APPENDIX

NOTES FOR FOMC MEETING
February 13, 1985
Sam Y. Cross

Once again the dollar opened the new year on a very strong note. In two waves--one around the turn of the year, the other in February--the dollar moved sharply higher. It has reached new peaks for the floating rate period against the German mark and records against sterling and most continental currencies. Since your last meeting, the dollar rose 10 percent against the Swiss franc, 9 percent against sterling, and about 6-7 percent against most continental currencies and the Japanese yen.

An improving outlook for the real economy in the United States, together with continuing good news on the price front, has certainly benefited the dollar. In addition, market professionals have consistently been impressed by the strength of commercial- and investment-related demand for dollars coming from their customers.

Concern about the economic implications of continuing large exchange-rate movements, as well as questions about the effect of declining oil price on sterling, led market participants to expect a policy response to the most recent market developments. In several countries, the authorities responded with monetary policy actions. The Bank of England took the initiative to help sterling, pushing up interest rates by reinstituting its minumum lending rate for one day. But sterling continued to weaken, and money market dealing rates rose further. In just over 2 weeks, short-term British interest rates increased 4-1/2 percentage points. In Germany, the Bundesbank raised its Lombard rate by 1/2 percentage point partly to stem continuing capital outflows and partly for technical reasons. This was followed by increases by the Netherlands Bank of its own lending rates. Central banks in Italy, France and Belgium, however, took advantage of

the tendency for their currencies to strengthen against the German mark to lower their interest rates somewhat.

Despite these actions market participants were of the view that the scope for major monetary policy tightening abroad was limited. European countries have still made only limited progress in reducing unemployment. As a result, attention focused on intervention as a policy tool. Around mid-January, the G-5 Finance Ministers' meeting was seen as providing an opportunity for the major countries to adopt a more active and coordinated intervention policy. In fact, the G-5 Ministers reaffirmed the 1983 Williamsburg Summit Accord on exchange market intervention. Coordinated and visible intervention operations were then conducted. The increase in intervention, together with more public discussion of intervention, for a time generated a sense of two-way risk.

Since the G-5 meeting, the G-10 central banks increased their dollar intervention to sell $2-1/4 billion net, up from only about $1/2 billion during the previous four weeks. The figure for the post G-5 meeting period includes total sales of $320.4 million against marks and yen by U.S. authorities. Between your last FOMC meeting and mid-January, the United States had not intervened. After the G-5 meeting, the United States intervened on four occasions to resist renewed rises in dollar rates. In these operations $271.6 million was sold against marks and $48.8 million against yen, shared equally between the Treasury and the Federal Reserve. As for the others, the Germans sold over $700 million, the British and Japanese each sold over $200 million and all others except the Swiss sold some dollars. The French and Italians, while intervening in dollars, also operated more extensively by buying EMS currencies, yen, and ECUs.

The current attitude of the other G-10 countries towards our intervention seems to range from frustration to irritation. They acknowledge U.S. concerns about our not being seen as bashing our own currency. They also recognize that the Fed is not a free agent in this matter. Also there is a view that during recent weeks the underlying situation with respect to the strength of the U.S. economy and the prospect for interest rates during this period made a rise in the dollar exchange rate perhaps inevitable. Certainly, they would like to see us intervene much more heavily, and some feel that the intervention operations we have undertaken have not been carried out in a way to get maximum attention and effect. Very broadly there is concern that the element of uncertainty introduced by the January G-5 agreement may be fizzling out unless there are some new initiatives.

Other Operations

Following a Philippine drawing on its standby arrangement with the IMF, the Philippines fully repaid its $45 million swap drawing with the U.S. Treasury, along with $30 million to the Bank of Japan, and $5 million to the Bank of South Korea. Also during the period since your last meeting, Argentina drew its $500 million bridge financing swap facility with the U.S. Treasury. Shortly after, in January, it repaid the drawing in two installments, using proceeds of the IMF credits under the Compensatory financing facility and a new standby arrangement.

NOTES FOR FOMC MEETING
February 12-13, 1985
Peter D. Sternlight

Following the December meeting of the Committee, the Desk sought a further easing of reserve pressures on the banking system, continuing the accommodative trend of the previous few months. Reserve paths were drawn allowing for adjustment and seasonal borrowing of $300 million (compared with $400 million just previously), and in day-to-day execution of policy uncertainties were resolved on the accommodative side, recognizing the Committee's initial preference for a borrowing level of "up to $300 million". Given that approach, further underscored by the 1/2 percent cut in the discount rate announced December 21, the reserve climate had an easy cast during the first several weeks of the period. Federal funds traded mostly around 8 1/4 percent, and occasionally slipped close to 8 percent or even below, giving rise to some sentiment that further easing steps might be in store. A bulge in the funds rate to an 8 3/4 percent average in the year-end week did not dent this view as the rise was widely regarded as a seasonal aberration.

By about mid-January, against a background of appreciably stronger monetary growth than envisaged at the Committee meeting, and evidence that the summer and early autumn lull in economic activity had given way to a renewal of sturdier growth, the Desk's approach was modified slightly to de-emphasize the extra tilt toward ease. While the paths were still drawn to allow for $300 million of borrowing, execution was no longer biased to the accommodative side. For a time, funds continued to average around 8 1/4 percent, but in the final days of January and early in February, the rate pushed up to around 8 1/2-3/4. This seemed to be due in part to unexpectedly high

Treasury balances, or other factors causing reserve shortfalls, perhaps abetted by market anticipation that rates might be allowed to edge higher given the stronger money growth. In the last several days, though, with some encouragement from Desk operations, funds trading backed off to a range around 8 1/4-1/2. Yesterday, it was 8 1/4.

Actual levels of adjustment and seasonal borrowing gyrated a fair amount during the period, especially in the year-end period when there were unusually large demands for excess reserves. In the two-week period ended January 2, borrowing averaged about $650 million, most of it in the year-end week. In the next two-week period, ended January 16, borrowing averaged a close-to-planned $260 million, followed by $383 million in the interval ended January 30. So far in the current period (through Sunday) the average has been about $370 million. Nonborrowed reserves exceeded the path objective by nearly $300 million in the year-end reserve period, while in the next two periods nonborrowed reserves were fairly close to path.

For most of the period, Desk operations were on the reserve absorption side, countering the seasonal release of reserves that stemmed mostly from post-Christmas currency return flows and seasonal declines in required reserves. Outright holdings of securities were reduced by a net $4.3 billion, including a market sale of $1.5 billion in bills, net sales of bills and notes to foreign accounts of about $.8 billion, and bill redemptions of $2 billion. Interspersed with these net sales, the Desk provided reserves temporarily on about a dozen and a half occasions through System or customer-related

repurchase agreements to cope with the uneven and sometimes unexpected behavior of factors such as the Treasury balance and Continental's discount window borrowing. There was no occasion for matched-sale/purchase transactions in the market, although they were used routinely with foreign accounts to provide an investment for part or all of the foreign repo pool.

Market interest rate developments were ruled by cross currents during the intermeeting period, with only modest net changes for the interval as a whole. Short-term rates pushed a little lower in the early days of the period, continuing the decline of the previous few months, and then backed and filled without trend through most of January. A prime rate reduction from the largely prevalent 11 1/4 percent level was just getting under way at the time of the last meeting and the rate edged off, sluggishly, to 10 1/2 by mid-January as banks seemed in no big hurry to narrow the gap between the prime rate and their cost of funds. By late January and early February short-term market rates moved somewhat higher, in apparent response to higher funds rates and a perception that the System had dulled the edge of its accommodative stance a bit. In yesterday's auction of three- and six-month bills, the average issuing rates were about 8.20 and 8.28 percent, up from 7.97 and 8.15 percent just before the last meeting.

Rates in the intermediate and longer term markets, which had changed relatively little in the final months of 1984 when short rates were declining noticeably, did decline appreciably in January. Market participants seemed particularly encouraged by what they regarded as

good prospects for containing inflation, a view that was bolstered by weakness in oil prices and the report on fourth-quarter GNP that highlighted a strengthening of real growth at the same time the deflator was edging lower. Incoming business news suggested that the late 1984 lull was not giving way to an over-exuberant boom but just a moderate pace of expansion that did not threaten renewed inflation. As the Treasury's quarterly financing announcement date approached, near the end of January, there was an atmosphere of near-buoyancy in which the market seemed to shrug off the prospect of huge deficits and focused on the possibility that rates could work lower in an environment of subdued inflation and moderate expansion. Some participants also expressed a bit more optimism about prospects for lower budget deficits. This happy idyll was interrupted shortly after the Treasury announced its record $19 billion mid-quarter financing, however, as market participants got a sense that further easing steps were not likely near term and indeed that a slightly firmer tilt might be under way. Analysts pointed to the somewhat higher funds rate, the persistence of substantial money growth, and the sense that the Desk was not meeting reserve needs with the same alacrity as earlier.

In this setting, the intermediate and longer markets gave back their earlier gains and the new Treasury issues came at rates appreciably higher than those anticipated on the January 30 announcement date. Moreover, while the 3-year note was well bid, the auctions for the 10- and 30-year issues were unenthusiastic, and just after the auctions all three new issues traded at lower prices than the bidders had paid. A little better atmosphere started to emerge

late last week reflecting a lessening of concern that policy was turning firmer, but the market gave ground again yesterday in the absence of retail demand for the still ample inventories. At yesterday's close the 3-year note was right around issue price while the 10- and 30-year issue were below in price.

Special attention was given to the 10- and 30-year issues this time because of the new ability to trade the separate coupon and corpus payments in book-entry form, and also because the 30-year bond is noncallable for its full term. While these new features generated much discussion, it appears so far that demand for stripping fell short of the market's eager anticipation of a few weeks ago. Still, the long-term possibilities for trading in the stripped payments appear to offer considerable potential. (Incidentally, the Desk plans to consider in due course whether System open market operations should include these new instruments.)

Taking the whole period, yields on intermediate and longer Treasury issues were about unchanged--perhaps not too bad a result considering that the Treasury was raising nearly $29 billion in the coupon market during the interval.

Not much activity is reported these days in the Treasury's 4- and 5-year foreign targeted issues sold last fall. Quoted prices suggest that these issues trade at yields very near or slightly above those on the companion domestic issues, and roughly a fifth of each issue has been converted into the domestic form where liquidity is greater. It doesn't seem likely that the Treasury will sell more of these soon.

As usual, market participants are mixed in their present rate outlook. Few expect to see the Fed leading rates downward, given the resumption of more robust growth in money measures and in the economy. Some do anticipate rate declines in longer maturities, though, if only because they regard real interest rates as still quite high, while the inflation outlook remains favorable. Others, more impressed with the likely strength of business and the intractability of budget deficits, expect the higher rates more typical of a maturing expansion. There is also a range of views about the System's current posture. Some believe that a slight firming was undertaken in the past couple of weeks. Others are not convinced of this and think that the market may have just overdone its earlier perception of the degree of intended ease. While there are occasional flirtations with optimism about budget prospects, the more persistent view seems to be that not too much should be expected on this front. The strength of the dollar in the foreign exchange markets also commands attention, being seen as a reason to bias policy toward the more accommodative side; but the dollar's strength is also seen by some as a source of vulnerability when a downturn in its value finally comes. At this point, I'd say the market is about priced to a funds rate around 8 1/4 - 8 1/2 percent.

Finally, as most of you know, we put out for public comment last week some revised standards of capital adequacy for Government securities dealers. It has been a long and arduous process to put this together because we wanted to work with the primary dealer

community to build support for what is essentially a voluntary standard. I think the effort is paying off in that at least the initial comments have been positive. Of course, we'll be hearing much more detailed comment over the next couple of months, and we also expect the standards to be the subject of a Congressional Subcommittee hearing next month.

Leeway

Once again, reserve projections suggest that it would be desirable to have more than the standard $4 billion leeway for changing the System's outright holdings between Committee meetings. In this case, the main factors absorbing reserves would be changes in currency in circulation, vault cash, and required reserves. Most likely a $1 billion increase to $5 billion would be sufficient, but to provide greater flexibility, I would recommend a temporary $6 billion level. That would be the same temporary ceiling that has been in effect since the last meeting when we needed the flexibility on the reserve absorbing side.

JLKichline
February 12, 1985

CHART SHOW -- INTRODUCTION

During our presentation this afternoon we will be referring to the package of chart materials 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 we extended through 1986. For monetary policy, we have assumed growth of M1 of around 6-1/2 percent--which is in the upper part of the Committee's tentative long-run range--and slower expansion in 1986. These monetary assumptions and our economic forecast are thought to be consistent with short-term interest rates around current levels or somewhat higher in 1985, but those rates could be moving lower in 1986 in conjunction with the effects of our fiscal policy assumptions, which include $50 billion in deficit-reducing actions. Other assumptions we have made include moderate declines in both oil prices and the foreign exchange value of the dollar.

The next chart provides additional information on the federal budget and compares the staff and recently released administration figures. In fiscal year 1985 the federal budget deficit on a unified basis is projected to be around $205 to $210 billion for both, and in the staff's estimate to decline to $189 billion in fiscal year 1986, or $11 billion above the administration's estimate. The

difference between the projections for 1986 is attributable to underlying economic assumptions, mainly our lower growth of nominal GNP. On a structural basis, measured at a 6 percent unemployment rate, the deficit narrows only a little.

The bottom left panel illustrates the composition of the assumed deficit-reducing actions. In contrast to the administration's proposed outlay reductions of $50 billion, we have assumed lower defense outlays, smaller cuts in nondefense programs, and some small tax increases. Nevertheless, as shown in the bottom right panel, the budget deficit in 1986 will be historically high at 4-1/2 percent of GNP.

The next chart provides some information on recent developments in the economy. The top panels indicate continuing expansion in employment following the summer pause, and a resumption in growth of production as inventory imbalances have been largely worked out. The industrial production index for January is estimated to have risen about 1/2 percent, similar to the rise in November and December. Consumer demands also picked up late last year as shown in the middle panels. Christmas sales were encouraged by price discounting and apparently were sufficiently good to reduce excess stocks. Auto sales recently have been on an uptrend,

with domestic sales hitting 8-1/2 million units annual rate in January. In the housing market, bottom left panel, the declines in mortgage interest rates by December had not shown through to any particular rise in activity, although we believe the irregular decline in starts through most of 1984 came to an end. For business capital spending, the expansion of outlays continues but at more moderate rates than the extraordinary gains earlier in the recovery. The bottom right panel displays new orders figures, which have been relatively weak over the past half year or so. In part the behavior of orders is a sign of moderation in domestic equipment spending, but it also reflects the substitution of imported capital goods for those produced domestically.

The next chart shows the broad outlines of the staff's GNP projection. Real GNP is expected to grow at a 3-1/2 percent pace in 1985 and less next year. Domestic spending is projected to moderate as well, but more of that spending will be satisfied from domestic production than was the case in 1983 and 1984. Price performance is projected to be about the same in 1985 as last year, and with a declining dollar prices are projected to rise a little faster in 1986. The slower growth in economic activity that is projected is consistent with some further, but smaller, declines in the unemployment rate.

Mr. Prell will continue the presentation with a discussion of the staff's domestic economic and financial forecast.

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MJPrell
February 12, 1985

CHART SHOW -- DOMESTIC DEVELOPMENTS

The next chart portrays the forecast for consumer spending. We are projecting a further strong gain of 4-1/2% in real consumer spending during 1985, followed by a 2-1/2% increase in 1986. This slowing generally follows the pattern of real income, so that, while the personal saving rate drops back a bit from its recent higher level, it averages close to 6 percent in both years.

Spending on durables has been very strong thus far in the expansion, and is projected to continue boosting outlays over the next several quarters. The 1980-82 period was one of rising unemployment and sluggish income growth, and during that period purchases of durables were especially depressed. The lower left panel shows that one result was a substantial further aging of the auto stock. The consequent replacement demand, coupled with recent declines in operating costs and increased production capacity, has led us to predict stronger auto sales, particularly in 1985. Similarly, stocks of non-auto durables per household, charted in the right panel, rose at rates well below trend during the early '80s. Although real interest rates are high, we believe the markets for non-auto durables will be strong, as positive income and employment prospects maintain a favorable sentiment toward spending.

As the next chart shows, we also are projecting a strengthening in housing demand in the months ahead. Starts are expected to rise to around a 1-3/4 million unit rate, with a larger share for single-family dwellings than was the case on average in 1984. A key factor in the outlook is mortgage rates, which (as indicated in the middle left panel) have declined almost 2 percentage points on fixed rate loans since last summer.

We are not projecting as strong an upsurge in starts as occurred a year ago, partly because, in light of continuing weak house prices, real borrowing costs may look higher to some potential buyers than they did then. Moreover, the strength in housing in early '84 was enhanced by the aggressive marketing of adjustable rate loans, reflected in the right panel. Since that time, underwriting standards have been tightened and teaser rates have become less common; as you can see, the share of ARMs in conventional loan originations has fallen considerably.

However, there probably is still a considerable pent-up demand for housing, especially for single-family homes and condos, as suggested by the bottom left panel. As the red line shows, the period since 1980 has seen the only significant drop in decades in the percent of households owning homes; furthermore, the crest of the baby boom wave is passing through the 25-to-34 year age group that traditionally has included many first-time buyers. The multi-family rental sector, in contrast, may face tougher going; vacancy rates--the right panel--are at a ten-year high and many additional units are under construction. Moreover, the Treasury's tax reform proposal has heightened uncertainty about whether the tax advantages that have spurred rental property investment will be maintained.

The next chart addresses the financial condition of the household sector, which we believe is sound enough to support substantial further gains in spending. The upper left panel shows that, while the ratio of debt to income has moved back to earlier peak levels, the sector as a whole had a hefty cushion of financial assets even before this year's stock market gains. Moreover, an historically high percentage of consumers still feel it would be OK to borrow in order to make a big purchase. As shown in the

bottom left panel, consumers have not yet experienced any real difficulty in servicing their installment debt--represented here by auto loans--although payment experience on mortgage loans has not improved since 1982--evidently reflecting mainly the combination of heavy leveraging, weak real estate prices, and still high unemployment. The final panel indicates our expectation that home mortgage flows will expand only moderately over the next two years, while net consumer credit flows should diminish, mainly because of a catchup in repayments relative to extensions.

Turning to the business sector, the top panel of the next chart puts recent inventory developments in a cyclical perspective. The long recession of 1981-82 was marked by a deep inventory liquidation. With recovery uncertain at first--and financing costs still high--the restocking process was initially very cautious, but it quickened as delivery times began to lengthen and businessmen began to worry about getting caught short. Then, when sales slowed last summer, they quickly cut orders and production--so that in the fourth quarter inventory accumulation dropped sharply. Although there may currently be some desire to build inventories at auto dealers and in a few other areas, the picture in the aggregate today seems to be one of reasonable balance with sales, and as indicated in the table, our projection anticipates that inventory investment will not be a significant factor either way in influencing production trends over the next two years.

In contrast, fixed investment, the next chart, should remain a supporting factor in the economic expansion. As the top panel shows, we have had the strongest BFI upswing since World War II--one stronger (especially in the equipment area) than seems explicable by past relations

to output growth or capital costs. One hypothesis is that there has been something of a technological revolution that has caused businesses to speed up the replacement of equipment. There is some statistical evidence that replacement investment has been unusually strong, and--as the middle panel shows--sales of high-tech equipment have indeed soared. They turned up smartly at the beginning of this cyclical upswing, and their tremendous growth since then has raised their share of total equipment spending to more than 45 percent recently.

