

APPENDIX

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

Open market operations since the last meeting fell into two distinct phases. In the first four weeks, the Desk pursued a nonborrowed reserve path that was adjusted downward to accommodate the weakening of M1B below expectations and the extraordinary bulge in borrowing over the Memorial Day weekend. The discount window borrowing associated with the path remained at \$1.9 to \$2.1 billion throughout this period. In its June 17 telephone consultation, the Committee accepted the shortfall in M1B that had developed to that point, and reduced discount window borrowing to be used in building the path in the next 3 weeks to \$1.8 billion.

For the second subperiod, the staff redrew the path on the basis of the M1B growth of 3 1/2 percent then expected from March to June, a growth that compared with the growth of 5 1/2 percent, or somewhat lower, set as an objective at the March 31 meeting. As M1B continued to weaken, the borrowing associated with the new non-borrowed reserve path fell to \$1.6 billion in the first two weeks of the subperiod. A second borrowing overshoot in the first week was also accommodated. In the most recent week further weakness in money and the demand

for total reserves suggest that borrowing at the window consistent with the path should be \$1.4 billion.

The Desk kept nonborrowed reserves close to the adjusted path during the first subperiod and we have been a bit above path during the current three-week interval. Total reserves were also close to path in the first interval, when path itself was lowered by \$180 million to accommodate the weakness in M1B. In the second interval, total reserves appear likely to fall short by \$165 million, as the demand for reserves has continued to decline without any further downward adjustment in the total reserve path.

Achievement of the nonborrowed reserve objective in the past three weeks would normally have produced some decline in the Federal funds rate, but this did not really happen. The Federal funds rate remained close to the 19 percent level prevailing since early May. During June banks evidently anticipated that the Federal funds rate would come down automatically with M1B weakness. In the week ended June 17 in particular, they were willing to accumulate large reserve deficiencies through Tuesday hoping that the Federal funds rate would come down from the 18 1/2 percent level prevailing before the weekend. On Wednesday, of course, they had to face up to the gap between their expectations and the reality of nonborrowed reserves being provided by the Desk. Federal funds traded as high as 30 percent and

borrowing mushroomed to \$6.4 billion. The cold shock of disappointment caused banks to be cautious thereafter, a caution exemplified in the past two weeks by unexpectedly strong demands for reserves around the statement publishing date and the 4th of July weekend. A reserve shortfall of \$2.2 billion last Thursday contributed to keeping the Federal funds rate this week well above the level of 18 percent one would expect from reserve availability near present levels.

The securities markets have been rather mystified by the stickiness of the Federal funds rate. A grudging appreciation has gradually developed that the Federal Reserve is trying to rein in excessive growth in the broader aggregates and help reduce inflationary expectations. But market participants were slow to reach that conclusion, in part because the Committee's March 31 directive, the latest published, indicated that M2 growth of 10 1/2 percent was acceptable in the second quarter.

As M1B turned weaker in late May and June, participants bet repeatedly on a near-term decline in short-term interest rates. A stream of reports on economic activity and price behavior confirmed that the economy was slowing and that speculative enthusiasms were wilting under the relentless pressure of high interest rates. By mid-June dealers and their customers had pushed rates on the key Treasury bill issues from

180 to 280 basis points below the near-peak levels prevailing just before the last meeting, while long-term bonds had rallied enough to reduce yields by 90 to 110 basis points. Dealers expected the reinvestment of the proceeds of a \$13 billion runoff in Treasury cash management bills a week or so later to reduce repo rates sharply and ease the financing of dealer positions.

The rise in the Federal funds rate above 20 percent on June 17 without Desk intervention to supply reserves dashed the market's near-term hopes. Prices of Treasury notes and bonds dropped sharply as dealers scrambled to prepare for the Treasury's sale of over \$12 billion of new issues in the last two weeks. The two-year note sold on June 18 at a yield of 14.72 percent, down a percentage point from the record levels of the month before. But the yields of 14.07 percent established on 7-year notes and of 13.45 percent on the 20-year bond were records, while the 14.02 percent yield on the 4-year note, was not far from the peak for such an issue.

Price fluctuations have been substantial during the entire period. Market hopes of lower short-term rates are again on the rise, as signs of a slowing economy accumulate. By last night Treasury bills had retraced a part of their earlier declines, with the 3- and 6-month auction rates down 165 and 100 basis points since May 18. Intermediate Treasury coupon issues

were generally 25 to 75 basis points lower in yield over the interval, while the 30-year bond was down 40 basis points to 13.15 percent. Rates on 3-month CDs ranged widely over the period, closing 135 basis points lower at 17.45 percent. The prime rate moved in a range of 19 1/2 to 20 1/2 percent, with nearly all banks currently at 20 percent.

In other sectors of the securities markets, tax-exempt securities remained the wallflowers of the industry with yields little changed over the interval. Interest remained lackluster from banks and insurance companies, while improving prospects for the Administration's tax-cut proposals raised concerns about their future attractiveness to high-bracket individuals. There was also market talk that Federal spending reductions might affect the creditworthiness of the states and localities. Corporate bond offerings picked up considerably with \$4 billion issued during June. A substantial volume remains waiting in the wings, as corporate willingness to finance near current rate levels has grown significantly.

One area that deserves special mention is the market for Federally sponsored agency securities. Critical analyses of the Federal National Mortgage Association have led many trust accounts and other investors to take the agency off their approved list

or scale back their holdings of its issues. FNMA wisely cut back its monthly offerings in May and June by \$850 million, but its recent \$600 million four-year issue required a yield about 110 basis points over a comparable Treasury issue, compared with spreads of 30 to 40 basis points about the time of the last meeting. The issue sold well at that spread. There appears to be a good appetite from money market funds and others for the 30- to 60-day discount notes being sold at an even wider spread, but there is a certain vulnerability in having so much short paper to roll over. The Federal Home Loan Banks were able to raise about \$1.8 billion in the interval, but the spreads of their issues against governments has also widened to 80 basis points or so. The Farm Credit agencies are generally trading at a spread of about 60 basis points.

Treasury financing in the third quarter appears likely to be a bit higher than the \$9 to \$12 billion the Treasury thought likely a few weeks ago. The current Board and New York estimates are at \$16 and \$18 billion, respectively, while some market estimates run as high as \$20 to \$21 billion. This would still be a considerable reduction from the \$28 billion sold in last year's third quarter.

Notes for FOMC Meeting
July 6-7, 1981
Scott E. Pardee

Since once again we had no operations for the account of U.S. authorities, and since previous tendencies continued, I can be brief. The dollar again advanced across the board, by a net of 6 to 7 percent against the German mark and the other European currencies tied directly or indirectly to the mark. The dollar also rose by 8-1/2 percent against the pound sterling. The dollar advanced somewhat less against the yen and marginally against the Canadian dollar.

The factors in the dollar's rise are:

- the continued apparent strength of our current account relative to most other industrial countries;
- favorable interest rate differentials, with yet another unexpected run-up in our rates recently;
- positive sentiment toward the Reagan Administration;
- better numbers here on inflation; and
- what the Europeans are calling "Euro-pessimism."

This last perhaps needs some explanation. It focuses on political divisions within countries, the broader uncertainties generated by the new socialist government in France --which for the first time included communists in the cabinet--and outside concerns such as with Poland. It focuses on the economic dilemmas those countries face, with stagnant economies, unemployment, current account deficits, and declining currencies. There are dangerous elements to this mood, and Europeans are prone to vent their frustrations by criticizing us. The criticism is mainly directed at our high interest rates and the dollar policy. Administration officials as well as many of us from the Federal Reserve have all tried to dispel this criticism. Our central bank counterparts at least understand what we are saying, and may even sympathize with us, but the feeling runs deep.

Right now, the market expects the dollar to remain strong for some time to come, but many participants believe that the dollar is unsustainably high. Our counterparts abroad are smarting from the lack of cooperation from the United States on exchange market matters. Should the dollar come under heavy selling pressure for whatever reason, it will have to fall a long way before other central banks would lift a finger to moderate the decline.

James L. Kichline
July 6, 1981

FOMC CHART SHOW -- INTRODUCTION

In our presentations this afternoon we will be referring to the package of chart materials distributed to you. The first chart in the package displays the principal policy assumptions that underlie the staff forecast. For monetary policy we continue to assume growth of M-1B of 4-3/4 percent this year, adjusted for shifts into NOW accounts, and 4½ percent next year. This assumption is embodied in long-run Strategy I in the Bluebook. The fiscal policy assumptions include restraint on growth of outlays and tax cuts, both revised somewhat since the last FOMC meeting to reflect our assessment of legislative developments. We now assume the administration will obtain about 4/5 of the expenditure reductions they are seeking in fiscal 1982, a little more than we had been assuming earlier. The personal tax cut has been scaled back to a 5 percent across-the-board reduction on October 1, with an additional 2 percent for selected cuts. A second-stage cut of 10 percent has been included beginning July 1982, a new element in the staff forecast assumptions. Together these personal tax cuts total about \$27 billion in fiscal 1982, while depreciation changes are expected to result in about \$8 billion of tax reductions to businesses.

The next chart provides further information on the federal budget. The fiscal assumptions along with the staff's economic forecast are projected to result in an appreciable increase in the budget deficit next fiscal year, to nearly \$80

billion. We do not yet have the administration's budget figures to be presented to Congress in the midyear review, but compared to their March program the staff deficit figures are about \$5 billion higher in fiscal 1981 and nearly \$35 billion higher for next fiscal year.

Both outlays and revenues are projected to remain quite high relative to GNP in the forecast period. The black line in the bottom left panel indicates that total outlays as a percent of GNP are expected to only level out in fiscal 1982 even with the sizable program reductions assumed. The underlying economic situation--including rising unemployment and high interest rate levels--acts to hold up outlays relative to GNP; as the red line shows, outlays excluding interest on the debt are projected to decline. Federal receipts as a percent of GNP, the right-hand panel, also are expected to decline somewhat, reflecting the assumed tax cuts. Historically, however, receipts still remain very high relative to GNP--a function largely of the impact of inflation.

Mr. Zeisel will continue the presentation with a discussion of recent and prospective developments in the domestic nonfinancial economy.

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Joseph S. Zeisel
July 6, 1981

FOMC CHART SHOW

The 8½ percent annual rate of GNP growth in the first quarter--shown in the top left-hand panel of the next chart--came as quite a surprise. It was probably in part a continuation of recovery from the collapse in the spring of 1980, in confluence with a number of otherwise disparate factors. In any event, most of the first quarter vigor derived from a surge in December and January; the economy actually began to lose momentum shortly after the turn of the year, and there is convincing evidence now of a slowdown in a wide range of sectors. It is likely that the economy experienced little or no growth in real GNP in the second quarter.

The bottom left panel shows the substantial decline in homebuilding beginning in February which has now carried starts to a 1.15 million annual rate--25 percent below the fourth quarter 1980 level.

As the upper right-hand panel shows, real retail sales turned downward in April, led by a drop in autos. Since then, auto sales have remained below their pre-rebate pace; domestic car sales in June were at a 5.4 million rate, down from 5.7 in April and May. Excluding autos, retail sales declined further in real terms in May.

The generalized weakness of economic activity in recent months apparently is now also being reflected in the employment

figures. Payroll employment adjusted for strikes fell in June by 150,000, with declines quite pervasive.

The next chart shows our view of the outlook for real GNP growth for the balance of 1981 and for 1982. The tax cuts late this year and in mid-1982 should provide some boost to activity. But the weakness of housing will stunt overall growth in the near term and, generally, the rise in GNP over the entire projection period remains constrained by monetary policy and curbs on government spending. On balance, real GNP growth is projected to average only about one-half percent over the next four quarters and pick up to about a two percent rate in the last half of 1982.

The top left panel of the next chart indicates the key role played by consumer demand in both the rebound of the economy through the first quarter and the sudden loss of momentum in the spring. Some of this reflected the rebate-associated shifting of auto sales from the second quarter into the first. Probably more important, however, is the cessation of real income growth--the right-hand panel--which accompanied the slackening of employment gains.

As the middle panel shows, we assume that consumer outlays will in general continue to track disposable income. Responding to the tax cuts late this year, and again in mid-1982, we anticipate real consumer spending will increase over the next six quarters at about a 2-3/4 percent annual rate--as compared to the half percent rise in 1980.

The saving rate--the bottom panel--is projected to remain relatively low by historical standards. But the tax reductions should permit some improvement in savings as well as in consumption; we are projecting the rate to edge up slightly into the 5½ percent range in the latter half of next year from its recent extremely low level--the lowest since the Korean War buying splurge.

The top panel of the next chart indicates the recent decline in housing starts in response to higher interest rates and tighter financial conditions. This drop in activity dictates a deterioration in real residential construction expenditures over the balance of the year.

Moreover, there is evidence of a generalized weakening of demand in real estate markets. Sales of new homes--shown in the middle panel--in May, were a fifth below their average level last summer; purchases of existing homes have also declined. As the bottom panel shows, average prices of new homes have continued to rise, but at a substantially slower pace than in the past few years. These figures may in fact understate the price deceleration, since home prices recently have increasingly incorporated payments for improved financing arrangements.

But, as the next chart indicates, it is our view that housing starts may now well be at, or close to, their bottom. Underlying demand pressures associated with population and migration trends remain strong and we are looking for an upturn as S&L deposit flows improve a bit--partly because of recent DIDC actions--

and new mortgage instruments increasingly gain a place in the market. By the end of 1982 we are projecting a 1-1/3 million unit rate of starts, some 200,000 at an annual rate above the current pace--but this would still be anemic by historical standards.

The next chart addresses the outlook for business capital spending. Real fixed investment outlays appear to have fallen in the second quarter following a first-quarter surge and commitments data suggest a stagnant situation for the balance of the year. As the top panel indicates, growth of real new orders for nondefense capital goods has stalled this year; orders for defense equipment, after rising strongly from mid-1979, have been on a plateau since about last fall; and new contracts for commercial and industrial construction similarly have shown no strength recently. These data appear to be generally consistent with results of the most recent Commerce capital spending survey, which suggested little or no growth of real investment outlays this year.

The investment outlook for 1982 is obviously more speculative. Liberalized tax incentives and the expanding defense program should stimulate increased capital spending as time goes on. But a number of fundamental factors appear likely to continue to damp investment outlays. As the next chart shows, the cost of debt capital is expected to remain high; after-tax profit positions relative to GNP are not projected to improve; and with capacity utilization remaining low, we expect little demand for expansion of capital stock, except in such fast growing sectors as defense and the energy-related areas. On balance, we

are projecting a small decline in capital outlays over the projection period.

As the next chart shows, the inventory situation does not suggest any serious problem at the moment. As is evident in the top panels, there was some backup in dealers' car stocks as a result of the weakness in auto sales in the past few months. But business stocks overall appear to be in reasonable balance with sales--the right panel. The distortions of last spring were largely eliminated by inventory liquidation in the latter half of 1980 and early this year. We are not projecting any collapse in sales, and we assume that businesses generally will succeed in avoiding significant stock imbalances. As the bottom panel indicates, we expect a moderate rate of increase in real inventory investment through the projection period--raising stocks somewhat relative to sales as growth picks up and reflecting the projected defense buildup.

The next chart addresses the government component of spending. Federal defense purchases are projected to continue rising strongly this year, but not quite at last year's pace; however, they are expected to accelerate again in 1982, moving up in real terms by about 7 percent. Excluding compensation, the real increase in 1982 would be about 9-3/4 percent. But given the curbs on nondefense spending, total real federal government purchases are projected to rise at slightly less than the 1980 pace.

In addition, we are anticipating substantial reductions in federal grants to states and localities. The curtailed spending by state and local governments projected for calendar years 1981 and 1982--shown in the middle panel--reflects this reduction in aid as well as budgetary pressure from continued high interest costs and depressed receipts. As shown in the bottom table, we are now expecting only a fractional rate of increase in real total government purchases through 1982.

The next chart portrays the outlook for the labor market. The relatively strong gain in total employment shown for 1981 reflects largely increases that have already occurred, in part a rebound from the cutbacks early last year. In line with projected output, however, we expect little employment growth over the remainder of this year and in 1982. As indicated in the second panel, limited job opportunities should depress labor force growth. Consistent with the experience in other recent periods of sluggish demand, we anticipate no increase in the rate of labor force participation. Nevertheless, the expansion of labor supply is likely to outpace job creation, and unemployment--shown in the bottom panel--is projected to rise from the current $7\frac{1}{2}$ percent rate to about $8\frac{1}{2}$ percent by the end of 1982.

The prolonged period of slack labor markets should soon pay dividends in some easing of wage inflation. Although compensation is still rising rapidly--the top panel of the next chart--some signs of moderation in wages have recently emerged and we expect this trend to continue, given the environment of sustained

high unemployment anticipated through the projection period. Reduced consumer price pressures should also contribute to improved wage performance.

As the middle panel shows, we also expect some gains in productivity. Given the modest rise in output, and in the light of its recent poor performance, we are forecasting less than a one percent rate of rise in productivity for 1982. Nevertheless, such an improvement, when combined with the expected reduction in wage pressures, would result in a distinct deceleration of unit labor costs, which are expected to be rising at only about a 7 percent rate in the latter half of 1982.

The outlook for prices is indicated in the next chart. The moderation of price increases recently has reflected mainly developments in the energy and food sectors. While the improved price performance in food, in particular, is likely to be temporary--in fact there are already indications of a rebound in meat prices--longer-term benefits should be evident in some feedback effects on wages, and possibly, a salutary impact on attitudes. More fundamentally, prices excluding food and energy, should also be showing measurable improvement soon, reflecting reduced pressure from labor costs as well as continued slack in product markets. The stronger position of the dollar in international markets should also help. Overall, we are now forecasting that prices will be rising at about a $7\frac{1}{2}$ percent rate by the end of 1982, off from the $9\frac{1}{2}$ percent rate recently.

