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

TO: Federal Open Market Committee DATE: December 10, 1986

FROM: Rosemary Loney

Enclosed are the greenbook, and special reports from the Boston and New York Banks summarizing the views of outside economists about the economic outlook. Also enclosed is a Class I memorandum on factors that might affect the monetary aggregates in 1987.

Enclosures

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FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professor Tobin was available for comment this month. He attached no significance to the increase in the index of leading economic indicators for October. Real GNP will grow only 2 to 3 percent at best in 1987, extending the relative stagnation of the past 2-1/2 years. There is some danger that the unemployment rate will rise. He feels that tax reform will hurt investment in the short run, although a small amount of expenditures (consumer and investment) may be shifted from next year into this year due to the changes in the tax law. He anticipates no stimulus from fiscal policy, with Congress balking at increasing defense spending. Tobin projects a decline in the structural deficit. The only hope for stimulus is an increase in net exports. However, an improvement in the trade deficit will occur slowly over the next year.

Tobin would welcome a reduction in interest rates. He feels current monetary policy is too tight as measured by the state of the economy and the level of real interest rates. Fear of a possible resurgence of inflation due to a declining dollar is not a justification for avoiding a decrease in domestic interest rates. So far, import prices have not reflected much of the dollar depreciation because profit margins on imports have been reduced as importers have tried to maintain market shares. In any case, he is not worried about a one-time increase in prices due to a dollar depreciation as long as it does not lead to a continuing price spiral. Given the weak economy and relatively low inflation rate at this time, there is little chance that a dollar depreciation would lead to such a spiral. We should continue to pressure Germany and Japan to stimulate their economies, but we should stimulate our economy whether or not they do so.

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CLASS II - FOMC

DECEMBER 1986

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Donald Maude (Refco Partners), Donald B. Riefler (Morgan Guaranty Trust Co.) and Leonard J. Santow (Griggs and Santow, Inc.):*

Maude: The U.S. economy should be going into a phase of deepening sluggishness at the very time that the Japanese economy is close to recession and the West Germany economy is in a state of stagnation. What would properly be required over the opening months of 1987 to breath new life into all three economies will be at least one more round of coordinated official central bank rate reductions. The latitude for such a move seems to be close at hand as the markets sense the oncoming weakness and realize that there are no early warning signs of any acceleration in the rate of inflation of consequence. These two ingredients--which would make further easing a credible policy--should fall into place over the opening months of 1987. In this regard, we suspect that most of the strength in the present quarter will represent borrowing of spending from the first quarter and from involuntary inventory accumulation. As such, while fourth quarter real GNP growth could come in at about 3.0 percent, the first quarter could slow to the 1.0 to 1.5 percent area. Given this, the continued sharp decline in M1 velocity and a slowing of the broader Ms, further easing in policy appears appropriate.

*Their views of course are personal, not institutional.

Riefler: Earlier fears that the price surge in precious metals, weakness in the dollar, steepening of the yield curve, and rapid growth in the money supply were harbingers of inflation seem to have been allayed. The domestic economy remains sluggish and reports from overseas project a slowing of economic activity elsewhere. The Fed's stable monetary policy has been appropriate during this period of uncertainty.

Looking ahead, a drop in rates in Germany seems probable in the new year and could easily create an atmosphere in which further easing action on the part of the Fed would be appropriate.

Santow: The U.S. economy in November showed signs of improvement, and the same picture is likely to continue in December. Real GNP growth for the quarter could easily come in at over 3 percent. However, there is a good chance that part of this strength is being borrowed from the first quarter. Due to the uncertainties surrounding these estimates, however, and the Fed's recent very generous approach to reserves--total, non-borrowed and free--this would be a good time to pause for reflection. Decision on meaningful policy change should be deferred to the February FOMC meeting which is right before the Chairman's Humphrey Hawkins testimony. This would be an appropriate time because important January economic data will be available and a preliminary estimate on first quarter GNP can be made.