

## APPENDIX

Notes for FOMC Meeting  
July 8, 1986  
Margaret L. Greene

Mr. Chairman:

After trading without clear direction for several weeks since early May, the dollar resumed its decline at the end of June. Yesterday morning, the dollar fell to a new post-war low against the yen -- just below Y 159. It also hit a 2 1/2 month low against the German mark -- just below DM 2.16. Though the dollar is trading a little above these levels now, market sentiment toward the dollar is decidedly negative for the near term. At the same time, the interest-rate incentive for international investors to hold on to dollar balances is diminishing except in the short maturities.

The dollar's performance early in the intermeeting period was broadly interpreted as reflecting a pause in the dollar's depreciation, not a change in trend. To some extent this pause reflected the market's perception that the authorities abroad were prepared to act to prevent a further drop in dollar rates for a while. Market participants believed in particular that the Bank of Japan would contain the yen's rise, relying on heavy intervention if necessary, in order to neutralize the adverse political effects of the yen's 9-month rise ahead of parliamentary elections July 6th. They also thought the Bundesbank might intervene if the mark appreciated

above DM 2.20, a level thought to reflect the breakeven point for many of the country's exporters.

More fundamentally, many in the exchanges were comfortable with the idea that a period of pause after the Tokyo Summit might permit an assessment of the effects of the declines in both interest rates and exchange rates that had occurred over the preceding year.

By late June, dealers rightly or wrongly started to reach conclusions from this period of reassessment. Two months of economic statistics cast doubt in their minds that significant changes in the underlying economic fundamentals were taking place fast enough to dispel the strong political and protectionist pressures here. The trade imbalances that caused concern last fall were seen to be even more out of line. Monthly U.S. trade figures continued to show huge deficits, while those for Germany and Japan showed record or near-record surpluses. Moreover, statistics on economic activity gave dealers the impression that recent declines in interest rates and in oil prices had not yet done much to revive growth, either here or in our export markets abroad.

Also by late June market participants perceived a growing disarray among the authorities of the G-5, with respect to both exchange market tactics and longer-term economic policy strategies. In the exchanges, the Bank of Japan had intervened to buy nearly \_\_\_\_\_ since early March. The Japanese operated especially heavily around the time of the elections

to convey to market participants that their approach to exchange rate policy would not change afterwards. In effect the Japanese bought more dollars in the past 3 1/2 months than they sold in the coordinated intervention of last fall. The Bundesbank did not intervene. Yet dealers still believe the German authorities would be unhappy to see a further substantial rise in the mark. As a result they feel vulnerable to a surprise intervention attack by the Bundesbank. The United States is perceived to have less interest in preventing the dollar from declining. Recent statements from Secretary Baker are being interpreted as suggesting that the United States will accept further exchange rate moves if progress is not forthcoming in improving the climate for U.S. trade.

In the longer-term policy sense, recent events also seem to bring into question whether the G-5 governments are still fully committed to the goal, set forth in the Plaza agreement last September, of a sustained and more balanced expansion. Dealers note that the German authorities appear to be resisting efforts to support internal demand in the face of a first quarter output decline. The Kohl government just last week characterized its fiscal program for next year as one of "strict budgetary discipline." In Japan, movement to moderate contractionary fiscal policy has been slowed by the political calendar there. These developments appear to leave monetary

policy as the only tool available in the short-run to keep the process of international economic adjustment alive. But here, too, there seem to be considerable differences of opinion, both about the scope for and possible effectiveness of any further monetary easing.

Under these circumstances, market participants now see little alternative to a further decline in dollar rates. The dollar started to move down last week. For the period since your last meeting the sharpest decline in the dollar was against the yen, of about 6 percent. Against the German mark and most other continental European currencies, the decline was about 4 percent.

These movements in exchange rates appear to show little relationship to changes in actual, short-term interest rate differentials between dollar-denominated assets, on the one hand, and Japanese and German assets, on the other. Indeed during the intermeeting period, as well as during the nearly two months since just before the April discount rate cut, short-term interest differentials have shown little real trend. They have stayed between 2 to 3 percentage points in both cases.

Changes in longer-term interest rate differentials have been more pronounced. Bond yields in both Germany and Japan backed up during the spring along with those in the United States. But only in the United States have long-term

(10 year) yields fallen back to levels below the lows of early April. As a result the long-term interest differential favoring investment in U.S. government bonds has narrowed to only 1/2 a percentage point vis-a-vis Germany and to 2.50 percentage points vis-a-vis Japan. The financial incentive to attract investors into U.S. governments is now the smallest vis-a-vis Japanese securities since 1980. Vis-a-vis German securities it has not been this narrow since before 1979.

Notes for FOMC Meeting  
Stephen G. Thieke  
July 8-9, 1986

Domestic desk operations since the last meeting have been directed at maintaining an approximately steady degree of reserve pressures, with the reserve path allowance for adjustment and seasonal borrowing remaining at \$300 million. This was against the backdrop of very strong growth in the monetary aggregates, but a fairly consistent pattern of sluggish economic data.

M1 and M2 outran the March-June pace anticipated at the time of the Committee's May meeting, with M1 growth being especially robust. Strength in the liquid components of M2, as well as in M1, contributed to stronger than expected growth in M2, which is now around the midpoint of its growth cone, as is M3.

Early in the period, the Desk was a bit cautious in the way it met the indicated reserve needs, inasmuch as M1 growth was showing no evidence of the desired deceleration and M2 was also showing somewhat more strength than had been expected. However, with the release of the weak May employment report in early June, followed by a string of sluggish economic data, the Desk moved a bit more promptly to meet indicated reserve needs.

For the three full maintenance periods, borrowings averaged \$285 million--close to the path allowance--but ran as low as \$193 million in one period and as high as \$354 million in the most recent period. By and large, this reflected variability in the level of excess reserves, which averaged about \$640 million in the June 18 period and \$1.3 billion in the July 2 period. An informal allowance for somewhat lower excess reserves was made late in the period of the 18th, yet excess still ran well below expectations. A formal allowance for \$1.1 billion in excess was made for the period with the

quarter-end statement date, with demand for excess reserves proving somewhat stronger than that.

Federal funds have tended to fluctuate in a narrow range since the last meeting, with effective rates averaging very close to 6-7/8 percent in each of the three periods. There was some expected firmness in the funds market around quarter end, with that firmness lingering on for a day or two, when settlement of new Treasury issues and wire related problems at a few Reserve Banks and the Treasury complicated reserve management.

To meet reserve needs over the period, the Desk purchased about \$4.4 billion of bills, including \$2.5 billion in an outright operation in late May and the rest from foreign accounts throughout the period. Around mid-June, the Desk was planning at least one additional outright operation in the market to meet what was then viewed as a sizeable and growing reserve need projected for late in the intermeeting period and on into mid-July. In fact, by mid-June, the size of the projected need had grown by almost \$3 billion--due largely to the faster growth in required reserves. This prompted the Desk to request a temporary \$3 billion expansion (to \$9 billion) in its between meeting "leeway" authorization to purchase securities for the System account. Shortly after that request was approved by the Committee, the size of the projected reserve needs foreseen through late July were reduced substantially. As a result, we did not have to use the added leeway to meet what now appears to be a sizeable but short-run need in the current two-week maintenance period. Instead, the Desk used numerous rounds of System and customer related repurchase agreements to meet the remaining reserve needs. This included four rounds of term System RPs, one of which was pre-announced on Wednesday, July 2, before the recent holiday weekend.

In the securities markets, an uneasy tone prevailed early in the period, with interest rates gapping higher during a few trading sessions around the end of May. At that time, the focus was on continued strong money growth and data for April which showed signs of a possible upturn in the economy. Adding to that tone was the release of the record of the Committee conference call meeting following the April discount rate cut and subsequent comments by some Committee members suggesting that inflation remained a potential concern. In this atmosphere, some market participants began to speculate that the System might have snugged its policy stance.

In early June, market psychology on the near-term outlook for the economy and interest rates abruptly reversed. Employment data for May began a string of statistical releases which contradicted notions that economic strength was building. While market participants did not initially look for an immediate easing of System policy, notions of a near-term firming were dispelled. Concerns about the Mexican debt situation contributed at the margin to these sentiments and had a small, positive impact on the short end of the yield curve. Toward the end of the period, signs of weakness in the economies of Japan and Germany spawned talk of another coordinated effort to reduce interest rates. The markets ended last week on a positive note, fueled by further weakness in the June employment data. They have given back some of the recent gains today, in part reflecting a [unintelligible] and perhaps a bit less concern on the [unintelligible].

Nevertheless, most market participants are expecting a cut within the next few weeks. Based on yesterday's refunding, key Treasury bill rates have declined by about 40 basis points since the last FOMC meeting. Bill rates are priced to an expectation of a discount rate cut, although not quite fully priced in the view of at

least some participants. Intermediate (4- to 10-year) Treasury coupon rates are about 60 basis points lower, while yield on the latest 30-year Treasury bond, which still reflects some unique considerations, is down about 50 basis points.

The supply shortage which had disrupted the long end of the market around the time of the May refunding abated by early June. The shortage initially developed when securities dealers and arbitrageurs set up large short positions in the 9-1/4 percent bond in advance of the refunding. This trading strategy was based on the expectation that large supplies of that bond would be sold by investors, including the Japanese, looking to move into the latest Treasury issues. When those sales did not develop, and as the price of the 9-1/4s continued to outperform other issues, dealers and others scrambled to borrow the bonds in order to reduce their fails. By late May, the extraordinarily large fails in this issue had been cleaned up. Similarly, many of the very large short positions have been closed out, or at least reduced.

We subsequently learned that the options writing activities of a California savings and loan association may have exacerbated this market problem. That institution had written a large amount of over-the-counter put options on long-term Treasury bonds, including the 9-1/4s. Those options moved deep into the money near their expiration dates which, it turns out, were around the time of the May refunding. Holders of those options were anxious to exercise them and bid up the market price of the 9-1/4s in order to acquire the bonds to make delivery.

The Treasury raised about \$24 billion of new money during the period, most of it in coupon issues. The June quarter end "mini refunding" of 4- and 7-year issues was a study in contrasts, with

exceptionally strong dealer and speculative demand for the 4-year issue, followed by lackluster participation the very next day in the 7-year offering. In the Agency sector, the Farm Credit System announced estimated second quarter losses of about \$600 million. This lead to about a 10 basis point widening of spreads on Farm Credit securities, which are now about 45 to 50 basis points above Treasuries for a [unintelligible] year issue.

One final note. During the period we published a revised list of primary dealers reflecting the deletion of Northern Trust Company, which had consistently fallen short of our market marking standards for an extended period of time, and the replacement of Crocker National Bank with Midland-Montagu Government Securities, a subsidiary of Midland Bank which had retained the primary dealer operation following the Crocker/Wells merger. In addition, just yesterday, Westpac Banking Corporation of Australia and William E. Pollock Government Securities announced agreement on plans for Westpac to acquire Pollock, subject to regulatory approvals in the U.S. and Australia.

J. L. KICHLINE  
July 8, 1986

FOMC CHART SHOW--INTRODUCTION

During our presentations this afternoon we will be referring to the package of charts that has been distributed to you. The first chart displays the principal assumptions that underlie the staff's economic and financial forecast. The monetary policy assumption entails growth of M2 and M3 around the middle of their ranges in 1986--that is around 7-1/2 percent--and similar expansion next year. It is thought that this growth and the staff's economic projection are likely to be consistent with interest rates remaining close to their current levels on average through 1987. For fiscal policy, deficit-reducing actions of about \$45 billion in fiscal year 1987 are assumed to be enacted; this is somewhat larger than in our previous forecast. Contributing to this fiscal package are receipts derived from incorporating the major features of the Senate tax reform bill. Other assumptions involve some expected further decline in the foreign-exchange value of the dollar and that oil prices settle around \$16 per barrel, higher than current spot prices.

The next chart provides additional information on the fiscal outlook. The federal budget prospects for fiscal

year 1986 have been deteriorating as outlays appear to be running higher than expected--principally in the agriculture and defense areas--while slower than anticipated growth of incomes has cut into receipts. Consequently, the staff expects a deficit this year of \$215 billion, marginally above the record set last year. The assumed deficit-reducing actions of \$25 billion in outlays and \$20 billion in receipts lead to a reduction in the deficit in fiscal year 1987 to \$170 billion, well above the recently passed Congressional Budget Resolution figure that was designed to be consistent with the \$144 billion Gramm-Rudman target. The Congressional Budget Resolution is based on an economic forecast developed early this year which--at least in terms of the outcome to date--appears too optimistic. In any event, there are many possible ways for the budget process to play out, including its interaction with tax reform. What is important, however, in the context of the projection is that there is a shift toward budgetary restraint next year of roughly the magnitude indicated by the high employment deficit numbers in the table--about \$30 to \$35 billion on a national income accounts basis.

As for tax reform itself, the key features we assumed are shown in the bottom panel. A reduction in personal income rates is phased in, with little aggregate personal income effects during the projection period.

Business tax revenues are increased overall during the forecast, and the features listed produce a higher cost of capital than would have prevailed otherwise. The adverse impacts show up particularly in business fixed investment and multifamily rental structures, but, in total, tax reform and the associated larger fiscal restraint take only about 1/4 percentage point off real GNP growth next year.

The next chart displays some indicators of recent economic activity. Total payroll employment has expanded so far this year at an average monthly rate significantly below that in 1985. The labor report for June was notably weak even after adjustment for strikes, and May employment growth was revised downward as well. The persistent weakness in the manufacturing area is apparent in employment and industrial output data, the right panel. The information now available suggests the industrial production index fell at least 1/2 percent in June, with a couple of tenths attributable to strike activity.

In the consumer sector, activity generally has been well maintained. Total auto sales, middle left panel, were in excess of 11 million units in each month last quarter as financing incentives seemed to assist sales of domestic models. The right panel indicates retail sales excluding autos, nonconsumer items and gasoline also performed rather well through May. In the aggregate it is likely that the

second-quarter GNP data will show a large gain for personal consumption expenditures in real terms. The bottom left panel shows that total housing starts continued around the elevated pace registered early in the year, as single-family starts have edged up in recent months; in May the decline in the total reflected a drop in multifamily starts. As shown in the bottom right panel, indicators of business fixed investment spending have been weak this year, and the latest data for May did not provide encouragement of a near-term improvement.

The top panel of the next chart indicates we are now estimating growth of real GNP--the red bar--of 1-1/2 percent annual rate in the second quarter, with GNP less net exports appreciably larger. The strengthening of real GNP growth during the second half of this year is still a feature of the staff forecast but it is less marked than earlier. On a fourth quarter to fourth quarter basis, growth of 2-3/4 percent is projected, rising to 3-1/4 percent next year.

The GNP deflator, middle panel, is projected to rise at a 2-1/2 percent rate this year, the same as our previous projection. In 1987, however, the deflator is

projected to rise at about a 3 percent rate, somewhat less than before. The unemployment rate, bottom panel, seems likely to us to drift down through 1987, reaching a year-end level around 6-1/2 percent.

Mr. Prell will discuss the domestic economic and financial projection in greater detail.

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Michael J. Prell  
July 8, 1986

### Domestic Economic and Financial Outlook

It isn't difficult to understand why, despite the sustained growth in GNP, the economy has seemed so troubled. As Mr. Kichline indicated, industrial output has contracted appreciably on balance since January. One part of the story--visible in the upper left panel of chart 5--is the cutback in auto assemblies, aimed at whittling down dealer stocks. Another part is the direct effect of the slump in the oil business, reflected in the rig count figures at the right. But, as the middle left panel shows, the decline has involved appreciable weakness across a range of consumer goods and business equipment. A broad, negative influence has been the continuing pressure on manufacturers from foreign competition; as you can see at the right, the rising trend of import penetration in the consumer and capital goods sector has yet to be halted. This undoubtedly has fostered a cautious attitude among manufacturers with respect to production and investment. Meanwhile, agriculture has yet to pull out of its decline. Overall net farm income is weak, and--according to USDA projections--increasingly dependent on government payments. The shaky prospects for farming have been mirrored in land prices, at the right.

Despite these sectoral difficulties, however, the recent period has been one in which households on the whole have enjoyed sizable gains in real income and wealth--and benefited as well from a decline in borrowing costs. The resultant impetus to aggregate demand has been most obvious in the case of residential construction, addressed in the next chart. Housing starts have averaged about 2 million units, at an annual rate, thus far this year. This level of building activity is at the high end of a range that would be suggested by underlying demographic trends. As the middle left panel indicates, our assessment is that--barring major economic disturbances--net

household formations should average in the neighborhood of 1.4 to 1.5 million per year over the remainder of the decade. Allowing for mobile homes, demolitions and the other factors affecting the size of the housing stock, such numbers would suggest an average annual need for somewhere around 1-3/4 million housing starts.