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

E.M. Truman
July 6, 1981

FOMC Chart Show Presentation

The red line in the top panel of the first international chart shows that, since July 1980, the dollar has appreciated steadily on a weighted-average basis. In June, the dollar's value averaged 25 percent more than a year ago and reached its highest level since 1976. As shown by the black line, the dollar's appreciation on a price-adjusted basis has been about the same, reflecting the fact that over the past year the pace of inflation in the United States has been about equal to the rate on average abroad.

The substantial appreciation of the dollar is the principal factor generating the staff's forecast swing of the U.S. current account into deficit in the second half of this year and in 1982. This movement, if realized, is expected eventually to contribute to some decline in the dollar's value. Meanwhile, as Mr. Zeisel mentioned, the appreciation of the dollar since last year should contribute importantly to the expected reduction in the rate of price inflation in the United States.

As is shown in the lower panel, although the initial phase of the dollar's appreciation was associated with a widening of the differential between U.S. and foreign interest rates in the latter part of 1980, the dollar's strength so far this year has not been associated with a further widening. Indeed, the differential recently has been smaller than it was at the turn of the year. Several factors appear to have contributed to the dollar's strength. Among them are the unsettled economic and political conditions in Eastern and Western Europe and the continued U.S. current-account surplus through the first quarter. But an important factor also

appears to have been a decline during the past six months in the rate of inflation expected for the United States combined with a rise in the average rate of inflation expected abroad. In the staff's forecast, for example, the net revision in expected consumer price levels is about 5½ percent by the end of the forecast period. This changed outlook has increased the differential between real interest rates.

The top panel of the next chart depicts the staff's outlook for consumer prices here and abroad. As can be seen, the gap between U.S. and average foreign inflation is projected to narrow sharply this year and essentially to disappear in 1982.

Meanwhile, as is shown in the lower panel, we expect for this year somewhat faster real growth in this country than on average abroad -- largely because of the first-quarter results. Next year the pattern is expected to be reversed. Thus, on balance during 1981 and 1982, real economic growth is expected to be generally similar here and abroad.

The next chart summarizes our outlook for the international oil market. The apparent glut that has emerged in this market in recent months has caused us to adopt a more optimistic assumption about the outlook for oil prices, which, in turn, has contributed to the staff's somewhat more optimistic outlook for inflation generally.

As is shown in the top panel, we expect the unit value of U.S. oil imports to decline very slightly during the rest of 1981, reflecting lower prices on the spot market and a unification of the OPEC price around the current Saudi price of \$32 per barrel. In 1982, we are assuming that the real oil price will rise slightly. This scenario implies a price about 12½ percent lower throughout the projection period than we were assuming six months ago.

The principal factor contributing to this improved outlook is the reduction in the global demand for oil, reflecting slow real growth and the response of demand to high oil prices. One result, depicted in the middle panel, is that OPEC oil production has declined from almost 31 million barrels per day in 1979 to less than 25 million barrels per day this year and is expected to edge off further next year. Moreover, non-OPEC production has increased somewhat absolutely and, more importantly, relative to OPEC production. With the major exception of Saudi Arabia, many producers need the export revenues generated by their current rates of production and, thus, the scope to scale back output, for an extended period of time, to sustain rising prices is more limited than was the case several years ago.

As is illustrated in the bottom panel, U.S. oil imports are now running about 2 million barrels per day less than the rate two years ago, and they are expected to decline further over the forecast period. We now expect that the U.S. oil-import bill in 1982 will be essentially unchanged from the roughly \$80 billion projected for 1981.

Turning now to the "bad news," as is shown by the red line in the upper panel of the next chart the volume of U.S. non-oil imports is expected to expand rapidly during the forecast period largely as a consequence of the dollar's appreciation. Similarly, as is shown in the lower panel, the volume of U.S. non-agricultural exports is projected to decline quite rapidly in the second half of this year and for the rest of the forecast period.

The implications of these shifts for U.S. aggregate demand are shown in the top panel of the next chart. As a consequence of rising real receipts on exports of services, the decline in U.S. exports of goods and

services, on a constant-dollar GNP basis, is projected to be moderate and not to start until early 1982. Nevertheless, the contribution of exports to U.S. aggregate demand this year will be substantially less than in 1978, 1979 and early 1980. Next year the contribution is expected to be negative.

Returning to current-dollar magnitudes, as is shown in the middle panel, the U.S. trade deficit is projected to increase sharply in the second half of 1981 and in 1982, reaching almost \$60 billion at an annual rate in the second half. Meanwhile, in contrast to the pattern in the late 1970s, the net surplus on non-trade transactions will show little change. Consequently, the U.S. current account is expected to swing into deficit, reaching a rate of about \$30 billion at an annual rate in the second half of next year.

Mr. Kichline will now complete our presentation.

James L. Kichline
July 6, 1981

FOMC CHART SHOW -- CONCLUSION

The staff's economic forecast is associated with an environment of considerable restraint on financial markets. The top panel of the next chart indicates an assumed growth of M-1B this year and next substantially slower than that experienced in the preceding several years and, to achieve the projected nominal GNP, will require sizable increases in velocity. There clearly are many pitfalls in linking a given rate of growth of money to expected GNP and interest rates, but our general view is that high interest rate levels--shown in the middle panel--will be required on average to restrain strong underlying demands for goods and services in the economy and related demands for money. Such restraint on financial markets likely would be consistent with a moderate volume of funds raised by nonfinancial sectors relative to GNP, as displayed in the bottom panel.

The household sector, the next chart, is the main area in which total borrowing demands are expected to be appreciably constrained. So far this year, household borrowing has remained close to the sharply reduced volume in 1980. We expect little growth of consumer borrowing next year, consistent with the generally sluggish activity projected for the credit-sensitive housing and durable goods markets. The reduction in borrowing from the rapid pace in the late 1970s has led to some decline in total debt outstanding relative to disposable income, as

shown in the bottom panel, and further declines are projected. This measure does not take account of the terms of debt taken on or the distribution of debt among households, so one can draw only a small degree of comfort when looking at this aspect of the financial status of households.

In the corporate sector, the next chart, financing requirements are likely to continue rising this year and next, as indicated in the top left panel. Businesses generally appear to be under appreciable financial strain and there is reportedly a strong desire to fund some of their short-term debts. While we anticipate a little rise of long-term financing over the course of the projection, the markets seem unlikely to be receptive to much more than is forecasted and firms may perceive rates to be unattractive. Thus, business borrowing at banks probably will be sizable--the top right-hand panel--and short-term debt will continue to rise as a proportion of total debt--the bottom left-hand panel. Pressures on balance sheets arise partly from the sluggish performance of profits, the bottom right-hand panel, and although profits after tax are projected to grow further next year they are weak relative to corporate outlays. Profits as a percent of GNP, a proxy for profit margins, are expected to remain depressed, which is not unusual for a period of slow economic growth and deceleration of inflation.

A key element in the outlook for inflation is the behavior of wages, shown on the next chart. The top panel indicates average hourly earnings this year have been diverted from the steep uptrend in 1980. The evidence on slower growth

of wages is still tentative since it hasn't persisted very long and it is not yet pervasive. But it is encouraging and should be assisted by the recent better price performance through somewhat smaller cost-of-living adjustments and through lower nominal wage demands. We anticipate persistent slack in labor and product markets will contribute to a further moderation of wage growth next year which will help slow increases in hourly compensation--the bottom panel. Moreover, legislated changes which add to compensation costs will be small in 1982 with no minimum wage increase scheduled nor a huge boost in social security payroll taxes as occurred this past January.

The top panel of the next chart indicates that unit labor cost increases have slowed recently, as discussed by Mr. Zeisel, and the projected slowing of compensation growth should be showing up in reduced unit labor cost increases over time. And as noted by Mr. Truman, the energy outlook and the behavior of the foreign exchange value of the dollar both will have favorable domestic price implications. Overall, we believe there are now in train a number of forces operating to put the economy on a path of reduced inflation and this continues to be reflected in the staff's forecast.

The last chart compares the preliminary administration revised forecast for 1981 and 1982 with the staff forecast. The main difference between the forecasts in 1981 is the projection of the implicit GNP deflator, although both point to

a considerable improvement over the 10 percent increase last year. In 1982 the price forecasts are similar, but they occur in the context of much different prospects for real growth. As a result the administration projection of nominal GNP expansion remains high historically, having been exceeded only once in the past 30 years.

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

July 6, 1981

Principal Assumptions

Monetary Policy

- Growth of M1-B of 4¾ percent in 1981, abstracting from shifts into NOWs, and 4¼ percent in 1982

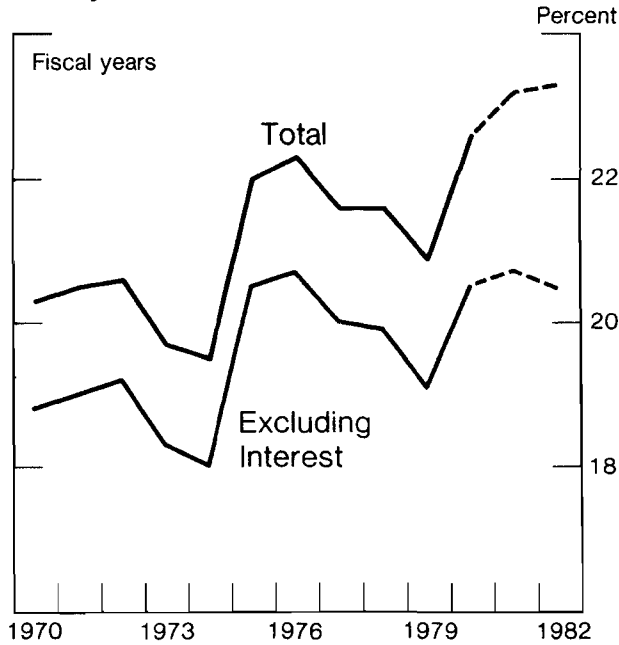
Fiscal Policy

- Unified budget expenditures of \$663 billion in FY 1981 and \$725 billion in FY 1982
- Personal and business tax cuts
Personal cuts of \$27 billion in FY 1982
Business cuts of \$8 billion in FY 1982

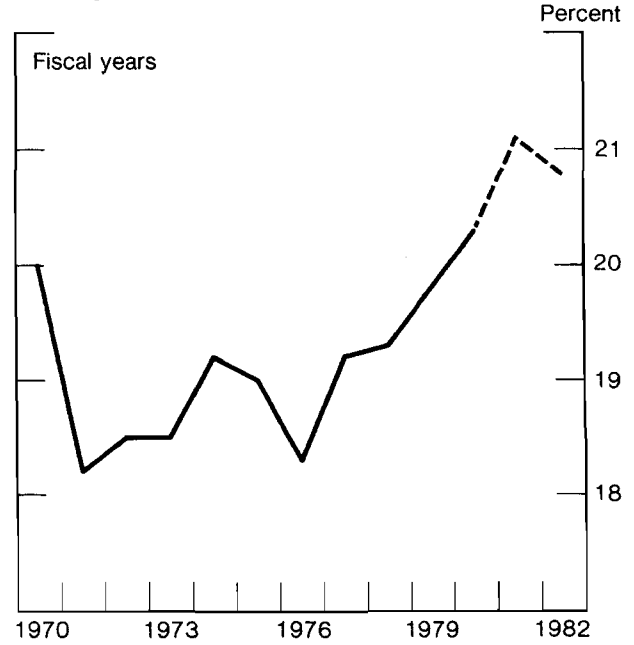
Federal Budget

	Fiscal Years, Unified Budget Basis					
	1980		1981		1982	
	Billions of Dollars	Percent Change	Billions of Dollars	Percent Change	Billions of Dollars	Percent Change
Outlays	\$ 580	17%	\$ 663	14%	\$ 725	9%
Receipts	\$ 520	12	\$ 603	16	\$ 646	7
Deficit	\$ 60		\$ 60		\$ 79	

