

## APPENDIX

Notes for FOMC Meeting  
February 11-12, 1986  
Peter D. Sternlight

Since the last Committee meeting, the Domestic Desk has aimed for the slightly more accommodative conditions of reserve availability agreed to in December. Undertaken against a background of seasonal reserve pressures, often very high Treasury balances, and some signs of more vigorous economic expansion, results were rather mixed. For most of the period, the Federal funds rate hugged the 8 percent level characteristic of the weeks just before the last meeting, and indeed in the days around year-end the rate was considerably higher than that. By late January the rate was more often below 8 percent and in the last few days, with the benefit of much lower Treasury balances at the Fed, funds have traded close to the 7 3/4 percent area contemplated at the time of last meeting.

Gauged by borrowing levels, pressures were about as intended or even somewhat lower--except for the reserve period ending January 1, when year-end strains, exacerbated by unseasonably high Treasury balances, resulted in average borrowing near \$900 million. In the next period, with the Desk resolving uncertainties on the side of more abundant reserve provision, borrowing fell off to average under \$150 million, although funds still averaged above 8 percent. Borrowing in the January 29 period was just slightly above the \$350 million path level while the average so far in the current period is close to \$200 million with funds averaging about 7.90 percent through yesterday (Monday). Nonborrowed reserves have come in fairly close to path except in the reserve period ending January 15, when doubts were resolved on the accommodative side and nonborrowed reserves turned out roughly a half-billion over path.

Among the background factors for the conduct of operations, money growth measures were reasonably in line with Committee expectations. December M-1 turned out strong, as had been anticipated, but January growth was quite modest and the current month seems to be starting on the moderate side, too. M-2 growth was moderate in December and much weaker than expected in January, while M-3 has been moderate in both those months. Behavior of the dollar in the exchange markets cast its shadow across domestic Desk operations as sporadic sinking spells were sometimes a factor counseling particular caution in providing reserves.

Normally, January is a time of substantial reserve absorption by the Desk, particularly to offset the release of reserves from post-Christmas declines in currency in circulation and declines in required reserves. This year was quite different because of the unusually high Treasury balances. In turn, this resulted largely from a huge issuance of special nonmarketable securities to State and local governments in the final weeks of 1985 as those bodies sold a record volume of tax-exempts to beat a possible year-end cut-off for certain types of securities. For us, this meant that the usual heavy reserve absorption was delayed until about the beginning of February when Treasury paid down part of its high balances through the usual round of monthly benefit outlays. Earlier in the intermeeting period, the Desk added reserves through purchases of about \$500 million of bills from foreign accounts. Then from January 30 through February 10 we sold about \$1.8 billion of bills to foreign accounts, and arranged to run off \$700 million of bills in the February 3 auction.

Substantial use was made of System and customer repurchase agreements to provide temporary reserves on 21 out of 36 business days in the period; this included a couple of occasions when System transactions were announced

the afternoon before they were to be consummated in order to provide the market with extra time to round up propositions. Matched sale-purchase transactions with the market were used in early February to help absorb the glut of reserves as Treasury balances came down.

Interest rates responded to a bundle of crosscurrents during the recent period and ended up with mixed and mostly moderate changes--somewhat higher rates for Treasury bills and private money market instruments, very little net change for intermediate and longer-term Treasury issues, and more noticeably lower rates for tax-exempts where the supply suddenly abated after year-end. Among the crosscurrents were periodic bouts of "disco fever"--or imminent expectation of a cut in the discount rate. The fever ran fairly strong in December, almost disappeared after the December employment data came out in early January, but reappeared around the time of the January G-5 meeting and the rumored and then actual cut in the Japanese discount rate. The fever receded again late last week with another strong employment report, but it hasn't disappeared altogether as market participants have sensed that our Desk is happier with a shade lower borrowings and Fed funds rates than was the case a couple of months ago. Also, while the business picture is seen as stronger now, and therefore providing less reason for official easing moves, the persistent weakness in oil prices is considered a counterweight--both because it will tend to dampen inflation and because it is adding to financial fragility. In addition, some market participants see a plus from oil price weakness in that it could add to the economy's growth and help reduce budget deficits.

Also bearing on the budget deficit, the market had of course drawn a lot of encouragement late last year from the passage of the Gramm-Rudman-Hollings amendment. Optimism faded early this year as doubts were aired

about its constitutionality, and last Friday's ruling that it is not constitutional detracted further. Still, the market is left with some feeling that there will nevertheless be serious efforts at budget deficit restraint, even if the Supreme Court follows the District Court on constitutionality.

All these ups and downs to sentiment have, as noted, left Treasury bill rates somewhat higher than seven weeks ago, with the increase perhaps attributable as much as anything to the lessened expectation of an early move on the discount rate. The three- and six-month issues were auctioned yesterday at average rates of 7.18 and 7.23 percent compared with 7.00 and 7.01 percent on December 16. The Treasury paid down about \$1 billion of bills in the meantime.

In the coupon sector, the Treasury raised roughly \$32 billion during the period, close to half of it in the quarterly refunding scheduled for payment next Tuesday. While rates for intermediate and longer issues were little changed on balance over the period, there were day-to-day variations that could catch the unwary. Thus bidders in the 20-year bond auction in early January took a swift loss when sentiment soured on stronger economic numbers, and bidders in the February refunding also took some lumps initially as bullish pre-auction sentiment got ahead of itself and then was dampened by fresh news on the economy and Gramm-Rudman. Briefly, late last week, all of the February refunding securities were trading below issue price, but yesterday's price gains brought the 10-year slightly above and the 30-year more noticeably above the auction levels. While these issues are not all distributed, and there is clearly day-to-day vulnerability, there is also an underlying market feeling, particularly with respect to longer-term issues, that somehow rates will work lower with the passage of time.

The fourth chart shows the broad contours of the staff's projection. Real GNP this year and next is forecasted to grow around 3 percent per year, up somewhat from the performance in 1985 and close to the average over the past 15 years. Prices, as measured by the GNP deflator, are expected to change little this year and rise somewhat in 1987 from recent trends and continue much better than the average pace over the 70's and 80's. The unemployment rate is projected to move slightly lower during the projection period.

Mike Prell will discuss the staff's domestic economic and financial projection in detail.

\* \* \* \* \*

also has been on the rise in recent months and the available information now suggests a further increase of .3 or .4 percent in January.

In the automobile market, the middle left panel, there has been considerable volatility in domestic sales given the off again-on again sales incentive programs. Dealer stocks were rebuilt in the fourth quarter and the reinstatement of financing discounts led to improved sales in December and January. Sales of imported models, not shown on the chart, have continued robust. Other retail sales, the middle right panel, have remained on an upward path with December showing a good gain. The only data on January sales are for chain stores and they appeared sluggish but are virtually impossible to relate to total retail sales.

The housing market, bottom left, also showed life in the fourth quarter. Total home sales rose somewhat and were at a high level, while housing starts finally picked up. New orders for nondefense capital goods, bottom right panel, shot up in December reflecting the strength in orders for aircraft and parts which have very long lead times; excluding this category, new orders were sluggish. After allowing for the surge in shipments late in the year, apparently to guard against possible tax changes, orders and other information suggest little near-term change in business equipment spending. On the whole, however, incoming information since the last meeting of the Committee has been upbeat.

Gramm-Rudman cuts to begin March 1. The court ruling declaring the implementation process of Gramm-Rudman unconstitutional apparently will not affect these cuts but throws into question what will happen on the 1987 budget; fallback procedures in the legislation could well stand although that removes the automaticity of cuts should the Congress fail to meet Gramm-Rudman target deficits. In any event, the staff assumes \$30 billion of additional deficit-reducing actions for FY 1987 which provides a staff deficit estimate appreciably higher than that of the Administration. A part of the difference between the two estimates reflects policy assumptions, but more than half stems from the economic assumptions given the staff's slower growth of nominal GNP.

Nevertheless, the lower panel shows that the budget is a restraining force in the projection. For the first time since 1981 the structural deficit in absolute terms or as a percent of GNP--the red line--moves down somewhat in 1986 and particularly next year.

Chart 3 shows the behavior of various indicators of recent economic activity. The top left panel displays changes in payroll employment; employment in manufacturing rose in the fourth quarter while other employment gains continued large and were unusually sizable in January. Some of the increase in January may be a statistical aberration, but even discounting the figure one is left with a strong picture. Industrial production



JLRichline  
February 11-12, 1986

FOMC CHART SHOW -- INTRODUCTION

During our presentations this afternoon we will be referring to the package of charts distributed to you. The first chart displays the principal assumptions that underlie the staff's economic and financial forecast for 1986 and 1987. For monetary policy, we have assumed M1 growth near 7 percent this year and around 6 percent in 1987. M2 is assumed to grow between 7 and 8 percent in each year. Those assumptions likely provide for some drifting down of interest rates over the course of the projection. For fiscal policy we have assumed deficit-reducing actions of around \$15 billion this fiscal year and an additional \$30 billion for fiscal year 1987. The foreign exchange value of the dollar is expected to move moderately lower over time, with the bulk of the decline behind us. Oil import prices now are assumed to move to about \$20 per barrel and stay in that area during the projection period.

Additional information on the federal budget is displayed in chart 2. The staff and Administration estimates on outlays, receipts, and the deficit are very similar for fiscal year 1986. These estimates include some savings from final actions on the 1986 budget and the first stage of the

cost of seeking devaluation beforehand. These EMS pressures have been exacerbated at times by the weakness of the dollar, which causes additional speculative flows into the German mark.

In summary, Mr. Chairman, during the period since the last Committee meeting, the psychology in the market seems to have shifted. There is a view that the dollar will if anything continue to soften, and there is a lot of attention and interest on whether or when there would be official moves to resist further dollar declines.

would resist any further drop of the dollar. This perception was particularly strong in Japan, and the yen traded steadily around Y200 to the dollar through December and most of January even after plummeting oil prices had led some to predict a higher yen. It was only after Japan's Finance Minister was quoted as suggesting that the Japanese authorities would accept a higher exchange rate that the yen suddenly jumped up toward Y190. The yen did not stop rising even after the Bank of Japan cut its discount rate, until public comments by Governor Sumita led market participants to anticipate official intervention to stop the dollar's fall.

At the same time, exchange market participants have continued to weigh public statements by some U.S. officials pointing to further efforts to lower the dollar. The President's call for a study of the possibility of an international monetary conference has been viewed against this background, and talk of target zones has contributed to apprehension over a possible further decline of the dollar.

Since the January G-5 meeting, analysts seem to have given up expectations that the major countries will agree on joint action to lower interest rates. The recent drop in oil prices is expected to provide a boost to the Japanese and German economies, and has helped relieve pressure for more stimulative action for the time being. Still, central bank officials in both countries acknowledge that they might consider cutting rates further if the dollar becomes too weak, in order to protect their economies' growth prospects. In the case of Germany, the desire to stave off a revaluation of the mark within the EMS is an additional factor that could influence the Bundesbank to cut its lending rates. EMS pressures have increased from time-to-time with the approach of March national elections in France--since most traders believe the present government would not accept the political

Notes for FOMC Meeting  
February 11-12, 1986  
Sam Y. Cross

Since your last meeting the dollar has fallen nearly 6 percent against major Continental currencies and about 7-1/2 against the yen. This means that since around the time of the G-5 meeting in late September the dollar has declined by 18 percent against the mark and nearly 24 percent against the yen (2.90 to 2.37-3/4 DM; Y242 to Y187).

Although the dollar has been buoyed at times by positive economic developments, market sentiment toward the dollar has tended to become more negative. Indeed, the decline of the dollar is all the more noteworthy when viewed against the backdrop of events that normally would support it. The last two months' gains in U.S. employment, which would normally trigger sharp buying of dollars, failed to generate any lasting rise in the dollar. The decline in the price of oil, instead of being seen as a benefit to the dollar because of the effect in slowing inflation and reducing imports, is viewed by market participants as providing a relative benefit to our major competitors and trading partners and helpful to their currencies. Indeed, the severity of the oil price decline was seen as raising questions about the conditions of our banks due to their exposure on lending to the energy sector and to major oil producing LDCs. Also striking was the fact that the dollar continued to ease even on the day the Bank of Japan cut its discount rate by 1/2 percentage point from 5 percent to 4-1/2 percent.

Official attitudes toward the dollar have remained a primary factor in the exchange markets. By mid-December many participants had concluded that the authorities of Japan and Germany were concerned over the domestic impact of their currencies' sharp appreciation and

Finally, I'd like to inform the Committee that the Domestic Desk began trading with an additional dealer on January 23. That was Greenwich Capital Markets, which had been on the primary dealer list for a year and a half. We now have trading relationships with all 36 primary reporting dealers.

Domestic Economic and Financial Outlook

It is clear that there are some significant uncertainties associated with the basic assumptions of our forecast. And the same can be said of many other aspects of the projection. If we are on the right track, though, the economy should experience not only appreciable overall growth in the next two years, but a more balanced expansion as well.

This is reflected in the top panel of chart 5, which shows the percentage point contributions to real GNP growth of selected components. Over the past six quarters, private domestic final purchases--i.e., the sum of consumption, residential construction, and business fixed investment--grew substantially, but declines in inventory investment and net exports held back output growth. Looking ahead, we believe that the inventory correction probably has come to an end and that the external balance should begin to improve.

Inventory investment actually turned upward in the nonfarm business sector at the end of last year, but only because of the unsustainable buildup in auto dealers' stocks. As you can see in the bottom panel, though, stocks outside of the auto sector have reached quite low levels--in manufacturing in particular--and some renewed inventory accumulation should be in prospect. We are not expecting a massive resurgence, given still high real carrying costs, the lack of imminent shortages of goods or materials, and a rather cautious attitude toward sales prospects. But we are anticipating that businesses will want to increase stocks in line with their rising sales.

As indicated at the top of the next chart, we are forecasting moderate gains in real consumer spending. To date in the cyclical upswing, strong demands for autos and other durables have paced an expansion of overall consumer spending that moved well ahead of disposable income growth last year, as may be seen in

the table at the right. In our forecast, income and spending move roughly in parallel, which means that the personal saving rate remains low.

The low saving rate is both a puzzle and a potential risk in our projection. The five-year revision of the national income accounts did turn up some additional income, but--as the middle panel shows--it was not enough to bring the saving rate back into line with historical norms. Later benchmarkings may well uncover more income, but there were some developments last year that could have depressed the saving rate. Among these are the weakness of interest income and the plunge in farm income; the evidence is that spending adjusts less in the short run to changes in these income categories than to changes in labor income. In addition, wealth has been rising strongly, owing to the stock and bond rallies; this not only may have boosted spending relative to current income last year, but, barring a major market reversal, it should buoy consumption this year as well, given the normal lags.

To be sure, the spectacular climb in consumer debt that has helped finance all this spending evidently has been more than some households could handle, and this is reflected in rising installment loan delinquencies, such as for auto paper at the lower left. Nonetheless, rising incomes and asset values have kept consumer sentiment regarding personal financial trends predominantly on the plus side. Moreover, there is no indication that lenders are becoming less willing to provide finance. Thus, while the high debt level and low saving rate are troubling, we are not looking for any significant retrenchment in spending.

On a more affirmative note, we are projecting appreciable improvement in housing construction, portrayed in the next chart. Overall starts are expected to rise considerably, with the gain centered in the single-family market. As

the middle left panel shows, the combination of rising incomes, declining interest rates, and limited price increases on average has made homes much more affordable.

Of course, one of the disappointments of 1985 was the flatness of housing construction in the face of a sizable drop in interest rates. At least two factors may help explain why housing activity has not exhibited a stronger response. First, as suggested by the survey data at the right, the softness of home prices in many locales has reduced the feeling that one needs to buy now because prices will be going up; in effect, the perceived real mortgage rates may not have dropped as much as nominal rates. A second factor is the tightening of various non-rate terms--including the reduced availability of low downpayment conventional mortgages, shown at the bottom left. Although, in all likelihood, these forces will remain in the market, they probably will not increase in intensity. As Jim Kichline noted, home sales have in fact perked up recently, and, in our view, the lagged effects of the recent sizable drop in mortgage rates and the further decline anticipated--combined with favorable demographics--will push single-family building upward in the months ahead. In contrast, though, reduced tax-exempt financing and substantial overbuilding of multi-family structures in many markets--reflected in the high rental vacancy rate at the right--will put a damper on that segment of the market.

Deep crosscurrents are no less apparent in nonresidential investment. As the top panels of the next chart indicate, we are projecting a small increase in real business fixed investment this year, followed by somewhat stronger growth in 1987. You will recall that surveys of '86 capital spending plans taken last fall depicted a weaker performance than we are forecasting. In light of the limited growth of overall output and the declining level of



capacity utilization in the industrial sector, plotted at the left, some slackening in investment growth was to be expected. The prospect of tax reform measures also may have had a negative impact on spending plans.

The tax reform picture unfortunately has yet to clarify, but a few recent developments could underpin a better investment performance. One is the continued depreciation of the dollar and the resultant improvement in the sales prospects of domestic producers; the greater competitiveness of our industrial sector should contribute to a small rise in capacity utilization. Another plus is the effect of the securities market rally on the cost of capital, charted at the right. In our forecast, there is some further decline in capital costs, though, of course, businessmen's calculations in this regard will be influenced importantly by their perceptions of potential tax law changes.

These considerations on the whole suggest to us that, as has happened in the past, the surveys will prove to have underpredicted capital spending. There will, however, be areas of weakness. It will come as no surprise that, under our assumptions, investment in oil production is projected to be soft. Drilling activity has been supported until recently by declining drilling costs, by desires to get oil out of the ground and perhaps by efforts to beat tax law changes. In the current environment, however, we expect that the decline in exploration reflected in the seismic crew figures at the lower left will presage lower outlays in this important component of structures. We also expect that high vacancy rates will cut into office building, although the behavior of contracts suggests that no near-term collapse in actual outlays is likely. Other categories of structures may be more buoyant than these, but it is the continued desire to replace outmoded equipment that should provide the basic thrust to investment in the next two years.

On the financial side, summarized in the next chart, conditions in the business sector appear generally supportive of rising investment. Operating profits, in the top panel, did very well in the aggregate in the face of the slowdown in economic expansion--in part reflecting the strenuous efforts to reduce costs and lower breakeven points. We see a flattening in profits in 1986-87, but with rising cash flow from depreciation, it should be possible to finance the bulk of outlays for inventories and fixed capital out of internally generated funds, as indicated in the middle panel. Borrowing is projected to remain sizable, because we have assumed that the substitution of debt for equity in connection with mergers, buyouts, and restructurings will diminish only slowly. There is an obvious risk in this pattern of finance, which has dramatically weakened the balance sheets of a good many companies. However, as shown at the right, nonfinancial corporations as a group have reaped major benefits in terms of a reduced interest payment burdens as rates have declined and they have refinanced at lower cost.