In the structures category, the right panel, commercial building evidently has been boosted by a good deal of speculative activity, often financed by loans with equity kickers or by tax-shelter syndications; meanwhile, other construction as a whole has posted a more moderate recovery.

Over the months ahead, we expect to see a tapering off in investment growth, as indicated in the bottom panel. This is partly the normal effects of slower output growth. But, in addition, the leveling off of homebuilding should be accompanied by less vigor in shopping center development, while high vacancy rates should temper office building.

The financial side of the business picture is covered in the next chart. The top panel indicates that, with profits expected to weaken as the growth of the economy slows, outlays for inventories and fixed capital are projected to outstrip internal funds by an increasing margin over the next two years. I perhaps should note that while large in absolute terms, this gap is moderate relative to, say, capital outlays. Our flow-of-funds forecast shows corporations able to cover this financing gap with a reduced level of borrowing--as indicated in the middle panel; this is because we've

assumed that the unusual absorption of outstanding equity shares through debt-financed mergers and buyouts will come gradually to a halt.

There has been a lull in short-term business borrowing recently, but we expect it to resume a fairly strong growth trend soon. Consequently, although issuance of intermediate- and long-term bonds (domestically and in the Euromarket) is projected to be substantial, the ratio of loans and short-term paper to total debt continues to creep upward in our forecast. The deterioration of balance sheet structure has left businesses vulnerable to cash flow pressures if interest rates should rise sharply; as it is, as indicated in the final panel, our projection--with no such jump in rates--shows an extension of the rise in net interest payments relative to corporate income that has accompanied the heavy borrowing of the past year.

The next chart focuses on the government sector. Real federal purchases are projected to decelerate over 1985 and '86, under our budgetary assumptions. In the state and local sector, spending spurted over the first three quarters of last year, especially for construction, but then slowed, and we are not looking for much impetus to aggregate demand from this sector in the period ahead. As the bottom panel indicates, the overall state and local surplus, including trust funds, is expected to remain large through 1986. However, operating surpluses are projected to shrink in 1986 after remaining sizable again this year. Many units evidently are taking advantage of stronger-than-expected revenues now to restore their cash balances and to otherwise improve their financial positions, but they likely will come under increasing pressure to undo earlier tax hikes.

The upper left panel of the next chart shows that debt issuance by states and localities is projected to dip temporarily this year in light of

the sector's budgetary position. Given the tightening of various rules, as well as the anticipatory borrowing surge at the end of 1984, private-purpose financing is expected to remain a bit below last year's volume. We have not assumed the adoption of proposed tax changes, which could affect this market dramatically. Federal borrowing--in the right panel--will remain heavy, continuing even in 1986 to absorb an extraordinarily large proportion of domestic credit.

The bottom panel pulls together the various sectoral spending and saving flows. As you can see, gross private saving and gross private domestic investment, as a share of GNP, were at the upper end of the historical range last year, but the general contour of the recent and prospective movements is not distinctly different from past cyclical patterns. The big story--the "crowding out" story, as it were--is the size of the government deficit, its lack of normal cyclical narrowing, and the counterpart negative net foreign investment (that is, the current account deficit). In the forecast, the government deficit does not change much relative to GNP, and it is primarily a growing foreign capital inflow that provides the marginal funding for private investment as weakening profits and personal saving cut into total private domestic saving.

The next chart focuses on labor market developments. Consistent with the slowing in GNP growth, we are projecting gains in payroll employment of 3 million in '85 and 2 million in '86, compared with 3-3/4 million last year. Factory payrolls are rising in the forecast, but remain below their 1979 peak, while other employment is projected to rise appreciably.

The middle panel, depicting the labor force participation rate, reflects our expectation that good employment opportunities will be drawing more job seekers into the market. In addition, the movement of the baby boom cohort into the age groups with more consistent labor force attachment will tend to lift the participation rate.

The lower panel indicates that we expect the unemployment rate to edge down over the coming year before leveling out as GNP growth in 1986 approximates the presumed trend rate of potential GNP growth. As you can see, the jobless rate is forecast to enter what we believe to be the vicinity of the so-called "natural rate," where labor market slack will no longer be sufficient to exert general downward pressure on wage increases.

Our projection of hourly compensation increases is laid out in the top panel of the next chart. Compensation increases have slowed further in the past few quarters, and have run at about the rate of inflation. This relationship --implying unchanged real wages--is not one likely to be sustained when productivity is trending upward. However, we do not foresee any noticeable pickup in compensation growth until 1986. Inflation expectations have been moving downward, as, undoubtedly, has the prevailing concept of what constitutes a "normal" wage gain.

The left panel is of interest in this regard. In major union settlements during 1981, a large share of wage increases fell in the 8 percent plus range. As the recession took hold and a number of industries experienced special difficulties related to changes in their domestic and international competitive environments, we saw a sharp diminution in the proportion of such large increases, and also a sizable number of wage freezes and cuts. By last year, despite the much improved conditions in

many industries, a pattern was emerging of increases most commonly in the 0-to-4 percent range, with cuts still occurring in cases where competitive pressures were especially intense or where relative wages were out of line. Looking at the '85 bargaining calendar, it seems reasonable to expect a similar picture.

As the right panel shows, wages in the non-union sector decelerated a little further in 1984; however, the gains outpaced those among unionized workers as they had in '83. The relative movement of the past two years has put only a small dent in the union-nonunion differential that had swelled over the preceding decade, and we anticipate a tendency for the recent pattern to continue.

Since we have moved beyond the initial stages of recovery when output per hour worked normally records its strongest growth, we are anticipating a considerably reduced productivity offset to rising compensation. Consequently, unit labor cost increases are projected to rise from the 2 percent figure of 1984 to around 3-1/4 percent this year and somewhat more next year.

Under the circumstances, we don't expect a further slowing of price inflation--as may be seen in the top panel of the next chart. Rather, prices, as measured by the index for gross business product, are projected to rise at about the same pace this year as in 1984, and then to accelerate gradually into the 4-1/2 percent area by the end of 1986.

The lower left panel highlights two components of prices for which special supply influences can be especially important. Food prices appear likely to rise on average at a rate just a shade above that for prices generally. As an aside, I would note that our forecast of crop and livestock prices suggests that farm income will remain weak. From that standpoint,

agricultural credit problems will not be eased. Energy prices, the black line, should be a highly constructive element in the overall inflation picture, as the decline in world oil prices more than offsets the influence of moderate increases in natural gas and electricity prices, at least until the latter part of '86.

A key element in the projected acceleration of prices over the next two years is the impact of the anticipated depreciation of the dollar. As the right panel indicates, the unit value of nonpetroleum imports is projected to pick up later this year and to rise at an 8 percent annual rate through 1986.

Mr. Truman will discuss further the outlook for the dollar and other international developments.

JLKichline
February 12, 1985

CHART SHOW -- CONCLUSION

The next table presents some areas of risk and uncertainty attached to the staff forecast. This is by no means a complete listing of factors that could evolve differently from our expectations, but it is sufficient to indicate a few points of vulnerability. The staff estimates trend productivity growth over the forecast of 1-1/4 to 1-1/2 percent per year, up from the dismal 70's pace but one could argue a lower or higher rate. If, for example, the pickup in investment, reduction in government regulations, and work experience of the baby-boomers are contributing to appreciably higher trend productivity growth than estimated, we could expect larger expansion of real GNP and lower rates of inflation.

Our estimate of the natural rate of unemployment--that is, the unemployment rate that would provide stable inflation in the long run--is around the middle of explicit or implicit estimates that range from below 6 to over 7 percent. If the rate is much different than our estimate, that would alter our view on the prospective rate of inflation and real GNP growth. Mr. Truman has noted risks associated with the exchange rate and oil prices. For the dollar, the appreciation of 1984 and early 1985 pushes

the domestic price and activity effects of the eventual decline into 1986 and beyond. For oil prices, a major break in the price would have important domestic price and activity impacts as well, but also produce questions about financial stability as decisions premised on much higher oil prices would become uneconomic. As to fiscal policy, our assumptions entail aggressive actions but much more needs to be accomplished to put fiscal policy on a sustainable longer-run path. On balance, we have grappled with these issues and others in preparing the projection and have made judgments that we believe represent the most likely outcome. Clearly, however, there is much room for alternative views.

The last chart presents the 1985 forecasts of Board members, Presidents, the staff and the administration. In general, the various forecasts are fairly close, with the staff figures tending to the low side for expected real GNP growth and the deflator. The forecasts presented to the Congress in July are shown in the bottom panel.

E.M. Truman
February 12, 1985

FOMC CHART SHOW -- INTERNATIONAL DEVELOPMENTS

The first chart after the divider provides a perspective on the U.S. dollar's remarkable appreciation during the past four years. As shown by the red line in the top panel, the nominal appreciation of the dollar against a trade-weighted average of foreign currencies was 65 percent from the fourth quarter of 1980 to the fourth quarter of 1984; the dollar has appreciated by a further 7-1/2 percent so far in 1985. As shown by the black line, the appreciation has been somewhat smaller after adjustment for relative movements in consumer prices. The staff continues to believe that the dollar's appreciation and the associated widening of the U.S. current account deficit are not sustainable indefinitely. Consequently we have, with considerable humility, incorporated in our forecast a depreciation of the dollar at an annual rate of 8 percent, starting from its average level in January.

The lower panel depicts one factor that is frequently cited as an important proximate determinant of exchange rates: movements in real, long-term interest rates. The association between the dollar's weighted-average value, shown in the top panel, and the differential in real, long-term interest rates, shown in the lower panel, is quite evident. It is equally evident that other factors have influenced the dollar's value, especially in the past two years when, on balance, this particular measure of the differential has been essentially unchanged.

The upper panels in the next chart present information on recent and prospective price developments in the United States and in major foreign industrial countries. As can be seen in the top panel, the United States enjoyed considerably more success in reducing consumer price inflation in 1982 and 1983. However, that margin narrowed markedly last year, despite the further appreciation of the dollar, and it is projected to be eliminated in 1986, in part because of the dollar's projected depreciation.

As is shown in the left-hand portion of the middle panel, the United States continues to enjoy a much larger advantage when inflation is measured in terms of wholesale or producer prices. However, this statistical edge is probably a misleading indicator of longer-run relative price trends because of the stronger direct influence of movements in exchange rates on commodity prices, which are more heavily represented in such indexes. This influence is illustrated more starkly in the right-hand portion of the panel where changes in the Economist index of commodity prices are plotted in terms of the U.S. dollar and in terms of foreign currencies. On both bases, commodity prices rose in 1983 as the world recovery got underway. The peak year-over-year change for the dollar index was 23 percent; the equivalent rise in terms of foreign currencies was 32 percent. In the second half of 1984, commodity prices declined sharply in dollar terms, while in foreign currency terms the percentage change was only slightly negative.

A separate issue raised by the right hand panel is why commodity prices, even when translated into foreign currencies,

have stopped rising. Contributing factors appear to include: (1) the pressures on many of the countries that produce primary products to increase their production and exports in order to help to service their external debts, (2) the moderate pace of OECD economic activity now that growth has slowed in the United States, and (3) the continued high level of real interest rates, which discourages stock building.

The bottom panel shows that the rate of growth of real GNP in the major foreign industrial countries edged up to about 3 percent, on average, by the end of 1983, remained at about that rate last year, and is projected to continue in that range during the forecast period. Although private domestic demands are expected to increase somewhat in these countries, this rise will essentially offset continued restraint on public expenditures and the reduced stimulus from the U.S. economy.

Turning to the non-OPEC developing countries, the top panel of the next chart depicts the dramatic improvements in their external accounts during the past three years. We estimate that their combined current account deficit shrank from more than $80 billion in 1981 to about $30 billion last year, and, as a group, they had a balance on merchandise trade close to zero.

We anticipate that this improvement will be sustained during the forecast period. The rate of growth in the volume of their exports should continue at a quite rapid pace, as is shown in the middle panel. Meanwhile, the growth in the volume of their

imports should also rise, partly as a further catch up from recent depressed rates and partly as a consequence of a slight acceleration in economic growth -- as is shown in the lower panel. Nevertheless, the growth of real GDP in these countries will remain on average significantly below that recorded in the 1976-80 period. These projections are based on the assumption that most of these countries will have very limited access to additional financing from foreign commercial banks. Moreover, in many cases the process of external adjustment is far from complete and the process of internal adjustment is at a very early stage. Indeed, these facts imply significant risks for the overall forecast.

Information concerning the oil situation, another key area of risk and uncertainty, is presented in the next chart. As can be seen in the top panel, we have incorporated in our forecast a continued erosion in the nominal, or dollar, price of imported oil -- specifically a 10 percent decline over the two-year forecast period, as Mr. Kichline has noted. The projected near-term decline is consistent with the outcome of the recent OPEC meeting and developments in the increasingly important spot oil market. As can be seen from the black line, this projection -- combined with the staff's inflation projection -- implies that by the fourth quarter of 1986 the real price of U.S. imported oil will have returned almost to its level in early 1979.

The erosion of the oil price has been associated with important changes in the world oil market. As is shown in the

middle panel, OPEC production of crude oil now represents a much diminished proportion of world production. Moreover, rising non-OPEC production and continued moderation in overall demand has generated substantial surplus capacity. As shown in the table, total production last year was about 39 million barrels a day, but that rate left 9 million barrels a day of surplus capacity -- most of it in OPEC fields. As a consequence, Saudi Arabia, in particular, has a much-reduced ability to cushion any softness in oil prices or increases in production by other OPEC or non-OPEC suppliers.

Against this background, the bottom panel presents our forecast for U.S. petroleum imports. Although we project a 20 percent rise in the volume of such imports over the next eight quarters, largely in response to rising economic activity and lower oil prices, their value rises much more moderately.

Turning to overall trends in U.S. imports and exports of goods and services, the top panel of the next chart provides a cyclical comparison of their growth in real terms. The rapid expansion of U.S. imports of both goods and services has been outside the range of any cyclical experience of the past 30 years. The explosion of U.S. imports of goods is well documented. The equally dramatic expansion of our imports of services -- line 3 -- may be less widely appreciated. It has been the consequence of high interest rates interacting with the rapidly growing stock of our external debts, plus the effects of the strong dollar and the booming U.S. economy.

As is shown in line 5 of the table, the performance of U.S. exports of goods, despite the effects of the strong dollar, has substantially outpaced that in the 1975 cycle -- the most directly comparable international cycle. In sharp contrast, service exports in real terms have been depressed by the effects of weak foreign activity and the dollar's appreciation on profits from direct investments abroad, as well as by the reduced pace of U.S. lending abroad.

As is shown in the lower panel, we are forecasting a recovery of real imports of goods and services in 1985, from the depressed rate recorded in the fourth quarter of last year, and some moderation in their growth in 1986, under the influence of the dollar's projected depreciation. On the export side, we expect receipts to be depressed in the short run by a decline in agricultural shipments but to recover in the second half of the year and in 1986.

The next chart summarizes the staff's projection of the U.S. current account balance and estimates of the hypothetical influence on that balance of the dollar's appreciation since the end of 1980. The top line in the top panel presents the actual and projected path of the price-adjusted dollar. The vertically shaded area in the chart indicates our rough estimate of the portion of the dollar's appreciation since the end of 1980 that can be associated with the effects of the relative rise in U.S. real interest rates. The portion labeled "fiscal expansion" shows the estimated direct contribution of the U.S. fiscal

expansion to the dollar's appreciation through changes in real interest rates. As I noted earlier, the size of the unexplained residual has increased in recent years.

The lower panel illustrates, in the lower line, the widening of the U.S. current account deficit projected for the next two years, reaching almost $140 billion by the end of the period. The pink area indicates an estimate -- based upon the unrealistic assumption that changes in exchange rates are entirely exogenous -- of the contribution of the dollar's real appreciation since the end of 1980 to that deficit. Despite the dollar's projected depreciation, the effect continues to increase in large part because of continuing interest payments on the huge stock of external liabilities built up in earlier years.

The table on the next page presents some estimates of the structure of U.S. capital transactions. Net private capital inflows -- line 2 -- expanded rapidly in 1984, as they did in 1983, but are expected to show little further increase this year. The composition of those inflows changed dramatically last year. In contrast to 1983, when the shift in flows was concentrated at banks, a wide variety of channels was used in 1984. As can be seen from line 4, bonds and stocks accounted for substantial net inflows last year as U.S. corporations issued Eurobonds at a record pace and private foreigners made substantial net purchases of U.S. Treasury securities; this trend could well continue this year. The net inflow through direct investment and other non-bank transactions -- line 5 -- also increased dramatically last year,

largely as a result of several large takeovers by foreign corporations; we anticipate a drop in such activity this year. Official transactions, in line 6, include lending activities as well as transactions affecting official reserves; we anticipate a reduced net outflow through such channels in 1985, partly as a consequence of our projection of the dollar's depreciation.

Mr. Kichline will now complete our presentation.

STRICTLY CONFIDENTIAL (FR) CLASS II-FOMC

Materials for

Staff Presentation to the Federal Open Market Committee

February 12, 1985

Principal Assumptions

Monetary Policy

- Growth of M1 of around 6½ percent during 1985 and 5½ percent in 1986.

Fiscal Policy

- Deficit-reducing actions of around $50 billion for FY 1986.

Other

- Oil prices decline 10 percent over forecast period.
- Foreign exchange value of the dollar declines 8 percent per year.

Federal Budget

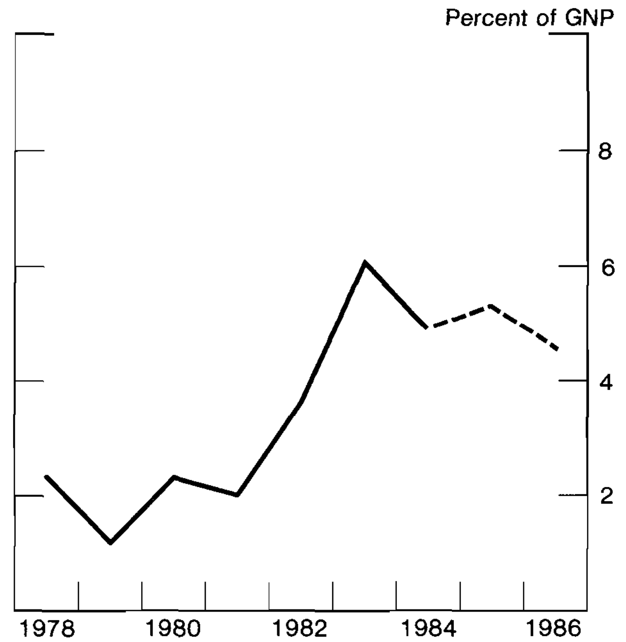
Unified Budget, Fiscal Year, Billions of Dollars

	1985		1986	
	Staff	Administration	Staff	Administration
Outlays	941	947	976	972
Receipts	735	737	787	794
Deficit	206	210	189	178
Structural Deficit	176	n.a.	167	n.a.