We are projecting starts to move back to that level over coming months, but with single-family building remaining quite strong. The percentage of households owning homes fell in the early Eighties, and many Americans undoubtedly have been waiting to cross the threshold of affordability. As the right panel shows, declining mortgage rates have pushed monthly payments on new homes down to the lowest level in some time, relative to disposable income. And, as you can see at the bottom left, homebuying conditions are perceived to be attractive today by an extraordinarily large percentage of households.

On the multifamily side of the market, high vacancy rates in some parts of the country should discourage new construction. In addition, the proposed lengthening of depreciation schedules and reduction in tax shelter opportunities would make investment in income properties much less appealing at current rent levels.

The recent step-up in housing activity is spurring outlays elsewhere, and it likely has contributed to the strength in consumer spending thus far this year. As the next chart shows, however, we are projecting a slowing in the growth of consumption expenditures in the period ahead. The deceleration reflects a weakening of real income growth in the aftermath of the sizable boost provided by sharply declining energy prices; we don't see a diminished willingness to spend. Indeed, consumer surveys point to very positive buying attitudes, owing in great measure to the decline in interest rates. The

decline in rates not only has raised asset values and lowered the financing costs for new purchases, it also has provided many households an opportunity to restructure debt obligations. This is most apparent in the mortgage market, where refinancing volume has soared. For example, the share of FHA endorsements related to refinancings, shown at the lower left, has tripled. In many cases, these transactions involve considerable upfront costs, but in time they do free up some cash flow.

In some cases, refinancings may occasion additional borrowing, to tap accumulated equity for other uses: spending, financial asset accumulation, or debt consolidation. Of greater importance in overall mortgage borrowing, however, is the turnover of existing properties, which has been at a high level of late. Net home mortgage borrowing--the striped layer in the graph at the right--appears to have rebounded in the second quarter after a surprising first-quarter drop that may have reflected delays in loan closings. While overall household borrowing increases only gradually from here on in the projection, that growth is more than accounted for by mortgages, as consumer credit flows are expected to continue moderating. Tax reform along the Senate lines of course would provide an increasing incentive for the direct or indirect substitution of mortgage for consumer credit, as non-mortgage interest deductibility is scaled back.

Tax reform obviously is important to businesses as well as households, and concerns about tax changes could well be a factor in the weak investment indicators depicted at the top of chart 8. Contracts and orders for capital goods, at the left, have continued on a sideways course, and the Commerce Department's spring survey, summarized at the right, showed businesses planning to spend about the same amount this year as last. This was bit weaker

picture than in the winter survey; not surprisingly, the petroleum and mining industries reported sharply reduced spending plans, but there were other areas of weakness as well--especially in the durable goods sector.

The staff's forecast for business fixed investment this year is in line with the Commerce survey, which--given the decline in the first half--implies a firming in outlays in coming months. Still, growth in real BFI is projected to be anemic through 1987. The tax reform measures, in effect, offset much of the stimulus to investment that might have flowed from the decline we've seen in financing costs. This is particularly true in the case of equipment, which is hit by the removal of the investment tax credit. The lower left panel provides projections of the cost of capital for a representative piece of equipment, as perceived by a businessman who anticipates the application of fully phased-in tax credit, depreciation and tax rate provisions along the lines of the Senate bill. This calculation leaves the cost of capital--with tax reform--a shade below the late '85 level, but--given the sensitivity of the numbers to assumptions about financing costs and patterns, price expectations, and other factors--a looser reading clearly is appropriate. In our view, it is not changes in capital costs but rather a continuing desire to modernize facilities that will be the major driving force behind renewed expansion in equipment outlays. That desire, among industrial firms especially, should manifest itself more strongly once our trade position begins to improve and sales trends come to look more favorable. On the structures side, we're assuming that oil drilling will bottom out before long, but we expect that the overbuilding in the office sector--documented at the right--will exert a continuing drag on spending.

The next chart shows our projection of business spending for inventories. As you can see, we are guessing on the basis of fragmentary data that nonfarm inventory accumulation slowed somewhat in the second quarter, reflecting a small decline in auto dealers' stocks after their earlier run-up. We are forecasting a further diminution in the pace of investment in the second half, as the recent rebuilding of oil stocks abates and as accumulation in the nonauto trade sector moves back into line with sales after a spurt in the spring. As indicated at the right, inventory investment is a negative for GNP growth in the second half, but a negligible factor, one way or the other, in 1987.

Putting the inventory and fixed investment outlays together, we foresee only slow growth in nominal capital expenditures by nonfinancial corporations, shown in the middle panel. However, higher taxes are expected to put a dent in internal funds, and a widening of the financing gap is expected over the next year and a half. If the volume of equity being absorbed in mergers continues to fall off and issuance of new shares remains strong, as indicated at the bottom left, the net borrowing volume should remain below last year's total. And, absent a substantial rise in interest rates, we would expect corporations to continue relying heavily on the bond markets for their credit needs, so that the recent mild improvement in balance sheet ratios--exhibited at the right--would be extended.

Like the corporate sector, the state and local government sector also has a considerable stake in the outcome of tax reform. But important, too, is the character of federal efforts to curtail deficit spending. As the top left panel of chart 10 shows, federal grants are increasing this year. But much of that increase reflects special, one-time, distributions of revenues from Continental Shelf leases and Exxon's overcharge penalties. At the same

time, growth in own-source revenues has been diminished by falling oil prices and weak economic performance in some parts of the country. Next year, revenue sharing is slated to end and total federal grants will drop. With the enactment of tax reform, however, a majority of states will benefit from the fact that they key their taxes to federal adjusted or taxable income definitions, which will reflect the base-broadening aspects of tax reform. How much of the potential revenue gain they will be able to retain will, of course, vary with local political and economic conditions.

On the credit side, unresolved issues in tax reform leave the outlook for borrowing costs and the permissible scope of tax-exempt financing subject to great uncertainty. Our forecast of borrowing--at the right--is based on the rather mild tightening of tax-exempt security provisions in the Senate bill and assumes that the reform measures, taken as a whole, will not cause a marked change in the demand for tax-exempt obligations.

As the middle panel indicates, we are projecting a slowing of growth in real state and local purchases this year, reflecting the cutbacks currently being made by financially stressed units. Spending accelerates in 1987, but only a little, with the sector's operating surplus on a national income accounts basis--at the right--remaining only marginally positive.

Apart from gyrations associated with CCC loans, growth in federal purchases--in the bottom panel--is negligible in the forecast. We've assumed in this projection that Congress will keep a tight enough rein on authorizations to hold defense spending essentially unchanged in real terms in 1987.

Although the moderate overall growth projected for the economy does not imply great pressure on resources, the news on wage and price inflation likely will become less favorable as time passes. The top panel of the next chart

shows our forecast of compensation per hour in the nonfarm business sector. Comprehensive measures of pay changes are not yet available for the second quarter, but the information on union settlements and production worker wages suggests that compensation increases will be smaller this year than they were in the preceding three. To some extent, this should reflect continued efforts to control medical and other benefits costs, indicated in the middle panel by the slower increase in the total Employment Cost Index than in the wage and salary component of that index over the past year or so. It also reflects the continuing competitive pressures in major parts of the goods-producing sector, which have given rise to the divergent trends in the indexes at the right. In 1987, however, as labor markets tighten somewhat, we expect to see a movement back to average compensation increases comparable to those earlier in the expansion.

To the extent that compensation does indeed reaccelerate, gains in labor productivity will become all the more important in containing costs. Unfortunately, the trend in output per hour has not been impressive and, while one can compile a list of factors conducive to better productivity performance, we continue to await clear evidence before building it into our forecast. Consequently, in the projection, output per hour fluctuates around a trend of roughly one percent per year, and unit labor costs rise almost 3 percent in 1987.

On the nonlabor side, producers have been benefiting from mostly stable or declining materials and energy costs. As the left panel of the next chart indicates, based on our oil price assumption, we expect energy prices on the whole to fall a little further in coming months as the competitive effects of lower oil prices are reflected across the full range of fuel and power sources.

In 1987, however, energy prices should be firming. The effects of dollar depreciation meanwhile will become more noticeable. We are expecting a quickening in the pace of increase in prices of non-petroleum imports. Apart from the direct influence at all stages of processing, the rising import prices will--as markets firm--provide greater opportunities for domestic producers to expand their margins. All told, we see inflation picking up gradually, edging back to the 3-1/2 percent neighborhood next year, as measured by the fixed-weight price index for GNP.

Mr. Truman will now discuss the international aspects of the outlook.

E.M. Truman  
July 8, 1986

FOMC CHART SHOW - International Developments

As is illustrated by the red line in the top panel of Chart 13, the weighted-average foreign exchange value of the dollar against major foreign currencies has declined by about 30 percent since February of last year. In price-adjusted terms (the black line) the dollar's depreciation has been about the same. The average value shown on the chart for June was higher than in May; however, as Miss Greene reported, the dollar in the last week or so has weakened again and approached the lows recorded in mid-May. As Mr. Kichline noted, we are projecting that the dollar will decline by about an additional 10 percent through the end of 1987.

As is illustrated in the lower panel, the dollar's continued depreciation in the early months of 1986 was associated with a further narrowing of the differential between U.S. and foreign real long-term interest rates, as U.S. rates declined more than rates abroad. Indeed, by April that real interest rate differential was essentially eliminated; we expect that it will be little changed on balance over the forecast horizon. This is one reason why we expect that the dollar's rate of decline will moderate.

The dollar's decline to date is the principal factor why we expect U.S. external deficits to begin to narrow, in real terms, in the second half of this year and, in nominal terms, in 1987. However, the

United States will continue to record huge external deficits. This is the major reason why we expect that the dollar will depreciate further.

The staff forecast relies primarily on the dollar's decline to generate an improvement in our external accounts. We focus on the dollar, rather than growth abroad, for two reasons. First, we are not projecting any acceleration in economic activity abroad relative to the pace of the past few years. Second, a continuation of such growth trends--with foreign growth approximately the same as U.S. growth--would by itself produce a widening of U.S. deficits because, in absolute size, imports are now so much larger than exports.

As is illustrated in the top, left-hand panel of Chart 14, the expansion of economic activity in the major foreign industrial countries--as measured by industrial production--has been anemic so far in 1986. In the first quarter in Germany, a sharp decline in construction activity, adverse weather conditions, and lower exports in real terms combined to produce a decline in real GNP. In Japan the decline was even sharper--propelled by lower export volumes and sharply reduced inventory accumulation.

As is shown in the upper right-hand panel, we are now expecting growth of real GNP to average around 3 percent in 1986 and 1987 in the major foreign industrial economies. Some of the factors depressing economic activity in the major foreign industrial countries in the first quarter appear to have been temporary. However, taking account of the sluggish pace of economic activity in the first quarter, we have marked down our forecast for 1986 as a whole by about 1/3 percent since the FOMC meeting in February. Nevertheless, we believe

that, abroad as well as here, lower real interest rates, lower oil prices, and less inflation will in due course help to stimulate domestic demand in the foreign industrial countries.

Meanwhile, as shown in the lower left-hand panel, inflation has slowed abruptly in these countries so far this year under the combined influence of a sharply lower dollar price of oil, generally stable dollar prices of other commodities, and the appreciation of their currencies. The lower right-hand panel shows that we expect consumer price inflation to average slightly more than 2 percent during 1986, but this average includes inflation rates of about 1/2 percent in Germany and Japan. As the effects of the decline in oil prices are attenuated in 1987, inflation is expected to pick up a bit in the foreign industrial countries but remain at a low level relative both to inflation in the United States and to historical experience.

Thus, along with this very favorable inflation outlook, we are projecting little additional stimulus to global economic activity from the foreign industrial economies compared with recent years. At the same time, as is shown in the upper left-hand panel of Chart 15, the economy of Mexico, our principal trading partner to the south, is in recession. Mexico's real GDP is projected to decline by about 4 percent this year under the influence of lower oil revenues, combined with monetary and fiscal restraint. However, we expect that with an IMF-approved adjustment program in place and additional external financing, growth will be positive next year. A 20 percent rise in non-oil exports, a cut of 10 percent in imports, and a lower interest bill in 1986 will offset about half of Mexico's \$7 billion loss in

revenues from lower oil exports. As a consequence, Mexico's current account will swing from a small surplus in 1985 to a deficit of at least \$2 billion this year--as is shown in the right-hand panel--with little change expected next year.

The other non-OPEC developing countries, as is shown on the left-hand side of the middle panel, and which as a group will benefit both from lower oil prices and lower world interest rates, are expected to record slightly faster growth in 1986 and 1987 than last year; these countries should experience a slight improvement this year and next in their combined current account position--as shown in the right-hand panel.

The situation in the OPEC members--shown in the bottom panels--is a bit paradoxical. With the increase in oil production in these countries, measured real GDP should expand this year--the table at the left. However, the increase in the physical volume of production and exports of oil will be more than offset by lower oil prices, and the OPEC group as a whole is projected to have an increased current account deficit--a deficit that for some members will be difficult to finance and will cause these countries to cut back on their imports. Hence, the lower GDP growth projected for 1987.

Against this background of a lower dollar but few signs of an acceleration of aggregate demand in the rest of the world relative to the average pace in recent years, the next chart presents our outlook for U.S. exports. As is shown by the red line in the upper left-hand panel, the volume of U.S. nonagricultural exports rose at a 10 percent annual rate in the first quarter of this year, apparently led by

increases in exports of machinery and consumer goods. Based on preliminary data for April and May, we do not think there was as large an increase in the second quarter as in the first. However, on balance, we are projecting a rapid expansion of the volume of these exports for the remainder of the forecast period; as prices rise, the increase in value--the black line--should be even more pronounced.

As shown in the table to the right, two-thirds of U.S. nonagricultural exports in 1985 were destined for Japan, Canada and other industrial countries, while the remainder went to developing countries. The latter group is likely to provide more limited potential for expanded U.S. exports because of financial constraints--in the case of OPEC and Mexico--and continued net real depreciation against the dollar over the past 18 months--in the case of the non-OPEC developing countries. However, in all these markets the United States should be able to improve its share relative to other industrial countries.

The lower left-hand panel presents our outlook for agricultural exports. After sharp reductions in the volume of these exports during the first half of this year (the red line), we expect a modest recovery as a consequence of lower crop support prices, a lower dollar, and better growth in the non-OPEC developing countries. Reflecting in part the lower support prices, the average price of these products is expected to decline on balance over the next six quarters, implying only a modest increase in overall value (the black line) compared with early 1985. As can be seen in the table to the right, about 40 percent of U.S. agricultural exports in 1985 went to Mexico and other non-OPEC and OPEC developing countries.

With respect to non-oil imports, the table in the upper left of Chart 17 shows that the prices of these imports increased on average by 6 percent at an annual rate over the fourth quarter of last year and the first quarter of this year. However, the pattern was uneven with the largest increases in automotive products and in foods, feeds and beverages--the latter largely because of coffee. [Unfortunately, a gremlin crept into our calculations, and the figures in the table for prices of industrial supplies are incorrect; they should read: minus 6 and minus 5.] We are projecting, as shown in the chart at the right and as Mr. Prell has already indicated, a somewhat more rapid rate of increase in non-oil import prices--about 10 percent at an annual rate--over the balance of the forecast period.

These price increases are necessary in order to induce the kind of decline in the volume of non-oil imports shown in the panel below (the red line). Even with the kind of volume response depicted, the value of non-oil imports (the black line) is projected to continue to expand--muting progress toward lower external deficits in nominal terms.

As is shown in the table to the left, almost three quarters of U.S. non-oil imports in 1985 came from Canada, Japan and other industrial countries. We expect this share to decline in the next couple of years reflecting the loss of price competitiveness of these countries vis-a-vis the developing world.

Chart 18 summarizes the staff's outlook for the U.S. current account. The decline in oil prices in the first half of this year has contributed to a reduction in the value of our oil imports--line 6.