One might say that, in our forecast, private capital formation is being "crowded in" by the retrenchment in the government sector (against a backdrop of accommodative monetary policy). The upper panel of the next chart shows that federal purchases of goods and services are slated, under our policy assumptions, to decline substantially in real terms during this calendar year after having been boosted the last half of 1985 by strong increases in defense and CCC outlays; purchases will then level out in 1987. State and local government purchases also appear likely to be restrained: even with the slow spending growth we have projected, it is probable that many units will be struggling to balance their budgets--needing to raise taxes in many cases to

offset the loss of federal grants and oil-related revenues. In the near term, the deterioration of the operating and capital account balance of states and localities is great enough to offset the steady growth of the trust funds for employee retirement benefits.

The top panel of the next chart pulls together the projected sectoral surpluses and deficits in a way that reveals again the departure from the patterns of the past several years that is implied by the assumed fiscal restraint and dollar depreciation. As you can see, both the combined government sector and net foreign investment are expected to begin moving back toward balance. The share of total private saving drifts downward a bit, reflecting declining retained earnings and weak personal saving, but it remains within the historical range--as does private investment, which edges up.

The reduction in the federal deficit helps retard the growth of total debt in the economy. However, as plotted below, the ratio of domestic nonfinancial sector debt to GNP is projected to rise considerably further. Business debt growth is expected to remain sizable, as I noted earlier. And household borrowing remains heavy, too, as mortgage credit use picks up while consumer installment debt decelerates.

The willingness and ability of households to continue borrowing and spending depends, of course, on satisfactory employment conditions. In the next chart you can see that we are projecting continued strong growth in total employment, with the manufacturing sector sharing modestly in the gains.

The growth in domestic output is showing through quite strongly in employment because we have assumed only a small pickup in the trend rate of productivity growth--to a shade over 1 percent a year. The recent revisions of GNP

and employment data suggest that, when one strips away the cyclical element in productivity, the underlying trend in output per hour during the first half of the '80s was only around 3/4 percent per annum. We can see demographic and other reasons for expecting some improvement, but that improvement is overdue and we are wary of forecasting a marked takeoff.

This productivity assumption has significant implications for business cost trends. In the next two years, we would expect to see some acceleration in hourly compensation, as the greater pressure in labor markets associated with a declining unemployment rate causes real wages to firm up. However, the renewed rise in productivity more than offsets the impact of greater wage gains on unit labor costs in 1986 and holds the cost rise to 4 percent next year.

The implications for prices are indicated in the next chart. The top panels highlight some special factors in the outlook. At the left, you can see that a bigger consumer food price increase is expected this year, owing to recent developments in the meat and coffee markets. However, the anticipated decrease in world oil prices should produce a more than offsetting decline in consumer energy prices. It should be recalled, however, that the oil price drop has a bigger impact on price measures relating to domestic consumption than on those relating to total domestic output. Moreover, the dollar depreciation we have assumed will be putting upward pressure on the prices of nonpetroleum imports and easing competitive pressures on domestic firms. Thus, all things considered, we are projecting a slight acceleration in GNP prices over the next two years.

Ted Truman will now discuss the international aspects of our forecast.

E.M. Truman  
February 11, 1986

FOMC CHART SHOW -- International Development

As is shown in the top panel of chart 14, the U.S. dollar has been declining for almost a year on a weighted-average basis against the other G-10 countries' currencies. The dollar's decline since the end of February last year has been about 25 percent; less than half of that decline has occurred in the four and a half months since last September's G-5 announcement.

As can be seen in the lower panel, the dollar's decline appears to have been influenced by a reduction in U.S. real long-term interest rates relative to the average of such rates in foreign industrial countries. The peak in the differential pre-dated the peak in the dollar. Nevertheless, the differential narrowed significantly further during the past year; most of the movement was generated by declines in dollar interest rates that can be attributed in large part to changes in the outlook for the U.S. economy.

As Jim Kichline indicated in his introduction, we have incorporated into our projection a further decline of the dollar but at a much more moderate rate than we have seen over the past year. Nonetheless, the decline that has already occurred is one of the key factors affecting our outlook.

As can be seen in the top panels of the next chart, the dollar's movement has already begun to influence comparative price developments here and abroad. The left-hand panel indicates that at the end of last year not only did U.S. wholesale prices begin to accelerate

a bit -- the black line -- but they did so at a time when wholesale price inflation was continuing to moderate in other major industrial countries -- the red line.

The right-hand panel focuses on the subset of commodities included in the Economist's index of commodity prices. The black line shows the index of those prices expressed in dollars; on this basis, the index -- helped along by sharp increases in coffee prices -- has shown positive year-over-year changes for the past two months. However, translated into foreign currencies -- the red line again -- the index has continued to record substantial year-over-year declines.

One commodity not included in the Economist's index is oil. As you can see from the red line in the bottom panel, the U.S. oil import price expressed in dollars has been declining gradually since the second quarter of 1981. Through 1985, the decline had cumulated to more than 25 percent. However, as shown by the black line, oil prices in foreign currencies actually increased by about 10 percent through mid-1985, though they subsequently have declined rapidly as the dollar has depreciated.

One of the major uncertainties in our forecast concerns at what level -- I could say whether -- U.S. oil import prices will stabilize. We are assuming that they will stabilize at around \$20 per barrel; this assumption is based on a judgment that OPEC crude oil production this year will average close to 18 million barrels per day -- up from about 16-1/2 million barrels per day last year -- with Saudi Arabia and Iraq supplying most of the expected increase.

The upper left-hand panel of Chart 16 summarizes some of the economic implications of these commodity price trends. We expect that consumer price inflation in the foreign industrial countries -- shown by the red bars in the upper left-hand panel -- will record a further substantial reduction this year but will not be significantly lower on average than in the United States. The primary reason is that the lower price of crude petroleum has a relatively larger impact on consumer price inflation in this country than abroad because of our heavier use of energy and the lower contribution of taxes to the energy prices consumers face. Moreover, the average for the foreign countries obscures the fact that in several of them -- Germany and Japan in particular -- consumer price inflation this year is expected to be less than 1-1/2 percent. In 1987, after the effects of lower oil prices are largely behind us, the influence on U.S. inflation of the dollar's depreciation dominates, and U.S. inflation is expected to pick up significantly relative to inflation abroad.

With respect to economic activity in the foreign industrial countries -- the right-hand panel -- we are projecting that the average pace of economic expansion during the next two years will not differ significantly from the three percent rate recorded during the past two years, despite the favorable effects of lower oil prices. This year, we are expecting a pick-up in growth in continental Europe to offset slower growth in Japan, Canada and the United Kingdom.

In contrast to the rather stable average rate of economic growth expected for the industrial countries, we have built into our forecast an assumption that the non-OPEC developing countries, helped by

Secretary Baker's "Program for Sustained Growth," will be able to achieve more rapid growth over the forecast period, as can be seen in the middle panel. This faster growth should be facilitated by the availability of additional external financing which should permit these countries to cover somewhat enlarged trade and current account deficits -- shown in the lower panel.

Turning to the influence of these various factors on the U.S. external accounts, the upper panels in chart 17 show that prices of U.S. exports of nonagricultural and agricultural products have declined relative to the average price level -- measured in dollars -- in foreign industrial countries. Our competitive position is expected to continue to improve in 1986 and 1987. As can be seen in the lower left-hand panel, this trend in price competitiveness should begin to have positive effects on the volume and value of our non-agricultural exports by the middle of 1986.

However, the lower right-hand panel shows that we do not expect a similar recovery in the volume of our agricultural exports. The lower dollar and lower U.S. agricultural support prices should arrest the decline in our agricultural exports that we have seen during the past five years, but in the face of ample supplies abroad these factors are not projected to produce any significant reversal of that deterioration.

Non-oil imports are depicted in the next chart. As can be seen in the top panel, the depreciation of the dollar is projected to push up the average price of these goods relative to the domestic price level.



In the second half of this year and in 1987, these higher prices are projected to slow growth in the volume of non-oil imports -- the red line in the bottom panel. The higher prices of these imports are a necessary part of the adjustment process and, indeed, set it in motion. However, they also will help to maintain the growth in the value of such imports at close to a 10 percent annual rate through the end of the projection period.

This differential movement of import volumes and values has a strong influence on the contour of our external projection that is presented in chart 19. Given the similar rates of economic expansion expected here and abroad, the projected increases in the dollar prices of our non-oil imports, and the normal lagged response of quantities of both imports and exports to price incentives, we are projecting, in the top panel, no improvement this year in our trade and current account deficits compared with the second half of last year. We are projecting a perceptible improvement in 1987.

Our trade and current account deficits are conventionally analyzed in terms of current-dollar magnitudes. In contrast, much of the focus in the GNP accounts is on real net exports of goods and services -- shown in the lower panel. In these terms, as Mike Prell has already noted, we are projecting a significant positive impetus to growth by the second half of this year and an even larger contribution in 1987.

This overall projection appears to be consistent with the information provided by the Reserve Banks in their recent "theme report" on the dollar's depreciation. It is not surprising that the respondents

did not identify uniformly significant influences from the dollar's depreciation to date; the process of economic adjustment involves institutional lags, and there are many differences in circumstances across firms and industries. What I believe is noteworthy in the report is the sense that the climate has changed over the past twelve months. The survey essentially describes an inflection point that can also be seen in the aggregate statistics: prices of non-oil imports have begun to rise -- or decline less rapidly -- and the quantities of such imports have begun to decelerate.

The last international chart provides an overview of U.S. capital account transactions. Comparing 1984 and 1985, we estimate that recorded increases in private capital inflows (line 2), especially through net purchases of U.S. bonds and stocks, more than covered the increase last year in the U.S. current account deficit. The major change in the pattern of U.S. capital account transactions that we now anticipate for 1986 is a shift in official transactions (line 6). We expect that the substantial U.S. and foreign intervention sales of dollars in 1985 will be replaced by a moderate accumulation this year.

Jim Kichline will now complete our presentation.

JLKichline  
February 11-12, 1986

### FOMC CHART SHOW -- CONCLUSION

A good deal of uncertainty surrounds the staff's economic projection given the underlying assumptions, but one could also question the assumptions themselves. In chart 21 are displayed illustrative impacts of alternative assumptions for money growth, oil prices, and fiscal policy. For purposes of this exercise the impacts are thought to be roughly symmetrical, that is lower money growth would provide about the same impacts of opposite sign as those with higher money growth. That need not always be the case, of course, and the oil price is of particular interest since a further plunge in oil prices could produce severe economic and financial dislocations with uncertain outcomes for the aggregate economy.

In any event an easier monetary policy as indexed by M1 growth 1-1/2 percent higher than in the staff forecast could have a powerful effect on real growth. However, the effect wanes over time as increased pressure on labor and capital resources brings with it much higher inflation, with the deflator in 1988 rising at a rate 2-1/2 percent higher than otherwise. Lower oil prices have much different effects. A \$5 per barrel reduction in oil prices is thought to lead to a reduction in prices of about 1/2 percent in both 1986 and 1987 and an equivalent increase in real GNP. Those immediate effects wear out, however, and the change

in prices and real growth are negligible in 1988. Less fiscal restraint also would act to stimulate real GNP in the short run, but would eventually entail greater pressures on resources, higher interest rates and prices, and in 1988 a slower growth rate.

The last chart in the package displays economic forecasts of Board members, presidents, staff, and the Administration. The lower panel displays the 1986 forecast reported to the Congress last July. In general the various forecasts are similar although FOMC forecasts are weighted toward somewhat less real growth than the Administration projection. On the GNP deflator, FOMC projections are clustered at or below the Administration. Compared to the projection prepared in July, forecasts of real GNP have moved up a bit while inflation estimates have moved lower.

\* \* \* \* \*

STRICTLY CONFIDENTIAL (FR) CLASS I-FOMC

*Materials for  
Staff Presentation to the  
Federal Open Market Committee*

*February 11, 1986*

## **Principal Assumptions**

### **Monetary Policy**

- Growth of M1 near 7 percent in 1986 and around 6 percent in 1987.
- Growth of M2 in the range of 7 to 8 percent in 1986 and 1987.

### **Fiscal Policy**

- Deficit-reducing actions of about \$15 billion for FY 1986 budget and an additional \$30 billion for FY 1987 budget.

### **Foreign Exchange Value of the Dollar**

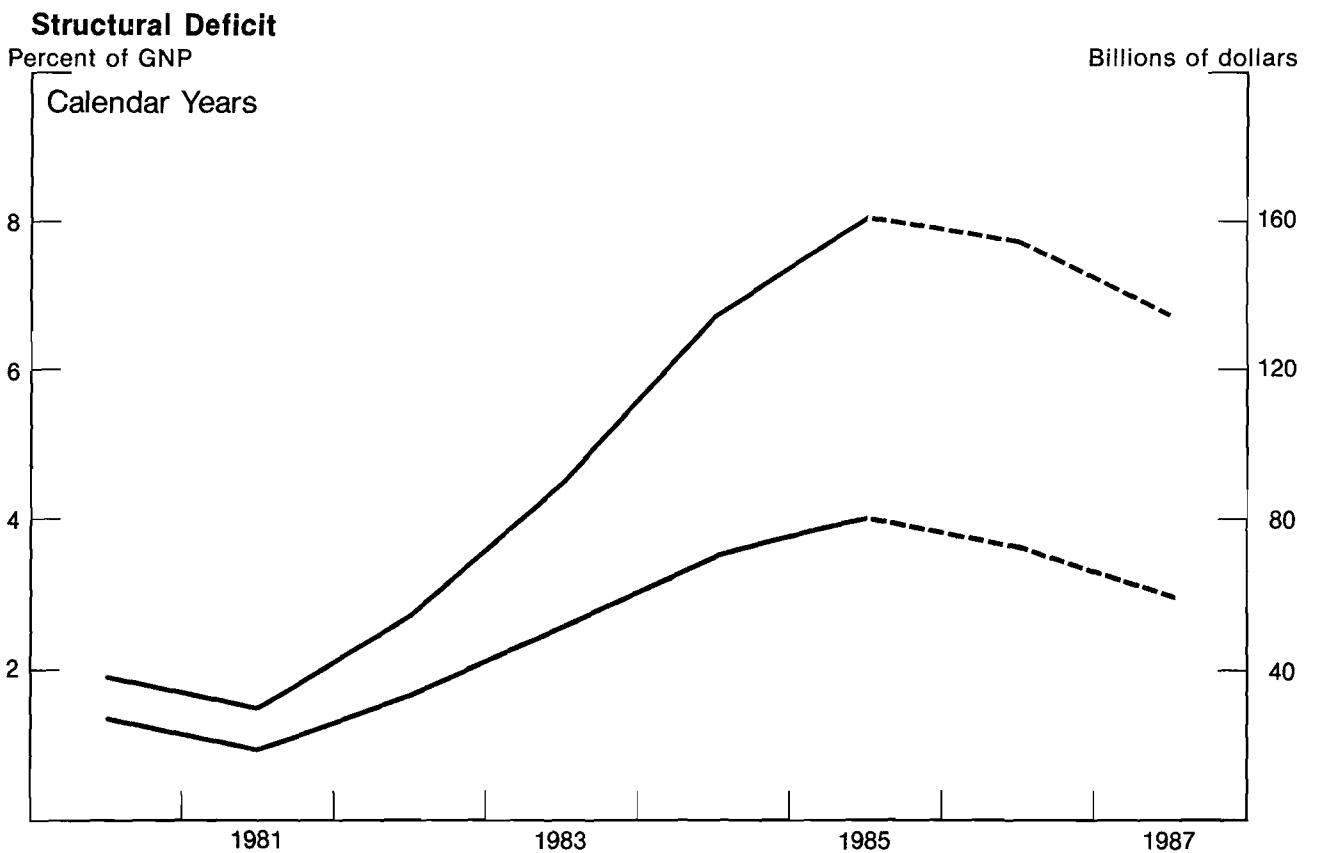
- Moderate further decline over the course of the projection.

### **Oil Prices**

- Oil import prices average around \$20 per barrel in 1986 and 1987.

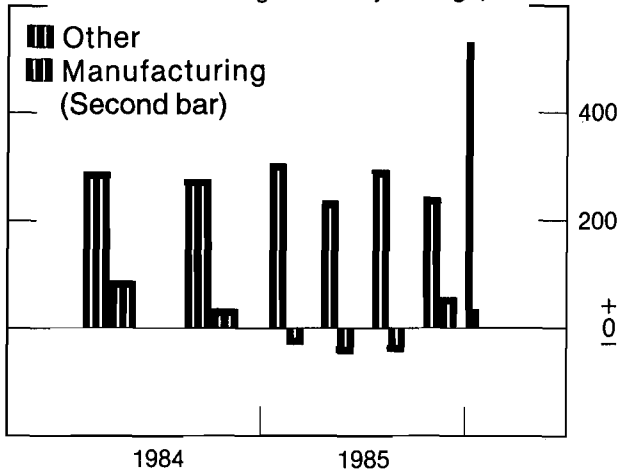
**Federal Budget, Fiscal Years**

	<u>1985</u> Actual	<u>1986</u> Staff Administration		<u>1987</u> Staff Administration	
Outlays	946	978	980	1,001	994
Receipts	734	777	777	834	850
Deficit	212	201	203	167	144



