APPENDIX

James L. Kichline
July 12, 1983

FOMC BRIEFING -- INTRODUCTION

During our presentations this afternoon we will be referring to the package of charts distributed to you. The first chart displays the monetary aggregate assumption and associated interest rates that underlie the staff's projection for the economy and financial markets. Our monetary policy assumption is indexed on growth of M2 of around 8-1/2 percent this year, after making a rough allowance for the effect of shifts of funds into MMDAs from sources outside M2; for 1984, we have assumed growth of M2 at 8 percent. These assumptions are consistent with short-run Alternative B in the Bluebook. The velocity of M2 in the projection increases somewhat in 1983 and 1984 following the unusually large decline in 1982. We believe the assumptions and the forecast are consistent with a little further rise of interest rates this year -- the 3-month Treasury bill rate averages 9-1/2 percent in the fourth quarter, about ½ percentage point above its current level; next year rates are projected to decline moderately.

The fiscal situation is presented in the next chart. Staff projections for receipts and outlays indicate actual budget deficits around $200 billion in both 1983 and 1984 fiscal years. These deficits on a structural basis rise from that in 1982, largely because of the personal income tax reductions effective July of last year and this July. Updated administration budget figures are not yet available, although it seems likely that the current fiscal year deficit will be close to that of the staff and lower in 1984, partly reflecting different economic assumptions.

Nevertheless, fiscal policy is an expansive force over the projection period and the actual budget deficits relative to GNP, shown in the bottom panel, are expected to remain historically large. At the present time we don't believe there is much possibility of a major change in the fiscal stance over the year ahead, given the administration's lack of enthusiasm for tax increases and deep cuts in defense outlays and the unwillingness of Congress to slash nondefense programs.

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

* * * * *

Joseph S. Zeisel

FOMC CHART SHOW
July 12-13, 1983

The expansion in economic activity has accelerated considerably in recent months, and has taken on most of the characteristics of a typical postwar cyclical recovery. While much of the rebound in demand earlier this year was accommodated by reducing stocks, more recently the sustained strength of sales has generated a vigorous growth in production and employment.

As is evident in the left hand panels of the following chart, consumers have played a major role in the recent acceleration in economic activity. Sales of furniture and appliances have been particularly strong, associated partly with the recovery in housing. There has also been a resurgence in auto demand--as shown in the right-hand panel. Domestic models sold at a 7-1/4 million unit annual rate in June, up nearly a fifth from the level late last year, and the strongest pace in almost two years. As the bottom right panel illustrates, dealers' stocks are now relatively low and substantial upward adjustments have been made in scheduled assemblies for the next few months.

As shown in the next chart, industrial production overall has continued to rise strongly--by May, output was 7 percent above its trough 6 months earlier, about in line with its average performance in postwar recoveries. Available data suggest that production continued to increase at about this same pace in June.

Consistent with the growth in output, nonfarm payroll employment has expanded strongly, rising by 350,000 in June, with gains widespread. The rebound in factory production earlier in the year was associated largely with a snapback in the workweek, shown in the bottom panel; lately, however, employers have been shifting more to hiring to meet their labor needs, suggesting increased confidence in continued expansion.

The next chart presents our view of the outlook for growth through 1984. We now estimate that real GNP rose at about a 7-1/2 percent annual rate in the second quarter--higher than the forecast of the Commerce flash three weeks ago. Moreover, it appears that the stimulus to production from rising employment and income will carry over into the third quarter, with GNP advancing at close to the second-quarter pace. We expect growth to ease somewhat toward year end and in 1984, but as indicated in the bottom panel, we are forecasting a slightly stronger than average second year of recovery--4-1/4 percent. For the two years combined, the projected expansion of nearly 10 percent is close to postwar cyclical experience.

In the next chart, we have disaggregated GNP growth to highlight the contribution of the major components. Several elements--in particular, CCC payments and farm inventories--have been excluded because their erratic fluctuations have tended to obscure fundamental movements in GNP. As is evident from a comparison of the first and second panels, we expect real gains in private domestic final purchases--that is, consumption, housing and business fixed investment--to hold up quite well on average in the latter half of this year. The swing from nonfarm inventory liquidation to restocking, which was a major factor in GNP growth in the first half, becomes less important as the year progresses, but this is offset in part by a smaller decline in net exports.

In 1984 (the bottom panel), GNP growth slows as final purchases lose some momentum and the process of inventory rebuilding comes to an end, although the shift of net exports from a negative to a small positive contribution to growth partially offsets the deceleration elsewhere. Excluding CCC, federal government purchases are not expected to play much of a role throughout this period, and in fact these outlays grow a bit more slowly in 1984 in real terms as the rise in defense outlays moderates.

Among the components of final purchases, housing (shown in the next chart) has contributed significantly to the overall recovery to date. But we expect considerably less support from this sector for the balance of the projection period. The upper left-hand panel illustrates the close inverse correlation between starts and mortgage interest rates recently. As the right-hand panel shows, new home buyers responded vigorously to the reduced mortgage rates, and sales of new homes have nearly doubled since their lows early last year. But mortgage rates have moved up in recent weeks, and with some further rise in prospect, as shown in the middle panel, it appears likely that housing demand and home construction will soon begin to stabilize. We anticipate little further growth in activity until mortgage rates begin to edge off again next year.

The next chart addresses the outlook for business capital outlays. As shown in the upper left hand panel, recent data on new orders indicate that a farily healthy turnaround in spending for business equipment appears to be underway. In contrast, outlays for nonresidential construction have continued to drop since late last year--the right hand panel. Given current vacancy rates, we expect office building construction in particular to remain weak through next year. In contrast, real spending for business equipment should continue to strengthen in 1984 as corporate profits improve and the slack in unused capacity narrows. Based upon revised figures, we are projecting capacity utilization in manufacturing to exceed 80 percent by late 1984. On balance, as shown in the bottom panel, we are projecting a recovery in fixed capital outlays of about 11 percent over the two years--slightly under the average cyclical rebound--reflecting the continued weakness of nonresidential construction.

The next chart addresses the outlook for consumption. The top left panel illustrates the dramatic improvement in attitudes that accompanied the resurgence of consumer demand recently. The sharp run up in stock prices (right hand panel) helped enhance household financial positions and undoubtedly contributed to the increased demand for autos and other big ticket items. It is our view that consumer demand will remain vigorous over the near term given recent strong gains in employment and income, augmented by the stimulative effects of the July tax cut. We expect growth in consumer demand to moderate in 1984 as gains in real disposable income taper off. But given the improved state of household finances, outlays should hold up better than income; as indicated in the bottom panel, the saving rate is projected to remain relatively low in 1984.

As the next chart shows, we expect fairly steady improvement in the labor market to accompany stronger growth in output, although initially at least, much of the pickup in demand is achieved by rising productivity. The growth in employment next year should be greater, but, as shown in the middle panel, along with improved job opportunities, we also expect more rapid labor force growth. On balance, this will lead to a relatively slow decline in the civilian unemployment rate to about 8-1/2 percent by the end of next year--still quite high in historical terms. We expect employment in the industrial sectors to remain well short of 1979 peak levels, with especially high unemployment rates in some heavy industries.

As the next chart shows, the prolonged weakness in labor markets has contributed to a considerable easing of wage inflation in all sectors of the economy. The overall index of average hourly earnings rose at a 4-1/4 percent rate in the past half year, down from a 6 percent increase in 1982. We believe the levels of resource utilization that are projected for the next year will continue to act as a restraint on wage increases. Moreover, there will be continued benefits from this year's good price performance on cost-of-living adjustments, and agreements already in place generally have rather moderate wage increases built in for next year. At the same time, however, improved business and profit performance is likely to lead to some firming of wage demands and pressure for reversing wage concessions granted earlier. Next year's social security tax increase will also add about half a percent to compensation costs, shown in the bottom panel. As a result, we are projecting a 5 percent increase in these costs over 1984, slightly more than in 1983.

As the next chart shows, we expect continued strong cyclical gains in productivity to help in damping inflationary pressures this year. Productivity growth was surprisingly strong last year in the face of declining output, suggesting that firms may have made special efforts to cut costs, possibly signaling more lasting gains in efficiency, and we have adjusted up our estimate of longer-run productivity trends slightly. As growth in economic activity moderates somewhat in 1984, we expect gains in productivity to slow, in rather typical cyclical fashion, but for the year as a whole to remain slightly above our notion of the long-term trend. In conjunction with the slight acceleration in compensation, unit labor costs are projected to rise at about a 3-3/4 percent rate in 1984.

The outlook for inflation is presented in the next chart. It is clear that the recent moderation of overall price increases owes something to the strong dollar and its impact on nonpetroleum import prices. As is shown, import prices rise sharply again in 1984 as a result of the projected depreciation of the dollar. In addition, food prices next year may be moving up a bit more rapidly in response to a variety of government efforts aimed at raising crop prices and boosting farm income. Business is also likely to attempt to improve profit margins as demand firms. But fundamentally, given prospective labor cost trends and relative slack in markets, it appears that the risks of a substantial acceleration in prices are quite small. On balance, therefore, we are forecasting only slightly higher rates of inflation in 1984 than in the latter half of this year--a bit over a 4 percent rate of increase in the GNP deflator.

Mr. Truman will now discuss the international outlook.

E.M. Truman
July 12, 1983

FOMC CHART SHOW -- INTERNATIONAL DEVELOPMENTS

The first international chart shows that the weighted average foreign exchange value of the dollar has recently regained its level of last November. In nominal terms, depicted by the black line in the chart, the dollar is slightly above its previous peak, but the relatively better inflation performance in the United States than on average in other industrial countries has caused a widening gap between the nominal value of the dollar and its price-adjusted value, shown by the red line.

It is instructive to note that although the dollar has appreciated in nominal terms by close to forty percent since the end of 1980, its appreciation has been only slightly more than five percent in the past 12 months. Moreover, the dollar's appreciation during this period has been primarily against the currencies of countries with rapid inflation, such as France and Italy. Against the German mark, the Swiss franc and the Canadian dollar, the U.S. dollar has been essentially unchanged in value, while it has depreciated somewhat against the Japanese yen. Thus, the dollar has remained strong over the past year, but it has not appreciated substantially further. However, as is shown in the lower panel, the dollar's continued high level has persisted despite the elimination (until recently) of the differential between short-term dollar interest rates and rates on short-term assets denominated in other currencies.

We expect that over the forecast period movements of interest rates on foreign currency assets will be essentially similar to movements in interest rates on dollar assets. Therefore, the explanation for the projected depreciation of the dollar shown in the top panel -- which amounts to about 15 percent over the next six quarters -- must lie elsewhere. It will not surprise the Committee to learn that our explanation for the dollar's projected depreciation continues to lie in the unprecedented U.S. trade and current account deficits that we are forecasting. One factor contributing to those deficits is, of course, the continuing effects of the strong dollar during the past year. However, economic conditions abroad will also play a role.

The upper left panel of the next chart shows that average inflation has declined in the foreign industrial countries to a year-over-year rate of less than six percent. We expect this deceleration to continue over the forecast period, with an average inflation rate of around five percent prevailing at the end of 1984.

As can be seen in the upper right panel, industrial production in the major foreign countries has picked up since the end of last year, but through early spring that revival was relatively moderate, averaging less than 1/2 a percent a month.

The lower panel shows that the recent recession in the industrial countries abroad was less severe, on average, than the recession in 1974-75. We project that the recovery will also be more moderate. The contrast reflects, in part, the continuing need for macroeconomic adjustment in France and Italy. However, we are projecting a weak recovery in Japan and Germany as well, in large part because of tight fiscal policies and relatively weak external demand.

The foreign industrial countries, as well as the United States, will experience little or no short-run stimulus from exports to the non-OPEC developing countries during the forecast period. As is shown in the upper left panel of the next chart, the volume of imports of these countries is expected to decline in 1983 for the second year in a row and to record only a moderate increase next year. Meanwhile, their exports are expected to expand and their terms of trade -- whose components are shown in the upper right panel -- should stop deteriorating.

Reflecting these factors, the lower panel shows that the trade deficit of the non-OPEC developing countries is projected to be less than half as large in 1984 as it was in 1979. The improvement in the current account position of these countries will be less dramatic. The more moderate contraction reflects growing interest payments on external debts that have been bloated by past deficits and refinanced at higher interest rates.

The next chart summarizes the impact on U.S. external accounts of the relatively robust U.S. recovery, slack demand abroad and our forecast for the dollar. The upper left panel shows the continued decline this year in the volume of U.S. exports, while the volume of U.S. imports rises by about 20 percent. Next year, with a pickup of growth abroad and the projected depreciation of the dollar, the growth of U.S. exports should turn positive and that of imports should moderate.

On the price side, as is shown in the right panel, the average price of imports should continue to decline this year, reflecting in part the decline in oil prices. As Mr. Zeisel has noted, even with no change in oil prices next year, prices of imports should pick up significantly. Prices of exports are projected to rise at about a 5 percent rate both years.

The lower panel shows that in the fourth quarter of this year we are projecting a U.S. trade deficit of almost $100 billion at an annual rate, and a current account deficit of about $70 billion. We are also projecting that by the fourth quarter of next year the trade deficit will be close to $110 billion. The current account deficit will increase less -- to about $75 billion -- because the expected recovery abroad, along with the dollar's depreciation, should boost direct investment receipts.

As I have noted before, we are less certain than we would like to be about our forecast of the dollar's external value. For this reason, the next chart summarizes an alternative forecast based on the assumption that the dollar does not depreciate below its average nominal value recorded in the second quarter of this year.

The estimated effects of a stronger dollar on the U.S. trade and current account deficits this year are small and the deficits might even be reduced slightly, reflecting so-called J-curve effects, if the dollar does not depreciate. By the end of next year, however, the deficits would be increased, with the current account deficit about $10 billion larger. This estimated effect grows to about $25 billion by the end of 1986.

The effects of a stronger dollar on U.S. real growth and inflation are somewhat less dramatic. As is shown in the lower panels, real growth during 1984 would be reduced by about a quarter of a percent and consumer price inflation would remain at less than 3-1/2 percent instead of rising above 4 percent. The effects on real activity tend to wash out in later years, but the price level would be about 2 percent lower at the end of 1986.

A continued strong dollar would, of course, have other implications that are more difficult to quantify. Among these are the encouragement of protectionism -- here and, in response, abroad -- and the effects on the debt service burdens of developing countries.

Mr. Prell will now review the domestic financial outlook.

Prell
7/12/83

DOMESTIC FINANCIAL DEVELOPMENTS

The next chart presents a broad view of credit flows in the economy. The inset in the upper panel shows that, in the first half of this year, the debt of domestic nonfinancial sectors grew a little faster than nominal GNP. This is a reversal of the usual pattern for the early stages of economic recovery, but is consistent with our earlier expectations. As is reflected in the chart, we are projecting that debt growth will outstrip GNP growth for the year as a whole and again in 1984. We thus see the credit aggregate growing at about the 10% midpoint of the Committee's 8-1/2 to 11-1/2% range for 1983 and slowing only slightly in 1984. Looking at the components of that credit growth, what stands out is the behavior of federal debt, displayed in the bottom panel, absorbing an extraordinarily large share of the total credit flow as it expands at almost a 20% per annum rate in 1983-84.

Among the nonfederal sectors, the major increase in credit use this year has occurred in the household sector. As may be seen in the upper left panel of the next chart, growth of mortgage and consumer debt has accelerated sharply, supporting the key elements of strength in final demand--housing and consumer durables, especially autos. The survey results depicted in the right panel suggest that there has been a shift in consumers' attitudes away from the conservative financial posture they had assumed during the period of recession and record high interest rates. Despite the stepped-up borrowing, however, the household sector's financial net worth has continued to rise, buoyed especially by the surge in stock prices, and, as indicated in the bottom right panel, consumer loan delinquencies have remained low while mortgage delinquencies have shown signs of leveling off.

The financial condition of the business sector also has improved. The top left panel of the next chart shows the narrowing of the financing gap faced by corporations--reflecting first massive inventory liquidation and then the cyclical upturn in profits. As fixed investment gathers speed next year, the gap is expected to widen despite further sizable profit gains. Another aspect of reduced pressures on firms recently is reflected in the right-hand panel, which indicates that, in the aggregate, interest payments already command a noticeably smaller portion of cash flows. The securities markets, moreover, have been much more hospitable to firms seeking long-term funds. The improving economy has brought a narrowing of quality spreads in bond yields, indicated in the lower left panel by the yield differential between corporates and Treasuries, and better profit prospects and lower interest rates have produced a marked reduction in the cost of equity capital, as reflected here in the earnings-to-price ratio for the S&P 500. These improvements have been sustained even through the recent back-up in interest rate levels. Companies have been able to achieve considerable progress in reducing debt-equity ratios and, as indicated in the right panel, in lengthening debt structures. We are projecting, however, that as recovery proceeds next year short-term borrowing will again take on substantial proportions, bringing a halt to the balance sheet reliquification.

The next chart focuses on the state and local government sector. Many states and localities are still wrestling with financial difficulties, but, as the upper panel shows, in the aggregate a combination of spending cuts, tax hikes, and cyclical revenue improvements has moved the sector back into operating surplus. We are projecting some narrowing of the surplus in subsequent quarters as building and repair spending picks up and some tax measures lapse. The credit markets meanwhile have been very receptive to tax-exempt borrowers, allowing units to sell huge amounts of bonds for prospective spending purposes and for the refunding of higher cost debt. As the middle panel indicates, we see a considerable fall-off in state and local borrowing in the months ahead, owing to the end of the pre-registration bulge and to the rise in interest rates. This will not, however, mean any commensurate relief for the markets in terms of basic rate pressures, since, as the bottom panel shows, much of the money borrowed has been reinvested in other securities--especially Treasuries.

The next chart shows that some key lenders have benefitted along with borrowers from the cyclical drop in interest rates. Variations in the frequency of reporting and problems of seasonality complicate the construction of consistent time series covering all commercial banks. Nonetheless, if we focus on the data in the boxes, it is fairly clear that the earnings--especially of the bigger banks--have been boosted by the effects of declining rates on interest margins. Indeed, the improvement in margins was great enough to offset the impact of higher loan loss provisions in the past few quarters. Obviously, though, credit quality remains the major area of vulnerability for bank earnings, with still considerable risks of write-offs of both domestic and international loans. For thrift institutions, interest rates are the critical variable. The thrifts moved to roughly break-even operating positions in the first quarter, but no further improvement would seem to be in store over the remainder of the year, given our rate projection.

James L. Kichline
July 12, 1983

FOMC CHART SHOW -- CONCLUSION

The top panel of the next chart presents a summary of the economic projections of Committee members, the staff, and the administration. The bottom panel shows the ranges of 1983 projections reported to the Congress in February. As indicated by the median figures for Committee members, the current projections for 1983 are quite similar for all the parties. Compared to the outlook in February, upward revisions to projected real GNP have placed the current forecasts near the top of the earlier range. The unemployment rate projected for the final quarter of 1983 is now near the bottom of the range, associated with the strengthened outlook for economic activity.

For 1984, the various forecasts are not markedly different, although the staff is on the lower side of most forecasts for the GNP deflator and consequently for nominal GNP as well.

For your possible reference the last chart presents forecasts on a year-over-year basis.