Deficit-Reducing Actions

	Billions of dollars
	1986
Total	50
Expenditures	40
Nondefense	20
Defense	20
Tax increases	10

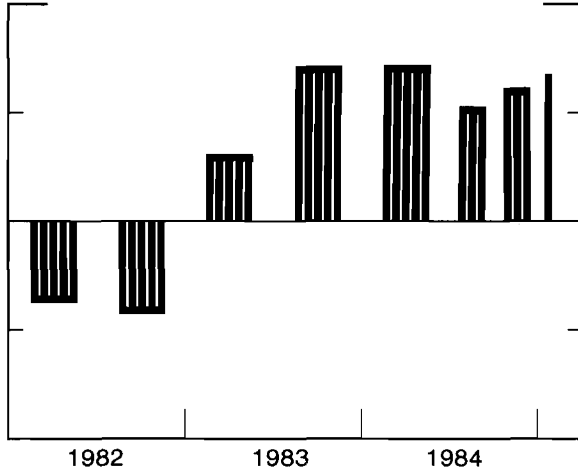
Deficit



Current Indicators

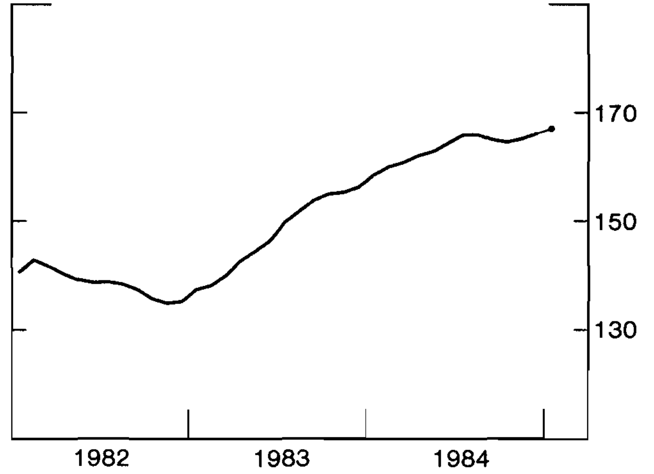
Nonfarm Payroll Employment

Change, annual rate, millions of persons



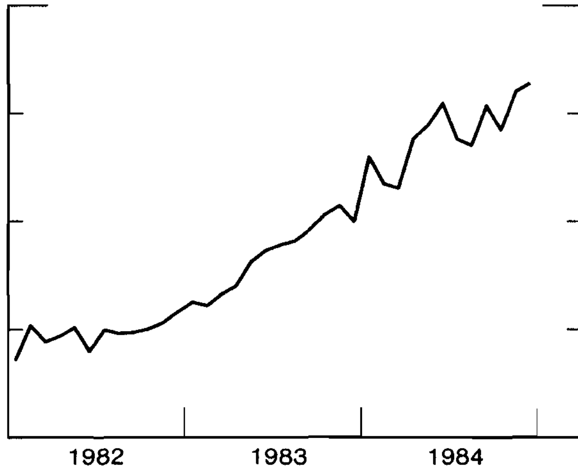
Industrial Production

Index, 1967=100



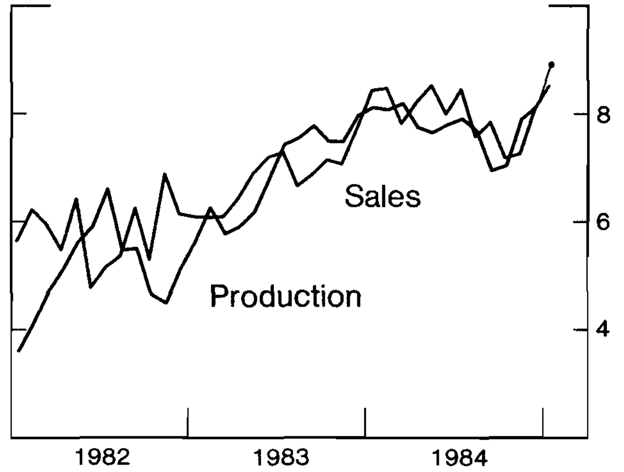
Real Retail Sales

Billions of 1972 dollars



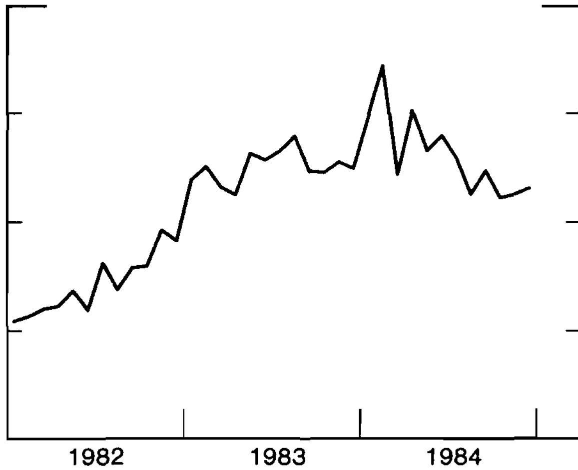
Domestic Autos

Millions of units



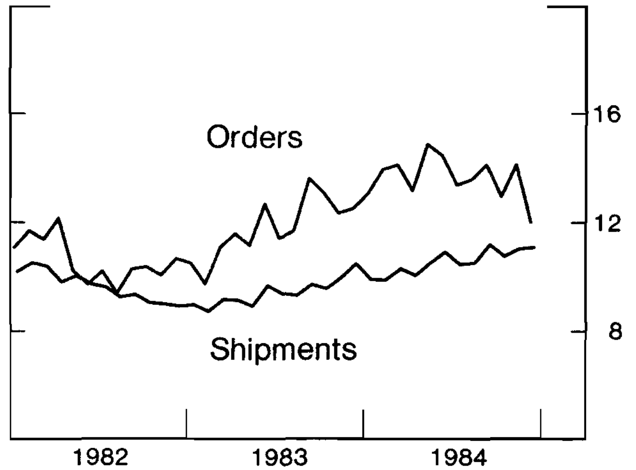
Housing Starts

Millions of units

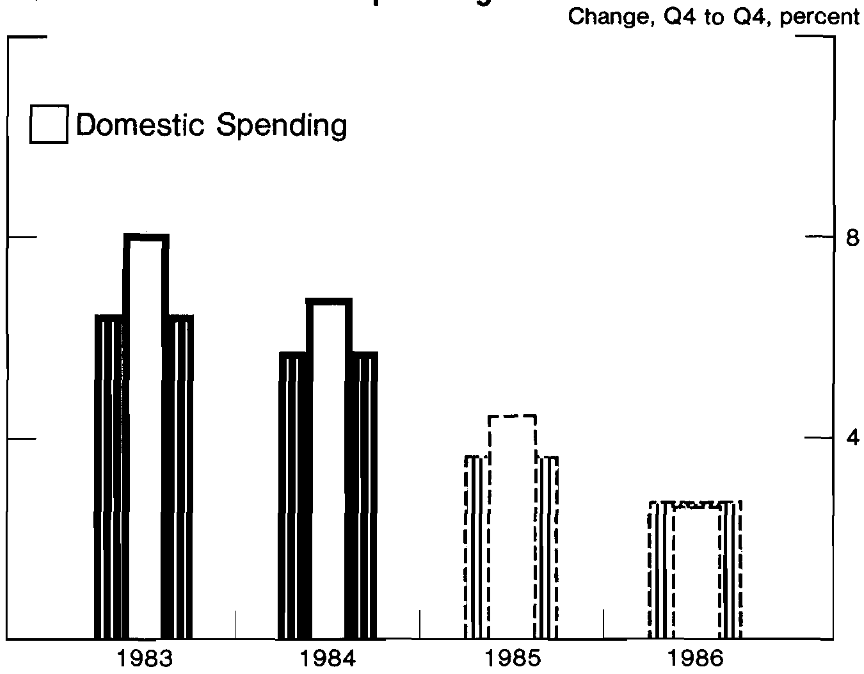


Real Shipments and Orders for Nondefense Capital Goods

Billions of 1972 dollars

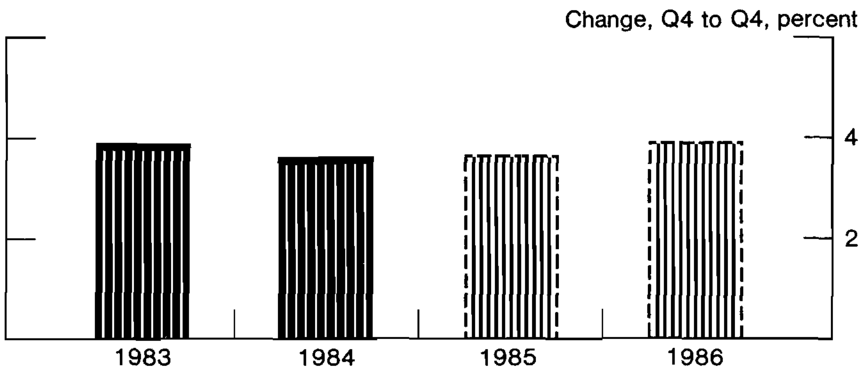


Real GNP and Domestic Spending



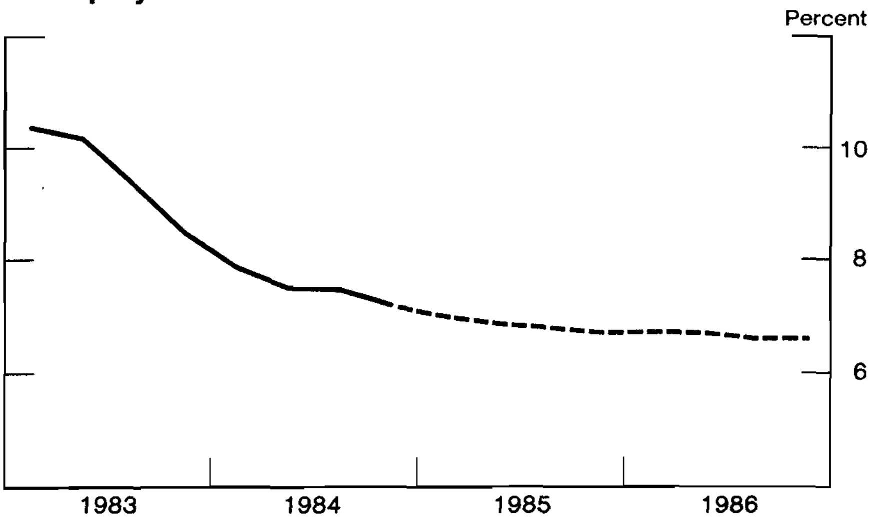
	Real GNP	Real Domestic Spending
1983	6.4	8.0
1984	5.6	6.7
1985	3.6	4.4
1986	2.7	2.6

GNP Deflator



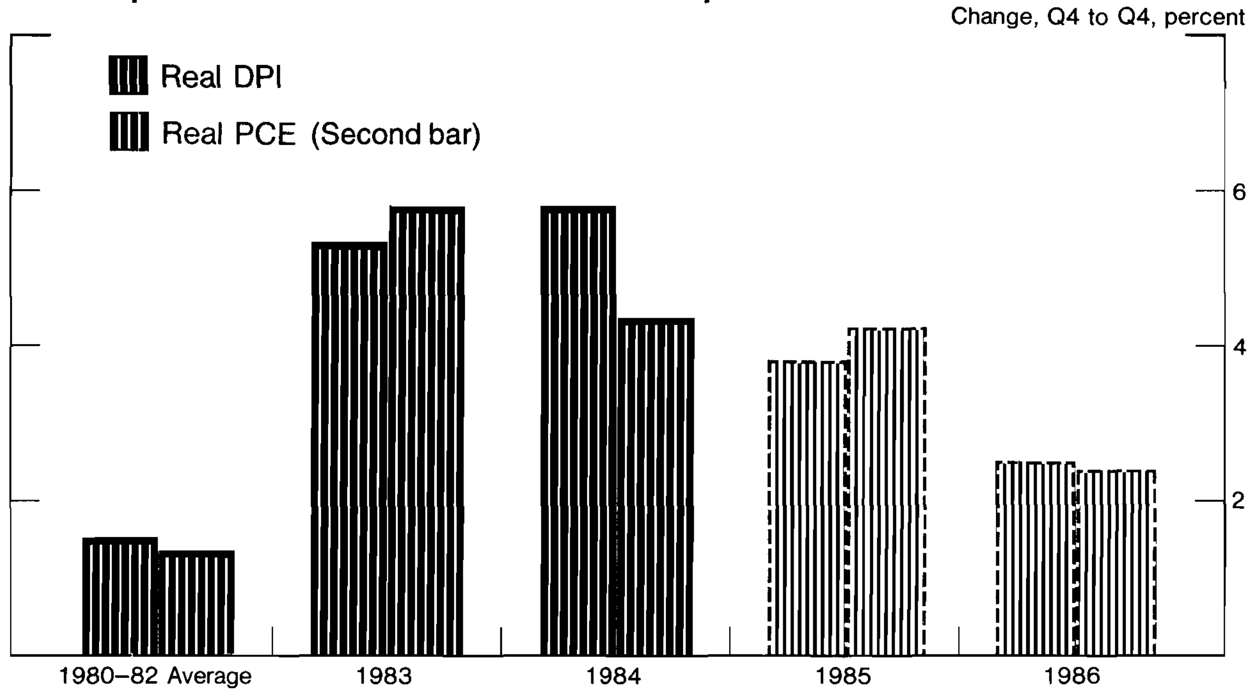
1983	3.8
1984	3.5
1985	3.6
1986	3.9

Unemployment Rate

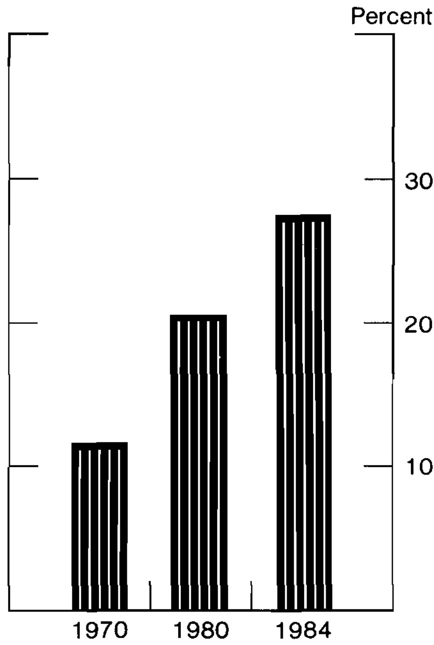


	Q4 Level
1983	8.5
1984	7.2
1985	6.7
1986	6.6

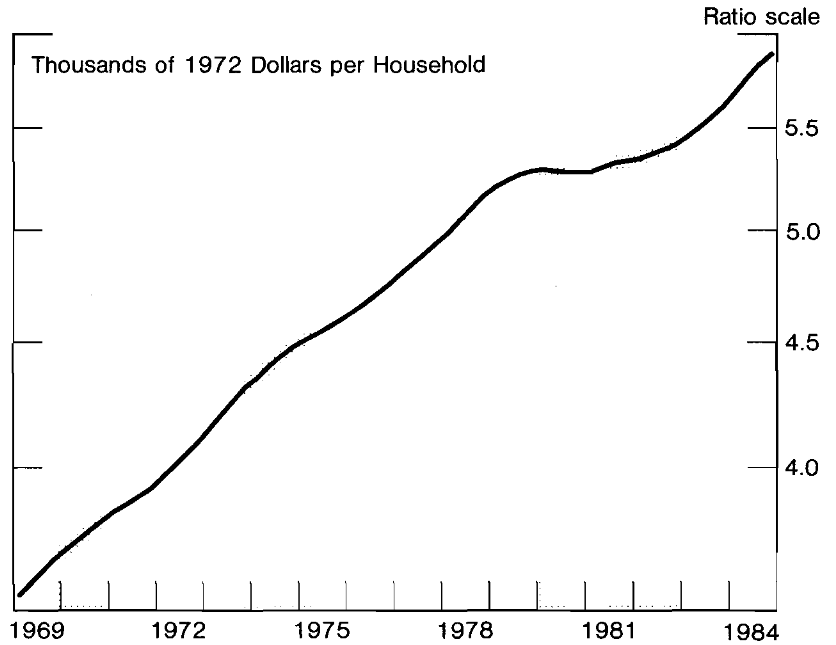
Real Disposable Personal Income and Consumption