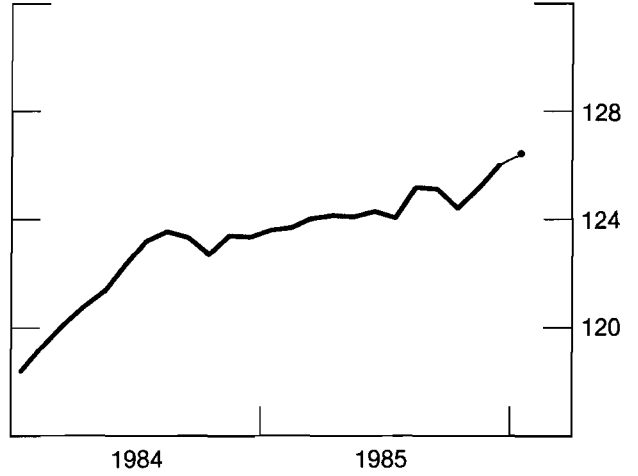
### Nonfarm Employment

Average monthly change, thousands



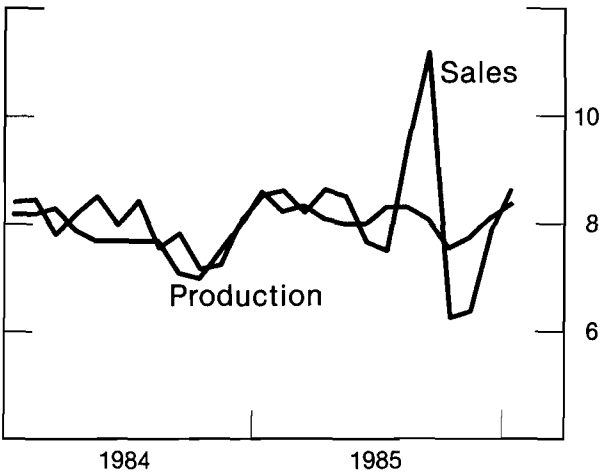
### Industrial Production

Index 1977 = 100



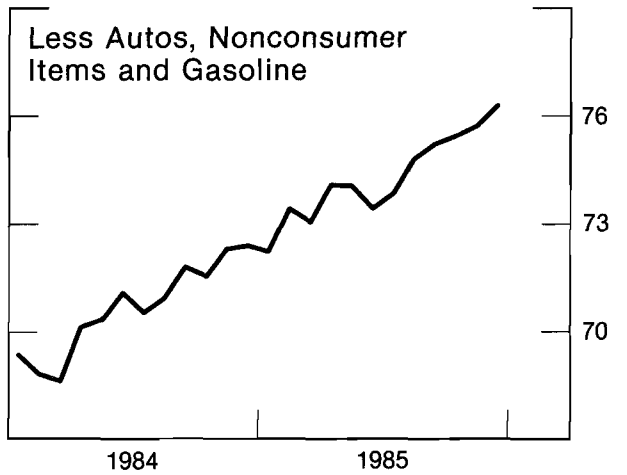
### Domestic Auto Sales and Production

Millions of units



### Retail Sales

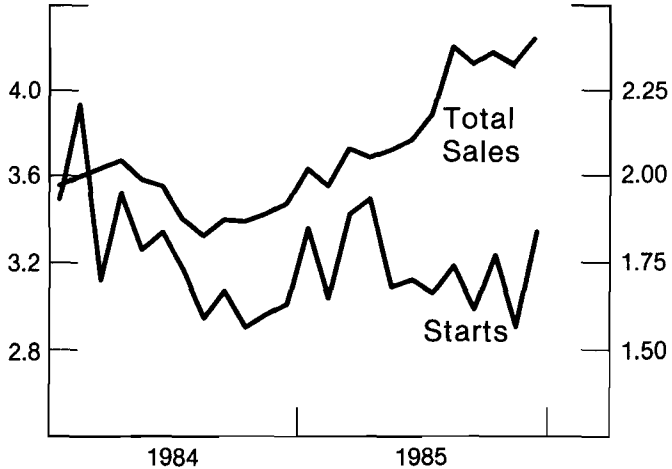
Billions of dollars



### Housing Starts and Sales

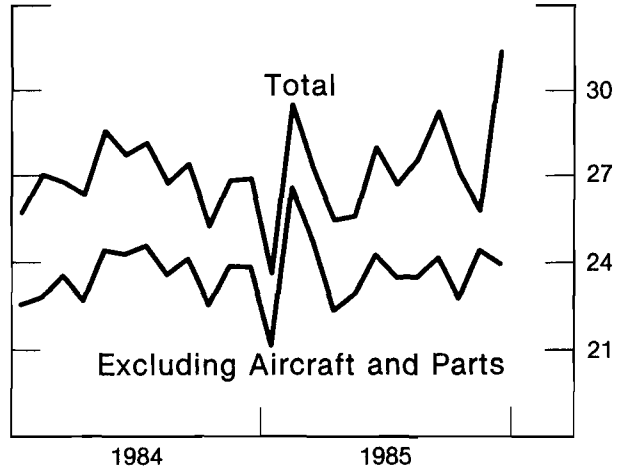
Millions of units

Millions of units



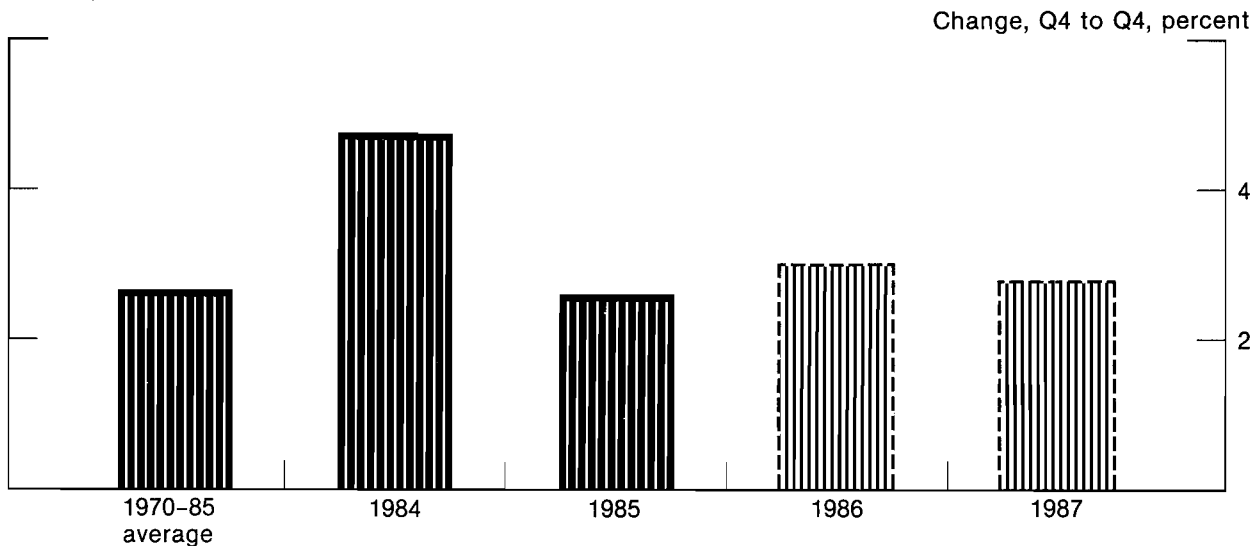
### New Orders for Nondefense Capital Goods

