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

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee   Date: July 11, 1984

FROM: Normand Bernard N.B.

Enclosed are the greenbook and supplementary information prepared at three Federal Reserve Banks.

Enclosures

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CONFIDENTIAL (FR)
CLASS III - FOMC

FIRST DISTRICT - BOSTON
SPECIAL DISTRICT REPORT
ACADEMIC PANEL

PROFESSORS HOUTHAKKER AND SAMUELSON WERE AVAILABLE FOR COMMENT THIS MONTH. BOTH ADVISE THE FED NOT TO WORRY ABOUT RISING INTEREST RATES BUT FOR DIFFERENT REASONS. SAMUELSON BELIEVES THAT RISING RATES ARE NEEDED TO CURB EXCESSIVELY RAPID ECONOMIC GROWTH. HE URGES THE FED TO LET INTEREST RATES RISE FURTHER, GIVEN THE STRENTH OF THE ECONOMY EVIDENT IN THE COMMERCE DEPARTMENT'S FLASH GNP ESTIMATE FOR THE SECOND QUARTER. IN HIS VIEW, ECONOMIC GROWTH NEEDS TO BE HELD TO NO MORE THAN 4 PERCENT FOR SEVERAL QUARTERS IN ORDER TO KEEP INFLATION DOWN. ONLY IF THE HOUSING MARKET COLLAPSES WOULD BE RESIST FURTHER INTEREST RATE INCREASES.

HOUTHAKKER THINKS THAT RISING INTEREST RATES SHOULD NOT CONCERN THE FED BECAUSE 1) THE FED CANNOT DO MUCH ABOUT THEM ANYWAY, 2) THEY KEEP PRESSURE ON CONGRESS TO REDUCE PROJECTED FEDERAL BUDGET DEFICITS FURTHER, #0 THE ECONOMY IS NOT AS STRONG AS RECENT STATISTICS SUGGEST; MUCH RECENT GROWTH IS ATTRIBUTABLE TO AN INCREASE IN INVENTORY INVESTMENT RATHER THAN FINAL SALES, AND 4) FURTHER INCREASES IN INTEREST RATES WOULD INHIBIT ECONOMIC GROWTH ONLY SLIGHTLY, PARTIALLY BECAUSE THEY BOOST THE INTEREST INCOME OF HOUSEHOLDS. HOUTHAKKER URGES THE FED TO CONCENTRATE ON KEEPING GROWTH OF THE MONETARY AGGREGATES WITHIN THEIR TARGET RANGES. IDEALLY HE WOULD LIKE TO SEE M1 GROWTH OW MID-RANGE.

BOTH ECONOMISTS BELIEVE THAT THE FED SHOULD NOT SACRIFICE ITS LONG-TERM GOAL OF KEEPING INFLATION IN CHECK IN DEALING WITH SUCH PROBLEMS AS CONTINENTAL ILLINOIS AND THE DEBT BURDEN OF DEVELOPING NATIONS. WITH RESPECT TO THE LATTER PROBLEM, BOTH MEN ENDORSED SOLUTIONS OTHER THAN A LOOSENING OF MONETARY POLICY SUCH AS INTEREST RATE CAPS OR THE IMF'S EXTENDING MORE CREDIT TO THE MOST FINANCIALLY STRAPPED DEBTOR NATIONS.

HOUTHAKKER IS CONCERNED THAT FURTHER RISES IN THE DOLLAR COULD ENDANGER THE CURRENT SYSTEM OF EXCHANGE RATE DETERMINATION. SPECIFICALLY, HE WOULD COUNSEL THE FED TO INTERVENE DIRECTLY IN CURRENCY MARKETS IF THE VALUE OF THE DOLLAR EXCEEDS 3 DEUTSCHE MARKS

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JULY 1984

SECOND DISTRICT--NEW YORK

FINANCIAL REPORT--FINANCIAL PANEL

This month we have comments from Henry Kaufman (Solomon Bros. Inc.), Donald Riefler (Morgan Guaranty Trust Co.), and Albert Wojnilower (First Boston Corp.):*

Kaufman: While the rate of economic growth is slowing, the economy is and will continue to do quite well. Real growth of 4 percent or more is likely in the second half. The easing tendencies in new housing activity and consumer spending are being partly offset by a capital expenditure boom and continued strong military outlays. The rise in interest rates to date, which in historical terms is large, will not terminate the economic expansion. Financial innovation and aggressive merchandising of credit is allowing the private sector to finance at the short end of the sharply positively sloped yield curve, thereby significantly negating the potential retarding influence of the jump in long-term interest rates. It is unlikely that short-term rates will lift dramatically over the near term to dislodge this new pattern of financing. Only very moderate monetary tightening is likely over the near term because: (1) inflation, which is being partly held at bay by huge imports, does not yet pose an imminent threat, (2) monetary growth still seems within a reasonable path, and (3) international debt and the occasional U.S. banking problems limit monetary options. Interest rates are still far from their peaks in this cycle, and the peak may well be more than 12 months away.