However, given our assumption that the price of imported petroleum will settle at about \$16 per barrel combined with growth of U.S. demand and declining domestic production, we expect oil imports to pick up a bit next year. Despite lower oil imports thus far in 1986, the trade balance, shown in line 7, is estimated to have been larger in the first half of this year than in the full year 1985, and it is expected to show essentially no improvement in the second half of this year. Over the course of 1987, the trade deficit is projected to narrow somewhat while the balance on other current account transactions--line 8--will deteriorate, largely because of the rise in net payments abroad on a growing external debt. As a consequence, the current account balance--line 9-- at the end of next year is projected to narrow only by \$10 billion compared with the first half of this year. The size of the deficit now projected for the last half of 1987 is \$125 billion. Despite the limited projected improvement in our external position in nominal terms, the balance on real net exports as measured in the GNP accounts, shown in the memorandum item in line 10, is projected to record a swing of about 55 billion 1982-dollars between the first half of this year and the second half of next year and to "contribute", in this arithmetic sense, significantly to the growth of domestic production over the projection period.

Mr. Kichline will now complete our presentation.

J. L. KICHLINE  
July 8, 1986

FOMC CHART SHOW--CONCLUSION

Chart 19 shows the economic forecasts of Board members, Presidents, and the staff. The bottom panel displays the forecasts for 1986 presented to the Congress in February. The current forecasts for nominal GNP growth have been revised downward appreciably since February, with the median figures falling short of the lower end of the central tendency reported earlier this year. That downward revision generally reflects reductions to real GNP and the deflator, while the level of the unemployment rate has been moved higher. For 1987, the median forecasts of Board members and Presidents, as well as the staff figures, suggest a pickup in real growth, a larger rise in the deflator and a little lower unemployment rate. The Administration and CBO have not yet completed their update on the economic outlook, but they will need to recognize the slower than anticipated expansion of nominal GNP during the first half of the year.

For the staff forecast, it still seems to us that an improvement of economic activity over the forecast horizon is in store, given our principal assumptions. In our view, the lower interest rates, oil prices, and foreign exchange rates that have developed over the past year or so

should provide the net stimulus necessary for the economy to grow somewhat faster than the 2-1/4 percent annual rate averaged over the past year and one-half. However, as indicated in the presentations, a great deal of uncertainty exists, especially in regard to the key sectors of business fixed investment and net exports.

\*\*\*\*\*

STRICTLY CONFIDENTIAL (FR) CLASS I-FOMC

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

*July 8, 1986*

## Principal Assumptions

### Monetary Policy

- Growth of M2 and M3 around the middle of their ranges in 1986 and similar expansion in 1987.

### Fiscal Policy

- Deficit-reducing actions of about \$45 billion in fiscal year 1987.

### Other

- Major features of Senate tax reform bill are implemented.
- Foreign exchange value of the dollar about 10 percent lower by year-end 1987.
- Oil prices settle around \$16 per barrel.

**Federal Budget**

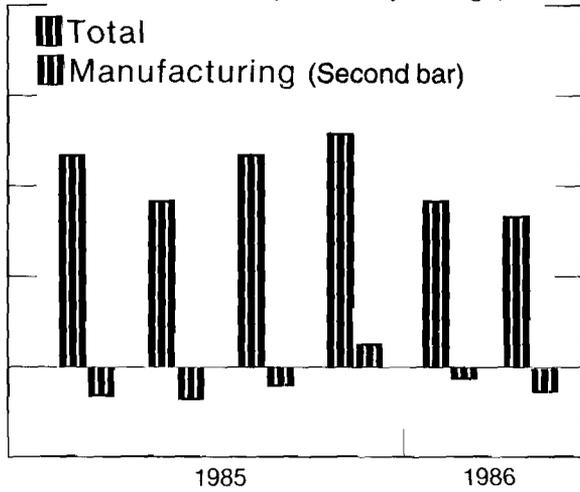
	<b>Actual</b>	<b>Staff</b>		<b>Cong. Resolution</b>
	FY 1985	FY 1986	FY 1987	FY 1987
Outlays	946	984	1003	995
Receipts	734	768	833	852
Deficit	212	215	170	143
High Employment Deficit	153	168	135	NA

**Key Tax-Reform Features**

- Phased-in Reduction of Personal Income Taxes
- Overall Increase in Business Taxes
  - Removal of Investment Tax Credit
  - Less Attractive Depreciation Allowances
  - Restrictions on Tax Shelters
  - Corporate Tax Rates Lowered

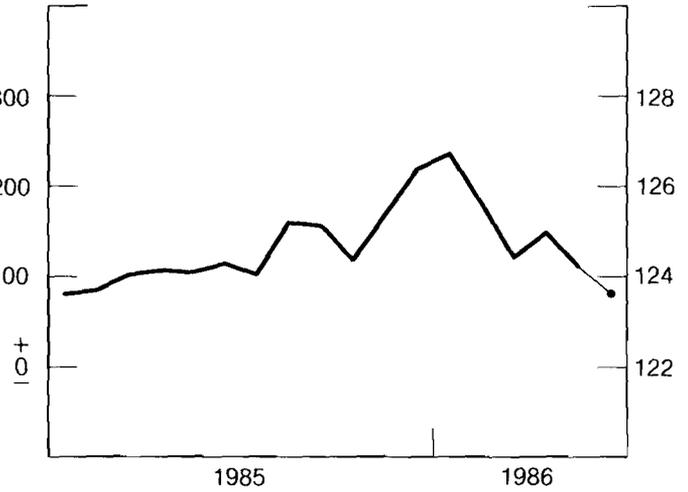
### Employment\*

Average monthly change, thousands



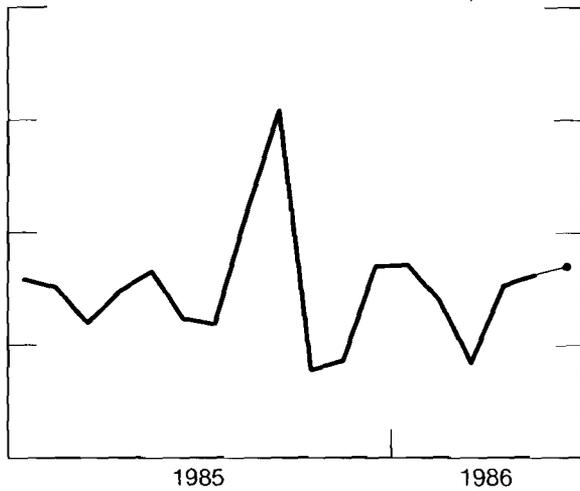
### Industrial Production

Index 1977 = 100



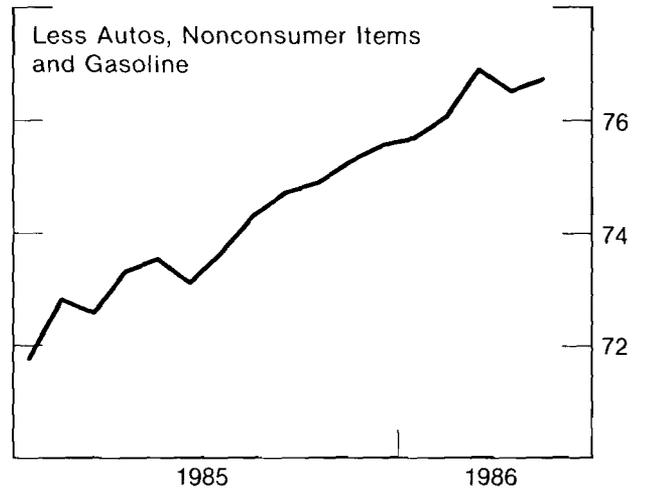
### Auto Sales

Millions of units, annual rate



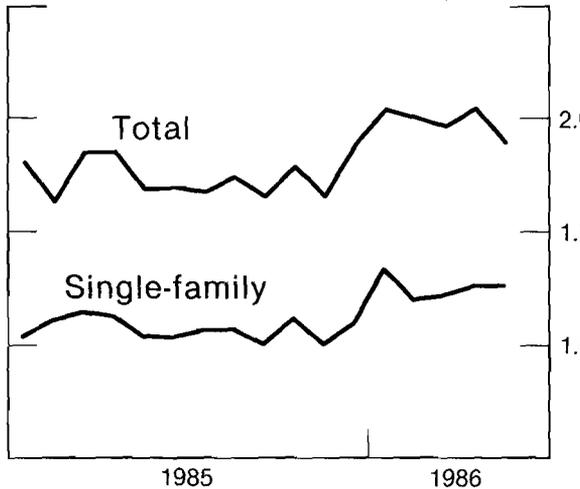
### Retail Sales

Billions of dollars



### Housing Starts

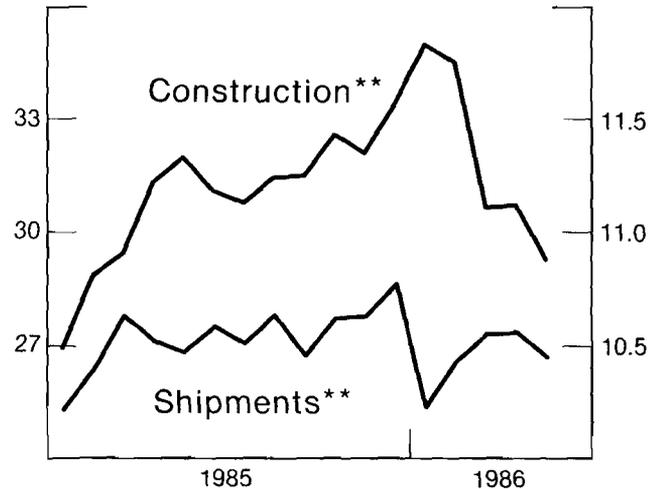
Millions of units, annual rate



### Business Investment

Billions of dollars

Billions of dollars

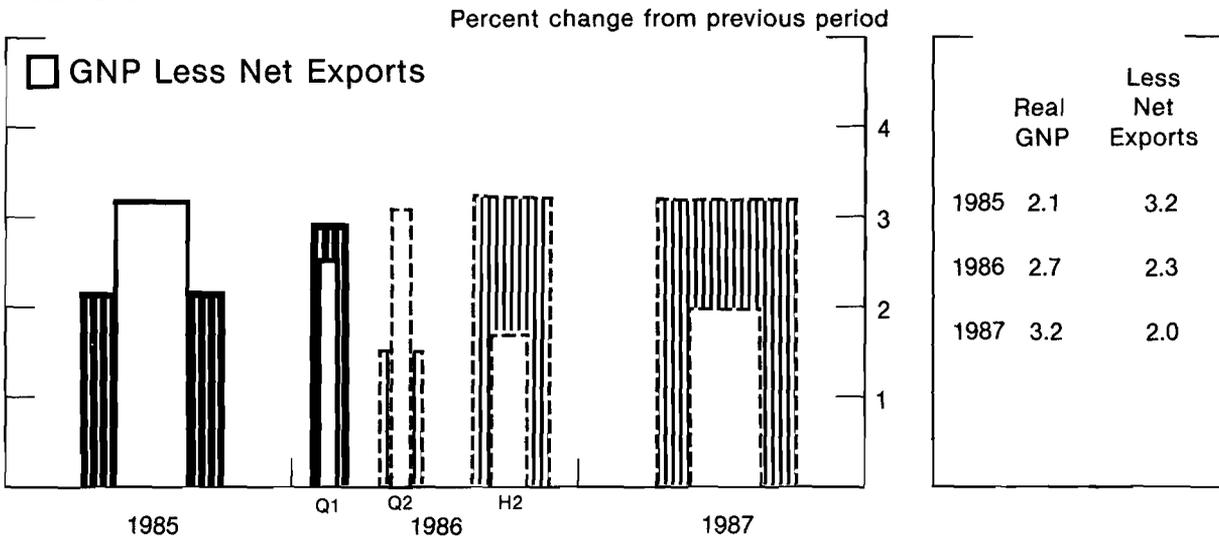


\*Adjusted for strikes.

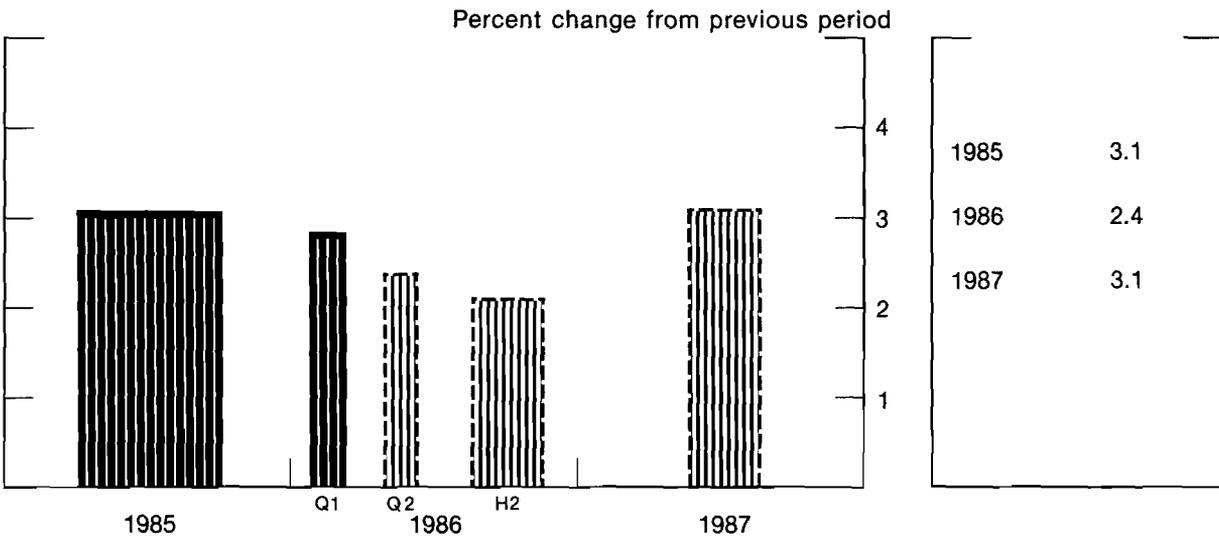
\*\*Nonresidential construction put in place.  
\*\*Shipments of nondefense capital goods.

Chart 4

### Real GNP



### GNP Deflator



### Unemployment Rate

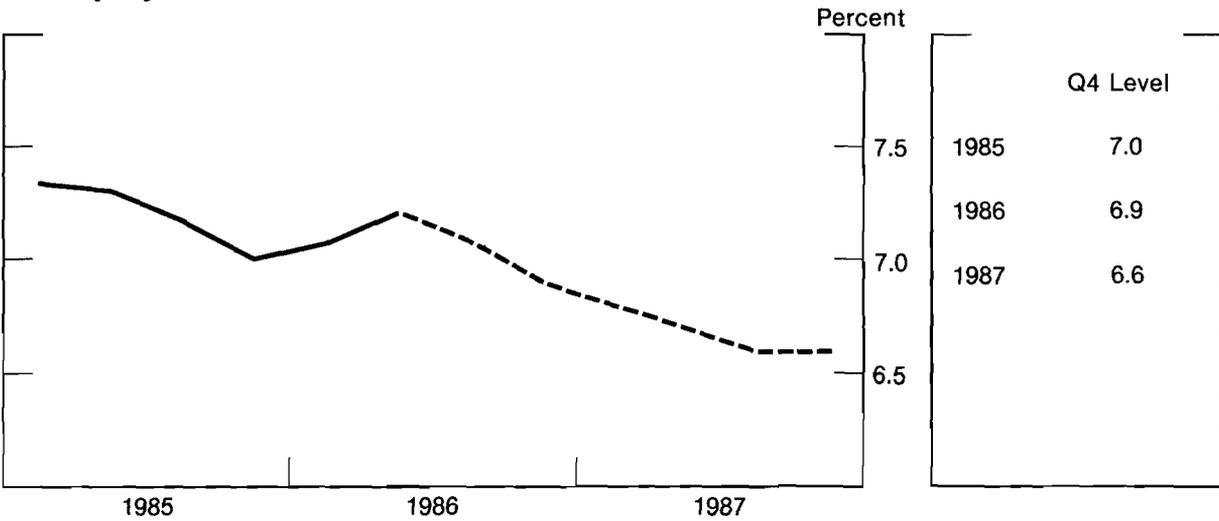
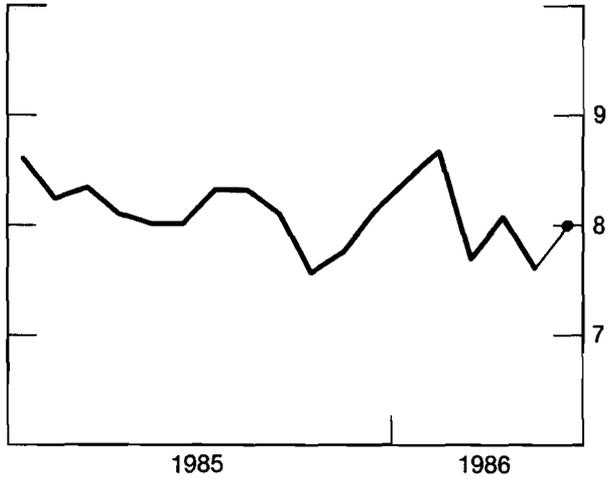


