APPENDIX

JLKichline
July 16, 1984

FOMC CHART SHOW -- INTRODUCTION

During our presentation 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. The monetary growth assumptions are essentially the same as we have used in forecasts prepared earlier this year. Given the staff's economic outlook, it seems likely that the monetary assumptions are consistent with a little further rise of short-term interest rates and maintenance of generally high rate levels throughout the forecast period ending in 1985. For fiscal policy, we are assuming deficit-reducing actions of around $25 billion for fiscal year 1985, which is consistent with the tax actions recently passed by the Congress and the expected further actions on spending bills still in the Congress. We also continue to assume that the dollar will decline over the forecast period although the 15 percent drop is from a higher level than we had been expecting.

The next chart provides some additional information on the federal budget. Outlay growth projected by the staff continues to be large, with particularly big increases for defense and interest. The budget deficit is expected to narrow somewhat in fiscal 1984, but given the policy assumed the deficit will be on the rise again in fiscal 1985. The Administration has not yet completed work on the budget update, although they are expected to show deficit figures below those of the staff.

The structural deficit, measured at a 6 percent unemployment rate, increases considerably in both 1984 and 1985. By fiscal year 1985 high rates of resource utilization in the economy translate into only a small cyclical component remaining in the budget. The bottom panel indicates outlays as a percent of GNP are projected at about 24 percent, around 5 percentage points above receipts. Current policy does not make any appreciable dent in the gap, and the budget posture will continue to exert a powerful influence on economic and financial developments.

Mr. Zeisel will discuss the recent and prospective domestic nonfinancial situation.

Joseph S. Zeisel
July 16, 1984

FOMC CHART SHOW -- NONFINANCIAL DEVELOPMENTS

The economy has been showing impressive strength at a stage of the business cycle when growth more frequently then not has decelerated considerably. As indicated in the top panel of the next chart, real GNP rose at a 9-3/4 percent rate in the first quarter, and we estimate that second quarter growth was 6-3/4 percent, about a percentage point more than the Commerce flash. The slowing in the second quarter reflected a lower rate of nonfarm inventory investment after a surge in the first quarter. As indicated in the lower panel, growth of real private domestic final purchases--i.e., consumption plus fixed investment--in the second quarter apparently equalled the extremely strong 8 percent plus first quarter pace.

Nevertheless, there have been indications recently of decelerating activity here and there in the economy, as the next chart indicates. Not surprisingly, housing, which is particularly sensitive to the cost of credit, has shown signs of weakening after the recent runup in interest rates. Starts on balance have trended down since early this year and at a 1-3/4 million annual rate in May were 10 percent below the average of the first four months. In manufacturing, as indicated in the right-hand panel, the rise in jobs has moderated from late last year. Moreover, growth of industrial production has slowed. In the past two months industrial activity has increased about half percent a month, following gains averaging about 1 percent earlier this year. Recently, as shown in the lower panels, strength has been concentrated in the business and defense and space equipment sectors, while production of durable consumer goods and construction supplies has levelled off.

As the next chart indicates, we are projecting a substantial moderation of GNP growth in coming months. We anticipate that consumer spending will remain fairly robust in the near term on the basis of recent gains in employment and income, and indicators of capital outlays are quite strong. Thus, GNP is projected to advance at a still-relatively-brisk 5-1/4 percent annual rate this quarter. But we expect that activity will be increasingly constrained by financial conditions implied by monetary assumptions and the expected increase in inflation. On balance, we are projecting a rate of real GNP growth of about 4-1/2 percent in the second half of this year and about 2-3/4 percent in 1985.

The bottom panel presents a disaggregated view of GNP gains by half years in 1984 and 1985. As is evident, the progressive slowing in growth of private domestic final purchases is the major factor affecting the pace of overall activity. In our forecast, inventory investment ceases to influence GNP growth significantly from now on as business stocks are kept about in line with sales. We presume that high interest rates and improved control methods will hold stocks at historically lean levels. The overall expansion, however, does receive some support from increased real government purchases (particularly defense outlays) and from improved net exports, which become a moderately positive force as the dollar declines.

Among the components of final purchases, the strength of business fixed investment has been a major surprise--the next chart. We estimate that real business fixed investment increased at about a 20 percent annual rate in the second quarter after a 16 percent annual rate rise in the first. As shown in the upper left-hand panel, new orders for capital goods have continued to climb vigorously, increasing backlogs and pointing to further gains in spending later this year. As shown in the right-hand panel, nonresidential construction has been extremely strong as well, with large increases evident in shopping centers and other commercial structures.

A number of factors have helped stimulate the growth of capital investment; the dramatic slowing in the rise in capital equipment prices, portrayed in the middle left panel, combined with tax law changes have significantly reduced effective capital costs. The opportunities for gains in efficiency with new high-tech equipment and the spillover from the ballooning defense program have undoubtedly also stimulated spending. And of course, the improved corporate profits position (illustrated on the right) has played a role.

In an environment of continued overall expansion and reduced capacity slack, we anticipate that capital outlays will remain strong, but the pace of growth should moderate considerably from that recently. We are projecting a 7 percent increase during 1985, down from a 16 percent rise this year. Nevertheless, as pictured in the bottom panel, we anticipate that this capital expansion will be the strongest in the postwar period.

As indicated on the next chart, the growth of real consumer outlays also has been contributing substantially to the expansion of activity. Over the past three quarters, real personal consumption expenditures have risen at an impressive 6-1/2 percent annual rate. While strong gains in employment and real income have played a key role, the high level of consumer sentiment, portrayed in the right-hand panel, undoubtedly has been important, and is consistent with the continued relatively low saving rate. Looking ahead, though, some of the factors that generated earlier improvement in consumer attitudes and stimulated spending, such as the strong stock market, the tax cuts and declining interest rates are no longer providing such support, and thus, as shown in the middle panel, we expect a reduced rate of growth in consumption as gains in real disposable income taper off. Our projections are consistent with the saving rate remaining relatively low through the period.

As indicated earlier, the clearest current evidence of weakness in a major sector is in housing where activity has begun to decline in response to the rising mortgage rates. As shown in the upper left-hand panel of the next chart, this weakness is also evident in new home sales, which have dropped for three successive months. Over the past year or so, the increasing use of adjustable rate mortgages, with initial interest rates well below those on fixed rate loans, provided considerable support for growth in housing activity. As shown in the right-hand panel, recently, ARMs have comprised roughly two-thirds of all conventional home mortgages closed, more than double the percentage a year earlier. However, figures for May and June show increases in the average initial rate on ARMs closed, apparently reflecting both the higher level of interest rates generally and reductions in the size of so-called "teaser" discounts. Although there remains a significant spread between the initial rates on fixed and adjustable rate mortgages, we believe the stimulative effect of ARMs will diminish appreciably in coming months.

Consistent with some further tightening in mortgage markets over the projection period, as indicated in the bottom panel, we have projected total starts to edge down to about a 1.6 million unit rate by next spring and to stabilize at that pace in the latter half of 1985.

Job seekers have been benefitting greatly from the strength of overall activity. As indicated in the next chart, although we are projecting about the same rise in real output during this year as in 1983, we expect to generate larger gains in employment, with productivity growth slowing in a typical cyclical fashion. As the two middle panels illustrate, improving employment opportunities also are stimulating an increase in labor supply. Nevertheless, job gains have been strong enough to reduce unemployment significantly. In June the rate dropped to 7.1 percent, down from over 8 percent last December; by the fourth quarter of this year, we are projecting an unemployment rate of about 6-3/4 percent. Employment increases are expected to be less impressive next year, along with the smaller rise projected for real output, and the unemployment rate should drift down to about a 6-1/2 percent rate by year-end.

The next chart illustrates the relatively temperate behavior of wages in the face of the considerable strength in activity and employment. The hourly earnings index shows continued moderation with the overall rate of increase for production workers in nonfarm industries only slightly over 3 percent so far this year. Forces affecting different industries vary considerably--in manufacturing where wage increases have been fairly stable this year, gains continue to be damped by multi-year contracts negotiated at the depth of the recession; in construction, a substantial increase in nonunion competition appears to be playing an important role in further reducing wage growth. But overall, the continued moderate rate of wage rise suggests that labor markets on the whole still contain a reasonable degree of slack and that rising inflation expectations are not as yet exerting significant upward pressure on wage bargains.

The recent experience has led us to revise downward somewhat our view of the outlook for wage inflation. Compensation per hour, shown in the middle panel, is now increasing at about a 4-1/2 percent annual rate on a four-quarter basis, the slowest pace in nearly two decades. But we still expect that conditions later this year and in 1985 will become less favorable to wage moderation. We already have seen a drop in the number of new wage concessions, and improved sales and profits, and tighter labor markets, will surely result in firming of wages generally. Next year, we are projecting compensation costs to rise about 6 percent.

As indicated, we anticipate that productivity gains will taper off further, consistent with our continuing belief that the long-term trend is a little over 1 percent; thus we can expect less of an offset to compensation costs. Unit labor costs are projected to rise about 3-1/4 percent this year, up from less than 1 percent in 1983; in 1985 we are projecting an increase of 5-1/4 percent.

The outlook for inflation is presented in the next chart. As with wages, the recent price performance has been better than we had expected, and we now project that the rise in gross business product prices will average about 4 percent during 1984--about the same as last year. Nevertheless, increased upward pressure on prices appears highly probable by late this year and in 1985 as labor costs rise--as shown in the top panel--and as slack is reduced. Other factors will also be working to boost inflation. As indicated in the bottom panels, food prices are expected to surge again later this year as meat supplies tighten, and overall energy prices are projected to edge up in 1985 after two years of drifting down slightly on balance. But most important, with the foreign exchange value of the dollar projected to decline 15 percent from its second quarter level, prices of non-oil imports--the right panel--are expected to rise markedly. And the effects on domestic inflation will be exacerbated by reduced competitive pressures from abroad. On balance, we now expect gross business product prices to increase about 5-1/2 percent during 1985, ending about two years of inflation in the 4 percent range.

Mr. Truman will continue the presentation.

E.M. Truman
July 16, 1984

FOMC CHART SHOW PRESENTATION -- INTERNATIONAL DEVELOPMENTS

The upper panel in the first international chart shows the substantial rise in U.S. short-term interest rates during the first six months of 1984. This rise has contributed to sharp criticism of U.S. policies from the developing countries, especially those in Latin America struggling with large dollar-denominated external debts carrying floating interest rates. The other industrial countries, except for Canada and, more recently, the United Kingdom, have not allowed the rise in dollar interest rates to affect their own interest rates. As a consequence, the differential between U.S. and foreign interest rates has widened significantly.

This widening differential has been a key factor behind the continued strength of the dollar so far in 1984 -- shown in the bottom panel. However, for the reasons the staff discussed at length in its presentation in May, we believe that the growing U.S. external deficits will weigh increasingly heavily on the dollar's foreign exchange value. With most of the rise in real interest rates behind us, we are projecting a depreciation of the dollar by 15 percent on average from the quarter just ended to the fourth quarter of next year.

The top panel of the next chart shows the growth of U.S. real domestic demand and real GNP. As can be see , the ga between the two growth rates has expanded steadily, reaching 2 percent in the first quarter of this year. This gap indicates that a significant share of the U.S. demand has spilled over to stimulate economic activity in other areas of the world -- shown in the lower two panels.

With the slowing of the U.S. expansion and projected depreciation in the dollar, the direction of this net impulse will be reversed by the second half of 1985. Meanwhile, the growth of economic activity in the foreign industrial countries is projected to remain in the range of 2-1/2 to 3 percent on average, as growth in Canada and, to a lesser extent, in Japan slows under the influence of slower U.S. growth. On the other hand, economic activity in the non-OPEC developing countries is projected to pick up further, reaching almost 3-3/4 percent on average by the end of next year -- still, however, far below the average pace of 5-1/2 percent that prevailed from 1976 to 1980.

The next chart provides some perspective on developments with respect to U.S. exports, which have been adversely affected in recent years by the strength of the dollar and the resultant deterioration in our international price competitiveness. Despite such influences, U.S. exports <u>have</u> increased from the low point reached in the fourth quarter of 1982. Indeed, the expansion has been about average for similar periods of U.S. economic recovery.

The heavy black line in the top panel shows that the value of U.S. exports in the fourth quarter of 1982 was 20 percent below the level in the first quarter of 1981. As the red line indicates, the percentage decline in exports to developing countries -- OPEC and non-OPEC -- was even larger. In dollar terms, the total decline in U.S. exports was about $50 billion, divided almost equally between developing and developed countries.

Since the fourth quarter of 1982, U.S. exports to developing countries have continued to stagnate, while exports to developed countries have almost regained the rate reached in early 1981.

As is shown in the middle panel, most of the recovery in U.S. exports to developed countries has been in trade with Japan and Canada; in the latter case, the data are affected by exports of automotive products that later return to the United States as completed vehicles. In contrast, U.S. exports to Western Europe, indicated by the red line, have increased marginally since the third quarter of last year, but in April and May they were still 20 percent below the rate of three years ago. The weaker performance of U.S. exports to Western Europe reflects not only the sharper appreciation of the dollar against the European currencies but also the relatively sluggish growth of activity in those countries.

U.S. exports to developing countries, shown in the bottom panel, have been generally weak. Most of the decline in such exports has been in those to Latin America. In recent quarters, exports to Mexico have recovered significantly, while exports to other Latin American countries, which are generally at an earlier stage in their own adjustment programs, have stabilized at the rate of early last year.

Although the expansion of U.S. exports will continue to be held back by the adjustment efforts of developing countries and the sluggish economic activity in other industrial countries, we expect a continuing expansion, especially next year, when U.S. exports should be boosted by the depreciation of the dollar. Thus, as is shown in the top panel of the next chart, we are projecting over the four quarters of this year and the four quarters of next year an expansion in U.S. non-agricultural exports at annual rates of about 15 percent in value and 7-1/2 percent in volume.

The bottom panel shows our projection for U.S. non-oil imports. For 1984, we anticipate a modest slowing in the growth of these imports in volume and value terms from the torrid pace of 1983. Most of the projected growth, however, was recorded during the extraordinary surge in imports in the first four months of the year. Next year, with the depreciation of the dollar, the dollar price of non-oil imports should rise markedly, as Mr. Zeisel has already indicated. This should bring about a slight decline in their volume.

Despite the projected change in the relative growth rates for non-oil imports and non-agricultural exports, the U.S. trade balance is projected to continue to deteriorate. As is shown in the top two panels of the next chart, payments for total merchandise imports now exceed receipts for total merchandise exports by more than $100 billion -- a margin of almost 50 percent. If exports and imports were to grow at the same percentage rate, the trade balance would expand further in dollar terms. The value of exports must increase correspondingly more rapidly than the value of imports to close the dollar gap, and this condition will not be met during the forecast period. As a consequence, the trade balance is expected to exceed $125 billion during 1985. With the further erosion of our net international investment position, the margin of service receipts over service and transfer payments will narrow further (despite the boost to direct investment receipts from the dollar's depreciation), and the U.S. current account deficit is projected to reach almost $115 billion.

Mr. Prell will now continue our presentation.

DOMESTIC FINANCIAL MARKETS

This year's brisk GNP growth has been financed by exceptionally rapid growth in debt. As may be seen in the top panel of the next chart, domestic nonfinancial sector debt increased at around a 13 percent annual rate over the first half--well above the Committee's monitoring range. If, as indicated in the box, we strip out a rough allowance for the credit used in corporate mergers and buyouts, the debt measure still grew a little faster than nominal GNP--and at a pace rivaling the strongest of the past three decades.

The bottom panels put the financial flows in cyclical perspective. Total funds raised in markets--both debt and equity--has been plotted here, to reduce the distortion of equity absorption in debt-financed mergers.[1] As you can see in the left panel, external financing by all sectors--relative to GNP--has run consistently above what was seen during earlier cyclical upswings. This initially reflected abnormally high borrowing by the federal and state and local governments, but (as the right panel reveals) financing by the household and business sectors, together, has been heavy relative to GNP since late last year.

The next chart focuses on the household sector. The top panel shows the remarkable surge of borrowing since late 1982, in both mortgages and consumer credit. We are projecting a diminution of this borrowing over the next year and a half. This fall-off is largely a function of higher interest rates and nonfinancial demand factors--rather than a response to any current financial strains among households. As may be seen in the bottom left panel, in the aggregate the indebtedness (in red) of the household

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1. Because not all share-liquidating mergers were debt-financed, this flow could understate a bit the external financing that would have occurred ex mergers.

sector has risen only slightly relative to income, while, despite the drop in the stock market, the financial asset position of the sector is still strong. The right hand panel indicates that--in an environment of rapidly rising employment--consumer installment loan repayment experience has been very favorable; mortgage loan delinquencies also have declined, but they remain relatively high and the recent aggressive marketing of ARMs of course raises some questions about the prospects for further declines.

In the business sector, covered by the next chart, the rise in borrowing this year has reflected more than just the financing of mergers and buyouts. As the upper panel indicates, nonfinancial corporations as a group have experienced a swing from net financial surplus a year ago to a net deficit --and our forecasts of investment and profits point to a growing financing gap through 1985. The bottom left panel portrays the composition of external financing activity by corporations. In the first half of this year, borrowing rose sharply, primarily to offset an unprecedented net absorption of equity in mergers but also to make up for a reduction in new equity issues prompted by falling share prices. Owing to the weakness of the bond markets--as well as the greater ease of raising funds initially from short-term sources for major mergers--the bulk of corporate borrowing in the first half occurred at banks and finance companies and in the commercial paper market. The result of all this was an unusually early end to the normal cyclical reliquification of corporate balance sheets. The heavy load of short-term and variable-rate debt exposes businesses to renewed cash flow pressures from rising interest rates. Nonetheless, as the right panel shows, we are projecting that, with interest rates remaining at high levels, short-term debt is likely to continue rising in relative importance.

The pattern of credit flows in the months ahead could be affected by the tensions apparent in the financial system. Concerns about the strength of commercial banks has, as may be seen in the next chart, resulted in higher rates on bank CDs and other liabilities and bank stock prices have fallen markedly, making equity capital more costly for these institutions. Such developments would be expected to hamper banks in their roles as financial intermediaries, but while bank credit growth slowed markedly in June and bank officers report a tightening of lending policies, we really do not yet have any clear indication of the macro-impact of the bank problems. Similarly, the activities of thrift institutions--whose lending has buoyed the housing market--could be affected by financial stresses in that industry. Rising interest rates since mid-1983 have been reflected in falling S&L share prices. S&L earnings have been slightly on the plus side, but a deterioration in industry operating results over the remainder of the year is implied by the staff's interest rate projection. A very sizable proportion of institutions will be in the red, and failures could multiply--possibly causing investors to shy away from S&L liabilities.

Mr. Kichline now will conclude the presentation.

JLKichline
July 16, 1984

FOMC CHART SHOW -- CONCLUSION

The last two charts in the package present economic projections of Board members, Presidents, and the staff; the first chart displays the information on the basis of changes measured fourth quarter to fourth quarter. For 1984, there aren't any particularly significant differences in the forecasts. Compared with the forecasts reported to the Congress in February, which are shown in the bottom panel, nominal GNP projected currently is at the top or above the central tendency. However, real growth is now expected to be appreciably stronger while prices are projected to rise less than previously forecasted.

