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

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: March 20, 1985

FROM: Nancy Steele NMS

Enclosed are the greenbook, supplementary information prepared at two Federal Reserve Banks, and the table on System swap lines.

Enclosures

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CLASS II - FOMC



# FIRST DISTRICT - BOSTON

## SPECIAL DISTRICT REPORT
## ACADEMIC LEVEL

Professors Houthakker, Samuelson, Solow, and Tobin were reached for comment. Houthakker projects growth continuing through 1985 at approximately a 3 percent annual rate. A recession this year is unlikely, but one in 1986 is more likely. The FOMC central tendency forecast for nominal GNP of 7-8 percent may be low because he is concerned that the inflation rate is on the verge of increasing. The anticipated acceleration of inflation is attributable to excessive growth of the monetary aggregates since November last year and an expected decline in the foreign exchange value of the dollar. He suggests the monetary aggregates be brought closer to their target range midpoints. The high value of the dollar could be attributed predominantly to little perceived progress on reducing projected federal budget deficits. Yet once progress is discerned, Houthakker expects a sharp decline in the dollar's value and a rise in interest rates which should not be accommodated by easing monetary policy.

Professor Samuelson foresees real GNP growing around 3.5 to 4 percent over this year, very good for the third year of a U.S. expansion. The target ranges appear to be consistent with sustaining this rate of growth; any further easing would generate only transitory output gains. Moreover, economic conditions in oil, crops, and primary metals markets favor a continued low inflation rate. Monetary policy could become more lenient in the near future as deteriorating conditions in agriculture and real estate erode the "quality of credit" associated with these industries. However, the primary goal of monetary policy should be sustaining economic growth. The Fed should not let exchange rate objectives distract monetary policy from this goal. A substantial depreciation of the dollar resulting from a lower net capital inflow would not be a tragedy.

Professor Solow believes that growth will be stronger in the first half of 1985 compared with the last half, a pattern similar to that of 1984. However, growth should average only 3 percent this year (fourth quarter over fourth quarter), unlike 1984. He expects the sluggish growth of late 1985 to continue into early 1986, suggesting that the unemployment rate may not be much lower in 1986 than it is now. Solow gave high marks to the Fed on the adjustment of monetary policy last year when economic growth slowed. If the growth rate remains below 3 percent for several consecutive quarters, he prescribes some further easing of monetary policy. Moreover, if the dollar depreciates and tends to raise U.S. interest rates, some easing would be appropriate since long-term bond rates are high currently (given the inflation rate). The inflation outlook continues to be favorable. As a long term recommendation, the Fed should stay alert to taking advantage of any opportunity to make monetary policy more lenient if Congress reduces expenditures, raises taxes, or both.

Professor Tobin believes that the inflation rate should remain near 4 percent during 1985 and an acceleration of inflation is unlikely. Although he views the recovery as "looking better" than it did a month ago, the slight decline in the unemployment rate last month suggests that a more "ambitious" monetary policy could be pursued. Growth of the monetary aggregates above the recently established target ranges should be tolerated to sustain economic growth. Such growth in these aggregates, he believes, would tend to lower the foreign exchange value of the dollar, which should be welcomed.

STRICTLY CONFIDENTIAL -- F.R.
CLASS II -- FOMC

FEBRUARY 1985

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from David Jones (Aubrey G. Lanston & Co., Francis Schott (Equitable Life Assurance Society) and Robert Stone (Irving Trust Co.):*

Jones: The U.S. economy has rebounded to a solid but by no means excessive growth path in early 1985. There is good upward momentum in real U.S. domestic demand. Consumers are generally optimistic and they are continuing to increase spending, particularly on autos and other durable goods. But consumers are nevertheless displaying a disinflationary psychology, in waiting for bargains or price discounts before they buy. Business spending on new plant and equipment is likely to moderate somewhat in the first half of 1985. However, there is likely to be an offsetting acceleration in housing activity. Looking further ahead to the final half of 1985, the increasing drag on the economy from a deepening U.S. trade deficit may begin to offset the stimulus from the still-excessive Federal budget deficit. This could result in a growth recession by the final quarter of 1985. On the inflation front, the outlook is for no acceleration in 1985. The outlook is for an uptrend in interest rates between now and mid-year, with the most pronounced increases in longer term rates. Serving to unsettle the bond market will be an accelerating economy, growing uncertainty over the U.S. dollar, and an unsettled Federal budget outlook.

*Their views of course are personal, not institutional.

Mr. Schott: The outlook is excellent for growth in the 3 percent to 4 percent area in 1985. Inflation should remain below 5 percent for the year, although it may well rise in the course of the year. Institutional flows of funds, including strong inflows from abroad, appear adequate to finance business and residential investment requirement at current or modestly rising interest rates over the year. Naturally, the outlook for stable financial markets within Federal Reserve aggregate targets will improve materially with enactment of a substantial Federal deficit reduction package.

Mr. Stone: The market is, I believe, prepared to accept at face value the Chairman's statement that although the Fed has stopped easing it has not tightened. And while the performance of the economy and the aggregates causes uneasiness, these factors do not by themselves explain the very unsettled conditions through which the market has passed. An important cause of that unsettlement, and of the difficulty the market has experienced in finding some sort of stable bottom, is in my view the behavior of the central banks in taking concerted action in the exchange markets and in making statements indicating their preference for a lower dollar. The market is very much aware that a sustained decline in the dollar is likely to be accompanied by a reduction--perhaps of substantial proportions--in foreign-owned portfolios of Treasury securities. Given the unending supply of Treasuries in connection with financing the deficit, the possibility of a significant enlargement of that supply tends to drive buyers to the side-lines. My prescription, therefore, would be for a bit of silence on the part of the central banks.

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SWAP ARRANGEMENTS BETWEEN THE SYSTEM
AND FOREIGN CENTRAL BANKS
March 20, 1985*

Listed below as of March 20, 1985 are the swap arrangements concluded on behalf of the Federal Reserve System with foreign banks.

| Foreign Bank | Amount of Agreement (millions of dollars | Maturity of latest authorized renewal |
|---|---|---|
| Austrian National Bank | 250 | December 3, 1985 |
| National Bank of Belgium | 1,000 | December 17, 1985 |
| Bank of Canada | 2,000 | December 27, 1985 |
| National Bank of Denmark | 250 | December 27, 1985 |
| Bank of England | 3,000 | December 3, 1985 |
| Bank of France | 2,000 | December 27, 1985 |
| German Federal Bank | 6,000 | December 27, 1985 |
| Bank of Italy | 3,000 | December 27, 1985 |
| Bank of Japan | 5,000 | December 3, 1985 |
| Bank of Mexico | 700 | December 3, 1985 |
| Netherlands Bank | 500 | December 27, 1985 |
| Bank of Norway | 250 | December 3, 1985 |
| Bank of Sweden | 300 | December 3, 1985 |
| Swiss National Bank | 4,000 | December 3, 1985 |
| B.I.S. — Swiss francs | 600 | December 3, 1985 |
| — Other currencies 1/ | 1,250 | December 3, 1985 |
| Total | 30,100 | |

* As of March 20, 1985 there were no drawings outstanding.

1/ This reciprocal arrangement provides for swaps of dollars against authorized European currencies other than Swiss francs.