APPENDIX

Notes for F.O.M.C. Meeting
January 30, 1984
Sam Y. Cross

Since your December 20 meeting the dollar has risen on balance by about 1-1/2 percent against the European currencies while showing little net change against the Japanese yen and Canadian dollar.

The dollar's rise occurred entirely in early January. After it had declined by 1 - 2 percent in thin year-end trading, the dollar turned around after the turn of the year and gapped sharply higher as commercial banks and their customers moved quickly to establish positions and to cover expected needs for 1984. On occasion, trading became hectic, with talk of large transactions by players such as the Russian foreign trade bank and the Monetary Authority of Singapore contributing to an uneasy mood. The dollar moved to unfamiliar heights against the mark, rising by 5 percent in just seven trading days. Trading was very active and became increasingly unsettled, with wide spreads and one-way trading, prompting the U.S. authorities to intervene on two trading days, January 5 and 9, selling a total of $143 million against German marks to calm disorderly markets. After mid-January, the dollar receded slightly from its peaks, and has since moved erratically, as traders try to determine whether the next major move will be up or down.

Since late December the exchange markets appear to have focused most of their attention on recent developments in the real economy of the United States. The view has now become more generally accepted that the U.S. expansion moderated significantly in the fourth quarter of 1983. But there is considerable uncertainty about the implications of this moderation for the outlook for continued U.S. growth, interest rates, and the dollar. For the time

being, market participants still believe the U.S. economy to be more buoyant than most others. But in some countries, the prospects for growth have recently improved, and the rise in many foreign stock markets might be reflecting a growing sentiment that investment abroad is looking increasingly attractive.

January's rise of the dollar has prompted comparatively little central bank intervention abroad. As a group, central banks remained net sellers of dollars, but their net sales during the past five weeks were only about half as large as in the previous inter-meeting period. The Bundesbank in particular scaled back its intervention sales to less than as compared with in the previous period. The major part of its dollar sales occurred on only one day, around the time of the January BIS meeting, when market expectations had built up that Germany, acting alone or in concert with others, would act to curb the mark's decline and the dollar's rise. When no evidence of such an intention was forthcoming, the Bundesbank felt a need to soften the market's reaction. Otherwise, the Bundesbank has limited its dollar operations to selling only small amounts at the Frankfurt fixings. European officials have spoken increasingly in recent weeks of the dollar's strength being a matter for the United States, not them, to deal with, and some have emphasized their view that the dollar is vulnerable to a decline that could be sharp and erratic. The French have called for capital controls to uncouple the European currencies from the dollar, but, except for Helmut Schmidt, that view has not gained wide acceptance elsewhere.

Uncertainty about the U.S. economic outlook and the sustainability of the dollar at current levels has imparted considerable volatility to dollar rates. During much of January, trading conditions progressively

deteriorated, and we have received several reports that market professionals are reluctant to take positions in the dollar, especially relative to the German mark.

There is no activity to report on Federal Reserve swaps. For information, on behalf of Treasury, we did set up with the Jamaican authorities a swap line of $50 million, of which $10 million has been drawn, looking toward an IMF agreement. Also, during the period Treasury used $691 million equivalent of its German mark and Japanese yen balances, to meet one half of that portion of the U.S. quota increase that is required to be paid other than in dollars.

REPORT ON OPEN
MARKET OPERATIONS

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

Desk operations since the Committee's December meeting have sought essentially to hold reserve availability about unchanged from the conditions prevailing before that meeting. Specifically, the directive called for "at least the existing degree of reserve restraint". Discussion at the meeting contemplated a modest firming if monetary growth tracked above desired rates and the economy's strength remained as vigorous as seemed likely at the time of the meeting--but in fact these conditions were not met so a "no change" course was deemed appropriate. According to the data available during the period, the broader aggregates, M2 and M3, were coming in a little below the Committee's preferred pace, although based on new seasonal factors their growth rates were very close to being on track. M1, after relatively slow growth last summer and fall, has been growing somewhat above its November-March contemplated pace, particularly after applying the new seasonals, but in any event this measure was still being monitored rather than targeted. Moreover, information on the economy suggested more pronounced deceleration than seemed in the cards at mid-December, though the pace remained respectable.

Weekly reserve objectives accordingly continued to be built on a $650 million level of adjustment and seasonal borrowing, unchanged since last September. Actual borrowing levels in fact turned out quite close to this path level in most weeks. Leaving

aside the week including year-end, when typical window-dressing pressures produced a bulge in borrowing to $1.3 billion, the average weekly levels were in a range of $500 million to $780 million and averaged $648 million. (We should always be so lucky with our targets.) The money market showed some variation early in the period, softening to about a 9 percent average Federal funds rate during Christmas week when extremely cold weather caused transaction problems and float bulged unexpectedly, and tightening to an average slightly over 10 percent in the New Year's week when year-end liquidity pressures were a factor. In each of the three subsequent weeks, funds averaged just a hair over 9 1/2 percent, about the upper end of the 9 1/4 - 9 1/2 percent range anticipated in association with $650 million of borrowing. So far in the current week, funds have edged down to about 9.35 percent.

The Desk's outright operations have been almost entirely on the reserve-absorbing side since the last meeting, effecting a net reduction of slightly over $4 billion in the System Account on a committment basis. Of this, $1.9 billion reflected redemptions of bills (including some runoff in today's auction), $1.1 billion a bill sale in the market (the first such go-around in two years), and the rest net sales of bills and notes to foreign accounts. These reductions in holdings were geared partly to immediate needs to absorb reserves, but also to the large need to mop up reserves in the weeks beginning this Thursday when there is a sizable reduction in reserve requirements. At times, while outright holdings were being cut, it was necessary almost simultaneously to replenish

reserve availability temporarily through repurchase agreements, particularly to cope with the effects of unexpectedly high Treasury balances at the Fed in late January. Once we get past the current month-end those Treasury balances are expected to drop back again, releasing reserves and augmenting the need for absorption at the same time that reserve requirements decline. On our present outlook, there is still a need for further reserve absorption in the upcoming weeks, a task that we will want to undertake with due care as this will also mark the outset of contemporaneous reserve requirements.

While the underlying Federal funds rate showed no trend over the period, most market interest rates moved lower, reflecting a perception of slower expansion in the economy and abatement of seasonal pressure noticeable in mid-December. The "flash" report on GNP, just a day after the last meeting, had a particularly marked impact on sentiment, relieving the concerns of some market participants who had been anticipating an early System move toward restraint. The Treasury's late December coupon financing, which had cast a deep shadow over the markets through much of December, generated good interest at the higher rate levels that developed before the auctions. Dealer and customer appetites increased as additional economic data tended to confirm the sense of moderating expansion. A few participants even began looking for a near-term easing although the preponderant view seems to be for no significant early change in rates in either direction. Looking further ahead, there's a divergence of views about rate prospects, but for the most part not very large differences, chiefly dependent on views about

the economy. There's perhaps a slight majority anticipating a little lower rates toward mid-year and some rise in rates in the second half.

Intermediate and longer term Treasury yields came down about 25-35 basis points over the intermeeting interval, while the market absorbed nearly $20 billion of additional supply--including $13 billion in the quarter-end financing. There was reported to be particularly good interest in intermediate and longer term zero-coupon issues for special purposes such as IRA accounts, defeasance of outstanding corporate or tax-exempt bonds, or buying by pension fund managers seeking to lock in yields without the uncertainty of reinvestment returns. In the last few days the Treasury market has been in a holding pattern, awaiting the Treasury announcement this Wednesday of the mid-February refunding. This will probably involve offerings of about $16 billion or somewhat more, raising roughly $12 billion of new money.

Treasury bill rates, meantime, have declined about 25-30 basis points, pretty much parallel to the decline in coupon issues even though the Treasury raised no new money in this sector. This concentration of new money raising mostly in the coupon sector is in keeping with the Treasury's debt-lengthening efforts. In today's auction, 3- and 6-month bills were expected to sell at average rates of about 8.85 and 8.95 percent, down from 9.04 and 9.24 just before the last meeting.

Rates on private short-term debt came down more than those on bills--closer to 50-70 basis points--reversing the widening of spreads on these issues compared with bills that had been developing toward year-end.

Corporate and tax-exempt bond yields also declined over the period, about in line or in greater measure than Treasury issues, depending on what particular index one observes. Corporate issuance picked up somewhat as we came out of the holiday period and yields declined. Tax-exempts, on the other hand, reached the market in lesser volume after a great rush to issue in the closing months of 1983 to get ahead of actual or prospective deadlines on certain types of special purpose issues.

Finally, I should mention that as of last Thursday the Desk began trading with another dealer--Manufacturers Hanover Trust. This bank has only recently developed a primary dealer operations, which they have kept quite distinct from the major clearing operations that they perform for a number of other dealers. The Desk now has a trading relationship with 36 firms--the same number that are on the primary reporting list.

JLKichline
January 30, 1984

FOMC CHART SHOW - INTRODUCTION

During our presentations this afternoon we will be referring to the package of charts distributed to you. The first chart displays the principal assumptions that underlie the staff's economic and financial forecast, a forecast that for this meeting of the Committee we have extended through 1985. For monetary policy we are assuming growth of M2 of 8 percent during 1984 and 1/2 percentage point lower in 1985, which is consistent with longer-run Alternative II in the Bluebook. The associated M1 growth entails an expansion of velocity of 2 to 3 percent, and we expect that to occur in an environment of interest rates generally tending to rise over much of the period--that is short-term rates up around 1 percentage point by the spring of 1985. On fiscal policy we are not assuming substantial deficit reducing actions that would have effects on the economy and financial markets during the forecast period. Finally, we continue to expect a decline in the foreign exchange value of the dollar, with the dollar down 17 percent by late 1985.

The next chart provides some additional information on the federal budget and fiscal policy. The administration's budget is scheduled to be released on Wednesday and at this point we are not in a position to make detailed comparisons between the staff

and administration figures. At the aggregate level, for both 1984 and 1985 the staff estimates are a little higher on outlays and a little lower on receipts; this produces a bit higher staff estimate of the budget deficits. As the economic expansion continues, the cyclical component of the deficit declines while the structural deficit rises further in both 1984 and 1985. These are huge structural deficits in absolute terms or as a percent of potential GNP as shown on the bottom panel. Thus fiscal policy is assumed to be a stimulative force over the projection and the large deficits will leave a major imprint on financial market developments.

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

Joseph S. Zeisel
January 30, 1984

FOMC CHART SHOW - DOMESTIC NONFINANCIAL DEVELOPMENTS

The rapid pace of the recovery through much of 1983 was fueled by inventory rebuilding, as well as by a surge of consumer and business spending responsive in significant part to tax cuts and lower interest rates. The economy is now entering a phase of more moderate and sustainable expansion in which the upward momentum derives mainly from growth in final demands. The top left panel of the next chart shows the slowing of real GNP growth from the 9-3/4 percent rate last spring to 4-1/2 percent in the past quarter.

As is evident in the right-hand panel, the rise in retail sales lost momentum after midyear, but consumer outlays have shown greater vigor again in the past several months. Although the reported pre-Christmas retail sales data proved weaker than had been suggested by qualitative reports, for the fourth quarter as a whole real personal consumption expenditures rose at an impressive 6-1/2 percent annual rate with a major factor being the strength of auto demand, shown in the middle left panel. Domestic car sales have been particularly strong recently running at close to an 8 million unit annual rate for the past month and a half.

The rebound of capital spending has been even more impressive--and surprising. The middle right panel portrays the vigorous recovery in shipments of nondefense capital goods, which have accelerated recently, with particularly strong gains in heavy industrial machinery and communications equipment. Sales of trucks have also been brisk.

The bottom panels present two significant offsets to the general strength of domestic production. As the left panel shows, in response to a backup of mortgage rates, housing activity appears to have stabilized, with

starts at around a 1.7 million annual rate, somewhat under the level at mid-year. And finally, the right-hand panel pictures the sluggish pace of exports, while imports have increased substantially in response to expanding domestic demands.

As shown in the next chart, growth of industrial production has been decelerating in recent months. As is evident, a slowdown in IP growth in the second year of recovery is characteristic of past cycles. The half percent rise of the index in December followed gains of 3/4 percent in the two preceding months and average monthly increases of 1-1/2 percent earlier in the year. As the middle panels show, production has slowed for construction supplies and related home goods, while business and defense equipment, and recently auto output, have been rising at a fast clip,

In labor markets, the bottom panels, there have been suggestions of some deceleration of employment gains recently. In December, nonfarm payroll employment rose 230,000, compared with average monthly gains of 325,000 in the preceding eight months. Moreover, the manufacturing workweek has continued edging down, in typical cyclical fashion. The unemployment rate dropped sharply further, however, falling to 8.2 percent.

The next chart presents our view of the outlook for GNP over the next two years. We expect growth to continue at close to the current 4-1/2 percent rate during the early part of this year supported in part by the last stage of inventory rebuilding. GNP gains are then expected to moderate, through 1985, reflecting the slowing of nominal income growth implied by the monetary assumptions and the projected increase of inflation. The policy assumptions strongly influence the composition of output

as well; we anticipate no impetus from housing activity, and consumer demand--especially for durable goods--is projected to lose some of its vigor. On the other hand, capital spending seems likely to remain a strong support to growth during the next two years; defense outlays are scheduled to continue rising, and export demand is expected to pick up.

As indicated in the panel below, the projected rates of increase in GNP of 4-1/4 percent in 1984 and 3-1/4 percent in 1985 are quite consistent with the past performance of the economy in the second and third years of recovery.

I would now like to review in more detail the major forces expected to influence these key sectors of the economy over the next two years.

The inventory sector, addressed in the next chart, remains one of the major question marks in this forecast. As may be seen in the top left panel, the contraction in manufacturing stocks was massive--in fact, the longest and deepest in the postwar period. This liquidation came to an end early last year, but the recovery has been accompanied by virtually no addition to manufacturing inventories. In contrast, trade stocks (excluding autos) were reduced relatively little--the right-hand panel--and have now been rebuilt to above their pre-liquidation peaks in real terms. The number of autos in dealer hands has risen as well in recent months, but they remain below pre-recession totals.

As the middle panel shows, relative to sales, overall business inventories thus are quite low historically. Manufacturers may be somewhat reluctant to rebuild stocks for a number of reasons--including the high cost of financing as well as vivid memories of recent imbalances.

In addition, new inventory control methods may be more effective. In any event, we expect these considerations to continue to influence business decisions. As the bottom panel indicates, following some further stock building early this year, we are projecting inventory investment to parallel the growth in sales and the overall stock-sales ratio to remain close to current rates throughout the forecast period.

We feel a bit more confident regarding our ability to forecast housing activity, at least within the framework of our financial projections. As the upper left panel of the next chart indicates, mortgage interest rates and housing starts have continued to behave in mirror image of one another. As the right-hand panel shows, new home buyers have responded about as consistently. Essentially, both housing construction and sales are now at levels a bit below last summer.

As indicated in the lower panels, we anticipate a slight upward tilt to mortgage rates over the projection period, with the fixed rate rising to about 14 percent late next year. We expect this will tend to keep total housing starts around or below the recent 1.7 million rate. Housing activity recently was supported somewhat by the spread of adjustable rate mortgages--involving an initial rate advantage of 2 percentage points or more--and the increased use of mortgage revenue bonds. But we expect little further expansionary effect from these financial innovations. Moreover, changes in the age structure of the population over the next few years will be tending to reduce the trend rate of growth in household formation slightly.

The biggest economic surprise recently has probably been the strength of business fixed investment. Real expenditures on capital

equipment rose at a 28 percent annual rate last quarter, one of the largest increases in the postwar period. As shown in the upper left-hand panel of the next chart, new orders for capital goods have continued to climb rapidly, pointing to further gains in spending later this year. As is evident in the right-hand panel, there has been strength in the structures category as well, with real outlays up at a 10 percent annual rate over the past half year. Real spending for business equipment should continue a strong although moderating pace of growth through the forecast period, given the improved corporate profit position, illustrated in the middle left panel, and the environment of rising capacity use. As shown, we are projecting the utilization rate to exceed 80 percent early this year.

The next chart presents real government purchases by sector. In order to avoid the distortions caused to the data by the PIK program, we have excluded CCC from the totals. As is evident, the defense program continues to play a major role in raising federal outlays in both 1984 and 1985. Defense spending lagged expectations in 1983 and stronger increases are now expected in 1984 and 1985. At the same time, nondefense purchases are projected to show little change in real terms.

At the state and local level, we anticipate larger increases in outlays. Facing cuts in federal aid in the past several years, many governments took actions to hold down expenditures and raise taxes, which improved their budget positions significantly. In 1983 alone, 31 states enacted tax increases. At the same time, state and local employment continues well below previous peaks and construction outlays remain depressed. Although states and localities will probably attempt to maintain a conservative stance, pressures are building for increased services and repair of

the physical infrastructure and these are likely to be accommodated as tax receipts continue to improve with stronger activity and income. As shown in the bottom panel, in total, real government purchases are projected to rise about 4 percent over 1984 and 3-1/4 percent in 1985, significantly more than in 1983.

The next chart addresses the outlook for consumption. The left-hand panel illustrates the upsurge in consumer attitudes early in 1983, that accompanied the rebound of consumer demand. Brighter prospects for employment and longer-run income growth, as well as the drop in interest rates and reduced inflation expectations, all likely played a role in the improvement. Some of the strength in consumption probably also reflected the substantial rise in household net worth--portrayed on the right--associated with the stock market boom. Increased consumer outlays also were supported by the tax cuts which raised disposable income. The stimulus to consumption from these developments largely has run its course, and we expect growth in consumer demand to moderate from this year's pace. But household balance sheets have improved and the saving rate has moved up somewhat from its extremely low mid-1983 level. In these circumstances it seems not unreasonable to expect outlays to grow about in line with disposable income, and the saving rate to remain relatively stable near its current rate of about 5 percent.

As indicated in the top panel of the next chart, with slower overall growth, we are projecting smaller employment gains, averaging about 2-1/2 percent per year, down one percentage point from that in 1983. We also anticipate a somewhat stronger rise in the labor force as participation rates--the left panel--begin to move up again in response to

improved job opportunities. But the overall labor force expansion will be inhibited by a slower rise in the working age population, the right panel--and we don't expect the kinds of huge labor force gains that occurred in the late 1970s. On balance, we project the civilian unemployment rate to decline to about 7-1/2 percent by the end of this year, and to reach about 7 percent by the end of 1985.

The top left panel of the next chart illustrates the substantial deceleration in wage increases over the past three years. The rate of rise for the less unionized trade and service sector showed a tendency to level off this year, but wage increases continued to moderate in the more cyclically volatile manufacturing and contract construction sectors despite overall improvement in employment and activity.

As shown in the right-hand panel, much of the slowing in union wages reflected smaller new settlements; another source of considerable deceleration has been the reduced contribution of COLAs. Cost of living adjustments may be larger in the next two years, and with improved labor market conditions we anticipate somewhat greater first year wage settlements. But the degree of labor market slack should continue to damp the rise. Moreover, gains in real wages have taken some of the pressure off bargaining, and the much smaller deferred wage increases negotiated in the past year or two will continue to restrain the average wage rise in 1984 and 1985.

On balance, as shown in the middle panel, we are projecting that hourly compensation will rise by about 5-3/4 percent this year, and by close to 6 percent in 1985, up from 5 percent last year. Almost half of

this year's acceleration reflects the recent increase in social security tax rates.

As indicated, we anticipate that productivity gains will moderate from the recent cyclically-induced high rate and return to the estimated longer-term trend, thus providing less offset to unit labor costs. These costs are projected to rise at about a 5 percent rate over the projection period, up from 1-1/2 percent in 1983.

The outlook for inflation is presented in the next chart. Some cyclical increase in price pressures appears inevitable over the next two years as slack is reduced in both labor and product markets. But as has been the case recently, other factors will be contributing significantly to the price picture. This month's large increase in social security taxes will boost cost pressures and, as illustrated in the left-hand panel, a more rapid increase is projected in food prices in the near term as meat supplies tighten and we feel the impact of the freezing weather on fruit and vegetable prices. Later this year, but mainly in 1985, we expect prices to be boosted significantly by the projected fall in the value of the dollar. However, the rise in food prices should ease by next year and, as shown in the right-hand panel, energy price increases are expected to remain quite small throughout the projection period, largely reflecting our assumption of stable world oil prices. On balance, as indicated in the bottom panel, we are projecting inflation to accelerate somewhat, with prices rising next year about in line with unit labor costs. Our projection for the gross business product price index calls for an increase of 4-3/4 percent this year and 5-1/4 percent in 1985, as compared with a 4-1/4 percent rise last year.

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

E.M. Truman
January 30, 1984

FOMC CHART SHOW -- INTERNATIONAL DEVELOPMENTS

The staff's forecast for the U.S. economy raises a number of controversial issues; a discomforting proportion of these issues involve the external sector. Two are depicted in the top panel of the first international chart: first, the high exchange value of the dollar and, second, its projected depreciation. The dollar has appreciated substantially further over the past year, bringing the total rise since the fourth quarter of 1980 to about 50 percent in nominal terms. The rise has been somewhat less when adjusted for the better U.S. price performance. As Mr. Kichline noted, we are projecting a 17 percent depreciation of the dollar over the forecast period.