The projections for 1985 generally point to slowing in growth of nominal and real GNP and some acceleration in the pace of inflation. The Administration's figures do not appear on the table, but it is our understanding that the projections to be used in the budget update essentially adjust to the developments in the first half of the year and maintain the previous forecasts of the period ahead. That approach provides numbers close to those of Board members and Presidents for 1984. For 1985, the Administration has forecasts of nominal GNP around 9 percent, with real growth of GNP at 4 percent--on the high side--and a deflator rising at 4-3/4 percent--on the low side of the Federal Reserve expectations.

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STRICTLY CONFIDENTIAL (FR) CLASS II-FOMC

Materials for

Staff Presentation to the Federal Open Market Committee

July 16, 1984

Principal Assumptions

Monetary Policy

- Growth of M2 of around 7½ percent during 1984 and 1985.

- Growth of M1 of 6½ percent in 1984 and 5½ to 6 percent in 1985.

Fiscal Policy

- Deficit-reducing actions of around $25 billion for FY 1985.

Other

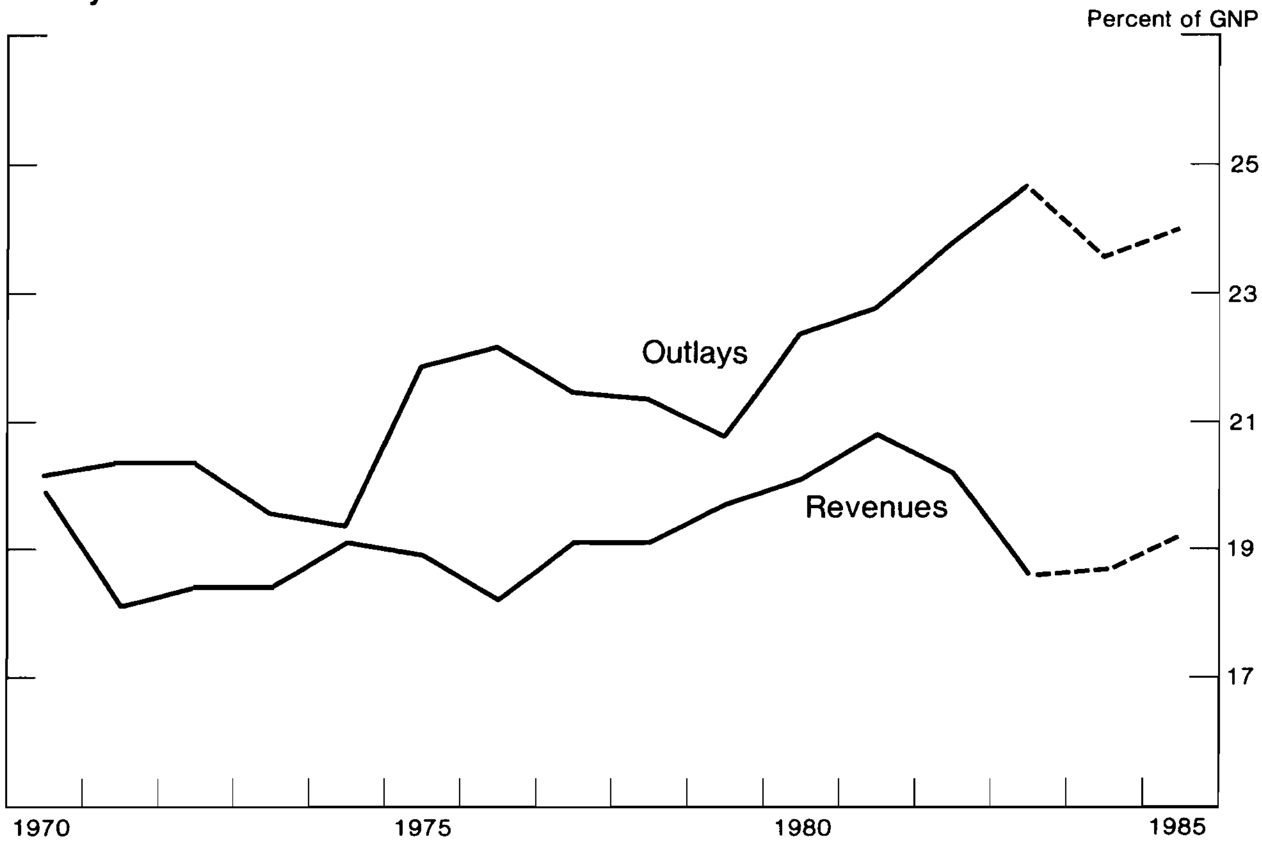
- Foreign exchange value of the dollar declines 15 percent.

Federal Budget

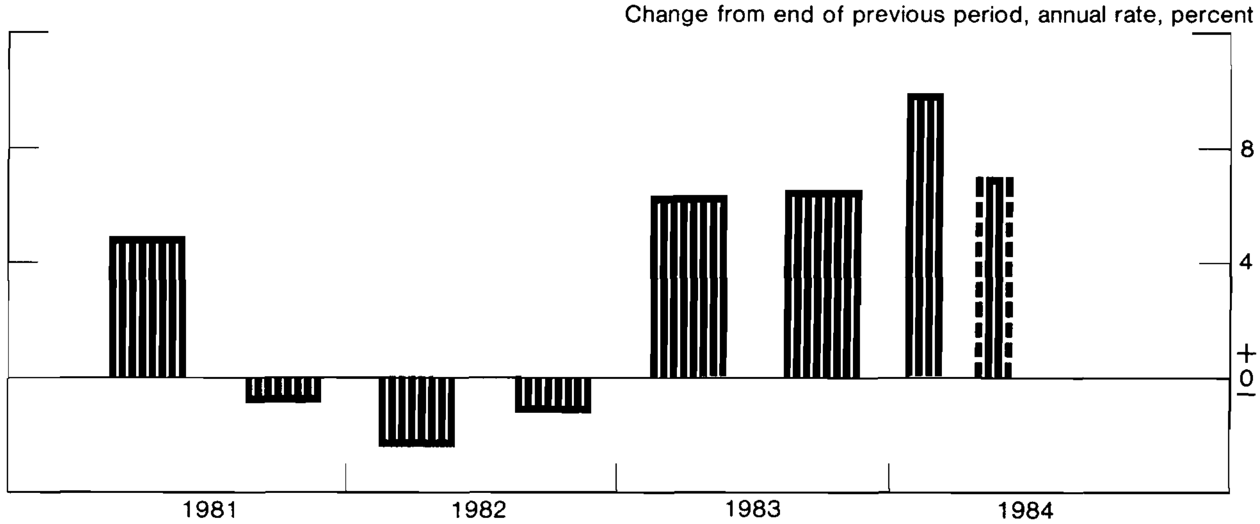
	1983	1984	1985
	Actual	Staff	Staff
Outlays	796	847	938
Receipts	601	671	749
Deficit	195	176	189
Structural Deficit	93	131	172

