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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

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Enclosed are the greenbook and supplementary information prepared at the Federal Reserve Banks of New York and Boston. Also enclosed is a summary, prepared at the Federal Reserve Bank of Boston, of special reports from each of the Reserve Banks on the "Effects of Dollar Depreciation."

Enclosures

National Summary

Special Report on the Impact of the Dollar Depreciation

In contrast to the situation in January 1986 when all Districts reported little, if any, impact from the dollar depreciation, most now indicate that the dollar's decline against the major OECD currencies has had at least a limited effect on businesses in their areas. The depreciation appears to have had a larger impact on exports than on import competition. Almost all Districts can point to several industries that have experienced an increase in export activity. By contrast, only half the Districts supplied examples of industries where import competition has been curtailed, and most import-competing firms are said to have felt little reduction in pressure from abroad. One major reason for this result is competition from suppliers in countries where the currency has not appreciated against the dollar.

Manufacturers and retailers in most Districts report mixed experiences with import prices. It is clear, however, that price increases for European and Japanese goods rarely reflect the dollar depreciation in full. Continuing domestic and foreign competition has prevented most U.S. manufacturers from passing import price increases on to their customers, although retailers have reportedly felt somewhat freer to do so.

Few manufacturers are shifting production back to the United States. Long-term commitments to foreign suppliers, the need for a local presence in some foreign markets, and the continued low costs in some less developed countries were among the explanations.

Respondents in over half the Districts expect some intensification of the effects of the dollar depreciation.

Exports

Except in the St. Louis, Atlanta and Kansas City Districts, manufacturers were generally able to report some increase in export activity. In the Cleveland District, the pickup was relatively recent and took the form of a growing number of inquiries from overseas customers. In several other areas increases were limited to a few industries. However, in Chicago and Dallas the increases, though generally modest, were broadly based, while in New York and Boston a majority of the firms contacted reported export gains ranging from slight to substantial. In the New York District, manufacturers of chemicals, toys and paper reported that export sales rose 15 percent or more in value, while producers of ball bearings, metal containers, photographic supplies and meat products experienced more moderate increases. Demand for U.S. exports strengthened primarily in Europe and Central America and in South Korean, Taiwanese or East European markets previously served by Japanese or German firms. New York and San Francisco District firms succeeded in exporting toys and agricultural products respectively to Japan.

So far, these export gains have had little effect on production and employment. Only in the case of New York and San Francisco District paper manufacturers has an increase in exports clearly led to an increase in production. No additional employment was involved, however, because of productivity gains at these firms.

Import Competition

Examples of decreased import competition were much more limited. Boston reported decreased import pressure in nonelectrical machinery, while Chicago noted lessened competition in paperboard and tourism, Cleveland in instruments from France and Germany, and San Francisco in bulk wine grapes. On the whole, however, manufacturers did not find that import pressure had declined significantly.

Respondents offered several reasons why imports had remained strong. As the Cleveland Bank points out, many importers prefer to establish long-term relationships with their foreign suppliers on the basis of quality, delivery, and service, with price a secondary consideration. In addition, long-term contracts and government subsidies may have helped to keep some import prices down. According to many respondents, however, the primary explanation for continued import pressure is the presence of suppliers in countries where the currency has not appreciated against the dollar. For instance, while Boston and Richmond firms saw a decline in European shoe, textile and furniture imports, imports of similar goods from Southeast Asia and Brazil expanded. Similarly, Chicago respondents mentioned increased imports of steel, cement and auto parts from Korea, Canada and several other countries. The competition from suppliers in such countries is also thought to explain why some European and Japanese exporters have cut their profit margins.

Import Prices

Manufacturers and retailers generally reported mixed experiences with import prices. U.S. firms importing from countries with currencies that did not appreciate against the dollar saw little change in import prices. Price increases for Japanese and European imports varied considerably but rarely reflected the dollar depreciation in full. The size of Japanese and European price changes depended in part on the strength of competition from U.S. and East Asian suppliers and the amount of excess capacity in the industry. For instance, excess capacity in semi-conductors and construction equipment was credited with keeping import price increases low in those industries. Prices of specialized products rose more than prices of undifferentiated goods, according to respondents in the Second and Fourth Districts.

