APPENDIX

James L. Kichline
February 2, 1981

INTRODUCTION -- FOMC CHART SHOW

During our presentations we will be referring to the package of chart materials distributed to you. The staff forecast presented in detail in the Greenbook is based upon several assumptions that are displayed in the first chart of the package. For monetary policy, we continue to assume growth of M-1A--abstracting from shifts into NOWs--of 4¼ percent in 1981 and 3-3/4 percent in 1982. The assumptions represent the midpoint of the tentative range set last July for 1981 and a further ½ percentage point reduction in 1982. The corresponding growth rate of M-1B is also shown. The fiscal policy assumptions include some restraint on growth of federal expenditures as well as a personal income tax cut and liberalization of accelerated depreciation allowances.

Additional information on the federal budget outlook is presented in the next chart. Federal outlays are projected to grow less rapidly in the current fiscal year than in 1980, and to moderate further in 1982. The assumed expenditure restraint falls on nondefense areas and amounts to cutting $7 billion out of the current year budget and about $25 billion out of the 1982 budget. These cuts seem roughly in line with the new administration's announced intentions, and are quite ambitious. However, the staff's economic and financial forecast differs from that underlying the official budget and entails higher outlays for interest and unemployment compensation as well as lower tax receipts. Thus, the unified budget deficit in 1981 is projected to be little changed from the preceding year and to rise to the neighborhood of $80 billion in fiscal 1982, without another cut in personal income taxes.

On the monetary policy side, the top panel of the next chart displays the behavior of M-1A and M-1B during recent years and the assumed growth for 1981 and 1982. The data shown have been adjusted to attempt to remove the effects of shifts into ATS and NOW accounts in the past, and to abstract from such shifts in the future. As is clear, the assumed growth in 1981 represents a considerable deceleration from that experienced last year. The staff forecast of the economy entails strong demands for goods and services at higher prices and along with monetary restraint results in sizable increases in the velocity of M-1B over the 1981-82 period--shown in the middle panel. Such growth of velocity well above secular trend would be consistent with rising interest rates, which are shown in the lower panel. While interest rates could well dip in coming months as nominal GNP growth slows from recent high rates, achieving the M1 growth assumed nevertheless would seem to require rising rates later in the year and on into 1982.

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

Joseph S. Zeisel
February 2, 1981

FOMC CHART SHOW

The economy recovered briskly from the sharp spring contraction, and ended the year on a surprisingly buoyant note overall. As is evident in the next chart, however, signs have emerged recently of a slowdown in several key sectors.

Retail sales in real terms are now little changed from their level in July. Much of the weakness has been in autos, with unit sales continuing well below prerecession levels. While the level of housing activity--the right hand panel--remains surprisingly strong in the face of historically high interest rates, starts have leveled off well below their previous high; and field reports and Redbook comments continue to suggest a downturn; the advance report on permits for the first half of January, in fact, shows a sharp decline.

The bottom two panels indicate the relatively strong production and employment rebound in the last half year. Both measures have about recovered their earlier losses. But as is evident, the production of motor vehicles and construction supplies remains conspicuously below earlier levels and with demand weak, further sharp cuts in auto output occurred in January. In the case of employment, total hiring appears to have outstripped growth in overall output--portending some downward adjustments of payrolls in the absence of further increases in demand.

The top panel of the next chart shows the sharp contraction and recovery in real GNP growth over the past year. Real output in the fourth quarter, however, was no higher than a year earlier, as illustrated in the lower panel. And, as is indicated, we are projecting a progressive slowing in the pace of activity over the first half of 1981, reflecting a contraction in housing activity, and a weakening in consumption owing in part to accelerating inflation and the bigger Social Security tax bite. The economic momentum evident at year-end still seems likely to result in a moderate gain in real GNP this quarter, but despite evidence of considerable potential demand, fundamental policy constraints dictate very sluggish growth, on balance, over the projection period. Following a small decline this spring, real GNP is projected to increase only fractionally through 1982.

The strength of consumer demand recently was particularly surprisingly but it became a bit less so with the issuance of revised national income and product data in December. As shown in the top panels of the next chart, both personal income and the saving rate were revised up, the latter by about 1¼ percentage points on average after mid-1979, suggesting less pressure on household budgets than had been assumed.

The lower two panels also are useful in understanding the relative strength in consumer outlays; the slower growth of consumer credit has permitted repayment obligations to be brought into better alignment with disposable income. The bottom panel illustrates the declining proportion of disposable income channeled into food and energy since last spring. Nevertheless, both of these ratios remain quite high historically, leaving discretionary consumer spending still vulnerable to a substantial weakening in real income growth.

As the top panel of the next chart shows, the revised saving rate remains relatively low--about a percentage point below the postwar average. The saving rate is projected to drop in the first half of the year in response to weaker real disposable income, and to begin rising with the midyear tax cut. Still, the rate is projected to move only into the 5-5½ percent range, reflecting consumers efforts to maintain living standards in the face of slow income growth.

As the lower panel shows, we are forecasting a sluggish pace of growth of consumer outlays, tracking the expected performance of real disposable income and overall activity.

The strong performance of housing recently in the face of exceptionally high interest rates, as portrayed in the top panel of the next chart, has led us to revise our forecast somewhat. In assessing the factors determining housing activity, it is clear that strong underlying demand pressures are in place. Homeownership has remained a key hedge against inflation. Moreover, the demand for housing is supported by fundamental demographic forces. Nevertheless, it is our view that financial considerations will remain a major factor damping activity. As the lower panel shows, we expect that the rise in the pre-tax costs of servicing standard mortgage contracts will continue to outstrip income growth, increasingly dissuading or disqualifying potential buyers. Higher financing costs also are likely to discourage construction, especially multifamily units that generally involve long lead times.

As shown on the next chart, we are projecting a decline in total housing starts from the current 1½ million annual rate to about 1.3 million units for most of 1981, with only a slight pickup in activity in 1982, reflecting accumulating demand pressures.

The next chart addresses the outlook for business capital spending. As indicated in the top panels, lead indicators of capital spending are generally below their recent peaks; real new orders for capital equipment have been trending down and backlogs have been shrinking. In addition, nonresidential construction contracts have been sluggish for some time. These facts suggest a continued, albeit moderate, decline in fixed capital outlays through 1981.

The investment outlook for 1982 is obviously more speculative. But the costs of debt capital will remain high and, as the middle panel shows, we expect capacity utilization to remain weak, generating little demand for expansion of capital stock except in fast growing sectors such as defense or energy-related industries. Nevertheless, assuming new tax incentives, we expect capital outlays to level off and start edging up in real terms during 1982.

As is evident in the top panels of the next chart, inventories have proven to be less of a problem than has been typical in periods of large swings in demand and output. The inventory imbalances that developed during last spring's recession appear to have been largely a function of the sharp contraction in sales, and inventory/sales ratios have moved much of the way down again. As shown in the middle chart, business firms generally are keeping stocks under control.

We are projecting that business will succeed in keeping inventories in line with sales, and as is evident in the bottom chart, this implies a small runoff in the second half of 1981, and little inventory investment through 1982.

The next chart addresses the government component of spending. Federal defense purchases are projected to continue rising in 1981 and 1982--moving up in real terms at about a 9 percent rate--somewhat more than budgeted by the Carter administration. We are assuming offsetting reductions in federal nondefense purchases, as well as substantial cuts in transfers to individuals and in real grants to states and localities--shown in the second panel. This cutback will further tighten the fiscal position of these jurisdictions--shown in the third panel--at a time when their operating budgets will already have deteriorated significantly due to high interest rates and increased pressure on receipts. As a result, we anticipate that real outlays of states and localities will continue to decline and, in aggregate, real total government purchases are projected to show little growth in the next two years.

As the top panel of the next chart indicates, we anticipate virtually no increase in employment over the projection period. Some decline in jobs is likely to accompany the cutback in production in early 1981, and only small gains are expected thereafter. Limited job opportunities should further damp labor force growth. Nevertheless, the expansion of labor supply likely will outpace job creation, and the unemployment rate--shown in the bottom panel--is projected to move up quickly this spring and then to drift higher, reaching 9 percent by the end of 1982.

As illustrated in the next chart, compensation costs are expected to continue increasing strongly during 1981 despite high and rising unemployment. The underlying trend in wage rates will be sustained in the near term by high rates of inflation in consumer goods. Moreover, the large recent hike in payroll taxes will add significantly to compensation costs early this year. By 1982, however, increases in compensation costs should moderate, reflecting the extended period of labor market slack, some slowing of inflation, and a smaller Social Security tax increase.

As the middle panel illustrates, it is not until 1982 that productivity is expected to begin to contribute to alleviating the impact of rising wages on labor costs. With no increase in output, we are forecasting another stagnant year for productivity in 1981 and only a slight rise in 1982 in line with the expected increase in activity. Nevertheless, this improvement, when combined with the reduction in wage pressures, is expected to result in a distinct deceleration of unit labor costs, which are projected to increase at about a 7½ percent rate in 1982.

The outlook for prices is addressed in the next chart. In addition to the continued pressure from rising unit labor costs, a rapid rate of rise in the general price level this year will be sustained by higher energy and food prices, as shown in the top panel. Recent OPEC price increases, as well as the President's decision to decontrol domestic oil immediately, concentrate the energy price rise in the early part of 1981, and energy price pressures are projected to ease considerably in the second half. Food price increases also are expected to be rapid in the near term, reflecting in part the impact of the Florida freeze, but more fundamentally the supply considerations that portend increased meat prices. But both food and energy prices should, absent more bad luck, be rising at a more moderate rate in late 1981 and in 1982, lending support to reduced pressure from labor costs in easing overall inflation.

As indicated in the bottom panel, we are forecasting that overall prices will rise at about a 7-3/4 percent rate in 1982, down from the 10 percent pace in 1980 and 1981.

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

E.M. Truman
February 2, 1981

FOMC Chart Show Presentation

The black line in the top panel of the first international chart shows that the foreign exchange value of the dollar recently has regained the near-term peak reached last March and April -- about 6 percent above its 1978 low. As shown by the red line in the chart, the dollar's appreciation since late 1978 has been somewhat more pronounced after adjustment for the faster pace of inflation in the United States than on average abroad.

The bottom panel of the chart shows movements in U.S. and foreign short-term interest rates over the past four years. Interest rates abroad have declined somwehat on average over the past 9 months. We expect that decline to extend into the forecast period, but the reduction will be small and is likely to be constrained by the persistence of high U.S. interest rates. Changes in the differential between U.S. and foreign interest rates over the past year or so have been dominated by movements in U.S. interest rates and have been an important factor affecting the dollar's foreign exchange value. However, interest rates do not provide a complete explanation of the dollar's trend; the nominal interest rate differential was almost as wide in late 1978 and last Spring as it has been recently. A principal difference is that the U.S. current account position swung into surplus in 1980.

Over the forecast period, we expect the dollar in nominal terms to remain close to the level it has reached in recent days. This projection is grounded on the continuation of relatively high U.S. interest rates and of the U.S. current account surplus, at a time when many other industrial countries continue to have deficits. However, as was the case last year, the dollar's trend could well be interrupted from time to time.

The upper panel of the next chart shows that the expansion of real GNP essentially came to a halt in the major foreign industrial countries in 1980. Three of the ten countries in our average -- the United Kingdom, Canada and, possibly, France -- appear to have experienced negative growth. We expect only a moderate pickup in growth abroad in 1981 and somewhat faster growth in 1982, although growth abroad is expected to be more rapid than is projected for the United States.

As is shown in the lower panel, we expect that on average consumer prices abroad will continue to increase at a less rapid pace than in the United States. In fact much of the reduction in the pace of inflation abroad shown in the chart for 1981 was already recorded late last year. This reduction reflected the end of the oil-related surge early in 1980 but also, more significantly, the decline in underlying inflation in Japan and the United Kingdom.

Against this background, the next chart presents our projections for the components of the U.S. trade balance. As is shown in the upper left-hand panel, the volume of U.S. non-agricultural exports declined somewhat in the second half of last year and is expected to show little or no expansion during 1981. Next year, despite the pickup in growth abroad, we expect a decline in the volume of such exports because of the cumulative effects of the erosion of U.S. price competitiveness.

In contrast, we are projecting a resumption of the gradual expansion in the volume of U.S. agricultural exports, as is shown in the upper right-hand panel. Lower harvests abroad in 1980 have contributed to strong demand for U.S. exports, some of which is now coming from non-traditional markets replacing demand from Russia.

Turning to the import side, in the lower left-hand panel, we expect an 8 percent rise over the next eight quarters in the volume of our non-oil imports. This increase is caused partly by the pickup in domestic demand in the United States and, more significantly, by the effects of the decline in U.S. price competitiveness.

Our projection for U.S. oil imports is shown in the lower right-hand panel. It is based on the assumption that the price of imported oil will increase 10 percent this quarter and another 6-1/2 percent next quarter. These assumptions reflect the recent OPEC price announcements and the tightness in the oil market associated with the effects on OPEC production of the Iran-Iraq war. We are assuming that after mid-year the price of imported oil will remain roughly constant in real terms. We expect that the volume of U.S. oil imports, after a recovery from the temporarily depressed rates in the second half of 1980, will continue to trend down under the influence of slow U.S. real growth and the lagged effects on consumption of earlier rapid price increases. Expected price increases, however, more than offset the expected decline in the volume; consequently we expect that the U.S. oil-import bill, which reached about $80 billion in 1980, will rise to about $90 billion in 1981 and $95 billion in 1982.

The last international chart summarizes our trade and current account forecast. As is illustrated in the upper panel, the U.S. trade deficit was reduced to about $15 billion at an annual rate in the second half of 1980. This year and next year, the trade deficit is expected to be in the $20-25 billion range. Meanwhile, the U.S. surplus on non-trade current account transactions showed little increase in 1980, reflecting the negative accounting effects of the Aramco takeover in the first half as well as the effects of sluggish growth abroad on recorded net investment income receipts. We expect that the surplus on non-trade items will increase more rapidly in 1981 and 1982.

Consequently, as is illustrated in the middle panel, we expect that the U.S. current account surplus, which is now estimated to have been about $16 billion at an annual rate in the second half of 1980, will be about $12 billion in 1981 and $18 billion in 1982.

Finally, as is shown in the lower panel of the chart, we expect only a small, positive contribution of exports of goods and services to GNP during the next two years, in contrast with the significant contributions during the past three years. Moreover, almost all of this projected contribution comes from increased service receipts. Meanwhile, imports of goods and services are expected to increase moderately from their recent, depressed levels.

Mr. Kichline will complete our presentation.

James L. Kichline
February 2, 1981

CONCLUSION -- FOMC CHART SHOW

The top panel of the next chart displays funds raised by domestic nonfinancial sectors thought to be consistent with the staff's economic forecast. Total borrowing is projected to be about the same in 1981 as the reduced volume last year, and to grow somewhat in 1982 although by less than the growth of nominal GNP. Restraint on borrowing appears in private sectors, where borrowing is not expected to change much over the forecast period and to remain appreciably below that experienced in the late 1970s when prices were lower. The credit market environment projected is, of course, a reflection of monetary restraint, strong potential demands, and resulting upward pressures on interest rates. Borrowing by the federal government is sizable, especially in 1982. Treasury borrowing relative to GNP, the bottom panel, rises in 1982 but remains below the recent peak in 1975. However, 1975 was a period of sluggish demands and a less restrictive monetary policy than that built into the forecast for 1982, and such borrowing in the forecast is consistent with more pressures on markets than appeared earlier.

In private markets, borrowing requirements of non-financial corporations--shown in the top left panel of the next chart--are projected to decline over the forecast period. Expenditures on plant and equipment and inventories are rather restrained for reasons discussed by Mr. Zeisel while growth of internal funds is bolstered by the assumed tax cut.

Total funds raised--the top right panel--is projected to continue falling from the peak in 1979, with especially reduced reliance on bank loans and short-term paper. Balance sheet structures will provide incentives to fund short-term debt even at rates that firms may not find as attractive as they would like. The ratio of short-term debt relative to total debt outstanding--the bottom left panel--declines somewhat over the forecast period but is still high in an historical context. Holdings of liquid assets relative to short-term liabilities also are projected to continue to improve from the low level reached in 1979. Even so it's an outlook with considerable risk for weaker firms given high nominal interest rates, their limited financial flexibility, and sales volumes that may well prove disappointing.

The restraint in household borrowing is shown on the next chart. Net residential mortgage loans taken on by households are projected to change little from that registered last year as real estate activity is damped by the financial environment. But activity is nevertheless relatively well maintained in the face of mortgage rates projected to remain in the area of 15 percent. Creative financing techniques will help to generate activity, with the actual interest rates paid at least initially averaging less than 15 percent. Other borrowing by households was severely depressed in 1980 as a result of credit controls and the collapse of consumer durable purchases in the spring. We expect such borrowing this year and next will run above the pace in 1980, but generally remain moderate in light of restraints on purchases of durable goods, especially autos.