Fiscal Years, Unified Budget Basis, Billions of Dollars

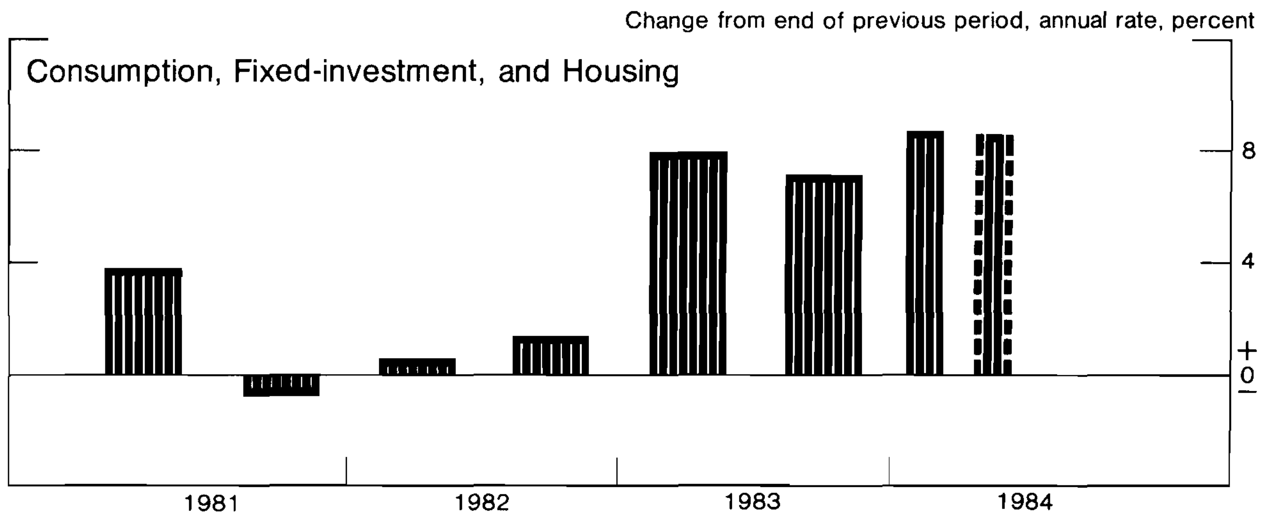
Outlays and Revenues



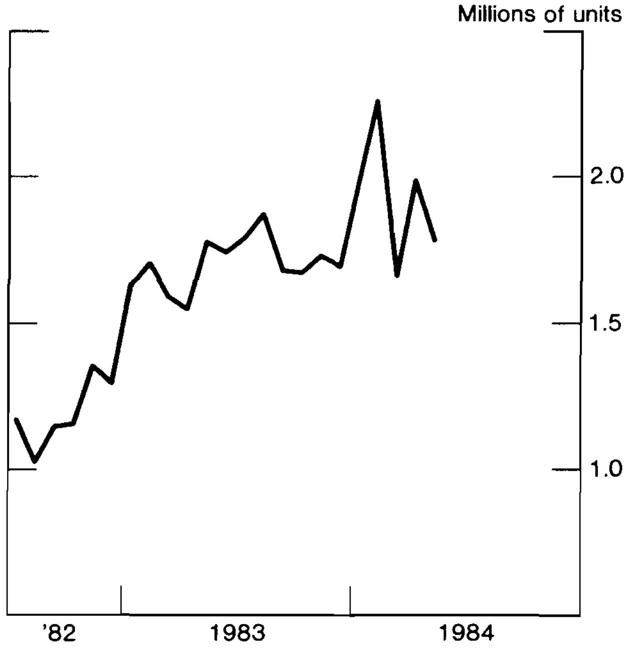
Real GNP



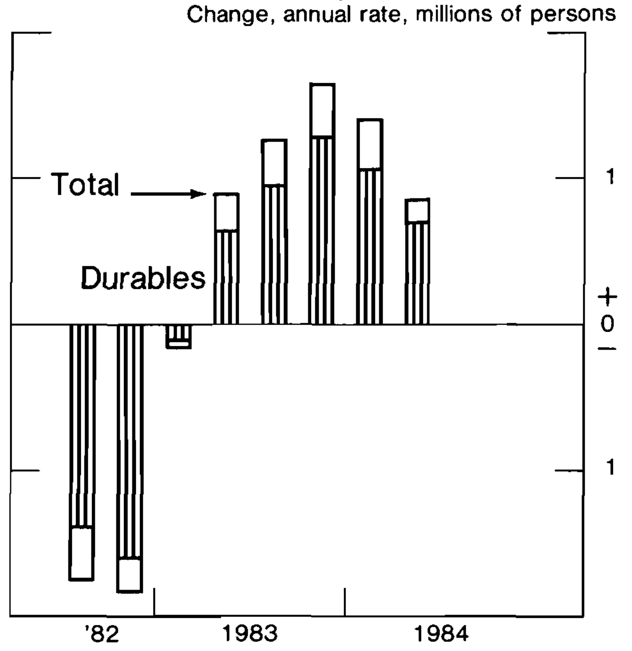
Real Private Domestic Final Purchases



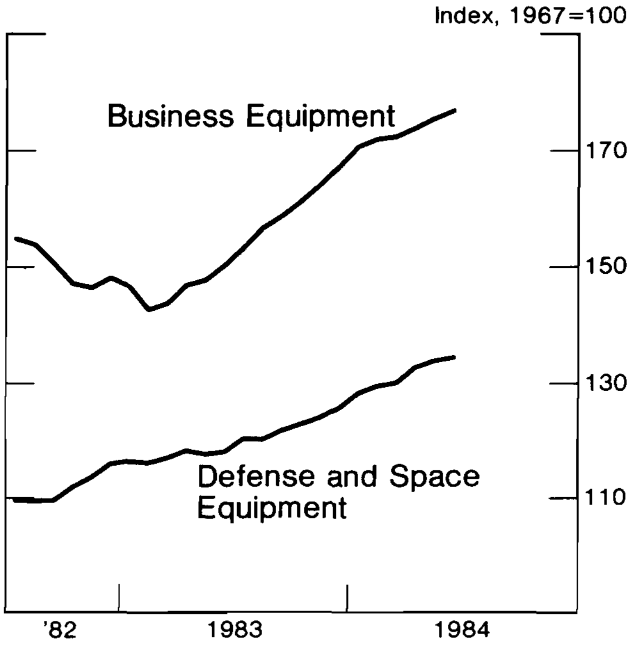
Private Housing Starts



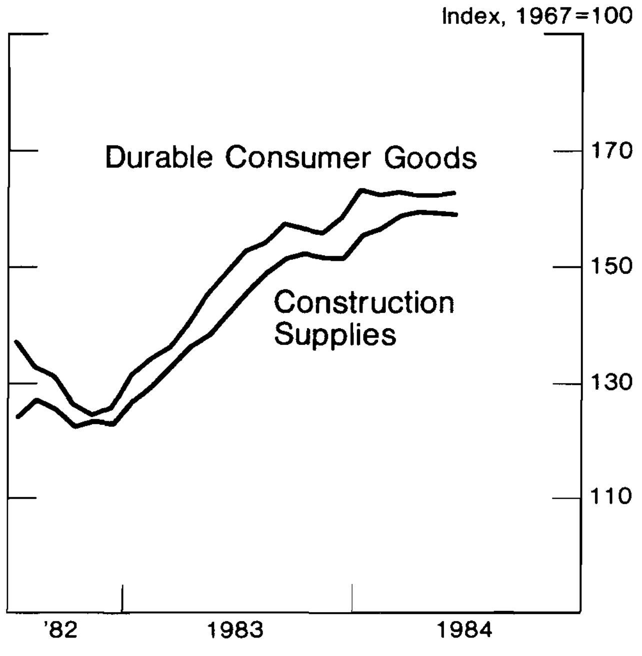
Manufacturing Employment



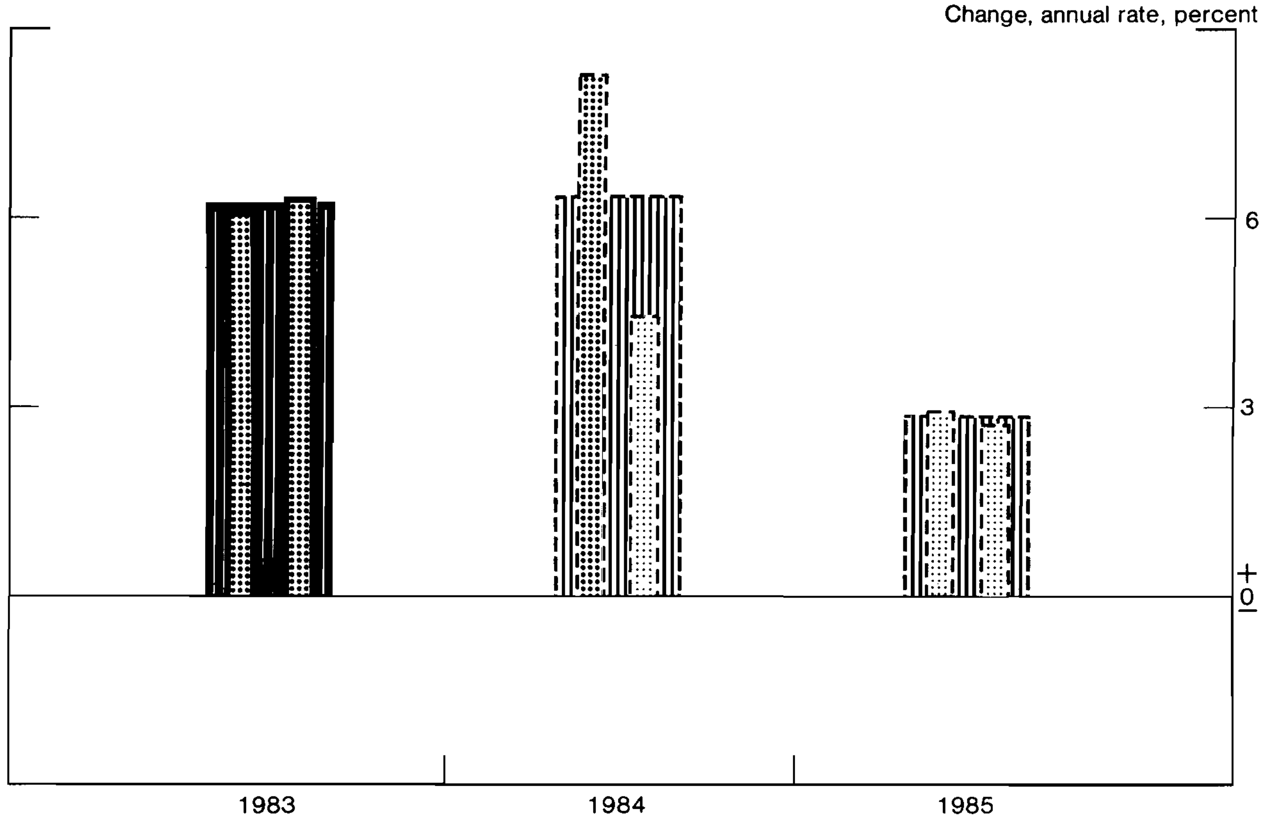
Industrial Production



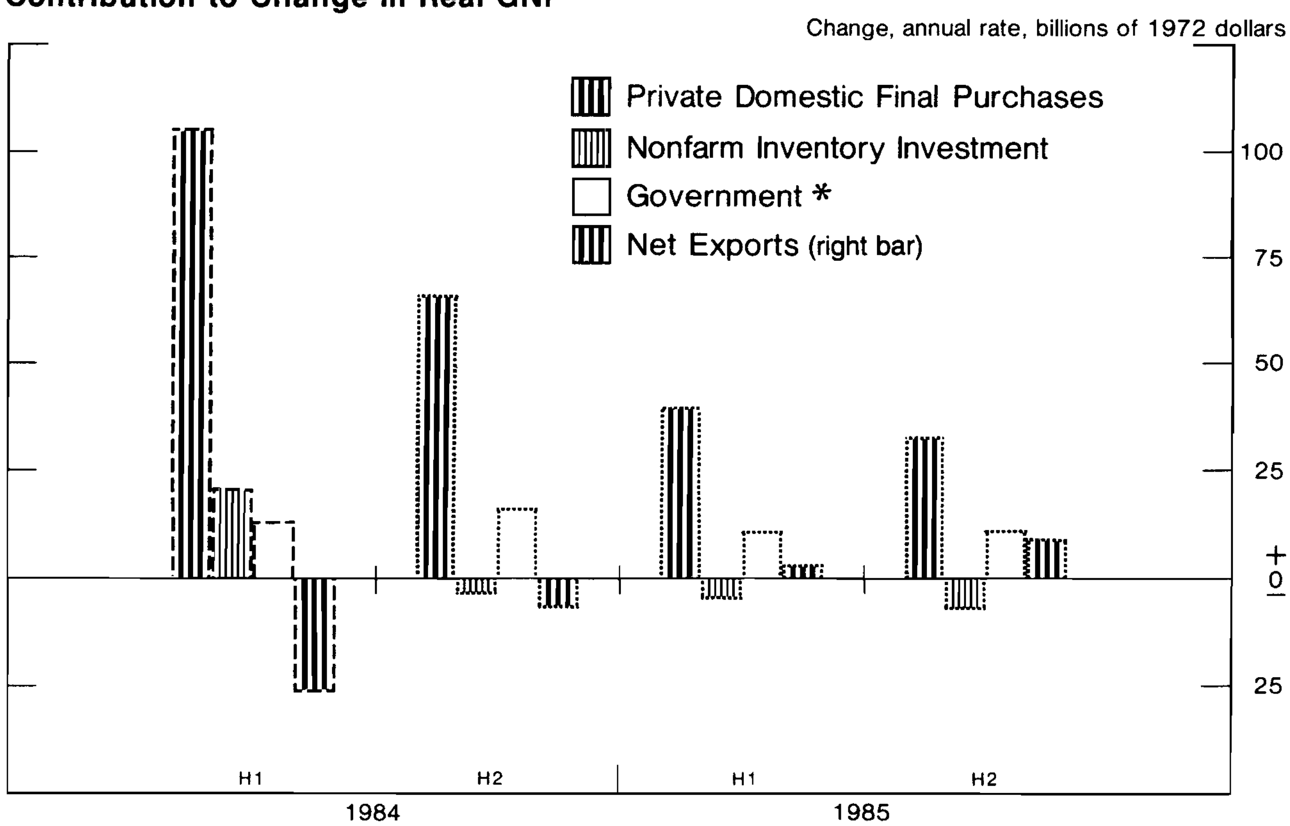
Industrial Production



Real GNP

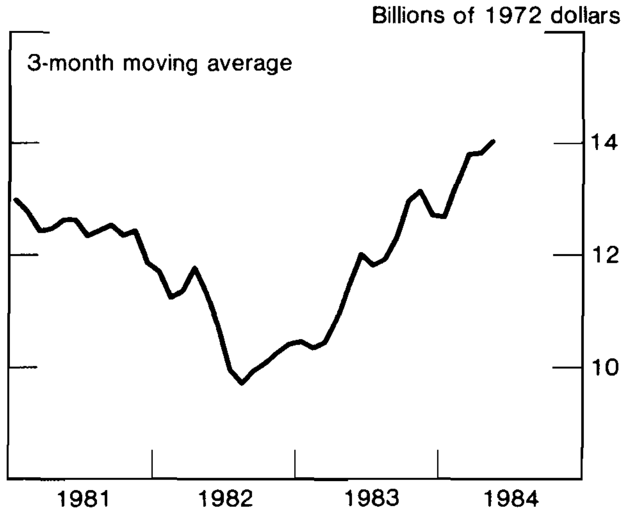


Contribution to Change in Real GNP

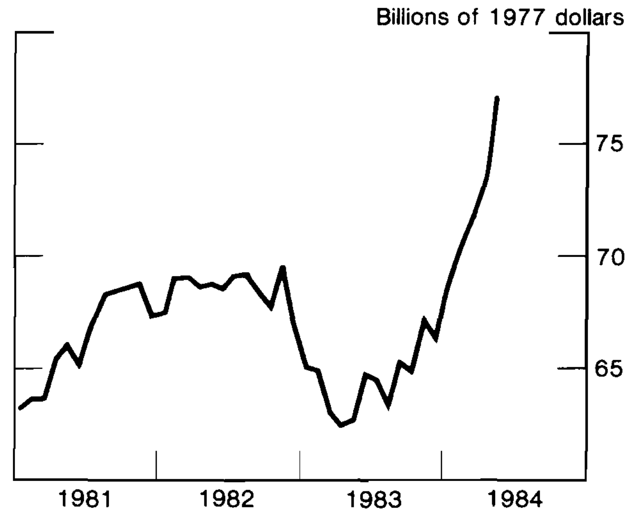


* Excluding CCC

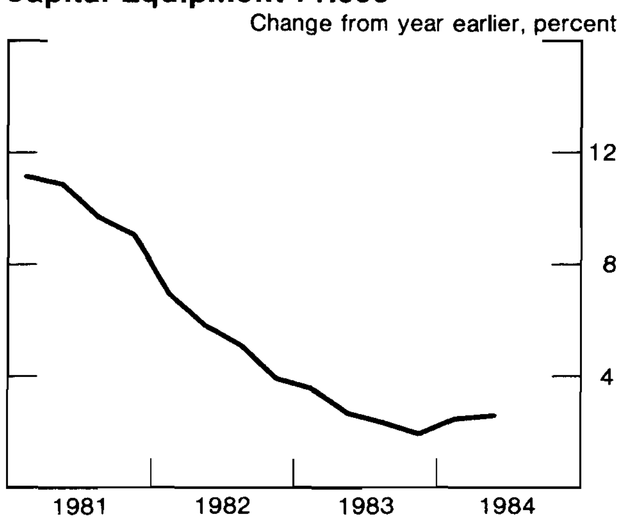
Real New Orders for Nondefense Capital Goods



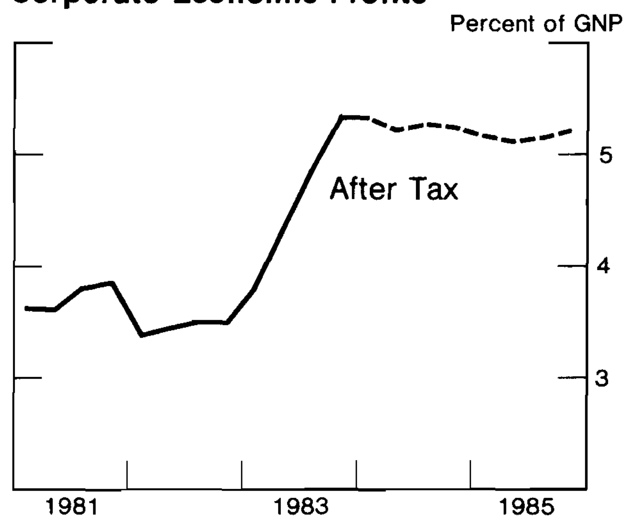
Real Value of Nonresidential Construction Put in Place



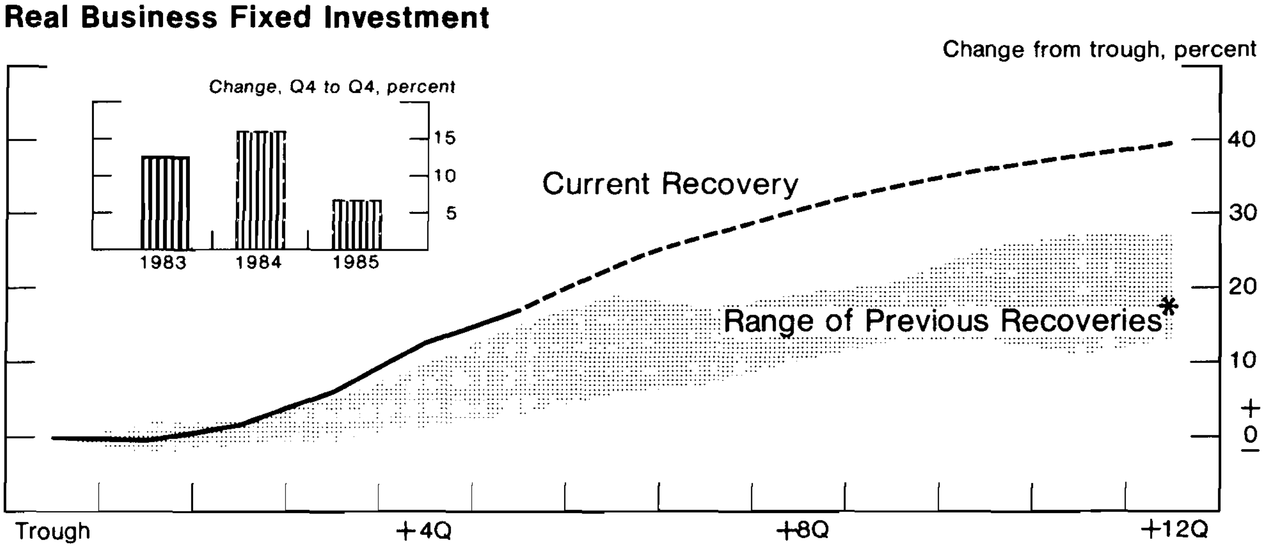
Capital Equipment Prices



Corporate Economic Profits

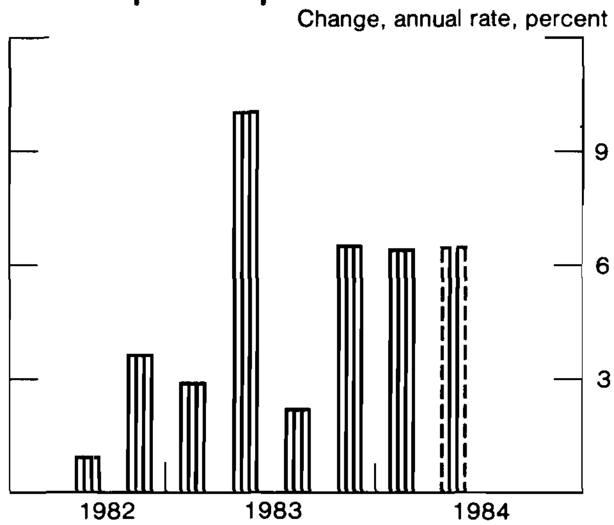


Real Business Fixed Investment

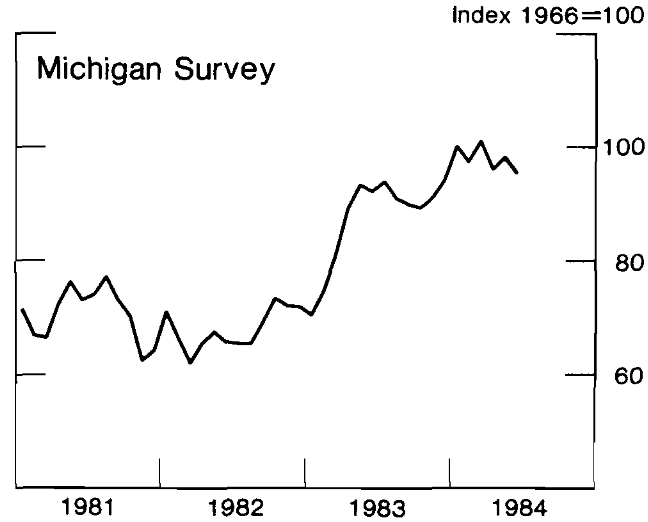


*Excludes recoveries following troughs in 1949 and 1980

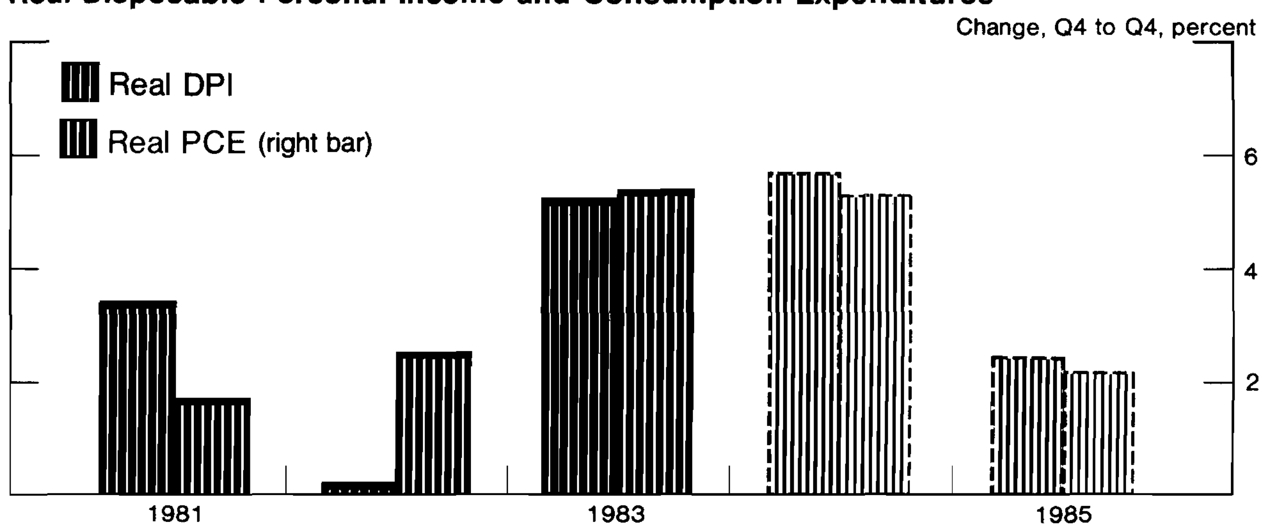
Real Personal Consumption Expenditures



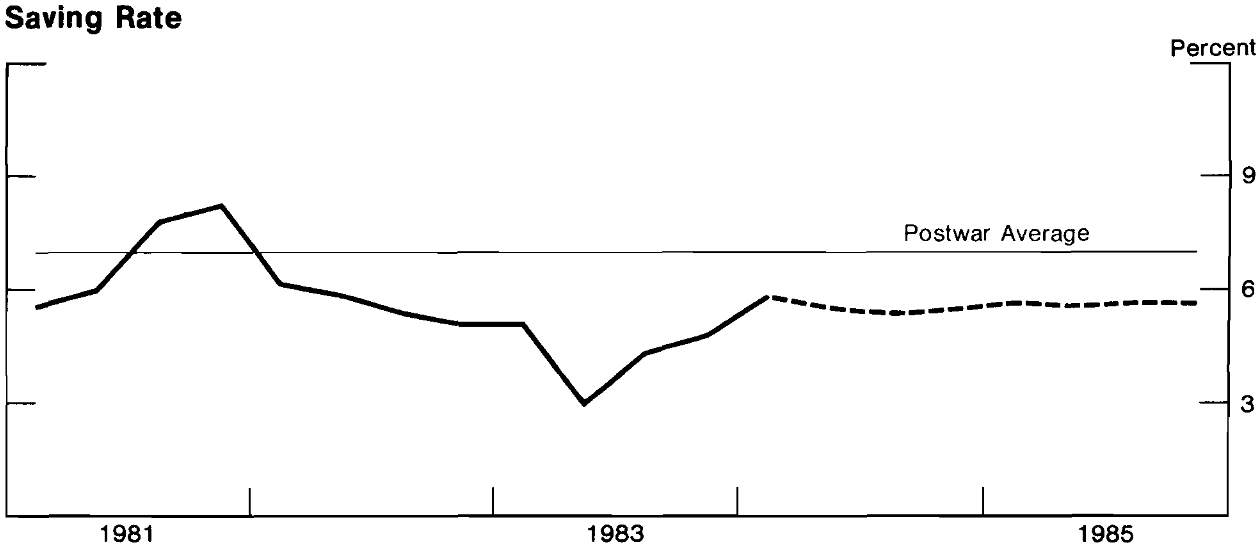
Consumer Attitudes



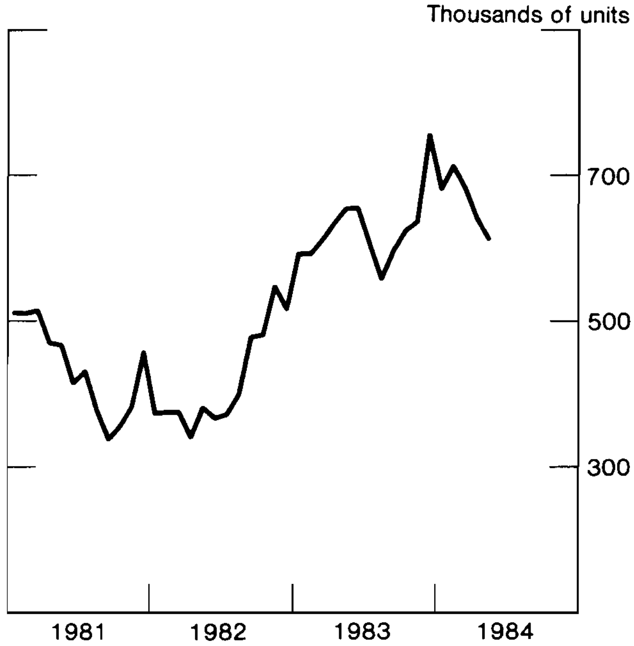
Real Disposable Personal Income and Consumption Expenditures