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Materials for

Staff Presentation to the Federal Open Market Committee

July 12, 1983

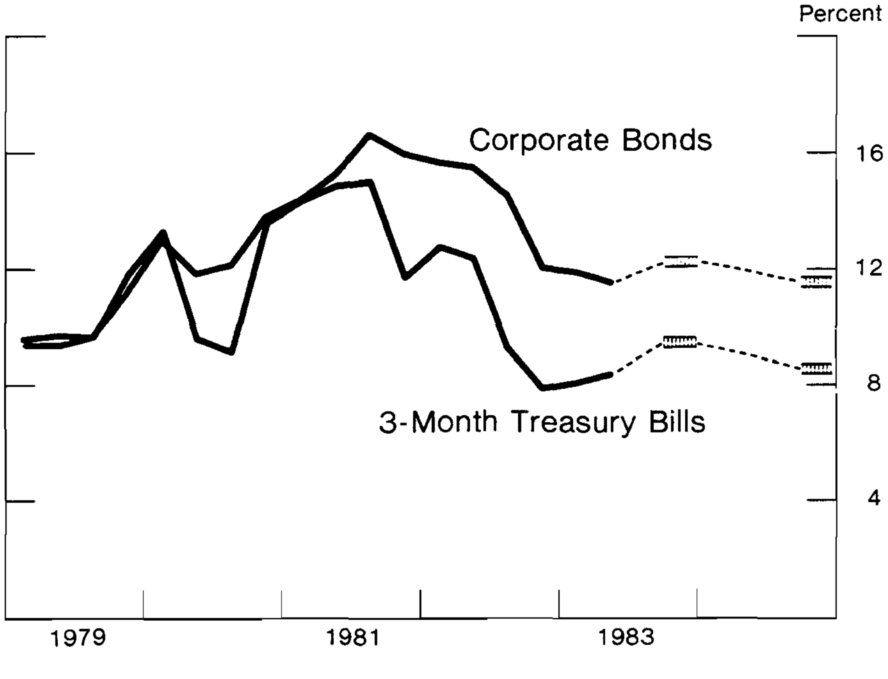
M2 and GNP

Change from end of previous period, annual rate, percent

	M2	Nominal GNP
1982	9¼	3½
1983 H1	15½ (8½)*	9¾
H2	8¾	9½
1984	8	8¼

* Adjusted for shifts into MMDAs from sources outside M2.

Interest Rates

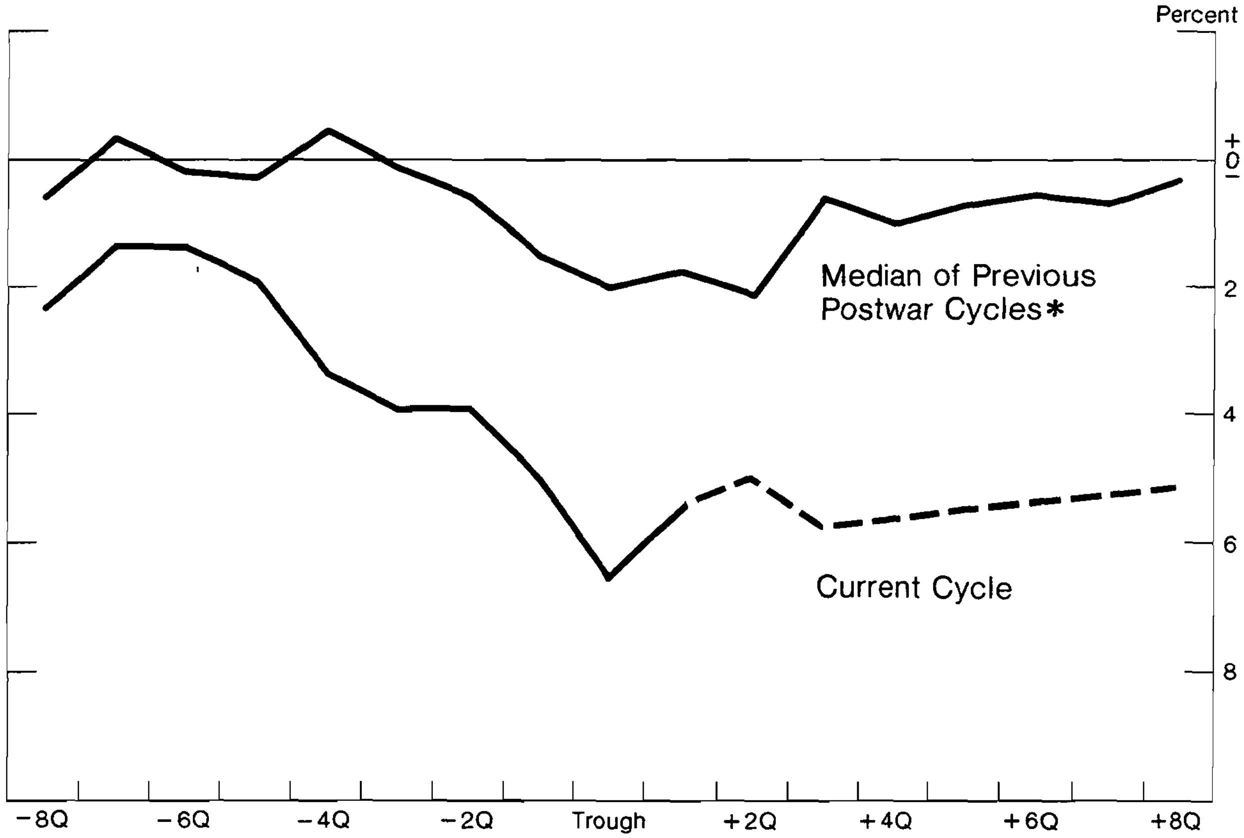


Federal Budget

Unified Budget Basis, Billions of Dollars

	FY 1982	FY 1983	FY 1984
		Staff projection	
Outlays	728	805	861
Receipts	618	600	663
Deficit	111	205	198
Structural Deficit	43	71	97

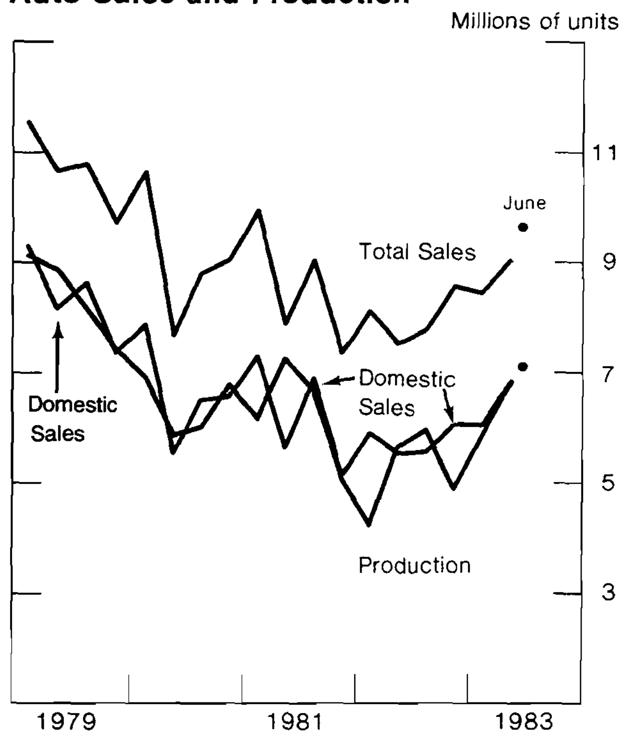
Cyclical Comparison of Surplus or Deficit as a Percent of GNP



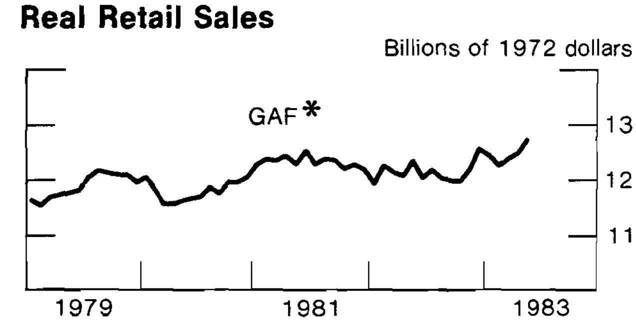
*Excludes 1948—49 and 1980 cycles.

Real Retail Sales

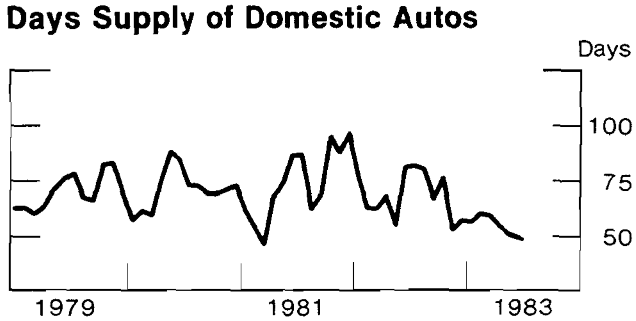
Auto Sales and Production



Real Retail Sales

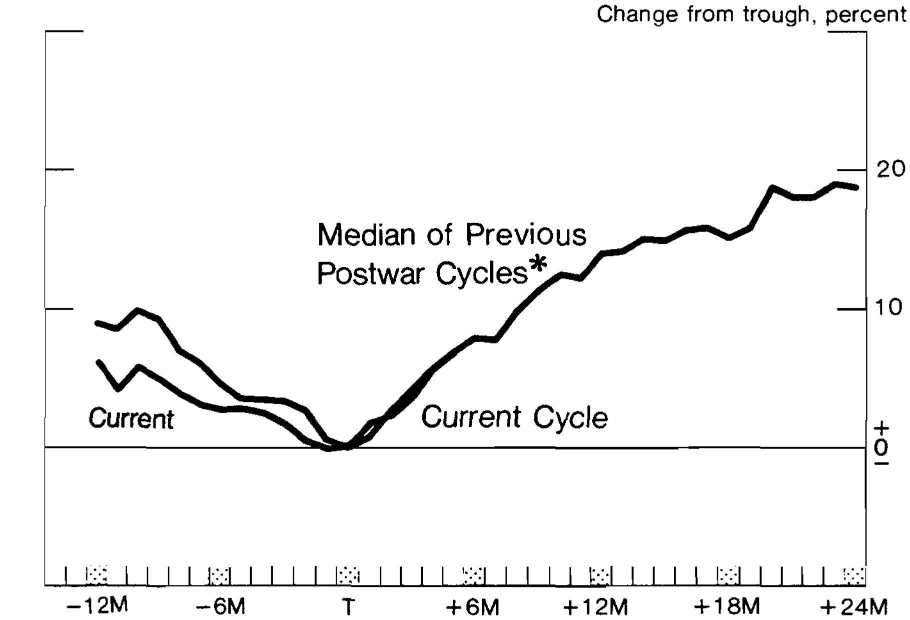


Days Supply of Domestic Autos

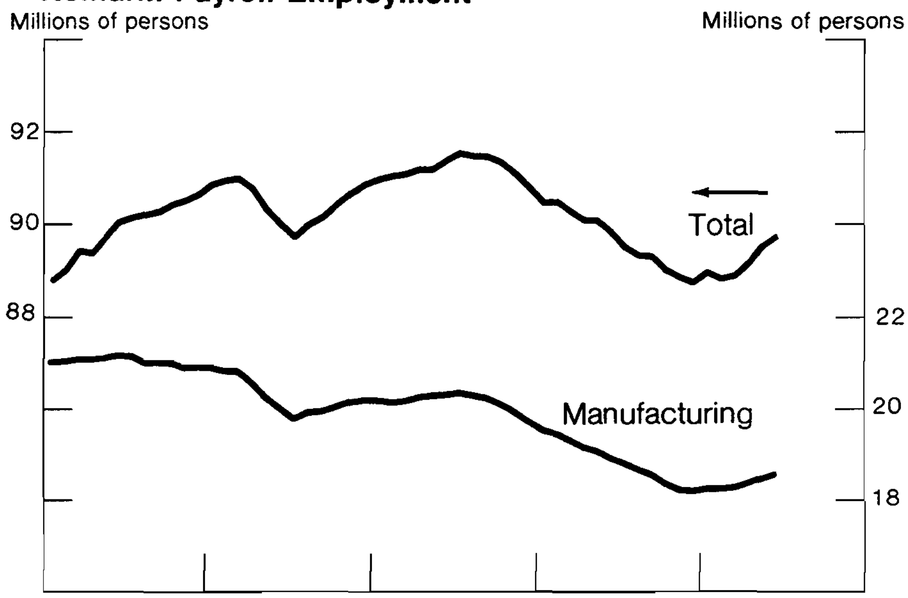


*General merchandise, apparel, furniture and appliance stores.

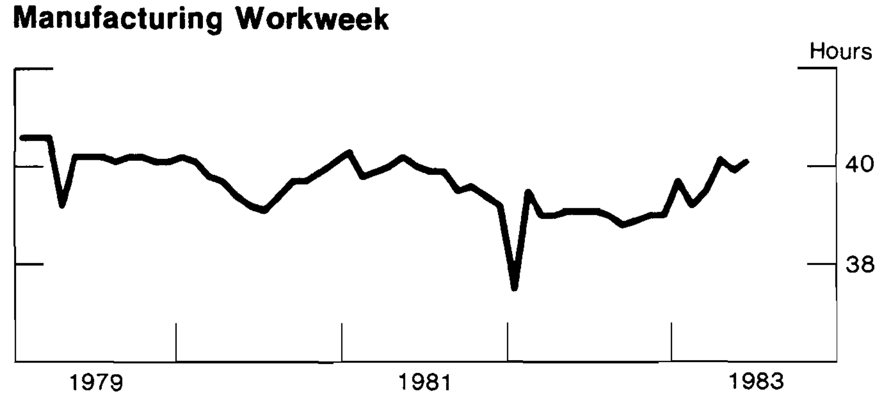
Cyclical Comparison of Industrial Production



