

## APPENDIX

James L. Kichline  
February 1, 1982

FOMC CHART SHOW -- INTRODUCTION

During our presentation this afternoon we will be referring to the package of chart materials distributed to you. The first chart in the package displays the principal policy assumptions used in the construction of the staff's economic and financial forecast. For monetary policy, the 4 percent growth of M1 assumed during 1982 represents the midpoint of the tentative range adopted by the Committee in July, and for 1983 we assumed 1/2 percentage point slower growth. The fiscal outlay and receipt assumptions include carrying through on the currently scheduled tax and expenditure cuts. In addition, we have assumed further expenditure cuts of about \$15 billion in fiscal 1983 and increases in taxes of about \$5 billion.

More information on the federal budget is presented in the next chart. Growth of expenditures slows over the forecast period as a result of reduced nondefense spending and the declining rate of inflation projected. But receipts are damped even more, reflecting the sluggish economy and tax cuts. Thus the budget deficit is projected to move above \$100 billion in the current fiscal year and go higher in fiscal 1983.

Information available to us on the administration's budget figures is still tentative. However, it appears that the official budget will show a deficit a little below \$100

billion this year and a declining deficit in fiscal 1983 and beyond. The falling deficit projection relies upon a more expansive economy than projected by the staff as well as imposition of larger expenditure cuts and tax raising measures.

On a high employment basis--the bottom panel-- the budget swings into deeper deficit in 1982 and 1983, driven importantly by the personal tax cuts scheduled for the middle of each year. The very stimulative posture of the fiscal side runs against what we interpret as a rather restrictive monetary policy, as indicated in the next chart. Growth of M1, although somewhat higher this year than last, is still assumed at a rate well below other recent years. Given our view of the strength of spending and associated credit demands, it seems likely that holding down M1 growth will result in a maintenance of high interest rates as shown in the bottom panel.

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

Joseph S. Zeisel  
February 1, 1982

FOMC CHART SHOW

Economic activity contracted sharply in the fourth quarter, as real GNP dropped at a 5½ percent annual rate. As the upper right hand panel shows, industrial production had turned down in midsummer, declining by nearly 7 percent between July and December, close to the drop in the first half of 1980. The sectors that have been performing poorly over the past few years--housing and motor vehicles--were major contributors to the sharp fourth-quarter contraction. But weakness was widespread, and in fact, the only sector of industrial output continuing to grow late last year was defense production.

As the bottom two panels indicate, the labor market has been severely affected by the recent drop in activity. Employment declined sharply in the last three months of the year; in manufacturing the level dropped below the 1980 trough. As the right hand panel shows, the unemployment rate moved up to 8.9 percent in December, about equal to the highest rate since World War II. A further increase in joblessness seems likely in the near term given the continued high level of initial claims.

As reported in the Redbook, there appears to be considerable evidence of continued weakness in the economy in January. At the same time, there are suggestions in recent data that the current downswing in activity is losing momentum. Housing demands and activity may have turned the corner in the past few months, albeit at extremely low levels, and in the auto sector, it is difficult not to

anticipate a pickup soon in assemblies from the January annual production rate of 3½ million, which is well under the recent sales pace.

The next chart presents our view of the outlook for real GNP growth through 1983. We anticipate the beginnings of recovery in the next several months, although such a turn would still be consistent with a substantially negative first quarter. The personal tax cuts in mid-1982 and 1983 are expected to provide the main impetus for expansion. Real GNP growth is projected to grow at a 3¼ percent annual rate in the last three quarters of 1982 and about 2¼ percent during 1983.

As the bottom panel indicates, we currently expect the contraction in real GNP to total about 2¼ percent, around the average for postwar cycles, although substantially under the nearly 5 percent drop in 1973-75. The expected recovery is stunted in comparison with past performance, constrained by monetary policy and slow increase in government spending; virtually every major sector of the economy is expected to grow more slowly than has been usual at this time in the cycle.

As the next chart shows, the major contribution to recovery comes from personal consumption expenditures. Responding to the scheduled tax cuts, we anticipate that real consumer spending will increase at an annual rate of 3 percent during the last six quarters of the projection. Although this is a

substantial improvement from the pace over the past two years, it is not a particularly ebullient performance by past cyclical standards.

As the bottom panel shows, we are projecting the saving rate to remain relatively low by historical standards, largely in response to the comparatively moderate growth in real income. While tax reductions and incentives should result in some improvement in the volume of savings, we are projecting the saving rate to average only 5-3/4 percent in 1983, still well below the longer-run average.

The next chart addresses the outlook for housing. We feel the dominant factor affecting residential construction activity and damping a vigorous recovery in this sector will be continued high mortgage interest rates. We project these rates to edge off to about 16½ percent in the latter part of 1983--only about a point below the current level.

It is not unlikely that housing activity is now at, or close to, its trough. Starts rose by 13 percent in December after having leveled off the previous month and new house sales picked up in November. The unusually bad weather and the recent rise in mortgage rates might depress starts briefly. But growing demand pressures associated with population trends should provide some support to the industry, and sales are expected to be helped by increased use of creative financing and adjustable rate instruments. Nevertheless, given continued high mortgage rates and

the persistence of an unfavorable economic environment, we are projecting a very anemic rate of starts for the next two years-- 1.1 million this year, and 1½ million in 1983.

The next two charts summarize the forces that are expected to determine the path for business fixed outlays over the next two years. Investment outlays have held up remarkably well in the face of high interest rates and declining capacity utilization. But real business fixed investment did drop sharply last quarter, and as the top panels indicate, orders figures paint a sluggish picture for the near term.

Over the longer haul, liberalized depreciation, and investment related to defense production and the conservation of energy, should stimulate increased capital spending. But a number of fundamental factors are likely to continue to damp outlays. As the lower two panels show, the cost of debt capital is expected to remain very high and corporate profits are projected to improve only moderately.

Possibly the most important determinant is illustrated on the next page--capacity utilization. With rates of capacity use below 75 percent and with product markets weak, we expect little demand for expansion of capital stock except in the aforementioned defense and energy related areas. As the bottom panel indicates, a further moderate decline in real capital outlays is projected through most of this year and only a modest 2 percent growth is expected over 1983.

The next chart addresses another problem area-- inventories. In recent years, businesses generally appeared to be making considerable effort to avoid the kind of inventory backup that plagued them in 1974. However, it is virtually impossible to completely anticipate a sharp decline in demand, and thus some degree of unintended stock accumulation is inevitable. At year-end auto dealers--particularly domestics--faced a substantial inventory problem--as the upper left panel indicates. But, as mentioned earlier, producers have taken draconian measures to cut production. Sales also perked up somewhat after the turn of the year; if they hold up, this situation could ease fairly soon. But the overall inventory/sales ratio for manufacturing and trade rose sharply during the autumn as sales weakened, and adjustments may take a number of months to be completed. As the bottom panel shows, we are projecting a moderate pace of liquidation in the first half of 1982, to be followed by a conservative pattern of increase in real inventory investment through the projection period--in fact, one that would be associated with a slight decline in the inventory/sales ratio.

The next chart addresses the government component of spending. Real federal defense purchases are projected to continue to rise strongly, at a 5 percent rate, in 1982 and accelerate to an 8 percent increase in 1983. For nondefense spending the wide swings shown in 1981 and 1982 are mainly the result of the timing of CCC and strategic petroleum reserve outlays; exclusive

of these, nondefense spending shows relatively little change. On balance, real federal government purchases are projected to decline slightly in 1982, but are expected to rise briskly in 1983--by some 5 percent.

States and localities are not expected to provide the support to economic activity that was typical in past cycles. Real purchases in this sector fell sharply last year and are projected to fall a further  $1\frac{1}{4}$  percent in 1982 and  $1/2$  percent in 1983. As indicated in the bottom panel, overall government purchases are projected to decline by about  $1\frac{1}{4}$  percent this year, and to rise by only about  $1\frac{1}{2}$  percent in 1983.

The sluggish overall recovery we anticipate for the next two years portends continued weak labor demands, as seen in the next chart. Following a further contraction in employment, the modest recovery in output in the second half of 1982 and through 1983 will be absorbed to a large degree by a pickup in productivity, with scant job gains. As a result, we anticipate virtually no rise in employment for 1982 as a whole, and only a small increase in 1983.

As indicated in the second panel, the scarcity of job openings should continue to depress labor force growth. Consistent with the experience in other recent periods of sluggish demand, we anticipate no increase in labor force participation rates overall. Nevertheless, the expansion of labor supply is likely to about keep pace with job creation, and the unemployment rate is projected to remain above 9 percent during the next two years.

As shown on the next chart, the rise in compensation costs eased somewhat in 1981, despite a large increase in social security taxes which offset some of the slowing in wage rates. We expect a gradual further moderation of compensation costs over the projection period, especially given the anticipated environment of sustained high unemployment. The spread of wage concessions recently and the absence of another large social security tax increase this year should support this trend.

As the middle panel shows, we also expect some help from productivity, which typically improves when aggregate demand picks up and more effective use is made of available capacity. In conjunction with the expected moderation in wage pressures, improved productivity should result in a distinct deceleration in unit labor costs, which are projected to be rising at about a 5½ percent rate toward the end of next year.

The outlook for inflation is addressed in the next chart. Recent data suggest a broad slowing of price increases. We expect this improvement in inflation to be sustained in 1982 despite some temporary upward pressure on food prices resulting from bad weather. With continued slack in markets, energy prices are not expected to be a problem over the next two years. Overall, we are projecting inflation to unwind gradually, largely reflecting reduced labor cost pressures and continued generally weak product markets. We now project the gross business product prices to be rising at about a 5 percent rate by the end of 1983.

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

E.M. Truman  
February 1, 1982

FOMC CHART SHOW PRESENTATION -- INTERNATIONAL

The red line in the top panel of the first international chart shows that the foreign exchange value of the dollar in January was about 17 percent higher than a year previously, although it was down 5 percent from the peak rate shown for August. Over the forecast period, we expect the dollar's average value to decline gradually as the U.S. current-account deficit widens.

As can be seen from the lower panel, the size of the differential between dollar and non-dollar short-term interest rates does not offer much of an explanation for the dollar's strength during the past year. Indeed, the differential is now somewhat narrower than it was a year ago. However, in recent months changes in the dollar's value do appear to have been positively correlated with changes in the differential in short-term interest rates. The decline in foreign interest rates from August to November was less than the decline in dollar rates, and the dollar depreciated moderately. In December and January, as dollar interest rates rose, foreign rates continued to decline and the dollar appreciated. Over the forecast period, we expect interest rates abroad will generally edge down further.

One factor contributing to the dollar's appreciation over the past year has been the political situation in Poland and in Europe more generally. However, to understand fully the dollar's sustained strength, one must look beyond international politics and relative interest rate developments to the basic thrust of U.S. economic policy, compared with the policies abroad. The actual and expected impacts of those policies on inflation are especially important. One manifestation of such underlying determinants is depicted in the top panel of the next chart. In 1981, the rate of increase in U.S. consumer prices was less than the average experienced abroad -- for the first time in four years. More importantly, this pattern is expected to continue during the forecast period.

As is shown by the red line in the middle panel, on average economic activity abroad was essentially stagnant during 1980 and 1981. Although a moderate expansion is projected for this year and next, the pace of recovery will not reach the average growth rate prior to 1973 and will be slower than in the recovery following the 1974-75 recession.

The bottom panel illustrates the frustrating situation confronting many policymakers abroad. Although the averaging process may slightly exaggerate the picture, the unemployment rate in major foreign industrial countries showed little or no decline after the 1974-75 recession, increased sharply during the past two years, and is likely to remain

essentially unchanged during the next two years. Meanwhile inflation on average is expected to decline only gradually.

Turning to the outlook for the external sector of the U.S. economy, the top panel of the next chart shows that non-agricultural exports have been declining in volume since the middle of 1980 and declining in value since the middle of last year. These declines have been spread widely across commodity groups. In recent months, exports of civilian aircraft, and of automobiles to Canada, have been particularly depressed. The dollar's appreciation and sluggish growth abroad have contributed to the decline in U.S. nonagricultural exports. Over the forecast period, these two factors are expected to diminish in strength and importance. However, as is shown in the chart, we do not expect a pickup in the volume of non-agricultural exports until early next year.

The outlook for agricultural exports, shown in the bottom panel, is somewhat more favorable. Although the price of these exports is expected to be lower on average this year than last, an increase in export volume associated with low stocks abroad should push up their value.

On the import side, shown in the next chart, the value and, especially, the volume of non-oil imports have been rising since mid-1980. Under the influence of the strong dollar, the average price of such imports actually declined at more than a five percent annual rate over the past three quarters.

Consequently, the volume of non-oil imports has risen across a broad spectrum of commodity categories, although imports of steel and automotive products from countries other than Canada have been quite moderate recently. We are projecting a small dip in non-oil imports this quarter and next, reflecting the U.S. recession, followed by a gradual rise through the remainder of the projection period.

Oil imports, shown in the lower panel, were unchanged in value in the year 1981 and declined significantly in volume. The price of U.S. oil imports declined more than \$3 per barrel after reaching a peak of more than \$36 per barrel in April. Although the price of imported oil rose slightly last quarter, we are assuming little further change this year and a constant real price in 1983. These assumptions, combined with a continuing gradual decline in import demand, are expected to produce a \$10 billion drop in the value of oil imports this year on average, followed by a small rise in 1983.

The last international chart summarizes our projection for the external sector. As is shown in the top panel, the trade deficit is expected to level off in the first half of this year before reaching about \$45 billion in 1983. Meanwhile, the surplus on non-trade current-account transactions is expected to shrink gradually as a consequence of lower earnings on direct investments abroad and a decline in the average level of dollar interest rates, which reduces net income on other investments.

Thus, as is shown in the middle panel, the U.S. current account should move gradually into deficit reaching a rate of about \$20 billion next year.

In terms of the GNP accounts, shown in the bottom panel, the lagged effects of the dollar's appreciation on real exports of goods and services are expected to continue to exert a negative influence on U.S. economic activity throughout 1982. The same factor will raise imports, except that in the first half of the year the effects of the appreciation are largely offset by lower overall domestic demand. It would be misleading, however, to interpret these negative impacts as if the dollar's appreciation has occurred in a vacuum. As I noted earlier, the appreciation has been in large part the consequence of U.S. economic policies adopted in recent years, and the declines in GNP net exports are best viewed also as a consequence of those policies.

Mr. Prell will now continue our presentation.

Michael J. Prell  
February 1, 1982

FOMC CHART SHOW--DOMESTIC FINANCIAL

As has been indicated, we see a restrictive monetary policy limiting the expansion of economic activity over the next two years. This restrictive influence on the economy is mirrored in the staff's projection of aggregate flows of funds shown in the top panel of the next chart. Total funds raised by domestic nonfinancial sectors has been virtually flat since 1978, and we see only moderate growth, on net, by 1983. Such growth would hold the ratio of funds raised to GNP--the red line--at its recent lower level.

Moreover, as may be seen in the lower panel, the U.S. Treasury will be absorbing a growing share of overall credit. A movement of fiscal policy in an expansive direction is common during recession and early recovery, but its continuation in the current environment of monetary restraint does seem to be a recipe for high real interest rates and a "crowding out" of private capital formation.

The next chart focuses on the nonfinancial corporate sector, where investment is expected to be lackluster over the next two years. The top panel indicates that, given weak profitability, there will continue to be a moderate gap between outlays and internal funds generated. Thus, we will not be seeing quite the typical cyclical respite in financing needs.

Owing to high interest rates and weak cash flows, many companies--especially those heavily reliant on short-term or floating rate debt--already have encountered difficulty in meeting debt servicing needs. As shown in the middle panel, net interest payments will continue to command a large share of income over the projection period. Moreover, absent a considerable improvement in the bond markets, we are likely to see a drift toward more vulnerable

balance sheet structures. For example, the ratio of short-term to total debt, in the bottom panel, already is at a record high, and it would take a massive volume of bond issuance to achieve reversal of the downtrend. The figures underlying this graph anticipate somewhat more bond issuance than in 1981 and a drop off in the merger activity that has absorbed stock and increased borrowing.

On the whole, these data point to an area of risk in the GNP projection: to date, the financial dislocations in the corporate sector have been well confined, but the possibility of broader disruption can not be dismissed.

The same sort of concerns arise--perhaps with less intensity--with respect to the household sector, shown in the next chart. Household borrowing, in the top panel, has shrunk dramatically over the past few years. The enthusiasm for leveraging up and acquiring houses and other tangible "inflation hedges" has ebbed as real interest rates have risen and income prospects have become less certain. We are looking for a weak pattern of borrowing in 1982-83; indeed, as indicated by the red line, borrowing is projected to fall still further relative to disposable income.

Household financial caution is likely to be reinforced by lender behavior. Deteriorating earnings margins and concerns about credit quality have prompted many institutions to tighten their lending policies. These actions have, we believe, been evident not only in the credit flow data but also in the loan delinquency figures. As may be seen in the lower panels, delinquency rates on installment loans have declined over the past year, while those for mortgages have risen. The contrast reflects at least in

part the quicker impact of corrective actions in the case of the short maturity loans. Looking ahead, it appears probable that many households will be struggling with debts that have accumulated over the years, with a particular area of vulnerability being the short-term mortgage obligations that have been assumed in anticipation of attractive refinancing opportunities.

The next chart is devoted to the state and local government sector. The top panel shows that, despite the restrained spending outlook, the operating surplus of states and localities is expected to disappear. The cutback in federal grants stands out quite clearly as a key factor here; as can be seen in the middle panel, those grants are programmed to fall considerably. Furthermore, this will occur at a time when many states have depleted their cash reserves.

Not surprisingly, there has been some talk of state and local financial difficulties; however, to date, such concerns have not been manifest in any clear way in the municipal securities market. As shown in the bottom panel, the yields on municipal bonds have risen markedly relative to those on taxable obligations, but this apparently reflects primarily a reduced desire for tax exempts on the part of banks and casualty insurers.

