APPENDIX

James L. Kichline
February 8, 1983

FOMC CHART SHOW -- INTRODUCTION

During our presentation this afternoon we will be referring to the package of charts distributed to you. The first chart displays the principal policy assumptions that underlie the staff's economic and financial forecast. For monetary policy, our working assumption is that M2 grows at 8 percent through the end of 1984 from a base period in the first quarter of this year. We are viewing that growth as an underlying rate that abstracts from the effects of possible shifts into MMDAs or Super NOW accounts from sources outside M2. For fiscal policy, we are assuming that the Congress essentially completed its actions on the fiscal year 1983 budget during the special congressional session late last year; the actions taken then have caused us to raise expected outlays by about $7 billion compared with our previous forecast. The budget assumptions for fiscal year 1984 entail enactment of deficit reducing measures of around $40 billion, a little less than proposed by the administration. For energy prices we are assuming that oil prices decline about 8 percent during 1983 and remain unchanged next year; that assumption provides a price of $29 for a barrel of crude by the summer, or a decline of about $2.00 from the level in the fourth quarter of last year.

The next chart provides additional detail on the federal budget. For both fiscal years 1983 and 1984 the staff is expecting actual deficits of around $200 billion. These deficits are close to those estimated by the administration, although there are compositional differences; for example, we are assuming somewhat larger cuts in defense outlays and smaller cuts in nondefense programs. Nevertheless, the budget remains a stimulative force, as the structural deficits continue to rise this year and next.

The chart on the bottom shows outlays and receipts relative to GNP since the mid-60s. As can be seen, a large gap between the two has opened up given the sizable net tax cuts and smaller outlay cuts. The gap is, of course, influenced by cyclical forces, but policy actions have led to a situation where the gap won't close even in a good business environment.

This hasn't escaped the attention of financial market participants and undoubtedly is influencing interest rates, shown on the next chart. The staff's policy assumptions and GNP and financial forecast are associated with rates expected to remain near current levels, or drift lower over time as further progress on inflation generates a reduction of expected inflation. The M2 assumption in the forecast is premised upon trendless behavior of velocity for that aggregate, but in arriving at our forecast we implicitly have assumed that unexpected behavior of the aggregate is largely permitted to show through in measured aggregate growth and is not mainly transmitted to interest rates.

Mr. Zeisel will continue the presentation with a discussion of the GNP forecast.

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Joseph S. Zeisel
February 8, 1983

CHART SHOW -- NONFINANCIAL DEVELOPMENTS

There have been persuasive signs recently that the economy is finally turning around. Although real GNP contracted in the fourth quarter, this was mainly the result of a massive inventory liquidation, while real final sales rose at a respectable $3\frac{1}{4}$ percent rate.

As indicated in the upper left-hand panel of the next chart, a major factor in the fourth quarter pickup was the rise in consumer demand, with domestic auto sales leading the way. Sales of U.S. models have improved during the past three months in response to interest rate concessions, and with demand exceeding assemblies, units in dealers hands were reduced to under a 60-day supply. This is generally considered a comfortable stock level, and paved the way for an increase in production.

As the right-hand panel indicates, real retail sales outside of automotive markets also have shown improvement, with general merchandise, apparel, furniture and appliances picking up toward year-end. The steady gain in housing activity over the last year, shown in the lower left-hand panel, has undoubtedly also played a role in firming the market for consumer durables.

Finally, employment figures for January indicate an upturn in labor demand. Nonfarm payroll employment rose over

300,000 in January, after falling at an average rate of over 200,000 a month in the latter half of 1982. Part of this probably reflected difficulties with seasonal adjustment, particularly in retail trade; but employment in the cyclically sensitive manufacturing industries edged up as well and the factory workweek -- generally a good leading indicator -- rose strongly.

The next chart presents our view of the outlook for growth during the next two years. We are projecting a rise in real GNP of 3½ percent this quarter, largely reflecting the tapering off of inventory liquidation. But we expect growth in activity to be sustained at about this rate over the year and to accelerate gradually to about a 4½ percent rate in 1984. As the bottom panel indicates, this falls well short of the average performance in previous postwar expansions.

We expect the housing sector to continue to lend support to overall growth during the current year. As the top left panel of your next chart shows, the rebound in housing starts has been inversely correlated with the decline in mortgage interest rates, which by year-end had fallen by over 5 percentage points from the high in the autumn of 1981. Home buyers responded vigorously to the rate reductions, and in the fourth quarter sales of new and existing homes rose to their highest levels since the recession began. With unsold new home inventories low, the improvement in sales has been quickly translated into a rising level of new construction activity. The expected further reduction in mortgage interest rates should help support the continued expansion in residential construction activity, and we are forecasting about a 1½ million rate of starts by the end of this year. We project a bit slower growth in outlays for housing next year with starts attaining about a 1-3/4 million rate by the fourth quarter.

As the next chart indicates, we are forecasting consumer spending to increase at a moderate pace this year. While a number of factors will be supporting growth in outlays including the scheduled 10 percent midyear tax cut, lower cost for consumer credit and reduced debt positions, incentives for saving will remain strong and income growth is projected to be quite modest. In 1984, the increase in consumption should be somewhat larger, reflecting the greater rise in income.

As reflected in the bottom panel, we anticipate that the saving rate will remain near its long-term average of about 6 percent through the projection period.

In contrast to household spending, the business sector -- presented in the next chart -- is likely to remain a drag on economic growth during most of the coming year. Low operating rates, depressed corporate profits and weak markets generally, suggest that businesses will continue to be extremely cautious in their investment plans, initially using existing plant and equipment more intensively to meet increased demand rather than investing in new capital. These attitudes are reflected in the results of recent plant and equipment spending surveys, which indicate further declines in real spending this year. But as the upper left-hand panel indicates, there have been some signs of prospective improvement ahead. New orders for nondefense capital equipment have risen in recent months, narrowing the gap with shipments and improving the outlook for a turnaround in capital goods production.

In contrast, as shown in the right-hand panel, nonresidential construction activity turned down in the latter half of 1982 and near-term indicators suggest further declines in the months ahead. With vacancy rates for office buildings up sharply, this sector of construction seems certain to remain weak for some time.

On balance, we expect that business spending -- particularly for equipment -- should begin to benefit shortly after the economy perks up and corporate profit positions improve. This has been the pattern in past recoveries with the turn first evident in stronger demand for short lead-time products such as motor vehicles and office machinery. As shown in the bottom panel, we expect such an upturn in the latter part of this year and a strengthening of the rise in 1984.

The inventory situation and outlook is portrayed in the next chart. As noted earlier, stock liquidation played a major role in the contraction of activity at the end of last year. But recent data suggest the inventory adjustment will soon be drawing to a close. As the top left panel shows, dealers stocks of domestic model cars were reduced to a historically low level by late in the year. In manufacturing, shown in the right-hand panel, the inventory total in real terms has been brought back down to prerecession levels. However, since sales have declined sharply as well, stock-sales ratios remain high in some sectors and we anticipate some additional overall liquidation in the next few months.

We are projecting an end to liquidation in real terms by the spring. But with the memory of recent stock imbalances still fresh, businesses are likely to maintain a cautious inventory policy and we expect a slight downtrend in the overall inventory-sales ratio through next year.

The next chart portrays the government components of spending. In order to avoid the distortions caused by the timing of CCC payments, the top three panels present annual average real dollar changes. As is evident, real defense spending rises substantially over the next two years. But this acceleration is partly offset by reduced nondefense purchases. At the state and local level, real purchases are expected to be essentially unchanged this year as a result of reduced federal support and weak tax revenues, but this situation should improve by 1984, as the cost of borrowing declines and tax receipts strengthen with activity and income. In total, government purchases rise about 1-3/4 percent in 1984 -- just a bit more than in the previous two years.

As the next chart shows, we expect the next two years to show the best employment rise since 1979. Nevertheless, the gains are comparatively small, especially this year -- reflecting the rather sluggish recovery anticipated and the fact that a pickup in demand will likely be accommodated first through an increase in the workweek and improved productivity.

Labor force growth is also likely to remain quite slow, given the limited improvement in employment opportunities and the relatively small rise in working age population. With employment growing only a bit faster than the labor force, the unemployment rate is expected to drop only slightly this year and to move to the 9½ percent range by the end of 1984.

As the next chart shows, the prolonged period of slack has brought a considerable easing of wage inflation. The effects were evident earlier in the hard-hit industrial sector, but over the past year or more, the wage rise has decelerated considerably in the service sector as well. The right-hand panel illustrates how union wages have moderated as a result of both smaller new wage settlements and reduced price inflation.

Overall, wage increases as measured by the index of average hourly earnings, rose at a 5½ percent rate in the second half of 1982 -- the slowest pace for a half-year period since 1972. We expect a further slowing over the next two years, although at a reduced pace. The factors making for some additional easing this year are already in place -- bargaining in an environment of continued high unemployment and moderate inflation is certain to result in smaller wage increases than called for in expiring contracts -- many of which were negotiated in 1980. At the same time, concessions negotiated last year will continue to damp wage increases -- about an unusually large portion (one-third) of the workers covered by major contracts negotiated last year are not scheduled to receive wage increases at all this year. Substantial slack and low rates of price inflation should continue to restrain wage increases in 1984, but with the economy firming, further slowing is likely to be small.

Total compensation costs are expected to moderate along with wages, but as indicated in the top panel of the next chart, the assumed speedup of the social security tax increase in early 1984 would tend to offset further improvement, raising hourly compensation by about one-half percent.

We do expect continued help from gains in productivity, however. Over the past year productivity growth -- at just under 2 percent -- has been surprisingly strong given the drop in production. Firms appear to have gone beyond their normal cyclical efforts to cut costs, and this could signal more lasting gains in efficiency. Productivity growth this year is expected to remain at a comparatively healthy 2½ percent annual rate as firms seek to hold down costs and rebuild profit margins. Then, as the recovery continues into 1984, productivity growth is expected to slow but still remain above our notion of its longer-run trend. These productivity gains when combined with a slower rate of increase in hourly compensation should hold the rise in labor costs over the next two years to close to 3 percent.

The outlook for inflation is presented in the next chart. The emerging weakness in international oil markets is expected to damp the rise in energy prices this year, although the effects of the oil price drop will be offset somewhat by a further rise in prices of natural gas. And of course if the dollar depreciates as expected, import prices will no longer be falling.

As shown in the right-hand box, we project that food prices will rise a bit faster over the next two years. Although underlying labor cost trends should hold down processing costs, a variety of government efforts appear to be in train that are aimed at raising crop prices and boosting depressed farm incomes.

But fundamentally, the trend in overall prices will continue to reflect largely labor costs and relative slack in markets and as shown in the bottom panel, these should continue to be forces for moderating inflation; on balance, we project prices to be rising at slightly under a 4 percent rate over the next two years.

Mr. Truman will now discuss the international outlook.

Edwin M. Truman
February 8, 1983

FOMC CHART SHOW -- INTERNATIONAL DEVELOPMENTS

The world economy has been experiencing a disinflationary process of unanticipated dimensions during the past three years -- in large measure as a result of policy actions here and abroad. The first international chart illustrates some of the feedback effects on the U.S. economy of that process.

As is shown in the upper left-hand panel, the weighted average foreign exchange value of the dollar rose by 45 percent from the third quarter of 1980 to last November -- propelled by U.S. macroeconomic policies and more recently by economic, financial and political uncertainties elsewhere in the world. Although the chart shows that the dollar declined in December and January from its November peak, it has recently retraced much of that decline.

The upper right-hand panel summarizes the extent of the recession in the other developed countries and the unprecedented stagnation in the non-OPEC developing countries. The latter countries have been forced to adjust their own policies rapidly in response to deflationary impulses from the industrial world and the reduced availability of external financing.

The lower panels illustrate some of the major consequences of these forces; U.S. exports declined by $50 billion from early 1981 through the end of last year -- a decline of slightly more than 20 percent in both nominal and real terms. A significant portion of the decline has been in exports to developing countries and in exports of agricultural commodities and industrial supplies.

The next chart illustrates, in the upper left-hand panel, the substantial progress in the major foreign industrial countries in reducing inflation -- an average improvement of about 4 percentage points over two years, compared with more than 5 percentage points for the United States. On the other hand, as shown in the upper right-hand panel, industrial production abroad has declined significantly. There are signs in recent data on residential construction, new orders and consumer confidence that economic activity in some countries abroad is beginnning to revive. As is shown in the lower panels, we are forecasting continued progress in reducing inflation in the foreign industrial countries in 1983, but a pick-up in real GNP this year and next that is markedly slower than in the United States.

As is illustrated in the next chart, we are forecasting that most of the decline in U.S. exports is behind us. By midyear, the stirrings of recovery in the industrial countries should contribute to rising export demand. On the basis of the staff's forecast that the dollar will have declined significantly by midyear, relative price effects should provide a major boost to real exports by the end of 1983 and especially in 1984.

Service exports have contributed to the recorded declines in real GNP during the recession -- especially in the past two quarters. These exports, shown in the middle panel, now amount to 45 percent of real GNP exports of goods and services, and their revival, largely as a consequence of rising direct investment receipts, should contribute to the overall rise shown in the bottom panel.

Turning to the import side, the next chart shows, in the top panel, the decline in the volume and price of our oil imports in 1982. This contributed to a $16 billion drop in the value of such imports last year, thus helping to mask the deterioration in our competitive position. As already noted, we are assuming a further $2 per barrel decline in the price of imported oil this year on top of the $5 reduction since the peak in April 1981. However, rising demand should more than offset the effects of this further price decline on the value of U.S. oil imports.

Of course, our assumption about a decline in oil prices is one key area of uncertainty in the forecast. We believe we have adopted a reasonable assumption. The relative price of oil to oil-exporting and to other oil-importing countries is projected to fall significantly as the dollar depreciates. In this sense, a considerable further collapse in oil prices is built into our forecast.

Our outlook for non-oil imports, shown in the middle panel, is that the stagnation and recent decline in these imports should end this quarter. The upturn in non-oil imports is projected to be substantial, especially in value terms, contributing importantly to the rise in the trade deficit shown in the third line of the table at the botton of the chart. We are projecting that the trade deficit will almost double this year and increase further in 1984. Since we expect little net change in services and transfers, the widening of our trade deficit translates into a \$30 billion increase in our current account deficit this year to \$37 billion and a further increase next year.

As is shown in the upper panel in the next chart, the U.S. current account was already in deficit at about a \$20 billion annual rate in the second half of last year. Although the deficit is expected to reach an annual rate of \$57 billion in the first half of 1984, it should then begin to turn around given our forecast that the dollar will depreciate significantly this year, as is shown in the middle panel.

The projected depreciation of the dollar, while essential to restoring U.S. price competitiveness, raises questions about the implications for U.S. inflation. Such judgments are hazardous, not least because they rest on the generally inappropriate assumption that exchange rates are exogenous variables. Nevertheless, the bottom panel tries to quantify the effects on the U.S. price level of the dollar's appreciation since the third quarter of 1980 and the effect of its projected depreciation over the forecast period. We estimate that the cumulative impact of the dollar's appreciation on the U.S. price level was about 2-3/4 percent by the end of 1982. If the dollar were to remain at its level in the fourth quarter, the cumulative impact would increase to 4 percent by the end of 1984. If instead the dollar follows the course we have projected, we estimate that the projected depreciation combined with the previous appreciation would have essentially a zero impact on the price level this year and a slight negative impact in 1984. The shaded area shows the differential effect of the two exchange rate paths.

While our projection is that the dollar will depreciate significantly in 1983 and that the depreciation will help to narrow the U.S. current account deficit by the end of 1984, questions have been raised about how our unprecedented current account deficits will be financed. The table on the next page tries to shed some light on this question.

The subtotal in line 5 of the table includes the current account and several relatively stable items in our international transactions. The circled figures on the right show an estimated \$36 billion swing in this subtotal between 1982 and 1983 -- not significantly different from the \$30 billion swing between 1976 and 1977 shown on the left. The recorded figures for net private capital flows in line 6 are rather stable. However, the continued relatively high level of real dollar interest rates might be expected to reduce the net outflow somewhat from that estimated for 1983 once the dollar is no longer expected to depreciate significantly further. The remaining gap would have to be covered in large part by an inflow of official capital -- line 7B. Two observations suggest that such a development might well be reasonable. First, the circled figures on the left show that the inflow of official capital increased by about \$20 billion between 1976 and 1977. This increase was more than accounted for by the exchange market intervention of the major foreign industrial countries as the dollar began to depreciate. Second, the net inflows of official capital in the past two years have been small, as is shown by the circled figures on the right. In fact, the major foreign industrial countries have run down their direct official claims on the United State by about $25 billion as part of their $70 billion in net intervention sales of dollars during the past two years. Thus, these countries would seem to have substantial scope to replenish their reserves.

I would emphasize that this analysis is highly conjectural, especially given the large flows involved, the many known potential channels, and the size of the uncertainties that are buried in the statistical discrepancy in line 4.

Mr. Prell will now review the domestic financial outlook.

Michael J. Prell
February 8, 1983

FOMC CHART SHOW -- FINANCIAL DEVELOPMENTS

My first chart provides an aggregative view of credit flows. As indicated in the top panel, the expansion of domestic nonfinancial sector debt moderated slightly last year while nominal GNP was decelerating sharply. Such a relative movement in debt and GNP is typical of recessions -- though a divergence of this magnitude has not occurred since the 1950s. We are projecting a narrowing of the gap between credit and GNP growth, but in past upturns GNP growth usually has outstripped credit growth.

The projected recovery of course departs from past norms in a number of ways, but one factor that bears directly on the credit outlook is ballooning federal cash needs. Not only will the Treasury be borrowing large amounts in absolute terms, but -- as the lower panel shows -- we are projecting an extraordinary share of total credit to be absorbed by the federal government. To be sure, the low level of economic activity is one reason for this, but as Mr. Kichline noted, we are also anticipating a widening of the structural deficit through 1984.

Turning to the next chart, we can see at the upper left where some of the large volume of financial assets created in the past year went. The growth of household financial assets -- shown here scaled by disposable income -- has far outstripped that of household debt since 1979. As surveys have indicated, in the right panel, households have had little taste for drawing down savings to finance outlays and the same has been true with regard to borrowing -- at least until just recently when cut-rate auto loans may have changed some attitudes.

The lower left panel shows that the general caution of households -- coupled with tighter lending terms -- has held down consumer loan delinquencies. In the case of mortgage loans, however, longer maturities have not permitted such a smooth adjustment, and with long-term joblessness spreading, mortgage delinquencies have risen sharply -- and may continue rising.

The business sector is just beginning the process of restoring its financial strength. As may be seen in the upper panel of the next chart, inventory liquidation and cutbacks in fixed investment have narrowed the gap between outlays and internal funds. In the fourth quarter, we estimate that the financing gap disappeared. In our forecast, however, firms will not experience the excess of cash flow over expenditures that has occurred early in other upturns, and thus the improvement of corporate finances that is needed to regain higher debt ratings and otherwise achieve a more solid basis for future expansion will be more difficult. Moreover, the decline in interest rates we've experienced and the prospective increases in profits point to only a slight decline in the ratio of interest payments to corporate income. And, as suggested in the bottom panel, though we expect that companies will continue their recent pattern of greater reliance on long-term capital, such measures of business liquidity as the ratio of short-term to total debt are not projected to reverse their long-run trends of deterioration.

The next chart deals with the state and local sector, which, as the upper left panel shows, last year experienced a noticeable budget deficit, net of retirement funds. Moreover, a number of states have largely depleted their cash reserves. Through further spending cuts and tax increases, and with the aid of economic recovery, we expect to see state and local governments close the budget gap in 1983 and move into surplus in 1984.

For many units that need to borrow, lowered credit ratings impose increased costs. The upper-right panel shows the effect of downgradings on the credit standing of state governments; the number with Aaa ratings has dropped markedly. But even for those units retaining high ratings, borrowing costs are substantial. As the lower-left panel shows, tax-exempt debt is carrying yields approaching those on Treasury bonds. This is largely because the key traditional institutional investors -- banks and casualty insurers -- have had little appetite for tax-exempt income in the past couple of years. Despite the high rates, though, as shown in the right-hand panel, tax-exempt bond issuance has soared, reflecting the increasing use of the market by private businesses and by municipally sponsored enterprises in power generation, hospitals, housing, and other areas. States and localities have, in effect, become enormous financial intermediaries. They may become even more important in that role in the months ahead as they sell debt for the purpose of eventually repaying higher cost obligations but in the meantime invest the proceeds in Treasury obligations.

The next chart focuses on some better recognized intermediaries -- banks and thrift institutions. The top panel shows that bank earnings have been trending downward since 1979. Moreover, as indicated in the middle panel, there is now an ominous upswing in loan loss provisions and charge-offs and the fourth quarter probably was marked by a substantial further rise. In the near term, the competition for MMDAs is hurting bank earnings a bit, and it is difficult to say how soon rates will settle to sustainable levels. But the problem of loan quality probably looms as a far bigger potential depressant on the earnings of many banks and may have some effect on the new loan exposures banks are willing to take on.

At the thrift institutions, in the bottom panel, the decline in interest rates may have eliminated operating losses, even with the recent MMDA-related boost to deposit costs. Assuming MMDA competition continues to simmer down, our interest rate projection implies a small profit for thrift institutions in 1983. Thrift liquidity is high now -- at least in terms of asset composition -- and we are anticipating that deposit flows will be adequate to encourage them to be somewhat stronger participants in home mortgage finance in the months ahead.

Mr. Kichline will now conclude the presentation.

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James L. Kichline
February 8, 1983

FOMC CHART SHOW -- CONCLUSION

The chart in the last section of the materials provides a summary of the forecasts of FOMC members, along with those of the staff and the administration. FOMC members generally tended to have a little higher forecast for nominal and real GNP, as well as for the GNP deflator, compared with the staff; the administration's forecast tends to be a bit lower on real GNP and higher on prices compared with both the FOMC members and staff forecasts. Overall, however, the differences appear to be rather small. In addition, the FOMC member forecasts tend to be fairly tightly clustered; for example, two-thirds of all forecasts on real GNP measured fourth quarter to fourth quarter fall within the range of 3½ to 4½ percent.

That completes our presentation.

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CONFIDENTIAL (FR) CLASS II-FOMC

Material for

Staff Presentation to the Federal Open Market Committee

February 8, 1983

Principal Assumptions

Monetary Policy

- Growth of M2 of 8 percent from 1983-Q1 base.

Fiscal Policy

- No further action on FY 1983 budget.
- Deficit-reducing actions of about $40 billion in FY 1984.