Outlays as a Percent of GNP



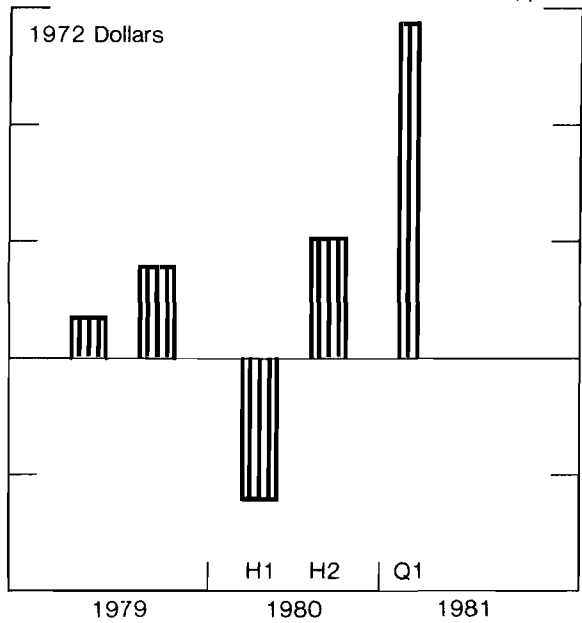
Receipts as a Percent of GNP



Economic Activity

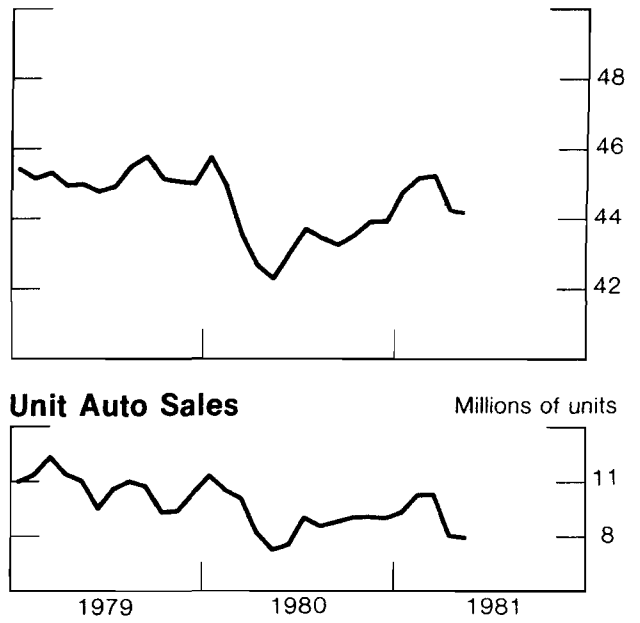
Real GNP

Change from end of previous period,
annual rate, percent



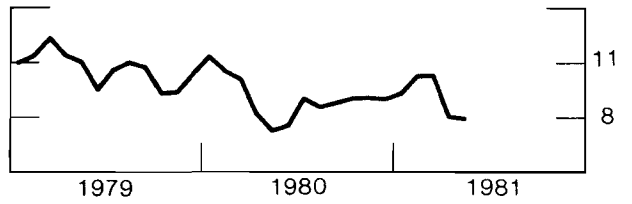
Real Retail Sales

Billions of 1972 dollars



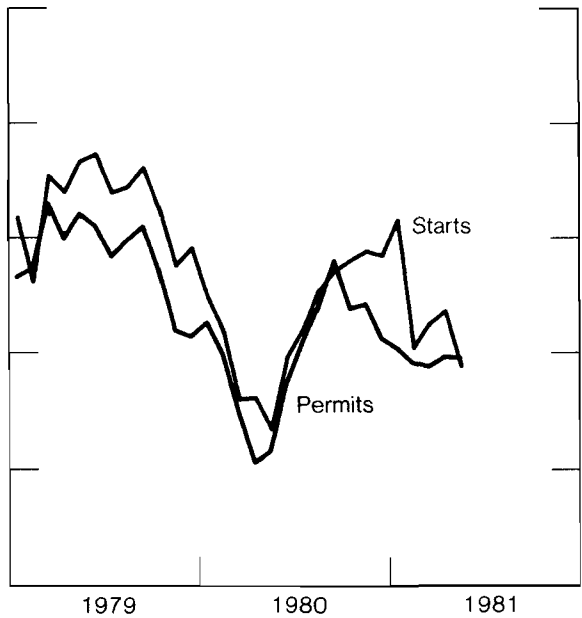
Unit Auto Sales

Millions of units



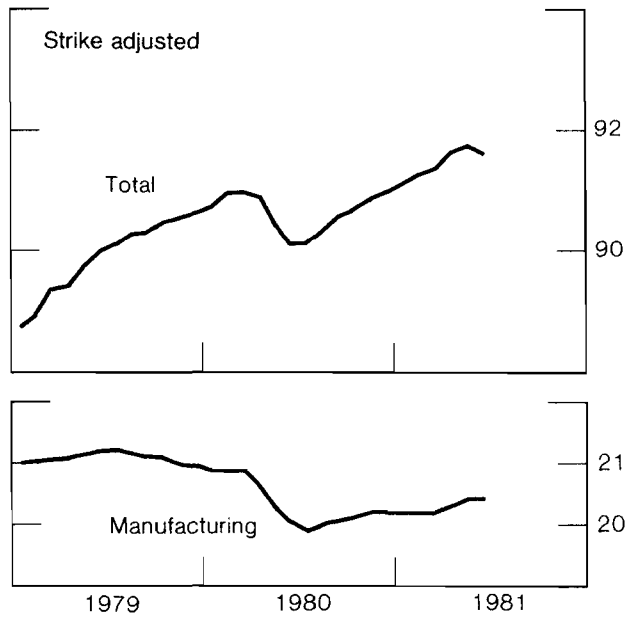
Housing Starts and Permits

Millions of units



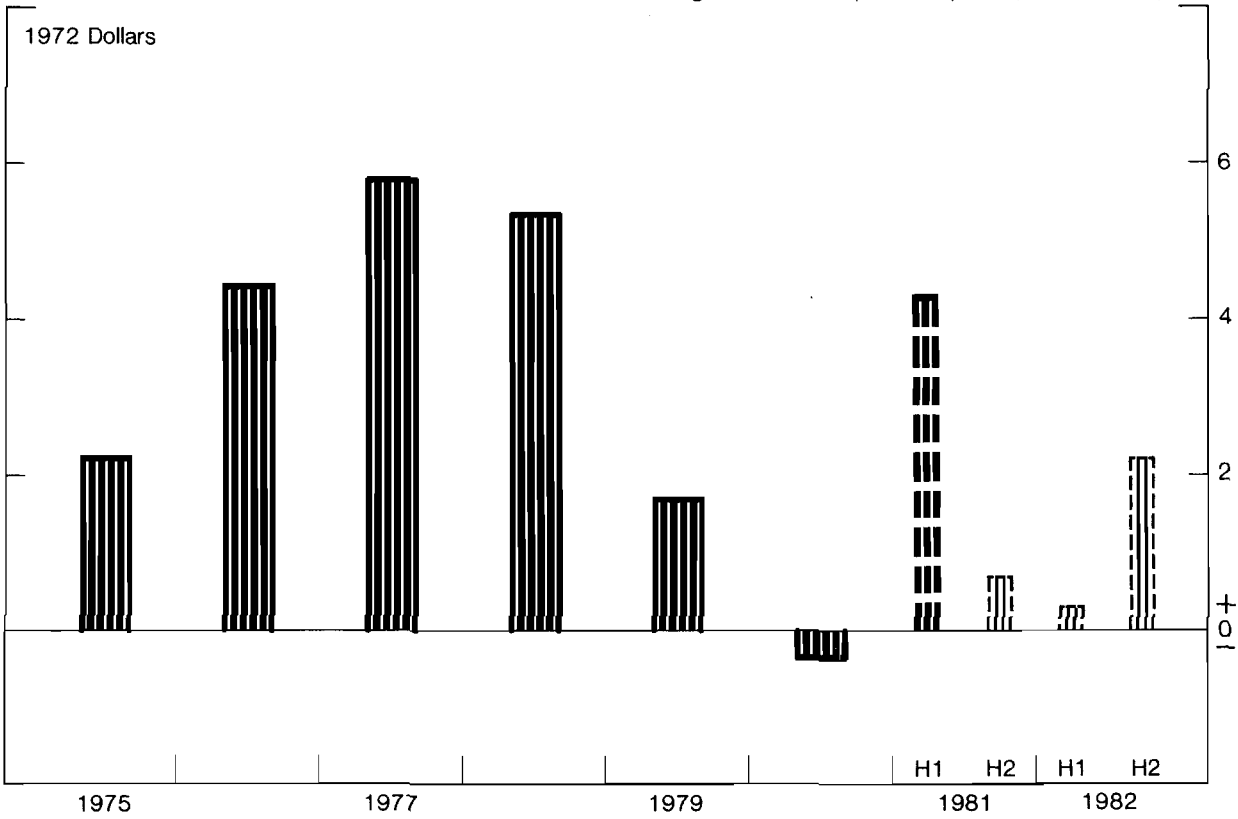
Nonfarm Payroll Employment

Millions of workers



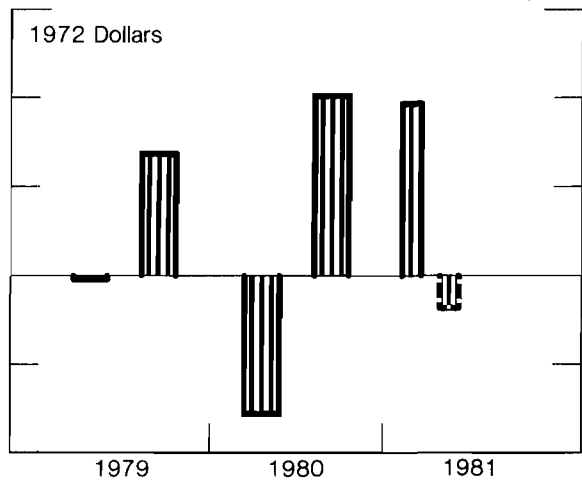
Real GNP

Change from end of previous period, annual rate, percent



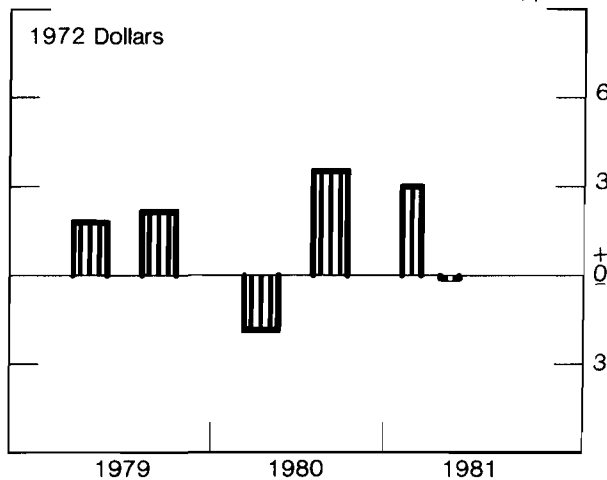
Real Personal Consumption Expenditures

Change from previous period, annual rate, percent



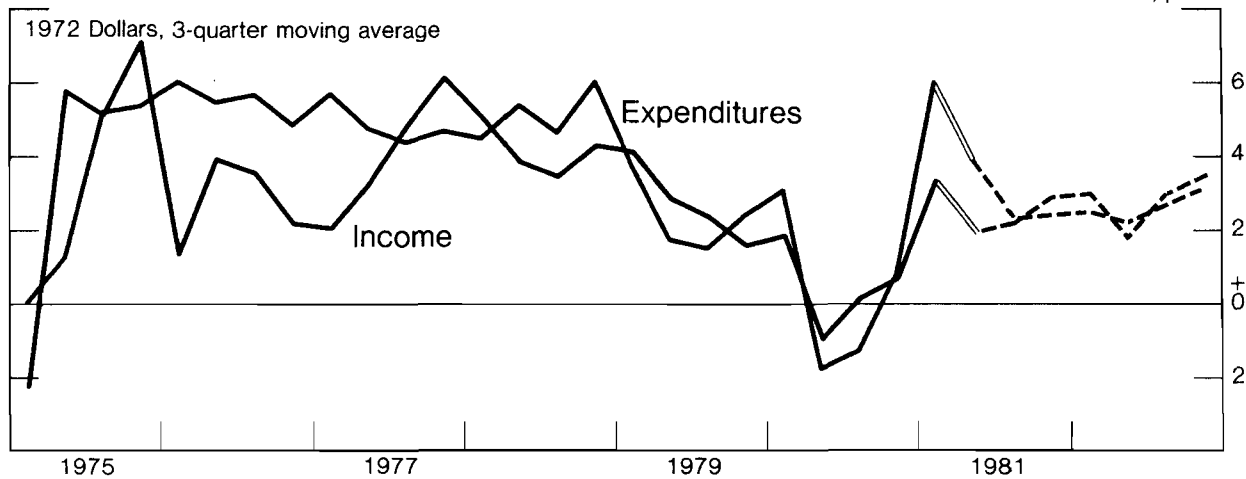
Real Disposable Personal Income

Change from previous period, annual rate, percent



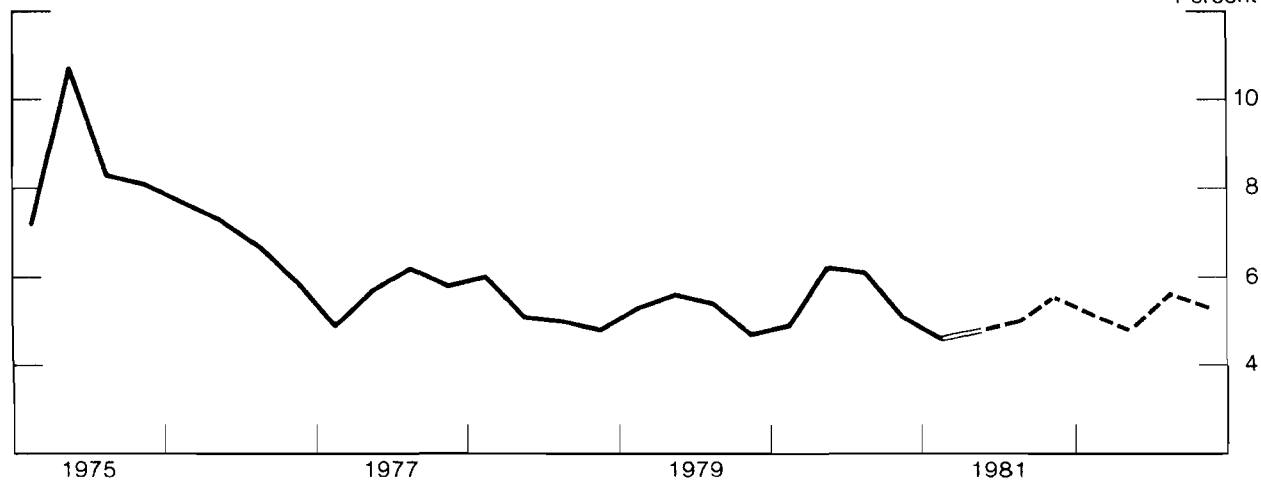
Real Disposable Personal Income and Consumption Expenditures