Billions of dollars

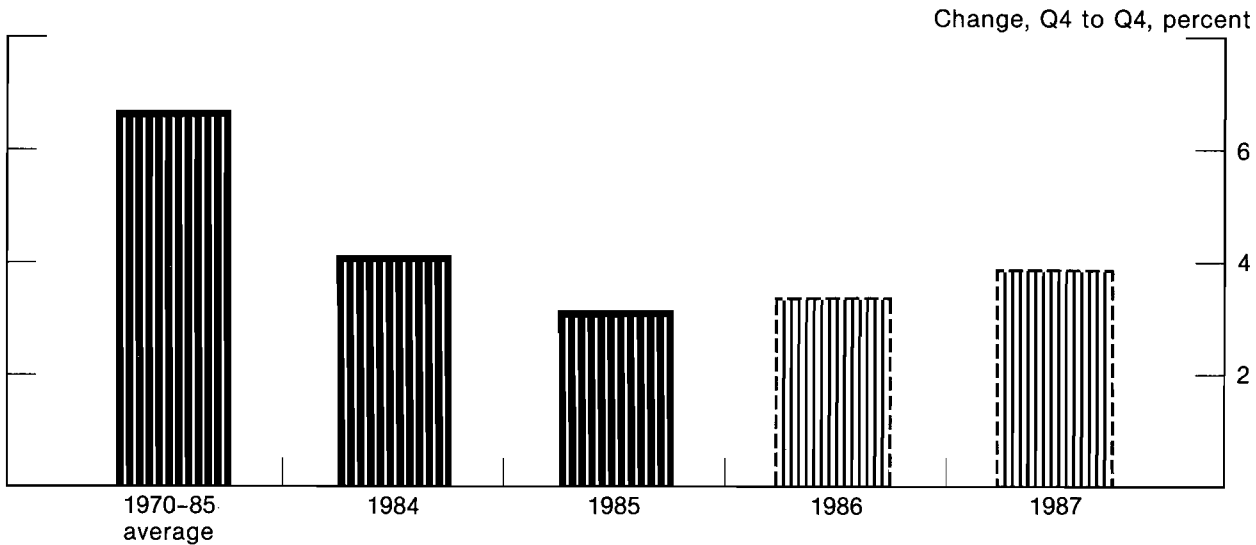




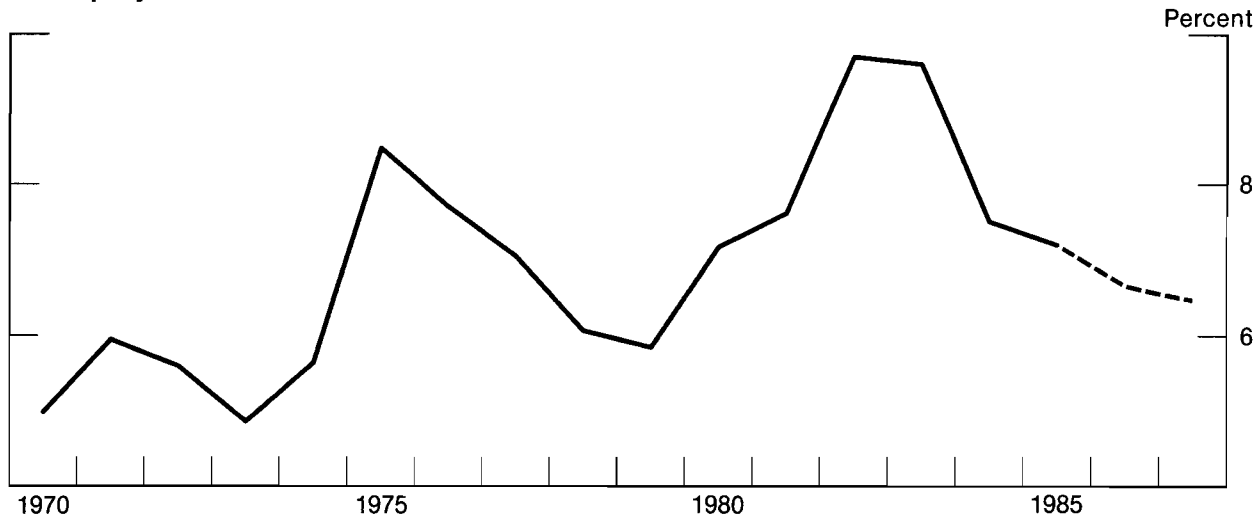
### Real GNP



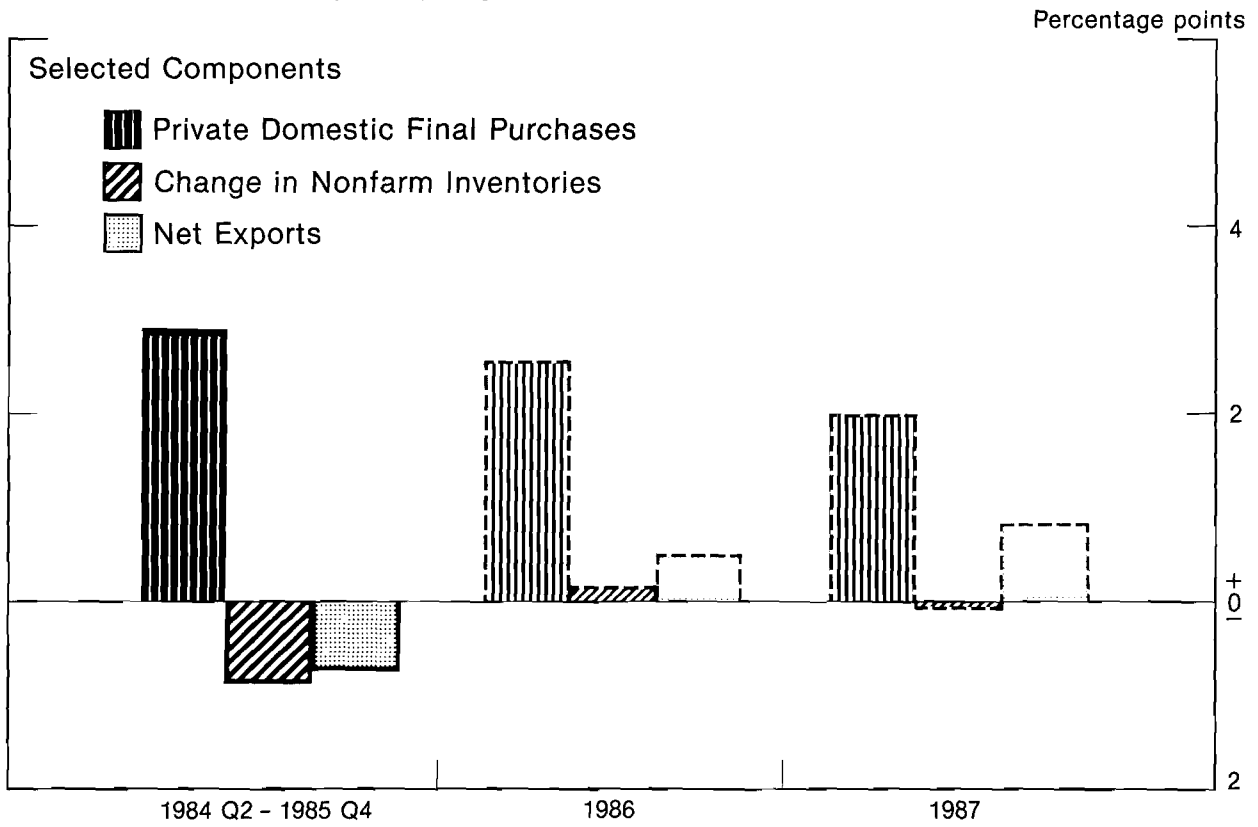
### GNP Deflator



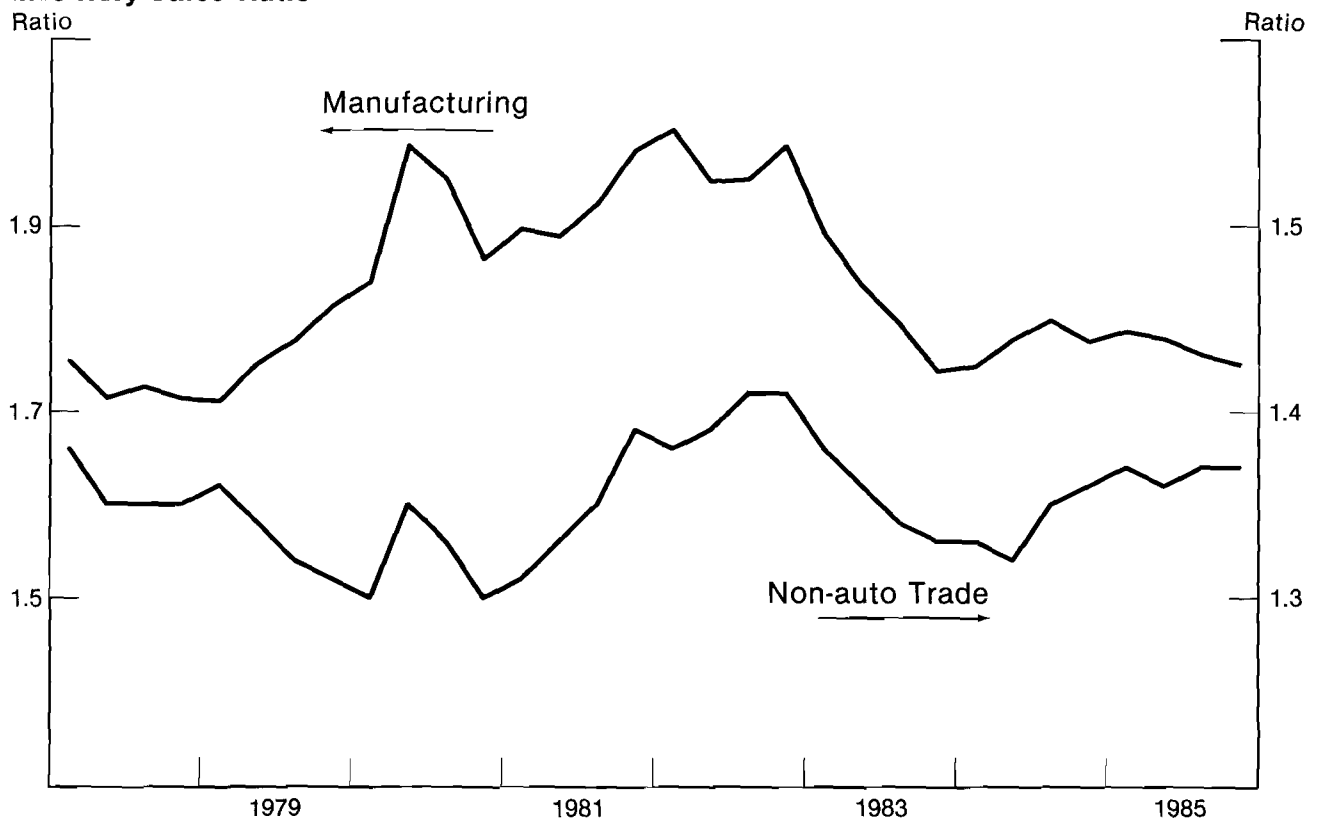
### Unemployment Rate



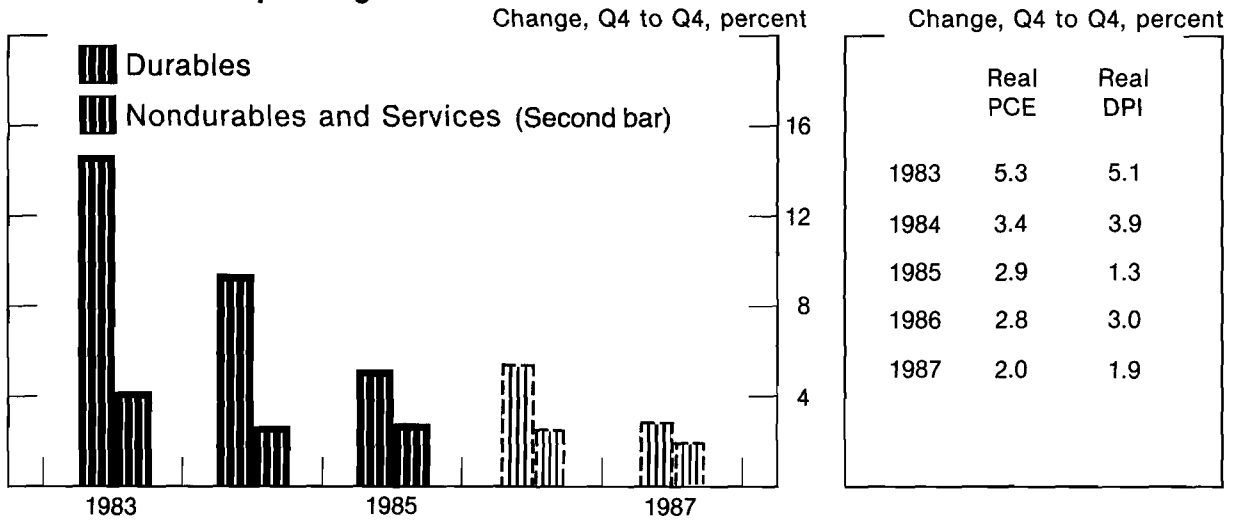
### Contributions to Real GNP Growth



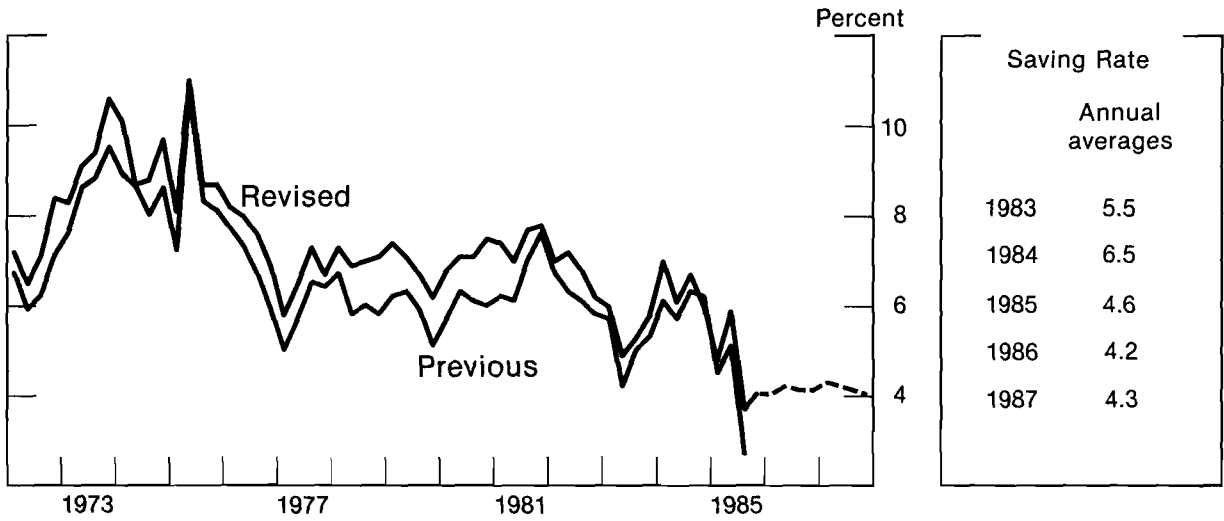
### Inventory-Sales Ratio



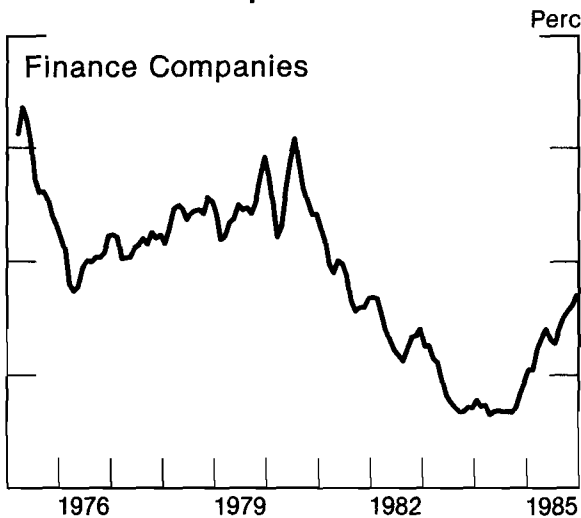
### Real Consumer Spending



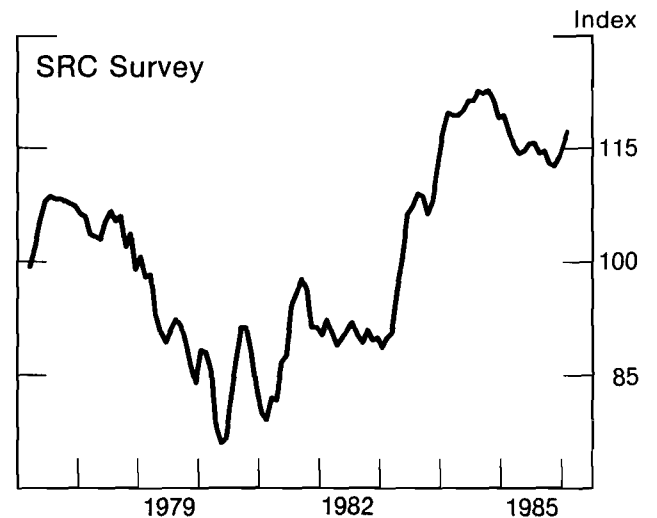
### Personal Saving Rate



### Auto Loan Delinquencies

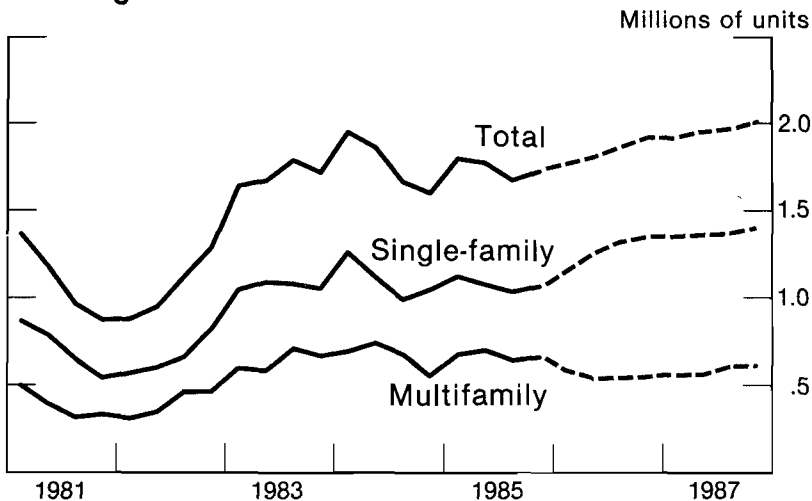


### Current Financial Situation\*



\*Compared to a year ago. Better minus worse plus 100.

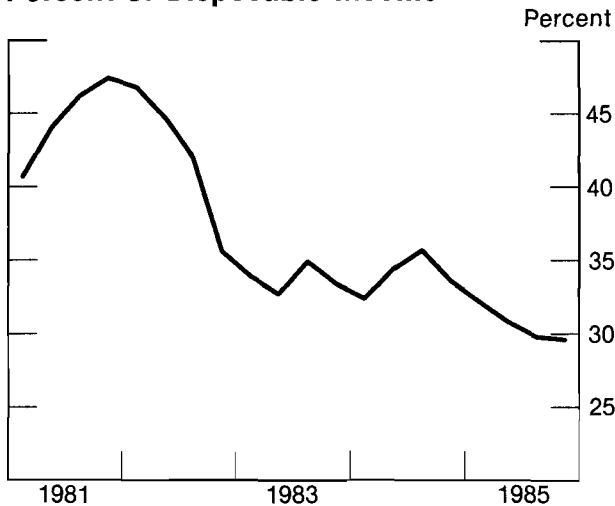
**Housing Starts**



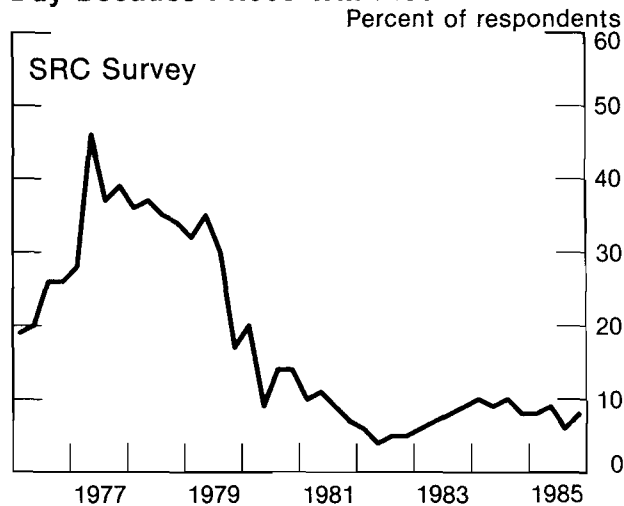
**Total Starts**

Year	Millions of units
1983	1.70
1984	1.77
1985	1.74
1986	1.82
1987	1.96

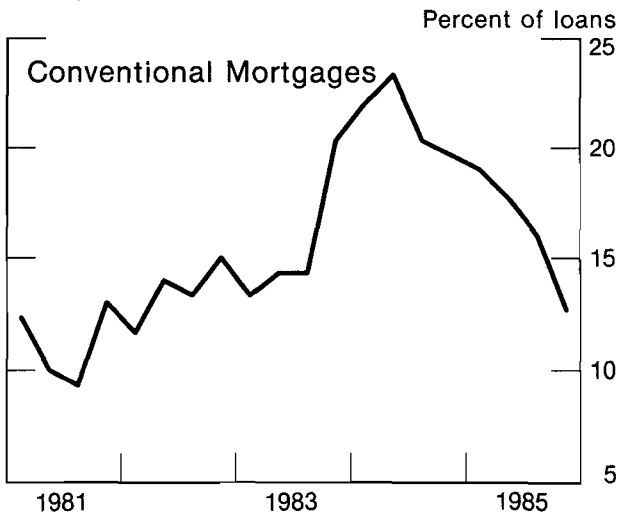
**Mortgage Payment as Percent of Disposable Income**



**Buy Because Prices Will Rise**



**Loan/Value Greater Than 90%**



**Rental Vacancy Rate**

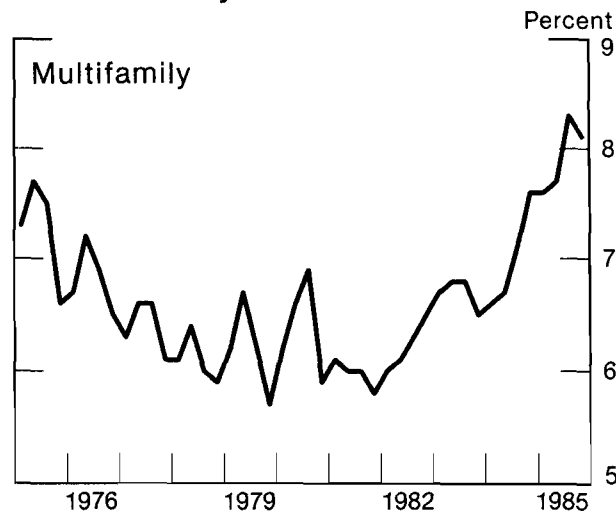
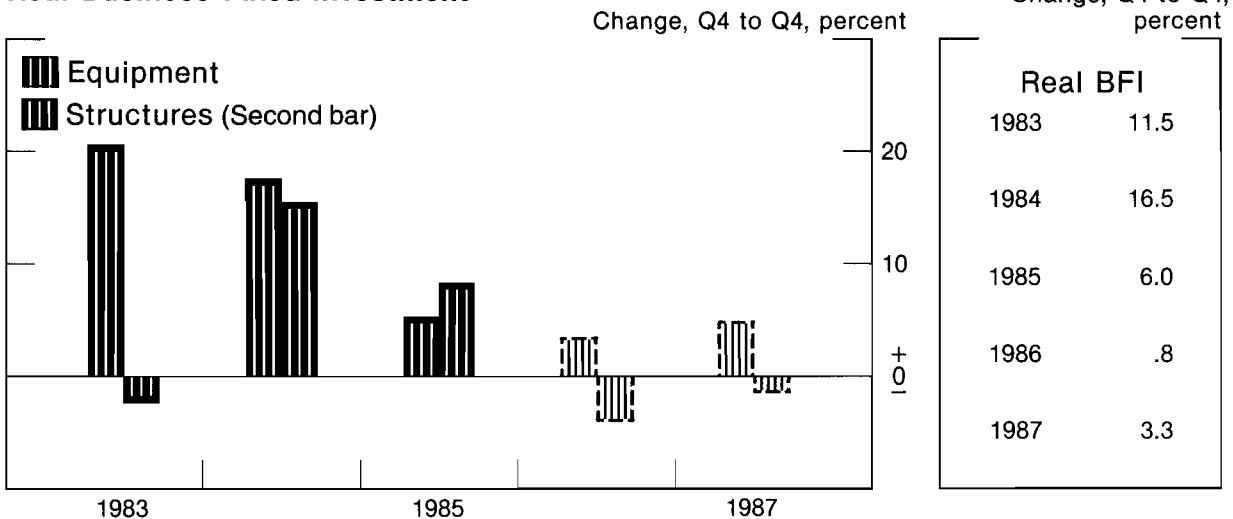
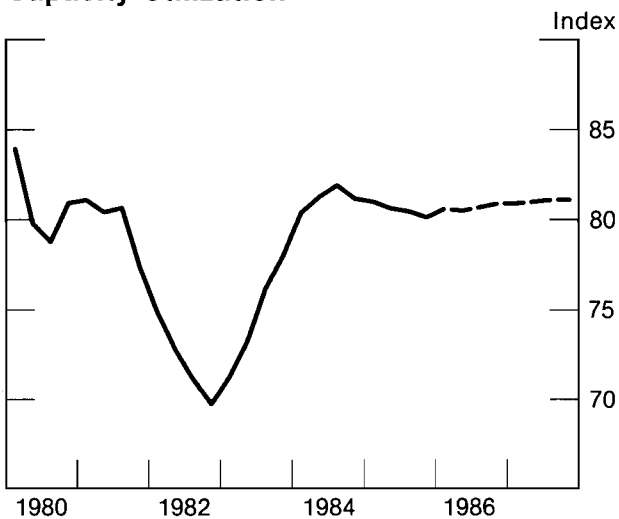