The limited growth of household borrowing should lead to some further improvement in financial positions, although many individual households could well experience severe pressures. Loan deliquencies and other similar evidence provide a mixed picture but on balance are not now indicating major problems.

For some financial institutions serious difficulties are in prospect. The next chart shows the earnings position of S&Ls and mutual savings banks. Net income relative to assets dropped considerably in 1980 and is projected to be deeply negative for both sets of institutions this year given the interest rates in the staff forecast. This is a situation that could well require special efforts to avoid financial disturbances.

The forecast implies a good deal of stress and strain on financial, product, and labor markets. The difficulties fundamentally relate to high rates of inflation and the lag in the effect of restrictive policies on ages and prices. The monetary and fiscal policies underlying the forecast will assist in making visible progress on inflation later this year and especially in 1982. But this is an environment in which there appears to be little or no room for real growth in the economy.

CONFIDENTIAL (FR) CLASS II-FOMC

Material for

Staff Presentation to the Federal Open Market Committee

February 2, 1981

Principal Assumptions

Monetary Policy

- Growth of M-1A of 4¼ percent in 1981 and 3¾ percent in 1982, abstracting from shifts into NOWs
- Growth of M-1B of 4¾ percent in 1981 and 4¼ percent in 1982, abstracting from shifts into NOWs

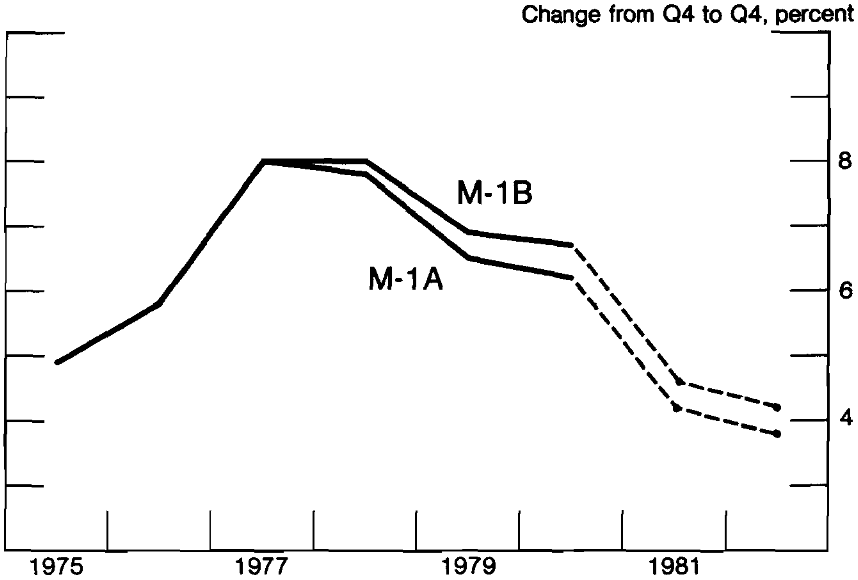
Fiscal Policy

- Unified budget expenditures of
  $ 656 billion in FY 1981 and
  $ 726 billion in FY 1982
- Tax reduction of $ 35 billion
  $ 29 billion for individuals effective mid-1981
  $ 6 billion for businesses retroactive to January 1981

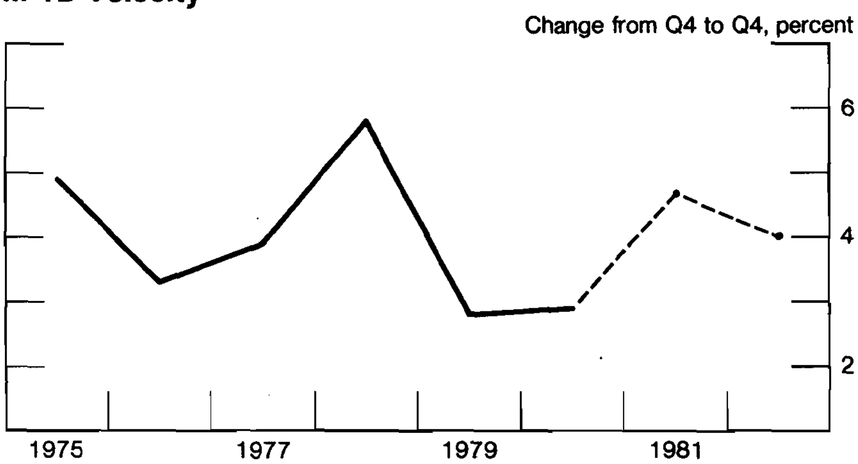
Federal Budget

	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%	656	13%	726	11%
Defense	136		162		187	
Nondefense	444		494		539	
Receipts	520	12%	600	15%	645	8%
Deficit	60		57		81	

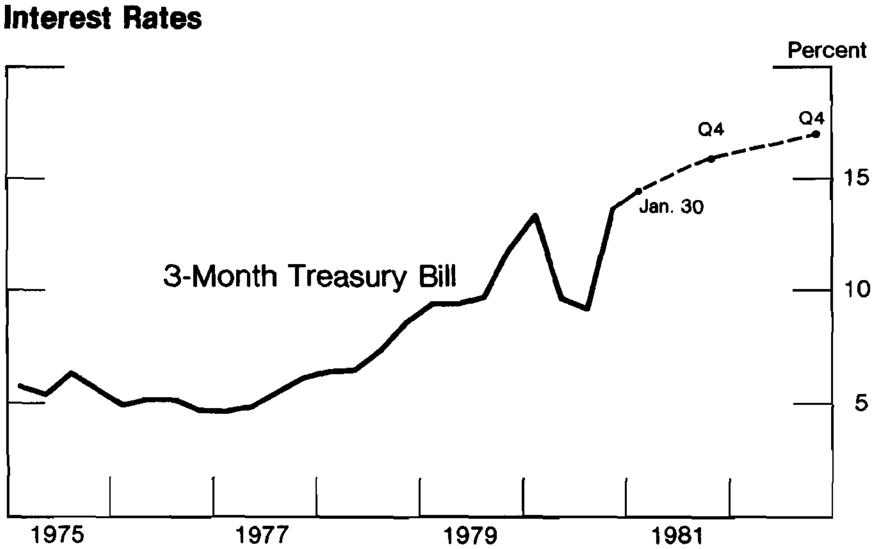
Monetary Aggregates*



M-1B Velocity*



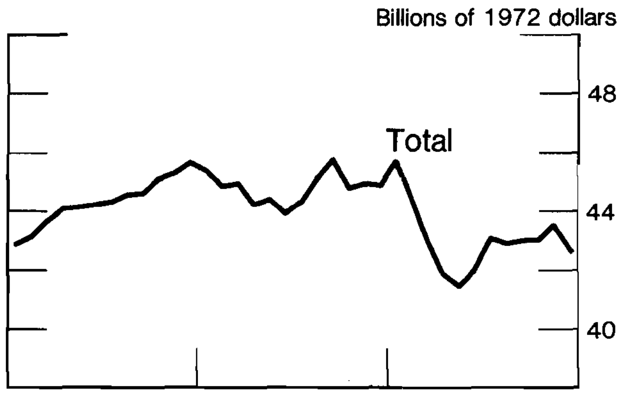
Interest Rates



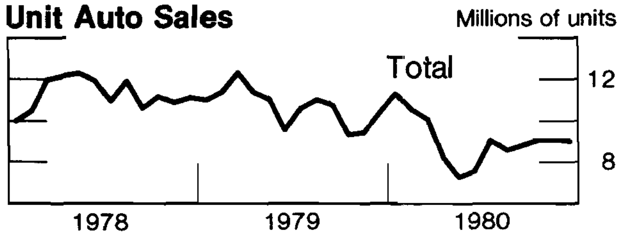
*Abstracting from shifts into ATS and NOW accounts.