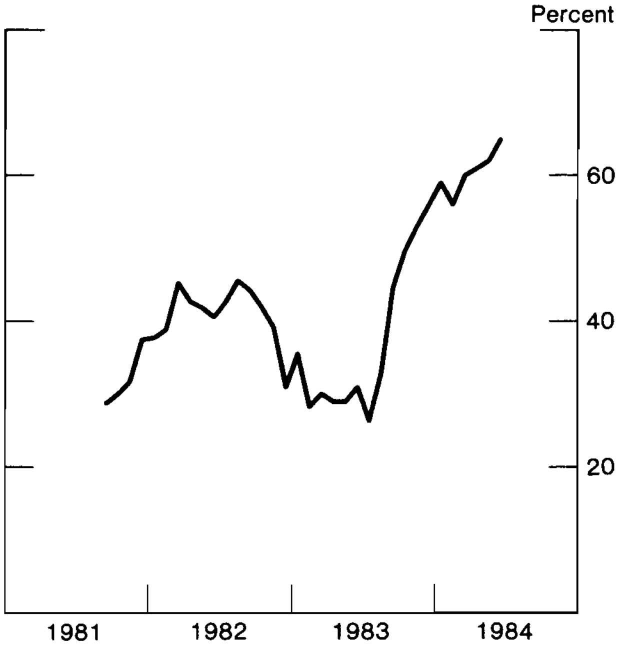
Saving Rate



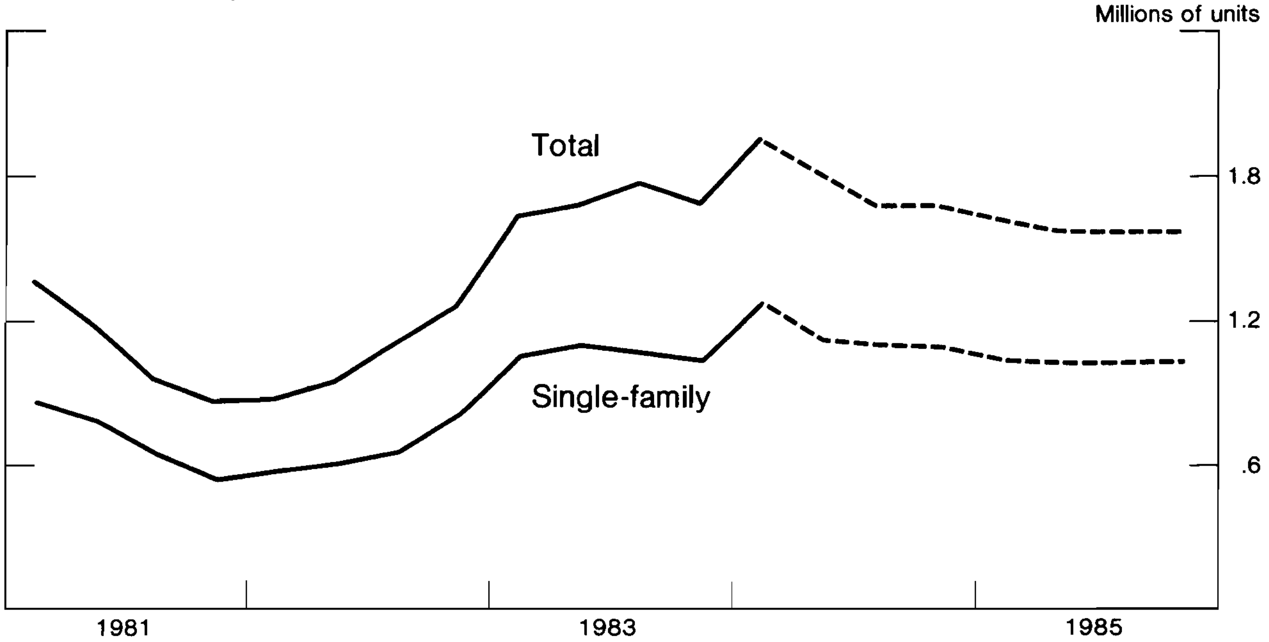
New Home Sales



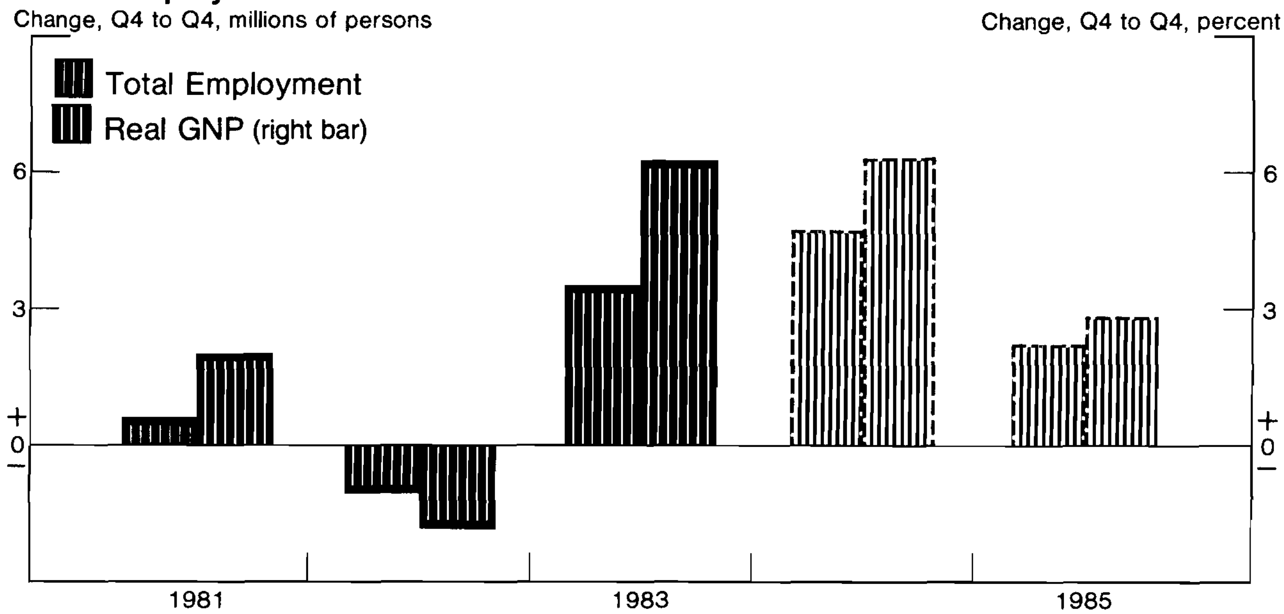
ARMs as a Percent of Total Conventional Mortgage Loans



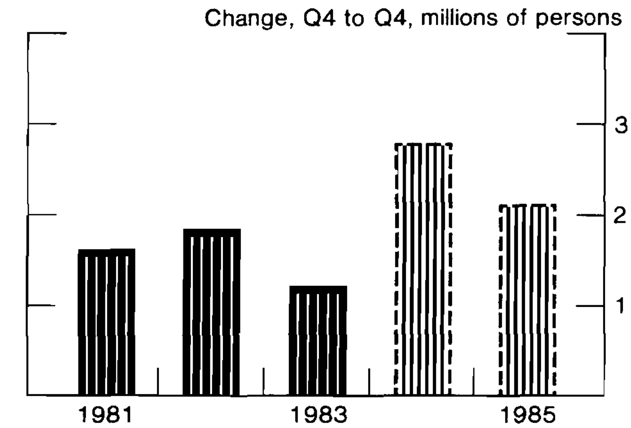
Private Housing Starts



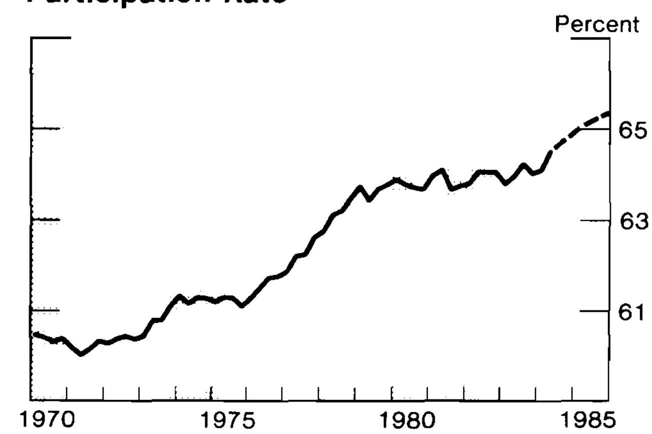
Total Employment and Real GNP



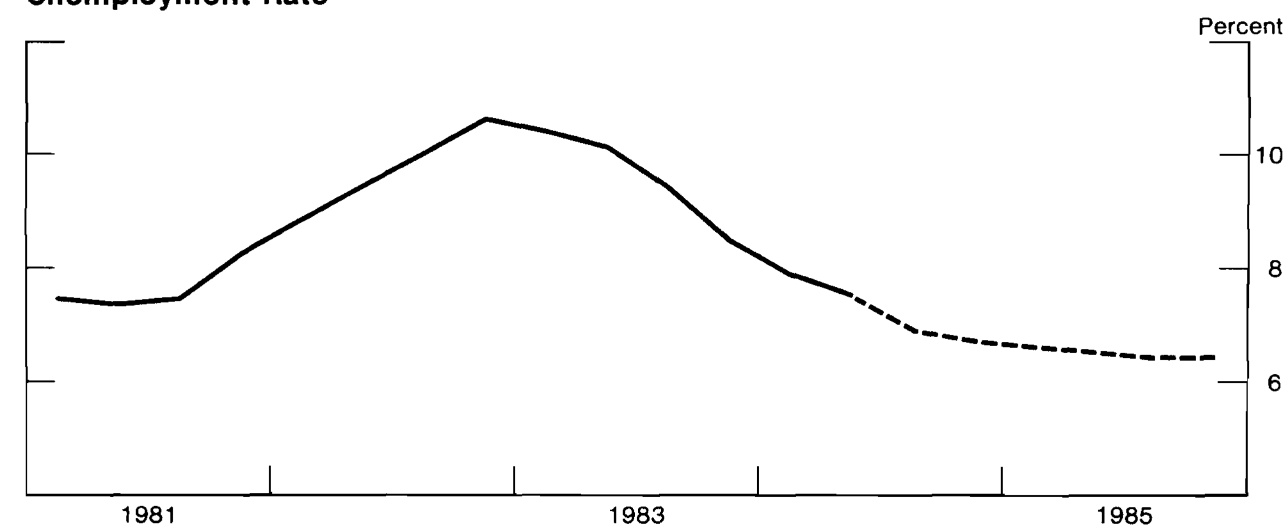
Civilian Labor Force



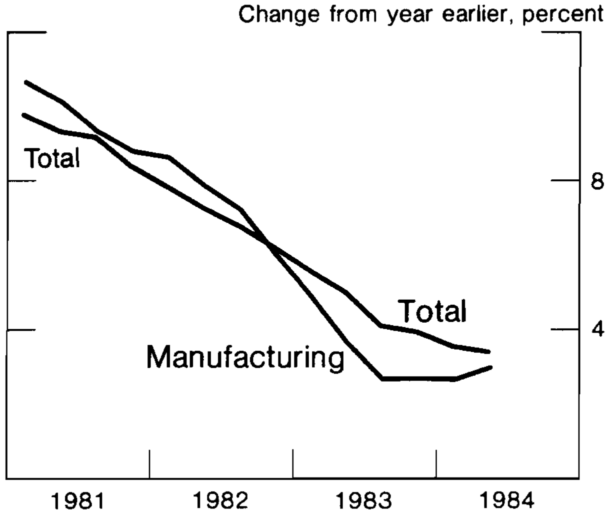
Participation Rate



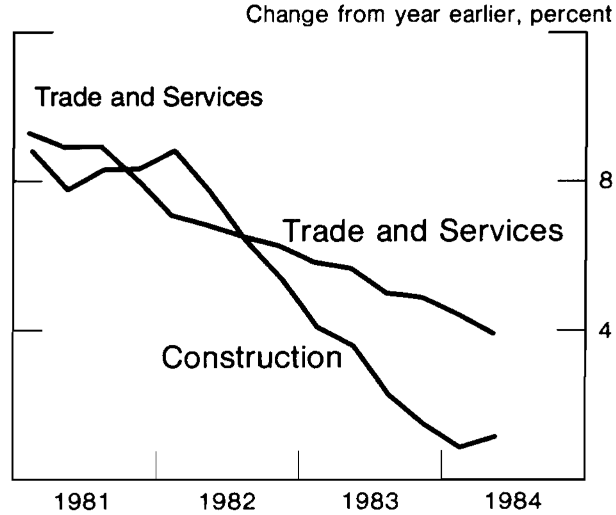
Unemployment Rate



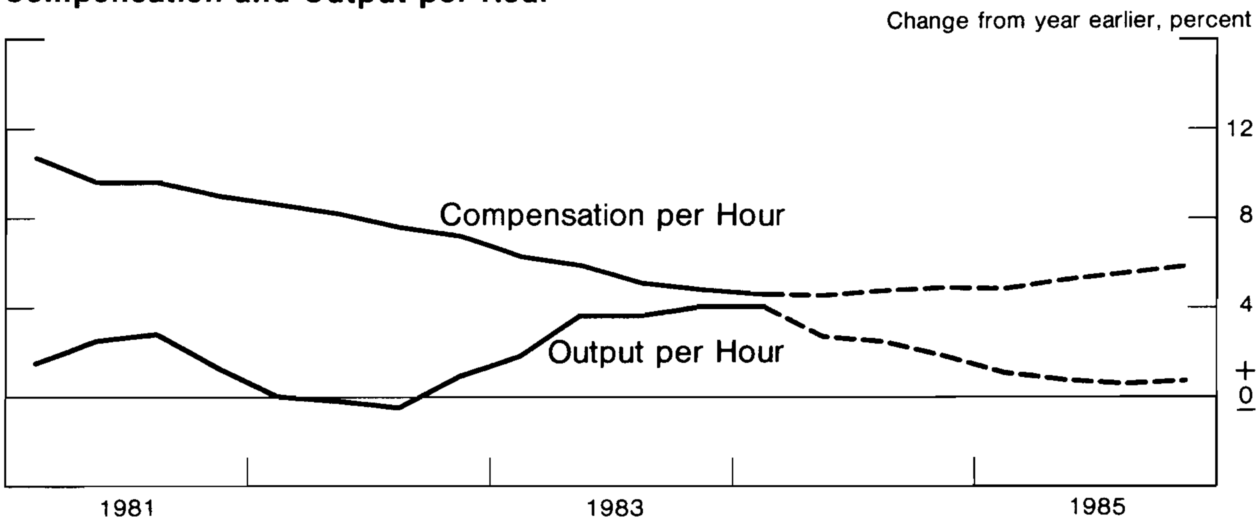
Average Hourly Earnings Index



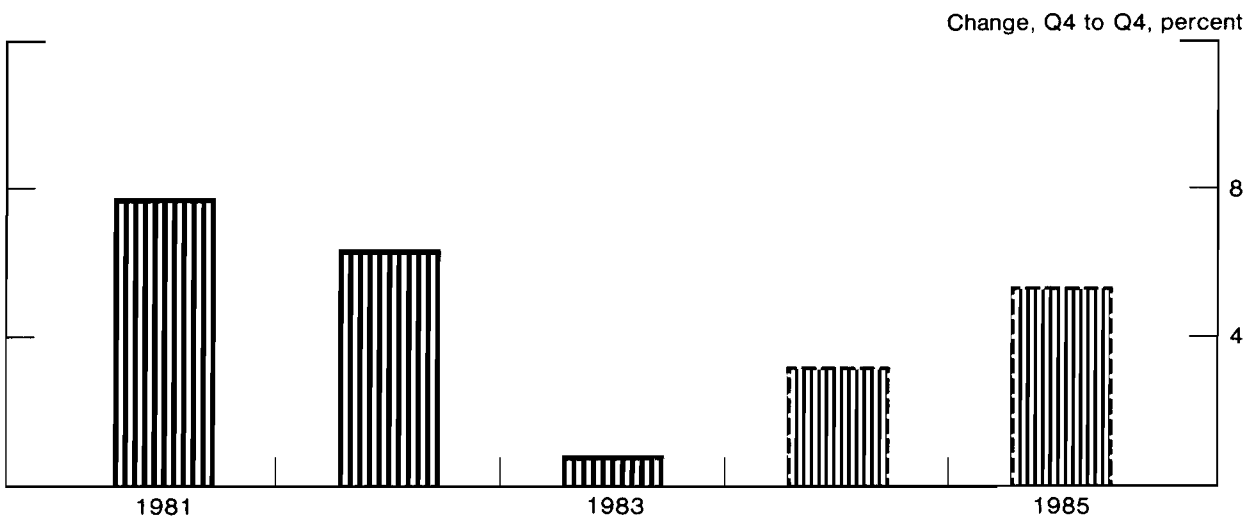
Average Hourly Earnings Index



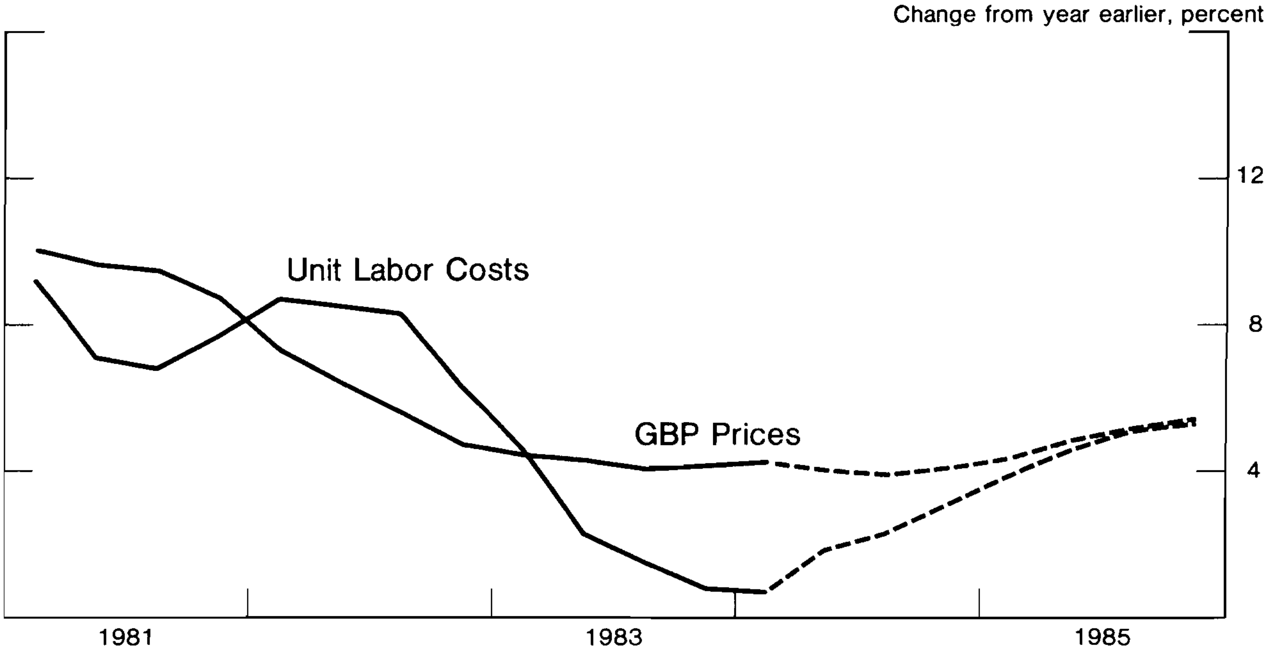
Compensation and Output per Hour



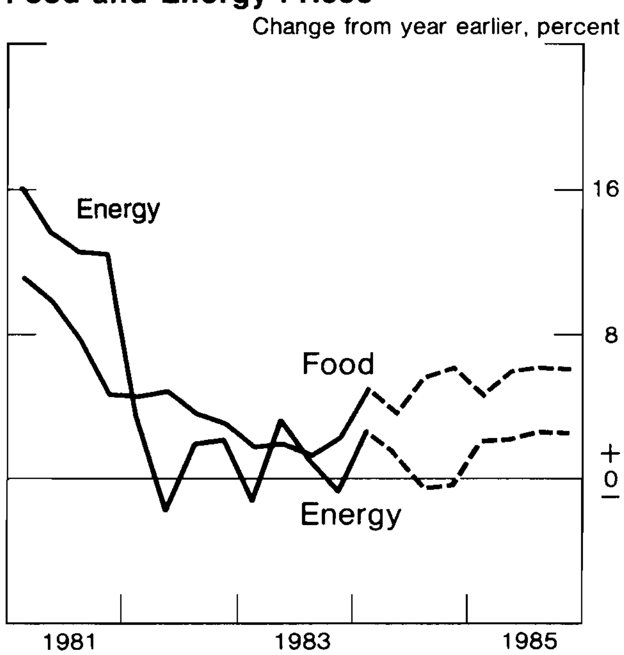
Unit Labor Costs



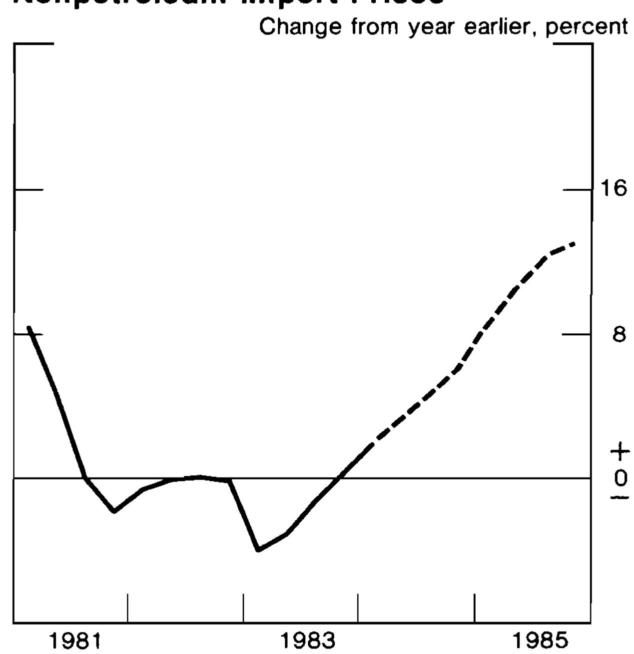
Gross Business Product Prices and Unit Labor Costs



