Authorized for public release by the FOMC Secretariat on 8/2/2022

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

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: September 25, 1985

FROM: Nancy Steele

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

Enclosures

Authorized for public release by the FOMC Secretariat on 8/2/2022

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT ACADEMIC LEVEL

Professors Houthakker and Tobin were reached for comment. Houthakker predicts that real economic growth will remain sluggish in the second half of 1985, real GNP rising at a 2-1/2 to 3 percent annual rate. In the absence of much action to curb the budget deficit, U.S. economic growth will continue to be weak in 1986. Houthakker was encouraged by the August decline in producer prices and consequently attaches a lower probability than previously to a resurgence of inflation in the near future. He did not attach much significance to the July decline in the merchandise trade deficit nor does he expect much improvement in that balance this year because the depreciation of the dollar in foreign exchange markets in spring and summer should not have much impact until next year. He expects little further depreciation of the dollar this year because he does not anticipate much progress this year on reducing the Federal budget deficit. Despite the good news on inflation, he recommends bringing M1 growth within its new target range; he attaches little policy importance to M2 and M3 which have grown more modestly.

Professor Tobin praised both the decision to rebase the M1 target range and the increased attention being given to movements in velocity. Since the decline in interest rates may have encouraged an increase in the nontransactions component of M1, the inflation rate and the rate of change of nominal GNP deserve greater attention in setting monetary policy. With

Authorized for public release by the FOMC Secretariat on 8/2/2022

the unemployment rate hovering at 7 percent -- which he considers above the natural rate -- and no evidence of bottlenecks, the Federal Reserve has room for a further easing of monetary policy and a reduction in the federal funds rate to spur growth in real GNP. Moreover, an accompanying depreciation of the foreign exchange value of the dollar should not only be welcomed, but also helped along. He added that a lack of further progress this year on reducing the budget deficit should not be regarded as an obstacle to a further easing of monetary policy given the present levels of the unemployment and capacity utilization rates.

Authorized for public release by the FOMC Secretariat on 8/2/2022

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

OCTOBER 1985

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Donald B. Riefler (Morgan Guaranty Trust Company), Robert Stone (Irving Trust Company) and Albert Wojnilower (First Boston Corporation):*

Riefler: This economic recovery continues to be characterized by an increasing number of credit problems. As long as the trend persists there is little room for the Fed to tighten monetary policy.

On the other hand, the high level of both the dollar and real interest rates would seem to give the Fed leeway to ease if conditions worsen. This fragile economy has shown modest signs of strength, in the most recent figures, so policy can remain unchanged for the immediate future.

Stone: What view should one take of the behavior of M1? The market takes the pragmatic view that it is important to accord M1 top priority in some circumstances and low (or no) priority in others. Such relationship between money and income as may have existed in the past do not seem to have survived such environmental changes as deregulation and the interest rate experience of 1979-82, at least over time periods relevant for policy formulation.

So what is the usefulness, if any, of M1? The market has a very short memory for most things and a very long memory for a few. Among the latter is the vivid recollection of the effectiveness of money targeting in

---

*Their views of course are personal, not institutional.

Authorized for public release by the FOMC Secretariat on 8/2/2022

bringing inflation down and in producing the high interest rates that were an essential part of that process. The market retained a healthy respect for the Fed's willingness and ability to focus on M1 again when and if the need should arise.

Accordingly, I think there is little risk in de-emphasizing M1. In my view, policy should continue to be focused on the performance of the economy and should remain about where it is until new and better evidence emerges as to just where the economy is headed.

Wojnilower: Soundings with retail chains indicate that August sales were strong, even after allowance for changes in the calendar and last year's weakness, and that the strength has existed into September. Reports from the electronic sector, including semiconductors, suggest that a bottoming may have occurred. All in all, inventories appear to be down to desired levels. In conjunction with the rapid monetary growth, this suggests that a potentially rather sizable quickening of business activity has begun.