Economic Activity

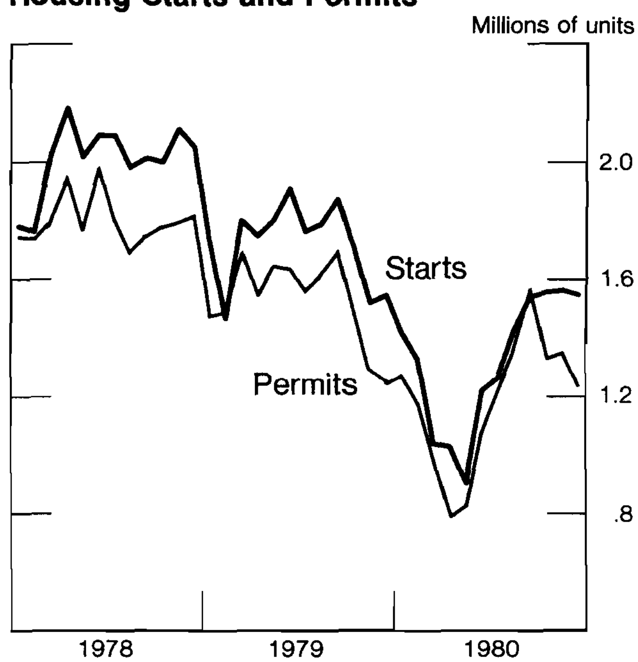
Real Retail Sales



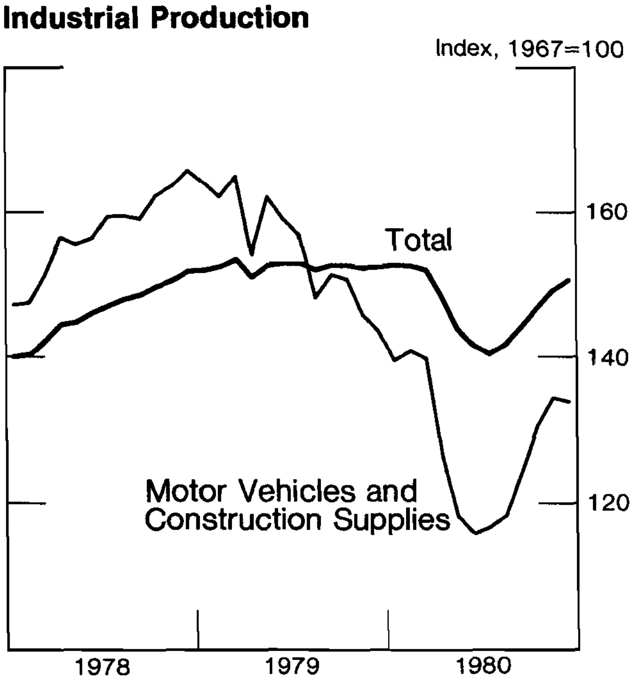
Unit Auto Sales



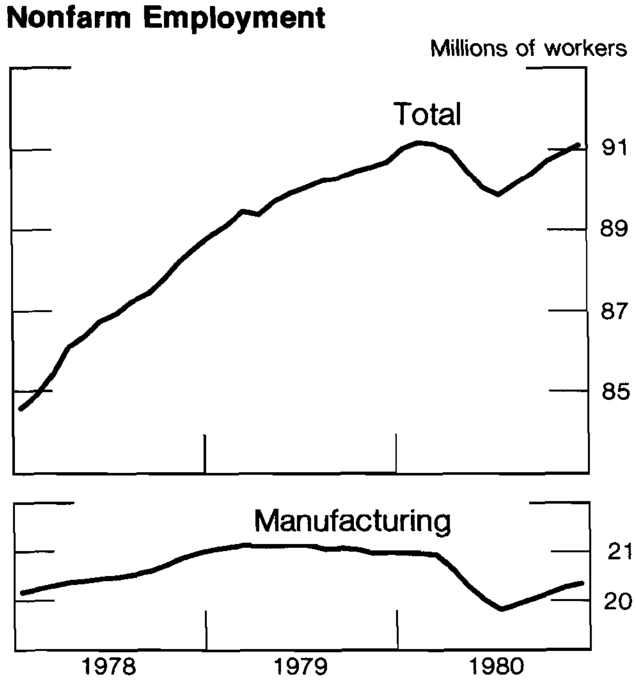
Housing Starts and Permits



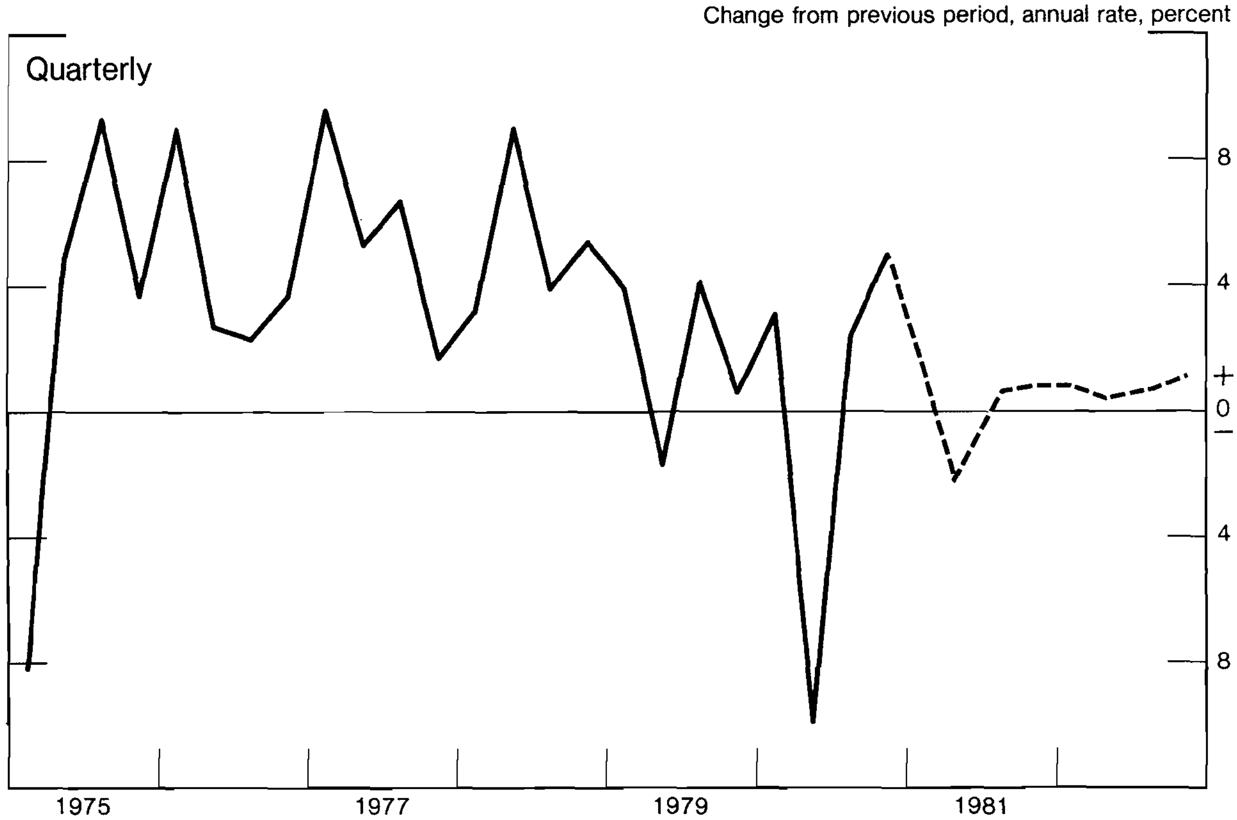
Industrial Production

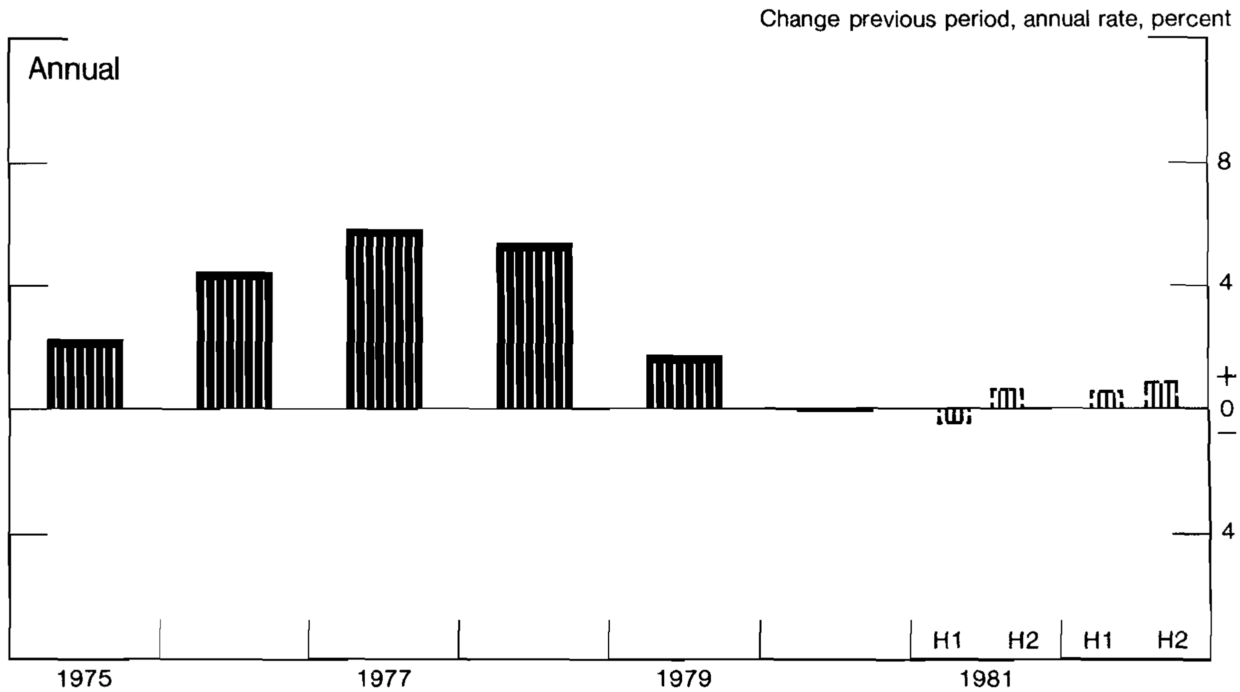


Nonfarm Employment

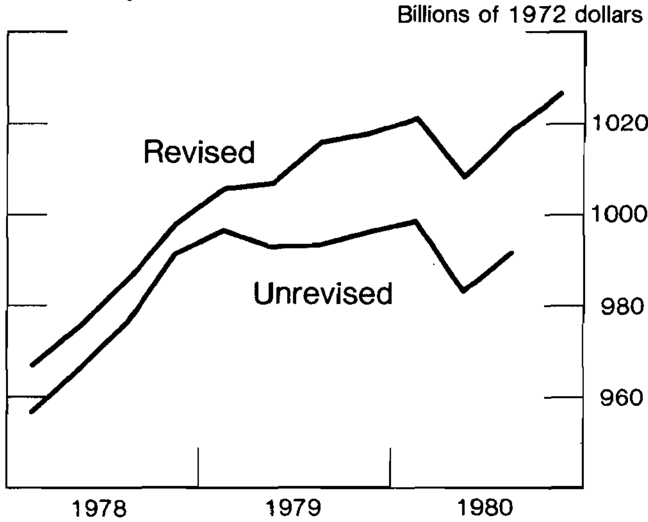


Real Gross National Product
1972 Dollars

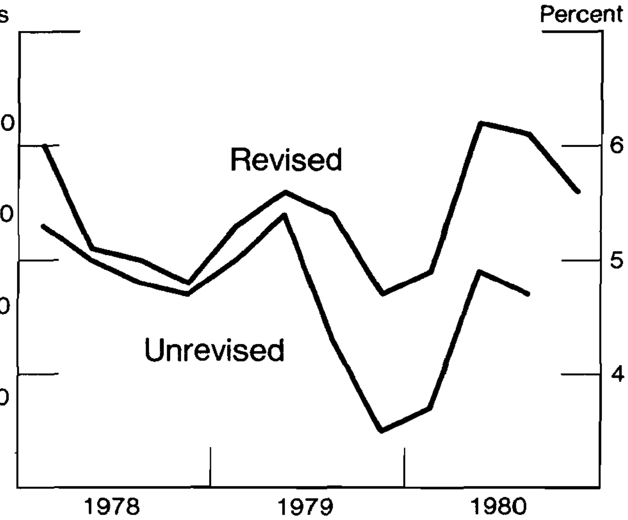




Real Disposable Personal Income



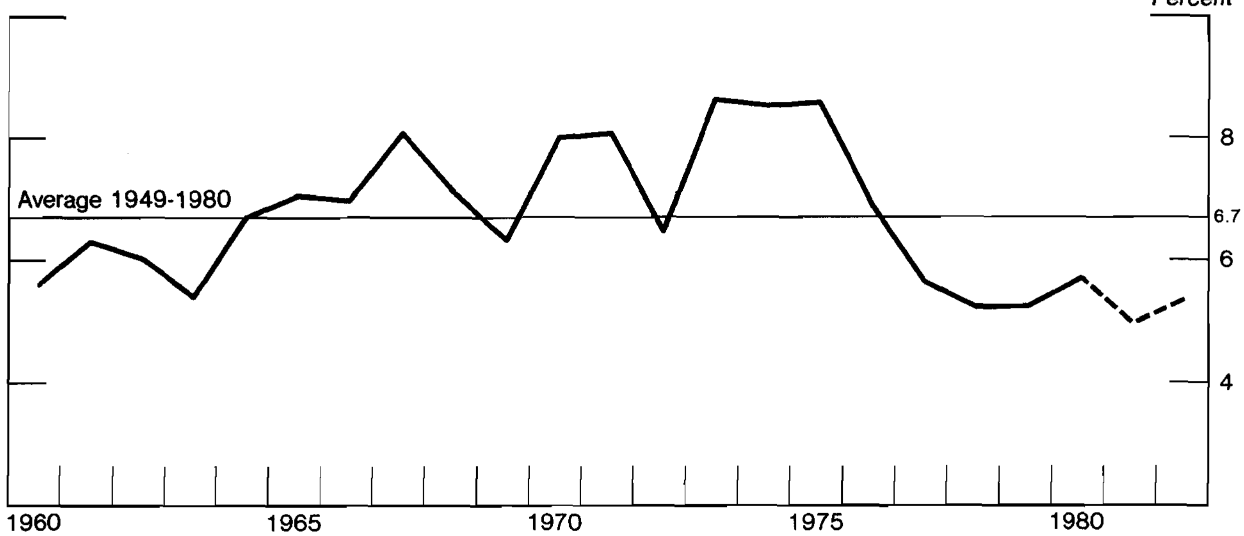
Saving Rate



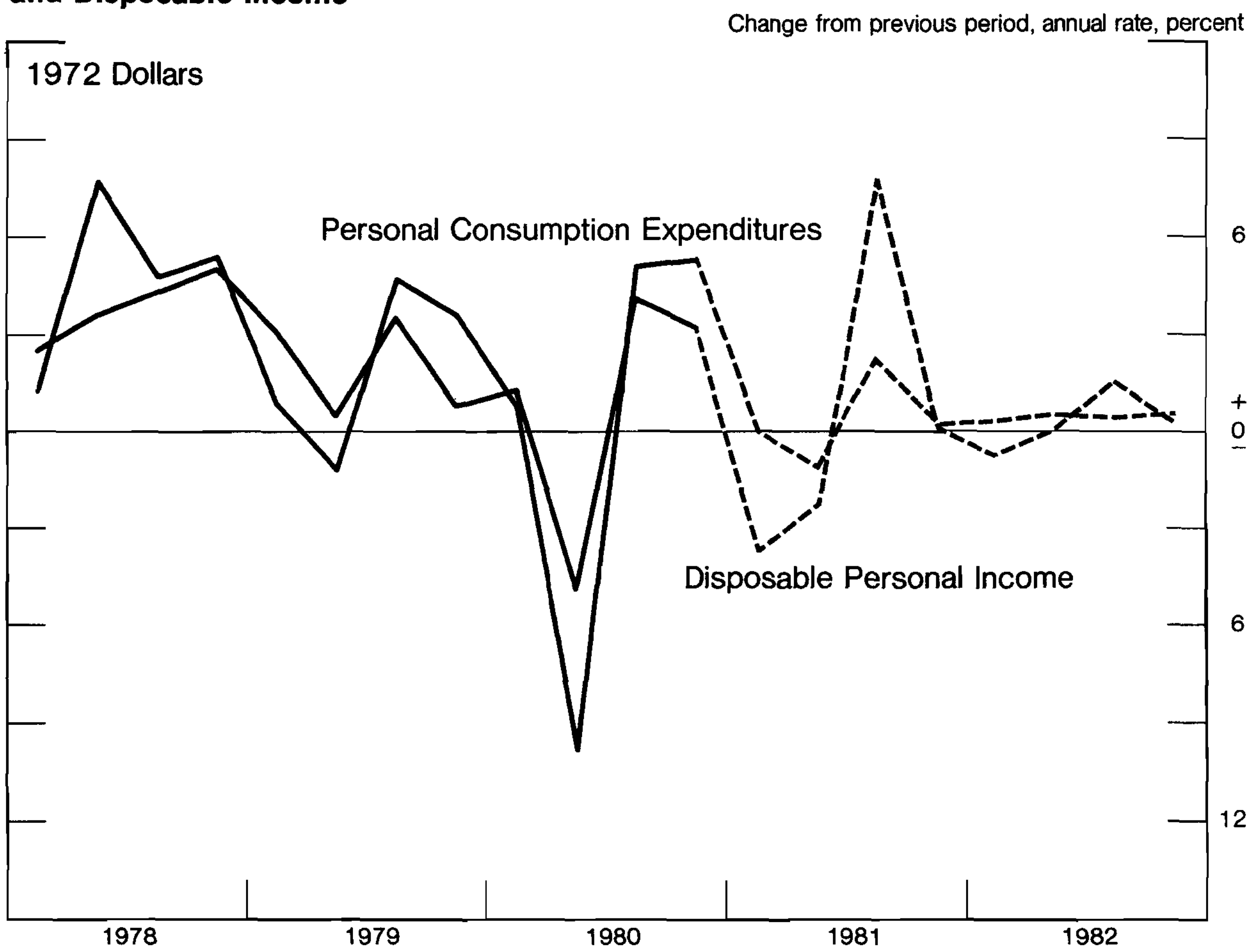
Household Debt Repayment
Relative to Disposable Personal Income

Personal Consumption Expenditures on Food and Energy
Relative to Disposable Personal Income

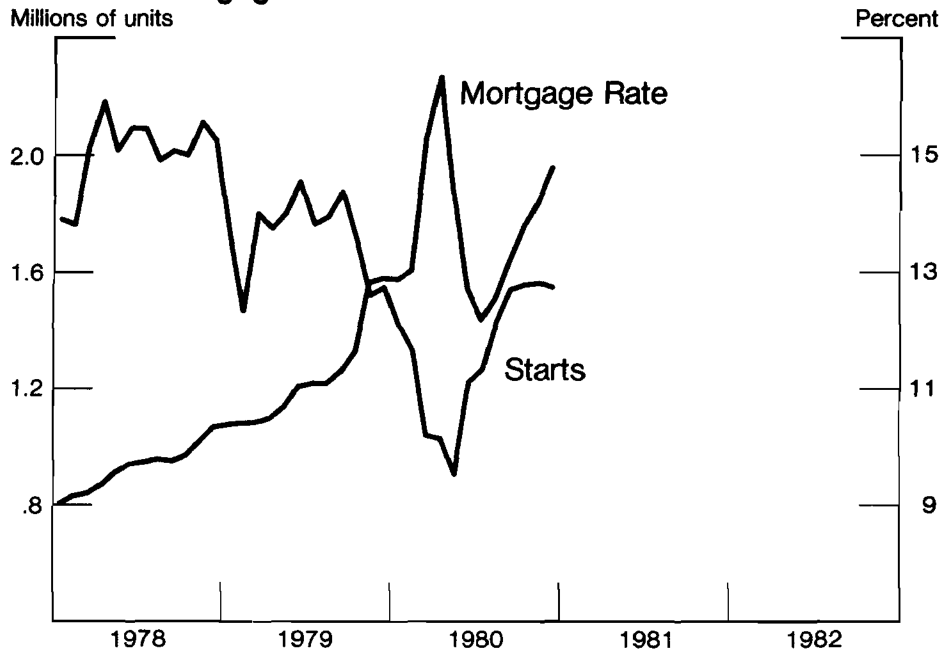
Saving Rate



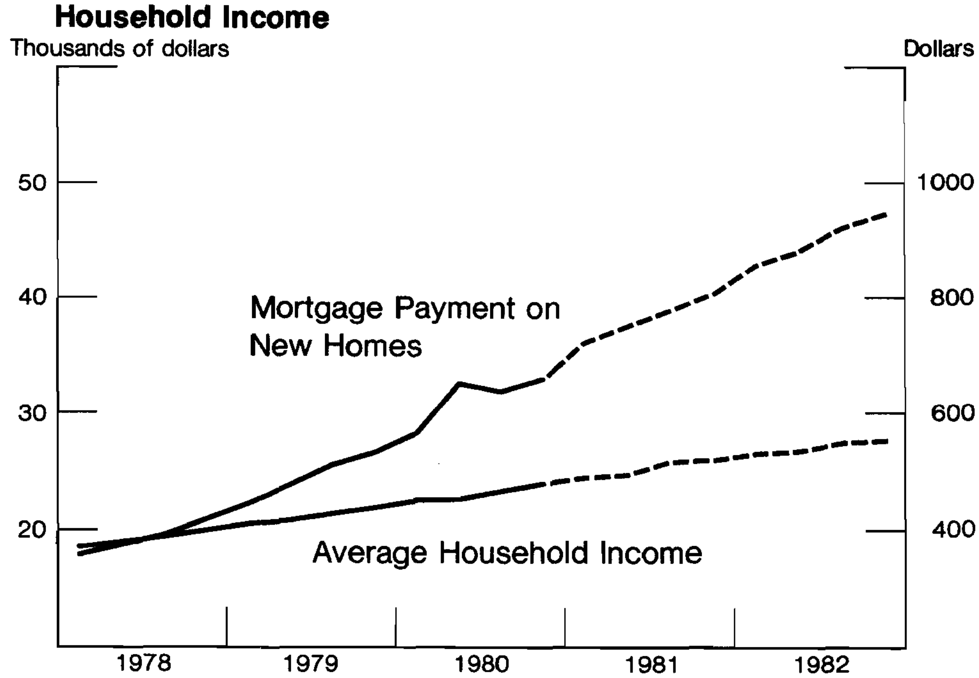
Real Personal Consumption Expenditures and Disposable Income



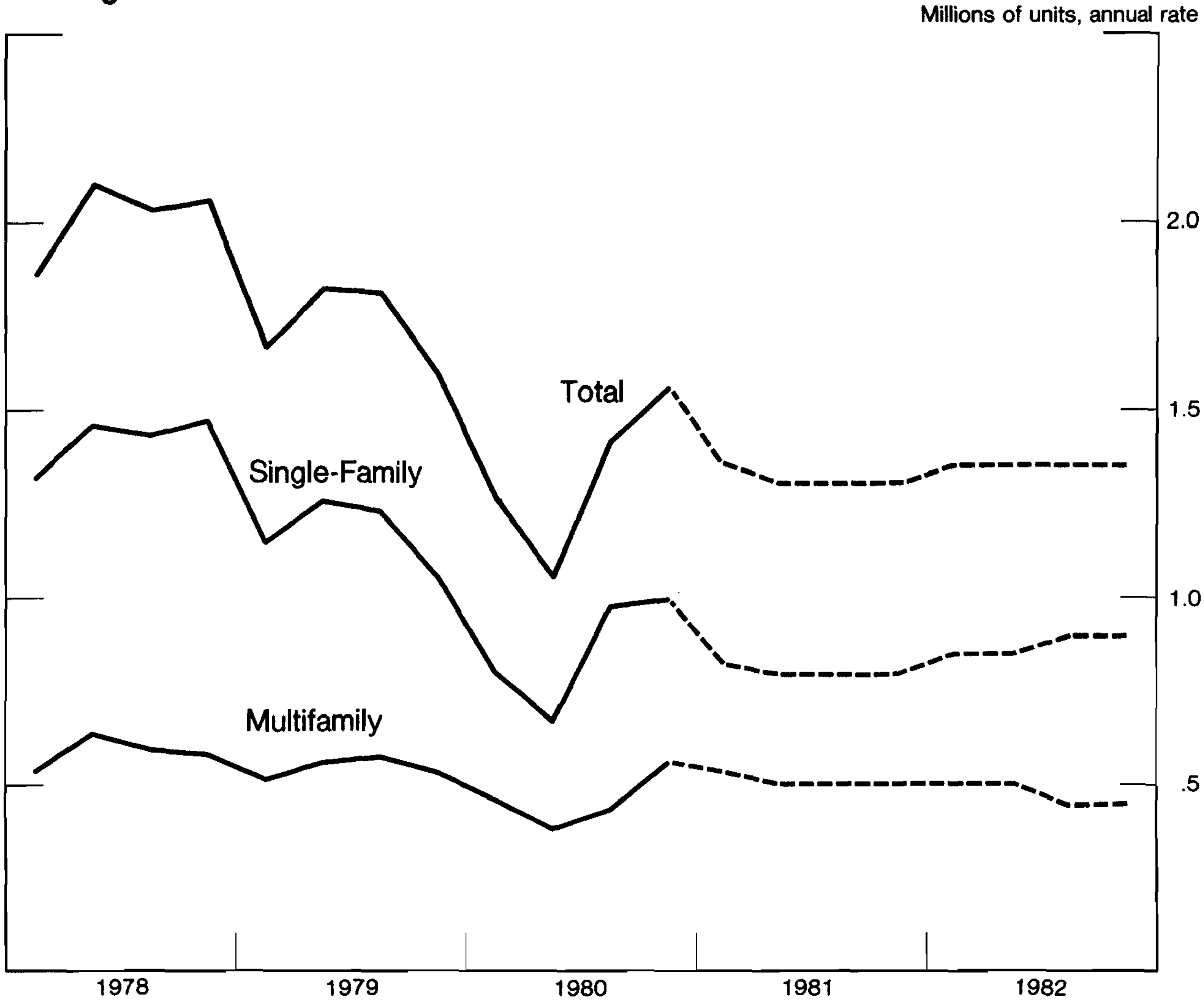
Housing Starts and Home Mortgage Rate



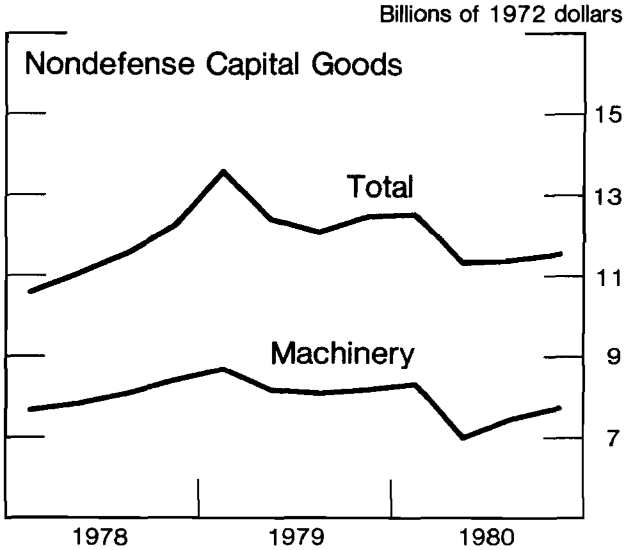
Monthly Mortgage Cost and Household Income