Energy

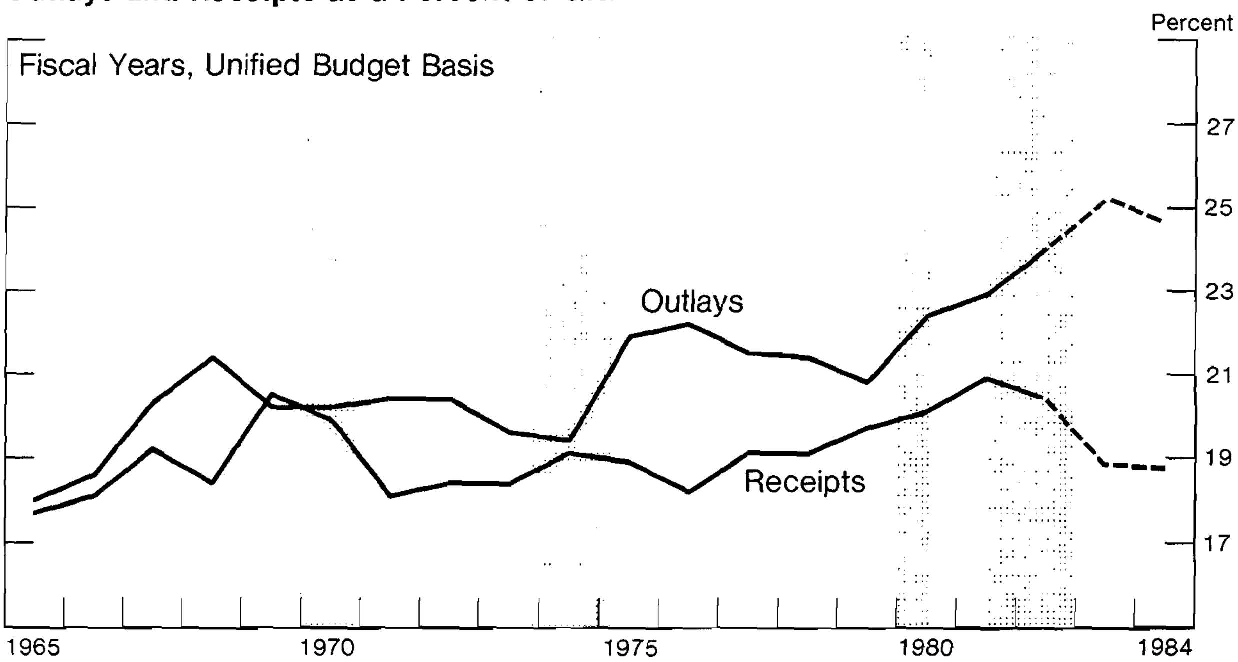
- Oil prices decline about 8 percent to $29 per barrel.

Federal Budget

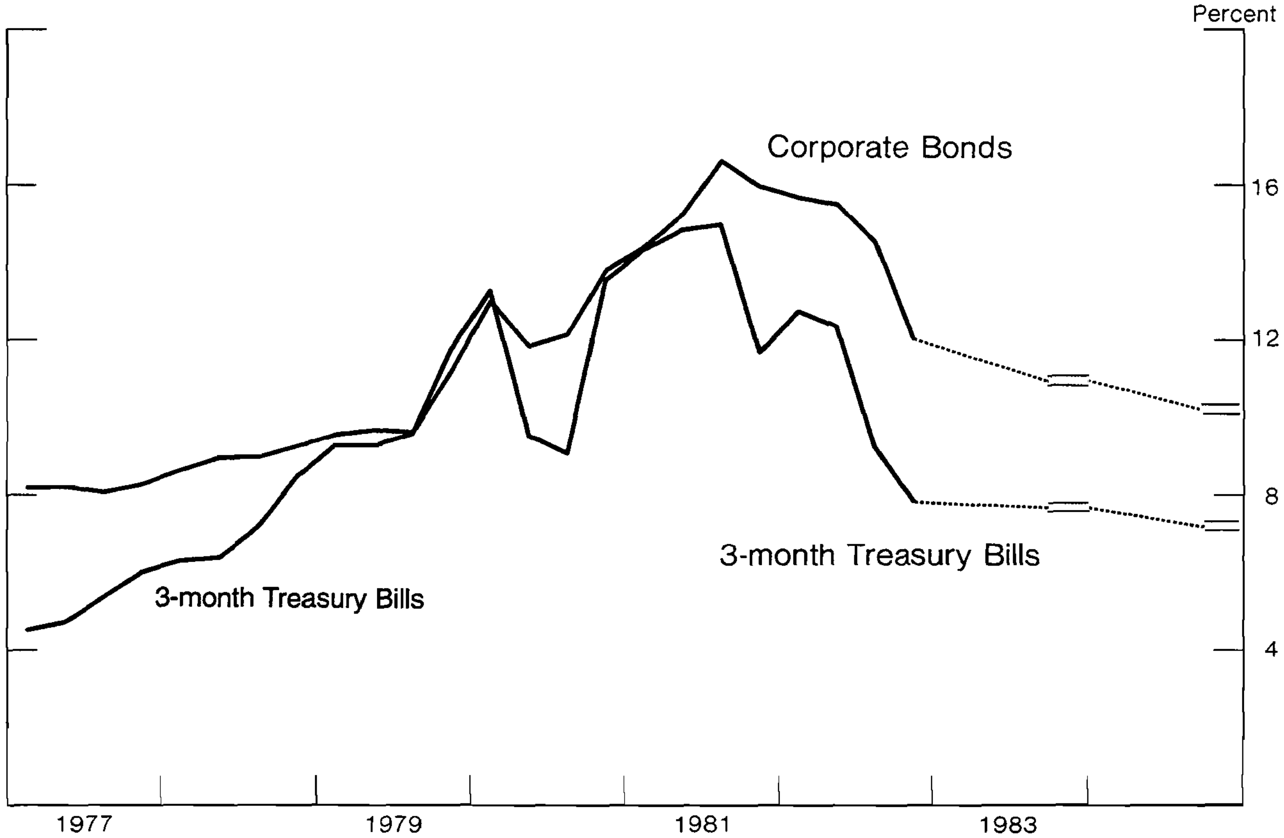
Fiscal Years, Unified Budget Basis, Billions of Dollars

	1982	1983		1984	
		Administration	Staff	Administration	Staff
Outlays	728	805	802	849	847
Receipts	618	598	600	660	643
Deficit	111	208	201	189	204
Structural Deficit	45	n.a.	72	n.a.	87

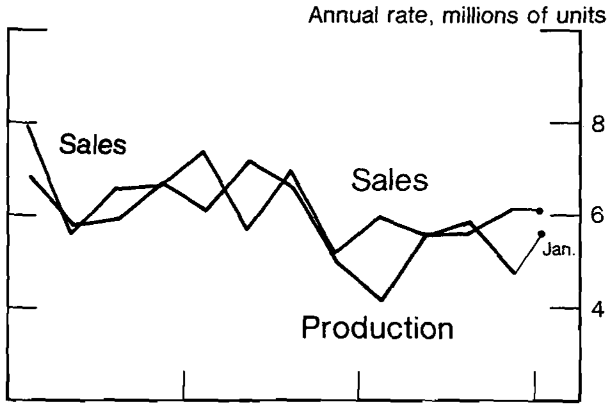
Outlays and Receipts as a Percent of GNP



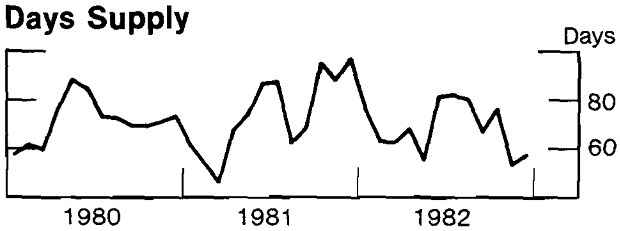
Interest Rates



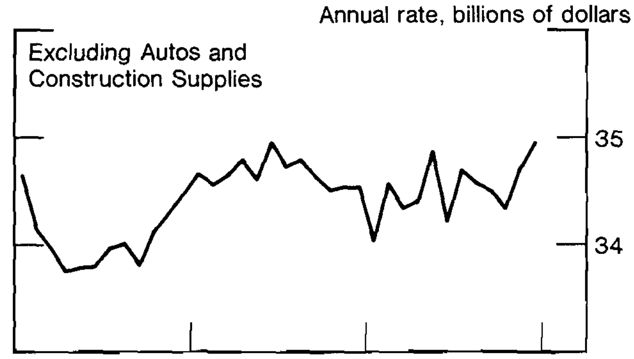
Domestic Autos

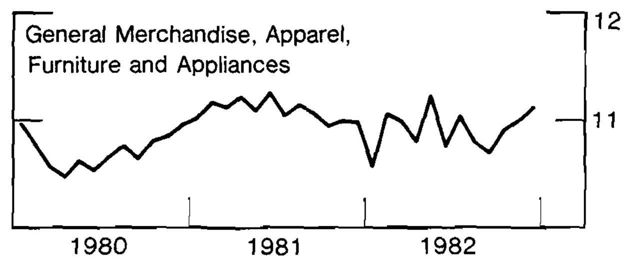


Days Supply

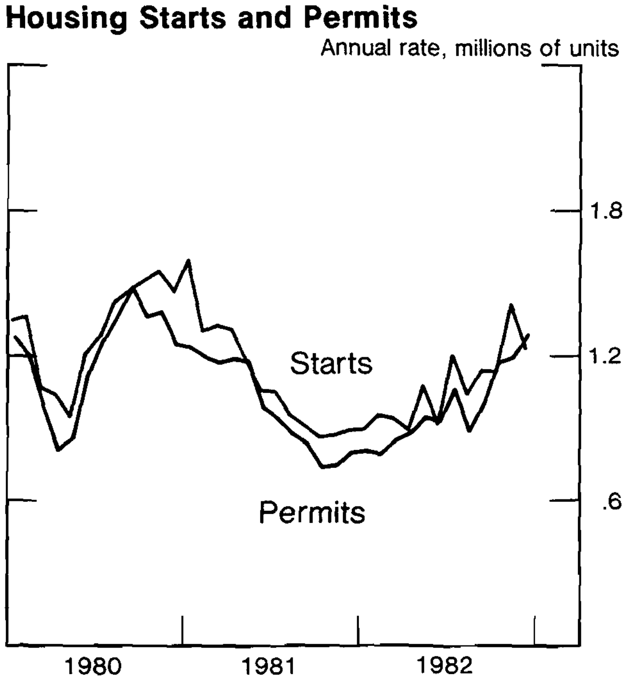


Real Retail Sales

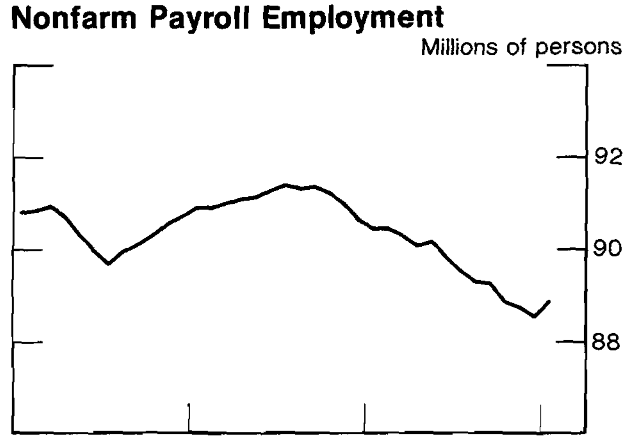




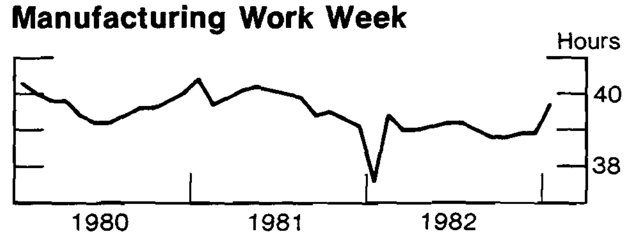
Housing Starts and Permits



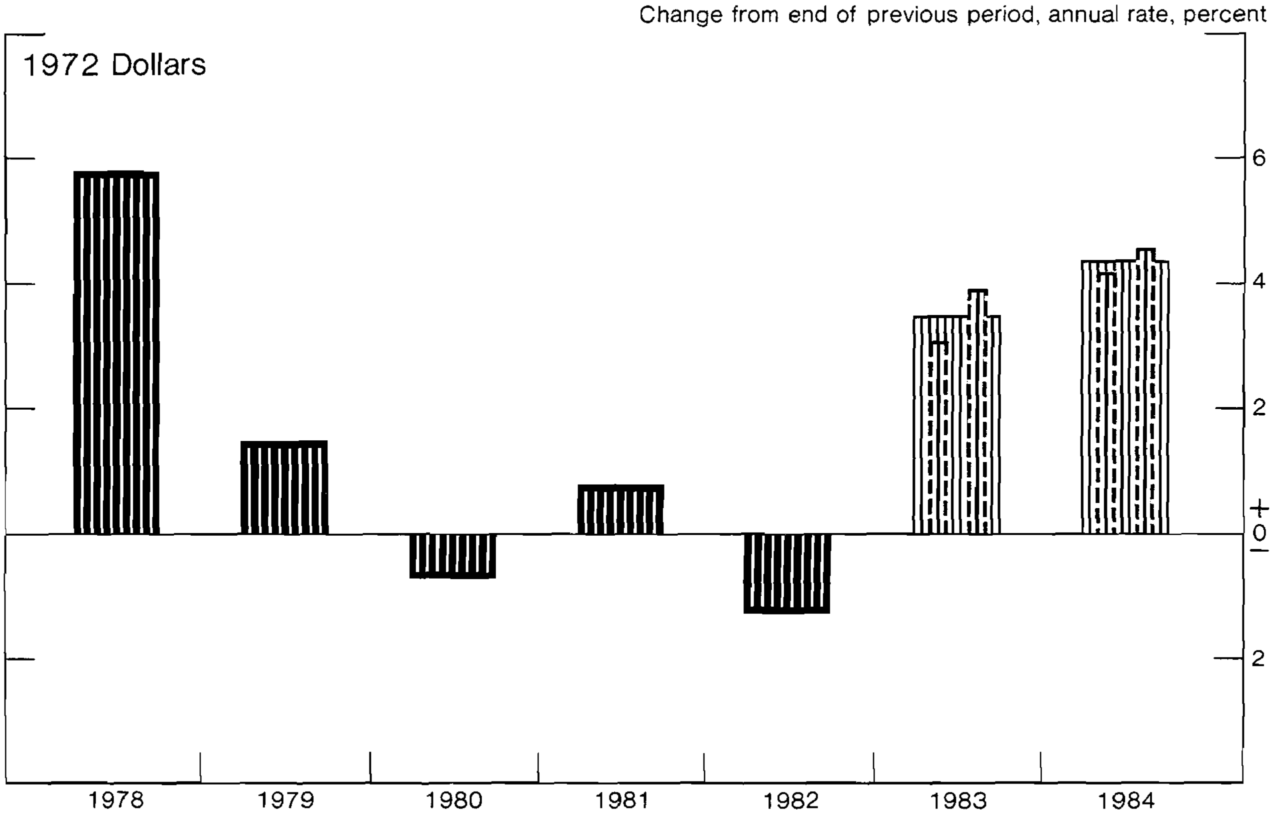
Nonfarm Payroll Employment



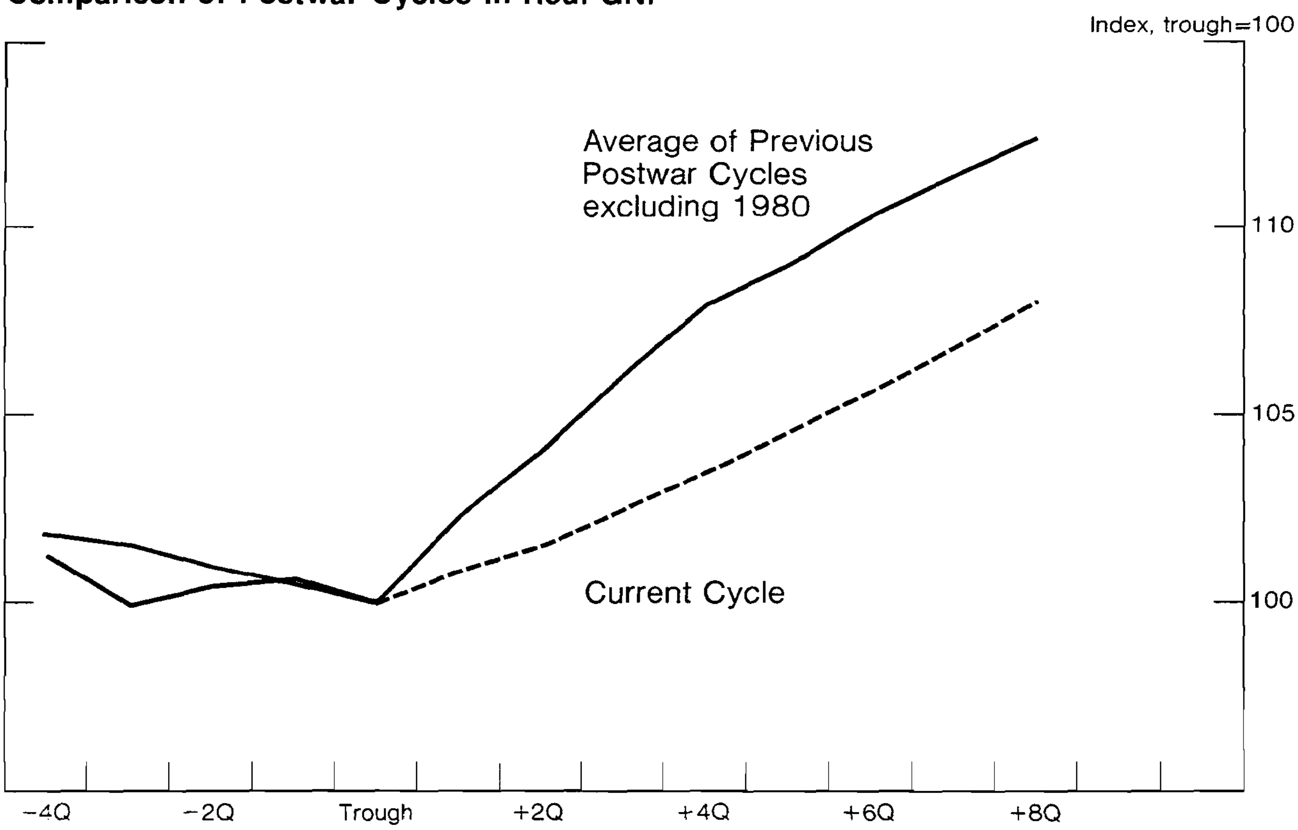
Manufacturing Work Week



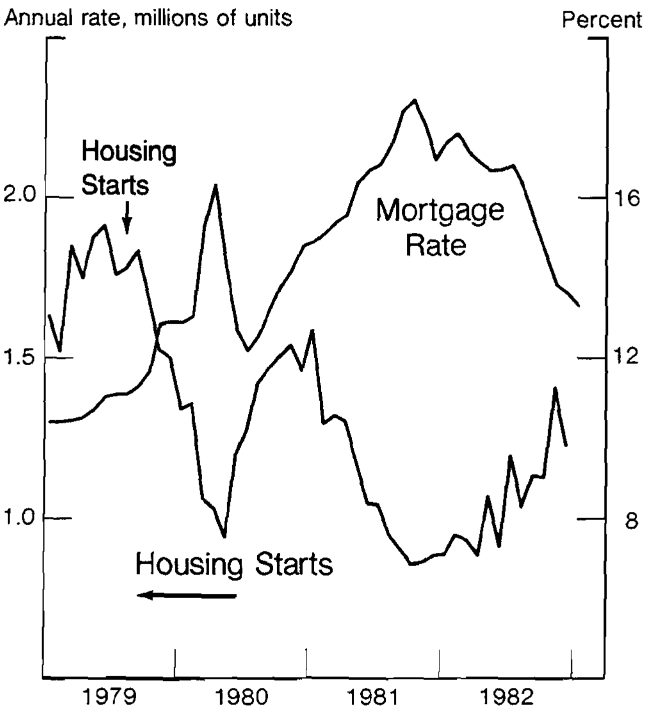
Real GNP



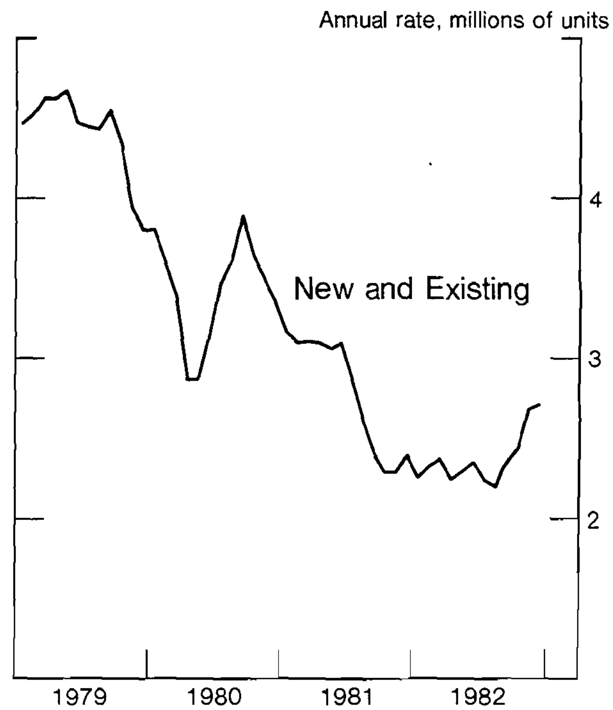
Comparison of Postwar Cycles in Real GNP