Nonfarm Payroll Employment

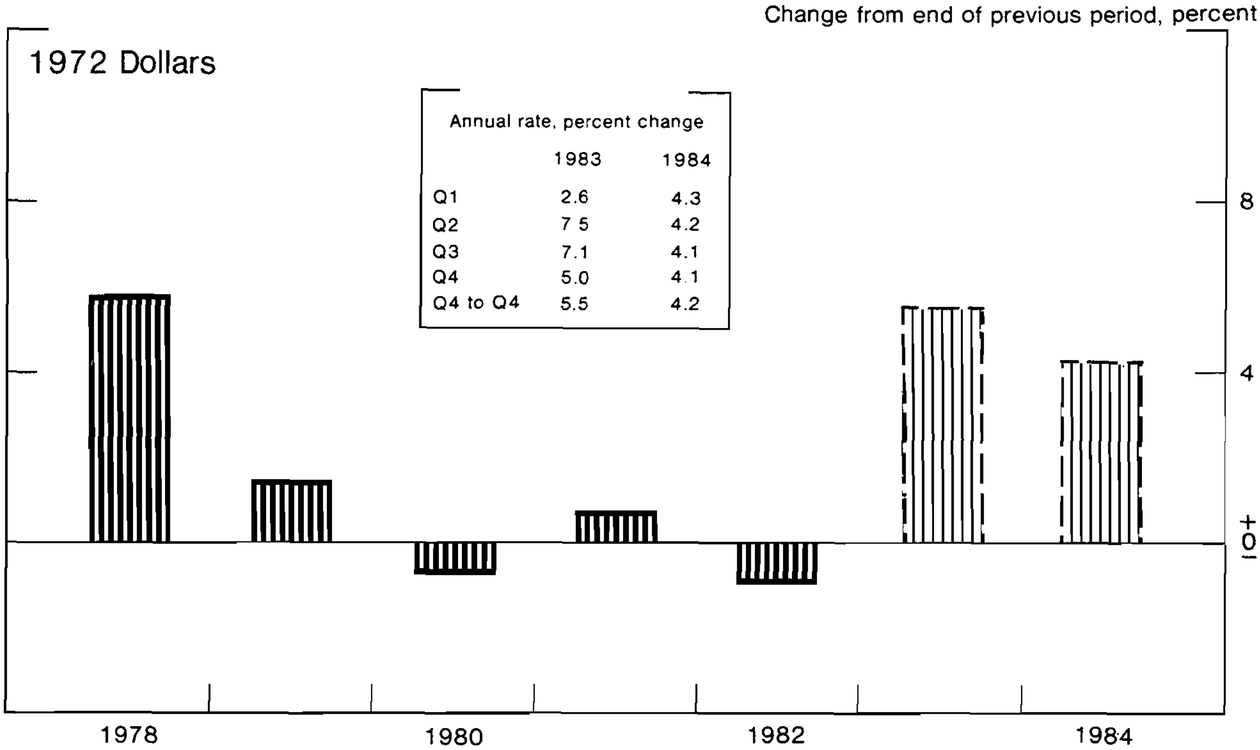


Manufacturing Workweek



*Excludes 1948-49 and 1980 cycles

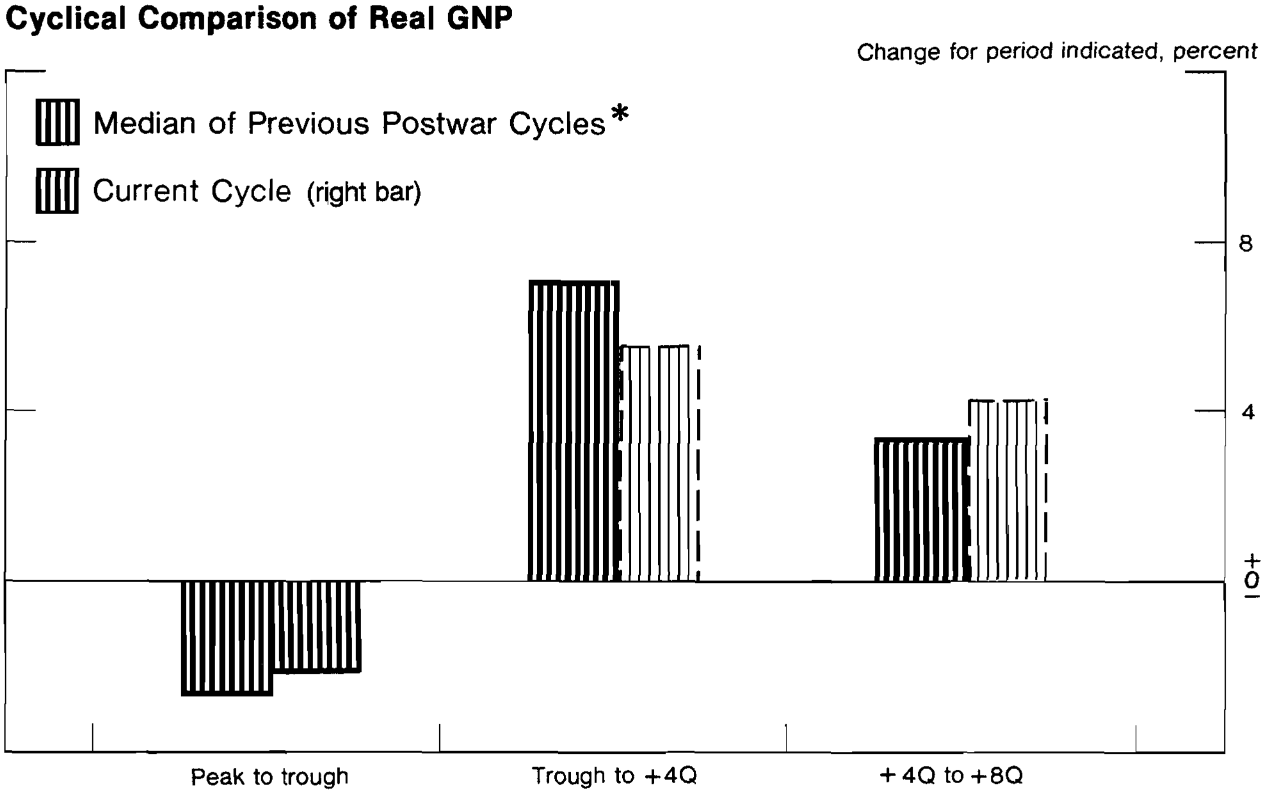
Real GNP



Annual rate, percent change

	1983	1984
Q1	2.6	4.3
Q2	7.5	4.2
Q3	7.1	4.1
Q4	5.0	4.1
Q4 to Q4	5.5	4.2

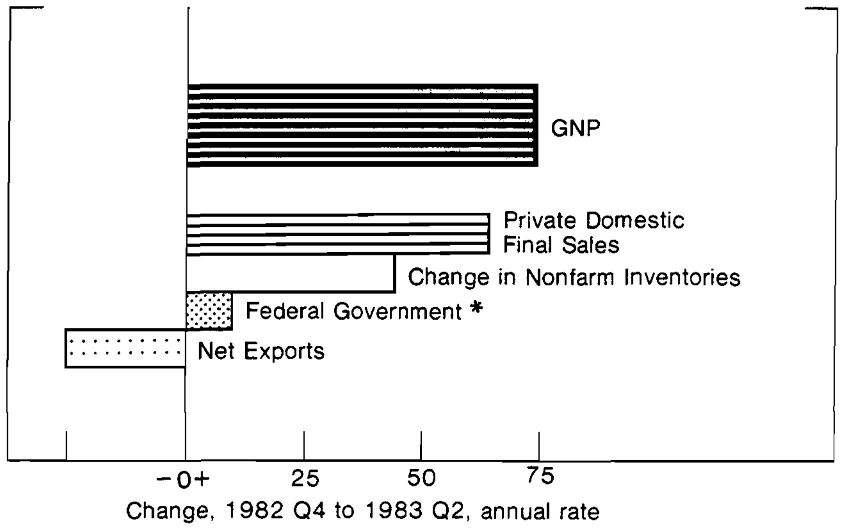
Cyclical Comparison of Real GNP



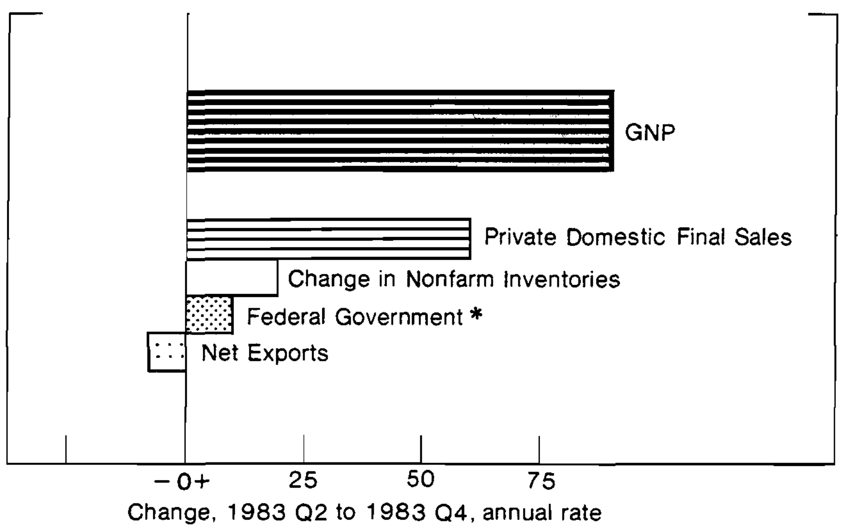
* Excludes 1948-49 and 1980 cycles.

Real GNP—Contribution of Selected Components
Billions of 1972 Dollars

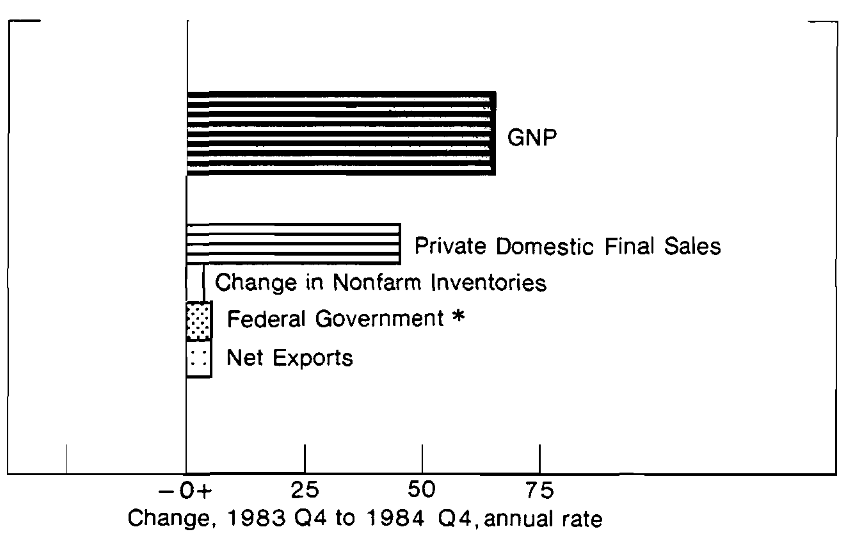
First Half 1983



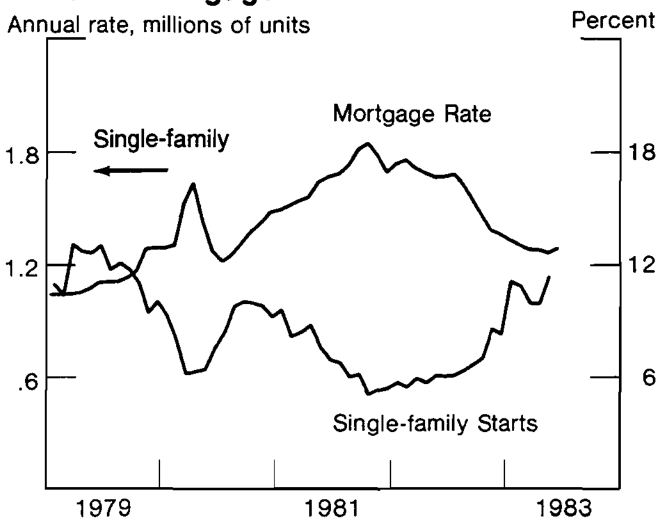
Second Half 1983



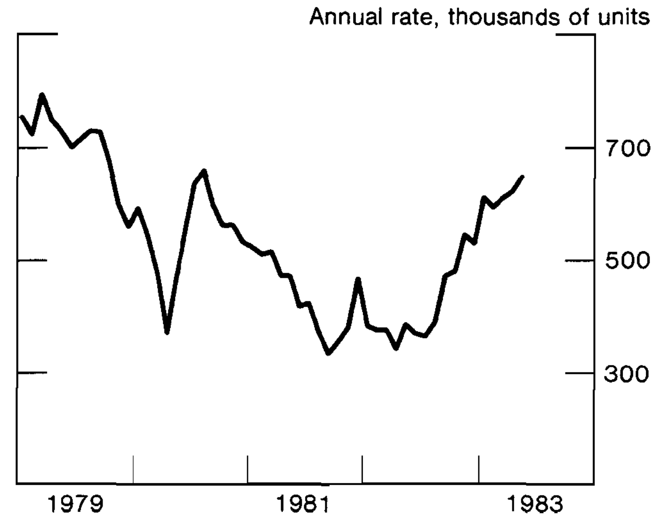
Year 1984



Housing Starts and Home Mortgage Rate

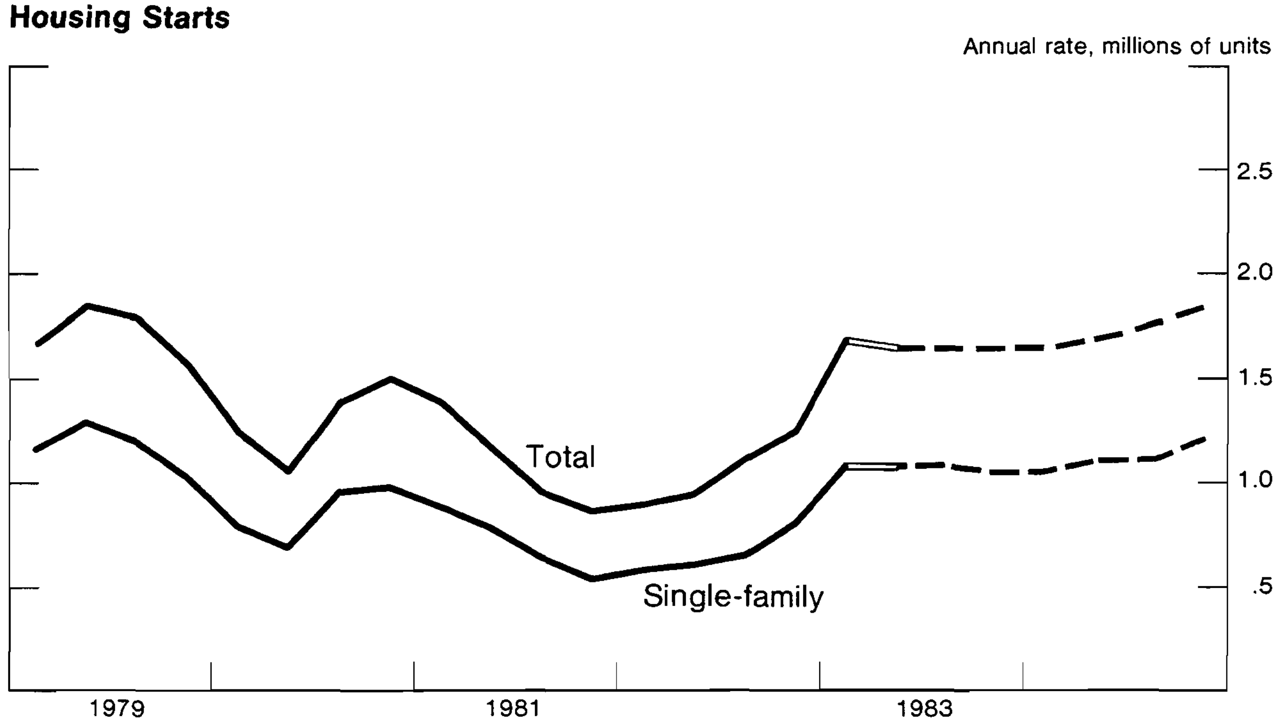


New Home Sales

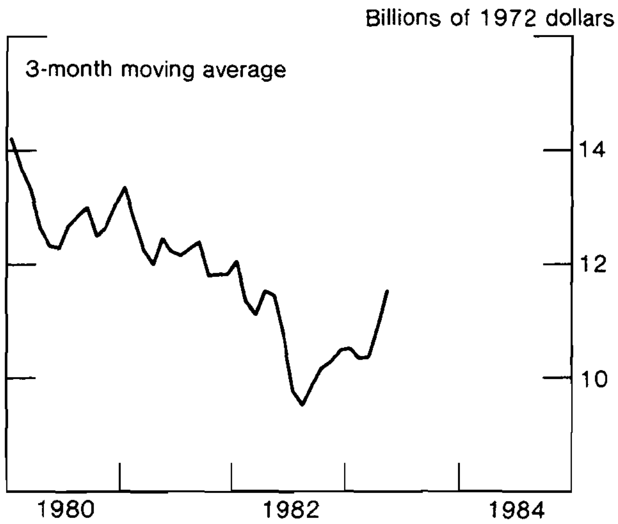


Home Mortgage Rate

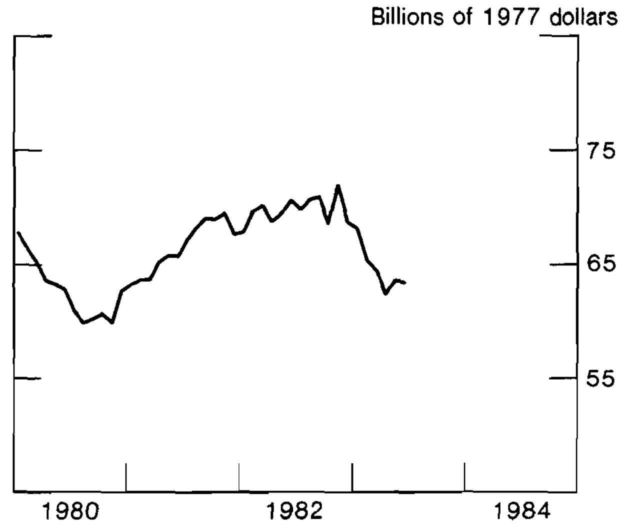
Housing Starts



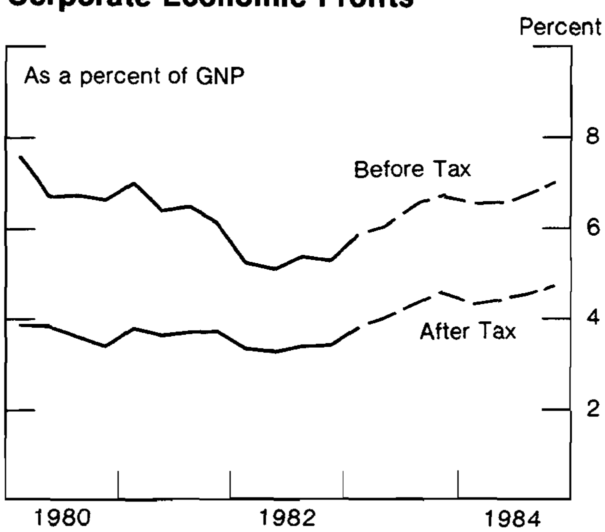
Real New Orders for Nondefense Capital Goods



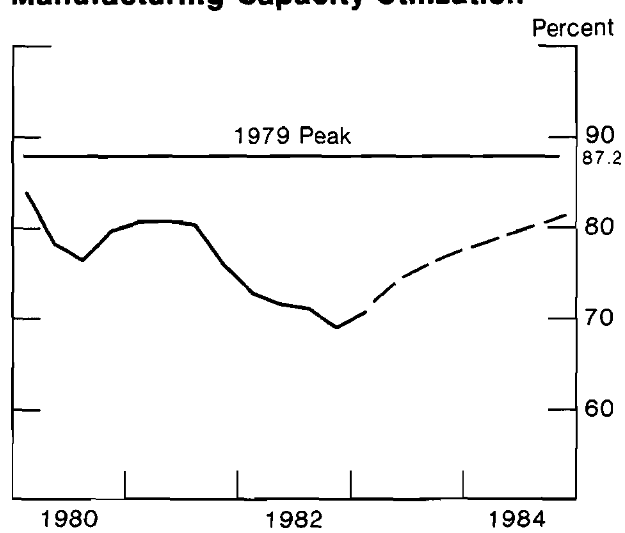
Value of New Nonresidential Construction Put in Place



