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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: February 5, 1986

FROM: Nancy M. Steele

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

Enclosures

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FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Feldstein, Houthakker, and Samuelson were reached for comment. Professor Feldstein expects the economy to grow 3 to 4 percent this year. With labor compensation increases low and oil prices declining, he predicts that the inflation rate in 1986 will not exceed last year's rate. He considers the tentative 1986 monetary aggregates growth rate ranges appropriate. Despite M1 growing above target in 1985, the existence of an M1 range benefits Fed credibility. Moreover, he suggests that M1 again be allowed to drift upward to maintain a desired rate of growth of nominal GNP. In light of significant potential reductions in the budget deficit, lower interest rates are preferable. However, he believes the Fed does not have to respond too strongly to budget cuts except if potentially contractionary tax reform legislation passes. He favors a continued decline in the foreign exchange value of the dollar, but not as a result of an active monetary policy.

Professor Houthakker predicts that the economy will grow between 3 and 3.5 percent next year and considers faster growth unlikely. Little evidence suggests that inflation will accelerate this year, given moderate compensation increases; he places little weight on recent food and energy price increases. With the present weakness in the oil market, inflation may even be lower in 1986 than in 1985. Consequently, room exists for lower U.S. interest rates, especially if led by foreign central banks. Such a decline would be consistent with the tentative ranges for M2

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and M3 growth, which he considers appropriate. However, with more deregulation this past January, he recommends a temporary suspension of the M1 target range. Houthakker is opposed to any significant loosening of monetary policy to offset the contractionary impacts of the Gramm-Rudman-Hollings legislation. He believes that a tax increase is very possible in the near future.

Professor Samuelson predicts that real economic growth in 1986 will be closer to 3 percent than to 2 percent, but he could not completely rule out 4 percent growth. His views were based partly on strong performances at the end of last year in retail sales, industrial production, housing starts, and disposable income. He believes this growth outlook is consistent with low inflation, perhaps rising to about 4.5 percent next year. This view takes into account the decline in oil prices, for which he sees the benefits clearly exceeding potential isolated costs. Given this forecast of inflation, he finds present monetary policy acceptable. Without any evidence of sluggish economic activity, the present level of interest rates seems appropriate. Any further drop in the foreign exchange value of the dollar should be welcomed; moreover, it should not be a reason to tighten monetary policy. As an aside, Samuelson noted that there was significant danger in having the Fed follow a commodity-price standard because of the vacillation in output that would be required to attain the price path.

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CLASS II - FOMC

FEBRUARY 1986

SECOND DISTRICT — NEW YORK

FINANCIAL REPORT — FINANCIAL PANEL

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

Kaufman: As the next few months unfold, expectations should strengthen that the American economic expansion will not terminate this year. Real growth from fourth quarter 1985 to fourth quarter 1986 will probably be in the range of 3 1/2 - 4 percent while inflation will be muted in the first half and tilting up somewhat in the second half. The credit market setting is conducive to economic expansion. Interest rates are considerably lower than a year ago; quality yield spreads are quite narrow; and institutional availability of funds is exceedingly good. Expectations will continue to play an important role in financial market behavior. The focus of market attention will be on the expected pace of inflation (which for the near term should be quite muted), the unity of views supporting Federal Reserve decisions, and the progress made in enforcing the Gramm, Rudman, Hollings legislation.

O'Leary: My view is that Federal Reserve policy should remain on an "even keel" until more evidence is available on the state of the economy. The very high rate of increase in both M1 and the adjusted monetary base, as well as signs of a pickup in business, suggest that further easing is out of the question, at least for the present, and that the next move may very well be toward a less accommodative policy.

It seems clear that Fed policy this year must be particularly vigilant about disorderly changes in foreign investment in U.S. markets. As we look to

*Their views of course are personal, not institutional.

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the future, the conditions which have favored foreign investment in our credit markets have undergone great change. The prospects for total return to foreigners on investment in U.S. Government bonds and U.S. corporate bonds have dampened considerably. If the dollar declines somewhat more, and if interest rates remain at near present levels or even rise somewhat, the prospects are that total return to foreign investors in our credit markets will be only a small fraction of the handsome return they have been accustomed to receiving. This will not only discourage new investments here. With large unrealized capital gains on their holdings, sophisticated foreign investors may do quite a bit of profit-taking, especially on long-term bonds.

Accordingly, it seems clear that in the current foreign investment climate, the Fed must be even more sensitive than ever that its policy be consistent with encouraging orderly conditions in the foreign flow of funds into and out of our markets. This objective, as well as the goals of maintaining high domestic employment and stability of our price level, can--in my view--be best served for the present by an "even keel" policy.

Schott: Moderate expansion at about 3 percent real GNP growth is likely for 1986. Inventory investment and the trade balance should improve during the year. Tax reform legislation and the Gramm-Rudman implementation, although given perhaps a 50 percent chance each in the financial markets, are still only small factors in business decisions affecting the real economy.

Current economic activity and the pace of money and credit expansion suggest the desirability of at least the present level of Federal Reserve restraint. However, the collapse of the oil price is distinctly dangerous to Mexico, Nigeria, several other friendly LDCs and to certain domestic financial institutions. The oil price may well go to $15 before stabilizing at around $18-20 in a year or two. Selective Federal Reserve action internationally and domestically to ease the transition strain may become a necessity. In addition, a slightly easier tone in Federal Reserve policy might be appropriate to provide reassurance.