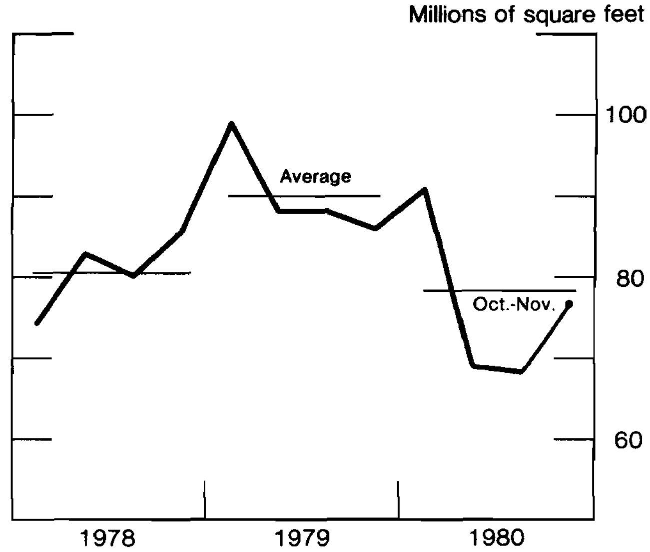
Housing Starts



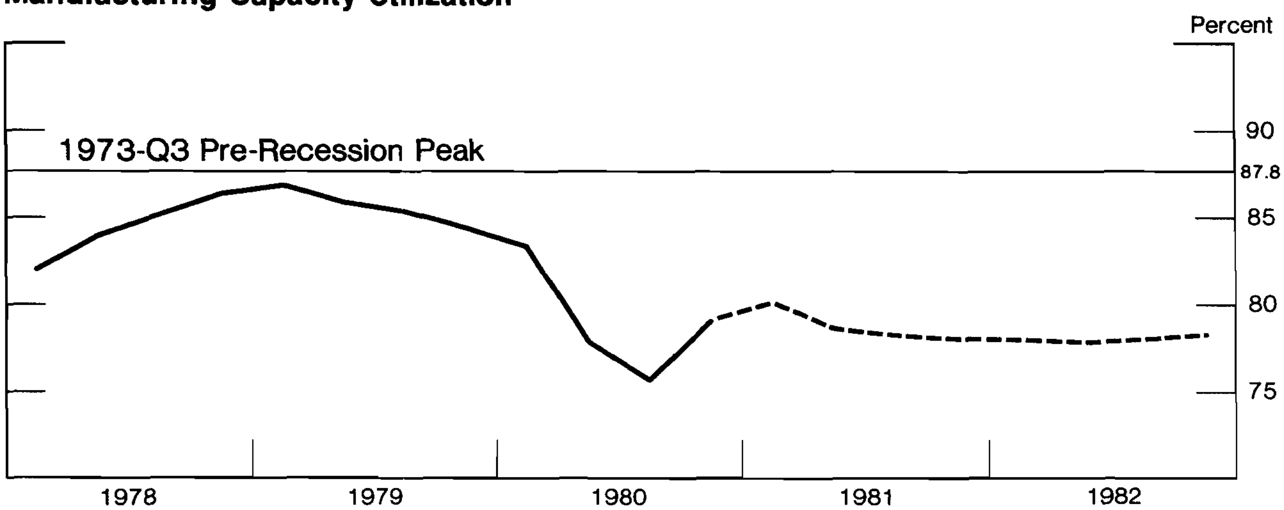
Real New Orders



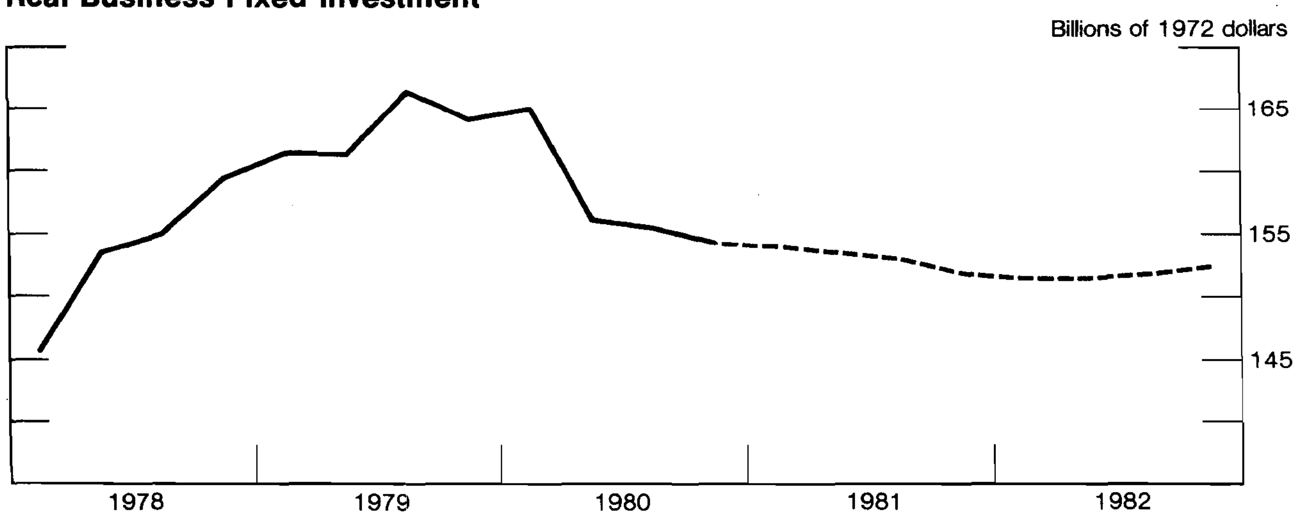
Business Construction Contracts



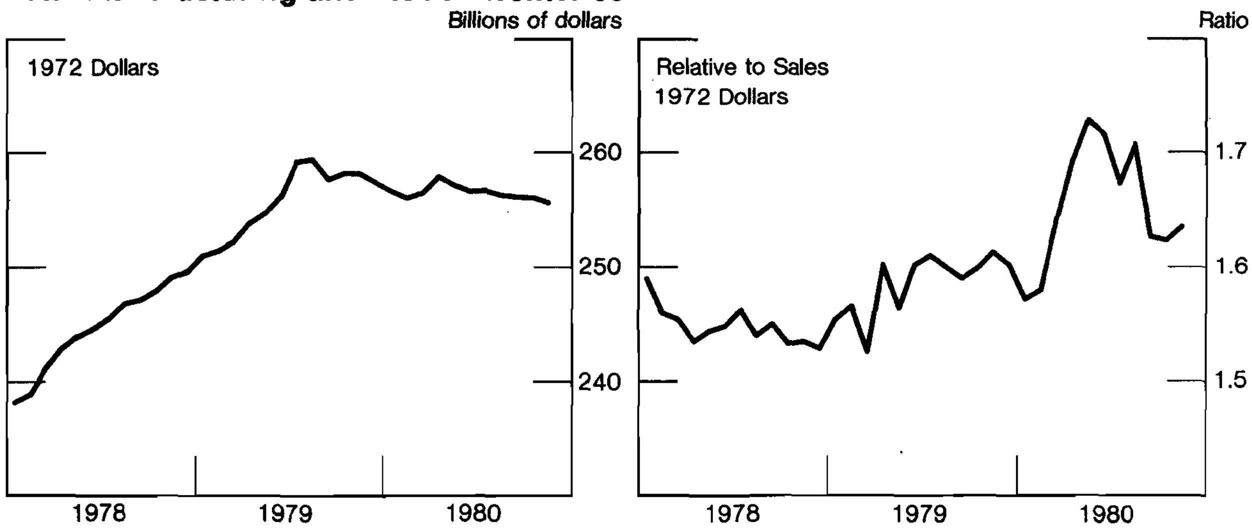
Manufacturing Capacity Utilization



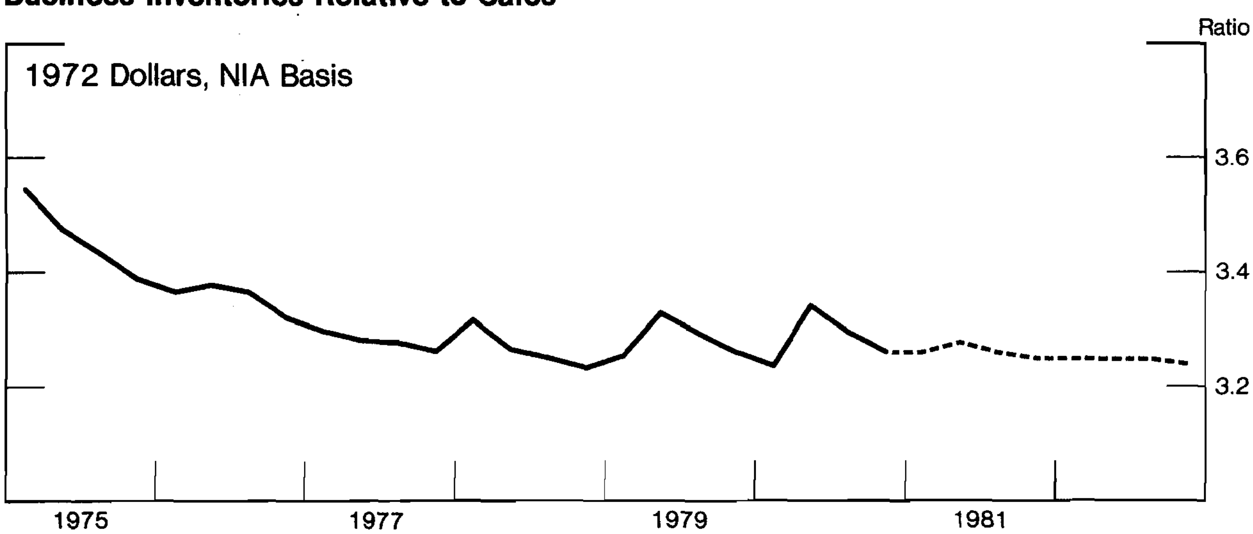
Real Business Fixed Investment



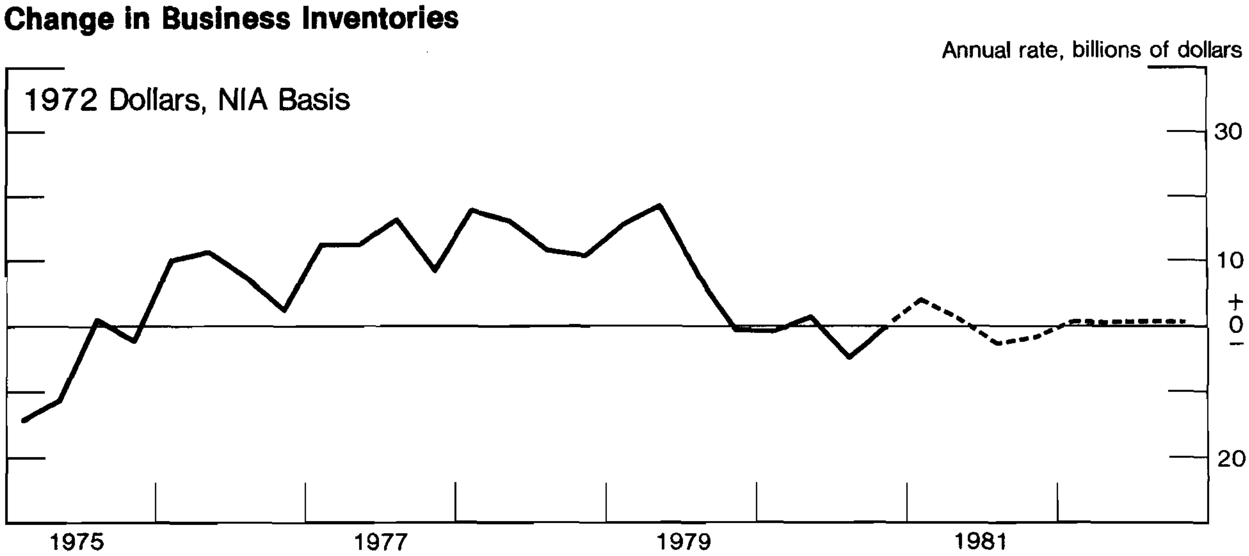
Total Manufacturing and Trade Inventories



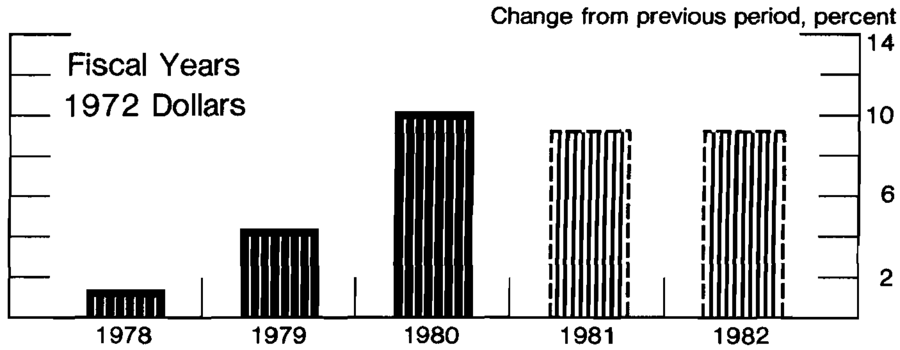
Business Inventories Relative to Sales



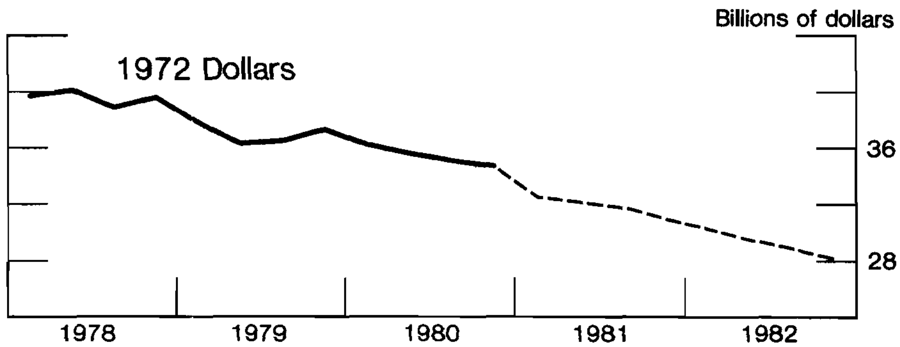
Change in Business Inventories



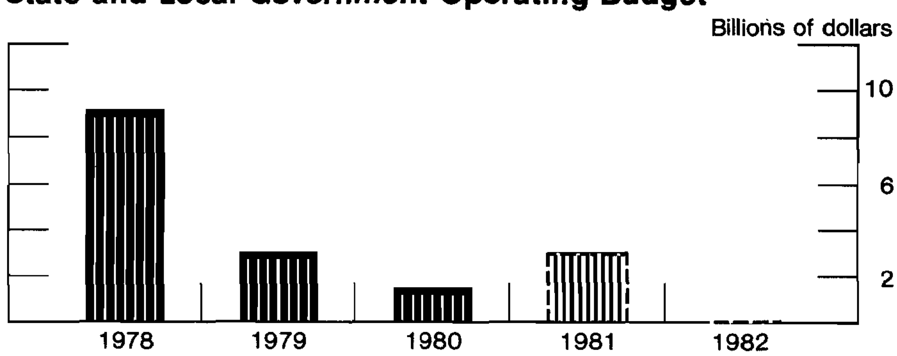
Real Defense Spending Less Compensation



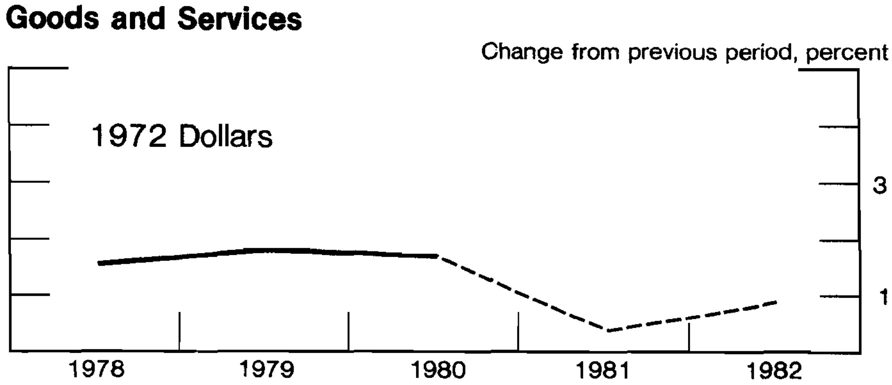
Real Federal Grants to State and Local Governments



