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CLASS II - FOMC

TO: Federal Open Market Committee

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Enclosed are the greenbook and supplementary information prepared at the Federal Reserve Banks, including a special report on prices, wages, and productivity.

Enclosures

SPECIAL DISTRICT REPORTS

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FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT ACADEMIC PANEL

Professors Samuelson and Houthakker were available for comment this month. Both believe that monetary policy is more or less on track and that the Fed should not attempt to resist the recent rise in short-term interest rates. According to Samuelson, by accepting the rise in rates, the Fed has an opportunity to "test the underlying forces driving the recovery." Given the unexpected strength of the economy in May and June, he believes that in the short run higher rates are not likely to arrest the recovery's momentum. He emphasized, however, that the Fed should terminate this "experiment" if the economy reacts adversely to it. Indications of an adverse reaction would include a sharp decline in the stock market or housing starts.

Houthakker is satisfied with current monetary policy because growth rates in the larger monetary aggregates are near or within their target ranges. He places little faith in Ml as a target of monetary policy and thinks that the Fed should pay more attention to growth in net debt.

Both economists are disappointed with the budget resolutions that Congress has produced so far, although Houthakker was mildly encouraged that the Congressional budgetary process did not break down completely.

Both fear that structural deficits are going to crimp capital spending by mid-decade. Samuelson feels that the most politically feasible route to a reduction of these deficits is an increase in taxes rather than a reduction

in nondefense spending. He is intrigued with the idea of a national broad-based consumption tax, such as a sales tax or value added tax, although he is not sure whether he can unreservedly support such taxes. His view on these radical tax alternatives would depend on the compromises needed to secure their passage in Congress.

Houthakker would like to see the Fed exert pressure on Congress to trim deficits, as it did last year. He also thinks that public statements by Mr. Volcker reaffirming the Fed's committment to its M2 and M3 growth targets would assuage investors' fears of rising inflation.

July 1983

This month we have comments from Henry Kaufman (Salomon Bros.), Donald Riefler (Morgan Guaranty Trust Co.) and Leonard Santow (Griggs and Santow, Inc.):*

Kaufman: The acceleration in the pace of economic activity during the second quarter should spill over into the remainder of this year with real GNP increasing at an annual rate of about 5 percent and an inflation rate of nearly comparable proportion. This step-up in economic activity should produce a closer fit between credit demands and the available supply of funds. Most private credit demands will increase. There will be a larger volume of mortgage deliveries, higher consumer credit financing demands and, from the business sector, at least a modest rise in external financing requirements against a backdrop of continued large financing needs of the U.S. Treasury. Both economic and financial forces suggest that the lows in interest rates are behind us and that some upward drifting in both short and long-term interest rates are likely during the remainder of the year.

Riefler: The economic recovery seems well under way but expectations for inflation are stabilizing in the 4 to 6 percent area. The outlook for interest rates is neutral. The Fed should continue to deemphasize monetary aggregates but start to reemphasize the idea that their long term aim is to eliminate inflation.

^{*}Their views of course are personal, not institutional

Santow: The economy is not overheating, inflation is not returning, and most of the M1 advance is technical, transitory and of doubtful significance. The economy is less robust than the second quarter GNP suggests, with strength concentrated in inventories, and the recovery, centered in interest-sensitive areas, remains fragile.

These considerations plus the international situation and the risk of flattening a yield curve in the face of three consecutive quarters of \$60 billion in net Treasury financing argue for no change in Fed policy. Any firming of significance would open up such a gap between Fed funds and the discount rate that the latter would have to be raised.

Fourth District - Cleveland

Economists who attended the Fourth District Roundtable meeting at this Bank on June 10 scaled up their forecasts of output from their March forecasts, and expect sustained but moderated growth through the end of 1984. The median of 30 forecasts now shows a 4.9% annual rate of increase in real GNP in the third and fourth quarters, and rates of 4.1%, 4.5%, 4.7%, and 4.2%, respectively, in next year's four quarters. The median forecast for growth of real GNP is 4.5% for 1983 (IVQ-IVQ) and 4.4% for 1984.

The median forecast has the unemployment rate falling steadily to 9.7% in 1983:IVQ and to 8.6% in 1984:IVQ.