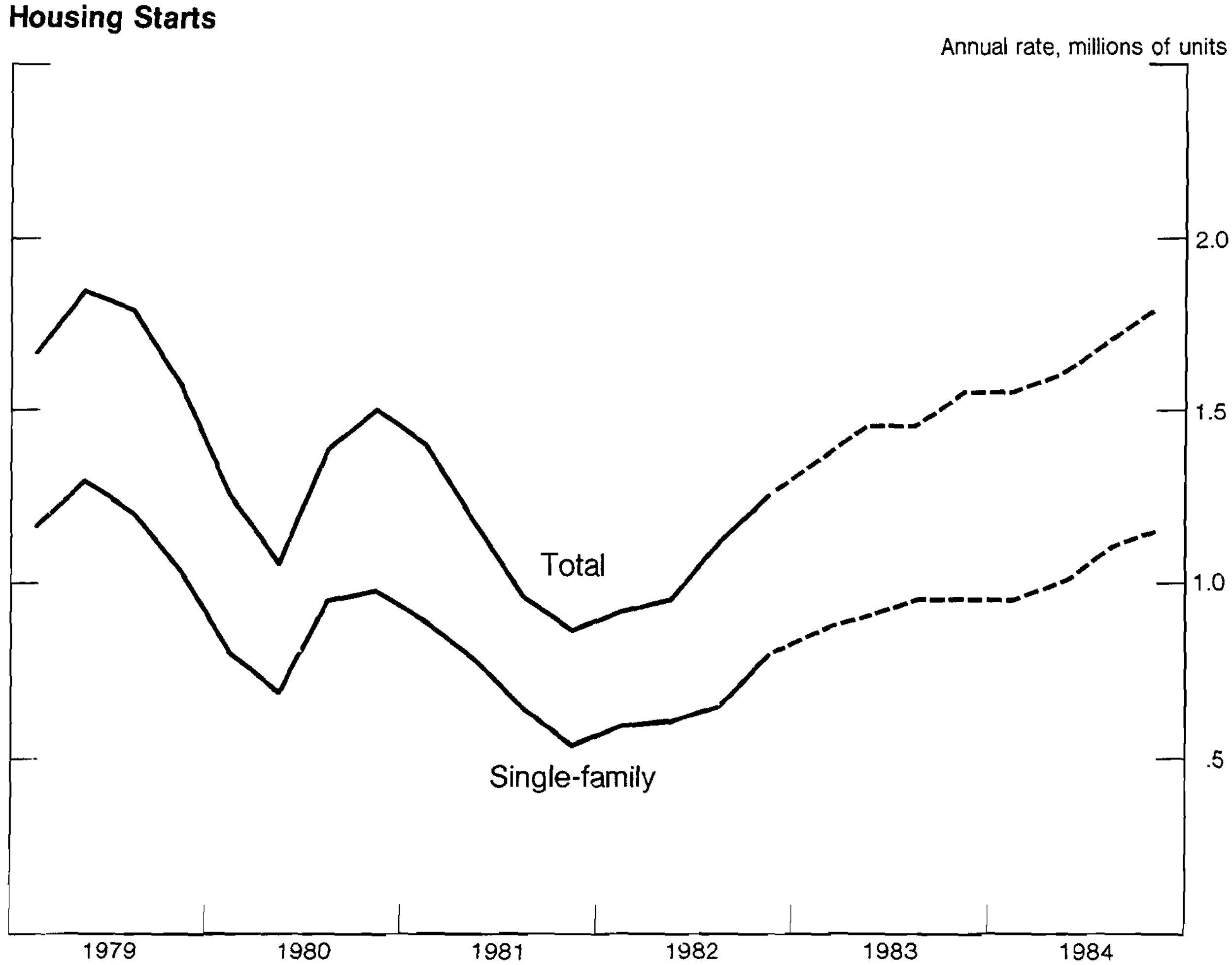
Housing Starts and Home Mortgage Rate



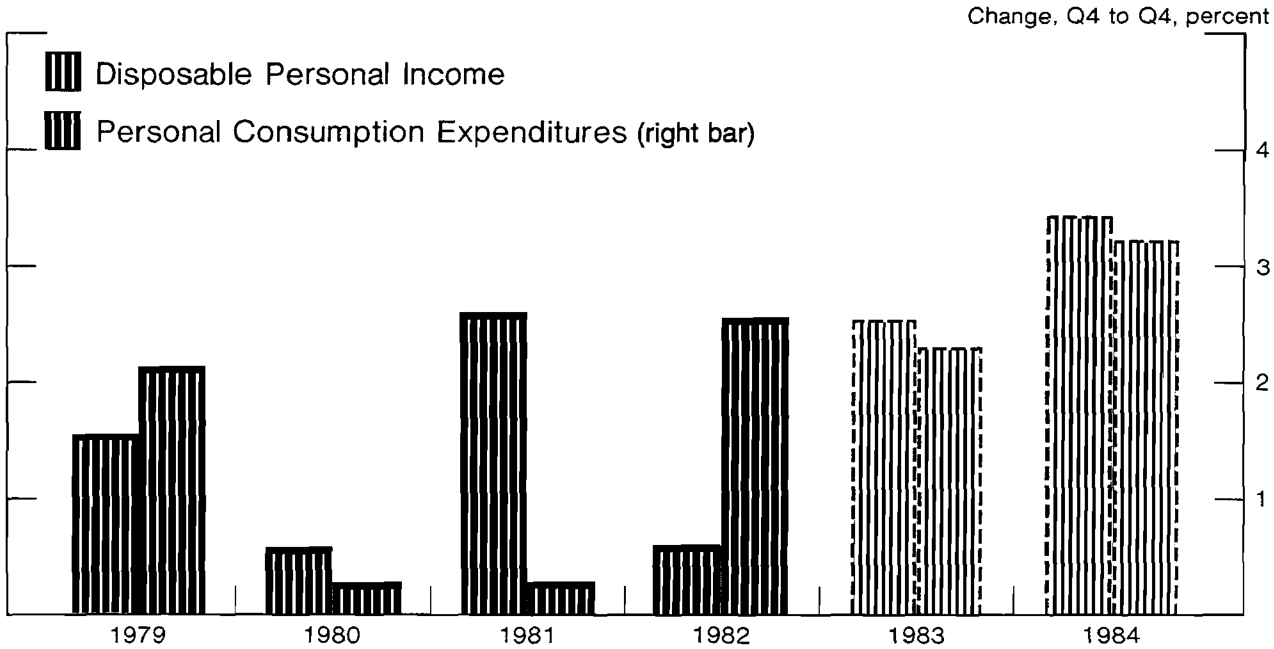
Homes Sold



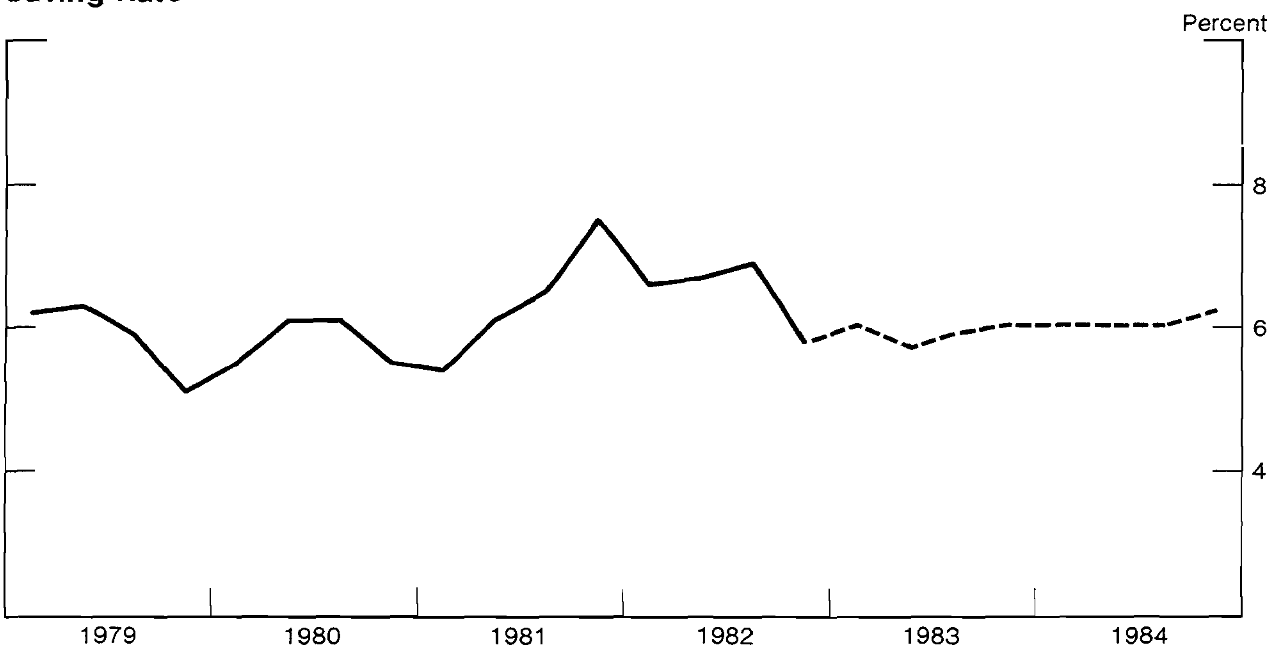
Housing Starts



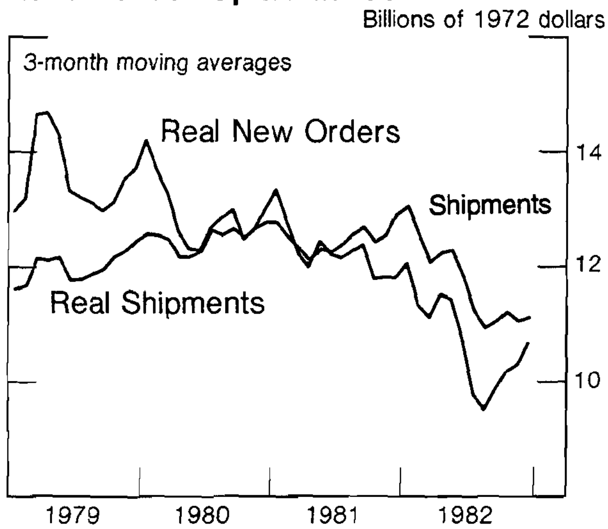
Real Income and Spending



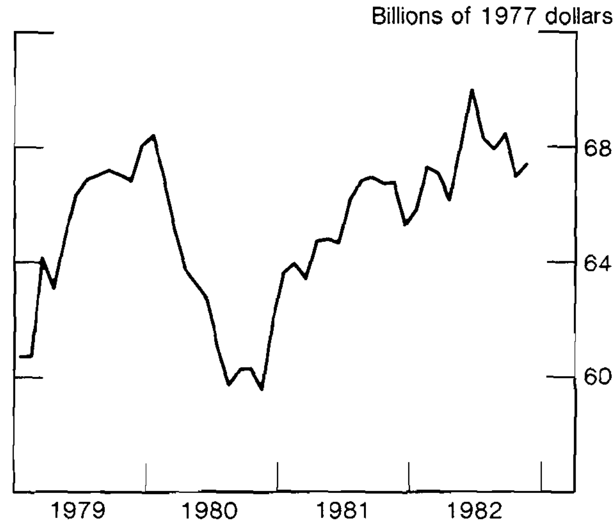
Saving Rate



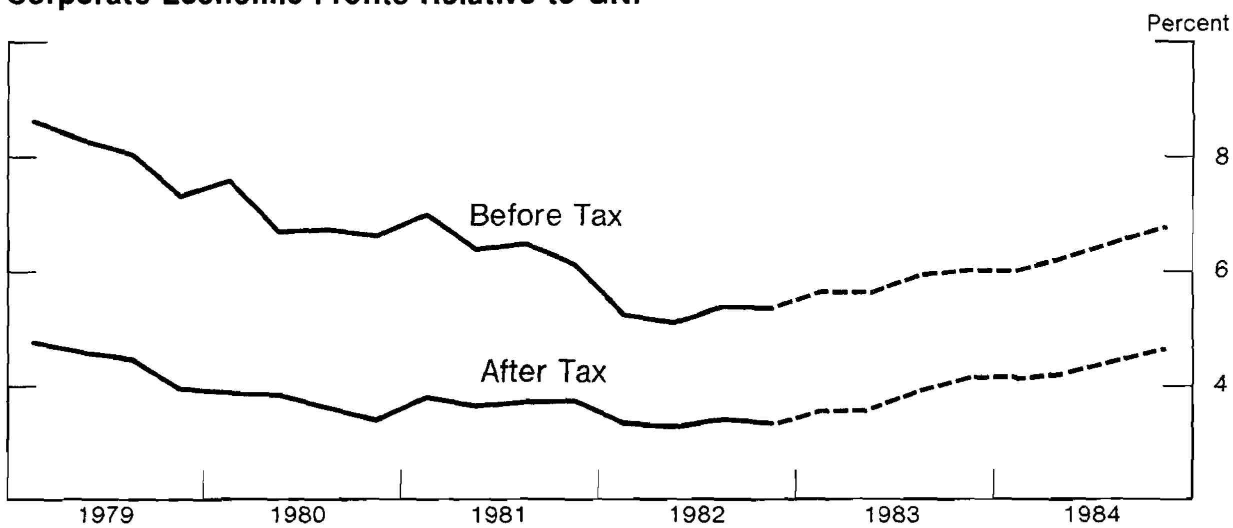
Nondefense Capital Goods



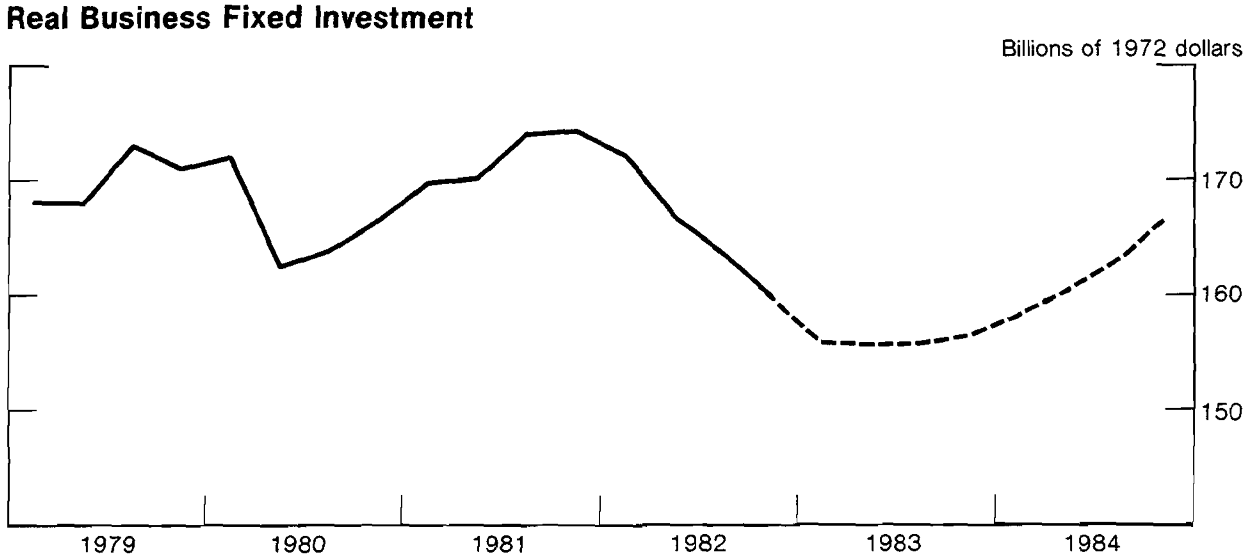
Value of New Nonresidential Construction Put in Place



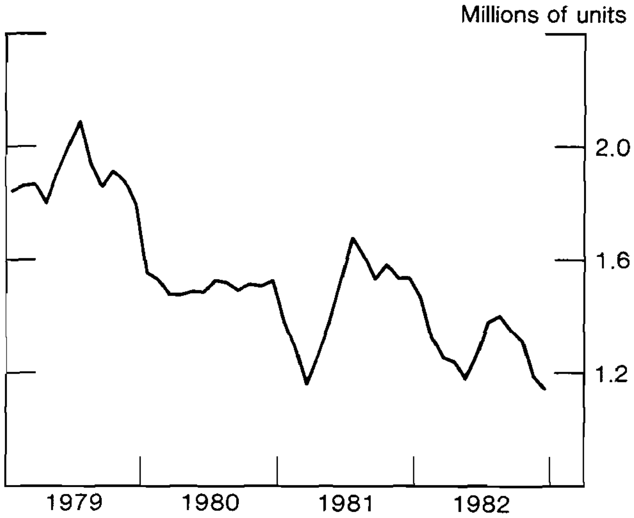
Corporate Economic Profits Relative to GNP



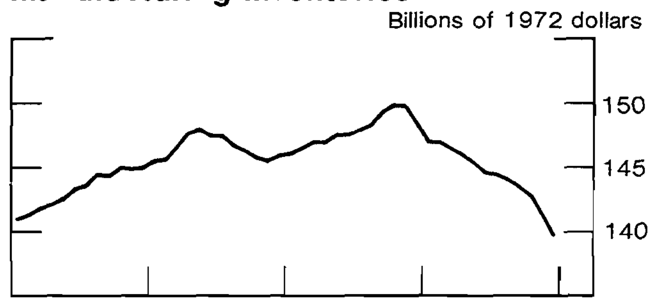
Real Business Fixed Investment



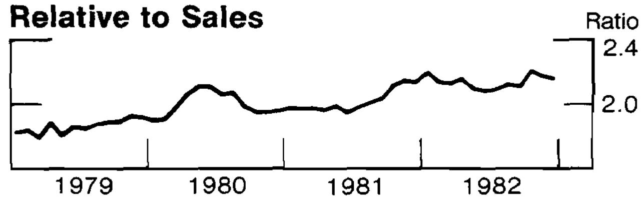
Domestic Auto Inventories



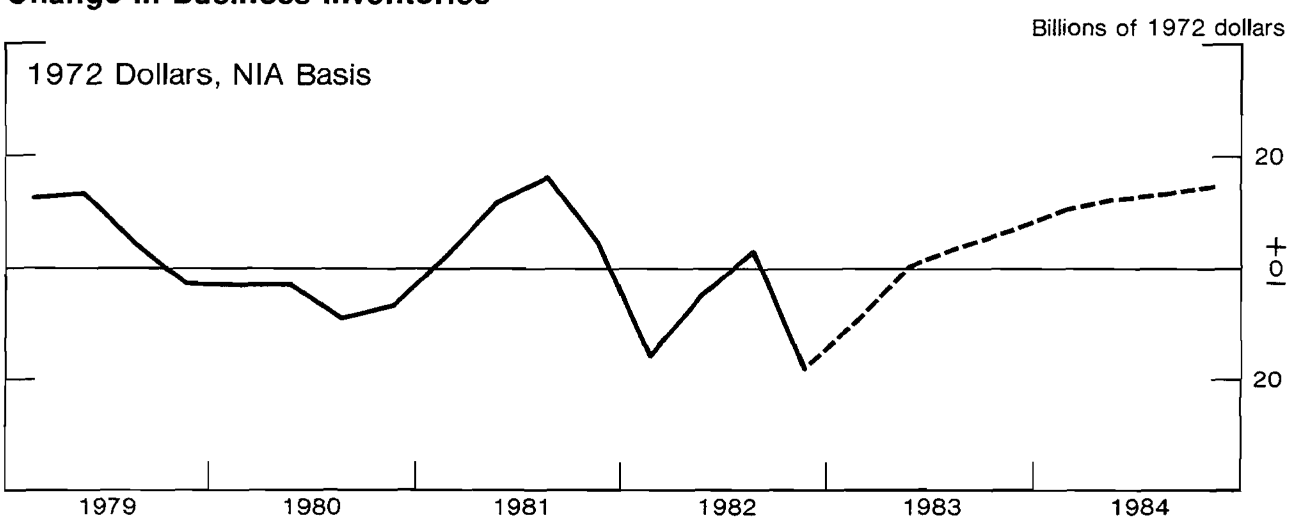
Manufacturing Inventories



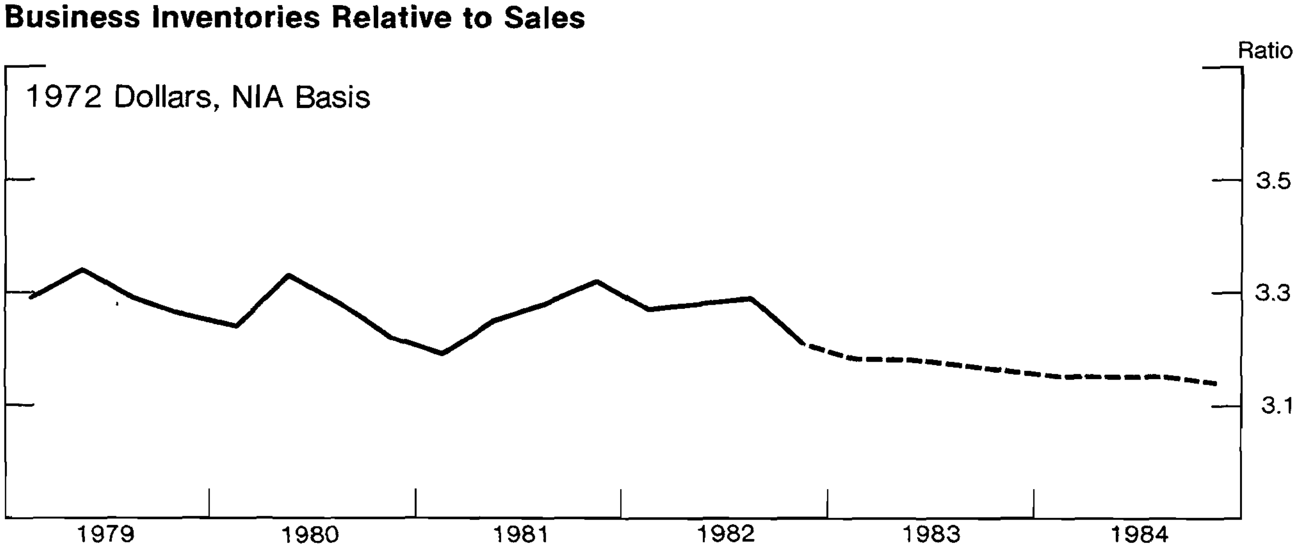
Relative to Sales



Change In Business Inventories

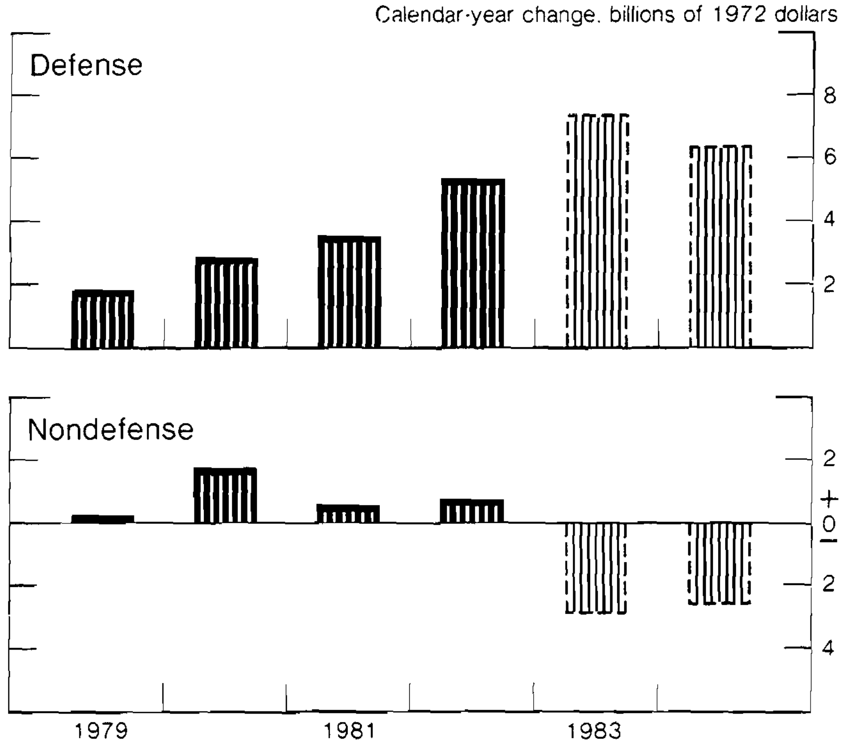


Business Inventories Relative to Sales



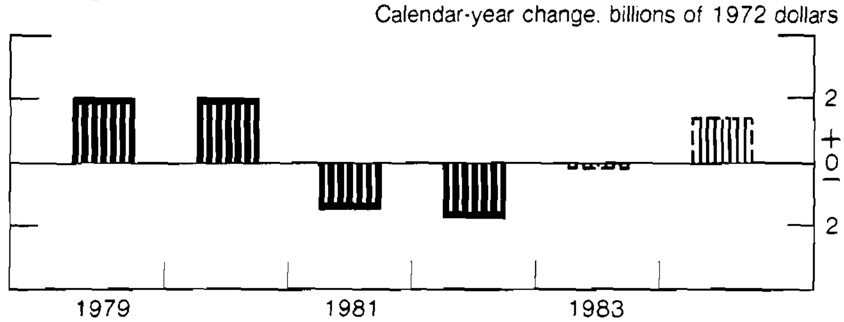
Change in Real Federal Government Purchases

Calendar-year change, billions of 1972 dollars



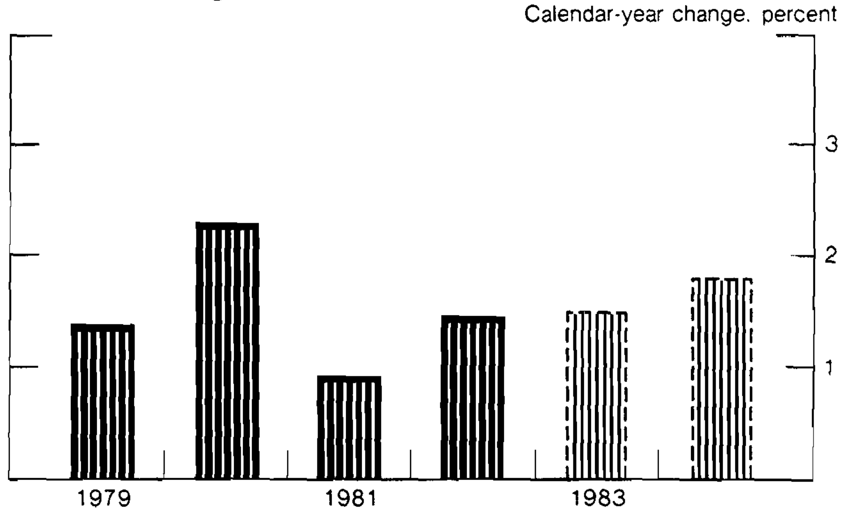
Change in Real State and Local Government Purchases

