

## APPENDIX

Notes for FOMC Meeting  
July 9, 1980

Since the May 20 meeting of the FOMC, the dollar has come under sporadic bursts of selling pressure. On balance dollar rates have declined by 3 percent against the German mark, 4 percent against the Swiss franc, by 2 percent against the pound sterling and 2 percent against the Japanese yen. Against the EMS currencies and the Swiss franc the decline would have been much greater except for our intervention. During the period the Desk sold a total of \$1.8 billion of German marks of which \$1 billion was for Federal Reserve account and the rest for the Treasury. Swap drawings by the Federal Reserve on the Bundesbank increased by \$734 million, to \$1,065 million. In addition, we sold \$187 million of Swiss francs, of which \$141 million was for the System and entailed drawings on the swap line in the amount of \$11 million equivalent. Since the German mark is low within the EMS currency band, we supplemented our operation in marks by selling also the currency which was at the top of the band, the French franc. Sales of French francs amounted to \$53 million, and we increased our swap debt to the Bank of France by that amount to \$127 million. In sum, Federal Reserve swap debt, all incurred since the turn in interest rates in April, now amounts to \$1,203.5 million equivalent. Selling pressure on the dollar has been particularly strong on recent days; market participants widely expect that the pressure will continue and perhaps intensify over the weeks ahead. To market participants we talk to, our operations are again being perceived increasingly as an effort to prop up the dollar rather than simply to smooth out fluctuations or to restore good two-way trading. It is precisely in such an environment that intervention rapidly loses its effectiveness.

The market remains extremely sensitive to interest differentials; through much of the period, short-term interest rates in the U.S. and the euro-dollar market have fluctuated at about the same levels and occasionally below interest rates in comparable instruments in Germany and in the Euro-mark market. This is a relationship which is considered unfavorable by market participants in view of the wide difference in inflation rates which remains between the two countries and which is expected to remain even as our own inflation rate may abate somewhat as the result of the recession here. Large amounts of funds have flowed into Germany, for longer-term investments as well as short-term; the German authorities have been quite receptive to those flows, particularly from major OPEC investors, in view of the need for Germany to finance its own substantial current account deficit this year. In addition, U.S. interest rates are currently below rates in all other major countries, with the exception of Switzerland. The pound sterling in particular has benefited from interest-sensitive inflows, but so have the French franc and the Japanese yen. The recent rise of the Swiss franc shows that speculative flows out of the dollar, simply on the expectation that the franc will appreciate against the dollar, are emerging once again.

Economic activity is no longer quite so buoyant in most other countries, although for the moment only the U.K. may be in a clear downturn. Some central banks have begun to cut their interest rates, such as the Dutch and the Belgians, and last week the Bank of England's minimum lending rate was reduced from 17 to 16 percent. But the German Bundesbank has not budged an inch, despite several indications of slower growth for the German economy. Indeed, the Bundesbank even allowed the Frankfurt money market to tighten up in late June and early July and although some liquidity has

since been pumped into the market, there is little expectation in the market that the Bundesbank is likely to ease up at least until the fall. In public pronouncements, Bundesbank officials have sought to encourage that expectation. Long-term rates in Germany have declined but this is widely interpreted as a sign that inflationary expectations in Germany are receding and that D-mark bonds have been attractive to OPEC and other international investors.

Interest rate comparisons are not the only concern of the market. Traders of course recognize that as the U.S. economy contracts sharply, inflation is likely to abate somewhat and that substantial improvement is possible in our trade and current account position. There are some private forecasts of a current account surplus for later this year and in 1981. But exchange market participants remain alert to any evidence that the U.S. authorities may be easing up on their resolve to combat inflation or are in any way distracted from their anti-inflation efforts because of the recession or because it is an election year. Consequently, the heaviest selling pressures on the dollar during the period erupted, first, after the partial relaxation in the Federal Reserve's special credit restraints in late May and, then, the announcement of the phasing out of those restraints last week. Market participants had no particular love for that program, to the extent that one provision or another was a constraint on their own actions individually. But the program has been a symbol of the resolve of the U.S. authorities to go to drastic lengths to deal with inflationary expectations and once that symbol had been removed, questions immediately emerged whether that resolve remains as firm as it had been.

In addition, the phasing out of the special restraint program was announced at a time when tax-cut fever seemed to have gripped American politicians. Market

participants, particularly Europeans, are worried that the Administration can no longer hold the line on fiscal restraint and that, with a recession developing during the election year, the Federal Reserve will also be subjected to intense pressure to ease monetary policy. Elsewhere, no one is questioning the resolve of the German authorities to fight inflation, or the Swiss authorities, or for the moment the British or the French authorities. The Japanese look like they may emerge with a strong government after the recent election, in which the fight against inflation was a major promise by leaders of the ruling party.

With market psychology becoming so adverse for the dollar, we have faced the risk that any significant selling pressure on the dollar could cumulate quickly. The position of us at the Desk, and of our counterparts at the Bundesbank, has been to coordinate our intervention closely so as to blunt the force of selling pressure early rather than let it build up a head of steam. The occasional but temporary firming up of U.S. interest rates, transmitted on to the Euro-markets, has also helped avoid the buildup of speculative positions.

Nevertheless, we have not had the luxury of a buoyant dollar in several months, and our margin for maneuver has dwindled. The dollar is now some 2 percent away from its historical lows against the mark, and in view of the many chartists in the exchange market these days, we could easily have an escalation of selling should the dollar fall to new record lows. We are beginning to dig more deeply into our intervention resources. Bundesbank officials are beginning to show that they would be reluctant to join us in continued sizable operations. The mark is one of the lowest currencies in the EMS, so the Bundesbank cannot act aggressively in the exchanges as a supplier of marks

even if they decided to. The market is beginning to talk of a new realignment in the EMS in September to take account of inflationary differentials since the last realignment last fall, which means that we could face added strains on the exchange market, and on the dollar, as a result of a buildup of speculative positions among European currencies.

Report to  
Federal Open Market Committee  
July 9, 1980

Paul Meek  
Monetary Advisor

In pursuing reserve objectives consistent with the monetary growth desired by the Committee, the Desk encountered for a time monetary weakness akin to that experienced in the previous intermeeting period, but as June unfolded, both M-1A and M-1B strengthened to achieve about the minimum growth desired while M2 continued to run well above its growth objective. As a consequence, the Desk pursued reserve objectives above the minimum levels implied by the Committee's objectives with the exception of a single week when the minimum reserve paths were in force.

Both total and nonborrowed reserves came in close to desired levels in the first 4-week subperiod and appear to be on target for the final three weeks. Adjustment borrowing, after a one-day bulge in the first week, has been minimal, averaging about \$75 million, and has been unaffected by the reduction in the discount rate from 13 to 11 percent in two stages. The Federal funds rate, which averaged  $10\frac{3}{4}$  percent in the week of the last meeting, came down quickly to the  $9\frac{1}{2}$  percent working floor established at that time. The rate came off further to the 9 percent area once the  $8\frac{1}{2}$  percent lower limit became effective following the June 5 telephone consultation. More recently, the rate has been trading more around  $9\frac{1}{4}$  to  $9\frac{1}{2}$  percent.

Since the Desk's reserve targets were consistent with frictional levels of adjustment borrowing throughout the interval, the lower end of the Committee's effective Federal funds rate range came into play on several occasions. In the early days of the

period, the Desk had to mop up reserves quite visibly, notably when the initial relaxation of the credit restraint program was followed by a drop in the rate well below the 9 ½ percent lower limit then prevailing. Then, following the June 5 consultation, the Desk intervened again to absorb reserves when the rate dropped below 8 ½ percent. A conditioning factor at the time was the downward pressure the dollar encountered in the foreign exchange market. A weak dollar was even more important after the second discount rate cut to 11 percent on June 12, when the Desk intervened early to mop up reserves when Federal funds again traded below 8 ½ percent despite a sizable projected reserve need. More recently, with the dollar weak in the exchange markets after termination of the credit restraint program, we intervened yesterday to absorb reserves in the market even with the Federal funds rate a bit above the bottom end of the range. Outright operations during the period included purchases of not quite \$900 million of Treasury coupon securities in the market and of about \$500 million bills from foreign accounts.

After declining sharply before the last meeting, yields on debt instruments continued to fall through about mid-June, but have since retraced a portion of their earlier post-meeting declines. Looking back over the entire episode since early April, one is impressed by the extent to which the coincident slowdown in the economy and the decline in key monetary measures in April-May galvanized both investors and issuers of securities into action. The rush to commit funds was so pervasive that the markets for corporate and municipal debt absorbed a record \$35 billion new issues during the second quarter, while the Treasury and Federally sponsored agencies raised net new cash of \$8 billion. Even after the recent backup of long-term taxable yields, yields on long-term



Treasuries (at about 10.30 percent) and on Aaa-rated telephone utilities (at about 11.30 percent) were 2 ½ to 3 percentage points below their peaks.

In this longer perspective, the recent backup in yields reflects a reappraisal, whose likely duration is being debated by market participants. Investors have turned notably cautious. The very size of portfolio acquisitions in the quarter significantly reduced the urgency of making further additions. The rebound in the monetary aggregates in June has suggested to many analysts that the Federal Reserve might not have to press reserves as aggressively on the banking system to achieve its annual monetary goals as they had thought earlier. Long-term investors also are concerned that a sizable Federal tax cut in 1981 could well increase the budget deficit to a range of \$50 to \$80 billion in fiscal 1981 and reduce the gains to be expected in reducing inflation. Analysts also have been increasing their estimates of the Treasury's near-term cash needs and note that the cut in reserve requirements will result in sizable System sales of securities.

Underwriters and dealers with sizable trading positions responded quickly to the shift in customer mood in mid-June. Their outright sales and hedging actions led to a rapid rise of 70 to 80 basis points in long-term taxable yields, albeit they remain 50 basis points or so below May 19 levels. The Federal Reserve's announcement last Thursday of the dismantling of the March 14 credit restraint package initially buoyed the hopes of market professionals that interest rates will still work irregularly lower, but concern about Treasury financing and the dollar have tempered that view. Investors are still not exhibiting much interest, remaining concerned that signals from the monetary aggregates and the real economy will be more mixed in the future than through most of the second quarter.

Short-term interest rates fell quite sharply through mid-June, but then backed up considerably as Federal funds and RP rates rose rather than continuing to fall as many had expected. Rates on three-month Treasury bills, which were around 9 percent at the time of the May meeting, fell below 6 ½ percent in mid-June, partly because of anticipated reinvestment demand and sizable foreign account buying. But demand proved disappointing and rates adjusted back to around 8 percent when financing costs exceeded rates of return by a sizable margin. In Monday's auction, rates of the three- and six-month bills were set at 8.21 and 8.11 percent, respectively, still down 74 and 81 basis points from the rates set just before the last meeting.

Increased Treasury financing needs resulting from the recession have already meant that the Treasury has raised more cash in the recent period than in the corresponding period a year ago. Looking ahead, the Treasury had estimated its third-quarter needs at \$11 to \$14 billion before the May quarterly financing. It now expects them to be above \$20 billion and market estimates range from \$18 to \$25 billion. Fortunately, the debt ceiling was finally raised to \$925 billion on June 27, so the Treasury will not face the need to re-schedule auctions as it did when temporary extensions of the existing ceiling beyond May 30 played hob with orderly marketing of debt. Even now, however, the Treasury may not be able to get additional bond issuing authority in time for the August financing. The amount of long-term bonds that can be sold may only be about \$1.5 billion, whereas \$2 billion or more would be typical. We had given some thought to the possibility of additional coupon purchases to help give the Treasury an incidental assist to the extent we purchased securities issued under present authority. But the reduction in reserve requirements in the July 30 week now makes that unlikely.

In view of the substantial cut in requirements, I would think it prudent for the Committee to increase the leeway for change in the portfolio between meetings to \$4 billion from the usual \$3 billion.

JAMES L. KICHLINE  
July 8, 1980

FOMC CHART SHOW--INTRODUCTION

During our presentations this morning we will be referring to the package of chart materials distributed to you. The first chart in the package displays the principal assumptions that have been employed in developing the staff's forecast. For monetary policy, we have assumed growth of M-1A averaging 4-1/2 percent over 1980--consistent with longer-run Alternative I in the Bluebook--and continuation of that growth on average in 1981. For fiscal policy, we have assumed unified budget expenditures a little higher than in the forecast prepared for the last meeting of the Committee. A more important change in the fiscal assumption, however, is the inclusion of a tax cut beginning January 1981. The tax cut includes income tax rate reductions for both individuals and businesses as well as liberalized depreciation allowances. Although the accelerated depreciation portion results in only a \$3 billion loss of revenues in the initial year, the revenue costs build over the next few years and the economic effects might be viewed appropriately as equivalent to an investment tax credit with first year costs of \$10 billion.

Both monetary and fiscal policy are viewed as exerting a restraining influence on the economy over the forecast horizon. The next chart shows the behavior of the Treasury bill rate expected to be consistent with the monetary aggregate assumption and the performance of the economy. The bill rate has plunged from its peak in the first quarter, but as growth of nominal GNP picks up later this year and especially in 1981 interest rates will have to rise to hold growth of M-1A to

4-1/2 percent. The bill rate is expected to be around 10 percent early in 1981 and rise further to the neighborhood of 11-1/2 percent late in the year, while the income velocity of M-1A is also rising substantially.

The next chart displays some information on the federal budget and fiscal policy. The Administration's mid-year budget figures are still in a highly preliminary state but they seem likely to entail a deficit somewhere between \$55-\$60 billion for FY 1980, or a little higher than that in the staff forecast. For FY 1981 the Administration deficit figure could be in the \$30-\$35 billion range, including the impact of a \$25 billion reduction in taxes. The much higher staff deficit is accounted for principally by a weaker economic recovery during 1981. Even with the assumed tax cut in the staff forecast the budget on a high employment basis--the lower panel--moves further into surplus. Thus discretionary fiscal policy would still act as a restraining influence, in distinct contrast to the performance during previous recessionary periods.

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

Joseph S. Zeisel  
July 9, 1980

#### FOMC CHART SHOW

The first chart in the next section portrays the sharpness of the contraction in key sectors of the economy during recent months. As shown in the upper left hand panel, housing activity weakened in early 1979, responding to monetary policy constraints, and starts turned sharply downward after last October's policy actions; they have fallen precipitously since. The picture for retail sales--the right hand panel--if anything, looks worse. Since their peak in January real retail sales have fallen more than 10 percent, the sharpest postwar four-month drop on record. Unit auto sales have been especially weak despite extensive price cutting, and significant declines have been recorded for sales of smaller, fuel-efficient models--both foreign and domestic--as well as for larger cars.

The bottom two panels indicate the associated production and employment adjustments. The cut in auto output has about matched the decline in sales and auto stocks have tended to stabilize, albeit at high levels relative to sales. Overall, however, production and employment adjustments are still being made to past declines in final demands.

As portrayed in the next chart, the staff expects that the contraction in overall output will continue to the end of this year. We estimate that the second quarter, just past, saw GNP fall at a near record 9 percent annual rate, and expect this to be the sharpest contraction in this cycle. Over the second half of the

year the rate of decline is projected to average about 4 percent. Assisted by the tax cut, recovery is expected to begin early next year with real GNP advancing by about 2-1/2 percent over the four quarters of 1981.

The bottom panel compares this cycle with other postwar contractions. The cumulative decline from its peak in the first quarter to the trough in the fourth is projected to total about 4-1/4 percent, substantially more than in any postwar drop other than 1973-75. Moreover, the recovery is anticipated to be more sluggish than any postwar experience, a function partly of comparatively tight monetary and fiscal policies.

There are several reasons for feeling that the momentum of the decline should moderate over the next few quarters. As I mentioned earlier, auto assemblies have been brought fairly closely into line with demand, and with the recent easing of credit conditions, sales and production should pick up somewhat in the near future.

Moreover, there are some suggestions that the contraction in housing demand and activity may be close to bottoming out. The top panels in the next chart show the sharp decline in mortgage lending commitments and the collapse of housing demand over the past half year. The recent sharp downward movement of mortgage interest rates, shown in the lower left panel, and the rebound in deposit growth at thrifts that accompanied the general decline in rates should turn housing demand and mortgage lending around.

Indeed, the top panel of the next chart illustrates clearly the close correspondence of mortgage loan volume, with a few months lag, and the movement in time and savings deposits at S&Ls, which have turned upward.

As is illustrated in the bottom panel, we are projecting a pickup in housing that is somewhat under the pace of past cyclical recoveries, with activity constrained by historically high interest rates as well as by sluggish general economic conditions. By the end of 1981 we expect housing starts to reach a level of about 1.4 million units.

The next chart portrays the inventory problem that has developed in the past few months in the wake of the precipitous drop in sales. In comparing the two top panels, it is evident that inventory-sales ratios have begun to take on the characteristics of the late 1974 situation. However, substantial production of adjustments are under way which should limit the extent of my inventory cycle. After an exceptionally large runup in April, manufacturers' stocks grew little and wholesale stocks declined in May, as industrial production was cut sharply further. A decline in output as large or larger appears to have occurred in June, which should prevent stocks from backing up further. As the middle panel shows, we anticipate that business will succeed in keeping stocks in line with sales, and as is evident in the bottom panel, this implies an inventory runoff during the second half of the year, with an upturn in the spring of 1981 when sales pick up.



Although inventory investment may support growth in 1981, business fixed investment may stunt the recovery throughout much of next year. In the next chart, the upper left hand panel shows the drop in demand for business vehicles over the past year. Typically, cancellations of short lead-time items such as trucks are among the first adjustments that are made in capital spending. The right hand panel portrays new orders for nondefense capital equipment, and indicates the developing weakness in commitments for longer lead-time capital outlays. In conjunction with the decline since early last year in contracts for commercial and industrial construction, these data portend a continued downtrend in fixed capital spending over the balance of this year.

The outlook for 1981 is more uncertain, but as is indicated in the middle panel, we are projecting a drop in capacity utilization rates in manufacturing to a level not much above that reached at the bottom of the 1975 recession, which should reduce the urgency for new capital formation. With profit performance poor and nominal interest rates high, we are forecasting a decline in real capital spending throughout 1981--but one that moderates as the effects of corporate tax cuts and accelerated depreciation begin to take hold.

The next chart addresses the government component of spending. As Mr. Kichline noted, fiscal policy in 1980 and 1981 remains unusually restrictive for this stage of a cycle. But we

do expect that defense spending will be accelerating. The projected rate of rise--about 8 percent in real terms--is somewhat above that proposed by the administration, but in line with recent Congressional actions.

Total real government purchases--the bottom panel--are projected to rise quite modestly, damped by continued restraint in federal nondefense outlays and a general decline in real state and local purchases as these jurisdictions react to downward pressure on their receipts, both taxes and federal grants.

The next chart presents in the top panel the pattern of projected change in aggregate real disposable income through 1981. Following a sharp contraction this year as employment is cut back, we foresee an historically weak recovery in real income in 1981 in line with the poor performance of overall output growth. It is also important to note that the assumed January 1 personal income tax cut only about offsets the bite of increased social security taxes and inflation-induced increases in personal income taxes. As the middle panel shows, the saving rate is expected to stabilize in the 5 percent range, significantly above the unusually low levels of the past few quarters, but well below the rates that obtained earlier. The low saving rate projected reflects our view that consumers will strive to maintain living standards in the face of sluggish real income growth and continued increases in the relative price of necessities such as energy.

