Authorized for public release by the FOMC Secretariat on 3/25/2022

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: May 17, 1984

FROM: Normand Bernard N.B.

Enclosed are the greenbook, supplementary information prepared at two Federal Reserve Banks, and a special report on Business Investment based on a survey by the Federal Reserve Banks.

Enclosures

Authorized for public release by the FOMC Secretariat on 3/25/2022

SPECIAL REPORT ON BUSINESS INVESTMENT

Confidential (FR) - Class III FOMC
May 1984

Authorized for public release by the FOMC Secretariat on 3/25/2022

CONFIDENTIAL (FR) - CLASS III FOMC

NATIONAL SUMMARY*

SPECIAL REPORT ON BUSINESS INVESTMENT

Reports from the twelve Federal Reserve Districts in May point to continued growth in some components of business investment but weakness in others. Most of the strength has been in inventories and outlays for capital spending as opposed to construction. Retail inventories have grown somewhat relative to sales, because of voluntary additions to stocks and also because of slower sales. Further growth in retailers' inventory-sales ratios is expected. Manufacturers, on the other hand, continue to keep a tight rein on shelf stock, despite strong demand in many industries. Capital spending growth persists in most parts of the nation, but new equipment is not necessarily being used to expand capacity. Office building construction remains healthy, while industrial plant construction is spotty. There is little activity in retail outlet building.

INVENTORIES

Retail inventories have risen relative to sales in recent weeks but there does not appear to have been a "surge" in actual stock levels. Rather, the inventory-sales ratio has increased for two reasons. First, in contrast to recently-released national sales figures for April, sales are reported to have slowed several weeks ago, falling below the optimistic forecasts many

---

*Prepared at the Federal Reserve Bank of Philadelphia

Authorized for public release by the FOMC Secretariat on 3/25/2022

retailers had made earlier this year. Second, despite the recent slowdown, most merchants expect sales growth to resume in the near future, and have been voluntarily adding to inventories. The reported sales slump certainly gave an extra upward push to the inventory-sales ratio, but it seems that retailers were planning to move in that direction already. Most Districts confirm that merchants are not concerned about any involuntary accumulation that took place, and have no special plans to work stocks down. In fact, retailers in general are planning further accumulation, but at a slower pace.

Autos are reported to be in short supply almost everywhere at this time, particularly, foreign cars and mid- and full-size domestic cars. Prospects for adding to retail auto inventories are slim, since many plants are already operating at full capacity and are having trouble meeting current demand, and because of production slowdowns due to retooling for early model changeovers.

Although some manufacturers experienced a sales slowdown that resulted in increases in their inventory-sales ratios recently, they are the exception and not the rule. In general, firms which supply materials to the homebuilding industry have seen stocks swell involuntarily, as have producers of farm equipment and heavy construction equipment. Overall, however, business managers in the industrial sector have had the opposite problem — difficulty in filling current orders. Auto producers, paper products companies, aluminum mills, makers of sheet steel, and electronics firms (especially those producing semiconductors) all have had trouble keeping their shelves stocked recently. Although some inventory-building is planned

Authorized for public release by the FOMC Secretariat on 3/25/2022

at such firms, manufacturers in general are still wary of increasing inventories of finished goods too much, with the lesson of 1974 still in their minds. Most Districts report that tight inventory control is still the rule, and that industrial firms are likely to continue to operate with relatively low inventory-sales ratios, aided by computerized inventory control techniques.

CAPITAL SPENDING

Most Districts report that capital spending has been growing steadily, although Minneapolis says it "has not been a source of strength." Both Chicago and Atlanta, however, say some slowing is anticipated. Manufacturers in the Richmond District say they have already seen a slowdown, but expect it to be transitory. Industries that are spending heavily on equipment at this time include electronics, rubber and plastics, chemicals, and paper products. In many cases, firms in these industries are operating at capacity. Businesses in the agriculture and construction industries, however, have not been investing in capital, leaving the demand for farm and heavy construction equipment weak. The vast majority of current capital spending is directed towards replacing or refurbishing old capital in an attempt to modernize facilities, increase productivity, and cut costs. The only real capacity expansion, reported by both Boston and San Francisco, is in the electronics industry.

Rising interest rates are not seen as a drag on capital spending at this time, because recent increases in rates have been relatively small, many firms have already received commitments for funds at fixed rates, and much of capital spending is financed with internal funds. The major barrier to further investment in equipment and expansion of capacity seems to be manufacturers' concern over the durability of the current economic

Authorized for public release by the FOMC Secretariat on 3/25/2022

expansion. Fearing that capacity expansion projects started now may be completed just as a new recession takes hold, many producers are holding the line on capital investment, even though they are currently operating at capacity.

NONRESIDENTIAL CONSTRUCTION

With the exception of Cleveland and San Francisco, all Districts indicate significant strength in office building construction. Leasing activity is generally healthy, and Chicago and New York report that rents have firmed. Office vacancy rates are mixed across the nation, but are generally too high for many real estate analysts to feel comfortable with the current pace of construction. There is significant concern over the possibility of overbuilding in the office market and of rising vacancy rates later this year and in 1985.