Mr. Kichline will now conclude the presentation.

James L. Kichline  
February 1, 1982

FOMC CHART SHOW -- CONCLUSION

The staff forecast entails sluggish growth of output on average over the next two years. The top panel of the chart indicates that the very slow growth of real GNP since the end of 1978 has led to a downturn in actual GNP relative to potential and a further decline is projected given the forecast of activity. Slack in markets was influential in bringing down the rate of inflation last year and we anticipate further, considerable improvement over the forecast period, shown in the lower panel of the chart. The combination of reduced but still high rates of inflation, high unemployment, and high interest rates obviously poses difficult problems, ones not confined to the United States. And it is a situation that has appreciable financial risks.

The staff forecast for 1982 is not markedly different from the figures provided by Committee members, which are summarized on the last chart. The chart does not contain information on the administration's forecast which will underlie the official budget program to be released next week. The tentative information suggests they will probably have a projection of nominal GNP growth in the area of 10-10½ percent, with real GNP growth of around 3 percent and a deflator of 7 percent. The unemployment rate in the fourth quarter of 1982 could be about 8½ percent.

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

*February 1, 1982*

## **Principal Assumptions**

### **Monetary Policy**

- Growth of M1 of 4 percent in 1982 and 3½ percent in 1983

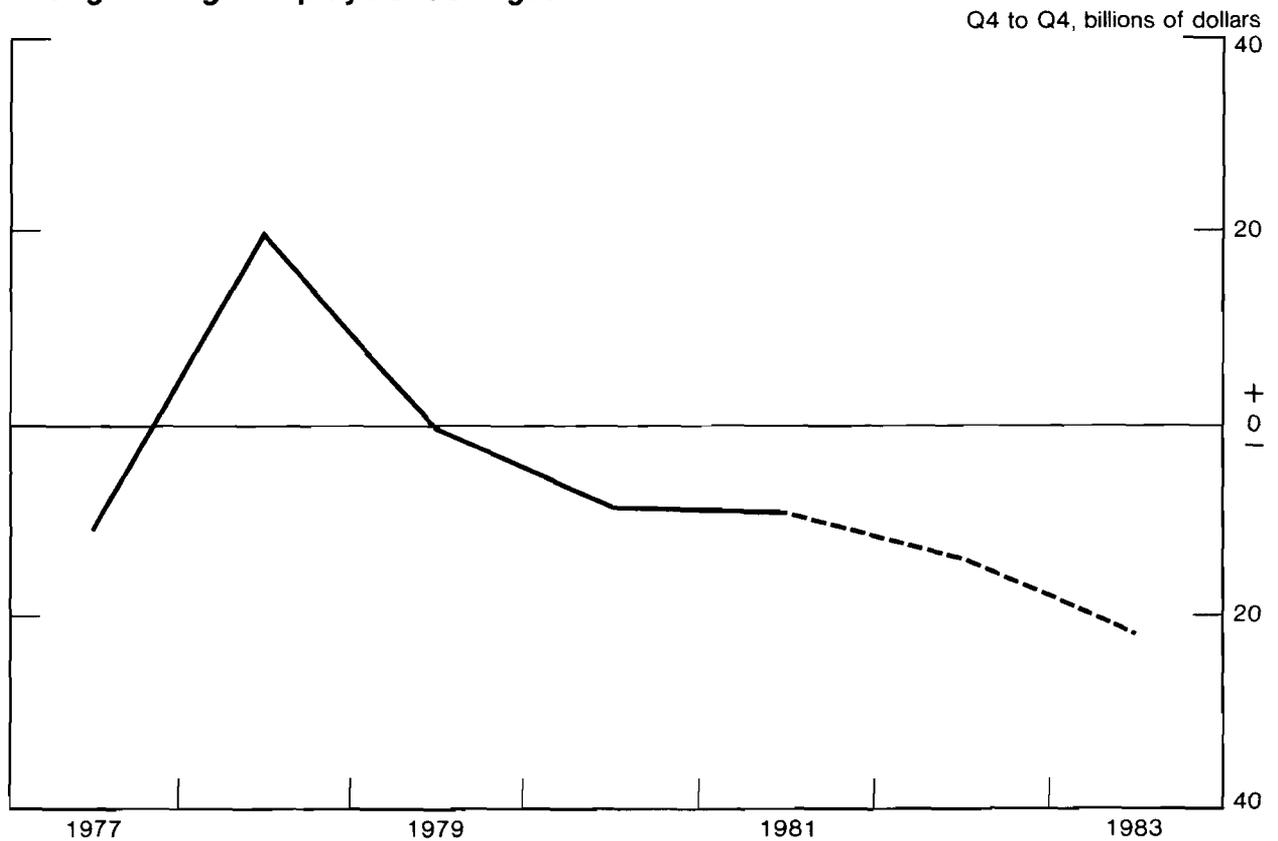
### **Fiscal Policy**

- Unified budget expenditures of \$ 734 billion in FY 1982 and \$777 billion in FY 1983
- Enacted tax and expenditure reductions implemented as scheduled
- Further expenditure cuts of \$15 billion and tax increases of \$5 billion in FY 1983

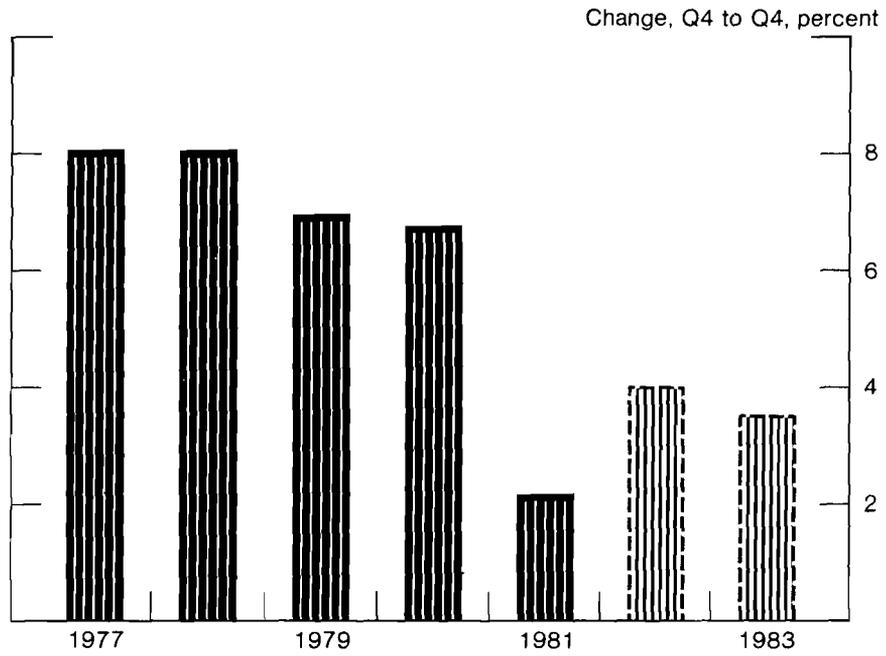
# Federal Budget

Fiscal Years, Unified Budget Basis						
	1981		1982		1983	
	Billions of Dollars	Percent Change	Billions of Dollars	Percent Change	Billions of Dollars	Percent Change
<b>Outlays</b>	\$661	14%	\$734	11%	\$777	6%
<b>Receipts</b>	\$603	16%	\$627	4%	\$635	1%
<b>Deficit</b>	\$ 58		\$107		\$142	

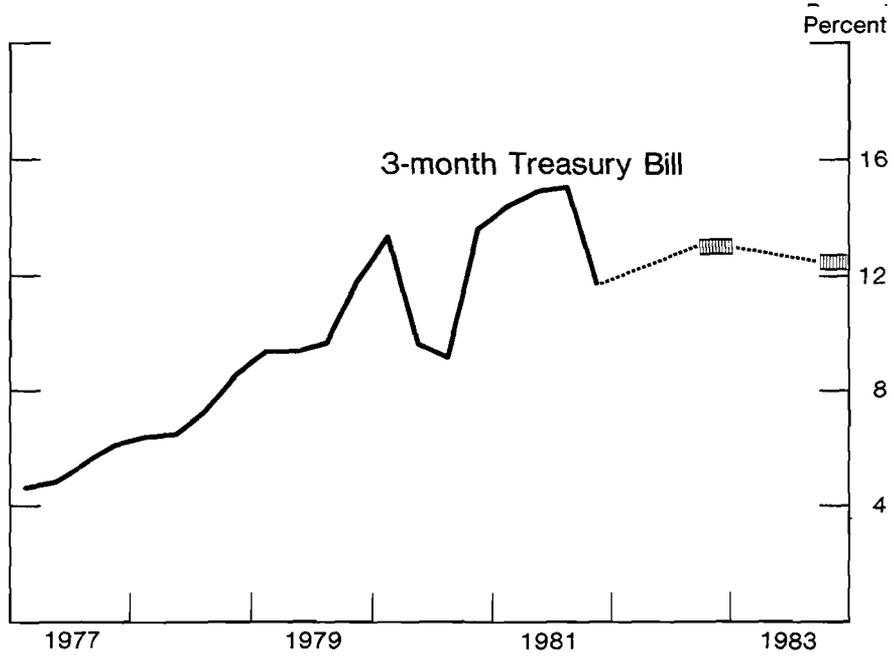
## Change in High Employment Budget



### M1\*

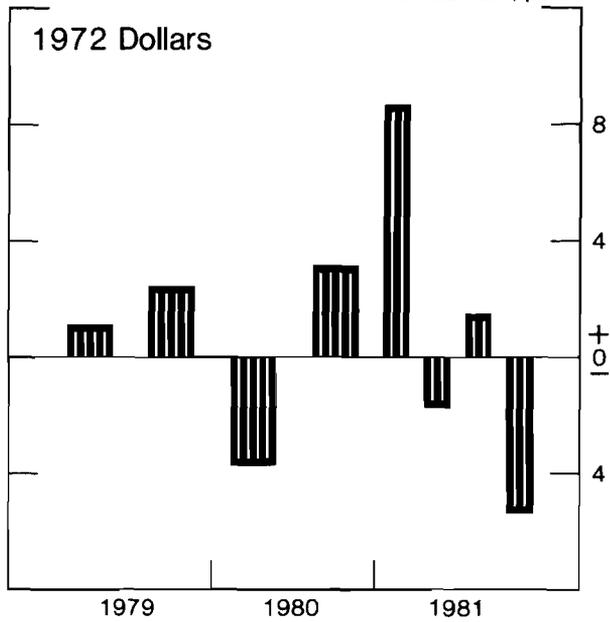


### Interest Rate

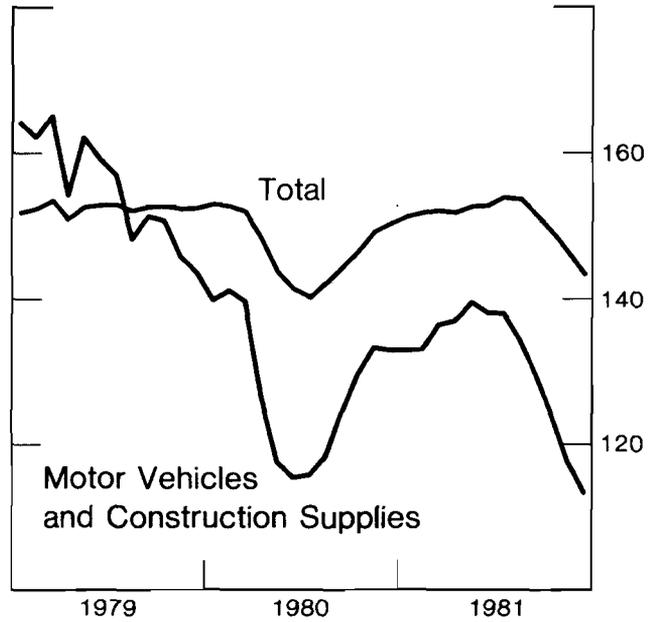


\*Adjusted for shifts into ATS and NOW accounts

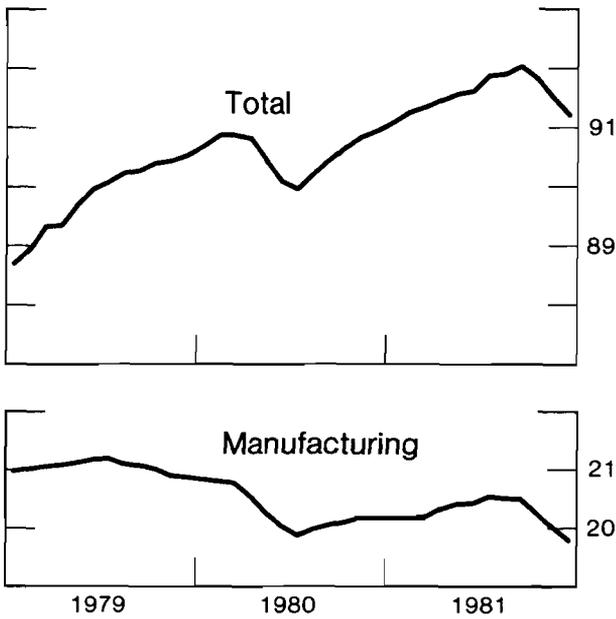
**Real GNP** Change from end of previous period, annual rate, percent



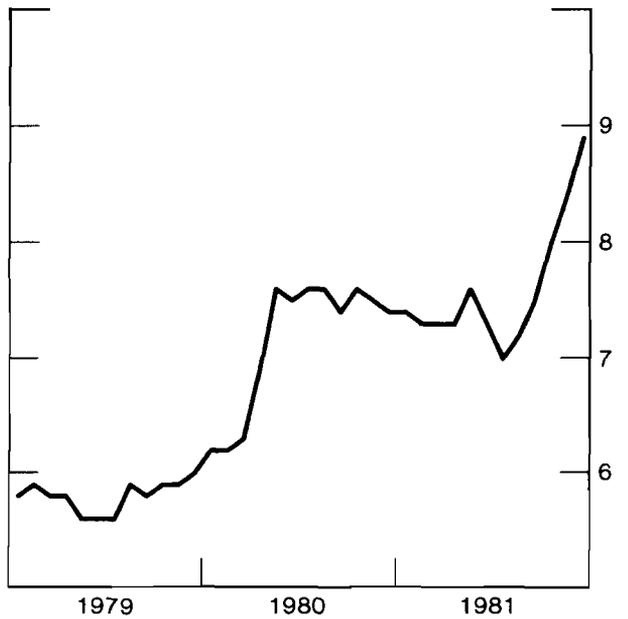
**Industrial Production** Index, 1967=100



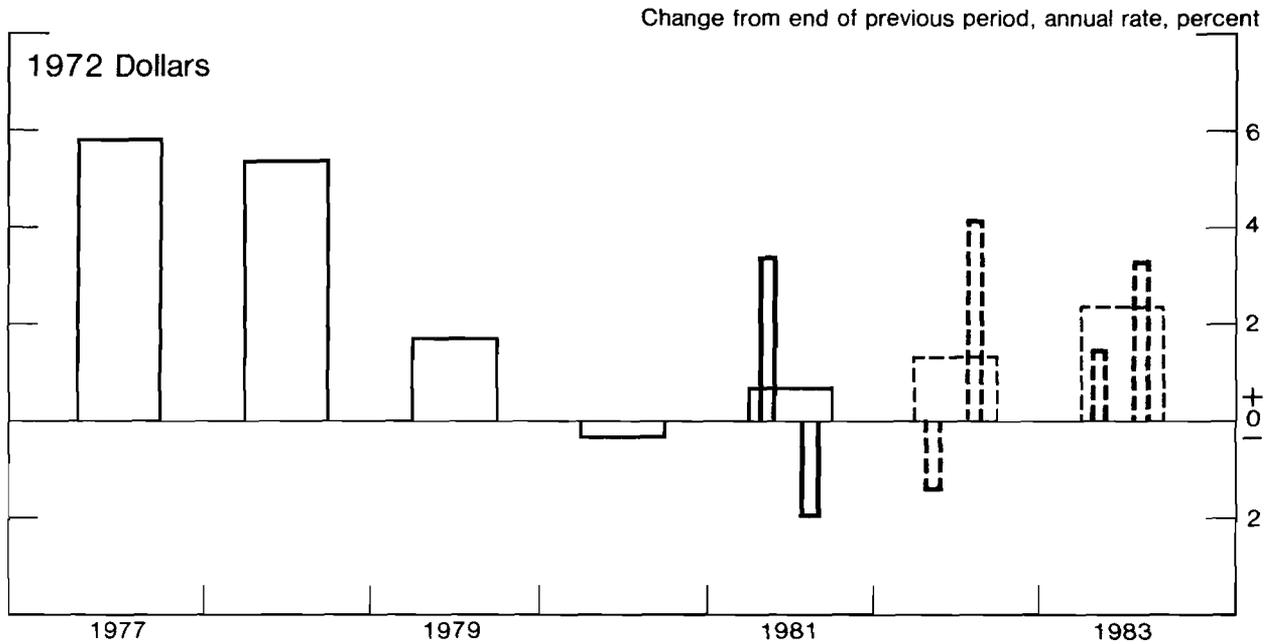
**Nonfarm Payroll Employment** Millions of workers