The group believes the inflation rate will bottom in mid-1983, with the Implicit Price Deflator rising at a 4.0% rate and accelerating to a 5.8% annual rate by 1984:IVQ. From 1983:IVQ to 1984:IVQ, the deflator is expected to increase 5.5%, compared with an expected 4.6% increase over the four quarters ending in 1983:IVQ.

The group assumed large budget deficits this year and next, and rapid growth of the money stock. The median assumption was for a federal deficit between \$191 billion and \$200 billion in FY 1983 and between \$181 billion and \$190 billion in FY 1984. Most of the panel (85%) assumed M-1 would increase by more than 8% in 1983, while the bulk of respondents preferred an M-1 growth rate between 6% and 8%.

The group's median forecast for interest rates has the prime rate flat at 10.5% for 1983:IIQ through 1984:IIIQ and then rising to 10.7% in 1984:IVQ.

The rate for Moody's seasoned Asa corporate bonds is forecast to fall steadily

from 11.5% in 1983:IIQ to 10.7% in 1984:IVQ. Roundtable participants judge interest rates to be a contributing cause for this recovery to be less robust than some earlier recoveries, but do not believe interest rates are a serious restraint except in housing. Mortgage interest rates are seen as causing housing starts to plateau at about 1.6 million this year and 1.7 million next year.

Several participants expressed a preference for a moderate economic recovery and are willing to take risks to achieve a disinflationary recovery. An economist with a national retail chain asserted that the way to prolong the expansion is to slow economic growth as the recovery proceeds, from his expected 6% growth in the first year of recovery to 5% in the second year and to 4% by the third year. He expressed willingness to accept slower growth in the second and third years of recovery in order to reduce prospects that inflation will reignite.

A bank economist believes that the FOMC should accept the first half 1983 overshoot in M-1 but should aim for second half growth from the new base at rates near the top end of the 1983 target range. In his view, M-1 is still a "good" measure of transaction money because he estimates that distortions in both directions about cancel out. Also, he expects an increase in velocity in the second half of 1983 at about a 2% to 3% annual rate because massive deposit shifts have about run their course, consumer and business confidence has been strengthening and interest rates have about troughed. Resumption of velocity growth in the second half of 1983 calls for growth in M-1 at a single-digit rate, which should allow growth in nominal GNP at about a 10% annual rate in the second half and again in 1984, even with some further slowing in growth of M-1 next year.

SIXTH DISTRICT - ATLANTA PANEL OF ECONOMISTS

Twelve members of our panel of economists, drawn from District banks, investment firms, and state forecasting projects, responded this month. The group's prevailing recommendation for monetary policy is that the Fed should reduce the growth rates of the monetary aggregates. Our panelists are optimistic concerning the inflation outlook for the rest of this year, but several believe that inflation expectations will be rekindled if money supply growth is not slowed. The panelists also see evidence of stronger-than-expected economic recoveries in their states.

Monetary Policy Recommendations. Ten of our twelve respondents feel strongly that growth in the money supply is excessive. Only two panelists think that the current money supply growth rate is appropriate, down from six in May. These respondents believe that monetary policy should become more restrictive only when there is solid evidence that inflation is being aggravated or industrial capacity utilization is strained. They do not see that evidence yet.

The remaining panelists can generally be placed into two approximately equal groups. One group thinks that money supply growth should be reduced immediately, even if that means a rise in interest rates and slowing of economic recovery. As one economist expressed it, "the Fed should reaffirm its anti-inflation stance this year, before money markets decide conclusively that the inflation fight is over."

The other group which urges monetary restraint sees the Fed "walking a tightrope." Panelists in this group fear that slower money supply growth may cause interest rates to rise and choke off the recovery. But, they also believe that continued money growth at the current rate will be received negatively by credit markets, causing long-term interest rates to rise. They recommend that the Fed tighten up as much

as possible "without aborting the recovery." They also hope that government demand for credit somehow can be pared because they foresee clashes between private and public credit demands and non-inflationary monetary policy.

General Inflation Outlook. Our panel of economists is optimistic concerning the inflation outlook for 1983. These economists generally share the recently-expressed opinion of southeastern business representatives that inflation is likely to remain low for the remainder of this year. Only two panelists foresee a significant pickup in inflation by the end of this year.

A majority of our respondents emphasized that inflation expectations are likely to rise if monetary growth continues along its current path. For 1984, several panelists expect inflation to be 1-2 percent higher than the 4-6 percent range expected for 1983.