As the bottom panel indicates, these various factors have led us to forecast a small growth of real consumer spending in 1981--about 1-1/2 percent, an unusually sluggish performance early in a recovery.

The next chart portrays the employment outlook. Job cuts are expected to continue through year-end, with only a small employment increase in 1981. Nonfarm employment has already fallen by over a million since February and is projected to fall further by over half a million by year-end, with most of the cuts in cyclically sensitive manufacturing.

While we assume that labor force growth also will slow--as it did in the 1974-75 period--we expect a rate of increase about in line with growth in working age population. Thus, unemployment should continue to increase, reaching about 9 percent in early 1981, and begin to ease off in the latter half of next year.

As the next chart shows, we expect the rise in unemployment to make only a small dent in the rate of increase in hourly compensation. With prices continuing to rise rapidly, we anticipate only a modest easing of wage pressures, particularly in the highly organized sectors where indexing is more prevalent. Moreover, any easing in wages will be offset in part by the scheduled sharp rise in social security taxes.

We do anticipate a cyclical improvement in productivity in 1981, shown in the middle panel, although the gain is likely

to be moderate, in line with the sluggish recovery in output. As the bottom panel shows, this still leaves unit labor costs rising at a relatively rapid 7-1/2 percent rate over 1981.

Moreover, the improvement in unit labor costs is likely to do little for prices. As indicated in the top panel of the next chart, unit labor cost increases are projected to remain above the underlying inflation rate throughout most of the period. Thus, firms may be expected to use any easing in their costs primarily to improve their profit positions.

As the bottom panel shows, the rise in energy prices is assumed to moderate significantly in 1981. Nevertheless, including the effects of decontrol, domestic energy prices are expected to be rising at close to a 20 percent rate over 1981. Food prices are expected to accelerate later this year as a result of reduced meat supplies, and in general the food situation is not projected to contribute to reduced inflation through 1981.

Finally, the next chart shows the staff's current view of the outlook for overall inflation. We expect the combination of an unusually protracted period of slack markets and a moderation in the upward trend of energy prices to result in some easing of the inflationary situation in 1981--but the progress will be slight; total prices are projected to ease from a 10 percent rate during 1980 to about 8-1/2 percent by the latter half of 1981.

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

The red line in the upper panel of the first international chart shows that the weighted average foreign exchange value of the dollar has fluctuated without a discernible trend for almost two years. Recently, the dollar has retreated to the lower end of its range of fluctuation, under the influence of declining interest rates on dollar-denominated assets. Meanwhile, as is shown by the black line, consumer prices have risen less rapidly on average in foreign industrial countries than in the United States. During 1979, consumer prices rose 9 percent abroad -- fourth quarter over fourth quarter. This year we expect a rise of almost 11 percent, followed by a deceleration to about 7-1/2 percent during 1981. Thus, over the forecast period the U.S. inflation rate will remain above the foreign rate, but the gap will narrow somewhat as U.S. inflation moves lower.

The lower panel of the chart shows the CPI-adjusted value of the dollar. On this measure, the dollar's real exchange rate is also about unchanged from two years ago, but it is up 5 percent from its lowest point in October 1978.

Turning to the next chart, as is shown in the upper left-hand panel, the average rate of increase of real GNP in foreign industrial countries is expected to have slowed after the first quarter of 1980 and to record an increase of about 1 percent between the fourth quarter of 1979 and the fourth quarter of 1980. However, the staff expects that only the United Kingdom and Canada will record negative growth this year. Average growth abroad is projected to pick up to about a 2-percent rate next year. Thus, as is shown by the ratio of foreign to U.S. real GNP in the lower panel, economic activity abroad will increase relative to economic activity in the United States through the end of this year. In 1981, we expect a reversal.

The last panel on this chart shows the interest rate on three-month, U.S. certificates of deposit and a weighted average of foreign, three-month, interbank interest rates. In April the U.S. CD rate fell below the foreign average for the first time since September 1977. More recently, interest rates abroad have declined somewhat, and the differential has narrowed marginally. Further gradual declines in average foreign interest rates are expected during the forecast period as the rate of increase in nominal demand slows abroad.

The next chart illustrates the influence on U.S. trade flows of some of the underlying factors that I have just reviewed. As is shown in the upper left-hand panel, the recent rapid expansion in the volume of U.S. non-agricultural exports is expected to come to a halt, reflecting the slowdown in foreign growth and the elimination of special factors, such as gold and silver exports, that boosted U.S. non-agricultural exports at the end of 1979 and in early 1980.

The lower left-hand panel shows the decline in the value and volume of U.S. non-oil imports during 1980 as a consequence of the U.S. recession. The peak-to-trough decline in volume is expected to be about 20 percent.

The table shows the staff's assumption that the rate of increase in the price of imported oil will moderate over the forecast period. However at the end of 1981 it is expected to be three times its level at the end of 1978. As is shown in the lower right-hand panel, the higher prices over the next six quarters will be only partially offset by a lower volume of U.S. oil imports resulting from the response to the U.S. recession as well as to the higher prices. Consequently, the U.S. oil import bill is expected to rise to more than \$100 billion, at an annual rate, by the end of the forecast period.

The last international chart summarizes our projection for the external sector of the U.S. economy. The top panel shows that we expect a progressive reduction in the trade deficit extending into early 1981 and a movement into current account surplus late this year. However, by the end of 1981, the trade deficit is expected to increase again and the current-account surplus to disappear.

In terms of the GNP accounts, illustrated in the last two panels, real exports of goods and services are expected to be essentially unchanged through the end of 1981. Thus, the course of real GNP net exports of goods and services, depicted in the bottom panel by the red line, reflects mainly projected cyclical movements in real imports of goods and services.

Finally, although the dollar's recent weakness may well not have played itself out, we expect the average foreign exchange value of the dollar to be somewhat higher a year from now than it has been recently. The strengthening of the dollar should be supported by rising interest rates on dollar-denominated assets at a time when foreign interest rates are expected to be declining. The expected move of our current account into surplus should also provide support for the dollar, while relative inflation developments should continue to be adverse.

Mr. Kichline will now complete our presentation.

JAMES L. KICHLINE  
July 8, 1980

FOMC CHART SHOW--CONCLUSION

The first chart in the final section of your packet shows the volume of funds raised by domestic nonfinancial sectors. Total funds raised this year are projected to decline appreciably from the peak reached in 1979 and to rise next year as economic activity recovers. The drop in borrowing this year is attributable solely to a fall in funds raised by the private sector and, in fact, can be traced mainly to developments last quarter when both business and household borrowing plunged. Federal financing requirements in 1980 and 1981 are projected to be considerably above those of last year, reflecting the larger budget deficit in prospect. In the bottom panel, funds raised relative to GNP are projected to exhibit a swing during the forecast horizon that is characteristic of past periods of recession and recovery.

However, there are a number of financial aspects of the forecast that appear to be quite different from past cyclical performance. In the corporate sector, for example--the next chart--capital expenditures remain well above gross internal funds which keeps the financing gap sizable. The forecast does not contain a massive inventory runoff nor a collapse of fixed investment spending in nominal terms which would take some pressure off corporate financial positions. At the same time the improvement in profits next year is constrained by weak markets and continued pressure on profit margins.



The lower panels indicate that firms probably will need to tap short-term markets for an appreciable volume of funds in 1980 and 1981. Even though firms generally would seem to be desirous of strengthening their balance sheet structures, the size of financing needs will limit the extent to which such restructuring will occur. Moreover, given the monetary policy assumption and the economic outlook, interest rates are likely to be rising late this year and in 1981 which may cause some hesitance to move into long-term markets.

Thus, as shown in the top left panel of the next chart, corporate liquidity positions are likely to remain fairly tight and to exhibit much less improvement than during the 1975 cyclical upturn in activity. In the household sector, the right-hand panel, financial positions are expected to strengthen as suggested by a decline in debt outstanding relative to disposable income. Even so, by the end of 1981 this ratio would still be higher than anytime prior to the runup over recent years. At financial institutions the bottom panels, a process of adding to liquid assets and reducing borrowing is under way. But rising interest rates and strengthened loan demands next year are expected to be associated with an abatement of this process, and banks and thrift institutions are likely to be once again reaching for borrowed funds in contrast to recovery periods of past cycles.

The developments in financial markets are a reflection of the policy assumptions and the economic environment. The next chart shows selected measures of GNP, prices, the unemployment rate, and interest rates through 1983, assuming a tax cut next year and without a tax cut.

The econometric model was used to extend the judgmental forecast and to derive the impact of the tax cut. In 1981, nominal GNP--the top panel--is projected to rise considerably faster than during 1980--with or without a tax cut. The tax cut is projected to increase growth of real GNP nearly 1-1/2 percentage points over what it otherwise would have been in 1981, and to have virtually no impact on prices in that year. The unemployment rate in the fourth quarter of 1981 is projected to be about 1/2 percentage point below the no tax cut forecast. However, in both forecasts the federal funds rate--the bottom panel--is projected to rise next year if money growth is to be held to the assumed 4-1/2 percent rate. In subsequent years the tax cut effects appear in prices while higher interest rates have their effects in crowding out private expenditures, thereby constraining growth of real GNP.

The last chart in the package compares the staff and administration economic forecasts. These forecasts assume a tax cut, although it is not clear what makes up the \$25 billion cut in the administration forecast. In both 1980 and 1981 the staff is forecasting less rapid growth of nominal GNP than the administration. The staff's forecast entails a larger decline in real GNP this year and a weaker recovery next, and is somewhat more optimistic on prices. The staff's forecast of unemployment is higher than the administration in both 1980 and 1981. Finally, it might be noted that the administration forecast does not involve an explicit assumption of growth in a monetary aggregate. However, the Treasury bill rate in the final quarter of 1981 is 9-1/2 percent, about 2 percentage points less than in the staff forecast.

**CONFIDENTIAL (FR) CLASS II-FOMC**

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

*July 9, 1980*

## Principal Assumptions

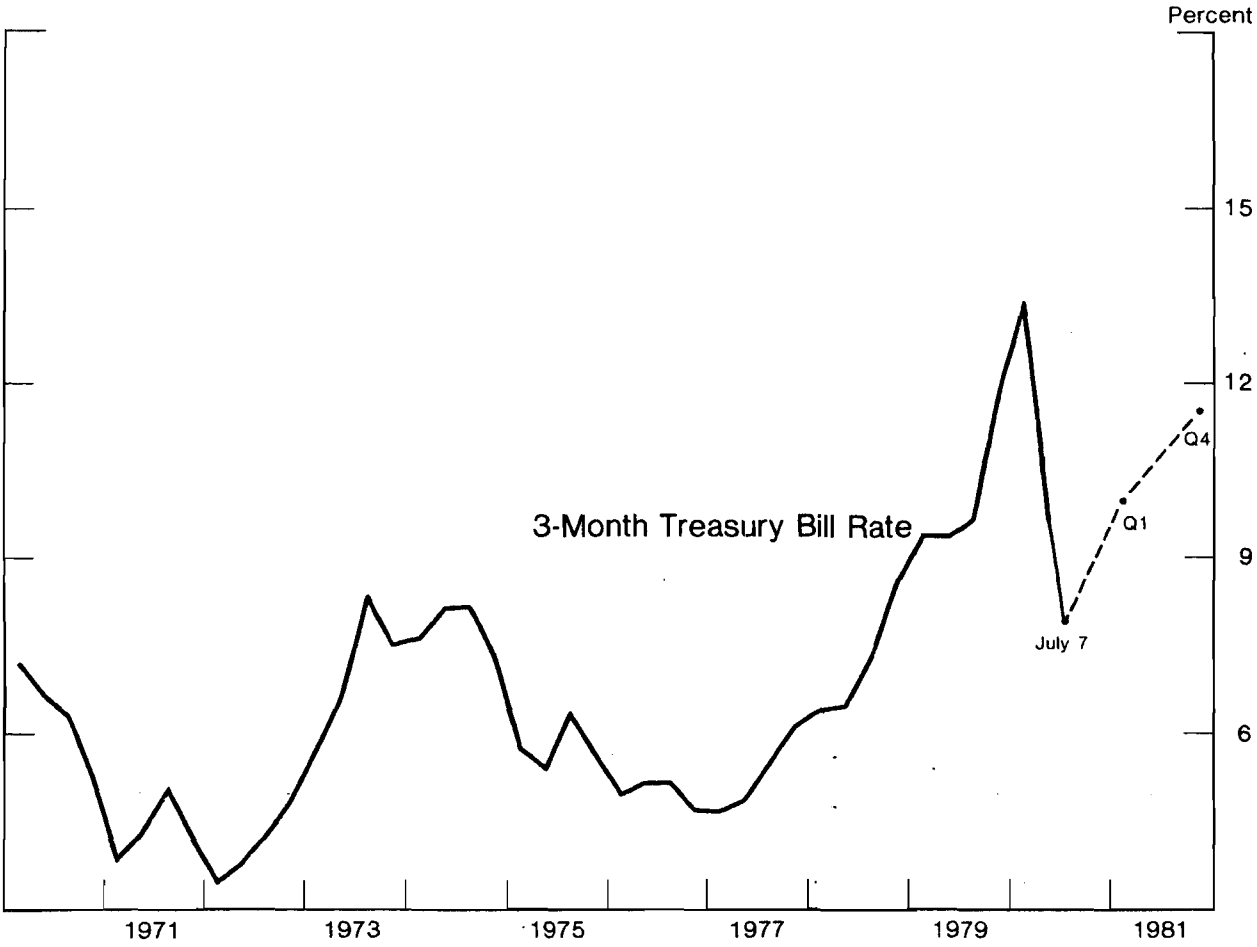
### Monetary Policy

- Growth of M-1A averages 4½ percent in 1980 and 1981

### Fiscal Policy

- Unified budget expenditures of \$575 billion in FY 1980 and \$626 billion in FY 1981
- \$28 billion tax cut effective January 1981
  - \$20 billion personal rate reduction
  - \$5 billion corporate rate reduction
  - \$3 billion initial effects of accelerated depreciation

# Interest Rates

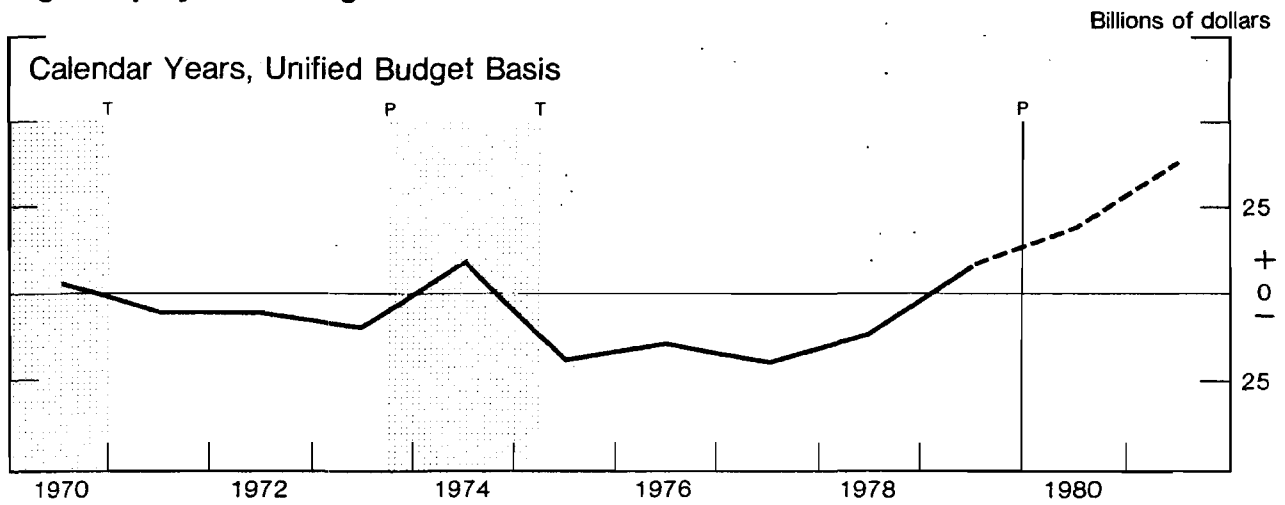


## Federal Budget

Billions of dollars

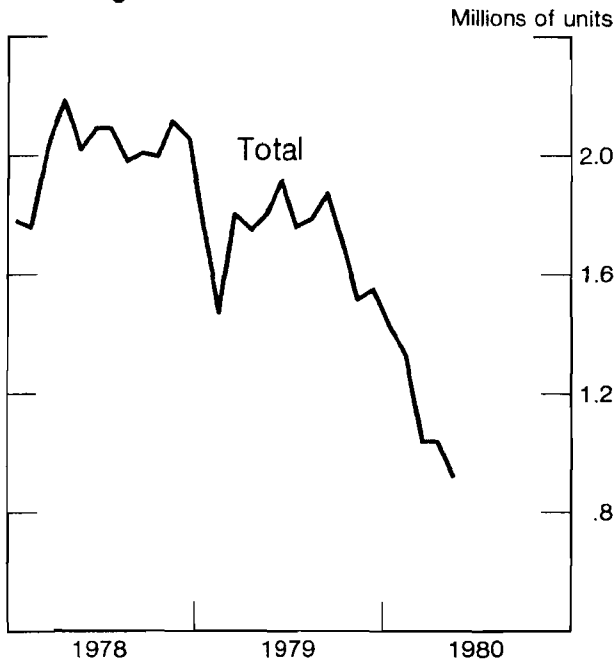
Fiscal Years, Unified Budget Basis					
	<u>1979</u>	<u>1980</u>		<u>1981</u>	
	<u>Actual</u>	<u>Admin.</u>	<u>FRB</u>	<u>Admin.</u>	<u>FRB</u>
Outlays	494	n.a.	575	n.a.	626
Receipts	466	n.a.	523	n.a.	573
Deficit	28	55-60	52	30-35	53