Calendar-year change, billions of 1972 dollars

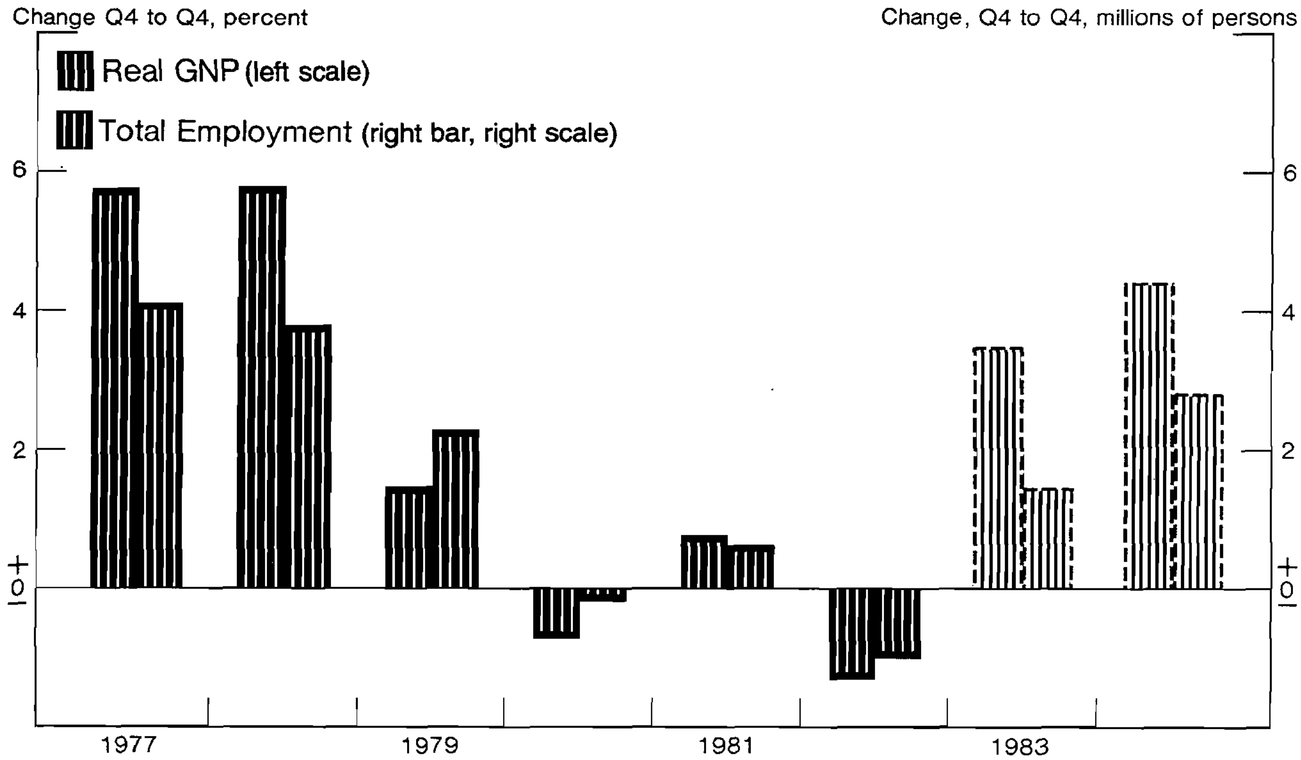


Percent Change in Real Total Government Purchases

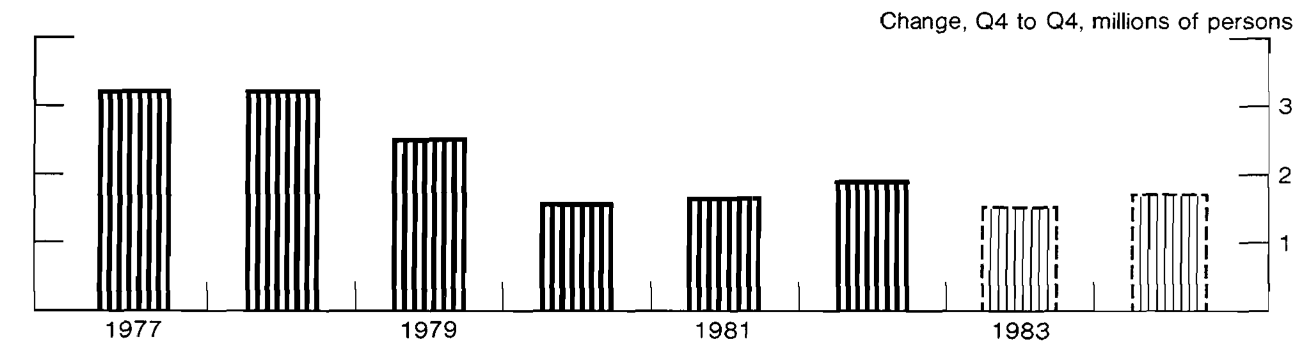
Calendar-year change, percent



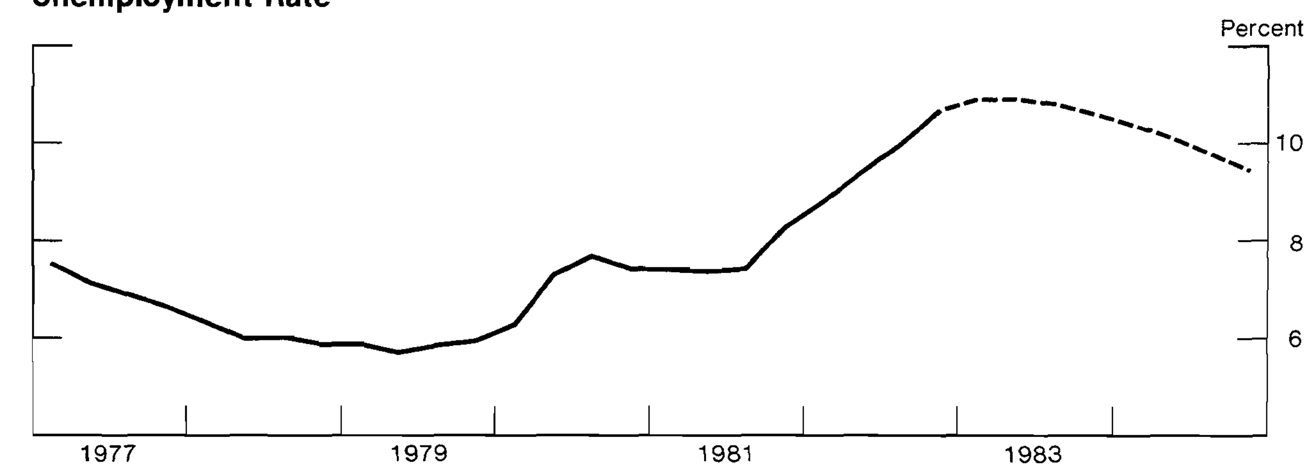
Total Employment and Real GNP



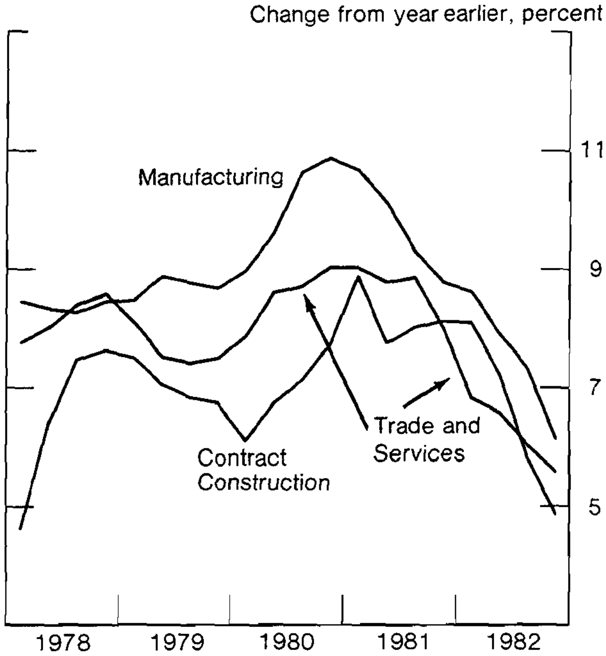
Civilian Labor Force



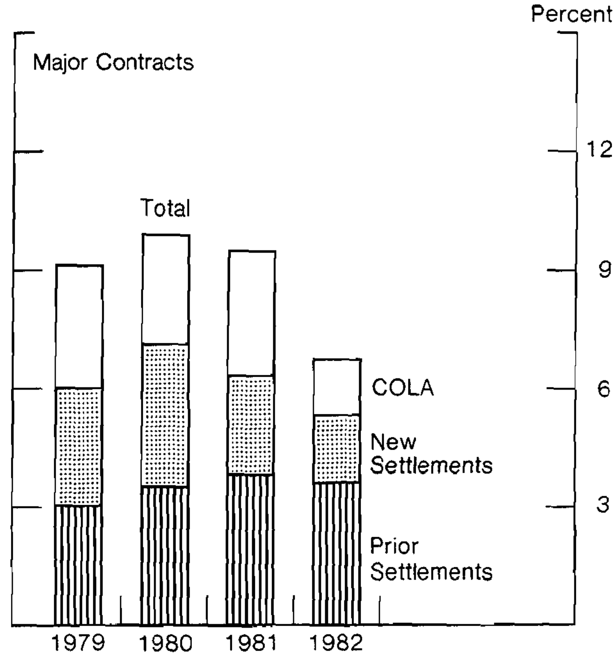
Unemployment Rate



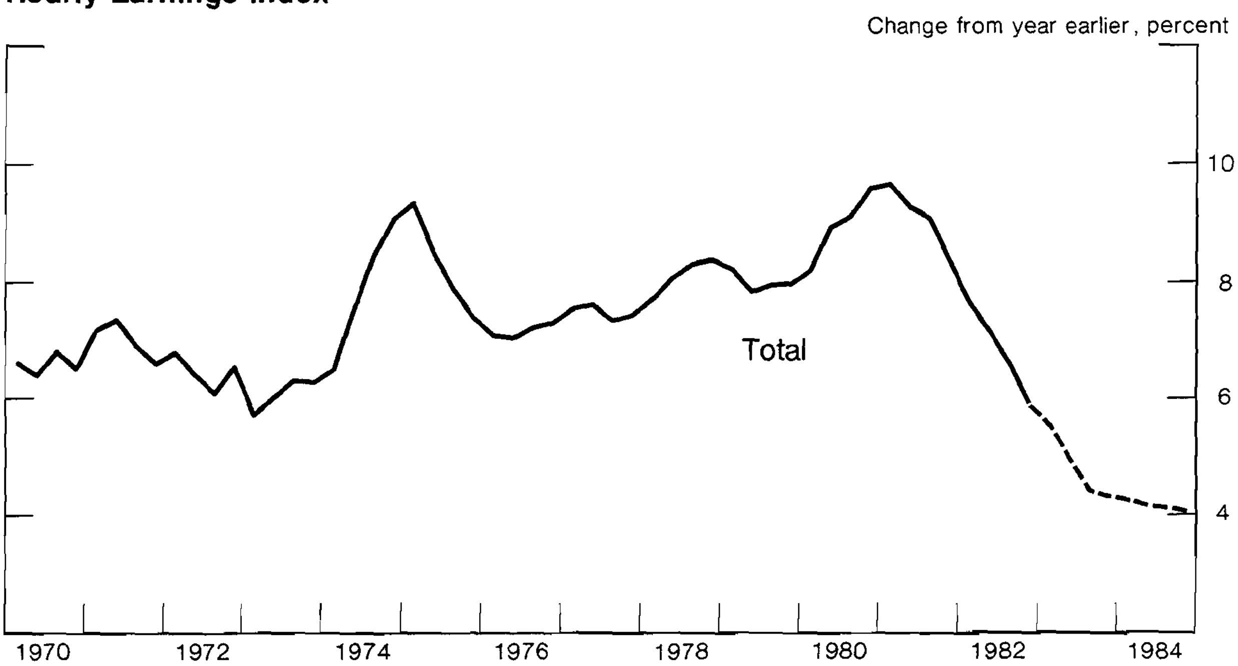
Hourly Earnings Index



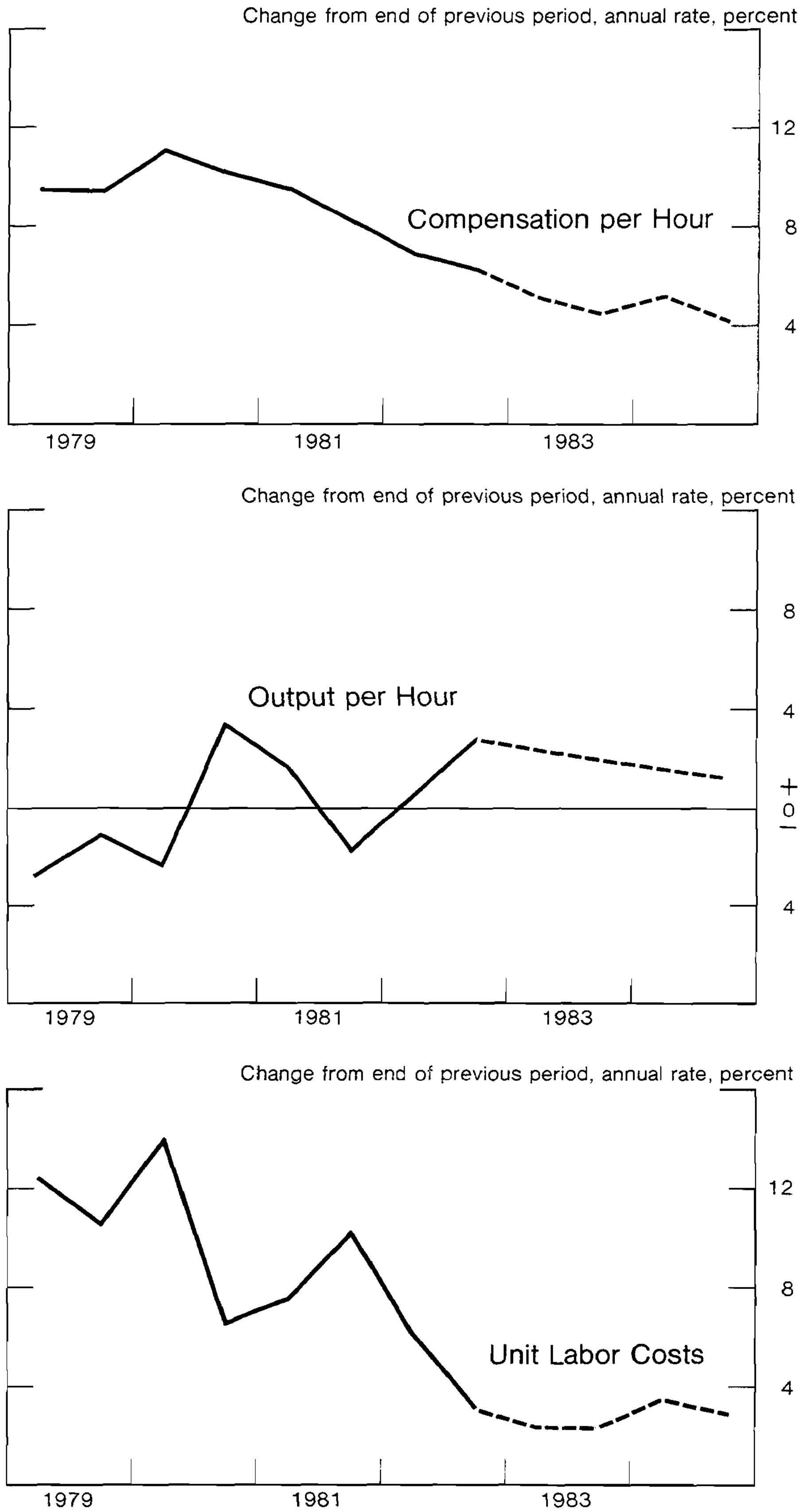
Union Wage Changes

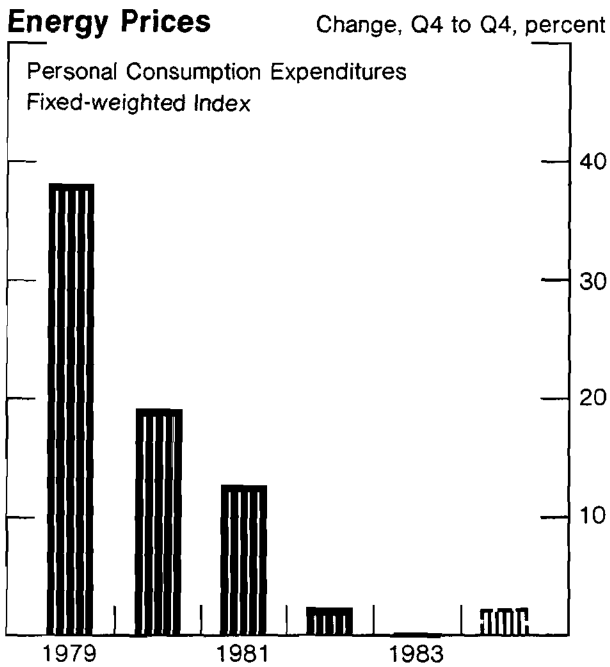


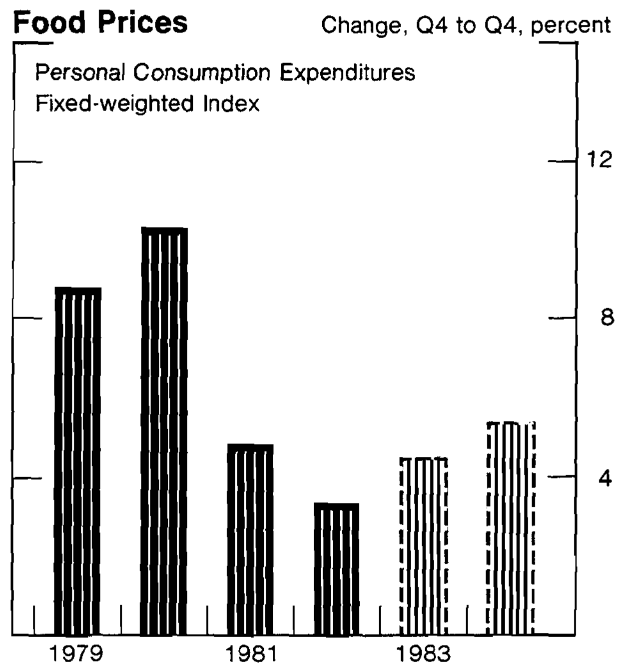
Hourly Earnings Index

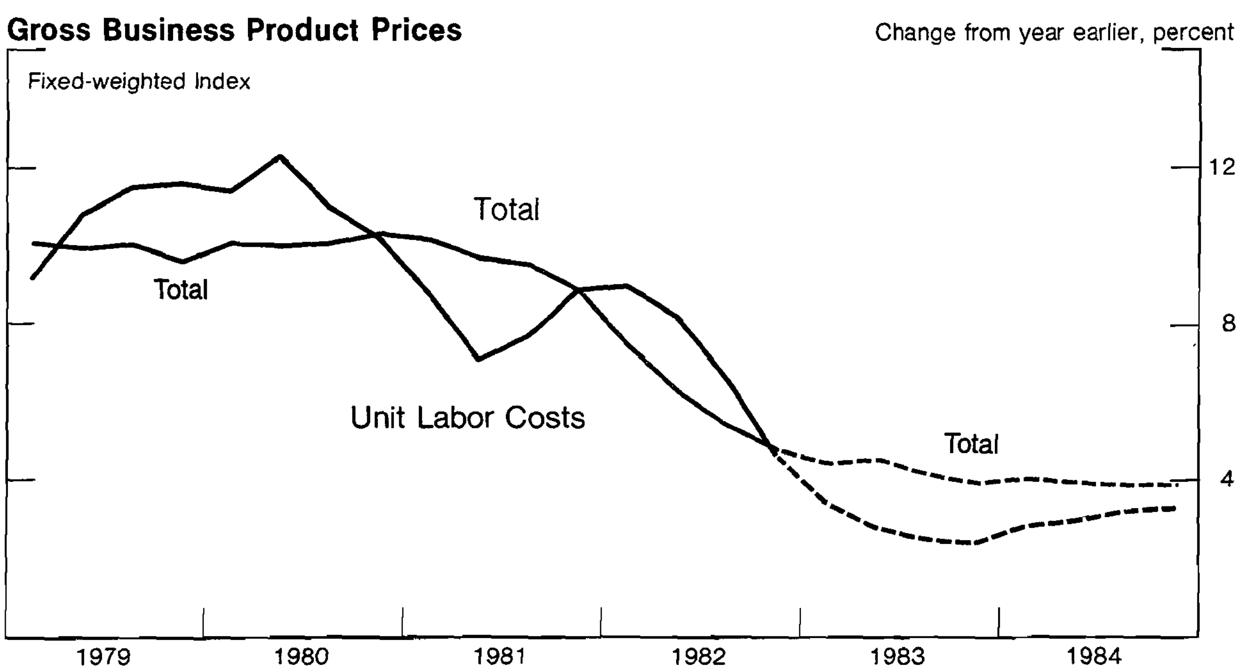


Unit Cost Indicators
Nonfarm Business Sector



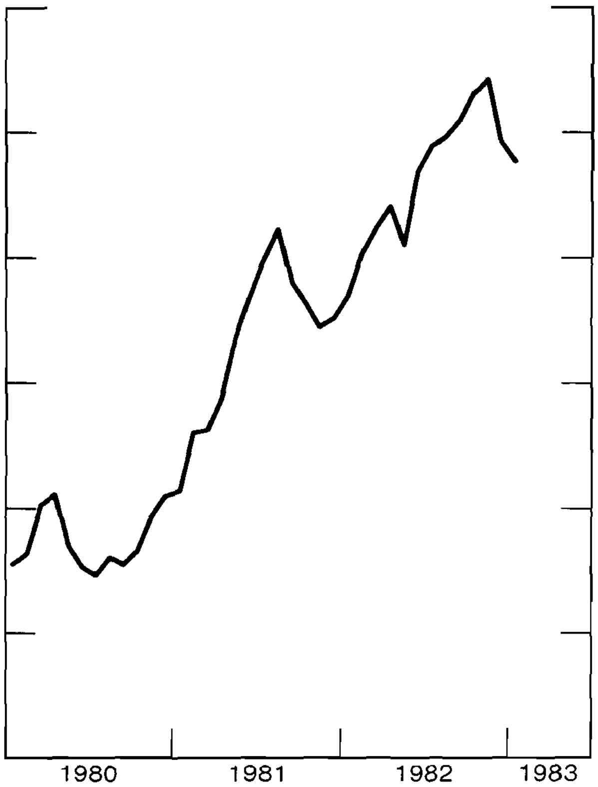

Energy Prices
Change, Q4 to Q4, percent
Personal Consumption Expenditures
Fixed-weighted Index
40
30
20
10
1979
1981
1983


Food Prices
Change, Q4 to Q4, percent
Personal Consumption Expenditures
Fixed-weighted Index
12
8
4
1979
1981
1983


Gross Business Product Prices
Change from year earlier, percent
Fixed-weighted Index
Total
Total
Unit Labor Costs
Total
12
8
4
1979
1980
1981
1982
1983
1984

