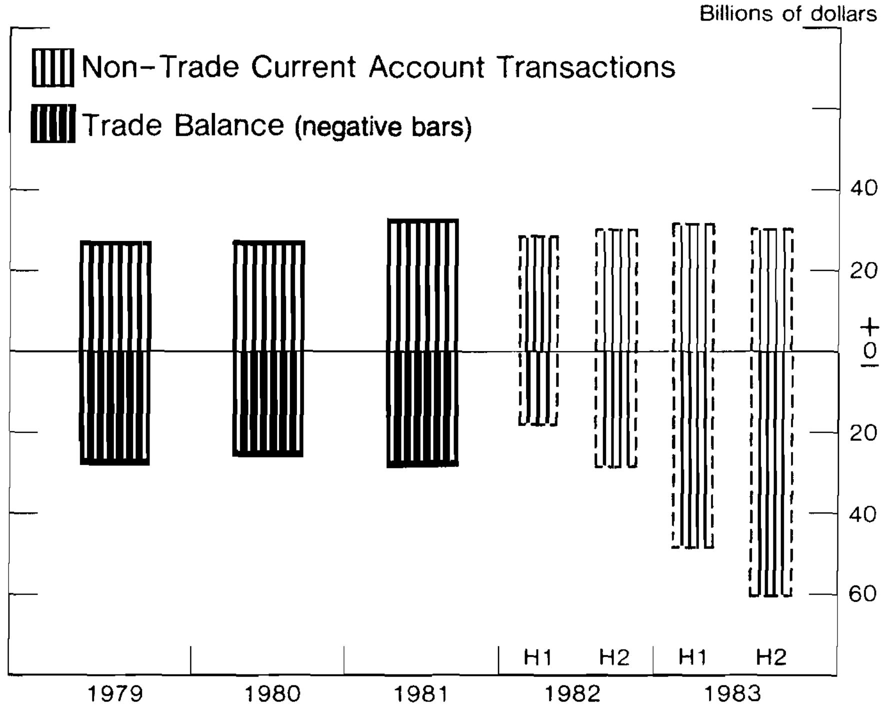
Oil Imports



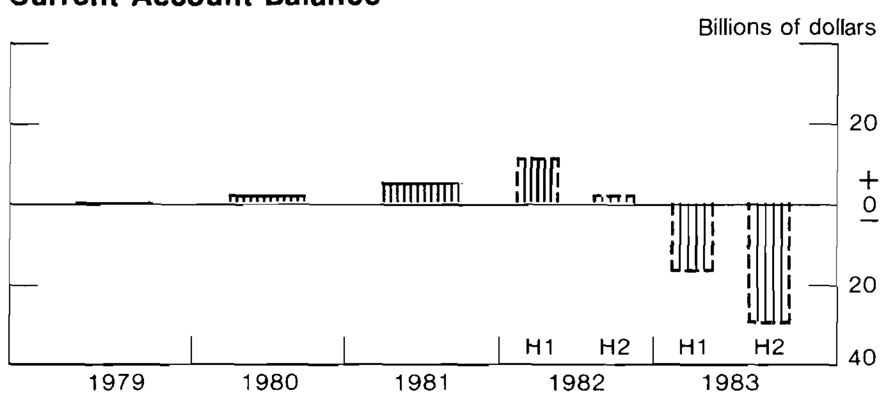
Average Price of Imported Oil

1979	$18.67
1980	30.46
1981	34.02
Projections	
1982	31.68
1983	33.15

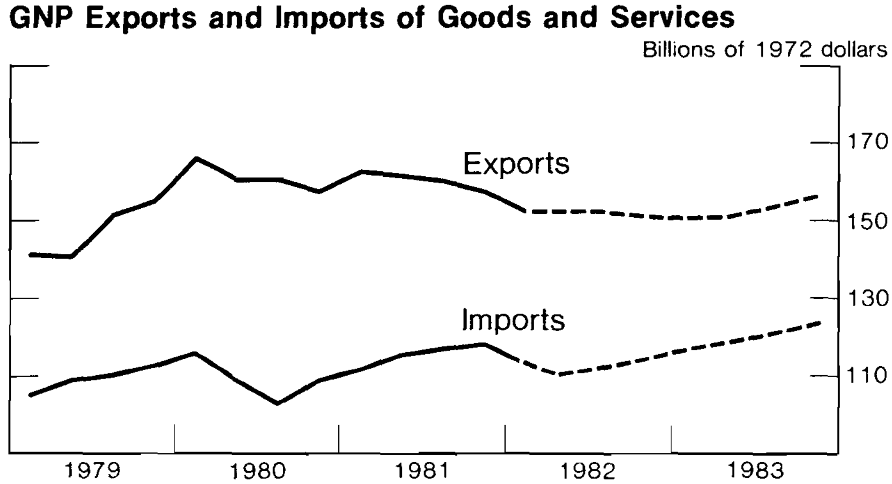
Current Account Transactions



Current Account Balance

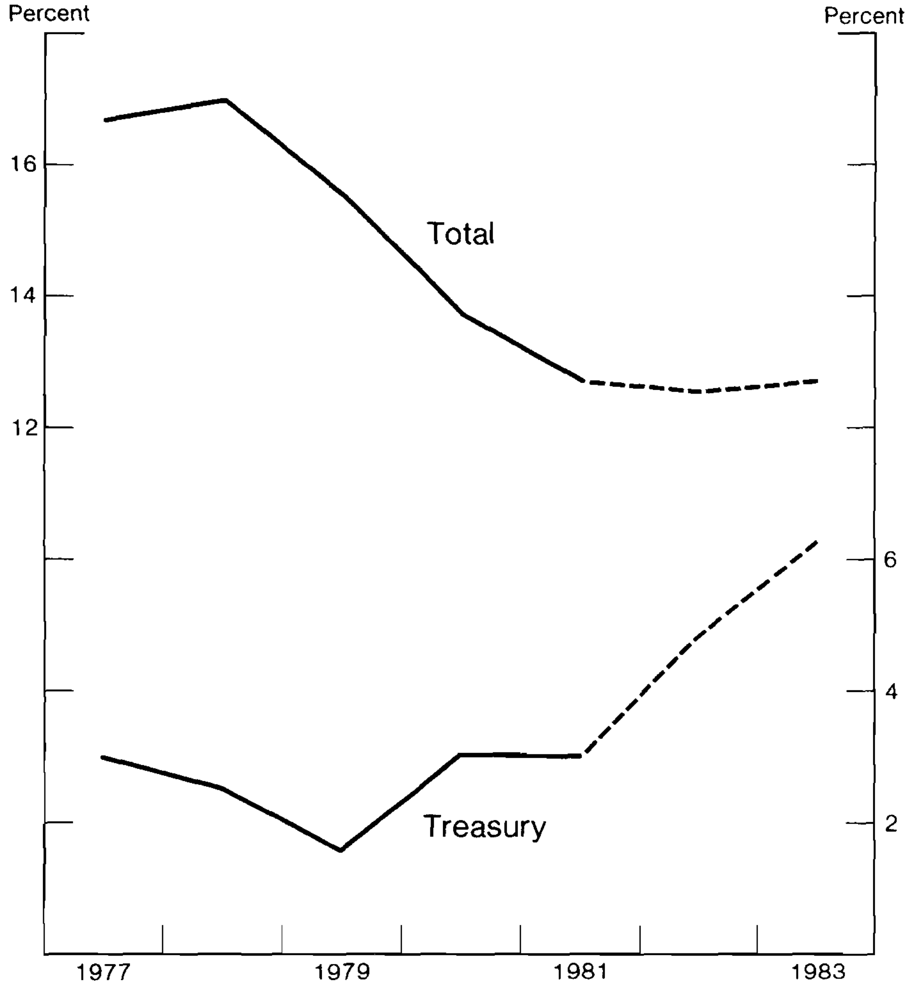


GNP Exports and Imports of Goods and Services



Funds Raised by Domestic Nonfinancial Sectors

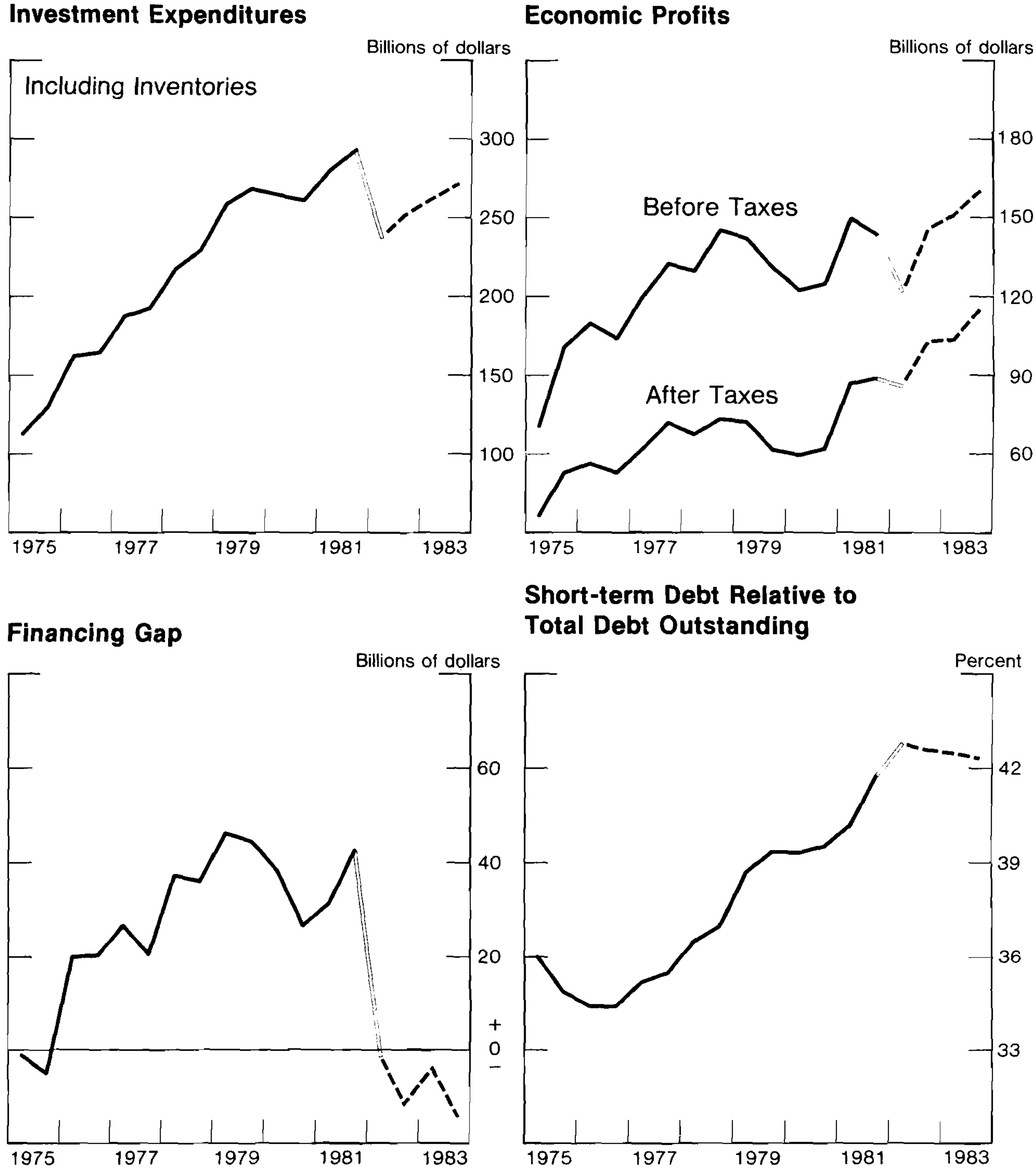
As a Percent of GNP

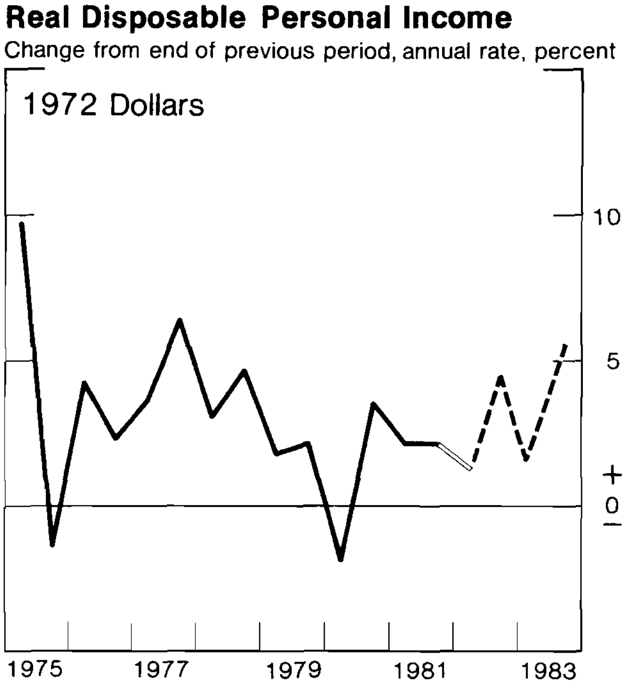


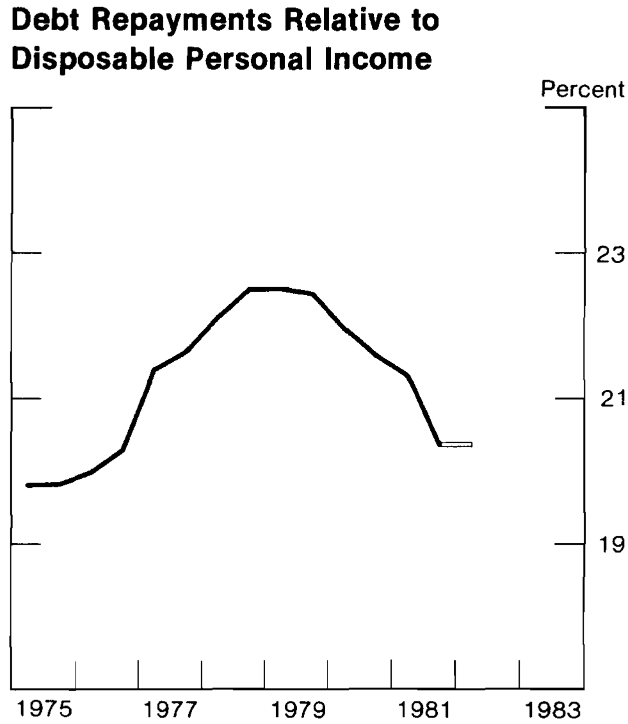
Billions of dollars

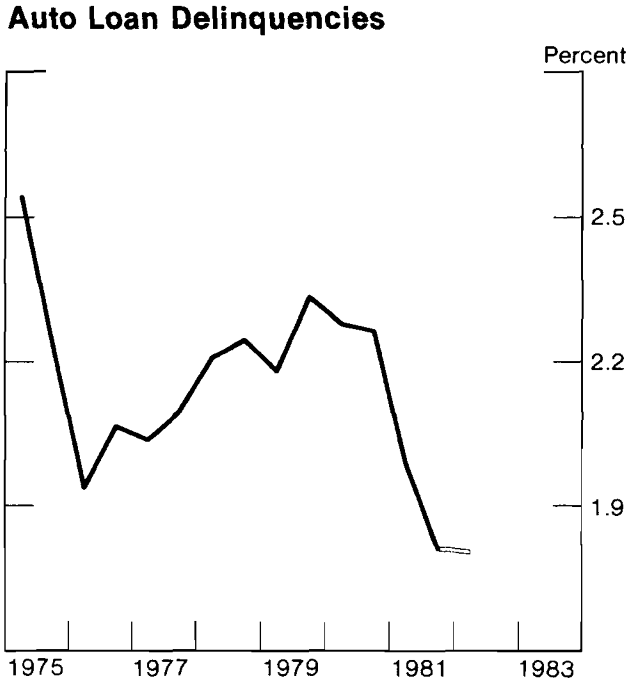
	1981	1982	1983
Total	371	386	420