One factor contributing to the rise in the dollar during 1983 was the widened differential between U.S. and foreign interest rates, shown in the lower panel. We expect that this differential will increase somewhat further over the forecast period, as U.S. interest rates edge up and foreign rates are essentially unchanged on average. However, we believe that this factor will not be enough to outweigh the negative effects on the dollar of ballooning U.S. trade and current account deficits and an eventual weakening of special forces supporting the dollar. In the absence of a better explanation, these latter forces are often described as "safe haven" demands for dollar assets.

The next chart presents an overview of recent developments and the economic outlook in foreign industrial countries. As is illustrated in the upper left-hand panel, industrial production

recovered on average in the major countries in 1983, especially in the second half. However, production is still about 3 percent below its previous peak in early 1980. Meanwhile, as is shown in the upper right-hand panel, the year-over-year increase in consumer prices moderated to less than 5-1/2 percent by the end of last year.

Turning to the outlook for economic activity in foreign industrial countries -- the lower left-hand panel -- we are projecting a moderate pick-up in 1984 and a further increase in 1985 from the rather sluggish pace of last year. However, growth abroad is expected to be less than in the United States throughout the projection period, not exceeding 3 percent on average. Actual growth is expected to be at or below potential growth, implying that unemployment rates, especially in Europe, are unlikely to be pulled down significantly.

It may be somewhat puzzling that the recovery in the foreign industrial economies is projected to be so weak. I would note that, although our forecast may look conservative, those for individual countries are generally at or above the consensus. The forecasts rest on our policy assumptions. Despite the fact that consumer prices are projected to increase on average at a slower pace than they have for more than a decade, most governments abroad appear to be content with the projected moderate pick-up of economic activity; accordingly, monetary and, especially, fiscal policies are restrictive. We do <u>not</u> expect a shift to more expansionary policies as the dollar depreciates.

Turning to the non-OPEC developing countries and to the next chart, it should come as little surprise, in light of the external financial constraints faced by many of these countries and

the generally inhospitable conditions in the industrial world as a whole, that we are projecting only a slight pick-up in real growth on average in 1984 -- the red line in the upper panel. The expansion of real GNP in 1985 is projected to rise to about 3 percent, which would be the fifth year in a row that growth has been less than the 5-1/2 percent average of the 1970s. Although the volume of imports is projected to increase somewhat in 1984 and 1985, these increases follow a cumulative average decline of more than 10 percent in the past two years.

One can take some encouragement from the projected expansion, in 1984 and 1985, in the value of the exports of goods and services of the non-OPEC developing countries, shown in the middle panel. But, as is shown in the bottom panel, gross interest payments on external debts are projected to absorb more than 16 percent of export receipts in 1985 -- down less than 3 percentage points from the peak share in 1982. The real component of those payments, shown by the red line, is a measure of the debt servicing necessary under the favorable assumption that the real value of external debt is maintained through relending. By this measure, the debt burden declines only slightly by 1985 to 9 percent of export receipts.

Against the background of sluggish growth abroad and the continued strong dollar to date, we are projecting a further widening of the U.S. trade and current account deficits in 1984 -- shown in the next chart. In 1985, with the projected depreciation of the dollar and the further pick-up in growth abroad, the current account deficit tends to flatten out at slightly less than $100 billion, and the trade deficit reaches almost $120 billion. Some view these deficits, and particularly the rise in imports, as a drain on the

U.S. economy. I view this phenomenon as a reflection of the strength of demand arising from the fiscal stimulus to the economy, and the deficits insulate investment partially from higher interest rates. On either interpretation, our external deficits respresent a departure from the pattern of the past and a possible threat to smooth expansion in the future.

The lower left-hand panel shows that GNP exports of goods and services are projected to increase in real terms in 1984 at close to the rate of last year, but to pick up considerably next year in response to the dollar's depreciation. On the other hand, the increase in imports subsides over the forecast period from the torrid pace of 1983. The slowdown in the expansion of goods imports alone is more pronounced because imports of services are sustained by rising interest payments on our rapidly growing external debt.

The prospect of an expanding U.S. current account deficit raises two important sets of questions. The first concerns the financial flows that are constrained by accounting identities to match, ex post, the current account balance.

The table on the next page presents an illustrative pattern of financing for the U.S. current account deficit, shown in line 1. As you can see in the last column, if we estimate the statistical discrepancy at $25 billion for 1984, which would be about the average rate of the past two years, recorded capital inflows (line 3) will have to be $58 billion -- about double the rate in 1983. A portion of the increase reasonably can be expected to take the form of a net inflow on official account, largely reflecting increased foreign

official purchases of dollars as the dollar depreciates. However, while dollar reserves might be rebuilt somewhat, we expect that there will not be massive intervention support for the dollar, since most authorities abroad have indicated that they expect, and would welcome, a depreciation of the dollar.

On the basis of these considerations, the bulk of the increased capital inflows would come through private channels. Net inflows other than to U.S. banking offices (the last line in the table) may increase somewhat. However, the potential for such flows, which include private purchases of securities and direct investment, appears to be quite limited. (Note that net inflows in this category are estimated to have been smaller in 1983 than in 1982.) Thus, a substantial portion of the increased financing of the enlarged U.S. current account deficit in 1984 may well be net flows into U.S. banking offices, as was the case in 1983. To the extent that these expanded inflows take non-deposit forms, the growth of M3 in 1984 could well be depressed relative to the growth of bank credit.

A second set of questions suggested by our projection for the U.S. current account concerns the depreciation of the dollar and the implications of its size and timing for the performance of the U.S. economy, in particular inflation. The bottom two panels on the next chart are designed to illustrate the implications for U.S. consumer price inflation of alternative trajectories for the foreign exchange value of the dollar, shown in the top panel.

The solid line in the middle panel shows the actual path of consumer price inflation from early 1981 and the projected path

through 1985. As is shown by the corresponding solid line in the top panel, the dollar appreciated rather steadily over the past 3 years but is projected to retrace part of that appreciation over the forecast period and reach an index value of 108 at the end of 1985.

With all the usual qualifications about the interpretation of experiments where exchange rates are treated as exogenous, the short-dashed line in the middle panel shows the hypothetical path of inflation on the assumption that the dollar rose only to 108 by the end of 1982 and somehow remained at that level for the next four years. (The path is consistent with our rule of thumb that a 10-percent exogenous depreciation of the dollar raises the price level by about 1-1/2 percent 2-3 years later.) You can see that the appreciation of the dollar has yielded an inflation bonus that has averaged a bit more than half a percent in 1982 and 1983 and continues through the first half of this year. Next year, that bonus is projected to be returned in part. Indeed, the hypothetical path shows inflation lower in 1985 than in 1984, while inflation picks up a bit in the staff's forecast. This phenomenon reflects not only the projected depreciation of the dollar but also the easing of the downward pressure on inflation that has been generated by the dollar's sustained appreciation to date.

The bottom panel illustrates the interaction of the staff's inflation projection with alternative exchange rate scenarios. If the dollar were to tumble by 25 percent to an index value of 100 by the end of the 1984 (shown by the red, dashed line in the top panel), the inflation rate (shown by the similar line in the bottom panel)

would average about half of a percentage point higher than is projected over the next 7 quarters. Alternatively, if the dollar were to continue to appreciate through the end of 1984 and remain at the new higher level in 1985 (as shown by the black, dashed line in the upper panel), we would receive a further inflation bonus (shown in the bottom panel) of about 1 percent on average. Toward the end of 1985, that bonus would begin to disappear. This occurs because the dollar's appreciation or depreciation has a permanent effect on the price <u>level</u>, but only a transitory effect on the <u>rate</u> of price inflation.

Mr. Prell will now continue our presentation with a review of the domestic financial outlook.

MJPrell
January 30, 1984

FOMC CHART SHOW - DOMESTIC FINANCIAL DEVELOPMENTS

As may be seen in the top panel of your next chart, there was a big jump in the ratio of domestic nonfinancial sector debt to GNP in 1981-82. Last year, debt and GNP grew at the same pace, so there was no movement back toward the earlier debt-to-GNP trend. At least arithmetically, the huge amount of federal borrowing accounts for the continuing high level of the ratio. And our projection shows a further rise in federal and total debt relative to GNP in 1984.

The middle and lower panels provide some perspective on how the federal deficit was financed in 1983. In terms of cyclical comparison, revealed in the bar chart, the extraordinary federal dissaving thus far in this upturn has had two key offsets: the capital inflow associated with the current account deficit--i.e., net foreign saving in the chart--and the large state and local surplus. The chart also shows that net private domestic investment has been unusually weak.

From a credit flow standpoint, depository institutions played a key role last year in absorbing the increase in federal debt: apart from normal cyclical factors, their large acquisitions reflected the shifting of funds from money market mutual funds to MMDAs. Domestic nonfinancial investors--particularly the state and local sector--were major purchasers, and acquisitions by foreigners grew somewhat with the deepening of the current account deficit and the increase in safe haven concerns. The 1984 projection raises some difficult analytical questions as one attempts to fit together the outsized current account and federal deficits in the context of continued economic expansion. Private investors abroad traditionally have had a limited appetite for Treasuries, owing to the interest withholding tax, which doesn't

apply to Eurodollar obligations. Consequently, on the assumption cited by Mr. Truman that official institutions will not support the dollar aggressively as it depreciates, we have projected only a portion of the widened current account deficit will be reflected in increased foreign acquisitions of Treasuries. Since the hemorrhaging from money funds has ended, we're anticipating an enlarged share of Treasury acquisitions by financial intermediaries other than depositories. With the strengthening of loan demand from businesses, we have projected that the bank share will decline substantially, but this does leave more Treasuries to be absorbed directly by households--a troubling conjecture, given that, with deposit deregulation, the mechanism that in the past produced such investment is absent. But to put more Treasuries into banks would also suggest some tensions, because either their asset growth would have to be still greater than the 10% we've projected or other borrowers would have to be turned away.

In any event, state and local governmental units likely will again be important buyers of Treasuries in 1984. As the next chart shows, the surplus of states and localities should remain large this year, whether one looks at the figures with or without the net flow to retirement funds.

The middle panel indicates that, despite the state and local budgetary surpluses, there has been a sustained high level of borrowing in the tax-exempt bond market. In 1983, there was a surge in advance refundings, but the continuing big story was the massive volume of private-purpose financing--covering everything from home mortgages to McDonalds to nonprofit hospitals. Although some of these activities may be close substitutes for traditional governmental functions, many others clearly are simply ways to fund private enterprise at

tax-exempt rates, and uncertainties regarding congressional action leave the outlook for municipal bond volume somewhat clouded.

The rise in muni volume during recent years has put upward pressures on tax exempt rates, and these have been reinforced by the absence of late of the traditional key institutional buyers--banks and casualty insurers. Moreover, the lowering of income tax rates has reduced the relative attractiveness of municipal bonds to individuals. Thus, as the lower panels show, the sharply higher share of household acquisitions in the past couple of years has required higher relative rates. The rate pressures probably would have been worse had it not been for the popularity of tax-exempt mutual funds and unit investment trusts, which channeled around $25 billion into the municipal bond market last year, versus only $8 billion in 1981.

The next chart focuses on the business sector, where a significant swing in funding needs is now in process. In late 1982 and through the first half of 1983, nonfinancial corporations in the aggregate experienced a sizable surplus of cash flow over outlays for fixed capital and inventories. The second half of last year saw investment edge above internal funds, and a growing financing gap is projected for 1984 and '85.

The middle panels focus on the major components of internal funds. As may be seen on the left, economic depreciation has been trending upward and constitutes the bulk of cash flow. Undistributed economic profits--the other component--which fell off moderately during the recession, owing to the effects of tax cuts on after-tax profits--picked up sharply in 1983. One of the developments security analysts have found heartening is the improvement in the "quality" of reported earnings. The right panel shows that reported profits in the late

'70s greatly exceeded true operating profits because they reflected inventory gains and an inadequate allowance for depreciation in an inflationary period. The gap has been closed, and indeed, accelerated depreciation now has resulted in more than adequate charges against income.

With the emergence of a moderate financing gap this year, we expect to see a considerable increase in external financing by businesses. In 1983, businesses maintained a fairly substantial financing pace; much of the fund raising occurred in the equities market as established firms strengthened their balance sheets and many young firms went public. As you can see on the bottom right, although the recent surge in short-term borrowing has brought an early halt to debt restructuring, companies in the aggregate have added substantially to their holdings of liquid assets.

Households meanwhile appear to have fared quite well financially in the past year. The upper panels of the next chart show that borrowing by households has gone through a fairly typical cyclical upswing to date and that both mortgage and consumer credit have participated in the pickup. The middle panels indicate that the increased borrowing has not been associated with any perceptible deterioration in household financial positions. The debt-to-income ratio has not risen appreciably, and loan delinquency rates have been declining.

The past year saw some impressive swings on the supply side of the mortgage and consumer credit markets. S&Ls resumed their role as major investors in the home mortgage market. Mortgage-backed securities continued to grow in importance; although S&Ls again were heavy acquirers of such instruments (and the figures shown here for S&Ls include those acquisitions),

other investors also absorbed large amounts. In the installment credit market, banks have become aggressive lenders as they sought safe, profitable outlets for their ample core deposit flows.

Mr. Kichline will now conclude the presentation.

JLKichline
January 30, 1984

FOMC CHART SHOW - CONCLUSION

The final chart in the package displays the 1984 economic forecasts of FOMC members, the staff, and the administration. In general, the forecasts are quite close and are not very different from those reported to the Congress last July--which are shown in the bottom panel of the chart. The only major change since July has been a reduction in the forecast of the unemployment rate, which is in response to the unexpectedly large decline in that rate during the second half of last year.

In summary, the staff forecast for 1984 and 1985 presents a picture of continued but moderating growth of economic activity, and some uptick in inflation but not a great deal. However, there are a number of problems and concerns that we've noted, including the expansive fiscal policy and the huge imbalance in our international accounts. In addition, the inflation rate does not trend lower over the forecast period while continued economic growth by 1985 brings the utilization of labor and capital resources to fairly high levels. In that context, the risks over time seem to be shifting in the staff forecast toward the potential for more inflationary pressures rather than less.

CONFIDENTIAL (FR) CLASS II-FOMC

Materials for

Staff Presentation to the Federal Open Market Committee

January 30, 1984

Principal Assumptions

Monetary Policy

- Growth of M2 of 8 percent and 7½ percent during 1984 and 1985, respectively.
- Growth of M1 of 6½ percent and 6 percent during 1984 and 1985, respectively.

Fiscal Policy

- No substantial deficit-reducing actions take effect during the forecast period.

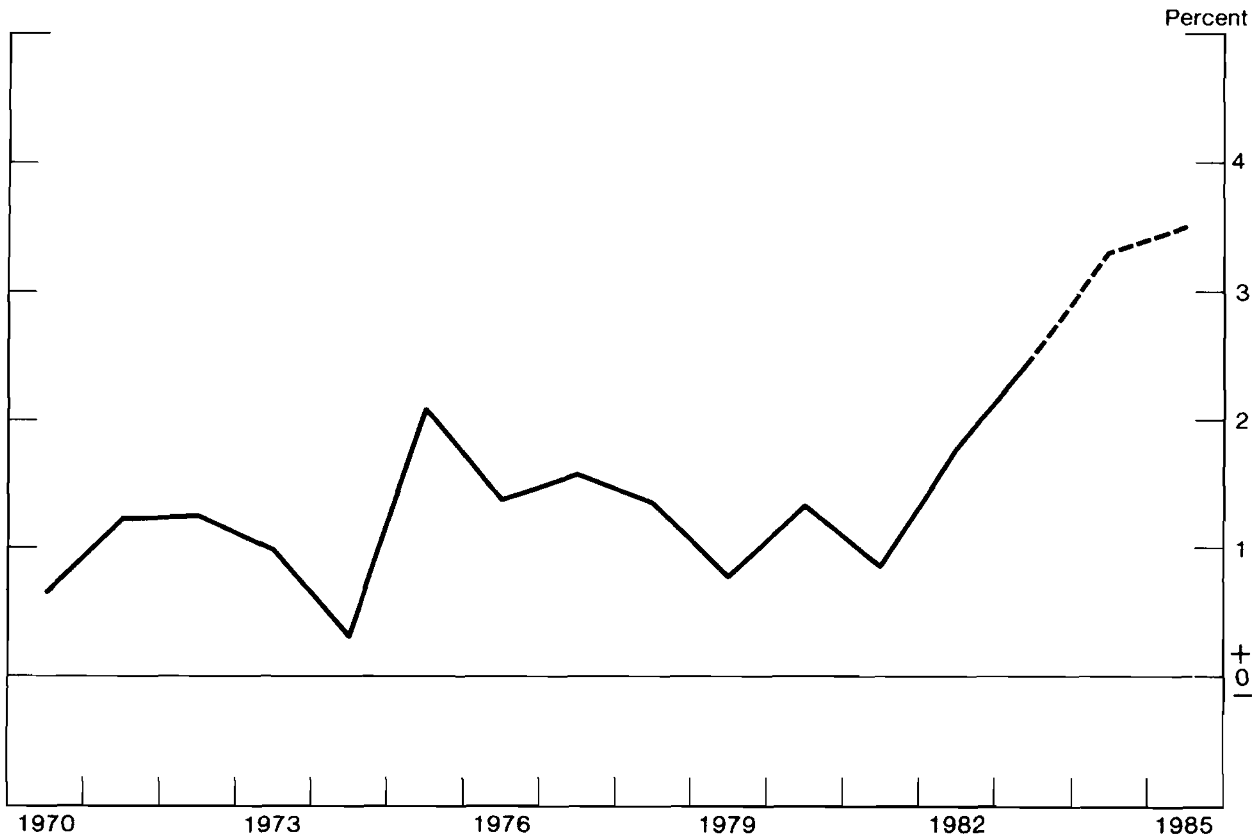
Other

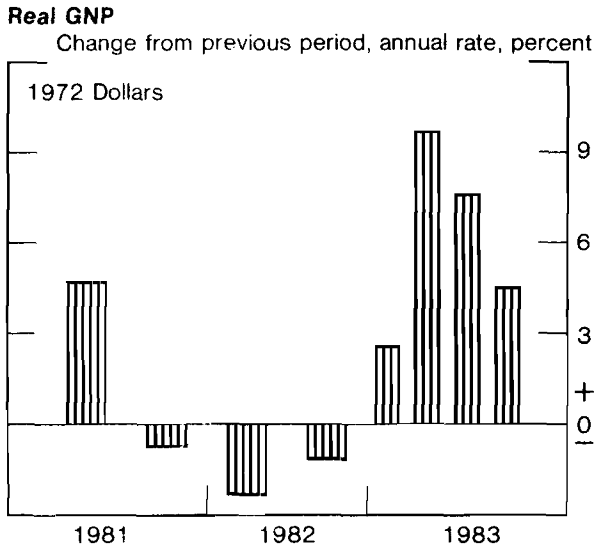
- Foreign exchange value of the dollar declines 17 percent during 1984-85.

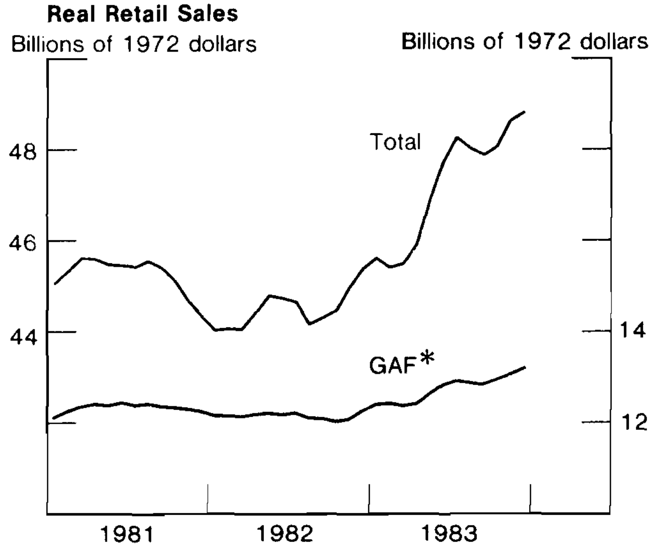
Federal Budget

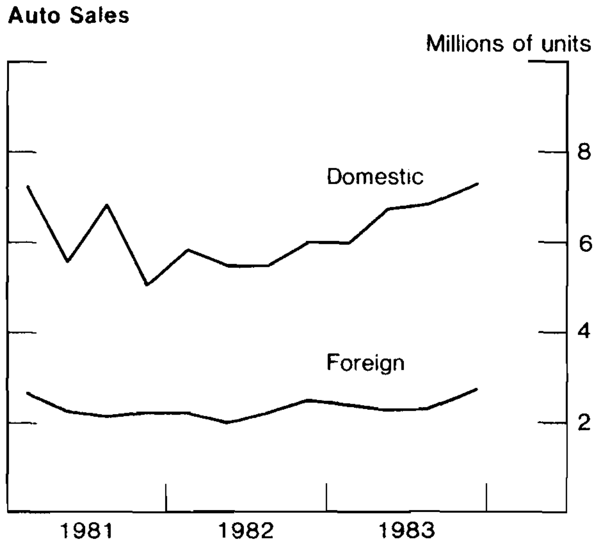
Fiscal Years, Unified Budget Basis, Billions of Dollars

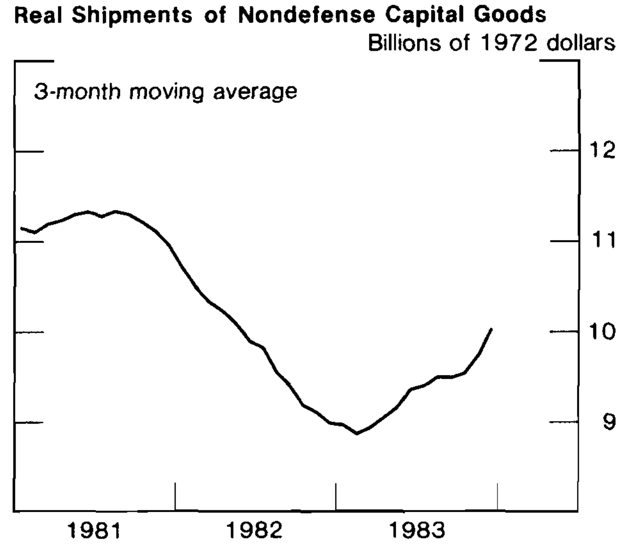
	1983	1984		1985	
		Staff	Administration	Staff	Administration
Outlays	796	856	853	936	925
Receipts	601	666	669	742	745
Deficit	195	189	184	195	180
Structural Deficit	85	122	n.a.	142	n.a.