Regional Economic Recovery. Generally, our panelists feel economic recovery in the southeastern states is stronger now than they had expected earlier. Local recoveries continue to center on the housing industry, but better-than-expected gains in auto sales, capital spending, orders and production by raw materials suppliers, and manufacturing employment, particularly for defense-related production, also were mentioned by panelists. Two contacts offered the comment that the housing recovery would be severely threatened if mortgage rates rise to the 13.5 to 14 percent range.

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EIGHTH DISTRICT - ST. LOUIS

Sales and production in the Eighth District continued to expand during May and most of June, and prices were nearly stable. Residential home sales, however, slowed from the pace attained earlier in the year, and many manufacturing plants continue operating substantially below capacity. Although there have been net employment gains, unemployment rose from its already high level, as the labor force was bolstered by graduates and students seeking summer jobs. Most respondents anticipate that economic activity will continue to expand during the summer and fall.

Centerre Bank Survey

Business executives of middle-sized firms in mid-America are clearly becoming more optimistic about the course of the economy. This was the finding of the June Centerre Economic Poll, a survey of executives in 312 companies primarily located in the Eighth District and with annual sales of \$25 million to \$300 million. Eighty-two percent of the executives believe their own business will improve in the next six months, while only 2 percent felt their business would decline. Two-thirds of the executives anticipate expanding their business in the next year, and 58 percent expect to modernize equipment within the same time frame. When asked to name the most pressing problem they face, the three most frequently cited were government spending and deficits, excessive government regulation and interest rates. Less frequently mentioned were productivity, imports, the recession, labor unions, inflation and uncertainty.

Sales

Sales at six department stores in the District averaged 7 percent higher in May and June than in the same period of 1982. The gains occurred

despite unseasonally wet weather in many areas of the District. Furniture, appliances, rugs and "Father's Day" merchandise showed strength. Apparel did less well, allegedly because the weather in May was too cool for customers to be interested in summer fashions.

Automobile sales improved in May and June at five dealers but slipped back at two dealers. One large dealer, with sales of both new and used cars about 25 percent ahead of last year, noted that he had difficulty maintaining adequate inventories for both autos and trucks. A dealer of foreign cars said he was readily selling all the cars allocated to him and could sell many more of the popular models if available.

Home sales in the Eighth District, which had been strong earlier in the year, decreased in May and June. The unseasonally wet weather in May and some inching up of mortgage rates in early June contributed to the slowdown. Residential construction, however, continued at a relatively high level.

Manufacturing Activity

Most industrial firms in the District reported an increase in orders and shipments since April. The gains continued to be largest for consumer-type goods and defense items. Firms producing business equipment reported little change in sales. Inventories at most firms are near desired levels. Despite production gains, railroad traffic continued sluggish.

Employment

Total Eighth District employment has crept up since April.

Because of productivity gains, however, the rise in employment was less than the increase in production. Moreover, a few firms still are trimming their work forces, primarily through early retirements and attrition, in

order to improve efficiency. Despite the net increase in total employment, the number of unemployed also rose moderately as the work force was enlarged by graduates and students seeking summer jobs. A Manpower Inc. survey found that one-quarter of St. Louis area employers plan to hire additional workers during the third quarter, and 7 percent plan reductions. Finance

Consumer loans rose during May and early June at large Eighth
District banks, but commercial and industrial loans declined. Real estate
loans changed little. Bank deposits increased, with both money market
deposit accounts and super-NOW accounts rising rapidly. Savings and loan
associations, also continuing to have an inflow of new funds, were able to
increase their lending and improve their liquidity. The financial
condition of savings and loans also has been strengthened by a slightly
lower cost of funds and a higher average yield on assets.

Price and wages

Prices have changed little, and wages have risen only moderately so far this year in the District. In general, expectations are that prices and wages will rise moderately during the rest of 1983. Projections through 1984, however, are more diverse: some analysts, focusing on excess capacity, believe wages and prices will accelerate only modestly; others, concerned about the huge Federal deficits and rapid monetary expansion, anticipate marked accelerations in wages and prices.

Agriculture

Crop plantings in the District—initially delayed by adverse weather—have been completed with scattered detrimental effects. Despite these losses and the land taken out of production by the PIK program, total production is now expected to be relatively large, reflecting record or near record per acre yields on the land planted.