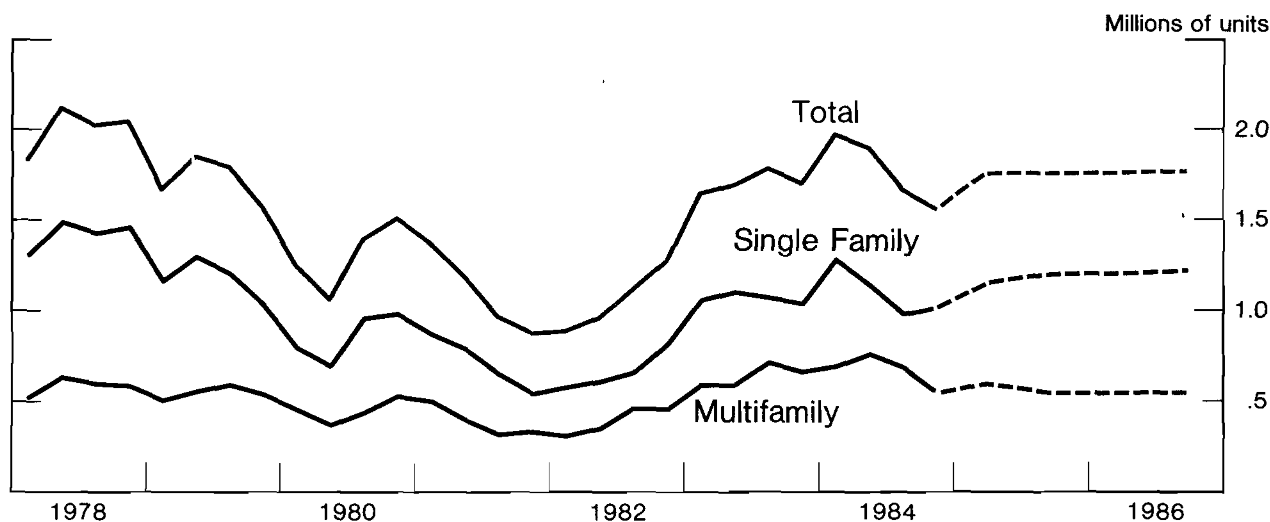
Autos Older Than 10 Years



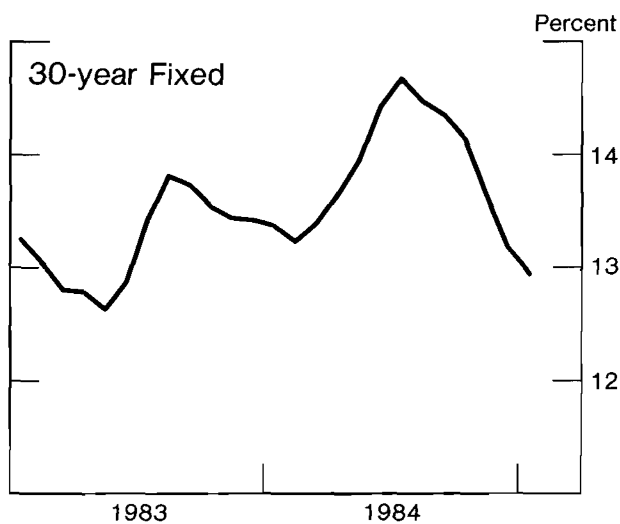
Stock of Nonauto Consumer Durables



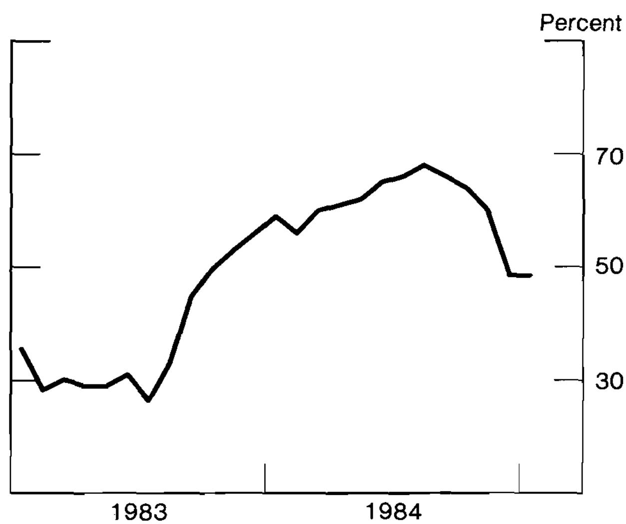
Housing Starts



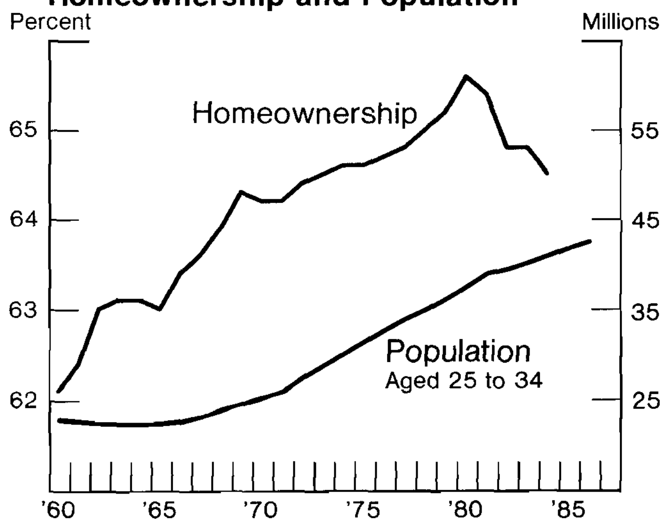
Mortgage Commitment Rate



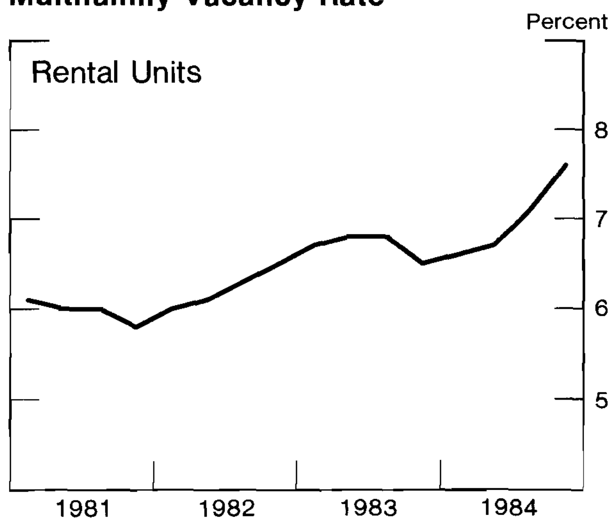
Proportion of ARMs



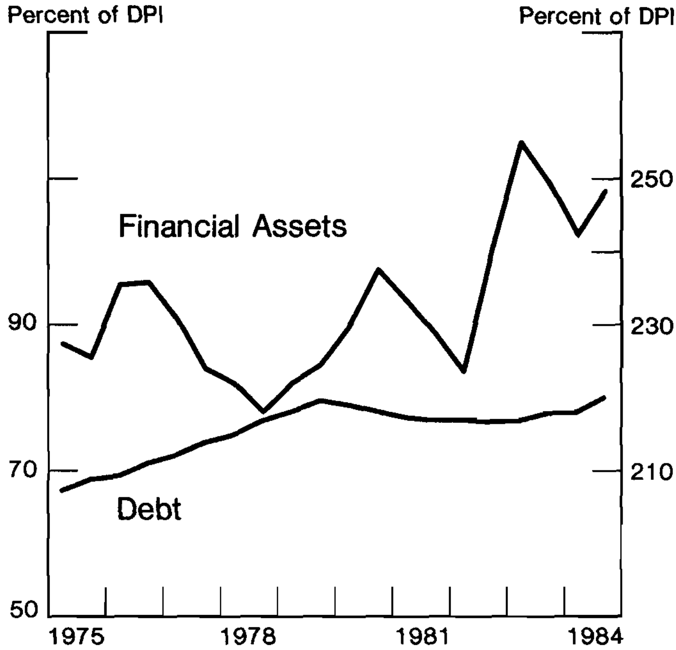
Homeownership and Population



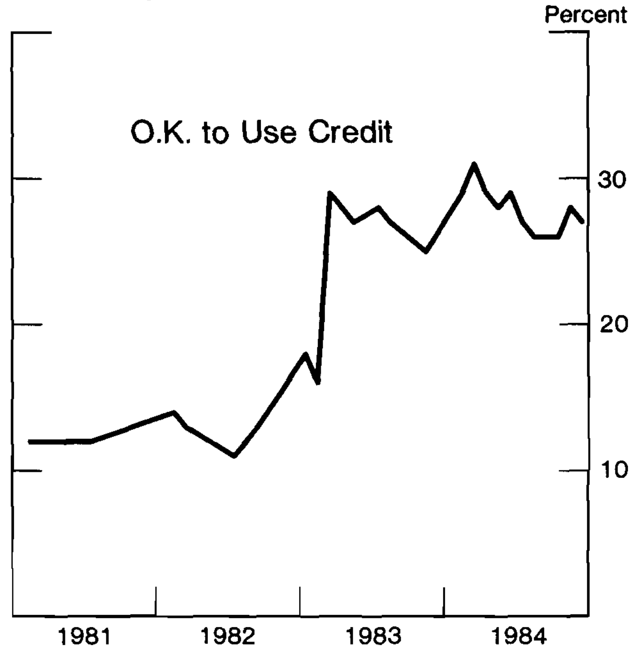
Multifamily Vacancy Rate



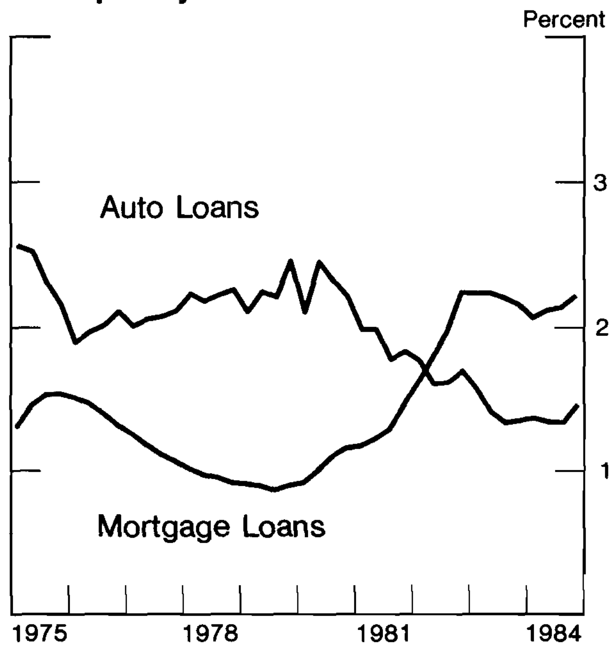
Household Financial Assets and Debt



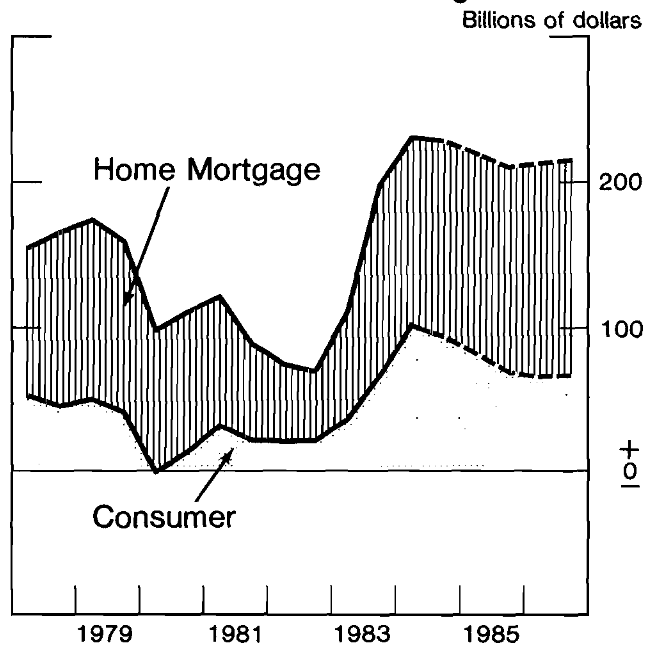
Borrowing Sentiment



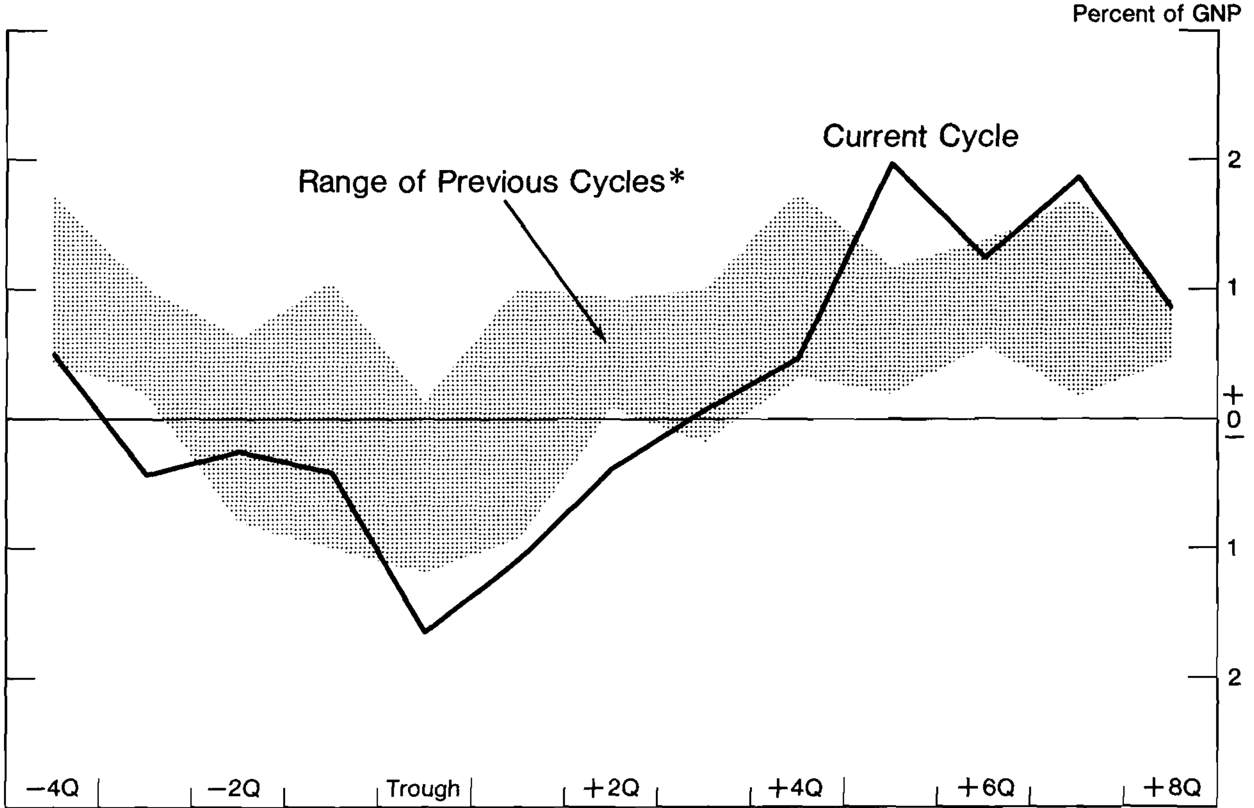
Delinquency Rates



Selected Household Borrowing



Real Inventory Investment



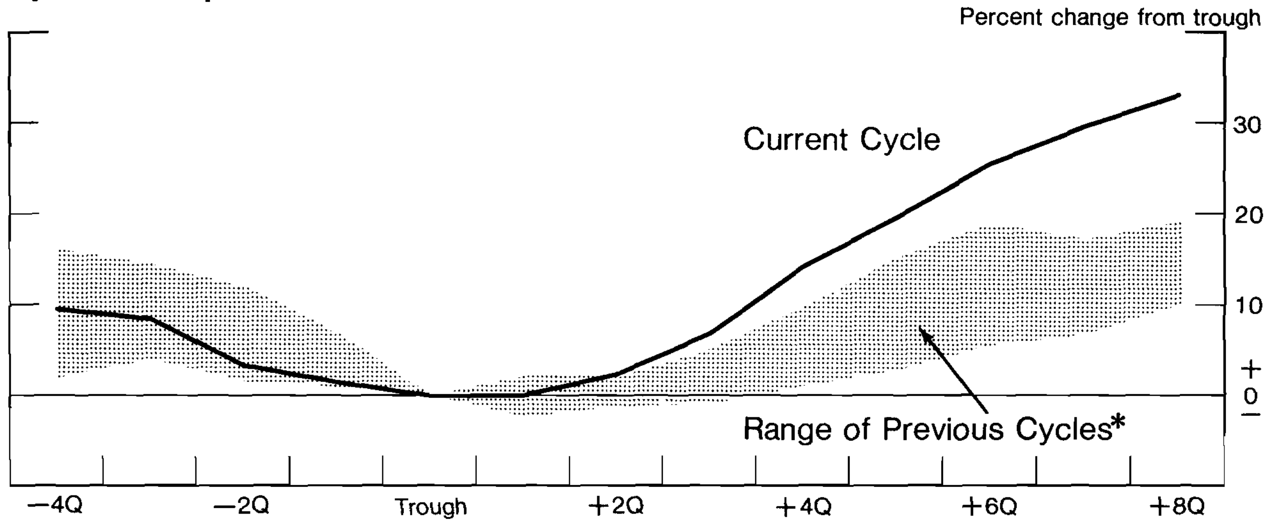
Contribution to Real GNP Growth

Percent, annual rate

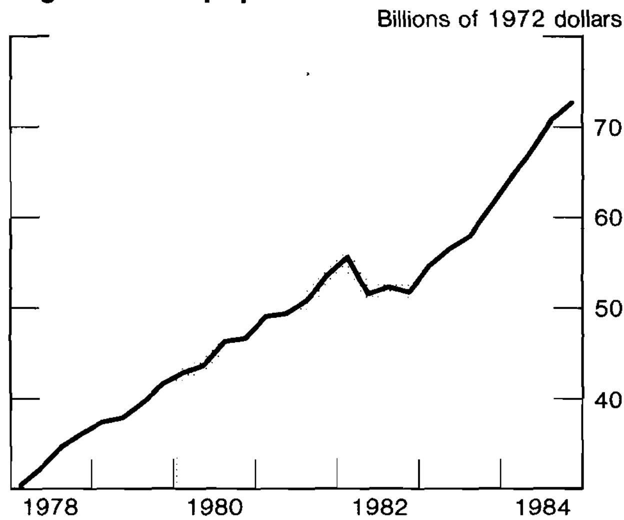
	Real GNP Growth	Contribution of Inventory Investment
1982	−1.5	−2.1
1983 H1	6.3	2.5
H2	6.4	1.7
1984 H1	8.6	1.7
H2	2.7	−.7
1985	3.6	0
1986	2.7	0

*Excludes cycles with troughs in 1949 and 1980.

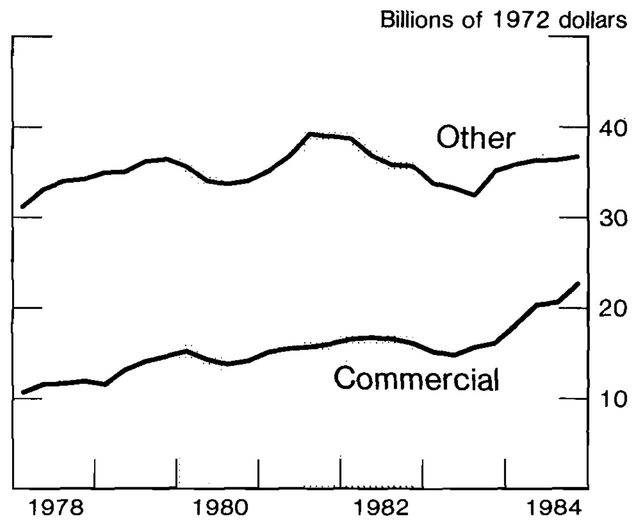
Cyclical Comparison of Real Business Fixed Investment