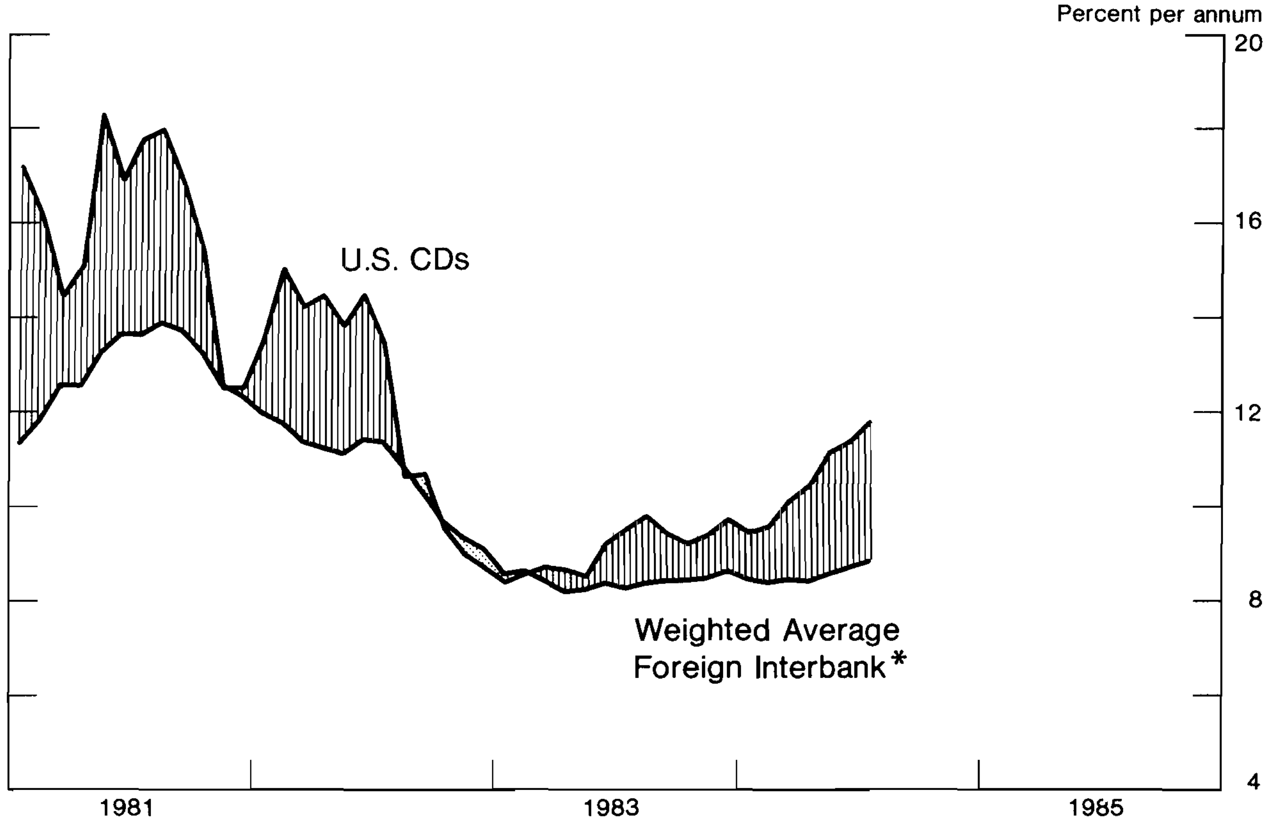
Food and Energy Prices



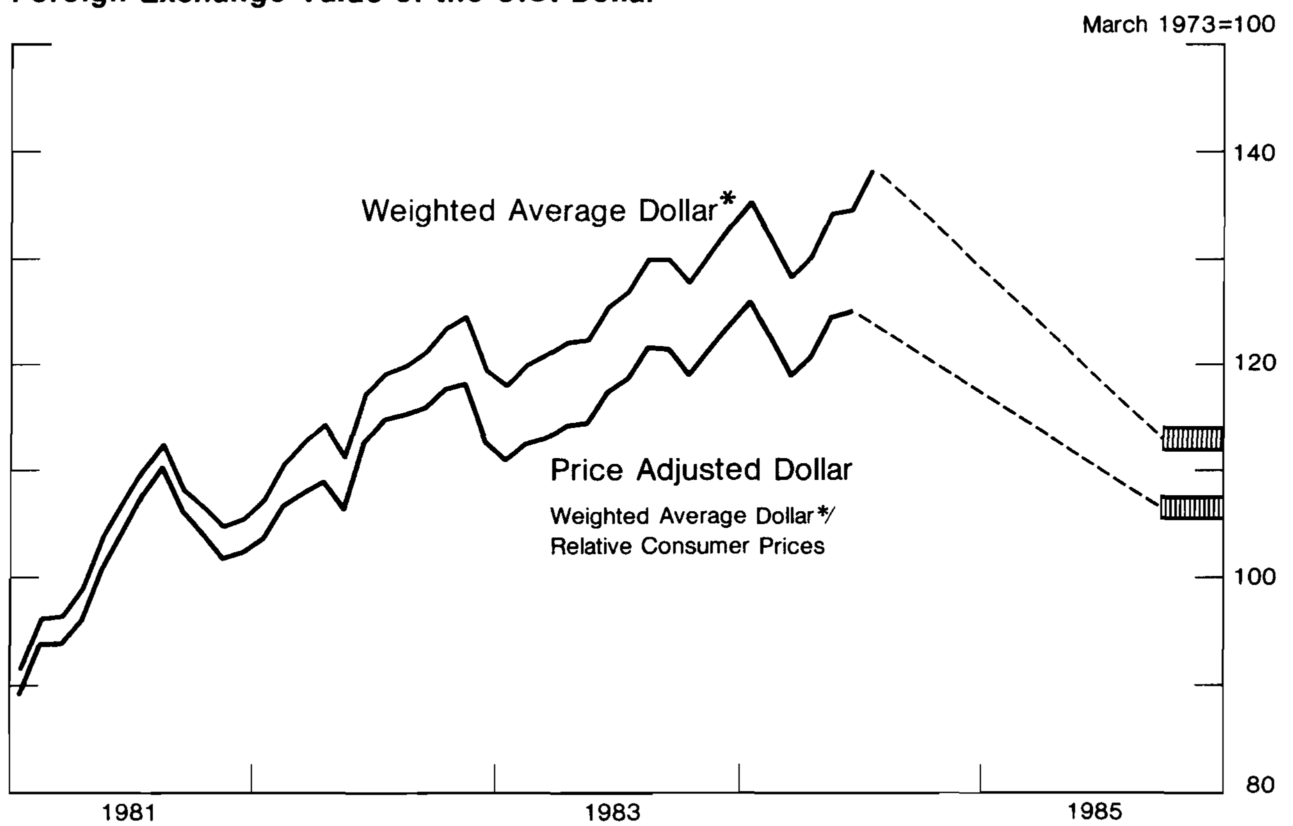
Nonpetroleum Import Prices



Short-term Interest Rates



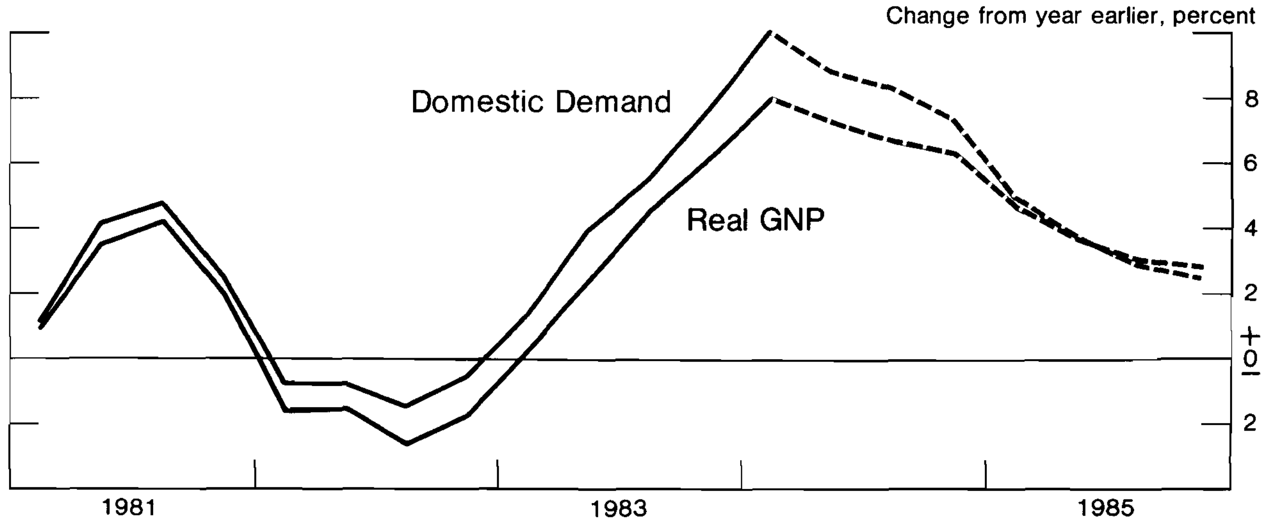
Foreign Exchange Value of the U.S. Dollar



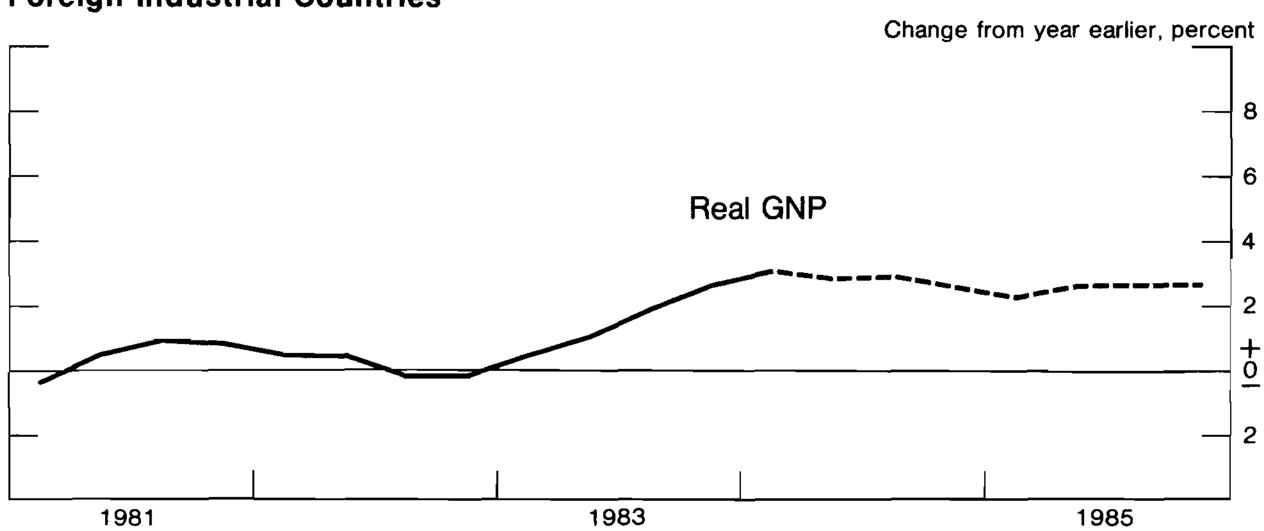
* Weighted average against or of foreign G-10 countries

