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

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: August 13, 1986

FROM: Rosemary Loney

Enclosed are the greenbook, special reports prepared at two Federal Reserve Banks, and a memorandum from Mr. Sternlight dated August 13, 1986, on the composition of the System portfolio and operations in Treasury coupon securities.

Also enclosed in separate envelopes are Class I materials including (1) a memorandum from Chairman Volcker, (2) the revised policy record, and (3) the final version of the minutes of actions for the July meeting.

Enclosures

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CLASS II - FOMC

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Samuelson and Tobin were available for comment this month. Samuelson noted that, in retrospect, above target M1 growth had been necessary to avert an outcome worse than the growth recession we have experienced. Assuming Japan and West Germany resume growing at about 3 percent, current indicators confirm that real growth of about 3 percent can be maintained here without another reduction in the discount rate. However, if the Gramm-Rudman legislation should trigger a strong dose of fiscal restraint, the FOMC must stand ready to offset any short-term weakness in economic activity.

Tobin sees a clear case for easing in the weakness of the domestic economy: Real interest rates are still high; the unemployment rate is stuck near 7 percent; and inflationary pressures continue to abate. Both Samuelson and Tobin would not resist further declines in the dollar to help correct the trade deficit. Samuelson would "like to see an overshoot, if it is necessary" to correct the problem. Tobin acknowledges that a free-fall panic could come some day in the foreign exchange market but dismisses the idea that it would be produced by easier monetary policy under current economic conditions. Tobin would not be concerned about declines in the dollar igniting sharp increases in the prices of traded goods because it would be a one-shot effect without major secondary repercussions, it will be necessary to cure our trade imbalance, and the past improvement in our inflation rate due to the rise in the dollar will have to be "paid back" sooner or later as the dollar drops.

STRICTLY CONFIDENTIAL--F.R.
CLASS II - FOMC

AUGUST 1986

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from David Jones (Aubrey G. Lanston & Co.), Donald B. Riefler (Morgan Guaranty Trust Co.) and Francis Schott (Equitable Life Assurance Society):*

Jones: The financial markets are in a state of uncertainty. In the middle of the Treasury's recent record-sized refunding, bond market investors were beset by less favorable fundamental forces including, most importantly, the apparent OPEC agreement reducing oil production. The best news on the inflation front is probably behind us and there is likely to be at least a moderate acceleration in real economic activity in the second half of 1986. Consumer spending on durable goods, services, and housing should pace the second half gain. Also, the trade deficit, though unyielding so far, is at least unlikely to get any worse. These positive factors should outweigh the negative forces in the economy, mainly centered in the deflation-depressed sectors, such as energy (which may, in light of the latest oil price spurt, have seen its low point), farming, mining, timber. On balance, real GNP growth should pick up to a 2.5 - 3.0 percent pace in the third quarter and increase further to perhaps 3.0 - 3.5 percent in the fourth quarter of this year. Yet a further acceleration in real GNP growth to 3.5 - 4.0 percent is expected in the first quarter of 1987, reflecting primarily an expected decline in the U.S. trade deficit in delayed response to a plunging dollar.

Against this background, a further Federal Reserve easing move is by no means a certainty. Odds slightly favor a "one-more-for-the-road" Fed discount rate cut to 5 1/2 percent from 6 percent, perhaps coordinated with a

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*Their views of course are personal, not institutional.

discount rate cut by Japan. But bond market participants are likely to perceive such a Fed easing step as the "last one," and the result could well be a further steepening in the yield curve as shorter term rates move down in line with the lower Fed discount rate while longer term rates move higher, reflecting increased investor inflationary expectations.

Riefler: The proposed OPEC accord on oil prices plus the upward revisions of GNP growth give the monetary authorities throughout the world some breathing room. Firmer oil prices reduce the threat of financial disaster for the domestic oil industry and oil exporting countries. The revised GNP figures changed the characterization of the economic expansion over the last couple of years from weak to moderate.

The authorities should use this time to press forward with economic coordination to foster a worldwide recovery on a more balanced basis.

Schott: The economy has been disappointingly sluggish despite strong Federal Reserve stimulus.

Nevertheless, there is reason to expect late-1986 improvement. The trade balance is beginning to respond to dollar depreciation, and passage of tax reform should remove the uncertainty impeding plant and equipment spending.

Federal Reserve policy has been appropriately easy. Credit availability is ample at short-term and long-term institutions. A holding pattern is currently appropriate.