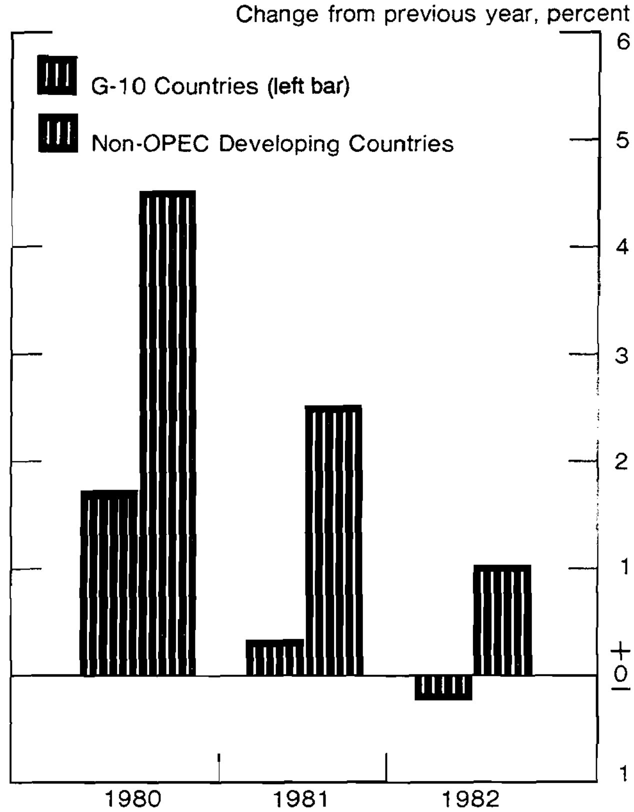
Foreign Exchange Value of the U.S. Dollar *

March 1973=100



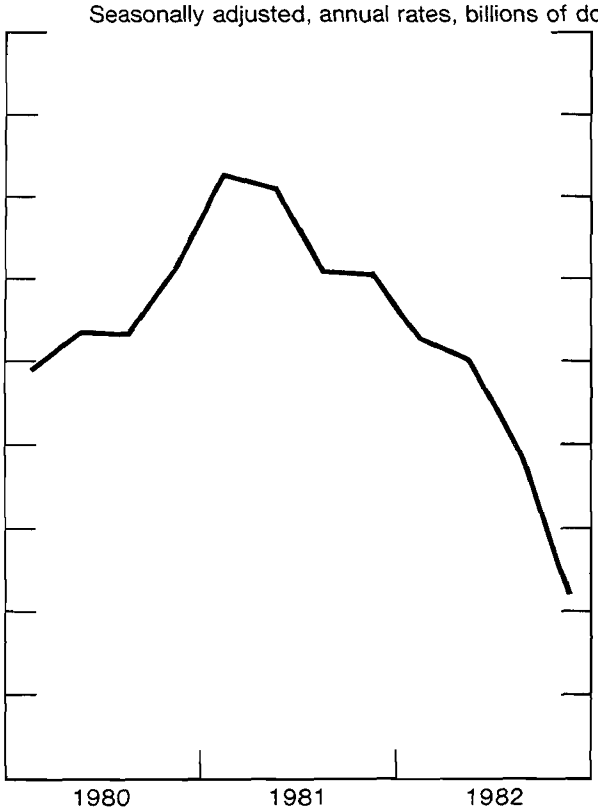
Foreign GNP Growth

Change from previous year, percent



U.S. Merchandise Exports

Seasonally adjusted, annual rates, billions of dollars



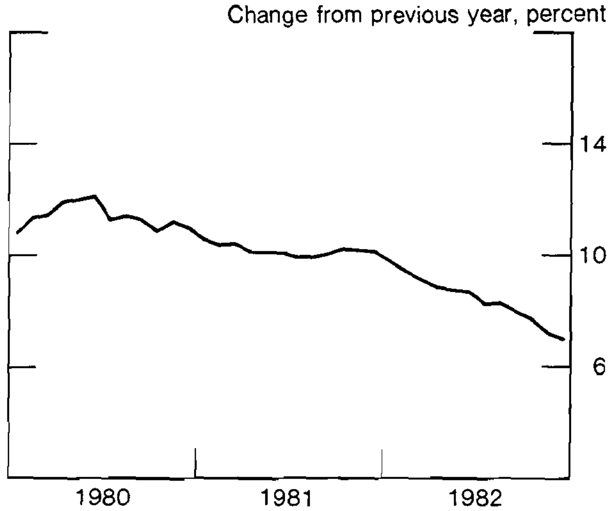
Components of the Export Decline between 1981 Q1 and 1982 Q4

Billions of dollars

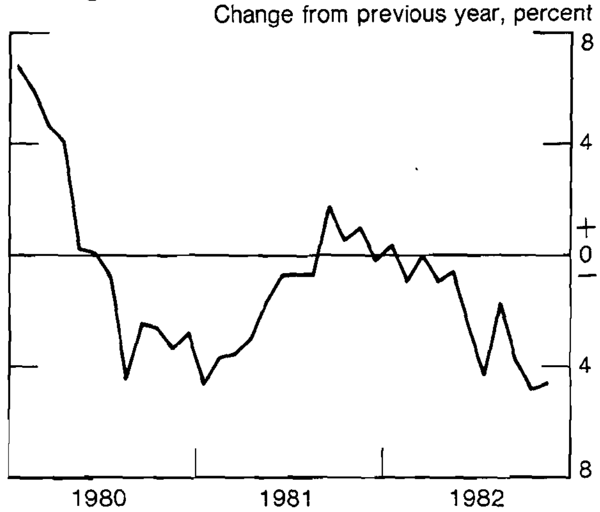
By Area		By Commodity	
Total	**—50**	**Total**	**—50**
Developed	—21	Agricultural	—18
OPEC	—1	Nonagricultural	—32
Non-OPEC Developing Countries	—22	Of which:	
		Industrial Supplies	—12
		Machinery	—7
Other	—5	Aircraft	—5

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

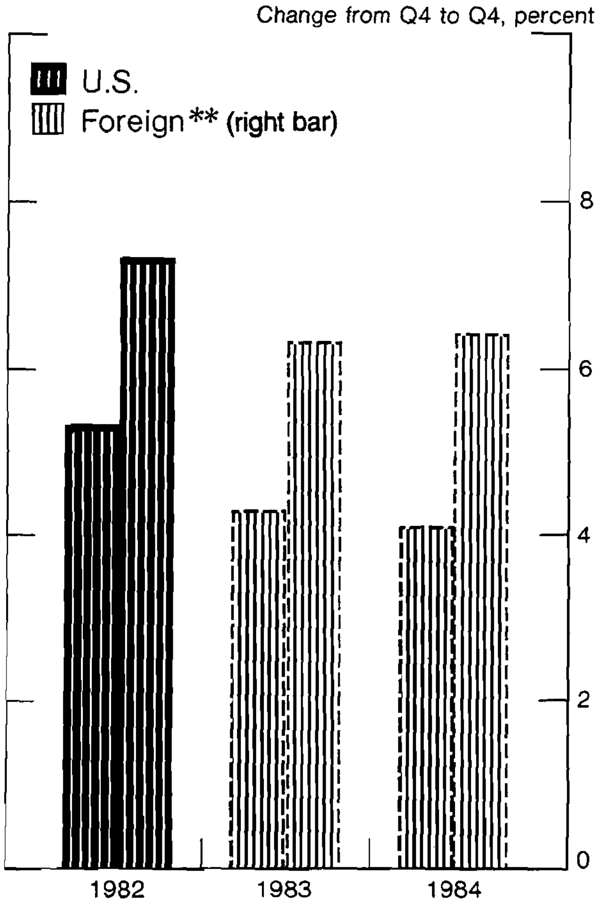
Foreign Consumer Prices*



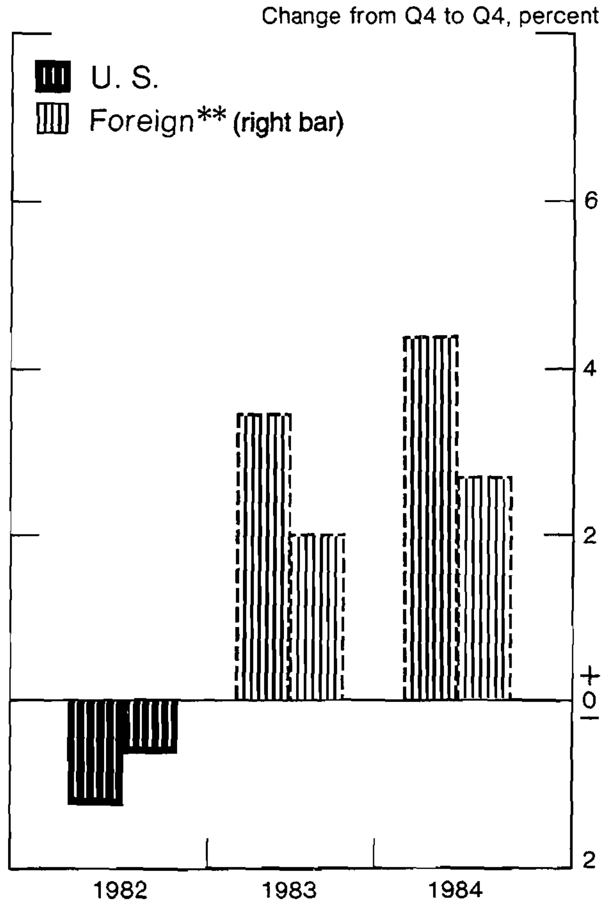
Foreign Industrial Production*



Consumer Prices



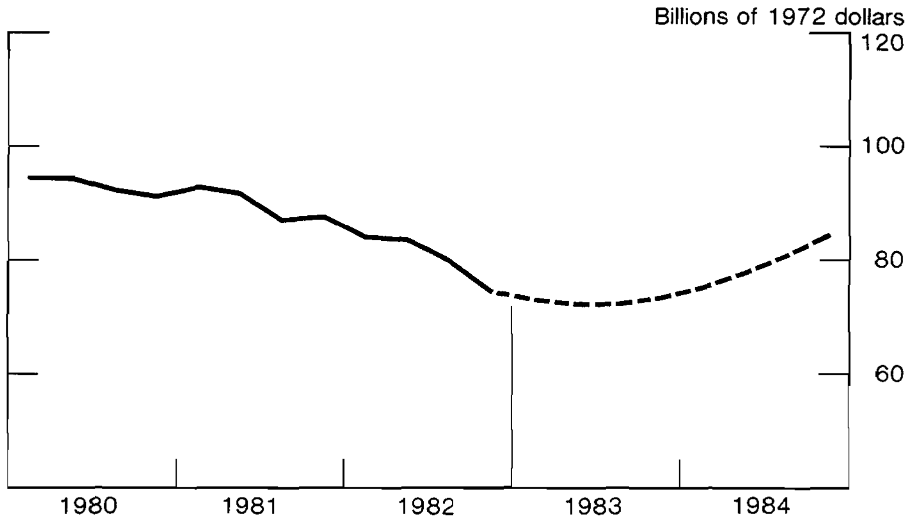
Real GNP



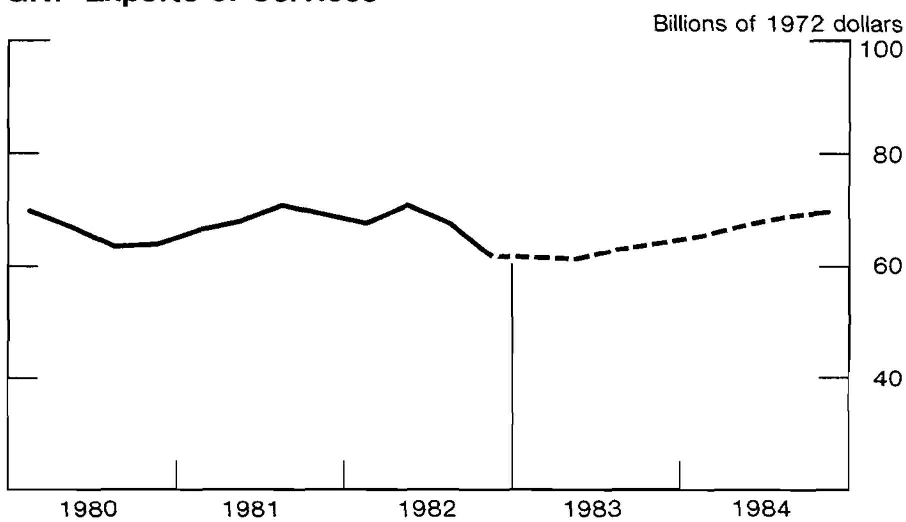
* Weighted average of six major foreign countries using total 1972-76 average trade of these countries.

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

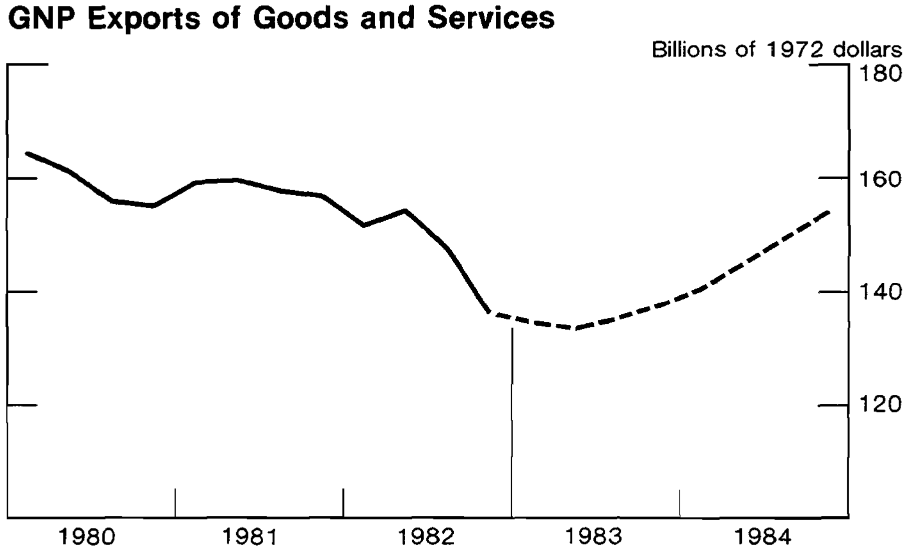
GNP Exports of Merchandise



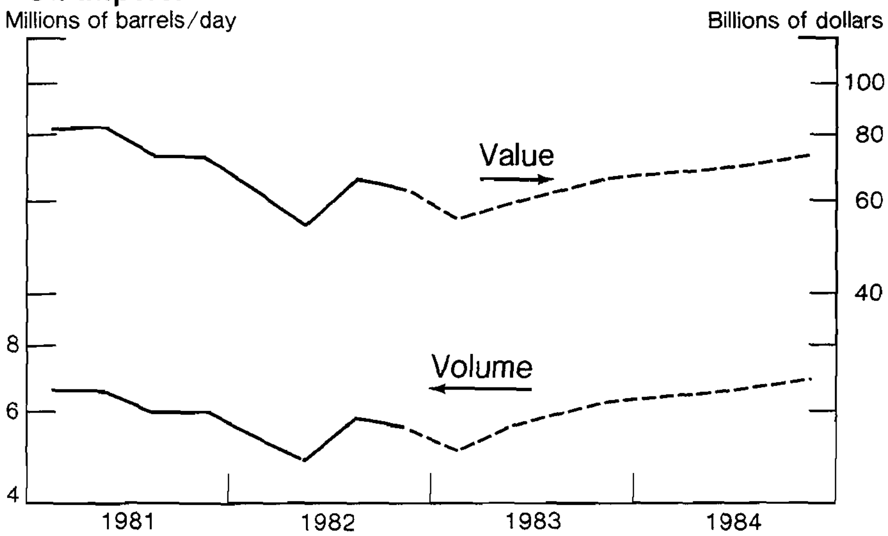
GNP Exports of Services



GNP Exports of Goods and Services



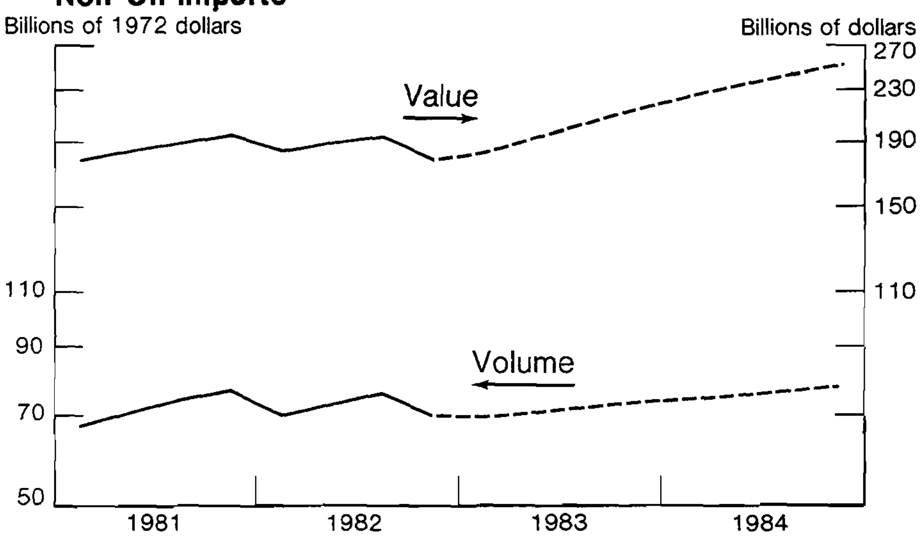
Oil Imports



Average Price of Imported Oil

1981	$34.00
1982	31.25
Projection	
1983	29.30
1984	29.00

Non-Oil Imports

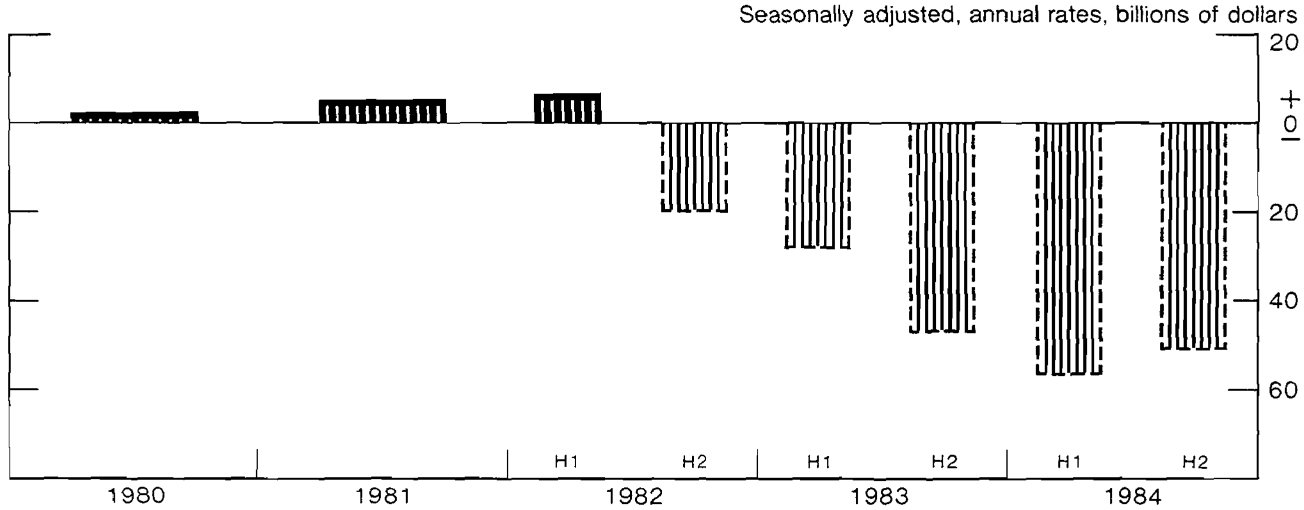


Billions of dollars

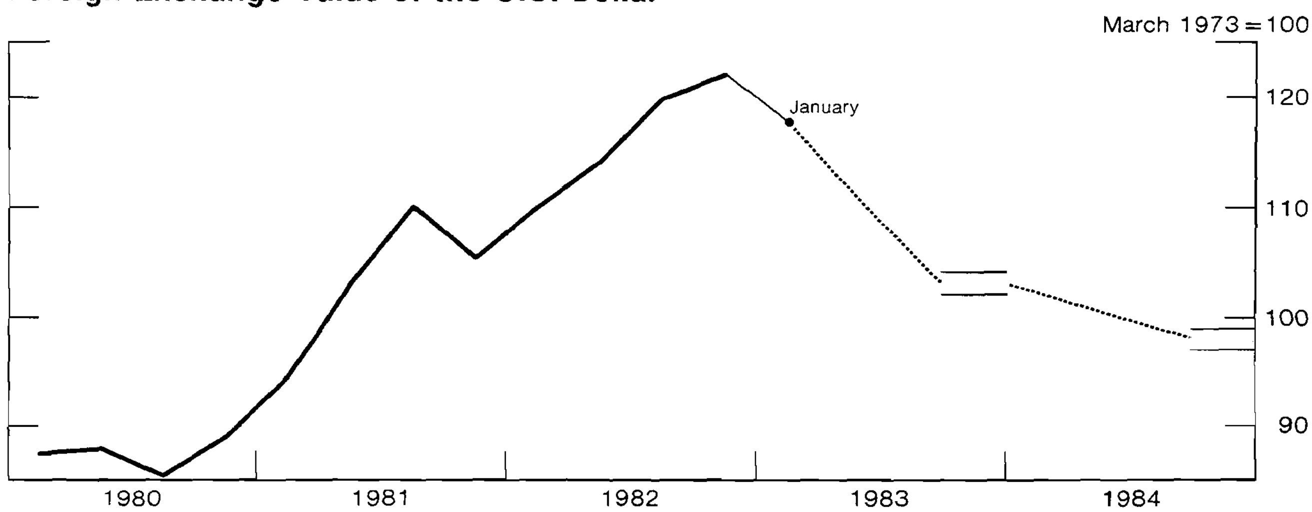
	1981	**1982**	**1983**[p]	**1984**[p]
Imports, Goods	264	247	259	307
Exports, Goods	236	211	193	225
Trade Balance	—28	—36	—66	—82
Services, Net	39	37[e]	38	39
Unilateral Transfers	—7	—8[e]	—9	—11
Current Account Balance	5	—7[e]	—37	—54

[e] *Fourth quarter is estimated.*
[p] Projection

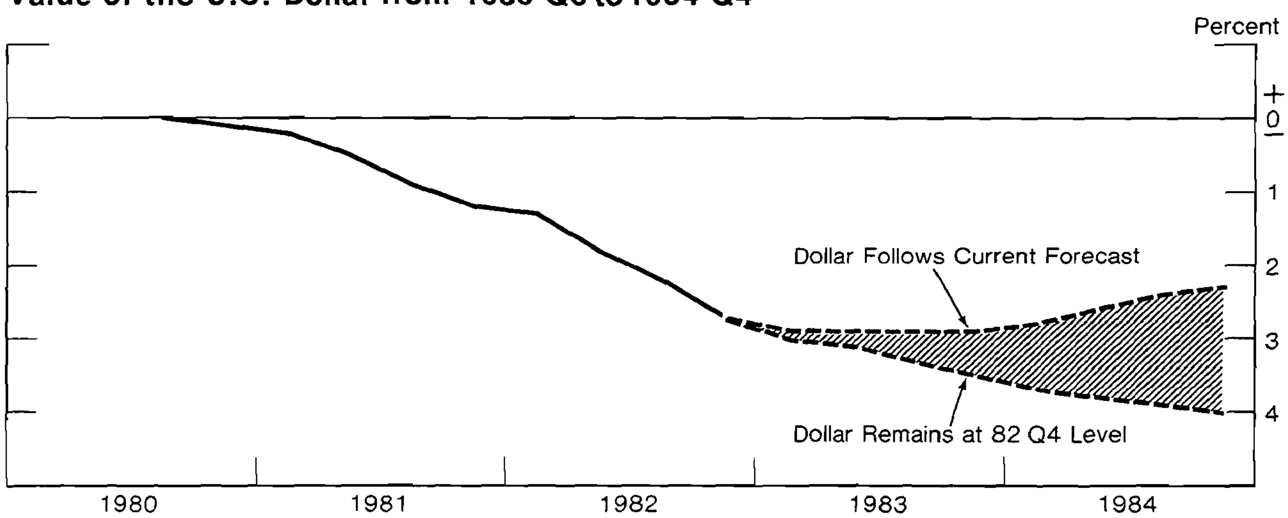
Current Account Balance



Foreign Exchange Value of the U.S. Dollar



Hypothetical Impact on Price Level of Changes in the Foreign Exchange Value of the U.S. Dollar from 1980 Q3 to 1984 Q4