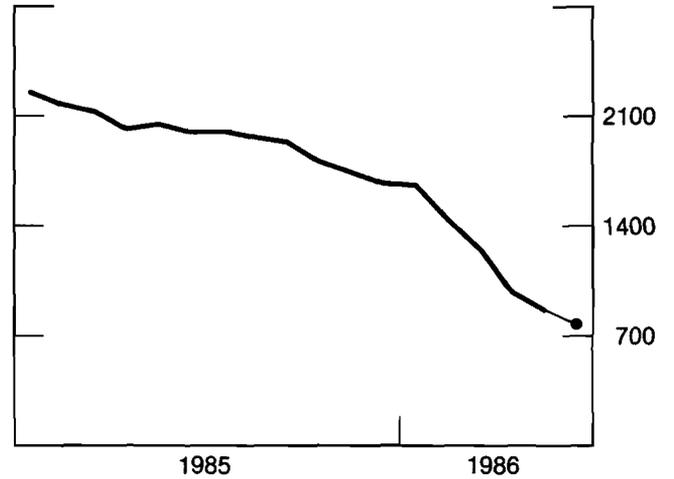
Chart 5

### Auto Production

Annual rate, millions of units

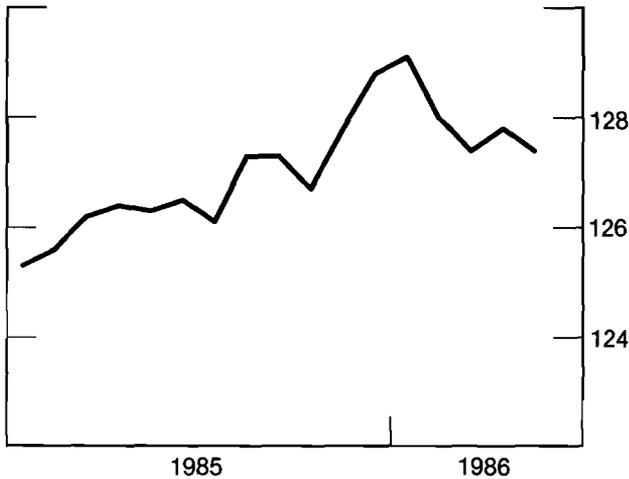


### Rotary Rigs in Use



### Industrial Production Less Motor Vehicles and Oil Drilling and Extraction

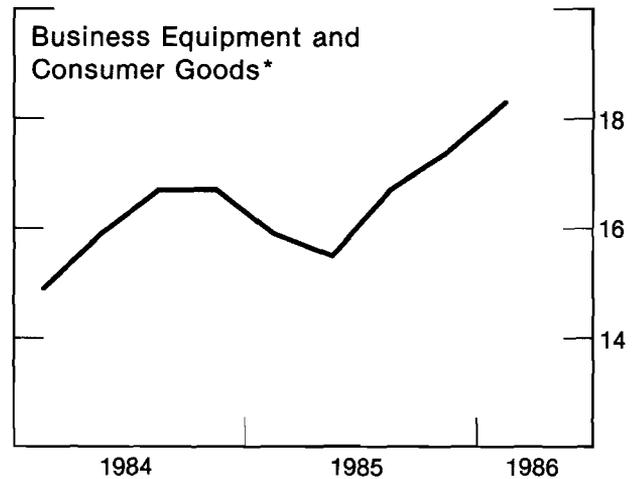
Index 1977 = 100



### Import Penetration

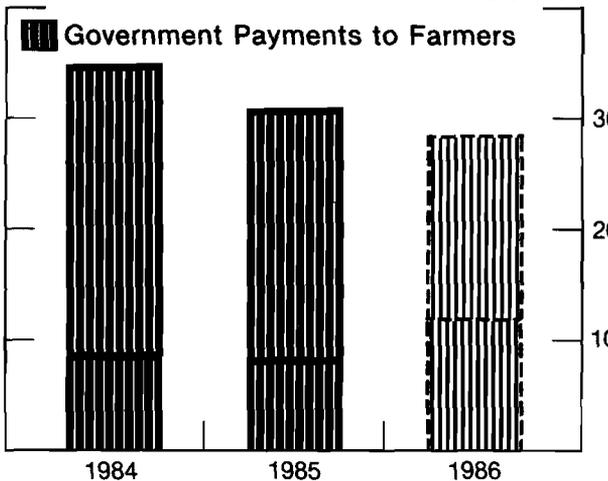
Business Equipment and Consumer Goods\*

Percent



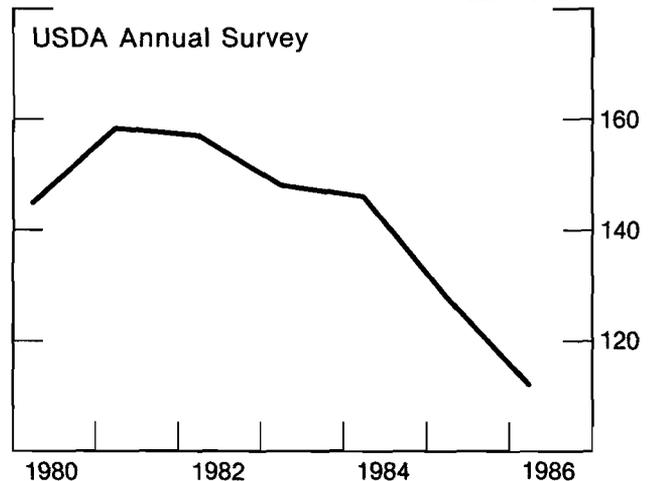
### Net Farm Income

Billions of dollars



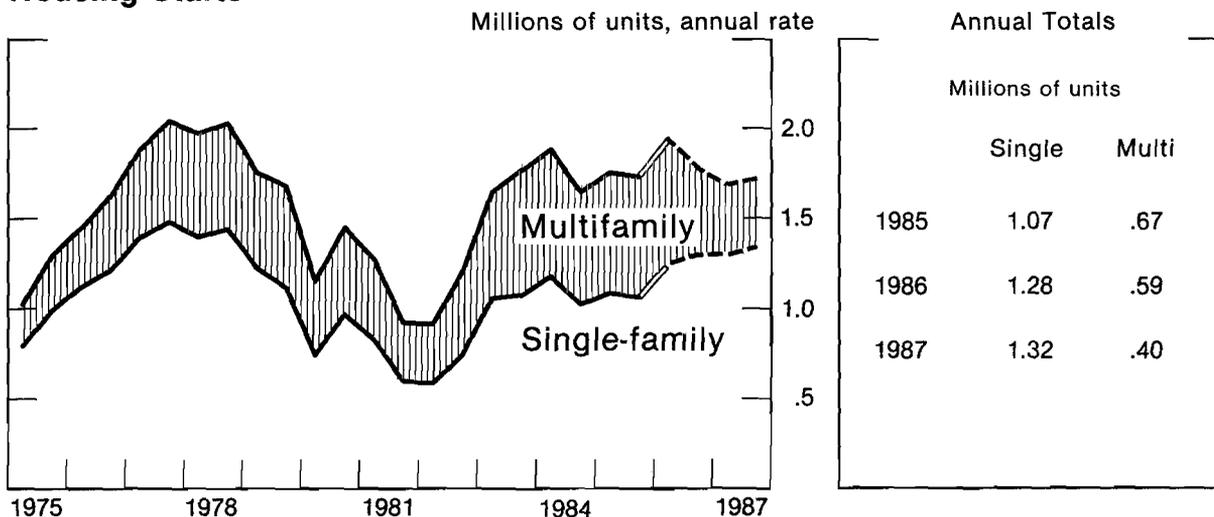
### Land Prices

Index 1977 = 100

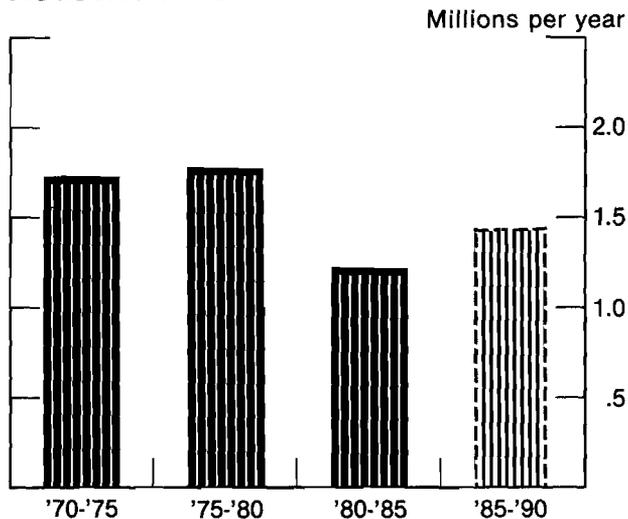


\*Imports of capital and consumer goods, excluding motor vehicles and food, relative to corresponding components of PDE and PCE.

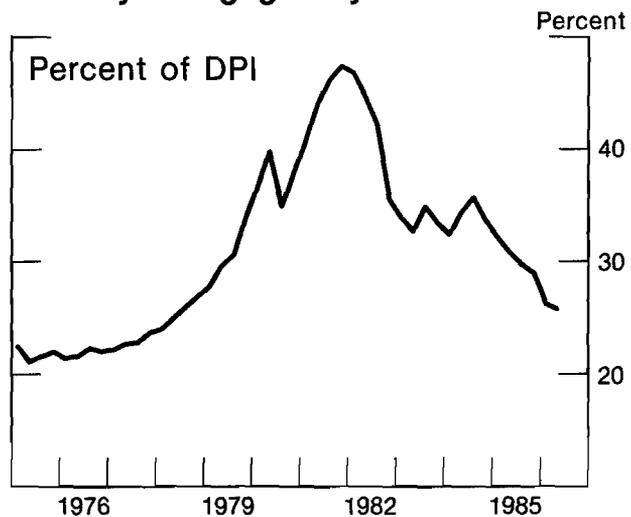
### Housing Starts



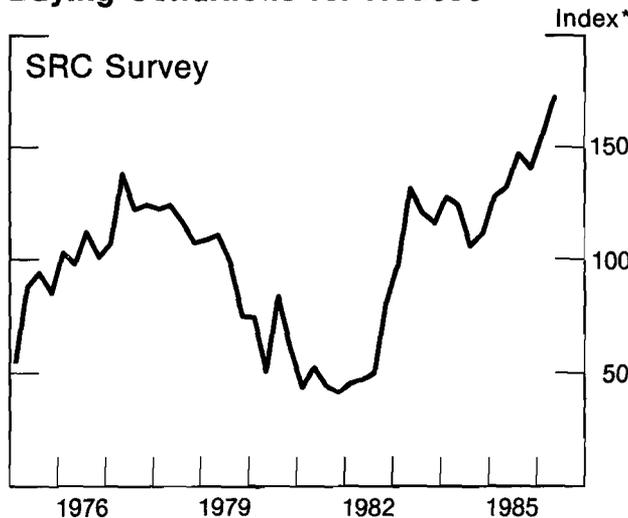
### Household Formations



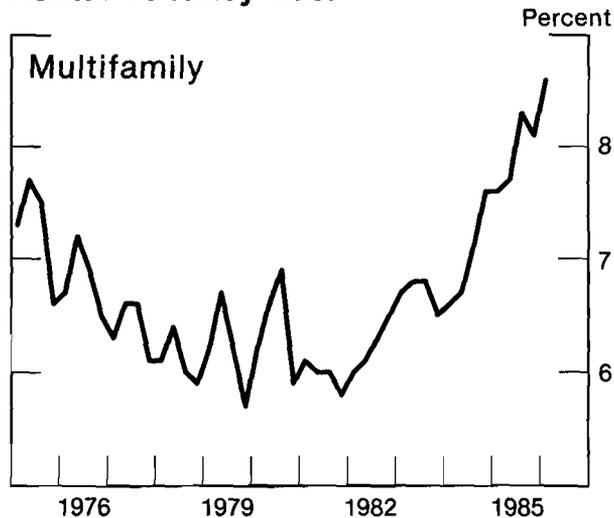
### Monthly Mortgage Payment



### Buying Conditions for Houses

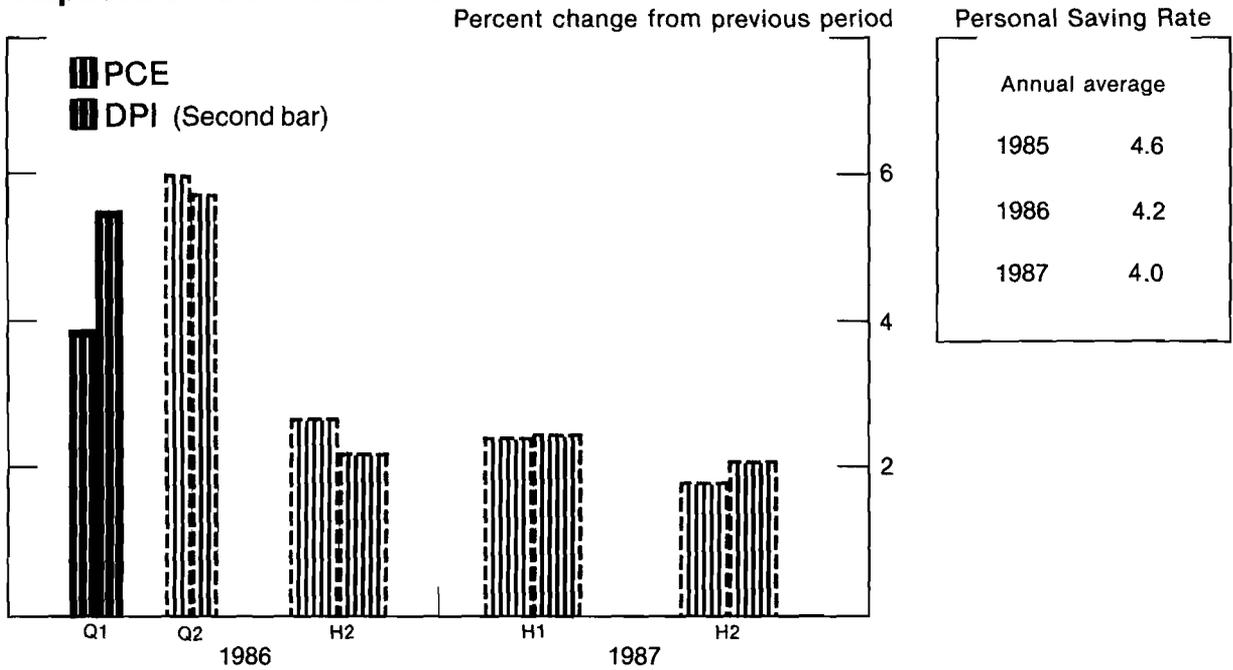


### Rental Vacancy Rate

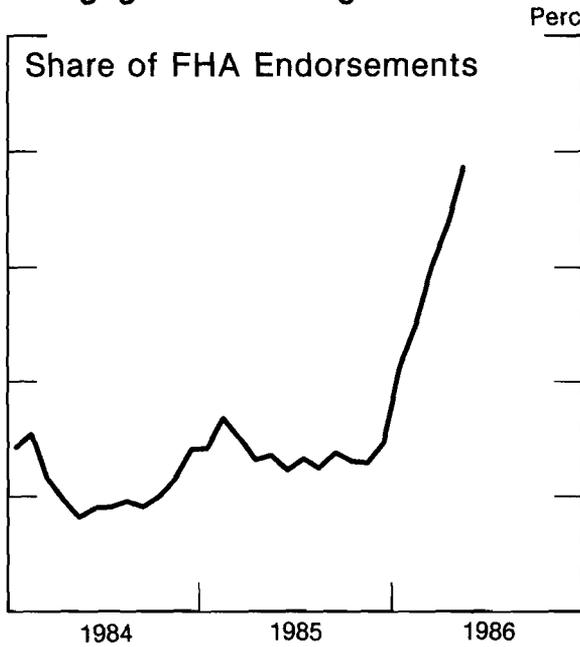


\*Good time to buy minus bad time plus 100.

