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OF THE
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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: October 29, 1986

FROM: Rosemary Loney RAL

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

Enclosures

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professor Houthakker was available for comment this month. He doesn't place much weight on the 2.4 percent growth in real GNP that was recently released, since recent releases have been followed by substantial revisions and a slightly better one quarter figure is not sufficient to alter his view of a generally weak economy. However, he foresees some increase in the growth of real GNP as we move into 1987. Both consumption and net exports will increase more rapidly as consumers reap the benefits of lower marginal tax rates and greater disposable income and as the lower value of the dollar reduces our trade deficit. He felt that there are some signs of an improved trade deficit with the favorable August trade figures, so there is no need for a further fall in the dollar. The path of investment is less certain, since the elimination of the investment tax credit and the lengthening of depreciation schedules may reduce the growth of investment, offsetting the positive effects of reduced marginal corporate income tax rates. Thus, the improvement in real GNP is unlikely to be strong enough to cause serious fears of increased inflation. While there may be some increases in oil prices and raw material prices, inflation is unlikely to rise above 4 percent in 1987. While temporary surges in reported price changes may prevent the Federal Reserve from lowering interest rates in the near future, he does see room for lower interest rates as we move into 1987.

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CLASS II - FOMC

NOVEMBER 1986

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from David Jones (Aubrey G. Lanston & Co.), Francis Schott (Equitable Life Assurance Society) and Robert Stone (Irving Trust Company):*

Jones: The outlook for the final quarter of 1986 is for a moderate further acceleration in real GNP growth to 3.0-3.5 percent. With the best news on inflation behind us, it seems likely that long-term Treasury bond yields will edge higher to the vicinity of 8 percent.

Serving to boost fourth quarter real GNP growth is likely to be a pickup in inventory accumulation and lessened drag on the economy from the trade deficit. Consumer spending on larger ticket items, though down from the sizzling pace of the second and third quarters, is likely to be buoyed, in anticipation of the ending of the sales tax deduction.

Looking ahead to 1987, the most important news is likely to be a less favorable real GNP-price mix. While real GNP growth is likely to be no higher than 2-2.5 percent, the pace of inflation, largely reflecting a declining trend in the dollar and gradually rising oil prices, could double to about 5 percent from roughly a 2 1/2 percent pace in 1986.

Schott: Employment and real income gains translate into sufficient consumer strength to offset weakness in capital

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*Their views of course are personal, not institutional.

spending and international trade. Nevertheless, the economy is likely to continue to be sluggish. Inflation remains subdued.

Credit availability is ample. Nominal and real rates of interest are acceptable to credit users. The need for foreign capital counsels caution in any further easing.

Tax reform effects are a question mark for 1987. At the moment, monetary policy is very well attuned to the balance of policy requirements.

Mr. Stone: I see no grounds for a Fed action that will push interest rates higher. The question is whether the unfolding pattern of events in the economy and in the markets indicates a need to push them lower. I think not.

The flow of economic data seems to be episodic, and the current episode indicates, on balance, a little more strength. This suggests a steady-as-you-go policy for another few weeks. This view is reinforced by the likelihood that the signing of the tax bill will trigger a lot of decision making that had been delayed pending passage of the bill. While it will take a long time for all of the effects of the bill to be played out, we could see some stimulus coming from that source fairly quickly. Why not wait and see.