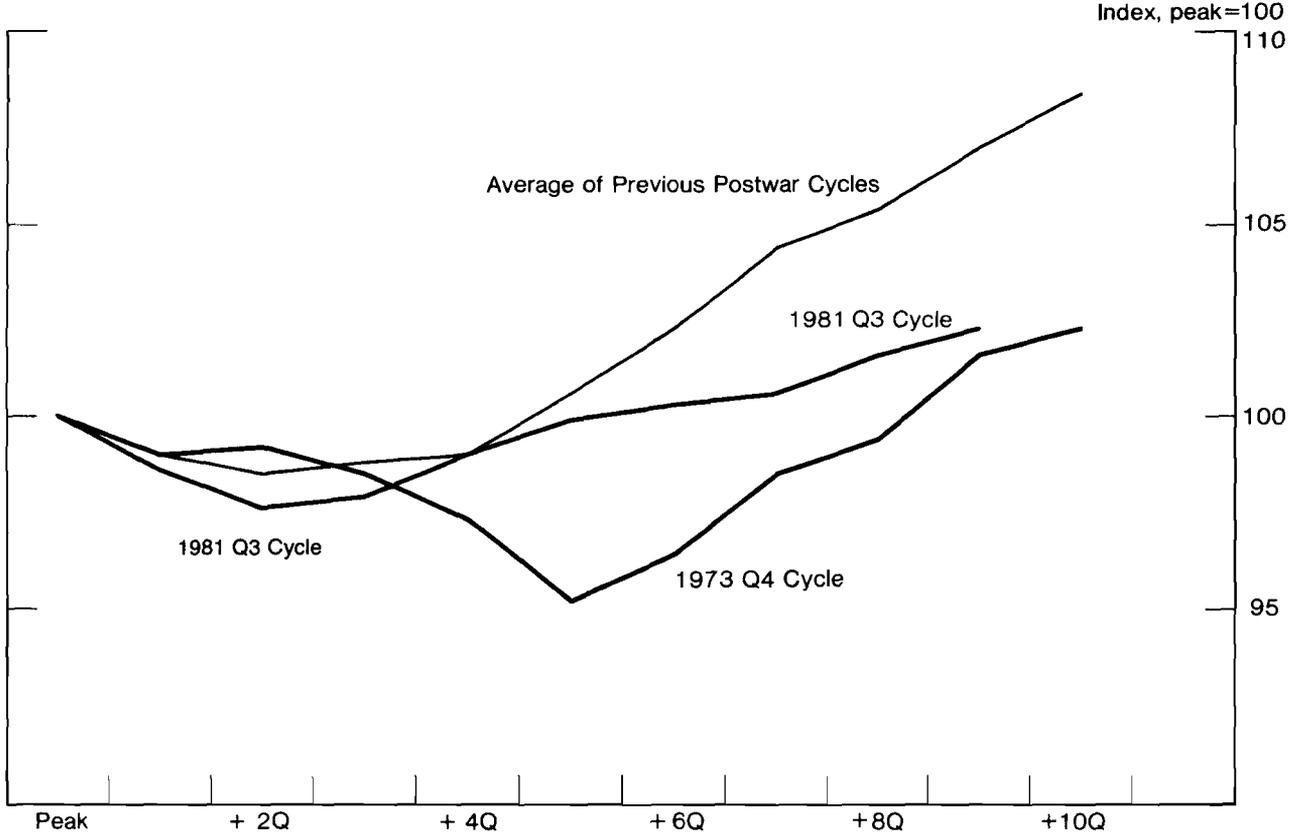
**Unemployment Rate** Percent



# Real GNP

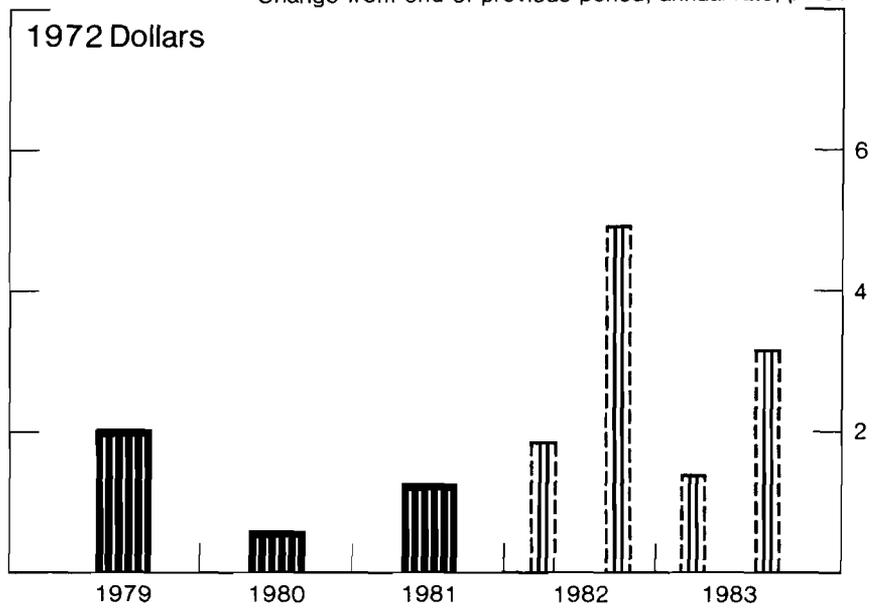


# Comparison of Postwar Cycles in Real GNP



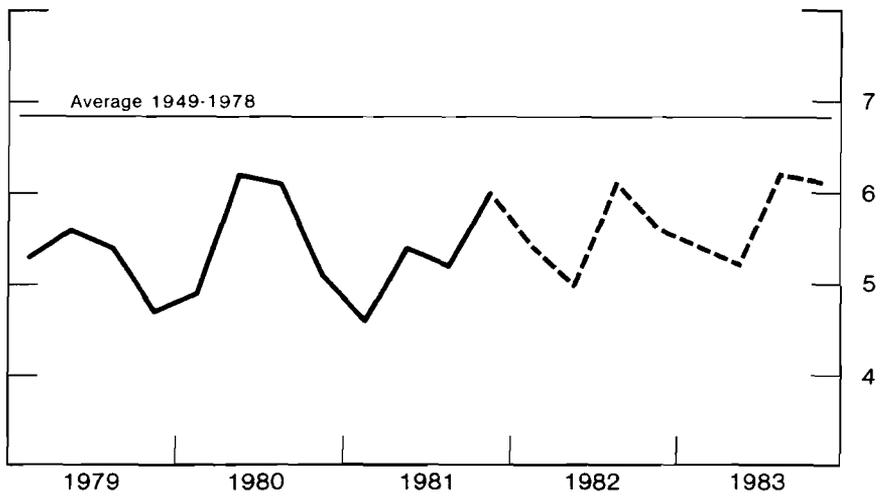
## Real Personal Consumption Expenditures

Change from end of previous period, annual rate, percent

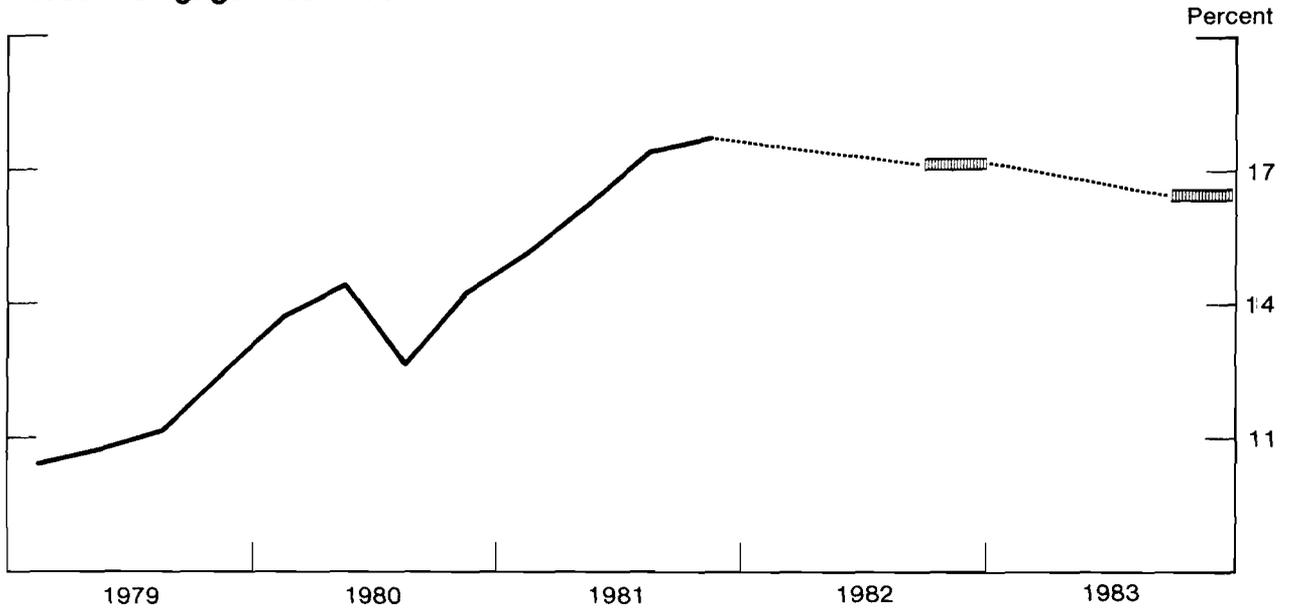


## Saving Rate

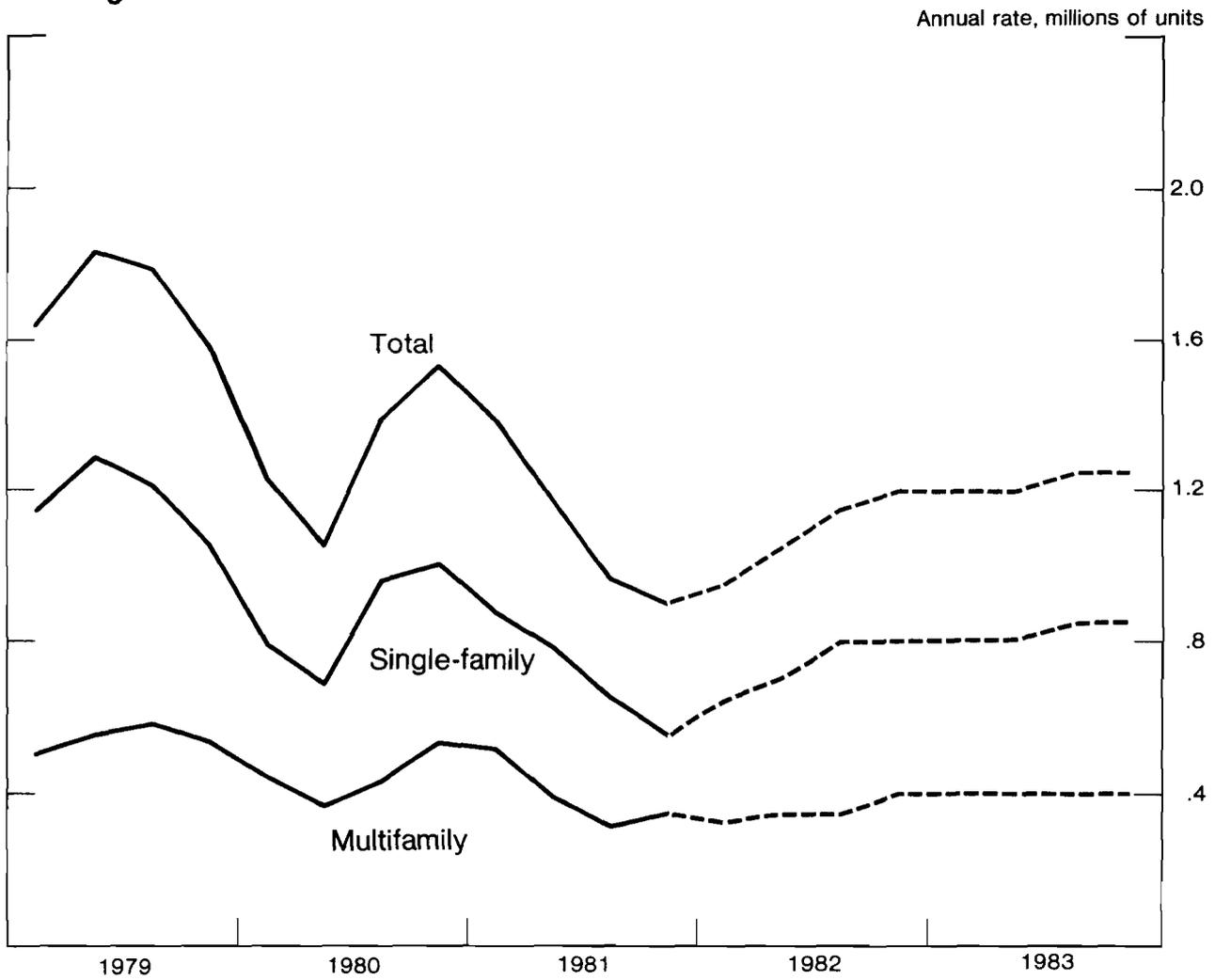
Percent



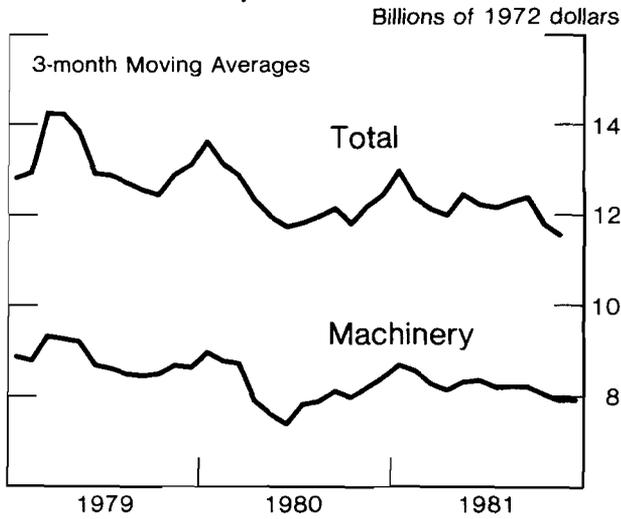
### Home Mortgage Interest Rate



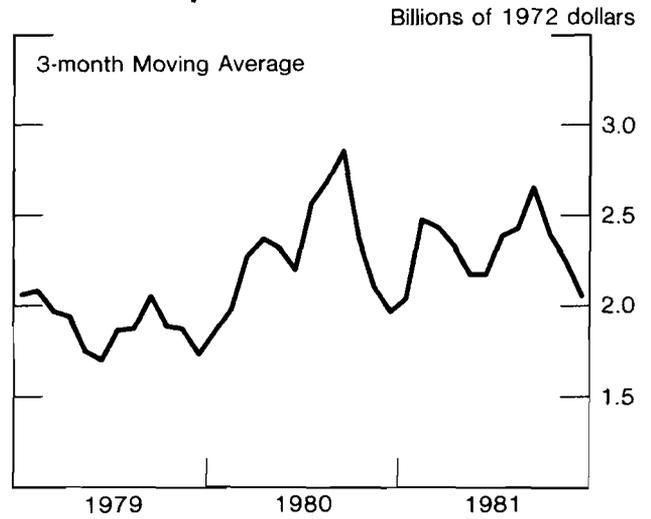
### Housing Starts



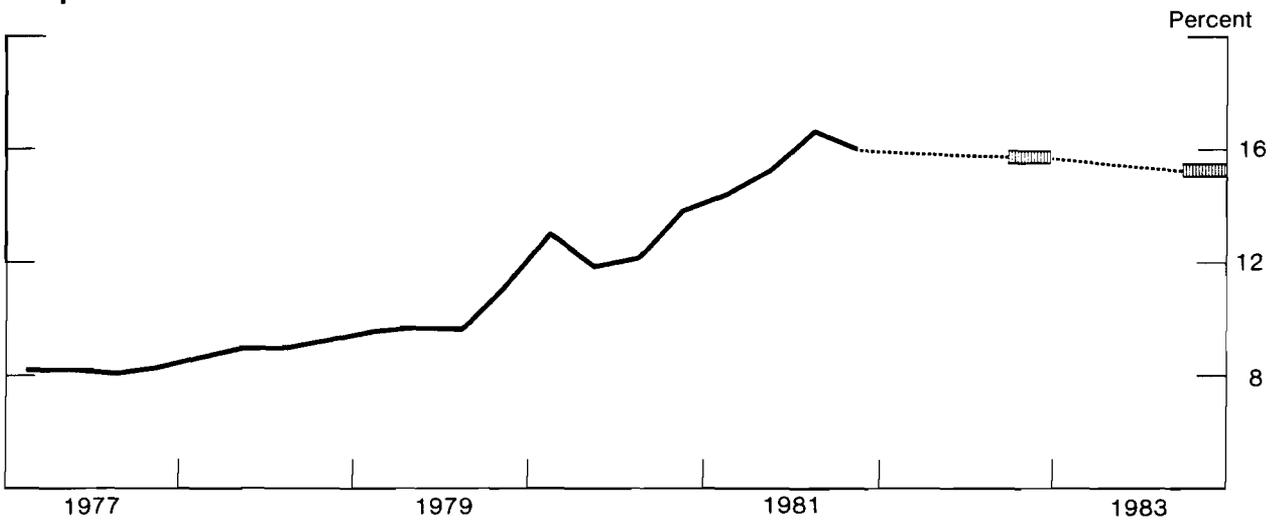
**Real New Orders for  
Nondefense Capital Goods**