* Their views of course are personal, not institutional.

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Riefler: The financial system is fragile. Credit problems are widespread and especially sensitive to interest rate increases. With nominal GNP growing at a reasonable rate, the dollar strong and inflation well contained, the Fed should not follow monetary policies designed to bring real GNP growth in line with earlier projections.

Wojnilower: The economy is less bouyant now, but still very strong on balance and likely to remain so. Soft spots have emerged in the basic metals and in textiles, and a pronounced weakening of the housing market must be anticipated for later this year. Consumer demand, however, is reported to be robust and capital goods orders are surging.

Recent suasion by the authorities regarding mortgage and leverage buy-out financing may be having a limited impact. On the whole, however, lending institutuions continue to be extremely aggressive--as they are virtually compelled to be by their poorer earnings prospects. Investors and large depositors' confidence in depository institutions appears to be shaken beyond short run repair. A permanently higher risk premium may be getting added to the banks' cost of funds. This would further raise the general level of interest rates and complicate the conduct of monetary policy. In my opinion, these problems cannot and will not be mitigated without some return to regulatory limitation of deposit interest rates.

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CONFIDENTIAL (F.R.)--CLASS III FOMC

July 1984

FOURTH DISTRICT--CLEVELAND

REPORT ON ROUNDTABLE MEETING

Summary

Economists who attended the June 8 meeting of the Fourth District Roundtable at this Bank expect that the pace of real economic growth between 1984:IIIQ and 1985:IIQ will slow substantially from the first half. They expect the inflation rate to rise gradually to a 5 1/2% or 6% annual rate by mid-1985, with anticipated dollar depreciation being a key variable. Residential construction is expected to decline sharply by year-end as the industry regains sensitivity to interest rates.

The Economy

The median of 28 forecasts shows an increase in real GNP of 3.8% in 1984:IIIQ and a 2.5% a.r. from 1984:IVQ through 1985:IIQ. The group expected nominal GNP growth of 8.5% in 1984:IIQ but overestimated inflation and hence underestimated output. The anticipated growth recession assumes tightening credit market conditions and rising interest rates will choke interest-rate sensitive sectors.

Inflation

The group's median forecast is for the implicit price deflator to rise at a 5 1/2% to 6% annual rate in the first half of 1985. One economist, however, expects inflation to accelerate to a 7% annual rate by yearend 1984 and to 8% by mid-1985 because of the lagged response of prices to rapid money growth in 1982-83. Another economist expects inflation to accelerate

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to a 7% rate by mid-1985 because of tightening labor markets, higher capacity utilization in manufacturing, and a 15% depreciation of the dollar by mid-1985.

An economist who is optimistic on inflation expects the deflator to be rising at a 5% annual rate in mid-1985. He argues that wage settlements have been small and productivity growth will be above average for the second year of the expansion because the large increases in investment have gone into productivity enhancing equipment instead of pollution control. He believes there is little prospect for accelerating food prices and oil prices are unlikely to rise, despite the Iran-Iraq war. He acknowleded that a sharp depreciation of the dollar would cause more inflation than he is forecasting.

Residential Construction

A mortgage market economist expects housing to be crowded out later in the cycle than usual. Deregulation of deposit rates will avert disintermediation, requiring higher-than-usual interest rates to effect the crowding out. Increased use of adjustable rate mortgages (ARMs) with low initial rates has weakened the impact on housing of rising fixed rate mortgage rates. However, as borrowers, lenders, and mortgage insurers become more sensitive to the credit risk involved in ARMs, the relationship between housing starts and mortgage interest rates will become closer. He expects housing starts to fall to a 1.2 million unit annual rate by yearend 1984.

Petroleum Supplies

A petroleum industry economist foresees little chance of an oil price shock in the event of a cessation of shipments from the Persian Gulf. Assuming shipments from the Gulf of nearly 5 million barrels per day (MBD)

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were stopped, at least 4MBD could be made up by higher output from other OPEC sources, 0.2 MBD from Mexico and Canada, and the balance from substitution of natural gas for oil. There is also the potential for drawdown of the U.S. strategic petroleum reserve, Western Europe/Japanese stocks, and loaded Saudi tankers floating outside the Gulf. If disruption of Gulf supplies were expected to last more than three months, consumers of petroleum products could convert to substitutes more easily today than was possible a decade ago.

Policy

A bank economist asserted that M-1 velocity will be more stable than in the recent past, and will have a slower-than-trend growth of about 2% because some M-1 balances earn interest. Thus, he argues targeting M-1 is becoming more feasible.

Another economist commented that monetary policy should not be constrained by international debt repayment problems because even another 150 basis point increase in interest rates is unlikely to have much perverse effect on debtor nations. Their problems are fundamental and long term and could neither be cured nor made incurable by an interest rate change of that magnitude.