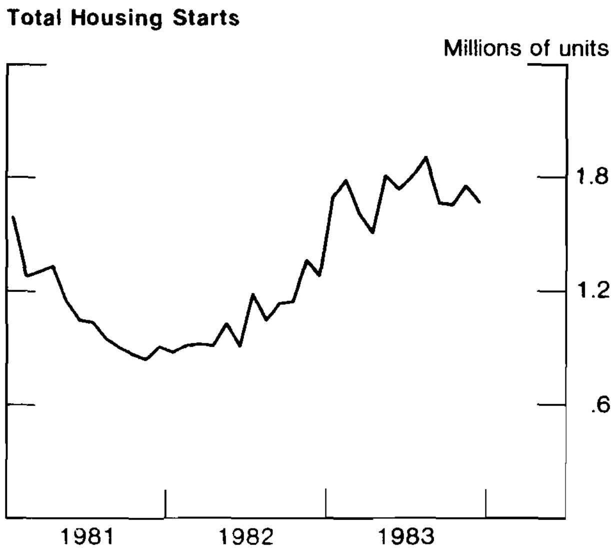




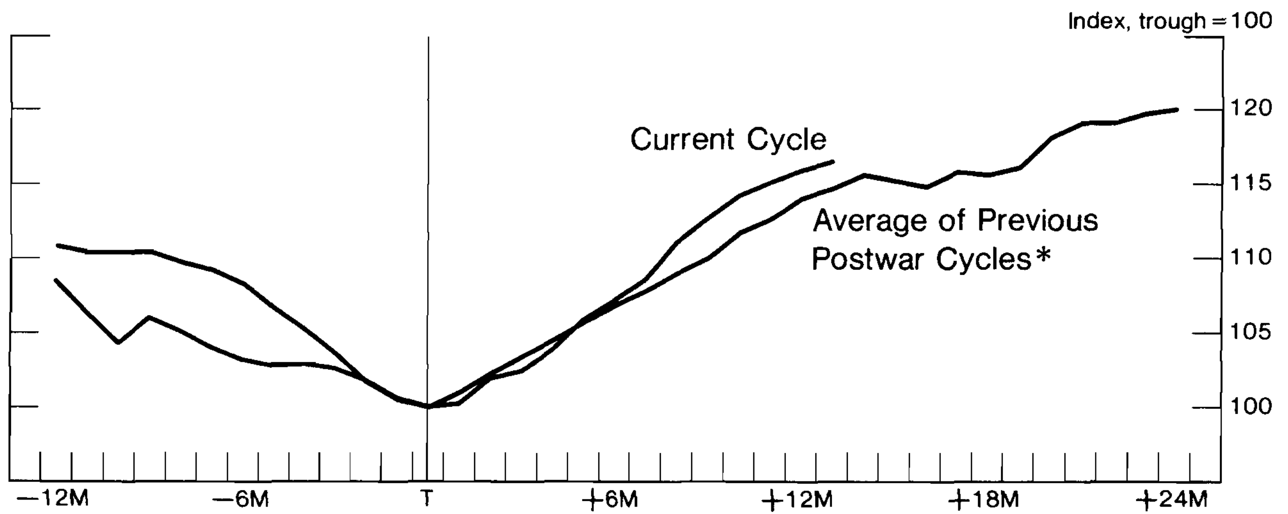


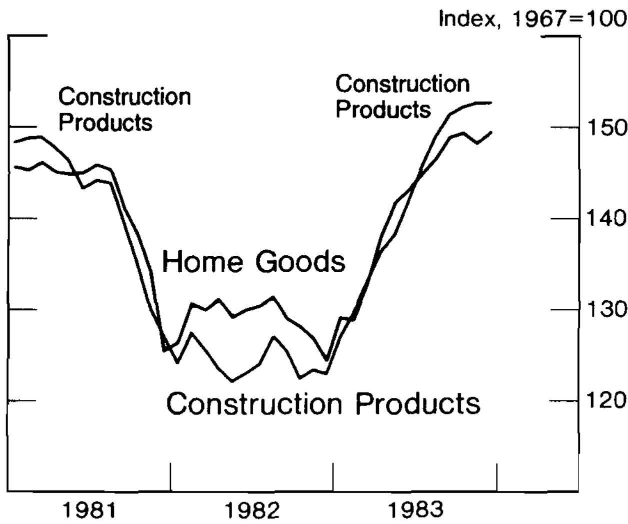


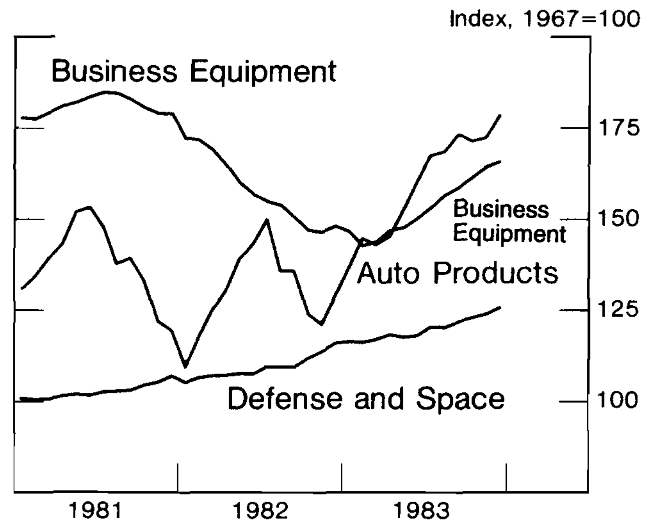


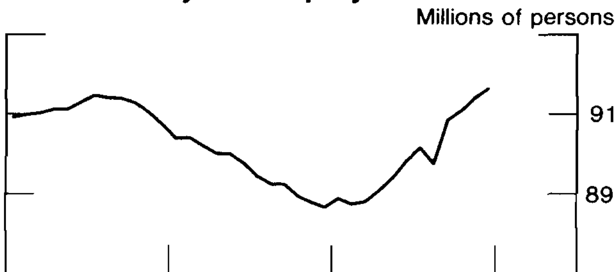


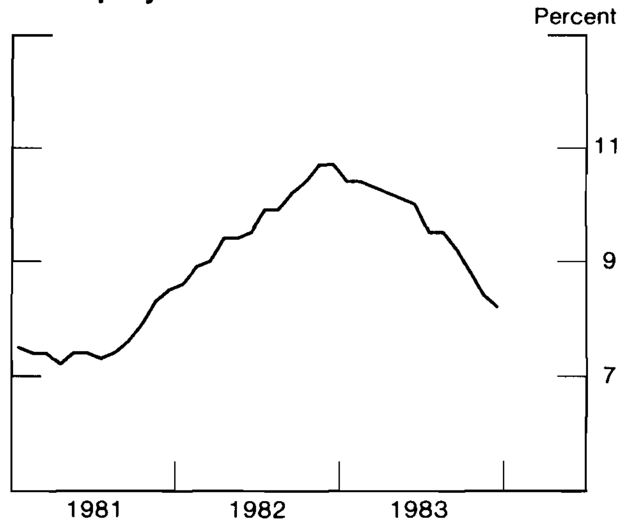
* General merchandise, apparel, furniture and appliance stores.

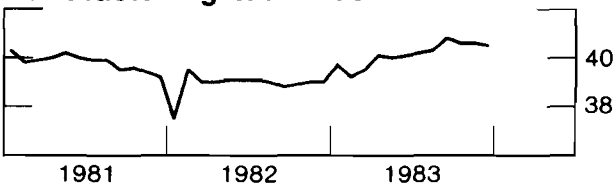






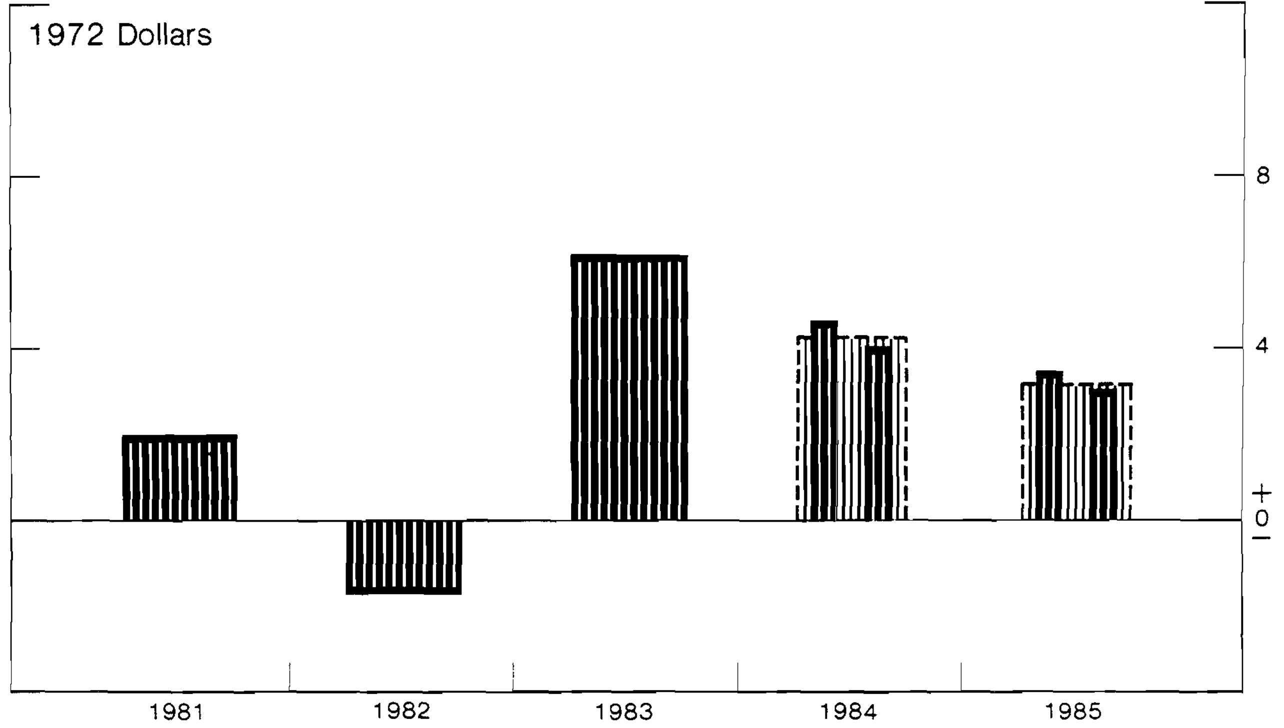




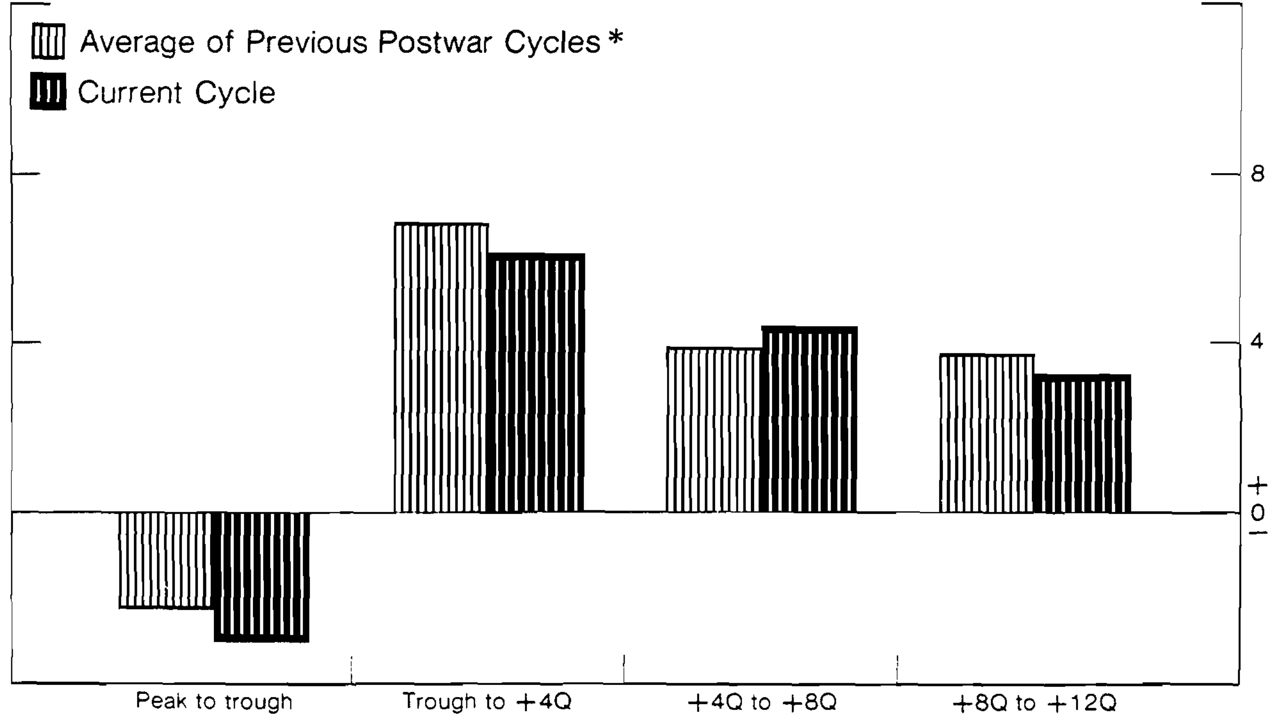


*Excludes 1948-49 and 1980 cycles.