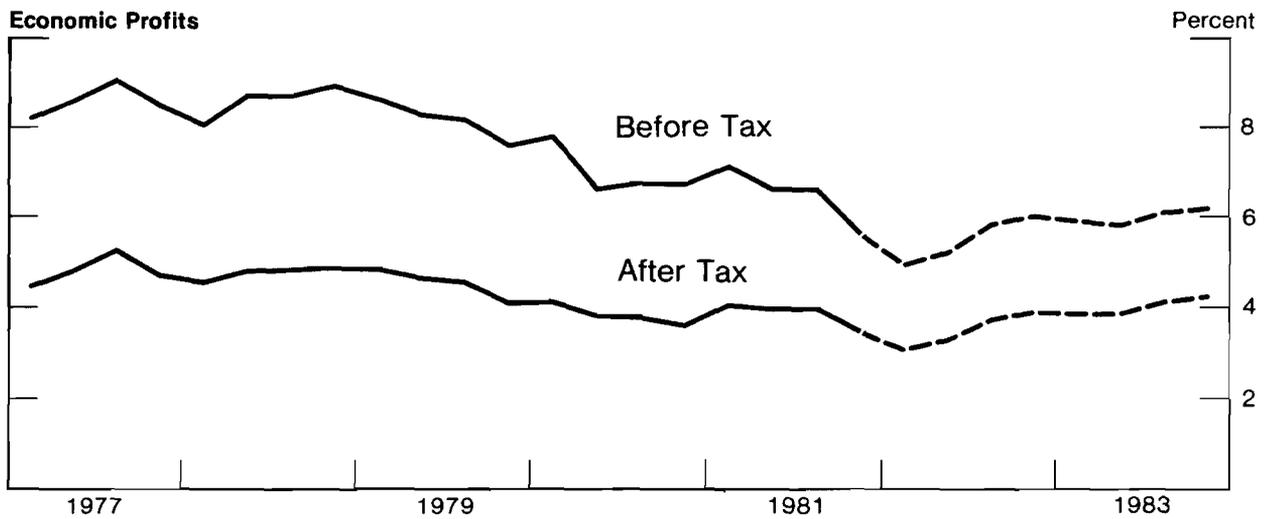
**Real New Orders for  
Defense Capital Goods**



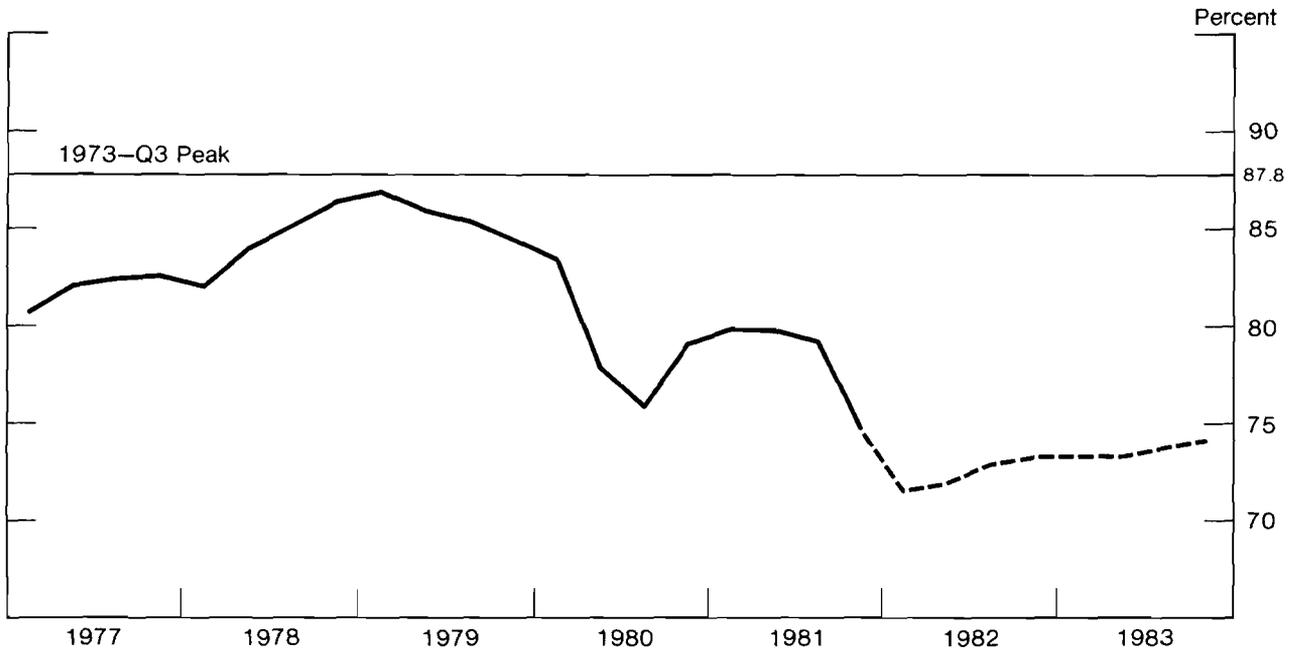
**Corporate Bond Rate**



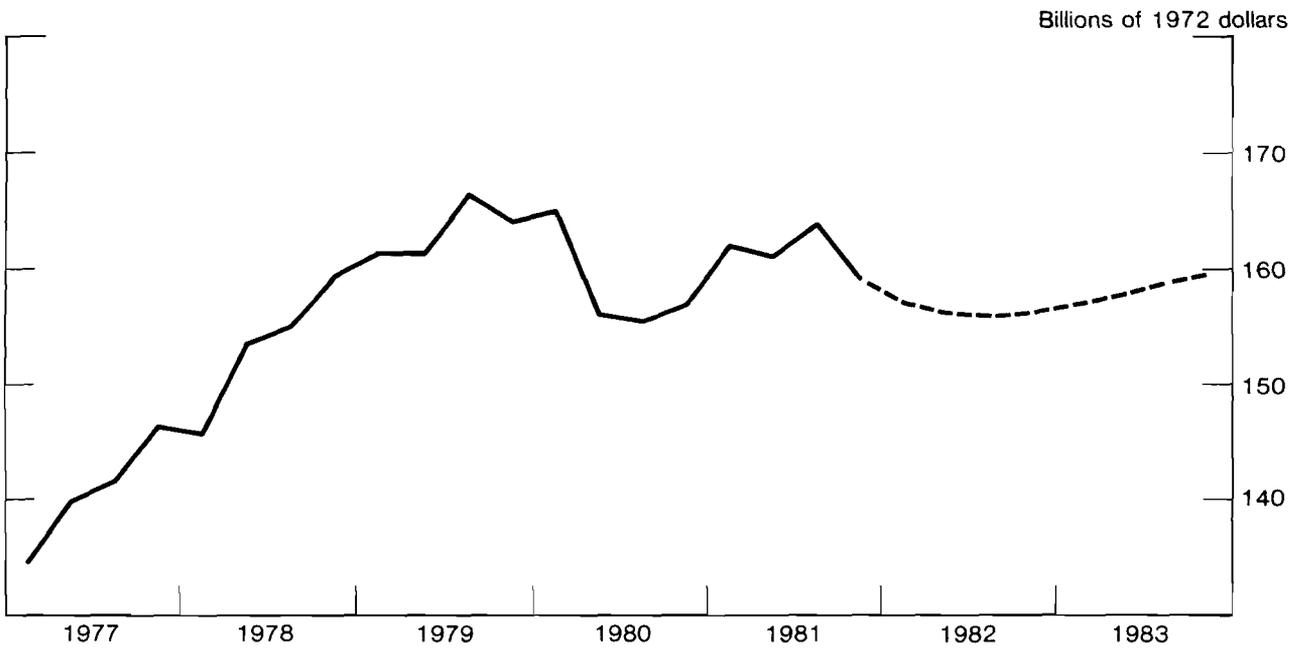
**Corporate Profits Relative to GNP**



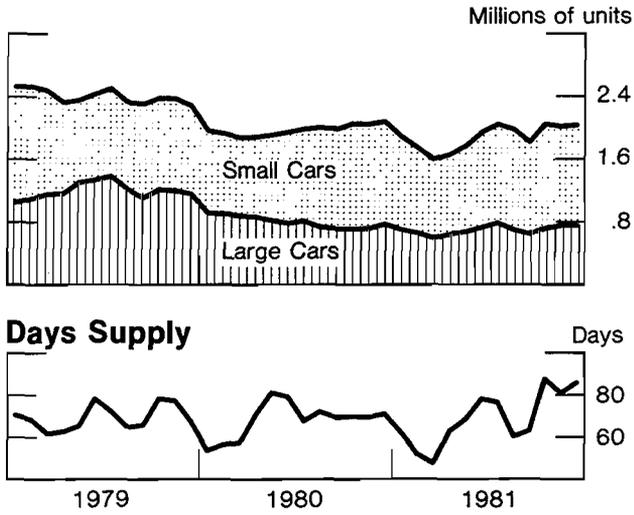
### Manufacturing Capacity Utilization



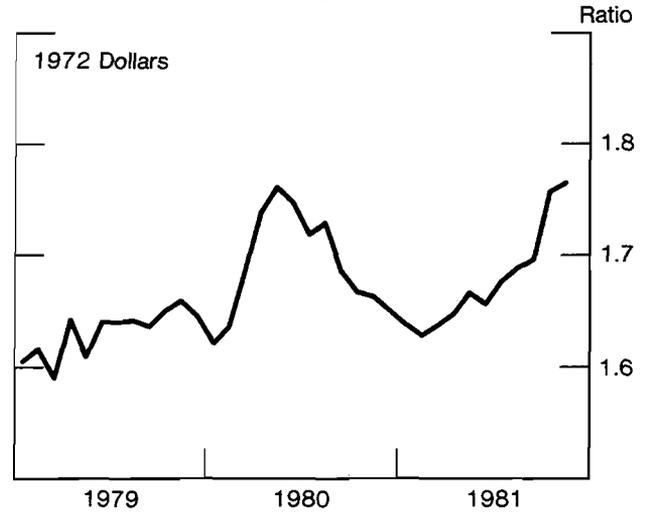
### Real Business Fixed Investment



### Auto Inventories



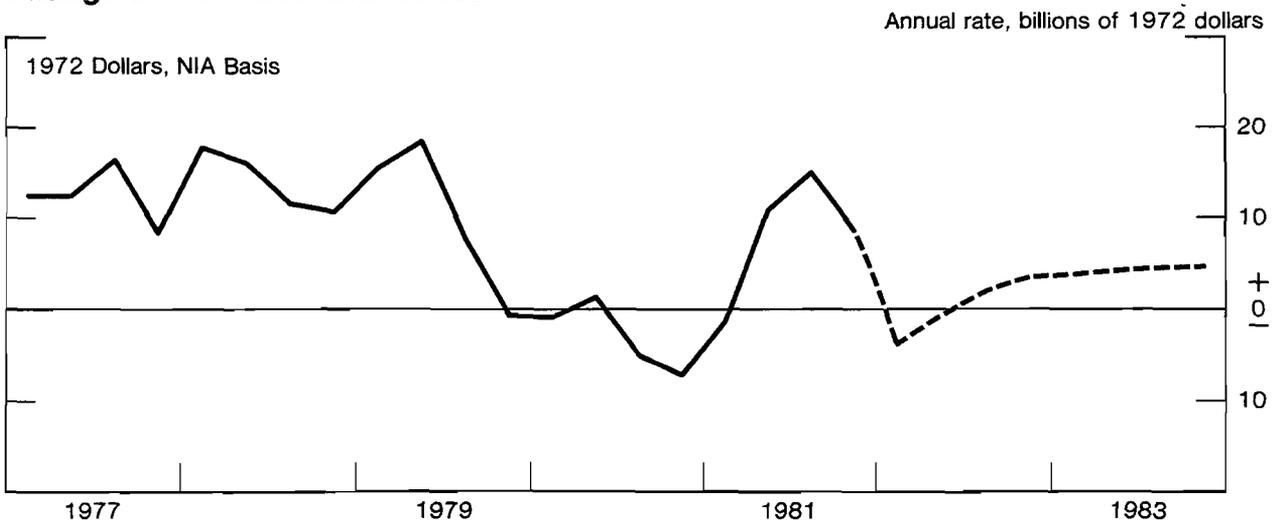
### Manufacturing and Trade Inventories Relative to Sales



### Business Inventories Relative to Sales

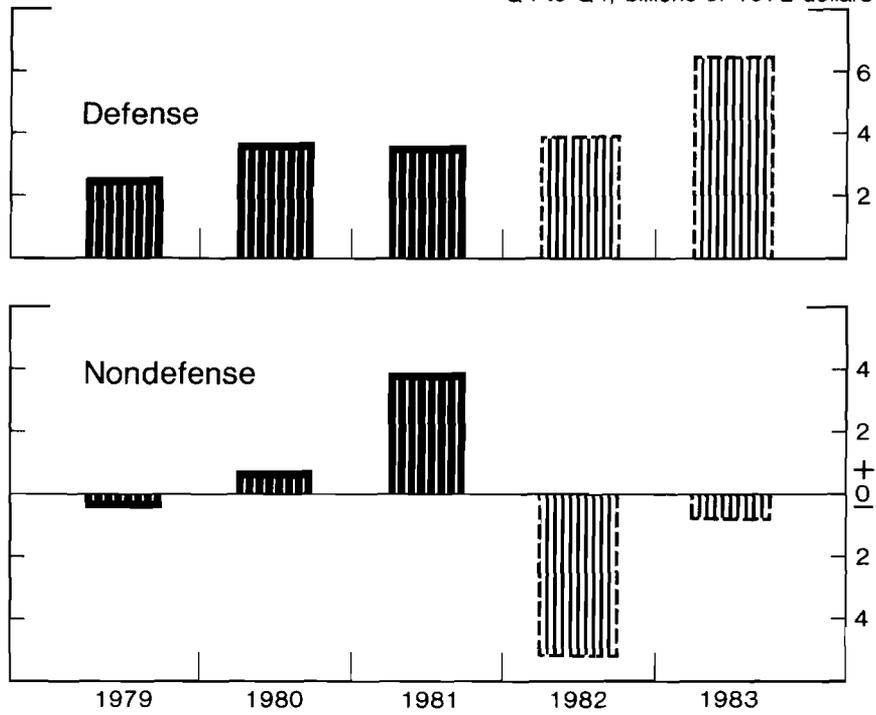


### Change in Business Inventories



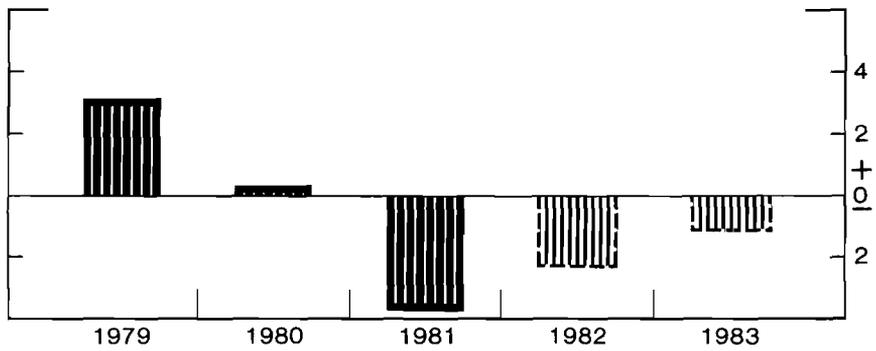
### Change in Real Federal Government Purchases

Q4 to Q4, billions of 1972 dollars



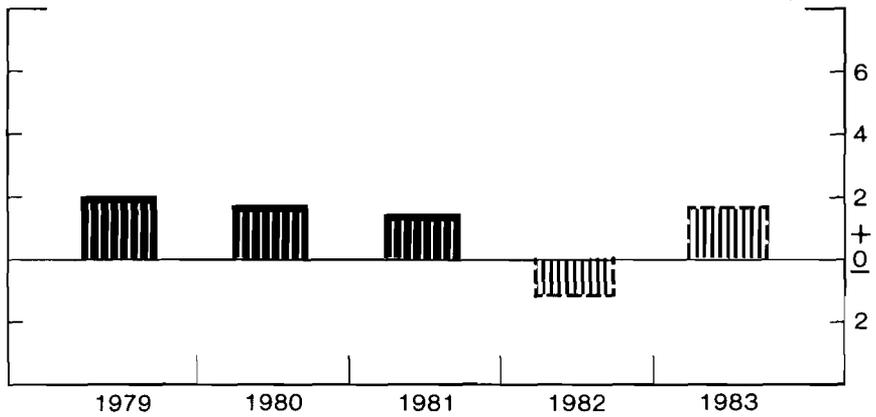
### Change in Real State and Local Purchases