Economic Activity

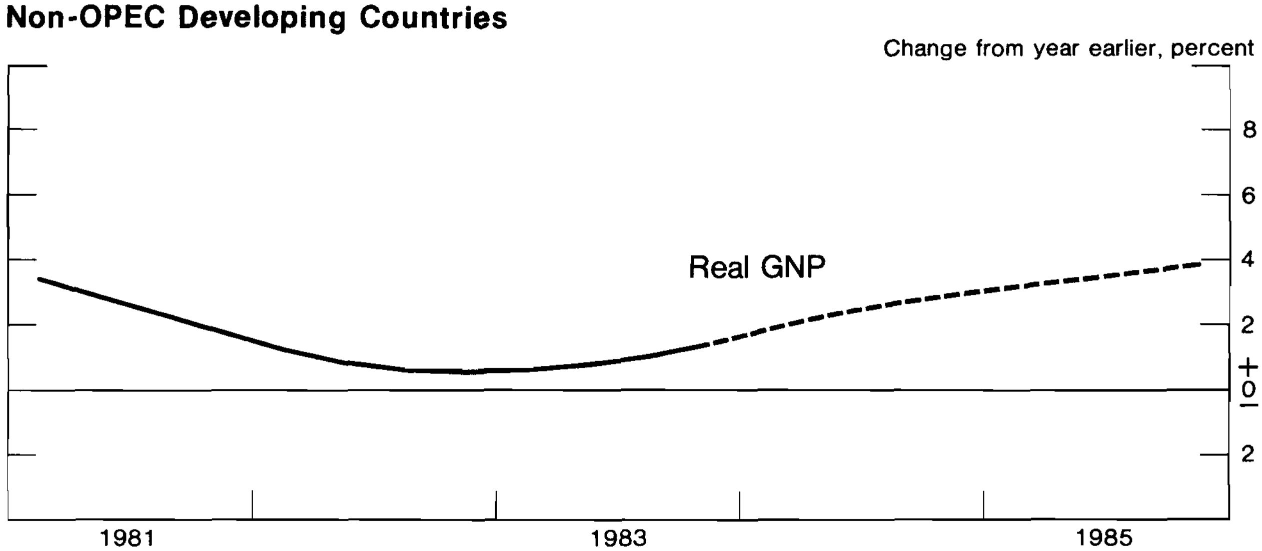
United States



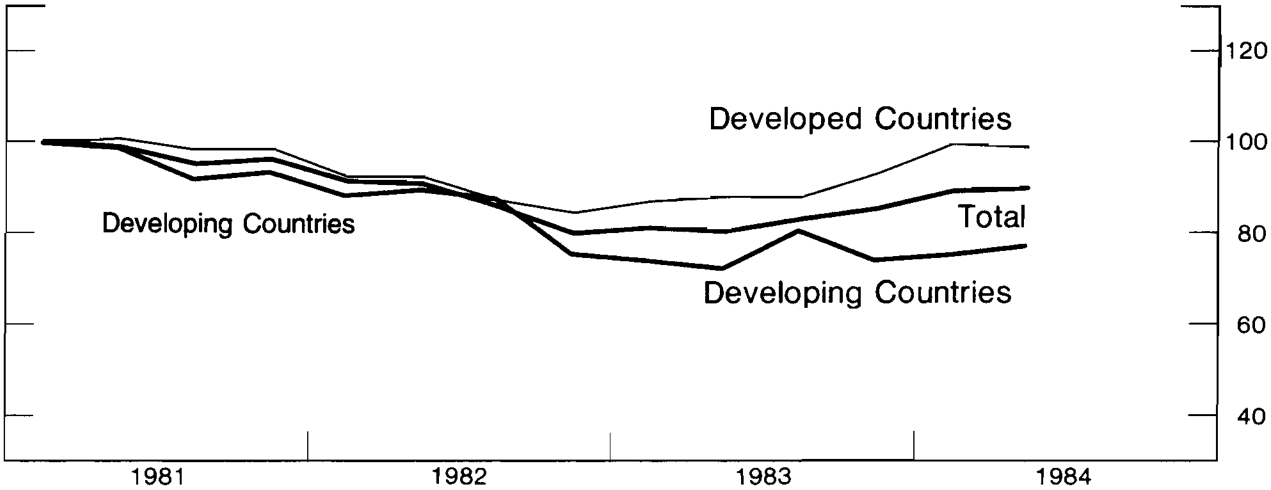
Foreign Industrial Countries



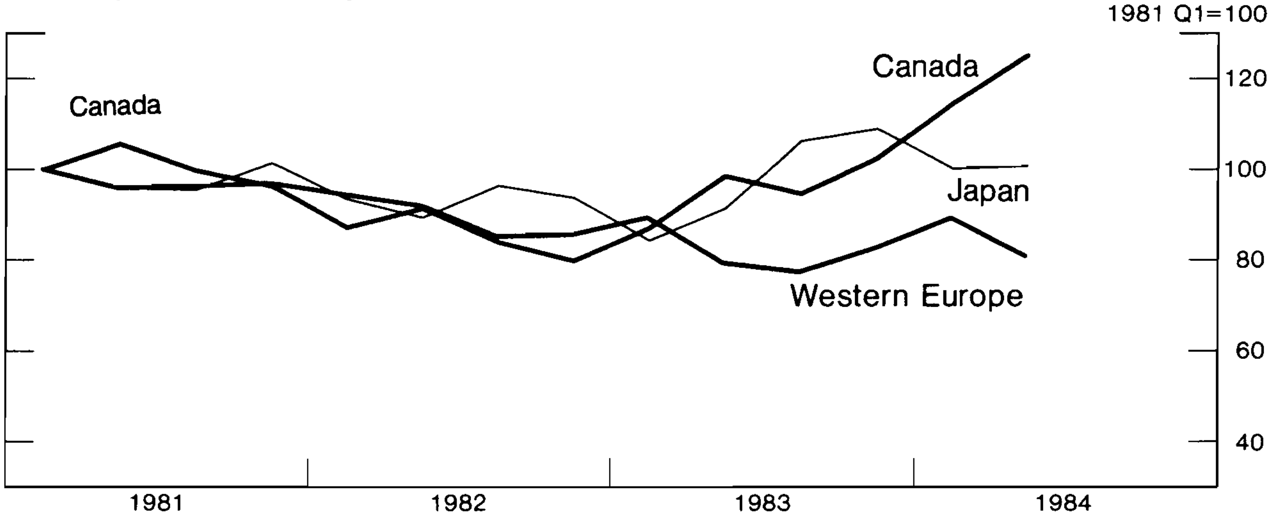
Non-OPEC Developing Countries



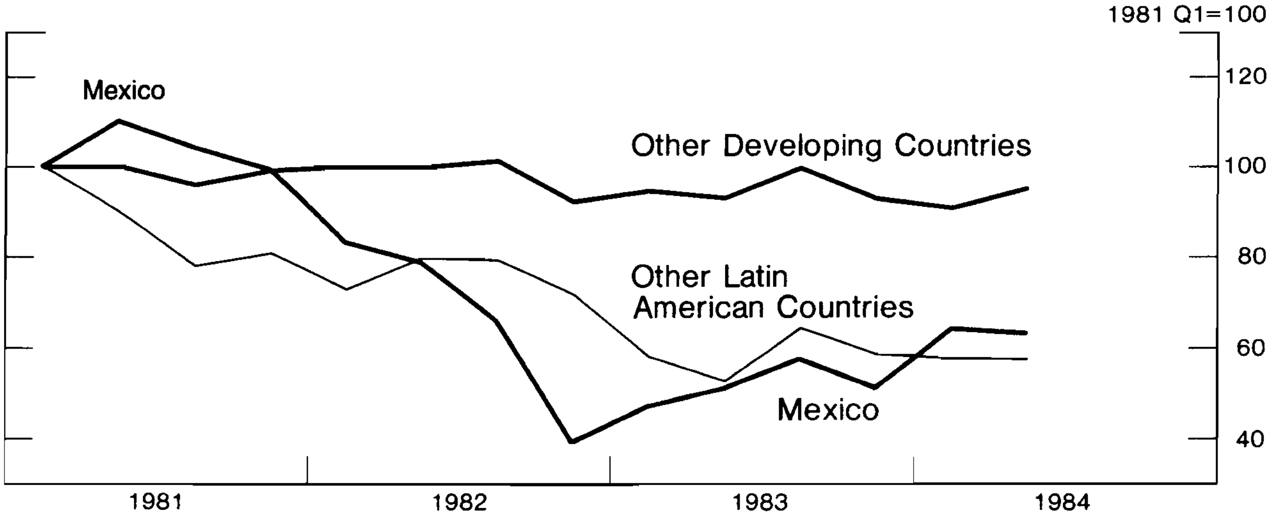
U.S. Exports By Area



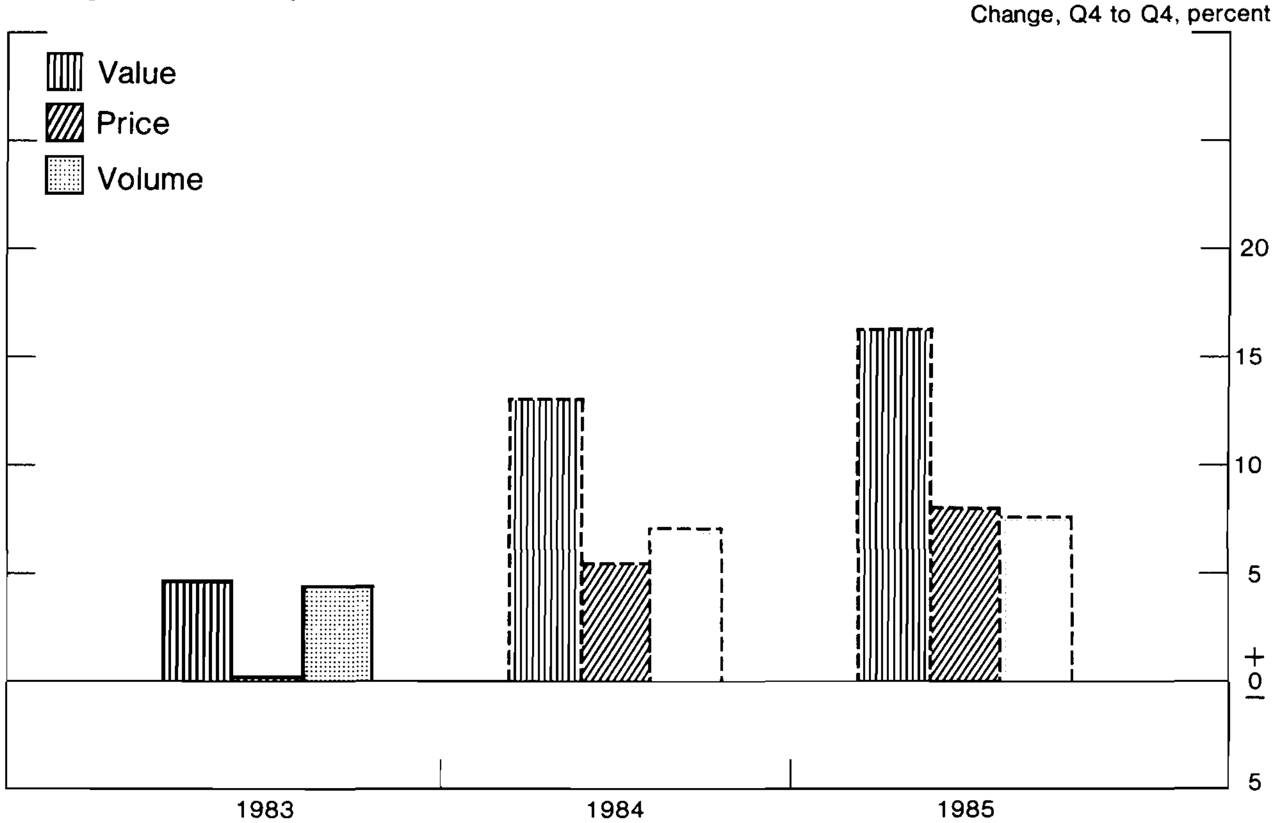
U.S. Exports to Developed Countries



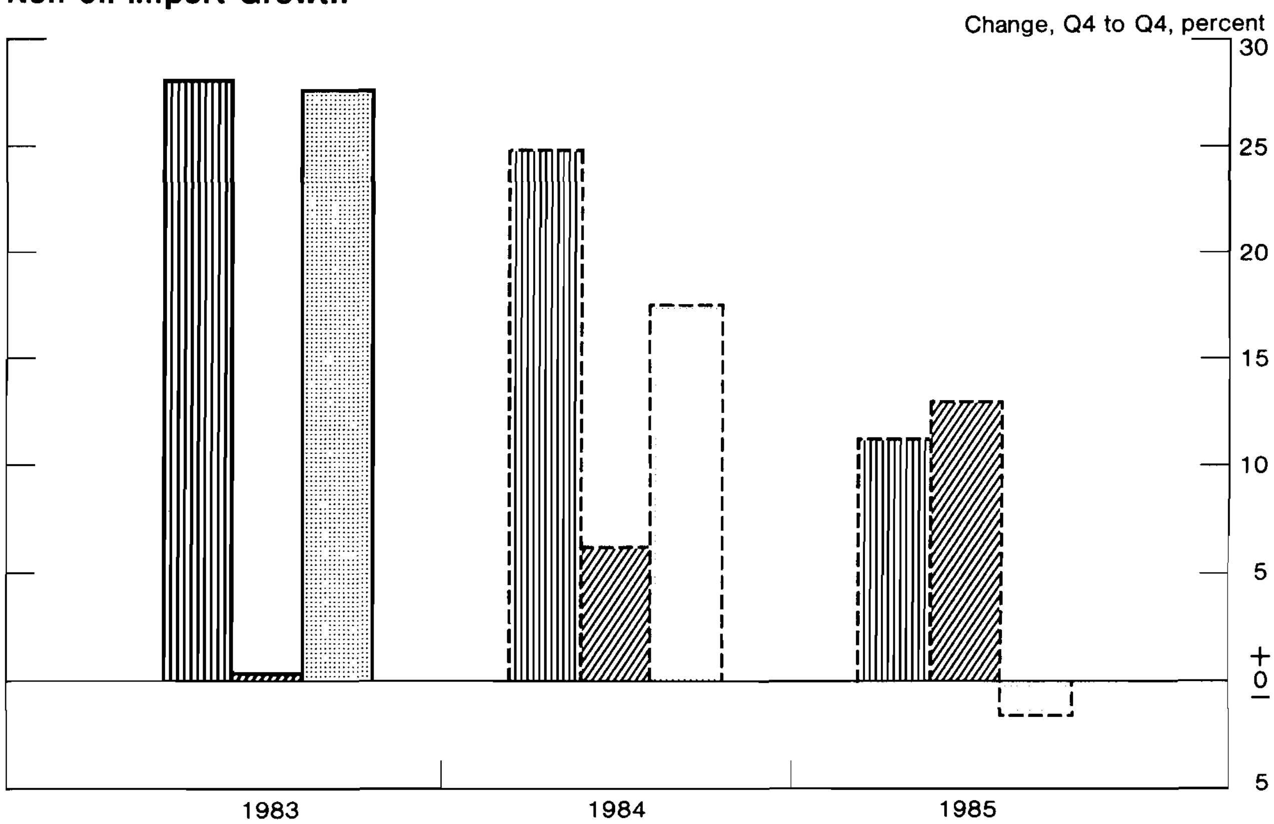
U.S. Exports to Developing Countries



Nonagricultural Export Growth

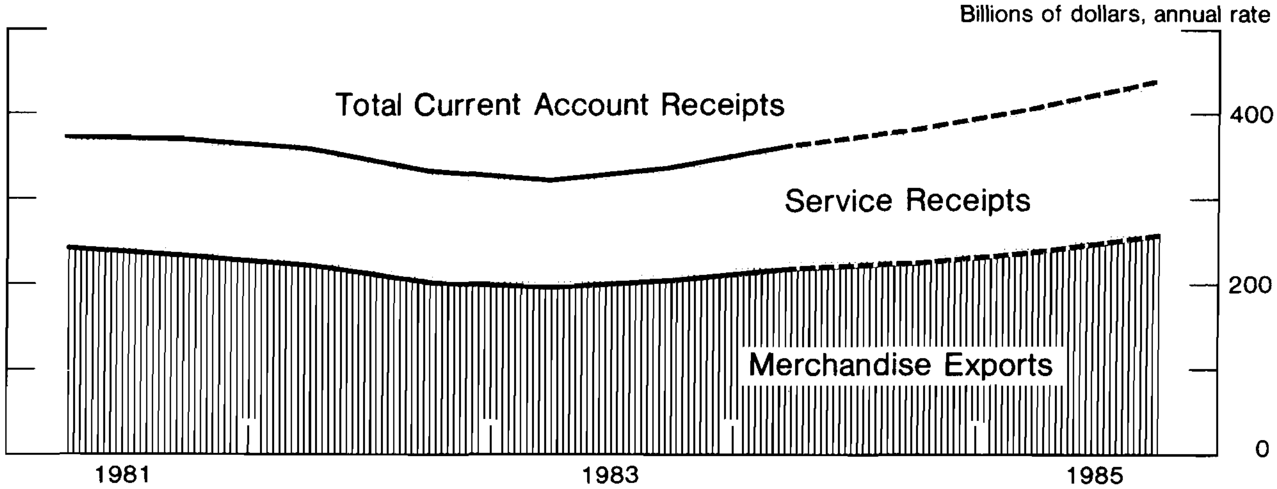


Non-oil Import Growth

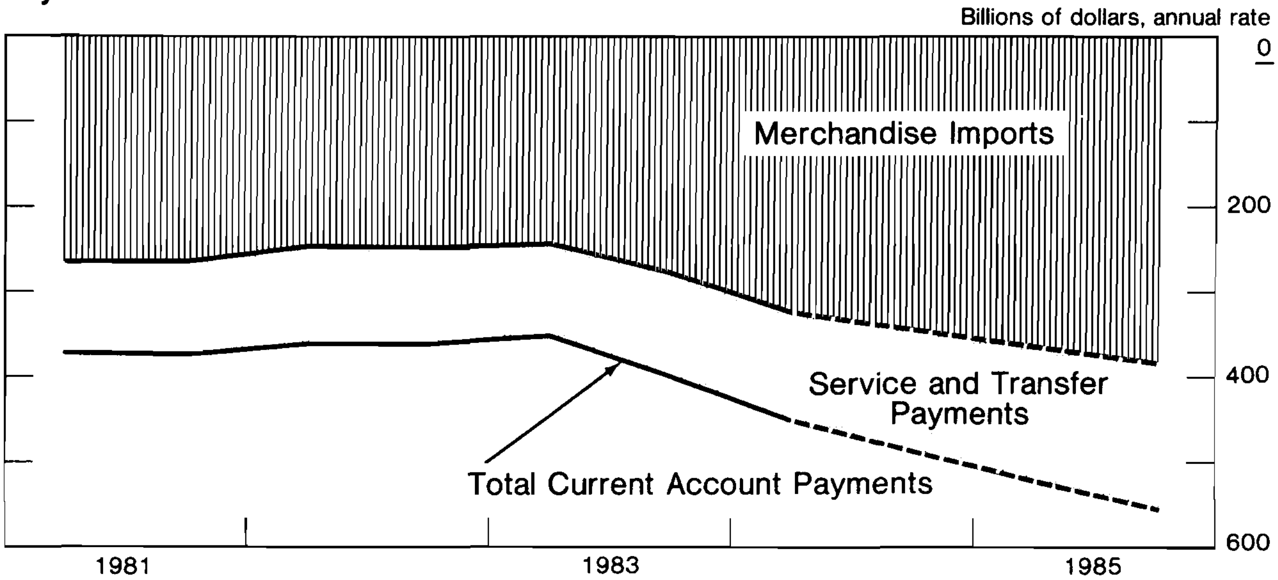


U.S. Current Account Transactions

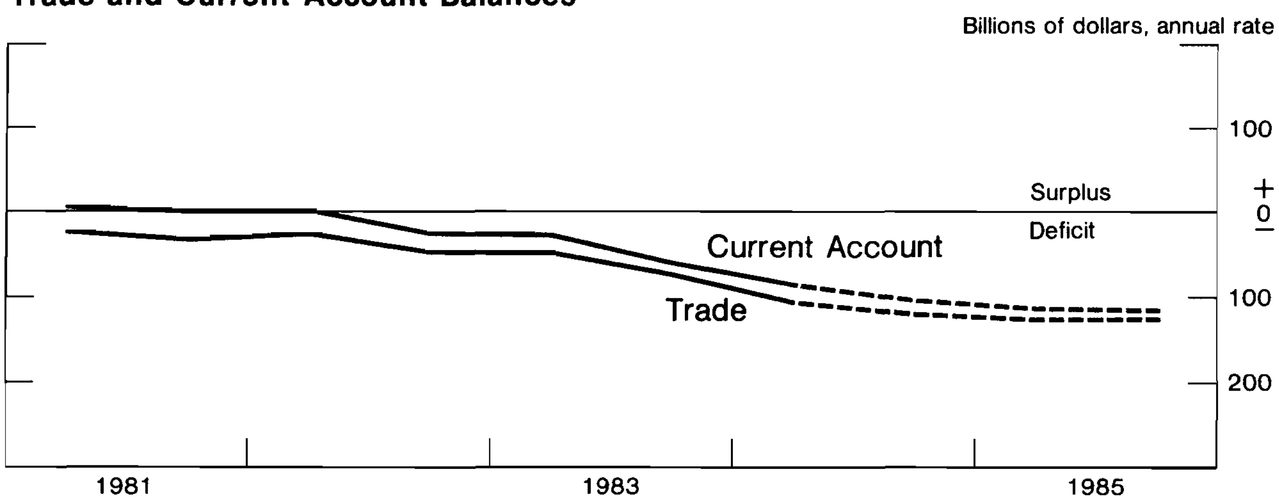
Receipts



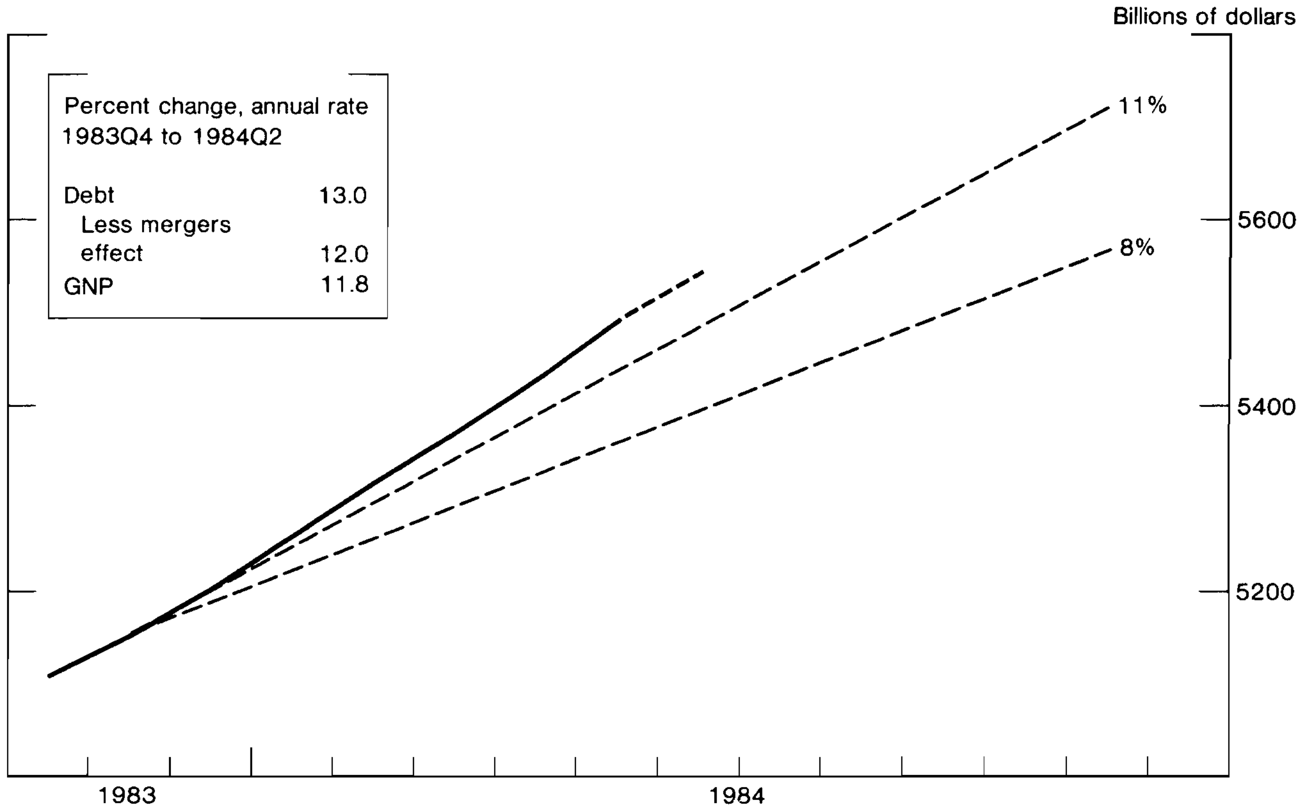
Payments



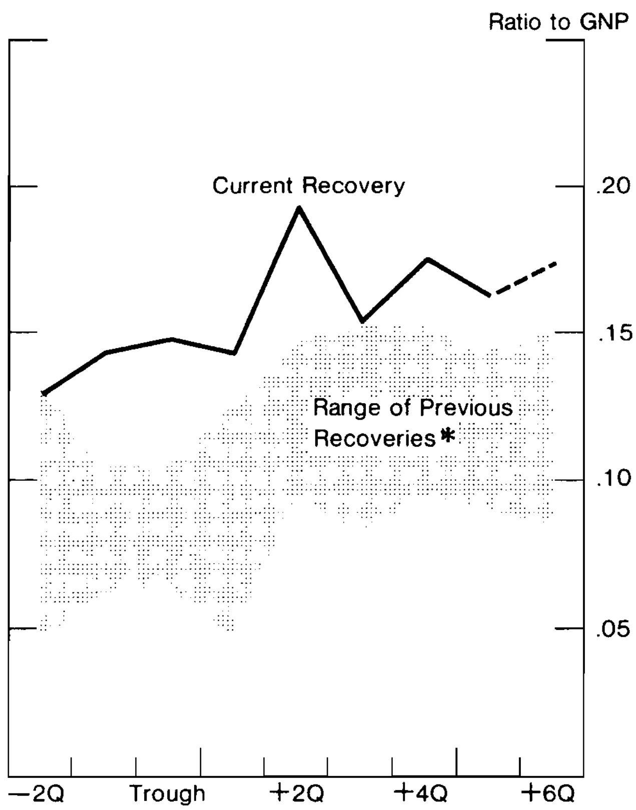
Trade and Current Account Balances



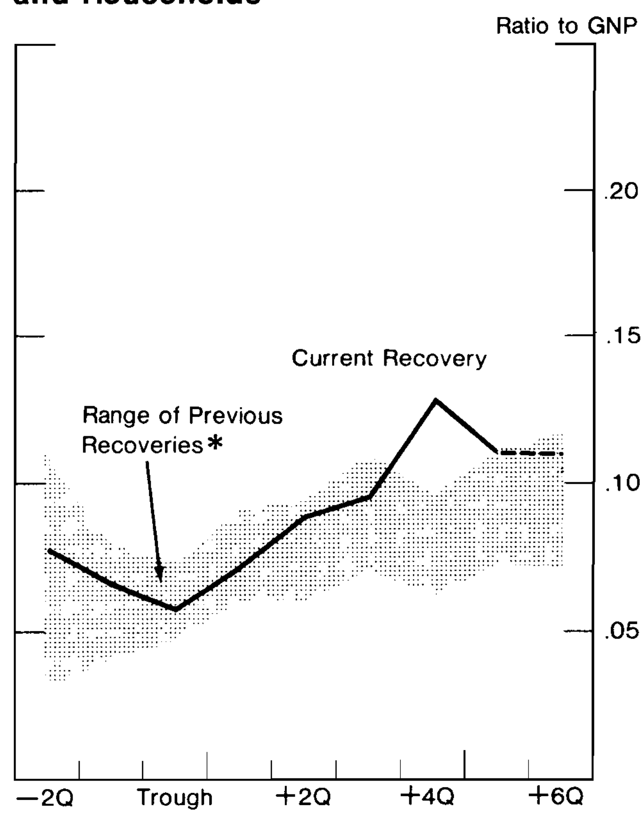
Domestic Nonfinancial Debt



Funds Raised by Domestic Nonfinancial Sectors



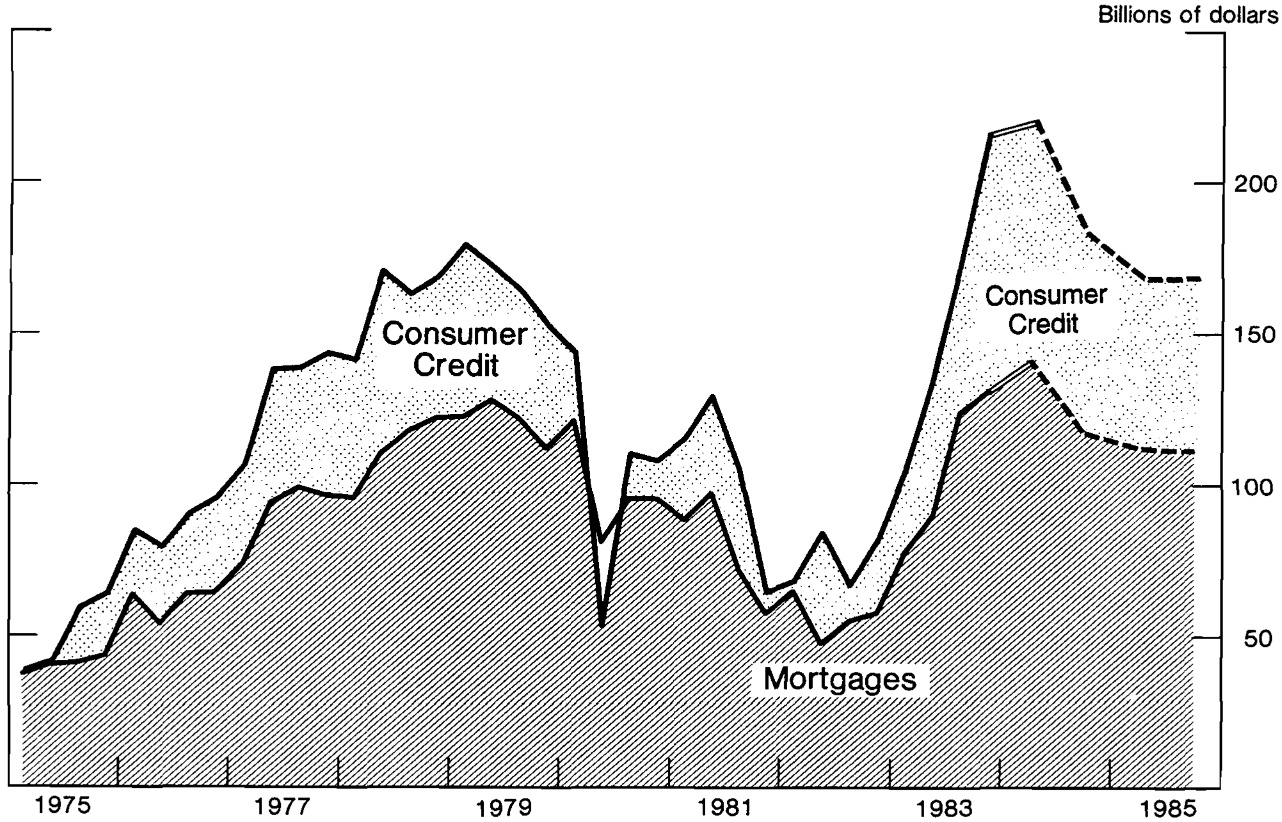
Funds Raised by Businesses and Households



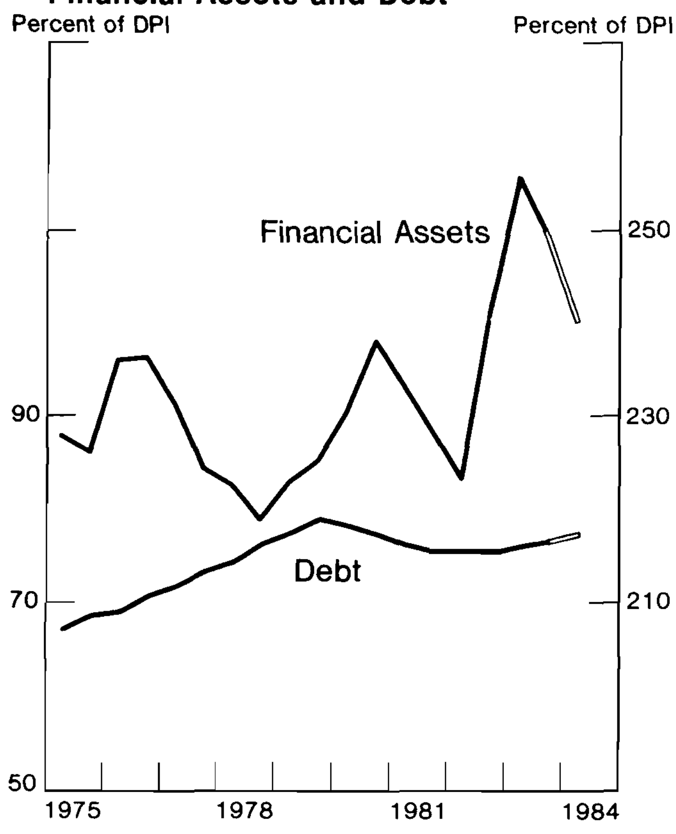
*Excludes recoveries following troughs in 1949 and 1980.