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CLASS III FOMC

January, 1986

FOURTH DISTRICT - CLEVELAND

SPECIAL DISTRICT REPORT
ON ROUNDTABLE MEETING

Summary.

Economists from major corporations and financial institutions who attended the January 17 meeting of the Fourth District Economists Roundtable at this Bank expect the pace of real economic growth to accelerate in 1986 and the first half of 1987. The unemployment rate is expected to fall very slightly while inflation accelerates. Short-term interest rates are expected to be flat while long rates rise. Consumer spending will grow in 1986 but less rapidly than in 1985. The group is very pessimistic about the likelihood of significant reduction of federal budget deficits.

The Economy.

The median of 21 forecasts submitted by participants shows growth of real GNP accelerating from an expected 2.7% in 1985 (IVQ/IVQ) to 3.0% in 1986 and 3.3% in the first half of 1987. This forecast is substantially more optimistic than the group's median forecast made in September 1985, when growth rates of 2.1% in 1985 and 2.4% in 1986 were expected. The latest median forecast shows growth of 2.7% (saar) in 1986:IQ and 3.0% in each of the remaining quarters of the year. The median forecast is for performance in 1986 compared to 1985 to be better for residential construction, business inventories, and net exports (smaller decline) and not as good for personal consumption expenditures, non-residential fixed

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investment, and government purchases. Only two of 21 forecasters now expect a recession in the period through 1987:IIQ, beginning in either 1986:IIIQ or 1986:IVQ. Thus, the group is much more optimistic than it was at the September meeting, when six forecasters had expected a recession in 1986. The improvement in outlook is exemplified by the forecast of a big-three auto manufacturer, who last September saw many risks to the economy and expected three negative quarters in 1986 but now expects continued slow growth. The group expects the unemployment rate to average 7.0% in 1985, 6.9% in 1986 and 6.8% in 1987:IH.

Consumer Spending.

The median forecast of the group expects real personal consumption expenditures to increase 2.4% in 1986 (year/year) compared to an expected 3.2% in 1985. The group expects the personal savings rate to rise slowly throughout the forecast period and average 4.2% in 1986 and 4.5% in the first half of 1987. One participant asserted that consumer debt is still not a constraint that will curb consumer spending. Another noted that a major automobile financing institution reports no indications that consumers are having any problems servicing their debts.

Industrial Production.

The index of industrial production is expected to accelerate throughout 1986, rising 2.6% (ar) in the first quarter and 3.5% in the fourth quarter, and then leveling off at 3.4% in 1987:IH.

The median forecast of six major car and truck producers and parts suppliers shows domestic production of cars by U.S. manufacturers falling from 8.2 million vehicles in 1985 to 7.3 million in 1986. They expect

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domestic truck production to fall from 3.46 million units in 1985 to 3.22 million in 1986. Despite high inventories, car production schedules have not been reduced except marginally, and probably won't be reduced before the current round of sales incentives ends on February 22.

The farm machinery industry is currently producing at about 30% of capacity as firms are slowly working down inventories that are more than three times as high as producers desire for the current rate of sales. Sales in 1985 were only 45% of their 1979 peak and currently are at 30%-40% of production capacity.

Inflation.

The group's median forecast is for the GNP implicit price deflator to accelerate from an increase of 3.0% in 1985 (IVQ/IVQ) to an increase of 3.9% in 1986 and 4.3% in 1987:IH. Similarly, they expect the consumer price index to accelerate from a 3.5% pace in 1985 (IVQ/IVQ) to 3.9% in 1986 and 4.8% in 1987:IH. Several participants in the meeting commented on the favorable price impacts from falling prices of oil and other commodities and the absence so far of much price increase impact from dollar depreciation. A bank economist commented that the inflationary impact of rapid M1 growth was moderated in 1985 by effects of previous dollar appreciation but in 1986 the effect of past dollar depreciation may augment the inflationary impact of rapid M1 growth. He also noted that the quarterly average level of M1 has not been rising rapidly for a long enough period to provide assurance that such a pace of M1 growth no longer carries a strong risk of inflation.

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Interest Rates.

The group expects the prime rate to remain at 9.5% at least through mid-1987. They see Moody's AAA corporate bond rate at 10.1% in the first three quarters of 1986, and then rising to 10.5% by early 1987. One participant noted that, so far, the financial markets seem to be assuming Congress will meet the requirements of Gramm-Rudman. But if Congress evades or softens Gramm-Rudman targets, interest rates will rise.

Policy.

For M1 growth in 1986, 44% of the group prefer a rate below 7% and 56% prefer a rate above 7%; 60% expect actual growth to exceed 7%. All participants prefer M2 growth in a 6%-9% range and 90% expect actual growth in that range. The group's federal deficit forecasts for FY 1986 center on a range of $180 billion to $200 billion. For FY 1987, the forecasts center on a range of $160 billion-$180 billion; only 15% of the group expect the FY 1987 deficit to be in the range required by Gramm-Rudman. These forecasts were made after enactment of Gramm-Rudman but before the CBO and OMB released their January estimates of the FY 1986 deficit. Comments at the meeting suggested extreme skepticism about the prospects for achieving Gramm-Rudman targets in FY 1987 and beyond.