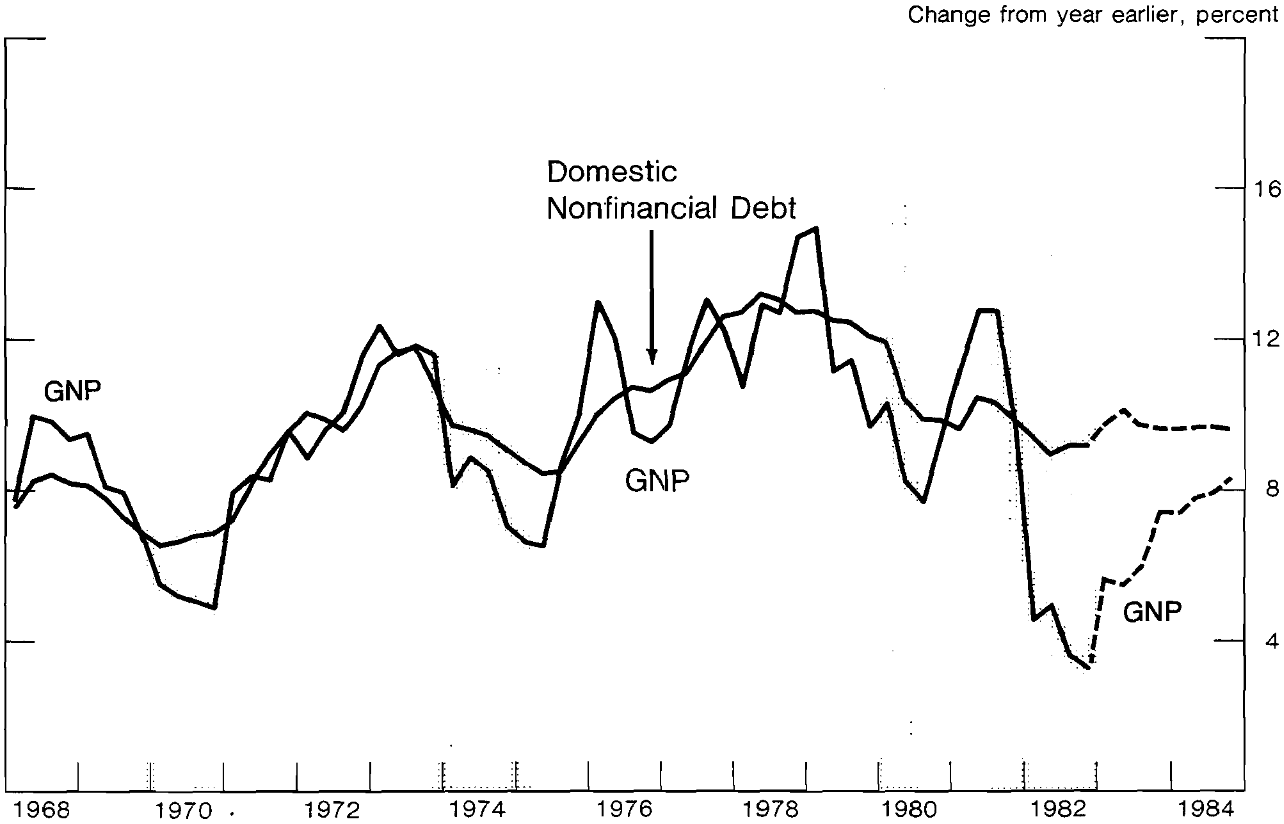
U.S. International Transactions

Billions of dollars

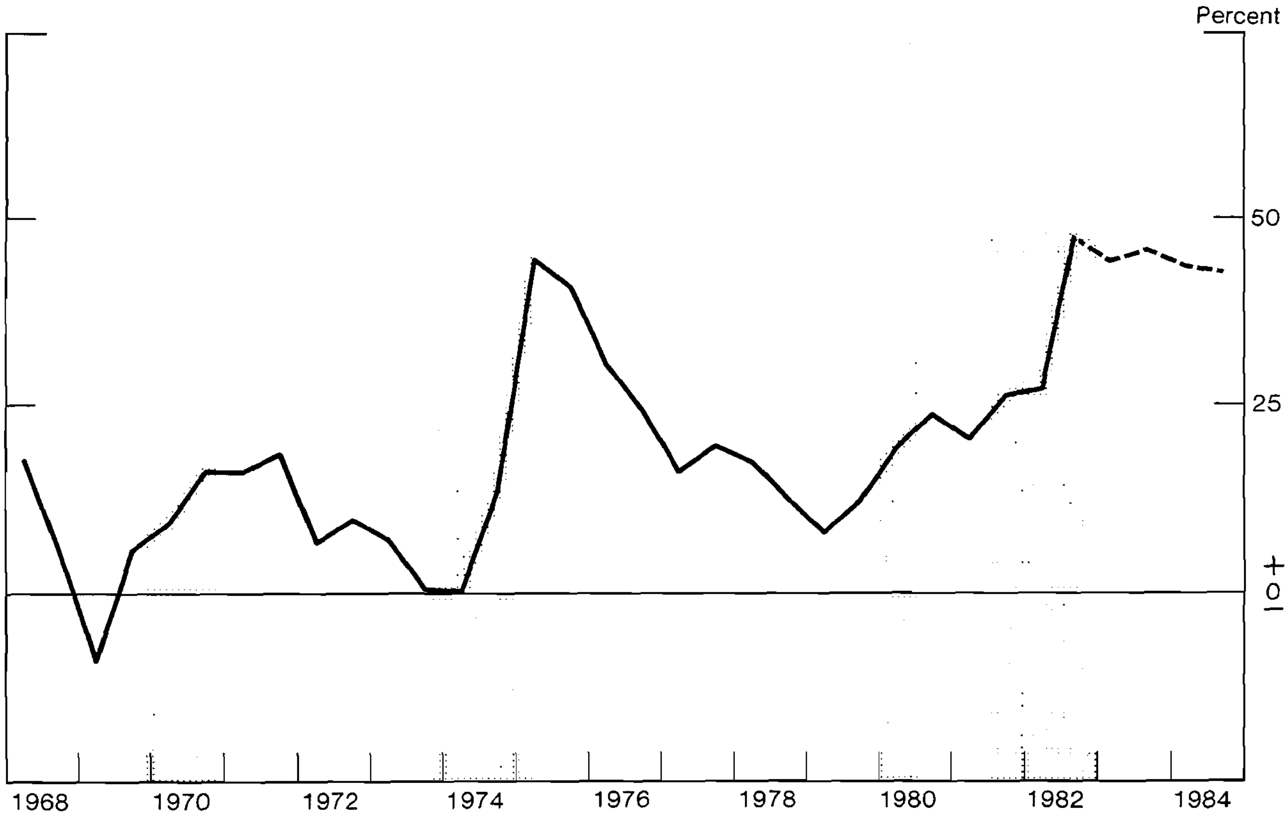
	1976	1977	1978	1979	1980	1981	1982*	1983P	1984P
1. Current account	**4.4**	**—14.1**	**—14.8**	**—0.5**	**1.5**	**4.5**	**—7**	**—37**	**—54**
less 2. Reinvested earnings, net	6.0	4.8	8.8	15.0	10.9	8.9	3.5	5	6
plus 3. Change in U.S. government assets**	—4.2	—3.7	—4.7	—3.7	—5.1	—5.1	—6.5	—6	—6
4. Statistical discrepancy	10.4	—2.5	11.9	25.2	28.9	25.8	30	25	25
5. Subtotal	**4.5**	**—25.1**	**—16.3**	**6.0**	**14.5**	**16.3**	**13**	**—23**	**—41**
6. Private capital	**—19.7**	**—11.4**	**—18.0**	**7.7**	**—23.0**	**—17.0**	**—11**		
a. U.S. assets abroad	—36.8	—24.3	—45.9	—40.5	—55.9	—86.0	—115		
b. Foreign assets in the U.S.	17.1	12.9	27.8	48.2	32.8	69.0	104		
7. Official capital	**15.1**	**36.4**	**34.4**	**—13.7**	**8.4**	**0.7**	**—2**		
a. U.S. assets abroad	—2.6	—0.4	0.7	0.0	—7.0	—4.1	—6		
b. Foreign assets in the U.S.	17.7	36.8	33.7	—13.7	15.4	4.8	4		

*Partially estimated.
**Other than U S. official reserve assets, line 7a.
P Projection

Aggregate Credit Flows

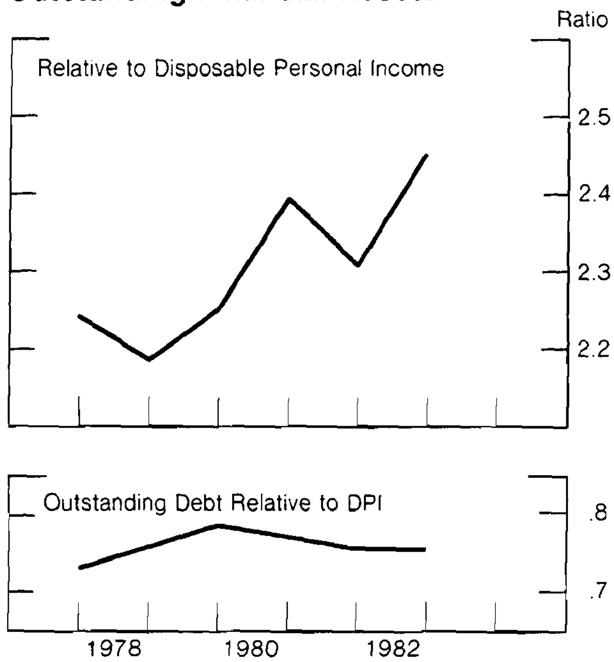


Federal Government Share of Total Credit Flows

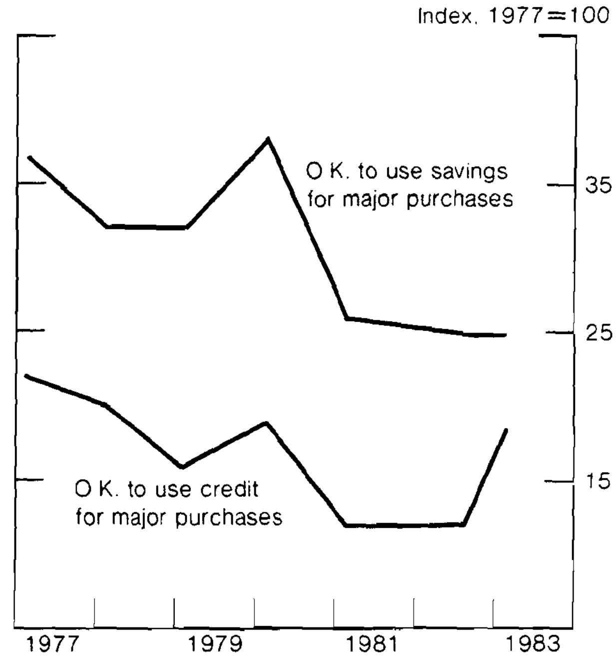


Households

Outstanding Financial Assets

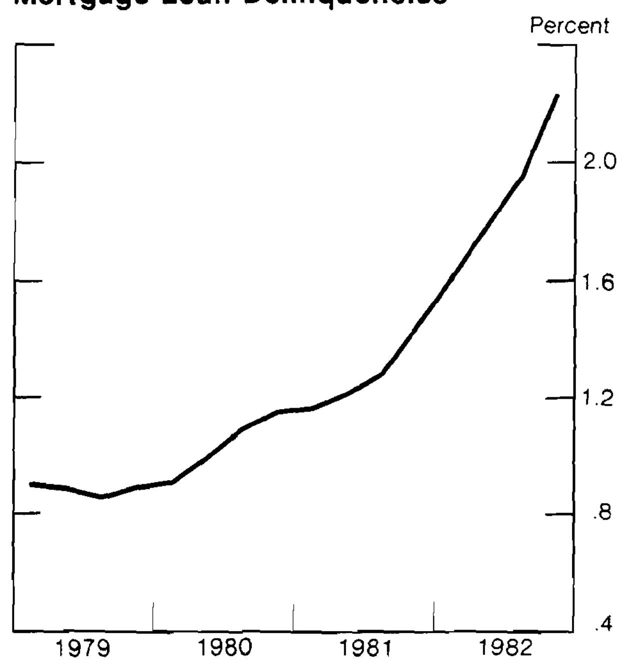


Consumer Attitudes



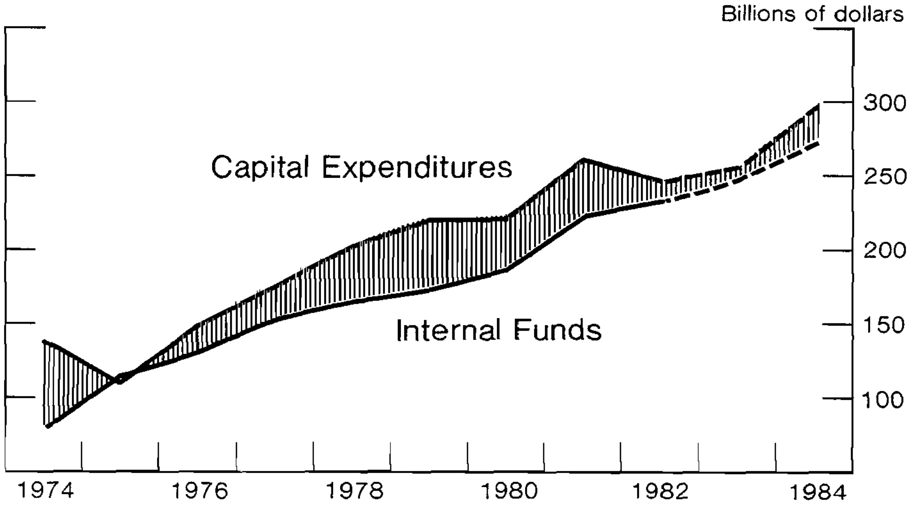
Consumer Loan Delinquencies

Mortgage Loan Delinquencies



Nonfinancial Corporations

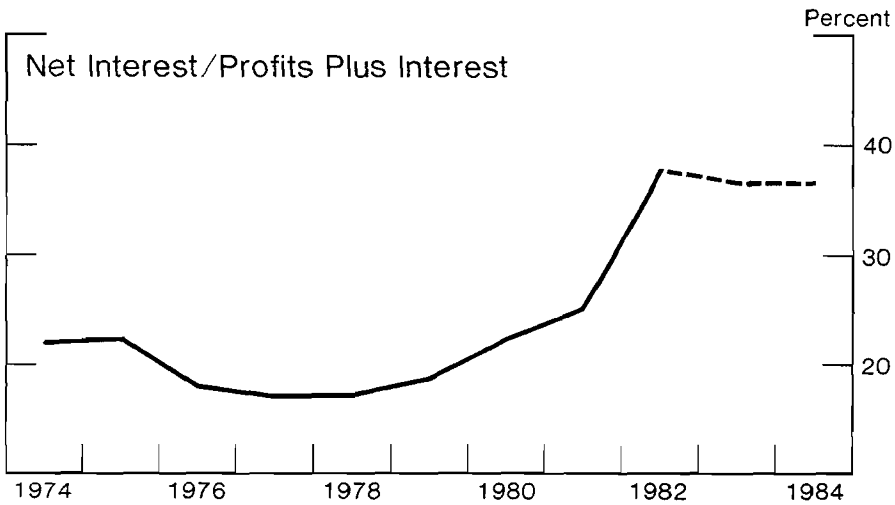
Financing Gap



Billions of dollars

	GAP
1982 Q1	12.4
Q2	20.0
Q3	28.3
Q4	—1.5

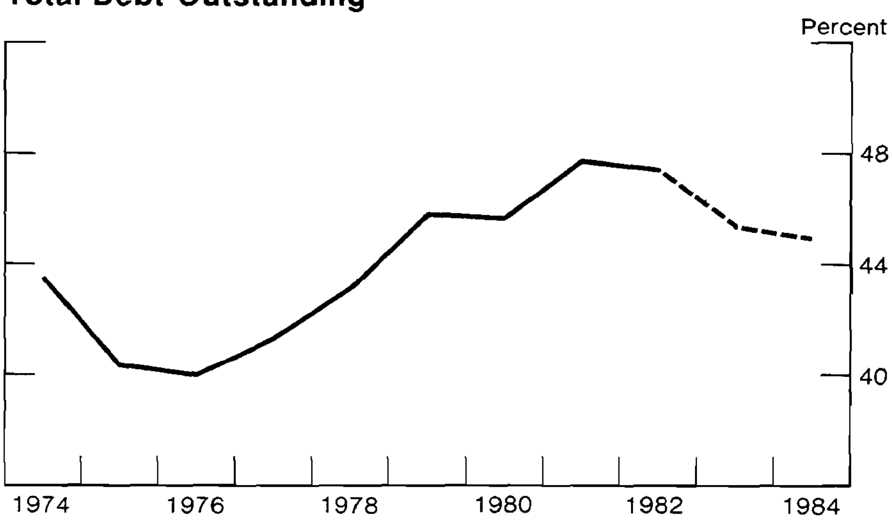
Interest Relative to Income



Percent

1982 Q1	37.3
Q2	38.4
Q3	37.0
Q4	37.2

Short-Term Debt Relative to Total Debt Outstanding

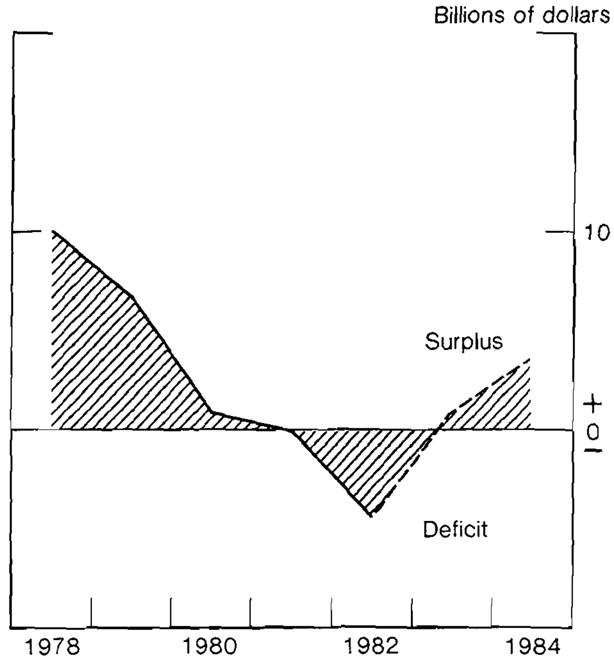


Percent

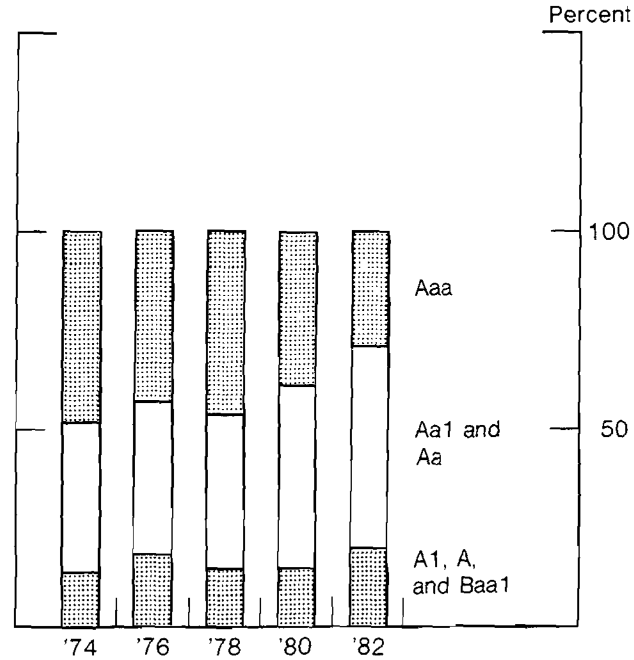
1982 Q1	48.4
Q2	48.6
Q3	48.6
Q4	47.5

State and Local Government

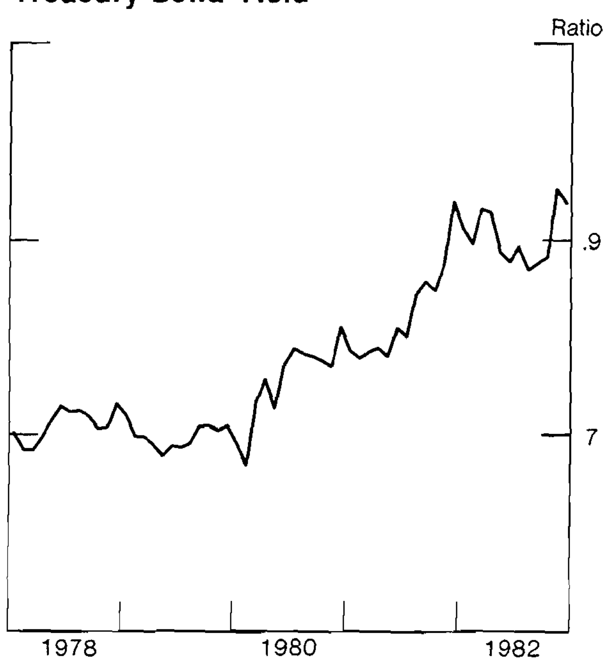
Operating Budget



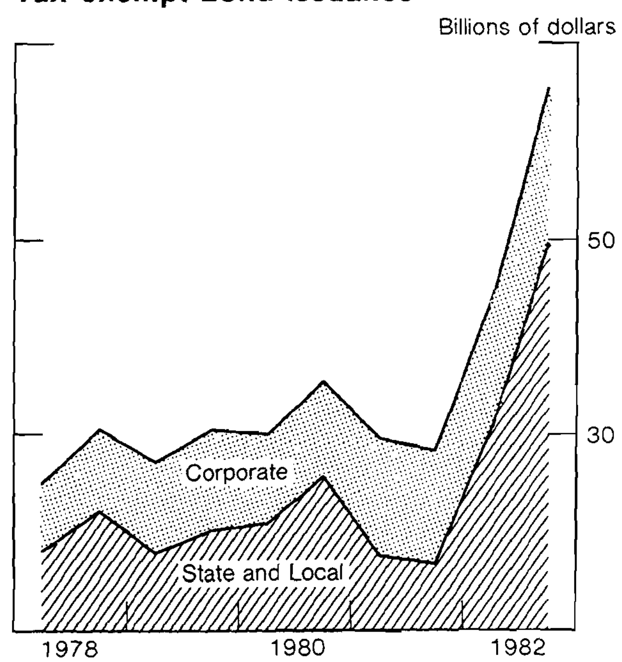
Ratings on State General Obligation Bonds