Real GNP

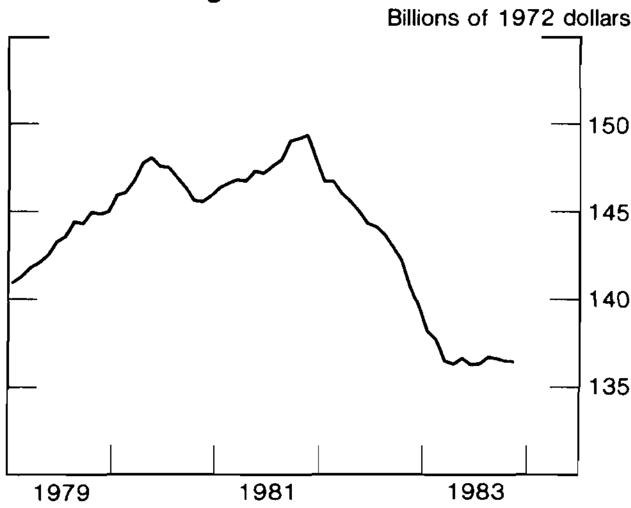


Cyclical Comparison of Real GNP

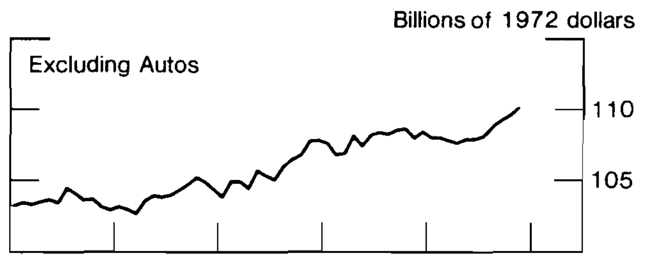


*Excludes 1946-49 and 1980 cycles

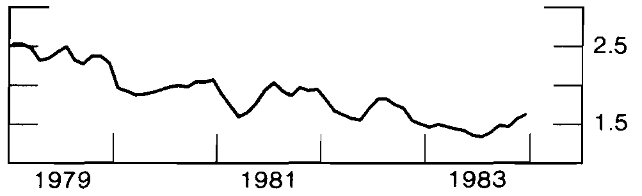
Manufacturing Inventories



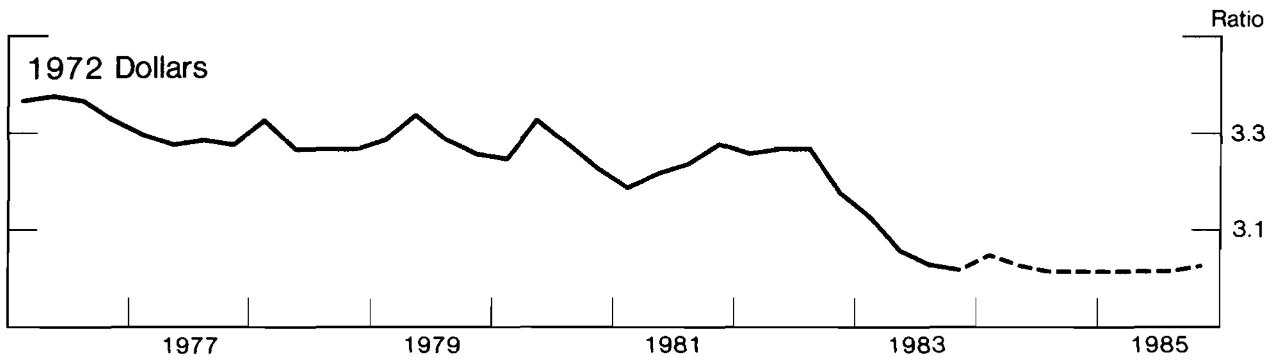
Trade Inventories



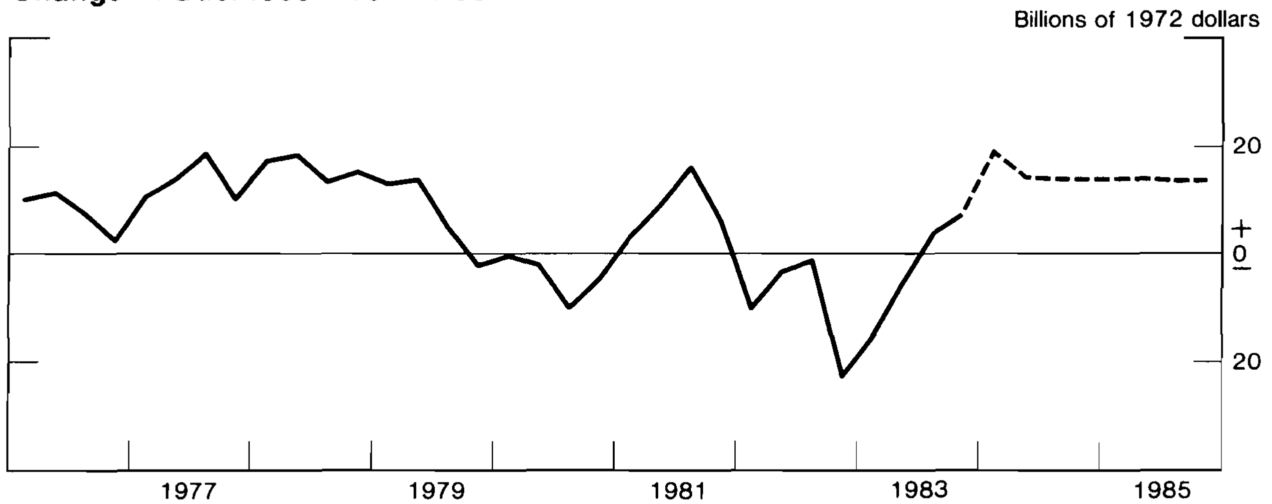
Auto Inventories



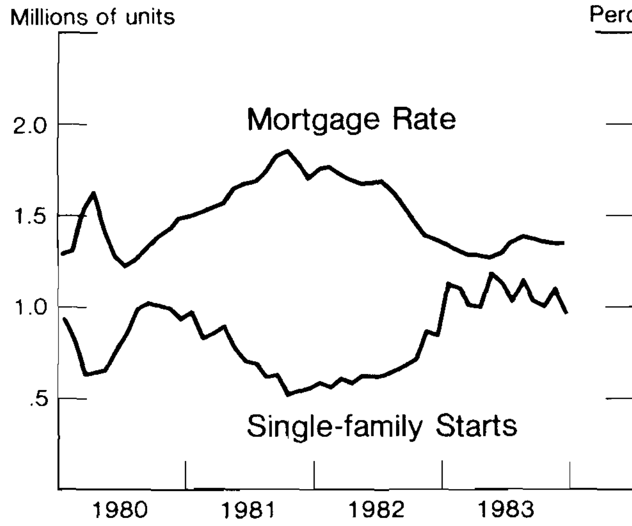
Inventories Relative to Sales



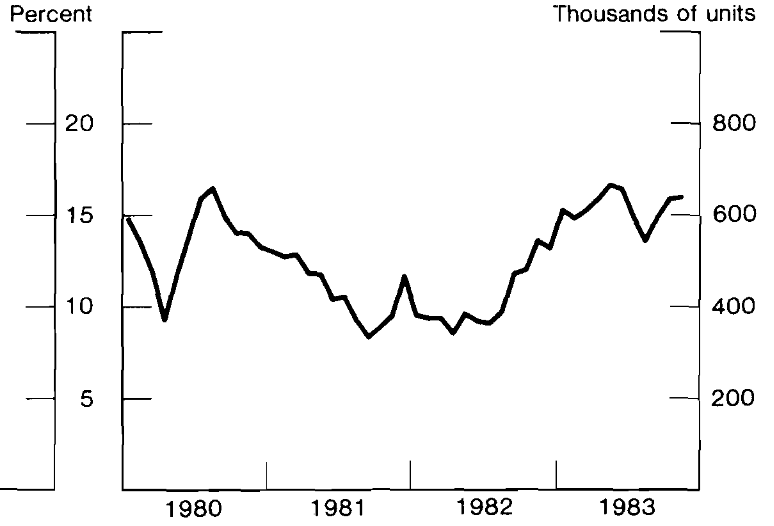
Change in Business Inventories



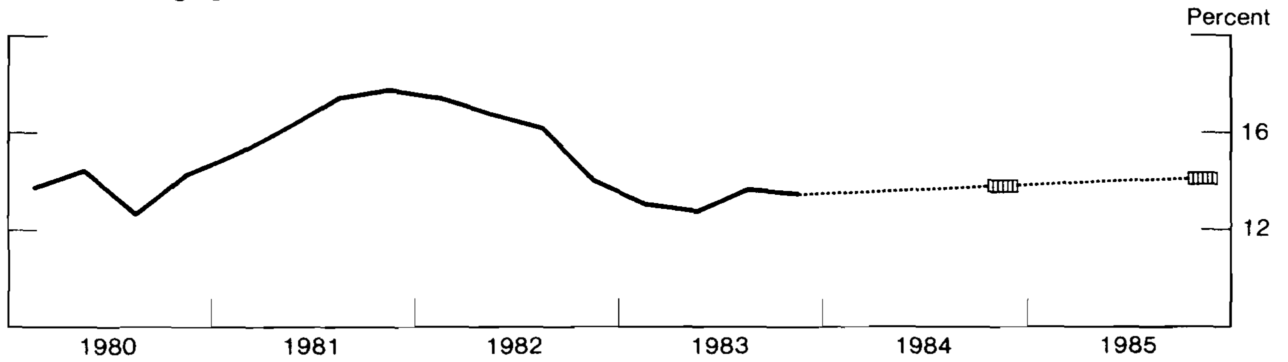
Housing Starts and Home Mortgage Rate



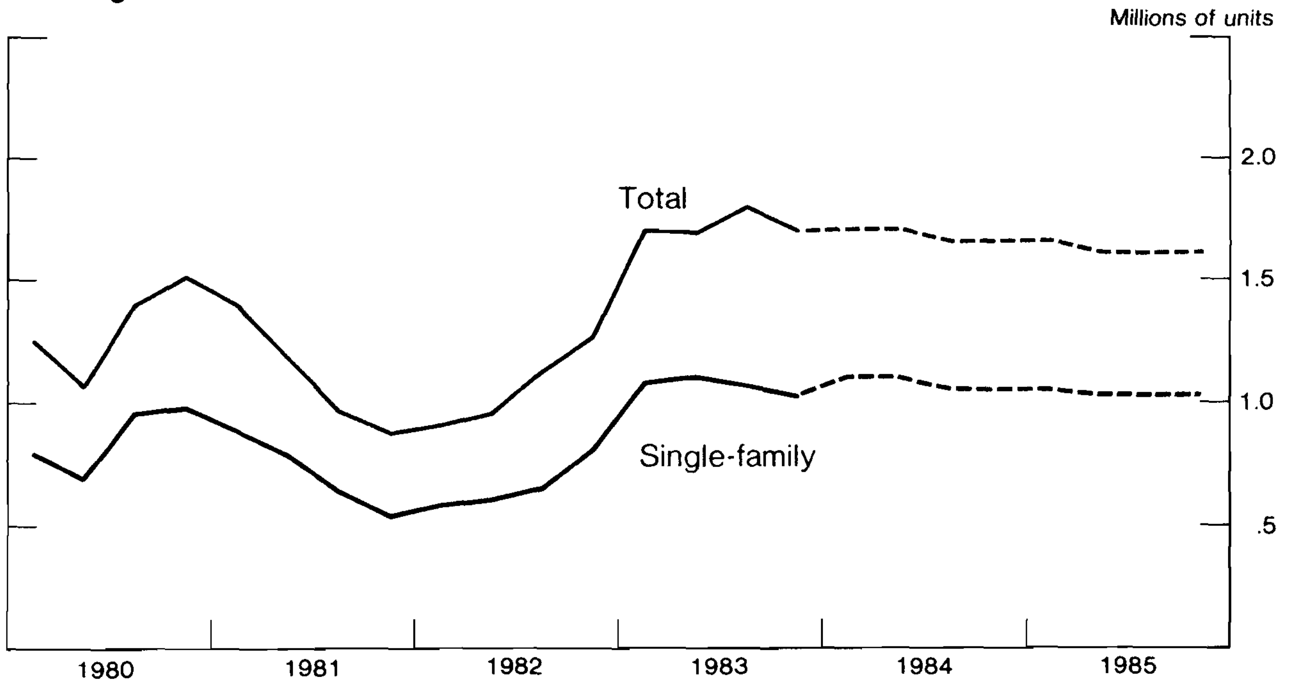
New Home Sales



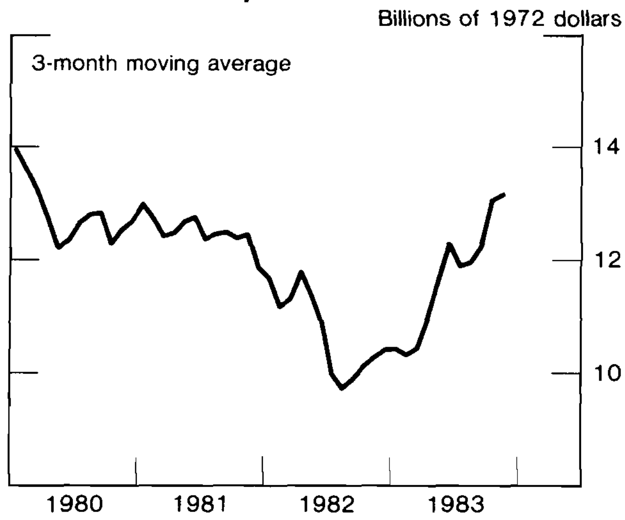
Home Mortgage Rate



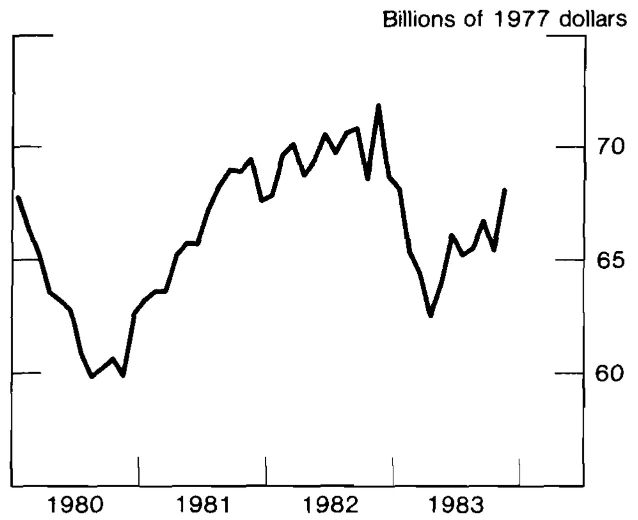
Housing Starts



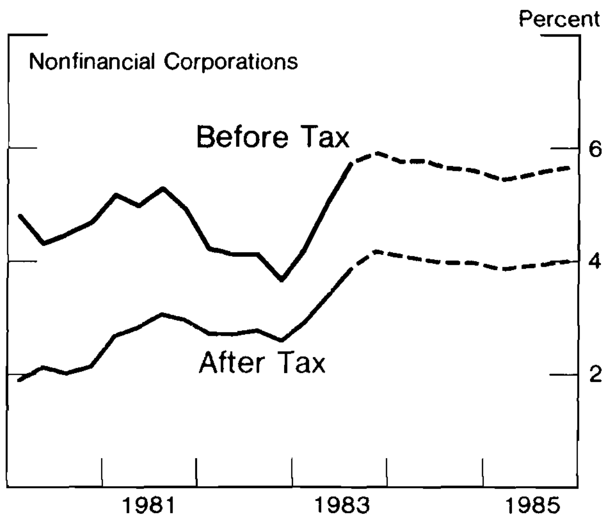
Real New Orders for Nondefense Capital Goods



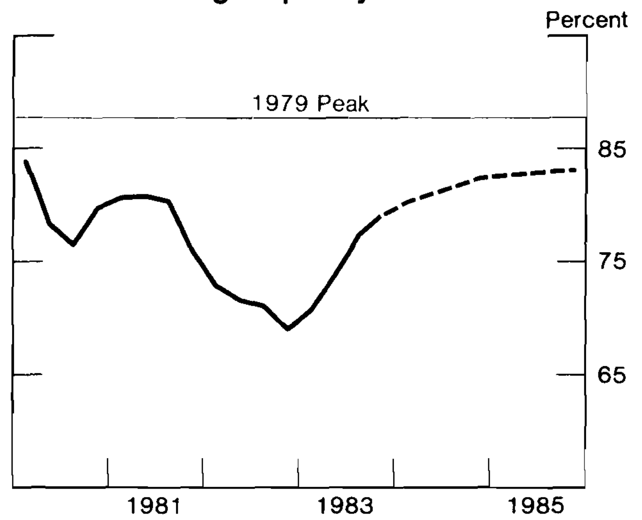
Nonresidential Construction Put in Place



