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

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: March 25, 1987

FROM: Rosemary Loney

Enclosed are the greenbook and supplementary information prepared at the Federal Reserve Banks of Boston and New York.

Enclosures

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CLASS II - FOMC

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Houthakker and Samuelson were available for comment this month. Professor Houthakker expects the economy to continue to grow at a rate of 2 to 2.5 for 1987. Despite this moderate growth, he is concerned that inflation will rise to 5 percent by year end. The sources of his concern are rising oil prices and import prices, as well as the rapid growth of the money aggregates. The rapid drop in oil prices that enabled inflation to be very low last year, have been partially reversed recently. As higher oil prices pass through the economy, reported inflation will rise. The delayed effects of the sharp decline in the dollar will also put upward pressure on inflation, though he doesn't expect the full decline to be passed on to consumers. While the Federal Reserve should have abandoned the M1 target, the institutional changes that caused velocity to be unstable have run their course and M1 may deserve to receive more attention in the future. The continued growth of M1 and M2 above target ranges could be a source of problems in the future.

Professor Houthakker would avoid policies that would cause any further decline in the dollar. The dollar has dropped sufficiently to cause improvements in the trade balance over this year. There is no reason for interest rates to change at this time but they may need to rise in the future if inflation rises as much as he anticipates.

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Professor Samuelson expects real GNP to grow between 2 and 3.5 percent. The stock market boom should improve consumer spending, particularly if consumers believe that stock prices will stay at their current high levels. Higher stock prices should also lower the cost of capital and encourage more investment spending. However, some caution should be used in relying on the stock market as a leading indicator since it is a noisy series and must be evaluated in conjunction with the very weak real GNP growth experienced last quarter. The growth in real GNP is likely to be uneven, with weak growth in the first half the year and stronger growth in the second half due to intertemporal substitution induced by changes in the tax code. Inflation will continue to be lower than predictions made by forecasters relying heavily on money aggregates. Inflation should range between 3 and 4.5 percent, which he feels is tolerable.

Professor Samuelson believes that monetary policy should not deviate much from its current course. He expects the money aggregates to continue to grow at the top of the target range. If the economy does pick up in the second half of the year, there may be a need for some tightening at that time.

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CLASS II - FOMC

MARCH 1987

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from James J. O'Leary (U.S. Trust Co.), Leonard J. Santow (Griggs and Santow, Inc.) and Albert Wojnilower (First Boston Corp.):*

O'Leary: The monetary authorities are faced with many complicated and interrelated problems, central to which is the enormous expansion of debt of all forms in the United States. With the development of our huge trade deficit, foreign holdings of U.S. assets have risen dramatically. Given the explosion of U.S. debt and the tremendous increase in foreign ownership of U.S. assets, a serious and extended recession would be disastrous, as would be a surge in economic growth bringing with it a worrisome rise in the inflation rate and rising interest rates, and then recession. Public policy--meaning essentially Federal Reserve policy--must be aimed at continuing steady growth, but at a moderate rate consistent with avoiding any serious rise in the inflation rate and with maintaining confidence in the dollar both at home and abroad.

It now seems that, in the interest of maintaining steady and moderate growth without a disturbing increase of the inflation rate, monetary policy should carefully shift to a somewhat less accommodative role. Although there is still great uncertainty, it seems to me that the greater risk today is stronger growth and greater inflationary pressure and not recession.

Santow: The economy on an underlying basis continues to remain in the 2 - 3 percent real growth area. If there has been any change in the economic outlook by business people in recent months, it is that a recession some time in the next year or so seems most likely. Inflation has increased moderately since last fall although no major breakout is likely during 1987. By the end of the

*Their views of course are personal, not institutional.

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year, a 4 percent rate of advance, or a touch higher, appears likely. Thus, the direction is more of a concern than the level.

The foregoing analysis suggests that current monetary policy is appropriate, and no basic change is necessary. Policy at this time is accommodative by virtually every standard and in no way impedes economic growth. If underlying real GNP should move out of the 2 - 3 percent growth range, or inflation should come in substantially different from 4 percent late in the year, a change in policy would need to be considered.

Wojnilower: The improvement in business activity that began last fall is continuing. While the better tone is most pronounced in the industrial sector, retailers also report good result (of course, with the notable exception of autos) and even the oil regions seem to be showing a slight lift. It is tempting to attribute that somewhat better performance to gains in international competitiveness, but I see little evidence of this. Rather, I suspect that we may again be in a phase of unsustainable inventory expansion, for which the ripple effects of the tax reform are probably importantly responsible.

At this juncture the securities markets do not anticipate either a recession or a rise in interest rates. This means that participants see little to fear. Furthermore, in view of the impediments to investment in the "new" countries and the weakening of business prospects in Germany and Japan, the U.S. is even more strongly perceived as the chief outlet for the investment of the world's saving. Thus, securities markets in the United States are having to "manufacture" their own risk by taking prices up to levels high enough to make investors and speculators nervous. There are few signs, if any, that they are nervous yet.