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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: March 26, 1986

FROM: Nancy M. 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 LEVEL

Professors Houthakker, Solow, and Tobin were available for comment this month. Houthakker believes that real growth will average about 3.5 percent this year and that inflation will average between 2 and 3 percent. Due mainly to weak productivity this year, inflation could rise to 5 percent in 1987. As a result, he believes that the Fed should not allow the monetary aggregates to grow too rapidly. Because we don't yet know how to interpret the behavior of M1 (and perhaps M2), M3 should be held within its target. Houthakker would be concerned to see the dollar decline any further. The Fed should continue to negotiate a coordination of policy with our trading partners so that we might continue to achieve our M3 targets without aggravating cyclical changes in exchange rates.

Solow believes that the recent decline in oil prices should foster economic growth this year. As a result, there is a good chance that monetary policy need contribute little or no additional stimulus for now. If, however, the lack of business inventory investment or federal government budget cuts threaten to impair growth later this year, then monetary policy may need to stimulate domestic spending. Eventually, the fall in foreign exchange the value of the dollar should foster the growth of GNP through net exports.

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Although the decline in the dollar may increase prices, it is a small price to pay for improving trade and for sustaining the recovery. Solow would welcome another 20 percent decline in the dollar, if it should occur, because with the degree of slack in the economy there would be no tendency for inflation to gather momentum.

Tobin is pleased by the recent reduction in the discount rate. Noting the relatively high rates of unemployment and of excess capacity, he believes that monetary policy should continue to foster a full recovery with all deliberate speed as long as there is no evidence rising inflation originating from domestic sources. The Fed should not defend the dollar in order to prevent a falling exchange rate from contributing to higher prices. When the dollar rose sharply, we "borrowed" an element of low inflation from our trading partners. With our current degree of economic slack, this would be as good a time as any to repay that "loan". Any further declines in the dollar would foster demand for our products at a time when the risk of igniting cumulative inflationary pressures is still very low.

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APRIL 1986

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from David Jones (Aubrey G. Lanston & Company), Leonard J. Santow (Griggs and Santow, Inc.) and Robert Stone (Irving Trust Company):*

Jones: Although the economy came close to floundering under the weight of a massive trade deficit last year, there are currently a unique set of powerful expansionary forces at work that are likely to fuel a sharp acceleration in economic activity in the last half of 1986 and the first half of 1987. While the fortuitous plunge in oil prices is likely to keep consumer price inflation low at 2-3 percent in this fourth year of economic expansion, it could have the not-so-desirable effect of lulling monetary policymakers into a false sense of security causing them to be unprepared to counter a potential surge to a 4-5 percent rate of increase in consumer prices next year. This increase in inflationary pressures will reflect a likely surge in GNP growth far in excess of its longer term growth potential, as well as an earlier pronounced decline in the dollar. In sum, real GNP growth is expected to advance at a moderate 2 1/2 percent pace in the first half of 1986. However, real GNP growth is likely to accelerate sharply to 4-4 1/2 percent in the second half of this year and could accelerate even further to a hefty 5-5 1/2 percent pace in the first half of 1987.

The expansion is getting a second wind from a powerful threesome: a sharp decline in oil prices; a precipitous decline in longer term interest rates; and the delayed impact of a declining dollar in stimulating exports, already evident in the paper industry. Only two factors seem likely to operate in the

*Their views of course are personal, not institutional.

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opposite direction to depress economic activity: prospective Gramm-Rudman budget cuts, though their precise nature remains uncertain; and curtailed business plant and equipment spending, reflecting not only weakness in the energy and mining sectors but also the uncertainties created by prospective tax reform legislation.

Santow: The economy is not as weak as the January and February data suggest or as strong as the December figures indicated. The March and April numbers are likely to substantiate this view. Moreover, the lagged impact from recent Fed easing and generosity will not show up in a noticeable way until the second half of the year. The budget deficit continues to run at a $200 billion annual level and the improvement for fiscal year 1987 is likely to be modest. Finally, the growth in the monetary aggregates in January and February is not indicative of growth rates in upcoming months and the advance in March and April should be noticeably stronger across the board.

Stone: Much has happened recently in the international economic arena and the Fed has made an important contribution to those events. There is no compelling case to be made for the Fed to take further actions at this time. The objective is sustainable growth with minimum inflation. It is now time to pause for a while and read the evidence to see whether developments are unfolding in a manner consistent with that objective.