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

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: May 15, 1985

FROM: Nancy Steele

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 Houthakker, Samuelson, and Tobin were available for comment this month. Although Houthakker sees signs of slowing growth due partly to the continuing adjustment of our trade balance to the high value of the dollar, he believes that the Fed should not try to overcome these forces by monetary stimulation. "Monetary policy is sufficiently stimulative, provided the Fed remains within its target range for the money stock." Houthakker believes that progress toward reducing the government deficit is the appropriate policy at this time. The dollar has begun "to trend downward," and a lower deficit should help sustain this trend. In time, a lower foreign exchange value of the dollar will restore adequate GNP growth by increasing the demand for domestically produced goods and services. The trend depreciation rate of the dollar may be about 10 percent. Foreign central banks (if not economic forces) probably will not allow the dollar to fall "precipitously." Houthakker believes a precipitous drop could be dangerous, perhaps causing significant losses or even bankruptcies in banking or financial industries.

Samuelson believes the recent economic news signals slower growth. During the past three quarters real GNP has increased 2.4 percent at an annual rate. According to Samuelson's survey of forecasts, the economy will grow only about 2 or 2.5 percent during the coming three quarters, which is within the definition of a growth recession. Samuelson believes

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that "a good policy shouldn't settle for less than 3 percent growth," given our high unemployment and low capacity utilization rates. If the current budget deliberations lead to a more restrictive fiscal policy during a growth recession, then the need for short-term activism by the Fed is even greater. If we are lucky, an accommodative monetary policy may allow interest rates and the foreign exchange value of the dollar to decline somewhat, eventually fostering the growth of net exports and aggregate demand.

Tobin remarked that a continuation of 3 percent growth, or less, "will not bring the recovery in for a soft landing." Noting that the unemployment and the capacity utilization rates have changed little since last summer, he fears that "the recovery may have already landed short of the runway." To date he has been impressed by the pragmatism that seemed to govern monetary policy. Now that the recovery appears to be faltering, he hopes this pragmatism would take precedence over a "mechanical adherence to monetary targets." There seems to be little risk of excessive growth; moreover, the high rate of unemployment, the low capacity utilization rate, and the low inflation rate indicate that faster growth may be needed to bring the recovery to a satisfactory completion. On the other hand, "a recession would have no therapeutic value for anything that is currently wrong with the economy."

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CLASS II — FOMC

MAY 1985

SECOND DISTRICT — NEW YORK

FINANCIAL REPORT — FINANCIAL PANEL

This month we have comments from David Jones (Aubrey G. Lanston & Co.), James O'Leary (U.S. Trust Co.) and Leonard Santow (Griggs & Santow, Inc.):*

Jones: The U.S. economy appears headed for a pronounced slowing, if not a mild recession that could start in the final quarter of 1985. The uniquely powerful drag on manufacturing activity exerted by the huge U.S. foreign trade deficit is likely to spill over increasingly into the high-tech and services sectors of the economy later in 1985 and in early 1986. Also operating to depress economic activity is likely to be a sharp decline in non-residential construction, particularly office building. Consumer spending is likely to moderate further later in 1985, and in the first half of 1986.

The U.S. dollar could fall sharply at times in the months ahead. This decline will likely reflect a prospective relative weakening in U.S. economic growth, compared with that in major foreign industrial economies. In addition, it can be expected that further Fed easing, aimed at countering U.S. economic weakness (and perhaps also at calming continuing financial jitters), will push U.S. short-term interest rates lower.

O'Leary: Public policy has now to be made in a highly dynamic international framework, with a huge Federal deficit and weaknesses in our domestic financial system. The Federal Reserve is to be commended for having recognized this revolutionary change promptly and for having adopted a more eclectic or pragmatic policy.

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*Their views or course are personal, not institutional.

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Given current economic conditions, it is appropriate for the Fed to be cautiously accommodative. The Fed must also continue to shape its policy from a longer run standpoint. One of its prime objectives must be to help restore a dependable, stable market for long-term fixed-rate bonds and mortgages. It is very important to bring the traditional long-term fixed-income investors back into the market. They have not come back to any large degree, because, despite the drop in the inflation rate, they still fear a return to a much higher inflation rate. Much of this fear is caused, of course, by the huge Federal deficit. Federal Reserve officials have been very constructive in the urgency they have expressed about cutting the deficit. But, the Federal Reserve itself must be perceived as not being content with a 4 percent inflation rate but rather only with the ultimate goal of zero inflation.

Santow: Current monetary policy is quite accommodative by past standards--and appropriately so. Present economic activity is moderate, and while this is likely to persist between now and year-end, the risk of unacceptable weakness is greater than the risk of unacceptable strength. Economic and monetary aggregate growth rates in May and June are likely to overstate underlying strength and, therefore, should be taken with a grain of salt.

Two technical changes in policy should be considered. One is to formally adopt the "tunnel" approach for showing monetary aggregate growth in relation to targets and to use the December-January average as the base period rather than a fourth quarter average since it would be more current. Second is to consider publishing M-1 as a two-week average rather than as a one-week average, but to publish the two-week number three days after the period ends rather than the current ten days. The initial two-week figure would be preliminary and the following Thursday it would be updated.