State and Local Government Operating Budget

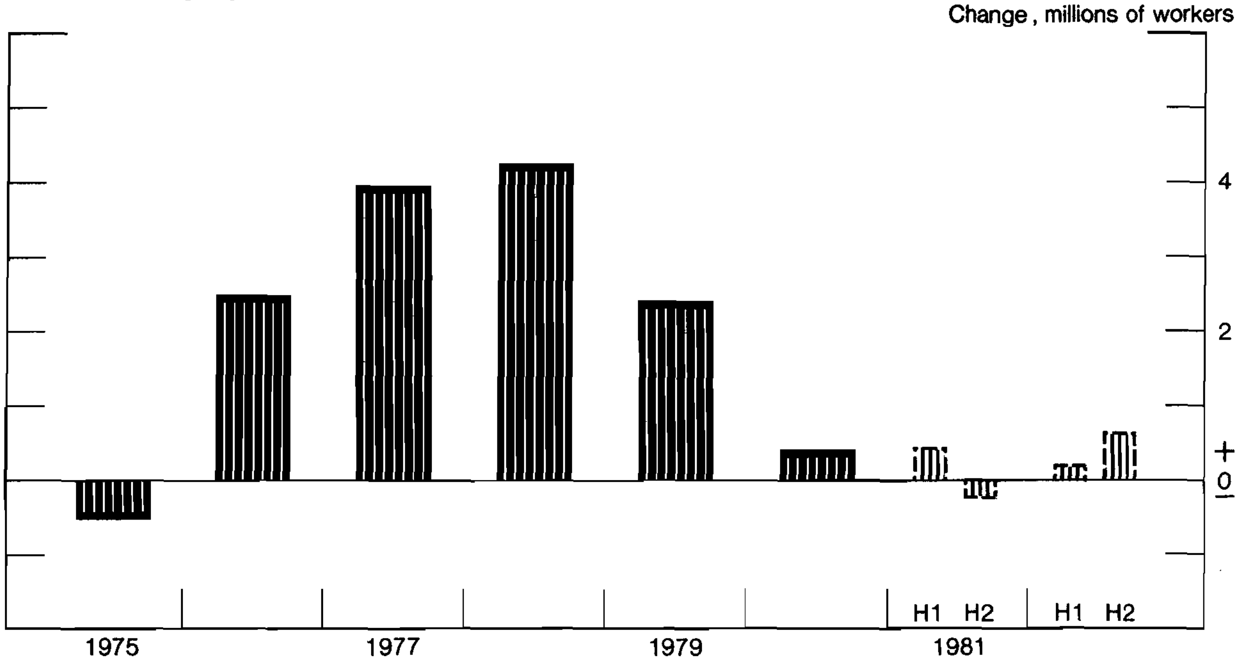


Real Total* Government Purchases Of Goods and Services

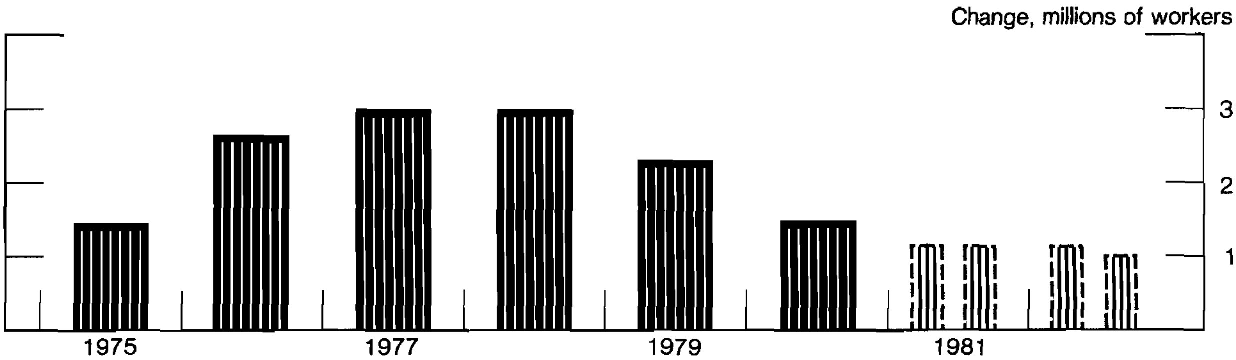


*Federal and State and Local

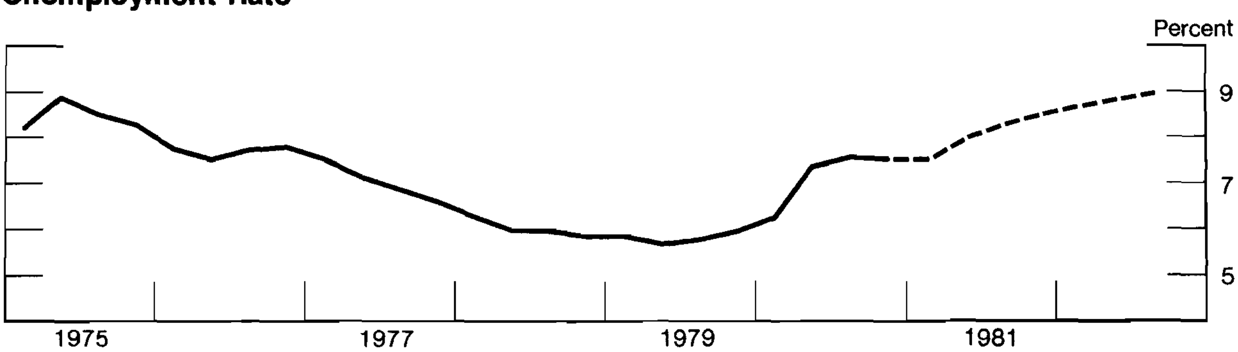
Nonfarm Employment



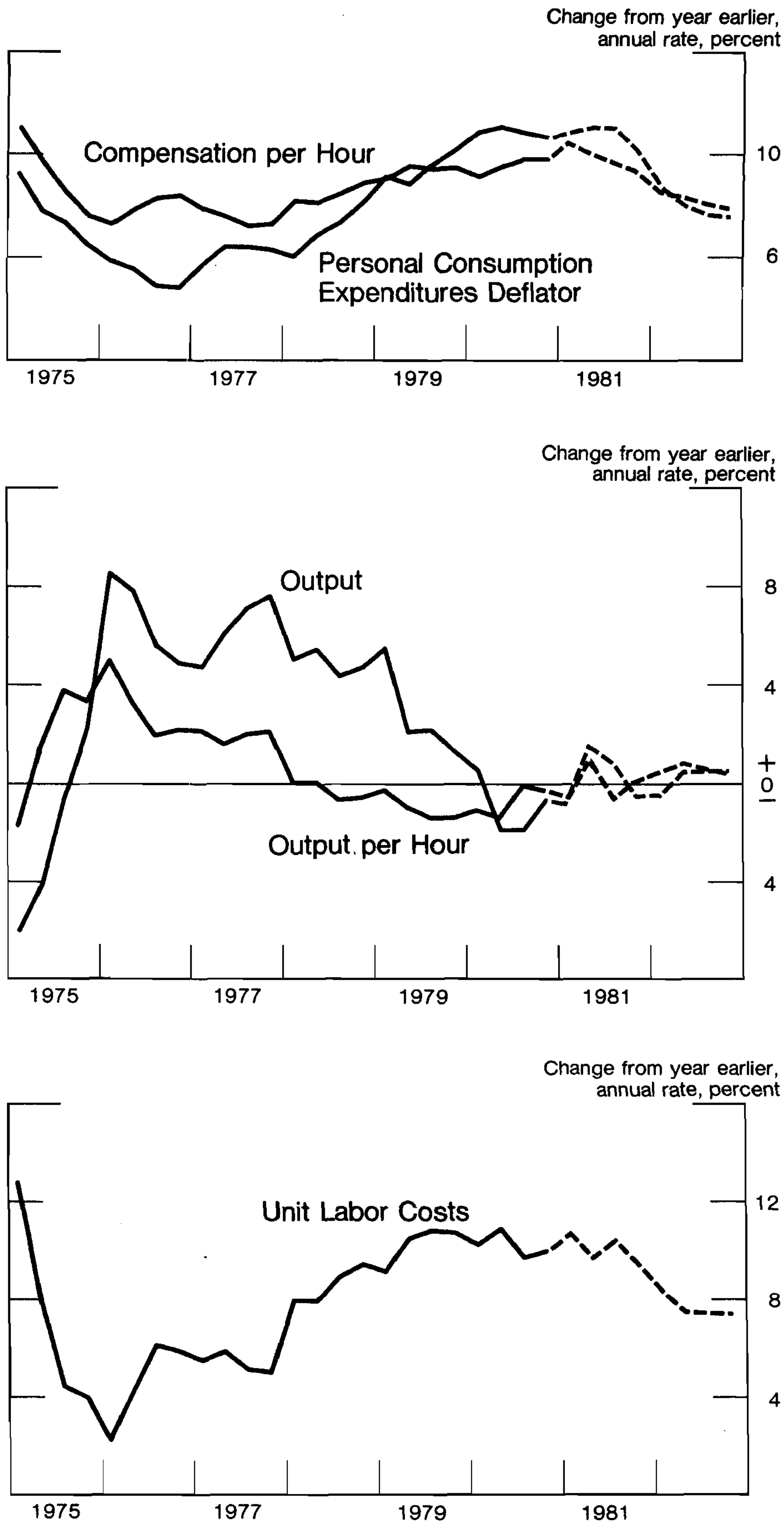
Civilian Labor Force



Unemployment Rate



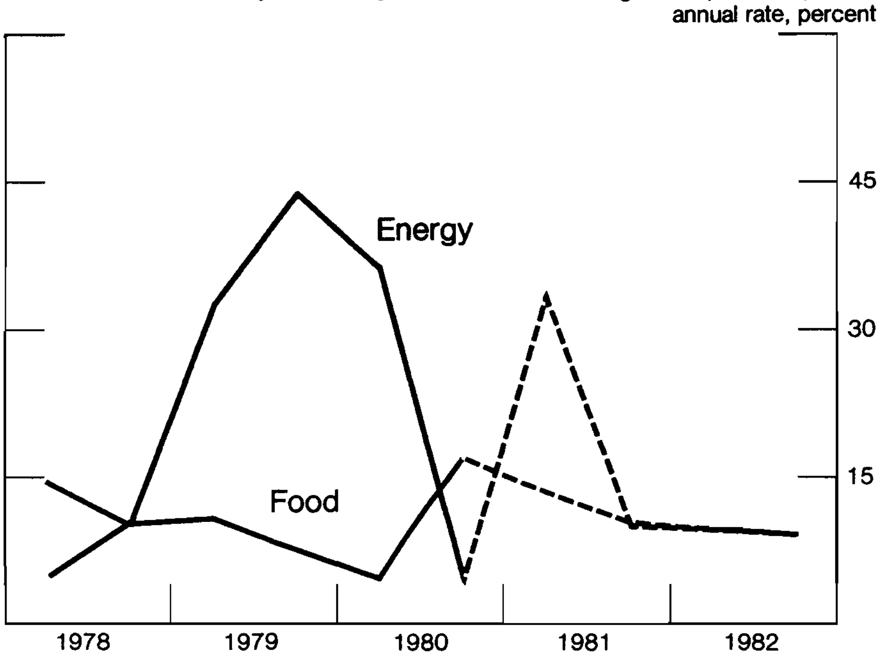
Unit Cost Indicators
Nonfarm Business Sector