Treasury	87	148	208
Other	284	238	212

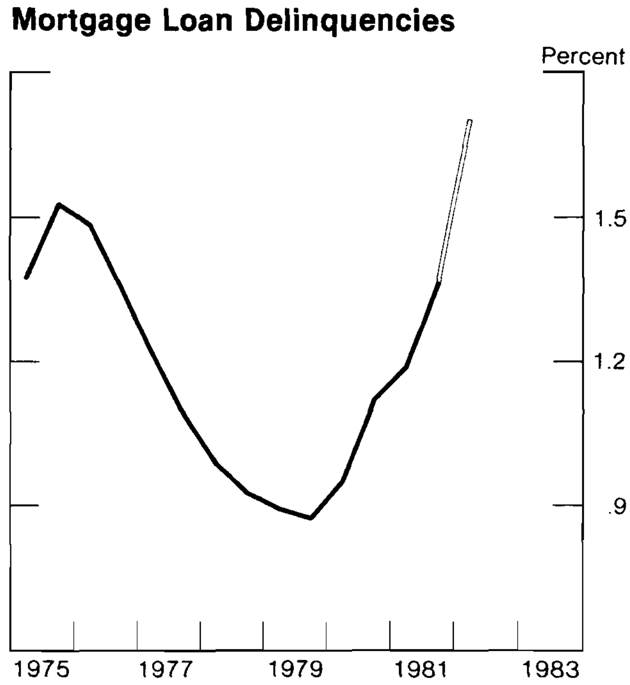
Nonfinancial Corporations




Real Disposable Personal Income
Change from end of previous period, annual rate, percent
1972 Dollars
10
5
+
0
−
1975
1977
1979
1981
1983


Debt Repayments Relative to Disposable Personal Income
Percent
23
21
19
1975
1977
1979
1981
1983


Auto Loan Delinquencies
Percent
2.5
2.2
1.9
1975
1977
1979
1981
1983


Mortgage Loan Delinquencies
Percent
1.5
1.2
.9
1975
1977
1979
1981
1983

Forecast Summary

	Board Members		Voting Presidents		Nonvoting Presidents		Staff
	Range	Median	Range	Median	Range	Median	
Change, Q4 to Q4, percent							
Nominal GNP							
1982	5½ to 7	6¼	6 to 7¼	6½	5½ to 7½	6½	5¾