Input Prices - Respondents in the Minneapolis, Dallas and St. Louis Districts reported little change in the prices of imported inputs. Dallas and

St. Louis firms pointed out that the prices of oil and coal, important inputs in these Districts, are denominated in dollars. Elsewhere, most firms saw some increases in import prices, especially on goods from Europe and Japan. For example, New York District respondents experienced price increases of 10 percent or more on imported telecommunications equipment, electrical machinery and specialty paper, and smaller increases on computers, metal containers and food products. The behavior of Japanese prices varied considerably by industry and even by firm. For example, prices of Japanese electrical components increased sharply while prices of machine tools did not. On occasion, Japanese list prices rose but the actual transaction prices remained unchanged.

For the most part, U.S. producers did not raise their own prices in response to the import price increases. Only wool and paper price increases were said to have been passed on to customers. Faced with rising prices for imported inputs, U.S. manufacturers have looked, often unsuccessfully, for satisfactory domestic substitutes or turned to suppliers in Southeast Asia, Eastern Europe or Canada.

Prices of Finished Goods - Although retailers also reported diverse experiences, prices of imported finished goods seemingly rose more than manufacturers' input prices. Again prices of imports from countries whose currencies did not appreciate against the dollar did not rise. An exception was an increase in the price of Canadian lumber, attributable to the U.S. tariff and Canadian export tax. For European and Japanese imports the extent of the increases again depended on the availability of substitutes and the extent of competition from East Asian and U.S. producers. For instance, Cleveland dealers reported large price increases for imported luxury cars but little change in price for low-end economy cars. Similarly, New York District retailers spoke of large price increases for two goods that face limited U.S. competition, 35 mm cameras and designer fashions.

In response to these import price increases, some retailers switched to U.S. or to East Asian and Brazilian suppliers or discontinued the product entirely because no U.S. substitute could be found. Others continued to buy the import, because its quality was superior to the alternatives.

Shifts in Production Site

Although several Districts could cite examples of firms considering shifting production from a European or Japanese site to the United States, most U.S. multinationals have no such intentions. Overseas operations are seen as long-term investments and it is said to be too soon for major moves. Some firms also noted the need for a local presence in foreign markets regardless of the value of the dollar. Others pointed to the continuing difference between production costs in the United States and most less developed countries. and, as reported by Boston, Chicago, Richmond and San Francisco, many U.S. firms are continuing to shift production to these low-cost countries. Two Boston respondents plan to increase production in Brazil or Mexico, in part for export to the United States, to take advantage of tax and export incentives. Respondents in Boston, Cleveland and San Francisco also noted an increase in foreign direct investment in their areas.

Because U.S. manufacturers have increasingly turned to suppliers abroad, respondents in several Districts have not been able to find satisfactory domestic substitutes for imported products - regardless of price. Firms in the Chicago and Dallas Districts commented that during the prolonged dollar appreciation, some U.S. manufacturers changed their product mix or closed their doors entirely. In a similar vein, two Boston District firms complained that major U.S. customers have moved so much production offshore that it has become very difficult to compete for this business.

Outlook

Views on whether the impact of the dollar depreciation will strengthen are divided. Respondents in half the Districts expect that import prices will rise in 1987 and beyond. They cite the depletion of inventories and the expiration of long-term contracts as contributing to the increase. Some respondents believe the Japanese will be reluctant to make further cuts in profit margins since they are probably already losing money on a variety of products shipped to the United States.

As for exports, respondents in eight Districts are hopeful that foreign sales will increase as long-term contracts end, new investment decisions are made, and the dollar continues to depreciate against major currencies.