Prices
Fixed-Weighted Indexes

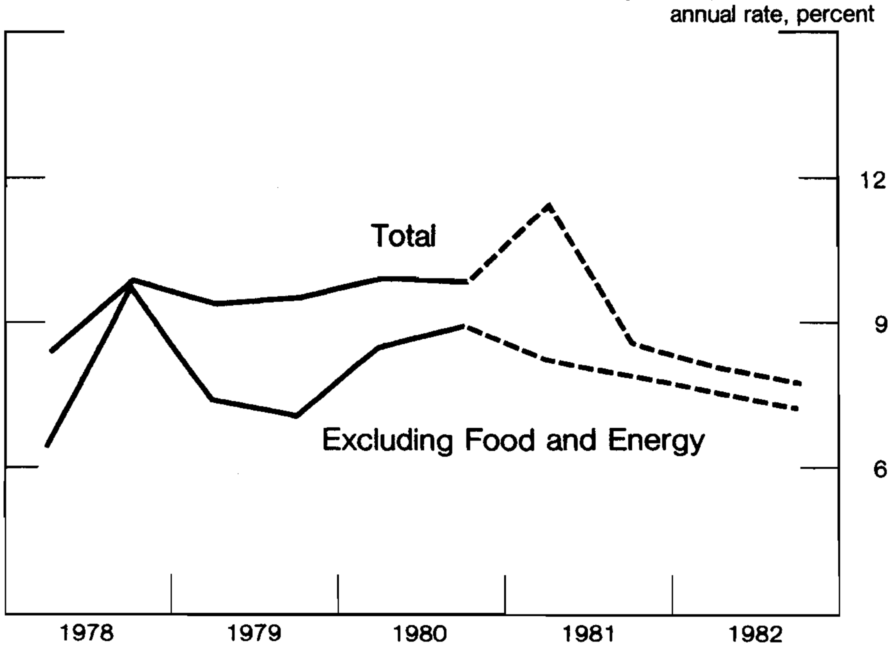
Personal Consumption Expenditures

Change from previous period, annual rate, percent

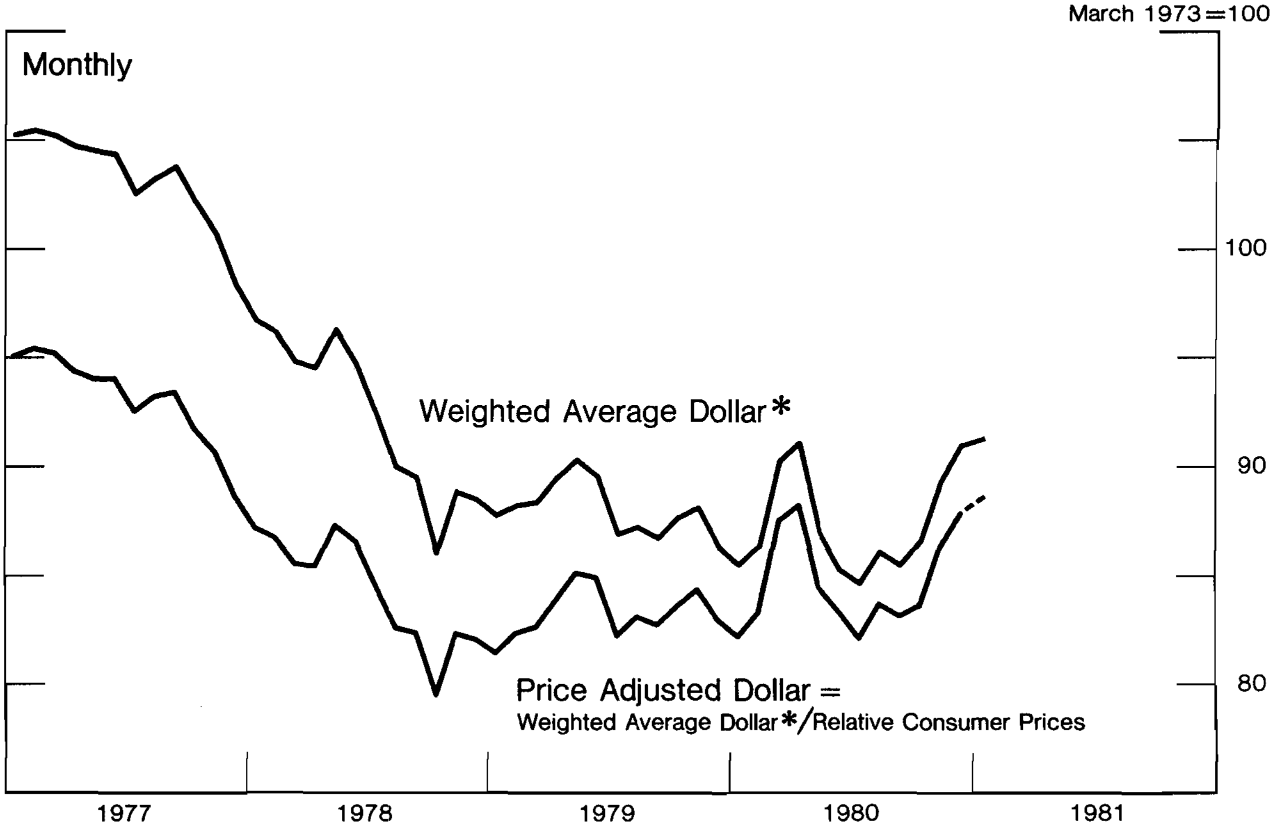


Gross Business Product

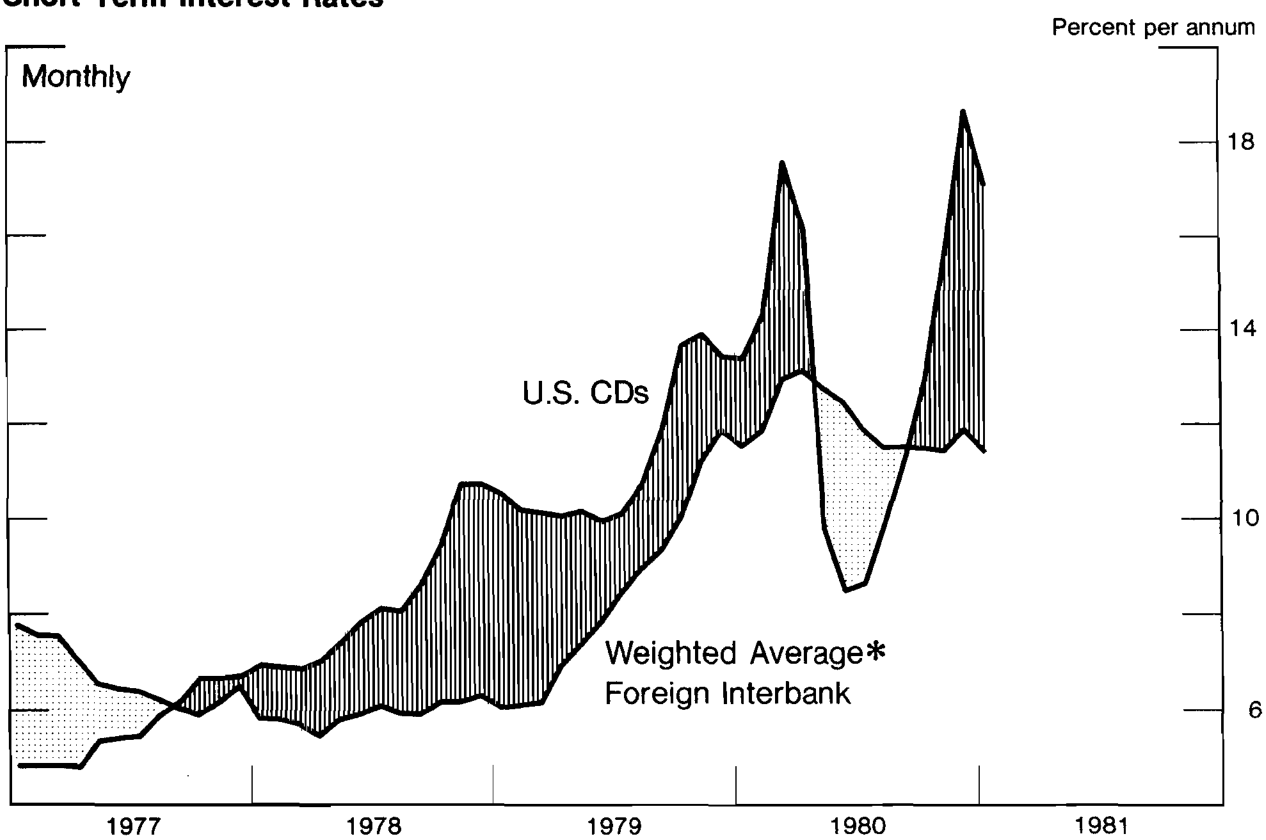
Change from previous period, annual rate, percent



Foreign Exchange Value of the U.S. Dollar

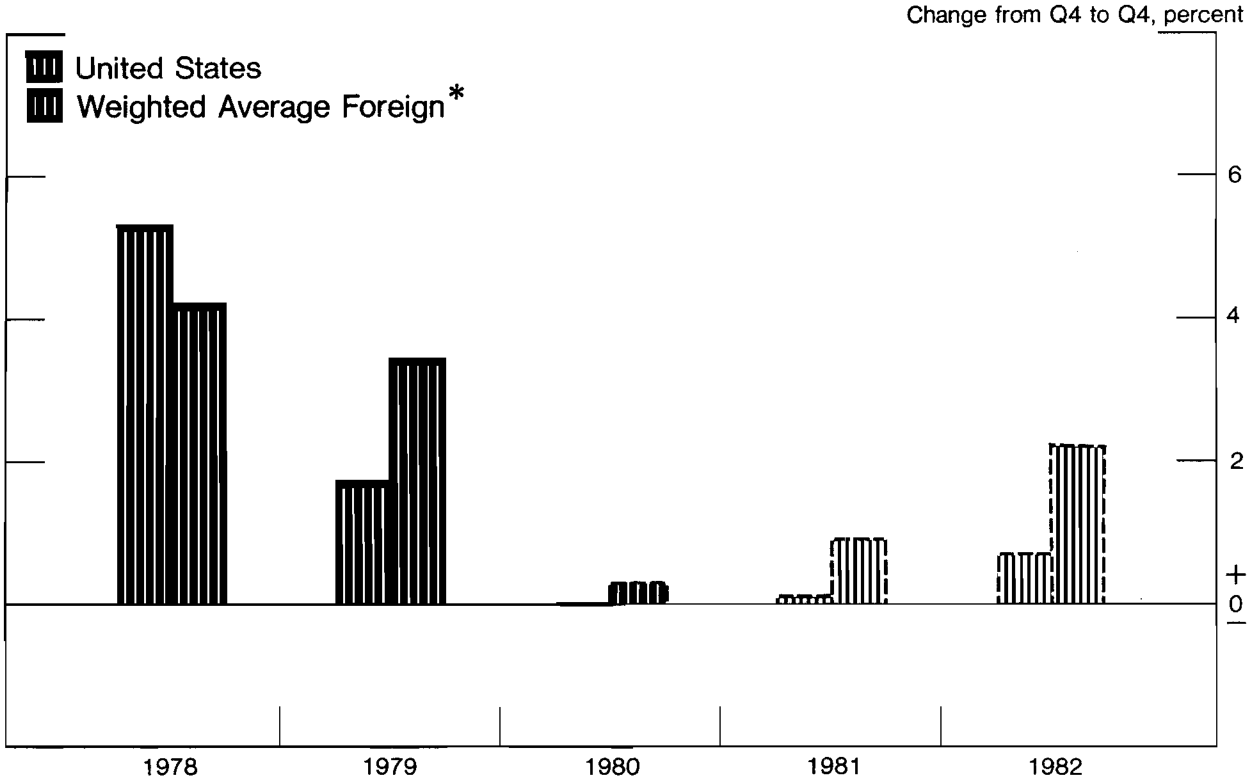


Short-Term Interest Rates

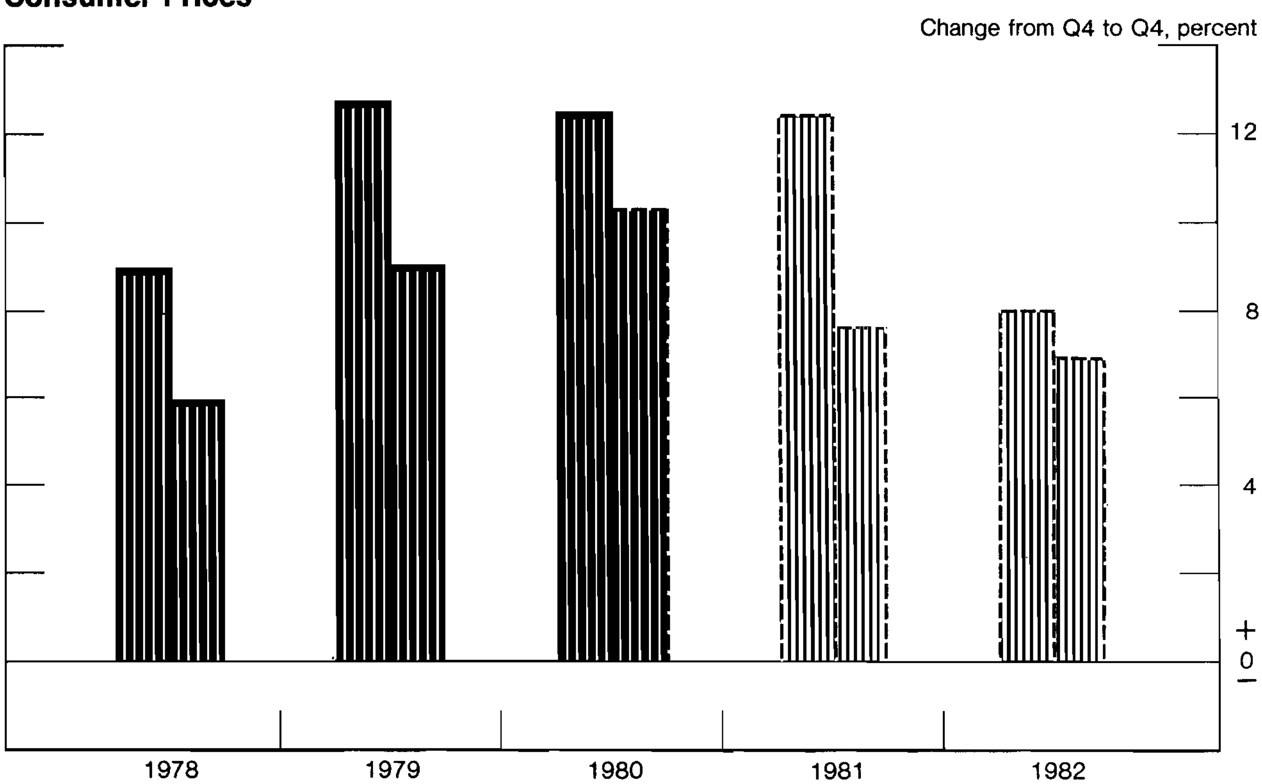


* Weighted average against or of G-10 countries plus Switzerland using total 1972–76 average trade of these countries.

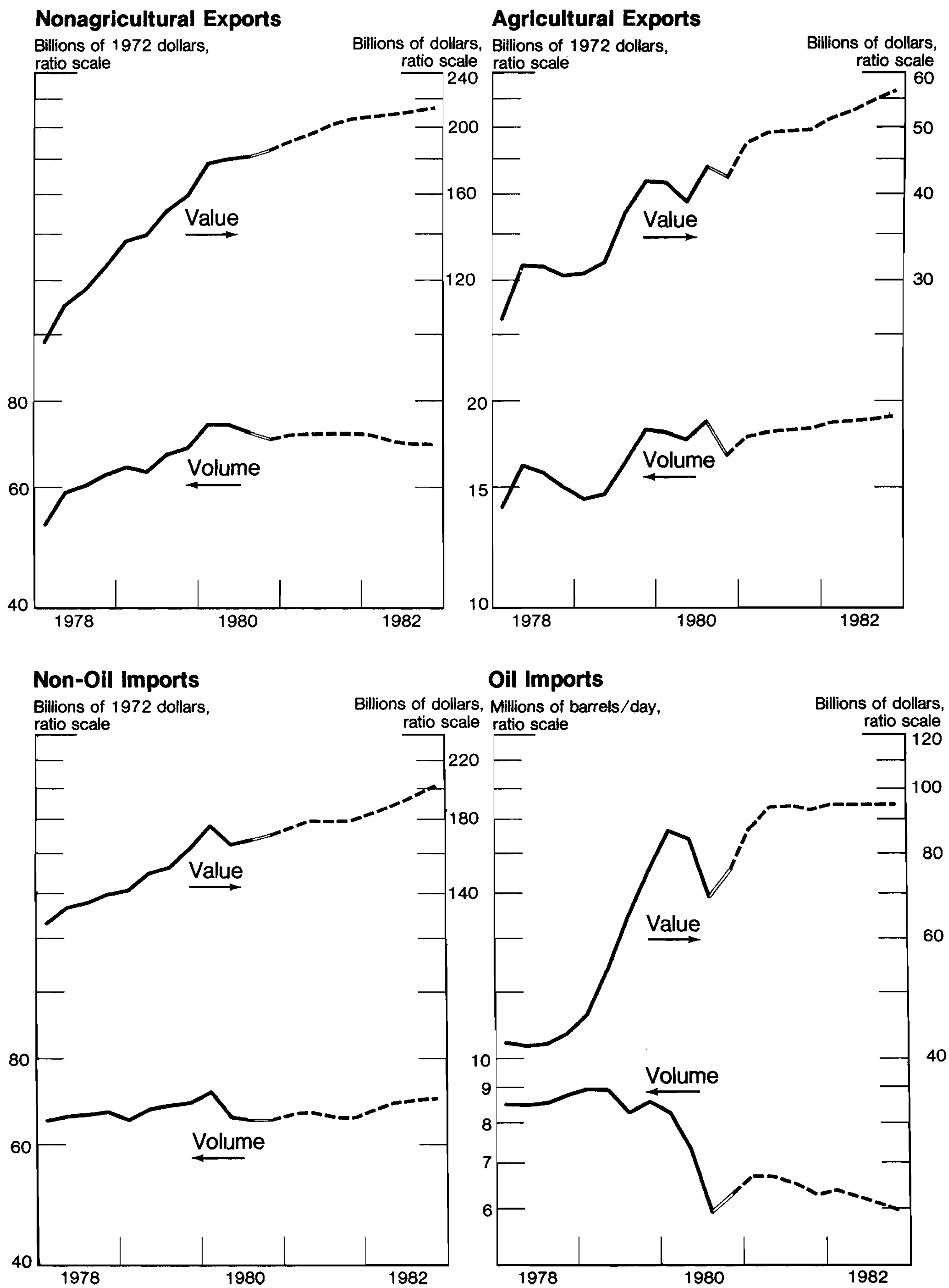
Real GNP



Consumer Prices

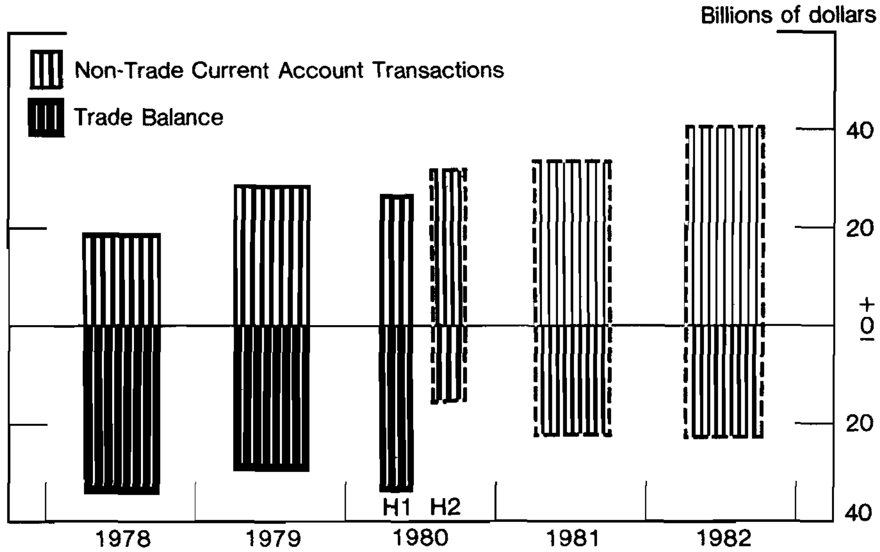


* Weighted average against G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