Change from previous period, annual rate, percent

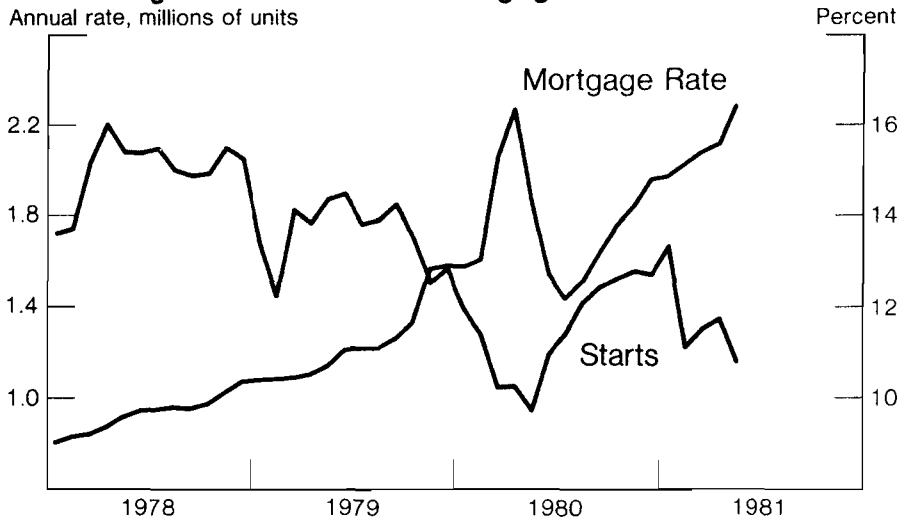


Saving Rate

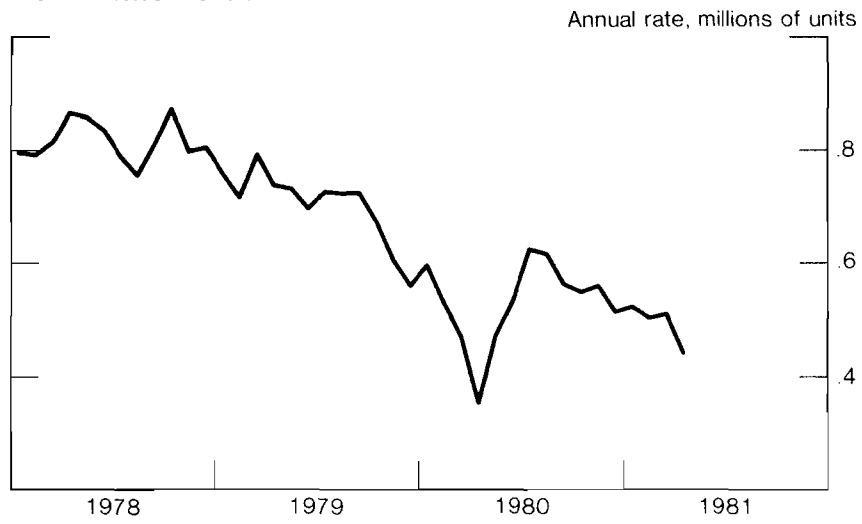
Percent



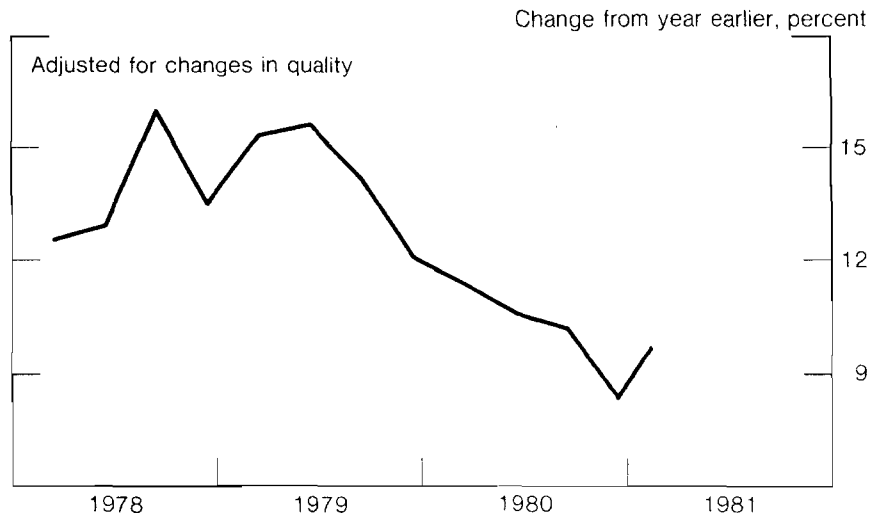
Housing Starts and Home Mortgage Rate



New Home Sales

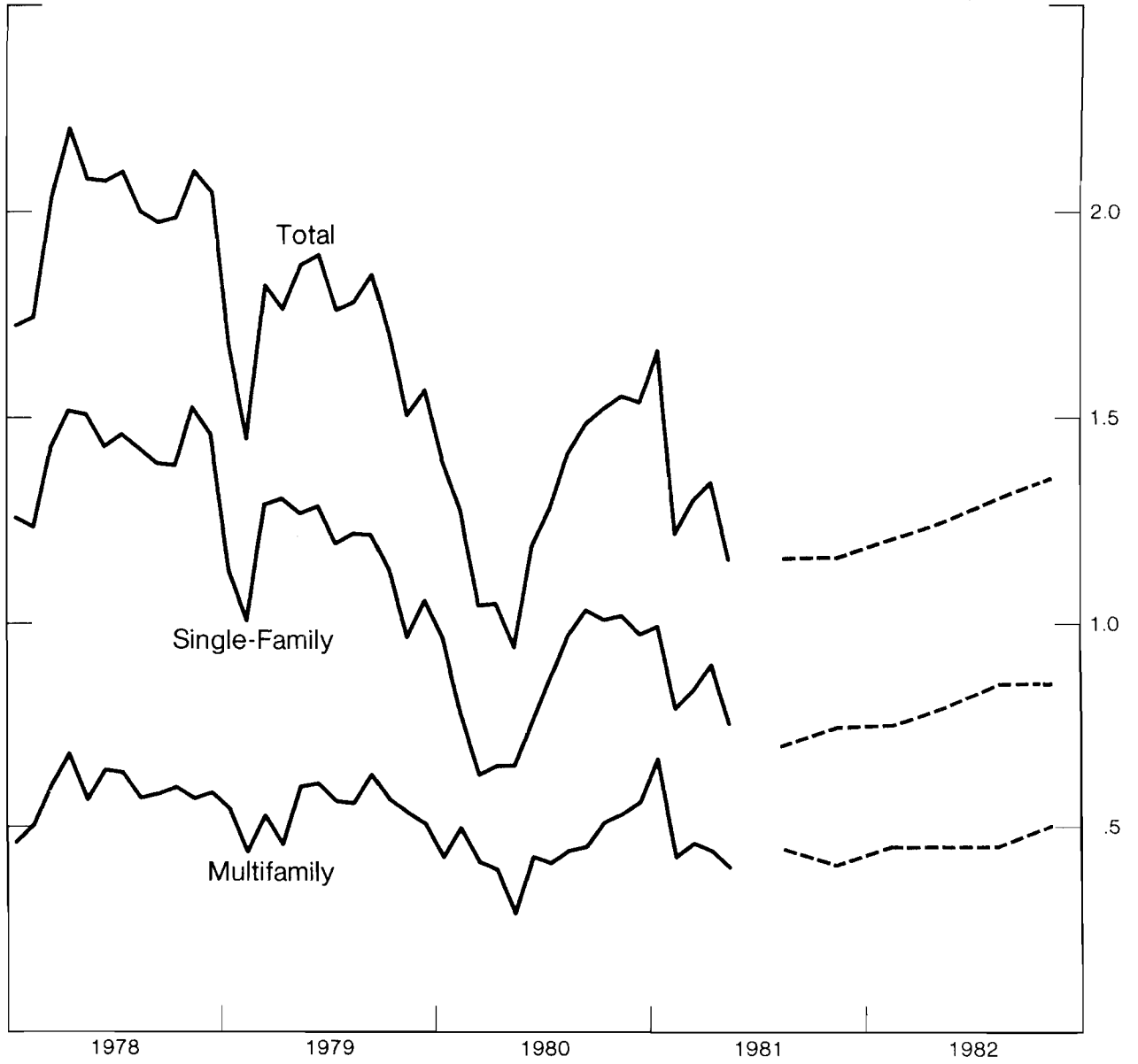


New Home Prices

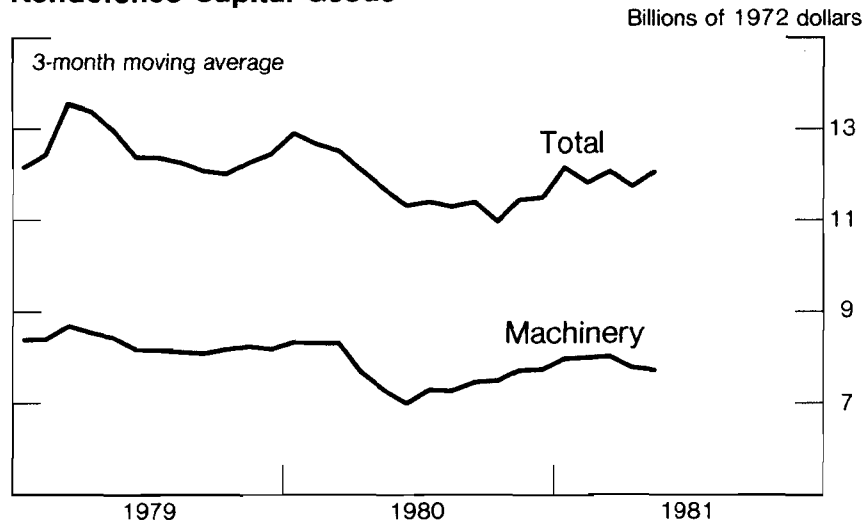


Housing Starts

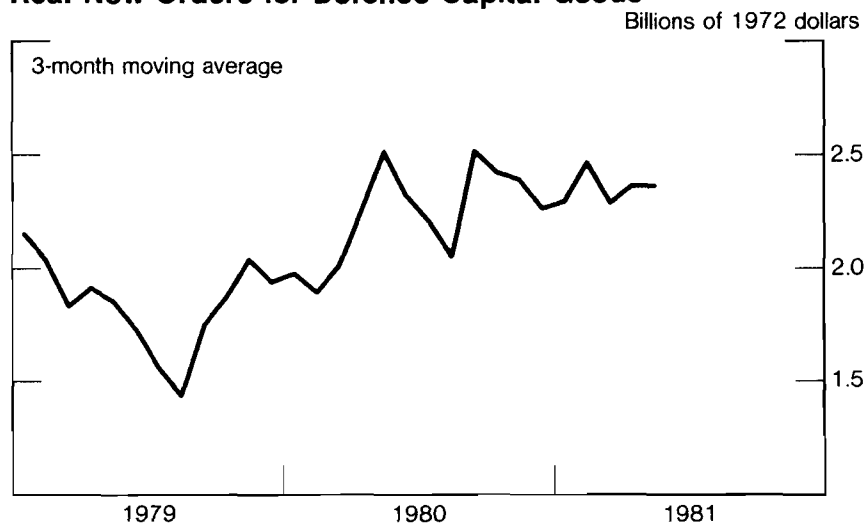
Annual rate, millions of units



**Real New Orders for
Nondefense Capital Goods**



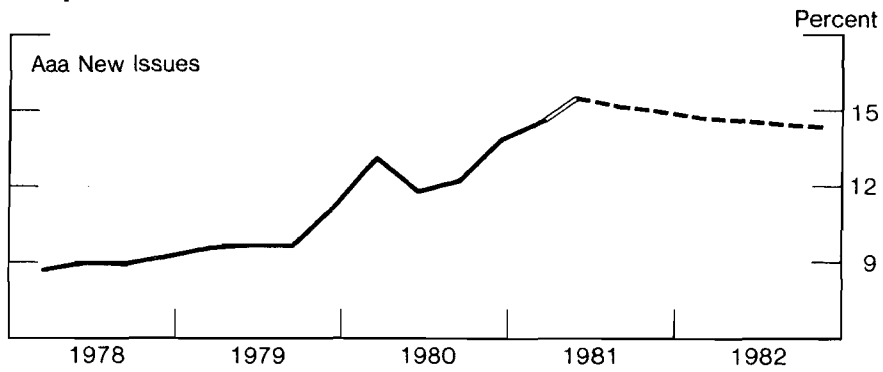
Real New Orders for Defense Capital Goods



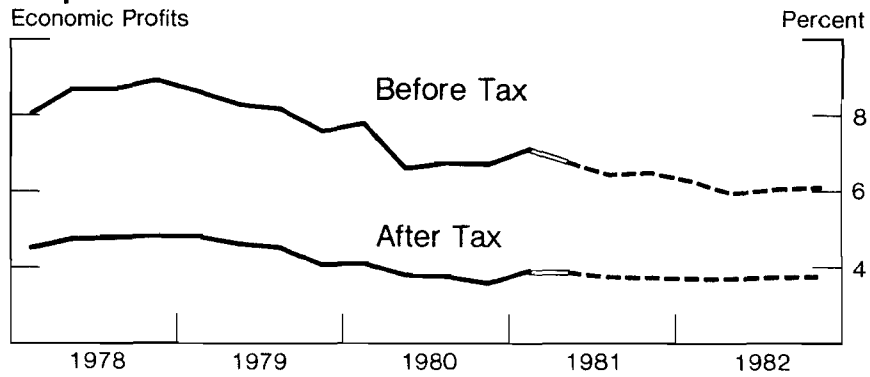
Business Construction Contracts



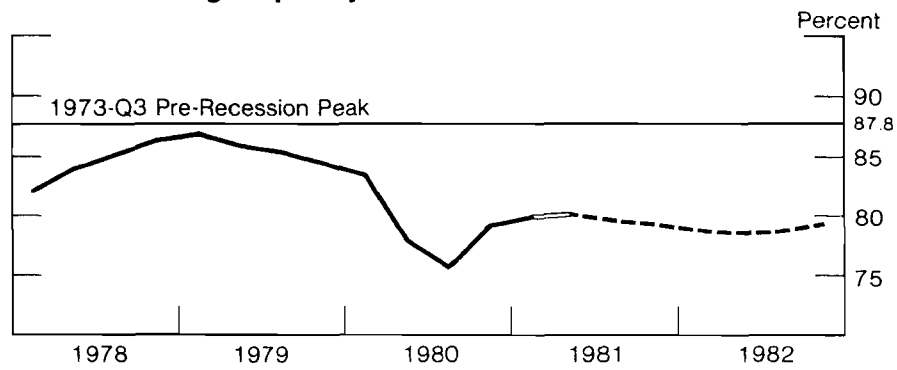
Corporate Bond Rate



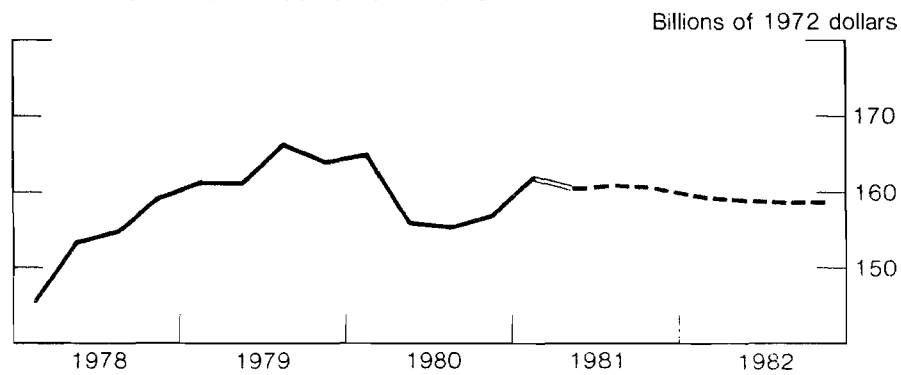
Corporate Profits Relative to GNP



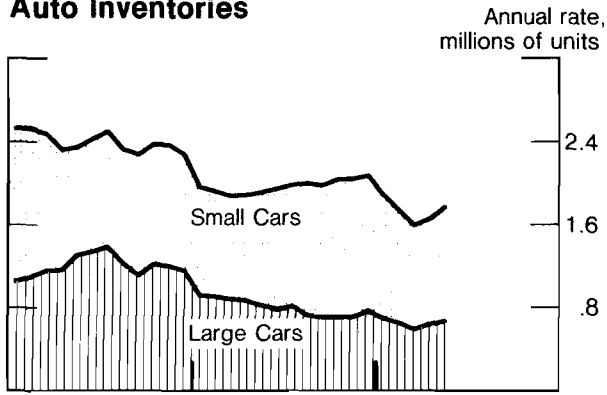
Manufacturing Capacity Utilization



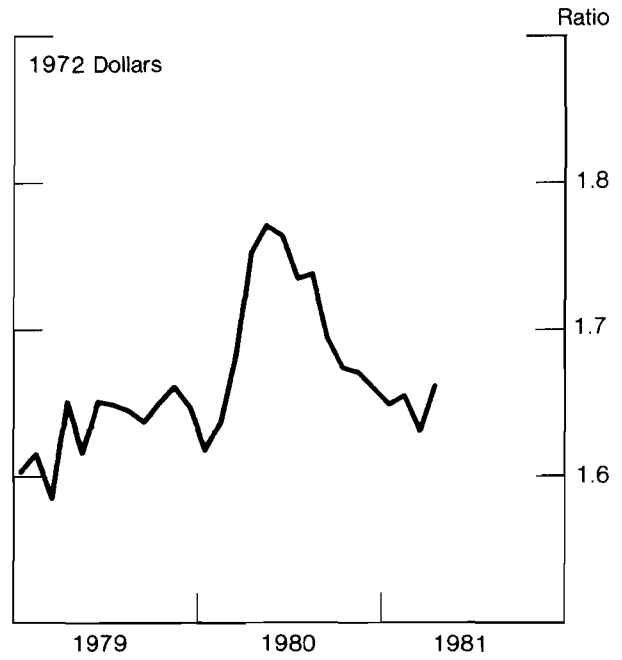
Real Business Fixed Investment



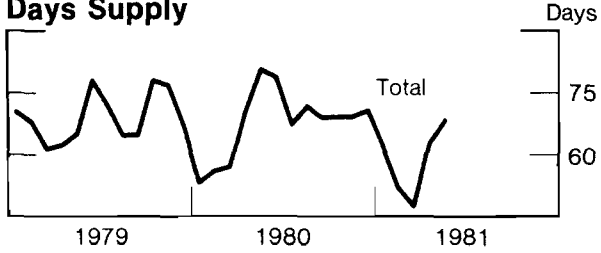
Auto Inventories



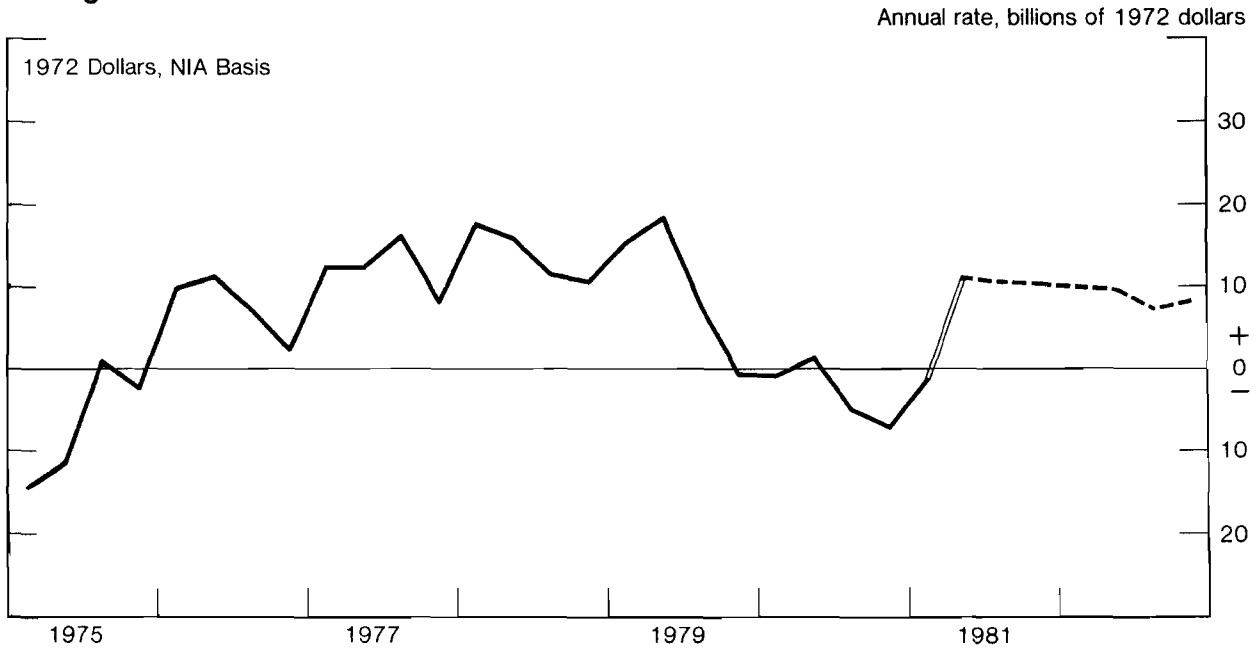
Manufacturing and Trade Inventories Relative to Sales