Households

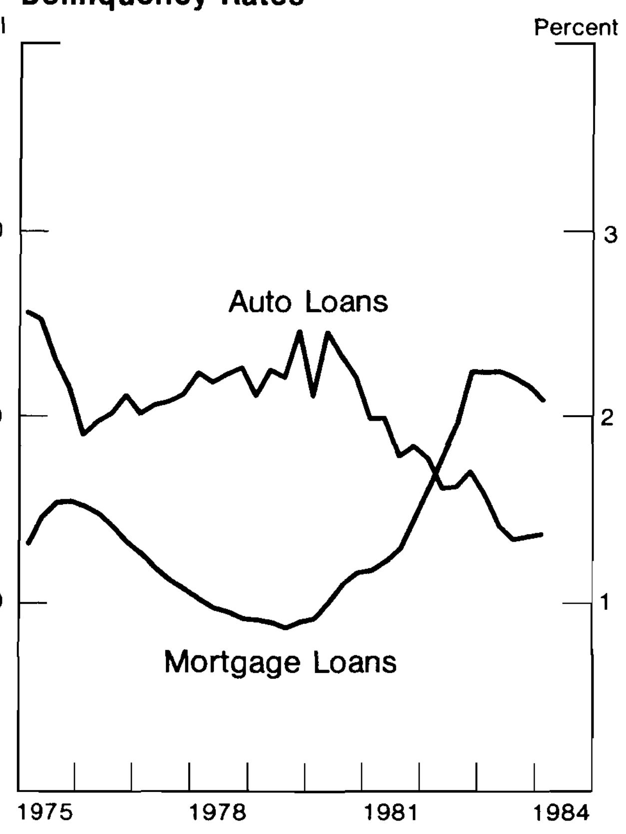
Selected Borrowing



Financial Assets and Debt

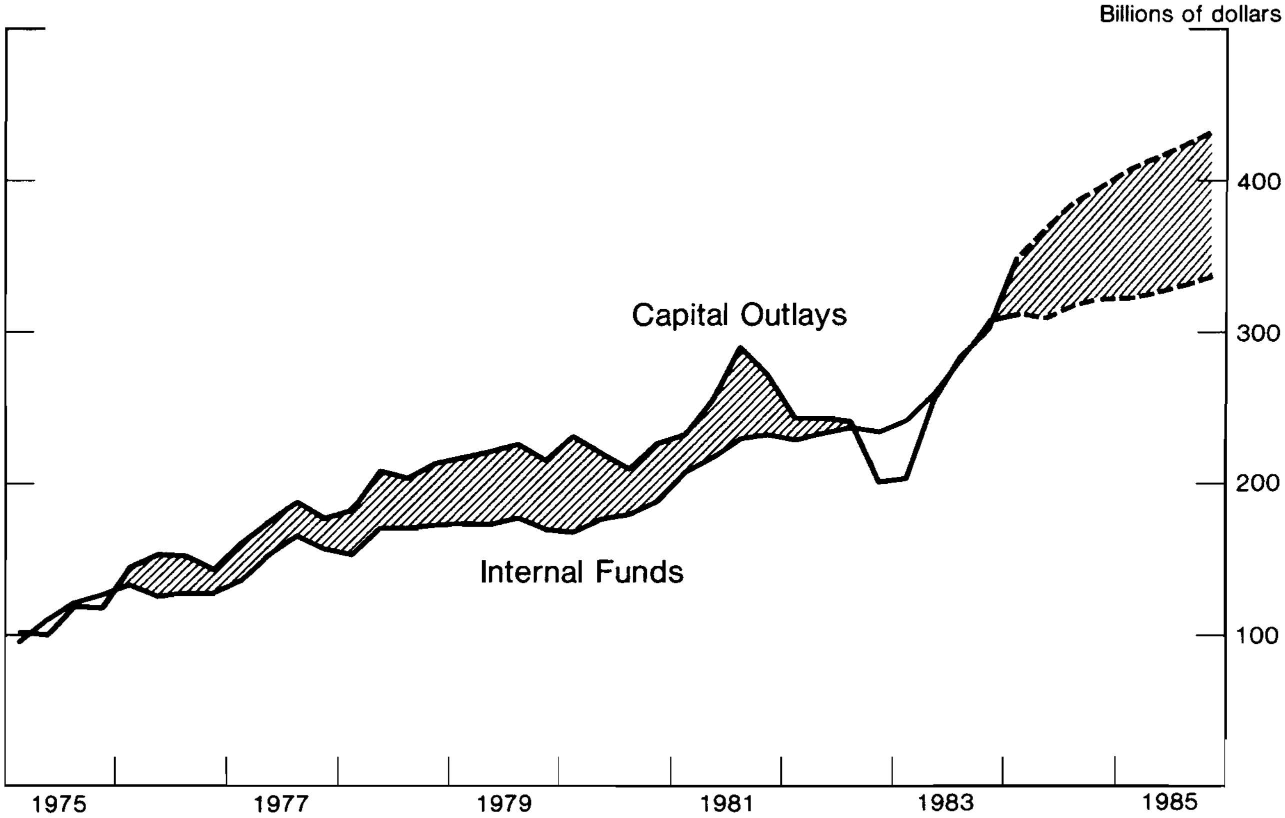


Delinquency Rates

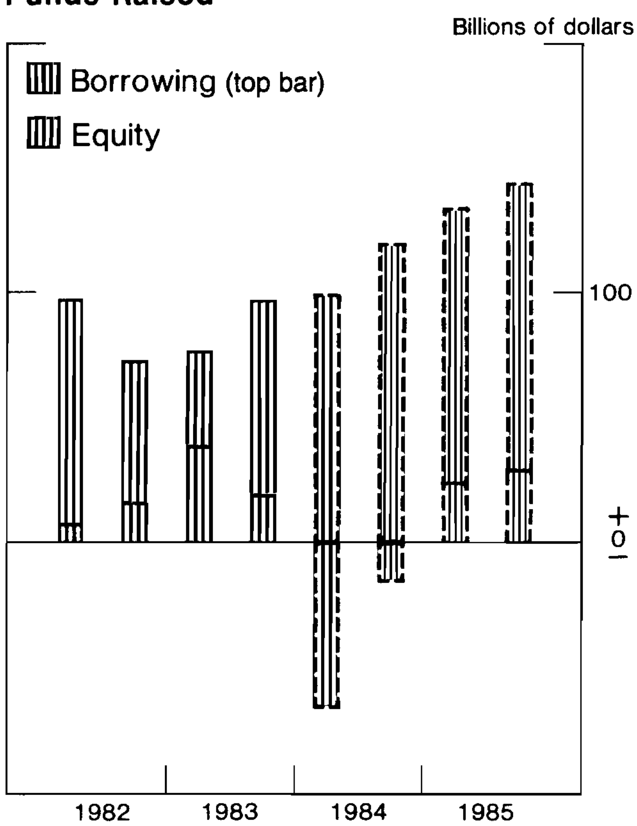


Nonfinancial Corporations

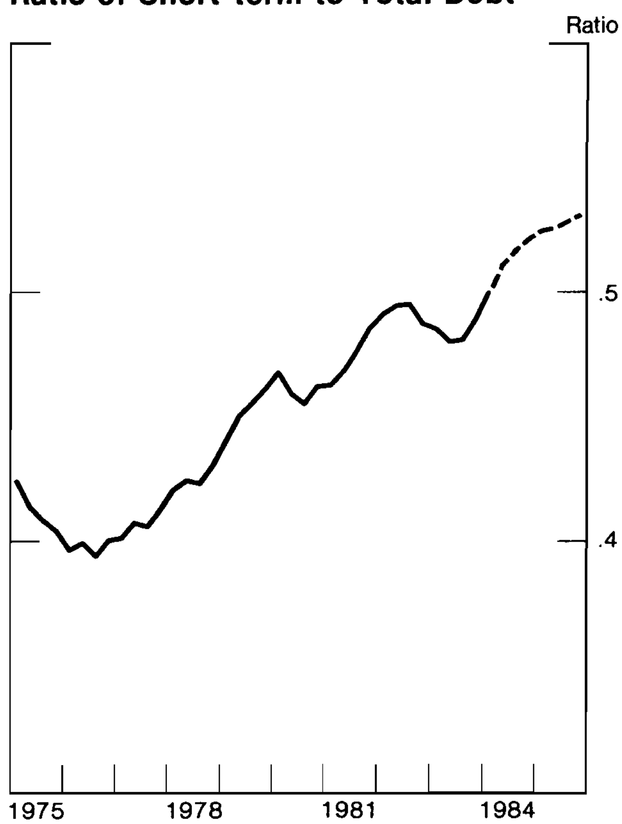
Financing Gap



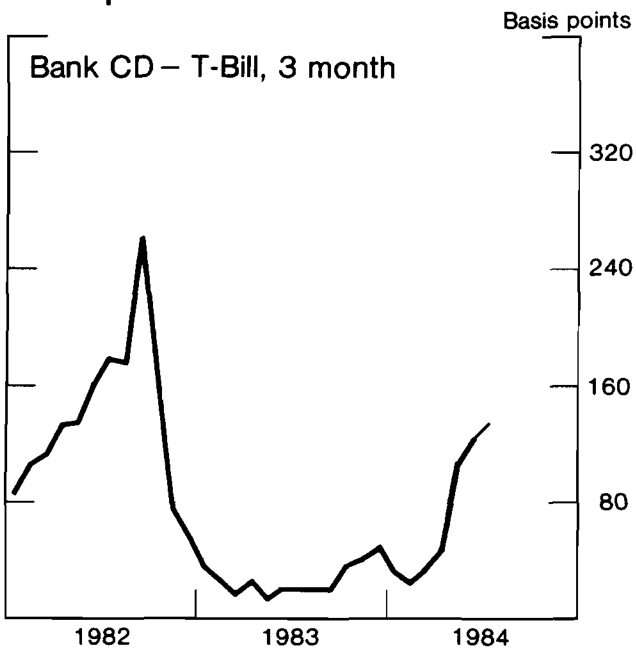
Funds Raised



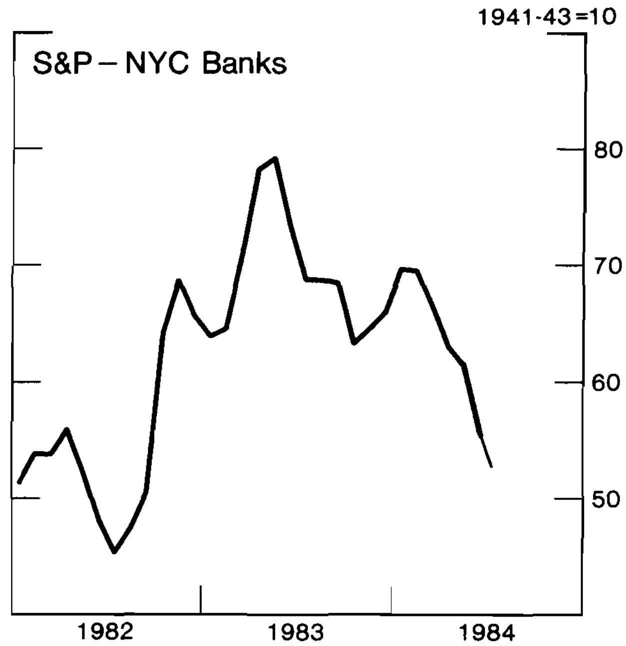
Ratio of Short-term to Total Debt



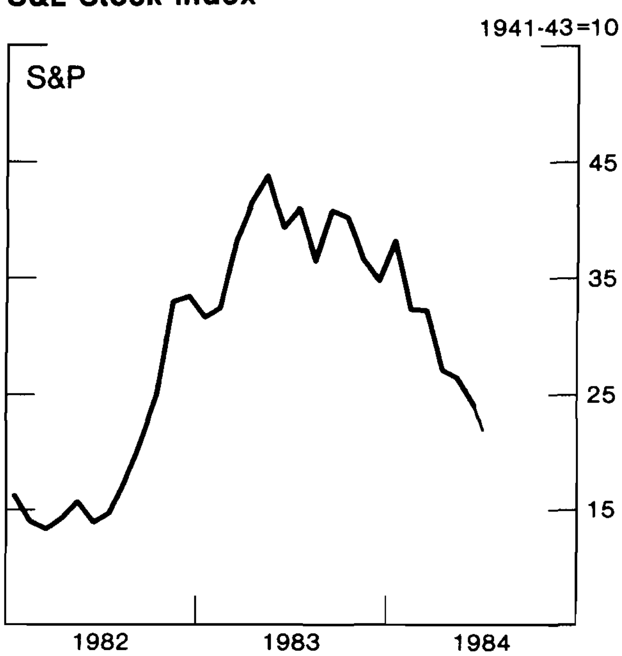
Rate Spread



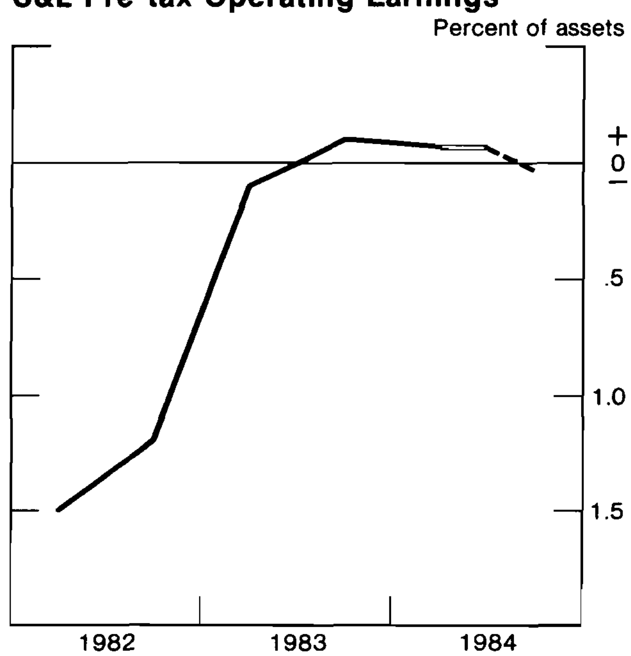
Bank Stock Index



S&L Stock Index



S&L Pre-tax Operating Earnings



Forecast Summary

Q4 to Q4

	Board Members		Presidents		Staff
Percent change, Q4 to Q4	Range	Median	Range	Median	
Nominal GNP					
1984	9¼ to 11	10	9 to 10¾	10¼	10½
1985	5¾ to 10	9	8½ to 10¾	8½	8
Real GNP					
1984	5¼ to 6½	6	5 to 6½	6	6¼
1985	½ to 4½	3½	2½ to 3½	3	2¾
GNP Deflator					
1984	3½ to 4¼	3¾	4 to 4½	4¼	3¾
1985	4 to 6¼	5½	5¼ to 7¼	6	5¼
Average level, Q4, percent					
Unemployment Rate					
1984	6½ to 7½	7	6¾ to 7½	7	6¾
1985	6¼ to 8	6½	6¼ to 7¼	6¾	6½

