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

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: May 14, 1986

FROM: Normand Bernard NB

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 PANEL

Professors Solow, Samuelson, Feldstein, and Houthakker were available for comment this month. Professor Solow expects real growth in GNP of 2.5-3 percent over the next four quarters, provided that there are no dramatic changes in oil prices or the value of the dollar. He feels that there is little danger of a "free fall" in the dollar, but that the dollar should depreciate a little further. The drop in the dollar should improve the balance of trade over the next 12-18 months, but is unlikely to cause a serious increase in inflation. While there is no need for substantial changes in monetary policy, he feels that both the real rate of interest and the unemployment rate may be too high. If there is continued fiscal tightening, some easing of monetary policy might be needed in the future.

Professor Samuelson sees continued improvement in real GNP, with real GNP growth expected to be in the 3-4 percent range for the rest of the year. He feels that we have not yet turned the corner of the J-curve in the trade balance, but that the drop in the exchange rate and improved growth abroad will improve the balance of trade over time. Any further drop in the dollar would provide further long-run improvements in the trade balance, and should be welcomed. Despite some sluggishness in domestic sales, the Federal Reserve need not attempt to reduce interest rates.

Professor Houthakker believes that real GNP growth will continue to be unimpressive due to a less rapid expansion of consumer spending. While he is surprised at how slowly the trade balance is adjusting, he expects that there will be substantial improvement by the end of 1986. There is no immediate need to ease monetary policy; however, with further fiscal tightening some future easing may be appropriate. Without a coordinated policy with our trading partners, it would be premature to lower the discount rate at this time.

Professor Feldstein feels that the economy will pick up in the second half of the year without further easing by the Federal Reserve. Because there is no short-term concern for inflation, this is a good time for further declines in the dollar. No change in current policy seems necessary.

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CLASS II - FOMC

MAY 1986

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Donald B. Riefler (Morgan Guaranty Trust Company), Leonard J. Santow (Griggs and Santow, Inc.) and Francis Schott (Equitable Life Assurance Society):*

Riefler: Recent economic indicators both domestic and overseas seem sluggish. The bond market has dropped in reaction both to its earlier strength and to the rise in oil prices. The strength in foreign currencies will eventually encourage their authorities to ease and meanwhile the Fed should keep policy about the way it has been.

Santow: "Pushing on a string" may aptly describe current Fed policy. The disappointment in the economic numbers is not due to Fed policy because policy is quite stimulative. Rather it is due to problems in energy and agriculture, uncertainties over taxes and tax reform, over-building and overcapacity in some industries, burdensome debt for many individuals, and inability to date to turn around the foreign trade picture. Thus, near-term benefits from additional easing are likely to be disappointing until the non-monetary factors previously mentioned begin to turn more positive. While this is likely to happen some time in the second half of the year, there is no evidence to indicate when it will occur.

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*Their views of course are personal, not institutional.

Schott: The lagged effects of lower oil prices, interest rates and dollar exchange rates will have a strongly positive effect on real GNP by the second half of the year. The first half, including the second quarter, is likely to be on the weak side.

Federal Reserve policy has already greatly facilitated the likely strengthening of the expansion. It is important not to precipitate a sudden external rout of the dollar.