Authorized for public release by the FOMC Secretariat on 8/2/2022

CONFIDENTIAL (F.R.)
CLASS III FOMC

September, 1985

FOURTH DISTRICT - CLEVELAND

SPECIAL DISTRICT REPORT
ON ROUNDTABLE MEETING

Summary.

Economists from major corporations and banks who attended the September 13 meeting of the Fourth District Economists Roundtable at this Bank expect the pace of real economic growth to accelerate in the second half and then trend down next year. Unemployment is expected to be flat through the period while inflation accelerates. Interest rates are expected to rise 50 to 60 basis points over the course of 1986. Consumer prospects remain good for 1986, but weaker than in 1985. The group prefers money growth to be slower than it has been, and there was general concern among participants that monetary policy might be becoming an engine of inflation.

The Economy.

The median of 21 forecasts expects growth of real GNP to accelerate to a 3.2% a.r. in the second half of 1985 and then slow to 2.6% in next year's first half and 2.2% in the second half. This outlook is relatively unchanged from the group's median forecast made in May 1985. The median forecast is for 1986 to be weaker than 1985 in personal consumption expenditure, non-residential fixed investment, and government purchases, but stronger in net exports and inventory investment. Residential construction is expected to remain flat. Overall, growth (IVQ/IVQ) would be 2.1% in 1985 and 2.4% in 1986. The unemployment rate is expected to average 7.3% in 1985 and in 1986.

Authorized for public release by the FOMC Secretariat on 8/2/2022

One participant forecasts growth in output in a range of 3% to 3 1/2% for several quarters. He expects strengthening in economic activity because he believes monetary policy is growth oriented, the declining dollar will reduce deterioration of net exports, and the inventory correction has run its course and the current rate of inventory accumulation is below a sustainable level. He cites drag on economic growth coming from some move toward fiscal restraint, overextension of commercial and multi-family construction, completion of plant and equipment spending's big push for this expansion, absence of pent up consumer demand, and the presence of high consumer debt.

Another participant noted the apparent inconsistency of forecasters who acknowledge important financial problems in farms, thrifts, nonfinancial corporations, and developing nations but continue to forecast steady economic growth.

Consumer Prospects

A financial economist judges that the household debt burden is not excessive and is relatively less than that of nonfinancial corporations, and concludes that consumer spending is more likely to be constrained by employment and income growth than by debt level. He noted that rapid growth in revolving credit for convenience has inflated the installment debt-to-income ratio. Another economist expects consumer spending to show strength because surveys show buying intentions are very strong, the median age of automobiles is the highest in years, and the consumer debt to liquid assets ratio is satisfactory.

Authorized for public release by the FOMC Secretariat on 8/2/2022

Inflation.

The group's median forecast is for the GNP implicit price deflator to accelerate from 3.8% in 1985 (IVQ/IVQ) to 4.3% in 1986. The consumer price index is forecast to accelerate from 3.6% in 1985 to 4.5% in 1986. One participant expects that inflation will remain in check for 12 to 18 more months because agricultural output is large, oil prices may decline, and strong import competition continues.

Interest Rates.

The group expects the prime rate to average 9.5% in the second half of 1985 and 10.2% in 1986. They see Moody's AAA corporate bond rate at 11.2% in the second half and 11.5% next year.

Policy.

The group's preference is for M1 growth between 5 1/2% and 8% in the second half of 1985 but they expect it to exceed 8%. For 1986 they would prefer M1 to grow between 5% and 8%. The group expects the federal deficit to fall to about a $190 billion to $200 billion range in FY 1986.

A bank economist asserted that the System had no choice except to accommodate rapid growth of M1 given that the economy is sluggish, inflation is low, velocity is negative, and the financial system is somewhat fragile. Nevertheless, he expressed concern that the System will not be willing to tighten later when it becomes necessary and inflation will again be a serious problem in 1987. Another bank economist says the major risk is that monetary policy will again become pro-cyclical.