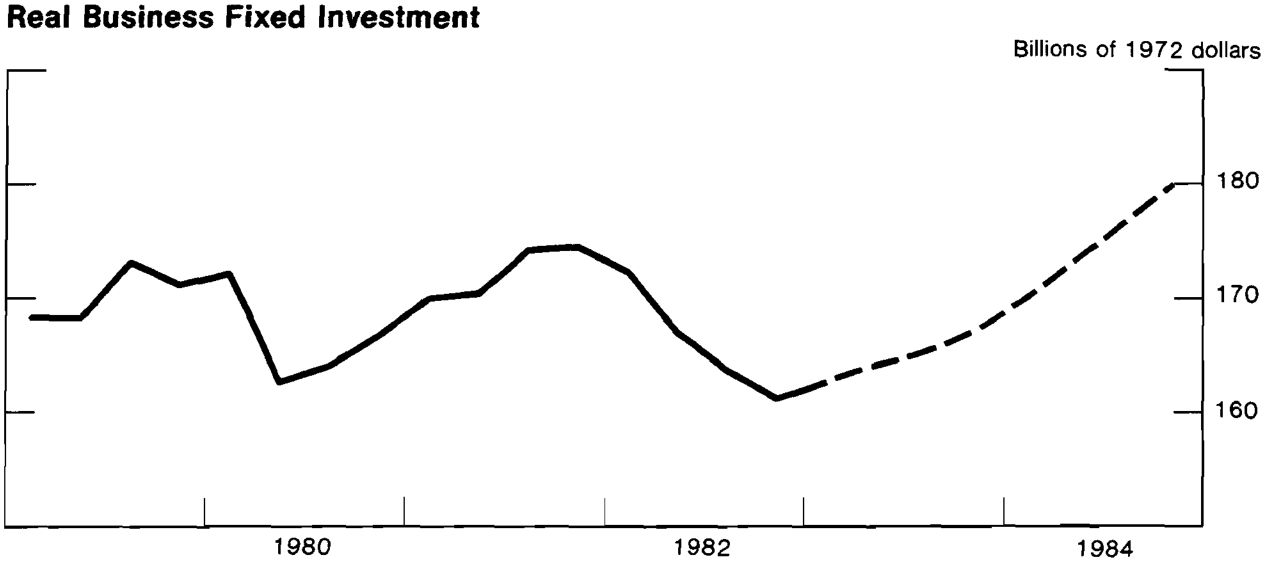
Corporate Economic Profits



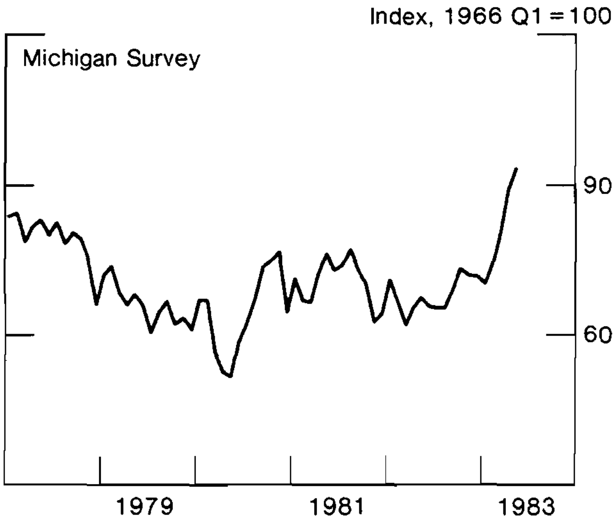
Manufacturing Capacity Utilization



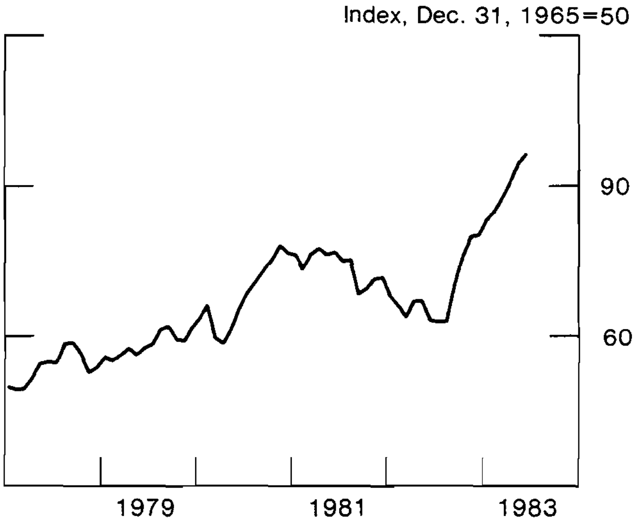
Real Business Fixed Investment



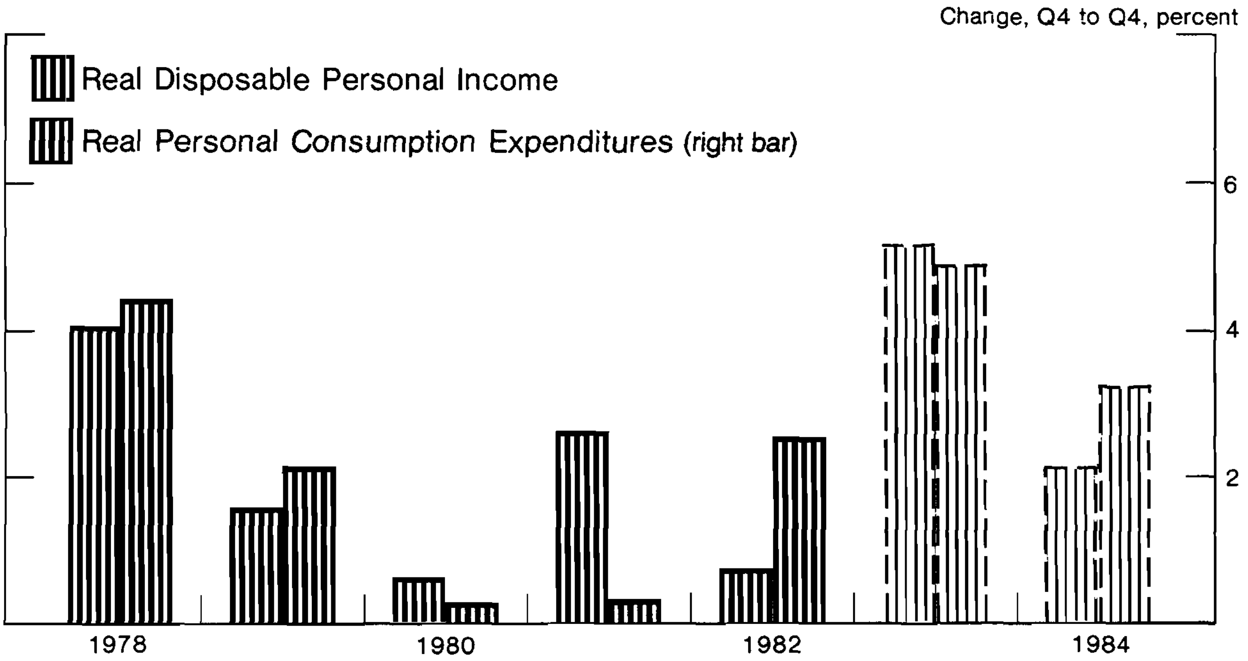
Index of Consumer Sentiment



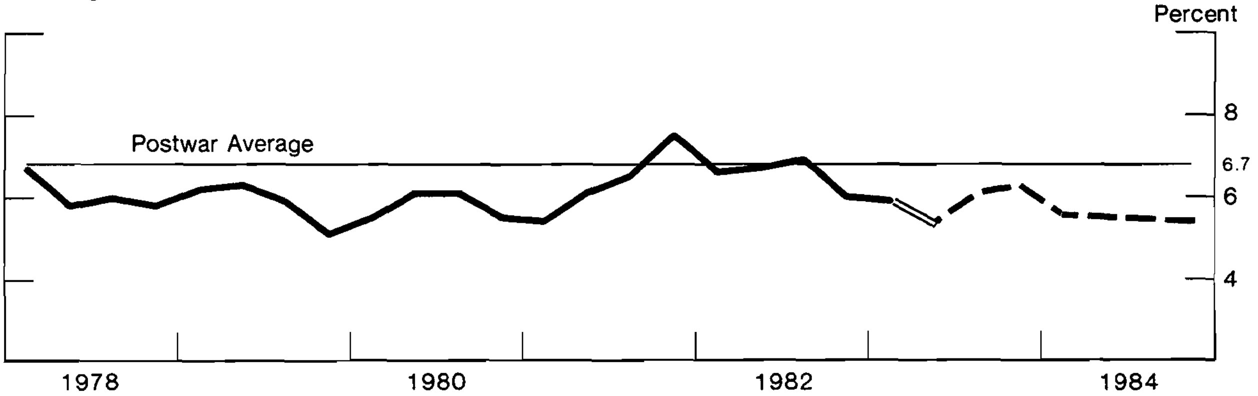
NYSE Stock Index



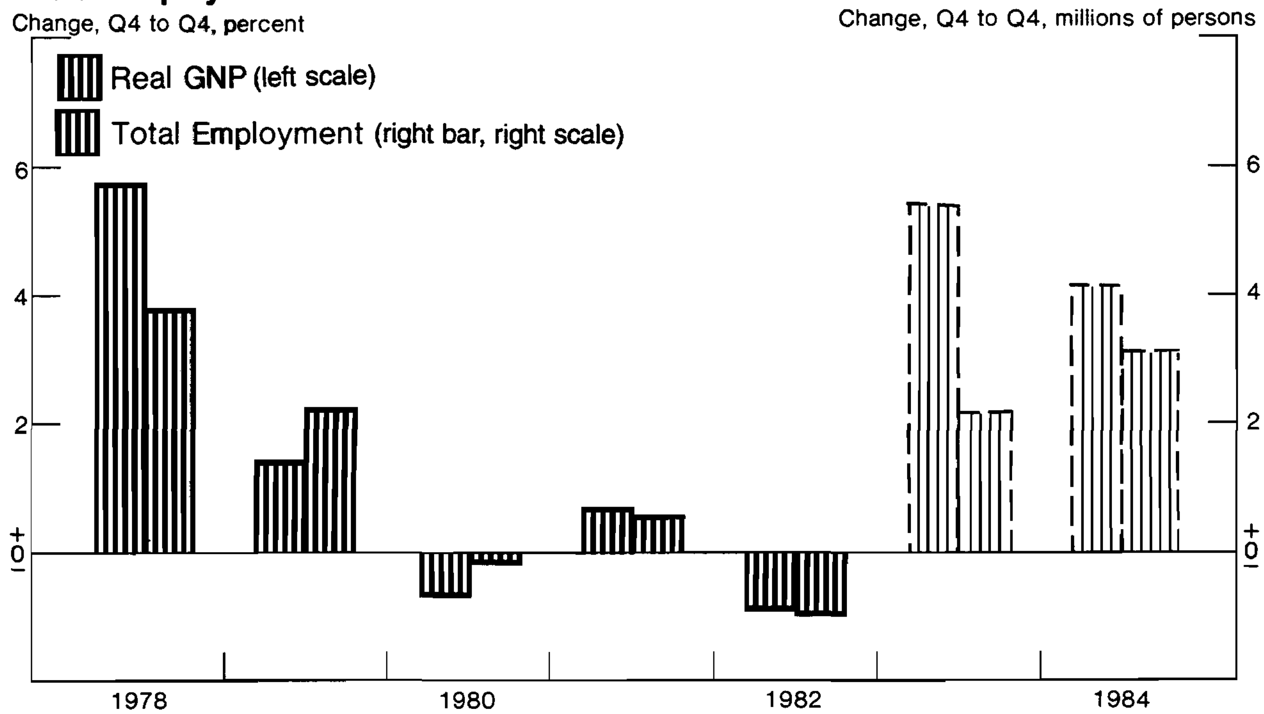
Real Disposable Personal Income and Consumption Expenditures