Chart 8

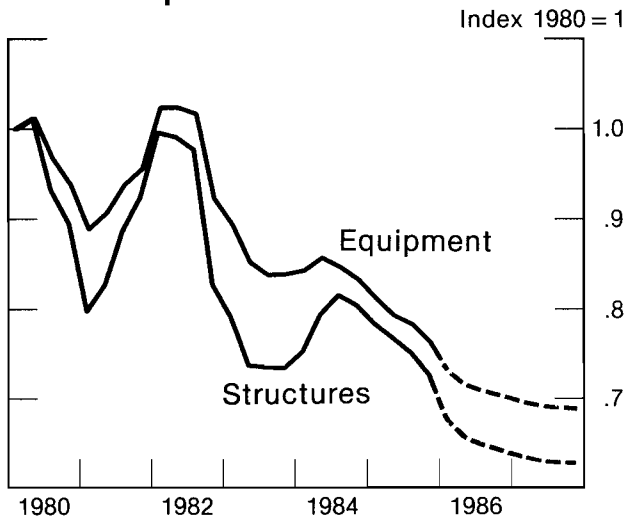
### Real Business Fixed Investment



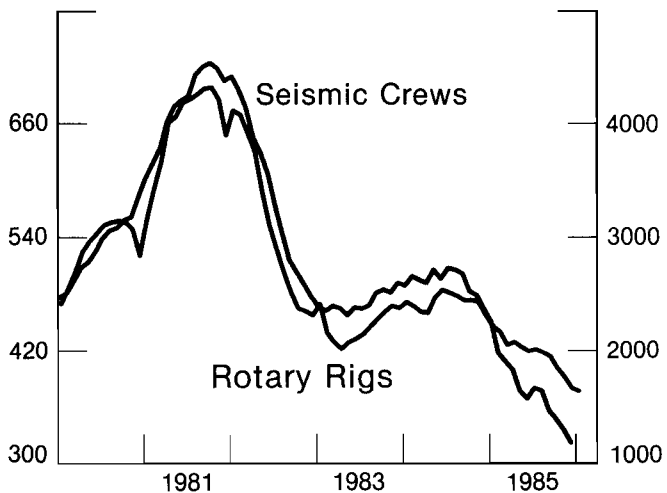
### Capacity Utilization



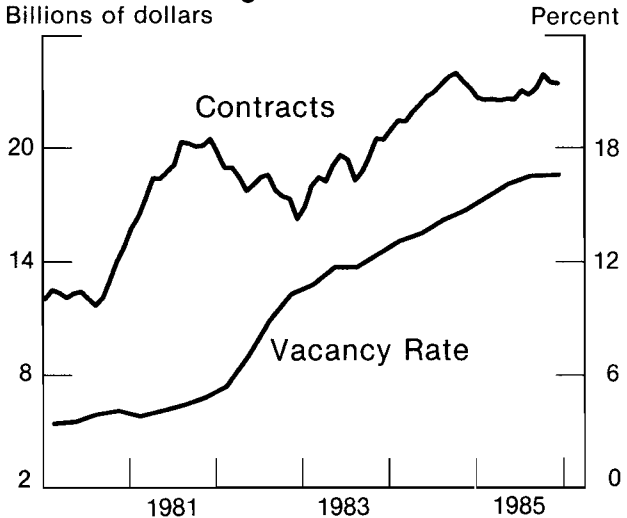
### Cost of Capital



### Oil Drilling

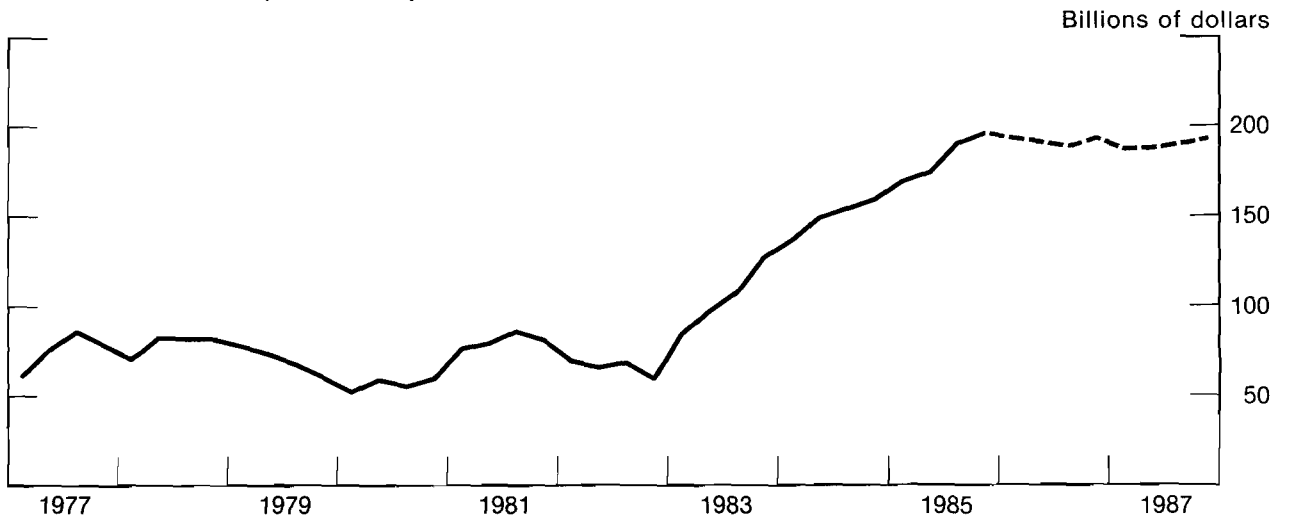


### Office Building

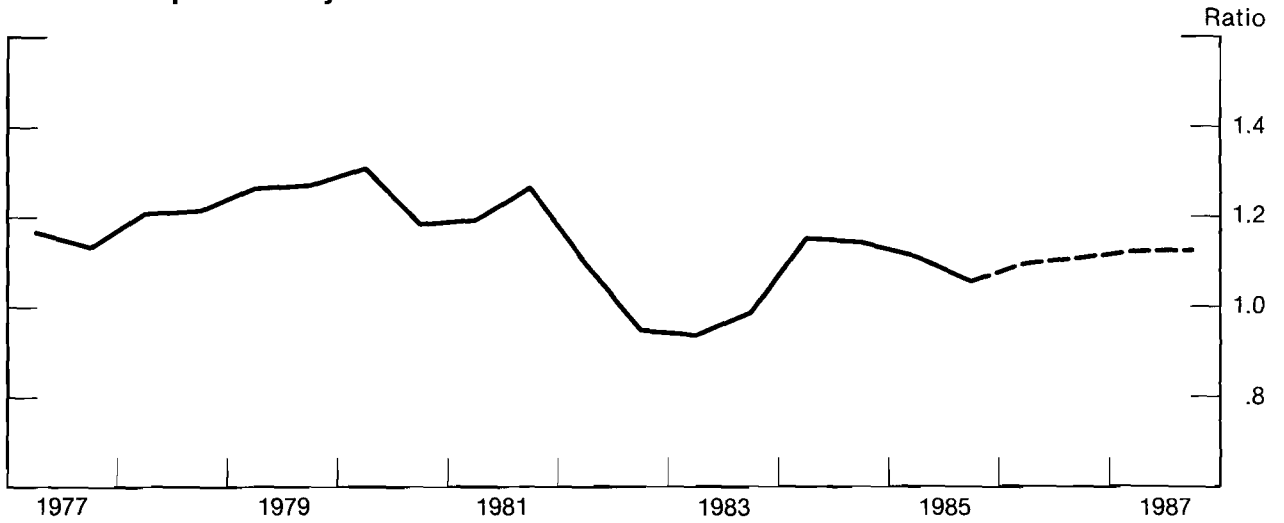


# Nonfinancial Corporations

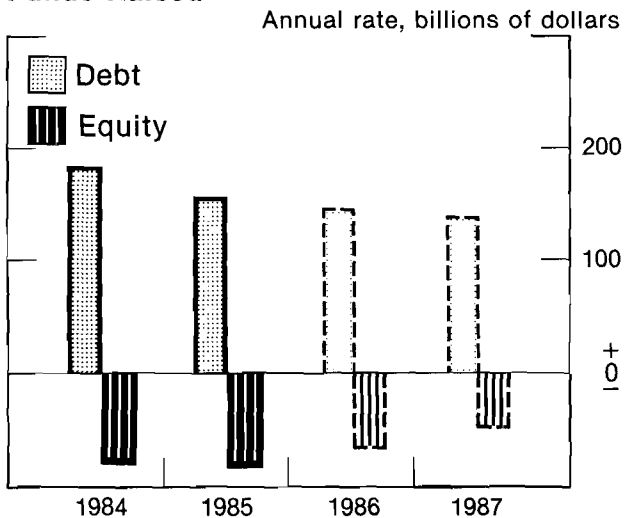
**Profits After Tax (Economic)**



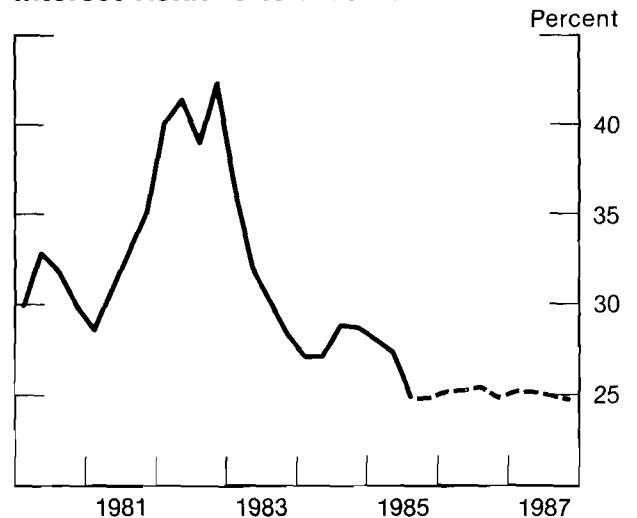
**Ratio of Capital Outlays to Internal Funds**



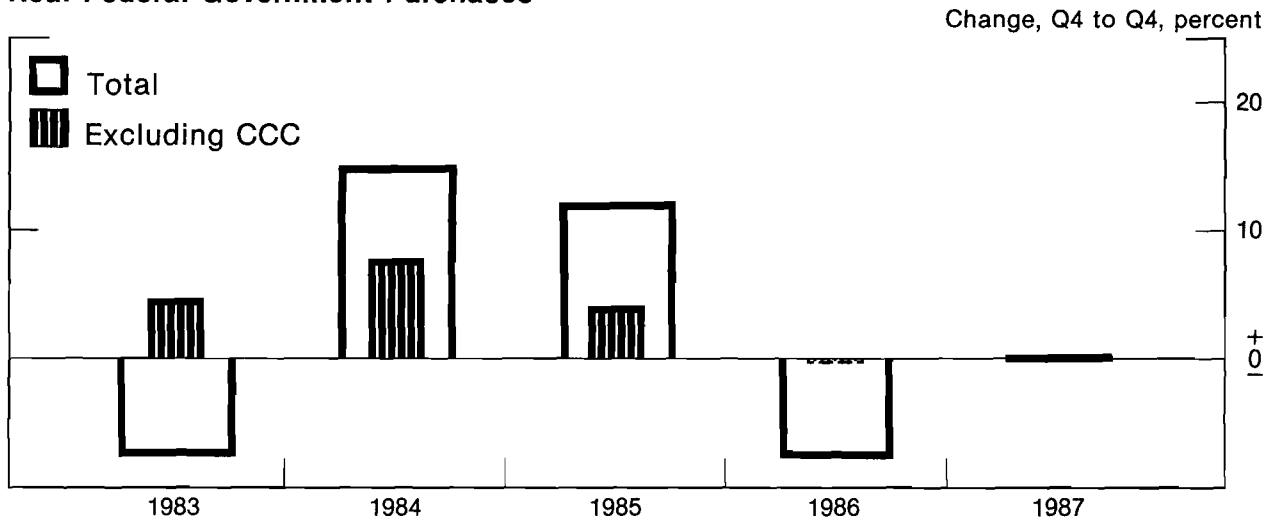
**Funds Raised**



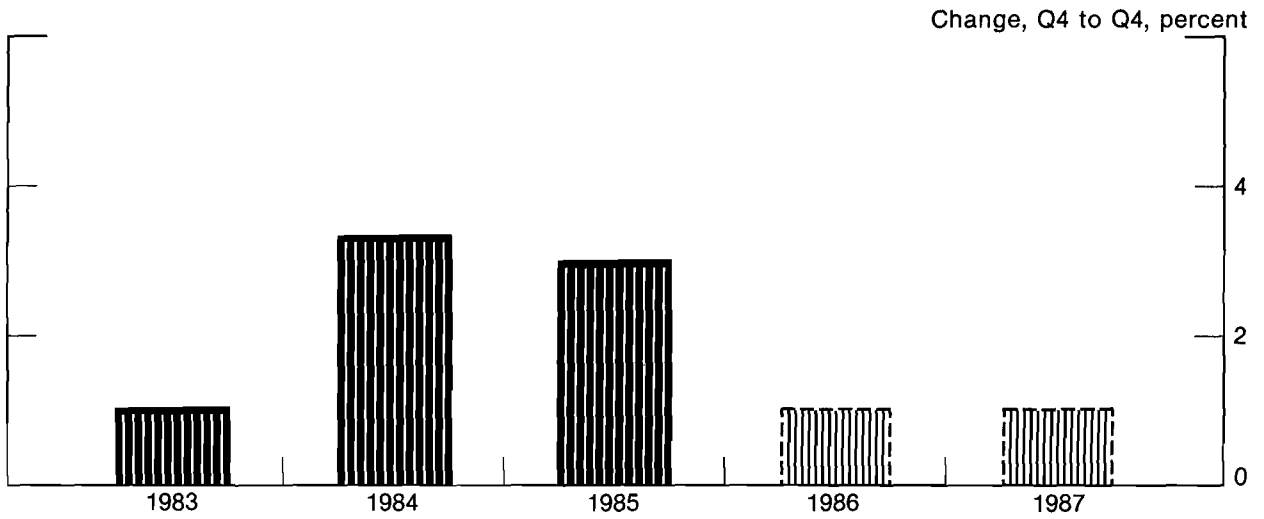
**Interest Relative to Income**



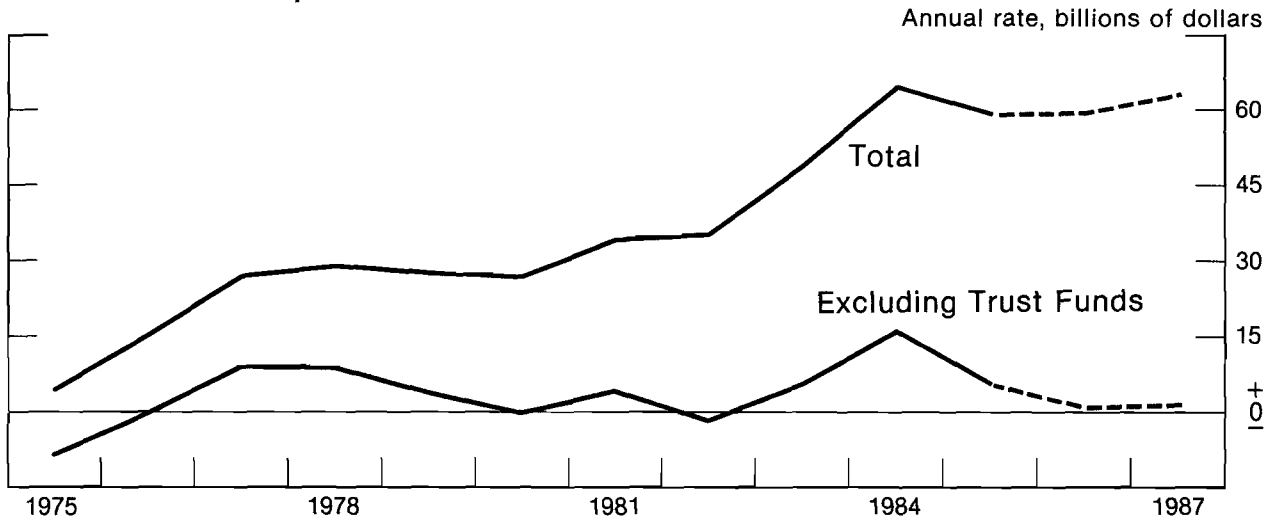
### Real Federal Government Purchases



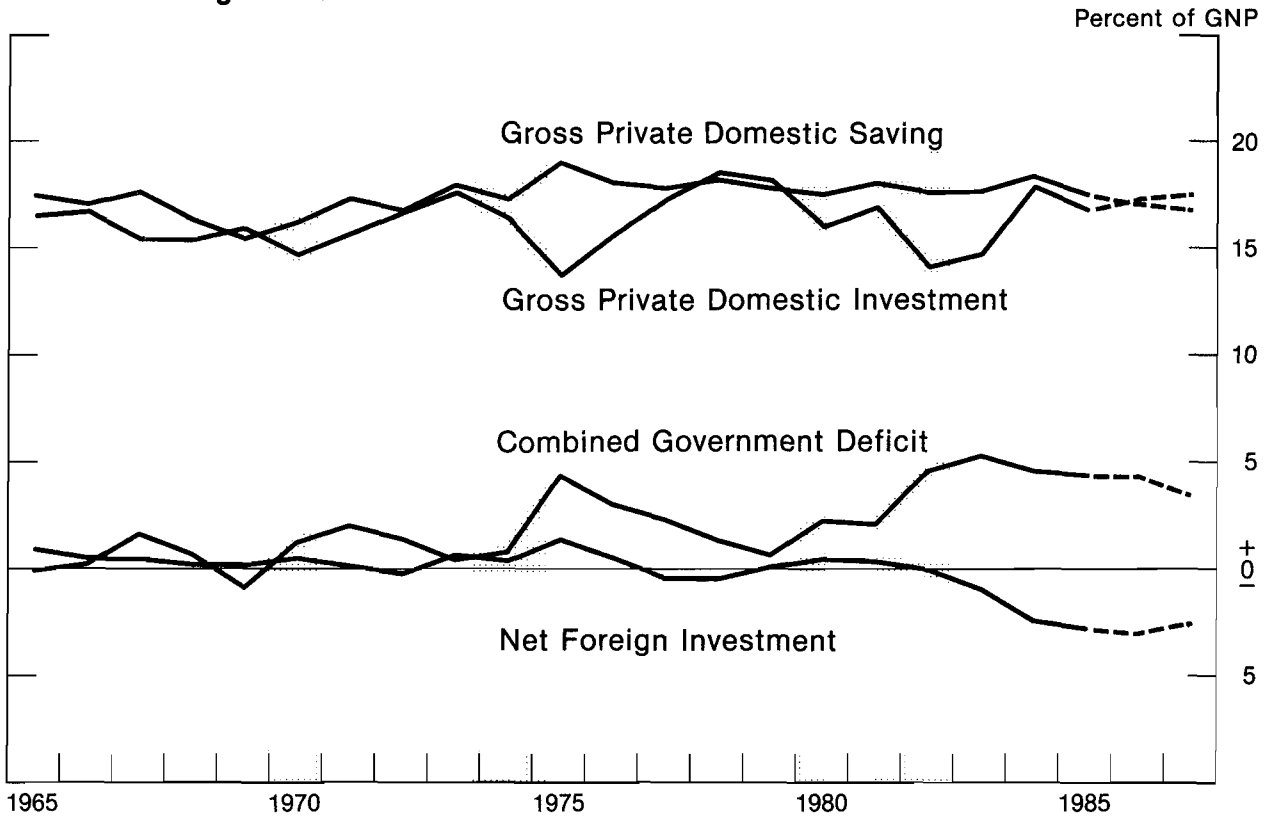
### Real State and Local Government Purchases