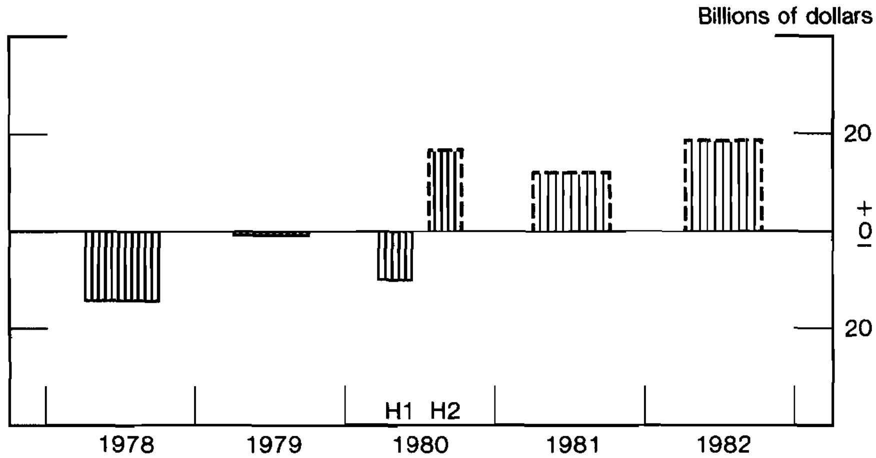


Nonagricultural Exports
Billions of 1972 dollars, ratio scale
Billions of dollars, ratio scale
240
200
160
120
80
60
40
Value
Volume
1978
1980
1982
Agricultural Exports
Billions of 1972 dollars, ratio scale
Billions of dollars, ratio scale
60
50
40
30
20
15
10
Value
Volume
1978
1980
1982
Non-Oil Imports
Billions of 1972 dollars, ratio scale
Billions of dollars, ratio scale
220
180
140
80
60
40
Value
Volume
1978
1980
1982
Oil Imports
Millions of barrels/day, ratio scale
Billions of dollars, ratio scale
120
100
80
60
40
10
9
8
7
6
Value
Volume
1978
1980
1982

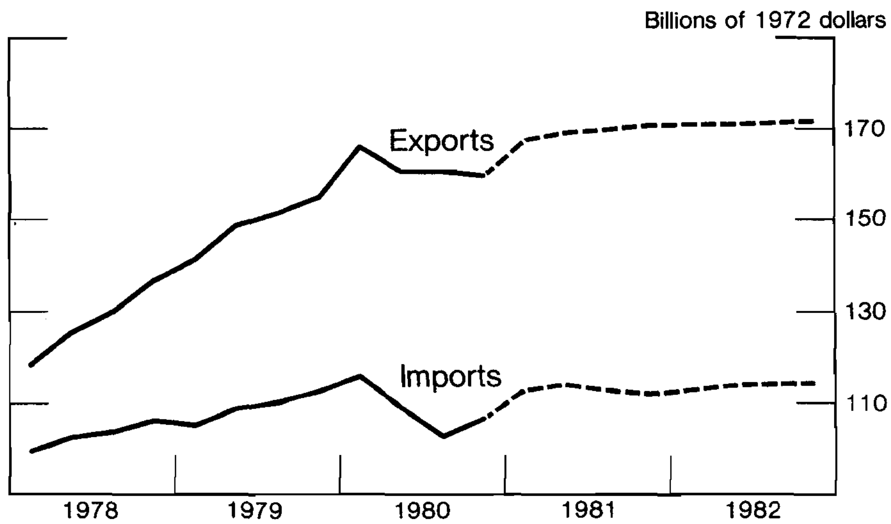
Current Account Transactions



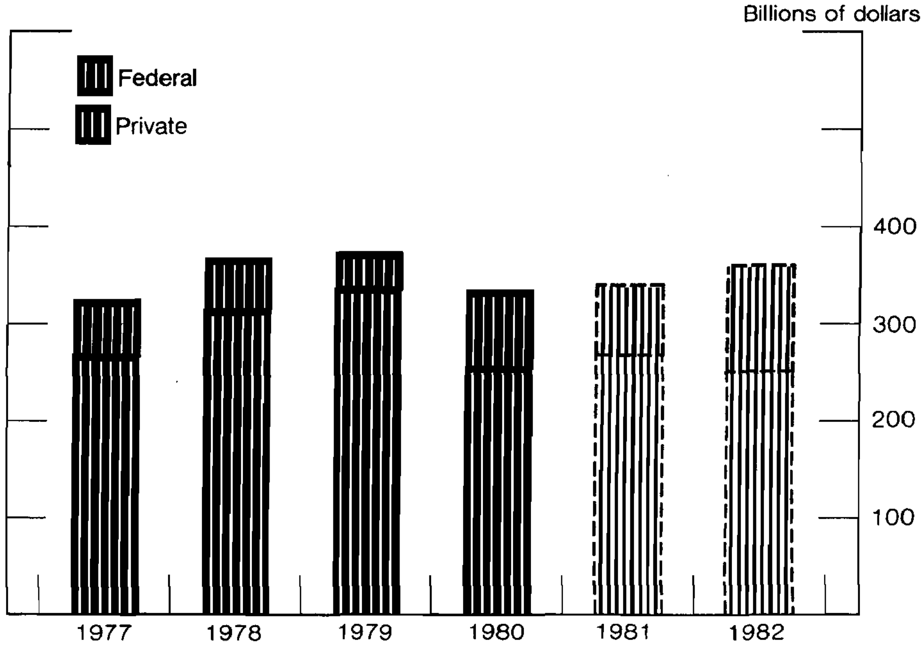
Current Account Balance



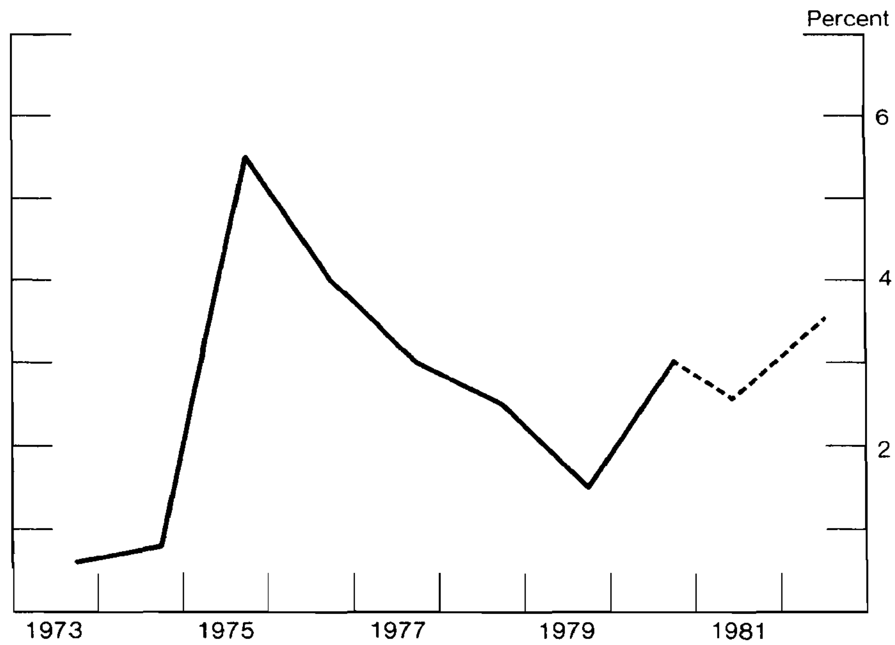
GNP Exports and Imports of Goods and Services



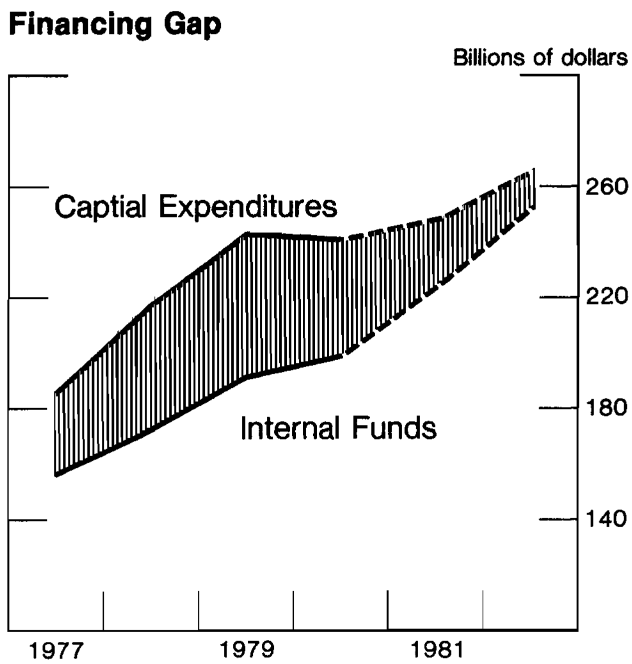
Funds Raised By Domestic Nonfinancial Sectors

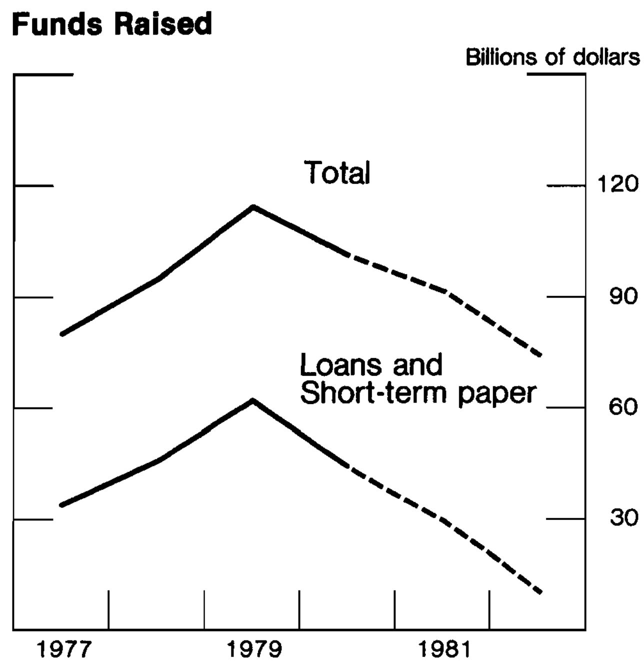


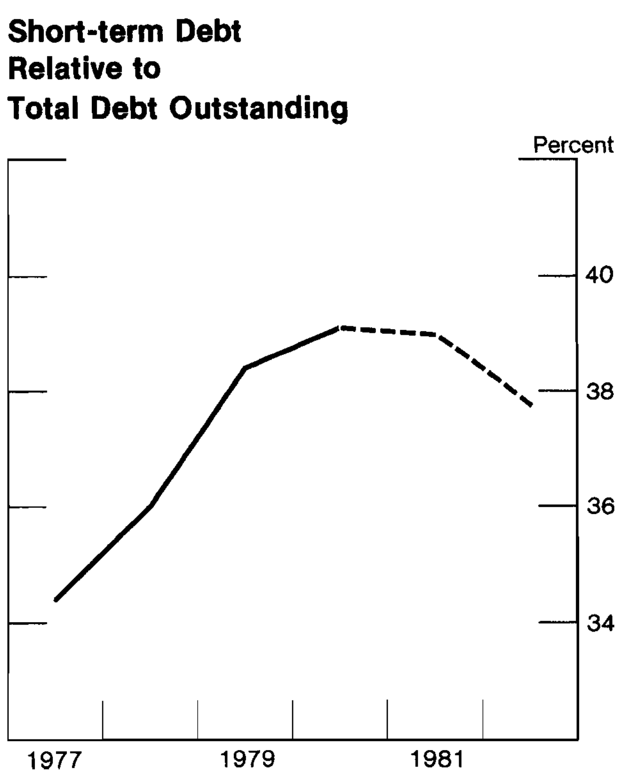
Federal Government Borrowing Relative to GNP