Q4 to Q4, billions of 1972 dollars



### Percent Change in Real Total Government Purchases

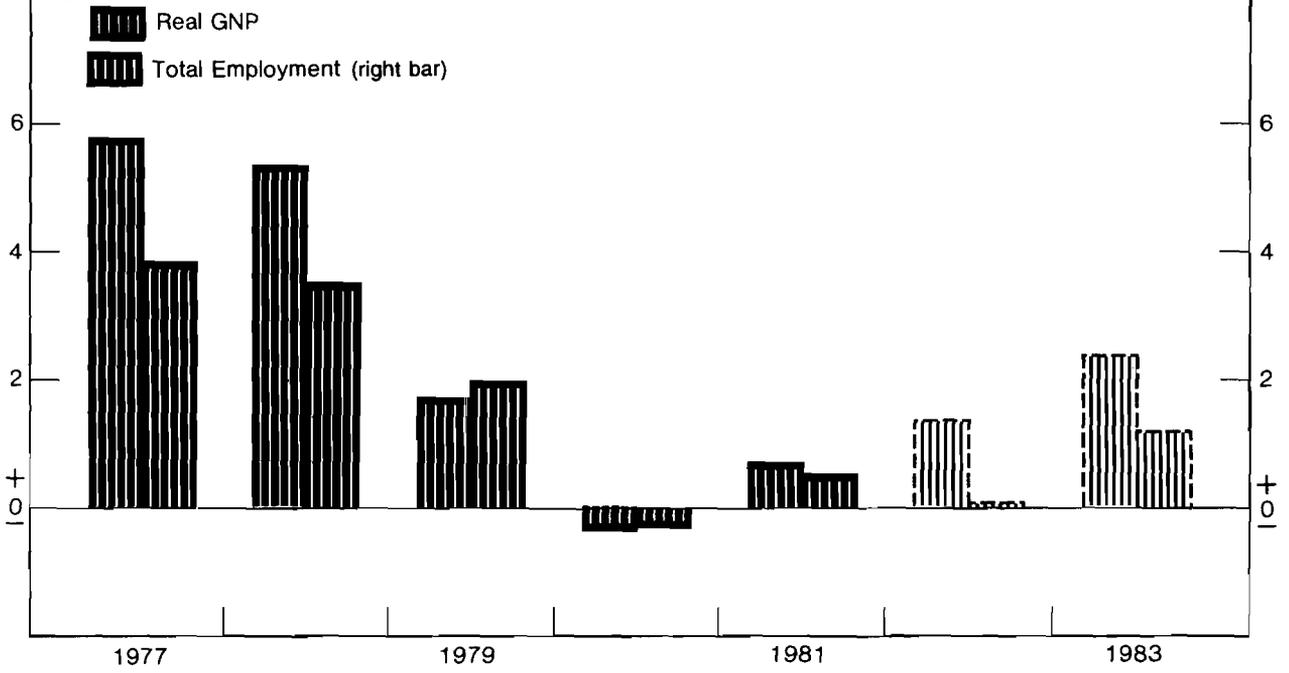
Q4 to Q4, percent



### Total Employment and Real GNP

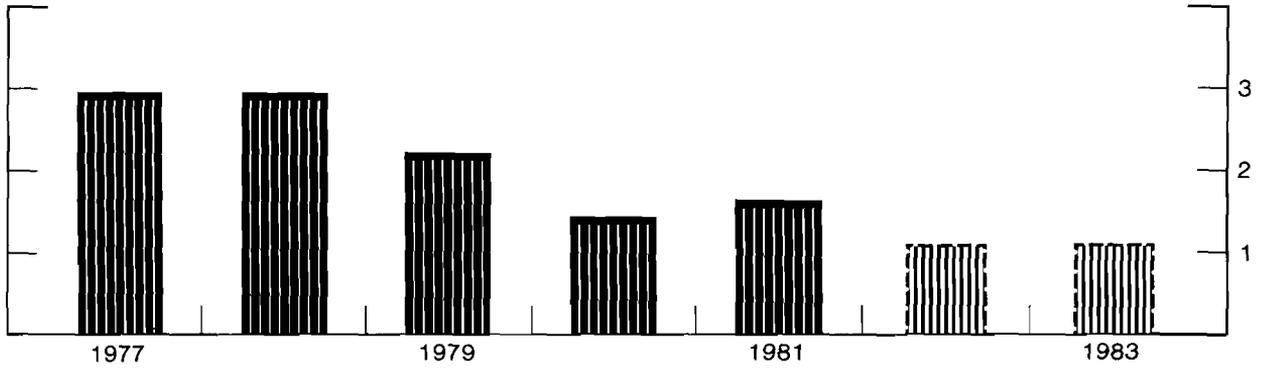
Change, Q4 to Q4, percent

Change, Q4 to Q4, millions of persons



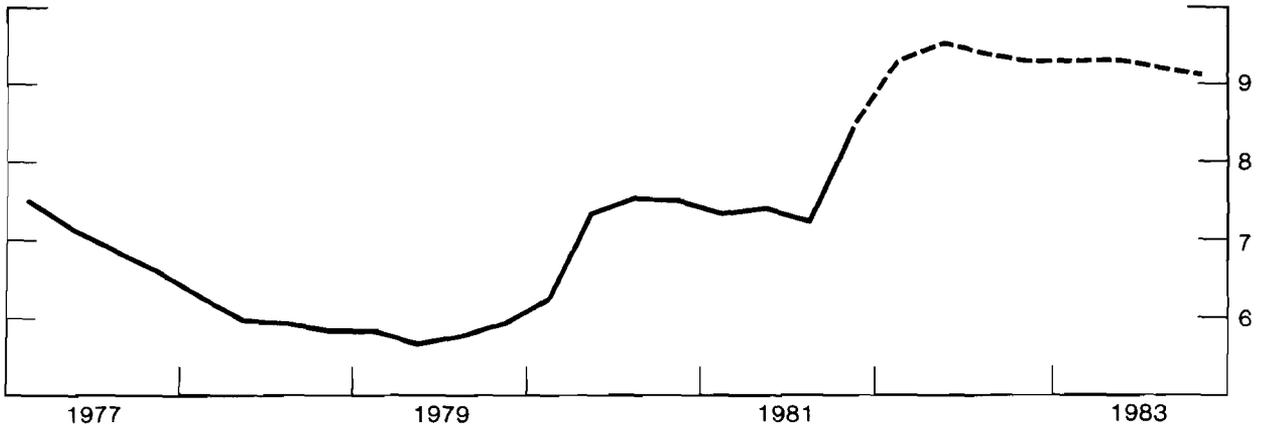
### Civilian Labor Force

Change, Q4 to Q4, millions of persons



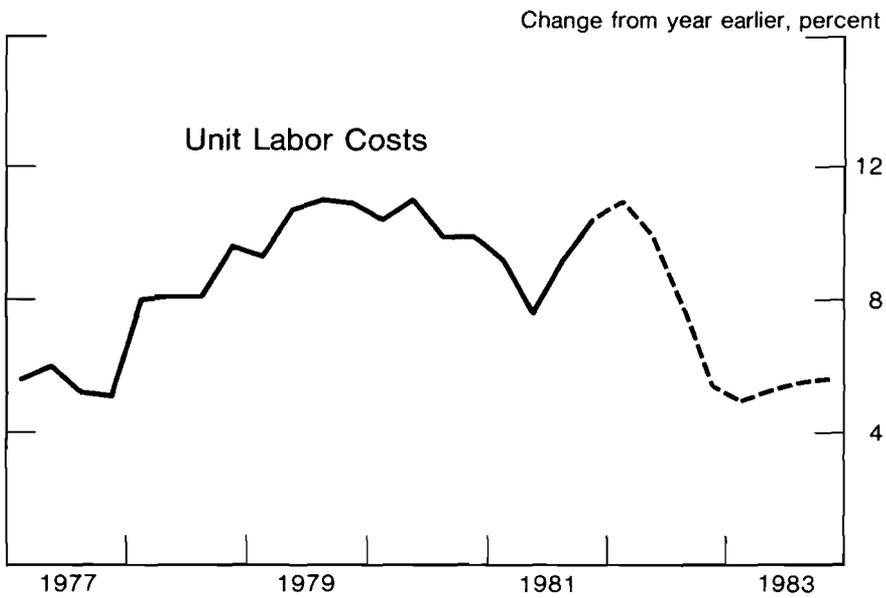
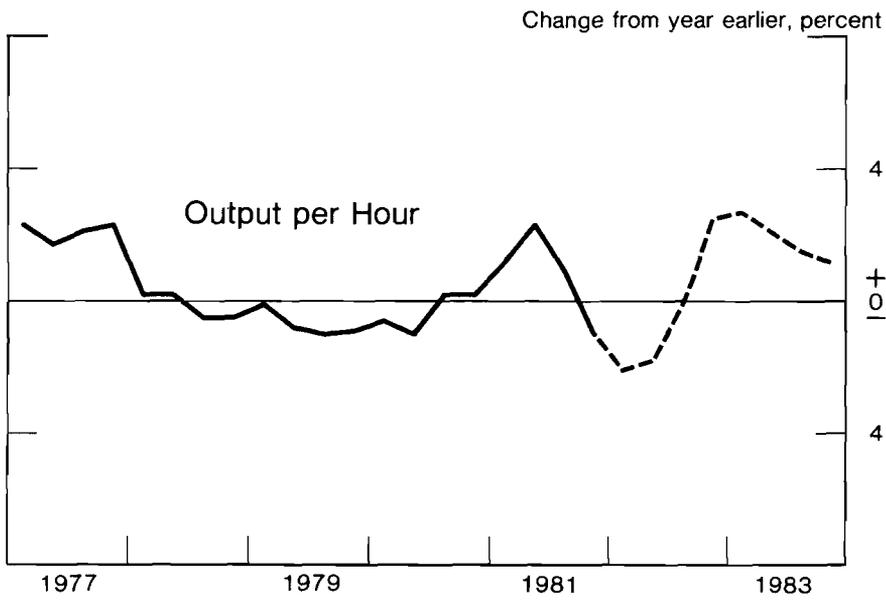
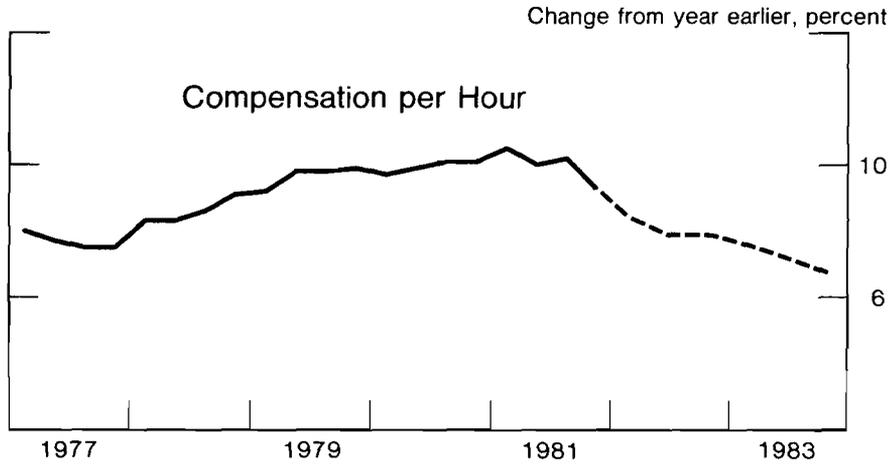
### Unemployment Rate