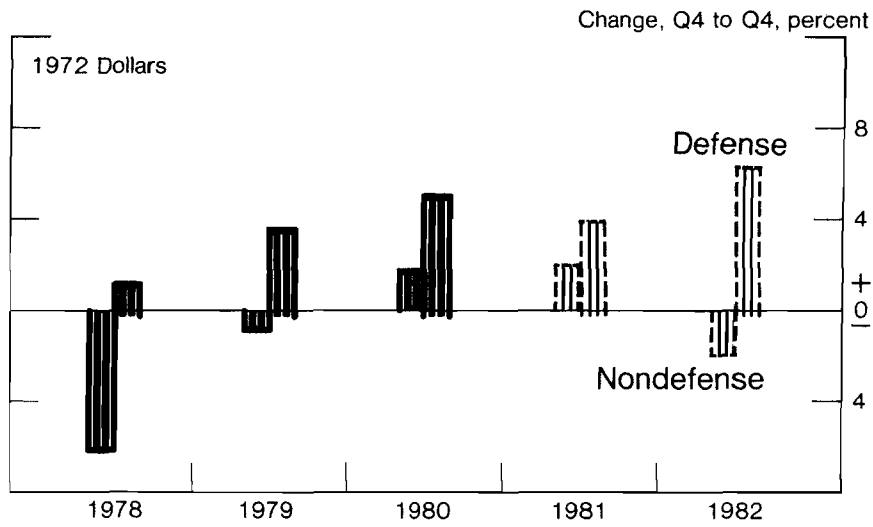
Days Supply



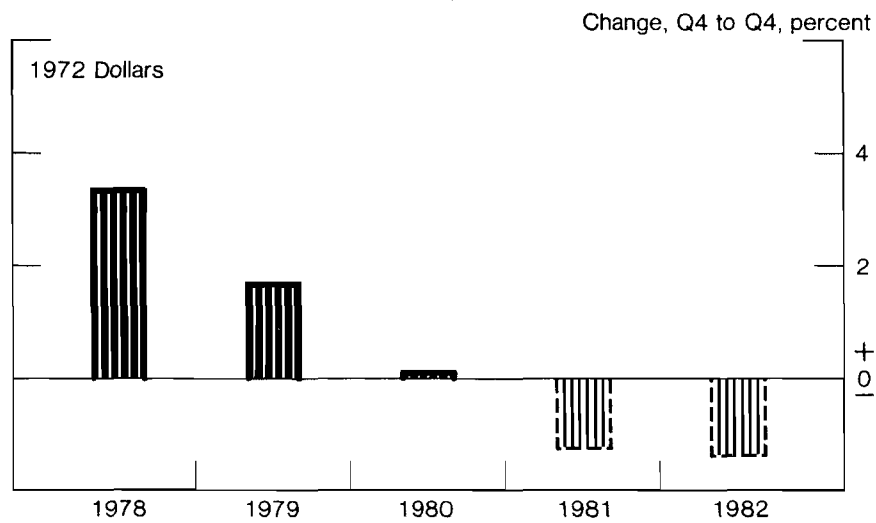
Change in Business Inventories



Real Federal Government Purchases



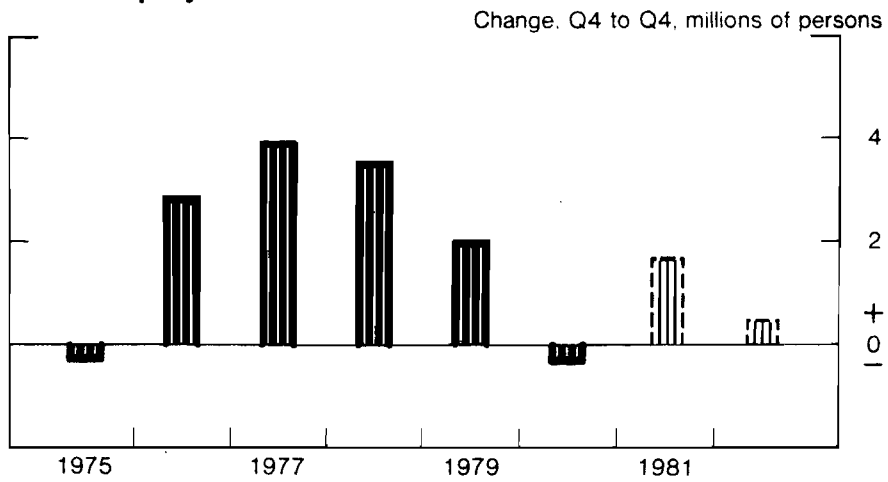
Real State and Local Purchases



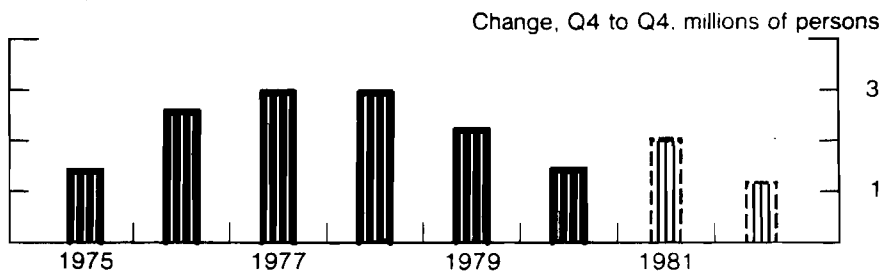
Real Total Government Purchases

1972 Dollars	
Change, Q4 to Q4, Percent	
1977	3.6
1978	1.6
1979	1.9
1980	1.6
1981P	0.4
1982P	0.6

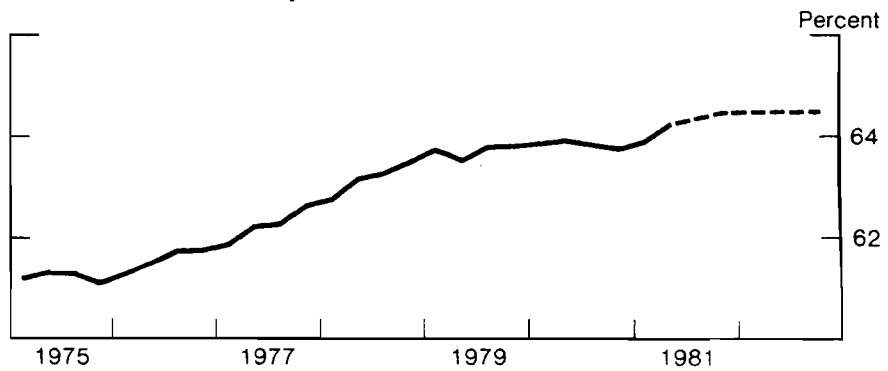
Total Employment



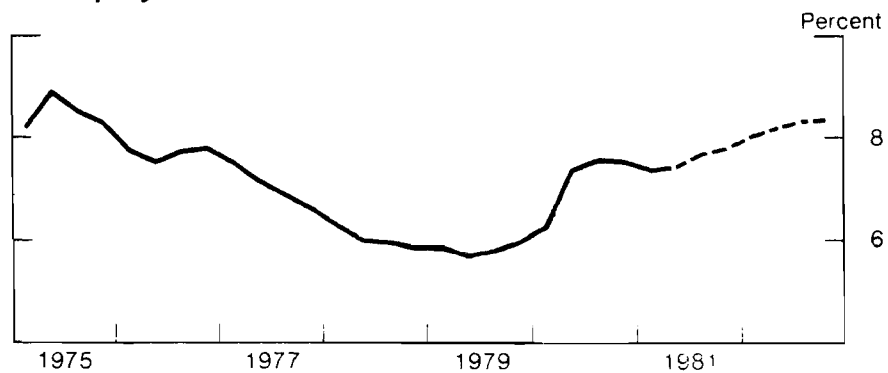
Civilian Labor Force



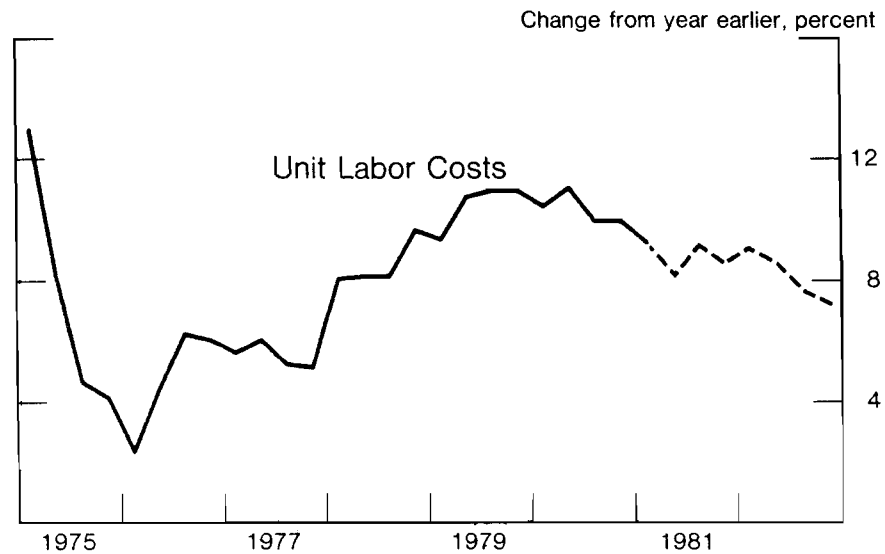
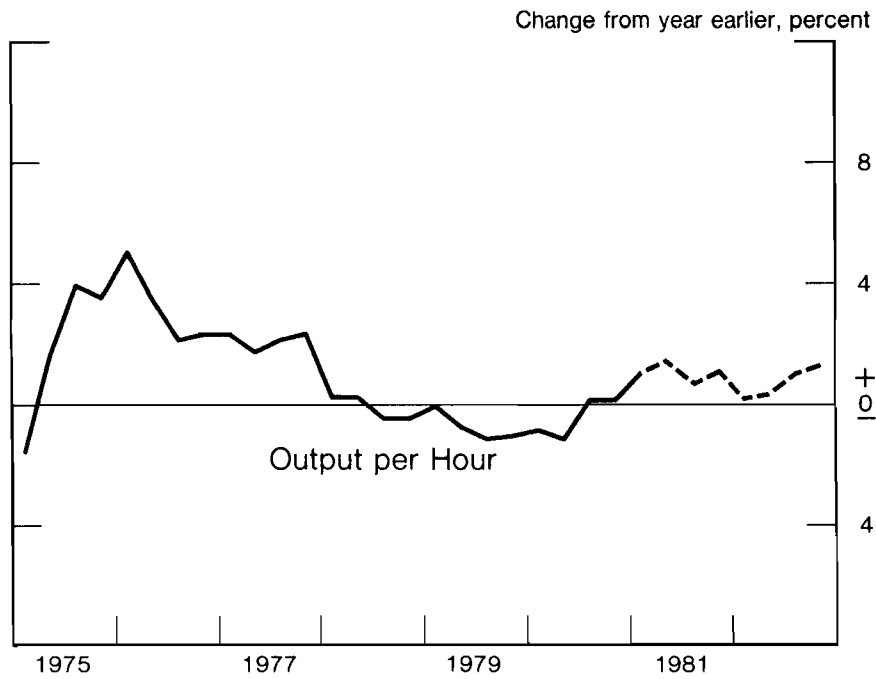
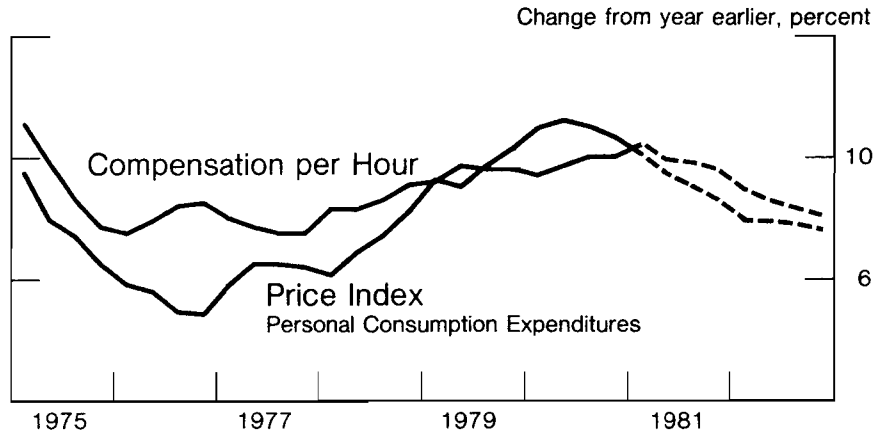
Labor Force Participation Rate



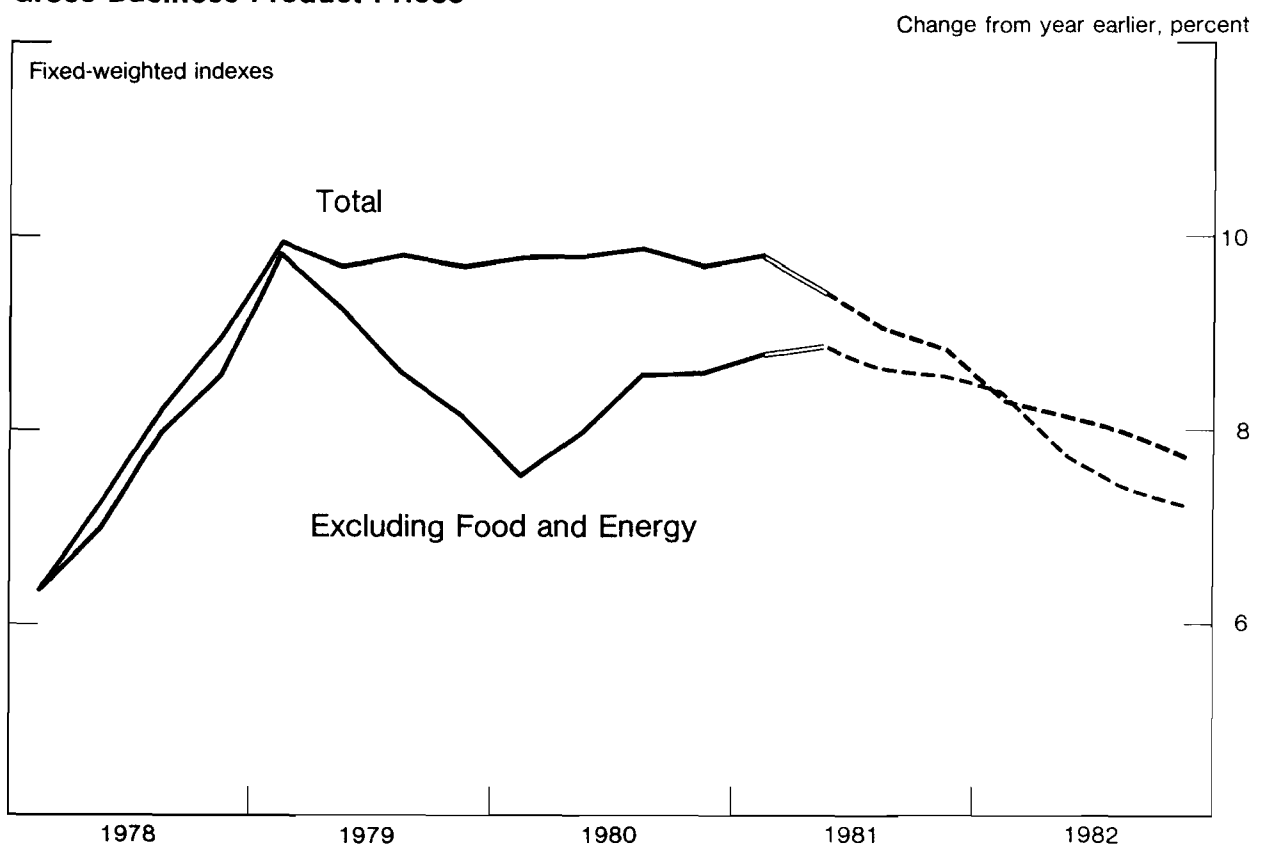
Unemployment Rate



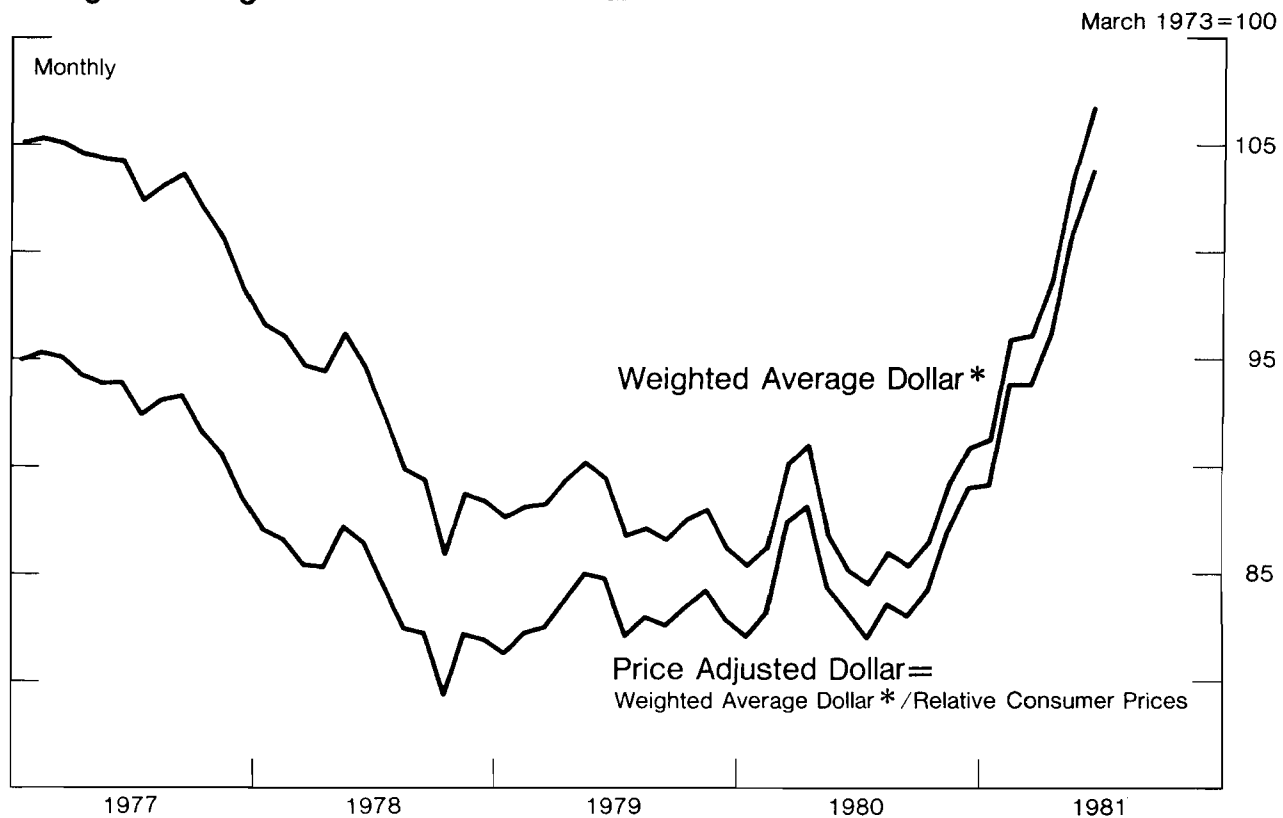
Unit Cost Indicators Nonfarm Business Sector