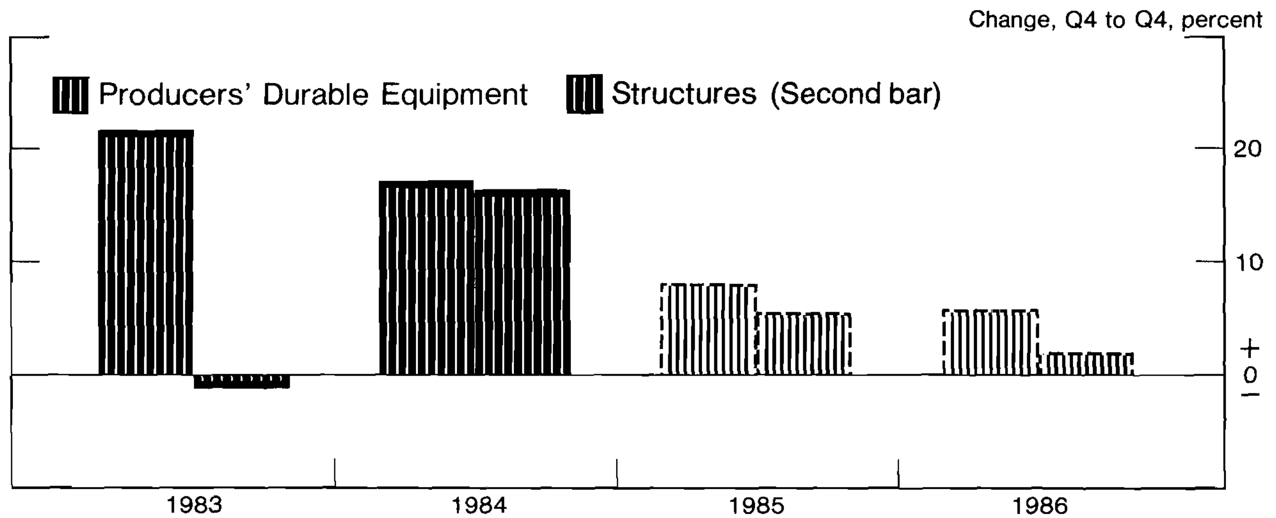
High-Tech Equipment



Structures



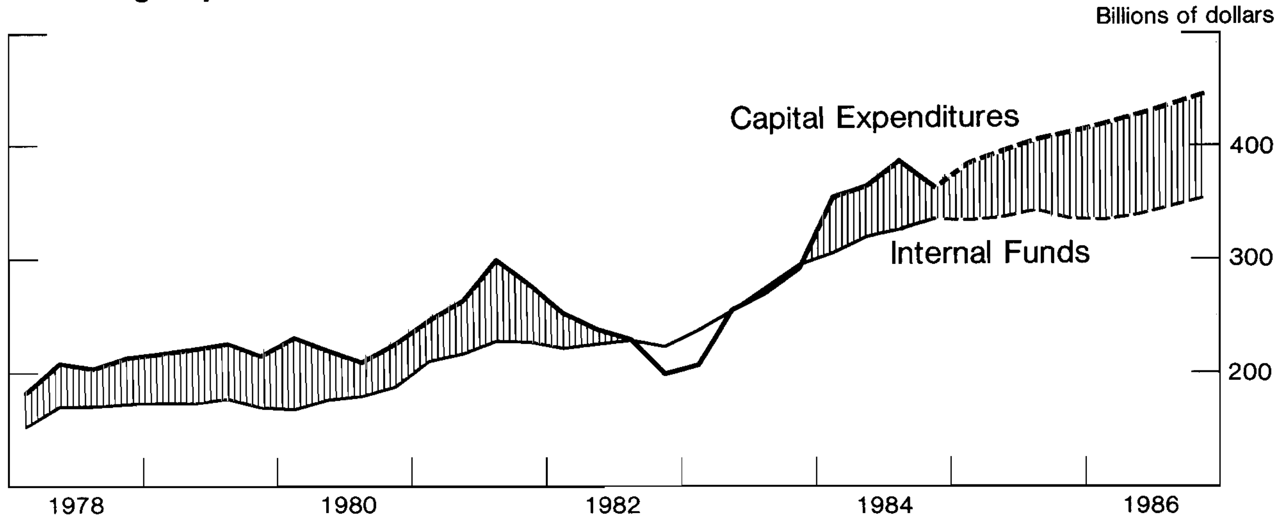
Real Business Fixed Investment



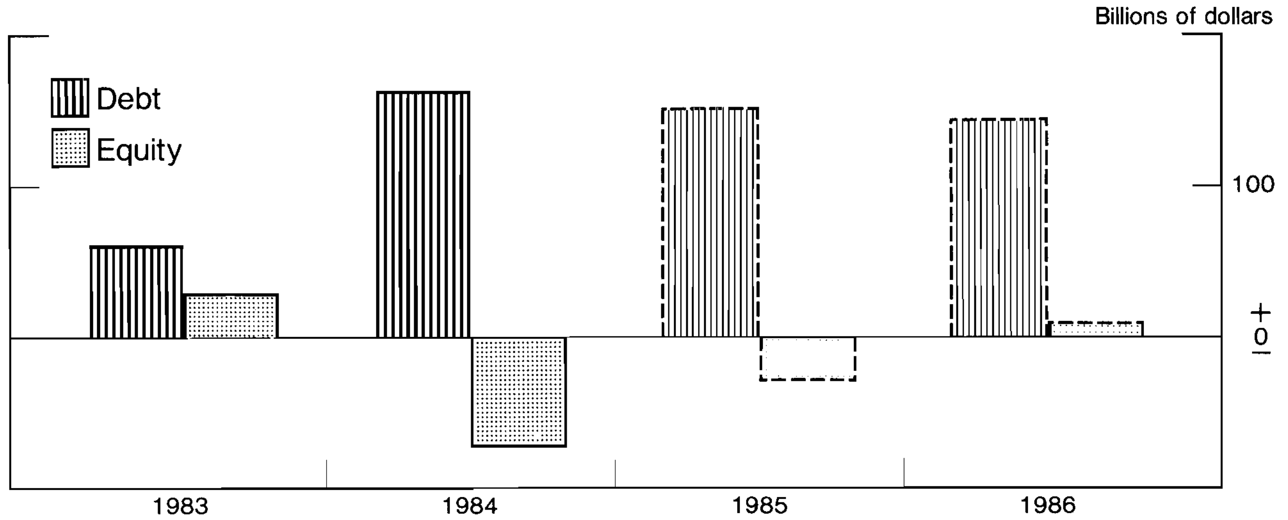
* Excludes cycles with troughs in 1949 and 1980.

Nonfinancial Corporations

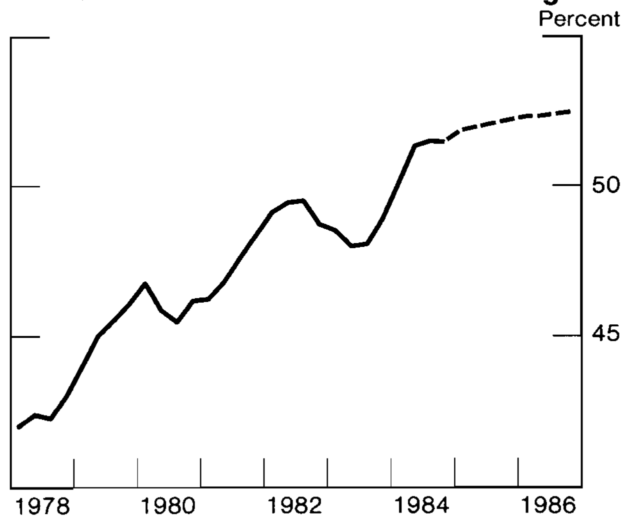
Financing Gap



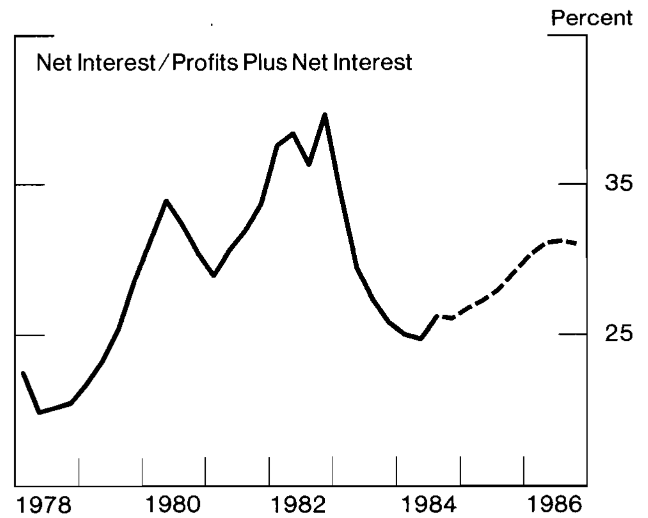
Total Funds Raised

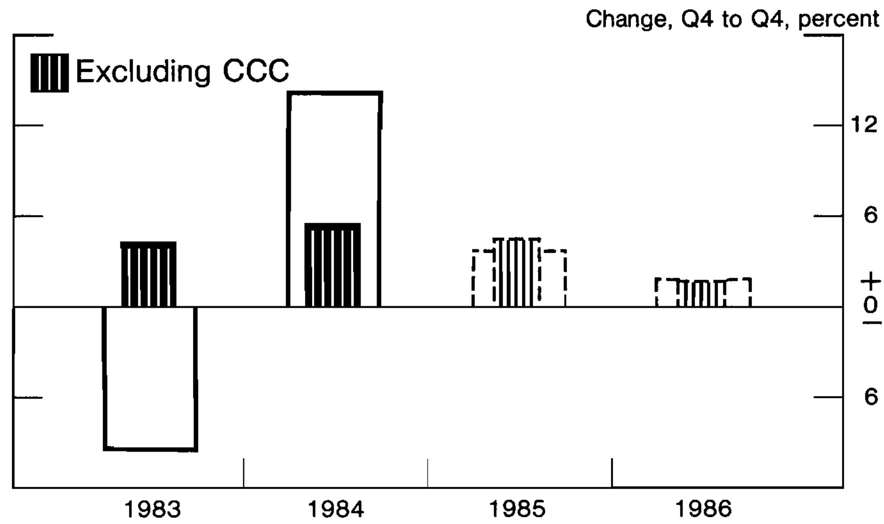


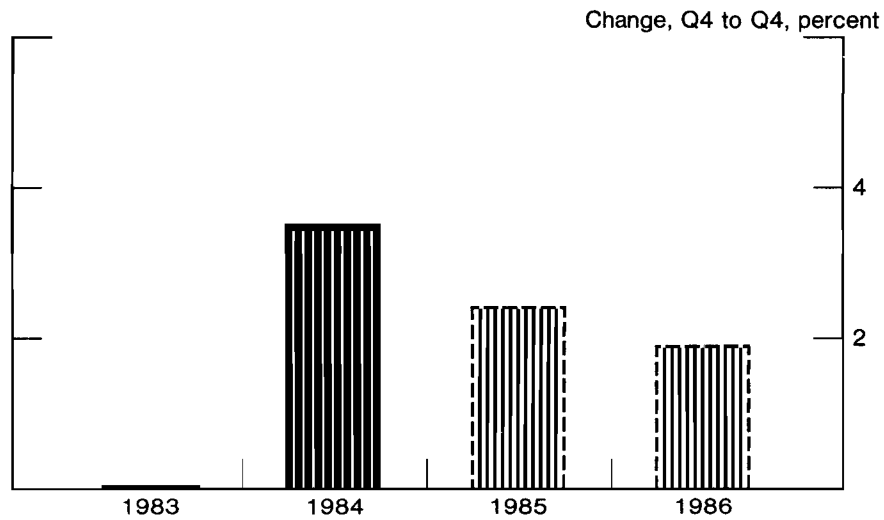
Short-term to Total Debt Outstanding

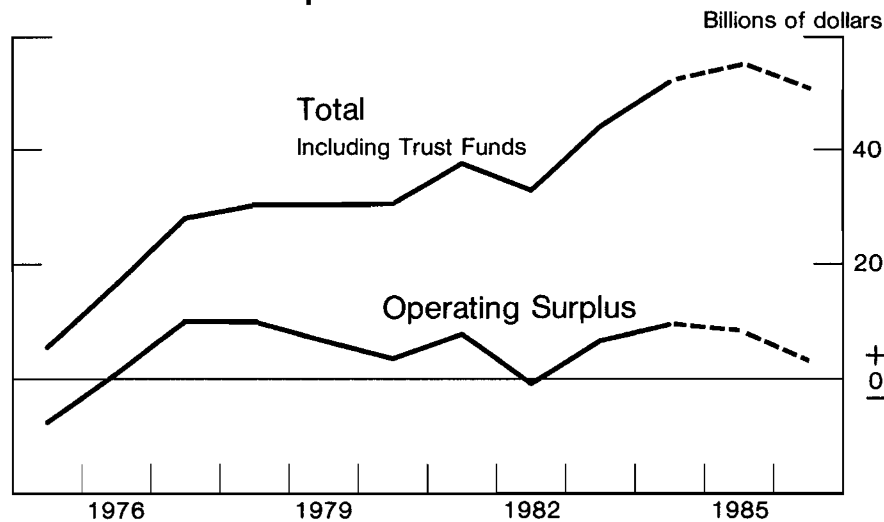


Interest Relative to Income

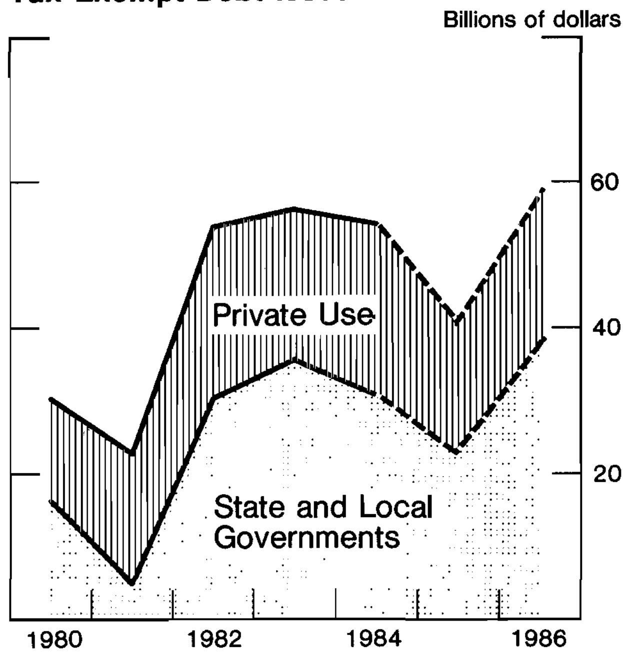



Real Federal Government Purchases
Change, Q4 to Q4, percent
Excluding CCC
12
6
+
0
−
6
1983
1984
1985
1986

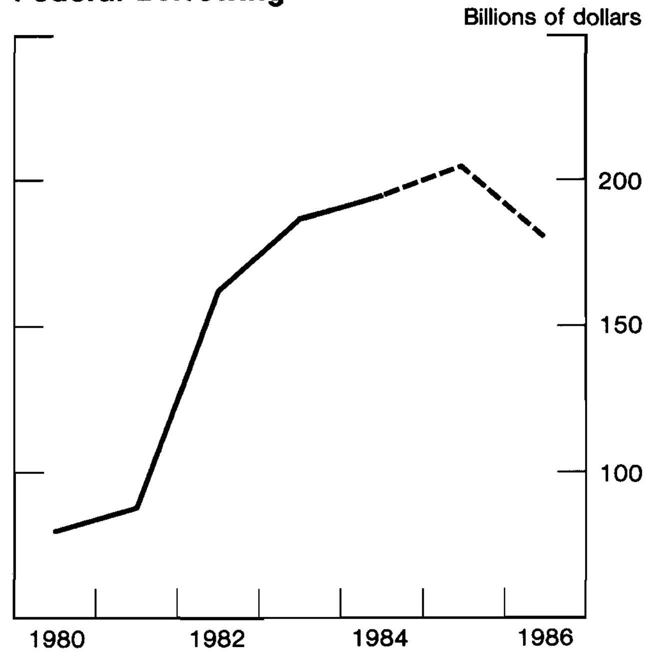

Real State and Local Government Purchases
Change, Q4 to Q4, percent
4
2
1983
1984
1985
1986


State and Local Surplus
Billions of dollars
Total
Including Trust Funds
Operating Surplus
40
20
+
0
−
1976
1979
1982
1985