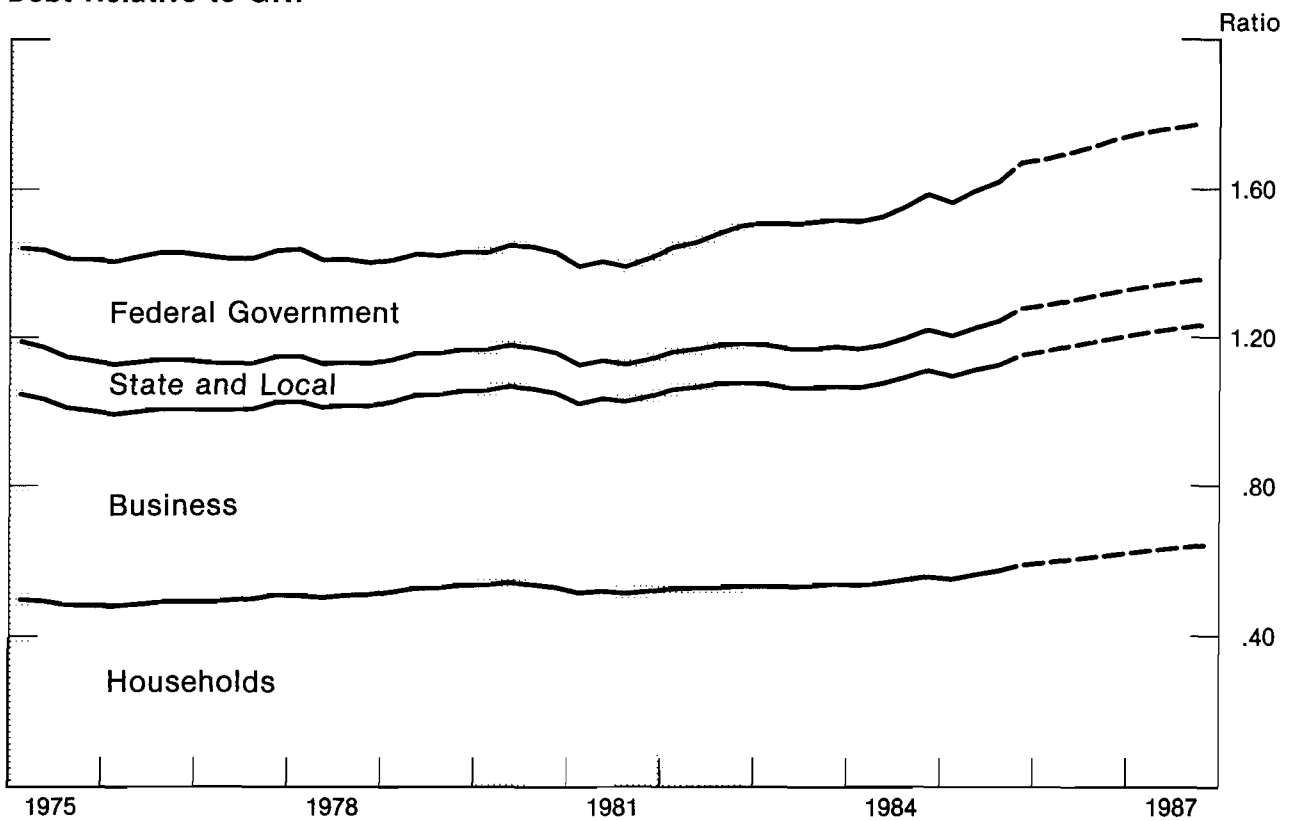
### State and Local Surplus



### Sectoral Saving Flows

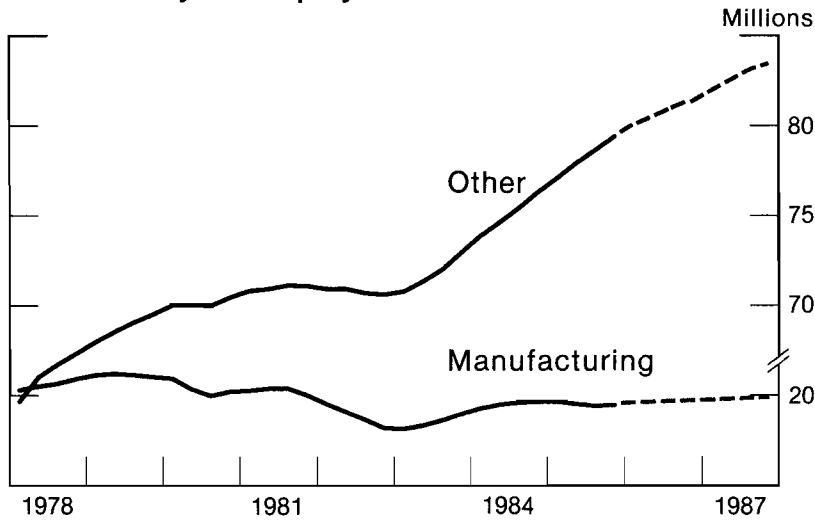


### Debt Relative to GNP





### Nonfarm Payroll Employment

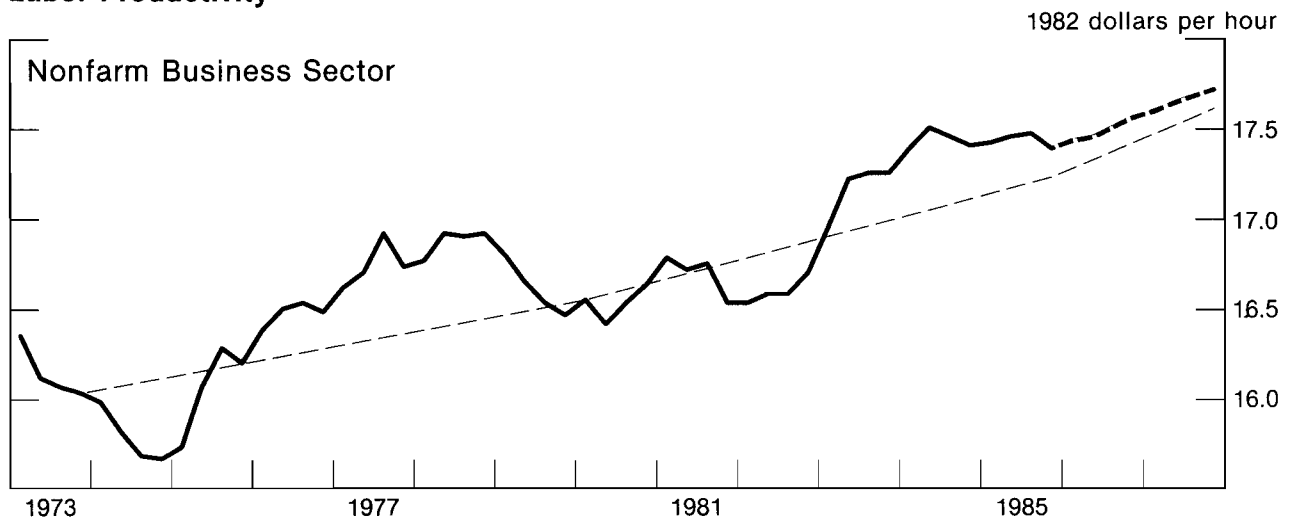


### Total Employment

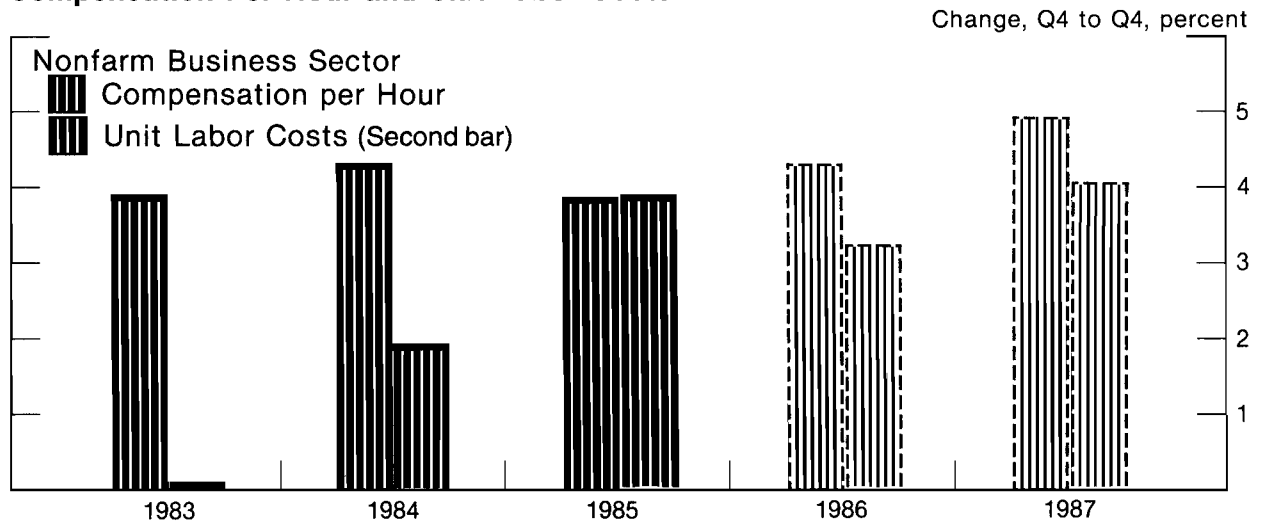
Change, Q4 to Q4, percent

1983	3.5
1984	4.4
1985	3.1
1986	2.5
1987	2.0

### Labor Productivity

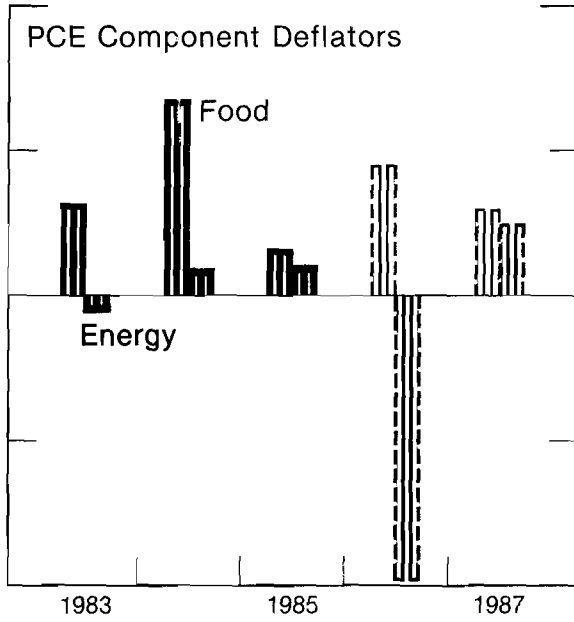


### Compensation Per Hour and Unit Labor Costs



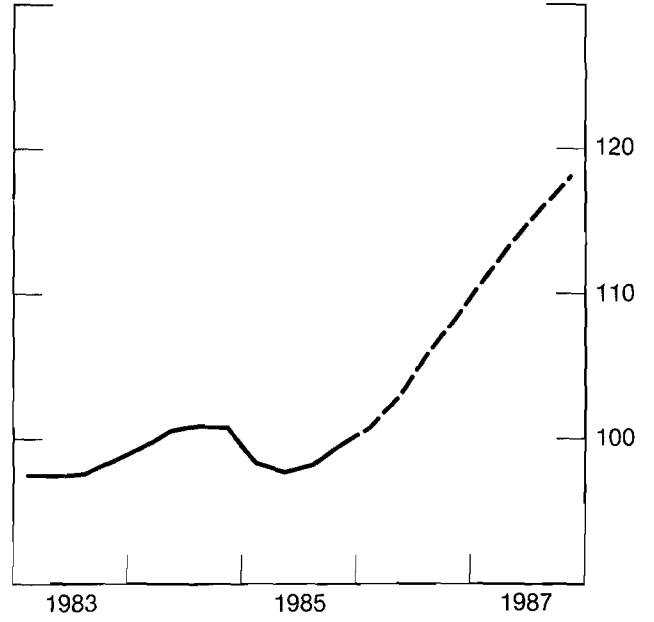
### Food and Energy Prices

Change, Q4 to Q4, percent



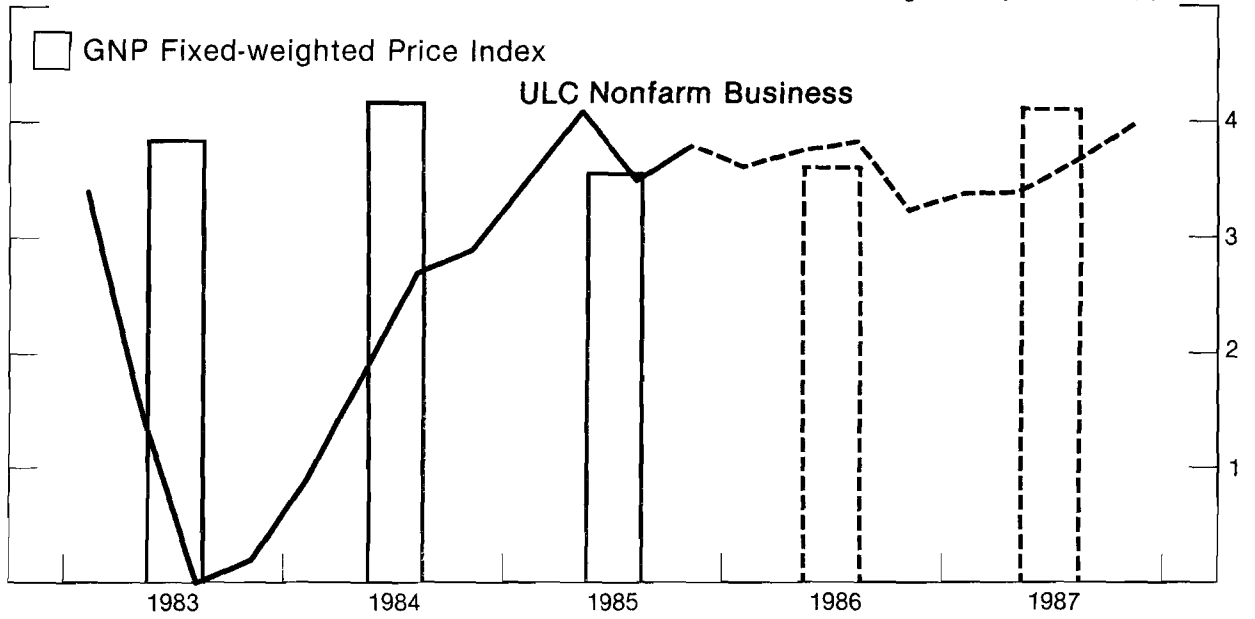
### Nonpetroleum Import Prices

Unit Value Index 1982 = 100

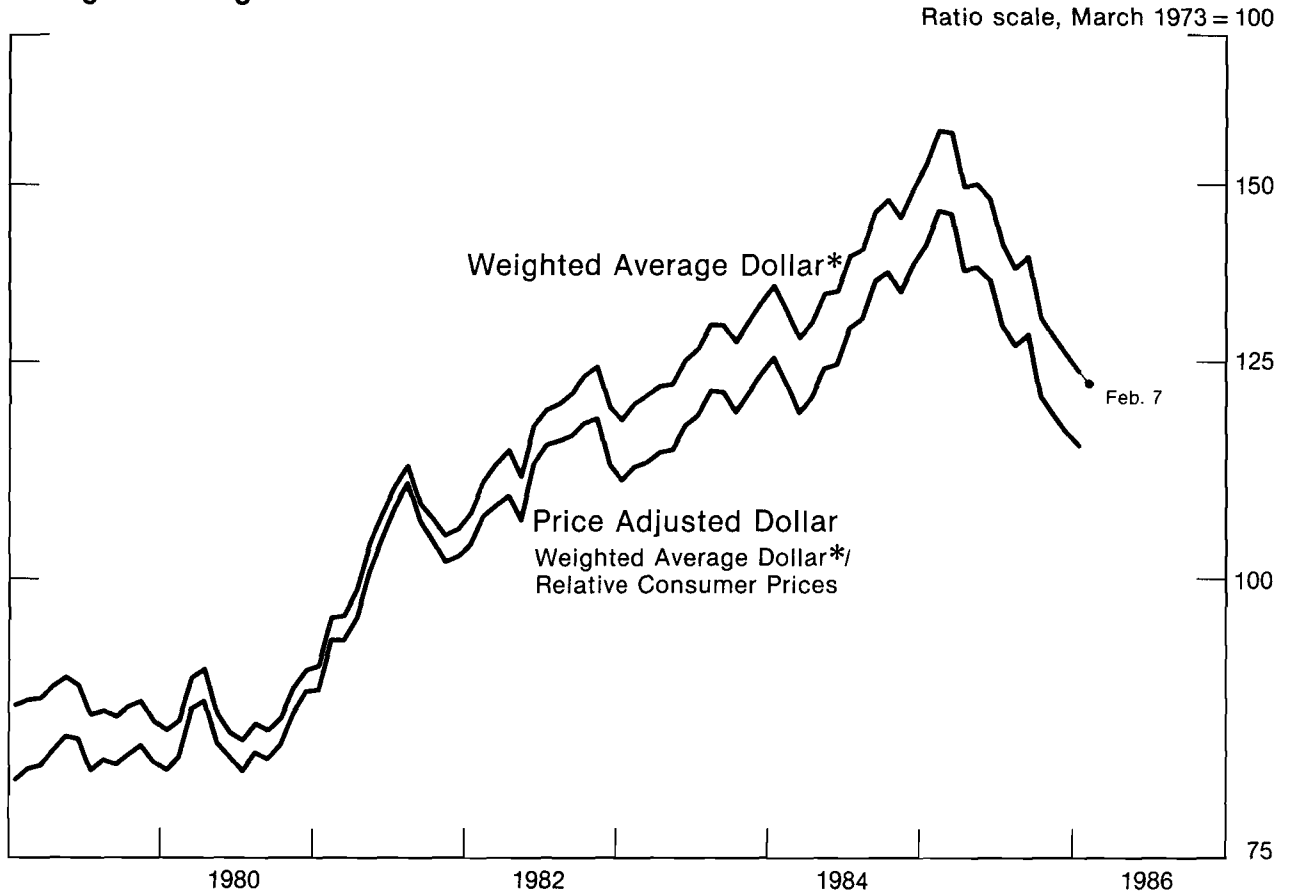


### Prices and Unit Labor Costs

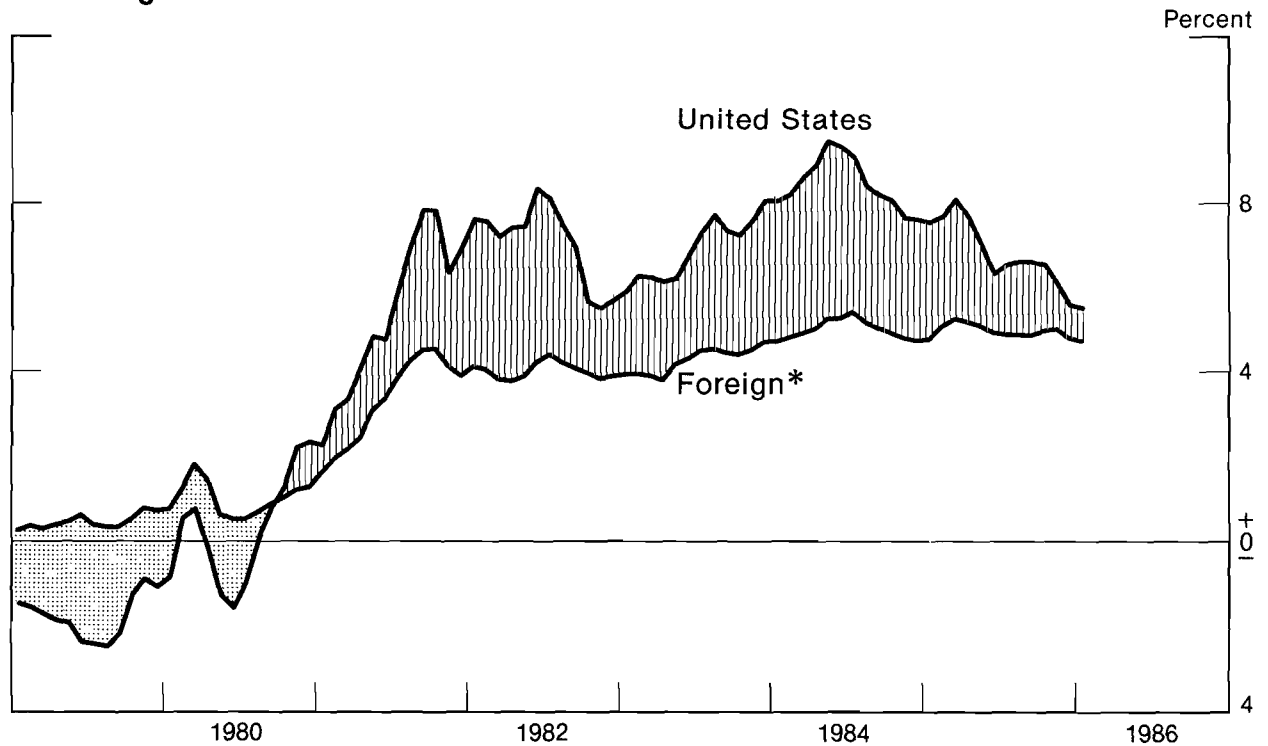
Change from year earlier, percent



**Foreign Exchange Value of the U.S. Dollar**

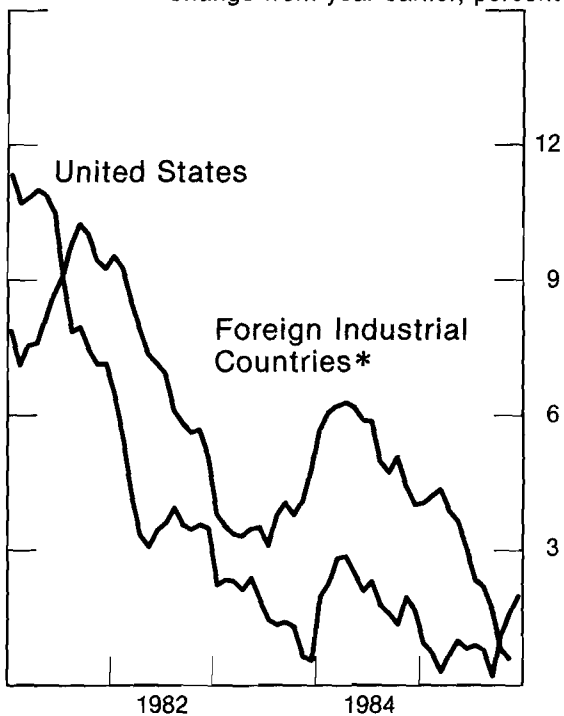


**Real Long-term Interest Rates\*\***

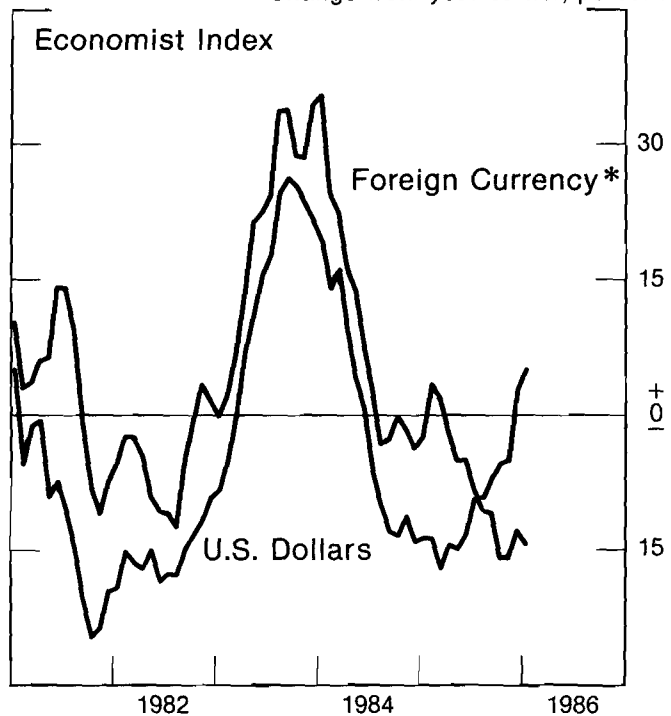


\*Weighted average against or of foreign G-10 countries using total 1972-76 average trade.  
 \*\*Long-term government or public authority bond rates adjusted for expected inflation estimated by a 36-month centered moving average of actual inflation (staff forecasts where needed).