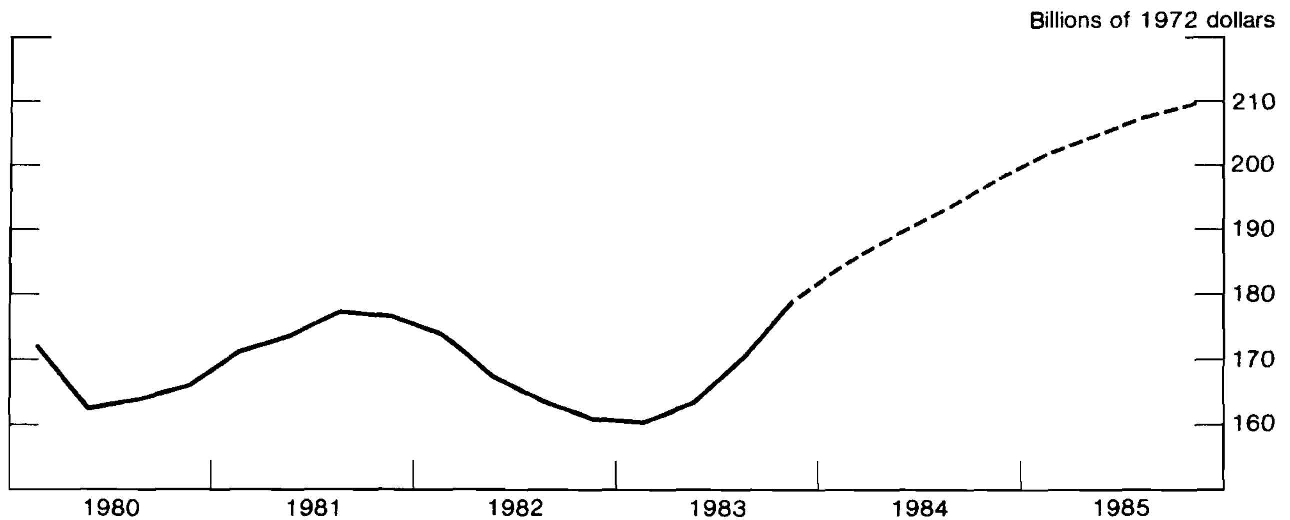
Economic Profits Relative to GNP



Manufacturing Capacity Utilization

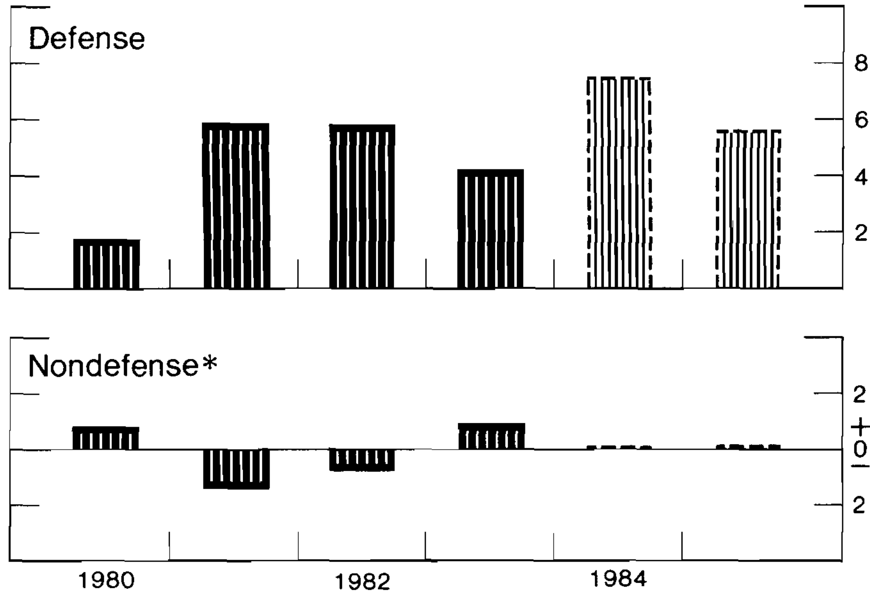


Real Business Fixed Investment



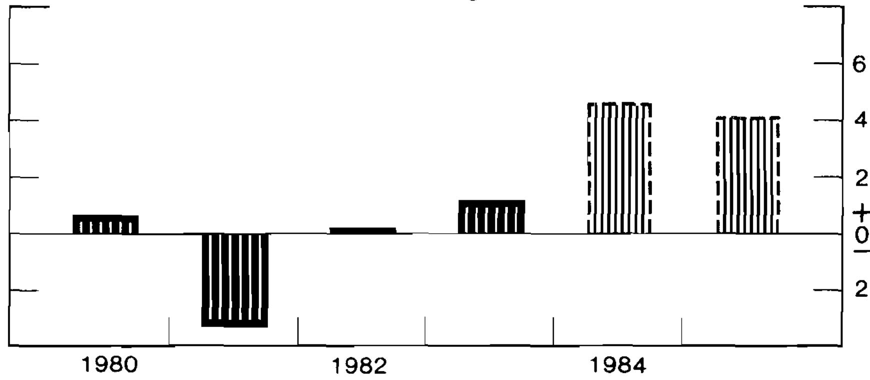
Real Federal Purchases

Change, Q4 to Q4, billions of 1972 dollars



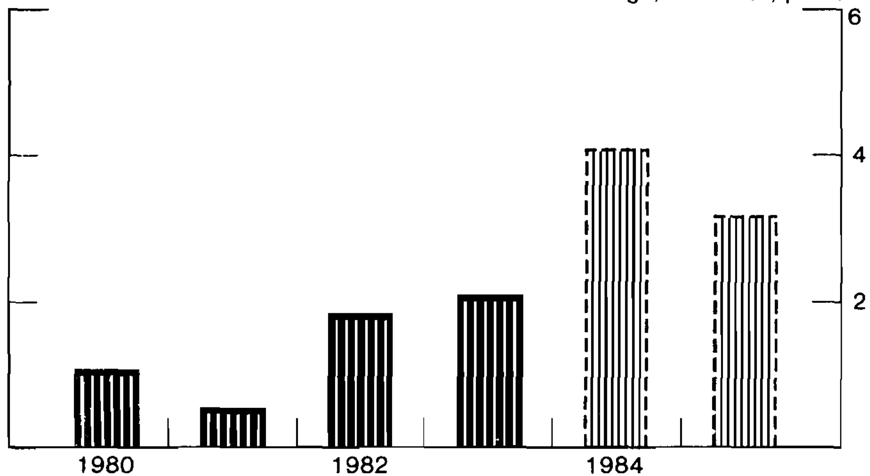
Real State and Local Purchases

Change, Q4 to Q4, billions of 1972 dollars



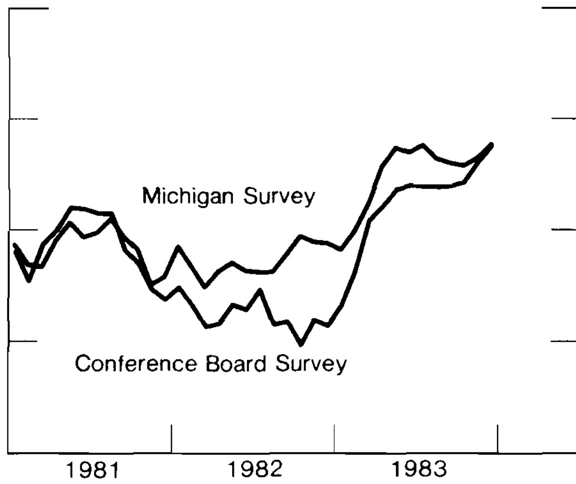
Real Total Government Purchases*

Change, Q4 to Q4, percent

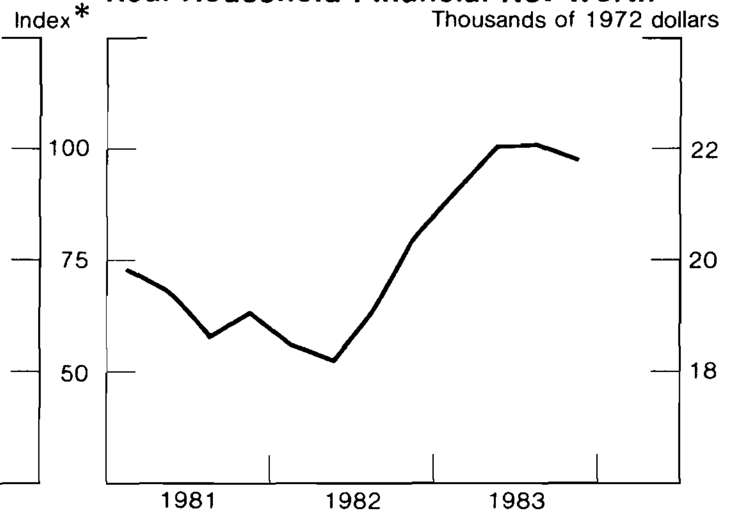


* Excluding CCC

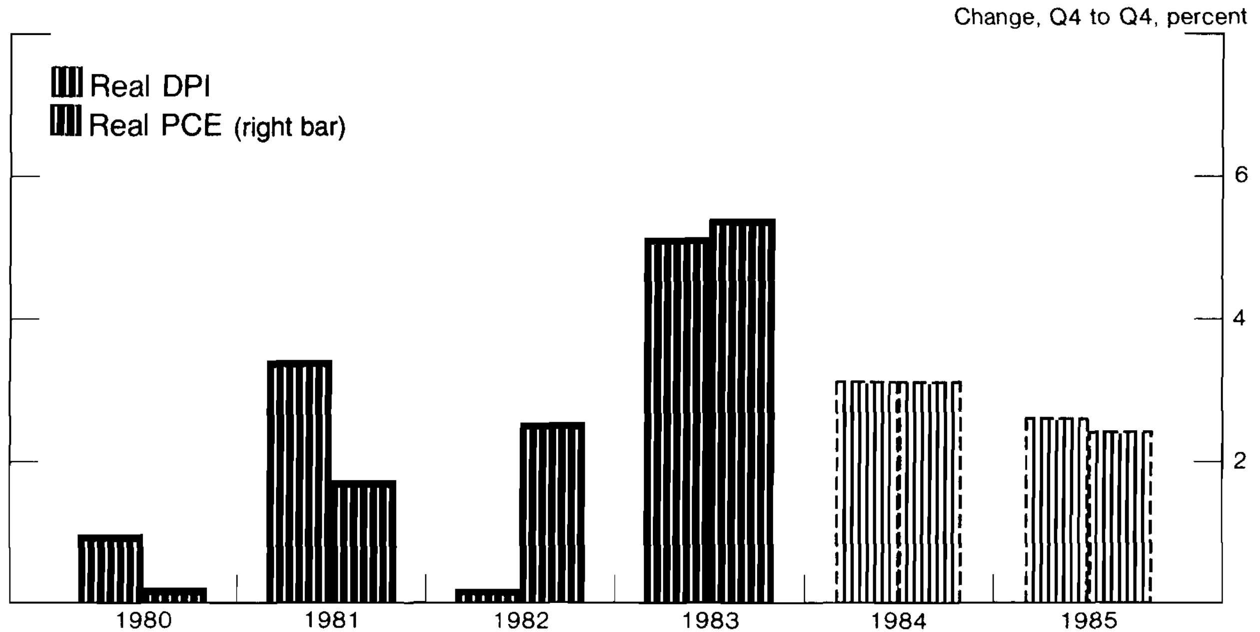
Consumer Attitudes



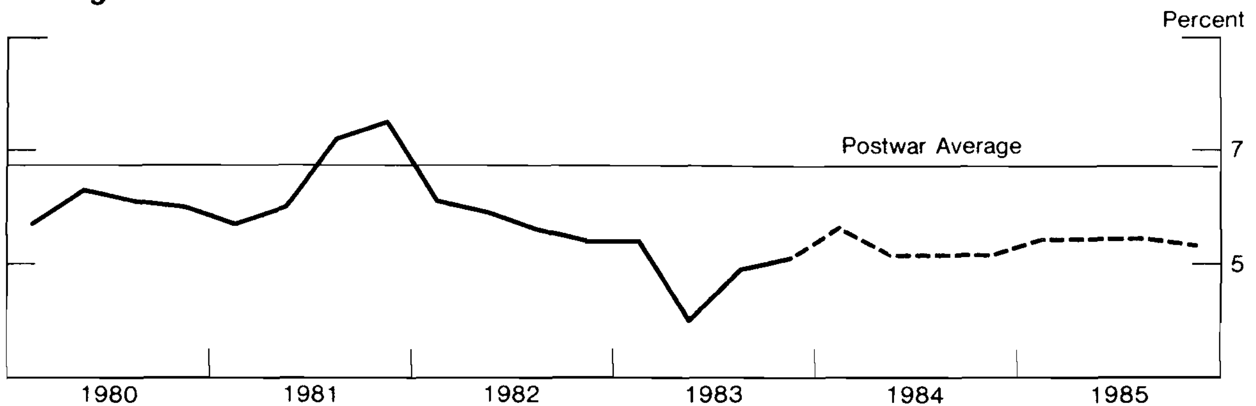
Real Household Financial Net Worth



Real Disposable Personal Income and Consumption Expenditures

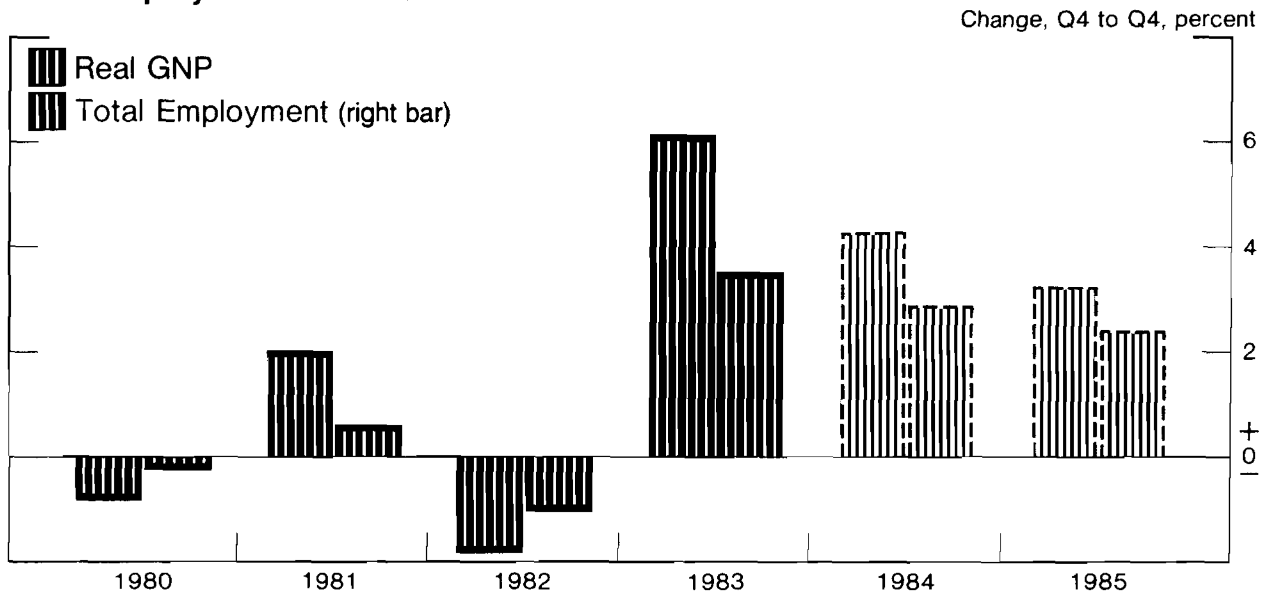


Saving Rate

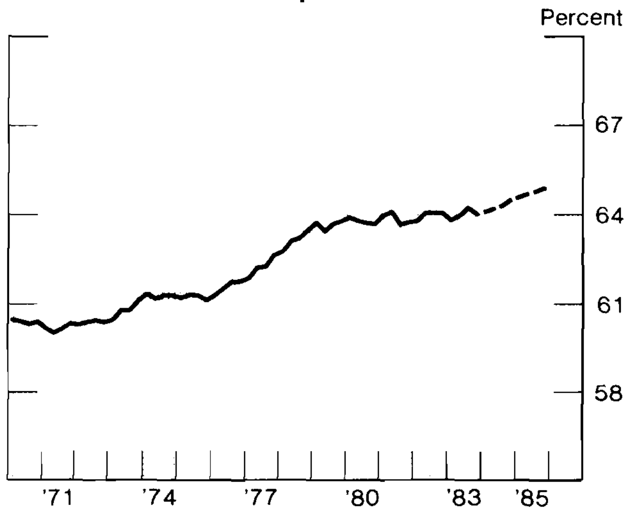


*Michigan Survey Research Center Index of Consumer Sentiment (1966 Q1=100) and Conference Board Index of Consumer Confidence (1969-70=100).