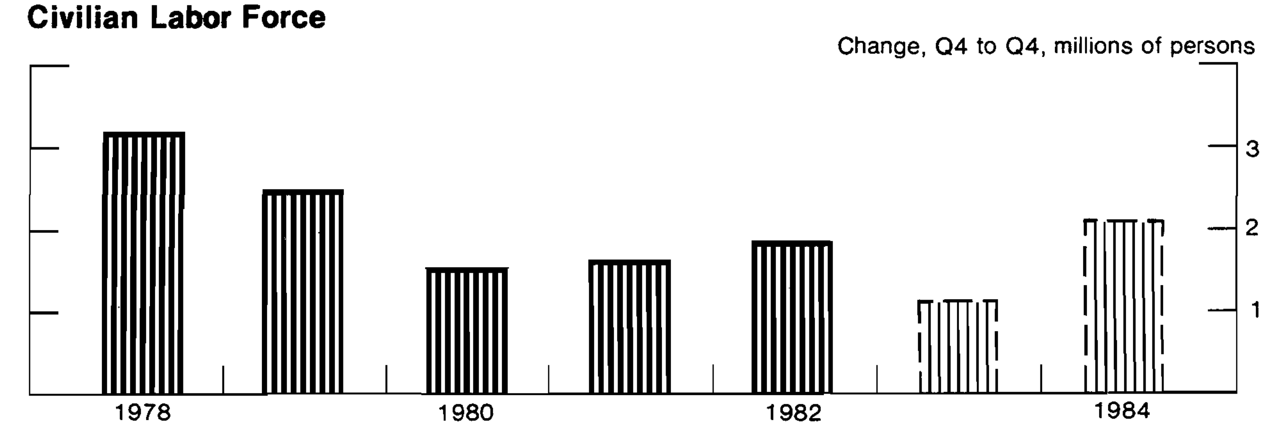
Saving Rate



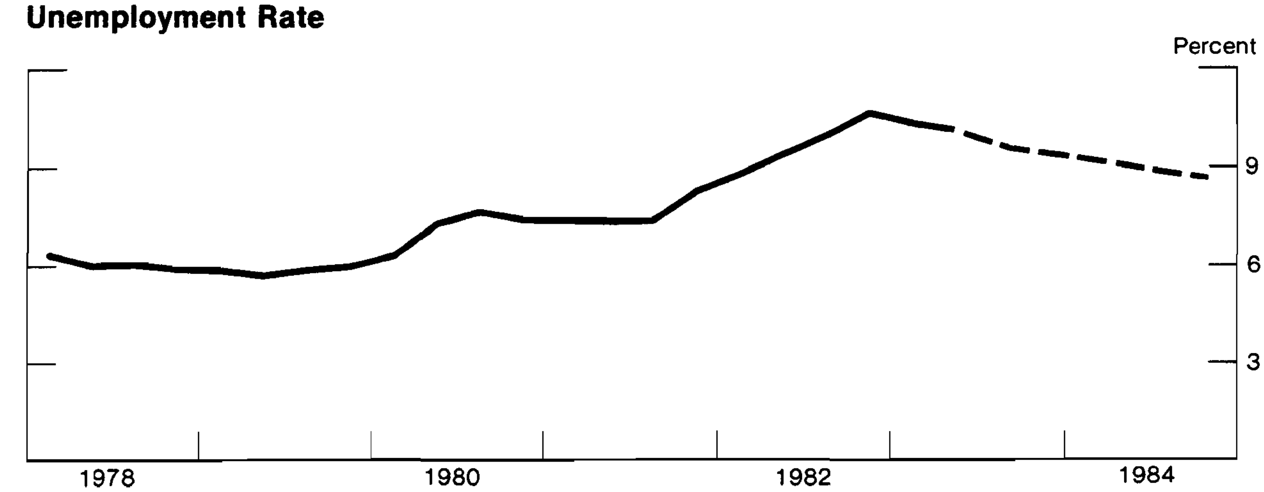
Total Employment and Real GNP



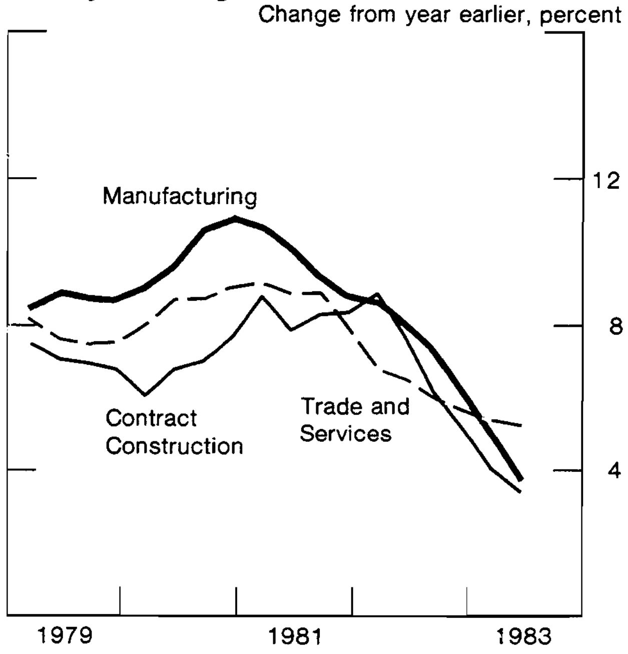
Civilian Labor Force



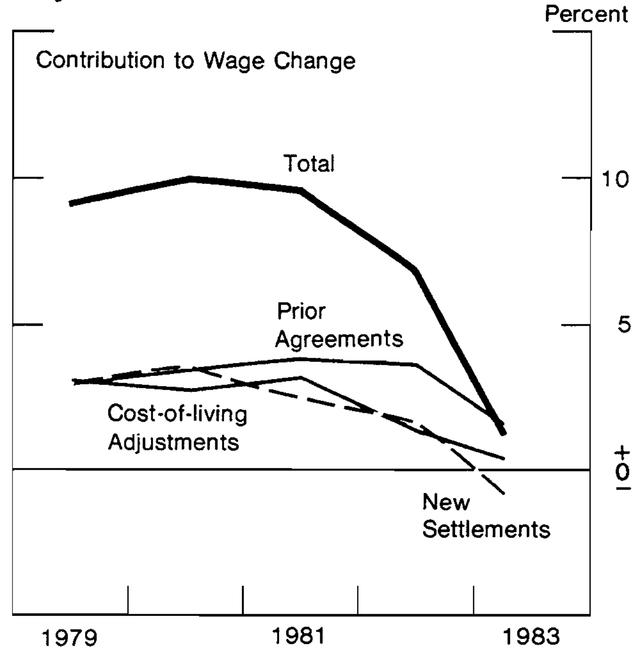
Unemployment Rate



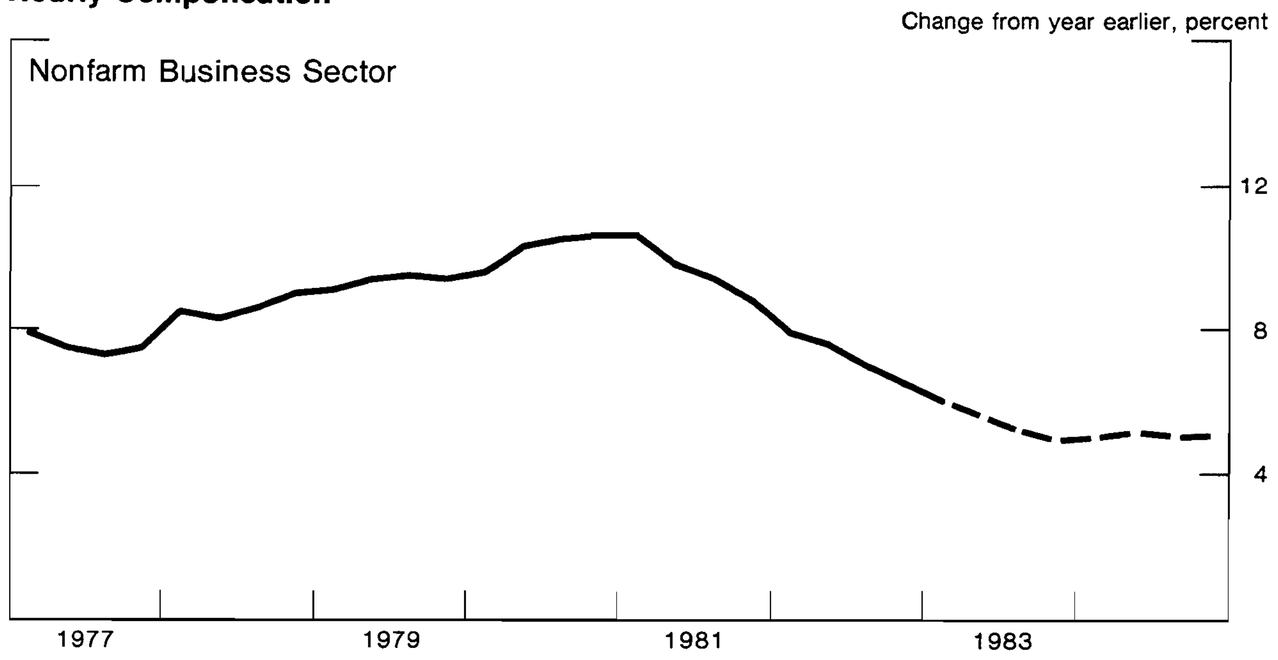
Hourly Earnings Index



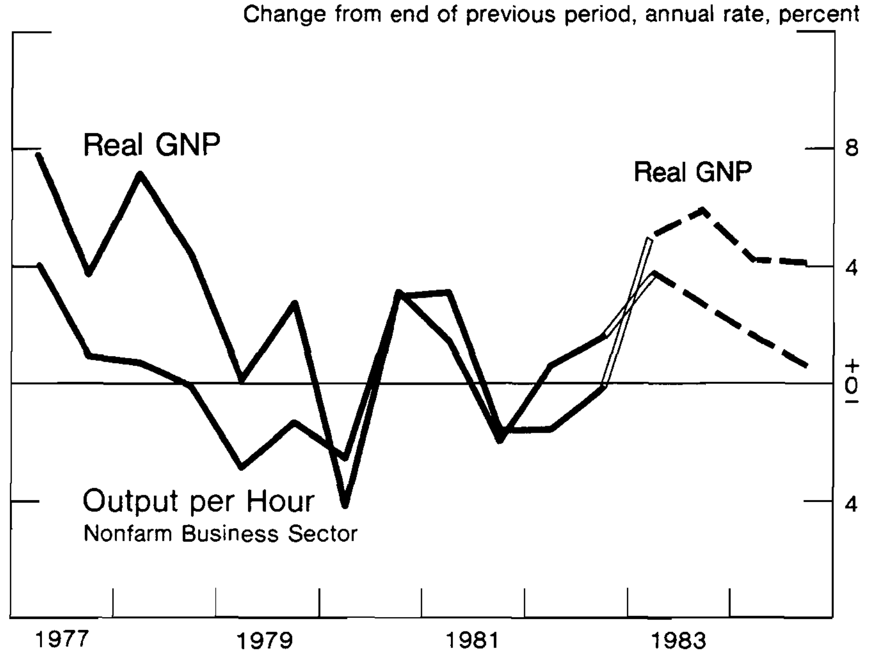
Major Union Contracts



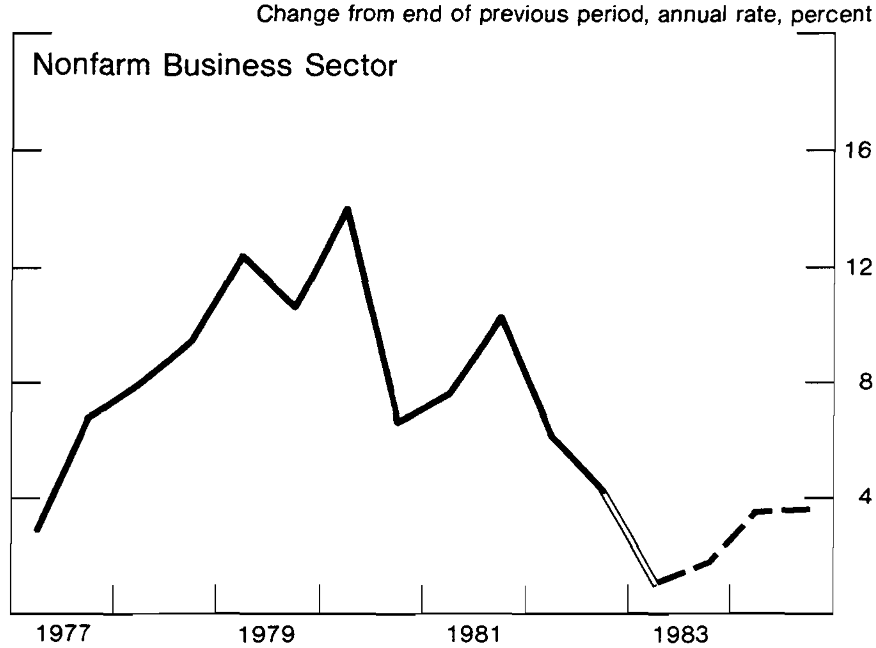
Hourly Compensation



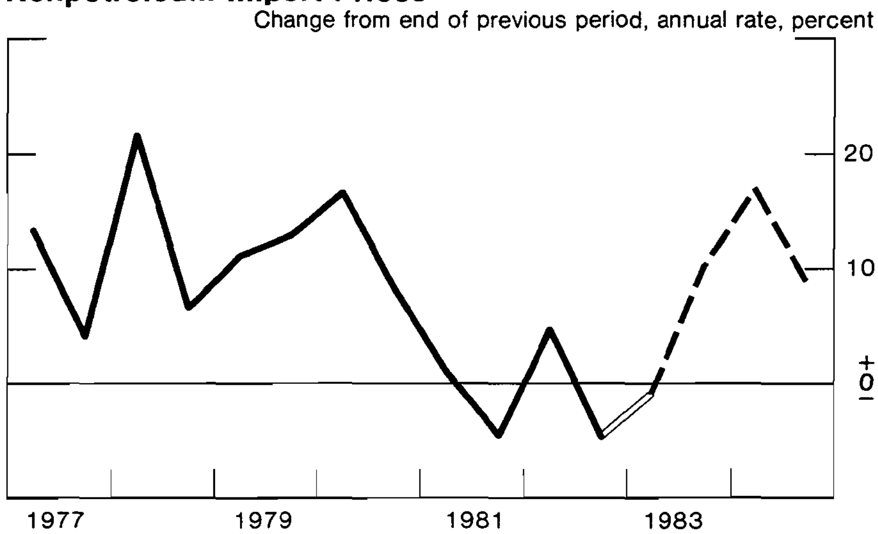
Output per Hour and Real GNP



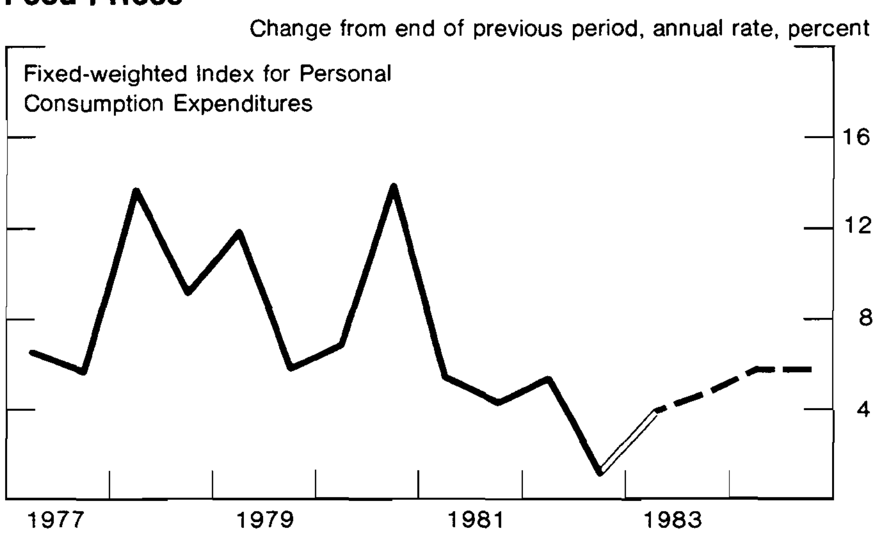
Unit Labor Costs



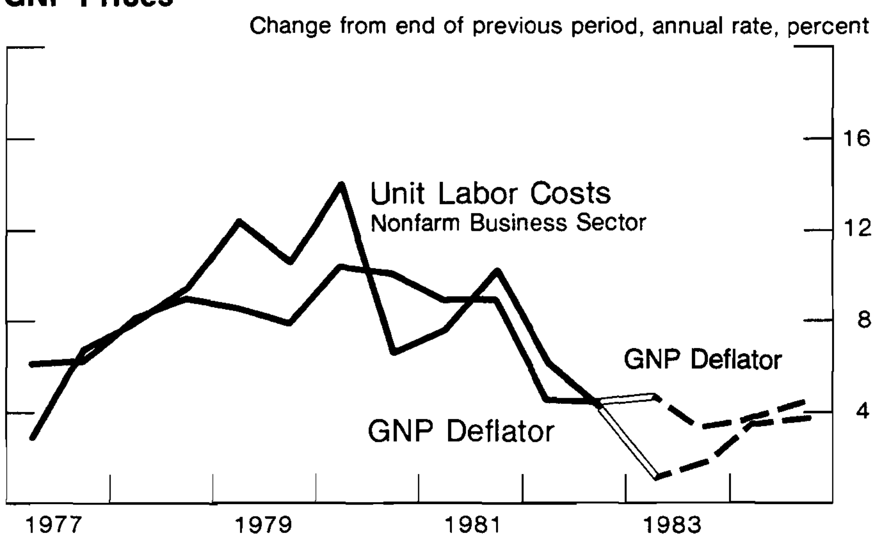
Nonpetroleum Import Prices



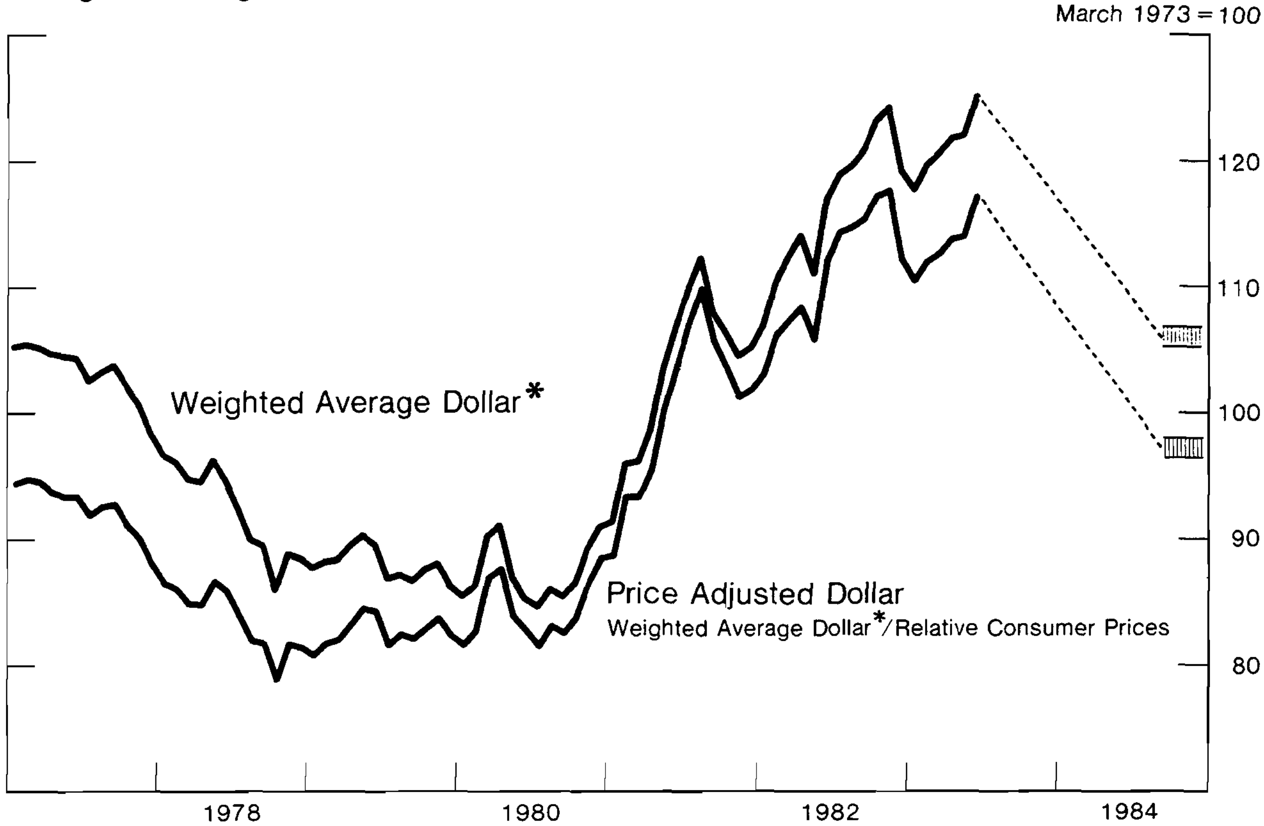
Food Prices



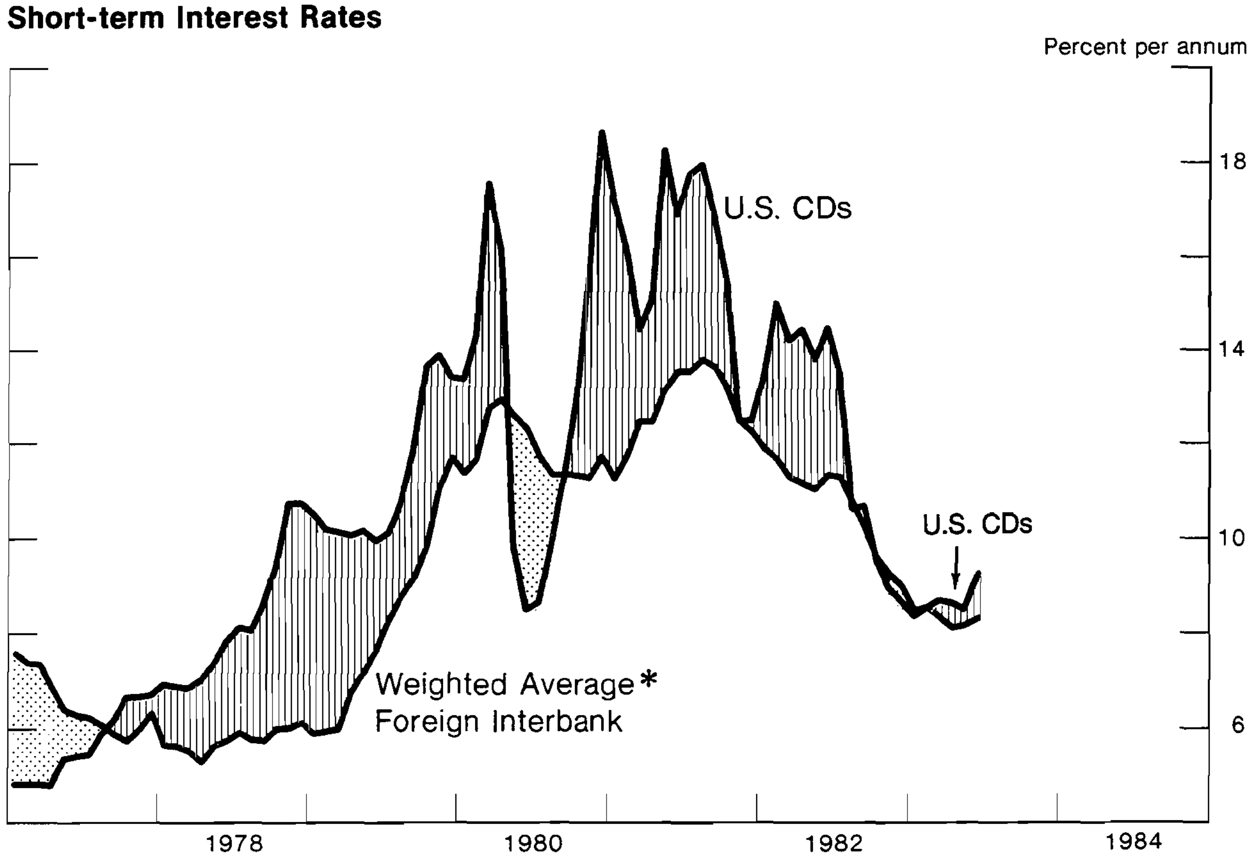
GNP Prices



Foreign Exchange Value of the U.S. Dollar



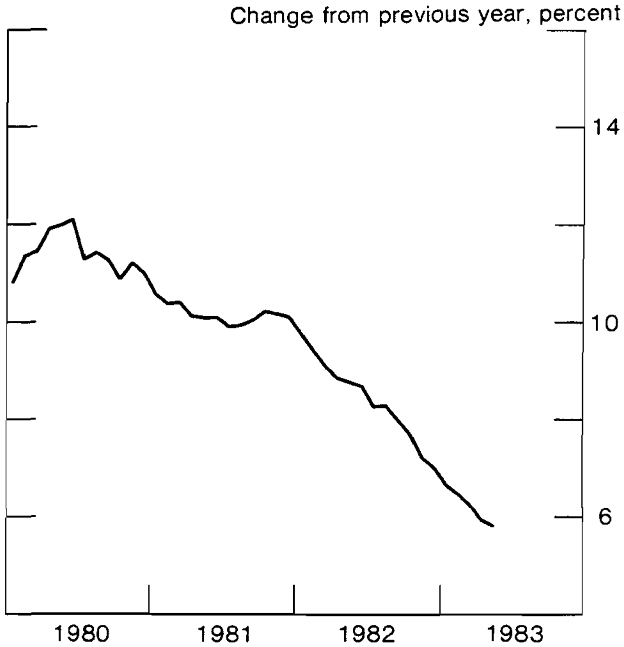
Short-term Interest Rates



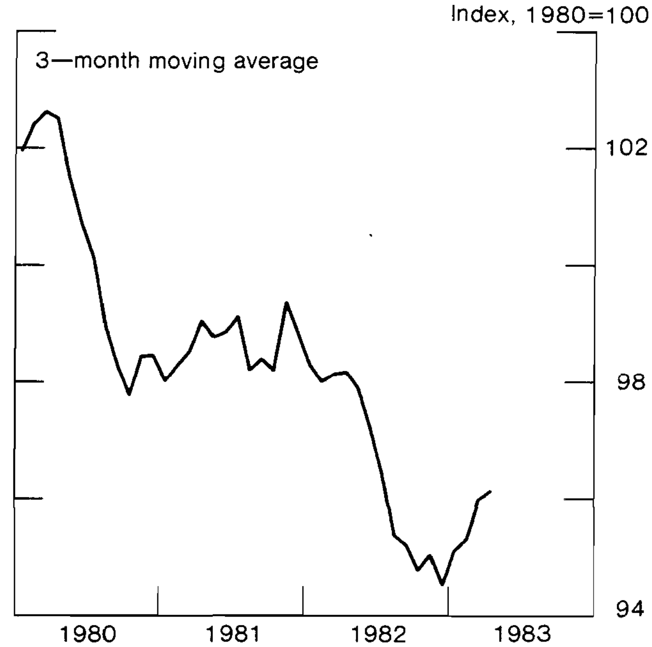
* [illegible] of G-10 countries plus Switzerland using total 1972-1976 average trade of these countries

Industrial Countries

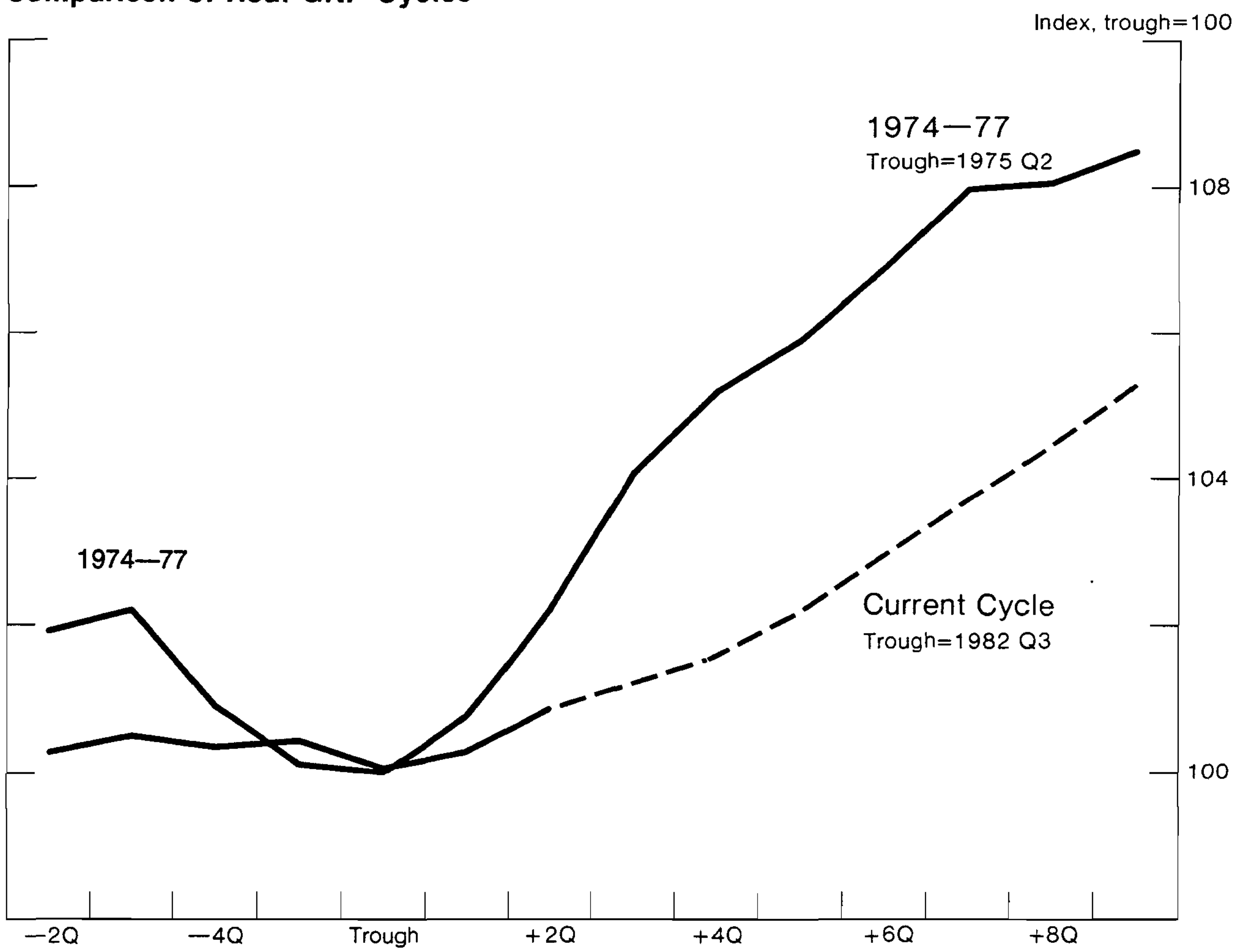
Consumer Prices *



Industrial Production*



Comparison of Real GNP Cycles **

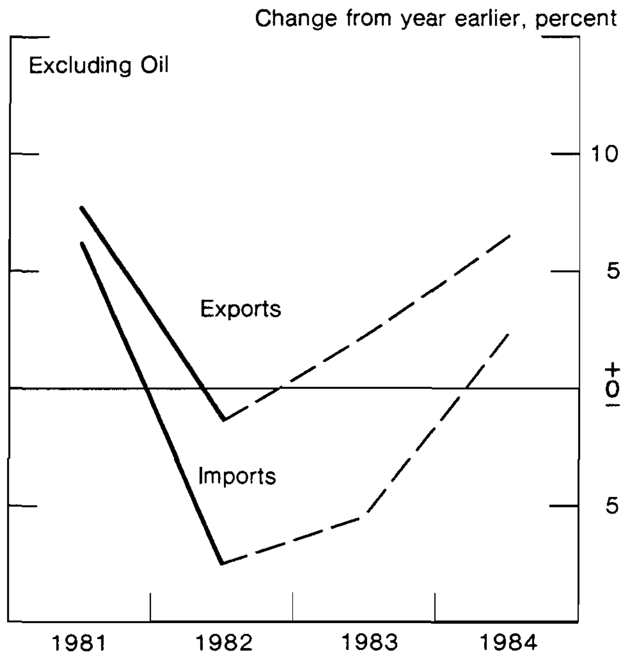


* Weighted average of six major countries using total 1972—1976 average trade of these countries