1983	7 to 9	7½	7¼ to 9½	9	7 to 9½	8½	7½
Real GNP							
1982	0 to 1¼	1	½ to 1½	1	0 to 1½	1	½
1983	2 to 3	2¾	2 to 3½	3¼	1½ to 4	2½	3
GNP Deflator							
1982	4¾ to 5½	5½	5 to 6	5½	5¼ to 6½	5½	5¼
1983	4½ to 5½	5	4 to 6	5½	4¾ to 7	5½	4¼
Average Q4 level, percent							
Unemployment Rate							
1982	9¼ to 9¾	9½	9 to 9½	9½	9 to 9¾	9½	9½
1983	8¾ to 10	9	8 to 9¼	8¾	8½ to 9½	9	9

PAUL MEEK

NOTES FOR FOMC MEETING

JUNE 30, 1982

Open market operations proceeded rather routinely between Committee meetings. To be sure, the Drysdale and Comark affairs, on which I will touch later, proved rather unsettling to the securities markets. But desk operations, though mindful of market sensitivities, continued to be addressed to reserve objectives. Estimates of growth in the monetary aggregates were not far from the Committee's desires during much of the period, and despite unexpected strengthening in the first half of June, both M1 and M2 growth appear on the latest evidence to be close to the Committee's guidelines. Since the M1 weakness of late June will affect reserves only in July, total reserves appear to be coming in about $150 million above path during the past six weeks. Adjustment borrowing is likely to be about $250 million on average above the $800 million adopted by the Committee at its last meeting for drawing up the nonborrowed reserve path.