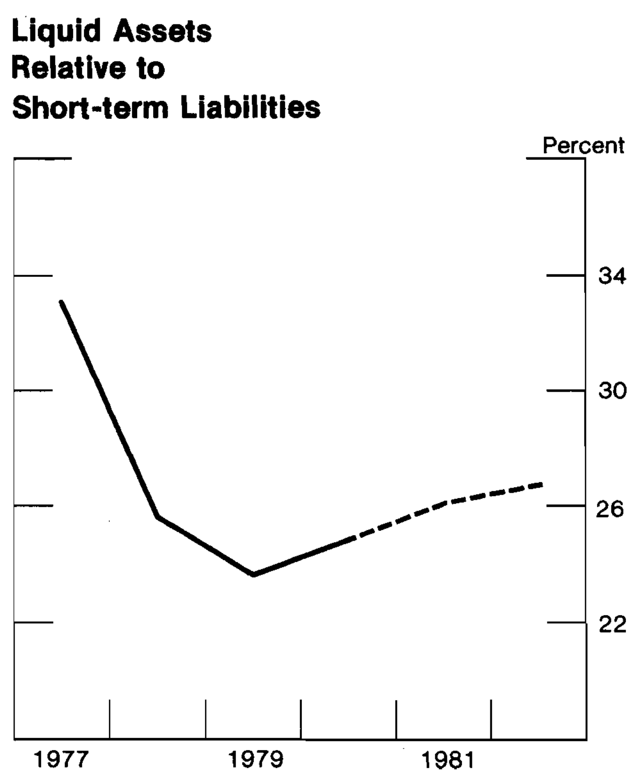


Nonfinancial Corporations

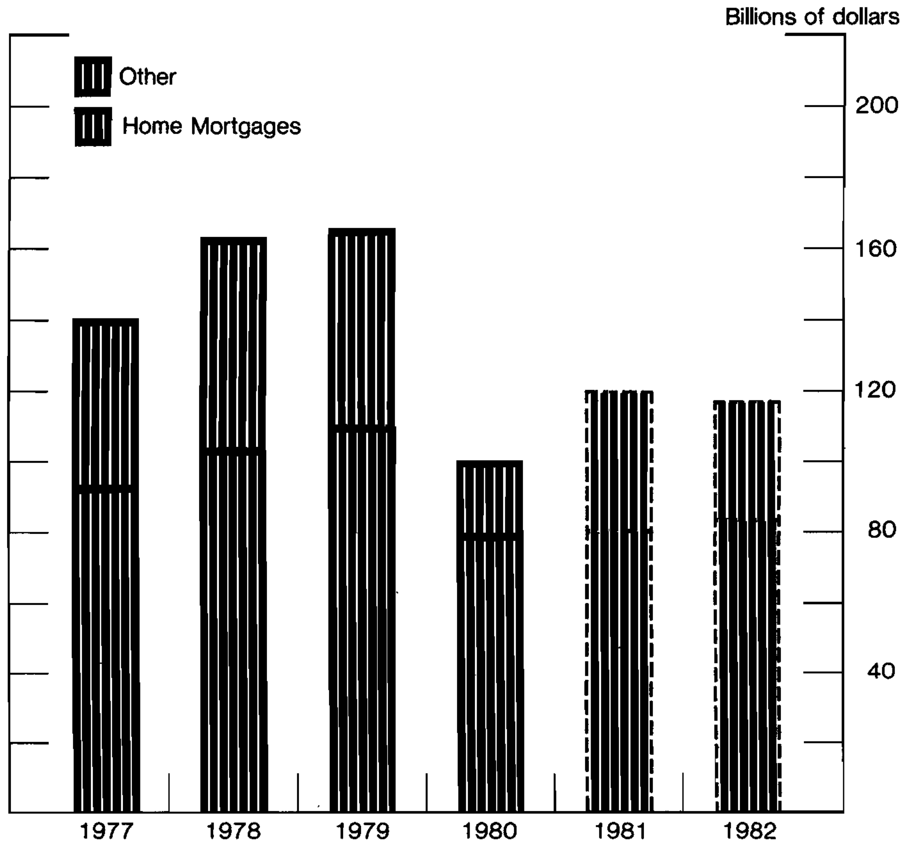






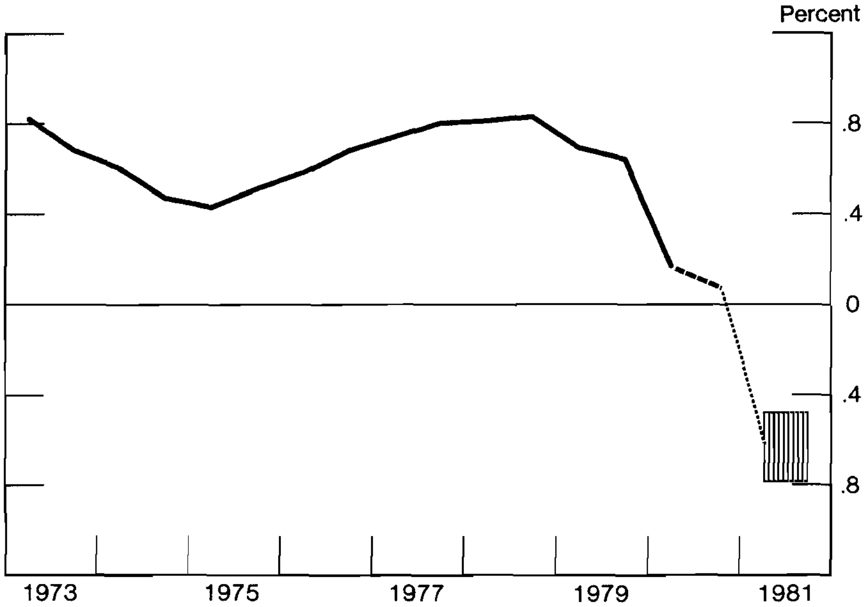


Household Borrowing

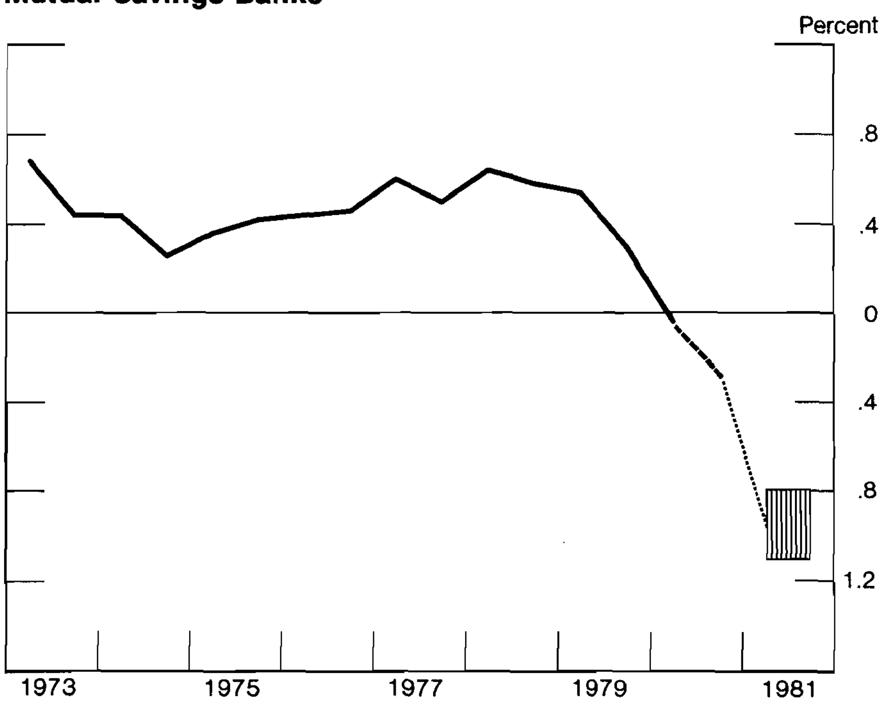


Net Income to Assets

Savings and Loan Associations



Mutual Savings Banks



Scott Pardee
FOMC Briefing
February 3, 1981

Since the December 19 meeting of the FOMC the dollar has advanced sharply against the German Mark and the currencies linked directly and indirectly to the mark. This morning, the dollar mark rate hit 2.16, the highest in nearly 3 years, up 9-1/2 percent from the level at the time of the last meeting. Profit taking has brought the rate back to about the 2.12-1/2 level, but for the moment few would consider this a reversal of the recent trend in favor of the dollar. Although the dollar is on balance down or little changed for the period against the pound sterling, Japanese yen, and Canadian dollar, the declines were early in the period and the dollar's recent strength has shown through against these currencies.

The main reason for the dollar's strength continues to be favorable interest differentials. U.S. interest rates have in fact slipped back from their peaks in mid-December, but few exchange market participants expect a replay of the sharp drop in rates that occurred last spring. They cite the evidence that the underlying economy has been stronger than expected; they note the strong statements of resolve by Chairman Volcker and other Federal Reserve policymakers on the need to fight inflation; and they have responded to the warnings by several money market gurus that higher interest rates are yet to come. For the near term anyway, corporate treasuries and money managers who are active in foreign exchange markets expect that U.S. interest rates will remain relatively high by historical standards, and well above rates in most other major countries.

A second element of strength for the dollar over the past few weeks has been the very positive response to the statements of intent by the economic policymakers within the Reagan Administration, especially the President himself and Treasury Secretary Regan. There is still considerable skepticism in the exchange market that a tax cut cum expenditure cuts will lead to an elimination of the fiscal deficit, and indeed forecasts of a larger fiscal deficit to come are among the reasons why money market gurus are warning that interest rates may shoot upwards once again. But the exchange market has been heartened by the belief that the new Administration means business about tightening up on fiscal policy and about dealing with inflation. It's mainly a matter of market psychology. Some market people have used the term euphoria in describing this response.

By contrast, and this is the other side of the coin of the dollar's strength, the German authorities are in the defensive, talking about the things they are not going to do and can't do to resolve their current problems. The problems are serious—a flat economy if not an economy in recession, rising unemployment, a continuing massive current account deficit, a currency which is declining under heavy selling pressure not only against the dollar but also against other major European currencies, and now an ominous upcreep of wholesale and consumer prices. Adverse terms of trade, J-curve, and vicious circle elements have come into play, also for the first time really since the early postwar period. The Bundesbank is caught in the middle. It has held a firm monetary policy despite heavy political and academic pressures to stimulate the domestic economy and to neglect the inflation rate and external value of the D-mark for the time being. But it has not taken the overt steps toward tightening policy that would satisfy those, from the other side of the policy debate, who believe that a low inflation rate and a strong D-mark should be the first priority to the neglect of growth and employment. The market has sensed this ambivalence by the Bundesbank and has become exceedingly bearish toward the D-mark. Again, it is largely a matter of market psychology—which can change—but for the time being it has propelled funds out of marks and into dollars.

In our operations, we have continued to amass D-marks although not as vigorously as we did when we were still covering our debts. Overall we purchased some $1,573 million equivalent of marks during the period, as against some $87 million of sales of marks when the dollar was slipping off in a thin market toward year-end. System balances in DM increased by some $750 million to $2182 million. This leaves the Desk with a leeway of some $300 million under the $2.5 billion limit set on our mark balances at the last FOMC meeting. The Treasury added a similar amount to its balances and it now holds some $1.2 billion of marks beyond what it needs as cover to the Carter notes. In other operations during the period, we sold $50 million of Japanese yen on one day early in January, when that market was particularly disturbed and the dollar was generally on offer. We also bought $20 million of Swiss francs last week for balances, shared with the Treasury.

Finally, the Swedish Riksbank drew $200 million under the swap line with U.S. The Krona had been under heavy selling pressure, leading to unexpectedly large dollar sales. Monetary policy measures have been taken and a fiscal package is hopefully in the offing. The drawing is a bridge financing toward a jumbo loan of $1 billion being negotiated by the Swedish government in the Euro-markets. The market has turned around yesterday and today and the Riksbank has bought dollars, so the immediate pressure is off. We will, of course, be following this situation closely.

Notes for FOMC Meeting
February 2-3, 1981
Peter D. Sternlight

After several months in which monetary growth exceeded the Committee's objectives, the December-January performance presented a marked change. December showed a substantial rate of decline in the narrow aggregates and only modest growth in the broader measures. January data, though subject to uncertainties of interpretation due to the massive shift into NOW accounts, seem to show a resumption of fairly robust growth in the narrow measures, but combined December-January growth remained below path. As a result of below-path monetary growth, demand for reserves tended to fall somewhat short of path levels. The shortfall in total reserves was about $100 million for the first four weeks of the seven-week interval, while in the final three-week subperiod, which ends tomorrow, it's estimated that total reserves could average about $400 million below path.

The usual and expected accompaniment of below-path growth in the aggregates would be a decline in borrowings and softening of the money market. Several factors worked to delay this result, however, leading to funds trading largely in a range of 19-20 percent over much of the period—thus maintaining the lofty level reached in mid-December before the aggregates weakened. In the closing weeks of December, borrowing ran somewhat higher than intended and the federal funds rate also tended to exceed expected levels, possibly due to sustained high demands for excess reserves. The reserve paths allowed for somewhat higher than normal excess reserves but apparently the allowance was not sufficient at that point. After the turn of the year, borrowing fell off, for a time, to around the expected range but the funds rate remained high—in fact averaging a snip over 20 percent in the first week of the year. Excess reserves continued to run above expectations, even though our expectations were progressively boosted. Pressure was also exerted on the funds rate by the heavy volume of dealer financing in early January, and bank preparations for large Iran-related payments around mid-month. Another persisting influence, probably, was the sheer inertia exerted by high rates in preceding days, bolstered by the markets' feeling that the System preferred rates in the area of 19 percent or somewhat higher. In the last week or so, the funds rate has slipped back from its predominantly 19-20 percent range to the area of 17-18 percent, oddly enough at the same time that discount window borrowing rose somewhat.

Desk operations during the seven-week period were complicated by large swings in the market factors and by uncertainties related to the Iranian payments settlement. Early in the interval, large and hard-to-predict changes in market factors called for large temporary injections and withdrawals of reserves. In mid-January the basic outlook called for reserve absorption in good part to counter seasonal reductions in required reserves and currency in circulation. But the money market was quite firm as banks prepared for the Iranian settlement. Against that background, when the Desk received instructions to sell $1.1 billion in bills for the Iranian account late on January 16, the most feasible course was to buy these bills for the System, with a view to taking appropriate offsetting action later on. The System's purchase had, in fact, no immediate reserve impact since initially the proceeds went into the pool of foreign account short-term funds employed in day-to-day matched sale-purchase transactions with the System account. Subsequently, the purchase of bills from Iran was much more than offset through sales of bills in the market and to foreign accounts, and run-offs of maturing bills. On a net basis, outright holdings of bills were reduced by $3.8 billion over the period, thus using most of the additional leeway voted by the Committee on January 23.

Around the time of the December Committee meeting, the fixed income markets were in the midst of a big price rally, spurred by indications of slowing monetary growth and views that the economy might be weakening, perhaps because of the fourth quarter's sharp rise in interest rates. The conviction that the peak in rates had been seen gained momentum in the closing weeks of December, with more news of monetary weakness. Market participants noted the persistently high funds rate but were inclined to shrug it off as a temporary phenomenon related to year-end pressures. Investors were less convinced than dealers, however, and as the period progressed the rally faded and markets gave back part of the earlier gains. The persistently high funds rate and high dealer financing costs affected sentiment adversely, and these factors were reinforced by signs of some continuing economic growth, anticipations of substantial Treasury cash needs, and a sense that the Fed might resist large rate declines even if monetary growth abated. Lower funds rates late in the period provided fresh encouragement to the market but indications of big Treasury needs worked in the opposite direction at nearly the same time. On balance over the period, rates declined fairly substantially at the short end—as much as 2 or 3 percentage points on some instruments—and more modestly for intermediate and longer issues.

Three- and six-month bills were auctioned yesterday at 14.66 and 13.74 percent, compared with 16.67 and 15.42 percent shortly before the December meeting.

The decline is more noteworthy since the Treasury added steadily to new market supplies during the period while the System was also a big net seller. Yields on intermediate-term coupon issues declined about 50 to 150 basis points over the period while long Treasury maturities were down about 25 to 50 basis points. The Treasury also added substantially to supplies of coupon securities during the period—by some $8 billion, not counting the net $3-1/2 billion they are picking up in the mid-February refunding for which the first auction is being held today. They announced last Wednesday that total new money needs in the first quarter of 1981 would be a mountainous $36 billion—a new quarterly record by far.

Elsewhere in the capital markets, there is reported to be a very large supply of intermediate- or long-term corporate issues poised for marketing if rates should dip somewhat lower.

In generally, one gets the sense that the markets would like to do better—especially participants would like to believe in the new Administration's confidence that productivity will improve, budgets will move toward balance, and inflation will work lower. At the same time there is considerable skepticism about whether this will really work as hoped for, and there is particular apprehension that large tax cuts may precede effective restraint on spending.

FOMC Briefing
S. H. Axilrod
February 2, 1981

The experience with NOW accounts in the early weeks of this year has certainly verified, indeed in that period magnified, that there are problems of interpreting M-1A and M-1B for policy purposes during the transition to nationwide NOW accounts. Measurement of the effective growth of these variables, abstracting from NOW account shifts, from actual data that reflect shifts is highly sensitive to the amount of shift and to the proportion of the shifted funds coming from demand deposits or other assets.

We can be reasonably certain about the amount of shifts. Since the trend growth in NOW accounts is relatively small in magnitude, virtually all of the change in interest-bearing checkable accounts (OCD accounts) can be said to reflect shifts related to introduction of NOW accounts nationwide. However, we are necessarily less certain about the fraction of these funds coming from demand or other accounts. And the adjustment to observed growth needed to obtain the effective growth that is significant for policy purposes is quite sensitive to these shift percentages. For instance, on the assumption that about 1/5 of the new OCD accounts came from other interest-bearing assets, M-1B growth in January was about 6¼ percent at an annual rate; however, if it is assumed that 1/3 of the funds came from these other assets effective growth in M-1B would be close to zero. Our information for January suggests that 1/5 is closer to the right fraction (it might even be a bit low), but we do expect that fraction to rise as the shifts of large demand deposit accounts to NOW accounts become relatively less important. Shifts of large accounts appear to have been a major influence in the very early weeks of the year.

It should be pointed out, though, that the extent to which uncertainty about the fraction of NOW account funds coming out of demand deposits or other assets affects interpretation of the basic behavior of M-1 should diminish markedly over the months ahead. We may remain uncertain about the fraction, but as the total amount of shifting declines--and it looks as if it will decline sharply from the January pace--the significance of differences in the fraction will diminish. The actual behavior of the series will more closely approximate its effective growth; this will be more true of M-1B than M-1A of course so long as shifts into NOWs are mainly out of demand deposits.

Nonetheless, it may be tempting from recent experience to conclude that more emphasis should be placed on broader aggregates for operating purposes, at least temporarily, since they are not much affected by NOW account shifts. There is, of course, something to that argument. But there are risks in that direction also. The broader aggregates contain a mix of short- and long-term assets whose yields now vary to a great extent with market interest rates and thus whose amounts are difficult to control by monetary policy actions that affect market rates. In those circumstances, most of the adjustments to overshoots or undershoots of the broad aggregates would be thrown on demand deposits, and--because of the inelasticity of demand for such deposits--there would be enhanced risk of more interest rate volatility in the short run.

Looking to policy operations over the next few weeks, if credence is given to the view that there are limits in the degree to which the broader aggregates can serve as an effective basis for day-to-day reserve management, and given that uncertainties in interpreting the narrow monetary aggregates will still be large, the Committee may wish to consider establishing a narrower funds rate range than even the 5 percentage point band of the last meeting. Such a narrower band would have the practical effect of permitting the Committee to judge the import of incoming evidence on both the broad and narrow aggregates before very substantial changes in credit market conditions are permitted to occur.

Whatever decision the Committee makes about the funds rate band, the speed with which outer limits of the band might be attained will depend in part on the particular path set for the monetary aggregates (with its associated reserve path). Alternative A hits the longer-run path midpoint for M-1B by March, but it implies relatively strong effective, and also actual, growth of M-1B in February and March that might raise questions about the System's commitment to lowering money growth--an issue that may be particularly sensitive in this period when the market will be closely assessing the interaction of fiscal and monetary policies. The alternative A path is also the path that is most likely to lead to a sharp drop of interest rates should the economy prove weaker than projected.

Alternatives B and C would not imply growth in M-1B by March to hit the midpoint of the FOMC's effective longer-run target for that aggregate--with the growth rate of alternative C keeping the narrow aggregates below the FOMC's longer-run range over the first quarter, given the December shortfall. This modest growth in M-1B of alternative C would, in contrast to alternative B, imply a substantial acceleration of growth from March to June should the Committee wish to hit the midpoint of its M-1B path by mid-year and might therefore also imply substantial downward interest rate pressures at that time should the economy be weakening as projected. This is not necessarily an argument against alternative C, of course. Rather, it might suggest, for instance, that if the Committee takes the alternative C approach at this time, it might also be willing to contemplate a slower move back to the midpoint of its longer-run M-1B path over the course of this year (not getting back by June in other words) as a reasonable strategy in view of the importance of reducing inflationary psychology, or as more consistent with constraining growth in M-2 and M-3.