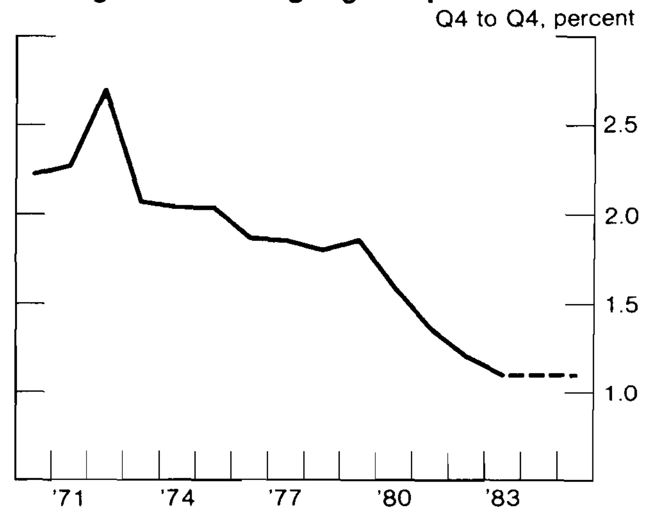
Total Employment and Real GNP



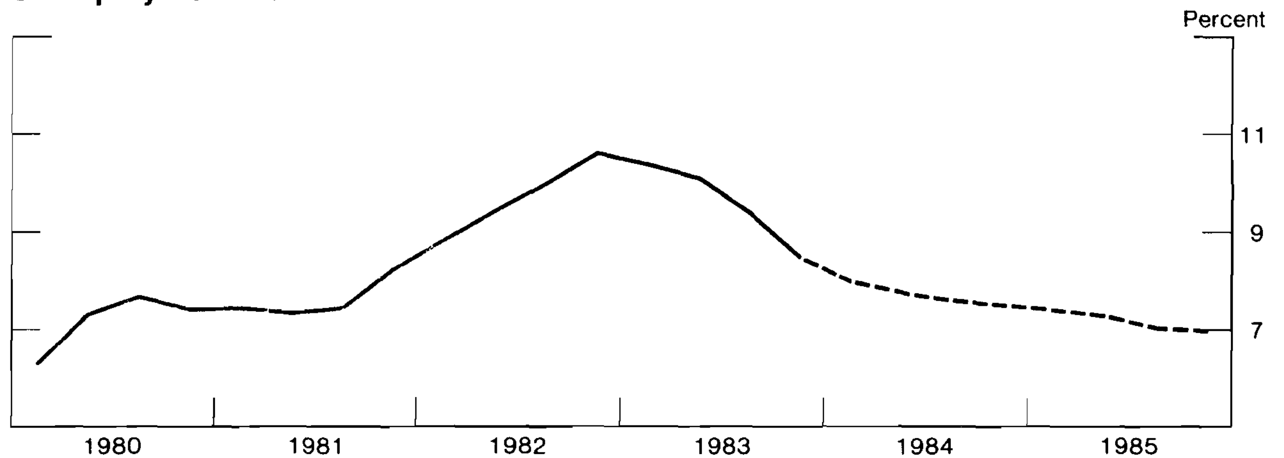
Labor Force Participation Rate



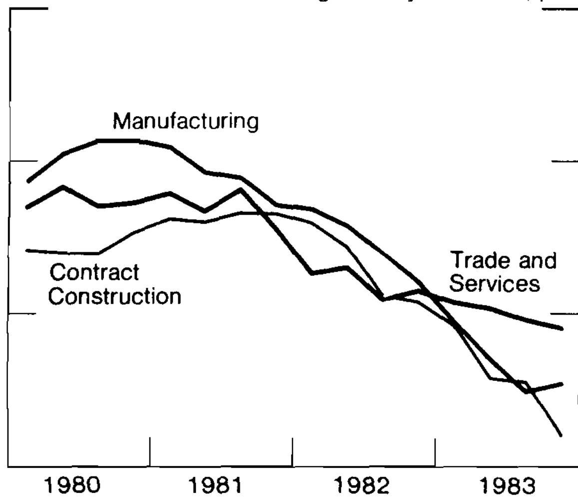
Change in Working Age Population



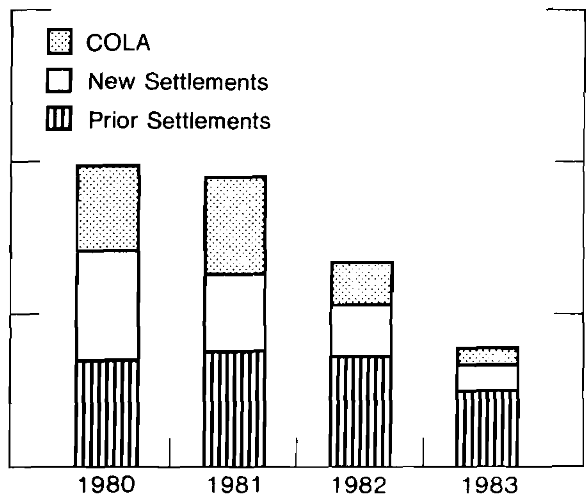
Unemployment Rate



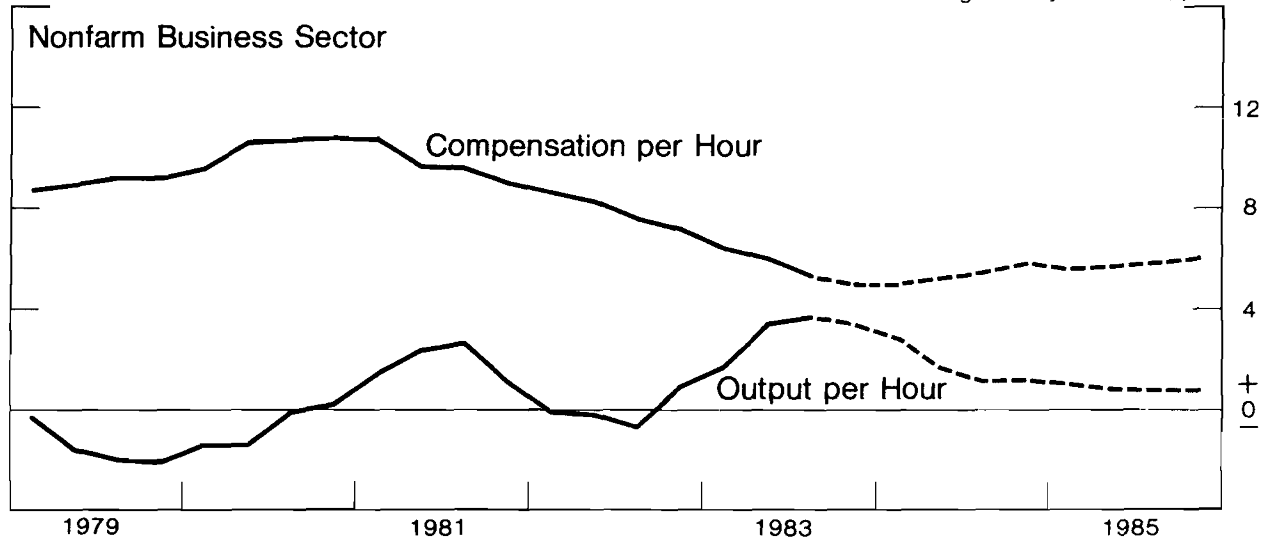
Average Hourly Earnings Index



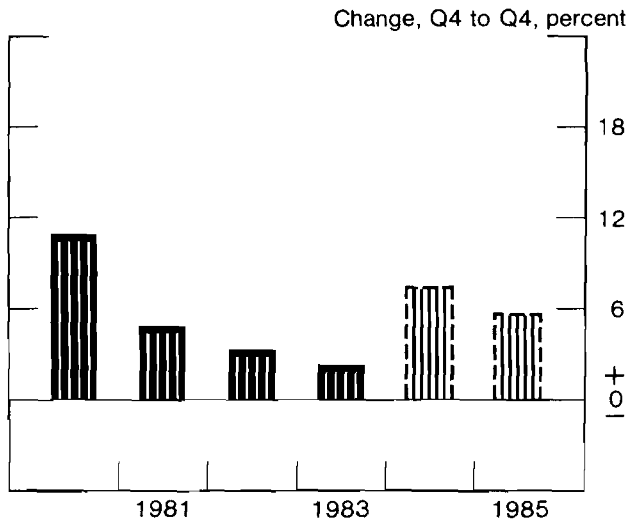
Union Wage Change



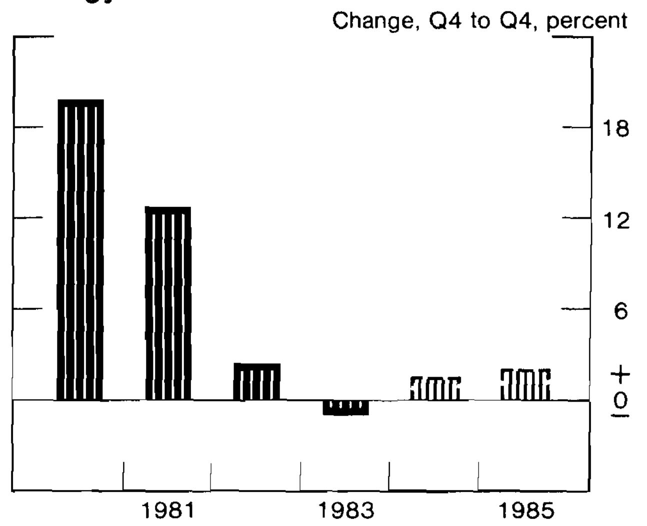
Hourly Compensation and Output



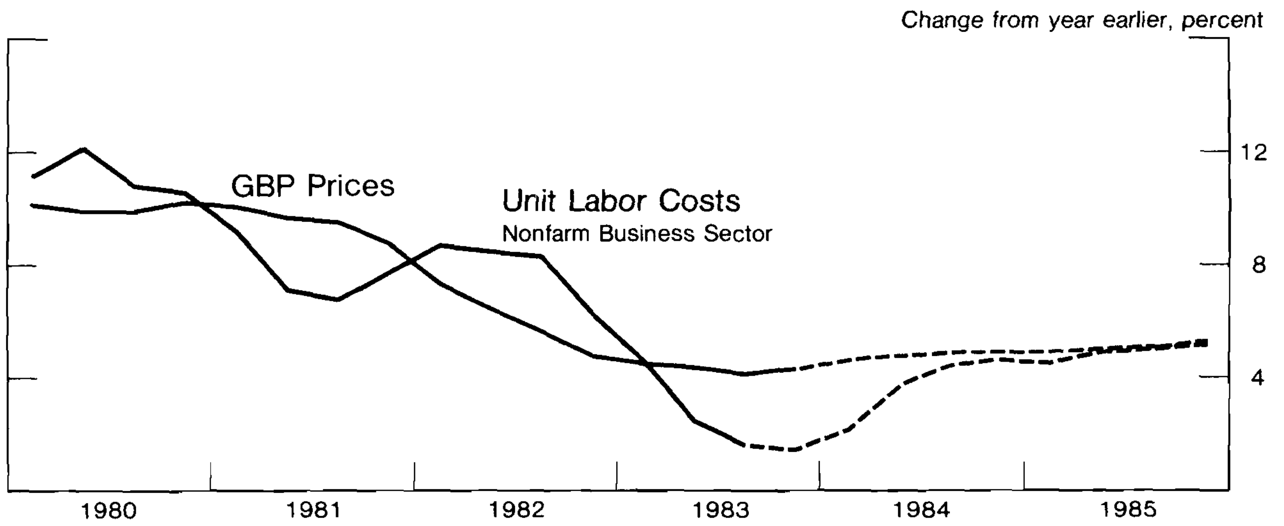
Unit Labor Costs



Food Prices
Change, Q4 to Q4, percent
18
12
6
+
0
-
1981
1983
1985

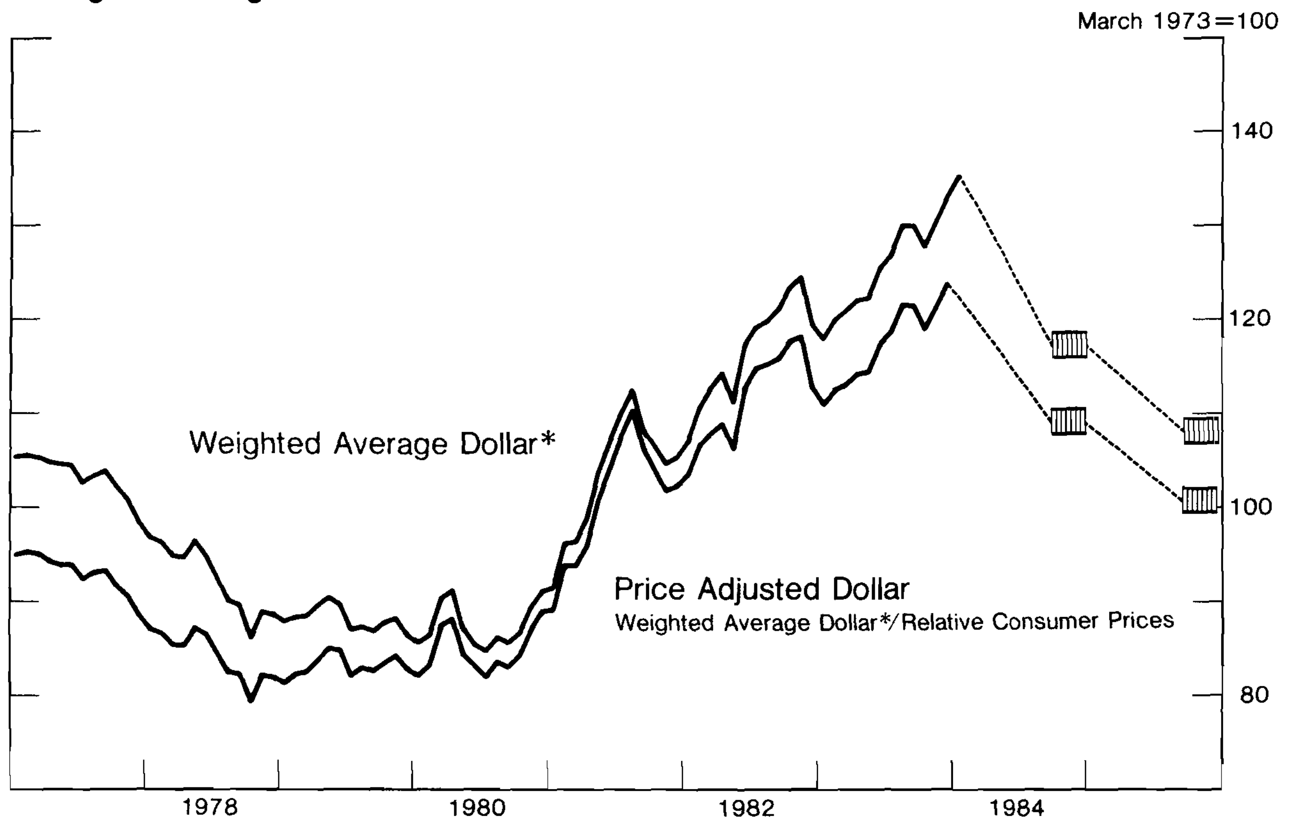


Energy Prices
Change, Q4 to Q4, percent
18
12
6
+
0
-
1981
1983
1985

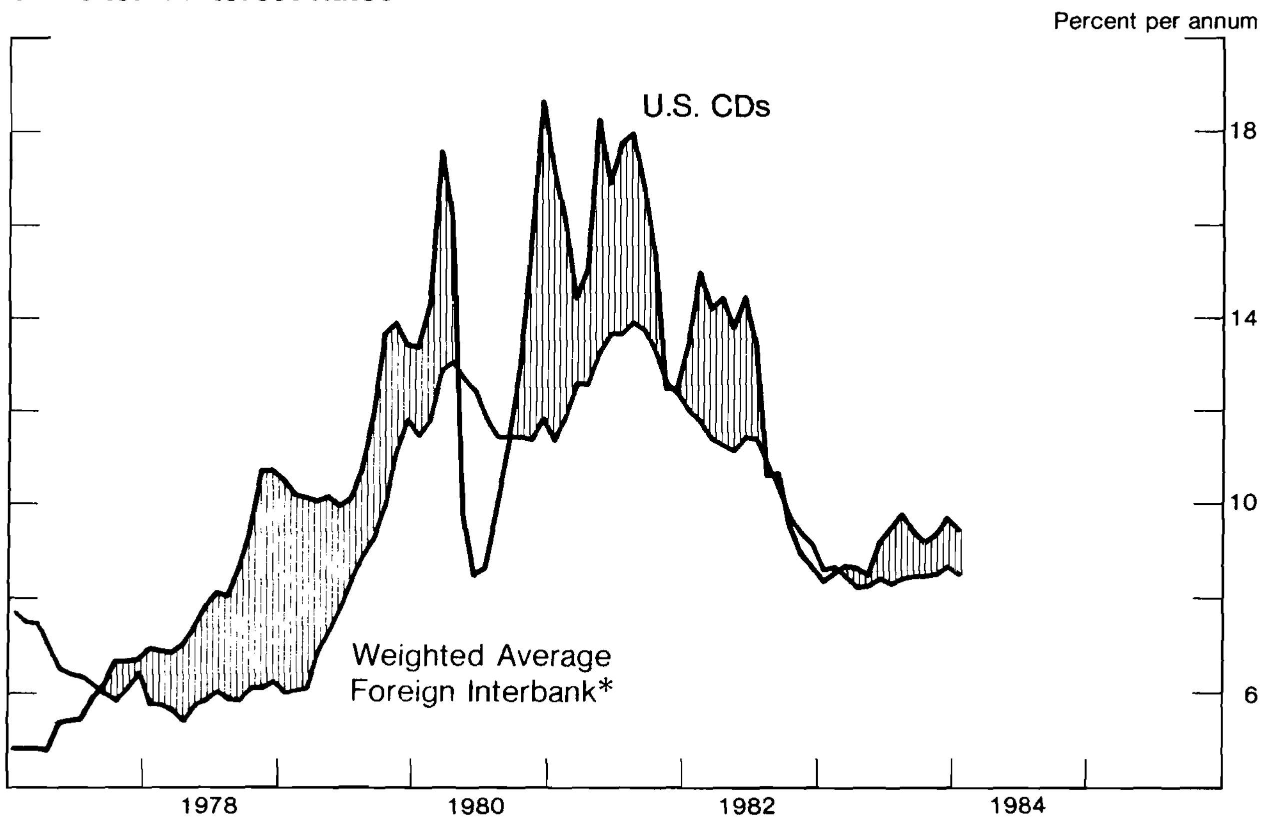


Change from year earlier, percent
GBP Prices
Unit Labor Costs
Nonfarm Business Sector
12
8
4
1980
1981
1982
1983
1984
1985

Foreign Exchange Value of the U.S. Dollar

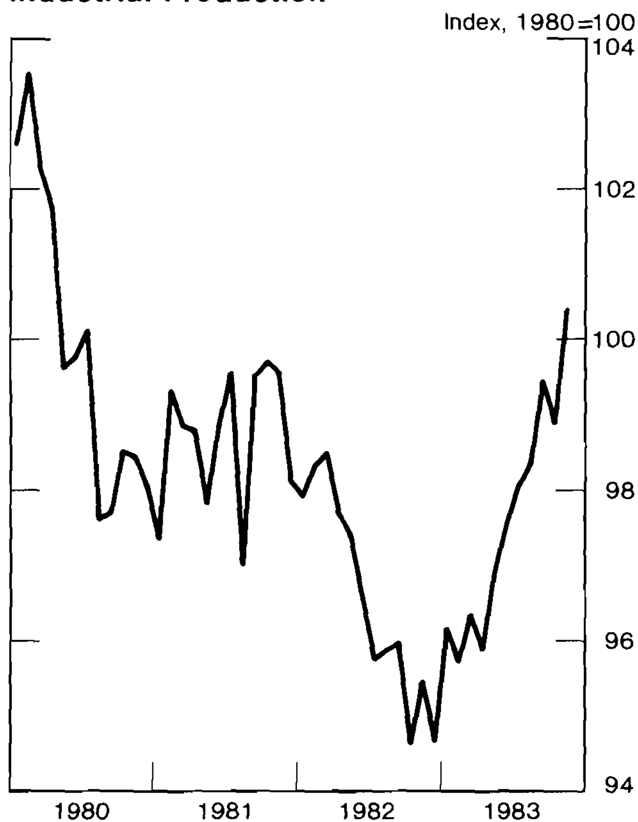


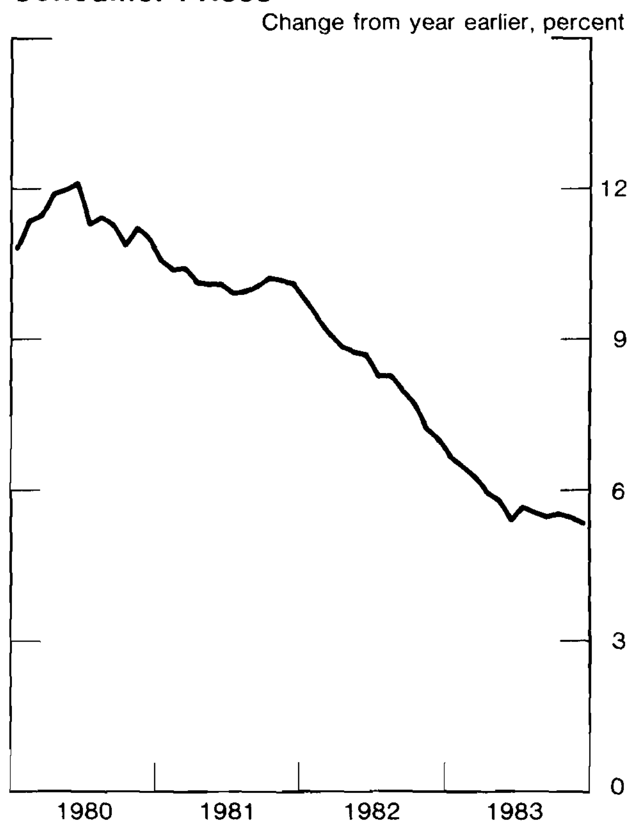
Short-term Interest Rates

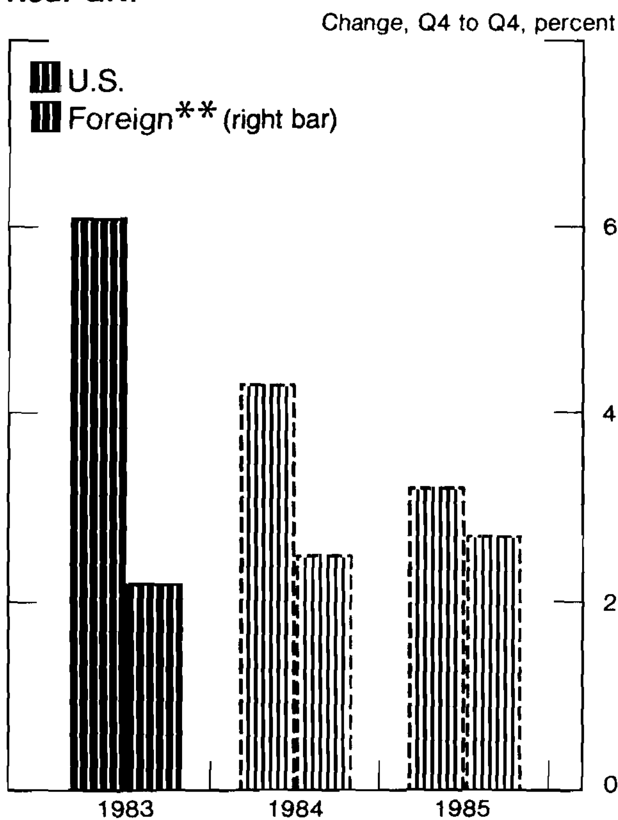


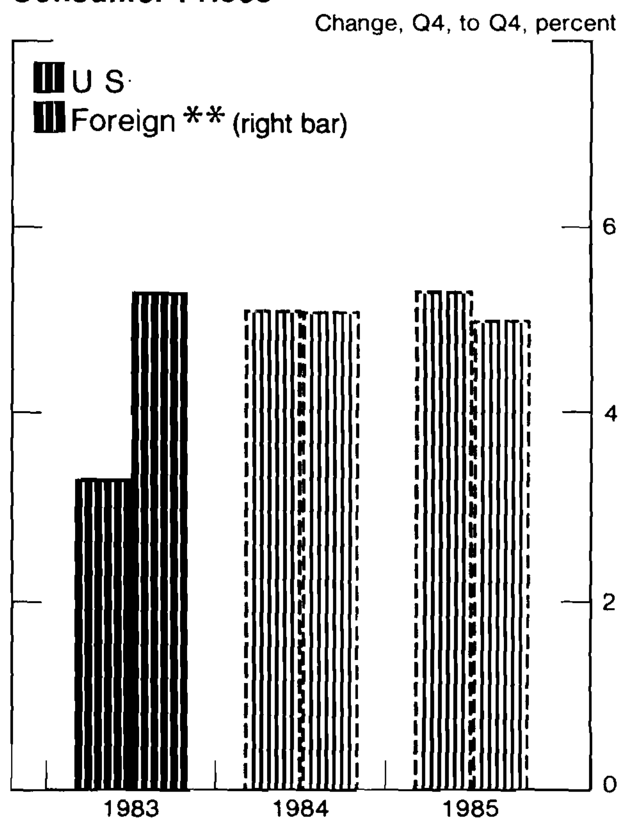
* Weighted average against or of foreign G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

Industrial Countries







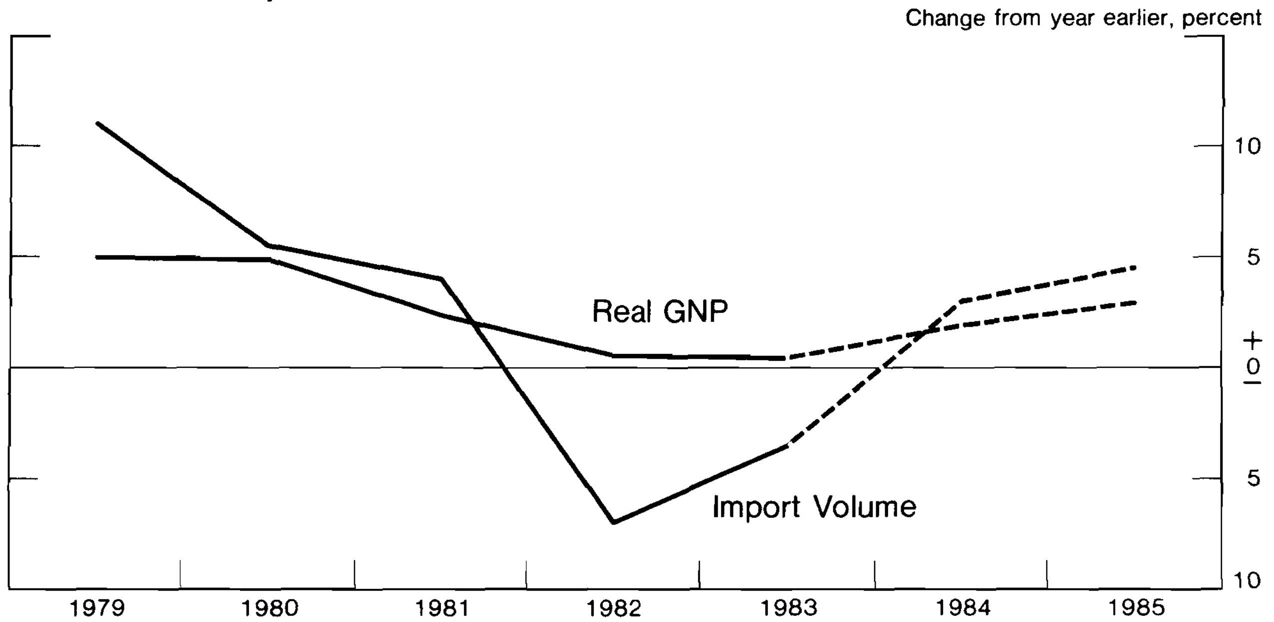


* Weighted average of six major foreign countries using total 1972-76 average trade of these countries.

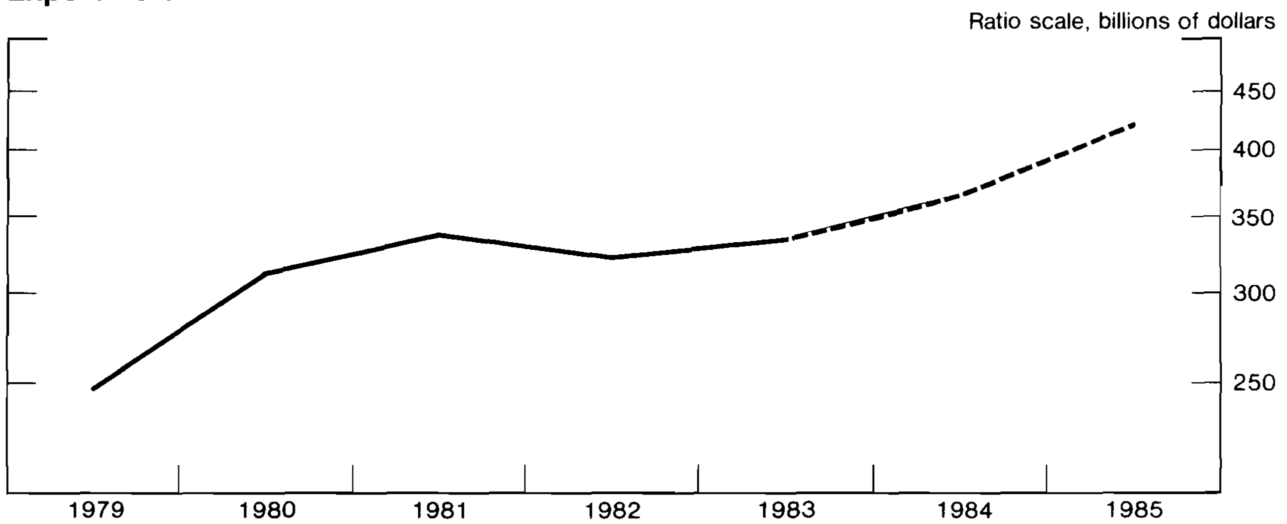
** Weighted average of foreign G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

Non-OPEC Developing Countries

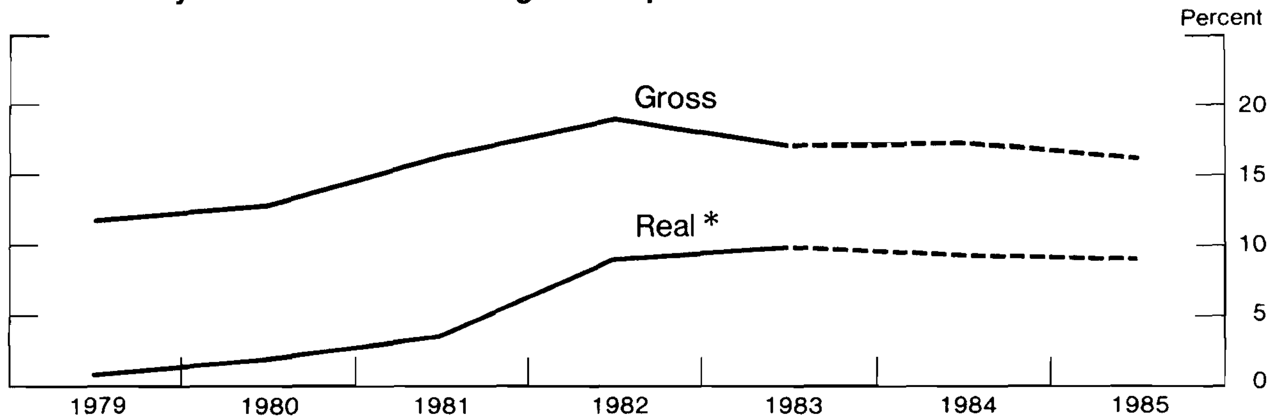
Real GNP and Import Volume



Export Value

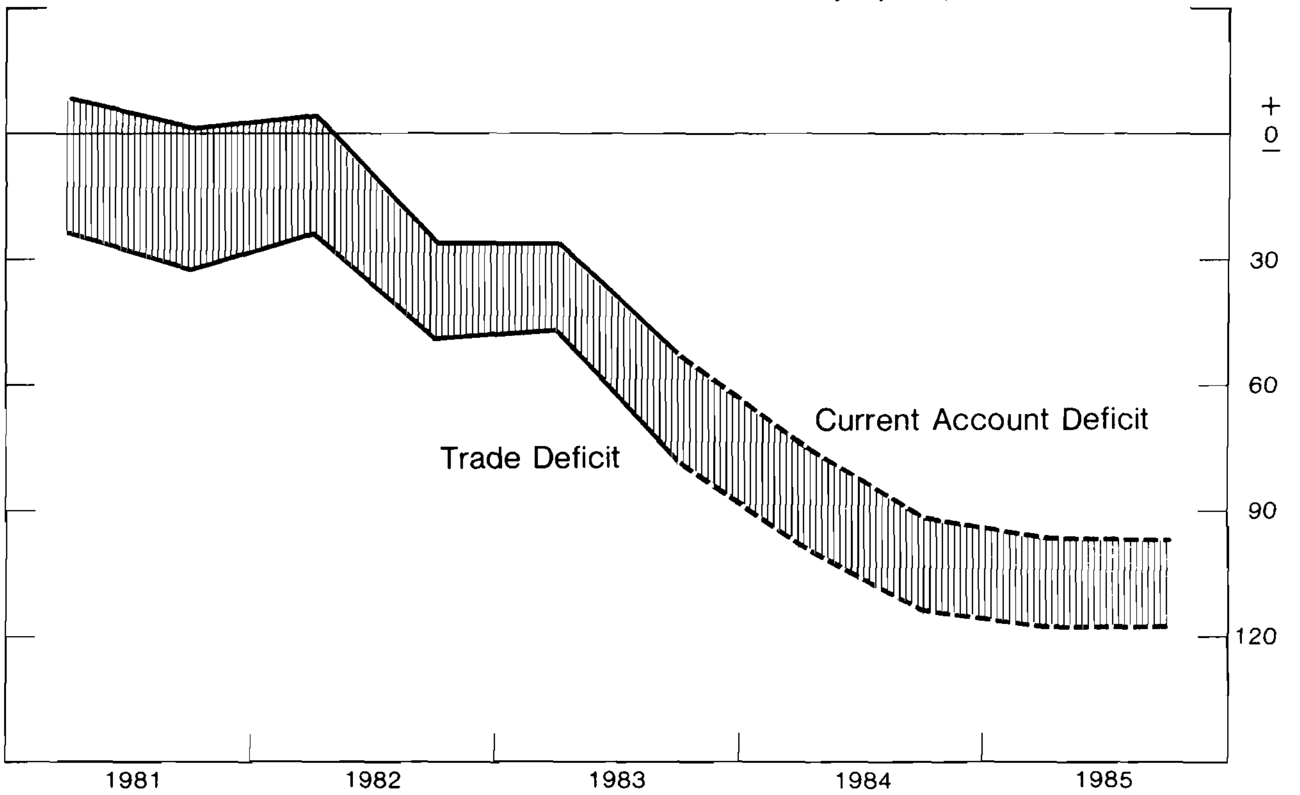


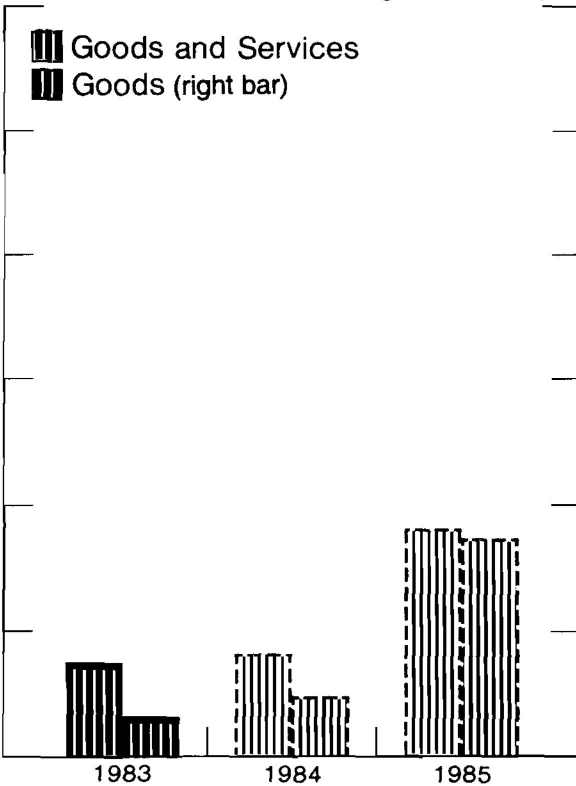
Interest Payments As A Percentage Of Export Value