The implementation of policy during the six weeks was affected by the usual vagaries of reserve forecasting and bank borrowing behavior. In the first half of the period, bank recourse to the discount window was heavier than was consistent with the reserve path, notably in the June 9 week when reserves on the final day fell far short of expected levels. Even so the Federal funds rate moved down from the 14 1/2 percent plus rate prevailing at the time of the last meeting to about 13 1/2 percent as seemed consistent with the path. The nonborrowed reserve path was adjusted downward by a total of $61 million in three weeks to allow for the apparent shift in borrowing demand. Subsequently, in the past two weeks, demand for total reserves rose above path, reflecting M1 strength in early June, and technical adjustments were taken to the extent that the intended borrowing gap rose to just over $1 billion. Full adjustment for technical factors last Friday would have caused the borrowing gap to jump to $1.3 billion, but this seemed inappropriate on the eve of the Committee's meeting. However, banks did, in fact, borrow heavily over the last weekend as they prepared for the June 30 statement publishing date, so that borrowing will probably be about $1.5 billion for the week. In the last two weeks, the Federal funds rate rose first to around 14 percent and then above 14 1/2 percent in the past week when preparation for the June 30 statement date pushed up the rate.

In the securities markets yields moved sharply higher over the interval, although there has been a partial reversal in recent days. The pressure exerted by open market operations on the banks was about the same at the end of the period as at the beginning. Initially, as the Drysdale affair broke and the System's more accommodative posture became apparent, Treasury bill rates dropped 50 to 100 basis points and intermediate securities rose in price.

But after the Memorial Day weekend there was an abrupt change in sentiment. Dealers had built up positions in expectations that a sluggish economy would result in declining short-term rates, which would encourage investors to move out to longer maturities. In early June their patience ran out as investors failed to follow their lead to lower yields in the five-year note auction. They began selling aggressively to lighten positions before the onset of heavy Treasury financing in late June and an expected bulge in M1 in July. Accumulating evidence that the recession was bottoming out reinforced the shift to caution. The Drysdale and Comark affairs also kept the market off balance, as successive waves of credit reevaluation contributed to investor caution and dealer retrenchment. The rise in the Federal funds rate in late June also added to market edginess. By June 25 dealer outright holdings of Treasury issues maturing beyond one year had dropped by $4.9 billion below their May 28 levels, with changes in futures positions providing an offset of roughly $1.7 billion. The Treasury itself raised $8.2 billion through coupon sales from mid-May through the end of June.

Passage of the budget resolution brought little lift to the market. The hopes of a major improvement in the budget outlook had been substantially attenuated by the time Congress reached agreement. Market forecasters are now looking for the fiscal year 1983 deficit to range from $120 billion upward to $160 billion or more. Their expectations are that the Treasury will have to raise about $40 to $55 billion through sales of marketable issues in the third quarter. The Treasury would not be surprised by a figure in the mid-40's. The Administration's mid-year budget review in about two weeks will bring an update on current estimates. An enlargement of the debt ceiling lasting until the end of September was accomplished, but the Treasury is still seeking legislative authority to resume bond sales.

Market expectations are that the Treasury's market borrowing over the next six months could be close to $100 billion, compared with $59 billion in 1981. The New York Bank estimates indicate a $120 billion borrowing need. Anticipation of the sale this week of $4 billion each of four-year and seven-year issues contributed to the recent rise in yields. In the event, prices recovered sharply after Tuesday's sale of four-year notes. The seven-year note is now expected to be well bid for tomorrow at 40 basis points below the 15 percent yield being talked about last week. Over the last six weeks, Treasury bill rates have risen by 30 to 90 basis points, while yields on Treasury notes and bonds have risen by 65 to 100 basis points. Corporate and municipal yields also rose considerably with congestion showing up the municipal market on occasion.

The Drysdale collapse, and the more orderly winding down of Comark's business, have exerted a pervasive sobering influence on market participants since mid-May. Dealers' customers have been significantly less willing to supply securities to dealers, which use them in matched-book operations or for short sales. Nonbank dealers operating without a large capital base have also had to pay somewhat higher rates than banks or large dealers for financing their positions. A few dealers have had to deal with rumors about their financial condition at a time when most participants have been scrutinizing carefully the credit standing of those with whom they trade. Not surprisingly, the volume of trading activity has receded, especially in coupon securities. The extent of the backup in Treasury yields doubtless reflects in some degree the increased caution evident in trading among both dealers and customers.

The renewed emphasis on credit quality has also been reflected in the markets themselves. The spread between CD and Treasury bill rates widened by about 50 basis points over the last half of June, although this reflected in part bank eagerness to pre-fund July maturities because of changing rate expectations. Commercial paper rates also rose relative to Treasury bill rates, and rates on A2/P2 paper widened versus those of A1/P1 paper. Despite these ripple effects, the short-term markets have continued to function well. We feel that the industry has the financial strength, even after recent reverses, to continue to make markets and underwrite Treasury offerings, albeit with wider margins for protection than obtained earlier this year.