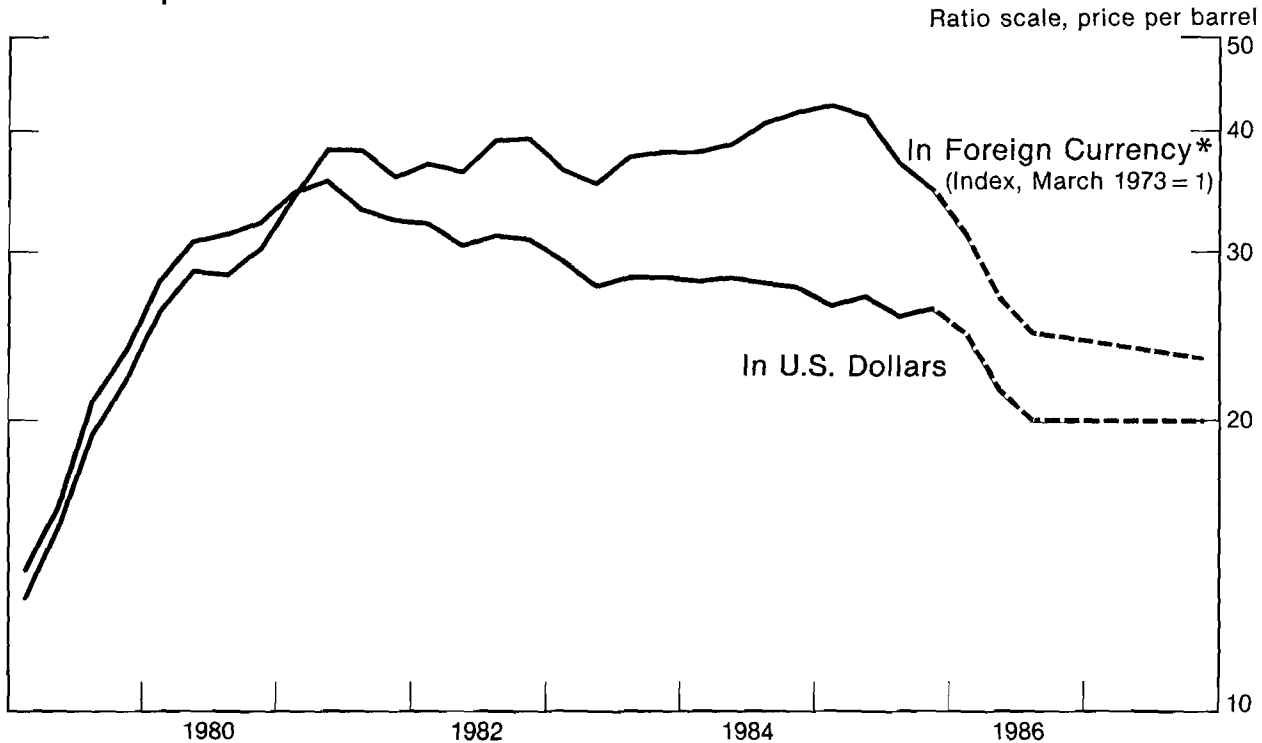
**Wholesale Prices**  
Change from year earlier, percent



**Commodity Prices**  
Change from year earlier, percent



**U.S. Oil Import Price**

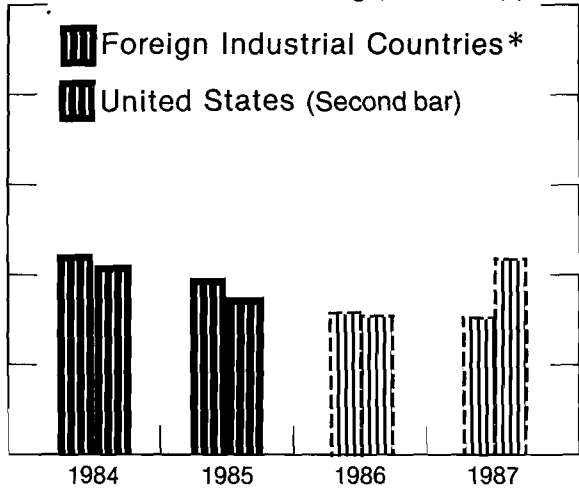


\*Weighted average of the six major foreign industrial countries using total 1972-76 average trade.

Chart 16

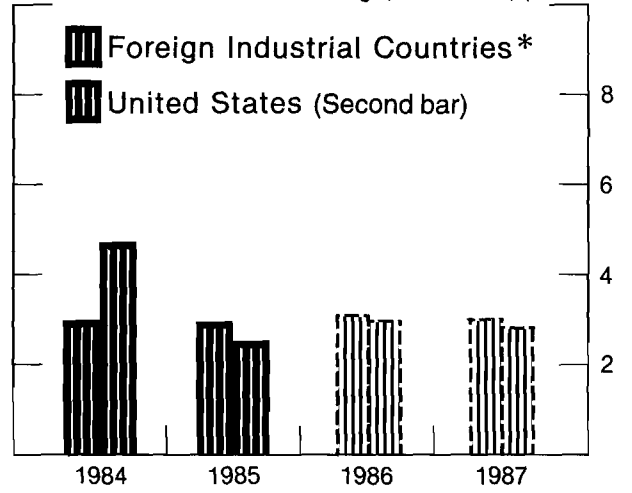
**Consumer Prices**

Change, Q4 to Q4, percent



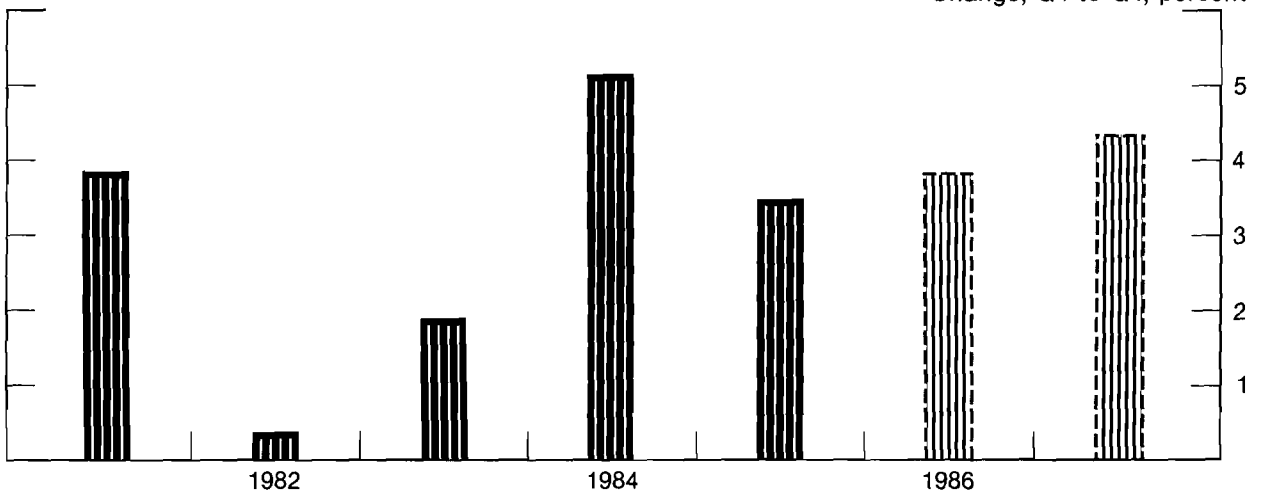
**Real GNP**

Change, Q4 to Q4, percent



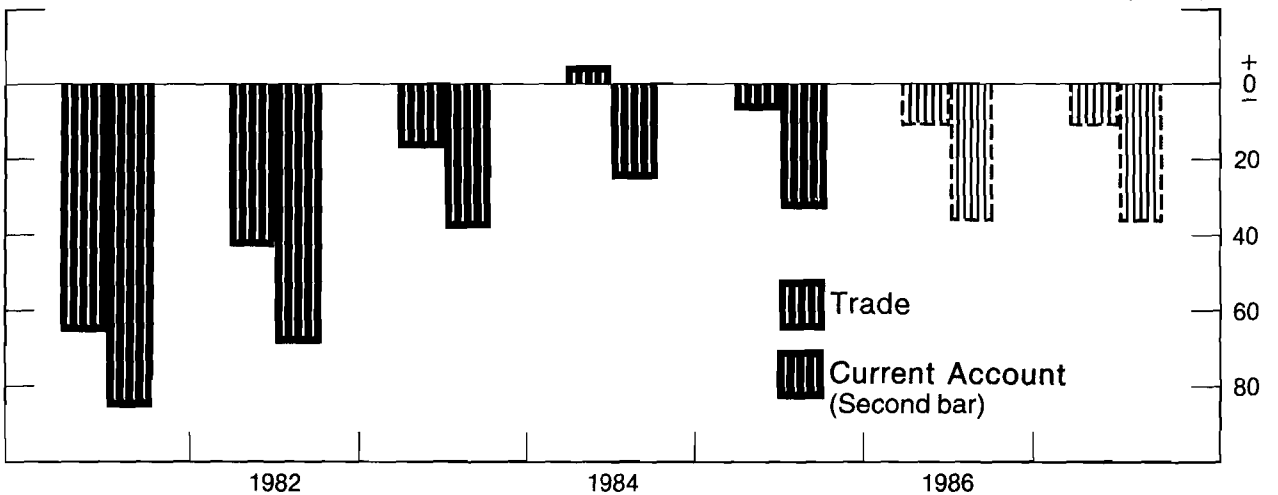
**Real GDP Growth—Non-OPEC Developing Countries**

Change, Q4 to Q4, percent



**External Balances—Non-OPEC Developing Countries**

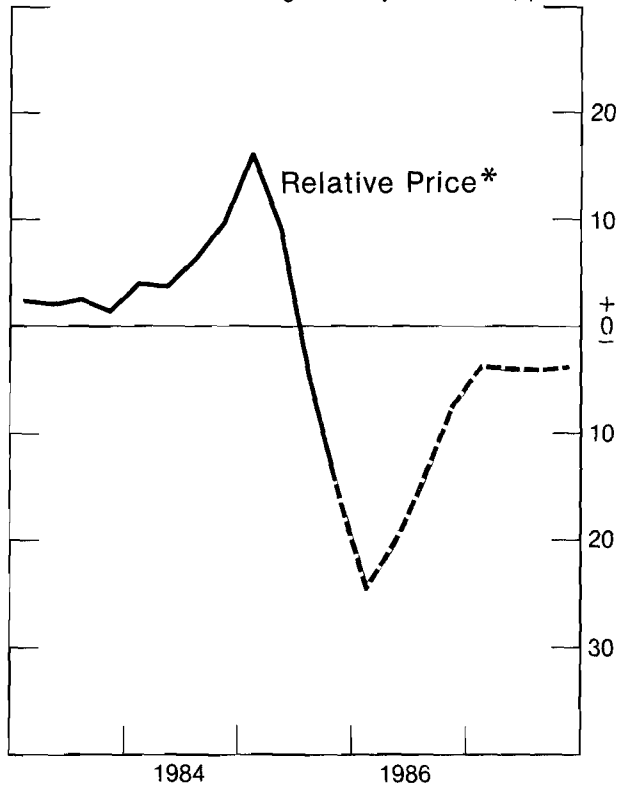
Billions of dollars



Weighted average of foreign G-10 countries using total 1972-76 average trade.