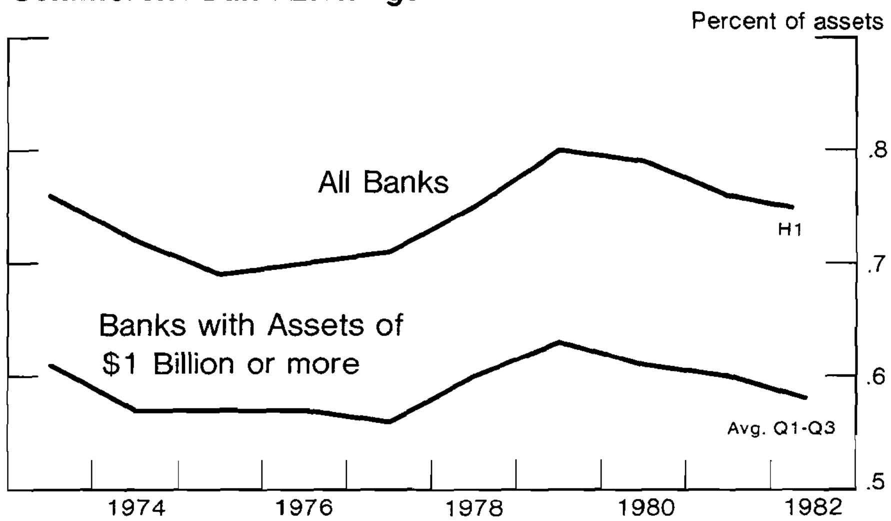
Municipal Bond Yield Relative to Treasury Bond Yield



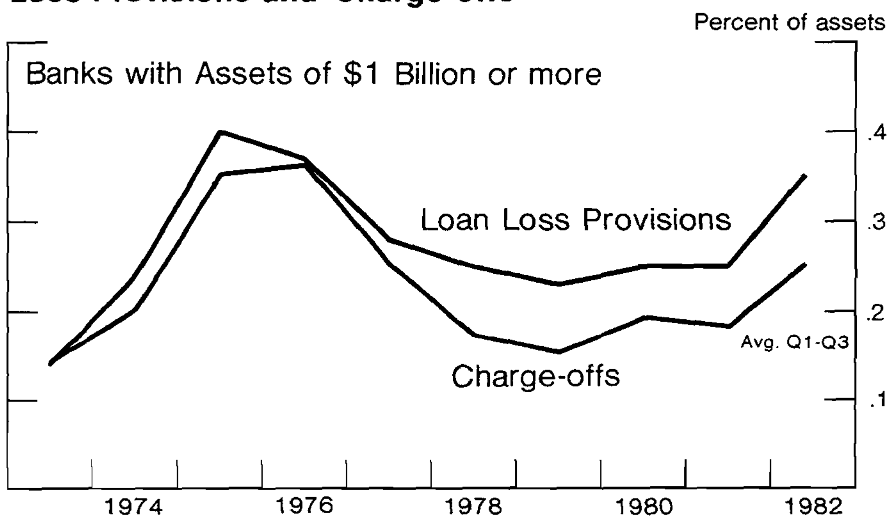
Tax-exempt Bond Issuance



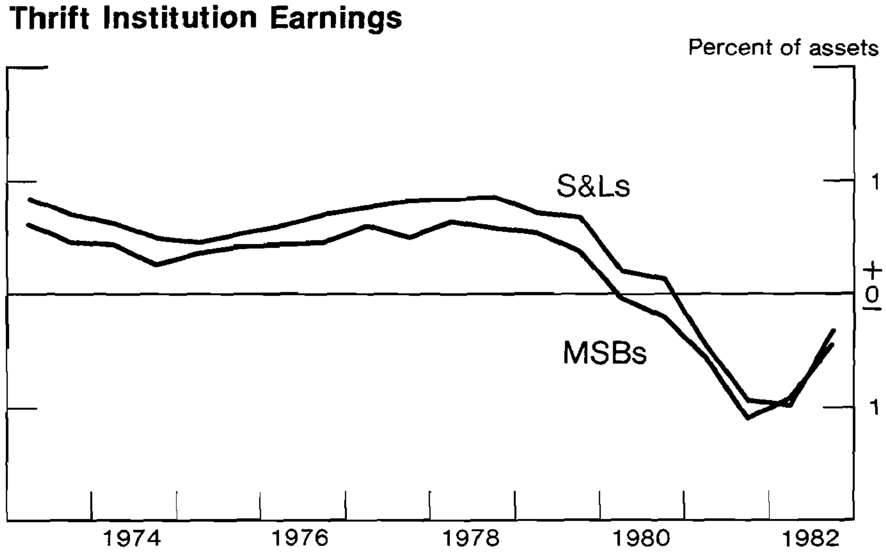
Commercial Bank Earnings



Commercial Bank Loan Loss Provisions and Charge-offs



Thrift Institution Earnings



Forecast Summary

	Board Members		Voting Presidents		Nonvoting Presidents		Staff	Adminis-tration
Percent change	Range	Median	Range	Median	Range	Median		
Nominal GNP								
1983 Q4 to Q4	7½ to 10¼	8¼	7¼ to 11¼	9	8 to 11	8¾	7.5	8.8
1983 annual averages	6 to 8½	6½	5¾ to 9	7	5¾ to 8½	6½	6.1	6.7
Real GNP								
1983 Q4 to Q4	3¼ to 5¼	4	3¼ to 5½	3¾	3 to 5½	4¼	3.5	3.1
1983 annual averages	1½ to 3½	2	1½ to 3½	2	1½ to 3	2	1.8	1.4
GNP Deflator								
1983 Q4 to Q4	3½ to 5	4½	4 to 5¾	5	3¾ to 6	4½	3.9	5.6
1983 annual averages	3¾ to 5	4½	4½ to 5½	5	4 to 5½	4½	4.2	5.2
Average level								
Unemployment Rate								
1983 Q4	9¾ to 10¾	10½	10 to 10¾	10¼	10 to 11	10¼	10.6	10.4
1983 annual average	10¼ to 11	10¾	10¼ to 11	10½	10¼ to 10¾	10½	10.8	10.7

FOMC Briefing
S. H. Axilrod
February 8, 1983

Two rather unexpected developments stemming from the recent introduction of money market deposit accounts and super-NOWs have implications for the long-run monetary targets to be considered for 1983. One unexpected development has been the extreme rapidity and large size of the reaction to the availability of MMDAs, coupled with a somewhat larger portion of these funds than might have been anticipated coming from non-M2 sources--and explained in part by the aggressive initial pricing of MMDAs by banks and other depository institutions in an effort to regain or retain market shares. The second has been the apparently minor involvement of M1 in these shifts.

These developments, for one thing, seem to make it virtually impossible to retain the tentative 6 to 9 percent M2 target range covering the period from QIV '82 to QIV '83 established at the July '82 meeting. In the bluebook, making what we hope are not unreasonable assumptions about future shifts into MMDAs (and we assume some continuation throughout the year but at a considerably slower pace), we translated the 6 to 9 percent into a 9 to 13 percent range. We would expect actual growth most likely to be in the upper half of that range, assuming growth abstracting from shifts of just over 8 percent for the year, and shifts adding about 3 to 4 percentage points. If in an effort to put the bulk of the shifts behind, the FOMC shifted the base for M2 to the February-March period, as suggested in the draft directive, it would still be risky to retain a 6 to 9 percent range, assuming an 8 percent underlying growth in M2 starting now. Our estimate of the shifts adds about one percentage point to the 8, so that the 9 percent upper limit has little flexibility in it.

A first-quarter base would more clearly require a higher range in part because the shifts that occurred early this year would not be as fully captured in the base for the growth rate.

What underlying growth for M2 is reasonable for 1983 is of course a basic issue for the Committee, although there is a genuine question about whether one can see through the ongoing institutional changes sufficiently to permit such an abstract concept to be measured with any real certainty. As Jim mentioned, we have assumed an "underlying" 8 percent for M2 from here on in making GNP forecasts. This presumes that--abstracting from shifts--the sharp drop in income velocity of M2 of last year is not repeated. Our assumption implies a slight decline in underlying velocity, not out of line with a view that the availability of market rates on key M2 components will work to keep growth in that aggregate over several quarters fairly closely in line with GNP. However, in light of last year's experience with velocity, it would not seem unreasonable to set an upper limit for the M2 range that provides some room for the possibility that money demand may continue to be stronger than normal in relation to income. The lower part of the range does provide scope for a reversal of last year's strong demand for liquidity relative to income should that develop out of the more stable financial and economic environment that is presumed at this point to be ahead.

The arguments for some continuing strength in basic money demand can also be made with respect to M1. The relatively minor involvement of M1 in recent shifts tends to make it a bit more plausible to consider stipulating an M1 range for 1983. If the Committee were to take such an approach at this time, that need not of course necessarily involve restoring M1 to clear primacy of place as a guide to short-run open market operations, but the public's perception would surely be that M1 had once again become important and there would be a need somehow to indicate its degree of importance.

The difficulties of interpreting M1 as NOW accounts, which combine transactions and savings features, increasingly become a more important component of the aggregate argue for relying less strongly on its behavior than in the past. At least for 1983, uncertainties of interpretation, including questions about velocity raised by last year's unusual behavior, also argue for setting a relatively wide range, if a range is to be given. A range with an upper limit of a couple of points above the 2½ to 5½ percent range for 1982 would still imply slower actual growth than last year. It would also allow for a much slower increase this year in the income velocity of M1 than historical patterns would suggest. A slower than average velocity rise this year may be most likely if short-term interest rates stay around current levels, as we have projected, keeping the interest rate loss from placing savings funds in NOW accounts (other than super-NOWs) small relative to market instruments, and if super-NOWs are to show any particular growth.

The monetary range which appears most susceptible to a reduction for 1983 relative to 1982 is that for M3. Reducing that range might not be consistent with institutional developments in the degree that banks and thrifts take advantage of MMDAs sharply to increase their share of total credit flows. However, we have assumed a relatively moderate increase in depository institutions' share of total credit this year, which leaves their share well below average experience of the past thirty years, and appears consistent with continued efforts this year by businesses to rely heavily on longer-term borrowing, rather than bank credit, to strengthen balance sheet positions. Moreover, some of the increase in depository institutions' share of credit would also come at the expense of money market funds, an offsetting factor in measurement of M3.

We have presented a total credit range, measured by domestic nonfinancial debt, for the Committee's consideration. The range centers on 9-1/2 percent growth, about the same as last year, and the suggested width of the range is consistent with the standard deviation in this growth rate over the past decade. The credit figures were developed out of the flow of funds accounts consistent with our GNP projection. As with the monetary aggregates, the credit figure does also imply a weaker behavior of velocity--the ratio of GNP to debt--than might be expected in a cyclical recovery. In part this may mirror expected asset behavior: it also seems to reflect a relatively weak internal cash flow for businesses, which are not therefore in a position to restrain borrowing as much as usual.

On balance, Mr. Chairman, it is hard to see a case for reducing annual monetary and credit growth ranges for 1983 relative to 1982 (except possibly for M3) unless one were to expect a very sharp reversal of last year's liquidity behavior. Institutional changes in process, and that have cumulated over time, appear to militate against a sharp reversal, accompanied by a substantial rise in velocity. While on the other hand it seems quite doubtful that velocity will be as weak as last year, there is enough prospect of a degree of weakness relative to historical patterns to suggest consideration of the need to raise the upper limits of some ranges. However, if that were done, the institutional basis for change would need to be carefully explained to minimize the odds that any increase in ranges would heighten existing fears that the large prospective budgetary deficits are going to prove to be inflationary because of accompanying monetary expansion.

NOTES FOR FOMC MEETING
FEBRUARY 8-9, 1983
PETER D. STERNLIGHT

Desk operations since the December 21 meeting have been aimed at maintaining an approximately steady degree of pressure on bank reserve availability, while monetary measures were subject to unusual flows because of new deposit accounts. Growth in the broad monetary aggregates turned out to be quite moderate in December, but there was a huge expansion in January, especially in M2, far above earlier anticipations. The massive growth in M2 reflected large flows of funds into newly authorized money market deposit accounts, starting in mid-December, as financial institutions competed aggressively for market share in these ceiling-free accounts. It seemed clear that a sizable part of the M2 bulge reflected redistribution of liquid asset holdings rather than fresh money and credit creation. M3 also showed sizable growth, although pale alongside M2, as banks permitted CD obligations to run off.

Against this background, and in line with Committee decisions in December, supplemented by conference call discussions in January, reserve paths were readjusted through the period to maintain a reserve gap of $200 million to be met at the discount window. A borrowing gap of that size would ordinarily be associated with Federal funds trading close to the 8 1/2 percent discount rate, and this did in fact emerge in the last few weeks of the period. In the late December and early January weeks, however, there were seasonal money market pressures compounded by heavy demands for excess reserves and late-in-the-week reserve shortfalls that produced higher than intended borrowing levels and funds trading over 10 percent at times. The financial markets took these unintended pressures around year-end pretty much in stride, with little or no thought that the System was deliberately curtailing reserve availability. Once past the year-end period, the four weeks from January 6 to February 2, borrowing averaged about $240 million and weekly average funds rates were within a few basis points of 8 1/2 percent. (In the last two full weeks, borrowing averaged about $150 million.) So far this week, borrowing averages about $110 million while funds average 8 1/2 percent. Excess reserves have continued to run higher than normal, although it's interesting to note that subsequent data revisions and reserve adjustments have pared down the earlier excesses from the levels reported initially.

Over the intermeeting interval, Desk operations drained a large amount of reserves through sales and redemptions of about $5 billion of Treasury bills, including $3.6 billion in sales to foreign accounts and $1.4 billion of redemptions. These reductions served to offset the release of reserves produced by seasonal return flows of currency from circulation after Christmas, compounded by declines in required reserves as a result of regulatory changes, seasonal deposit declines, and paydowns of large CDs. Frequently, though, it was necessary to intersperse the outright sales or redemptions with temporary injections of reserves through arranging System or foreign account repurchase agreements. This was done, for example, to cope with temporary enlargements of the pool of foreign repurchase orders, or to deal with occasional day-to-day reserve shortfalls. On just one occasion, the Desk absorbed reserves temporarily through matched sale-purchase transactions in the market.

Incidentally, during the full calendar year 1982, the System's outright holdings of Treasury and agency securities increased by about $8 billion, or about $10 billion if you include repurchase agreements. The $10 billion figure was about equal to the rise in currency in circulation over the year, with other factors roughly offsetting.

Interest rate changes were modest in size and mixed in direction over the interval since the last meeting, responding to a variety of influences. Most short-term rates tended downward after getting past the period of year-end pressures, partly responding to lower Federal funds rates and fairly widespread expectations of another discount rate cut. In the last couple of weeks, however, short rates have backed up, in some cases returning to levels as high or higher than at the time of the last meeting. In part this reflected dwindling anticipations of another discount rate cut--or more generally an expectation that a reviving economy is less likely to see further rate reductions and may encounter increases instead. In addition, market supplies have been a factor in some cases.

Treasury bills, for example, are higher in yield now than at the time of the December meeting. Three- and six-month bills were auctioned on Monday at 8.25 and 8.35 percent, compared with 7.86 and 8.10 percent just before the last meeting and lower rates than that in mid-January. Unremitting Treasury additions to weekly and monthly bills have more than offset some maturities of cash management bills, while the drop in the System's bill holdings also augmented supplies. Rates on bank CDs ended the period with little net change--slightly lower for very short maturities and higher for the longer maturities--while total supplies contracted. Banks cut their prime rate by 1/2 percentage point to 11 percent in early January, but there seems little expectation of another reduction soon.

Yields increased for most intermediate and longer term issues, especially in the latter weeks of the period as most market participants gave up anticipating a discount rate cut and focussed more on the huge Treasury deficits and signs of a developing business recovery. Reports of moderate money growth in December were reassuring, but renewed growth in January generated some concern--even though such concern was tempered by the realization that major redistribution flows are distorting the usual measures. Rates on intermediate term Treasury issues rose about 10-25 basis points while the over 10-year rates pushed up more like 25-35 basis points. The Treasury raised some $20 billion through sales of coupon issues--including about $9 billion in the refunding issues sold last week. Comparing the auction rates of those 3, 10 and 30-year issues with the similar maturities three months--and two discount rate cuts--earlier, the recent rates were higher by 12, 44 and 55 basis points. The market is still working to digest these issues, with all three trading this morning a bit under issue price.

Yields on corporate issues rose more modestly than on Treasuries. Offerings were light around year-end, and only moderate after the new year began, probably reflecting a combination of unreceptive markets and lack of great urgency from the issuers' side. Tax-exempt yields, on the other hand, came down noticeably after year-end, as new issuance abated with the ending of the rush to market definitive securities before year-end. The date for requiring issues to be in registered form has now been moved to July 1, so perhaps we can anticipate another mad rush of bearer form bonds just before mid-year.

NOTES FOR FOMC MEETING

February 8-9, 1983

Sam Y. Cross

At the beginning of 1983 the dollar appeared to be firmly established on an extended downward trend, a downward trend that had begun in mid-November when the exchange market was particularly attentive to our declining interest rates and to our emerging very large trade and current account deficits and widely reported upward revisions in those deficits.

But in mid-January, the situation changed abruptly. The dollar rebounded sharply, rose about 6 to 7 percent against the major creditor currencies, recovering about half of the earlier decline. The rebound reflected a shift in interest rate expectations when the discount rate failed to fall further and the conviction spread that U.S. interest rates might rise. Attention focused on the first signs of economic recovery, and most importantly on the prospect of huge budget deficits without evidence of a political consensus on how to deal with those deficits. The shift in the interest rate environment overshadowed other factors, including concern about the current account deficit even though the prospects of serious balance of payments deterioration remained.

Technically the dollar had been oversold, and the rebound after mid-January was reinforced several times at progressively higher levels as market participants moved to cover short dollar positions which had been established since mid-November. Our data on the foreign exchange position of banks, and on the much higher levels of trading and of large open positions in the foreign currency futures markets seem to be consistent with a covering of short positions at that time. The markets in January were often characterized as volatile and choppy, and our measures of daily volatility showed some increase in January.

There was much less official intervention on a net basis than in previous months. Partly this reflected less pressure within the EMS, as the market judged that no realignment would occur prior to the French and German elections in early March. Partly the lower intervention may have reflected a German interest not to be influencing the rate too much before the elections. But the dollar's rise was seen by others as essentially a dollar phenomenon, and there was little resistance to that rise through intervention, even though the exchange rate was a constraint to easing of monetary conditions in other countries, and apparently delayed or forestalled such moves.

More recently the dollar has been moving up and down within a rather broad trading range. In terms of the German mark, the range seems to be from about 2.40 to about 2.48. Within that range there are a lot of transitory movements seemingly related to day-to-day shifts on interest rates and other political and economic factors.

FOMC RECOMMENDATIONS

Since the last meeting of the Committee, the Bank of Mexico was granted five drawings totaling $320 million on its combined $1.85 billion BIS-U.S. special credit facility, leaving $140 million still available in that facility. The Mexican authorities were also granted three-month renewals of five earlier drawings totaling $586.9 million. The Bank of Mexico repaid $327 million of its $700 million drawing on the regular Federal Reserve swap line using the proceeds of its first drawings under the IMF agreement. On February 3 it was agreed that the Federal Reserve would extend until February 28 the remaining $373 million oustanding on this line, which had been scheduled to mature on February 4.

Mr. Chairman, swap drawings totaling $142.2 billion by Mexico under the Federal Reserve special swap arrangement will mature between now and April 8, 1983. Of these, six drawings totaling $61.2 million will come up for their first renewal and seven drawings totaling $81.0 million for the second renewal. I would proposed that all of these drawings be extended for three more months. You will recall that all drawings on this facility are subject to three renewals of three months each and are to be liquidated by August 23, 1983.

CHARTS ON VELOCITY

Chart 1

Velocity of M1: Standard and Alternative (M1 Lagged 1 Quarter)
(Quarterly, seasonally adjusted)

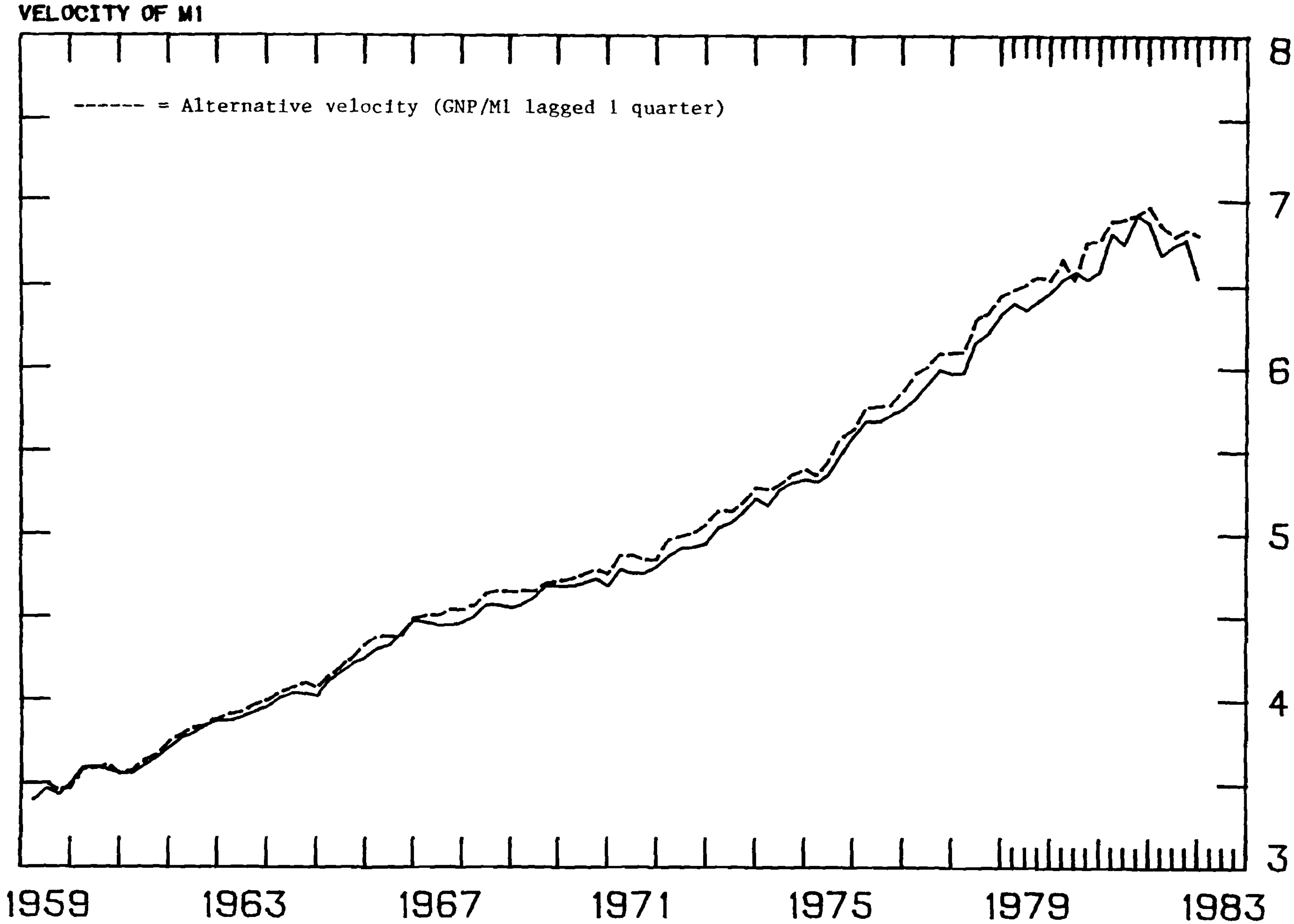


Chart 2

Velocity of M1: Standard and Alternative (M1 Lagged 2 Quarters)
(Quarterly, seasonally adjusted)