In the wake of these disturbances, we have been exploring vigorously the steps that we and the dealers need to take to remedy the deficiencies revealed by the Drysdale and Comark affairs. We are actively pursuing changes in the RP market that would materially reduce the possibility that another Drysdale-type operation could develop. We are also in the process of upgrading the standards we set for Government securities dealers to qualify for the reporting list and a trading relationship with the desk. We are developing plans to strengthen considerably our monitoring of dealers as well as to be more active in developing improved market procedures with the dealers in several areas of mutual concern. Together with our associates in bank supervision, we are also reviewing the operational and credit approval processes used by the major banks to monitor and control their securities clearance operations.

NOTES PREPARED FOR THE FOMC MEETING
June 30 - July 1, 1982

Margaret L. Greene

Mr. Chairman:

Just about the time of your last meeting, a month-long decline of the dollar came to an end; and ever since the dollar has risen strongly, almost without interruption. It reached its peak against most currencies early Monday, the last day for trading before the quarter-end. At that point, the dollar was up 5 percent against sterling and the Canadian dollar, about 7 percent against the German mark and currencies that trade roughly in line with the mark, and 9 percent against the Japanese yen. It advanced even more (14 percent) against the French franc which, along with the Italian lira, was devalued within the EMS over the weekend of June 12-13. With the passing of quarter-end, however, the dollar has eased back 1 1/2 percent across the board by today in generally light trading.

The dollar's strength reflected in some measure a market view that, even after some reassessment during April-May, many of the fundamentals were still favorable to the dollar. There was growing sentiment that the U.S. was making sustainable progress in its fight against inflation as more evidence pointed to a moderation of wage demands in the United States. Also, our balance of payments position looked comfortable enough for this year with strong investment income apparently expected to cushion the effects of any deterioration of the trade account. Moreover, the dollar continued to benefit from a desire for security in the face of political uncertainties. At a time when the international landscape was cluttered with military conflicts around the world, the relatively stable political climate in the

U.S. was attractive to investors from abroad. And, although there continued to be frustration and disappointment over the debate about fiscal policy in the U.S., similar policy controversies were taking place in a number of countries abroad. In Germany, for example, a budget dispute threatened the survival of the Schmidt government and both political parties in that coalition suffered local election setbacks. Also in France, opposition to a post-devaluation austerity package provided the first serious domestic test for the Mitterand Government.

The main factor behind the dollar's gains, however, was a sharp reversal of the widespread expectation, or perhaps hope, that U.S. interest rates would hold steady or decline further. This shift occurred as markets became concerned about the possibility of a renewed money supply bulge in July, the heavy financing needs of the Treasury, the evident strength of private credit demands, and the creditworthiness of counterparties in the market. In effect there developed by mid-June a further sudden increase in the liquidity preference in all dollar markets that happened to coincide, and possibly exaggerate, the pressures that normally appear as banks prepare for their end-June statements and for the heavy buildup of loan rollovers scheduled at that time. The bidding for short-term funds in the Euro-markets and elsewhere put sharp upward pressure on Euro-dollar rates and, to a smaller extent, also on the short and long-term interest rates for other currencies. By early this week the differentials against the mark were, for instance, almost 7 1/2 percentage points for three-month deposits and about 4 1/2 percentage points for 10-year government bonds. As this process developed, the dollar was marked up in trading that was quite choppy and frequently produced abrupt and unexplainable movements in rates.

With the passing of quarter-end pressures and no new development to incite more concern over creditworthiness of counterparties, short-term interest rates have eased back from their peaks. By now, three-month Euro-dollar rates have retreated almost 1 percentage point and the differential vis-a-vis three-month Euro-marks was lower by about 3/4 of a percentage point. But the markets remain vulnerable to any new financial or political development.

During this period that the dollar was rising, a number of currencies came especially under pressure. Among those was the French franc which came under repeated bouts of speculative selling in late May and early June, reflecting market conviction that French economic policy would result in continued inflation and repeated devaluations of the currency within the EMS. And then, over the June 12-13 weekend, the French franc and the Italian lira were devalued, and the mark and Dutch guilder revalued, the total change in the mark-franc parity amounting to 10 percent. This realignment coincided with a number of politically unsettling developments, including the death of the king of Saudi Arabia and a breakdown of the first cease fire in the conflict in Lebanon. In this environment, on Monday June 14, a significant portion of post-realignment speculative reflows from the strong EMS currencies came into dollars instead of francs, and the dollar rose considerably. As the dollar continued to move up in trading in New York, the Desk intervened on behalf of the Federal Reserve and the Treasury jointly to sell $21 million against German marks and $9 million against Japanese yen. That the Desk had intervened was publically announced by the Treasury soon after the fact, generating market rumors of concerted central bank action that dampened the dollar's rise for some days thereafter.

