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

TO: Federal Open Market Committee DATE: July 3, 1985

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Enclosed are the greenbook, summary of special Reserve Bank reports on capital spending plans, and supplementary information prepared at two Federal Reserve Banks.

Enclosures

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National Summary of Theme Reports on Capital Spending Plans

Overview

While some respondents across the country reported a downward revision in their capital spending plans for 1985, the majority indicated little or no change. Among those revising their plans, lower than anticipated sales, profits, and cash flow were most often given as the reasons. The proposed tax reforms were not cited as a factor. By far the bulk of planned investment expenditures is for modernization and replacement rather than for capacity expansion. Retailers were the main group planning to expand. Growth in the services industry was most frequently cited for the commercial building boom which is expected to slow in most areas this year.

1. Revision of Capital Spending Plans. Nine of the twelve Federal Reserve Banks report that the majority of their respondents have made little or no change in their capital spending plans for 1985. San Francisco and Kansas City, however, say that, on balance, firms in their areas are reducing their capital spending plans, while the net impact of upward and downward revisions in Richmond is unclear.

Among the minority of respondents who reported a downward revision in planned capital spending for 1985, the factors most frequently cited were lower than anticipated sales, profits, and cash flow. Increased foreign competition

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and excess global capacity also were mentioned, particularly in the chemical, apparel, textile, oil, and semiconductor industries. In addition, the deepening agricultural crisis contributed to reductions in the spending plans of some farm equipment producers. By and large, manufacturers were much more likely to report some scaling back of plans than were services industries.

With regard to the proposed tax reforms, virtually no one other than real estate developers believes that these have had any impact thus far on capital spending plans for 1985. However, several respondents, including a food producer and defense contractor, mentioned the possibility that some capital spending currently planned for 1986 might be moved to 1985 to take advantage of the existing tax laws. In general, opinions were mixed as to the effect the proposed reforms would have in the future. The proposed changes in tax credits and depreciation are viewed as unfavorable to the capital goods industry and to capital-intensive firms. However, the reductions in corporate income tax rates would have an offsetting effect.

In only three of the twelve Districts--Atlanta, Philadelphia and Richmond--did firms report actual cancellations of previously planned capital projects. These firms were a supplier to farm equipment makers and producers of apparel, chemicals, lumber and textiles. Businesses in six of the twelve Districts reported shifting some investment abroad. However, in a reverse move, one oil company cancelled some overseas projects because of excess supply.

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2. Mix of Investment: Modernization versus Expansion. By far the bulk of investment expenditures planned in every District is for modernization and replacement rather than for expansion of capacity. However, as some respondents pointed out, plant modernization and improved productivity often have the effect of increasing capacity without the actual addition of new facilities.

Several reasons were given for the current emphasis on modernization and replacement. Eleven Districts reported that foreign competition was a motivating factor for a number of firms seeking to cut operating costs through modernization of equipment and increased efficiency. In addition, some companies in two Districts continue to install new equipment to conserve energy and meet stricter environmental standards. Rapid changes in technology and the maturing of existing capital stock were also cited in six of the Districts as reasons behind capital spending decisions. Many respondents throughout the country state that new computerized technology, particularly computer-related manufacturing and office equipment, has been an important element underlying both their recent capital spending and future investment plans. Indeed, a leading computer manufacturer says that business demand for personal computers remains robust. However, construction of new manufacturing facilities is generally being limited to the replacement of old plants or for the introduction of new product lines.

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Retailers are the major group with plans to expand capacity. Apparently in the expectation of a high level of consumer spending, merchants in many areas intend to build new stores or add to existing capacity. In contrast, in most Districts manufacturing firms are generally not expanding, though there are several exceptions. High tech companies in the Boston area are adding to capacity and continuing to build new facilities, while in the New York area significant expansions are planned in 1985 by a producer of communications equipment, a pharmaceutical manufacturer, and a computer manufacturer. In addition, with operations at or close to capacity, paper firms in the Atlanta and Dallas Districts intend to enlarge their facilities this year.

3. The Commercial Building Boom. The report from most of the Districts is that the commercial building boom, fueled by fast growth in various services industries such as electronic data processing and financial and legal services, is expected to slow this year. Excess supply, rental discounting and rising vacancy rates are cited as indications of an impending downtrend. However, strong demand for commercial space is expected to persist into 1986 in the Atlanta and Philadelphia Districts, although probably not enough to prevent some upward pressure on vacancy rates. In addition, respondents in the San Francisco and Dallas Districts expect demand outside the major metropolitan areas to continue to be relatively strong for

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warehousing, light industrial facilities, and office space. Boston and New York also report projects still in the pipeline that will keep construction activity up in 1986.