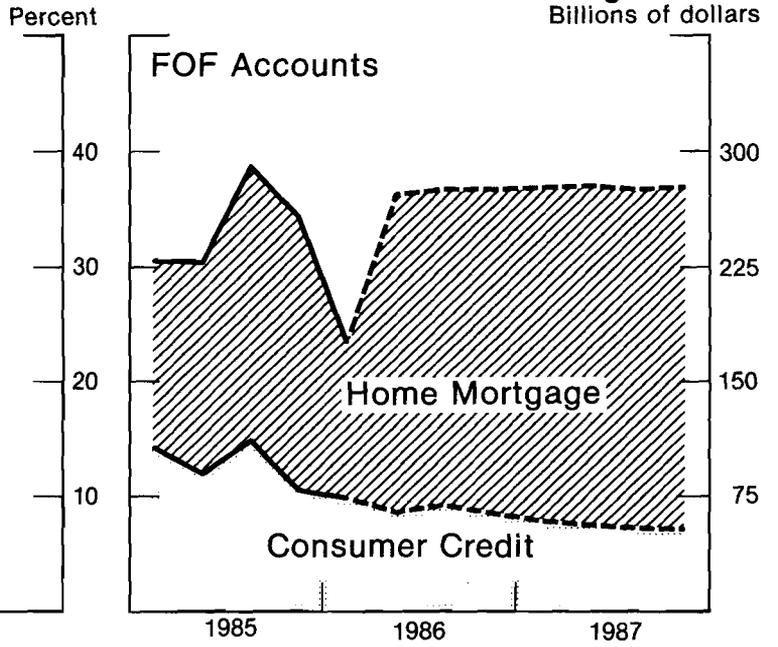
### Real Personal Consumption Expenditures and Disposable Personal Income



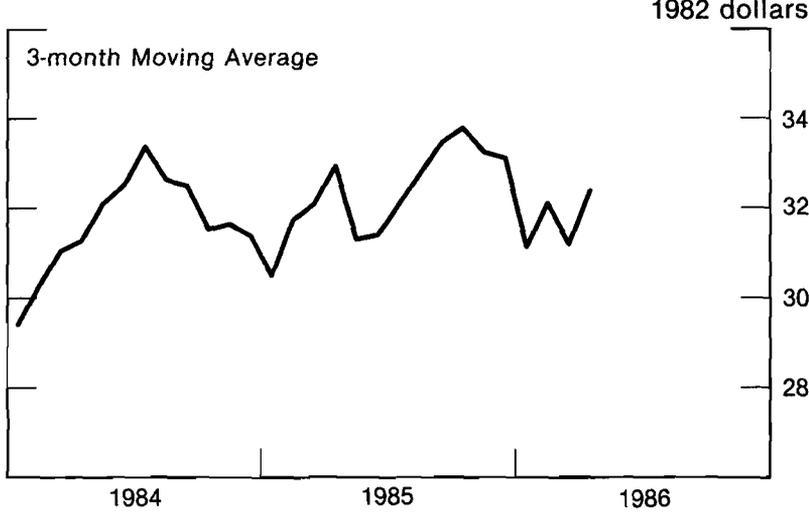
### Mortgage Refinancings



### Selected Household Borrowing



### Contracts and Orders for Capital Goods

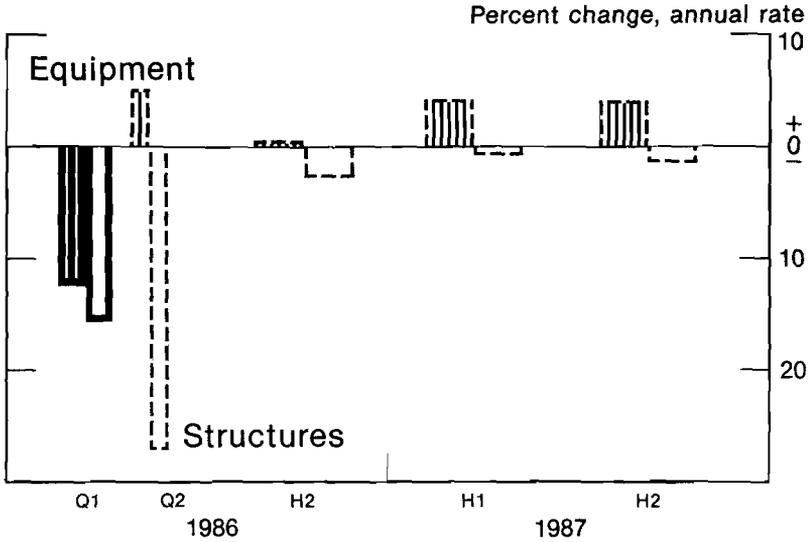


### Commerce Department P&E Survey for 1986

Percent change from 1985

	Winter	Spring
Total	2.3	.2
Total less Petroleum and Mining	3.7	3.2

### Real Business Fixed Investment

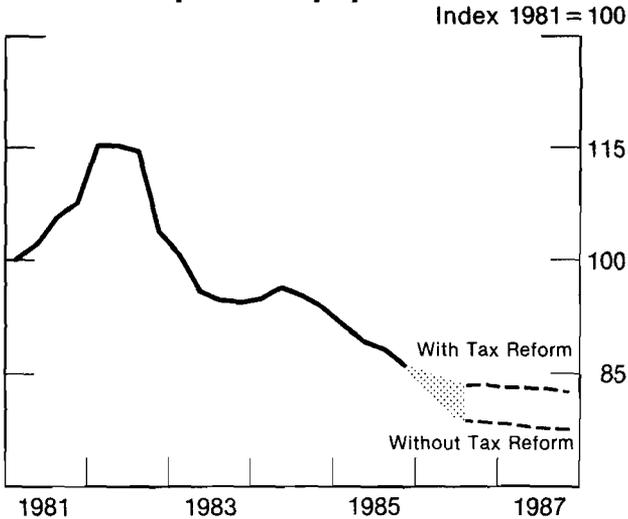


Total BFI

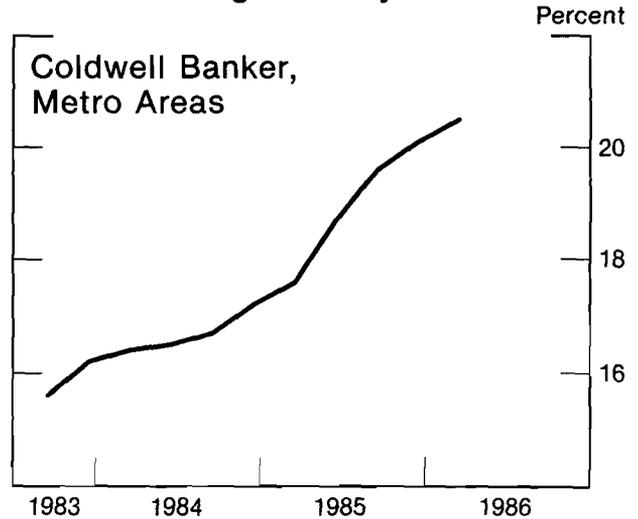
Percent change, annual rate

1986 Q1	-13.3
Q2	-7.1
H2	-0.4
1987 H1	2.5
H2	2.4

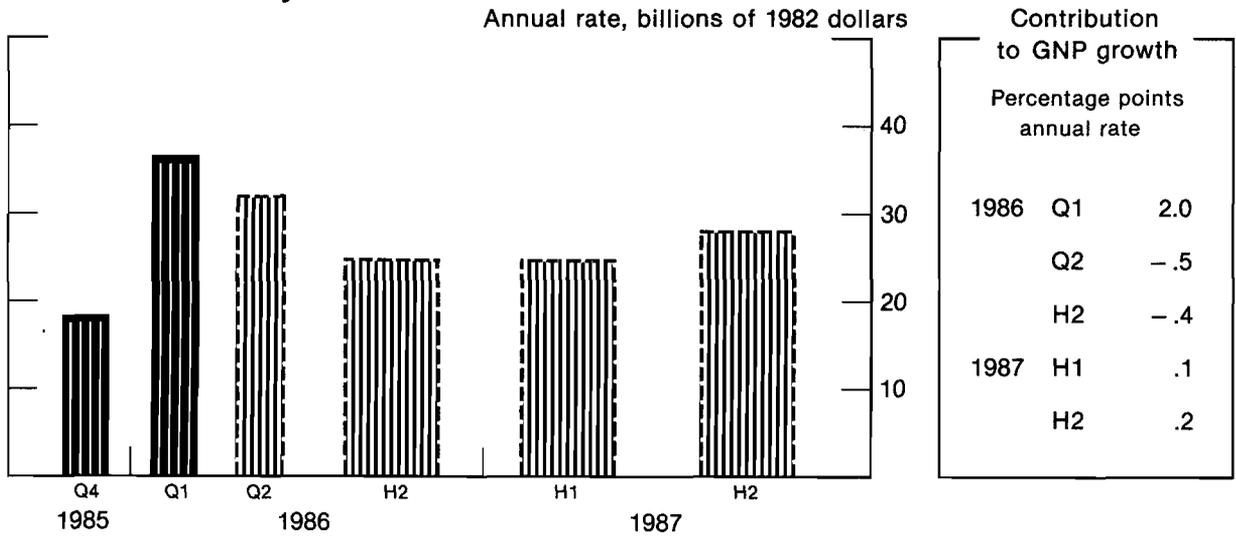
### Cost of Capital—Equipment



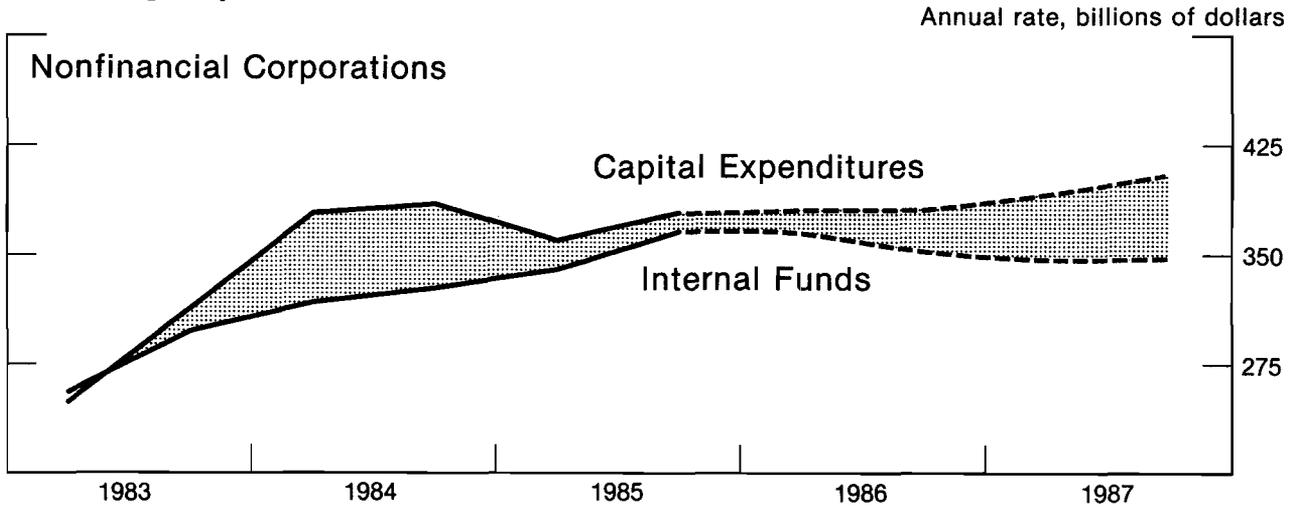
### Office Building Vacancy Rate



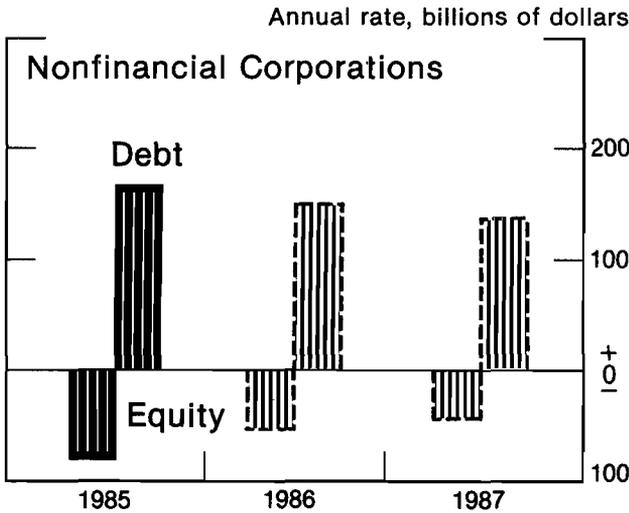
### Nonfarm Inventory Investment



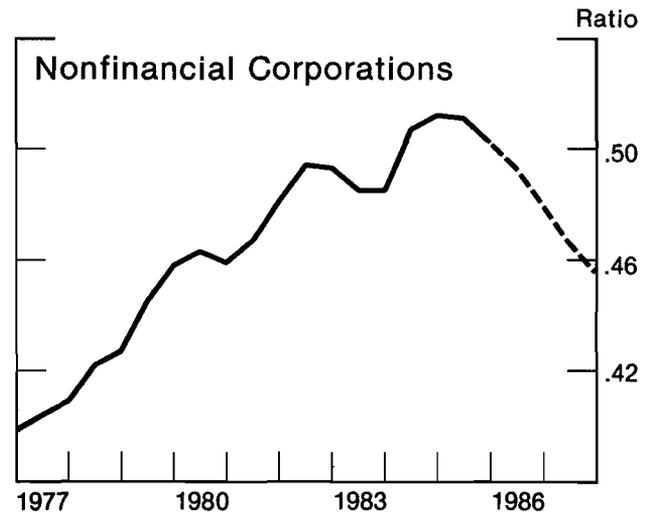
### Financing Gap



### Net Funds Raised



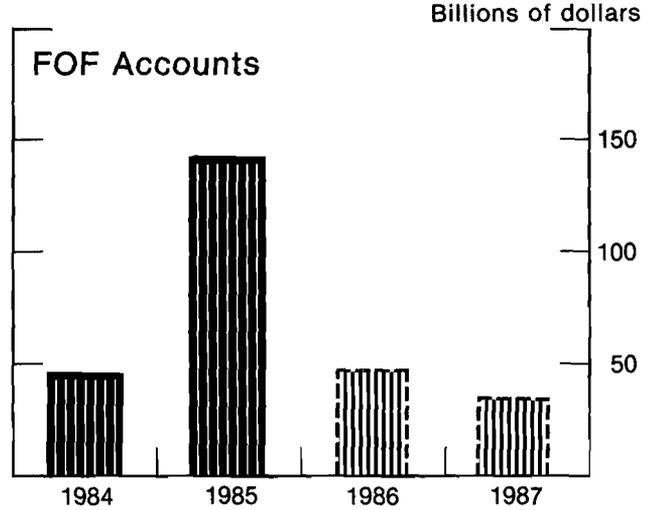
### Loans and Short-term Paper Relative to Total Debt



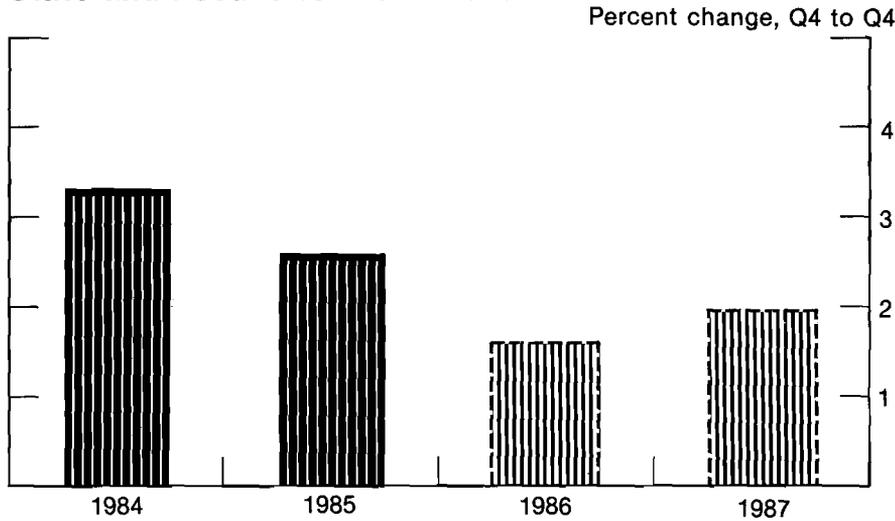
**State and Local Government Receipts**

Billions of dollars			
	Total Receipts	Federal Grants	Own-Source
1984	540	94	446
1985	575	99	476
1986	607	105	502
1987	637	99	537