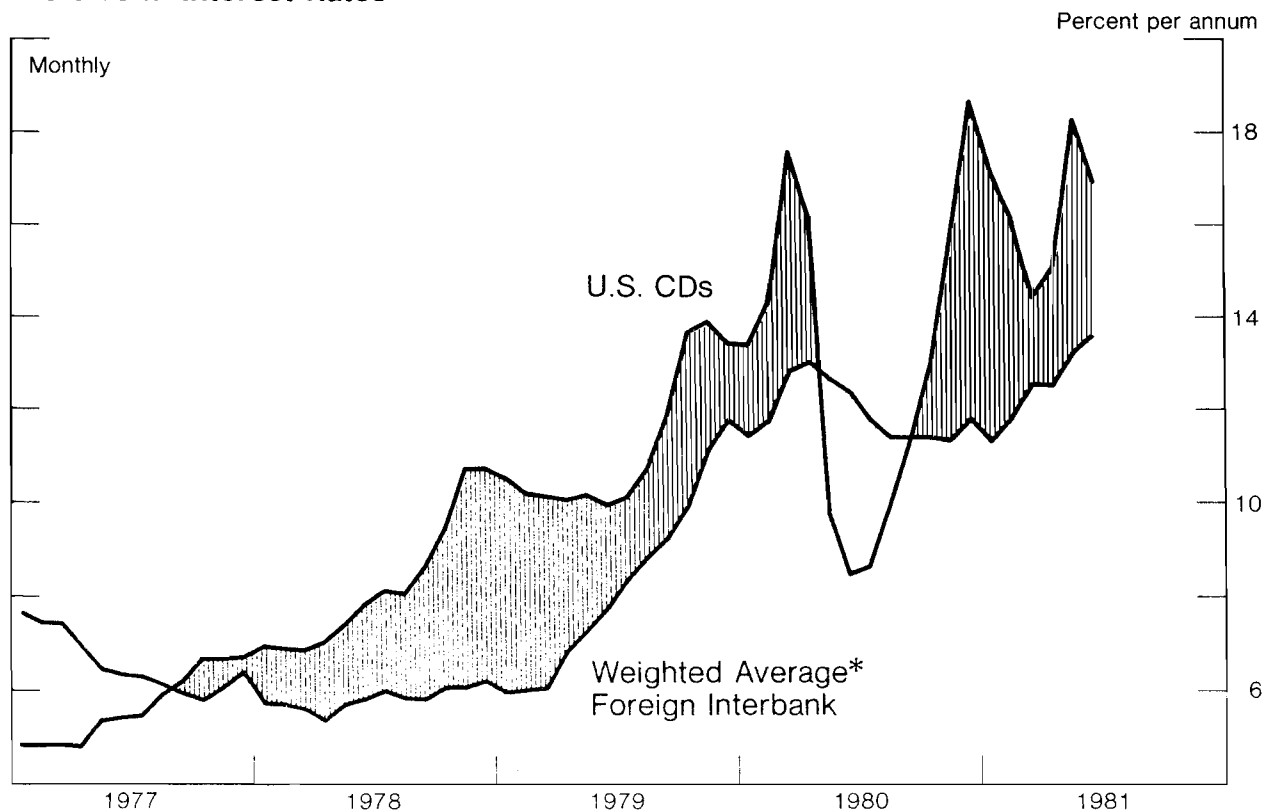
Gross Business Product Prices



Foreign Exchange Value of the U.S. Dollar

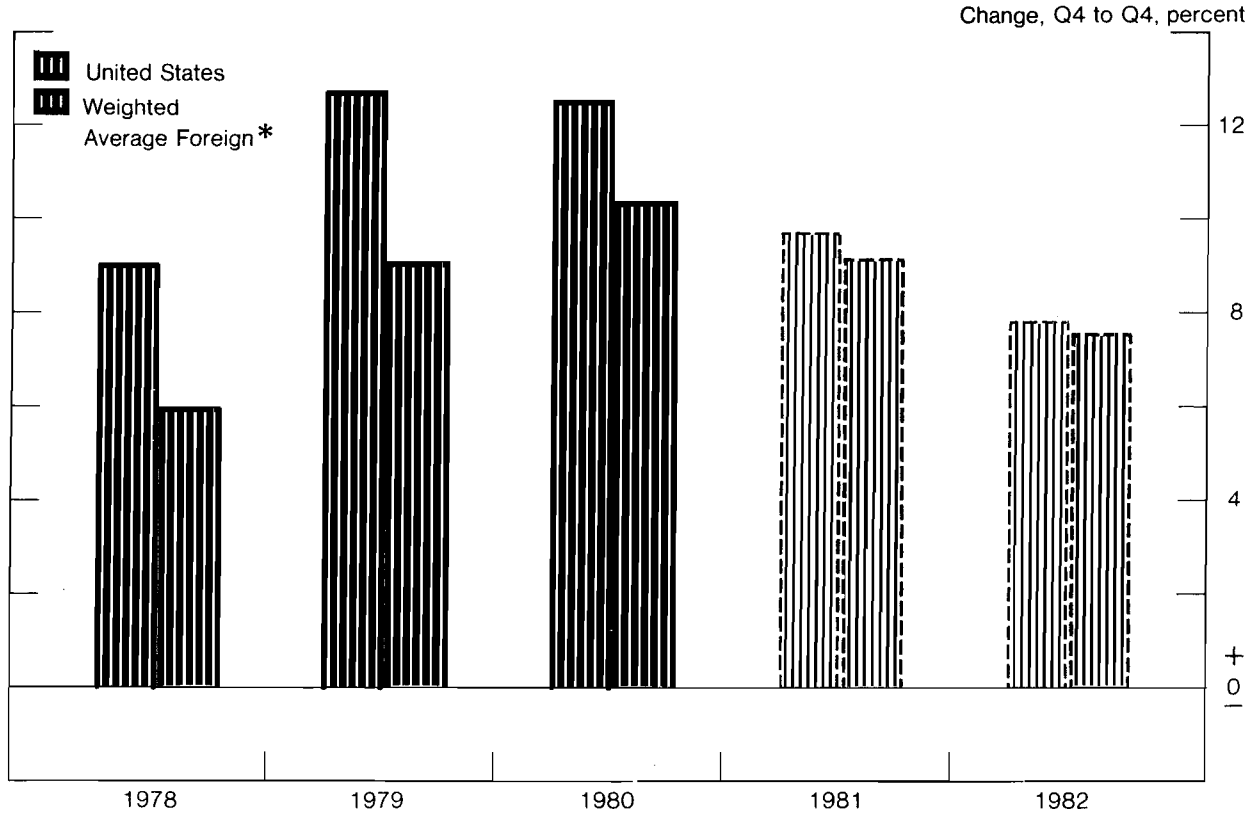


Short-Term Interest Rates

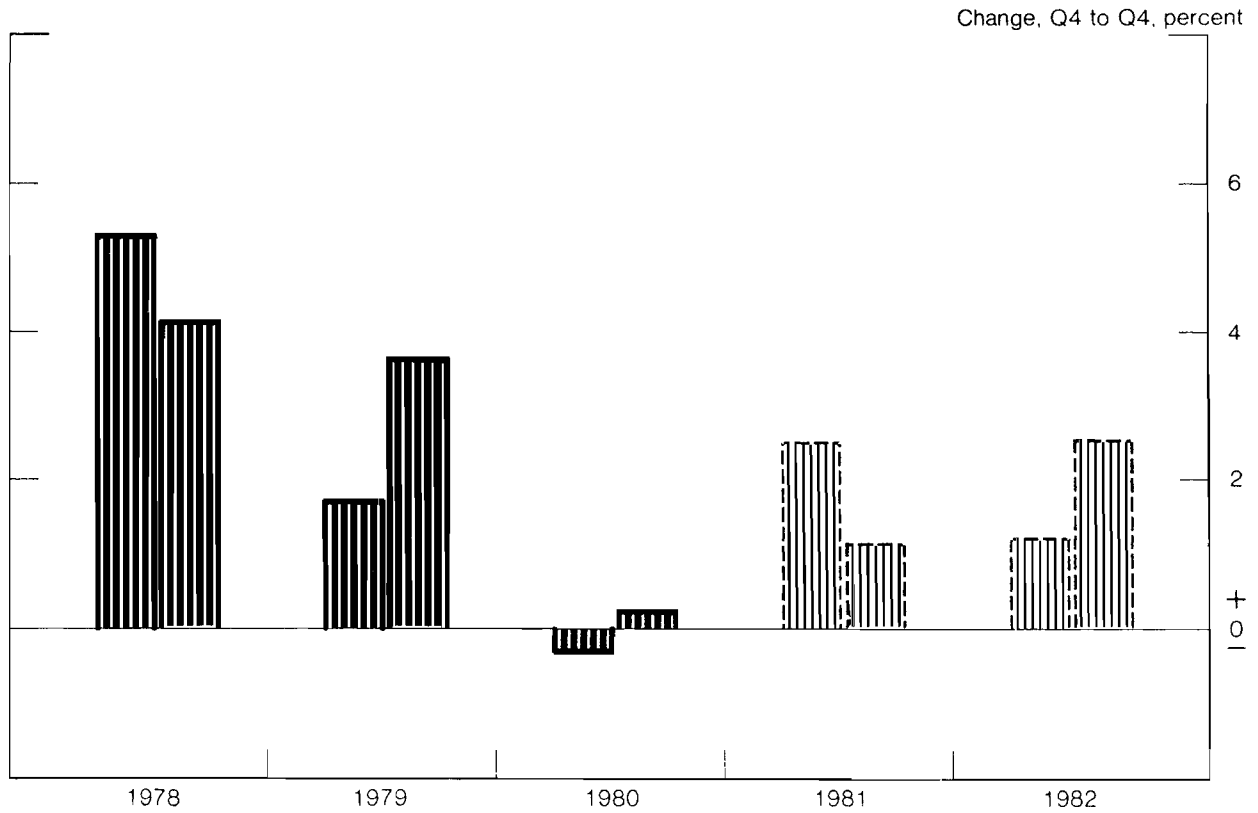


**Weighted average against or of G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

Consumer Prices



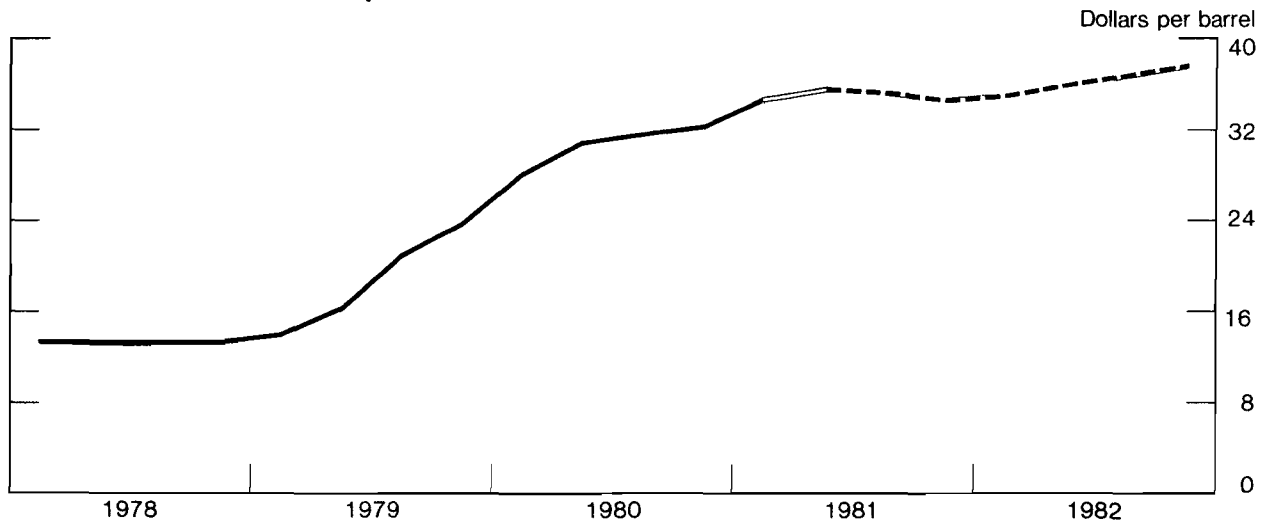
Real GNP



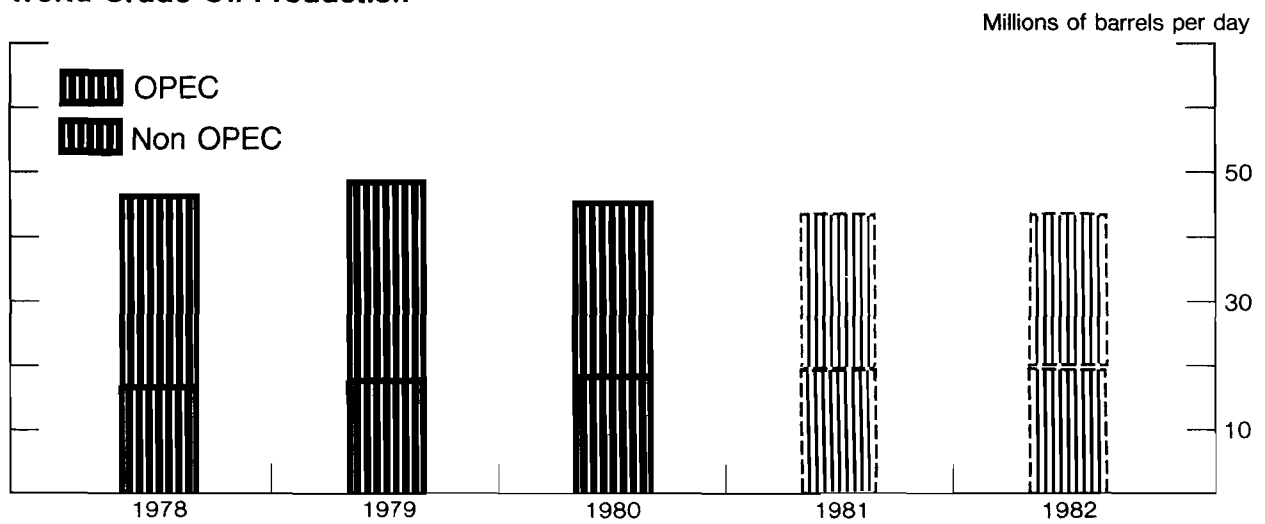
* Weighted average of G-10 countries plus Switzerland using total 1972-76 average trade of these countries

International Oil Market Developments

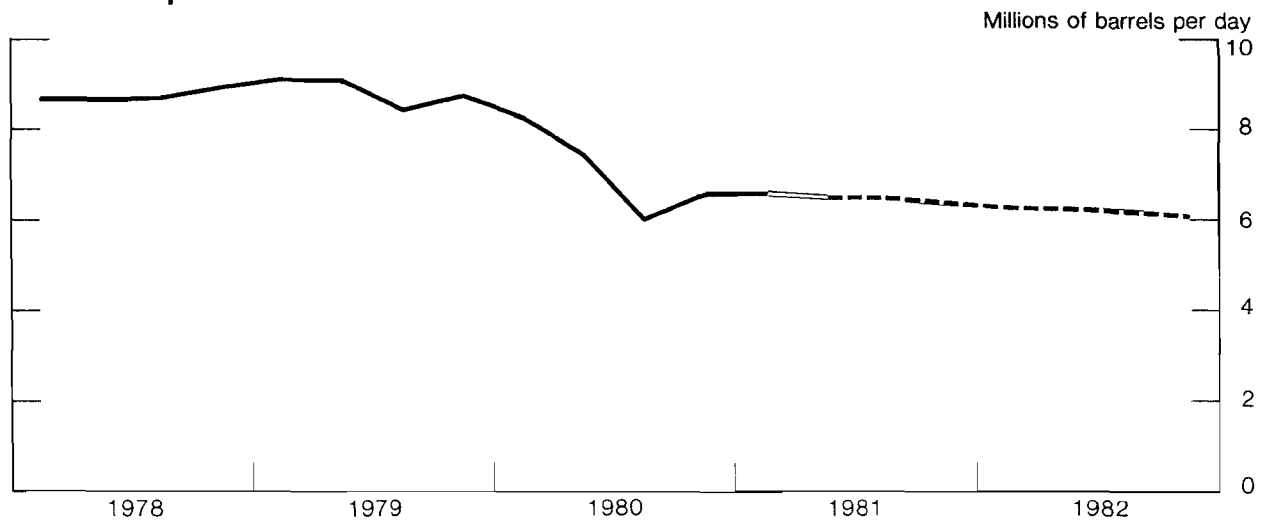
Unit Value of U.S. Oil Imports



World Crude Oil Production*



U.S. Oil Imports

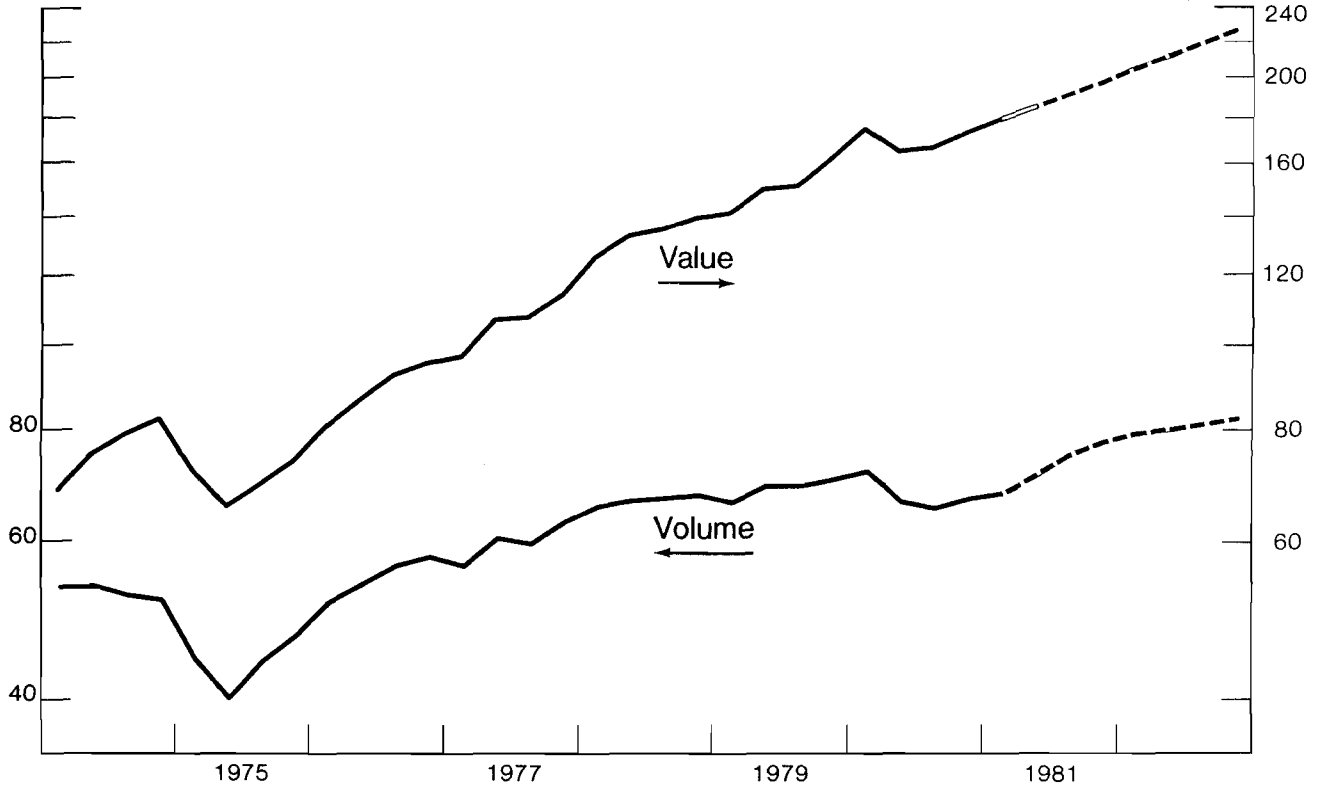


*Excluding the USSR and China.

