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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: September 26, 1984

FROM: Normand Bernard N.B.

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

Enclosures

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CONFIDENTIAL (FR)
CLASS III - FOMC

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC PANEL

Professors Houthakker, Samuelson, Solow, and Tobin were available for comment this month. All 4 economists foresee only a modest acceleration in inflation over the next several quarters. All of them characterized the recent settlement between General Motors and the United Auto Workers as moderate. Solow was the most emphatic in his belief that the settlement will restrain compensation increases in other industries. He forecasts an increase in unit labor costs of only 4 to 5 percent over the course of 1985. Houthakker is optimistic about inflation in the short run because he believes that the dollar will remain strong throughout next year, keeping import prices low.

Although none of the economists believes that the economy will fall into a recession in 1985, both Samuelson and Tobin are mildly concerned that the economy may be weakening to the point where the Fed should attempt to lower interest rates. Houthakker and Solow see no need for an easing of monetary policy at this time. Solow, however, would urge the Fed to accelerate money growth if the Congress enacted significant deficit reduction measures.

All four economists view the latest decline in the dollar as an aberration induced by central bank intervention. Tobin expressed concern that the Fed might overreact to a more significant permanent fall in the dollar's value. If such a decline should begin, he hopes that the Fed will not attempt to resist it in order to minimize increases in import prices.

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In his view, given that the dollar is too strong, the benefits of a decrease in its value, especially the resulting stimulus to U.S. exports, would outweigh the cost of higher inflation.

If the dollar were to decline precipitiously and the Fed wanted to slow its decline to a more orderly pace, Tobin hopes that the Fed would do so by using direct intervention in exchange markets. He would urge the Fed to refrain from slowing a fall in the dollar by raising the federal funds rate. In fact, he fears that raising interest rates could perversely accelerate the dollar's fall because such a display of extreme concern on the part of the Fed could further undermine confidence in the currency.

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CLASS III - FOMC

SEPTEMBER 1984

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from David Jones (Aubrey G. Lanston), Donald Riefler (Morgan Guaranty Trust), and Leonard Santow (Griggs & Santow):*

Jones: The U.S. economic expansion is on an amazingly favorable growth path - - solid real growth and unexpectedly low inflation. Furthermore, the expansion's momentum is likely to carry through most, if not all, of 1985. Assuming that President Reagan is reelected, there will be no significant progress in reducing the Federal deficit from a projected $170-180 billion range for fiscal year 1985. No tax increases will be forthcoming in 1985. However, there is a better-than-even chance that the Reagan Administration will impose a Value Added Tax in 1986. Real U.S. interest rates will remain abnormally high throughout 1985. The U.S. dollar will remain strong, particularly in terms of the German mark and other key European currencies, through most, if not all of 1985. While the worst of the foreign country debt crisis may be behind us, there remains a better-than-even chance of a run on one or more large money center banks in the event of poor profits or possible persisting domestic debt problems.

Riefler: For about five months the Open Market Committee apparently targetted about $1 billion in average bank discount window borrowings. That target when combined with the new biweekly reserve settlement procedures for the banking system produced, perhaps inadvertently,

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* Their views of course are personal, not institutional.

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an ever rising Federal Funds rate. More recently the markets (bond, currency and commodity) have been indicating that short-term interest rates are too high. The Open Market Committee should adopt policies that will allow Fed Funds to drop to a level that is more consistent with market expectations.

Santow: The economy is not as weak as the July-August data suggest and the same is true for the monetary aggregates. Both the economy and the aggregates, between now and year end, should show somewhat greater strength but not to a point where there are any problems. This analysis would suggest no basic change in monetary policy and given the political realities, a policy which also gains little public notoriety. To avoid having the market read too much into trading desk operations, the Fed might well consider placing more emphasis upon running off bills in auctions in periods when the Fed has considerable reserves to drain and buying bills when having considerable reserves to add. This would be preferable to frequent use of RP or match sales operations. As for the international side, the Fed is virtually an innocent bystander in what happens to the dollar and how it affects capital flows, inflation and the financial markets. If the dollar should begin to decline, there is very little that the Fed could effectively do to counteract the trend.