**State and Local Net Borrowing**

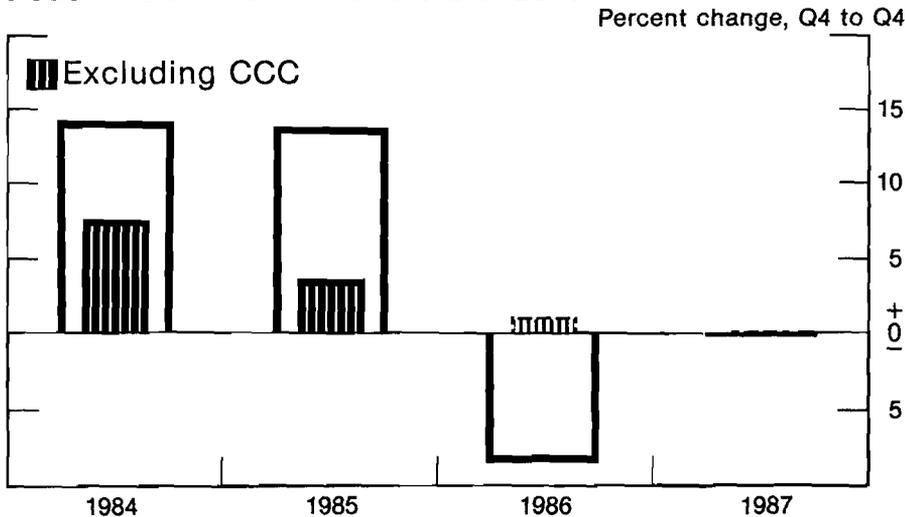


**State and Local Real Purchases**



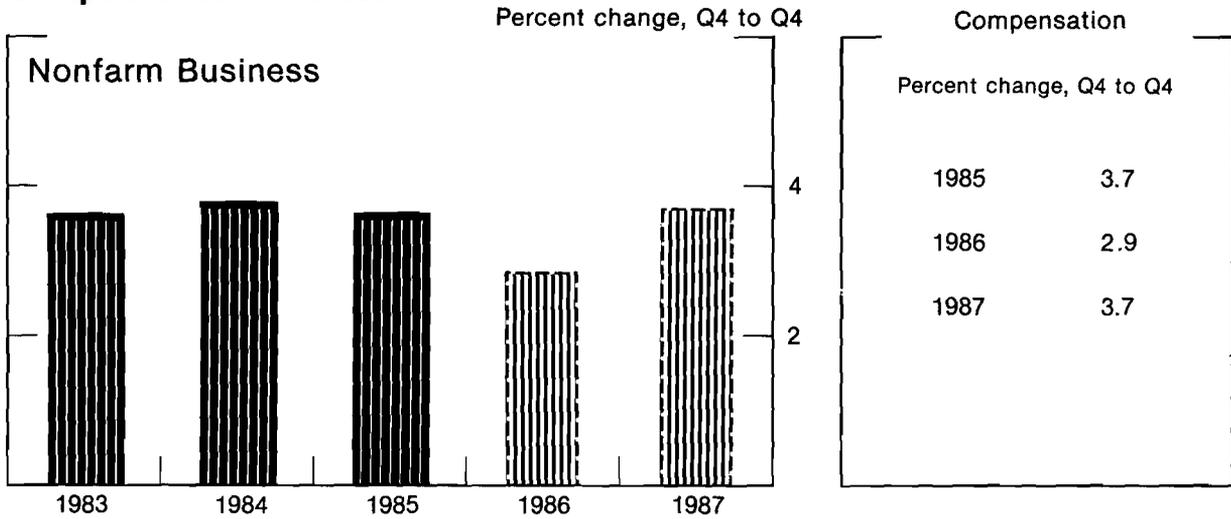
Operating Surplus	
Billions of dollars	
1984	15.9
1985	6.2
1986	1.7
1987	1.9

**Federal Government Real Purchases**

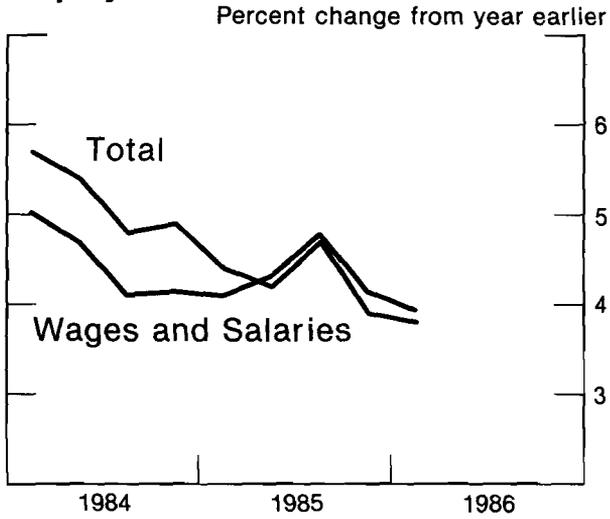


Real Defense Spending	
Change, Q4 to Q4 percent	
1984	7.6
1985	5.9
1986	1.3
1987	.4

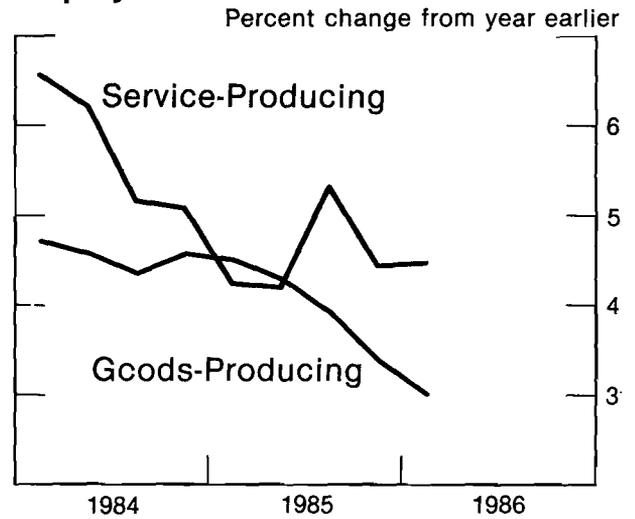
### Compensation Per Hour



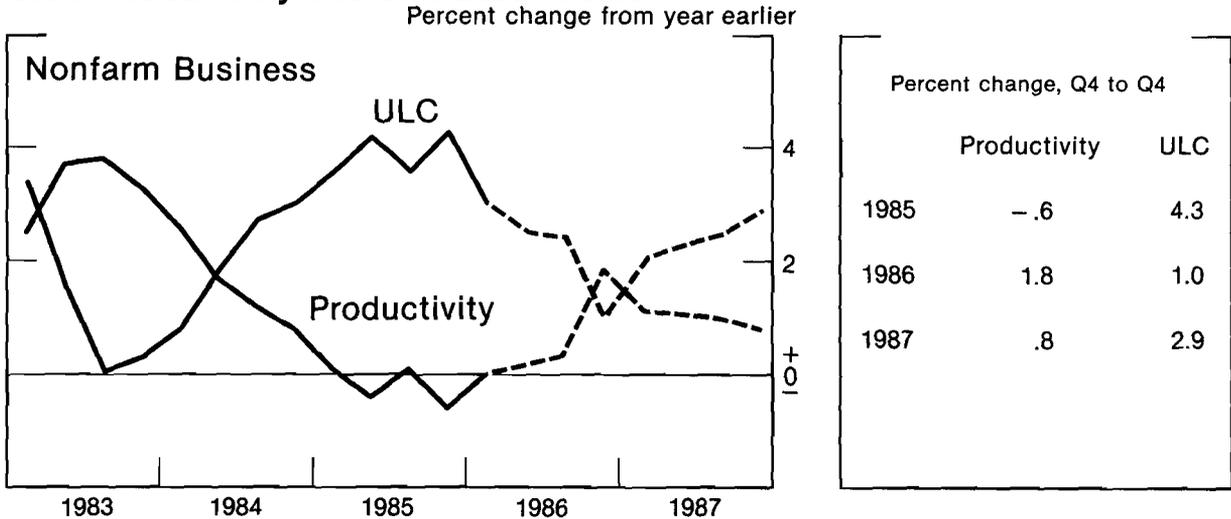
### Employment Cost Index



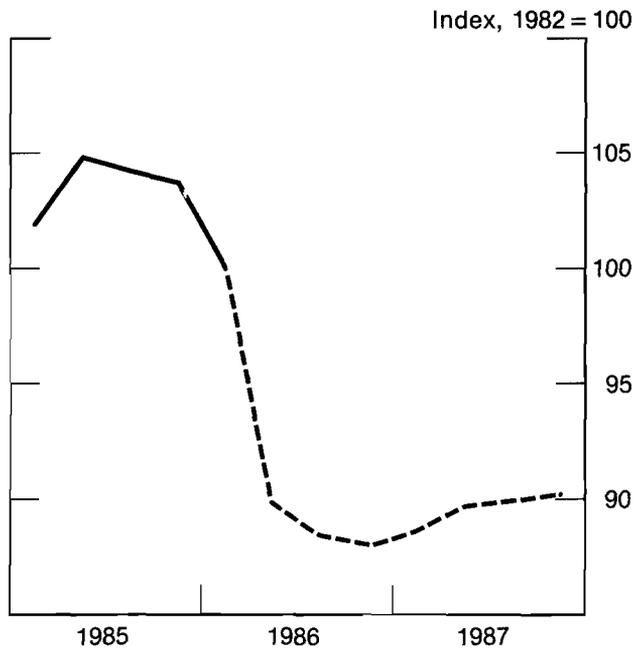
### Employment Cost Index



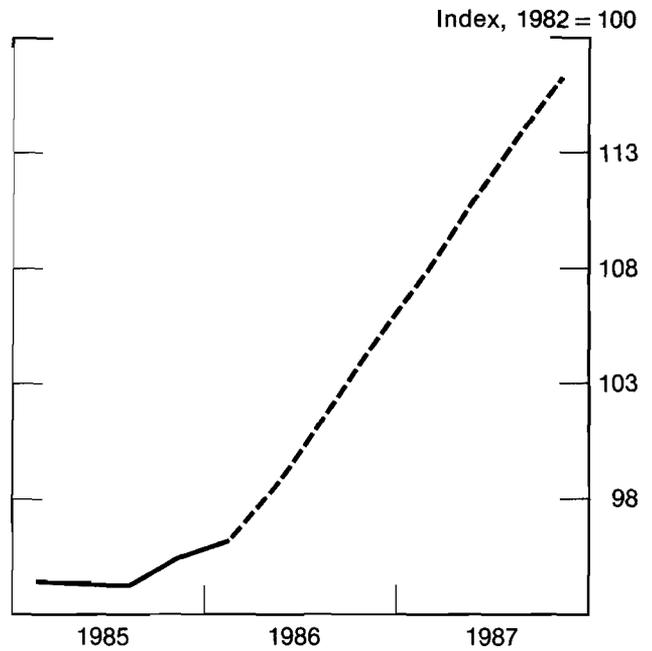
### Labor Productivity and Unit Labor Costs