Percent

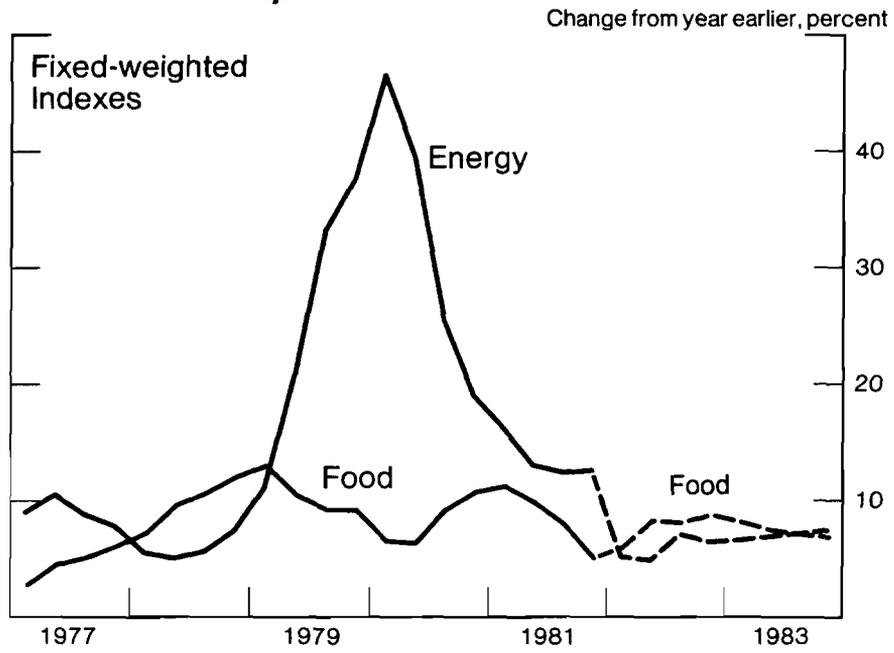


# Unit Cost Indicators

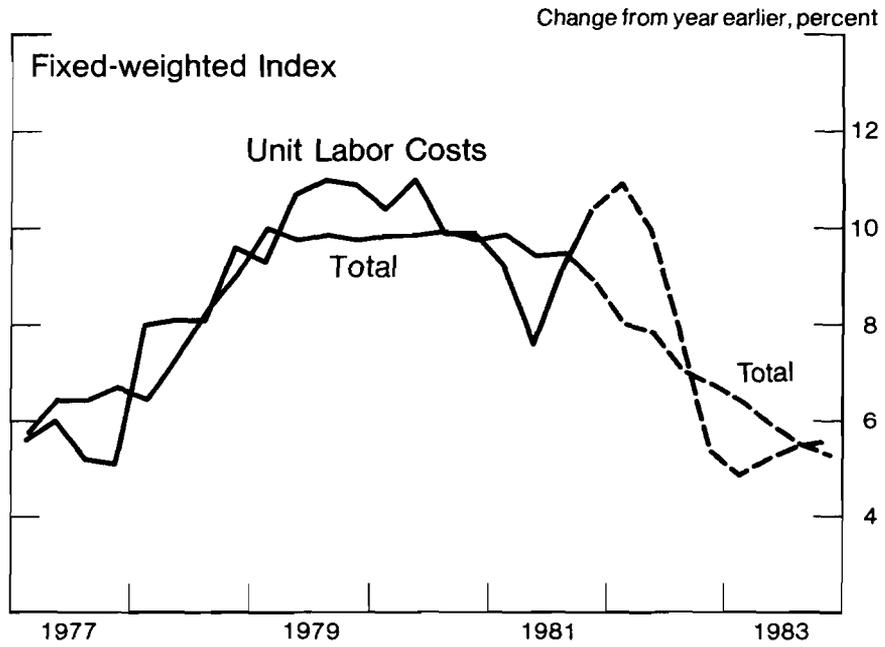
## Nonfarm Business Sector



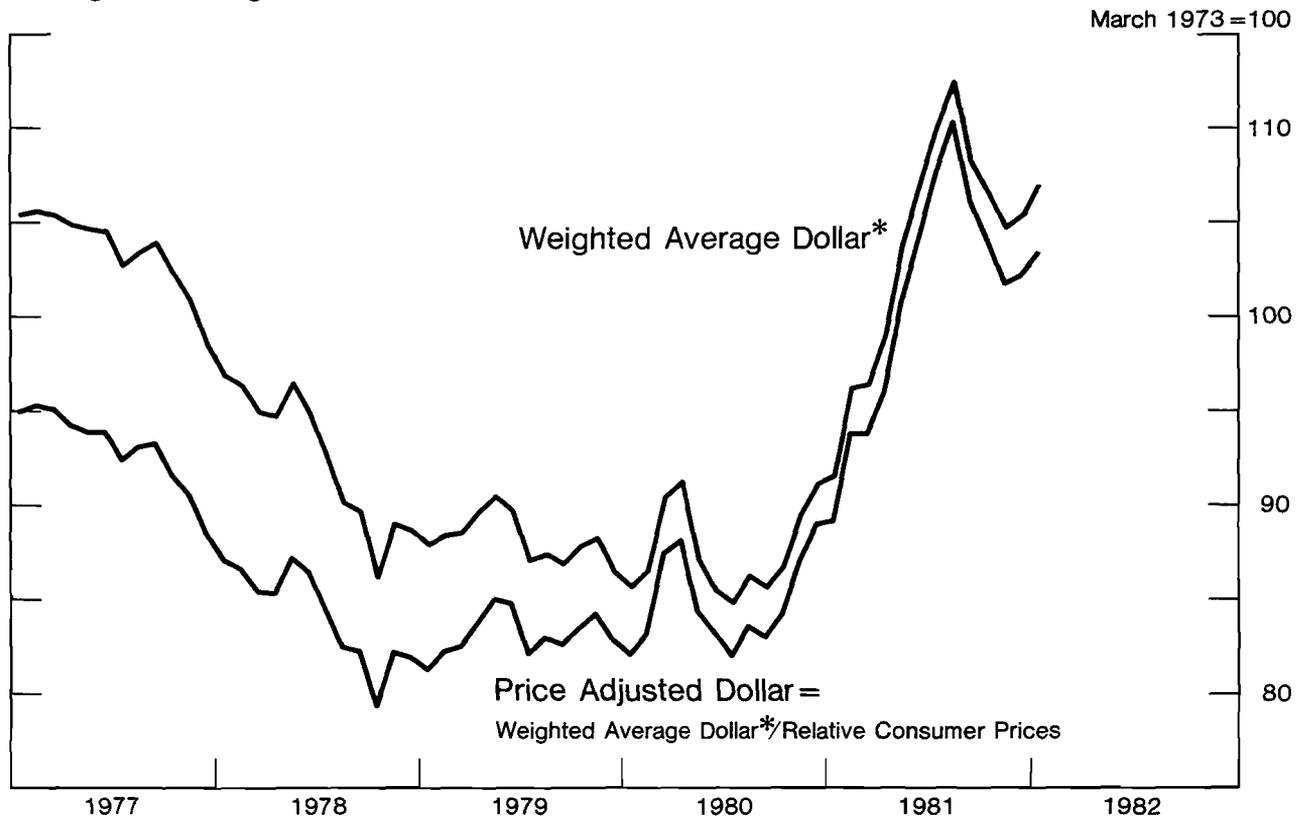
### Personal Consumption Prices



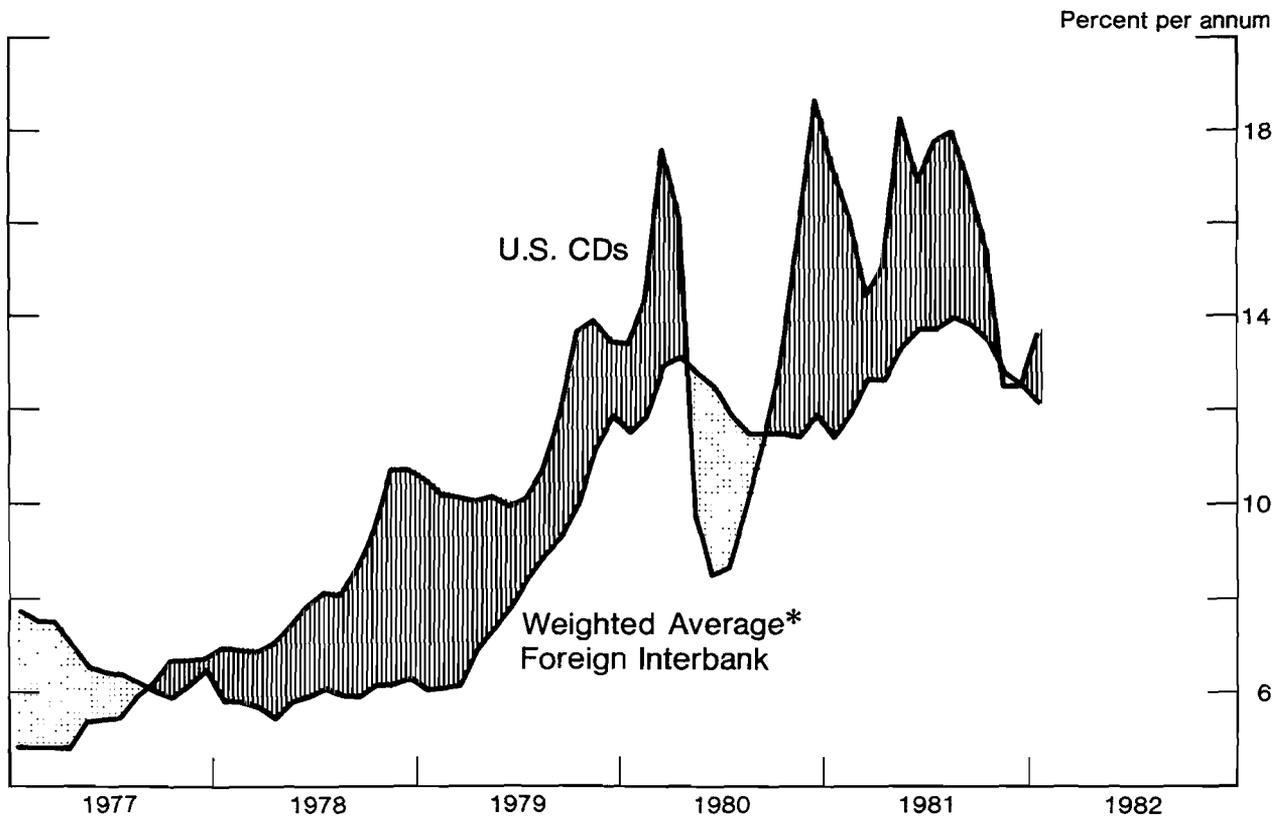
### Gross Business Product Prices



### Foreign Exchange Value of the U.S. Dollar

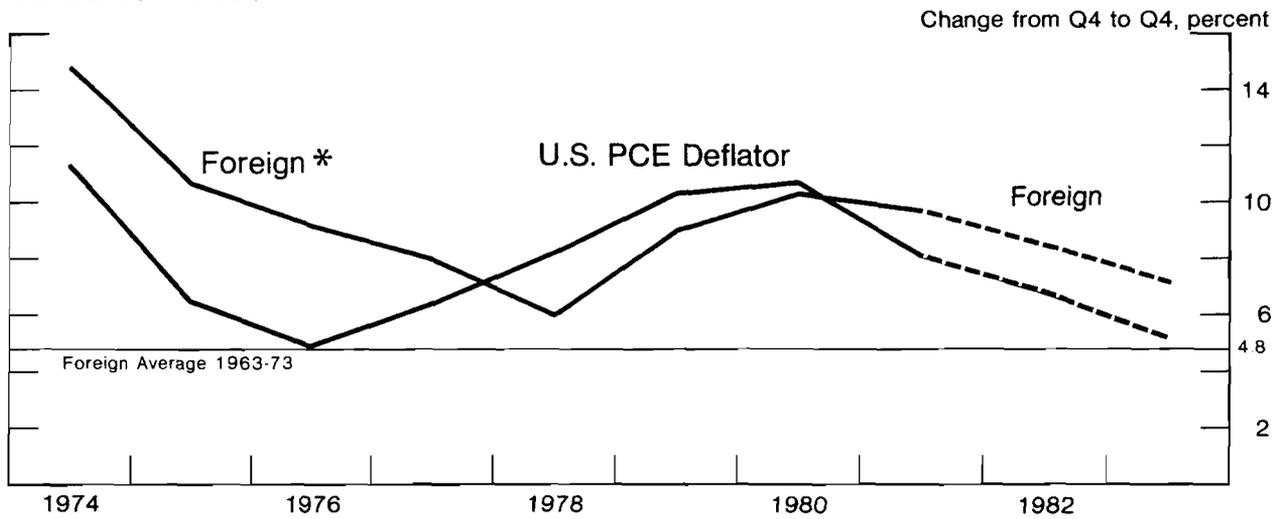


### Short-term Interest Rates

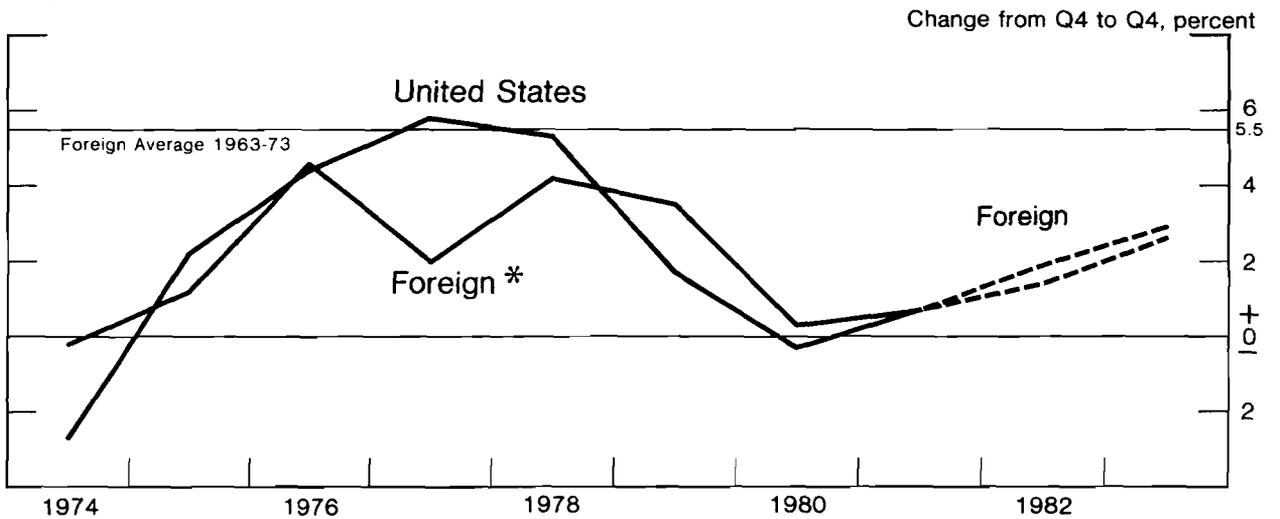


\*Weighted average against or of G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