Tax-Exempt Debt Issuance



Federal Borrowing



Sector Savings Flows

Percent of GNP

Gross Private Domestic Saving

Gross Private Domestic Investment

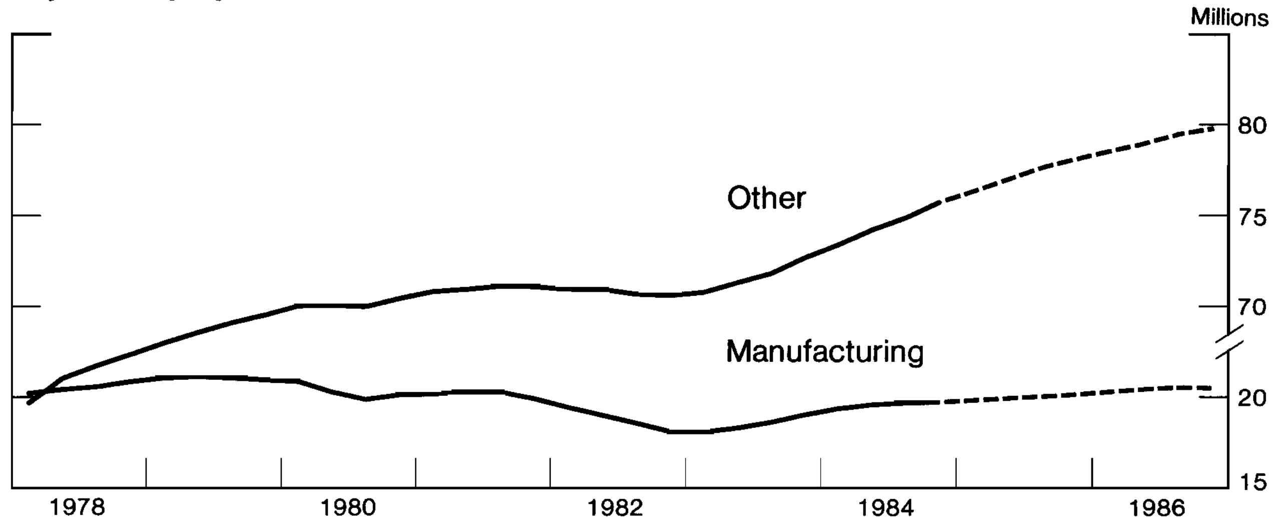
Overall Government Deficit

Net Foreign Investment

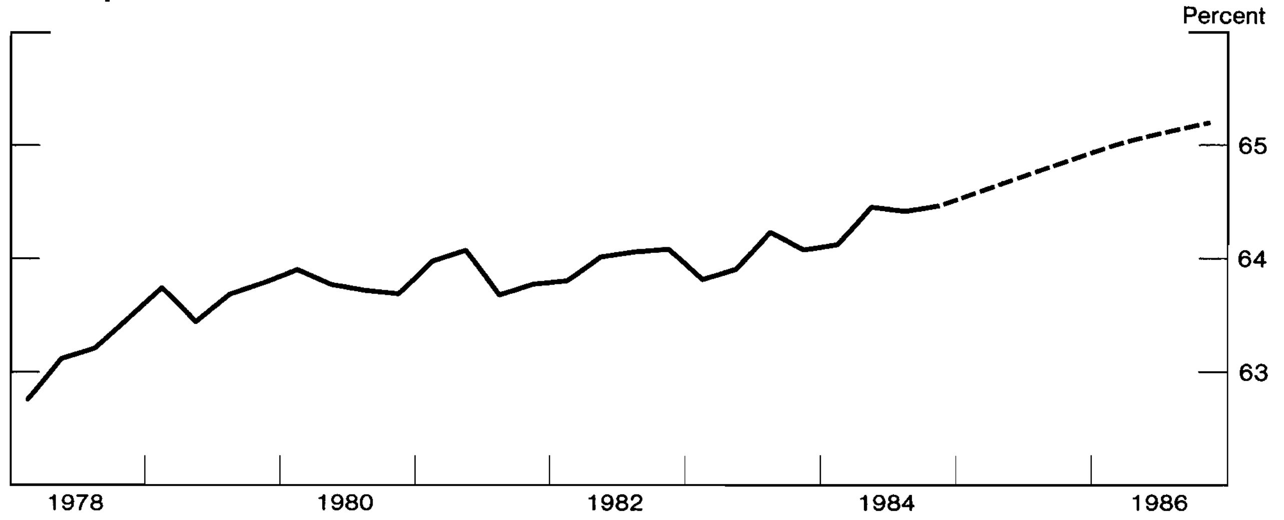
15
10
5
+
0
−
5

1965 1970 1975 1980 1985

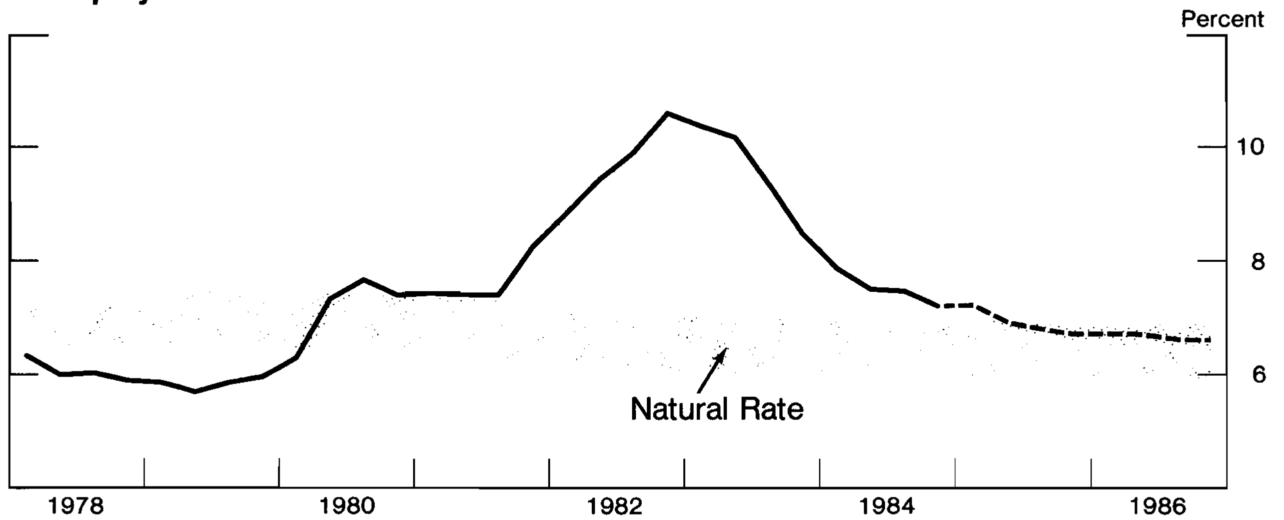
Payroll Employment



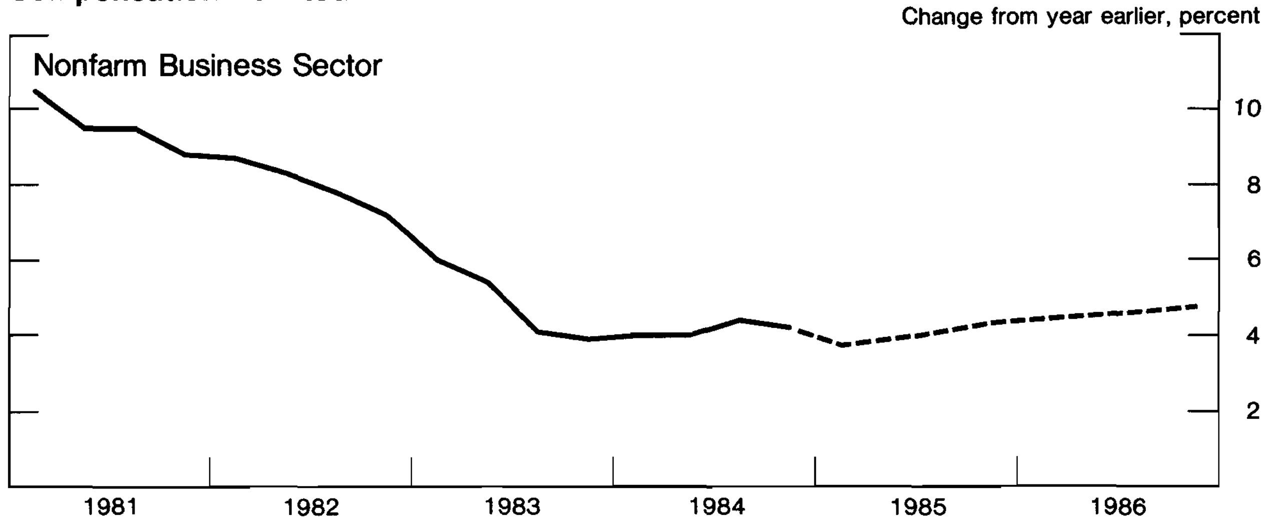
Participation Rate



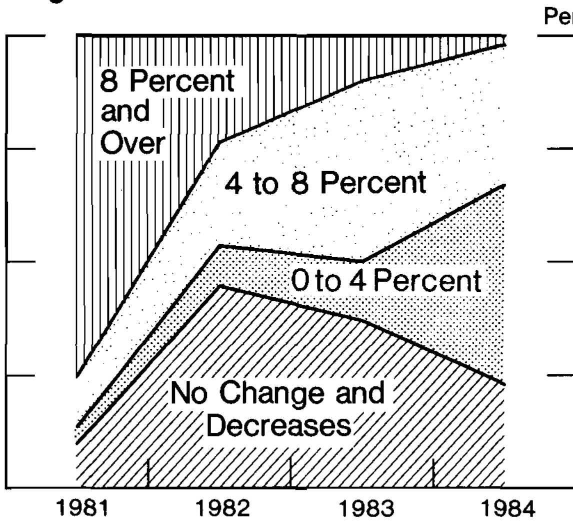
Unemployment Rate



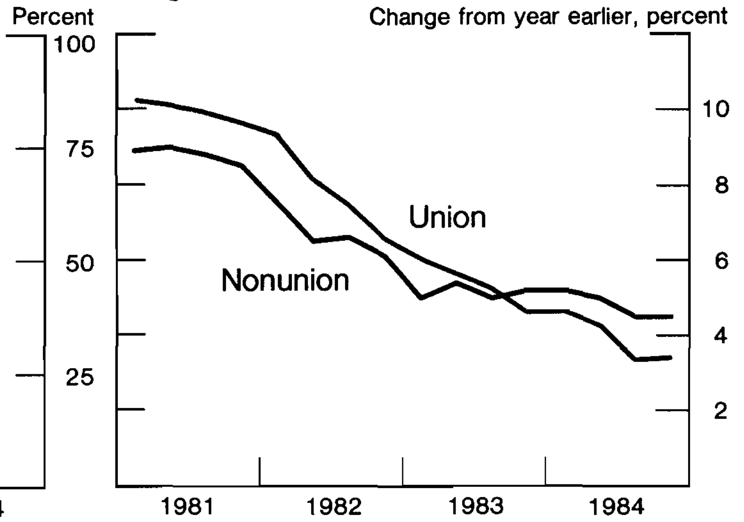
Compensation Per Hour



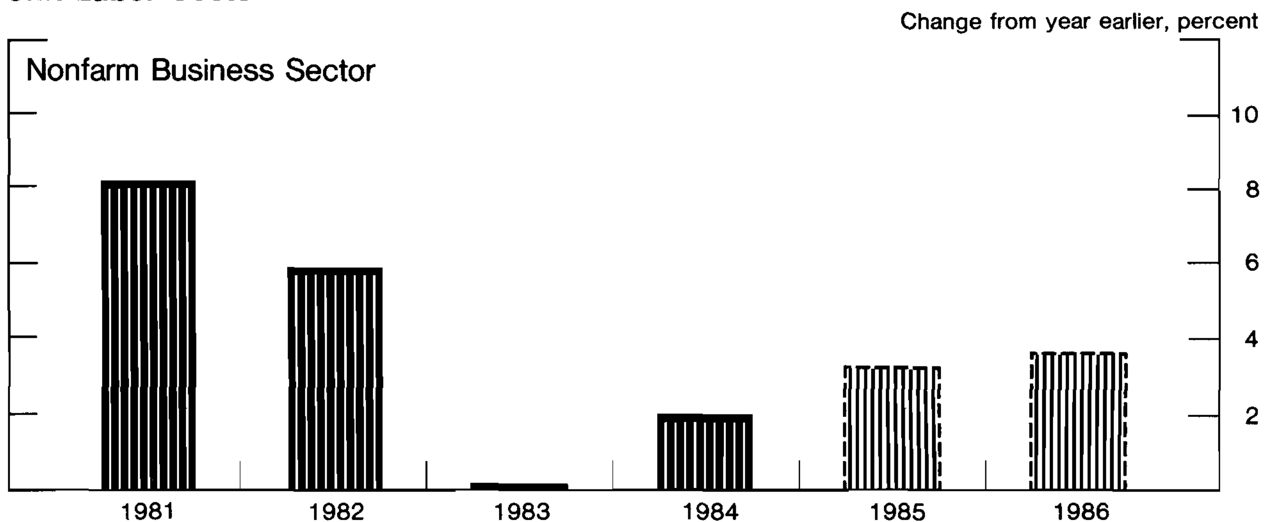
Wage Settlements



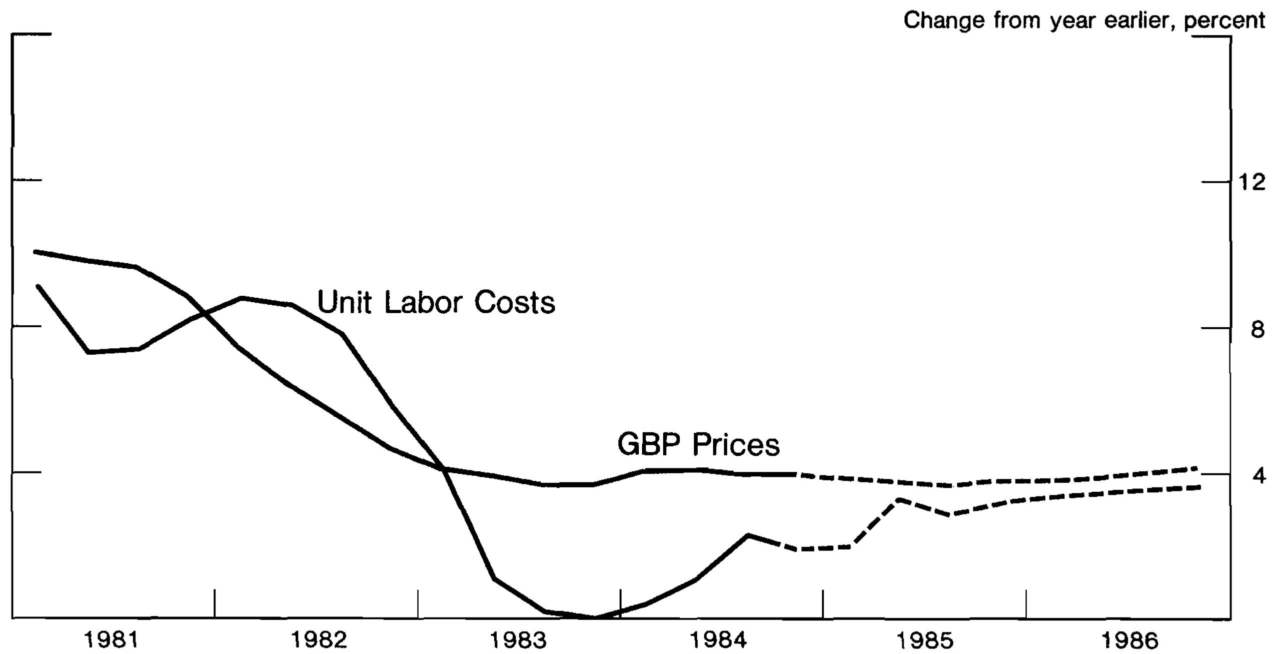
Wage Rates



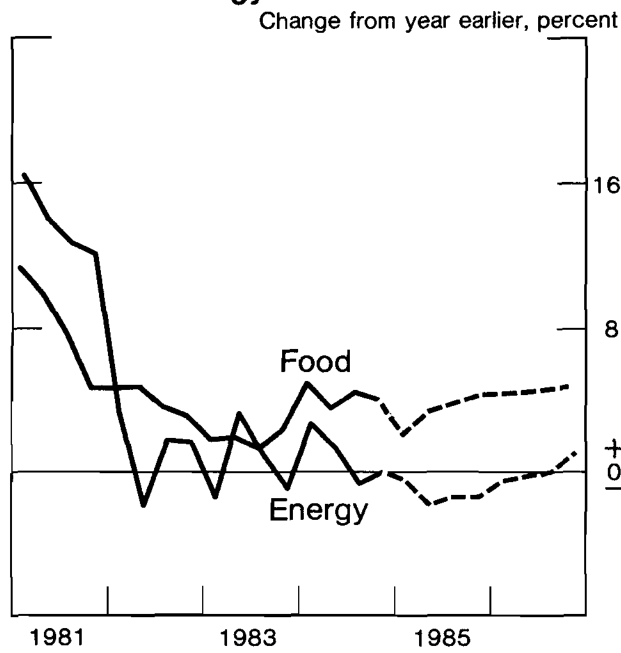
Unit Labor Costs



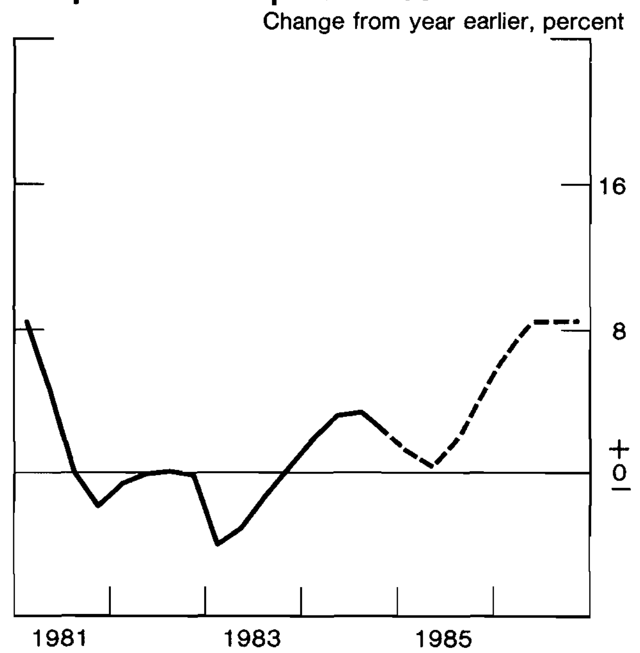
Gross Business Product Prices and Unit Labor Costs



