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Name of Document: BRIEFING PAPERS FOR PRESIDENT'S SCHEDULED APPOINTMENTS FOR JAN 11 84

Subject Codes:

PR 007-01

FG 368-

1) **Subject:** Meeting with the President's Economic Policy Advisory Board

ROUTE TO:		ACTION		DISPOSITION		
Office/Agency	(Staff Name)	Action Code	Tracking Date YY/MM/DD	Type of Response	Code	Completion Date YY/MM/DD
RMHENL		RSZ			C	

Referral Note:

has seen

THE SCHEDULE OF PRESIDENT RONALD REAGAN

Wednesday, January 11, 1984

9:00 am (30 min)	Staff Time (Baker/Meese/Deaver)	Oval Office
9:30 am (15 min)	National Security Briefing (McFarlane)	Oval Office
9:45 am (15 min)	Senior Staff Time	Oval Office
10:00 am (60 min)	Personal Staff Time	Oval Office
11:00 am (60 min)	Meeting with Commission on Central America (McFarlane)	Cabinet Room
12:00 m (60 min)	Lunch	Oval Office
1:00 pm (30 min)	Meeting with Foreign Intelligence Advisory Board (McFarlane)	Cabinet Room
1:30 pm (30 min)	Meeting with Secretary Shultz	Oval Office
2:00 pm (60 min)	Meeting with the President's Economic Policy Advisory Board (Svahn)	Roosevelt Room
3:00 pm (5 min)	Meeting with William Wilson and Archbishop Pio Laghi (McFarlane)	Oval Office
3:05 pm	Personal Staff Time Remainder of the Day	Oval Office/ Residence

UNP REVISED 01/11/84 8:45 am

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THE SCHEDULE OF PRESIDENT RONALD REAGAN

Wednesday, January 11, 1984

9:06 – OVAL

9:00 am (30 min)	Staff Time 9:08 (Baker/Meese/Deaver) 9:31 BUSH	Oval Office
9:30 am (15 min)	National Security Briefing 9:34 (McFarlane), , POINDEXTER 9:57	Oval Office
9:45 am (15 min)	~~Senior Staff Time~~	Oval Office
10:00 am (60 min)	Personal Staff Time 9:57 –	Oval Office
11:00 am (60 min)	Meeting with Commission on Central America 11:07 – 11:57 (McFarlane)	Cabinet Room
12:00 m (60 min)	Lunch 11:58 – 1:01	Oval Office
1:00 pm (30 min)	Meeting with Foreign Intelligence Advisory Board 1:02 – 1:35 (McFarlane)	Cabinet Room
1:30 pm (30 min)	Meeting with Secretary Shultz 1:36 – 2:06	Oval Office
2:00 pm (60 min)	Meeting with the President's Economic Policy Advisory Board 2:10 – (Svahn)	Roosevelt Room
~~3:00 pm (5 min)~~	~~Meeting with William Wilson and Archbishop Pio Laghi (McFarlane)~~	~~Oval Office~~
3:05 pm	Personal Staff Time Remainder of the Day	Oval Office/ Residence

UNP REVISED 01/11/84 8:45 am

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~~3:00 pm (5 min)~~	~~Meeting with William Wilson and Archbishop Pio Laghi (McFarlane)~~	Oval Office
3:05 pm	Personal Staff Time Remainder of the Day	Oval Office/ Residence
4:00 -	A. Adler Res.	

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01/11/84
8:45 am

THE SCHEDULE OF
PRESIDENT RONALD REAGAN

Wednesday, January 11, 1984

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1:00 pm (30 min)	Meeting with Foreign Intelligence Advisory Board (McFarlane) (distributed separately)	Cabinet Room
1:30 pm (30 min)	Meeting with Secretary Shultz	Oval Office
2:00 pm (60 min)	Meeting with the President's Economic Policy Advisory Board (Svahn) (TAB A)	Roosevelt Room
3:00 pm		
3:00 pm	Personal Staff Time Remainder of the Day	Oval Office/ Residence

UNP 01/10/84
4:00 pm

THE WHITE HOUSE

WASHINGTON

January 10, 1984

MEETING WITH THE PRESIDENT'S ECONOMIC POLICY ADVISORY BOARD

January 11, 1984
2:00 p.m.
Roosevelt Room
(60 minutes)

From: John A. Svahn JAS

I. PURPOSE

To review our monetary policy developments, international trade policy issues in 1984, and the budget and economic outlook.

II. BACKGROUND, PARTICIPANTS, AND PRESS PLAN

A. Background:

This is the eleventh meeting of your Economic Policy Advisory Board. The Board last met on July 20, 1983.