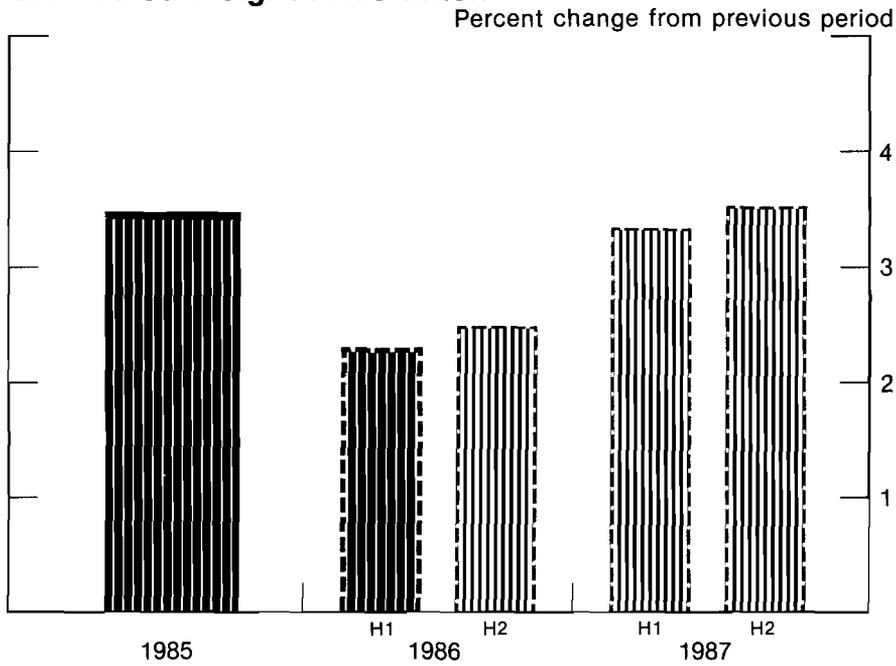
### PCE Energy Prices



### Non-Petroleum Import Prices

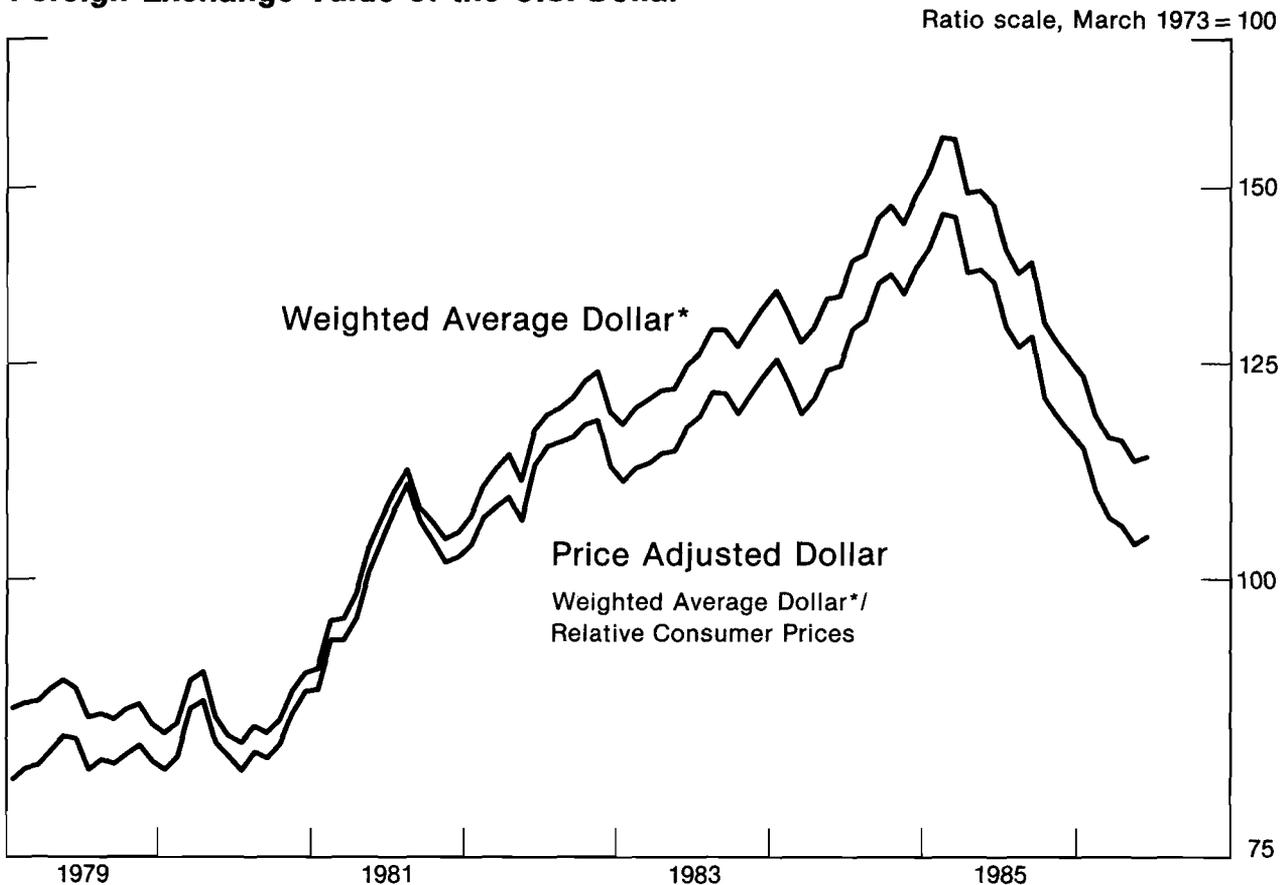


### GNP Fixed-Weight Price Index

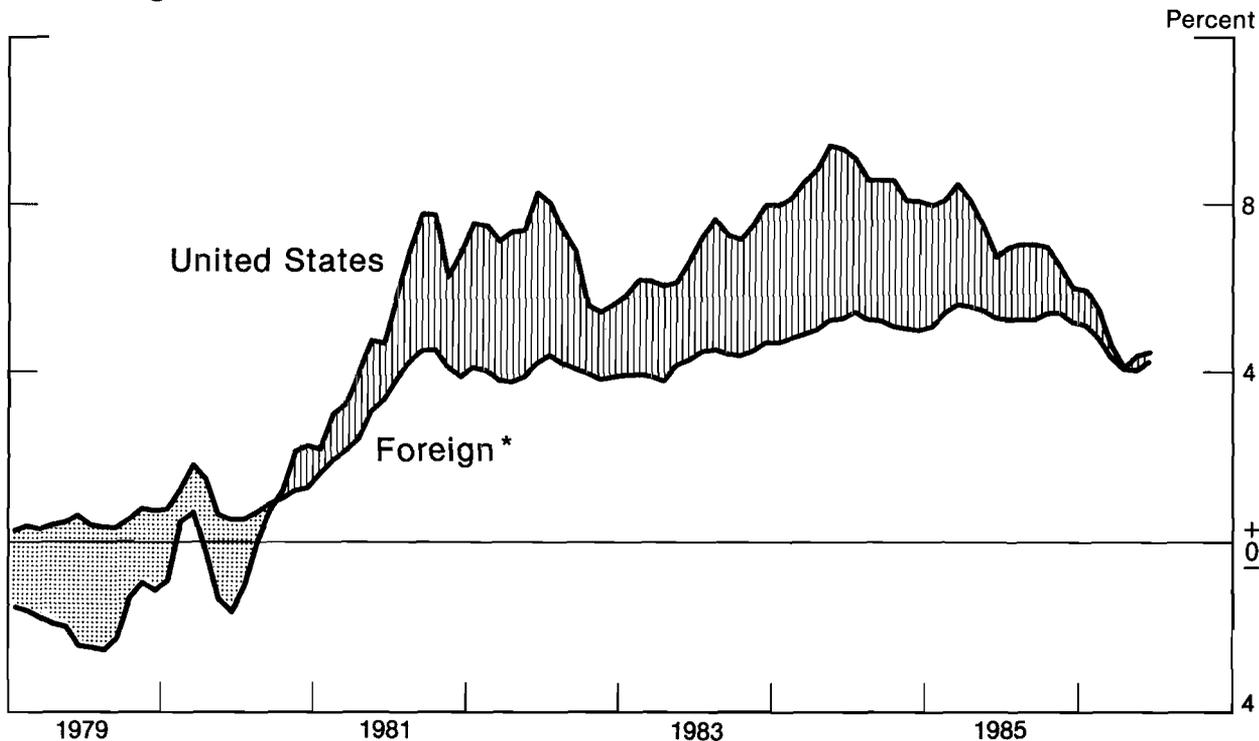


Change, Q4 to Q4 percent	
1985	3.5
1986	2.4
1987	3.4

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



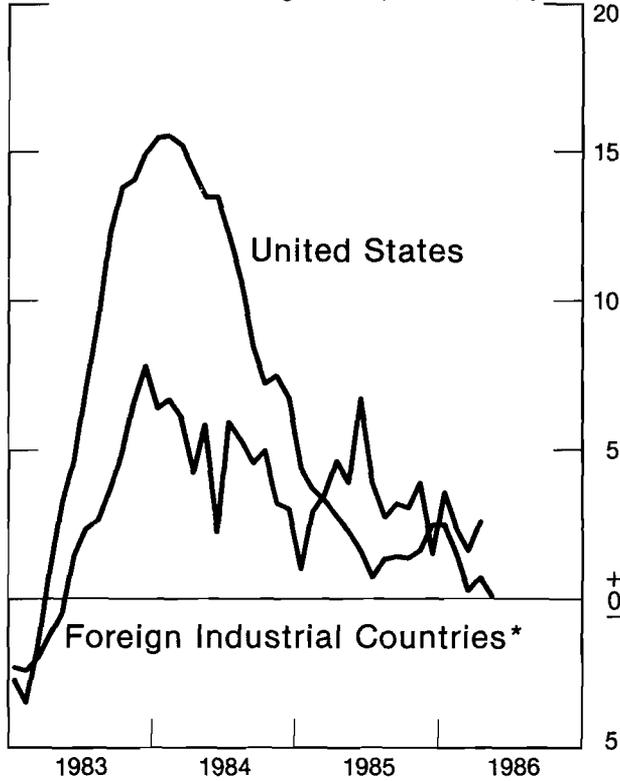
**Real Long-term Interest Rates\*\***



\*Weighted average against or of foreign G-10 countries using total 1972-76 average trade.  
 \*\* Long-term government or public authority bond rates adjusted for expected inflation estimated by a 36-month centered moving average of actual inflation (staff forecasts where needed).

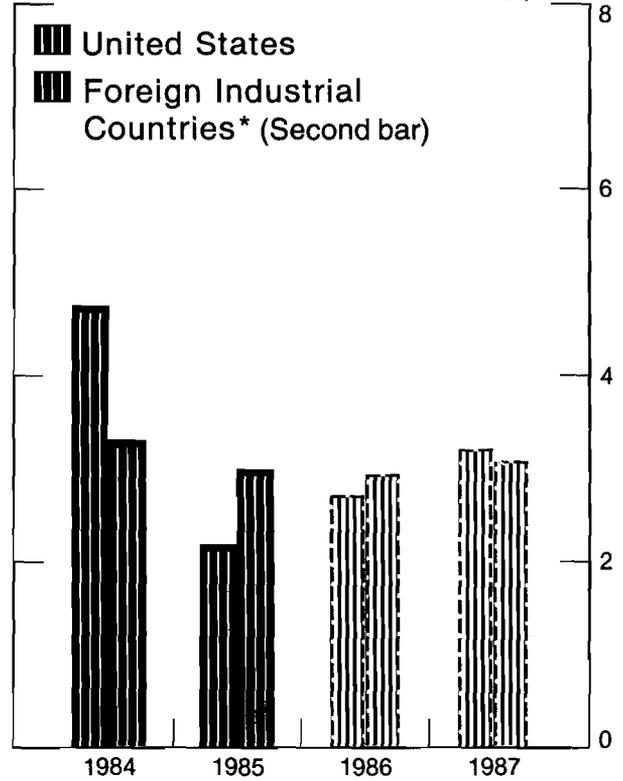
### Industrial Production

Change from year earlier, percent



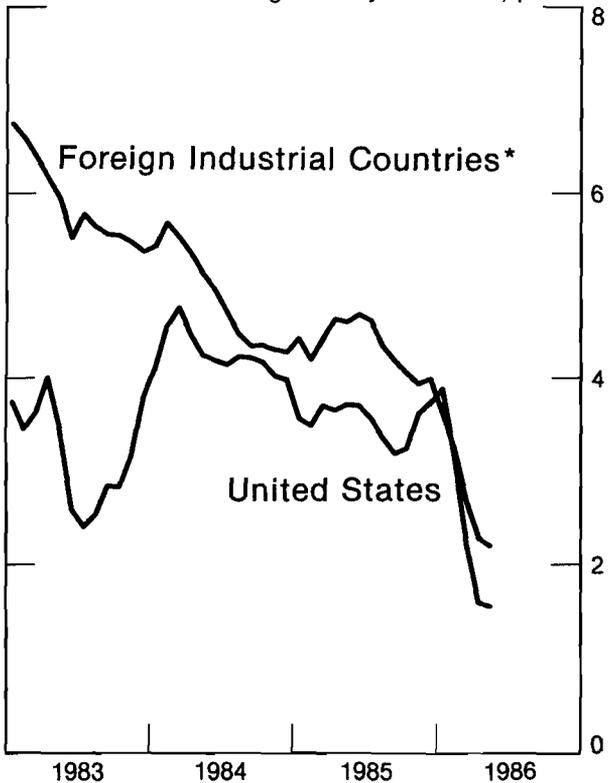
### Real GNP

Q4 to Q4, percent



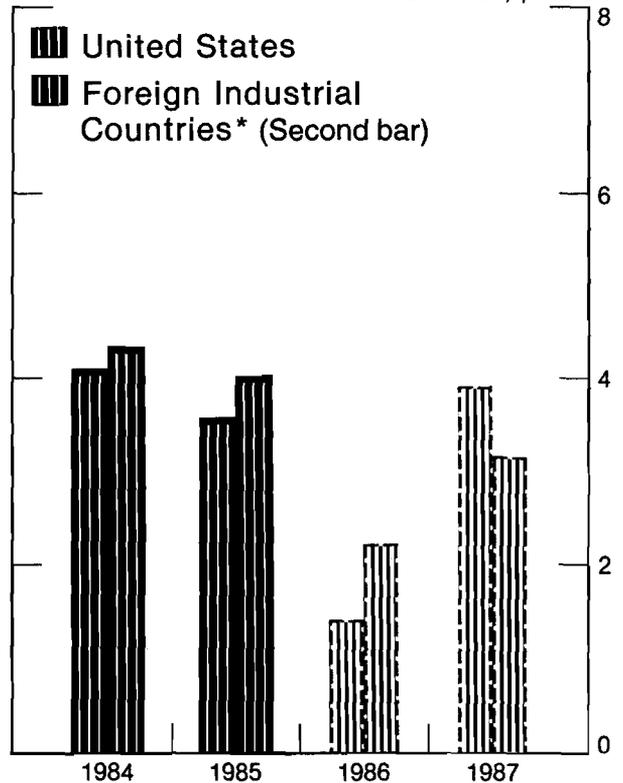
### Consumer Prices

Change from year earlier, percent



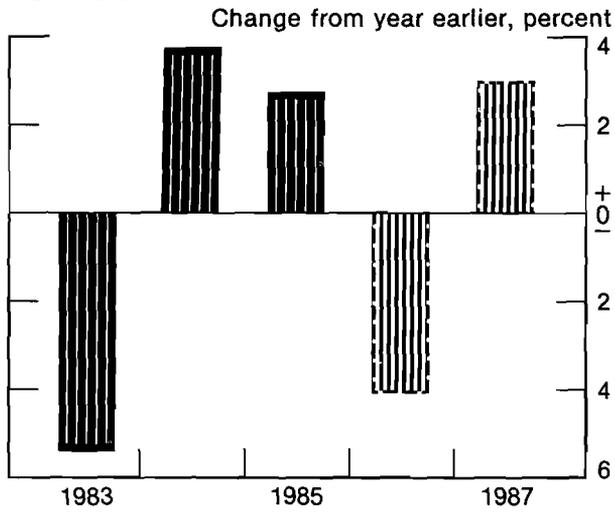
### Consumer Prices

Q4 to Q4, percent



\*Weighted average of the six major foreign industrial countries — Canada, France, Germany, Italy, Japan, United Kingdom — using total 1972-76 average trade.

**Mexico**  
Real GDP

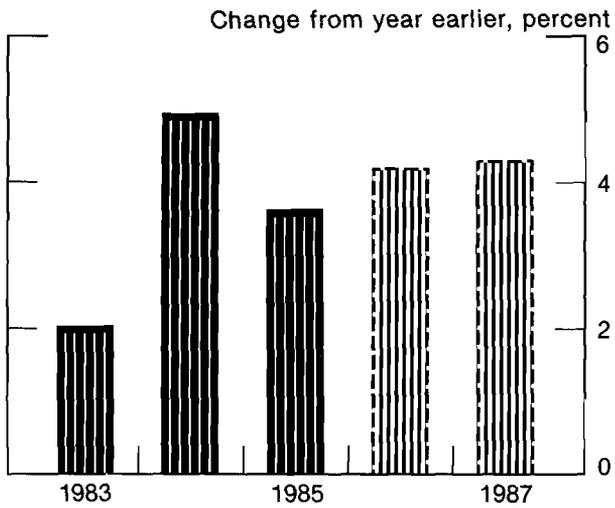


Current Account

Billions of dollars

1982	- 7.0
1983	5.2
1984	4.2
1985	0.5
1986	- 2.1
1987	- 1.8

**Other Non-OPEC Developing Countries**  
Real GDP



Current Account

Billions of dollars

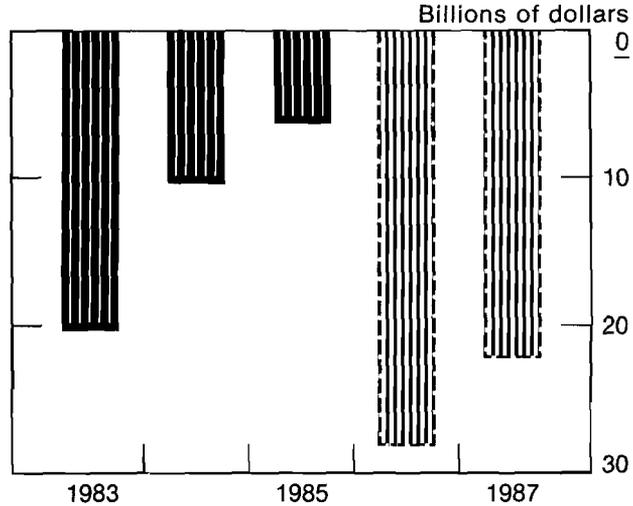
1982	- 61
1983	- 42
1984	- 27
1985	- 28
1986	- 25
1987	- 23

**OPEC—Real GDP**

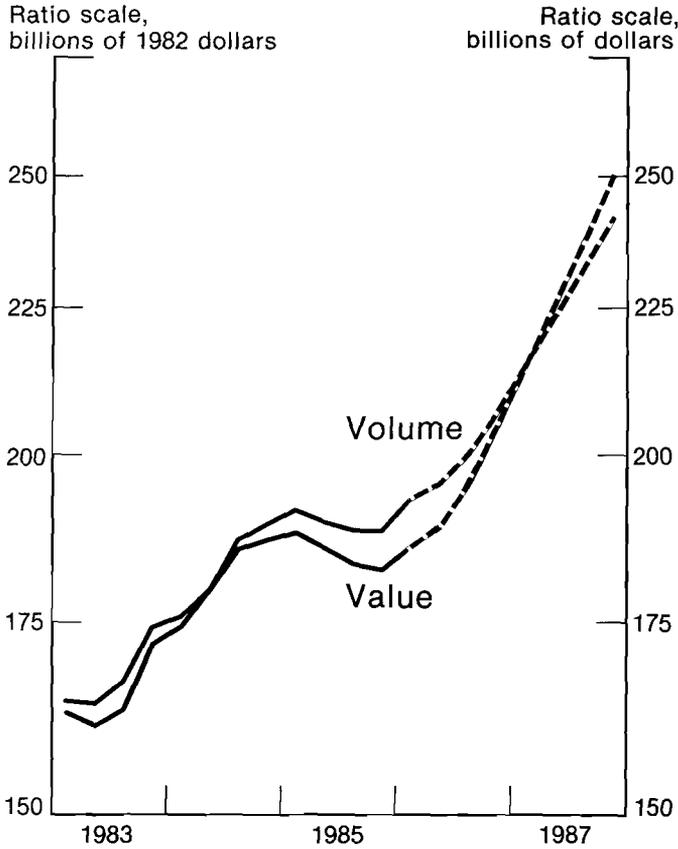
Change from year earlier, percent

1983	- 0.8
1984	1.6
1985	0.4
1986	2.5
1987	- 3.0

Current Account

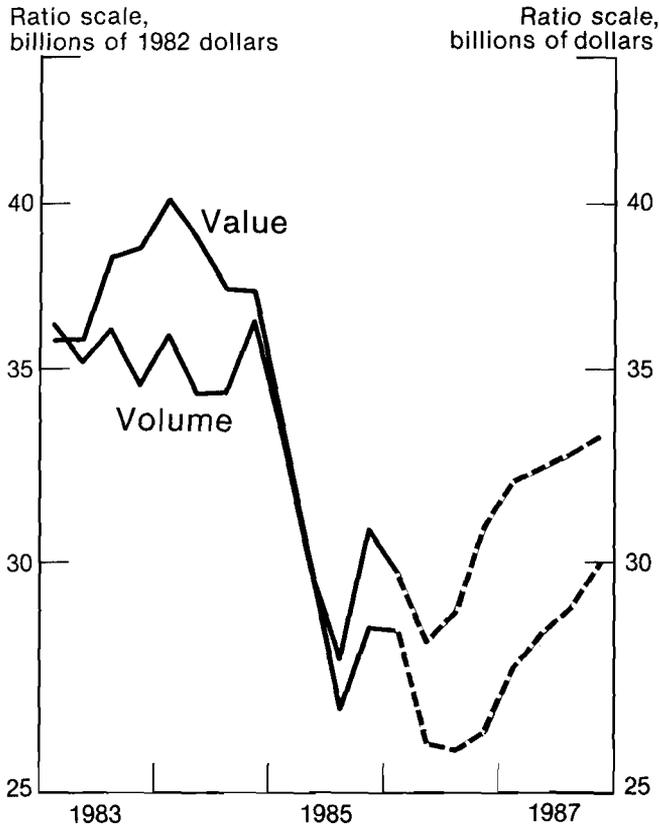


### Nonagricultural Exports



Destination of 1985 U.S. Nonagricultural Exports	
	Percent
Japan	9
Canada	28
Other Industrial Countries	30
Mexico	3
Other Non-OPEC Developing Countries	6
OPEC	19
Communist Countries	5

