BOARD OF GOVERNORS
OF THE
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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: October 30, 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

Professors Samuelson and Tobin were available for comment this month. Samuelson notes that in contrast to the third quarter when a consensus correctly anticipated real growth slightly above 3 percent, forecasters do not yet agree whether the economy is gaining or losing momentum. Despite the uncertainties created by auto promotions and federal agricultural purchases, Samuelson's reading of final sales in the third quarter suggest that growth should remain about the same for the remainder of 1985. Contrary to some forecasts, however, he does not see any grounds for "expecting 1986 to be a whole year of pickup, following the period of weak growth from mid-1984 to 1985. The best thing going for 1986 is a good outlook for inflation: there should be no supply bottlenecks or surges in the unit cost of output. As a result, the Fed has room to maneuver." Samuelson believes that maintaining 7 percent unemployment is "unsatisfactory" and that it would be "defeatist" to aim for less than 3 percent growth. He is "apprehensive about the consequences of tightening monetary policy to achieve the upper zone of monetary targets, unless the economy shows strength." We may also have to tolerate above-target money stocks given our stated intention to reduce the value of the dollar. Only if nonmonetary forces produce an unexpected boom in 1986 would allowing above-target money growth be risky.

Tobin believes that "the Fed should worry more about the economy rather than M1. The unemployment rate has changed little during the past 15 months and GNP is falling behind the projections of the FOMC reported in July. To the extent these projections reflected the intent of policymakers, the high rate of unemployment and surprisingly low rate of inflation would seem to allow monetary policy to resume the strategy of gradually lowering unemployment as long as there is little risk of rising inflation." Tobin notes that the increase in disposable income that would accompany a one percentage point reduction in the unemployment rate would bring a large increase in savings and investment. He also observed that "the campaign of the Group of Five to lower the exchange value of the dollar would warrant lower interest rates in the United States, unless the fires of aggregate demand threaten to overheat the economy. History tells us there is not much hope for sterilized intervention, so to be successful the Fed should undertake unsterilized purchases."

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

NOVEMBER 1985

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from David Jones (Aubrey G. Lanston & Co.,), James J. O'Leary (U.S. Trust Co.,) and Francis Schott (Equitable Life Assurance Society):*

Jones: For the third year of a recovery, the U.S. economy is remarkably free of imbalances and there is no immediate threat of a near-term renewal in inflationary pressures. However, there are grounds for expecting that the best news on subdued inflationary pressures may be behind us. (1) The Fed is in fact almost fully monetizing the Federal deficit. (2) After a brief pause, the U.S. dollar is likely to decline another 10-15 percent in the first half of next year. (3) This further weakening in the dollar is likely to eventually cause increased inflationary psychology, rising import prices and a pickup in consumer prices.

The U.S. trade deficit could decline by as much as \$50-\$60 billion over the next two years. This would mean a boost from the foreign trade sector for the U.S. economy. However, the U.S. economic performance in 1986 and perhaps 1987 is likely to consist of relatively more inflation and relatively less real growth than we have become accustomed to in the first three years of expansion. Moreover, interest rates could remain higher than otherwise would be the case unless the expected drop off in the inflow of foreign capital (corresponding to the decline in the trade deficit) is countered by an equivalent decline in the Federal budget deficit.

O'Leary: The monetary authorities now have the most difficult task in the history of the Federal Reserve System. The inflation rate has been

*Their views of course are personal, not institutional.

brought down to the lowest level that can be achieved safely without causing a spreading of dangerous deflationary forces. The Fed must not abandon the objective of wringing inflation completely out of our system, but it must recognize that under today's conditions it could be disastrous to continue to push too hard. The emphasis of policy should now shift to correcting the excesses which have spread through our credit system. We need a centralized and effective system of regulation and supervision of all lending institutions.

In just the past seven years the total outstanding debt in the U.S. (public and private) has more than doubled. The rate of expansion of debt (or credit) is continuing this year in spite of the slower economy. There is abundant evidence that overly aggressive lending and slipshod credit quality standards have contributed to the very high growth rate. The lending institutions in their insatiable urge for growth have played a key role in the credit excesses, especially the thrifts. The removal of interest rate ceilings may have been a colossal mistake and the Fed should take the leadership in re-examining the issue. It has certainly been a factor in the high rate of private credit expansion. The massive use of credit to finance mergers and acquisitions is outrageous and needs to be brought under control. This is something the Fed can deal with in part by applying strict credit standards.

Schott: Recent money supply developments should not hide the reality of weakness in certain key economic sectors. For example, large office building construction is likely to experience far fewer starts in 1986 than in 1984-85 because of widespread oversupply. The present stance of monetary policy and the modest decline of the dollar are likely to support a real GNP advance of only 2 1/2-3 percent until mid-1986 and perhaps beyond. However, the need to restore debt disciplines in a noninflationary environment suggest that "hanging tough" may be the most appropriate policy.