## High-employment Budget

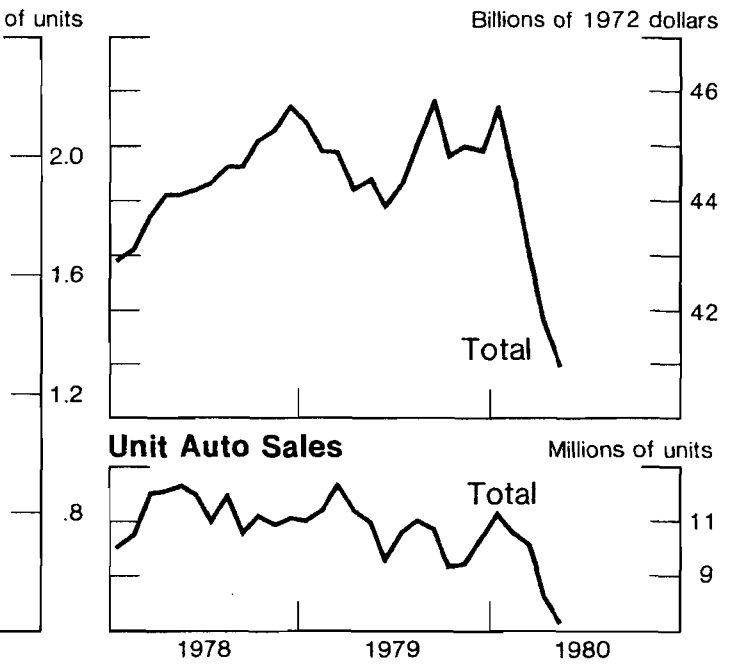


# Economic Activity

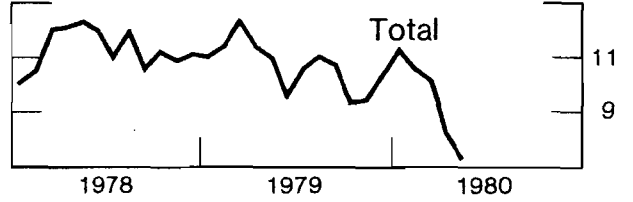
## Housing Starts



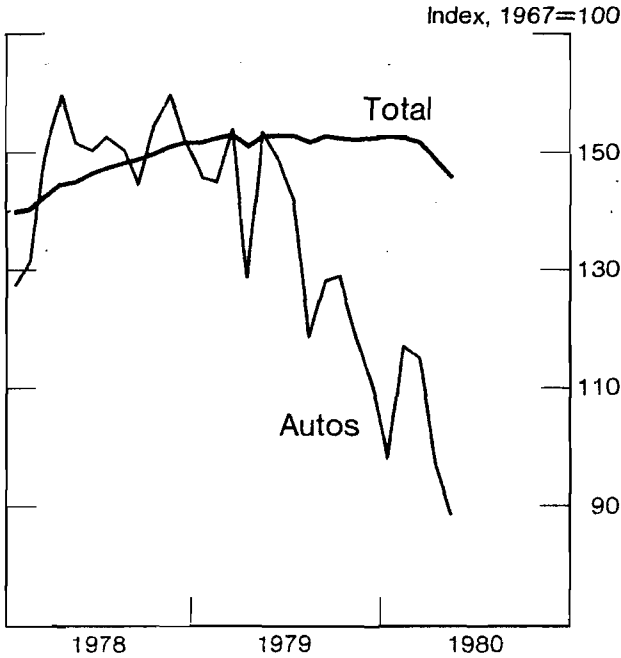
## Real Retail Sales



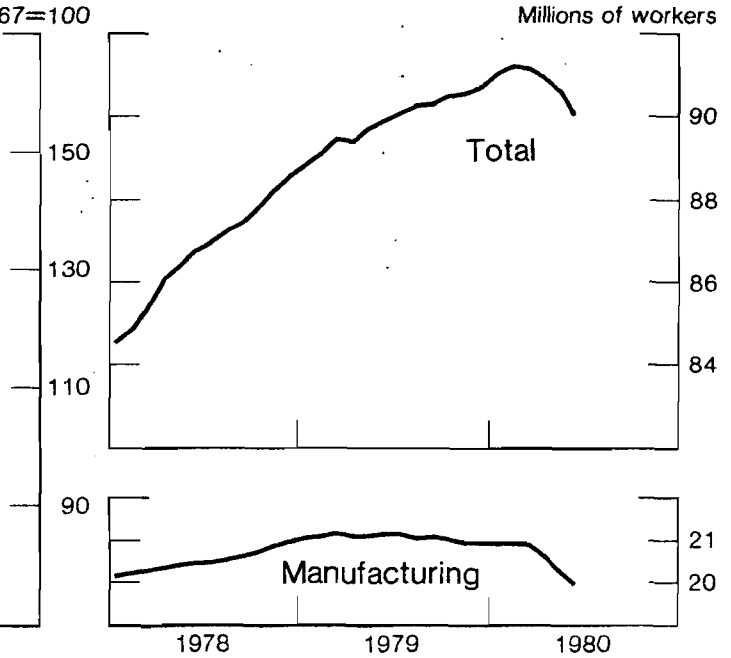
## Unit Auto Sales



## Industrial Production

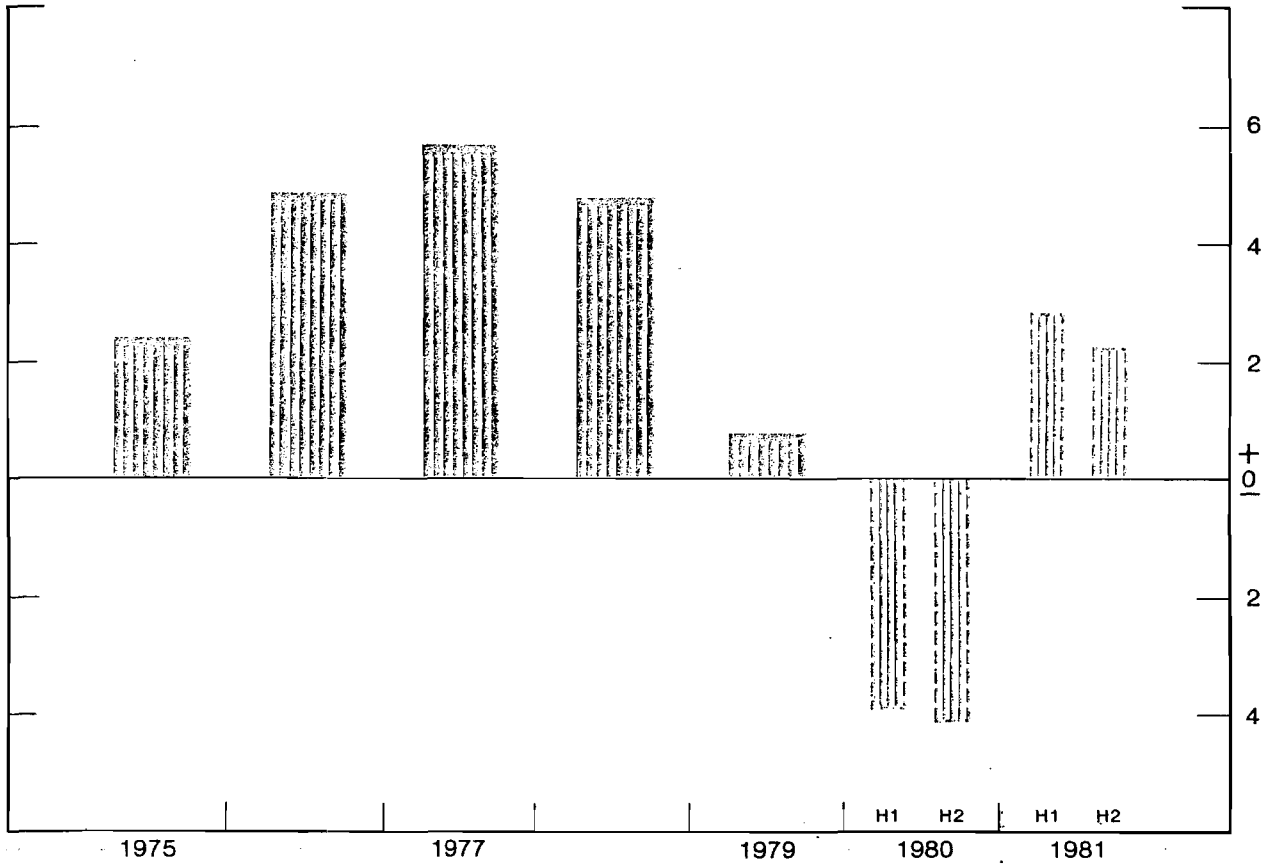


## Nonfarm Employment



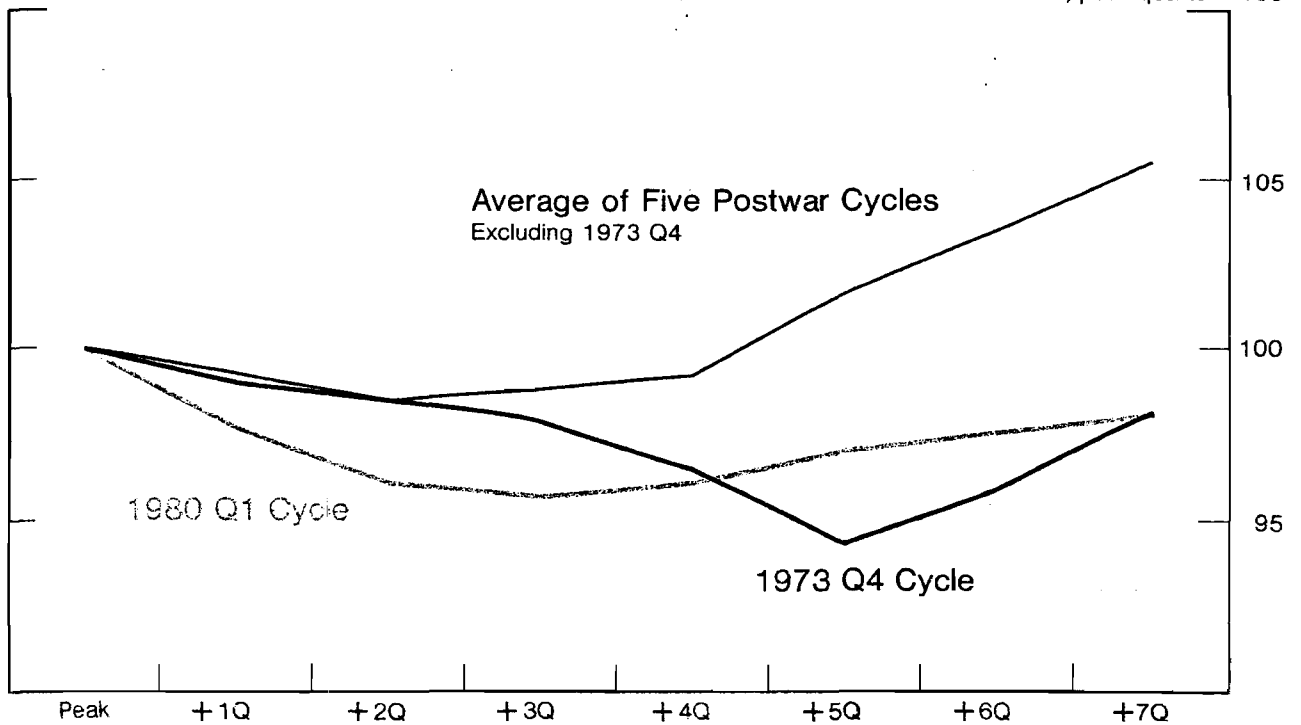
### Percent Change in Real GNP

Change from previous period, annual rate, percent



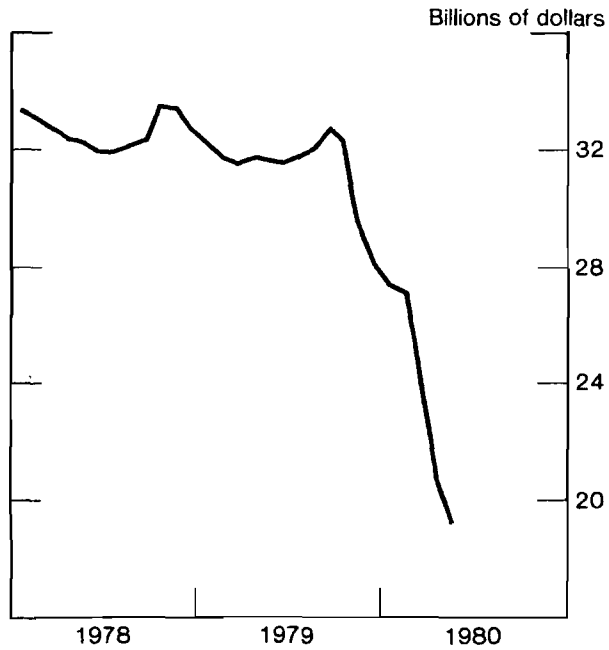
### Cyclical Comparisons of Real GNP

Index, peak quarter=100

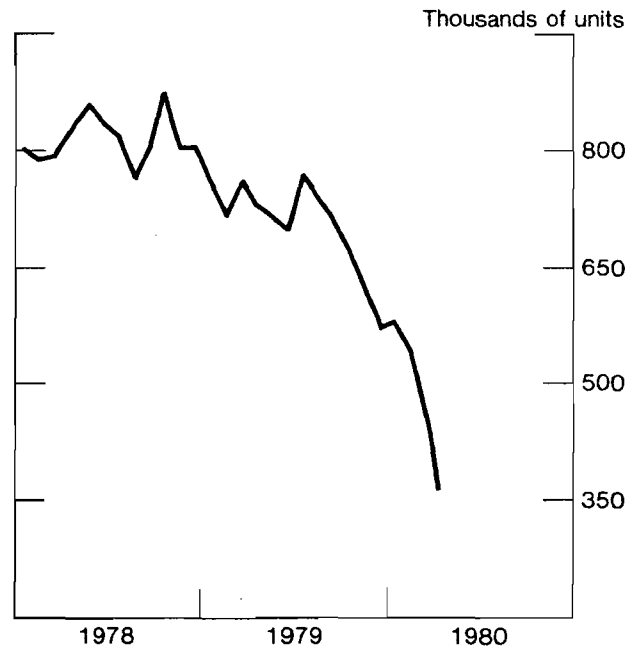




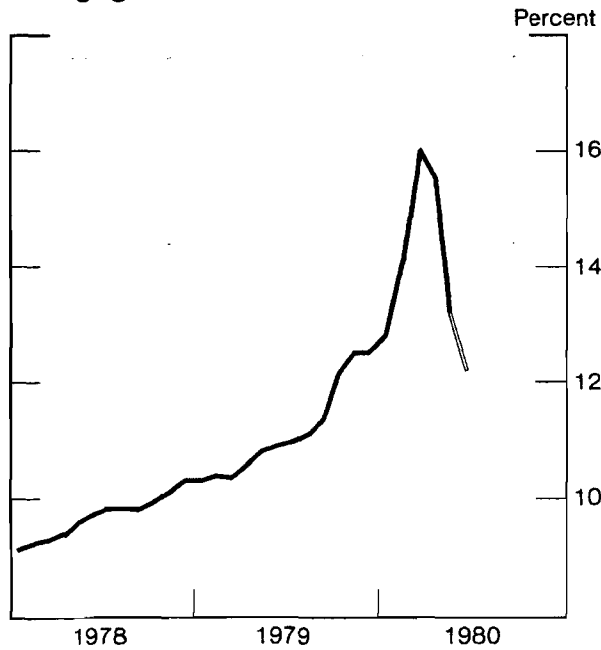
**Outstanding Commitments at Savings and Loan Associations**