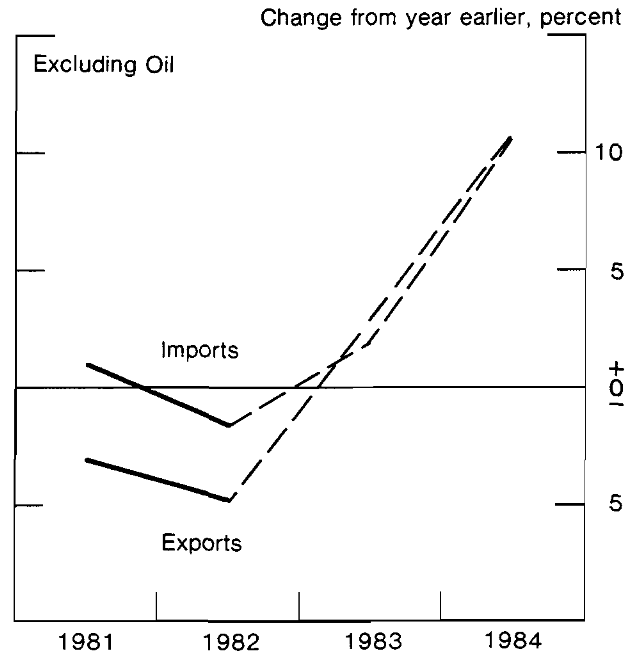
** Weighted average of G-10 countries plus Switzerland using total 1972—1976 average trade of these countries