Non-Oil Imports

Billions of 1972 dollars, ratio scale

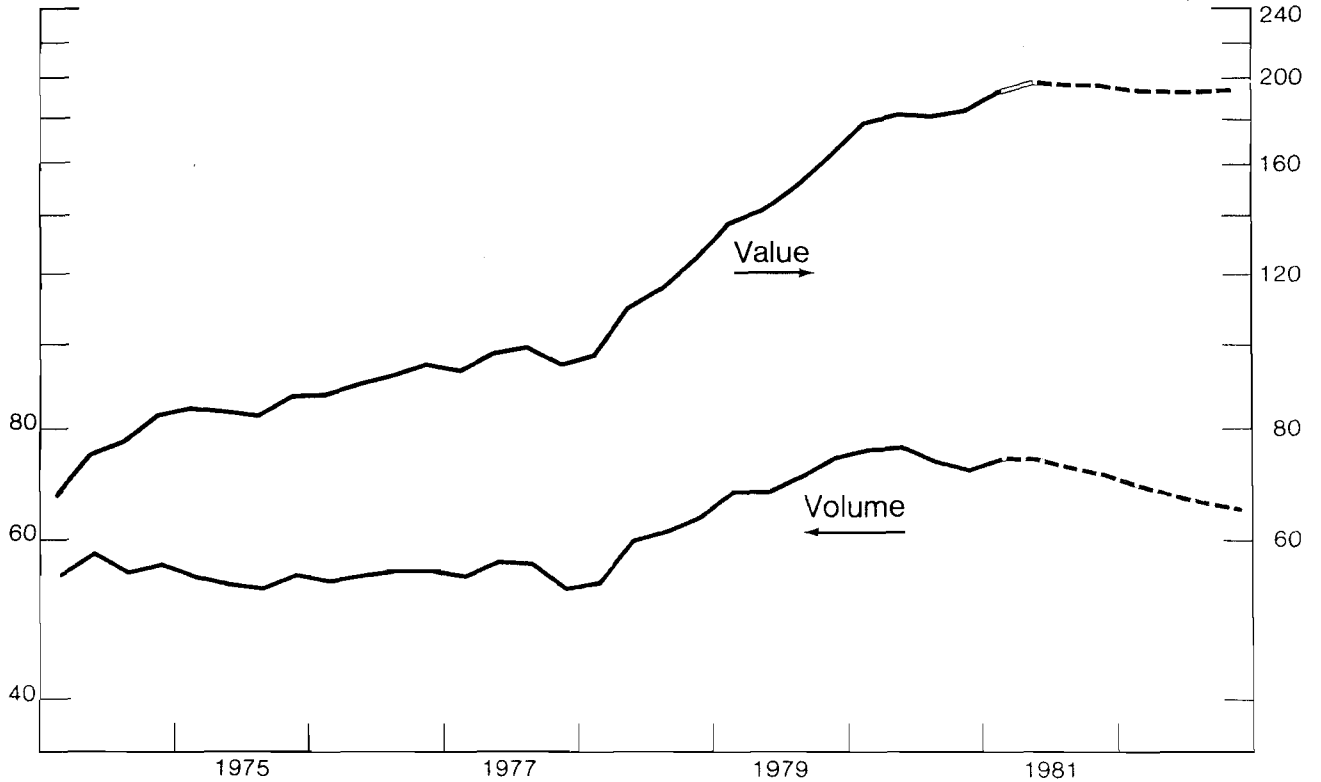
Billions of dollars, ratio scale



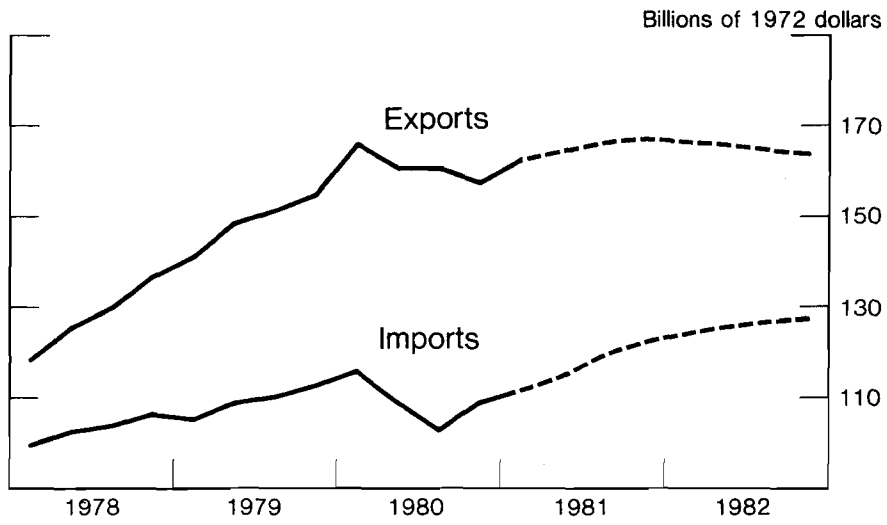
Nonagricultural Exports

Billions of 1972 dollars, ratio scale

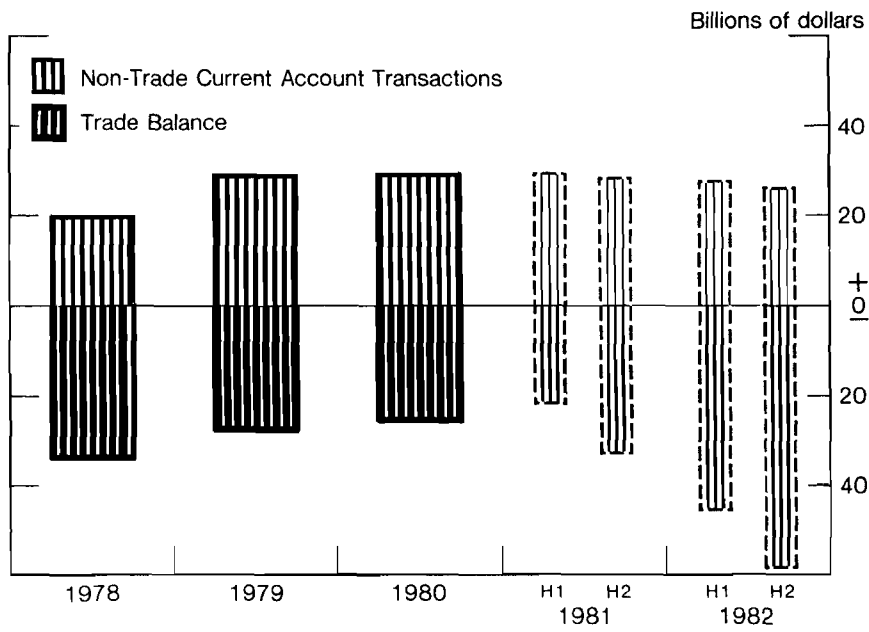
Billions of dollars, ratio scale



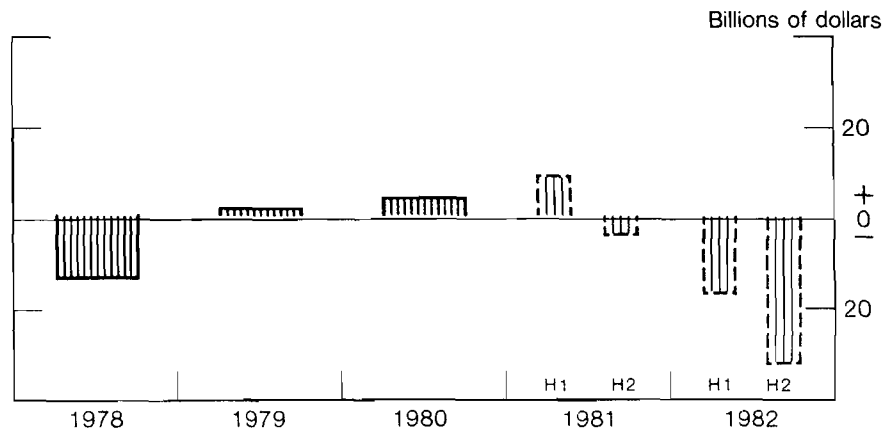
GNP Exports and Imports of Goods and Services



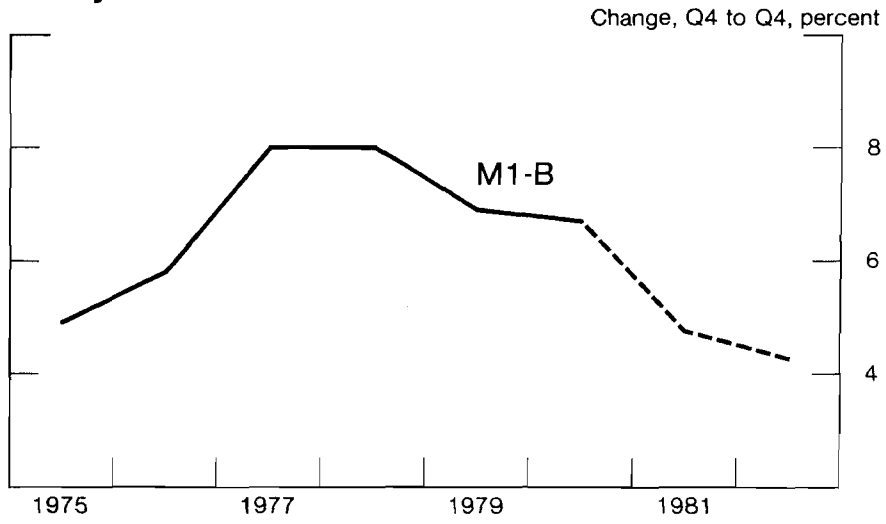
Current Account Transactions



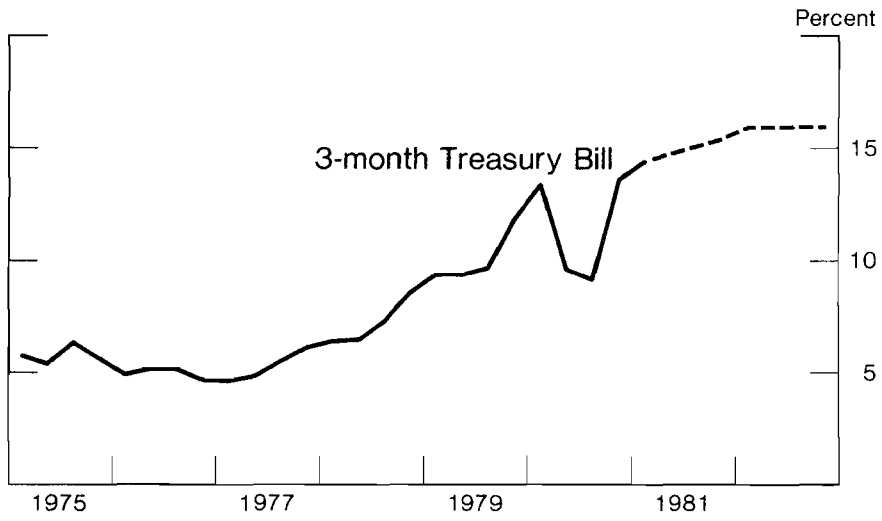
Current Account Balance



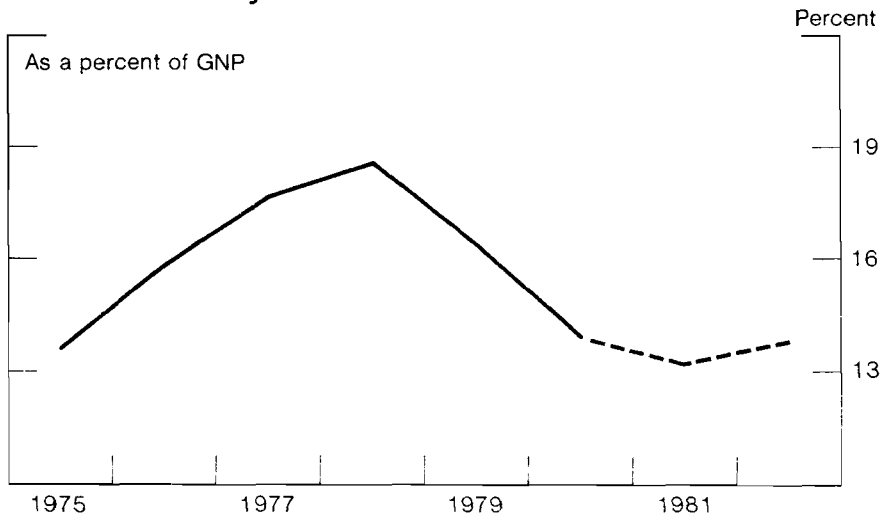
Money*



Interest Rates



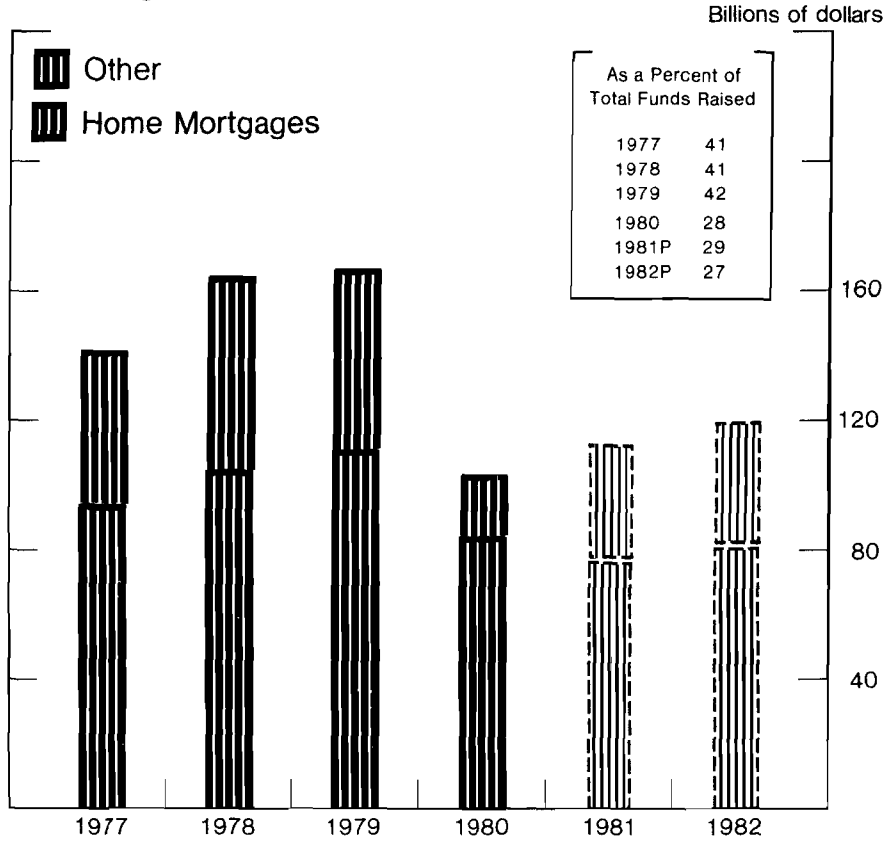
Funds Raised by Nonfinancial Sectors



* Abstracting from shifts into ATS and NOW accounts.