The meeting will commence at 10:00 a.m. and will focus on three agenda items:

1. Monetary policy;

2. International trade issues in 1984; and

3. Budget and economic outlook.

Walter Wriston, chairman of the Board, has prepared and circulated a paper entitled, "Monetary Policy and 1984 Economic Performance," to serve as the basis for the Board's discussion of the first agenda item. This paper and a short summary of it are attached at Tab B.

Arthur Burns will present some ideas to lead off the discussion on international trade issues in 1984.

Alan Greenspan will present some ideas to lead off the discussion on the budget and economic outlook. No papers have been circulated for the second and third agenda items.

B. <u>Participants</u>:

A list of participants is attached at Tab A.

C. <u>Press Plan</u>: White House Photographer only.

III. <u>SEQUENCE OF EVENTS</u>

When you enter the Roosevelt Room at 2:00 p.m., the members of the Advisory Board will have been meeting since 10:00 a.m., with a break for lunch from 12:00 to 1:00. As in past meetings, you should sit opposite Walter Wriston, the Advisory Board chairman. Wriston will briefly summarize the Board's morning discussion before a more general exchange involving all Board members.

PARTICIPANTS

Members:	Walter B. Wriston, Chairman Arthur F. Burns Rita Ricardo-Campbell Peter M. Flanigan Alan Greenspan Arthur B. Laffer James T. Lynn Herbert Stein Murray L. Weidenbaum
Administration Officials	Vice President Bush Donald T. Regan Edwin Meese John A. Svahn Martin Feldstein Richard G. Darman David Stockman Craig L. Fuller Roger B. Porter Joseph R. Wright Larry Speakes Lee Verstandig William A. Niskanen William Poole

IV. TALKING POINTS

A. It is always a pleasure to meet with this group and to have the benefit of your advice.

B. I know that you have already met since 10:00 this morning and I trust that your extensive discussions have produced the usual consensus that occurs when a group of economists gets together.

C. I understand that you have focused your meeting today on monetary policy, the international trade issues you see ahead during 1984, and the budget and economic outlook. It is difficult to think of three more important and pressing questions on the economic policy horizon and I am looking forward to hearing your views.

Monetary Policy and 1984 Economic Performance

Walter Wriston has prepared a paper for the Economic Policy Advisory Board which discusses recent monetary policy and its implication for the continued recovery in 1984.

Mr. Wriston makes several significant points:

- The Federal Reserve has programmed a significant slowdown in economic growth in the first three quarters of 1984. From the end of July through December 1983 the money supply, as measured by M1, has grown at a 3 percent annual rate. The Federal Reserve's target for M1 is 5 to 9 percent.

- Past experience would suggest that falling from a 13.5 percent rate of growth of the money supply for a full year to 2 to 4 percent rate of growth for several months could cause the economy to stall.

- The financial markets are beset by a number of cross currents. There is an awareness that the Federal Reserve is conducting a tight monetary policy. But simultaneously participants in the financial markets are skeptical that the recent low rates of inflation will continue. The market is also unsettled in some degree by the evidence that the Federal Reserve has returned to pegging interest rates. That policy procedure is associated with pre-1979 policies that led to higher inflation.

- It cannot be overemphasized that the present predicament is a result of exceptionally high growth in the money supply from mid-1982 to mid-1983. The economy cannot avoid great volatility if the money supply is highly volatile.

- A sharp slowdown in economic growth in 1984 will be blamed on the large Federal deficits and not on monetary policy. Because it is fashionable to believe that large deficits will terminate the recovery, monetary policy will not be held responsible in the public mind for the poor performance of real GNP.

Memorandum Prepared for the President's Economic Advisory Policy Committee

From: Walter B. Wriston January 5, 1984

Re: Monetary policy and 1984 Economic Performance

- Since the end of July 1983 through December the money supply (M1) has increased at an annual rate of 3% -- the July level vs. the December level. Broken down between the third and fourth quarters of the year, the growth rate was 9% and 2%, respectively. This slower average growth in the past six months follows a 12-month period from mid-1982 to mid-1983 during which M1 grew at a 13 1/2% annual rate.
- The money supply grew much more rapidly than the monetary base -- currency and bank reserves -- between the summer of 1982 and the summer of 1983. The three percentage point "growth gap" between these two aggregates was extraordinary for so sustained a period. It largely reflected the contraction of time deposits which "freed" reserves to back extra demand-deposit growth and the public's decision to hold less currency. Then in the fourth quarter of 1983, money supply grew much more slowly than the monetary base, returning toward a more normal relationship of the "base multiplier" or the ratio of the money supply to the base. This contraction was largely due to the return to more normal growth in time deposits and also reflected some speedup in the currency component of the monetary base which had the effect of constraining the multiplier.

Thus it would seem that the Federal Reserve's monetary policy has been inadvertently thwarted in achieving a higher growth in the money supply because of a decline in the base multiplier. Historically, when such a decline in the multiplier has taken place, it has ultimately come back to track again.