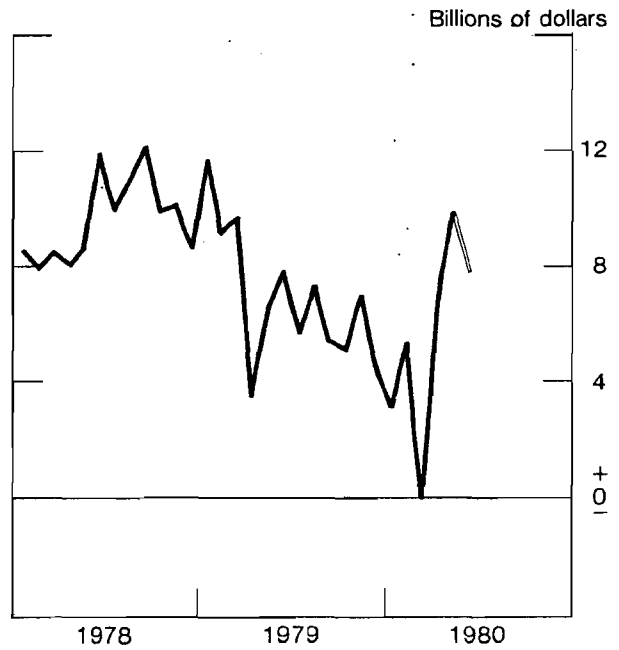
**New Homes Sold**



**Mortgage Rate**

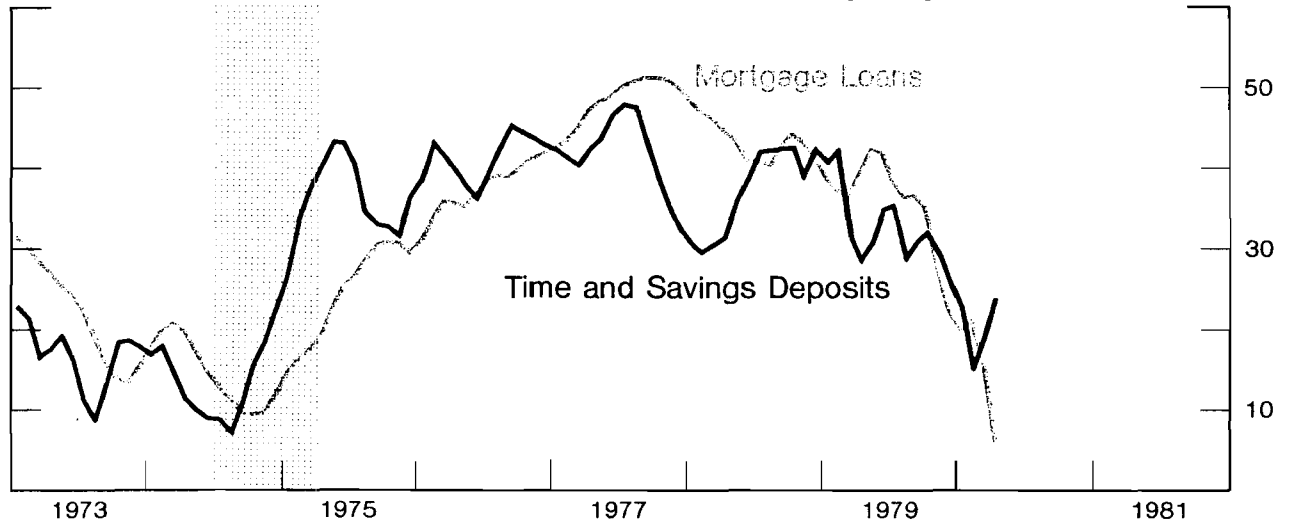


**Deposit Growth at Thrift Institutions**



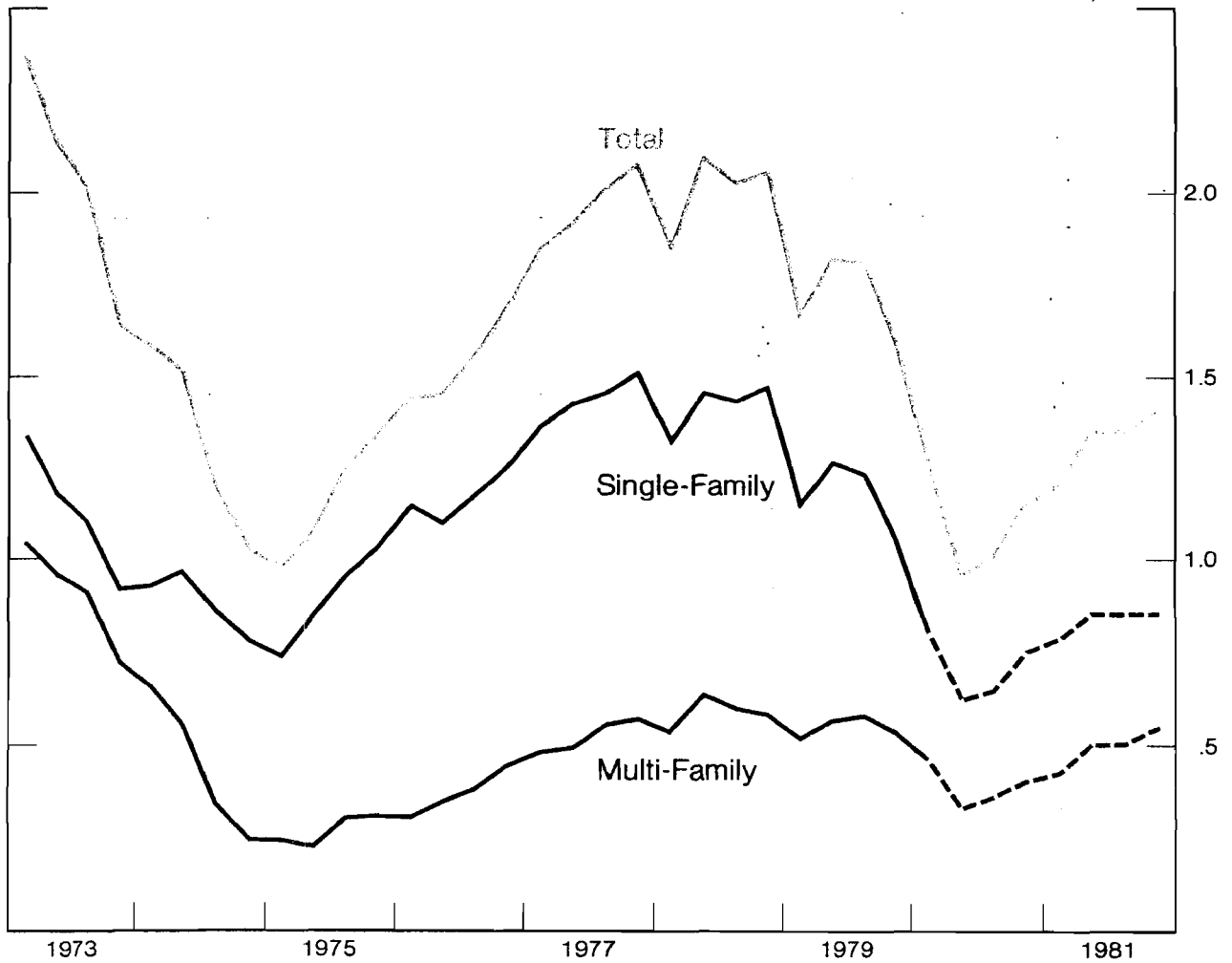
### Net Change in Selected Assets and Liabilities of Savings and Loan Associations

3-month moving average, annual rate, billions of dollars

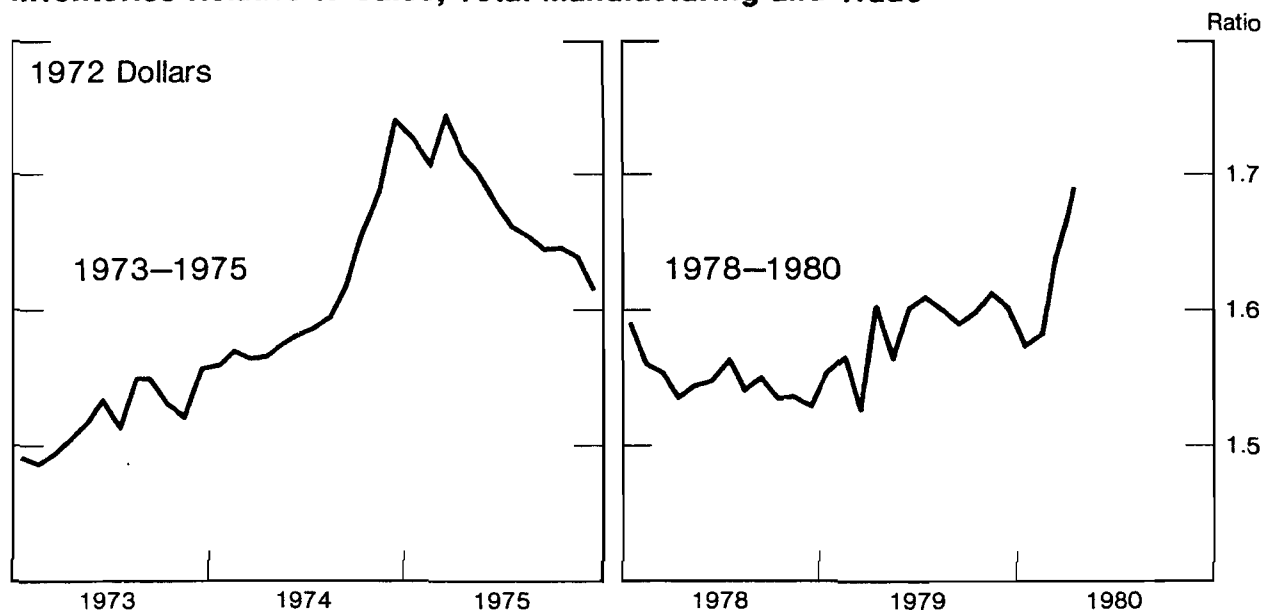


### Housing Starts

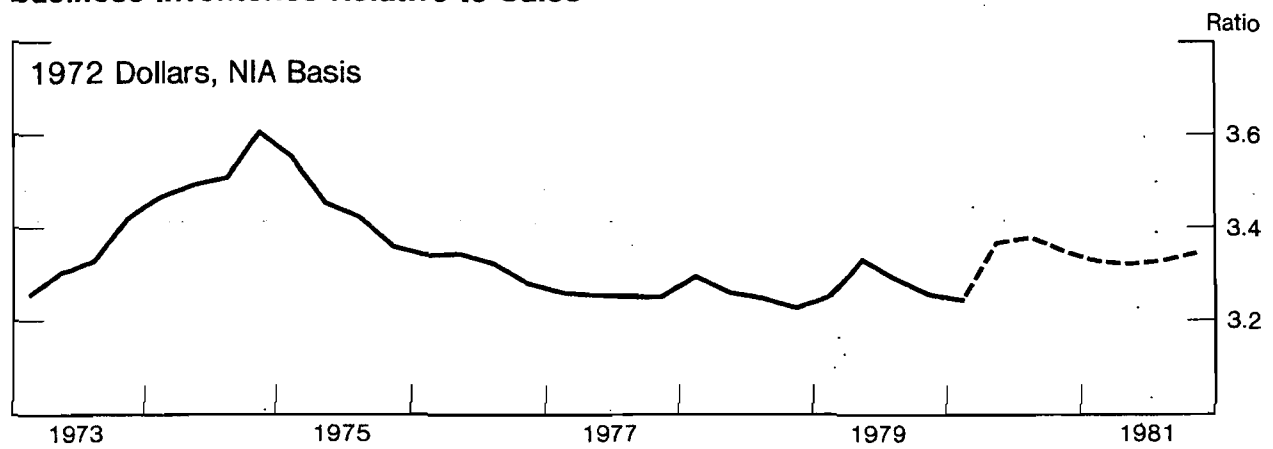
Millions of units, annual rate



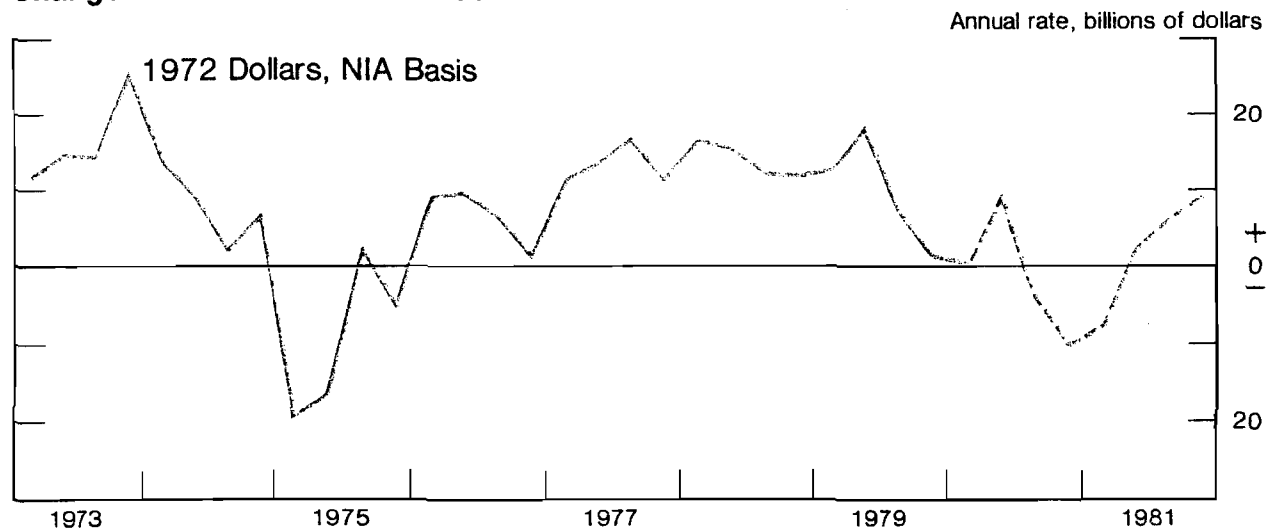
### Inventories Relative to Sales, Total Manufacturing and Trade



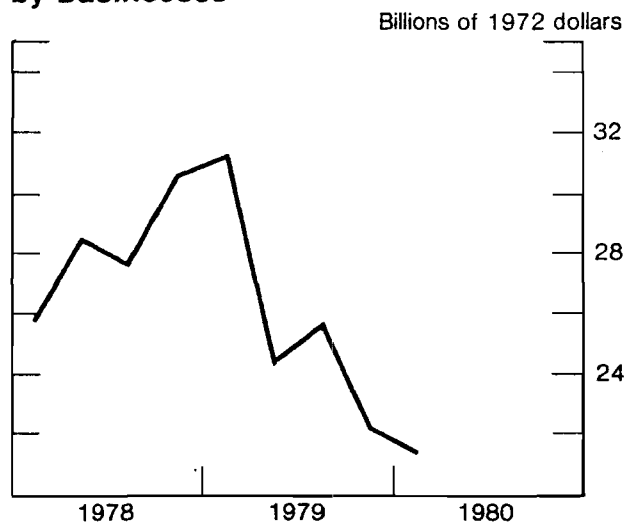
### Business Inventories Relative to Sales



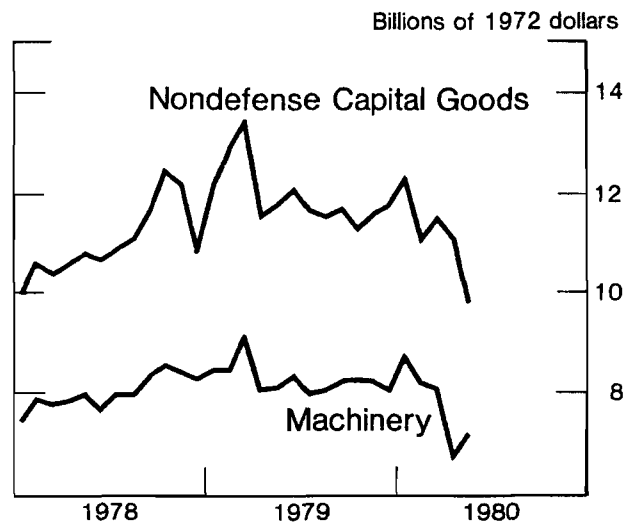
### Change in Business Inventories



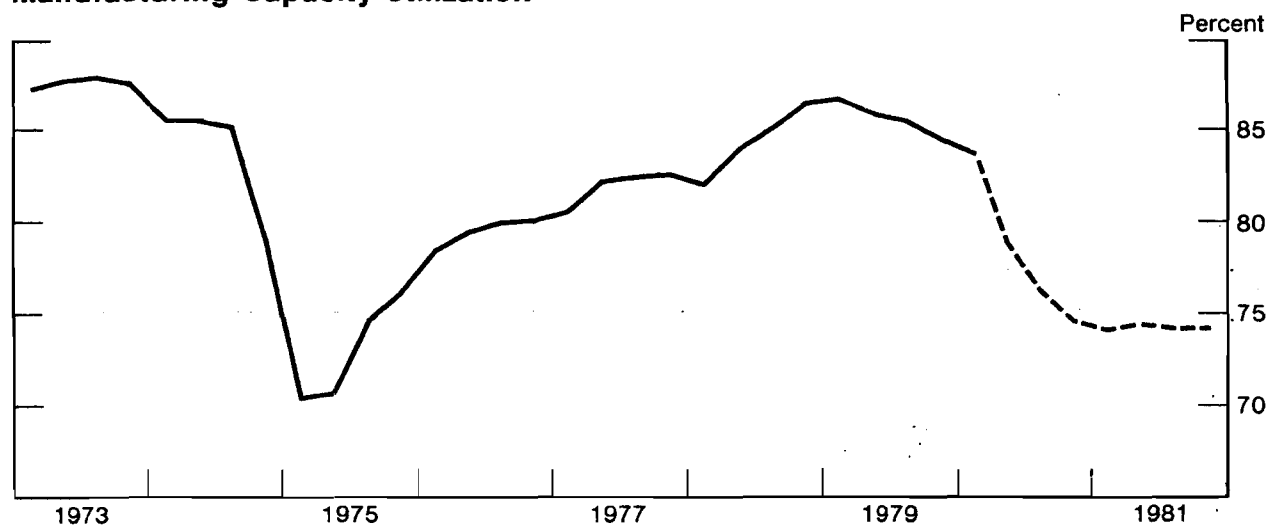
**Purchases of Trucks and Cars by Businesses**



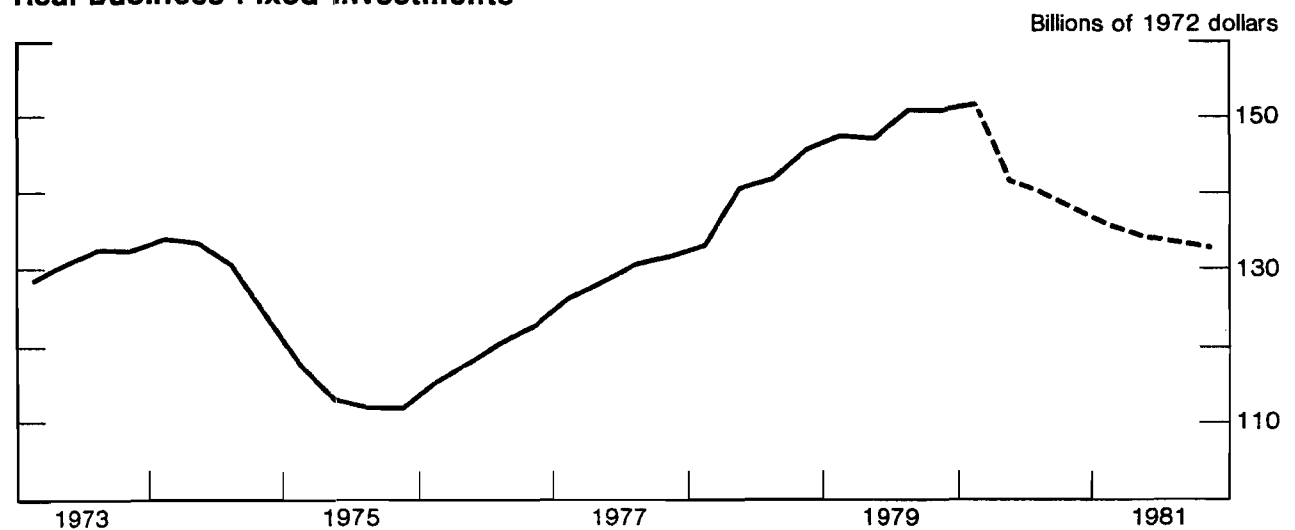
**Real New Orders**



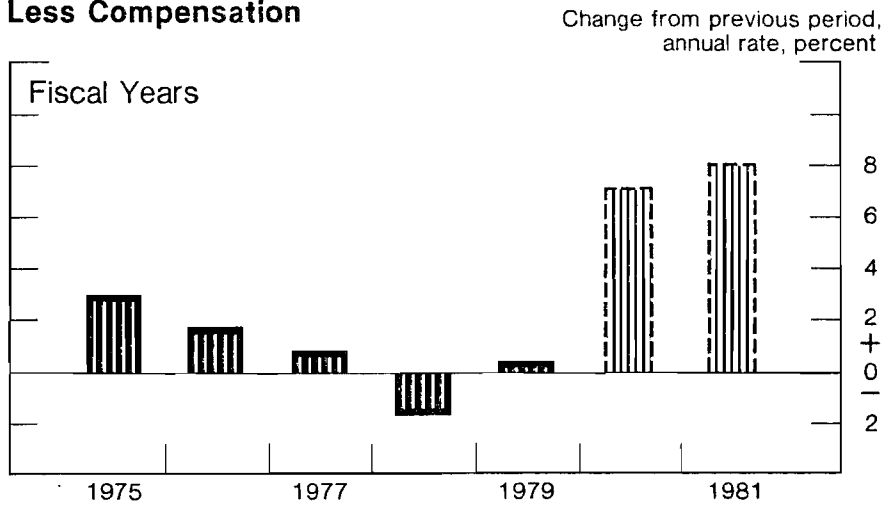
**Manufacturing Capacity Utilization**



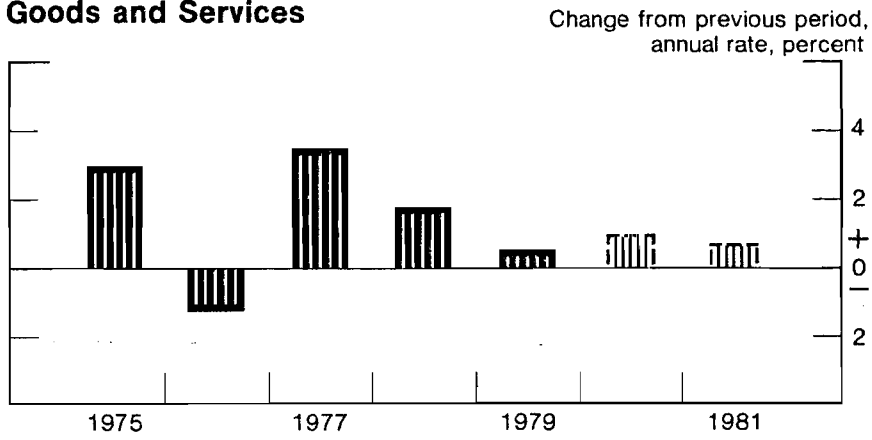
**Real Business Fixed Investments**



**Real Defense Spending  
Less Compensation**



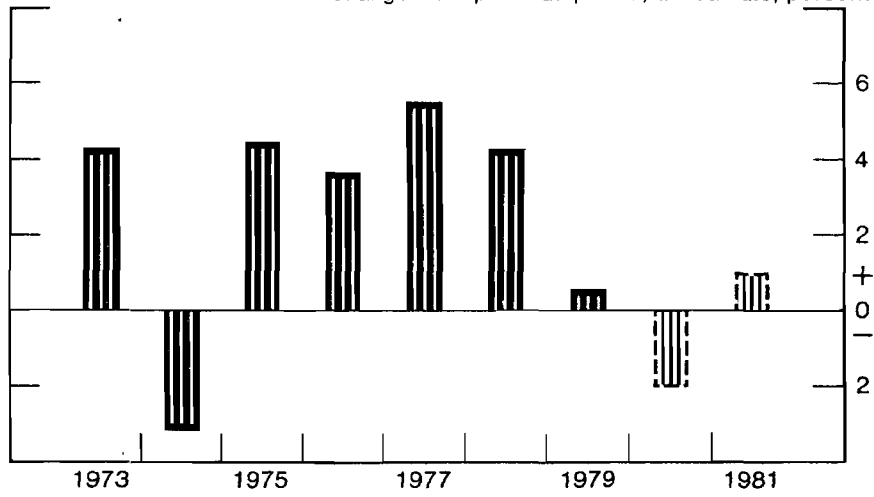
**Real Government\* Purchases of  
Goods and Services**