Apart from the United States, other central banks intervened during the period to sell a net $6 billion. Although this represents a sizable amount of intervention, it is smaller than for other periods of equal length in which the dollar was well bid during the past year. By far the largest seller was the Bank of Canada, inasmuch as the Canadian dollar was one of the other currencies to be under especially severe pressure in the face of a strenuous debate over the direction of economic policy there. In addition, the Bank of France intervened in dollars as well as EMS currencies to support the franc at its lower band in that arrangement before the devaluation and has been able to recoup some reserves since. Also, the central banks of Japan and Sweden have been large or regular sellers of dollars. The Bundesbank has intervened in size but only on occasion, generally acting to counter developments other than the pull of U.S. interest rates. The Swiss National Bank also intervened, for the first time this year, to sell dollars as part of a joint operation with the Bundesbank. Meanwhile, most of the authorities abroad, with the possible exception of the French, have apparently postponed further action to ease domestic monetary policy. The Bundesbank did act in mid-June to provide liquidity on a permanent basis by raising its rediscount quotas DM 5 billion; but at the same time transactions to provide liquidity on a temporary basis were allowed to run off.

For the record, perhaps I should mention something about Mexico. Mr. Chairman you referred yesterday to a request by the Bank of Mexico to draw up to $700 million on its swap line with the Federal Reserve. After consultation with the Bank of Mexico and review by members of the Committee, the request was granted for a month-end drawing to be repaid July 1, but in fact only $200 million was utilized.

Recommendation

Mr. Chairman, I would like to report to the Committee that the Bank of Mexico has requested a drawing on its swap arrangement with the Federal Reserve for the full $700 million, not only for month-end window-dressing purposes as agreed on Tuesday, but also to meet a real reserve need during the next several months. You may remember that, shortly after the last FOMC meeting, the Mexican government announced end-May foreign exchange reserves of about $3.9 billion, somewhat higher than was expected. The increase mainly reflected bridge financing to a "Jumbo" bank loan, and the end-May reserves level has not been sustained in the face of continued capital outflows during June. In addition, the sales of participations in the "Jumbo loan" by syndicate leaders has gone very slowly, limiting Mexico's ability to rollover existing credits and raise the new money needed until the stabilization program begins to show clearer results.

Meanwhile the Mexico authorities have begun to implement the measures envisioned in the stabilization program of April 21. But with the long election process underway, the government has felt constrained from taking some of the more forceful actions included in that program. They are optimistic about the prospect of taking further actions following the election on July 4 and recent public statements by the Finance Minister appear to be preparing the way for more action.

In discussions about this latest request to draw, it has been made clear to us that the Mexican government is willing to assure, in the event the Bank of Mexico is otherwise unable to repay all of its obligations to the Federal Reserve by end October, that the government will have established a conditional credit arrangement with the IMF timely enough to help repay the drawing. In view of this undertaking by the Mexican government and the present difficult circumstances in Mexico, we expect the Treasury to feel that it is appropriate for the Federal Reserve to respond favorably to the Mexican request at this time. You probably remember that the Treasury, through the Exchange Stabilization Fund, has a swap agreement with the Bank of Mexico that requires Mexico to be eligible to draw under a credit arrangement from the IMF. Once Mexico has agreed with the IMF on an appropriate program, the Treasury has indicated a willingness to participate in a credit to Mexico, including if necessary the provision of funds in order to limit the time in which the Bank of Mexico's swap line with the Federal Reserve is in continuous use.

FOMC Briefing
S. H. Axilrod
6/30/82

During the first half of this year the behavior of the economy in real terms--as indicated by the 1½ percent annual rate of decline in real GNP--was little different from staff projections at the time the Committee initially set this year's targets for the monetary aggregates last February. However, interest rates and prices have behaved somewhat differently from earlier projections. Price increases have been less, with the result that growth in nominal GNP has been about 2 percentage points (annual rate) slower than projected, while interest rates--both short- and long-term--have run a little higher than anticipated. At the same time both narrow and broad measures of the money supply expanded over the first half of this year (measuring from QIV '81 to QII '82) at annual rates from ½ to almost 1½ percentage points in excess of the upper limits of the ranges. These averages would be less through June.

The strength of money aggregates in face of both slower growth in nominal GNP and sustained relatively high short-term interest rates suggests enlarged demands for liquidity on the part of the public, given economic circumstances which have almost certainly generated considerable uncertainty about future income prospects and financial conditions. Another way to assess the meaning of growth in the aggregates thus far this year is to note that growth has been accompanied by fairly substantial declines in the income velocity of both M1 and M2 over the first half of this year. Such declines are often associated with downward pressures on short-term interest rates but this year have been associated with a modest increase in short rates from their average level in the fourth quarter of last year, presumably reflecting strengthened demands for liquidity.

An increase in liquidity demands was associated with surprisingly strong credit growth in the first half of the year. Part of the credit expansion reflected enlarged U.S. Government borrowing, of course, but in addition nonfinancial businesses increased their borrowing at a time when as a group their net need for external funds was apparently declining. While there are gaps in the data, the added borrowing has been accompanied by greatly increased expansion in business's holdings of liquid assets, particularly in the second quarter. It seems some firms may have borrowed to improve their liquid asset positions, particularly firms which might have reason to fear that a tightening in bank lending or commitment policies could reduce their normal access to bank credit. It is also quite probable, of course, that liquid assets were built up by firms who did not borrow to obtain them but rather viewed these assets as a better investment than inventories, given their high return and the uncertain economic outlook.