Non-OPEC Developing Countries

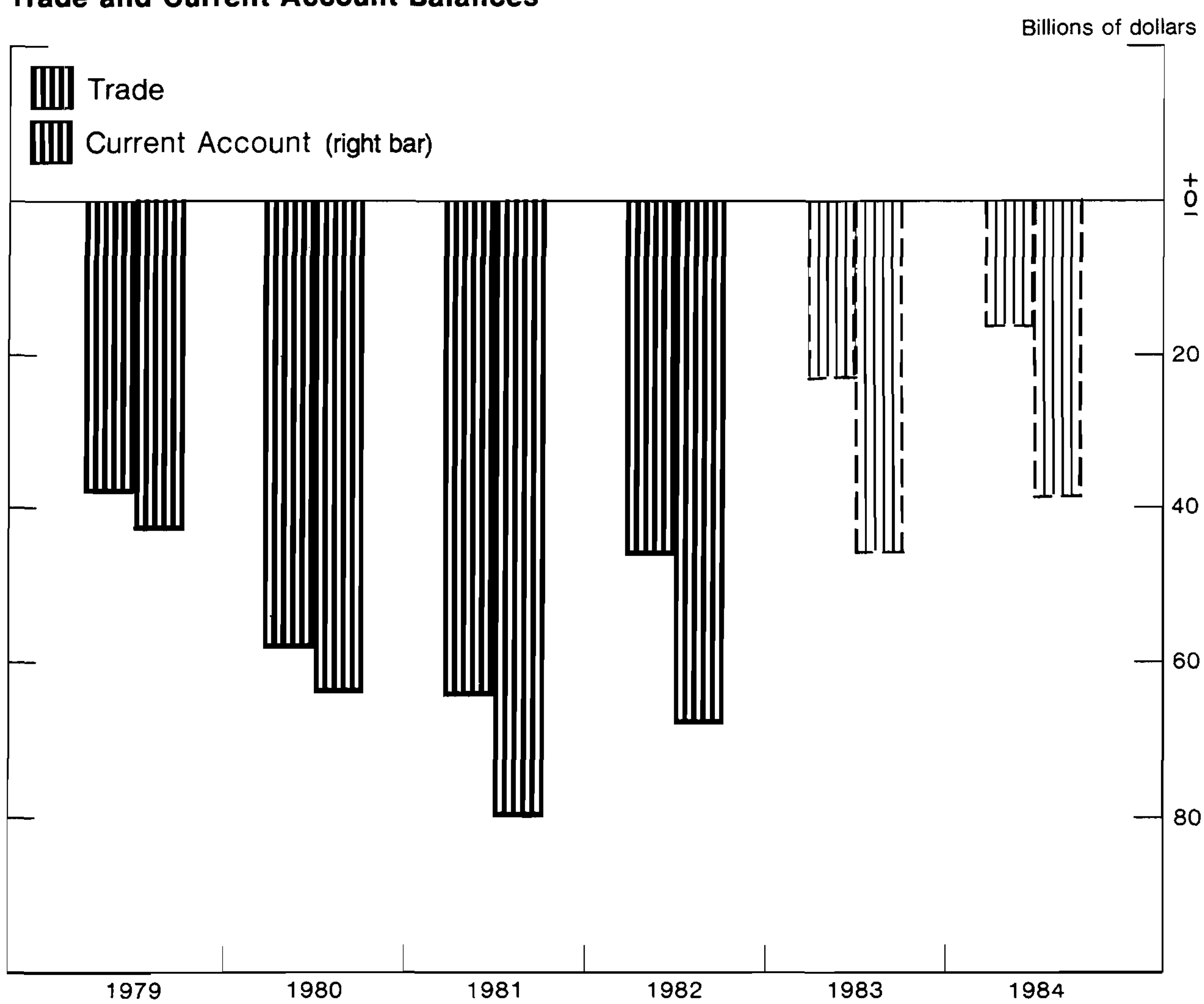
Trade Volume



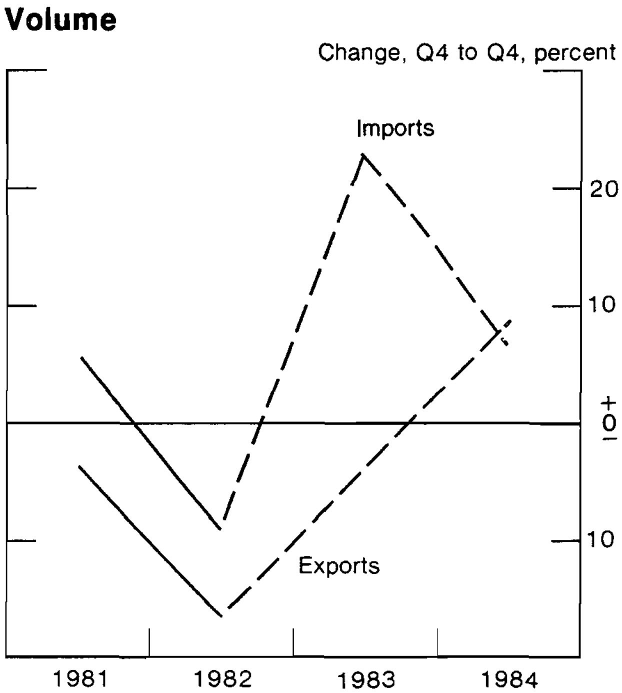
Trade Prices

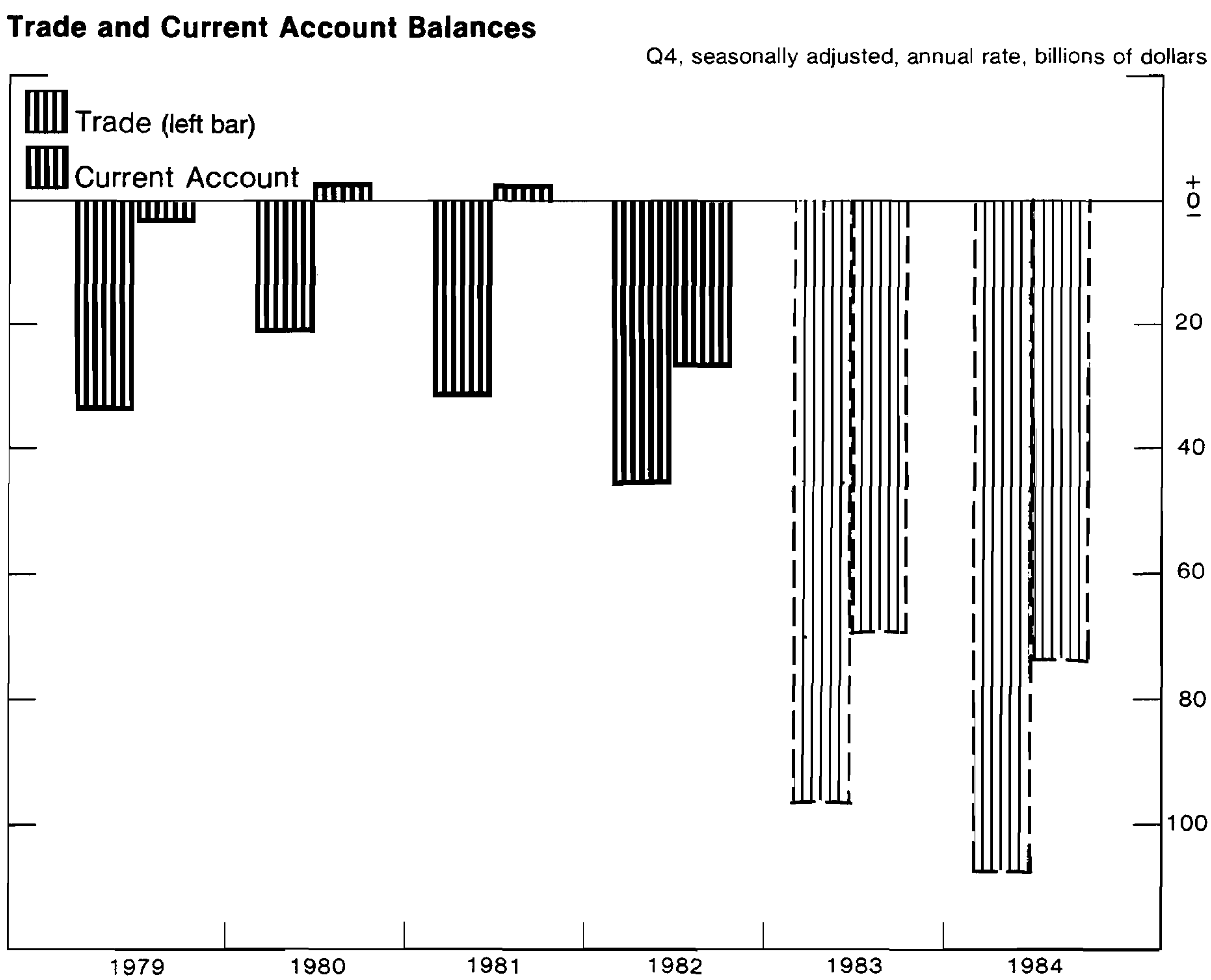


Trade and Current Account Balances



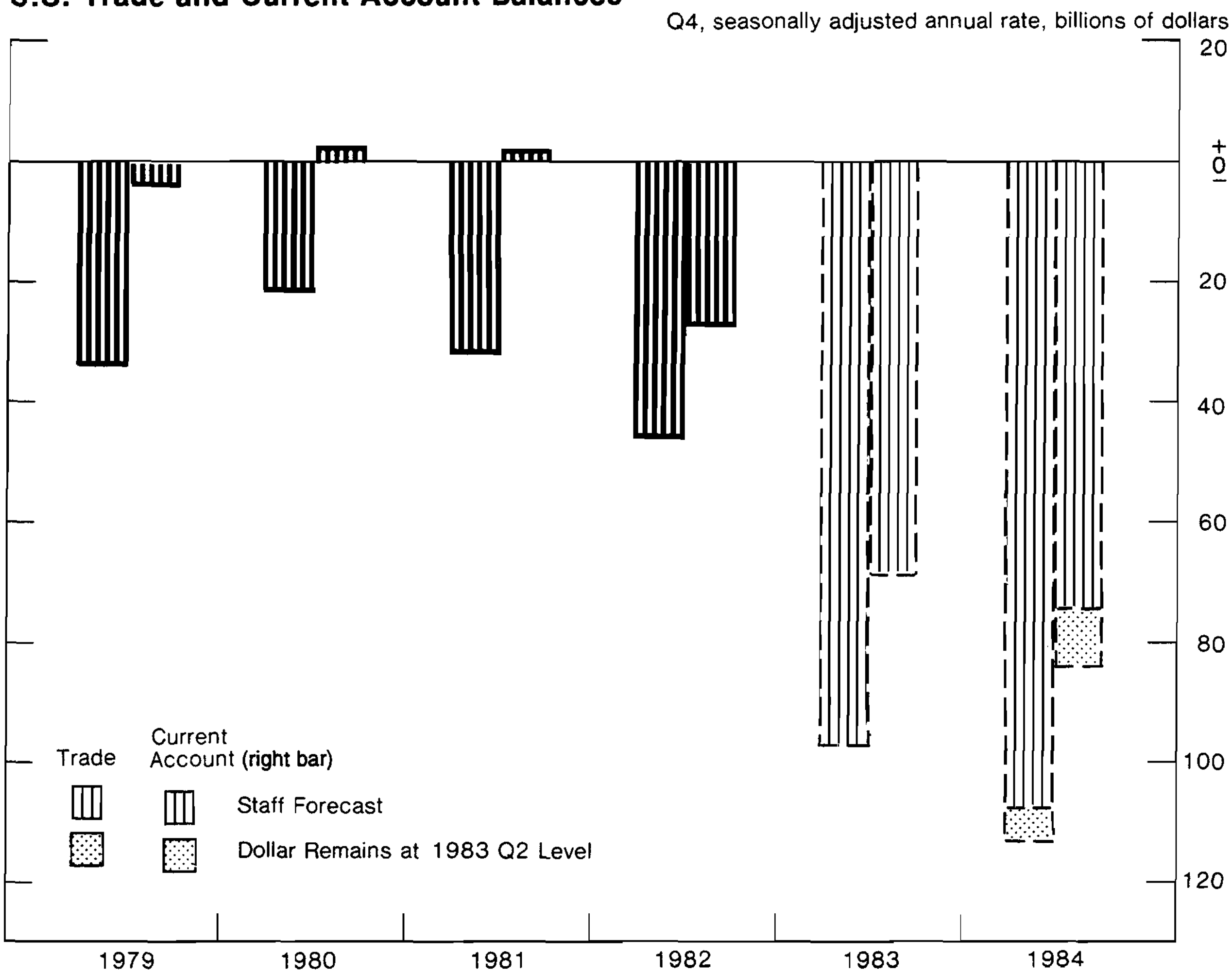
U.S. Merchandise Trade



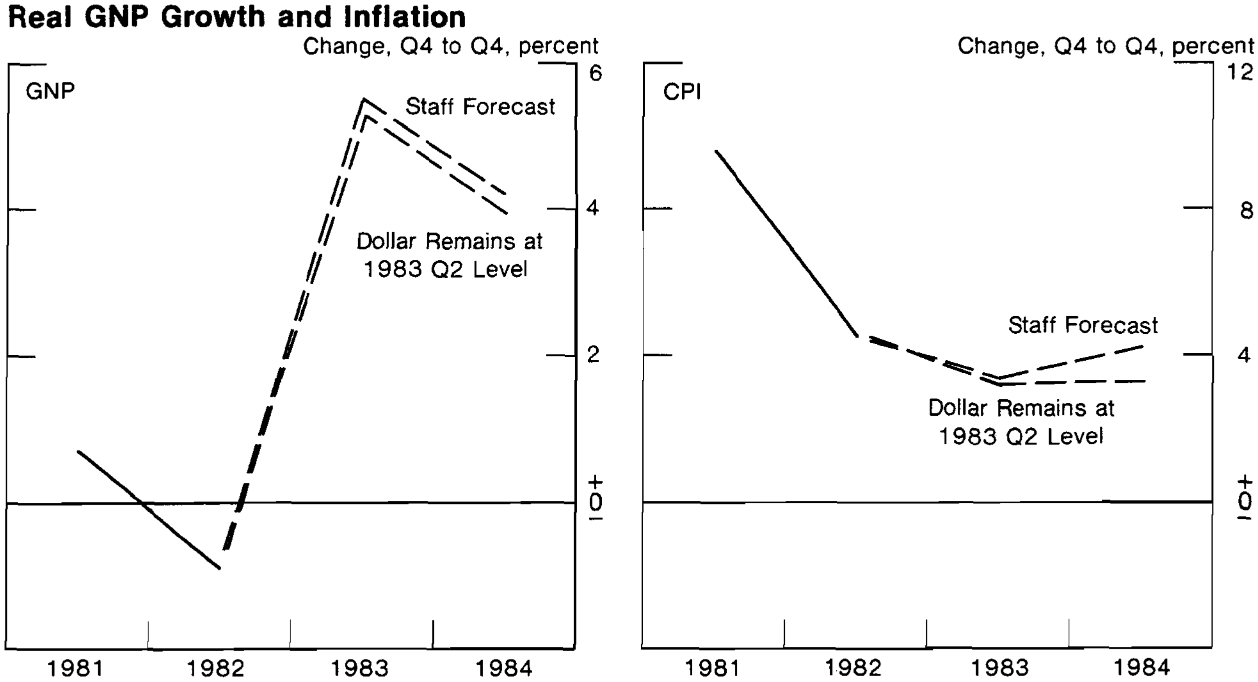


Estimated Effects of Stronger Dollar

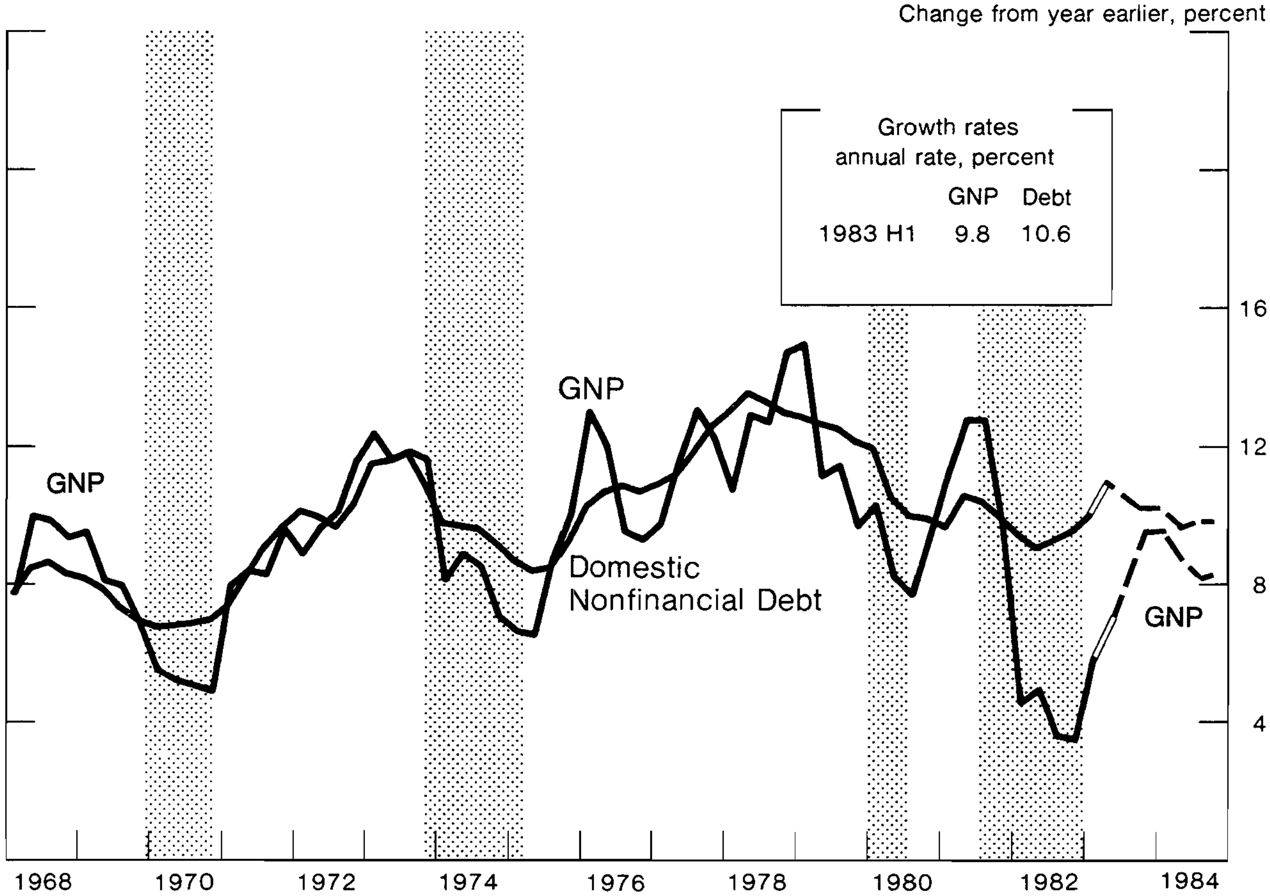
U.S. Trade and Current Account Balances



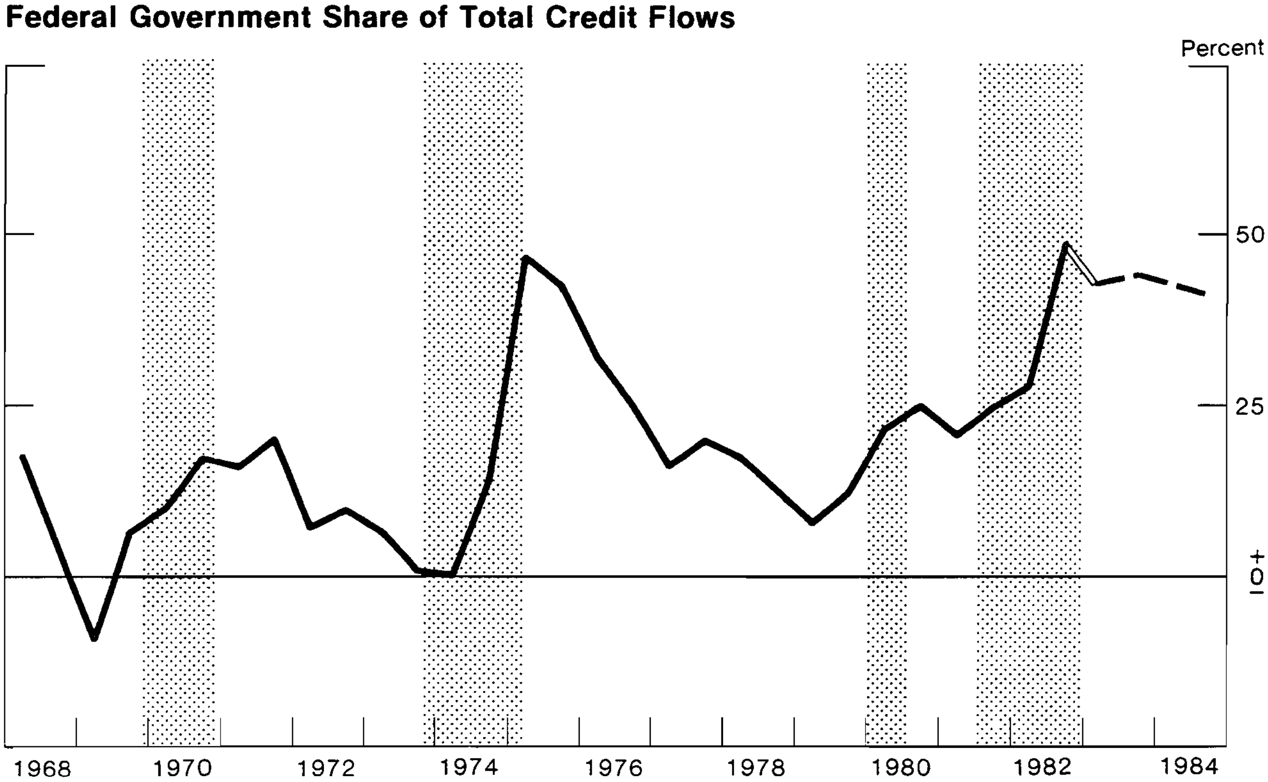
Real GNP Growth and Inflation



GNP and Credit Growth

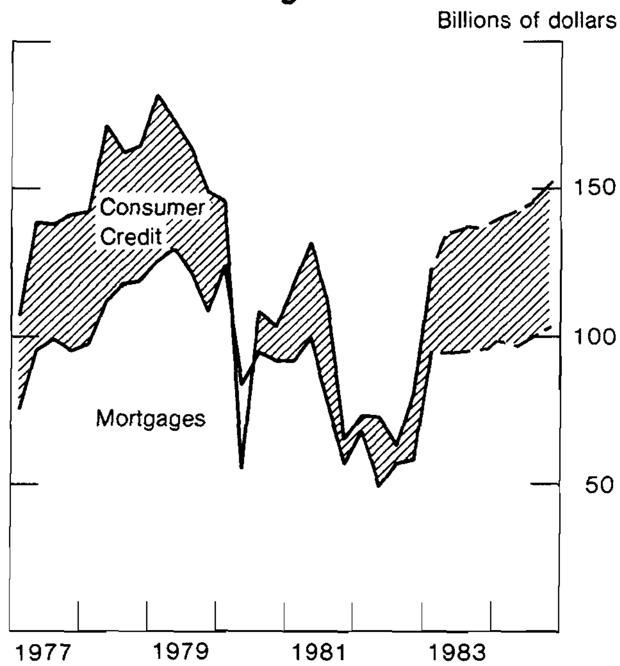


Federal Government Share of Total Credit Flows

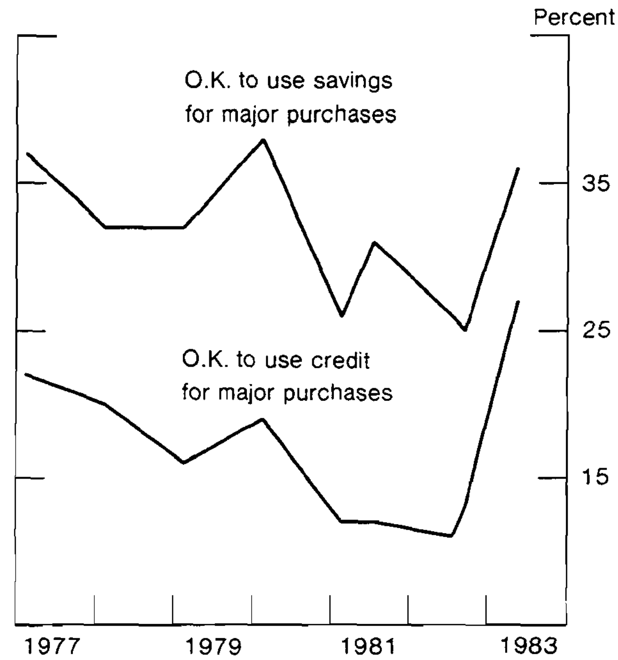


Households

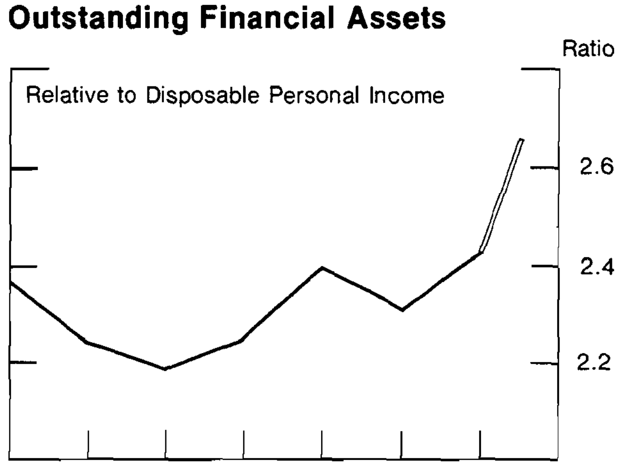
Selected Borrowing



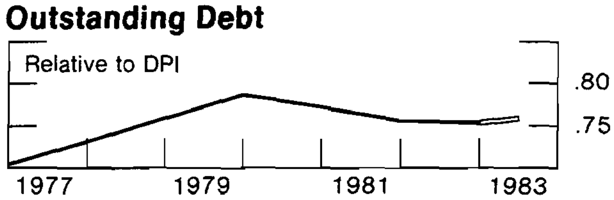
Consumer Attitudes



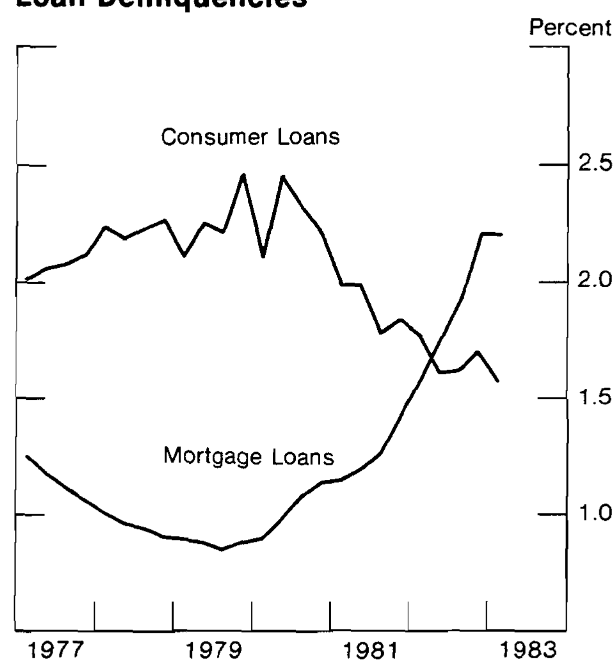
Outstanding Financial Assets



Outstanding Debt

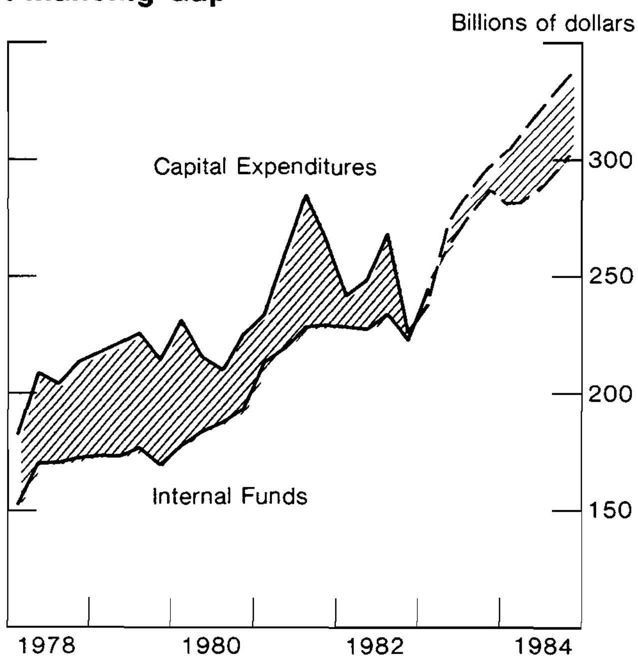


Loan Delinquencies

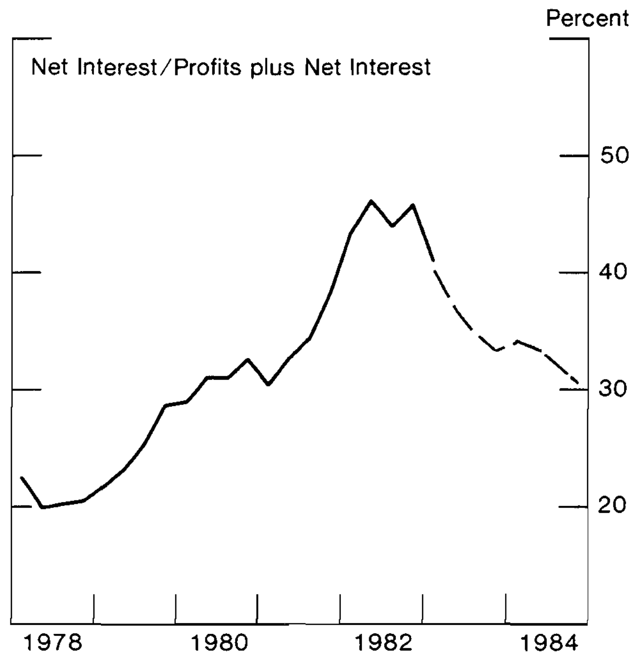


Nonfinancial Corporations

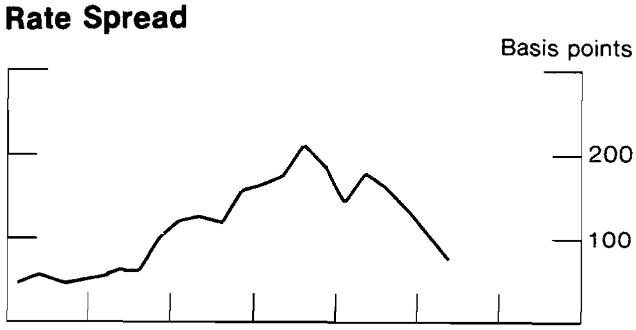
Financing Gap



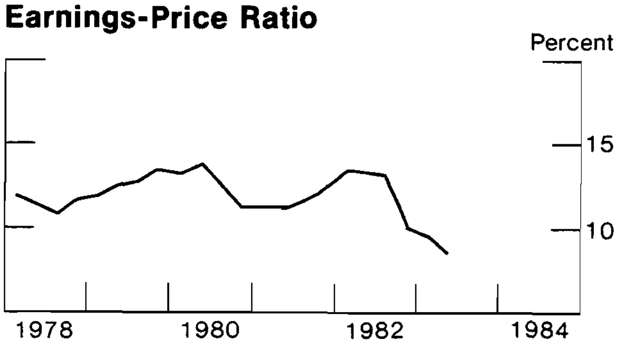
Interest Relative to Income



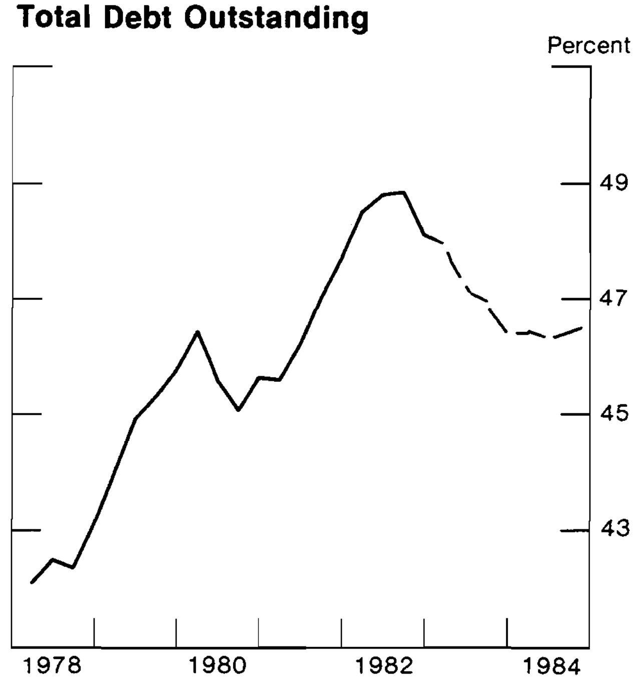
Corporate Less Government Bond Rate Spread



Earnings-Price Ratio

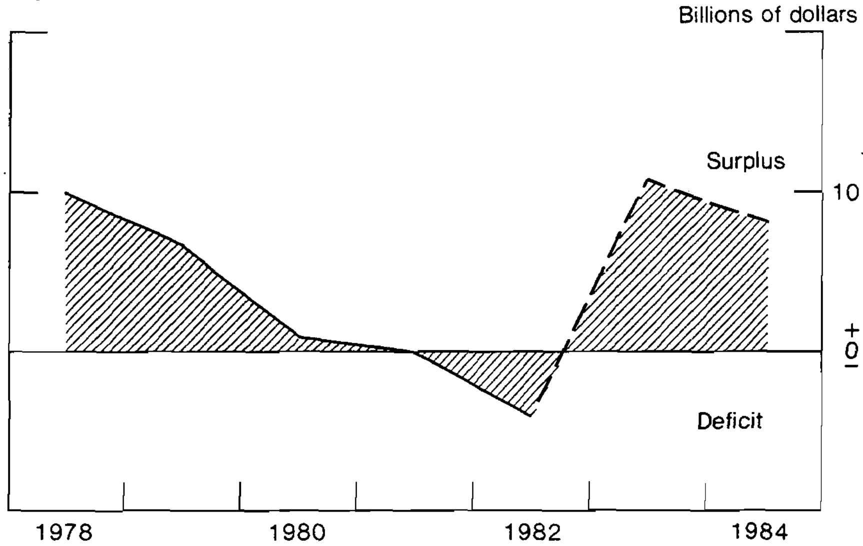


Short-term Debt Relative to Total Debt Outstanding

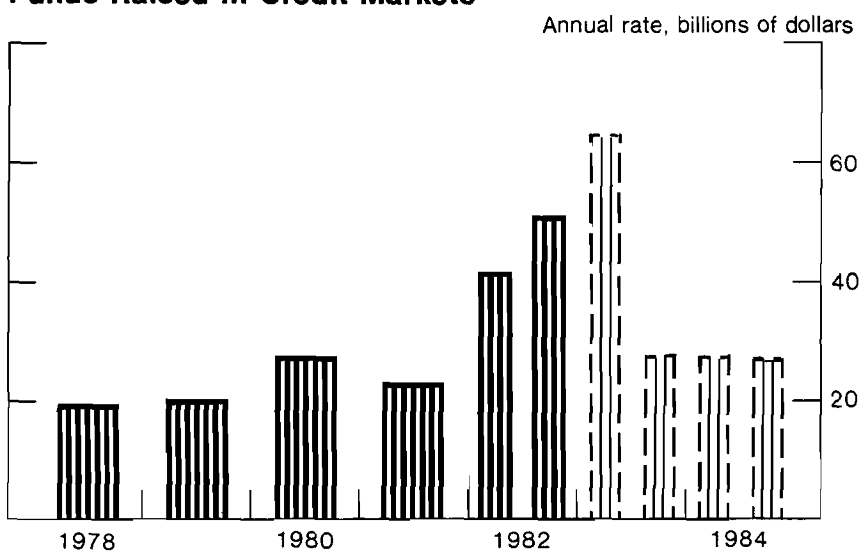


State and Local Government

Operating Budget



Funds Raised in Credit Markets

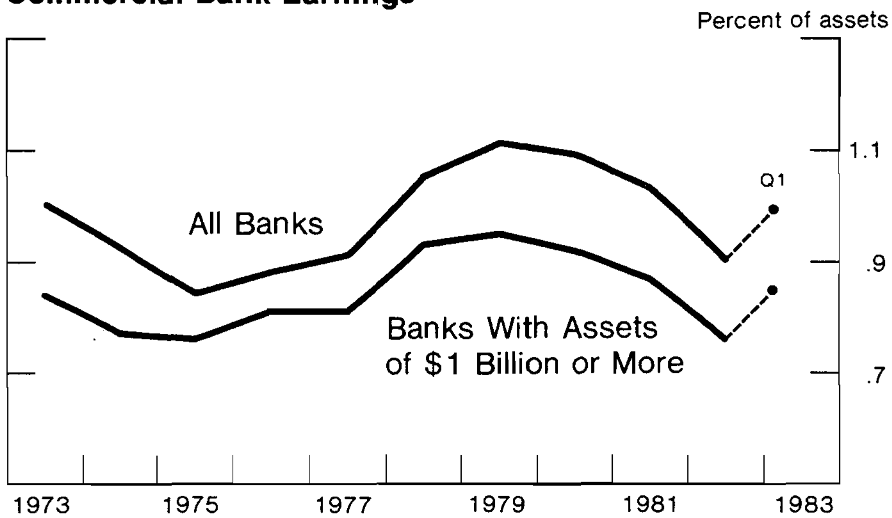


Selected Sources and Uses of Funds

Annual rate, billions of dollars

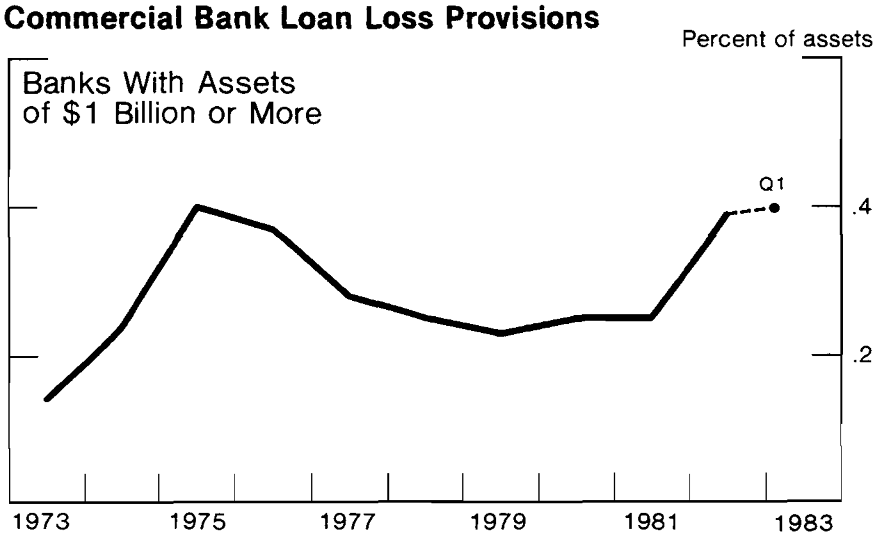
	1981	1982	1983 H1
Net borrowing	22.3	45.8	64.5
Net acquisition of financial assets	23.0	42.4	75.2
U.S. Treasury	8.8	30.0	72.0