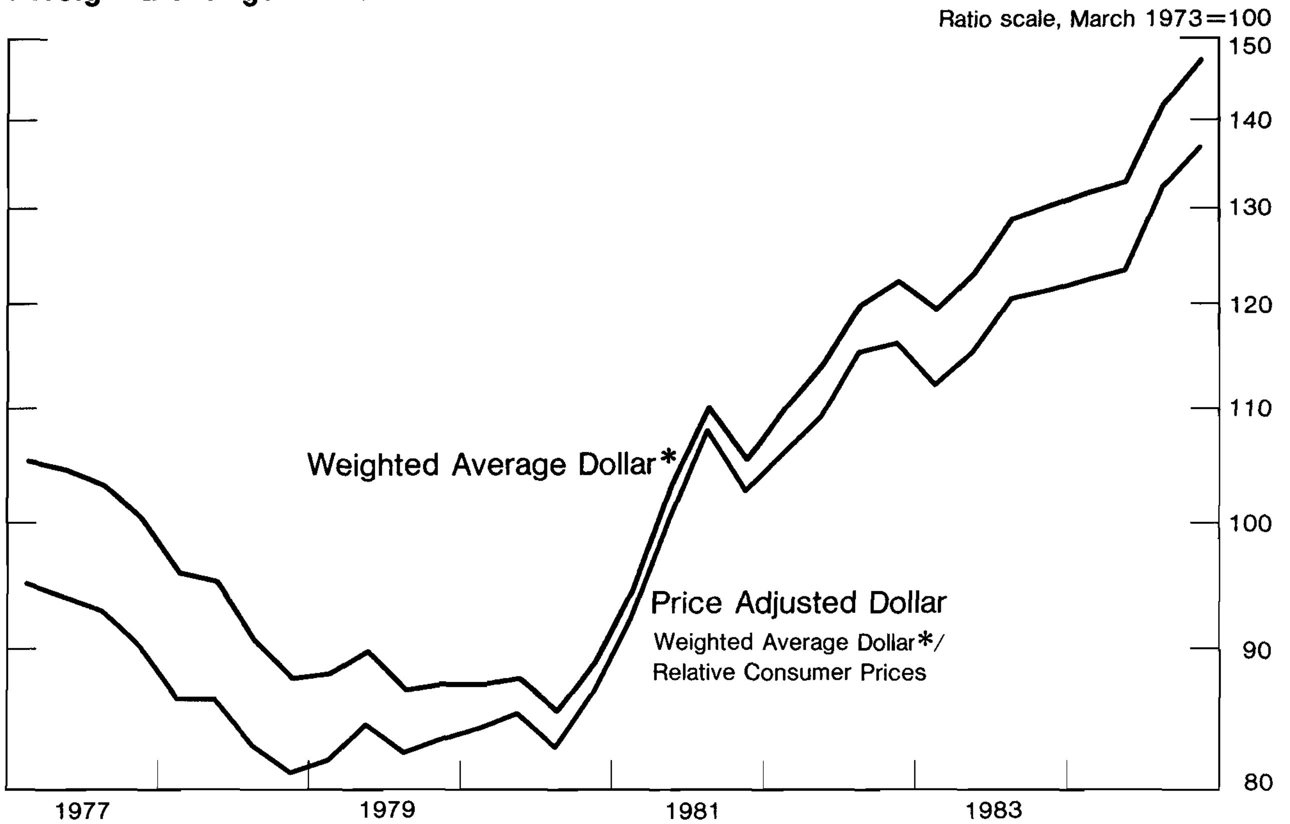
Food and Energy Prices



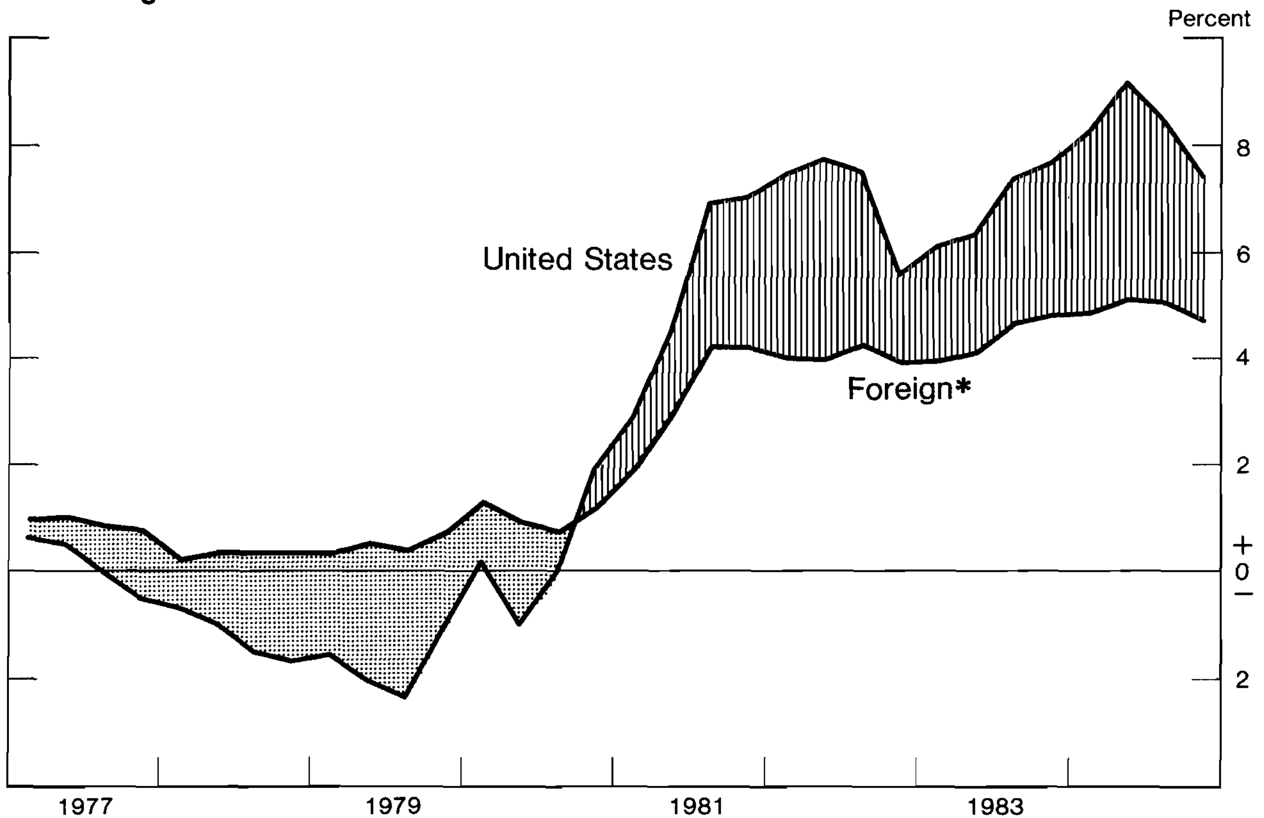
Nonpetroleum Import Prices



Foreign Exchange Value of the U.S. Dollar



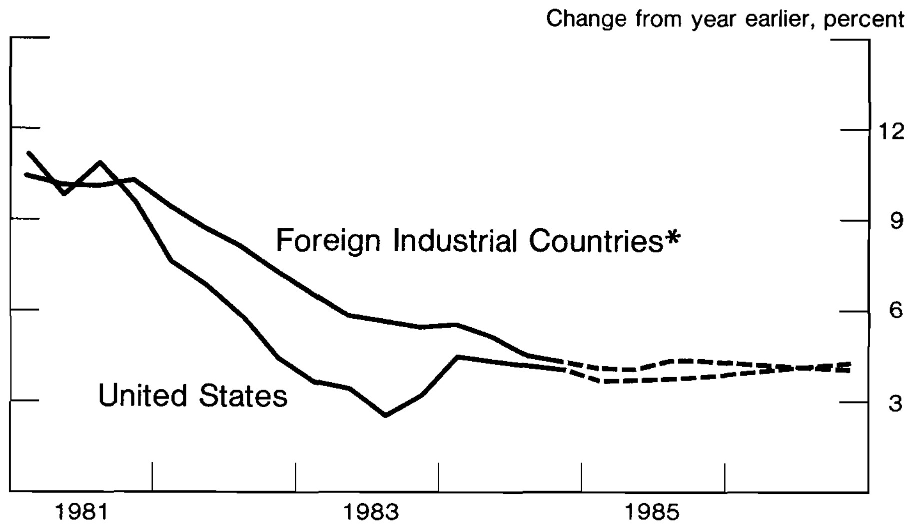
Real Long-term Interest Rates**



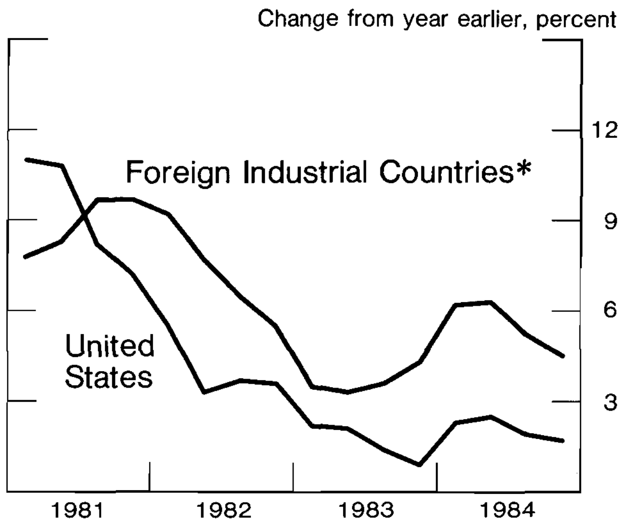
* Weighted average against or of foreign G-10 countries.

** Long-term government or public authority bond rates adjusted for expected inflation estimated by a 36-month centered moving average of actual inflation (staff forecasts where needed).

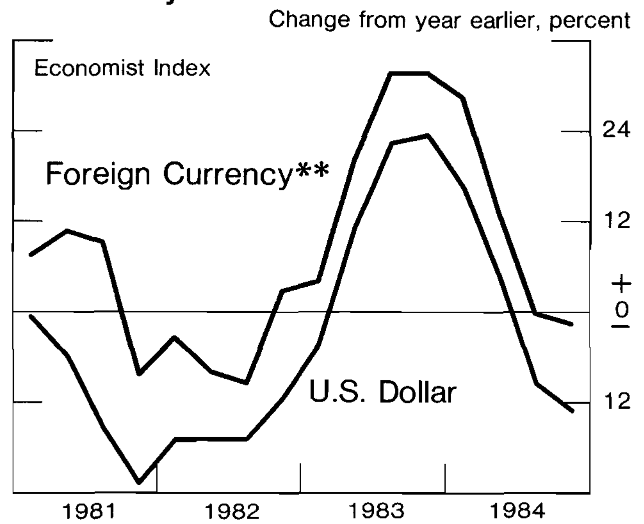
Consumer Prices



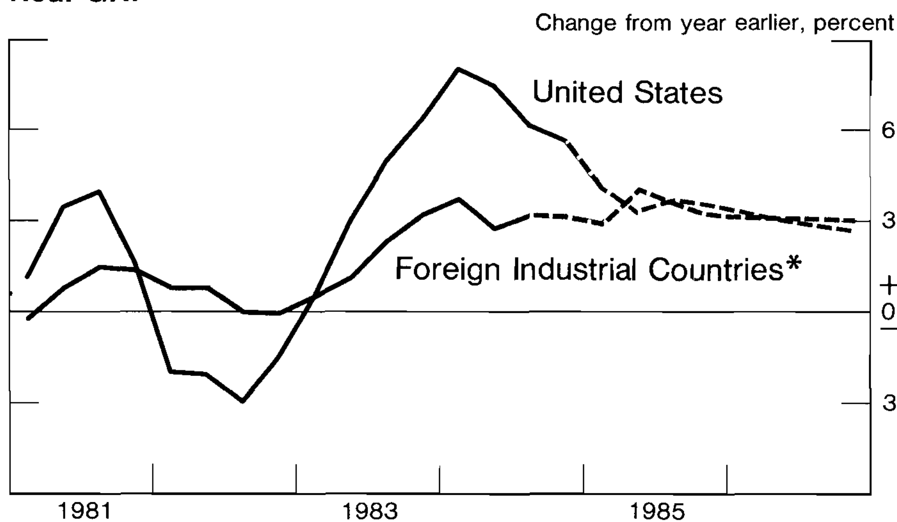
Wholesale Prices



Commodity Prices



Real GNP

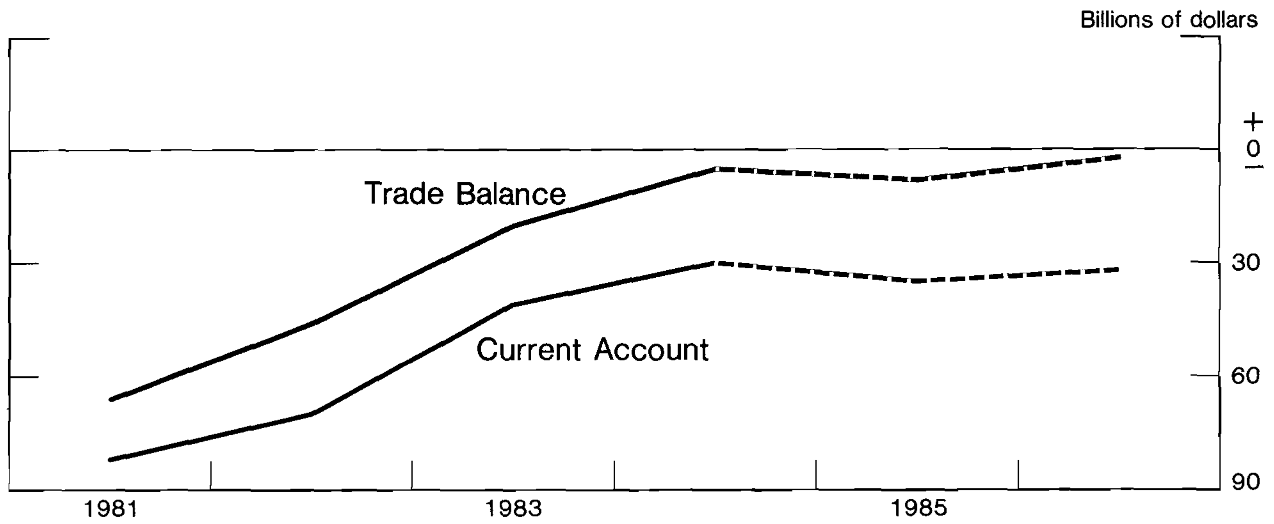


*Weighted average of the six major foreign industrial countries using total 1972-76 average trade of these countries.

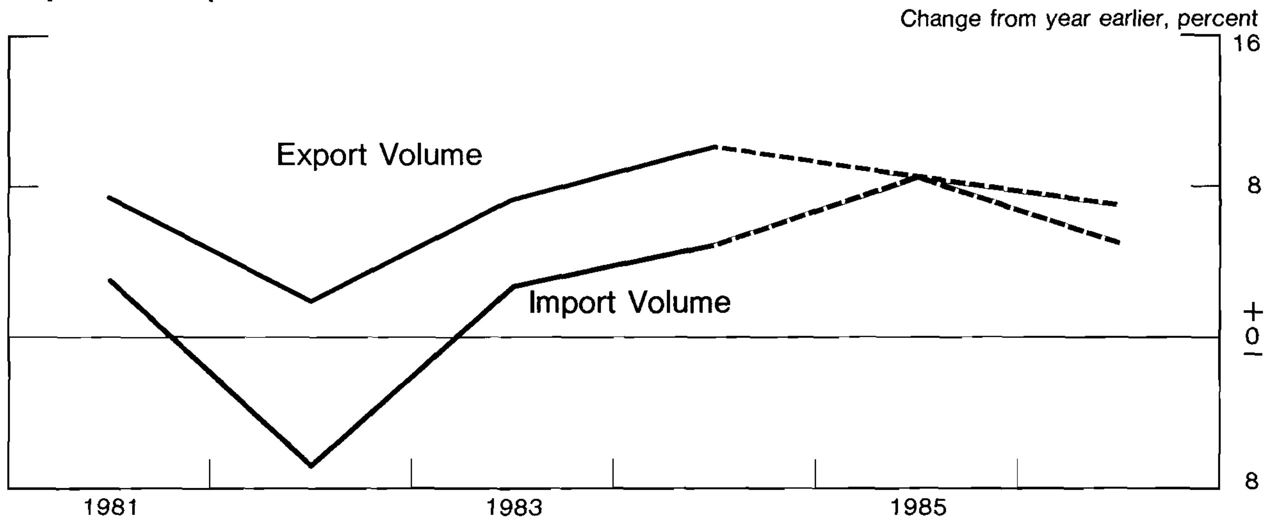
**U.S. dollar index multiplied by the index of the weighted average value of the dollar against G-10 currencies.