### Agricultural Exports



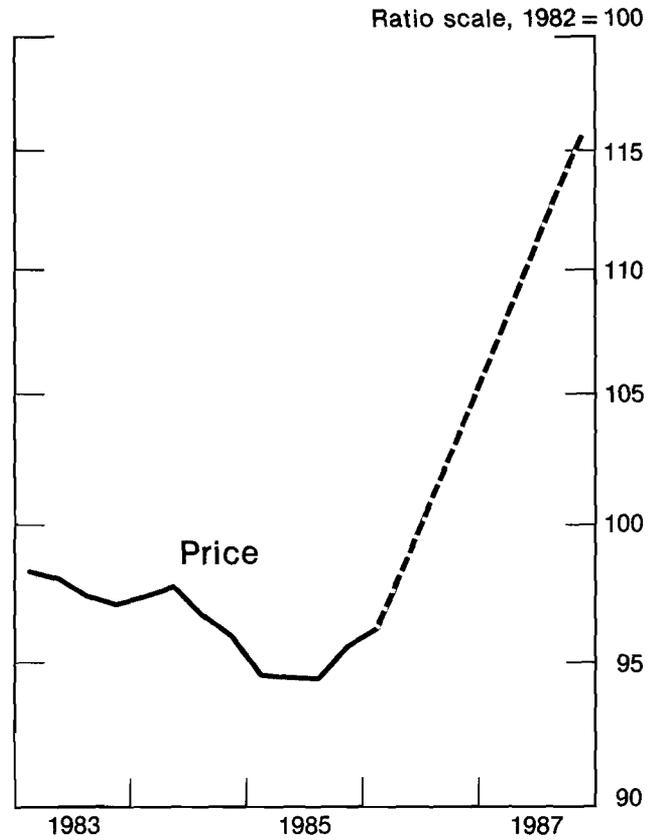
Destination of 1985 U.S. Agricultural Exports	
	Percent
Japan	18
Canada	7
Other Industrial Countries	25
Mexico	8
Other Non-OPEC Developing Countries	5
OPEC	30
Communist Countries	7

# Non-oil Imports

**Changes in Price of U.S. Non-oil Imports**

Percent, seasonally adjusted annual rates

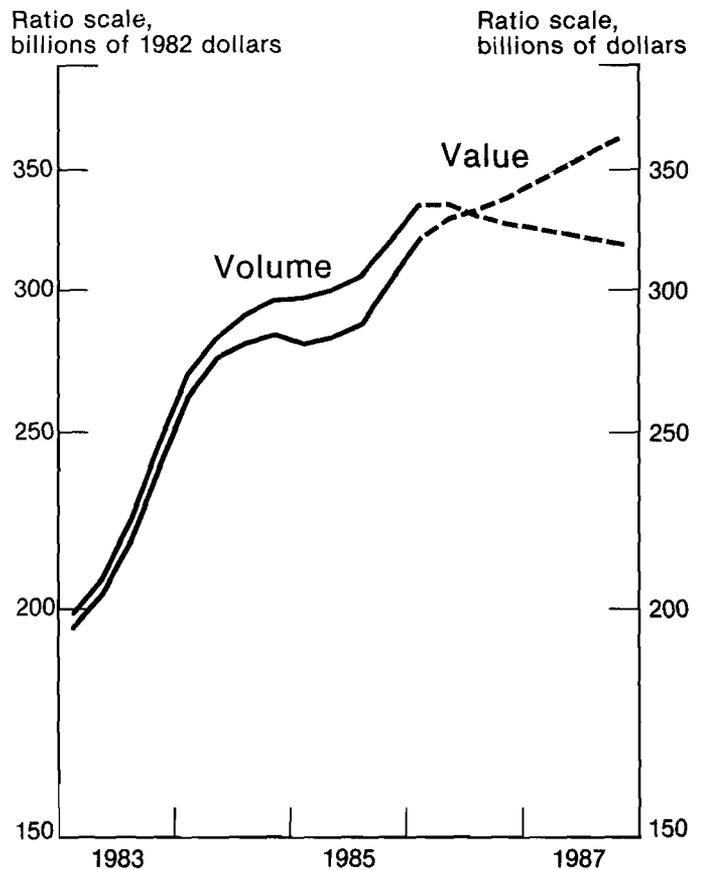
	$\frac{1985Q3}{1984Q3}$	$\frac{1986Q1}{1985Q3}$
Foods, Feeds, Beverages	- 7	15
Industrial Supplies	- 10	3
Capital Goods	- 3	6
Automotive Products	2	15
Consumer Goods	0	6
<b>Total</b>	<b>- 3</b>	<b>6</b>



**Origin of 1985 U.S. Non-oil Imports**

Percent

Japan	23
Canada	22
Other Industrial Countries	27
Communist Countries	1
Mexico	4
Other Developing Countries	23



## Summary of U.S. Current Account Transactions

Billions of Dollars, Seasonally Adjusted Annual Rates

	1985	1986		1987	
		H1	H2	H1	H2
1. Exports	214	214	227	250	275
2. Nonagricultural	185	187	200	222	245
3. Agricultural	30	27	26	28	30
4. Imports	339	360	370	383	400
5. Non-Oil	288	325	336	348	363
6. Oil	51	35	34	35	37
7. Trade Balance	-124	-145	-143	-133	-125
8. Other Current Account Transactions, Net	7	9	5	0	0
9. Current Account	-118	-136	-138	-133	-125
10. Real GNP Net Exports of Goods and Services (1982 Dollars)	-108	-146	-135	-112	-92

**Forecast Summary**

	<b>Board Members</b>		<b>Presidents</b>		<b>Staff</b>
	Range	Median	Range	Median	
Percent change, Q4 to Q4					
<b>Nominal GNP</b>					
1986	3¾ to 5½	4½	4¾ to 6½	5¾	5
1987	5 to 7	6	6 to 8¼	7½	6½
<b>Real GNP</b>					
1986	2¼ to 2¾	2¼	2½ to 3½	3	2¾
1987	2 to 4¼	3	2¾ to 4	3¼	3¼
<b>GNP Deflator</b>					
1986	1½ to 3	2¼	2 to 3¼	2½	2½
1987	1½ to 3¾	3	3 to 4¼	3¾	3
Average level, Q4, percent					
<b>Unemployment Rate</b>					
1986	7 to 7.2	7.0	6.9 to 7.1	7.0	6.9
1987	6¾ to 7.0	6.8	6½ to 7.0	6¾	6.6

**FOMC Projections for 1985**

	<b>Range</b>	<b>Central Tendency</b>
Percent change, Q4 to Q4		
<b>Nominal GNP</b>	5 to 8½	6½ to 7¼
<b>Real GNP</b>	2¾ to 4¼	3 to 3½
<b>GNP Deflator</b>	2½ to 4¼	3 to 4
Average level, Q4, percent		
<b>Unemployment Rate</b>	6¼ to 6¾	About 6½

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FOMC BRIEFING  
Donald L. Kohn  
July 8, 1986

The major issue facing the Committee in its review of the ranges for 1986 is, of course, the target for, and treatment of, M1, with credit growth also presenting some questions. M2 and M3 are well within their ranges, and seem likely to remain there over the balance of the year. With respect to M1, hitting the 8 percent upper end of the current range would require growth at only around a one percent annual rate from June to December. While a spontaneous deceleration of this aggregate cannot be totally ruled out, it seems most likely that a slowing of this magnitude could only be achieved through a substantial tightening of reserve availability and rise in interest rates. Such a policy course would appear to be inconsistent with a moderate strengthening of economic activity in the second half of the year and into 1987 and perhaps with the broader aggregates remaining above the lower bounds of their ranges as well.

Absent such a tightening, another substantial decline in velocity for 1986 appears in train--marking the third year in the last five that M1 has outrun GNP by a sizable amount. Moreover, the staff forecast for 1987 involves a much more modest pick-up in GNP growth than might have been predicted based on past lagged relationships between M1 and spending, extending the period in which M1, taken by itself, has been a poor indicator of future GNP. A major reason for the deterioration of the M1-GNP relationship is the changing nature of this aggregate, resulting from deposit deregulation and the spread of cash management techniques. For one thing, these processes have left us with a great deal of uncertainty about the relationship of this aggregate to other economic variables, as evidenced by the failure of most money demand equations to explain a substantial portion of second-quarter growth. It does seem clear, however, that M1 has become

more sensitive to changes in interest rates, not only in its OCD component as deregulation has proceeded, but in demand deposits as well. This latter development may reflect the shifting of household balances into OCD and the spread of cash management to smaller businesses. These businesses have been able to reduce excess cash balances, which likely were not very responsive to rate movements, and they are probably purchasing cash management services disproportionately from regional banks, which tend to emphasize payment via interest-sensitive compensating balance arrangements.

A highly interest-sensitive aggregate is a notoriously poor guide for monetary policy. The question of whether rapid growth in such an aggregate following a drop in rates will give rise to rapid income growth can not be answered without reference to the level of interest rates themselves and a judgment about their likely implications for the economy. The staff's GNP forecast suggests that the current level of rates will support a moderate pick-up in economic expansion. In that context the current decline in velocity can be viewed as representing relatively permanent additions to cash balances as interest rates have adjusted downward to levels more consistent with lower inflation and sustainable growth. The more modest rate of M2 growth also provides some comfort in this regard, by suggesting that the growth in M1 represents more a shift in the locus of savings--albeit in a more liquid and immediately spendable direction--than an overall build-up in the public's monetary assets that is likely to end up stimulating spending excessively.

The Committee has several options for dealing with M1 in this situation. One would be simply to forego setting a new range for this aggregate, announcing that it would be expected to exceed the current range, but

by an unknown amount. A new range consistent with Committee objectives for the broader aggregates and the economy would be difficult to establish under circumstances of considerable uncertainty about the relationship of M1 to income and interest rates, and about the likely level of interest rates, which will importantly influence the course of M1. However, dropping the range altogether might be interpreted as implying a complete lack of concern about the growth of an aggregate that has provided a key reference point for monetary policy over the years--one that still might send important signals to the Federal Reserve and the public under certain circumstances. One possibility would be to retain the 3-to-8 percent range as a benchmark for the future, but without immediate significance in the current implementation of policy. It would signal within a very broad area the general range for M1 growth the Committee expects will be needed in attaining price stability over time--under conditions in which interest rates should be fluctuating over a narrower range and an underlying trend in velocity can re-assert itself.

Alternatively the Committee could establish a new range for M1 that was expected to be compatible with the Committee's objectives for economic performance and its targets for the other aggregates. As suggested in the bluebook, the 11 percent upper limit of alternative II could well be consistent with some pickup in GNP at current, or slightly lower interest rates. However, should interest rates need to decline substantially further to sustain GNP, M1 growth might not slow much, if at all, from the first half, and could run around 12 percent for the year. Spreads of market rates relative to those on NOW accounts already are extremely narrow, and with offering rates on these accounts apparently reacting sluggishly to

declines in market rates, inflows to M1 might remain quite sizable, at least for a time, under these circumstances.

Should the Committee wish to establish a new M1 range, two related questions would need to be addressed. One would be the weight to give growth of this aggregate relative to its range in policy implementation. It could be designated "monitoring" range, similar to the status now accorded the debt aggregate. Such a designation would seem to imply that the Committee would be tracking developments in this aggregate, but under most circumstances would be unlikely to react to growth outside the new ranges. Another issue is whether to rebase to the second quarter. Certainly, a strong case can be made for "forgiving" the growth of the first half of the year. But, even if interest rates do not decline further, the period of abnormal M1 growth and declines in its velocity is probably not behind us. The staff expects rapid money growth in the third quarter on a quarterly average basis--amounting to 11-1/2 percent under alternative B--owing to the continuing effects of the recent decline in interest rates, as well as to the arithmetic effect on the third-quarter average of the rapid money growth late in the second quarter. As a result, even with rebasing, the Committee may find it has to raise the numerical range; for example, the 11 percent upper end of the alternative II range is consistent with growth of over 9 percent for the second half.

The growth of nonfinancial debt also is well above its range--though not quite to the extent of M1--and the staff projects that it will remain so for the year. Borrowing has slowed this year, but not sufficiently to offset the effects of the surge in December on growth measured from the fourth-quarter average. Underlying demands for credit apparently remain very strong and debt-to-income ratios continue to rise. The Committee

could raise the range to encompass expected growth--an upper end of 12 percent might be barely sufficient--or, as it has when facing this problem several times in the last few years, the Committee could leave the range unchanged but indicate that it expected growth to run at or over the upper end. In following this latter approach in the past, the Committee has suggested that recent growth in debt is not considered consistent with economic and financial stability over time.

Turning to the tentative ranges for 1987, the question is whether and to what extent the Committee wishes to reduce the ranges relative to 1986. The bluebook presents two alternatives. Both alternatives retain the 3 to 8 percent range for M1, which would represent a substantial deceleration from growth expected this year. The level and treatment of the 1987 ranges for this aggregate might depend in part on the Committee's decision with respect to M1 for 1986. If the Committee chose to raise the 1986 range, then a higher range for 1987 might also be considered. For example, should the Committee chose a range of 5 to 10 or 6 to 11 percent for 1986, then a 4 to 9 percent range for 1987 would still convey the general intent to slow M1 growth from 1986. The 3 to 8 percent range does encompass the staff's best estimate of M1 growth of around 7 percent for 1987, but a 4 to 9 percent range would more comfortably allow for the chance of some further decline in velocity.

For the broader aggregates and credit, alternative I would carry over the 1986 ranges, while alternative II would reduce the ranges by one-half point. One wouldn't want to make too much of the differences in these alternatives--both are considered consistent with stronger economic growth accompanied by only a modest pick-up in inflation in 1987 as in the greenbook

GNP forecast--but the choice between the alternatives can be seen as related to a weighing of the risks to such an outcome, or even whether the outcome itself seems adequate.

Maintenance of the current ranges would seem more consistent with concern about the strength of the expansion. It would allow for faster growth of nominal income, perhaps permitting greater expansion of real activity in the face of some pick-up in inflation. If a weak economy were mirrored in slack demands for the broader aggregates, then the ranges of alternative I would tend to signal the need for ease more quickly than the lower ranges of alternative II. Alternative I also allows more scope for faster money growth should interest rates need to decline--and velocities with them--to maintain income in the face of weak demands.

Alternative II would be more consistent with greater emphasis on the potential for more rapid inflation. Such concerns might intensify should the dollar decline sharply further, or the economy begin to accelerate more substantially, eating into unused margins of labor and capital, and threatening wage and price pressures--if not in 1987, then beyond. Alternative II implies a bit more restraint on income growth under such circumstances, reducing the likelihood of price pressures getting built into an inflationary spiral. It would underline the Federal Reserve's often-stated belief that some slowing in money growth over time was needed to attain and sustain reasonable price stability.