Industrial plant construction is mixed both geographically and by industry. Cleveland, Chicago, and San Francisco report weak industrial building activity, and Dallas says plant construction is up, but weaker than other commercial building activity. Philadelphia says speculative construction of industrial space by developers is strong, but that the building of committed space is limited. Elsewhere, industries that are operating near capacity are, naturally, spending more on construction than others. As with capital investment, though, much of this spending is directed towards modernizing existing facilities rather than toward augmenting capacity. Reports from St. Louis indicate that this situation may change in coming months, however. The spectre of higher interest rates is mentioned as one factor keeping the lid on plant building, in addition to recurring concern over how much longer the recovery will last. Manufacturers in the Dallas District

Authorized for public release by the FOMC Secretariat on 3/25/2022

also cite tighter inventory control techniques as one reason behind the lack of demand for new space.

Aside from Kansas City, where shopping center construction is up, but slower than either office or industrial building, only Cleveland and San Francisco indicate any significant activity in retail outlet construction, and that is limited to mini-malls or strips. There is a general feeling that most major retail markets were saturated with large malls in the 1970s, and that it is not likely that more will be built in the near future. Vacancy rates at many large malls are reported to be high.

Authorized for public release by the FOMC Secretariat on 3/25/2022

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC PANEL

Professors Houthakker and Tobin were available for comment this month. Both believe that real growth in GNP will decelerate from its first quarter pace, but neither see any danger that the recovery will abort. Houthakker attaches little significance to the economy's weakness in March, attributing it to bad weather and a late Easter. Both economists see only a modest acceleration of inflation over the second half of 1984.

Houthakker believes that the dollar will remain strong over the short run because the federal government will continue to offer interest rates high enough to maintain a sizeable inflow of foreign capital. In his view, the foreign capital is needed to compensate for the shortage of domestic capital created by the large federal deficit. However, interest rates will not become so high that they will jeopardize the recovery.

Both economists give the Fed high marks, but for different reasons. Houthakker praises the Fed for bringing the monetary aggregates within their target ranges and recommends that the targets continue to be respected. Tobin thinks that it was "natural and appropriate" for the Fed to let interest rates rise somewhat after the surprising strength displayed by the economy in the first quarter. He thinks the Fed can now loosen monetary policy somewhat, given that inflation still appears to be under control, the exchange rate of the dollar is still high, and a considerable amount of slack remains in the economy.

Authorized for public release by the FOMC Secretariat on 3/25/2022

STRICTLY CONFIDENTIAL—F.R.

May 1984

SECOND DISTRICT—NEW YORK

FINANCIAL REPORT—FINANCIAL PANEL

This month we have comments from Donald Maude (Merrill Lynch), and James O'Leary (U. S. Trust Co.):*

Maude: At the present time, it appears as if further tightening in response to a surge in economic growth in April and continued rapid total credit demands might be ill advised. This would appear to be the case for several reasons. First of all, a good portion of the rapid short term business credit demands appears to stem from a combination of merger and acquisition activities, a dwindling in equity issuance and an unreceptive corporate bond market. Second, the April surge in economic growth should be viewed in conjunction with an artificially depressed March performance and not as a harbinger of growth to come in May and June. In effect, it appears that the bias of monetary policy at the present time is to react to past strengths in the economy and anticipated rising inflation and inflationary expectations. What would probably appear more appropriate would be to take into account the potential slowing in the economy for which the seeds have already been sown with recent sharp increases in rates of interest. As such, it would appear appropriate to take a "wait and see" attitude until the May economic numbers and June monetary data can be more closely assessed.

O'Leary: The persistent and substantial rise in long-term bond and mortgage yields since early this year is the result of an

*Their views of course are personal, not institutional.

Authorized for public release by the FOMC Secretariat on 3/25/2022

escalation of the fear of investors that sooner or later inflation will heat up again. Investors are convinced that very little will be done in the current political climate to reduce the massive Federal deficit. I find little to criticize in Federal Reserve policy. It appears that total domestic nonfinancial credit expanded at a rate well above the Fed's guidelines during the first four months of the year. The Fed had no alternative but to begin a move toward restraint in the face of the high rate of private credit expansion. We are now seeing clearly the "crowding out" process, especially in the short-term markets. Market pressures would have been greater had not so much money flowed into the short term markets away from intermediate and longer-term obligations. If the Fed had not moved toward restraint the fear of inflation would have been even more intense and the carnage in the long-term fixed-rate markets even greater. The Administration's "down-payment" on the deficit, even if enacted, is not likely to have much effect toward allaying the fear of inflation. The main burden of calming this fear rests on the shoulders of the Fed. It must direct its efforts toward reducing the rate of increase of private credit and to slowing the pace of the economy. This will mean somewhat higher short-term rates in the near-term, but it will help to stabilize long-term rates. Higher interest rates present serious dangers from the standpoint of the LDC debt problem, but the Fed has no alternative but to press forward with a program designed to cool the domestic U.S. economy.