\* Federal and State and local

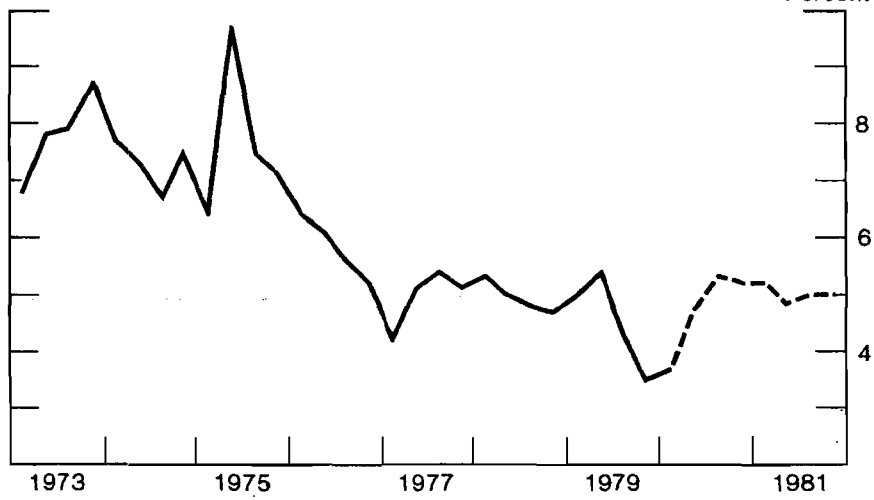
### Real Disposable Personal Income

Change from previous period, annual rate, percent



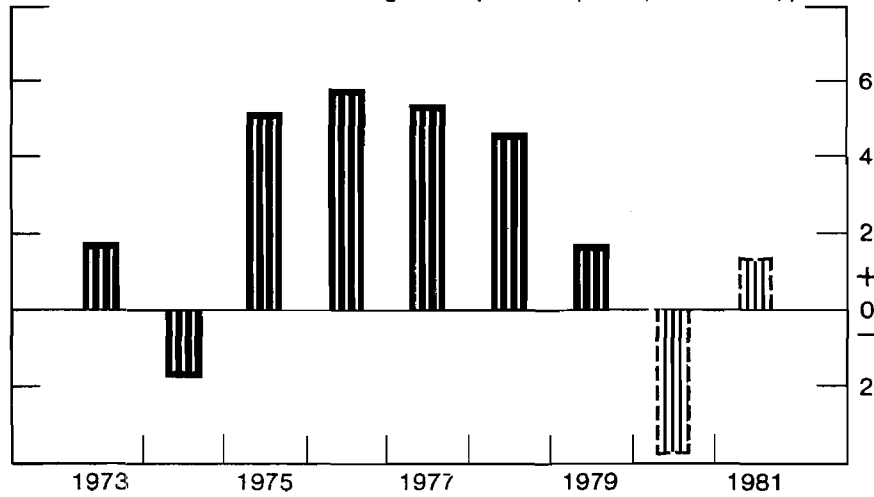
### Saving Rate

Percent



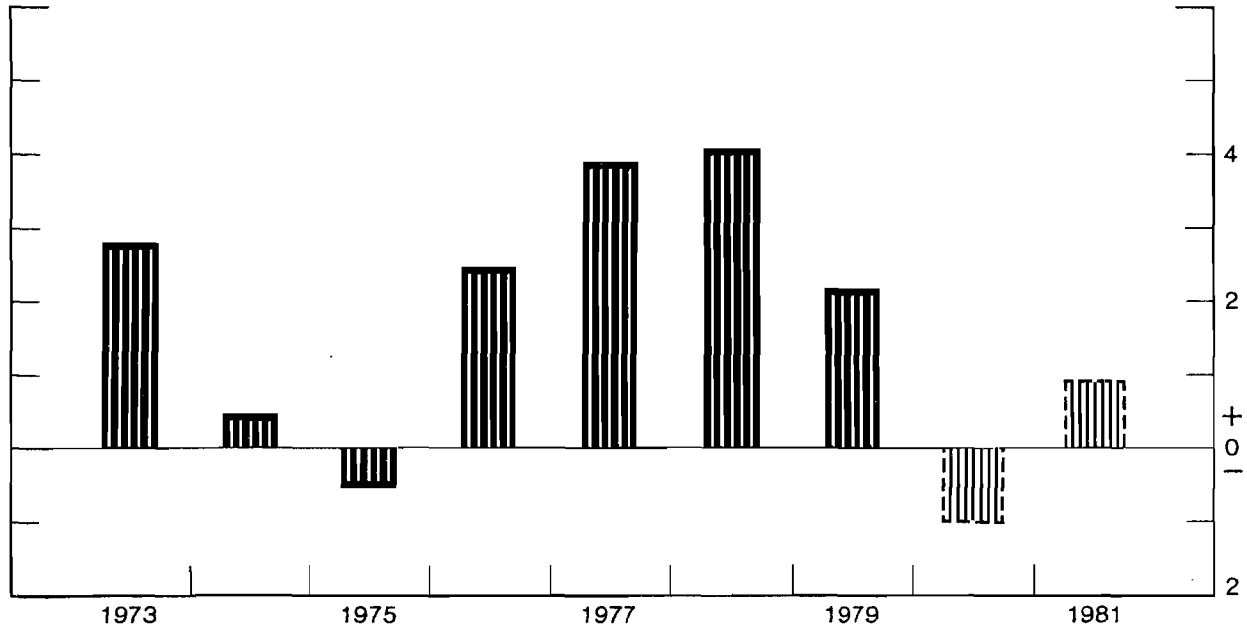
### Real Personal Consumption Expenditures

Change from previous period, annual rate, percent



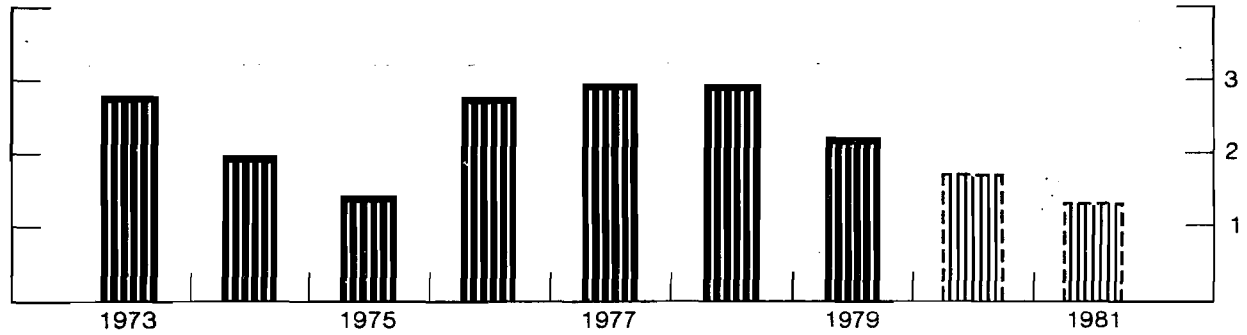
### Nonfarm Employment

Change from Q4 to Q4, annual rate, millions of workers



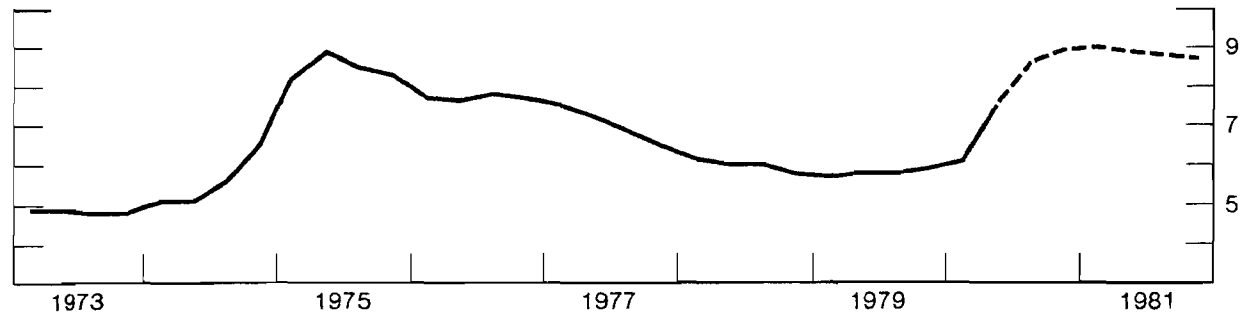
### Civilian Labor Force

Change from Q4 to Q4, annual rate, millions of workers

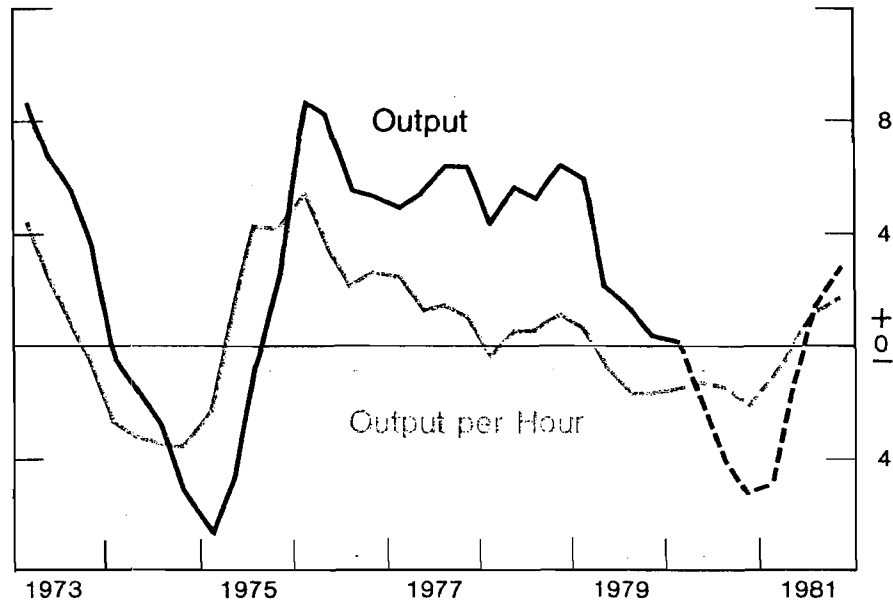
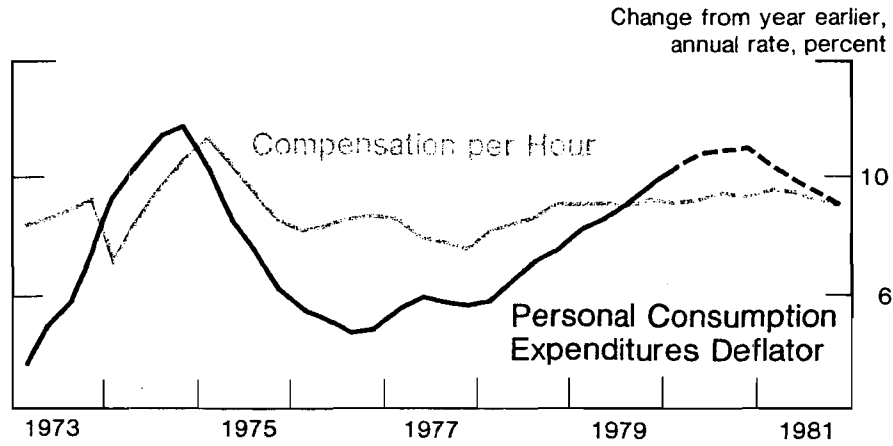


### Unemployment Rate

Percent



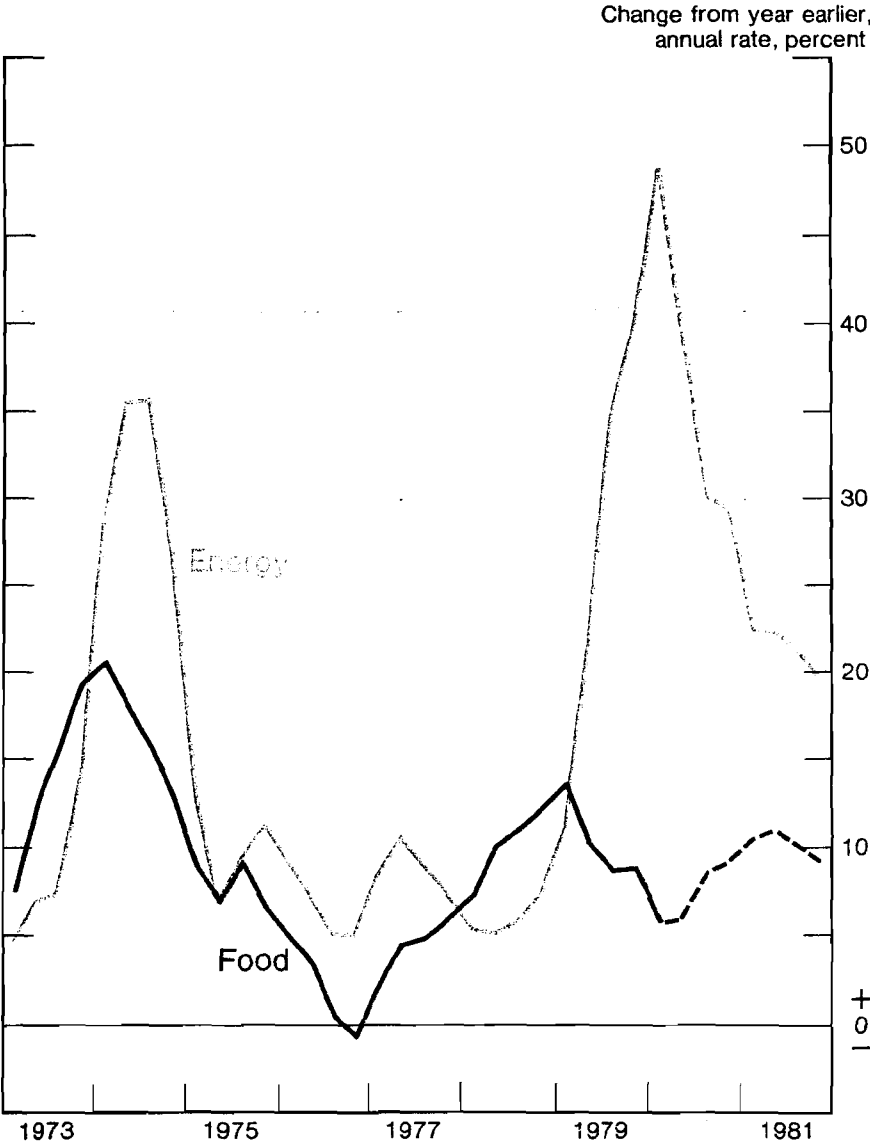
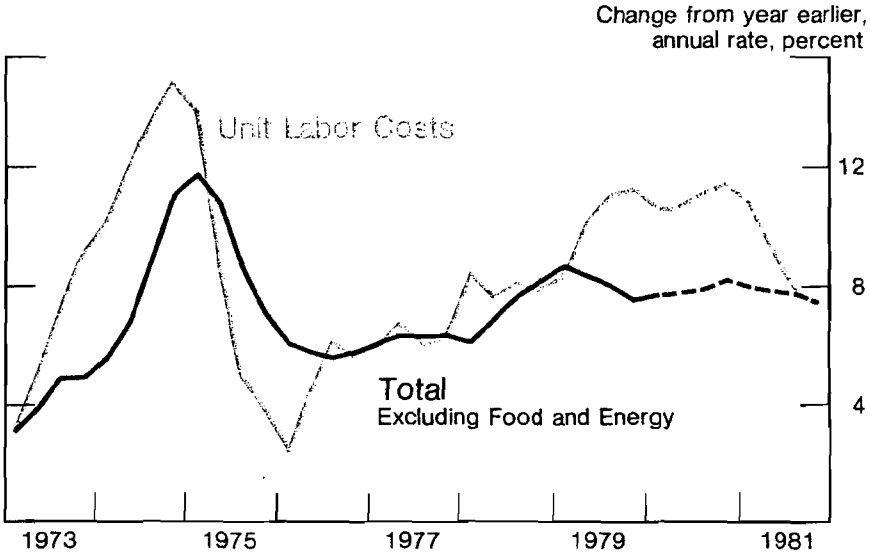
## Unit Cost Indicators Nonfarm Business Sector