Households

Borrowing

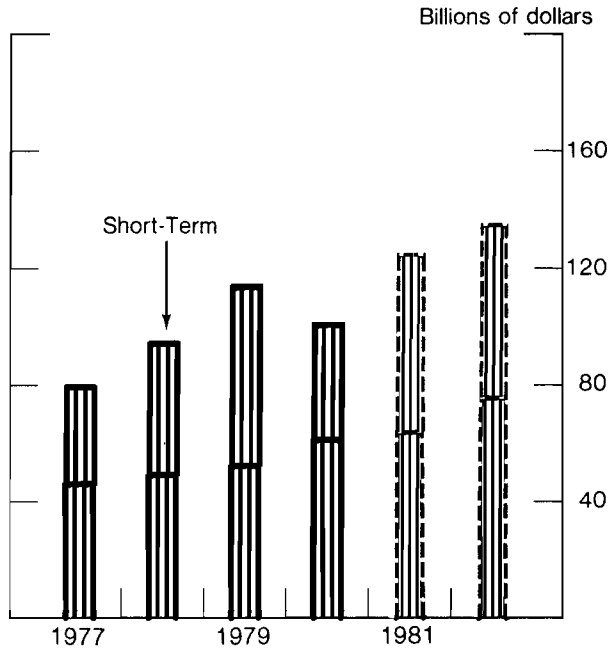


Total Debt Outstanding Relative to Disposable Personal Income

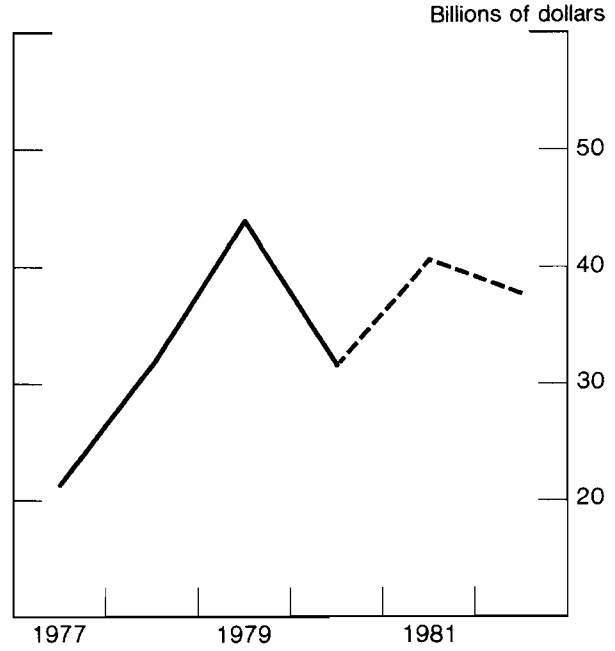


Nonfinancial Corporations

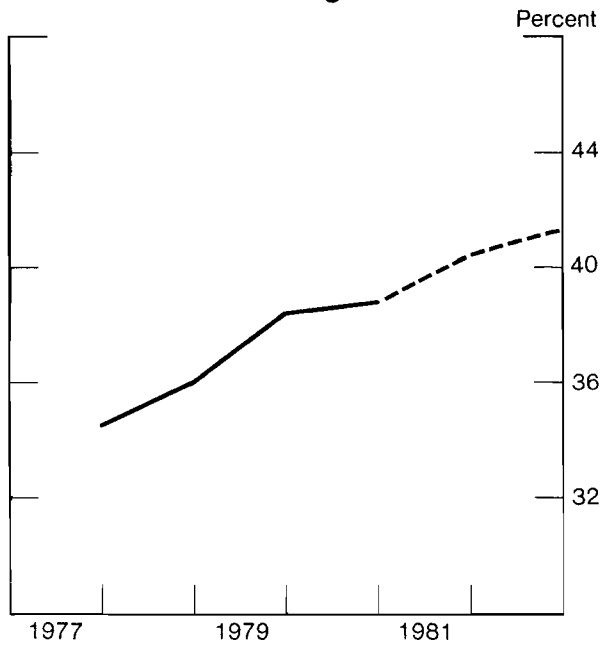
Funds Raised



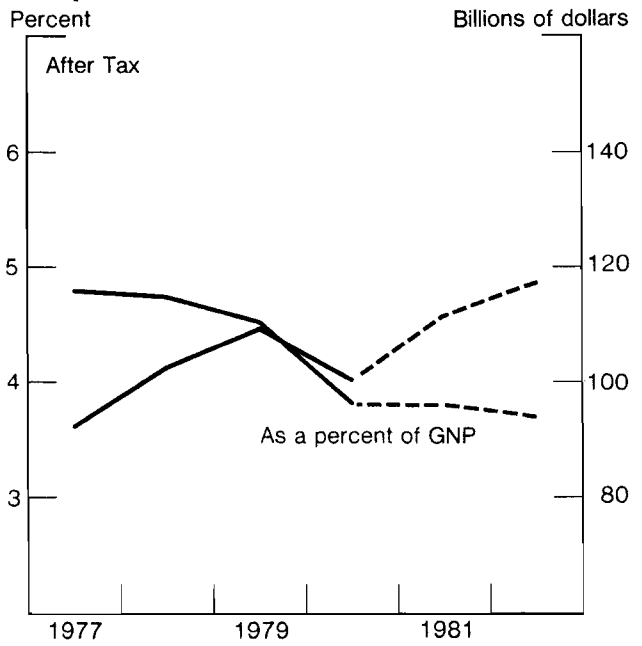
Borrowing at Banks



Short-Term Debt Relative to Total Debt Outstanding

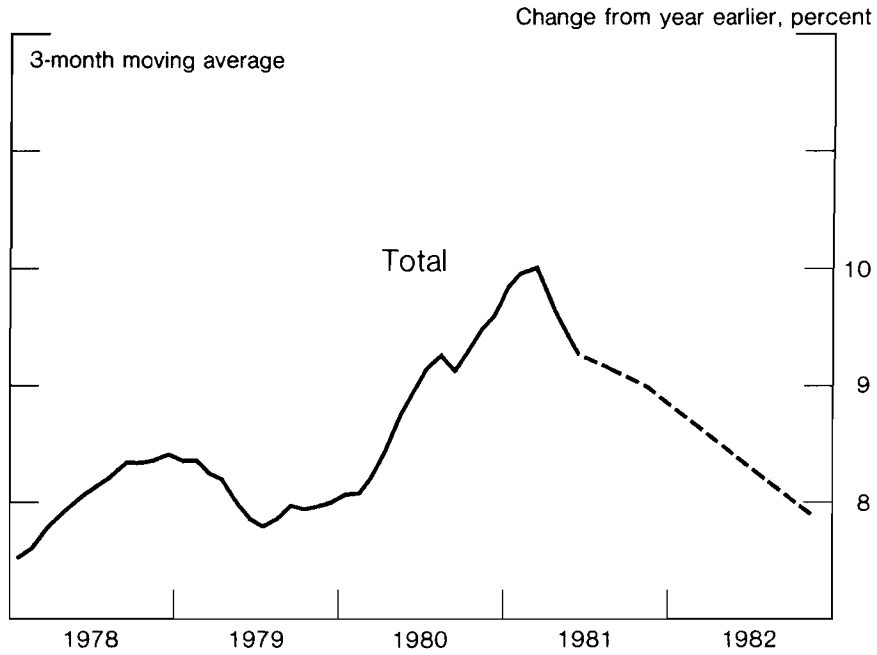


Corporate Profits



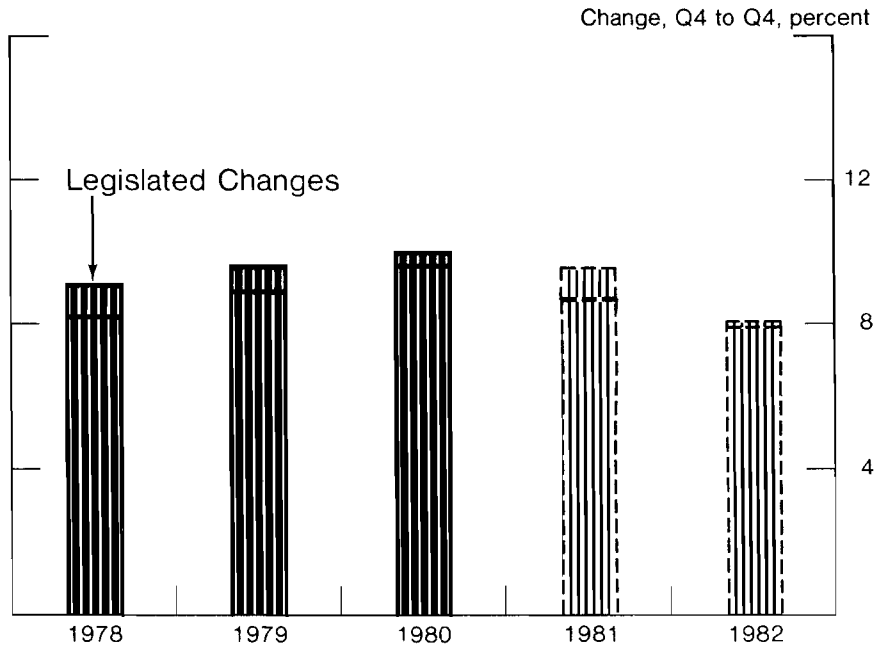
Average Hourly Earnings Index

Nonfarm Business Sector

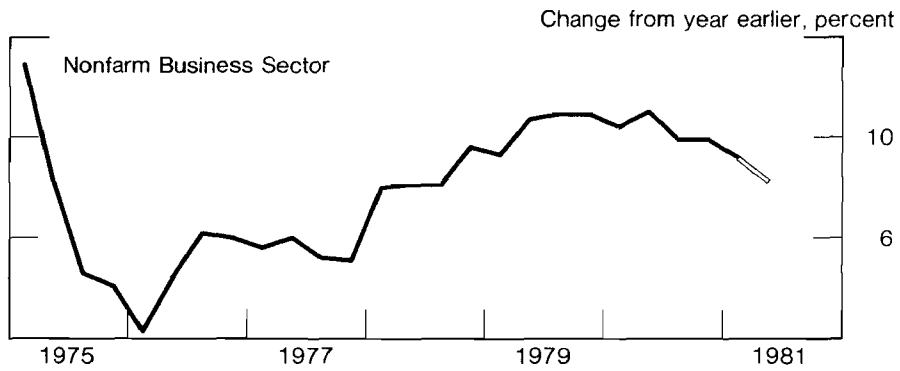


Hourly Compensation

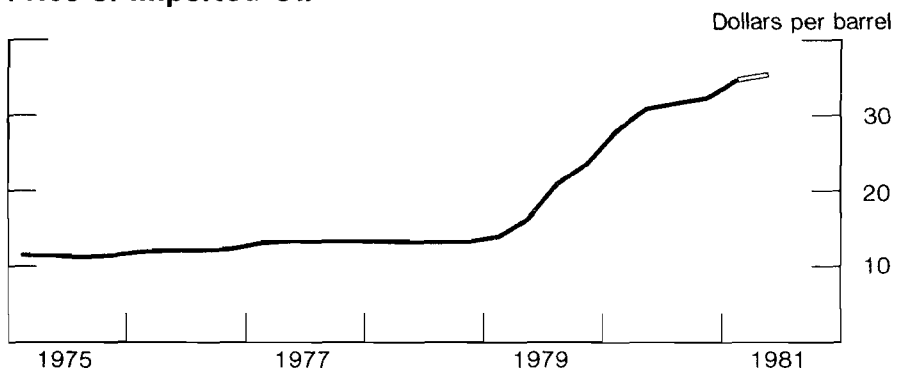
Nonfarm Business Sector



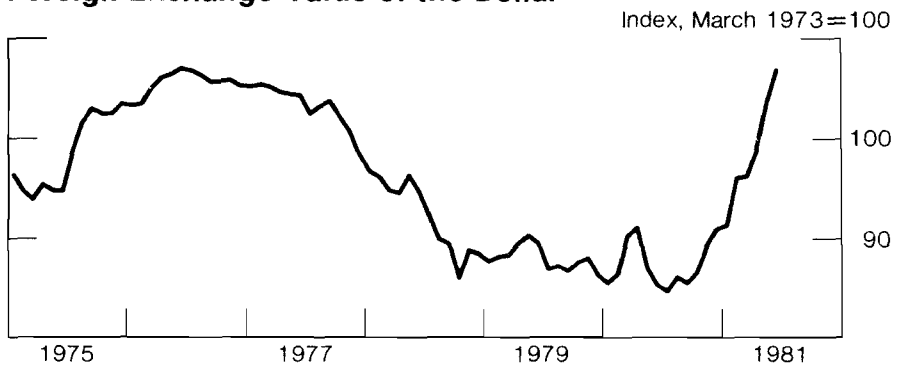
Unit Labor Costs



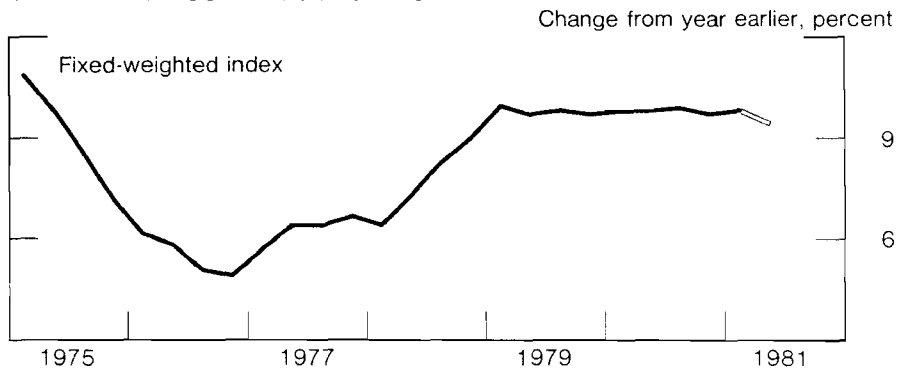
Price of Imported Oil



Foreign Exchange Value of the Dollar



Gross Business Product Prices



Comparison of Staff and Administration* Economic Forecasts

	Percent change, Q4 to Q4			
	1981		1982	
	Staff	Administration	Staff	Administration
Nominal GNP	10.8	11.8	8.4	12.9
Real GNP	2.5	2.5	1.2	5.2
Implicit GNP Deflator	8.1	9.1	7.0	7.3
Unemployment Rate	7.8	7.7	8.3	7.0
Q4 Level				

*Preliminary and subject to change.

FOMC Briefing
S. H. Axilrod
July 7, 1981

Clearly, the process of setting longer-run money targets is not getting any easier. Assessing the impact of changes in financial regulations and technology is a continuing problem. As a minor point, the recent DIDC decisions, for instance, complicate estimates of M2. Of more basic relevance at this time, the public's response to NOW accounts, and also to the sustained high level of short-term rates, has been in many ways unexpected, and leaves considerable uncertainty in its wake. There is uncertainty about when the shift to NOW accounts will be essentially completed. There will also be uncertainty about how to evaluate future behavior of the M1-B aggregate; its composition and presumably in some degree its behavior will differ from previous narrow money measures because it has a sizable component that pays explicit interest, that possibly may behave more like savings accounts, and that gives increased weight in the total to household's demands for transactions balances and liquidity. Then there is some uncertainty about what to make of the sharp rise in velocity of M1-B, particularly shift-adjusted, on average in the first half of this year. Does it indicate that a sustained period of downward shift in public preference for cash is in process? Or should it more be taken as evidence that the short-run relationship between narrow money and GNP is loosening further, given the wide variety of near substitutes for narrow money that has developed.

Judgments about these and similar issues affect the Committee's targets for 1981 and 1982. With regard to the shift-adjusted range for M1-B for 1981, the principal argument for lowering it would be a view that

a sustained downward shift in demand for narrow money relative to GNP is in process and one which would produce for this year a shift noticeably larger than the $2\frac{1}{2}$ percentage points assumed in staff GNP projections at the time this year's target was set in February, and which is also embodied in the staff's current projections. If there were such a larger shift, attempts to achieve the present $3\frac{1}{2}$ to 6 percent target range would be more expansionary than the Committee originally bargained for.

The absence of a further downward shift of money demand in the staff's projection along with fairly strong continued growth in nominal GNP are why our interest rate projections for the balance of the year call for rather sustained high levels of rates. Unless GNP is considerably weaker than projected, we would expect a rebound in money demand, on the thought that the public has economized on cash this year by about as much as it can, or is willing, given existing financial technology, interest rates, and the learning curves of depositors and institutions. An expectation of such a rebound in money demand would argue for leaving the present shift adjusted M1-B range unchanged for 1981--and would suggest rather strong actual M-1B growth at some point over the next few months.

Keeping the present range unchanged does have certain problems. If the midpoint of the current range is attained by year-end, shift-adjusted M1-B will have grown by around a 10 percent annual rate over the next six months--though on a quarterly average basis this would work out as growth at about a $7\frac{1}{4}$ percent annual rate from the second quarter to the fourth quarter of this year. Such a rapid growth might have an adverse impact on inflationary psychology, of course. On the other hand, aiming at much more moderate growth could place substantial further pressure on interest rates and the fabric of the financial system if staff estimates

of money to GNP relationships are correct. One solution is for the Committee to accept or aim at a more moderate growth in M1-B over the next several months that brings growth for the year near the low end of the present target range, especially should that develop in an environment of stable or declining interest rates. If the Committee were to lean toward such an approach, and were at the same time to resist money growth in the 10 percent or higher area, this would not be inconsistent with some little lowering of this year's M1-B target range--or aiming in the low part of the present range.

As explained in the blue book, we still anticipate that the broader aggregates for 1981 will come in high relative to the announced ranges for them, particularly so if the midpoint for the M1-B growth range for the year is attained. Thus, the Committee may wish to consider whether or not to raise these ranges for the broader aggregates. However, the credibility of the Committee's will to continue monetary restraint might be called into question if the broader ranges were raised, especially in light of the increased attention given to broader aggregates because of uncertainties surrounding the interpretation of M1-B.

With regard to 1982, Mr. Chairman, perhaps just a few words are in order. There seems to be no need for the Committee at this time to declare whether the shift into NOW accounts will or will not be over by next year. If the Committee wishes to continue on the course of gradually reducing its growth ranges, it is probably simplest to consider taking at least another $\frac{1}{2}$ point off the shift-adjusted M1-B range (the staff boldly suggests dropping M1-A). But because of uncertainties surrounding the behavior of M1-B, alluded to earlier, there is good reason to broaden the M1-B range from a $2\frac{1}{2}$ percentage points width to a 3 percentage point

width (an even wider range probably lacks credibility). Two logical alternatives if that approach were taken are ranges of $2\frac{1}{2}$ to $5\frac{1}{2}$ percent and 3 to 6 percent--advantages and disadvantages of which were noted in the blue book.

A lower range for M1-B next year does imply some further downward shift in narrow money demand as measured by our quarterly model money demand equation, given the $8\frac{1}{2}$ percent increase in nominal GNP that we have projected for the year. In light of this year's experience, and our projection of continued historically high interest rates, which would provide somewhat more incentive than usual to economize on cash, that does not seem implausible. But if nominal GNP were projected, or targeted, to grow much more than $8\frac{1}{2}$ percent in 1982, its consistency with a reduced target range for narrow money next year might well be called into question. (I might add-- parenthetically--that if nominal GNP growth were unexpectedly weak next year, including with it a considerable deceleration of price increases and a sharp drop of interest rates, there is likely to be a substantial and probably one-time increase in the demand for narrow money as presently measured that the Committee would need to consider accommodating).

Ranges for the broader aggregates next year pose a problem similar to this year in that their projected growth, given M1-B, may be relatively high. But the problems would appear to be less pronounced than this year. The lower nominal GNP growth projected for next year will tend to hold down growth in the broader aggregates; moreover, we are not at this point projecting a substantial drop in market rates that would divert savings flows from market instruments to time deposits. Thus, there seem to be greater odds next year that broader money aggregates will fall within the

ranges currently in place, though in the upper part. Indeed, on the basis of the projections presented in the blue book, it would not seem implausible to lower the 1982 range at least for M3 by $\frac{1}{2}$ point from this year's range.

Finally, Mr. Chairman, I have not mentioned the problem of the ranges for actual M1-A and M1-B growth in 1981. You will recall that the M1-B range for 1981 thought consistent with the $3\frac{1}{2}$ to 6 percent shift adjusted range was 6 to $8\frac{1}{2}$ percent. The question arises whether that should be changed in view of unexpectedly rapid growth in OCDs over the first half of this year. Given the recent slowdown in OCD growth, it would not seem that much more than a $\frac{1}{2}$ point increase in the range for actual M1-B is needed, as explained in the blue book. Indeed, the range could well be left unchanged in the thought that it is wide enough to encompass the likely result for the year, given the increase of only $6\frac{1}{2}$ percent at an annual rate in actual M1-B experienced over the first half of the year. It would appear more necessary technically to lower the range previously published actual range for M1-A. But all this becomes so complicated that the Committee may wish to consider simply abandoning the actual ranges and stick to the shift-adjusted ranges only.