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

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: July 2, 1986

FROM: Rosemary R. Loney RRL

Attached are special reports from the Boston and New York Banks summarizing the views of outside economists about the economic outlook.

Attachments

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Samuelson and Tobin were available for comment this month. Professor Samuelson expects the present growth recession to continue into the second half of this year with real GNP growing at a 2.5 to 3.0 percent annual rate. He feels the unemployment rate will not decline in the last half with such growth and may rise. The recent decline in housing starts raises concern that the gains from this past spring's interest rate declines have been exhausted. Another month of bearish economic news suggests the need for further easing. Moreover, the Fed need not err on the side of restrictiveness because of recent rapid growth in the monetary aggregates or for fear of a sharp decline in the foreign-exchange value of the dollar. Rapid monetary aggregate growth reflects high relative yields on these assets over their alternatives. And a precipitous decline in the dollar's value is not likely; even if such a decline did occur, it would not be a tragedy.

Professor Tobin indicated that further interest rate cuts are warranted in light of continued stagnation in the economy. He feels the consensus forecast of 2.5 to 3.0 percent real growth is not sufficient to reduce the current unemployment rate, which he considers above the natural unemployment rate. He expressed skepticism that consumer gains from the sharp decline in the price of oil will offset reductions in investment and output in the domestic oil industry. The reductions in domestic interest rates are needed with or without interest rate cuts abroad. A decline in the foreign-exchange value of the dollar expected to be associated with a unilateral U.S. interest rate cut should even be welcomed; Tobin attached a low probability to a freefall in the dollar's value with such a policy move.

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

JULY 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 Albert Wojnilower (First Boston Corp.):*

Kaufman: Strong economic growth will not assert itself in the second half of the year. Support for the economy will come mainly from consumption while new housing activity will plateau at current levels. In contrast, exports will be retarded by the absence of strong economic recoveries abroad; capital outlays by business will decline; and inventory pruning will remain a priority in business decisions. The proposed tax reform legislation will also contribute to initial uncertainty in business spending.

Against this backdrop, the financial markets will continue to display a high degree of volatility and sensitivity to near-term developments, with fundamentals and additional monetary accommodation supporting some further declines in interest rates that will be supported by additional monetary accommodation. Most importantly, it seems that the external financing needs of business corporations will continue to be exceedingly modest. Business open market financing will, therefore, be confined to the restructuring of liabilities. Municipal financing will again be large through the end of the year in view of the tax reform legislation. U.S. Treasury financing will remain the pacesetter in the second half of the year with considerable focus remaining on the participation of the Japanese in this market.

O'Leary: In spite of an aggressively easy monetary policy this year and an impressive decline of interest rates, the overall expansion of the

*Their views of course are personal, not institutional.

U.S. economy as measured by real GNP, industrial production, and employment remains quite disappointing. Weakness in the oil sector, along with the trade deficit, continues to keep the overall economic indicators looking lackluster. Given the current situation, it is difficult to argue against a further move by the Federal Reserve toward lower interest rates. At the same time, it is doubtful that still easier credit and lower rates will do much to stimulate general business activity.

Aside from the disappointing response of the overall economy to ready availability of credit and a pronounced decline of rates, the lower rates are helping greatly to reduce the burden of carrying the mountain of debt which has been built up in the past several years, and they have aided greatly to restore many financial institutions to a healthier position as well as to reduce the carrying cost of LDC debt. Although risks to the dollar must be taken into account, my best judgment is that a further moderate move by the Fed toward lower rates is now in order. Hopefully during the second half we shall see real progress toward whittling the trade deficit as well as encouraging progress toward a reduced Federal deficit and a healthy rate of general economic expansion.

Wojnilower: Faster growth in the U.S. economy is unlikely until the weaknesses in energy, defense, autos, and tax reform affected industries are more fully absorbed, which may take until late this year or even longer.

Recent bond price behavior reveals no middle grounds for Federal Reserve System policy or the market. As long as our implicit G-5 commitment not to raise short-term rates is perceived as wholehearted, long rates hover narrowly above short rates. Whenever the commitment is in doubt, long rates run up.