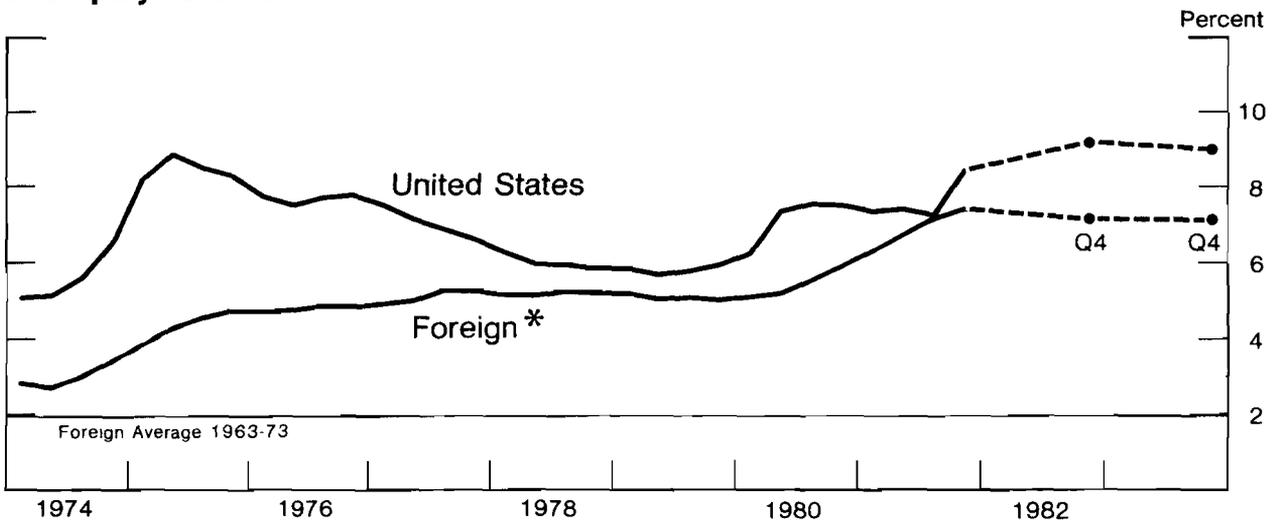
### Consumer Prices



### Real GNP

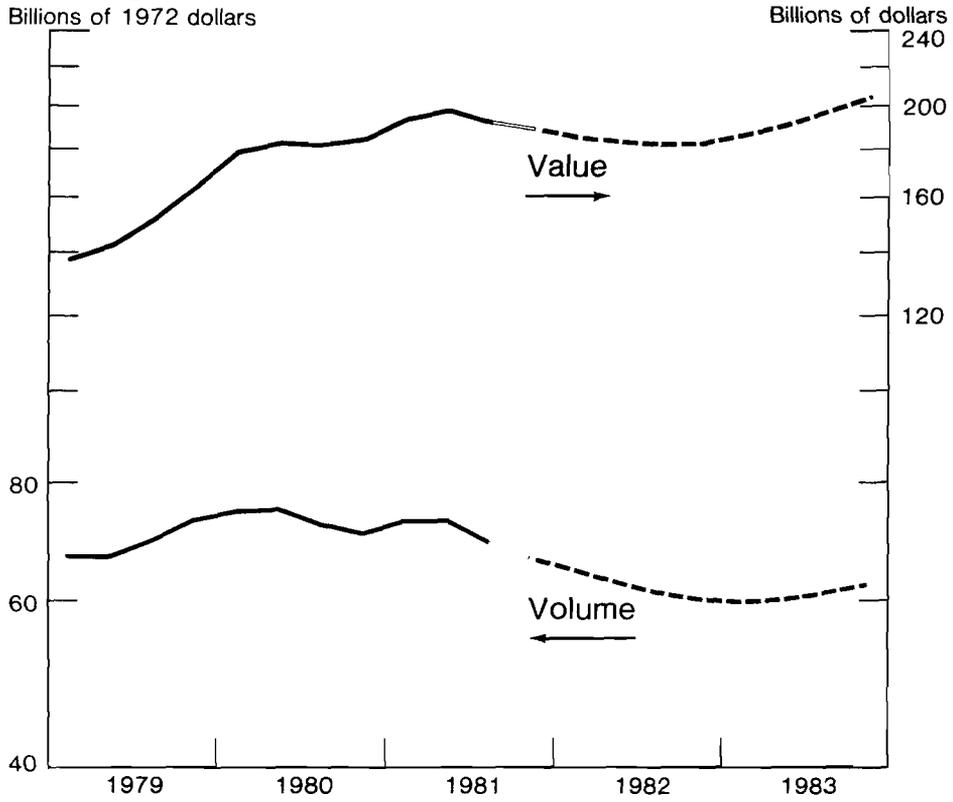


### Unemployment Rate

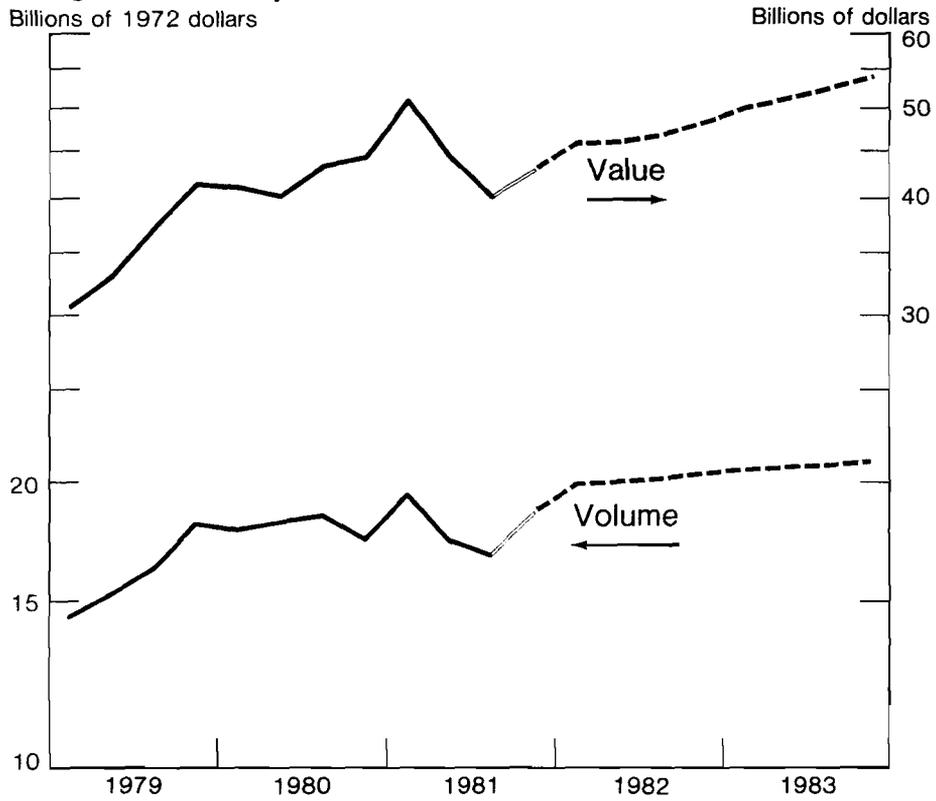


Weighted average of G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

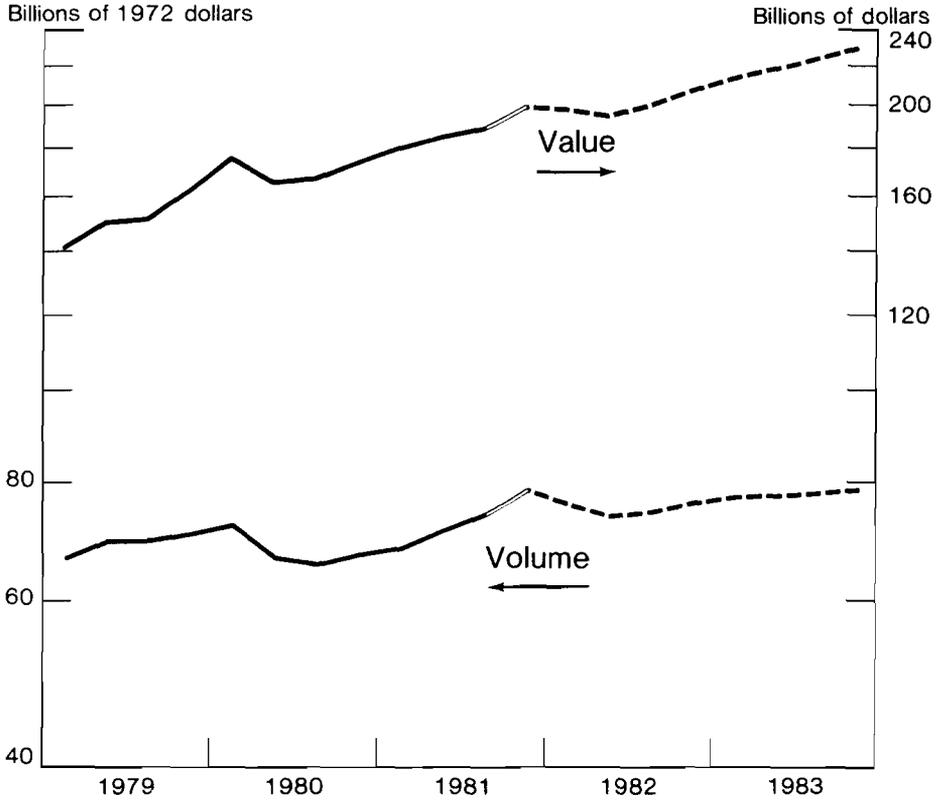
### Nonagricultural Exports



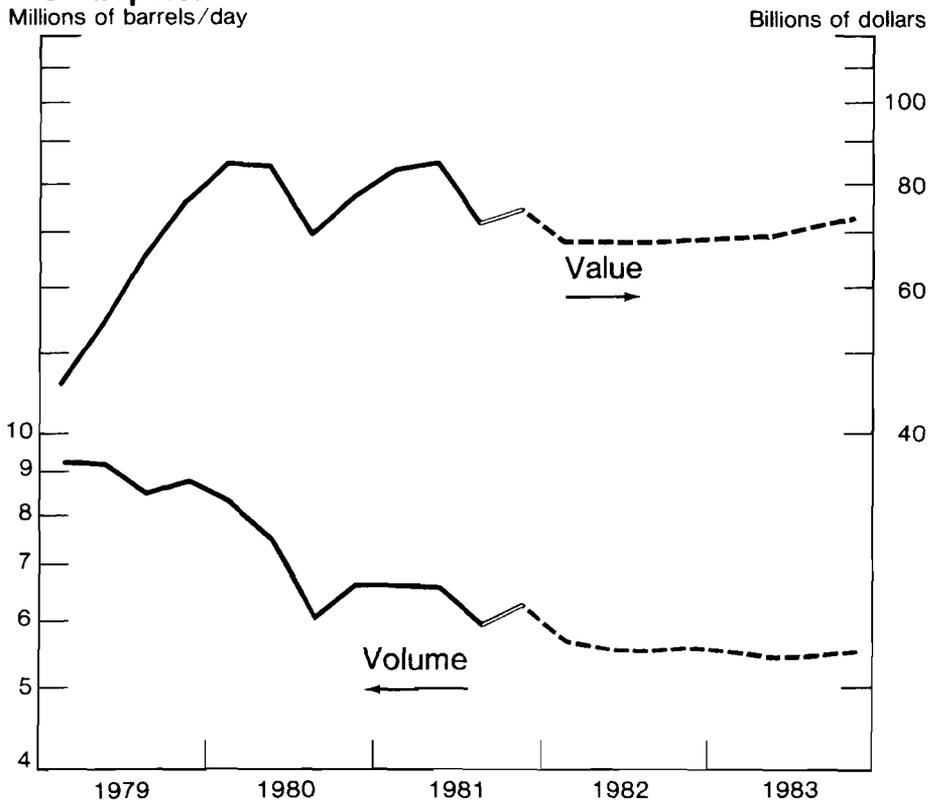
### Agricultural Exports



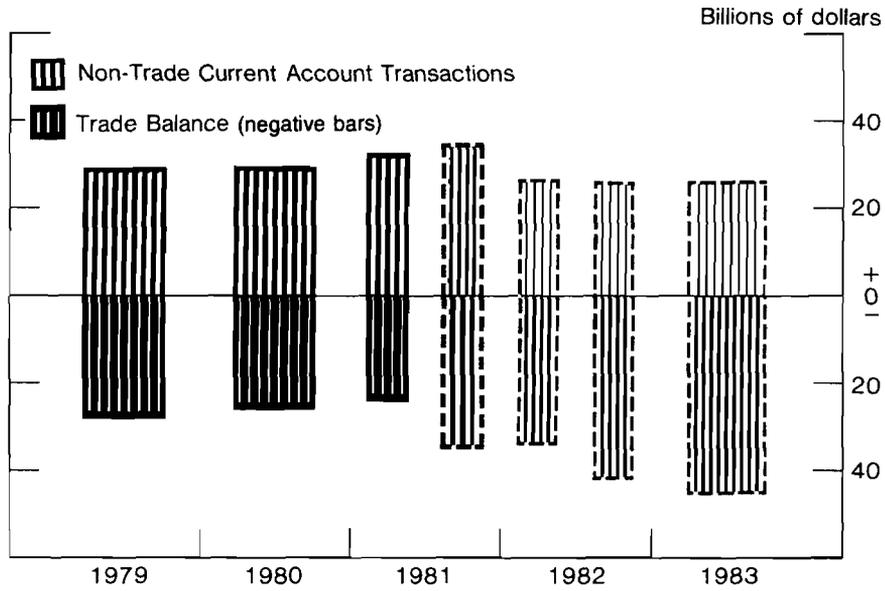
### Non-Oil Imports



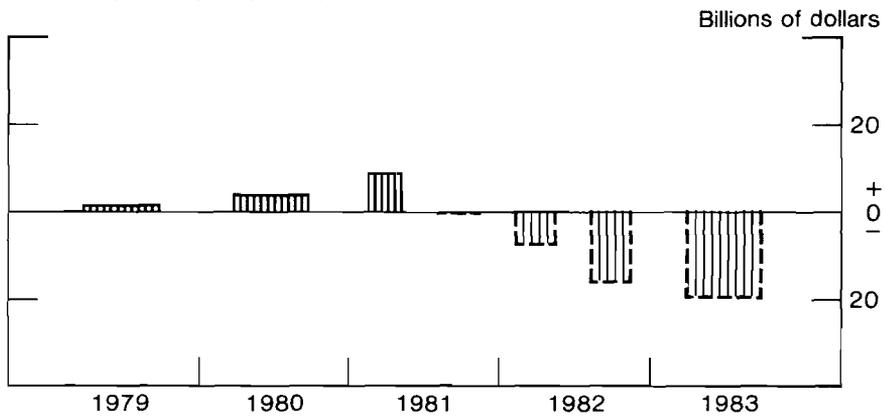
### Oil Imports



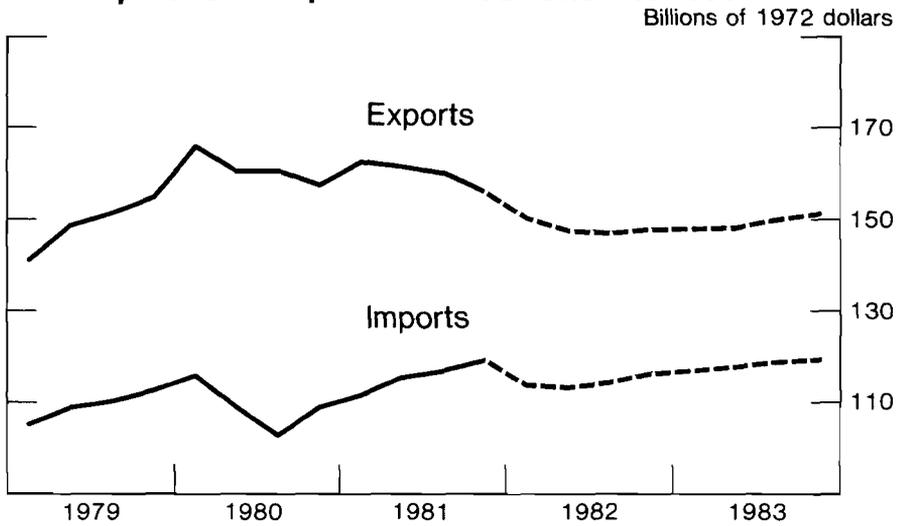
### Current Account Transactions



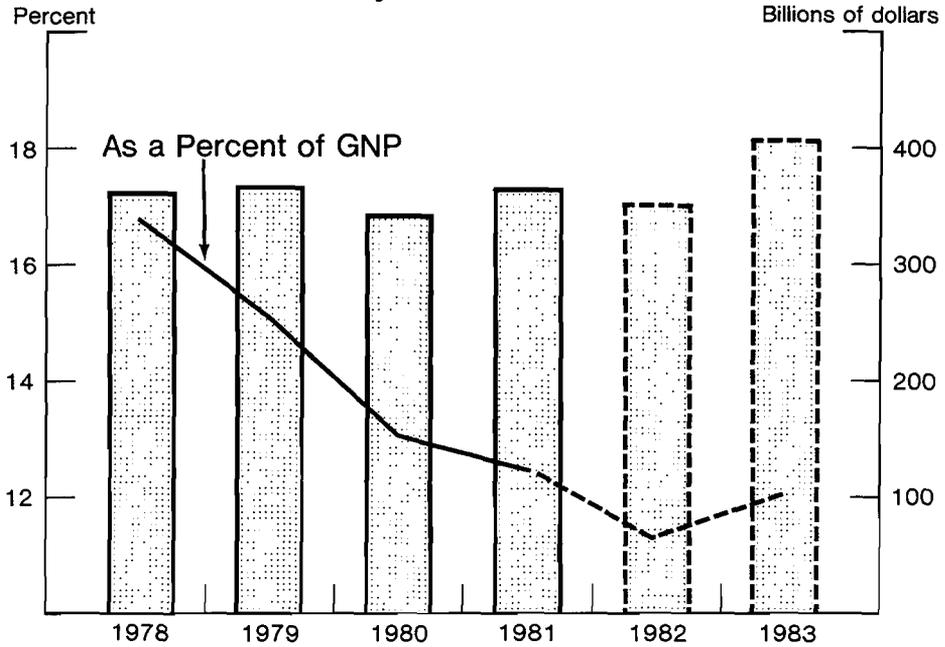
### Current Account Balance



### GNP Exports and Imports of Goods and Services



### Total Funds Raised by Domestic Nonfinancial Sectors

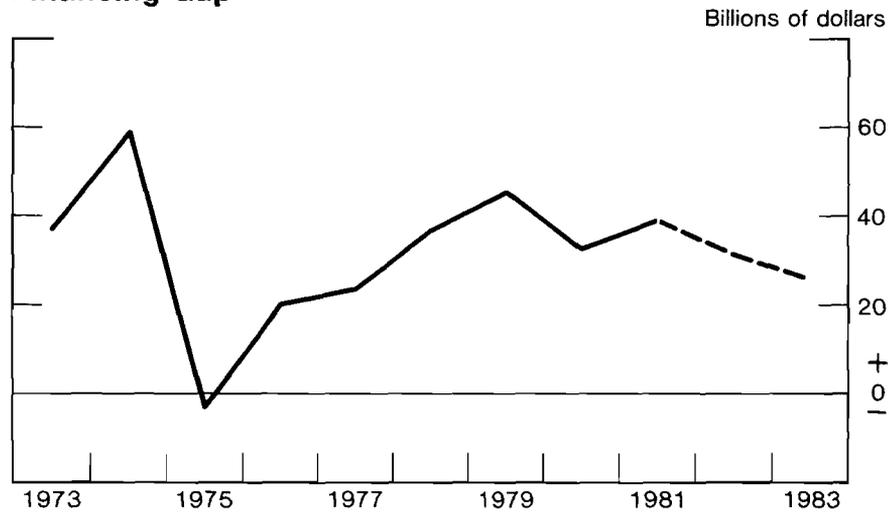


### U.S. Treasury Borrowings as a Percent of Total Funds Raised by Domestic Nonfinancial Sectors

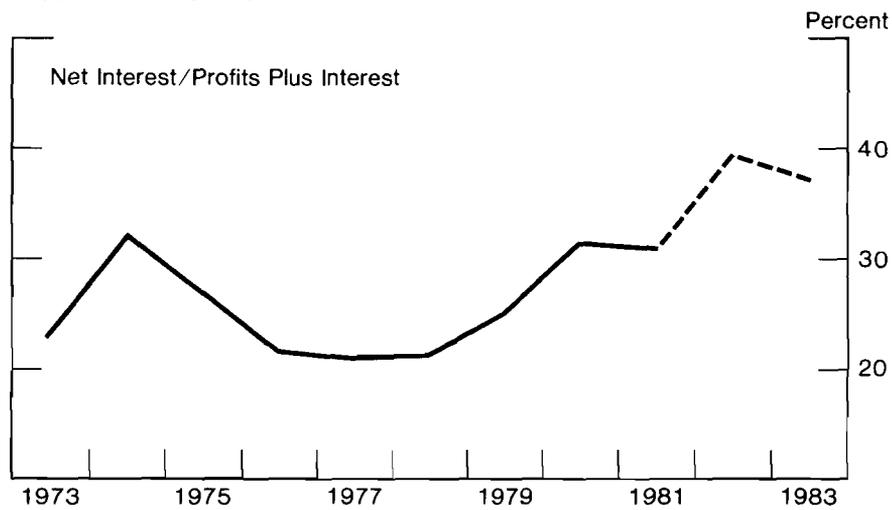


# Nonfinancial Corporations

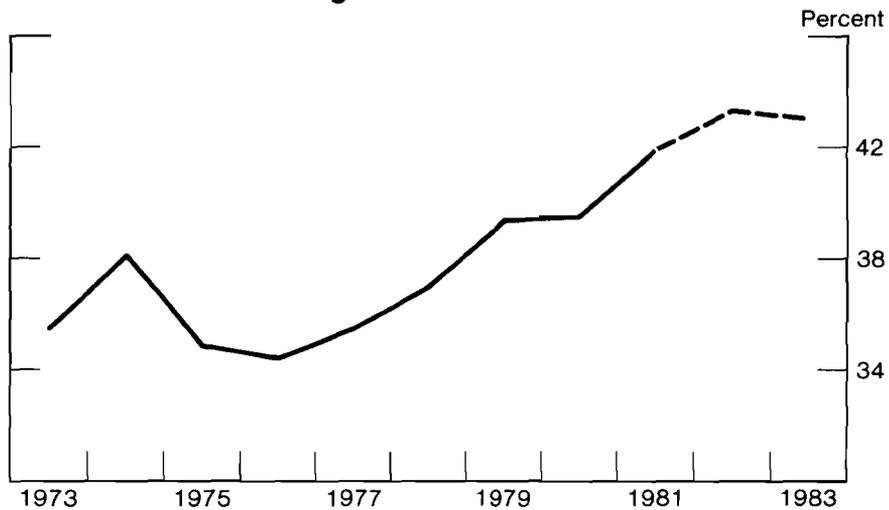
## Financing Gap

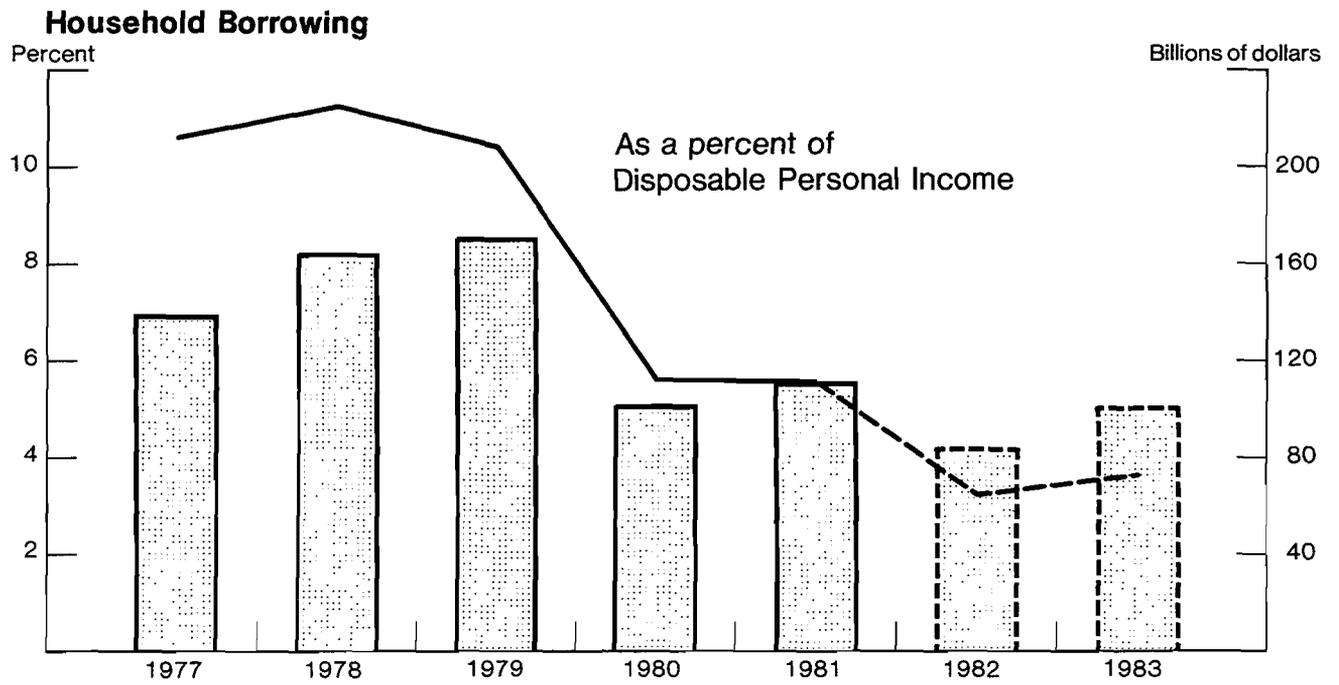


## Interest Relative to Income

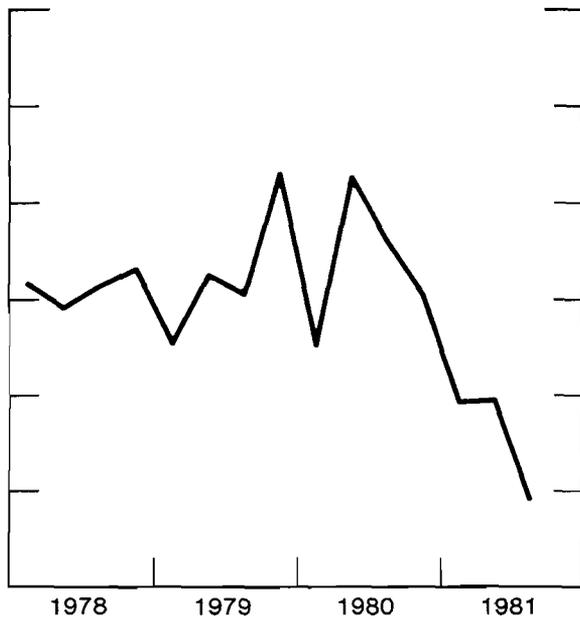


## Short-term Debt Relative to Total Debt Outstanding

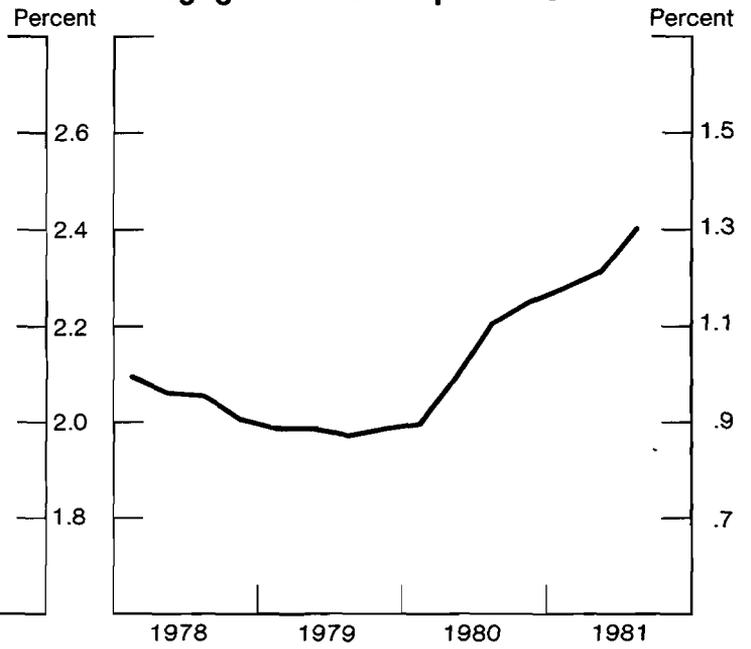




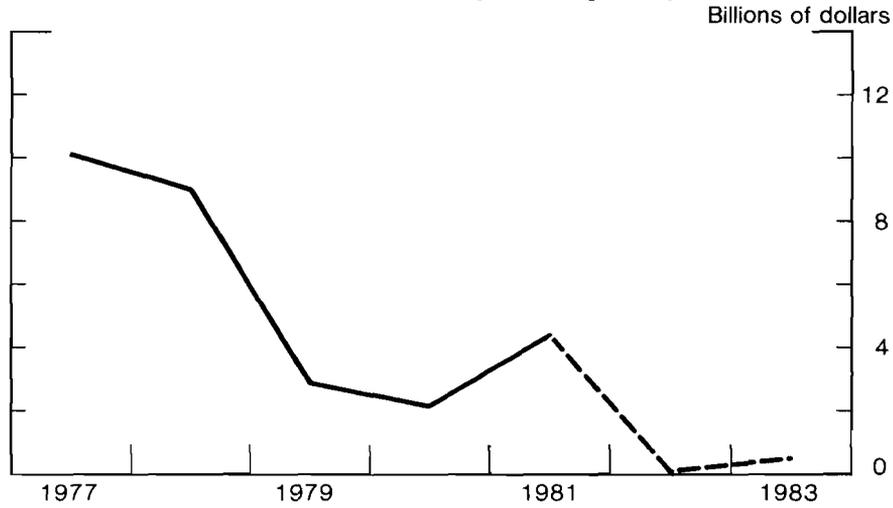
### Auto Loan Delinquencies



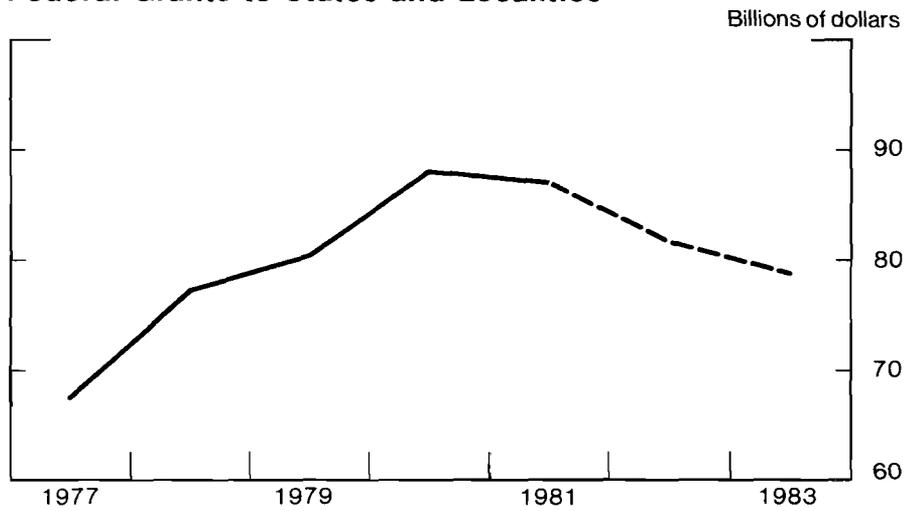
### Mortgage Loan Delinquencies



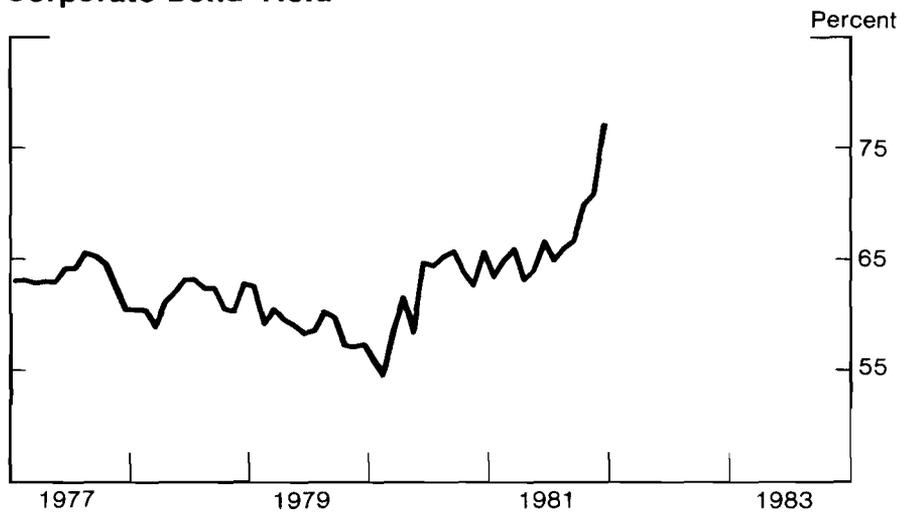
### State and Local Government Operating Surplus



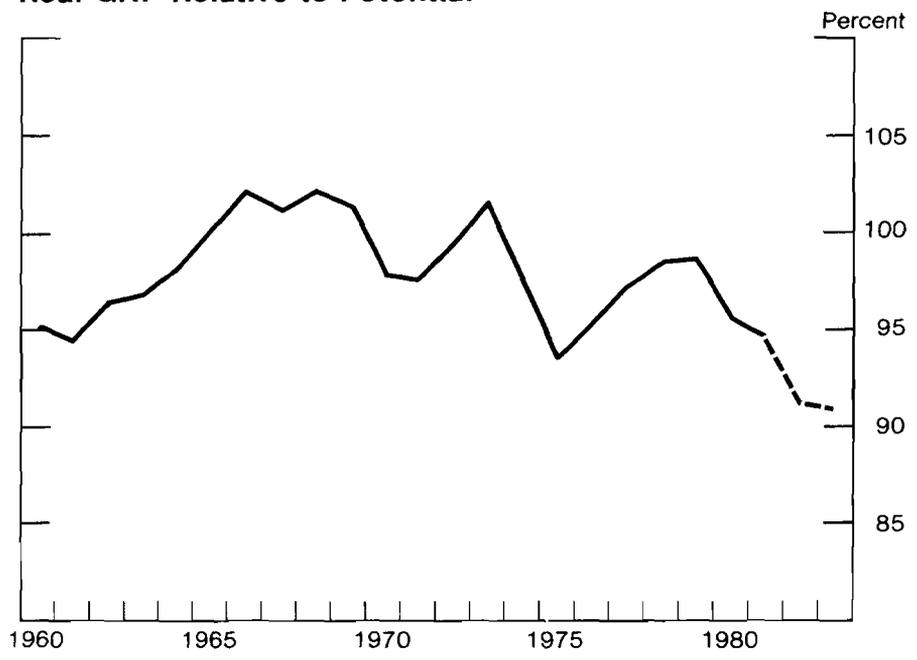
### Federal Grants to States and Localities



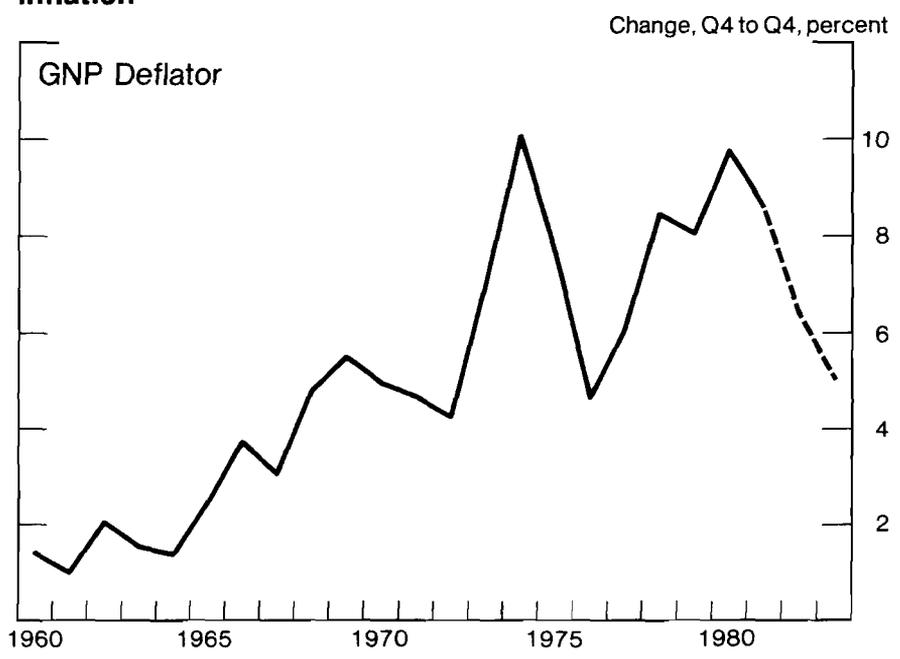
### Tax-exempt Bond Yield Relative to Corporate Bond Yield



### Real GNP Relative to Potential



### Inflation



## 1982 Forecast Summary

	<b>Board Members</b>		<b>Voting Presidents</b>		<b>Nonvoting Presidents</b>		<b>Staff</b>
	Range	Median	Range	Median	Range	Median	
Change, Q4 to Q4, percent							
Nominal GNP	8—10	8¾	8—9½	9	6½—9½	8½	8
Real GNP	½—2	1¾	1—2½	2	0—2	1¾	1¼
GNP Deflator	6½—7¾	7½	7—7¼	7	6¼—7½	7	6½
Average Q4 level, percent							
Unemployment Rate	8¼—9½	8¾	8½—9	9	8¼—9½	9	9¼

PETER D. STERNLIGHT  
NOTES FOR FOMC MEETING  
FEBRUARY 1-2, 1982

Desk operations since the December meeting have been conducted against a background of strong monetary growth and higher interest rates. As the intermeeting period proceeded, the rise in money growth produced a steadily higher demand for reserves, compared with the Committee's path desired. The latest estimate placed the demand for reserves some \$600 million above path, on average for the six-week interval. Largely in consequence, but also reflecting some downward adjustment of the nonborrowed reserve path to strengthen the resistance to excessive money growth, the banking system was pushed into substantially greater reliance on discount window borrowings. While borrowing trended higher over the period, there was considerable week-to-week variation--partly due to special pressures around the year-end period, and partly to short-run difficulties with reserve projections. For the whole period, including this week, borrowing may average about \$1 1/4 billion.

At the start, borrowing was expected to be around \$300 million, the near-frictional level indicated at the December meeting. This was expected to be associated with a Federal funds rate close to the 12 percent discount rate. Expected borrowing levels moved up to about \$500 million around

year-end and just afterward as money growth strengthened. Actual borrowing pushed even higher--to about \$1 1/4 billion in the week that bridged the year-end. Further into January, as monetary strength persisted, expected borrowing levels grew to about \$1.2 and then \$1.5 billion. Actual levels fell short of, and then exceeded, these anticipated levels, with borrowings in the area of \$750 million and then \$2.3 billion in the weeks of January 20 and 27. The latter high level was partly induced by Desk action to make reserve needs more pressing early in the week, and then exacerbated by unexpected reserve shortfalls later in the week. So far in the current week, borrowing has averaged about \$1.7 billion--somewhat above the anticipated \$1.5 billion level.

The funds rate, meantime, climbed from levels modestly above the 12 percent discount rate at the beginning of the period. It temporarily averaged nearly 13 percent in the year-end week, briefly receded to around 12 1/2 and then rose more sturdily to about 13 and then 14 percent in the weeks of January 20 and 27. Thus far in the current week, funds have averaged about 14 1/2 percent--including a jump-up yesterday to about 15.70 percent which may have stemmed in good part from the publication of heavier borrowing last Friday. Today funds opened at 15 1/2 percent.

Day-to-day operations were complicated by the aforementioned pressures on bank reserve management around year-end and by considerable difficulties in projecting reserve supplies

through much of January. The effects of bad weather, including a temporary shut-down of some Federal Reserve offices, contributed to these difficulties. Another factor was the exceptionally high Treasury balances at the Fed, as surprisingly heavy tax receipts came in after mid-January, and the Treasury was unable to put back funds in commercial banks to the desired extent.

For most of the period, the Desk was draining reserves, much of it offsetting the effects of reductions in currency. In fact, all of the System's outright operations were in a reserve-absorbing direction, roughly reversing the large outright acquisitions in late 1981. Holdings of Treasury bills were reduced by some \$3.4 billion, including market sales of \$1.4 billion, sales to foreign accounts of nearly equal size, and redemptions of \$600 million. A small amount of agency issues was also redeemed. Repurchase agreements were used extensively around year-end, and again in the last several days to cope with the high Treasury balances. Matched sale transactions were employed continually with foreign accounts and on several occasions in the market as well.

Interest rates have pushed higher in the past six weeks, about as might be expected against the background of rising money supply, steeper day-to-day financing costs, and looming Treasury deficits. Much of the rate rise came early in the period, before the huge January money bulge was reported, as the market anticipated a bulge (albeit a lesser one). Also,