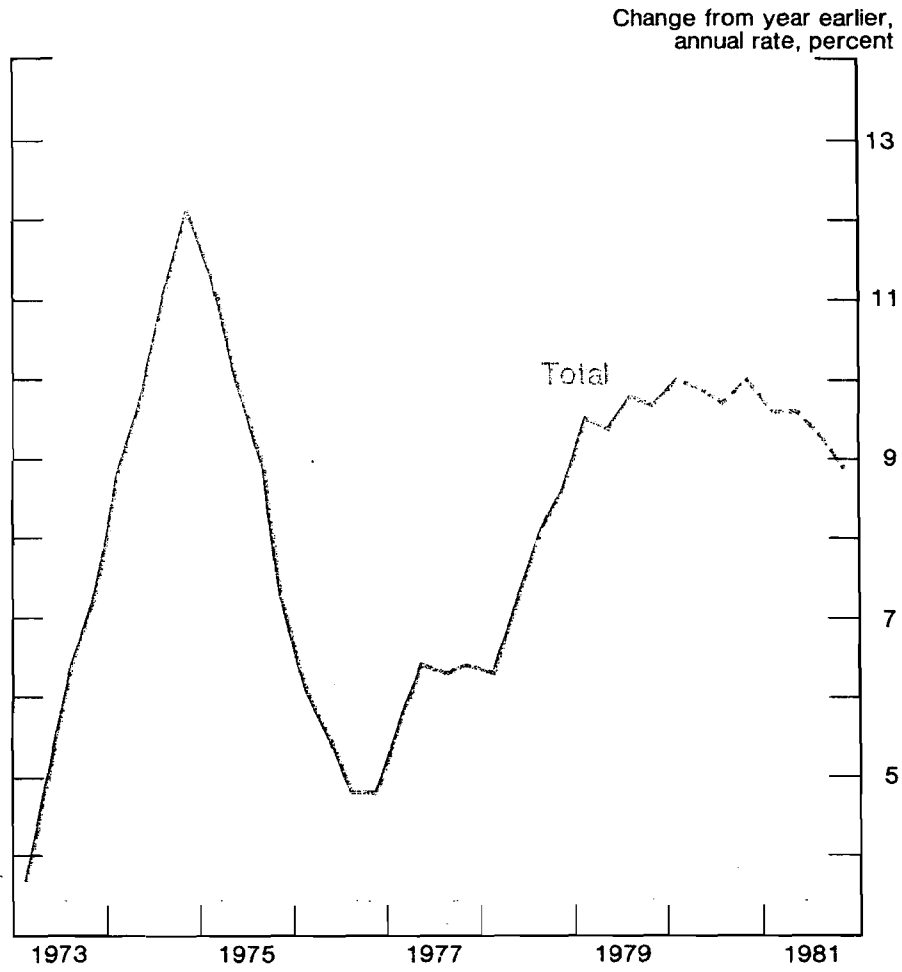
# Prices I

## Gross Business Product

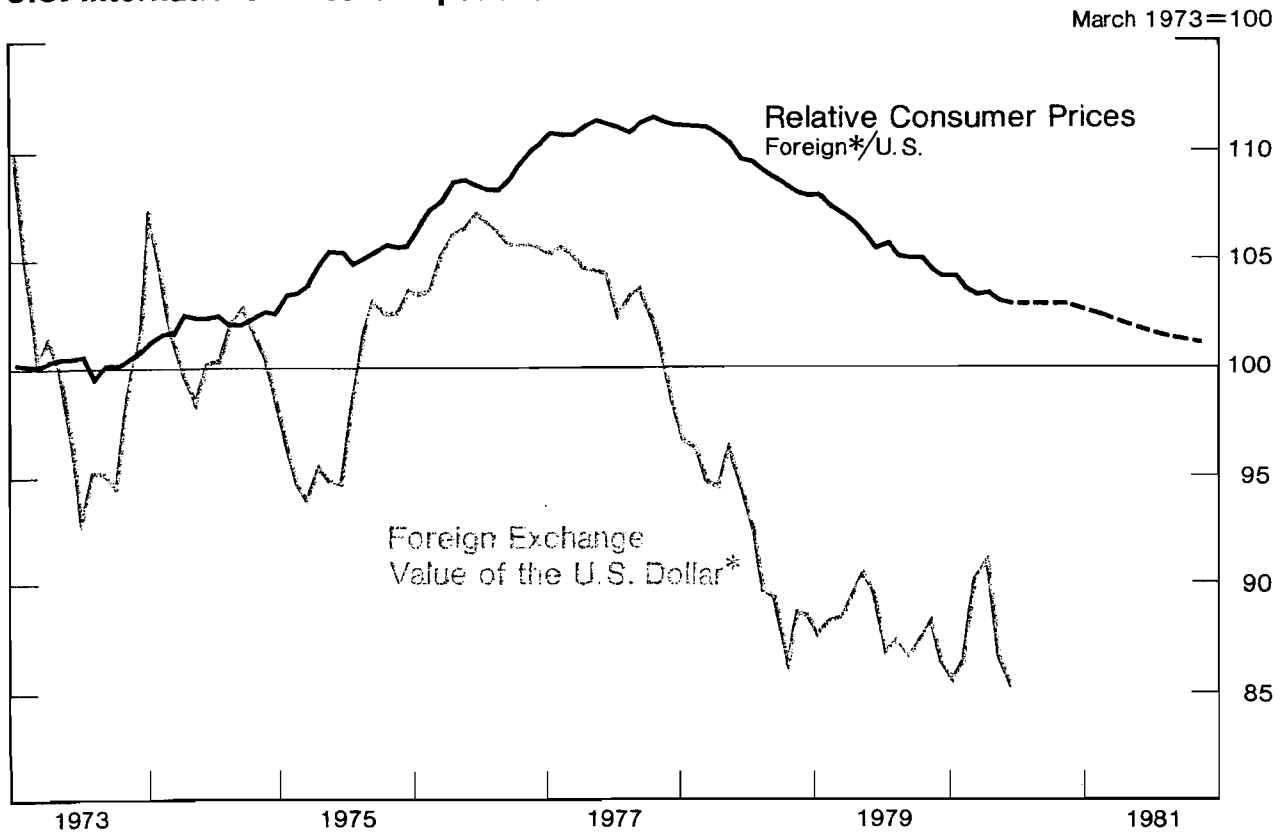


# Prices II

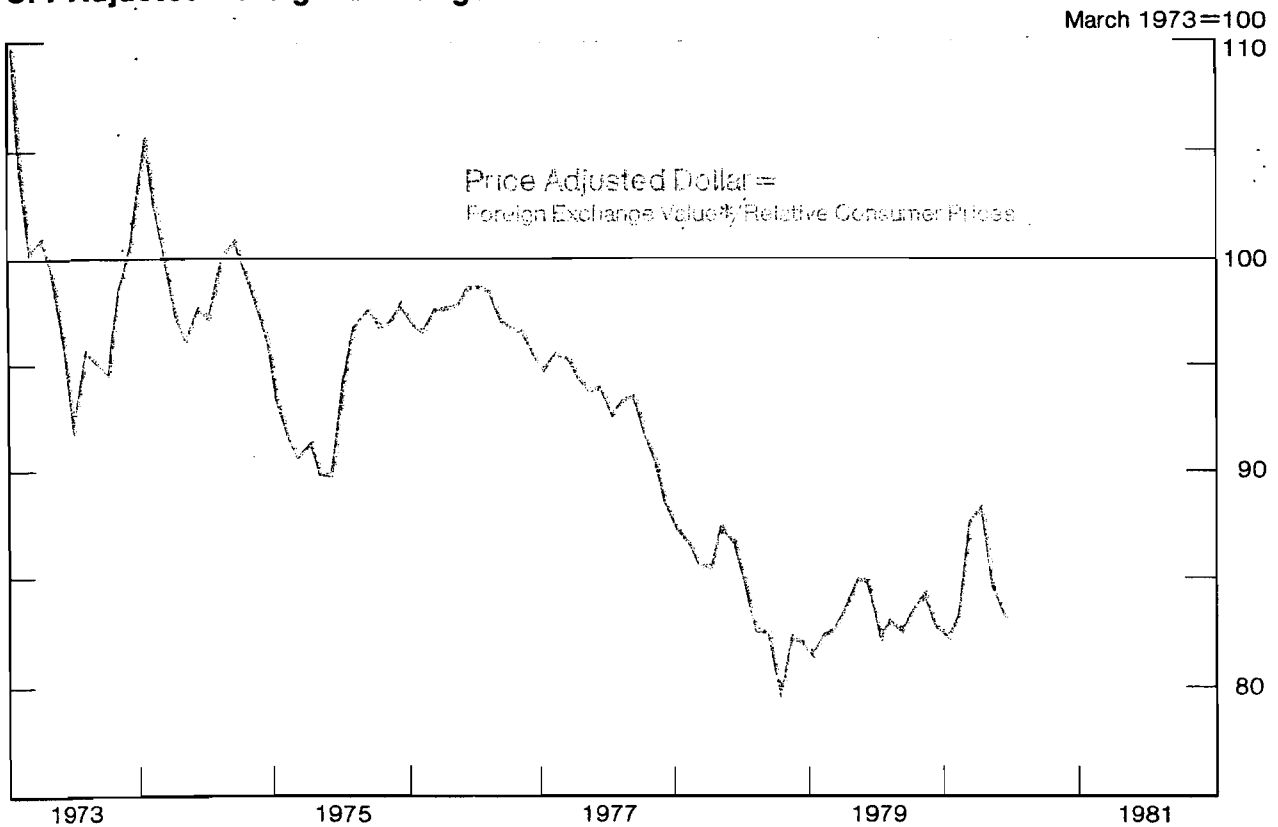
## Gross Business Product



## U.S. International Price Competitiveness

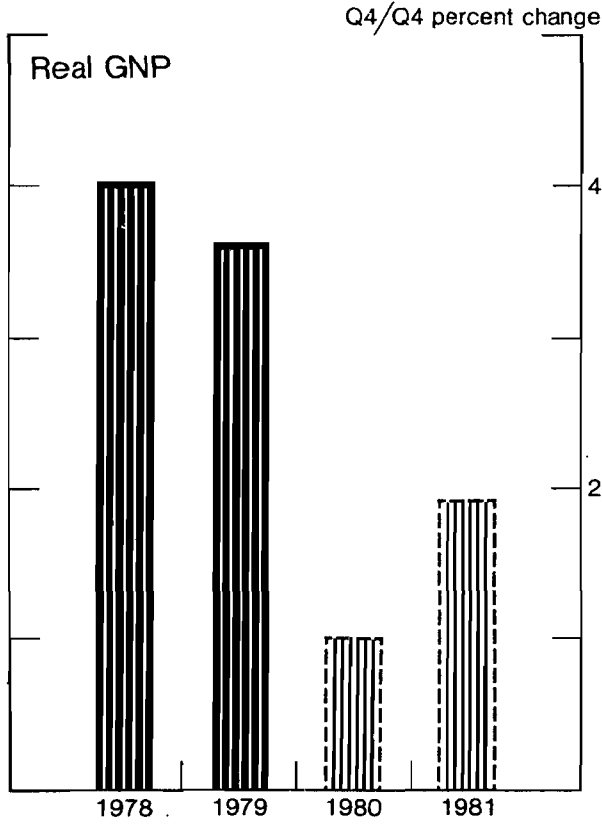


## CPI-Adjusted Foreign Exchange Value of the Dollar

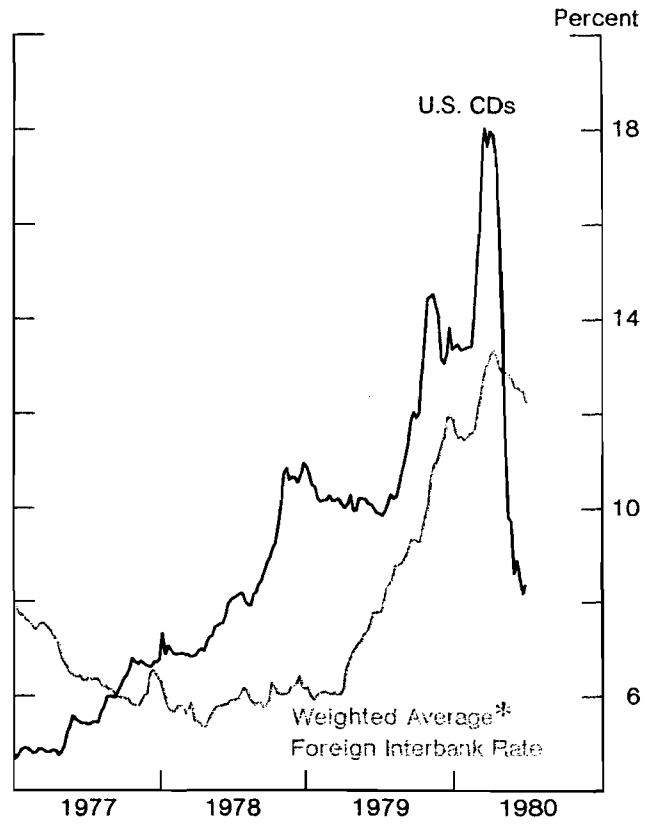


\* Weighted average against G-10 countries plus Switzerland using total 1972-1976 average trade of these countries.

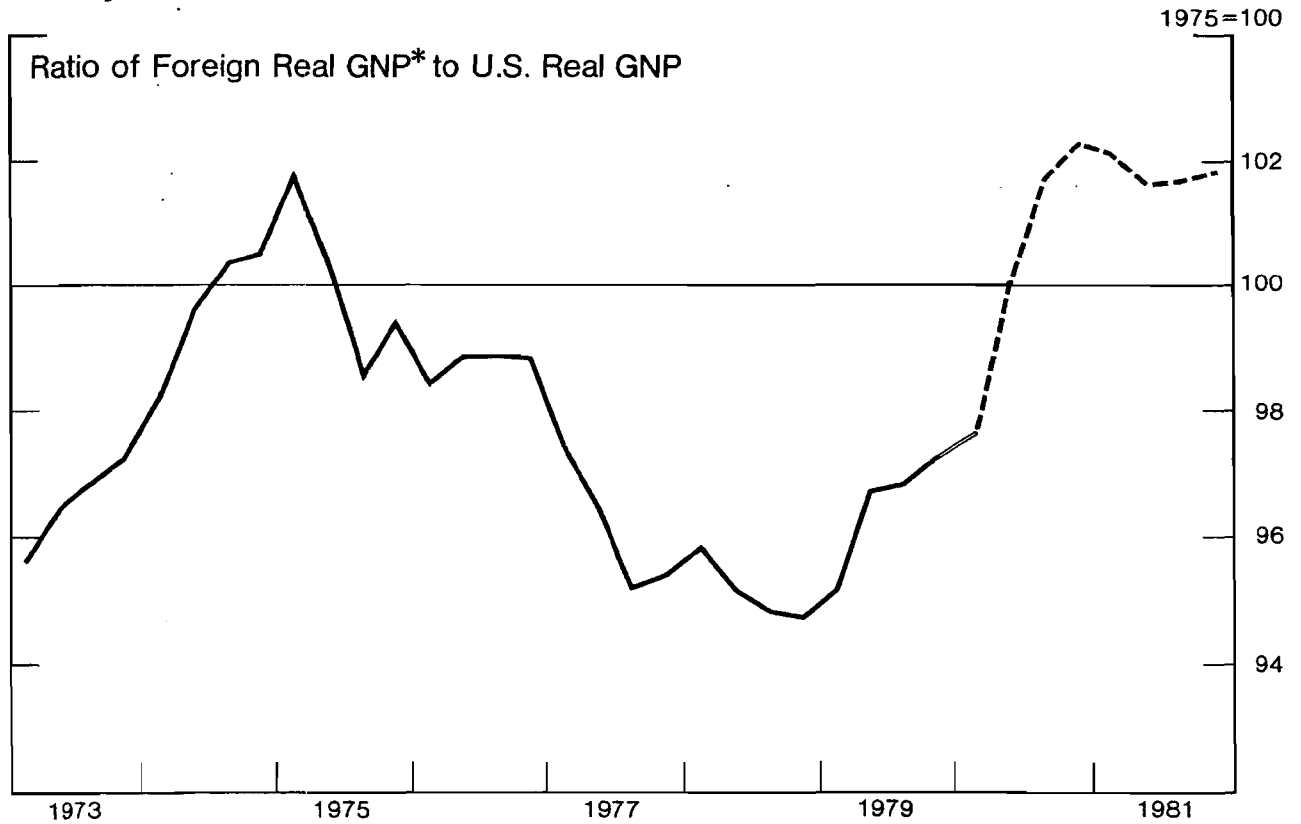
### Foreign Growth\*



### 3-Month Interest Rates



### Activity Ratio

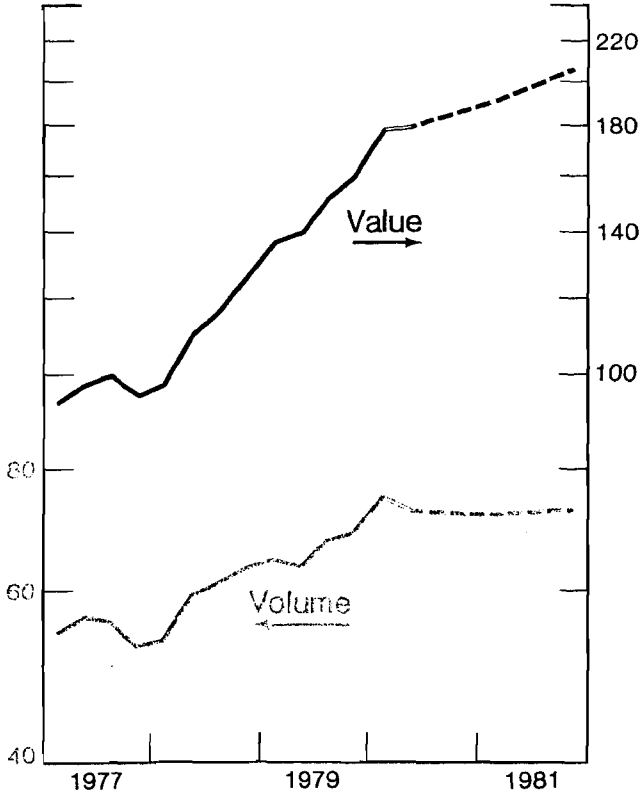


\* Weighted average of interest rates of other G-10 countries plus Switzerland using total 1972-1976 average trade of these countries.