FOMC Projections for 1984

Reported to Congress Feb. 7, 1984

	Range	Central Tendency
Percent change, Q4 to Q4		
Nominal GNP	8 to 10½	9 to 10
Real GNP	3½ to 5	4 to 4¾
GNP Deflator	4 to 6	4½ to 5
Average level,Q4, percent		
Unemployment Rate	7¼ to 8	7½ to 7¾

Forecast Summary

Annual Averages

	Board Members Range	Board Members Median	Presidents Range	Presidents Median	Staff
Percent change, annual average					
Nominal GNP					
1984	10 to 11¼	10¾	10 to 11¼	10¾	11
1985	6½ to 10	9¼	8½ to 10½	9	8½
Real GNP					
1984	6 to 7	6¾	6½ to 7	6¾	7
1985	2 to 5	3¾	3 to 4	3½	3½
GNP Deflator					
1984	3½ to 4	3¾	3¾ to 4¼	3¾	3¾
1985	4 to 5¾	5	5 to 6½	5¼	4¾
Average level, percent					
Unemployment Rate					
1984	7 to 7½	7¼	7¼ to 7½	7¼	7¼
1985	6½ to 7¾	6½	6½ to 7¼	6¾	6½

FOMC Briefing
S.H. Axilrod
July 16, 1984

With regard, first, to the longer-run monetary and debt ranges for 1984, the principal issue for the Committee appears to be whether to retain or raise the current ranges for M3 and credit. There seems no reason, on the basis of recent experience, to alter the existing ranges for M1 and M2.

Unless the economy slows down considerably more than expected, there seems to be little chance for credit growth in 1984 to fall within the Committee's existing 8 to 11 percent range. We currently anticipate that total debt will grow at a 12-1/2 percent or so rate this year. Roughly half of the overage can probably be attributed to mergers, which are estimated to add about one percentage point to growth in the first half of the year but are assumed to slow considerably in the second half. Mergers also might be viewed as contributing some to the relatively rapid growth of M3, though it's quite conjectural to determine how banks would otherwise have behaved in the absence of mergers. Our current estimate for growth of M3 this year is about 9-1/2 percent.

The upper limits of the alternative ranges suggested for M3 and debt for 1984 in the blue book would barely, if at all, encompass the staff's current projections for these aggregates. If the Committee were interested in ranges that had greater odds on encompassing actual growth, those ranges would need to be even higher, by 1/2 point or more. But any adjustment in ranges would have to balance the disadvantages of giving signals that might be construed as undue relaxation of restraint in face of an unexpectedly strong economy against the advantage of accommodating to special factors distorting the credit picture, such as mergers. Under present conditions, retaining the present ranges for debt and M3, but perhaps indicating that actual growth may be somewhat higher because of merger activity, has a good deal to be said for it. It would have less chance, as compared with an increase in ranges (particularly a sizable increase) of being misinterpreted at this time as signalling a more accommodative posture by the Committee as the still large federal budget deficit and expanding private credit demands come increasingly into conflict.

With respect to the tentative ranges for 1985, arguments are of course strong for continuing with the process of reducing the ranges over time to rates eventually consistent with reasonable price stability. There do not appear to be special factors arguing for an increase in ranges, or even perhaps unchanged ranges--unless one has the expectation that market interest rates will drop sharply next year. In that case, there would be the real possibility that M1 growth would need to accelerate to accommodate to shifting public demands as NOW accounts again become relatively attractive outlets for savings as compared with market instruments and time deposits. However, as of now, the staff has little expectation that interest rates will be lower next year than this; indeed, the odds are rather tilted the other way.

Assuming the Committee wishes to continue with the process of reducing targets for the aggregates, the pace of deceleration will depend on judgments about the degree of resistance to upward price pressures that will produce an over-all satisfactory economic result, taking account of the need to maintain economic growth and, to put it a bit crudely, to keep a full blown liquidity crisis at bay. There are two reasons that argue for a quite gradual deceleration of money growth in the face of fairly substantial upward price pressures. First, a large deceleration of money might entail an excessive shock to the economy; and second, a modest deceleration in money when prices are tending to move up will in any event entail substantial restraint since growth in <u>real</u> money balances will decelerate considerably more than nominal money and real money balances may even actually decline.

But looking to 1985, the most surprising element in the background is the lack of signs so far of a substantial upsurge of inflationary pressures. The staff projection of GNP does entail an acceleration of price increases, but it is fairly moderate. In any event one might well argue that the present favorable price climate presents an opportunity to make a marked downward adjustment in the ranges for 1985, or to reinforce whatever abatement of inflationary psychology in labor and product markets that may be keeping upward price and wage adjustments to quite modest proportions.

The largest reduction in ranges for next year suggested in the blue book is 1/2 percentage point. Somewhat larger reductions would not be inconceivable if one were to accept something like the preceding argument. The alternative of narrowing the M1 range from the present 4 to 8 percent to 4 to 7 percent by reducing the upper limit by a full percentage point might be construed as involving a somewhat stronger move than simply lowering the upper and lower limits by 1/2 point. The upper limit of the M1 range has been, on recent experience, more binding, so that such a move might send a stronger signal, even though its midpoint is no different from that of an alternative 3-1/2 to 7-1/2 percent range.

There are in addition arguments for narrowing the M1 range so that it is at least no wider than the ranges for other aggregates. Over the past year, its behavior has been much less deviant in relation to income than was the case in 1982 and early 1983. Thus, a narrowing in the range would represent an acknowledgment of a return to something akin to "normality"--or at least acknowledgment that M1 as an aggregate, or guide, has become no less uncertain than other aggregates.

Finally, Mr. Chairman, I should mention that discussion of monetary policy solely in terms of the money and debt aggregates does seem a bit abstract at a time like this, when financial markets are quite volatile, when large banks are subject to severe strain because of, among other things, the international debt crisis, and when thrift institutions are again on the verge of unprofitability. That environment seems to argue for a continued judgmental approach to the implementation of monetary policy, though perhaps at the moment with a little more confidence in the signals being generated by M1. Thus, it appears important to continue with the short, one sentence paragraph in the directive that indicates the aggregates need to be considered in relation to behavior of the economy and conditions in domestic credit markets.

Notes for F.O.M.C. Meeting
July 16, 1984

Sam Y. Cross

At the time of the last FOMC meeting, the dollar was in one of its temporary downturns. In the wake of the Continental Illinois' funding crisis, the exchange market became concerned about the possible vulnerability of large U.S. banks and particularly those with large Latin American exposures. These concerns and the perceived emergency aid provided to Continental by U.S. monetary authorities led the exchange markets to question the ability of the monetary authorities to pursue a tight or even firm monetary policy.

On the Thursday following your last meeting, rumors that several banks were experiencing liquidity problems spread like wildfire through the Eurodollar and domestic markets. The dollar fell sharply, exchange market conditions became quite disorderly, and we intervened, selling $135 million equivalent of German marks, to contain these pressures and restore more normal trading conditions. By the next day the markets, while still nervous, had stabilized somewhat though the dollar continued to slip for a couple of weeks.

In early June, however, the dollar abruptly reversed direction and began an increase which has continued for most of the period since. A firming of the U.S. short-term interest rates persuaded traders that the authorities would be able to handle the repercussions from Continental's problems without jeopardizing monetary policy. At the same time, fears of an aggressive Latin American debt cartel were diminished by the moderate results of the Cartagena meeting, and a more positive outlook developed for Mexico. A clarification of U.S. accounting procedures for non-accruing loans also helped to clear the air and signaled to the markets that the authorities felt confident that the banks could sustain the adverse impact on their earnings. Generally, these developments were seen as allowing U.S. authorities to resume or continue a firm monetary policy, and continued evidence of vigorous economic expansion gave further reason to expect that monetary policy would indeed be firm.

The dollar has also been boosted by lower-than-expected increases in consumer and other prices. A drop in the price of gold since early June that got as large as 14 percent suggests a downward revision in expectations of U.S. inflation. This, together with the strong economy and advantageous interest rate differentials, appears to have stimulated investor interest in the dollar. Moreover, the imminent repeal of withholding tax on interest paid to foreigners has caused talk of increased foreign investments in U.S. Treasury and U.S. corporate securities, although as yet the impact of this move is difficult to assess.

The dollar may also have obtained some support from investors to the extent that the alternatives to the dollar were seen as not very attractive. Strikes and labor unrest in several European countries, as well as slower than expected growth and low interest rates, cast a pall over European currencies, while uncertainty about oil supplies in the Gulf reminded investors of Japan's heavy dependence on imported oil. The German metalworkers' strike, which hung over the mark for the many weeks, was finally settled, but doubts about the impact of the settlement on the economy persist and so far the mark has not responded positively.

Foreign monetary authorities reacted in different ways to this latest rise of the dollar, some intervening, others raising interest rates and a few doing both. The Bundesbank has stated that mark interest rates have been decoupled from U.S. interest rates. Since early 1984 short-term rates for the mark have remained essentially unchanged, as the recent 1/2 point hike in the discount rate was primarily a technical adjustment. Nonetheless, the Bundesbank has intervened in size since your last meeting, selling to support the mark. Moreover, other EMS central banks, in conjunction with the Bundesbank, purchased an additional equivalent of marks. In the same period Canada also intervened somewhat more than usual and, in addition, had to raise its interest rates by more than the increase in U.S. interest rates. The Japanese also intervened, but modestly, in support of the yen before it hit new lows for 1984 against the dollar. The Bank of England shied away from any heavy intervention to support the pound, but it has had to accept a substantial rise of interest rates of almost 3 percentage points in the last ten days in response to exchange market pressures on sterling. The Swiss authorities stood on the sidelines and the Swiss franc depreciated not only against the dollar but also against the mark.

To conclude: now in mid-July, the dollar is trading on average significantly above the earlier peak in mid-January. Factors which earlier in the year were expected to weaken the dollar--*e.g.*, that U.S. economic expansion would peter out, that inflation would revive, that the current deficit would force the dollar down, that monetary policy would be accommodating in an election year--have not had that effect. Still, the present strong dollar is at least in part sustained by large interest rate differentials, which have increased by 200 basis points or more in many cases from the differentials existing at the dollar's earlier peak in January.

PAUL MEEK
FOMC NOTES
JULY 16-17, 1984

Open market operations over the past eight weeks have taken place within the context of monetary aggregate behavior broadly in line with the Committee's desires. M1 was to the strong side from March to June, growing at 8 percent versus the 6-1/2 percent rate expected. For a time, growth in M2 and M3 also seemed likely to exceed the Committee's expectations, but their growth moderated to bring them out quite close to the 8 and 10 percent rates anticipated. RPs declined as bank underwriting positions fell with higher interest rate expectations. Term Eurodollar liabilities also declined, presumably as money market funds and other U.S. investors allowed holdings to run off after the exodus of funds from Continental in May.

The timing and magnitude of Desk operations during the interval were significantly affected by changing bank behavior related to the Continental Illinois situation and market concerns about bank loans to Argentina and other Latin American countries. Investors were preoccupied with credit quality, as evidenced by a widening of the spread between 3-month CDs and Treasury bills to about 160 basis points at one point. Banks became increasingly concerned about liquidity as the quarter-end statement date approached. The large banks switched to accumulating reserve surpluses, after having previously run reserve deficiencies in the first week of their settlement period since CRR began. The market shift in demand patterns crested in the first half of the July 4 period when excess reserves rose to $2.4 billion with $1.8 billion of this held by large banks.

Against this background, open market operations sought to provide flexibility for liquidity needs without relinquishing the desired degree of pressure on the banks to borrow at the window. On occasion, the Desk more than met the projected reserve need in the face of insistent bank bidding for reserves that was pushing the federal funds rate above the 11-1/2 percent upper limit of the Committee's consultation range. The Desk was prepared to absorb reserves later that became redundant, but in the July 4 period, in particular, the reserves market remained under pressure until very late in the final day.

Whereas nonborrowed and excess reserves ran above planned levels in two of the four settlement periods, discount window borrowing remained remarkably close to the Committee's desired $1 billion level, tracking Continental's borrowing as extended credit. There was, however, a build-up in money market pressure as the major banks not only sought to accumulate excess reserves but also shied away from borrowing at the Federal Reserve. The federal funds rate, which averaged 10-1/2 percent in the June 6 statement period moved up to range around 11 and 11-1/4 percent in the past six weeks. Contributing to the precautionary and seasonal pressure was the belief that the strength evident in the economy probably warranted a lasting increase in the funds rate even after seasonal pressures subsided.

In the present reserve period, the major banks seem to be relaxing somewhat, willing once more to accumulate reserve deficiencies in the first week of the period. Market participants also appear to be lowering their expectations for interest rates. It seems quite possible that the federal funds rate associated with $1 billion of borrowing could recede toward the 10-1/2 to 10-3/4 percent level prevailing before June.

Operations over the period were complicated at times by greater-than-usual difficulties in projecting reserves. The Treasury's balance bounced around quite a bit toward the end of the quarter, and Continental's borrowing at the window was also variable. The Desk bought $1.4 billion of Treasury bills from foreign accounts, mostly by early June. We used System and customer-related RPs on sixteen occasions. A rise in Continental's borrowing from the $2 billion level to $4.5 billion provided most of the pre-holiday need for reserves. I should mention that our phasing out of RPs on bankers' acceptances took place on July 2 on schedule without significant market comment or difficulty for Desk operations.

Investor uneasiness about bank paper became pervasive during the period. Anxiety about Argentine and other loans added to the nervousness touched off by the flight of funds from Continental in May. There was no wholesale selling of paper into the secondary market as occurred after Penn Square in mid-1982. But money market funds and others apparently did redirect funds toward Treasury bills and industrial commercial paper as well as increasing the representation of regional and foreign banks in their portfolios before June 30. Continental experienced a further run off. Major banks generally relied on writing short-term CDs and commercial paper directly with customers to tide them over the statement date. Most major banks had to work harder to cover their expanding loans. The rate spread between CDs and bills widened to 160 basis points in late June, almost 100 basis points above the level of early May. This increase in costs figured in the prime rate rise to 13 percent on June 25.

A modest tiering of rates developed in the markets for bank paper. The standing of Japanese and regional banks improved, while

Manufacturers Hanover paper has been trading in the secondary market at 10 to 15 basis points above the rates on the top banks because of its large exposure to Argentina. The money market has calmed considerably and expectations of further rate rises have diminished. The spread between 3-month CDs and Treasury bills has fallen to about 130 basis points. The worst seems to be over, although tiering remains. CD rates were up 45 to 85 basis points over the period.

The market for Treasury securities underwent several marked changes of mood over the interval between meetings, with yields closing 15 to 40 basis points higher through four years and 20 to 35 basis points lower at the long end. Investor demand kept rates on short-dated Treasury bills insulated from the rise in the federal funds rate for much of the period. But rates in yesterday's 3- and 6-month auctions were about 20 basis points higher than those of eight weeks previously.

In the note and bond market, sentiment was extremely gloomy in late May as participants worried about Treasury financing, a vigorous economy, and strong credit demands, as well as the ability of international debtors to repay loans. Yields on issues of seven years and beyond rose 50 to 60 basis points from the meeting to the vicinity of 14 percent. However, the sale of the Treasury's 5-year two-month note on May 30 precipitated a rush of investor buying and yields tumbled quickly. They remained below the end-of-May highs even when the rally faltered on the flash report of unexpected strength in real GNP and on the approach of the Treasury's $15.5 billion end-of-quarter financing. More recently, investors have been encouraged by the decline in gold and commodity prices as well as the repeal of withholding on interest income earned by foreigners. An improved inflation outlook undergirds broader investor participation. Some have also concluded that the Federal Reserve may not soon increase the pressure on banks or raise the discount rate. Dealers, which operated with sizable net short positions through most of the period, have worked to cover those in the past 10 days, fueling a strong rally. With coupon stripping helping depress the yields on longer issues, the yield curve now has a modest downward tilt from about 7 years out.

Corporate bond yields have moved roughly parallel with Treasuries over the period. New issue activity has been light with bank holding companies prominent among the issuers, selling $1.4 billion of notes. Municipal offerings were not heavy until two weeks ago when the final tax package spurred a flow of mortgage financing bonds. Yields on these issues rose sharply initially but dropped back later on strong demand to close only slightly higher for the period.

I should like to report that the ongoing discussions with the Primary Dealer Committee of the Public Securities Association have resulted in the Group's endorsement in principle of the promulgation of capital adequacy guidelines, applying to their membership as well as to other dealers. Discussions are continuing to refine the technical aspects of the guidelines.