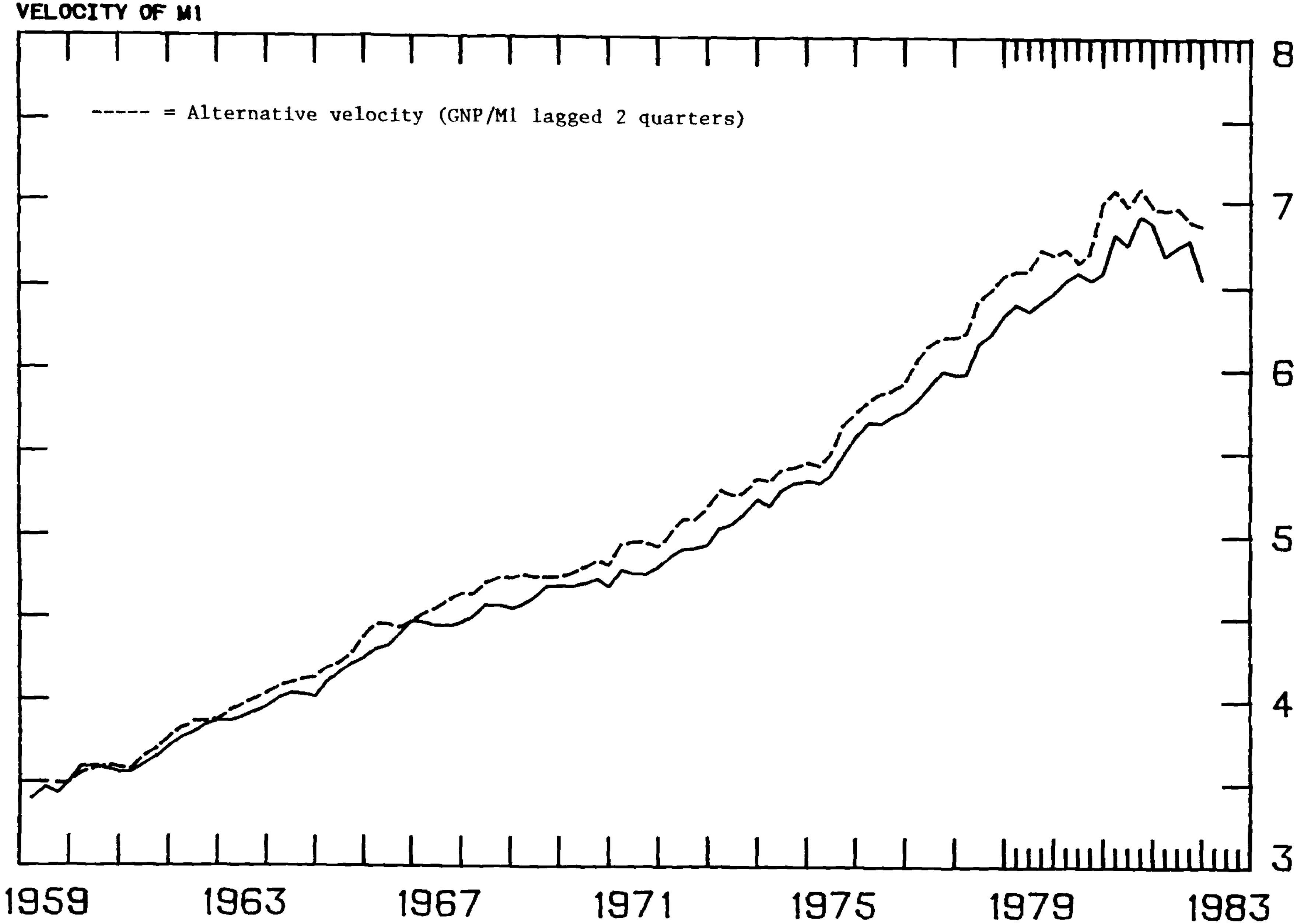


Chart 3

Velocity of M2: Standard and Alternative (M2 Lagged 1 Quarter)
(Quarterly, seasonally adjusted)

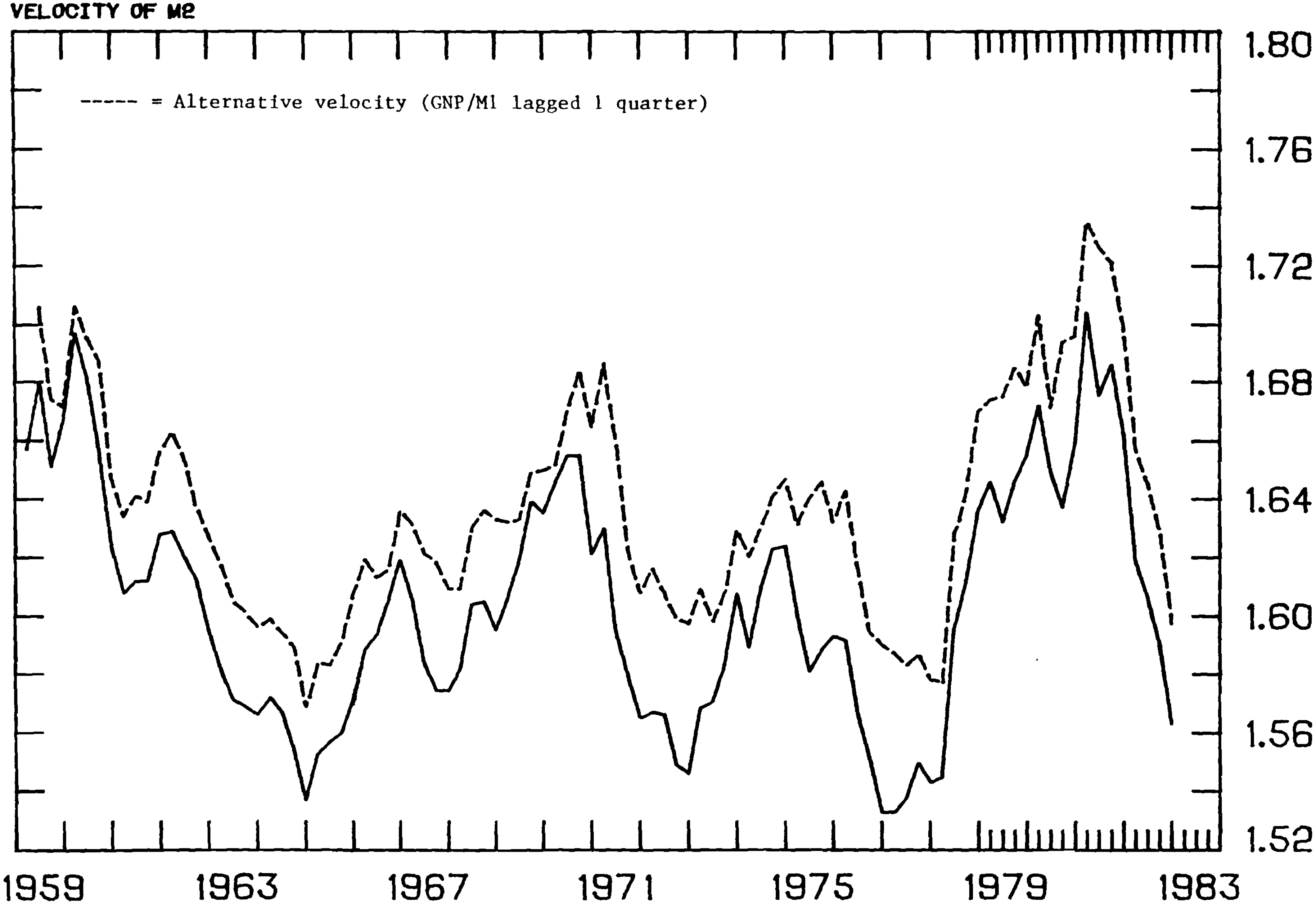


Chart 4

Velocity of M2: Standard and Alternative (M2 Lagged 2 Quarters)
(Quarterly, seasonally adjusted)

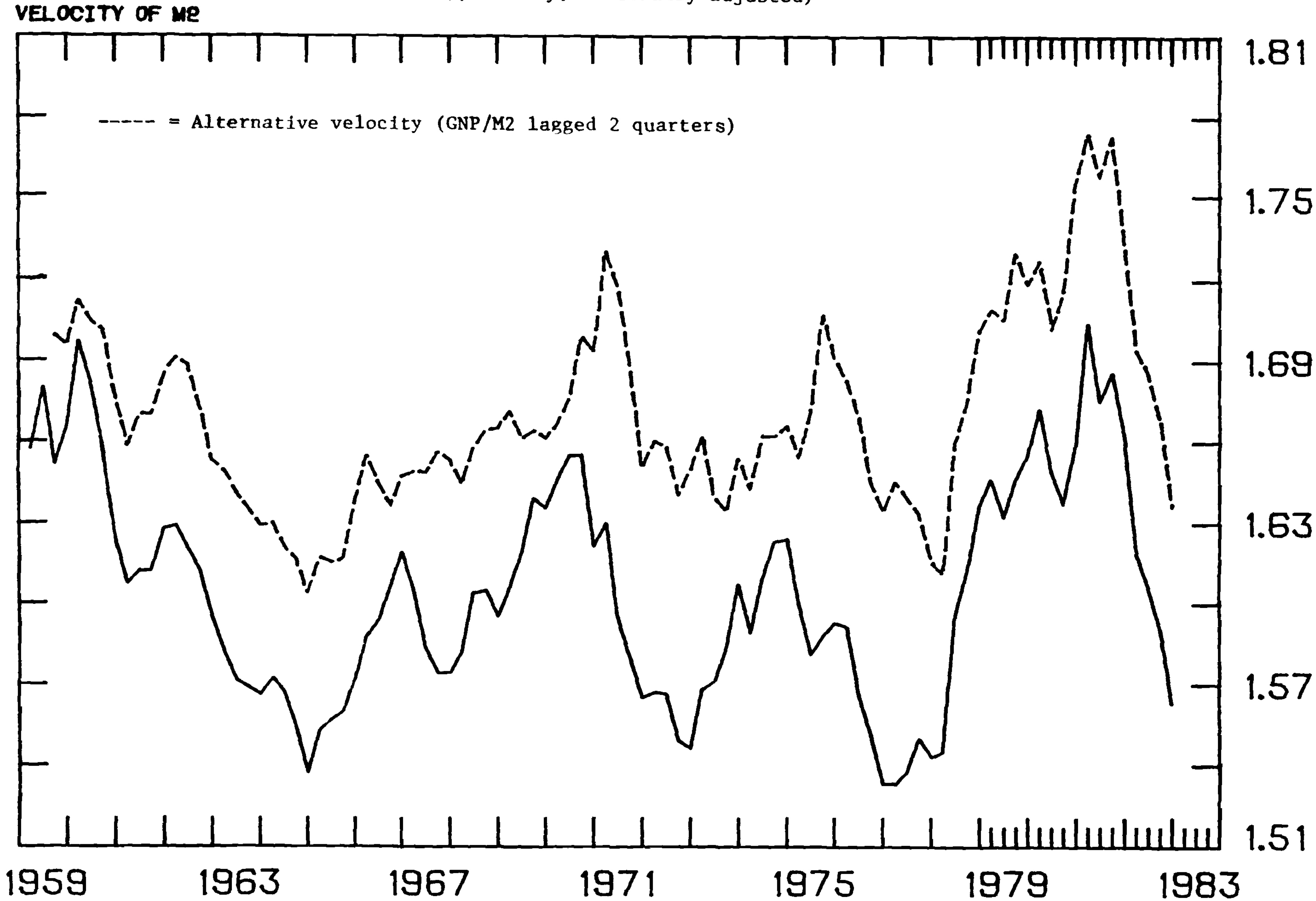


Chart 5

Growth of M1 Velocity: Standard and Alternative (M1 Lagged 1 Quarter)
(Quarterly, seasonally adjusted at annual rates)

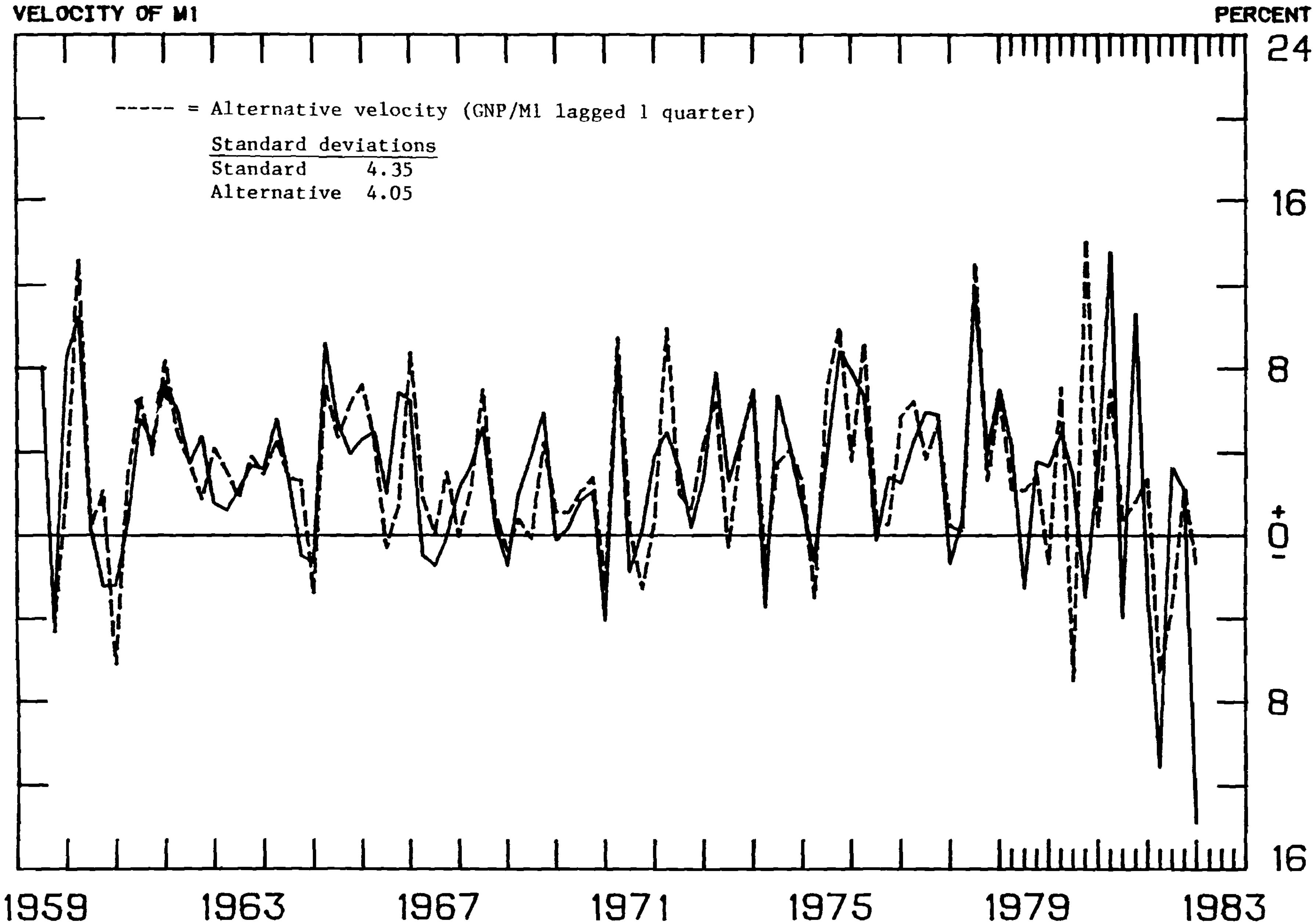


Chart 6

Growth of M1 Velocity: Standard and Alternative (M1 Lagged 2 Quarters)
(Quarterly, seasonally adjusted at annual rates)

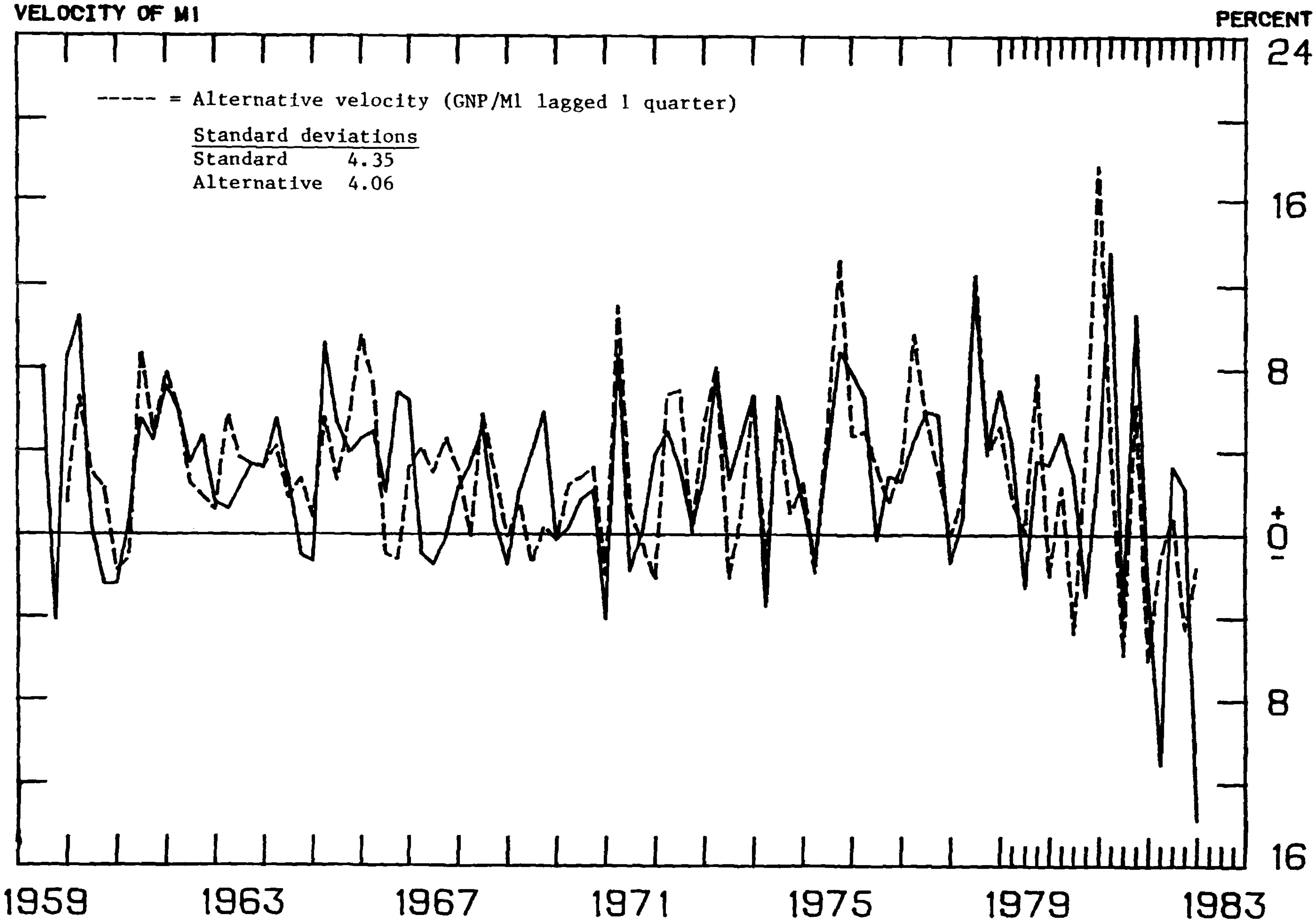


Chart 7

Growth of M2 Velocity: Standard and Alternative (M2 Lagged 1 Quarter)
(Quarterly, seasonally adjusted at annual rates)

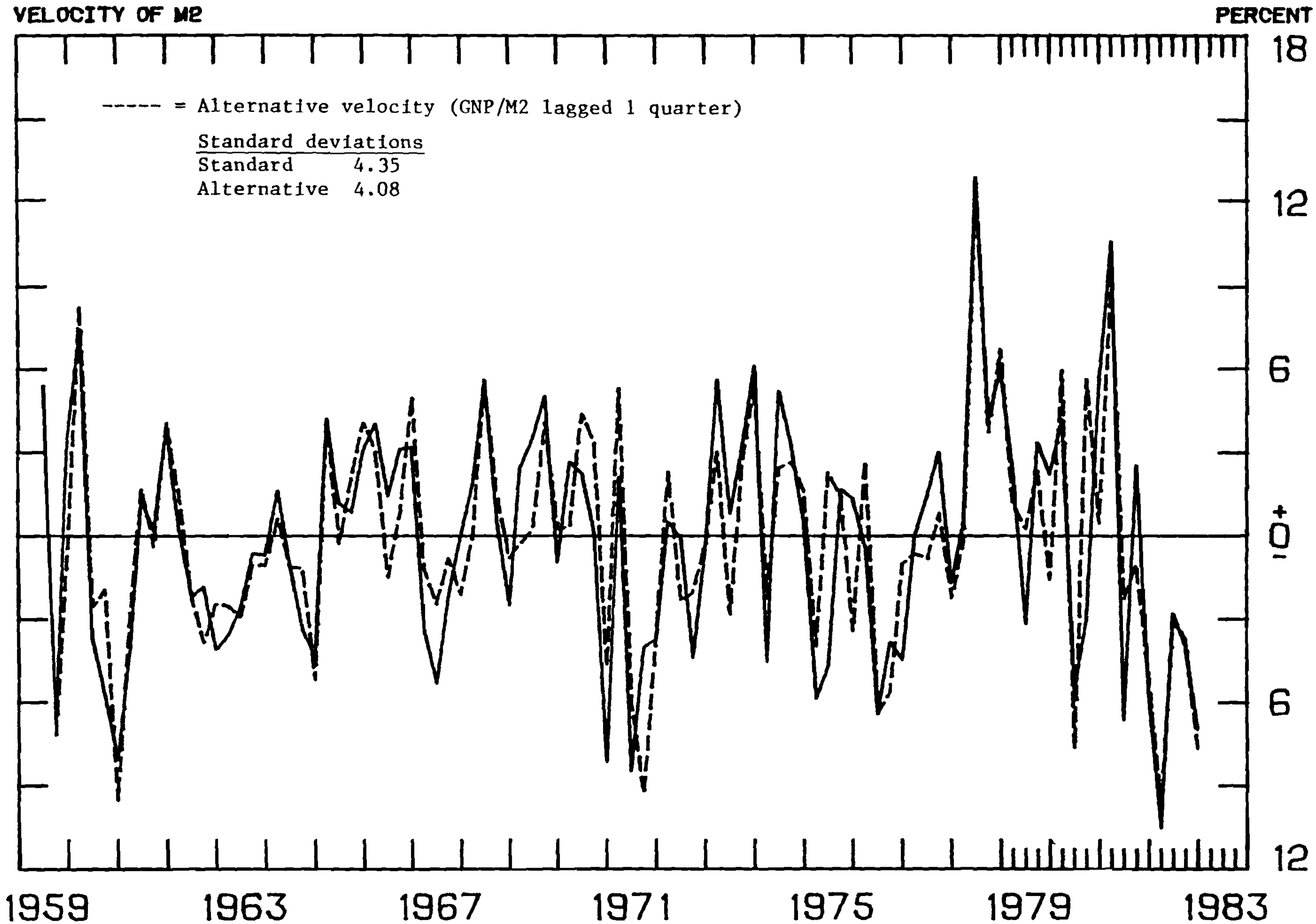


Chart 8

Growth of M2 Velocity: Standard and Alternative (M2 Lagged 2 Quarters)
(Quarterly, seasonally adjusted at annual rates)