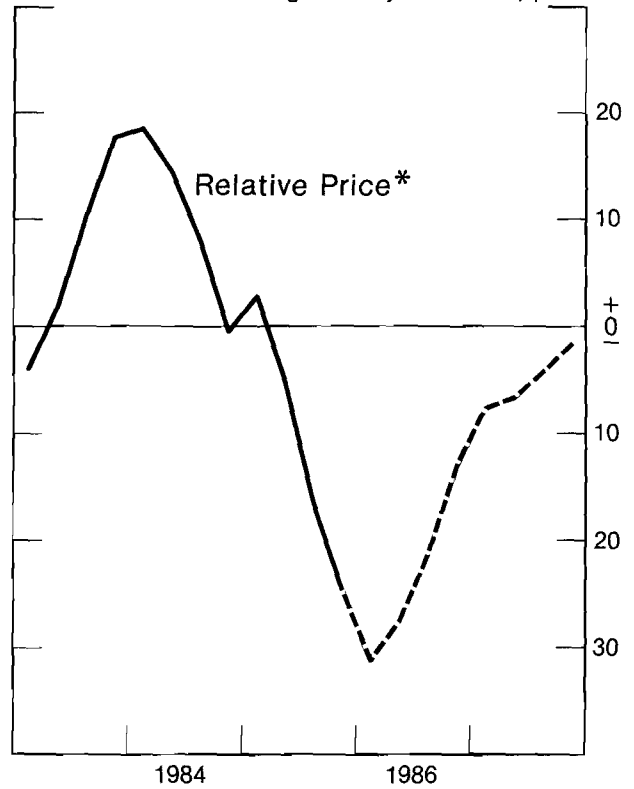
**Nonagricultural Exports**

Change from year earlier, percent



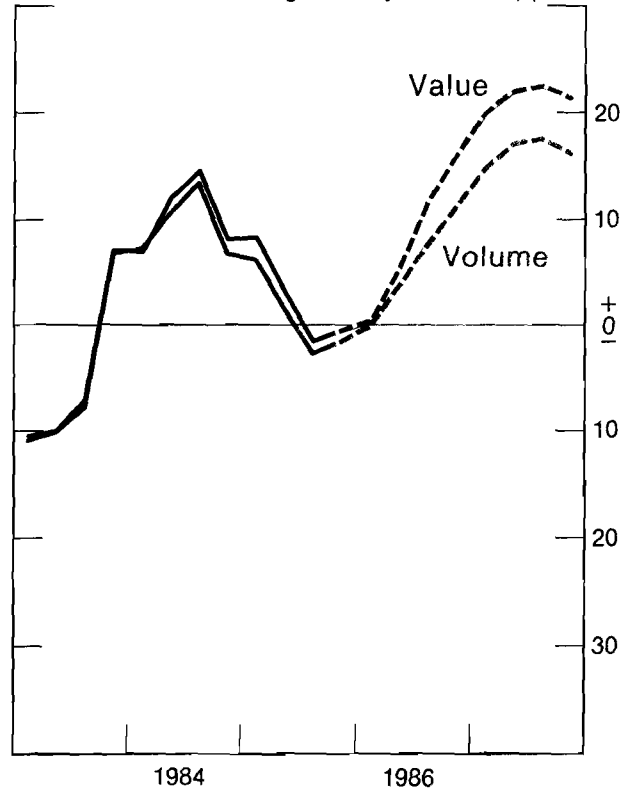
**Agricultural Exports**

Change from year earlier, percent



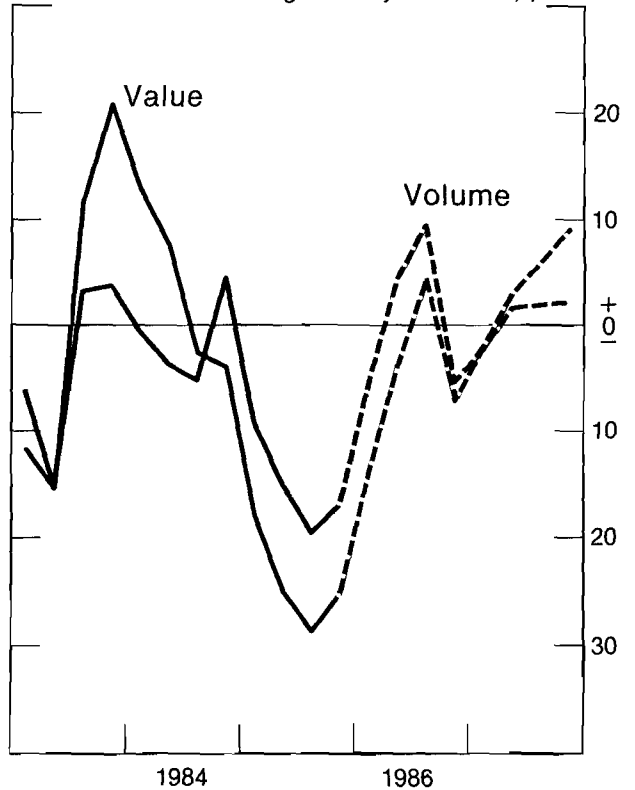
**Nonagricultural Exports**

Change from year earlier, percent



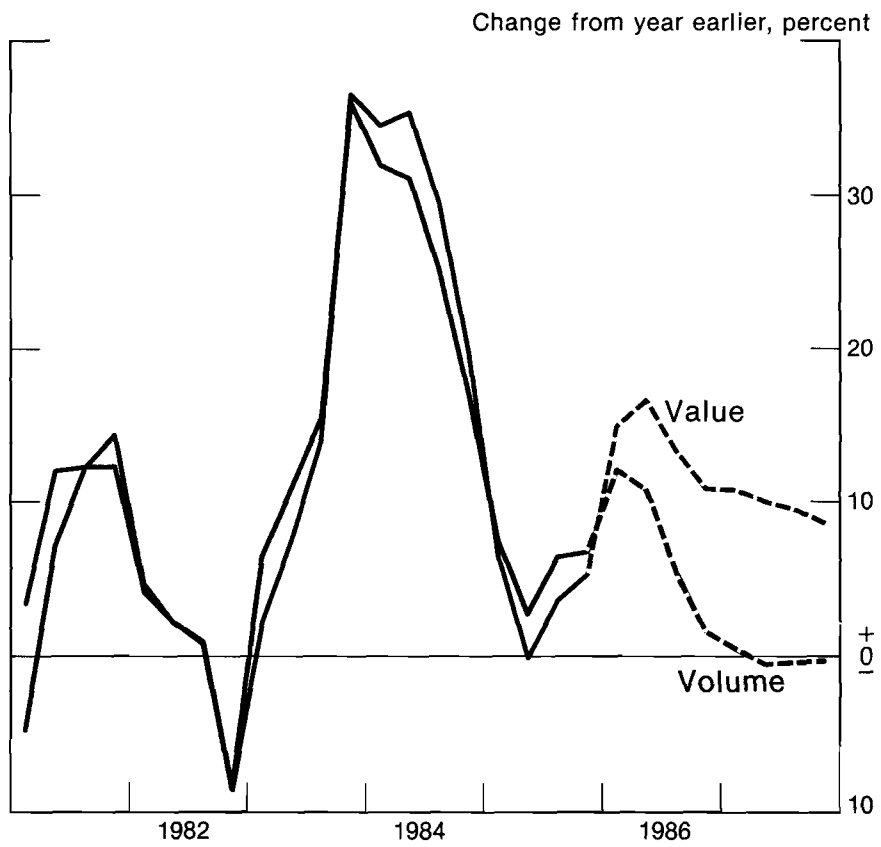
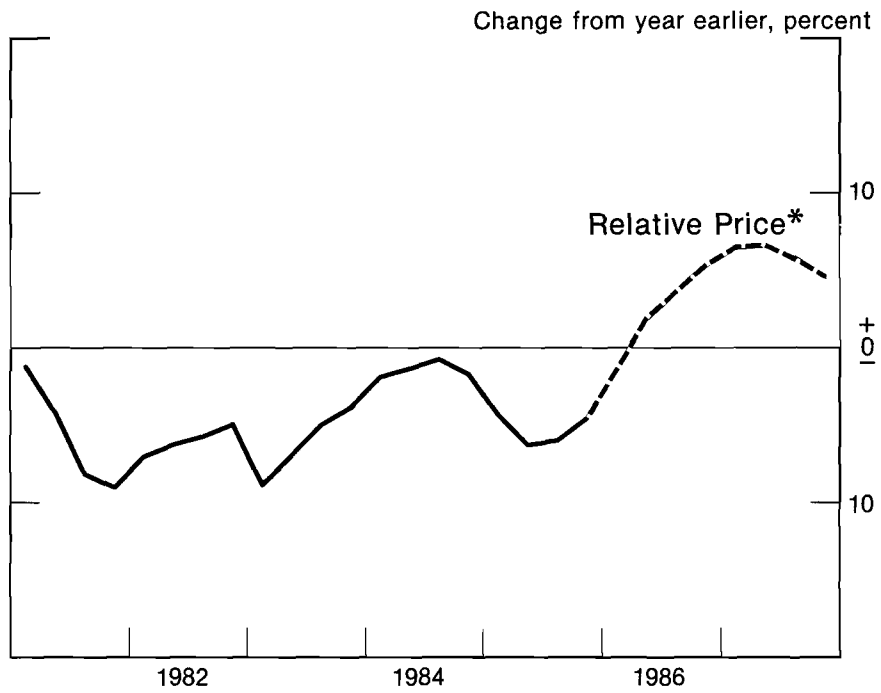
**Agricultural Exports**

Change from year earlier, percent



\*Unit value divided by the average consumer price level in other G-10 countries expressed in U.S. dollars.

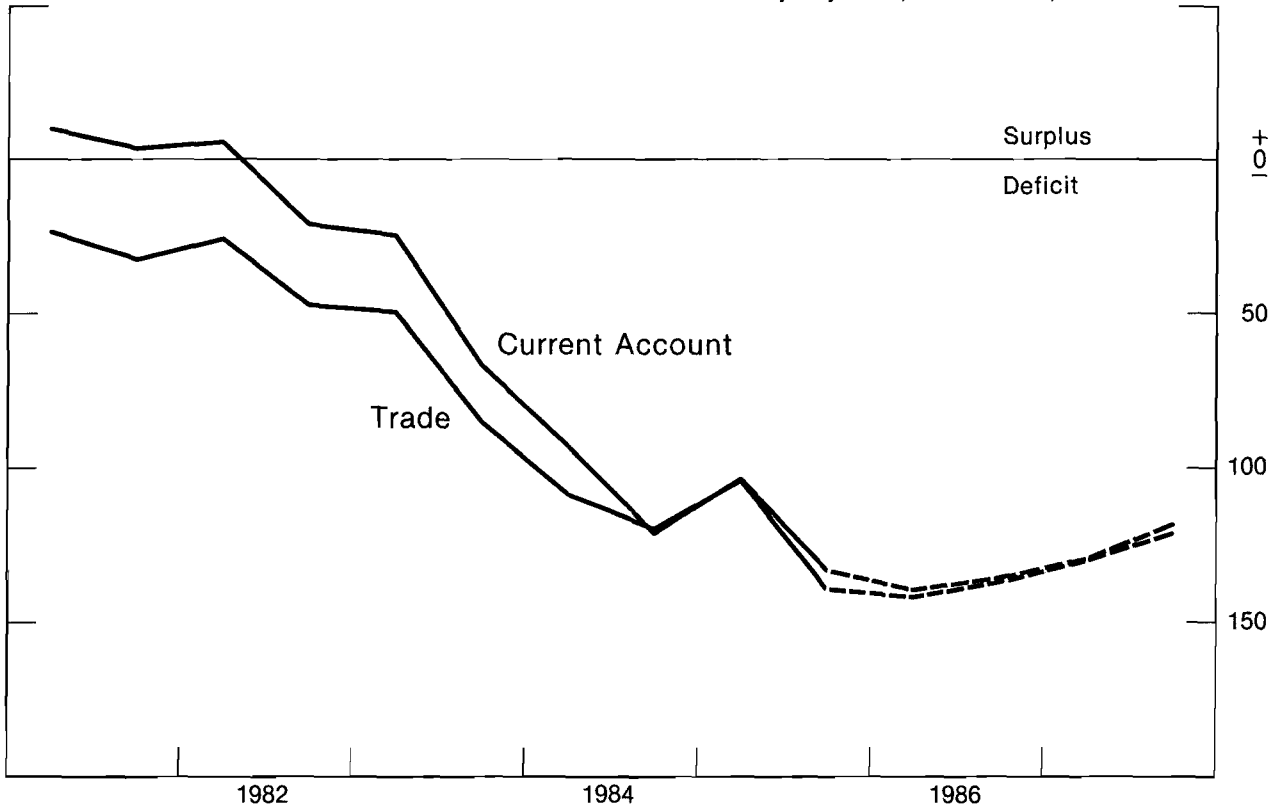
# Non-oil Imports



\*Unit value divided by U.S. GNP fixed-weighted price index.

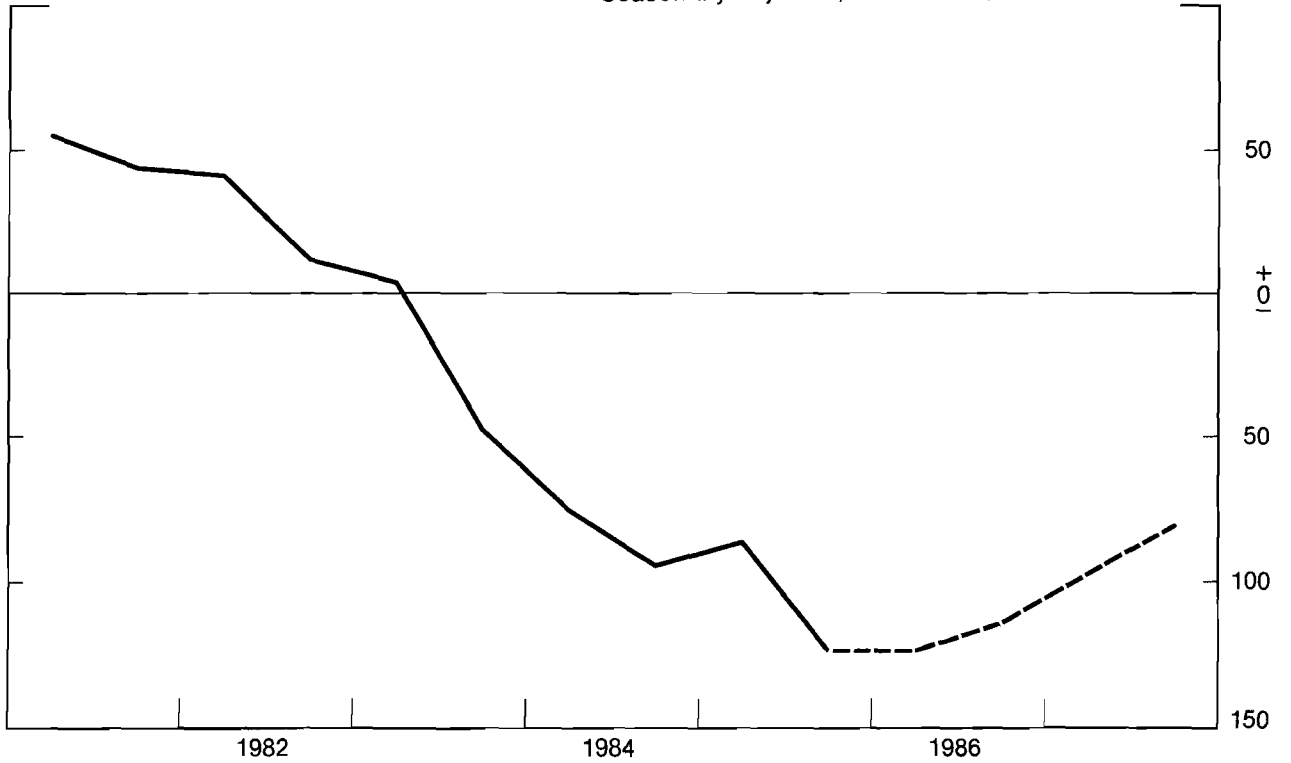
### External Balances

Seasonally adjusted, annual rate, billions of dollars



### Real Net Exports of Goods and Services

Seasonally adjusted, annual rate, billions of 1982 dollars





## U.S. Capital Transactions

( Billions of Dollars; Net Inflows = + )

	1982	1983	1984	1985 <sup>e</sup>	1986 <sup>p</sup>
<b>1. Net Private and Official Capital Flows</b>	<b>- 24</b>	<b>29</b>	<b>77</b>	<b>88</b>	<b>104</b>
2. Private Capital Flows	- 17	30	82	98	100
3. U.S. Banking Offices	- 45	19	23	33	33
4. Bonds and Stocks	14	14	34	62	68
5. Direct Investment and Other Non-Bank Flows	13	- 4	25	3	- 1
6. U.S. and Foreign Official Transactions	- 7	- 1	- 5	- 10	4
<b>7. Statistical Discrepancy</b>	<b>33</b>	<b>17</b>	<b>30</b>	<b>31</b>	<b>34</b>
<b>8. Balance on Current Account</b>	<b>- 8</b>	<b>- 46</b>	<b>- 107</b>	<b>- 119</b>	<b>- 138</b>

e Estimated

p Projected

## Impact of Alternative Assumptions

	1986	1987	1988
<b>Change in Real GNP (%)</b>			
Higher Money Growth	1 1/4	1	1/2
Lower Oil Prices	1/2	1/2	0
Less Fiscal Restraint	3/4	1/4	- 1
<b>Change in GNP Deflator (%)</b>			
Higher Money Growth	1/4	1	2 1/2
Lower Oil Prices	- 1/2	- 1/2	0
Less Fiscal Restraint	0	1/2	1
<b>Unemployment Rate (Q4 level, %)</b>			
Higher Money Growth	- 1/4	- 1	- 1 1/4
Lower Oil Prices	0	- 1/4	- 1/2
Less Fiscal Restraint	0	- 1/2	- 1/4
<hr/>			
Higher Money Growth	=	M1 growth rate 1 1/2 % higher than staff forecast.	
Lower Oil Prices	=	Oil prices \$5 per barrel lower than staff forecast.	
Less Fiscal Restraint	=	No additional deficit-reducing actions beyond FY 1986 actions.	

**Forecast Summary for 1986**

Percent change, annual average	Board Members		Presidents		Staff	Adminis- tration
	Range	Median	Range	Median		
Nominal GNP	5 to 7	6 $\frac{1}{4}$	6 to 8 $\frac{1}{2}$	7 $\frac{1}{4}$	6 $\frac{1}{2}$	8.0
Real GNP	2 $\frac{1}{2}$ to 4	2 $\frac{3}{4}$	3 to 4 $\frac{1}{2}$	3 $\frac{1}{4}$	3	4.0
GNP Deflator	2 $\frac{1}{2}$ to 4	3 $\frac{1}{4}$	3 to 4 $\frac{1}{2}$	3 $\frac{3}{4}$	3 $\frac{1}{2}$	3.8
Average level, percent						
Unemployment Rate	6 $\frac{1}{2}$ to 7	6 $\frac{3}{4}$	6 $\frac{1}{2}$ to 7	6 $\frac{3}{4}$	6 $\frac{1}{2}$	6.7

**FOMC Projections for 1986**

Reported to Congress July 16, 1985		
	Range	Central Tendency
Percent change, Q4 to Q4		
Nominal GNP	5 $\frac{1}{2}$ to 8 $\frac{1}{2}$	7 to 7 $\frac{1}{2}$
Real GNP	2 to 4	2 $\frac{1}{2}$ to 3 $\frac{1}{4}$
GNP Deflator	3 to 5 $\frac{1}{2}$	3 $\frac{3}{4}$ to 4 $\frac{3}{4}$
Average level, Q4, percent		
Unemployment Rate	6 $\frac{3}{4}$ to 7 $\frac{1}{2}$	6 $\frac{3}{4}$ to 7 $\frac{1}{4}$

FOMC Briefing  
S. H. Axilrod  
February 11, 1986

While differences among the long-run alternatives for the aggregates shown in the blue book are arithmetically small, choice of one or the other does depend in part on the degree to which the Committee believes the greater risks this year and tending into next lie on the side of more inflation or on the side of inadequate real growth. As the material presented to the Committee implies, this is a particularly difficult period for making such judgments. In the fall of 1979, it was clear that inflation was the main problem. In the fall of 1982, the need to stimulate real growth was evidently the problem. But in the winter of 1986, there are more conflicting tendencies, though at the moment some may seem to be more latent than manifest.

The inflationary risks stem from three sources: First, the potential for a sharp further drop in the exchange value of the dollar should the world at large become notably less willing to finance our large current account deficit. Second, the possibility that the process of fiscal restraint will break down in practice, adding more to aggregate demand pressures than anticipated. And, third, as the unemployment rate continues to drop either because productivity is weak or economic growth is strong or both, there is the question of whether we are not nearing the point where upward wage pressures, with feedback effects on prices, will become more evident. These sources of inflationary risk can of course be offset, though only for a time, by the favorable effect on price indexes and possibly inflationary expectations of a significant further decline in the oil price should that develop and be passed through into retail prices.

Risks of unduly slow growth would seem to be based on: the possibility that substantial fiscal restraint will in fact develop without a more or less automatic compensating rise in private spending; the potential for adverse business attitudes should longer-term interest rates still seem high in real terms relative to real profit potential; and a possible adverse impact of debt burdens on consumer and institutional behavior. These risks may be offset over the period ahead by the positive effects on real domestic demand and on business attitudes of a sharp further drop in the dollar and a significant further drop in the oil price.

Of the longer-run alternatives presented, alternative II, which embodies the highest growth ranges, may in this context be construed as more consistent with a view that the risks of slow growth outweigh those of inflation. The other alternatives would represent more restraint against a resurgence of inflationary pressures because of the lower upper limits proposed for the M1 and M2 ranges. Alternative III includes the lowest limits, and might be viewed as taking the opportunity of a sharp drop in the oil price to secure associated anti-inflationary gains, with constraints on real growth, if any, relative to the nation's potential depending on the extent of price decline and other developments. Alternative I perhaps can be viewed as more evenly balancing the risks of inflation as against economic weakness.

Given the uncertainties in the current economic outlook, there would appear to be much to be said for avoiding signals that could be misinterpreted in either inflationary or deflationary directions in the market. The ranges of alternative I since they have already been tentatively adopted, and with the aggregates so far this year currently running within

or quite near the ranges, would seem to bear least risk of such interpretation problems.

Alternative I as tentatively adopted, however, has an M1 range that is the same width as for M2 and M3. For the reasons noted in the blue book--including evidence that M1 may have become more interest sensitive than the broader aggregates--the Committee may wish to consider employing an M1 range that is broader than for the other aggregates. A 3-1/2 to 7-1/2 percent range would be symmetrical around the tentative 4 to 7 percent M1 range, as would the wider 3 to 8 percent range that is the same as had been adopted for the second half of 1985. The latter range would more tend to downplay the role of M1 in policy. On the other hand, the one point rise entailed in the tentative upper limit could also raise some questions about the anti-inflationary thrust of monetary policy--though that would probably be judged against the volatility of M1 in recent years.

Perhaps the prior question with respect to M1 is whether it should be reduced to a monitoring range or continue to have some weight in policy implementation. Recent evidence about M1 and its demand and indicator properties was presented to, and discussed by, the Committee at its December meeting. The evidence in my view is not entirely reassuring. We could explain a large part of the aberrant M1 behavior in the 1982-1983 period and in 1985 by responsiveness to interest rate changes, so that its demand properties have not been a complete mystery. However, M1 has not served well as an indicator of future GNP in recent years--indeed in part because institutional change has made the aggregate more interest elastic than it had been and also because interest rates have undergone a relatively

sizable though bumpy downward adjustment in the transition toward a much lower rate of inflation.

While M1 itself may have become less reliable, at least in recent circumstances, that does not necessarily mean it is without significant value as a policy indicator when considered not in and by itself but as one of three monetary aggregates, including M2 and M3. We have continued with efforts to determine the conditions under which M1 foreshadows nominal GNP and when it doesn't. It does appear that M1 does a significantly better job of foreshadowing GNP when it is concordant with behavior of M2 and M3 (with M2 generally the more significant addition)--that is, when all three aggregates are behaving similarly relative to their recent trends M1 is much more likely to presage future GNP behavior relative to its recent trend. This is of course true for M2 as well. The collectivity of the aggregates in other words appears to have more significance for future GNP behavior than any one aggregate separately. Of course even when M1 and M2 are giving similar signals, there is still considerable looseness in their relationship to subsequent GNP movements. However, on average over the past 15 years each aggregate has been a significantly better precursor of GNP when it is concordant with the other aggregate than when it diverges or than when tests are run without reference to behavior of the other aggregate. In the latter respect, in the 1980's so far some tests show that M2 has done a little better on its own than M1, but in the 1970's on average M1 did a little better than M2.

These results--tentative as all results in this area must necessarily be in a period of institutional and economic change--suggest the desirability of retaining M1 along with other aggregates, with the

relative weight of the aggregates in policy implementation largest when M1 and M2 are giving similar signals, judged of course in the context of other economic and financial developments. Such an approach seems generally in line with how the Committee in effect has been treating M1 over the past three years or so.