### Nonagricultural Exports

Billions of 1972 dollars,  
ratio scale

Billions of dollars,  
ratio scale



### Price of U.S. Oil Imports

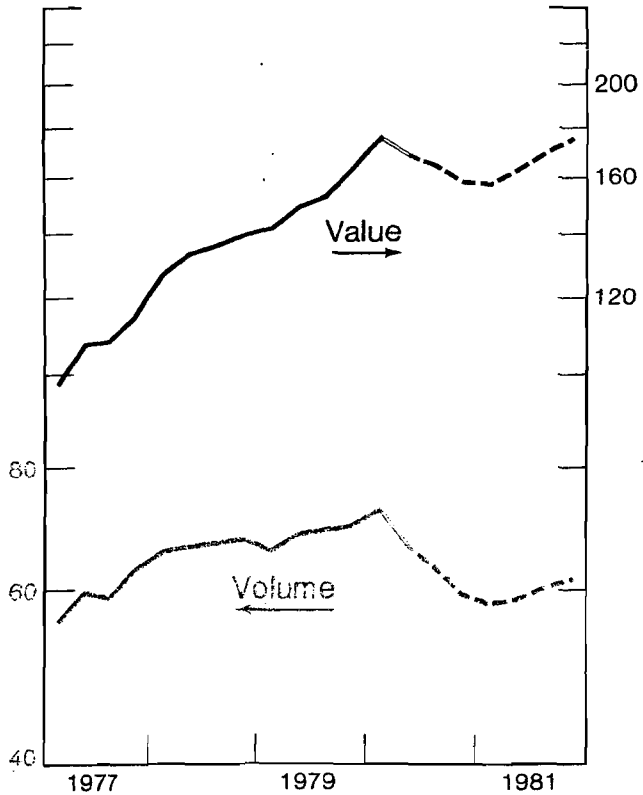
	Dollars/barrel fourth quarter	Percentage change
1978	13.35	—
1979	23.68	77
1980 <sup>P</sup>	34.20	44
1981 <sup>P</sup>	39.70	16

<sup>P</sup> = Projection

### Non-Oil Imports

Billions of 1972 dollars,  
ratio scale

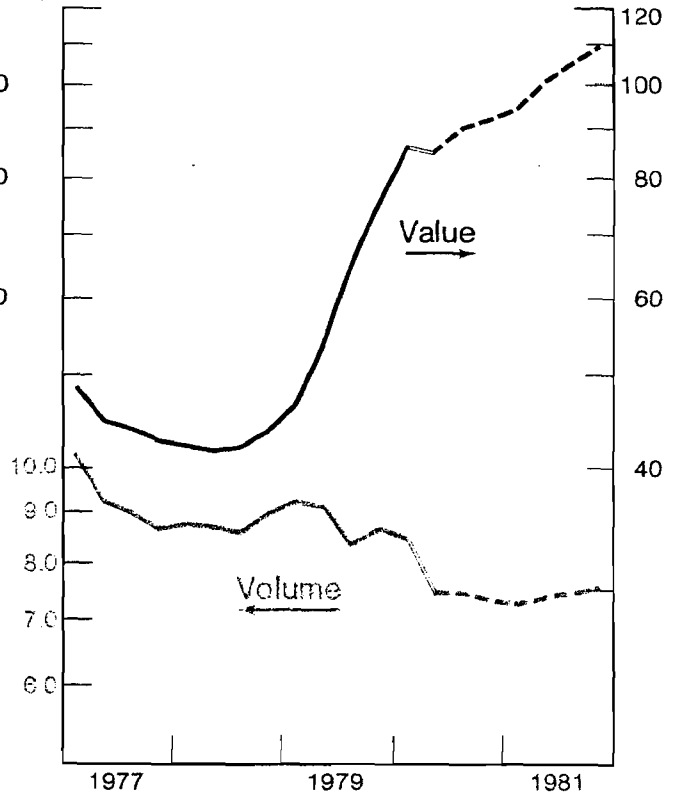
Billions of dollars,  
ratio scale



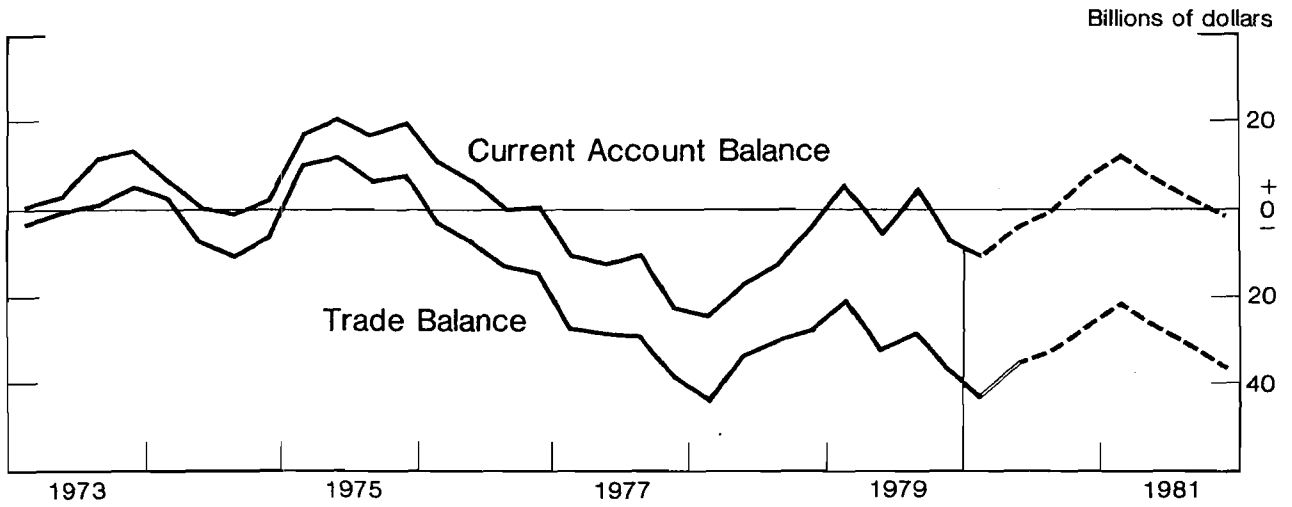
### Oil Imports

Millions of barrels/day,  
ratio scale

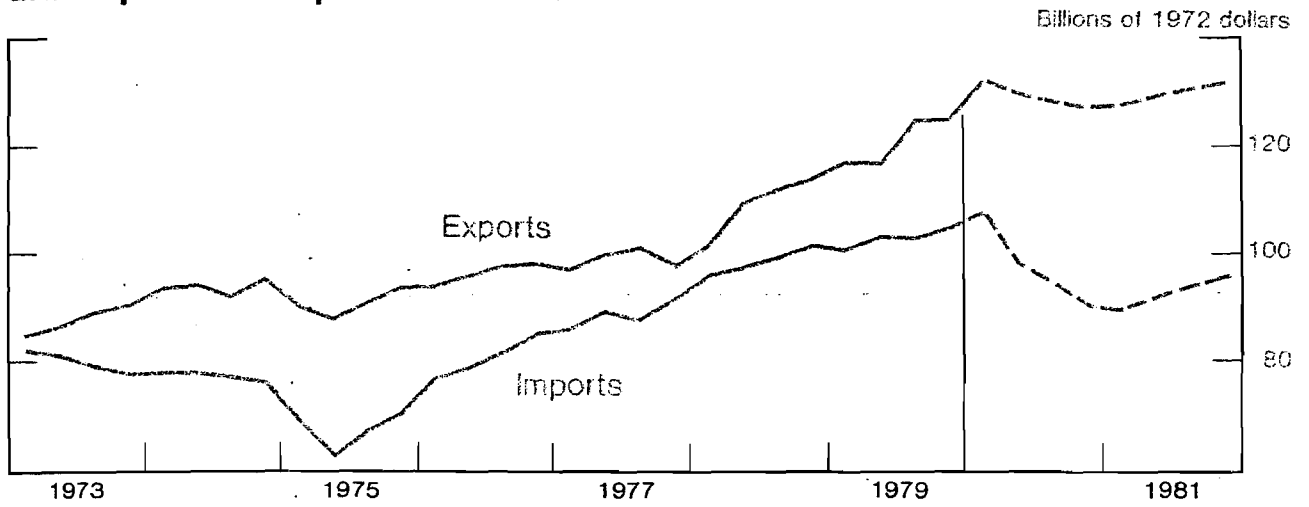
Billions of dollars,  
ratio scale



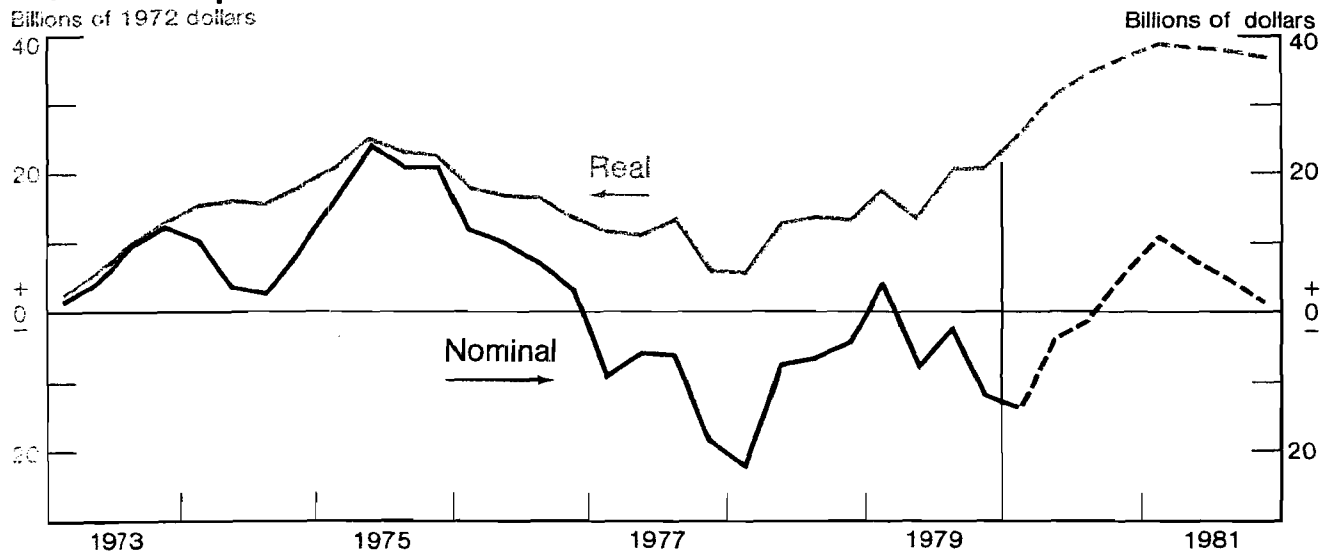
### Merchandise Trade and Current Account Balances