the market was already reacting in December to the signs of money growth then apparent, and in early January to the absence of a post year-end easing in money rates that many participants had expected. Rising estimates of Treasury needs were also a factor. When the \$10 billion money supply rise was reported in mid-January, it was something of an anti-climax and reaction was tempered by earlier anticipations and by expectations of a quick reversal of some of the bulge. Although the next week's numbers failed to provide that reversal, reaction was again moderated, in part by continued anticipation of declines to come and in part by the sense that reserve pressures were not mounting steeply. This past Friday, and continuing yesterday, there was a more substantial upward rate reaction as weekly numbers showed a disappointingly small decline in money and even more because of the sharp reported rise in discount window borrowing. Broadly speaking, though, the market reaction to money growth has been tempered by the sense that a slowdown or reversal in that growth is likely given the continuing evidence of weakness in the economy.

A subdued view of the economy has also moderated the reaction to new information on the Treasury financing outlook as it became clear that the Administration would not seek significant tax action to reduce forthcoming deficits. The market greeted rather calmly the Treasury's news of this week's \$10 billion quarterly refunding operation, and their plans to borrow

\$41 billion of net new cash in the current quarter. Both the mid-quarter refunding and the quarterly cash need are records.

Yields on intermediate and long-term Treasury coupon issues are up about 1/2 to 1 percentage point since the last meeting date, while the Treasury raised about \$7 billion in the coupon area. A \$5 billion 3-year note will be auctioned today and may yield close to 15 percent, compared with a yield just under 14 percent on that maturity just before the last meeting. A \$2.5 billion 10-year note will be auctioned tomorrow and a like amount of reopened 30-year bonds on Thursday. Both may set auction yield records, although secondary market yields in those maturities were higher last fall.

Bill rates, meantime, have risen about 1 1/2 to 2 1/2 percentage points while the Treasury raised some \$8 billion in the bill market. Both three- and six-month bills were sold yesterday at average rates of 13.85 percent, compared with 11.04 and 11.84 percent just before the last Committee meeting.

In other sectors of the capital market it is noteworthy that virtually no standard-type long-term corporate issues have been sold in the U. S. market in the recent period. Some corporations raised funds through zero-coupon offerings in the Eurodollar market, though, with Japanese investors reported to be particularly interested in such issues. The rise in corporate yields, like that in Governments, retraced part, but by no means all, of the sharp decline in yields in late 1981.

In the tax-exempt sector, though, yields hit new highs in the recent period, although there was some price recovery near the end as moderate investor demand and the light volume of new issuance produced some technical improvement.

NOTES FOR FOMC MEETING  
February 2, 1982

Sam Y. Cross

Mr. Chairman:

Since the December meeting, and more particularly after the year-end, exchange markets have focussed very closely on the near-term prospects for monetary policy and interest rates--both in the United States and abroad. With unemployment rising throughout industrial Europe and North America, in some cases to levels considered politically unacceptable, market participants came widely to expect some moderation in the generally restrictive monetary policies that most countries had in place. At New Year's time, the questions being asked were: How much monetary easing would take place, and to what extent would these policy adjustments be coordinated among the major countries? Exchange market participants watched each and every development they thought might yield a clue about the course of interest rates in New York and other financial centers.

In early January, European interest rates indeed did generally drift downward, but U.S. money market rates moved higher, and this unexpected divergence pushed the dollar higher in the exchanges. This trend continued, and in the middle of the month there were widespread rumors that the G-5 had agreed to coordinate policy internationally and that the U.S. would either lower interest rates or join in exchange market intervention. But after a few days these rumors of concerted action vanished, as the differentials between U.S. and European interest rates continued to increase rather than to narrow. By the end of January, the market had come to the view that Europeans,

in particular the Germans, might continue to ease their restrictive policies, even without easing on the part of the United States and despite possible exchange rate consequences. This view was strengthened first when the Germans openly intervened in the amount of nearly \_\_\_\_\_ in a three-day period, and later when improved current account data for Germany, released during the month, suggested more room for maneuver for the German authorities.

On balance, the dollar rose in January by about 4 1/2 to 5 percent against the continental currencies, and by 5 1/2 percent against the yen. On three-month Euro-currencies, interest rate differentials expanded by more than 200 basis points against the continental currencies and by somewhat less against the yen. Yesterday and today the dollar has strengthened further, with the further increases in U.S. interest rates as well as the continuing political uncertainties in Germany. In the past 24 hours we have seen the dollar as high as 236.85 against the DM, and 233.75 against the yen, though it is now down a bit from those levels.

The exchange market's preoccupation with monetary policy adjustments may simply be a reflection of the views that volatile interest rates can induce capital flows that can swamp other influences on exchange rates. Or it may reflect the view that at times like the present when most countries' balance of payments changes are small and tending toward convergence and most countries' inflation rates are tending to decline, that such fundamentals will be of less importance than in the past in influencing exchange rate movements. Whatever the reason, the exchange markets' present concentration on interest rates is clear. And I should add, there is increasing criticism, in Europe and elsewhere, of what they see as a U.S. policy which results in great volatility of interest rates, which leads to great volatility of our and their exchange rates, while we are not prepared to help them deal with it in terms of intervention.