BOARD OF GOVERNORS
OF THE
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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: February 6, 1985

FROM: Nancy Steele NMS

Enclosed are the greenbook, supplementary information prepared at two Federal Reserve Banks, and the table on System swap lines.

Enclosures

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professor Feldstein, Houthakker, Samuelson, and Tobin were reached for comment. Feldstein foresees real growth of a little more than 3 percent and continued low inflation. The effects of the anticipated drop in the dollar will not be felt until late in the year at the earliest. He favors a nominal GNP goal of 7 percent for 1985, for which the tentative 4 to 7 percent M1 range should be "more than enough if the old relationship is back on track." The 7 percent goal would be appropriate whether or not the dollar drops. However, the Fed should be alert to the possibility of another velocity drop like the one in the second half of 1982. Feldstein continues to anticipate significant legislation this year, i.e., sufficient to reduce the federal deficit by more than $100 billion in 1988.

Although a recession is still some time away, economic activity is not increasing vigorously, according to Professor Houthakker, due to uncertainty about fiscal policy and perhaps about monetary policy. He is happy with the tentative '85 monetary ranges and is worried that M1 now exceeds the range. He believes the dollar may rise further and is skeptical about the efficacy of intervening to prevent it. A steady monetary policy — M1 growth in the upper part of but not above the top of the range -- is the most the Fed alone can do for both the domestic and world economy. The unfortunate effects of floating rates require a rethinking of the international monetary system.

Samuelson gives the Fed good marks for its policy since mid-1982, praising its reaction to the economic pause in late 1984. He believes the recent cross currents in economic data are "not a bad thing" and lend credence to the forecast of a little more than 4 percent real growth this year. This optomistic outlook hinges less on natural cyclical forces than the assumption that the Fed can and will successfully counter any unpleasant surprises. He believes that the primary goal should be continuation of the expansion and that the value of the dollar should be given little weight. A drop in the dollar should be welcomed even though there is no guarantee that the dollar will decline smoothly -- "overshooting on the downside would not be a tragedy."

Professor Tobin believes that since October, 1982, the Fed has pursued a policy oriented toward macroeconomic performance rather than the monetary aggregates per se. He sees no conflict yet between a sustained expansion with lower unemployment and inflation. While the risk of recession has abated and is not the most likely case, it cannot be ruled out. Tobin views the international situation as an additional reason to keep on an expansion path; the Fed should accommodate the inflationary impact of a drop in the dollar so long as it does not get incorporated in domestic cost/wage inflation. To the extent that the improvement in inflation has been due to a temporary increase in the dollar, the reversal of this effect should not be considered an increase in the trend inflation rate that we have to oppose by a tighter monetary policy.

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

JANUARY 1985

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Henry Kaufman (Salomon Brothers, Inc.), Leonard Santow (Griggs and Santow, Inc.) and Albert Wojnilower (First Boston Corporation):*

Kaufman: The reacceleration in economic activity will become more noticeable within the first half of this year when real economic growth will be at least in the 4 - 5 percent range. This economic lift will be encouraged by the recent decline in interest rates, the continued fiscal stimulus, and very good availability of credit. The decline in interest rates will probably terminate by the end of this quarter as the demand for funds increases and adverse market expectations develop due to the limited progress in resolving the budget deficit. In the meantime, the very sharply sloped positive yield curve will continue to induce a huge volume of short-term and floating rate financing. A shift into medium-maturity financing will occur when market participants perceive that the decline in short-term rates is over and somewhat higher rates may loom ahead. A massive volume of long-term fixed-rate financing is unlikely to develop soon.

Santow: Monetary policy in December and January when viewed in terms of reserve growth, aggregate growth rates, free reserves and borrowing at the window, is probably the most accommodative it has been, since late 1979. Therefore, the recent modest change to a less generous reserve stance

* Their views of course are personal, not institutional.

is warranted and should have little impact on economic activity. However, since this was the first change in policy direction since mid-1984 and was in the opposite direction from what investors had expected, there is a risk that market psychology could deteriorate more than circumstances warrant. Therefore, it would be in the best interest of the Fed to communicate to the market that this is not the beginning of the general movement toward firming.

With respect to the monetary aggregates the target ranges for M2 and M3 seem too low and both should be revised upward by about 1 percent. Otherwise both will run above policy targets throughout the year and the Fed will be in the awkward position of trying to regularly justify why policy is not responsive to these numbers.

Wojnilower: The inventory adjustment is nearing completion but at diverse rates in different industries. My information suggests, for example, that orders are continuing to fall for aluminum, have flattened but not yet started to recover in textiles and fibers, but have improved notably for steel. The adjustment in nonautomotive retail inventory should be just about over now.

With the ending of these inventory corrections, a further strong resurgence in economic tone seems likely. This is being supported by the sharp rise in securities prices, which I expect will soon carry over modestly into industrial commodities and also, but only very temporarily, soften the dollar.

In sum, I expect the economy and the financial markets to repeat in 1985 the same manic-depressive performance pattern that prevailed within 1984 and 1983.