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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: August 14, 1985

FROM: Nancy Steele

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

Enclosures

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CLASS II - FOMC

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Houthakker and Samuelson were reached for comment. Houthakker sees no merit in the change of the 1985 long-run M1 target, which he regards solely as a way of covering a change of policy. The current policy stance may involve another revision in the targets because the near-term outlook is for continued slow growth. Houthakker believes monetary policy is predicated on a future fall in crude oil prices. If that does not materialize, he fears the inflation rate will be driven higher by faster wage growth and low productivity. To combat this threat, Houthakker advocates a smooth return of M1 to its original target range.

Professor Samuelson urged that movements in the exchange rate be interpreted in a broad economic context. Declines in the dollar in an environment of falling interest rates and a weak economy should be welcomed and abetted by further downward pressure on interest rates. In contrast, a drop in the dollar would be a matter of concern in the context of rising interest rates and a strong economy.

Samuelson argues it would not be prudent to base policy on a rosy forecast. Large increases in domestic final demand, such as occurred in the second quarter, have not been closely associated with large gains in domestic production in the following quarter. In addition, the dogma that there is no reason for a recession so long as inflation behaves is not an automatic conclusion based on some modern version of Say's Law. The argument is instead based on an assumed reaction of the Federal Reserve to economic weakness. It

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took double-digit monetary growth to keep the recent slowdown no worse than a growth recession and "might take as much an overshoot again" to achieve a strong rebound. Samuelson does not, however, recommend "a real activism." Continued double-digit monetary growth may raise credibility problems and kindle fears of inflation. The Fed should, therefore, seek to keep M1 growth within the new target range.

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CLASS II — FOMC

AUGUST 1985

SECOND DISTRICT — NEW YORK

FINANCIAL REPORT — FINANCIAL PANEL

This month we have comments from James J. O'Leary (U.S. Trust Co.), Leonard Santow (Griggs and Santow, Inc.) and Francis Schott (Equitable Life Assurance Society):*

O'Leary: I expect real GNP to expand at a 3 1/2-4 percent rate in the second half and for this rate of expansion to continue in the first half of 1986. The risk is that the rate of expansion may be greater than 4 percent. There are very good reasons for the Fed to "even keel" at this point: (1) M1 has been expanding at a very high rate; (2) The Federal deficit reduction exercise has been grievously disappointing; (3) The danger of a further slide in the dollar; and (4) Total outstanding debt in the U.S. has exploded in recent years.

All this,despite the encouraging low inflation rate,contributes to the conviction of investors that there is an excessive interest rate risk in longer term obligations which explains why real long-term rates remain so high.

Santow: Current Fed policy can be characterized as generous and accommodative, and any disappointment in upcoming economic numbers would not be due to any Fed actions. To tighten would be a mistake because the underlying strength of the economy lacks breadth and it could jeopardize the recovery. Also, while inflation is still a long-run consideration, there does not appear to be any problem, at least over the next several quarters. Looking to the aggregates, M2, M3, and domestic nonfinancial debt are all close enough to target to be acceptable. While M1 continues to grow at an

*Their views of course are personal, not institutional.

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excessive rate, the numbers now seem more palatable and are still being distorted by special factors.

Yet, any movement towards additional ease would also be a mistake. The problems for the Fed, if the dollar weakens from current levels, are much greater than if it strengthens, especially in view of the Fed's limited capability to intervene in the market and the problems that higher interest rates would bring to the domestic economy. Moreover, after the disappointing budget performance by Congress where the best that can now be hoped for is maintaining a $200 billion deficit level through FY-1986, additional easing would give the wrong message to Congress and to the financial markets.

Schott: The economic advance should benefit, with some lag, from lower interest rates and dollar depreciation. Ample institutional credit supplies are available, especially in the 5-10-year maturity area.

Foreign investor confidence is fragile. Long-term direct investment in the United States is likely to remain strong, but portfolio flows could be discouraged by further rapid exchange rate decline.