Non-OPEC Developing Countries

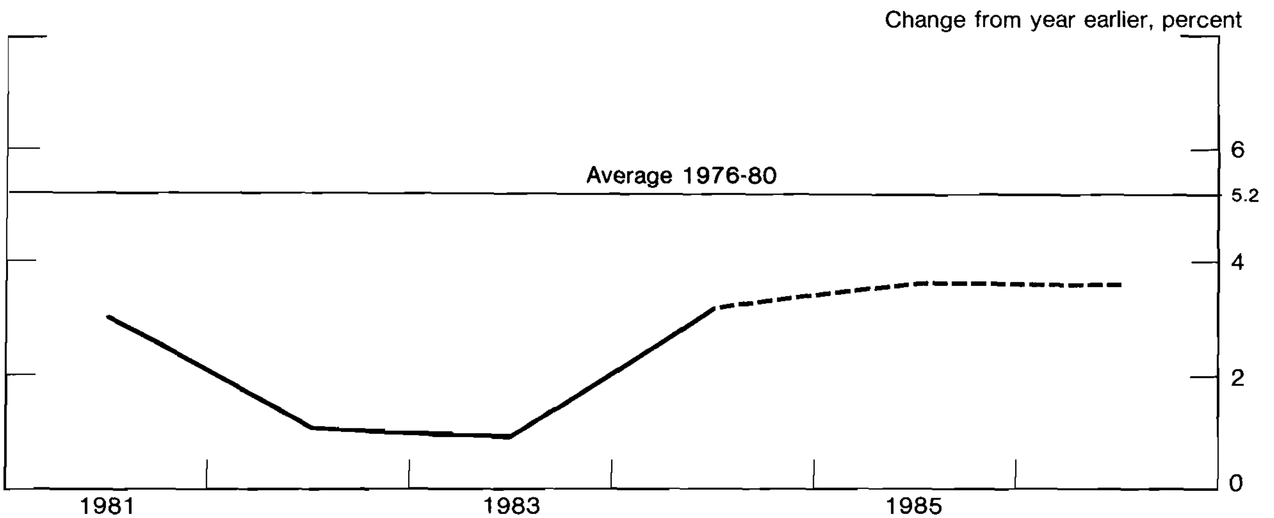
External Balances



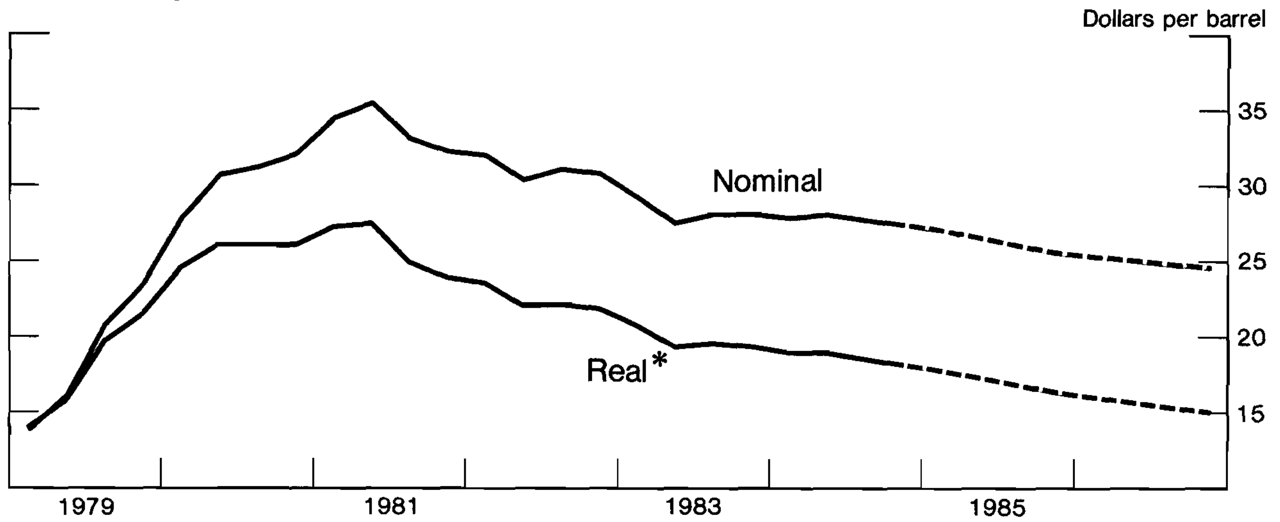
Export and Import Growth



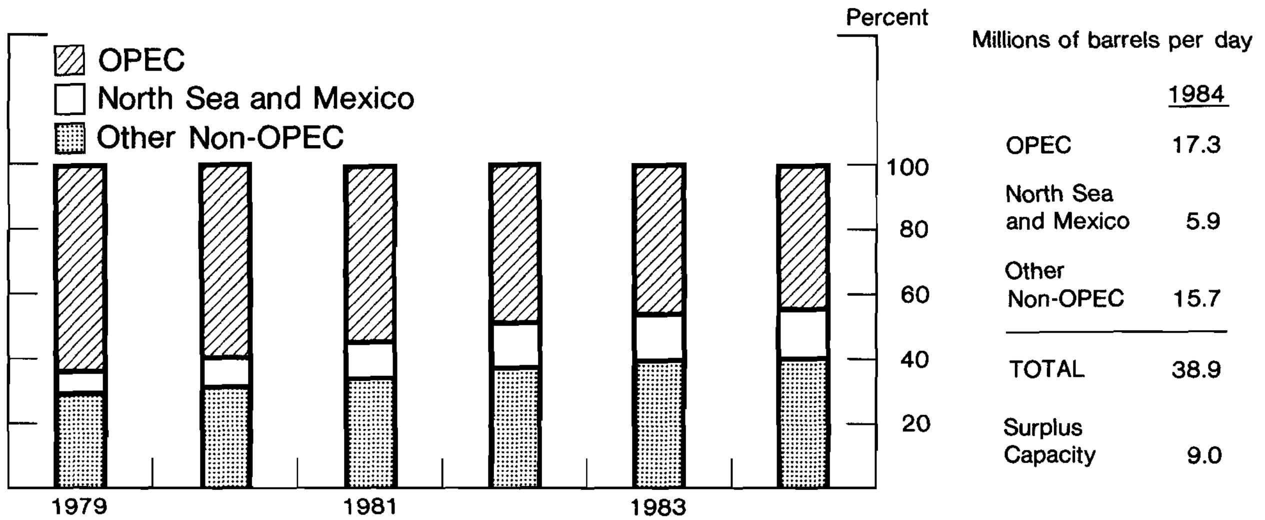
Real GDP Growth



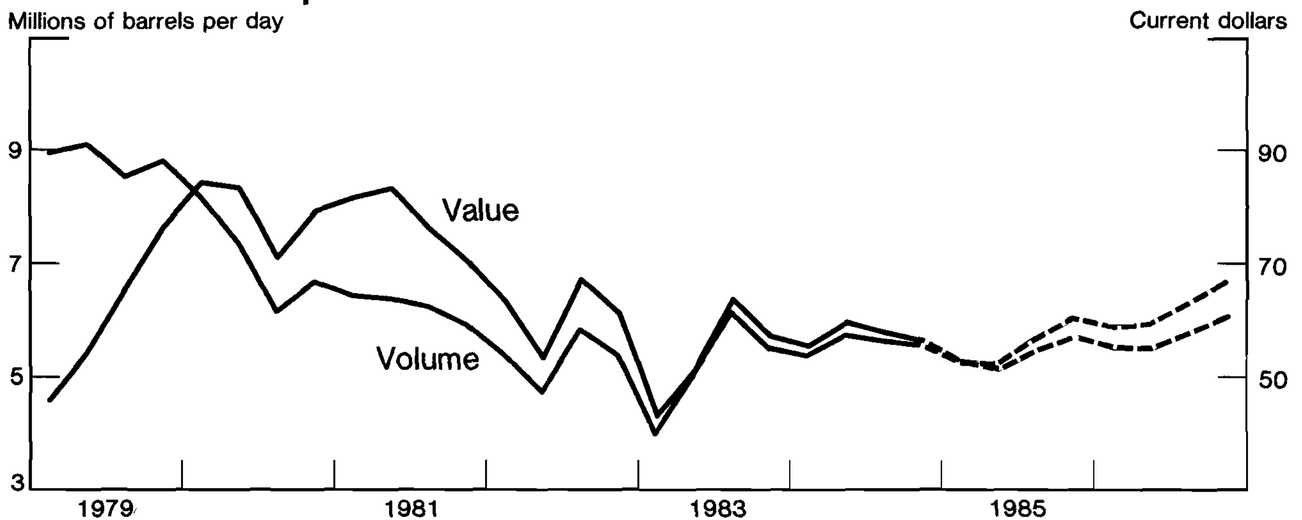
U.S. Oil Import Price



Non-Communist World Crude Production



U.S. Petroleum Imports

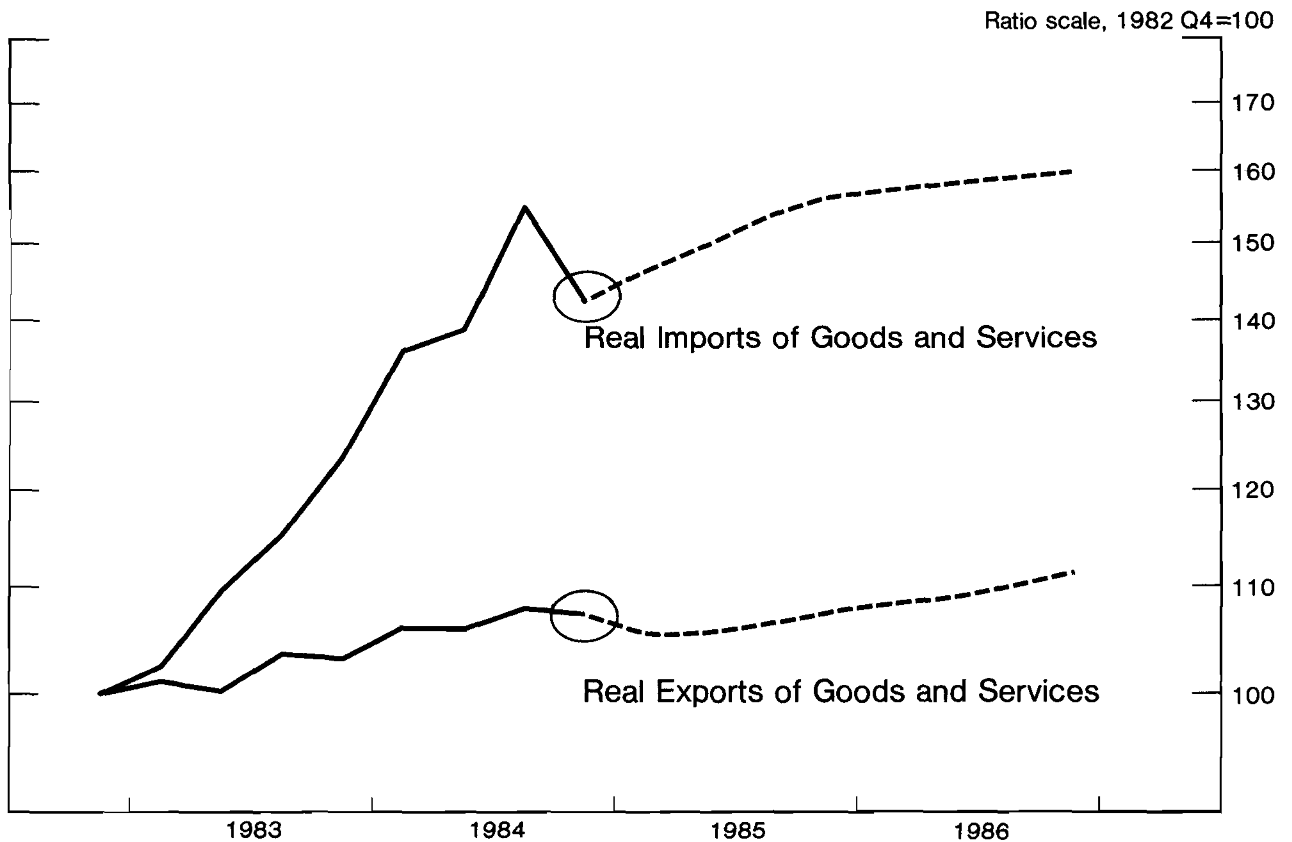


*Oil import price divided by U.S. CPI (1979 Q1=1.0).

Real Imports and Exports of Goods and Services

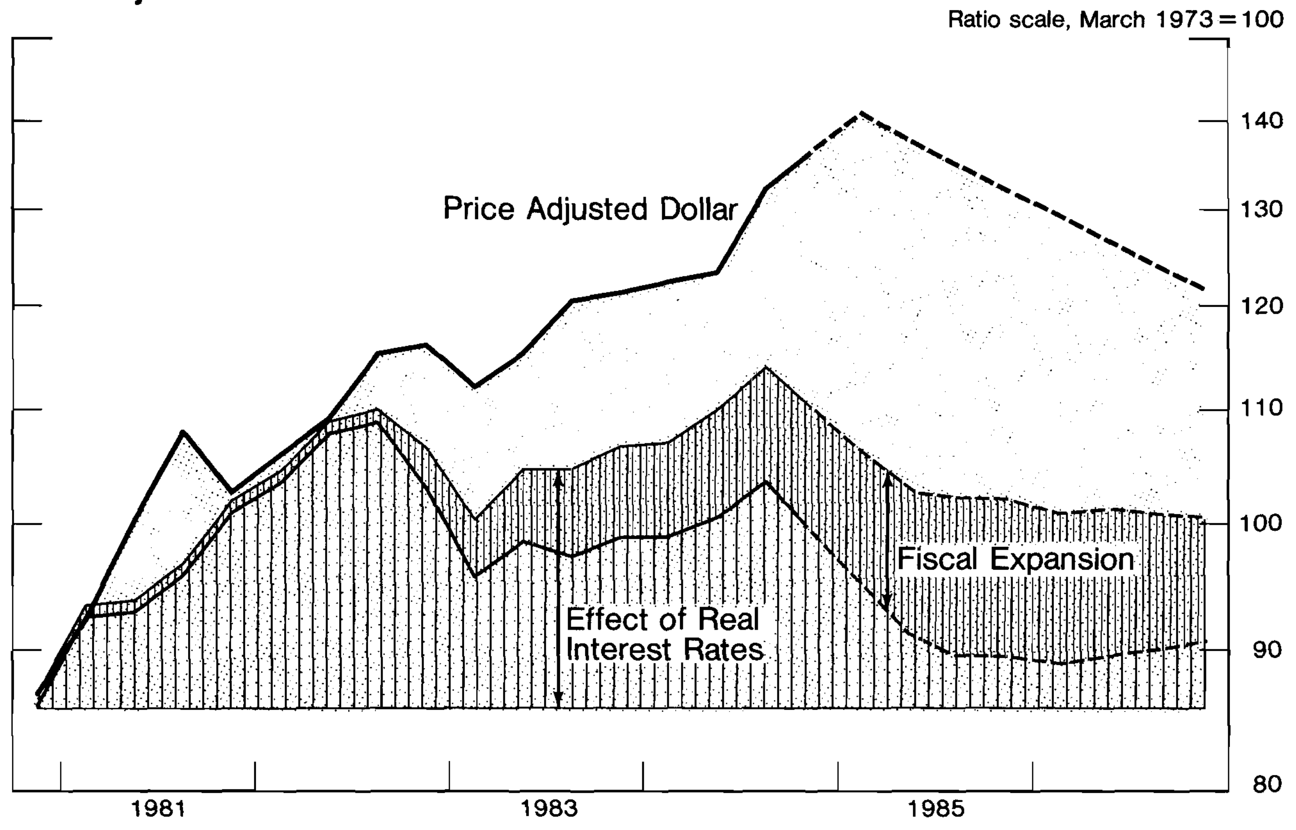
Expansion Eight Quarters After The Cyclical Trough
(percent)

	Current Cycle (to 1984 Q4)	1975 Cycle	Average of 5 Past Cycles*
1. Imports of Goods and Services	42.4	23.4	17.8
2. Goods	46.1	30.6	23.6
3. Services	34.6	7.3	8.1
4. Exports of Goods and Services	7.3	6.7	13.3
5. Goods	11.4	1.7	10.7
6. Services	2.5	15.8	18.9

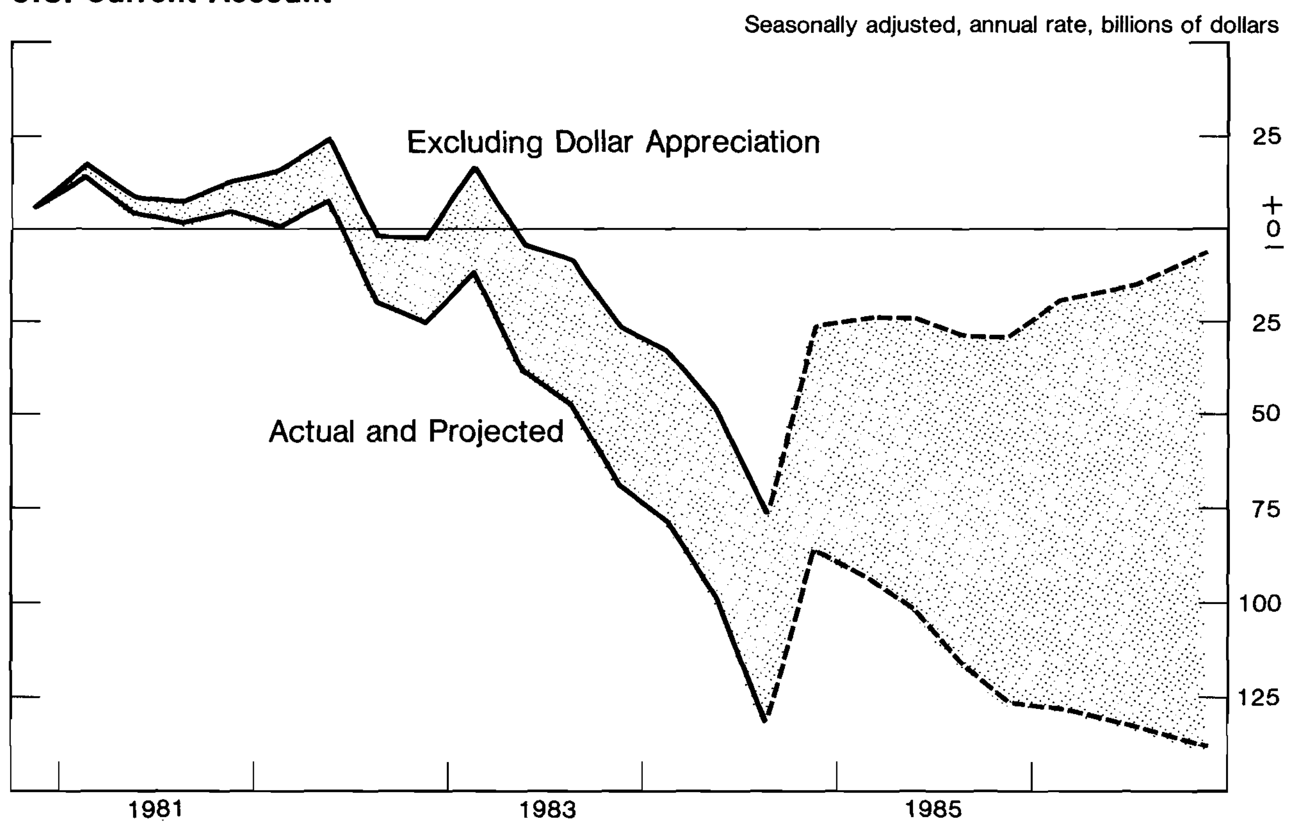


Note: Data for 1984 Q4 are FR staff estimates.
*Includes cycles of 1954, 1958, 1961, 1970 and 1975.

Price Adjusted Dollar



U.S. Current Account



U.S. Capital Transactions

(Billions of Dollars; Net Inflows = +)

	1982	1983	1984[e]	1985[p]
1. **Net Private and Official Capital Flows**	**−24**	**32**	**79**	**89**
2. Private Capital Flows	−16	33	90	89
3. U.S. Banking Offices	−45	24	30	30
4. Bonds and Stocks	14	13	35	40
5. Direct Investment and Other Non-Bank Flows	15	−4	25	19
6. U.S. and Foreign Official Transactions	−8	−1	−9	0
7. **Statistical Discrepancy**	**33**	**10**	**20**	**20**
8. Balance on Current Account	−9	−42	−99	−109

[e] Estimated
[p] Projected

Some Risks and Uncertainties

	Staff Estimate or Assumption
Trend Productivity Growth	1¼ to 1½ percent
Natural Rate of Unemployment	6½ percent
Exchange Rate	8 percent per year decline
Oil Prices	10 percent decline over forecast period
Fiscal Policy	$50 billion deficit reduction

Forecast Summary for 1985

Percent change, Q4 to Q4	Board Members		Presidents		Staff	Administration
	Range	Median	Range	Median		
Nominal GNP	7 to 8¼	7½	7¼ to 8¾	8	7¼	8½
Real GNP	3¼ to 4¼	3¾	3 to 4½	4	3½	4
GNP Deflator	3 to 4½	4	3½ to 4¾	4	3½	4¼
Average level, Q4, percent						
Unemployment Rate	6¾ to 7¼	7	6½ to 7¼	7	6¾	7

FOMC Projections for 1985

Reported to Congress in July 1984

	Range	Central Tendency
Percent change, Q4 to Q4		
Nominal GNP	6¾ to 9½	8 to 9
Real GNP	2 to 4	3 to 3¼
GNP Deflator	3½ to 6½	5¼ to 5½
Average level, Q4, percent		
Unemployment Rate	6¼ to 7¼	6½ to 7

FOMC Briefing
S.H. Axilrod
2/12/85

A principal issue for the Committee in choosing monetary targets for 1985 is to decide how to weigh the need for enough monetary growth to encourage satisfactory economic expansion, with unemployment still relatively high, against the need to keep enough restraint on monetary growth to foster further progress toward reasonable price stability and to be perceived to be doing so by continuing gradually to lower monetary growth ranges. If a continued 4 percent rate of inflation is deemed satisfactory for 1985, there may not be much of a dilemma. But should the Committee wish to make further progress in 1985, then there may be a greater dilemma, given what we now take to be the underlying rate of inflation, since that may risk leading to real growth below, say, the upper part of a 3 to 4 percent range.

The growth ranges presented in alternative II might be construed as representing something of a compromise in these respects. They are, with the exception of credit, the same growth ranges adopted tentatively last summer--which contemplate reductions for M1 and M2 but not for M3 and credit. They are also relatively tight ranges in the sense that they leave little, if any, scope for realization of upward price pressures significantly greater than 4 percent, given real economic growth in the 3 to 4 percent area. This assumes, as noted in the blue book, that the trend rate of rise in the velocity of M1 is 1 to 2 percent, abstracting from the impact of interest rate movements. Such a trend rate presumes that velocity growth will be held a little under post world war II experience because deregulation will lead to a lower rate of financial innovation in the future. If that analysis and estimate of the trend are correct--a big if, of course, given the still limited

experience with deregulation and the new checking and closely related accounts--then the odds are that M1 growth this year will be in the upper part of the 4 to 7 percent range given under alternative II.

We believe that growth of M2 and M3 will also be close to the upper limits of their respective alternative II ranges, as noted in the blue book. With respect to credit, the tentative range adopted in midsummer does not seem attainable, except perhaps barely so if there is no unusual amount of credit at all raised for mergers and related activity this year. Thus, a higher credit range seems technically more consistent with the monetary aggregates. However, adoption of such a range does have the disadvantage of possibly signalling greater willingness by the Federal Reserve to accommodate to a still expansive federal deficit. If the range is left the same rather than raised, perhaps some mention should be made at least in the policy record that the range assumes no unusual credit expansion related to such transactions as mergers and share redemptions.

The probability that the monetary aggregates under alternative II will run in the upper part, or close to the upper limits, of their ranges suggests that stronger inflationary pressures, or real demands for goods and services, than projected or expected would need to be rather promptly reflected in upward adjustments of interest rates. Indeed, the staff projection itself may entail some rise of interest rates from current levels, particularly if M2 and M3 are to be kept within alternative II ranges for the year but also perhaps consistent with projected M1 growth.

The suggested growth ranges of alternative I would be an approach to targeting for 1985 that provides more leeway on the upside of the

ranges. It has certain advantages as compared with alternative II. First, it would provide allowance should trend velocity for M1 be even lower than, or on the low side, of a 1-2 percent per year range. Second, there would be scope to let the Ms run strong should demand for goods and services be weaker than currently anticipated at present levels of interest rates and exchange rates, or should inflationary pressures be significantly less than now expected. Under those conditions, the lower interest rates that would be required to keep the economy growing at a reasonable pace might also be associated with a significant strengthening in demands for monetary assets. Third, as a mere technical matter, it would simply make the midpoints of the ranges closer to the most likely outcome.

The alternative has important disadvantages, however. First, retaining the 1984 M1 and M2 ranges, and raising those for M3 and credit, as is proposed, might be taken as signalling a lessening of will on the part of the Fed in keeping inflation curbed. Such an interpretation is more likely under current circumstances, when fiscal policy for the year 1985 is likely to be more expansive than in 1984 and when the economy does not seem especially weak. It may also serve to reinforce a view that the 4 percent rate of inflation of the past two years is an irreducible minimum, perhaps, to be followed by an upward adjustment to a higher rate. Second, the ranges for alternative I, by providing more leeway than alternative II, may delay an interest rate response in short-term markets that may be needed, at least temporarily, should demand pressures strengthen more than now expected with the potential for leading to a sustained acceleration of prices.

Alternative III, which contemplates lower growth ranges than alternative II and tilts toward an actual lowering of M1 growth in 1985 relative to 1984, may well seem to be reaching a bit at this point. But something like it would need to be contemplated sooner or later if the Committee is to signal an intention to encourage a further reduction in the rate of inflation. Its main disadvantage, in my view, would be that it is probably premature. Its main advantage is that it would more firmly work toward a further abatement of inflationary expectations at the risk, however, of retarding real growth perhaps unduly in 1985 but with the potential of more sustained growth in subsequent years.

A final point if I may, Mr. Chairman. Should the Committee adopt monetary growth ranges in the expectation that the outcome may be in the upper part of them, it may wish to consider indicating that to the public. Such a phrase is suggested for M1 in the proposed directive language--indicating that growth in the upper part of the range is acceptable because of growth below the midpoint in the year just past. That may be a useful way of signalling an intention, but it does not necessarily convey the crucial economic reasoning. It has the disadvantage of making it seem that so-called "base drift" is necessarily undesirable, when in practice whether it is or not depends on assessment of the changes that may be occurring in demand for money relative to GNP, the psychological state of the public, and how M1 is to be assessed relative to other monetary aggregates and domestic credit and exchange market conditions. It might be more economically pertinent to suggest M1 growth in the upper part of the range would be acceptable in view of the potential for relatively slow growth in velocity and so long as inflationary pressures remain subdued.