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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: December 11, 1985

FROM: Nancy Steele

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

Enclosures

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Houthakker, Samuelson, and Tobin were available for comment this month. Houthakker believes that "1986 will resemble 1985. There is no recession in the near future; the economy will continue crawling along." According to Houthakker, "a modest reduction in the discount rate may be appropriate since the rate of inflation is low and shows little sign of reviving." A lower discount rate also may help prevent the foreign exchange value of the dollar from rising. "The dollar is now in a satisfactory range. But the fall of the dollar to date is 'artificial' in the sense that it has been accompanied by very heavy intervention. The dollar is more likely to rise than fall without this central bank intervention."

Although Samuelson sees no clear signs of recession, the economy appears not to be "intrinsically strong." There also are no signs of rising inflation. Despite these conditions, Samuelson believes there is no need to cut the discount rate at this time, because we may need to do it later "to keep the dollar down." The decline in the value of the dollar was better than we "dared hope." Holding today's level may become a problem, and "easier interest rates may help the cause in the future."

Tobin believes the economy has substantial slack, resulting in lost savings and investment. "A policy that would reduce the unemployment rate by one percentage point would yield $50 billion in savings per year." He advocates a lower discount rate to foster economic activity and capital formation. He does not believe such a step would precipitate "a free fall" for the dollar. A lower discount rate may tend to depress the dollar, but "we have little reason to defend today's exchange rate, unless our growing net exports threaten to overheat the economy." Tobin sees no signs of such rapid growth now or anytime soon. West Germany and Japan appear to be comfortable with the dollar's current value; he believes that they would adjust their economic policies with ours to prevent a "free fall." Furthermore, Tobin was disappointed that "the only significant policy change following the G-5 agreement appears to be Japan's tightening of money," raising the value of the yen.

DECEMBER 1985

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Donald B. Riefler (Morgan Guaranty Trust Company), Leonard J. Santow (Griggs and Santow, Inc.) and Albert Wojnilower (First Boston Corporation):*

Riefler: Improving financial market conditions hold promise for a better tone in the economy as 1986 unfolds. However, much of the optimism in markets seems based on indications that (1) the budget problem will at last be addressed; (2) the Baker initiative will help solve the LDC problem; and (3) that the G-5 will be successful in dealing with the foreign exchange imbalances. A reversal in any of these assumptions could cost problems. The Fed's monetary policy seems about right under these circumstances.

Santow: There are early signs that the economy is starting to improve in the manufacturing sector--the Purchasing Managers' Report, the Conference Board help-wanted index, and the November increases in manufacturing employment, overtime and weekly earnings all support this view. This should come as no surprise in view of the recent decline in interest rates and the Fed's generosity in terms of reserve availability. The big improvement in the stock market and more bullishness in the corporate profit outlook have also added to the better economic picture. Under these circumstances, the Fed should be in no rush to ease an already very accommodative monetary policy.

In addition, there are some other reasons for the Fed to hold off on any policy change. M-1 in November and December will apparently grow at double-digit rates and the dollar could weaken more than desired if the discount rate

*Their views of course are personal, not institutional.

is reduced. In addition, if Gramm-Rudman is not passed, Fed easing might send the wrong message to the markets. Finally, it would make sense to study closely the revised GNP data before any decision is made as to whether the economy needs additional stimulation.

Wojnilower: Straws in the wind from clients in the electronics and other manufacturing businesses, as well as in autos and other retail trade suggest at least a modest improvement in the business situation and outlook.

Of course, a large majority of financial market participants (although not as overwhelming as before) has locked in the expectation of a dull economy. Thus even a year-to-year Christmas sales as large as 8-10 percent is already labeled as a negative and disappointing result. In similar fashion, most market participants (but not quite as many as a few weeks ago) still take for granted that the Federal Reserve will lower the discount rate in the near future. Only in the event of the collapse of the dollar does the market view any rise in short rates as even remotely conceivable.

Thinking for myself, the economy appears to be in the beginning of a significant business acceleration. For several months manufacturing output and orders have been rising, while inventories are shrinking rapidly. Some key prices have firmed a little. All this in combination with rapid monetary growth, lower long-term interest rates, and the bull market in stock and bonds is exactly the pattern one would expect at the beginning rather than at the end of business expansion.

The only cloud is the predictable deflationary response in Japan at a time when the whole Pacific Basin is already experiencing a significant economic slowdown. In my opinion, the effort to devalue the dollar is a more harmful beggar-thy-neighbor policy than protectionism.