### GNP Exports and Imports of Goods and Services

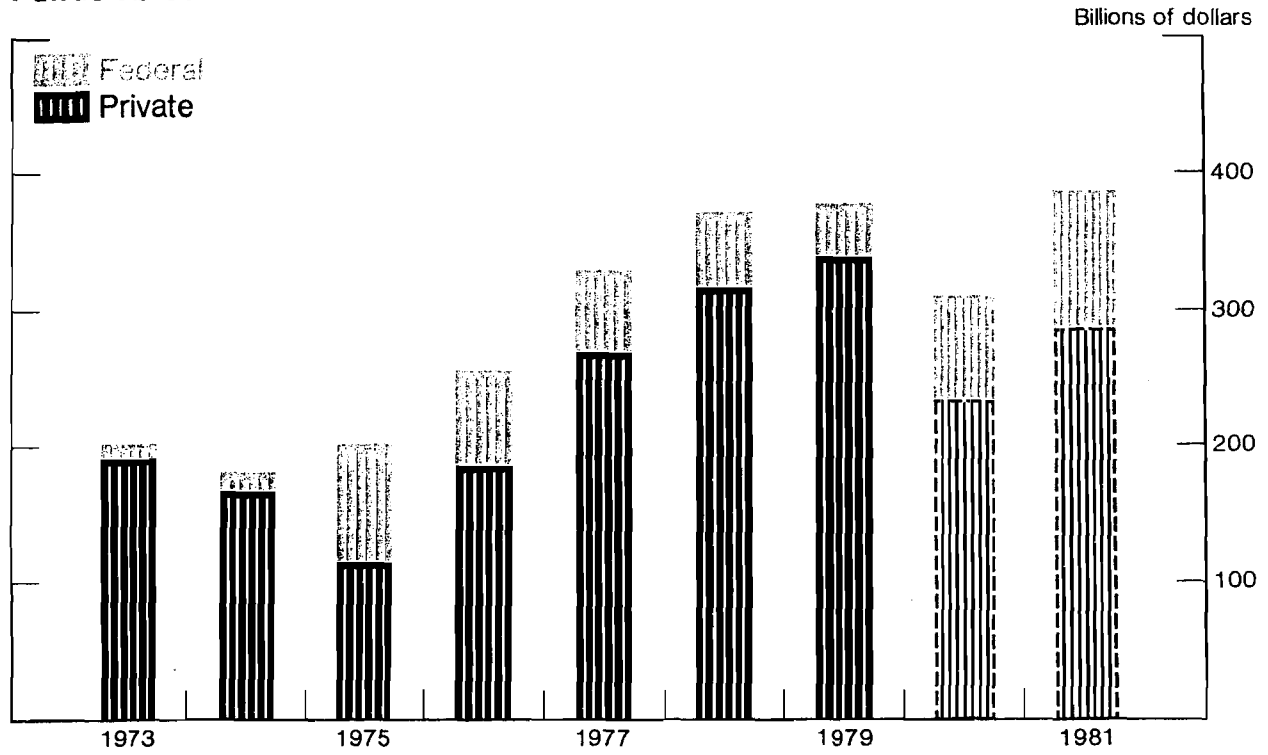


### GNP Net Exports



# Domestic Nonfinancial Sectors

## Funds Raised

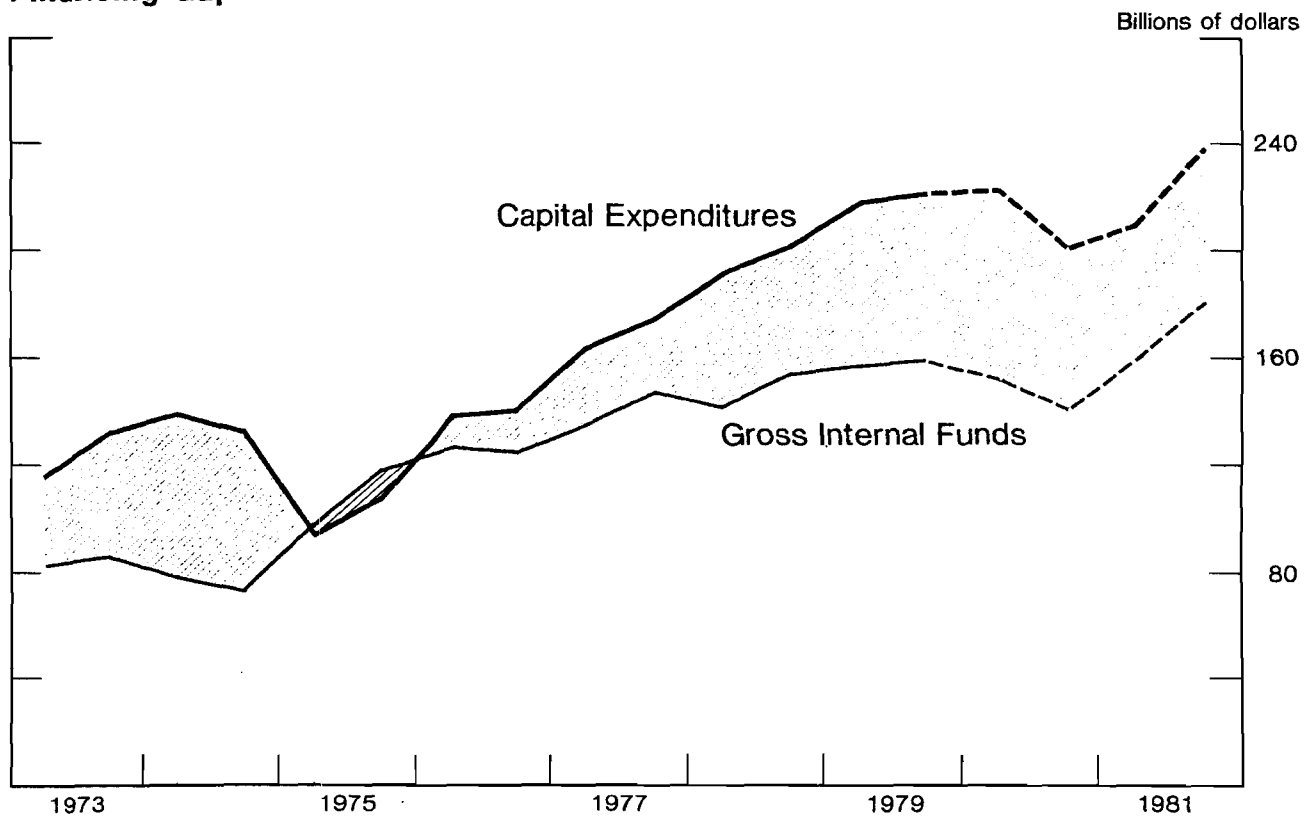


## Funds Raised as a Percent of GNP

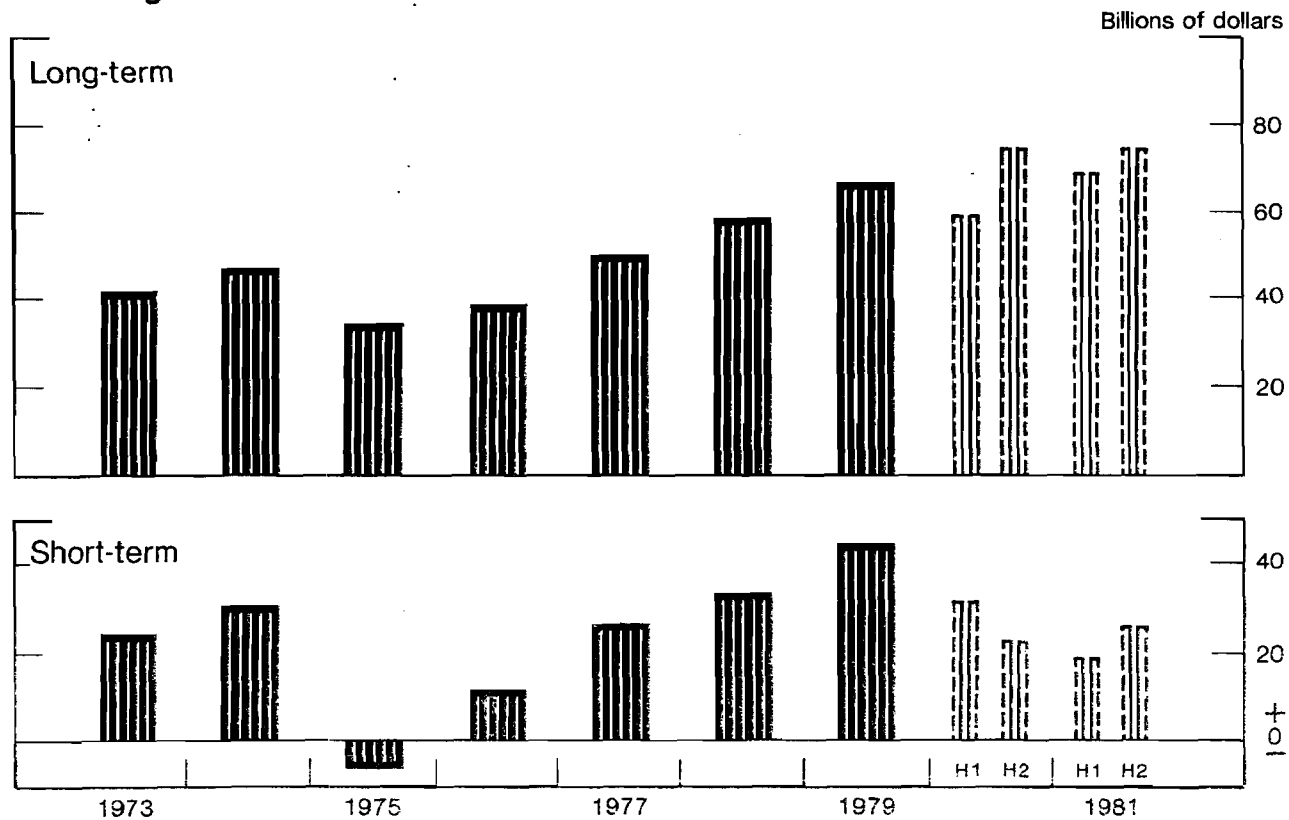


# Corporate Finance

## Financing Gap



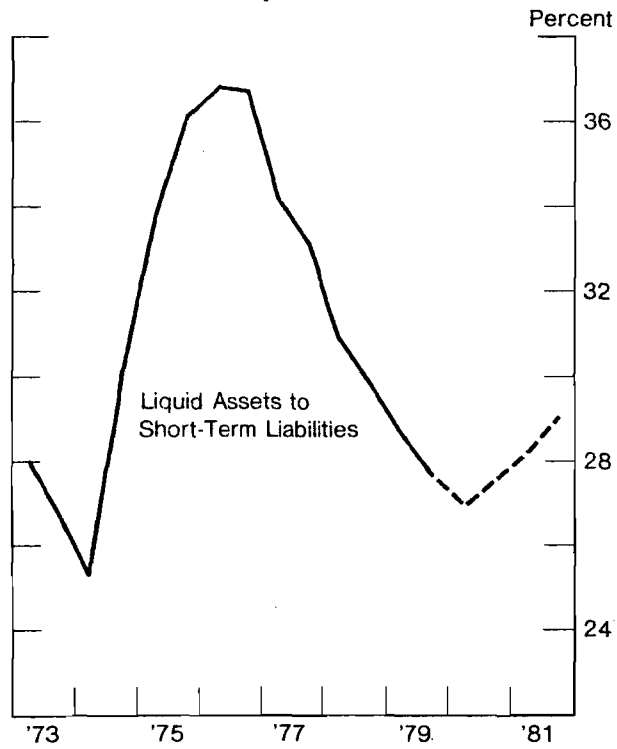
## Borrowing



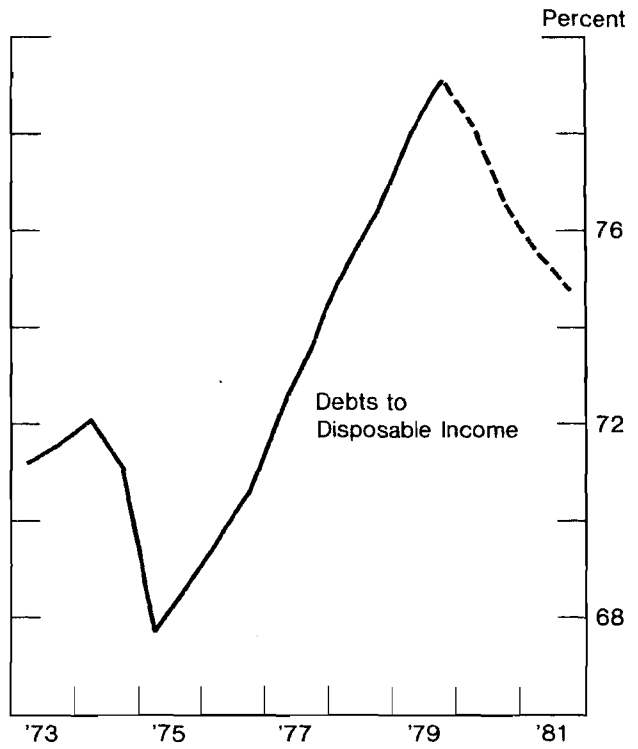


# Selected Balance Sheet Ratios

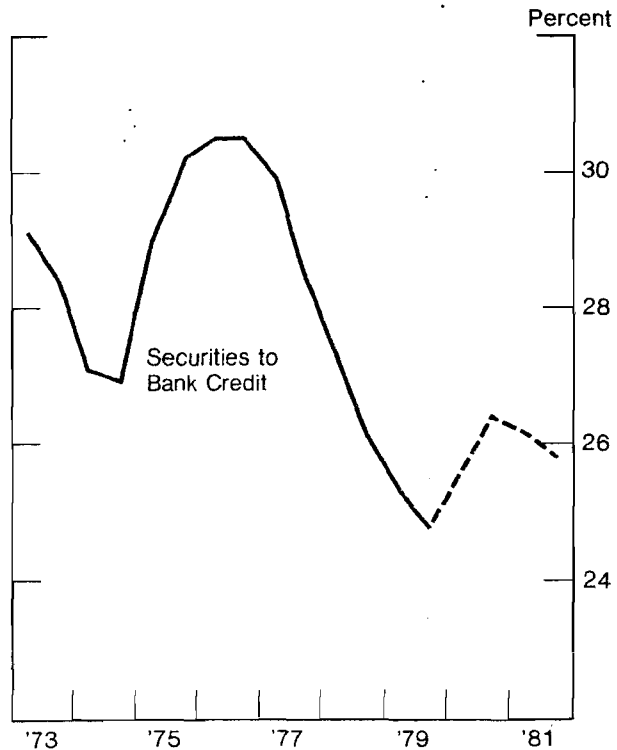
## Nonfinancial Corporations



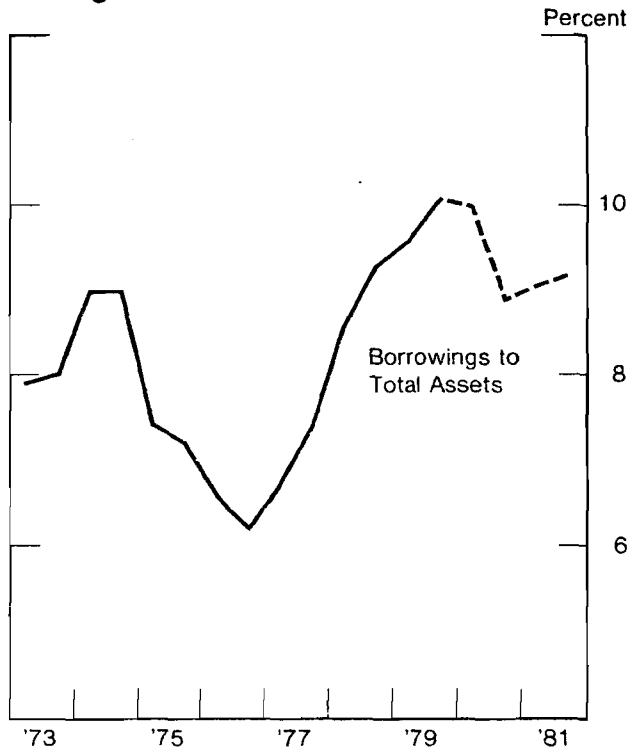
## Households



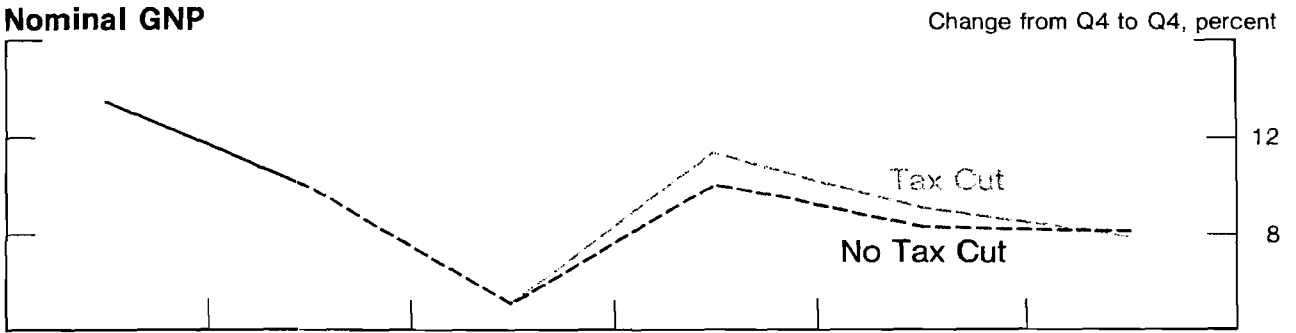
## Commercial Banks



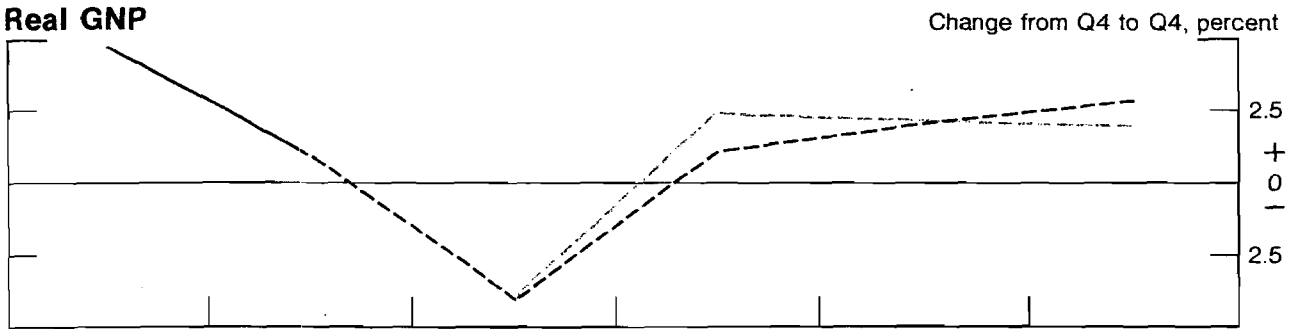
## Savings and Loan Associations



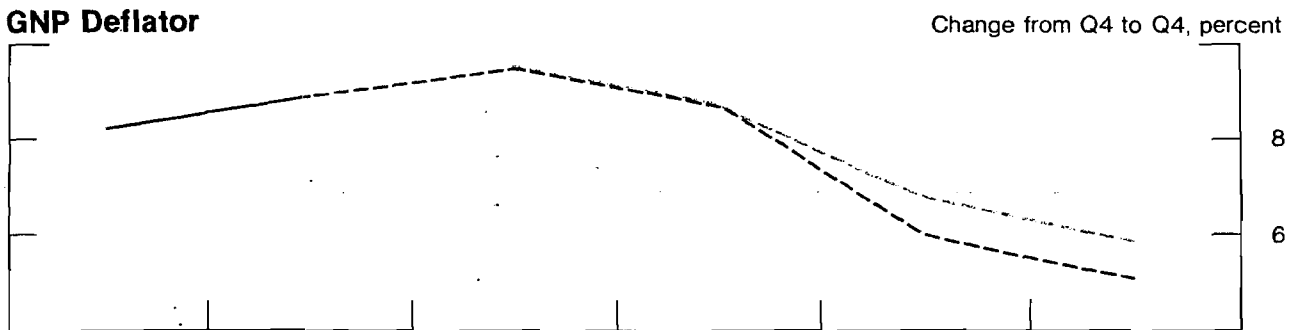
### Nominal GNP



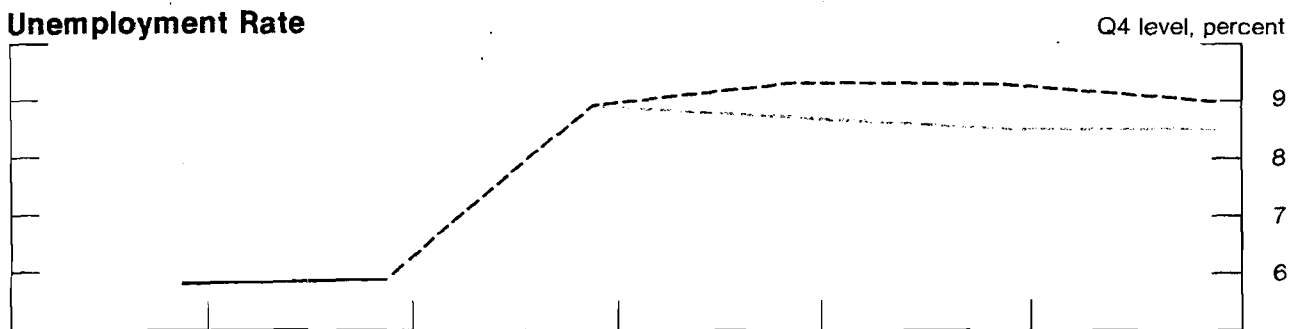
### Real GNP



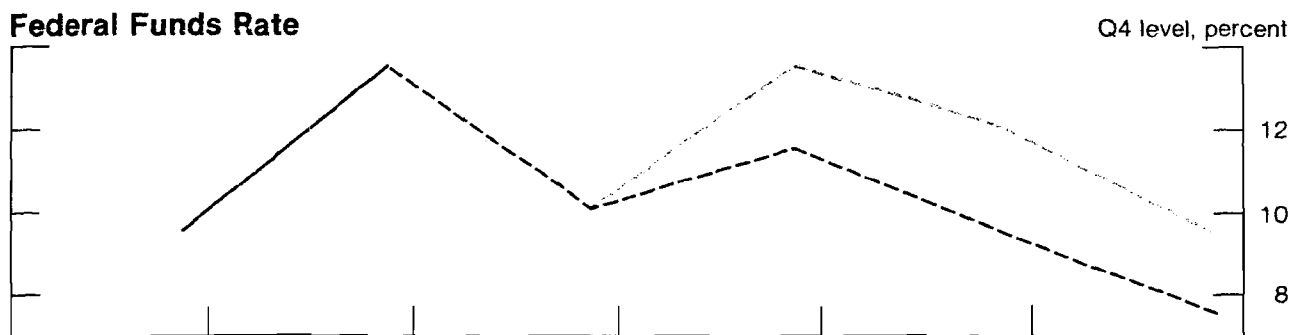
### GNP Deflator



### Unemployment Rate



### Federal Funds Rate



1978 1979 1980 1981 1982 1983

**Comparison of Staff and Administration  
Economic Forecasts**

	1980		1981	
	Staff	Administration	Staff	Administration
<b>Nominal GNP</b>				
Percent change, Q4 to Q4	5.1	6.7	11.4	13.7
<b>Real GNP</b>				
Percent change, Q4 to Q4	-4.0	-3.1	2.5	3.7
<b>GNP Implicit Deflator</b>				
Percent change, Q4 to Q4	9.4	10.1	8.8	9.7
<b>Unemployment Rate</b>				
Q4 level, percent	8.9	8.5	8.7	8.1

FOMC BRIEFING  
Stephen H. Axilrod  
July 9, 1980

Against the background of the chart show, I would like to review a number of considerations that may affect the Committee's choice of longer-run monetary targets.

As explained in the Bluebook, we believe that the marked short-fall in M-1A growth in the second quarter relative to our models' predictions will not persist over the balance of the year--and that there will, in fact, be some minor effort by the public to rebuild excessively depleted cash balances. Thus, despite no more than about a 5 percent annual rate of nominal GNP growth projected for the second half of this year, we would anticipate demand for narrow money to grow at a rather faster rate. This assumed behavior of money demand would make it plausible for the Committee, if it wished, to retain its present 3-1/2 to 6 percent range for M-1A for 1980. For example, growth in M-1A at a 7 to 8 percent annual rate over the second half of the year would be sufficient to bring growth for the year 1980 into the lower half of the present longer-run range and might be accomplished without extremely large further changes of interest rates.

There are two risks to such a course. On the one side there is an inflationary risk. We have assumed, as I noted, that the public will not continue to shift away from cash over the balance of the year as it did in the second quarter--indeed, that the public will try to make up a bit of the recent cash shortfall. Should the public continue, however, to shift away from cash--somewhat as they did from 1974 through mid-1977--attempts to supply enough M-1 to move that aggregate into its longer-term range would lead to a very substantial lowering of short-term market

interest rates from present levels, probably a negative real rate of interest over the balance of the year in short-term and possibly also long-term markets, and evidence of inflationary growth of the aggregates becoming more evident in the behavior of M-2.

I would not want to exaggerate the inflationary risk of an effort to move M-1 back up into its longer-term range. The odds on a further significant shift away from cash over the balance of this year seem reasonably small. The so-called shift in the second quarter represented the largest quarterly shortfall since our experience with shortfalls beginning with the mid-'70's. And on that ground alone, we may be dealing in good part with an aberration, at least in magnitude.

Which leads to the second risk--the deflationary one. If the second quarter was in part aberration and the public should wish to reconstitute depleted cash balances at a more accelerated pace than assumed, efforts to constrain growth to the assumed pace would raise interest rates in the short run by even more than we have projected and exert further downward pressure on nominal GNP.

A balancing of the risks might suggest that the range for narrow money in 1980 should be left unchanged, or, perhaps, reduced a bit. But decisions about 1980 also need to take account of the prospects for 1981. Last year at this time the Committee indicated that it expected growth in the year ahead--which was then 1980 of course--to be within the ranges adopted for the current year, and then added a caveat about emerging economic conditions and changing deposit mix from legislative developments. This year, I would assume that the Committee would wish to consider a

similar approach, or possibly suggest that it might seek lower growth next year, without being very specific.

Either of these two approaches raises a problem, though, and the problem would be compounded if the 1980 range for the narrow aggregates were lowered. The problem relates to the fairly large almost 11-1/2 percent rise in nominal GNP that is currently projected for 1981, given the tax cut that we have assumed. If the Committee wished to seek such a rise in nominal GNP, and if narrow money growth were kept at around the midpoint of the present range, it would require as noted in the Bluebook, a rise in the income velocity of narrow money at a rate that has not been seen for a calendar year since 1955 or on a 4-quarter basis, since the first four quarters of the 1975 recovery. Our model would suggest that, even given the rise of interest rates we have projected, narrow money growth should be about 3 percentage points higher, and growth of income velocity correspondingly lower, to finance an 11-1/2 percent GNP growth. Of course, the model is not to be taken literally, and it may well be underestimating the degree to which the public wants to economize on cash at the presumed high level of interest rates, given the increased and increasing sophistication of savers and the ready availability of money substitutes. Still there remains the non-trivial chance that even the upper end of the present longer-run ranges for M-1A or M-1B would not be sufficient to finance GNP growth in the 11-1/2 percent area next year.

There may not be so much of a problem for M-2, though. The projected growth of income velocity of M-2 in 1981 is more within the admittedly wide range of its historical experience. Apart from that, measured M-2

next year will not be affected by introduction of nationwide NOW accounts, as will measured M-1A and M-1B. However, even with this aggregate, there seems to be little, if any, scope for reducing the range next year. We would project growth in both M-2 and M-3 to be near the upper limits of their present ranges in 1981 as recovery of income generates more saving and increased credit demands cause banks and thrift institutions to bid actively for those funds. Thus, it may be difficult to achieve a reduction in money growth rates even if the Committee shifted its emphasis from M-1A or M-1B to M-2.

In sum, it would appear that the most promising practical choices before the Committee are:

- with respect to the money supply ranges for 1980, either
  - (a) leave them unchanged, though perhaps indicating that the narrow money measures may be in the lower part of the ranges, or (b) lower the ranges for M-1A and possibly also M-1B, perhaps only the bottom ends of the ranges, to suggest the possibility that the Committee would not seek very sharp acceleration of money growth over the balance of this year. If the top of the range were lowered to avoid a widening of the range, or to achieve a narrowing, this would increase the risk that growth in 1981 might be above the upper limit of the 1980 range.
- with respect to the money supply ranges for 1981, either
  - (a) indicate that growth would be expected to be within the ranges established for 1980, or (b) suggest that further

progress in lowering growth is expected, without being specific as to growth rates or growth ranges at this point, while noting that the degree of progress depends on economic circumstances and that in any event interpretations of the aggregates will be affected by the impact of introduction of nationwide NOW accounts and further development of such newer investment outlets as money market funds.

-- with respect to bank credit, that would appear to be the clearest candidate for some range reduction in 1980; a reduction to a 5 to 8 percent range might mean that the range would not need to be raised in 1981 as credit demands increase in line with economic recovery.