As for the President's tax proposals, commercial developers in most Districts expect a negative effect due to the proposed elimination of current real estate tax advantages. In six Districts developers actually are speeding up new projects as a result of the proposed tax reforms. However, the Boston and New York Banks found that builders were not yet reacting to these proposals.

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FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC PANEL

Professors Feldstein, Houthakker, Samuelson and Tobin were reached for comment. Feldstein is concerned about the danger of revenue loss from the tax reform proposal; he still believes a $100 billion reduction in Federal spending by 1988 is the most likely outcome but now regards that figure as a maximum, not a minimum, that can be achieved. He favors no change in the monetary growth targets but does not advocate an attempt to return to the midpoint of the M1 range.

Houthakker was concerned about the prospect of higher inflation, pointing to recent wage developments and the impact of a decline in the dollar which "has to come." Houthakker wants no change in the targets and M1 brought back to the top of its range before the end of the year. Until M1 is returned to its range, there is no point in lowering the 1986 targets. He feels that M1 growth outside the target range makes Congress less willing to act to reduce the deficit.

Samuelson notes that, despite strong M1 growth, the economic outlook is weaker now than a year ago when the tentative 1985 targets were set, and weaker than when the targets were set earlier this year. He sees no signs of a significant increase in inflation over the next year to year-and-a-half. Thus, ignoring its "public reactions" aspect, there is a *prima facie* economic case for raising the targets. The high level of the dollar supports the case for further easing. Samuelson notes that in recent years the decision to take

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"the risks and the flak" associated with above-target money growth has been necessary to sustain the momentum of the expansion. This risk seems worth taking now, even if an acceleration of inflation some years ahead would be vaguely traceable to that decision. On the tactical side, Samuelson has some sympathy for rebasing M1 -- "Lord protect us from sin but not just yet."

Seeing no sign of price misbehavior and noting that the unemployment and capacity utilization rates have been flat for at least a year, Tobin believes the Fed's primary task should be to try to prevent a growth recession. He feels that the Fed has been overly cautious in weighing its monetary targets against a continuation of the recovery. Tobin urges disconnecting monetary policy from "the M1 religion," and he applauds the emphasis on velocity surprises and the need to offset them with the money stock. The fact that the February targets no longer seem consistent with the February economic projections is a sufficient reason to reexamine those targets. It would be "better to face the problem head on" by raising the targets than to rebase M1.

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JULY 1985

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Henry Kaufman (Salomon Brothers, Inc.), Donald B. Riefler (Morgan Guaranty Trust Company) and Albert Wojnilower (First Boston Corporation):*

Kaufman: While the tax reform proposals are probably contributing to some economic uncertainty, the economy is nevertheless likely to rebound in the second half of this year with real GNP increasing at an annual rate of 3 1/2 to 4 percent. Support for the economic rebound will come from continued fiscal expansion, a stimulative monetary policy and a financial market setting that is conducive to financing economic activity. Especially supportive from a financial market perspective is an interest rate structure that has a sharply positive slope and relatively narrow yield spreads between high and medium quality obligations. A continued large volume of corporate bonds is expected to come to the market in the next few months and a very large new volume of municipal obligations is likely in the final quarter of 1985 if tax reform proposals are taken seriously by state and local borrowers. These developments should contribute to a very modest but not spectacular rise in both short and long-term interest rates before year end.

Riefler: There are more crosscurrents than usual in the markets. Interest rate reductions in primary markets seem significant but credit conditions remain fragile. The dollar has a slight downward bias but remains at high levels against other currencies. Budget deficit reducing

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*Their views of course are personal, not institutional.

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measures have been passed by both legislative bodies but agreement on specifics is in doubt.

The Fed should follow a stable policy pending resolution of these issues.

Wojnilower: Anecdotal reports continue to suggest poor performance in manufacturing and lackluster profitability in retailing, although retail sales volume appears to be doing pretty well. Economic activity appears to be continuing to expand, but recent gains have been less robust than I had expected.

The bond markets remain dominated by an outlook that sees little chance of major rises in interest rates but some significant possibility of a major drop. If the economy weakens the Federal Reserve is expected to ease substantially, but if the economy strengthens the Federal Reserve is not expected to tighten for a considerable time. Similarly, oil prices may decline a great deal--which would warrant a sizable step downwards in interest rates--but no chance is feasible of any rise in oil prices in the nearby future. Meanwhile, the market again has demonstrated the low weight it places on Federal budget developments as compared with the short-term outlook for business and the Federal funds rate.