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Houthakker and Samuelson were available for comment this month. Professor Houthakker, seeing no evidence in recent data to alter his forecast of slow but steady growth, sees no reason to change monetary policy at this time. He places little weight on the preliminary fourth quarter data, because the recent reduction in the unemployment rate suggests that these initial estimates, when revised, will show that growth exceeded 1.7 percent last quarter. Due to the decline in the dollar and the end of oil price declines, the inflation rate should increase in 1987, but remain below five percent. Professor Houthakker expects interest rates to be a little higher by the end of the year. He foresees a slight improvement in the trade deficit during 1987, but is concerned about efforts to talk down the value of the dollar. While some fall of the dollar is inevitable, we should not interfere with market forces.

Professor Samuelson predicts that the growth of GNP in 1987 will be in the two and a half to three percent range, somewhat below the government forecast. The demand for automobiles and other durables will be weak in the first quarter. Furthermore, we are still waiting for the J-curve effects, although there are signs that we may soon see some improvement in the balance of payments. But the evidence does not yet suggest that a recession is likely before the end of the year. Due to the weakness in the economy, a reduction in interest rates may be warranted later this year, requiring rates of money growth exceeding normal targets. The Fed should not increase interest rates and tighten monetary policy to sustain the dollar's value near the 155 yen level, because equilibrium in the balance of payments will not occur at the present exchange rate. If the market says the dollar should decline, then we should go along agreeably.

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CLASS II - FOMC

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SECOND DISTRICT - NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Richard B. Hoey (Drexel Burnham Lambert, Inc.), David Jones (Aubrey G. Lanston & Co.) and Francis Schott (Equitable Life Assurance Society):*

Hoey: We expect a long expansion since the growth recession has postponed late cycle pressures. A U.S. discount rate cut could have a perverse impact on long rates due to the dollar. We continue to expect a 50 percent decline in the dollar from February 1985 highs due to the cumulative rise in external liabilities, but a pause is likely soon as the trade balance turns. Any further declines in the dollar will be more inflationary than past ones have been since (1) oil prices are no longer falling, (2) the U.S. industrial sector will not remain weak and (3) foreign profit margins have already narrowed.

The stock market has been undervalued for the last year on quantitative valuation based on current interest rates and expected earnings and dividends. It is now fairly valued. The persistent rise in stock prices supports the thesis that many corporate takeovers in 1985 and 1986 were due in part to superior anticipation of improved fundamentals.

The greatest recession risk is from a further rise in oil prices if Iran is victorious. The depression risk is low. There is a greater depression risk from retaliatory protectionism than from financial stresses. Gradual creeping protectionism is more likely than catastrophic protectionism.

Jones: For 1987 as a whole, the rate of increase in real GNP growth is likely to be 3 - 3 1/2 percent:

(1) The Federal Reserve by accommodating an explosion in money and credit growth and exerting downward pressures on interest rates in 1986 has set the stage for faster spending in interest-sensitive sectors.

*Their views of course are personal, not institutional.

(2) Easy-money conditions and declining money market rates have set the stage for soaring stock market prices in early 1987.

(3) Consumer spending will be boosted in 1987 by the positive wealth effects of rising stock prices and home prices. These effects will far outweigh any negative effects caused by heavy consumer debt burdens.

(4) The surge in stock prices will sharply lower businesses' cost of capital in 1987. This will lead to an acceleration in business spending on new plant and equipment later in 1987, particularly in export industries benefitting from a declining dollar. And

(5) The declining dollar is already beginning to benefit U.S. export industries.

Consumer prices will increase by 4 - 4 1/2 percent in 1987 up sharply from the 1.2 percent pace in 1986. Increases in import and oil prices will pace the 1987 advance. Serving to limit the acceleration in consumer prices in 1987 are likely to be a continued large margin of unused domestic and foreign production capacity and modest wage cost pressures.

Schott: Stock market strains and readily financed corporate restructuring activity suggest ample liquidity. Besides, rising raw material prices and the declining dollar point toward an early upturn of the inflation rate.

It is true that first-quarter business activity will be held down by late-1986 tax-related buying. Yet, monetary policy has little relevance to this problem. Watchful waiting will suffice.