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

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: January 25, 1984

FROM: Normand Bernard N.B.

Enclosed are the greenbook and supplementary information prepared at two Federal Reserve Banks.

Enclosures

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FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC PANEL

Professors Eckstein, Houthakker, Samuelson, and Solow were available for comment this month. While all agreed that economic growth has decelerated in recent months, they were uncertain about the accuracy of recent data documenting the slowdown, such as the flash estimate for fourth quarter GNP and advance December retail sales. Eckstein thinks that last month's lack of growth in retail sales was attributable to declining gasoline and food store prices rather than stagnant unit sales.

All the panelists except Eckstein believe that the Fed should continue its current monetary policy as long as economic growth slows no further and inflation remains in check or accelerates only slightly. Eckstein said that the Fed "should be pleased" to accommodate a modest decline in interest rates, given that the money supply is behaving and inflation is low. He believes lower rates would encourage badly needed renovation and modernization of the nation's industrial capital stock.

All of the panelists expect little or no change in interest rates. All but Houthakker believe that an easing of monetary policy or a further deceleration of economic growth would bring interest rates down and therefore weaken the dollar. Houthakker attributes high interest rates primarily to large prospective federal deficits. In his view, as long as these deficits persist, the government's demand for credit will keep interest rate high and the dollar strong.

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Solow believes that the Fed should continue to deemphasize M1 as a monetary target because, given the recent pace of financial innovation, its velocity is, at best, no more predictable than that of other aggregates. Samuelson thinks that more importance should be attached to M1 than last year but counseled the Fed to continue to monitor a broad spectrum of monetary, financial, and economic indicators. Since the outlook for inflation in 1984 seems so good, he suggested that the Fed minimize risk to the recovery by reducing the boundaries of M1's target range by no more than 1/2-percentage point. Although financial innovation has shaken Houthakker's faith in M1, he still thinks it is more closely related to economic activity than any other aggregate.

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SECOND DISTRICT—NEW YORK

FINANCIAL REPORT—FINANCIAL PANEL

This month we have comments from David Jones (Aubrey G. Lanston), Donald Maude (Merrill Lynch), and Albert Wojnilower (First Boston):*

Jones: Economic recovery momentum is likely to continue strong at least through the early months of this year. Beyond this, however, the outlook is less certain. Real interest rates are likely to remain unusually high throughout 1984 and may begin to depress activity in interest-sensitive sectors. For 1984 as a whole, real GNP growth (fourth quarter-to-fourth quarter) may rise at only about a 3.5 percent pace. The U.S. dollar, owing largely to expected continued high real rates, will continue unexpectedly strong in 1984. The potential for world recovery will be severely limited in 1984 and beyond. The U.S. inflation rate will be lower than generally expected in 1984, perhaps with prices showing no more than a 4 percent increase. Short- and longer term nominal interest rates are likely to show a flat trend with minimal volatility in 1984. For example, the prime rate should hold generally in a 10 1/2 - 11 1/2 percent range while the rate on 30-year Treasury bonds should fluctuate mostly in a 11 1/2 - 12 percent range. Significant declines in real U.S. longer term interest rates--required to assure sustained world recovery—are only possible if there is a dramatic and credible reduction in the Federal Budget deficit, say, to $50 billion or less by no later than 1987.

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*Their views of course are personal, not institutional.

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Maude: With the economy decelerating, given the current level of real interest rates, money supply growth under control and inflation restrained, a steady monetary course would appear appropriate over the near term. However, the risks seem to have shifted from the economy being too strong to a potential slowdown sharper than presently envisioned as we enter the spring months. As a result, any tilt down the road should be toward less restraint when the situation renders such a stance credible to market participants. Given the fact that velocity is now behaving more in line with past cyclical experience, the aggregates should begin to carry more weight in policy deliberations. If this pattern continues into the first half of 1984, moderate growth in M1 and M2 would be suggested, since our nominal GNP forecast for the first half of the year is in the 9-10 percent range. Should this moderate growth evolve in a weakening economic environment, it would probably produce the last "window of opportunity" to ease rates down before the long awaited clash between private and public sector borrowing emerges sometime in late summer. If rates have to rise, it would be ideal to have them rise from lower levels than presently exist.

Wojnilower: The economy is continuing to improve smartly and much more strongly than some recent economic indicators would suggest. Reports from the retail sector are buoyant and capital goods orders are being increased and include more longer lived items. Twelve or 18 months from now the Federal Reserve will be critized for not having tightened policy at this time.