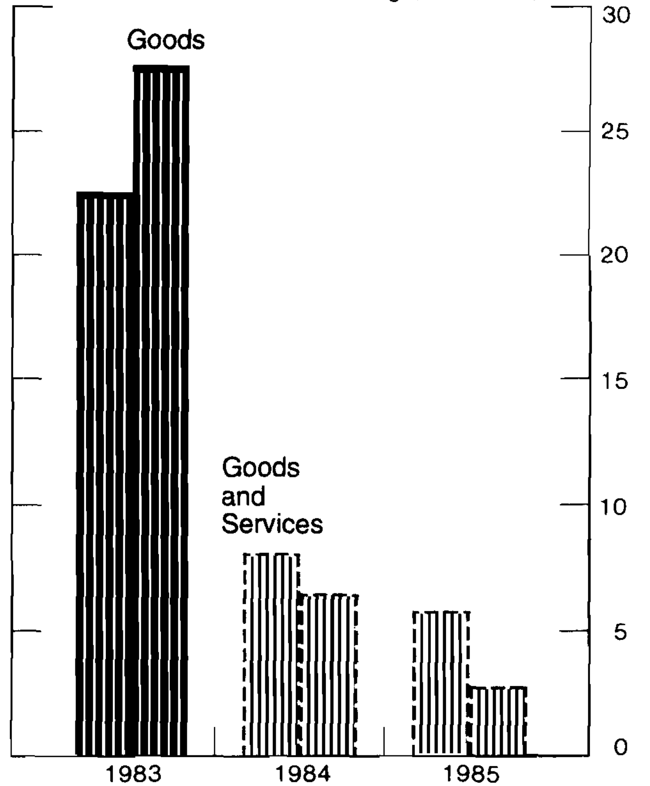


* Gross interest payments reduced by portion compensating for inflation as measured by the U.S GNP deflator

U.S. External Accounts







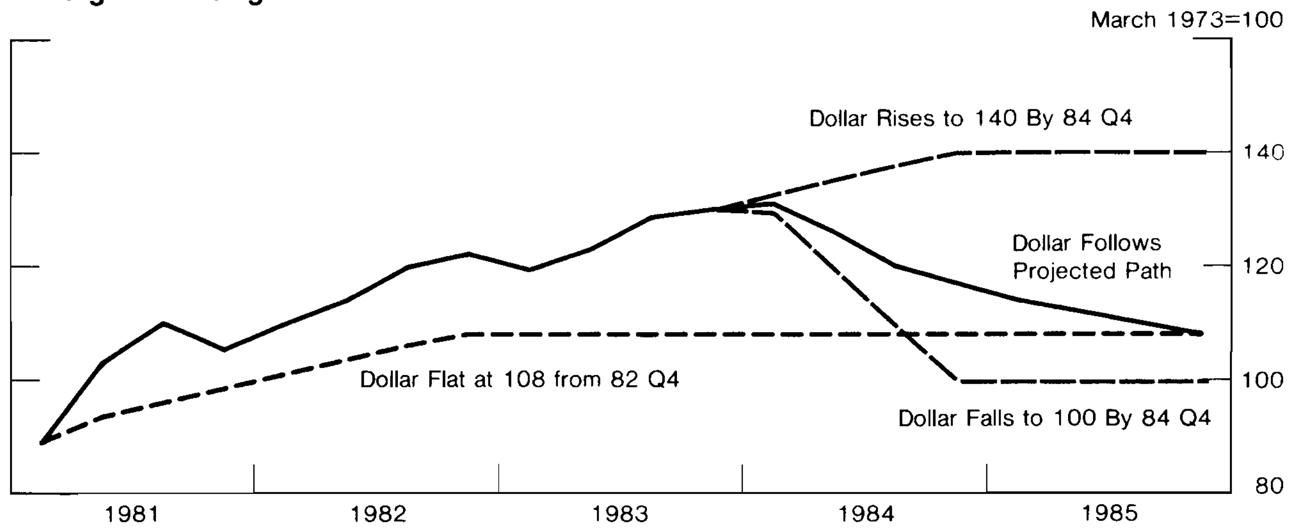
Illustrative Pattern of Current Account Financing

	Billions of dollars		
	1982	1983*	1984p
1. Current account	– 11.2	– 40	– 83
2. Statistical discrepancy	41.4	11	25
3. Recorded capital flows (+ = inflow) [lines 4 + 5 = – (1 + 2)]	– 30.2	29	58
4. Official capital, net	– 2.1	4	13
5. Private capital, net	– 28.1	25	45
a. U.S. banking offices	– 39.6	17	30
b. Other private capital	11.5	8	15

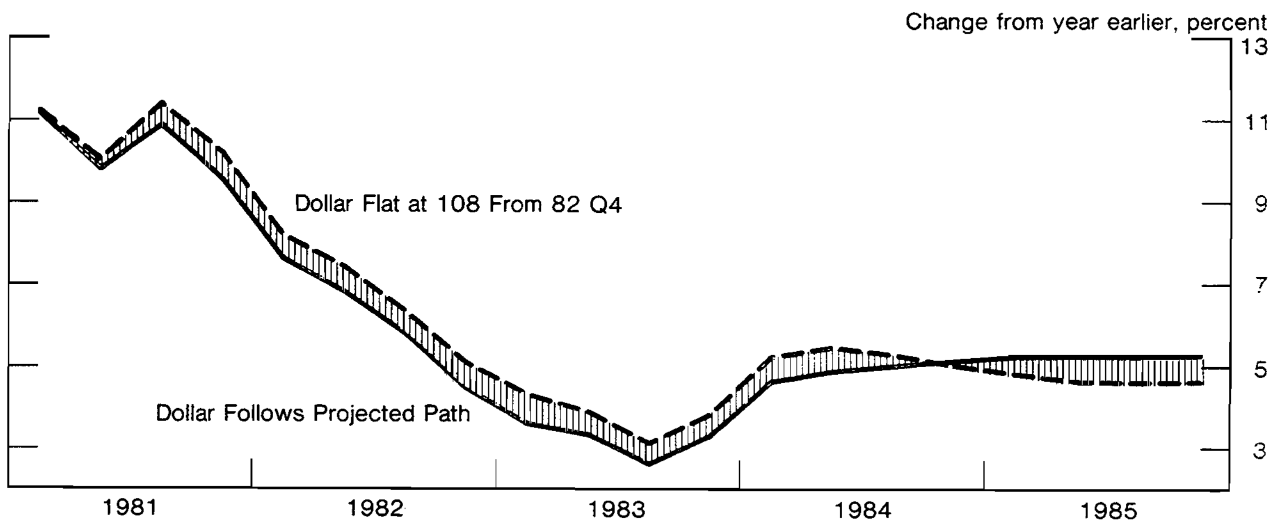
* Partially estimated

p Projected

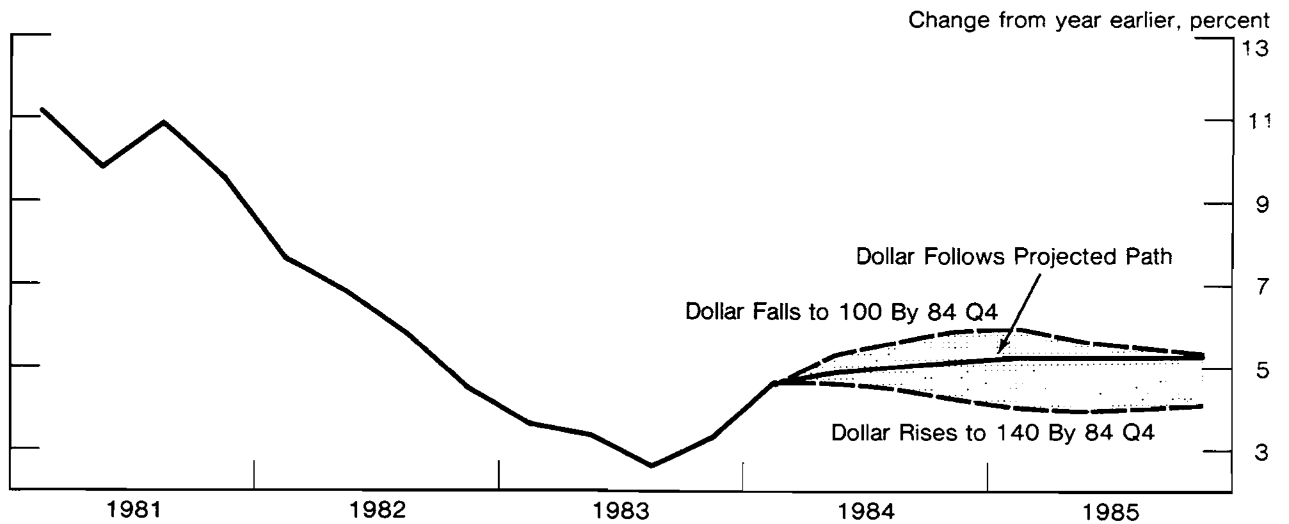
Foreign Exchange Value of the U.S. Dollar



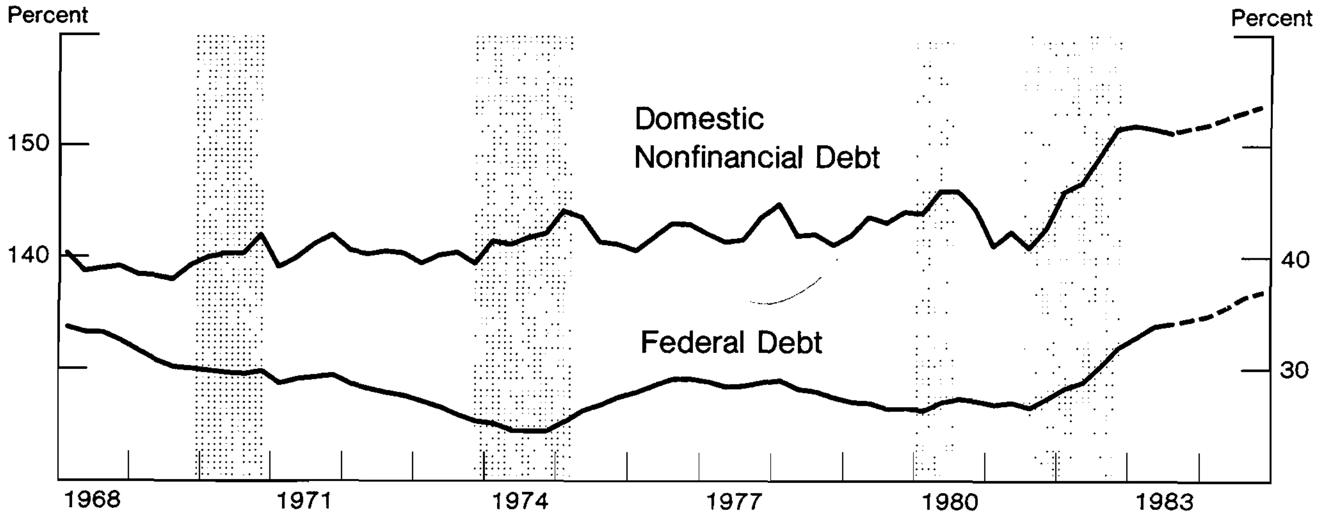
Consumer Prices



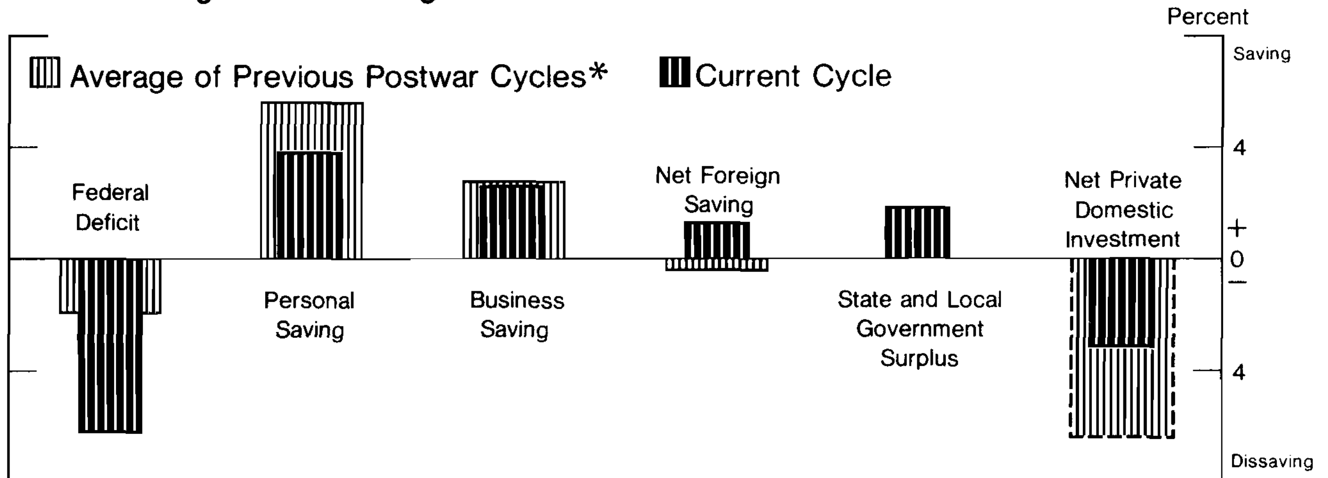
Consumer Prices



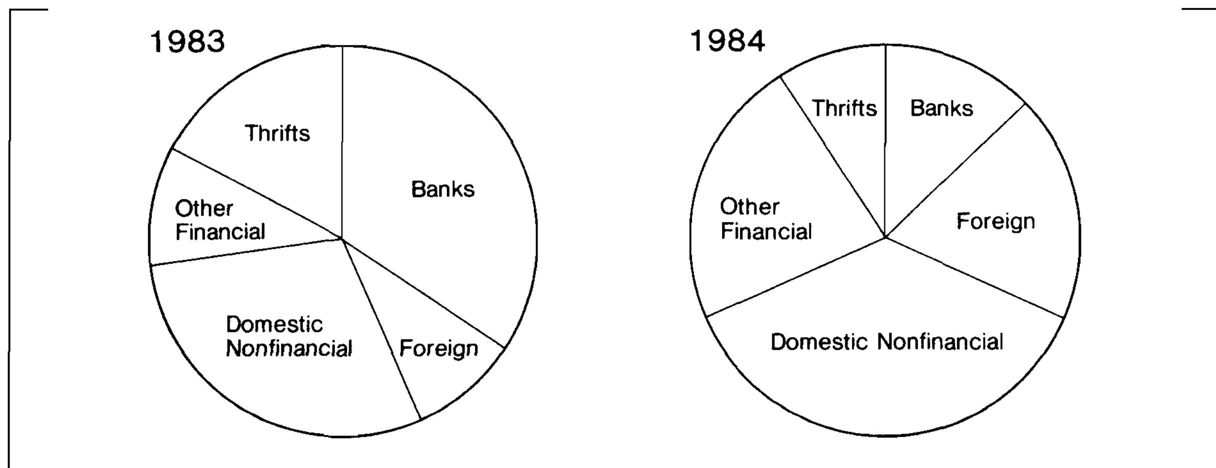
Domestic Nonfinancial Debt Relative to GNP



Sector Saving and Dissaving Relative to NNP

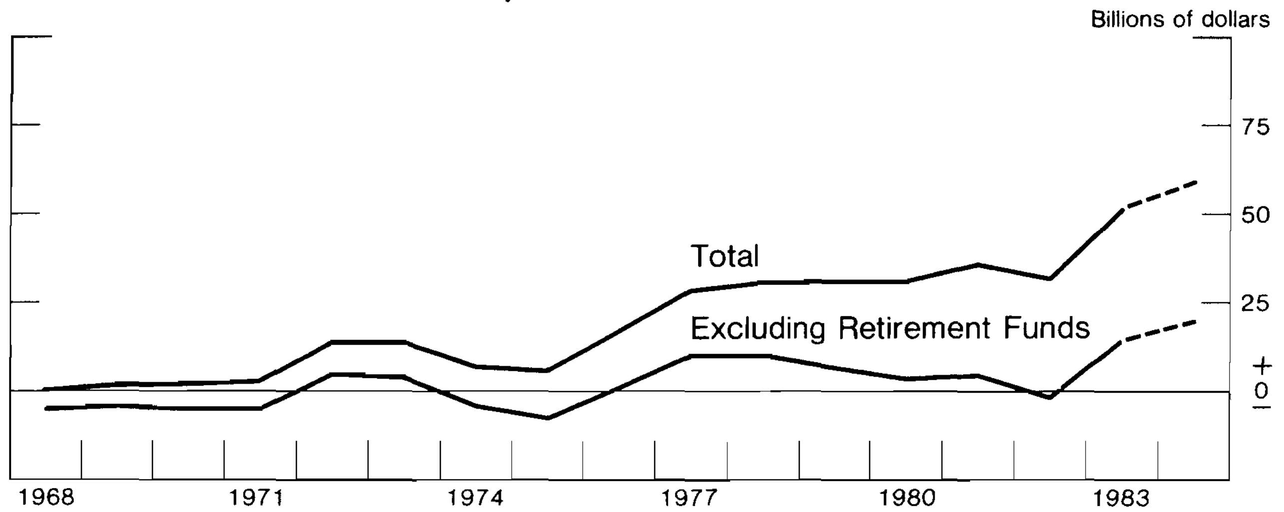


Absorption of Federal Debt

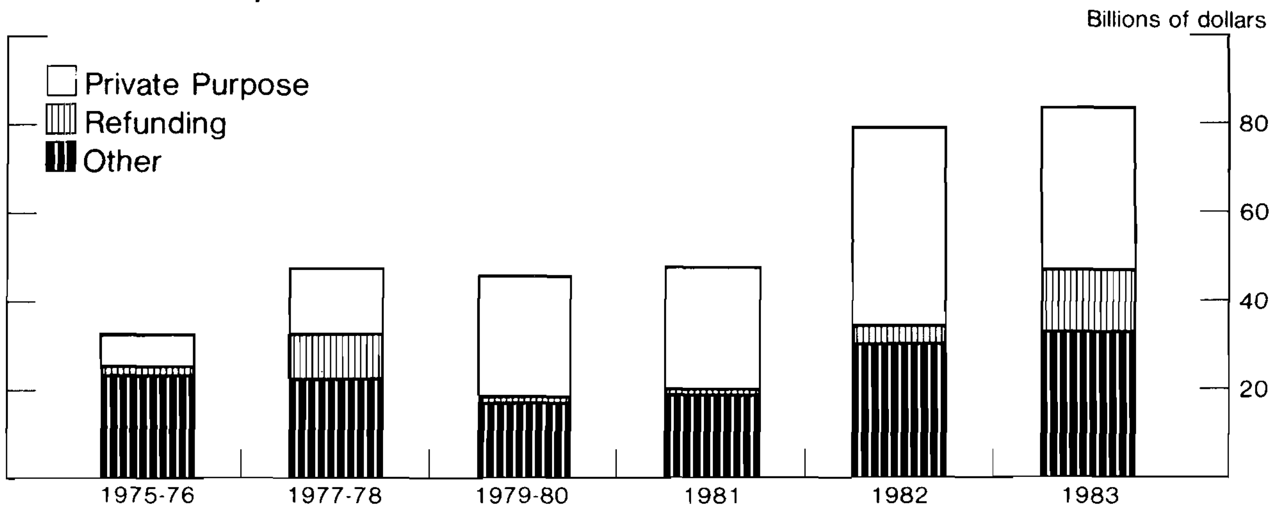


*Excludes 1948-49 and 1980 cycles.