In view of the behavior of the monetary aggregates in the first half of the year, and associated behavior of interest rates and velocity, the Committee's assessment of the monetary ranges for 1982 might reasonably involve, as noted in the blue book, either maintaining current ranges or raising them. There are three principal arguments for maintaining the ranges: (1) an increase would run excessive risk of casting doubt on the Committee's longer-run intentions to curb inflation, with adverse impacts on whatever emerging tendencies there may be for labor and business to temper wage bargains and pricing decisions; (2) the rise in velocity of M1 consistent with both coming within the ranges this year and encouraging a reasonable economic recovery in the second half is in any event not out of line with past cyclical experience and might be accomplished with little further upward interest rate pressure, particularly as the public willingly begins to work down liquidity built up earlier this year; and (3) Federal fiscal policy is itself stimulative enough to encourage a reasonable economic recovery.

Arguments for raising the range include: (1) a judgment that "announcement" effects on inflationary expectations are not likely to be adverse in a period when plant capacity and labor resources are greatly underutilized; (2) a view that fairly strong demands for liquidity are likely to persevere and work to moderate any cyclical rebound in velocity; and (3) an analysis which suggests that a lower level of interest rates than forecast by the staff would be needed to stimulate private spending, even in face of a tax cut, particularly if reduced inflationary expectations might be restraining the willingness of consumers and also businesses to incur debt.

If the Committee decides to retain the 1982 range, it may wish to consider indicating that actual growth could be expected to be around the upper limits of the ranges or somewhat below. If the ranges were raised, that change itself would probably serve notice that growth near the upper end was being contemplated.

With regard to ranges for 1983, the logic of the situation seems to point either to retaining the existing 1982 ranges or reducing them. The ranges could easily be retained at this stage but possibly with an indication that actual growth within the ranges next year would be expected to be lower than this year--while also noting uncertainties such as those connected with the impact of further deregulation by DIDC, with other possible changes in financial structure (e.g. sweep accounts), and with shifting liquidity demands in an uncertain economic environment. However, a reduction in the 1983 ranges from the existing ones for 1982 would also be consistent with continued economic recovery next year, though quite a modest one, as indicated by the staff's GNP forecast. Growth in the aggregates would be expected to be near the upper ends of slightly reduced ranges. The odds that a slightly reduced range would be consistent with a stronger performance of real GNP next year than is currently projected by the staff seem fairly small, though, and particularly so of course if progress in slowing price increases is not as rapid as we have estimated.

SECRETARIA
DE
HACIENDA Y CREDITO PUBLICO

August 3, 1982.

MR. PAUL VOLCKER
CHAIRMAN
BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
20 STREET & CONSTITUTION AVE., N. W.
WASHINGTON, D. C. 20551
U. S. A.

Dear Chairman Volcker:

We are pleased that agreement has been reached on activating August 4, 1982, the swap arrangement between the Banco de Mexico and the Federal Reserve System. In order to bolster market confidence and strengthen Mexico's reserve position, the Government of Mexico in coming weeks will accelerate the implementation of its stabilization program that was announced on April 21 and, as necessary, intensify that program.

The Banco de Mexico intends to repay its drawing as soon as its reserve position permits. The agreed drawing will have a maturity of three months, subject to one additional three-month renewal on mutual agreement. In any event, any and all drawings made under the swap arrangement will be finally liquidated no later than January 31, 1983. The Government of Mexico and Banco de Mexico will take all actions required to meet these obligations including, if necessary to meet the final liquidation date, timely drawings from the International Monetary Fund. Accordingly, if necessary to meet these obligations, the Government of Mexico is prepared to undertake detailed discussions with the International Monetary Fund with a view to establishing an International Monetary Fund program for Mexico in the fall.

Yours sincerely,

Lic. Miguel Mancera
Director General
Banco de México, S. A.

Lic. Jesús Silva-Herzog
Secretario de Hacienda
y Crédito Público

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

August 4, 1982

Dear Paul:

The Federal Reserve System has been requested to agree to an emergency drawing of up to $700 million by the Bank of Mexico on the Federal Reserve swap arrangement.

I understand that Secretary Silva Herzog has provided you with assurance that Mexico will accelerate and, as necessary, intensify the stabilization program announced on April 21, and has further indicated that if any drawings are outstanding on January 31, 1983, the Government of Mexico will if necessary by that date at the latest have established a conditional IMF credit arrangement designed to correct the Mexican economic and financial situation and to help repay any outstanding swap drawings by January 31, 1983, at the latest. In this connection, the Treasury through the Exchange Stabilization Fund is prepared to participate in credit to Mexico as soon as the IMF agreed to a conditional credit program for Mexico. It is understood that this participation may serve to limit the length of time that the Bank of Mexico's swap arrangement with the Federal Reserve is continuously in use.

Under the present circumstances and with these understandings, agreement to a drawing by the Bank of Mexico on the Federal Reserve appears clearly appropriate.

Sincerely,

Donald T. Regan

Donald T. Regan

The Honorable
Paul A. Volcker
Chairman of the Board of
Governors
Federal Reserve System
Washington, D. C. 20551