Commercial Bank Earnings



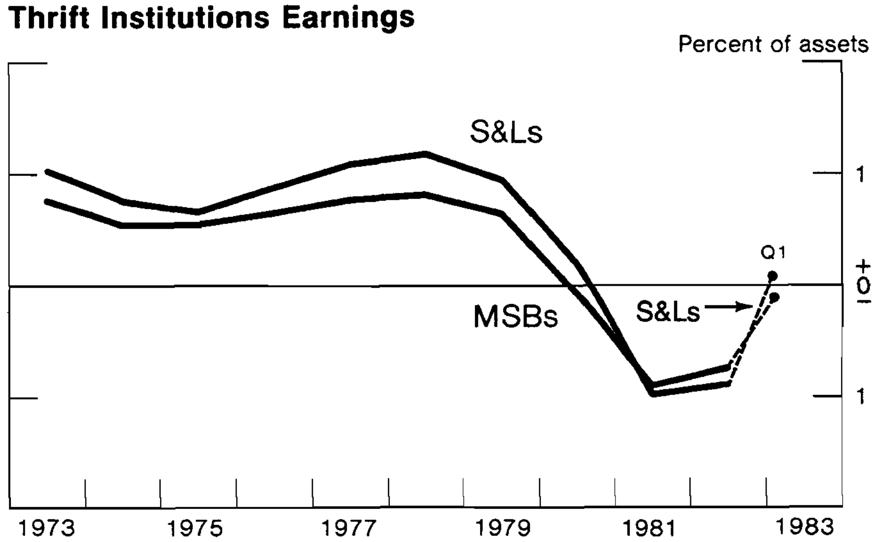
	All Banks	Larger Banks
1982 H1	.97	.71
H2	.88	.82
1983 Q1	1.00	.84

Commercial Bank Loan Loss Provisions



	All Banks	Larger Banks
1982 H1	.29	.31
H2	.50	.47
1983 Q1	.38	.40

Thrift Institutions Earnings



	S&Ls	MSBs
1982 H1	−1.29	−.92
H2	−.46	−.56
1983 Q1	.08	−.11

Forecast Summary

Percent change, Q4 to Q4	Board Members Range	Board Members Median	Voting Presidents Range	Voting Presidents Median	Nonvoting Presidents Range	Nonvoting Presidents Median	Staff	Adminis-tration
Nominal GNP								
1983	9¼ to 10½	10	9½ to 11½	9¾	9 to 11¼	10¼	9.6	10.4
1984	7 to 10½	9¼	8¼ to 11	10	7¾ to 11¼	9½	8.3	9.7
Real GNP								
1983	5 to 6	5½	4¾ to 6	5	4½ to 6	5	5.5	5.5
1984	3 to 5¼	4½	3 to 4½	4¼	4 to 5	4½	4.2	4.5
GNP Deflator								
1983	4 to 5	4¼	4½ to 5½	4½	4¼ to 5½	4½	3.9	4.6
1984	3¾ to 5	4¾	4 to 7	5½	3½ to 7	5	4.1	5.0
Average Q4 level								
Unemployment Rate								
1983	9¼ to 9¾	9½	8¾ to 9¾	9½	9¼ to 9¾	9½	9.4	9.6
1984	8¼ to 9	8½	8 to 9¼	8¾	8¼ to 9¼	8¾	8.6	8 6

FOMC Projections

Reported to Congress February 16, 1983

	Percent change, Q4 to Q4
Nominal GNP	7¼ to 11¼
Real GNP	3 to 5½
GNP deflator	3½ to 5½
	Average level in the fourth quarter, percent
Unemployment rate	9½ to 10½

Forecast Summary

Percent change, annual averages	Board Members Range	Board Members Median	Voting Presidents Range	Voting Presidents Median	Nonvoting Presidents Range	Nonvoting Presidents Median	Staff	Adminis-tration
Nominal GNP								
1983	7½ to 9¼	8	7½ to 9	7½	7¼ to 8¼	7¾	7 7	7.8
1984	8½ to 10¼	9¾	8¾ to 12	9¾	8½ to 12	10¼	8.7	10.2
Real GNP								
1983	3 to 5	3¼	2¾ to 4	3	2¾ to 3¼	3	3.2	3.1
1984	4¼ to 6	5	4 to 5	4½	4 to 5¾	5	4.9	5.2
GNP Deflator								
1983	4¼ to 4¾	4½	4½ to 5	4½	4½ to 4¾	4½	4.3	4.6
1984	3½ to 4¾	4¼	4 to 7	4¾	4 to 6½	4¾	3.6	4.8
Annual average level								
Unemployment Rate								
1983	9¾ to 10	10	9½ to 10	9¾	9¾ to 10	10	9.8	9.9
1984	8¾ to 9¼	9	8½ to 9½	9	8½ to 9½	9	8.9	8.9

FOMC NOTES
July 12-13, 1983
Paul Meek

Open market operations over the past seven weeks sought to foster the slight increase in reserve restraint which the Committee voted on May 24 and reaffirmed in the telephone consultation of June 23. As noted in the regular reports, the period was characterized by a quickening of monetary aggregate growth, relative to expectations at the May meeting.

In its operations over the interval, the Desk encountered a willingness by banks to borrow at the discount window as reserve restraint increased, as well as changing market views of the Federal Reserve's policy stance, which fed back on bank behavior. The persistent tendency of borrowing to run high, in part, reflected higher-than-expected levels of excess reserves. But banks also turned to the window with enthusiasm to borrow at the 8-1/2 percent discount rate as the federal funds rate rose. Such a tendency is not unusual in a period when most banks have clean records. Borrowing by non member banks and seasonal borrowing rose a bit and wire problems also led to occasional recourse to the window.

Early in the period, the Desk was slow to supply reserves in the week of Memorial Day in order to allow the System's slightly more restrictive stance to be reflected quickly in the money market. The federal funds rate did move up to 8-3/4 percent or a bit higher rather promptly. We were then caught a bit by surprise when the

Bank borrowed from the discount window on Thursday, June 9, about a week earlier than expected and only a day after we had bought $1 billion of Treasury bills to supply reserves seasonally. But we reversed direction with 3-day matched transactions the following Monday, allowing a rather tight market to emerge on the last date of the June 15 week without our intervention.

In this and the following week, we erred on the side of caution because of the further strengthening of the monetary aggregates, while excess reserves continued to exceed path levels. Adjustment and seasonal borrowing at the window rose well above the $350 million level incorporated in the path, and the federal funds rate moved up above 9 percent. Some of this tautness evaporated in the June 29 week, when non money market banks stepped up their use of the discount window. (Coincidentally, this was after the Committee's consultation affirmed a $400 to $500 million range for borrowing.) A measure of tautness was restored last week over the statement date and July 4 weekend, and federal funds have been trading around 9-1/8 percent in the current week.

Some analysts were slow to identify the System's shift of emphasis. They explained away the tightening of money market conditions as seasonal, in effect interpreting the rise in discount window borrowings and the federal funds rate as a consequence of a seasonal demand for excess reserves. Since market analysts tend to focus on net reserve positions, the high levels of excess reserves often exceeded adjustment borrowing at the window to produce a net free reserve number.

The financial markets moved to considerably higher yields during the intermeeting period, despite some backing and filling. However analysts read the numbers, traders prepared for a higher federal funds rate and increased supplies of Treasury issues. The federal funds rate has risen about 50 basis points since the May meeting and 70 basis points since early May. Changed expectations as well as increased reserve restraint contributed to the rise. Rates on Treasury bills rose from about 60 basis points for 3-month bills to 90 basis points for 6 to 12-month maturities. Banks stepped up CD issuance in June as they moved away from anticipating further rate declines. But there was good demand for such paper at narrow spreads against Treasury bills, given the previous fall in CDs outstanding made possible by MMDA inflows. The rise in CD rates to about 9-1/2 percent for three-month maturities has put considerable upward pressure on the prime rate, but thus far the competition for loans in a slack market has seemed to reinforce political reasons for not raising the prime rate.

Prices of Treasury notes and bonds have fallen significantly over the interval, responding to an abundance of supply, the rise in the fed funds rate, and a stronger economic outlook. In the past seven weeks the Treasury raised $26 billion of new cash from coupon issues, in addition to $10 billion from Treasury bills. Three weeks ago, just before the quarter-end financing, yields rose abruptly as the market probed for levels that would entice investors to buy. In the event dealers underwrote the Treasury issues but yields had to rise even higher before customers were willing to buy. There was a crescendo of dealer anxiety before the securities finally were placed with prices at levels that discounted a fed funds rate of perhaps 9-1/2 percent over the near term. The market has stabilized since in a lower trading range with yields ranging 75 to 100 basis points higher than on May 23 for intermediate securities and about 70 basis points higher for 20- to 30-year issues.

The market's skittishness reflected a realization that the sheer volume of Treasury financing calls for finding an ever-widening circle of buyers. Estimates of the Treasury's cash needs in the next six months range up to $115 billion-indicating a need to raise almost $4.5 billion of net new cash each week. There will be unremitting pressure in the coupon sector. The New York staff estimates that the Treasury will sell $60 billion of coupon issues in the third quarter against maturities of $23 billion. The Treasury estimates its needs will be a few billion dollars less. The conflict between the demands of the Treasury and those of an expanding economy does not seem as far away as it did a few months ago.

In the corporate bond market, yields have risen about in line with Treasury issues but the pace of new offerings has receded. Treasurers have kept their offerings on a well-stocked shelf, hoping that a window of lower rates will appear some time over the next six months. Meanwhile, they have been able to raise money in the stock market, from banks, or from internal sources. But a decline of rates from current levels would probably trigger a substantial flow of issues to market. The municipal market has performed rather well in relation to other markets as the bulge in issues sold to beat the June 30 deadline for bearer bonds passed; yields rose about 25 basis points. The much publicized difficulties of the Washington Public Power Supply System adversely impacted some power related issues but not the market as a whole. Still, increased supply and the "WHOOPS" situation appear likely to pose problems for the market as we go forward.

As noted in the regular weekly reports, we suspended trading with the Securities Groups New York Hanseatic Division on May 31, in view of the merger on June 1 of its activities with a savings and loan association owned by The Securities Groups--without requested prior approval. The dealer was dropped from the reporting list on June 6. A review of its past performance, and current operations and financial structure is continuing. In addition, the

Federal Home Loan Bank Board is expected to make a formal ruling on the permissibility of such activities for an S&L.

FOMC Briefing
Long-run Targets
S. H. Axilrod
7/11/83

As noted in the blue book, the principal issue for the Committee in reassessing the longer-run ranges for 1983 appears to revolve around M1. So far as we can see there appears to be little chance of coming close to the present 4 to 8 percent 1983 range for that aggregate by year-end without a more rapid rise in interest rates than contemplated in any of the short-run operating alternatives presented for this meeting. Thus, we have shown in the blue book an alternative longer-run range for M1 of 7 to 11 percent which seems more practicable, particularly if the Committee adopts a policy course that entails <u>some</u> rise in interest rates over the balance of the year. It could be argued that an 8 to 12 percent range would be even more practical; such a range would be more likely to accommodate a policy course that did not necessarily involve further interest rate increases.

It must be recognized, however, that substantial elements of uncertainty still surround M1. Our recent research suggests that M1 has become more responsive to interest rate changes as regular NOW accounts have become a relatively more important component. That would suggest that a small rise of market interest rates would place greater restraint on M1 than it had in the past. Yet actual demand for M1 over the past three quarters (given income and interest rates) has run even stronger than our new M1 equation suggested, even though the equation itself was generating what seemed to be unusually strong demands. So there still appears to be some question about whether we have much of a handle on M1 demand. Moreover, that demand should in any event be in process of changes if and as super-NOW accounts assume a more important role, which would act to reduce the responsiveness of M1 to market interest rates over time from what it had recently been.

None of this would deny that there is a small chance that M1 growth could decelerate very substantially over the balance of the year. But that would seem to depend on holders of regular NOW accounts shifting funds out without much lag in response to small interest rate increases and to holders of demand deposits finding that the surprisingly strong and sustained build-up in such accounts over the past several months (excepting January and February) has brought these balances to levels that are more than ample for transactions and compensating balance needs. The greater odds are on a relatively moderate deceleration in M1 growth over the balance of the year, accompanied to be sure by the probability of some increase in the income velocity of M1 after several quarters of decline.

Whether such a possible return to slightly more "normal" behavior of M1 velocity is sufficient to give that variable more weight in operations than has been the case since last fall is, of course, another major question. Despite the recent apparent tendency for velocity of M1 to become less negative and perhaps turn positive, its demand properties, as I mentioned earlier, are still rather uncertain--at least as judged from model results, including the variety of different results one can get from different models. On the other hand, nominal GNP was stronger than earlier expected in the second quarter of this year and seemingly will be so in the third quarter. The strength of nominal GNP in the second and third quarters, not to mention earlier quarters, is considerably less than most monetarist-type models would have predicted (since they would probably not have taken account of a structural downward shift in velocity), but the strength of M1 did to some extent foreshadow the surprisingly strong nominal income growth of the past quarter and this one and to some degree is also probably reflecting growing transactions needs on a current basis.

Against that background, we have made an effort to suggest possible alternative language for the directive should the Committee wish to give more weight to M1. Because of the inherent demand uncertainties that are probably still with us, I am afraid the proposed language necessarily is not much clearer than the existing language indicating the Committee will monitor M1 with its weight dependent on more predictable velocity characteristics.

There seems to be little reason, Mr. Chairman, to alter the 1983 ranges for the broader aggregates. The proposed directive provides optional language for consideration that indicates an expectation that these aggregates may be in the upper part of their ranges. Our models do not make me much, if any, more comfortable about predicting M2 than M1, but that optional language may better fit a policy approach that looks to unchanged (or declining) interest rates over the balance of this year than one that contemplates some rise in rates.

The options laid out in the blue book for 1984 are pretty much self-explanatory. It seems probable that modestly lower growth in the broader aggregates next year relative to this will in practice be consistent with continued relatively good economic recovery, given the projected moderateness of wage and price pressures. Whether the tentative growth ranges for 1984 should as a matter of policy be lowered from 1983 at this time would seem to depend as well on assessment of the contribution that such a reduction could make to holding down wage and price pressures as the recovery proceeds and the fiscal stimulus gets larger.

M1 growth in 1984 should be considerably slower than in 1983, but there is a small chance that it will not. On the face of it, considerably slower growth than this year should naturally be expected since the upward stock adjustment of M1 balances in late '82 and the early part of '83 to a much lower level of interest rates will have been behind us for some time. On the other hand, if the current economic recovery is not as sustainable as projected at the continuing apparently fairly high level of real interest rates, one would have to assume either that price increases will be strong next year or nominal interest rates will be lower. If the latter should be the case, M1 growth could again be strong as short-term rates move down further toward NOW account ceiling rates.

NOTES FOR THE F.O.M.C. MEETING
July 12, 1983

Sam Y. Cross

Over the period since your last meeting, the dollar has continued to strengthen about 2 to 4 percent against most of the European currencies and the Japanese yen. Against the traditionally strong currencies like the German mark and Swiss franc, the dollar is now back to the highs reached last November. Against some of the weaker currencies, the dollar has set new records. On a trade-weighted basis, the dollar reached an all-time high in mid-June and is at about that level now. It stands some 7 percent higher than the level at the beginning of this year.

The major factor behind the dollar's strength over this period has been the changing outlook for interest rates. In May and early June the exchange markets' hopes for further declines in U.S. interest rates faded, and then gave way to expectations of renewed increases in response to growing evidence of a robust recovery in the U.S., together with large actual and prospective federal budget deficits and rising money supply. In other countries, expectations that interest rates generally would continue to decline persisted longer than in the United States, and interest differentials favoring the dollar widened.

The current strength of the dollar apparently reflects anticipation of a possible tightening of U.S. monetary policy. Nevertheless, there were occasions particularly in late June when there was enough skepticism about how long the dollar would maintain these levels that it came off rather sharply though briefly on adverse news. Skepticism was generated by figures published during June suggesting a faster deterioration in the U.S. trade position than had been anticipated. At the same time, large trade surpluses were again reported for Germany and Japan. The prospects for financing a widening U.S. current account deficit came more into question with publication of statistics for May showing a slowdown in capital outflows from Germany and Japan. Also during this time, there was some evidence of at least occasional shifts of funds back into Germany and Japan, and there was less talk of foreign inflows into U.S. securities.

At the present, therefore, the exchange market seems to be reflecting a short-term focus on interest rate prospects, although we may see more medium-term concern about the outlook for our balance of payments and its financing.

On July 26, 1983, the last Carter bond to mature will be redeemed. The Treasury intends to use marks warehoused with the System to cover this repayment, thereby eliminating all balances warehoused for the Treasury.

FOMC Recommendations

Mr. Chairman, swap drawings totaling $269 million by Mexico under the Federal Reserve special swap arrangement will mature between now and September 2, 1983. Of these, $115.5 million mature before August 23, 1983. I would propose that these drawings, $14 million of which comes up for first renewal and $101.5 million for second renewal, be extended to August 23, 1983. Mexico fully intends to repay these and all other drawings under the special swap arrangement on the maturity date. Indeed, the possibility is being explored of their making a deposit or investment of $500 million in anticipation of repayment of the BIS-U.S. credit arrangements.