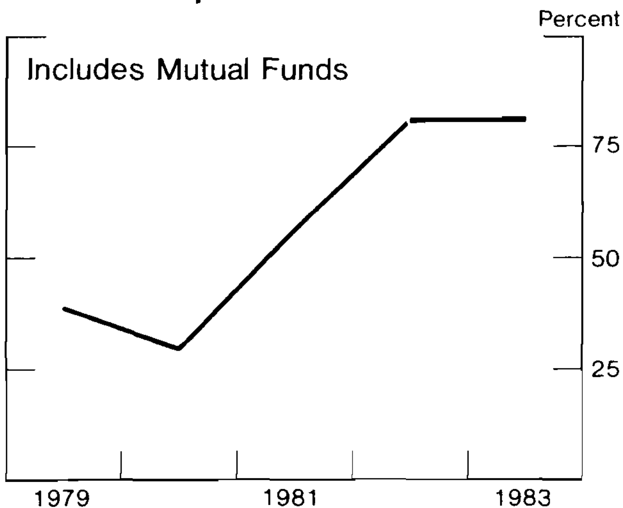
State and Local Government Surplus



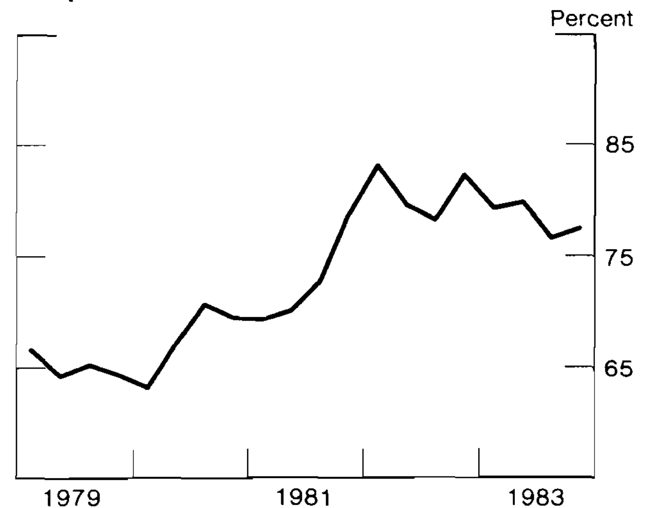
Gross Tax-exempt Bond Issues



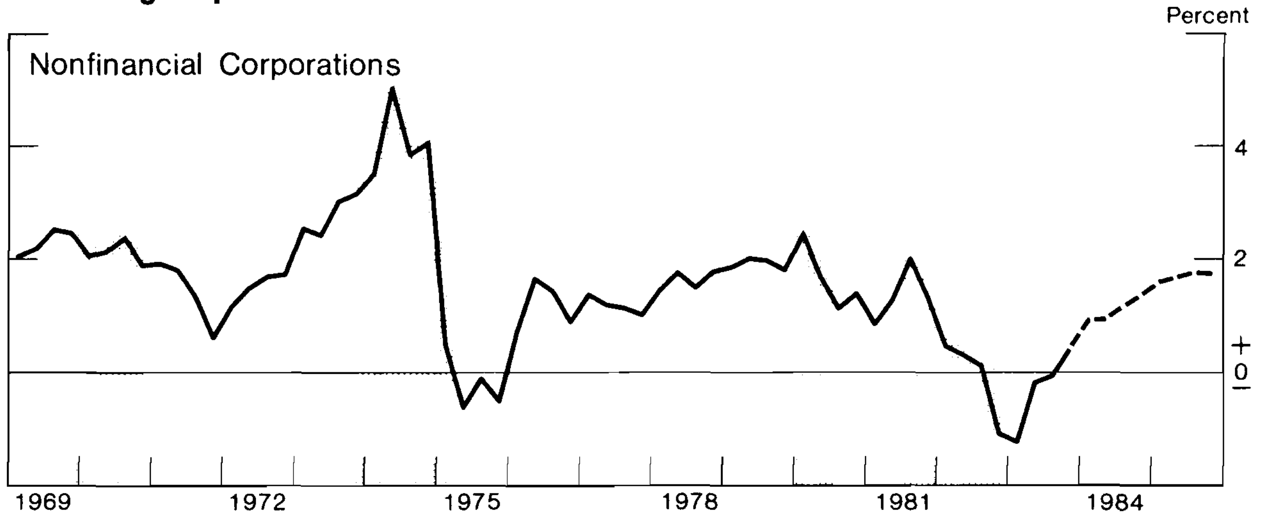
Household Absorption of Tax-exempt Debt



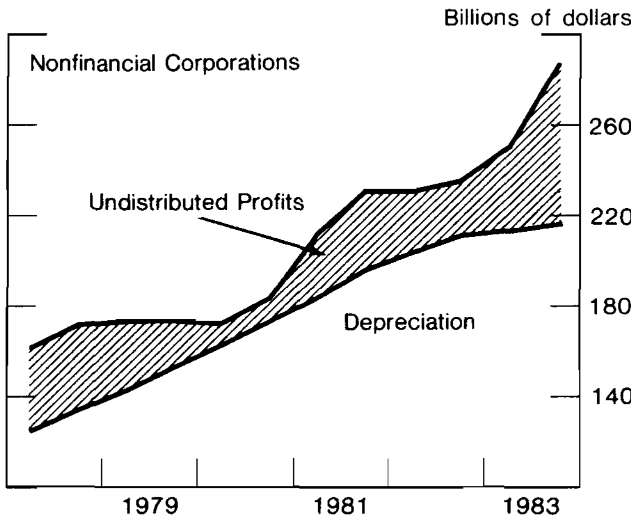
Ratio of Municipal to Corporate Bond Yield



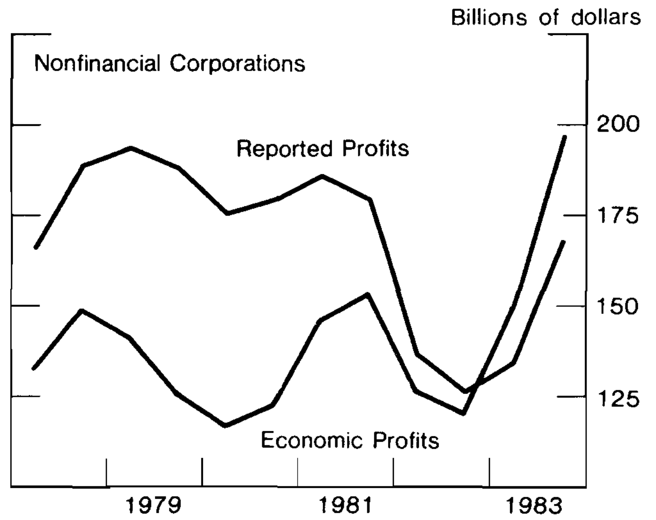
Financing Gap Relative To GNP



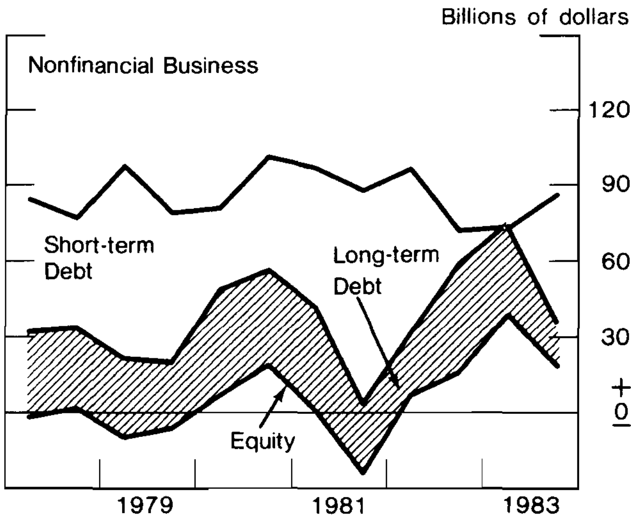
Internal Funds



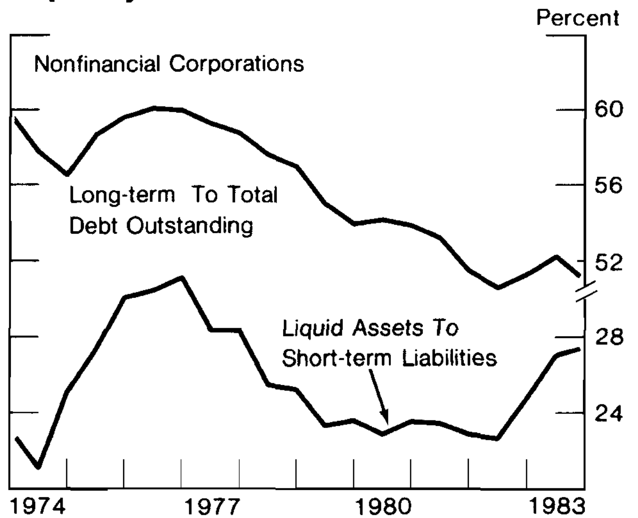
Profits Before Tax



Funds Raised

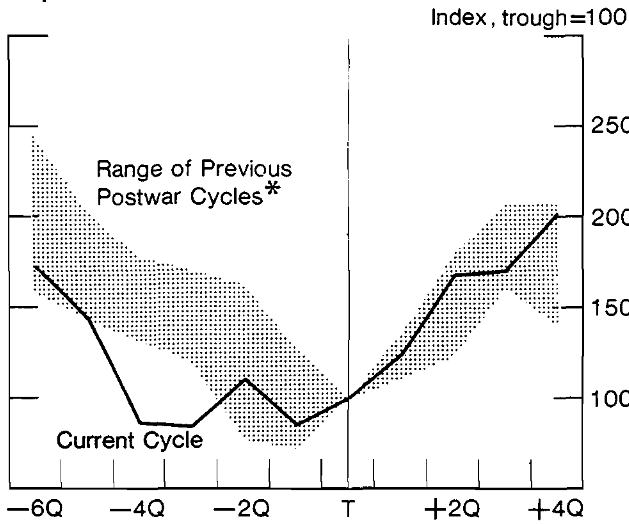


Liquidity Ratios

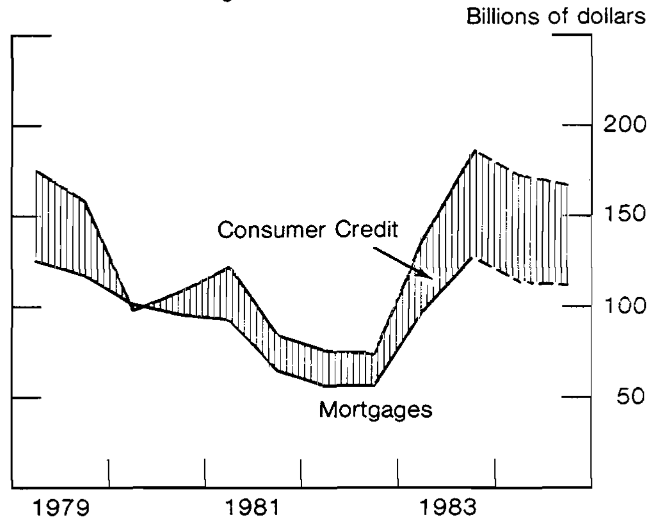


Households

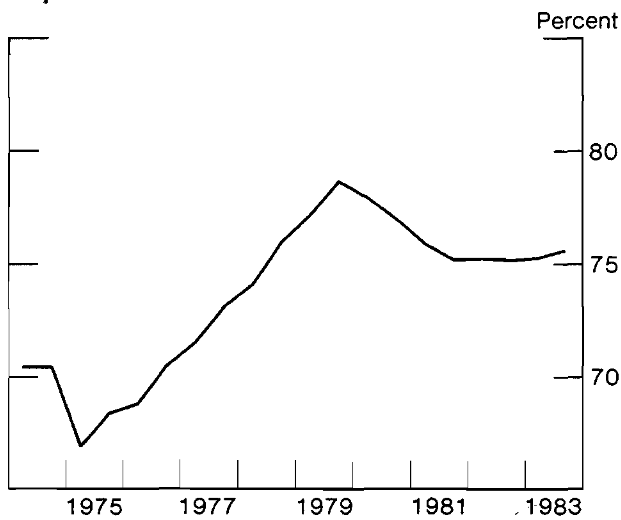
Household Borrowing Relative to Disposable Personal Income



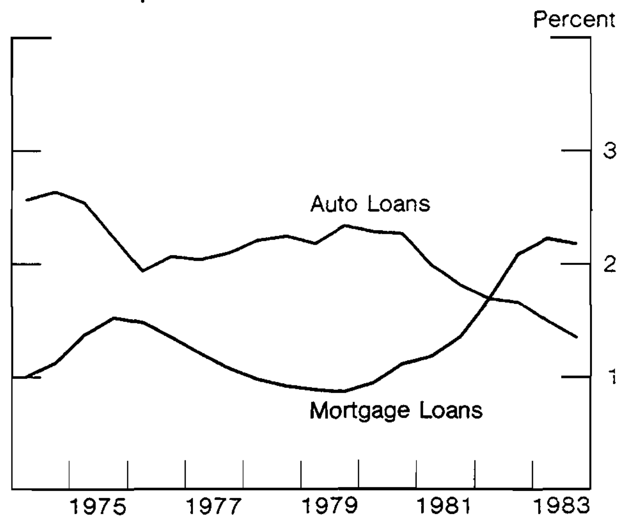
Selected Borrowing



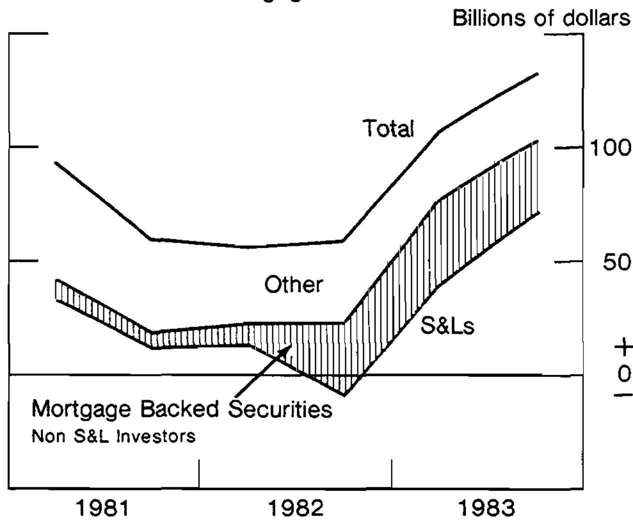
Household Debt Relative to Disposable Personal Income



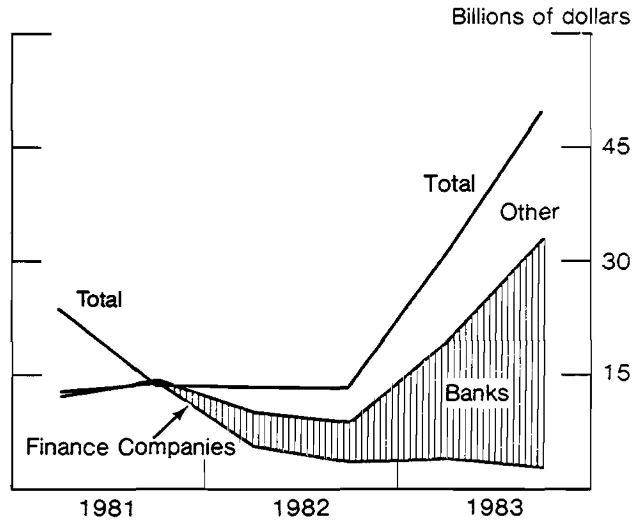
Loan Delinquencies



Sources of Home Mortgage Credit



Sources of Consumer Installment Credit



* Excludes 1948-49 and 1980 cycles.

Forecast Summary

	Board Members		Presidents		Staff	Adminis-tration
Percent change	Range	Median	Range	Median		
Nominal GNP						
1984 Q4 to Q4	8 to 10½	9	7 to 10	9½	9	9¾
1984 annual averages	9 to 10½	9½	8¼ to 10½	9¾	9¾	10
Real GNP						
1984 Q4 to Q4	4 to 4¾	4½	2 to 5	4¼	4¼	4½
1984 annual averages	5 to 5½	5¼	3½ to 5¾	5	5	5¼
GNP Deflator						
1984 Q4 to Q4	4 to 5½	4½	4½ to 6	5	4½	5
1984 annual averages	4 to 4¾	4¼	4 to 5½	4½	4¼	4½
Average level						
Unemployment Rate						
1984 Q4	7¼ to 7¾	7¾	7¼ to 8	7¾	7½	n.a.
1984 annual average	7½ to 8	8	7½ to 8	8	7¾	7¾

FOMC Projections for 1984

Reported to Congress July 20, 1983

	Percent change, Q4 to Q4
Nominal GNP	7 to 10¼
Real GNP	3 to 5
GNP deflator	3¾ to 6½
	Average level in the fourth quarter, percent
Unemployment rate	8¼ to 9¼

FOMC Briefing
S. H. Axilrod
January 30, 1984

The setting of long-run targets for 1984 involves three principal issues--first, should the ranges continue to be reduced; second, if so, by how much, and how distributed among the aggregates; and, third, should more weight be given to M1 in presentation of the ranges and in policy implementation.

With regard to reductions in the ranges, the ranges for 1983 were well above those likely to be consistent with reasonable price stability, so that reductions from them would seem to be called for if price stability is a long-term goal of policy and the public is to be convinced of it. Moreover, some reduction is not likely to impede continuation of expansion in real economic activity at a satisfactory pace. The natural and desirable slowing of real growth in the second year of economic recovery would generally be consistent with slower money growth, and perhaps particularly so in current circumstances when real growth will in any event be sustained by a further rise in fiscal stimulus.

The second issue--how much of a reduction and how distributed among the aggregates--seems a bit more difficult. The extent of reduction depends in part on a judgmental balancing of how much added restraint against prices can be exerted--given the existing degree of wage and price flexibility in the economy--without excessively slowing the rate of economic expression. The 1/2 point reductions in the tentatively adopted ranges for the broad monetary aggregates and credit would seem to exert the minimum added restraint--although in the case of M3 and total credit the actual restraint would be greater than indicated by

the 1/2 point reductions if the outcome for next year were near the midpoints of the ranges rather than in the upper halves, given actual growth over 1983.

There are special considerations with respect to M2, however. A 1/2 point reduction from last year's 7 to 10 percent range does not appear to be a "real" reduction since, as explained in the blue book, last year's range allowed leeway for something like 1/2 to 1 percent more on growth from the lingering impact of shifts related to the introduction of MMDAs and super-NOWs. A 6 to 9 percent range for M2 would thus seem to be more consistent with the restraint implicit in the ranges for M3 and total credit. The midpoint of that range is lower than assumed in the staff's GNP forecast--a forecast that allows for some acceleration of price increases in 1984 relative to 1983.

If the Committee wished to exert even greater restraint against the possibilities of added price pressures as the economic expansion proceeds, consideration could be given to a drop in the M2 range to 5-1/2 to 8-1/2 percent, as suggested in alternative I in the blue book. Consistency with such an approach would also appear to entail cutting back on the M1 range from the tentatively adopted 4 to 8 percent range--a 4 to 7 percent range is suggested. Unless upward wage and price pressures turn out to be less than currently projected by the staff, such an approach to policy seems more likely than, say, the tentatively adopted ranges, to involve a significant rise of interest rates, given the increases in velocity of M2 and M1 that would be implied next year at the midpoints of the ranges--2 percent in the case of M2 and 3-1/2 percent in the case of M1. The restraint generated may also hold back credit and GNP growth

from that currently projected, and a 7-1/2 to 10-1/2 percent range for credit might be considered in this context.

A three-point range for M1 was suggested in the more restrictive alternative partly because reducing the lower limit of the M1 range to below 4 percent might seem unrealistic. But a three-point range for M1--whether 4 to 7 or somewhat higher under the other alternatives--might also be considered should the Committee wish to indicate that more weight is being given to M1 in policy formulation and implementation. In that respect, the behavior of the velocity of M1 in recent quarters has been more in line with historical experience in the sense that a cyclical rebound in velocity, though a much muted one, has developed. Moreover, the period of greatest shifting of funds in response to the introduction of new MMDA and super-NOW accounts is well behind. These developments alone would seem to suggest that at least somewhat more weight could now be placed on M1.

However, even that hesitantly positive note about M1 might need some qualification. There are now about $125 billion of NOW and related accounts in M1, of which about $40 billion are super-NOW accounts. About 20 or 25 percent of all NOW accounts are estimated to represent funds that formerly were in savings accounts of one kind or another. Thus, these accounts may be more responsive to savings motives than M1 has been historically, as indeed may be the case for other NOW accounts whose holders may have become more sensitized to the availability of interest earning alternatives. Moreover, and perhaps more importantly, the behavior of M1 deposits probably will be influenced more than in the past by the interest rate strategies of depository institutions.

All of this means that we cannot be very certain about the interest-elasticity of demand for M1 since there has not been sufficient experience with an M1 with this mix of deposits. That is not a strong drawback in a period of little interest rates change--like a period such as we've had over the past year when the velocity of M1 has come to look more stable or predictable. On the other hand, should there come to be a period of significant interest rate change--such as might develop if the demands for goods and services were either a lot stronger or weaker than currently anticipated--it is possible that the demand for M1 and its velocity behavior would once again change noticeably. For instance the demand for M1 consistent with a given level of income could fall if rising market interest drew money out of the fixed ceiling rate NOW accounts and banks did not raise super-NOW interest rates sufficiently to retain the funds. Or demand for M1 could rise for a time consistent with a given level of income if falling market rates drove funds from outside M1 into fixed ceiling rate NOW accounts as market rates fell toward the ceiling rates.

I do not want to overstress these possibilities since banks are now in a better position--with the flexibility given by super-NOWs and MMDAs--to make adjustments to offering rates that might dampen the volatility of flows into and out of M1 as market rates change. But there is uncertainty in the outlook because we have only limited experience with bank and public reactions to changing market conditions in the new, deregulated era.