Consequently, one could argue that if in the first quarter of the year, the multiplier continues to return to a more normal trend and if the base continues to grow at the same rate of the past six months, money supply will respond with an increase in the neighborhood of 5% to 6%. On the other hand, if the multiplier continues to decline at an unusually sharp rate and there is no offsetting jump in bank reserves, the money supply will continue to show a relatively low increase thus threatening a decline in real economic activity.

- The money supply numbers for 1983 are subject to revision. The revised numbers will become available in February. However, on a preliminary basis it appears that the largest revision will apply to the fourth quarter of 1983. The 2.3% increase, which has been reported, may well be revised upwards to about 3.5%.
- Monetary theory, based on empirical evidence, holds that the change in the rate of change of the money supply has a very important bearing on the future growth in nominal GNP. Sharp swings in monetary growth (big changes in the rate of change) can "shock" the economy and lead to volatile movements in nominal and real GNP. Consequently, past experience would lead one to worry that coming from a 13 1/2% rate of growth of the money supply for a full year to an increase of say between 2% and 4% for a number of months could cause the economy to stall or decline for a quarter. Had monetary policy been less expansionary in 1982/83 or if a slowdown in money growth had been undertaken sooner in 1983, the rebound in the economy would have been less robust, but the hazards of managing a slowdown without risking a decline would be much less.

- The financial markets today are beset by a number of cross currents. There is an awareness that the Fed is very tight -- "very stingy" -- with money growth at present. But simultaneously participants in the financial markets are very skeptical that the good inflation numbers will hold. Bank portfolio managers are frightened by the rapid GNP growth. It's what people see and talk about and it's reflected in the very steep yield curve. The market is also unsettled in some degree by the evidence that the Fed has returned to pegging interest rates. That policy procedure is associated with pre-1979 policies that led to higher inflation.
- It is not unusual for the market not to anticipate the possible decline in the economy resulting from the tight monetary policy. Remember the high rates in early 1982 when the recession was well advanced. Skepticism about monetary policy and the long-run inflation outlook -- as unreasonable as some may believe that to be -- is dominant today in the market and it's been nurtured by the high money growth of 1982-83 and the resulting high economic growth. People in the marketplace remember earlier recoveries that led ultimately to significantly higher inflation.
- Interest rates may decline when market participants are surprised by a sharp slowdown or a decline in the economy. But as the Fed reverses policy and becomes overly expansionary again -- due to its faulty steering mechanism -- rates will rise again as they have repeatedly (except for a five-month period in the second half of 1982 when inflation expectations were plummeting) every time money growth explodes. Thus, at some point during the second half of 1984 interest rates could be rising as inflation moves higher than the 1983 average, and the economy struggles to pull out of a stall or an outright decline. The second half of 1980, incidentally, was just such a period.

- The question is how will the recent slowdown in the rate of growth of M1 affect the rate of increase of nominal and real GNP during 1984? Additionally, and perhaps more to the point, how will M1 growth during the next three to six months influence the rate of growth of nominal and real GNP?

Citibank's macroeconomic model (CitiSim) uses M1 as an important variable in forecasting changes in nominal final sales to which inventory changes are added to arrive at nominal GNP. The table below summarizes how the model did in predicting GNP, final sales, and prices in 1983. The "forecast" uses the actual M1 (adjusted for NOW accounts) and assumes no growth in trend income velocity of M1 for the first three quarters of 1983 and a 1.5% increase in trend velocity in the fourth quarter.

Percent Change, Fourth Quarter 1982 to Fourth Quarter 1983

	Actual	CitiSim "Forecast"
Final Sales	7.8%	8.1%
Real Final Sales	3.7	4.6
Final Sales Deflator	3.9	3.3
GNP	10.5	11.3
Real GNP	6.0	7.4
GNP Deflator	4.2	3.7

Because of the way the model is constructed, assumptions about trend velocity impact nominal GNP or nominal final demand and price, but leave real (GNP or final sales) virtually unaffected in the short run. A lower velocity assumption would lower nominal GNP and price, and just the reverse with high velocity leaving real GNP unchanged in the short run.

The appendix includes tables which show the model projections for 1984 based on three different assumptions with respect to rate of change in M1. Following are brief descriptions of each forecast:

Forecast I

- If we assume that the fourth quarter money growth numbers are revised up to 3 1/2%, which we believe is highly probable, and a 5% increase in the first quarter of 1984, there is no decline in the economy in the second quarter but a sharp slowdown in the rate of real GNP to a rate of less than 2%.

Forecast II

- If we assume M1 grows at 3 1/2% in the fourth quarter of 1983 and 1% in the first quarter of 1984, we show a decline of about 1% in real GNP in the second quarter of 1984.

Forecast III

- If we accept the fourth quarter increase in M1 of 2 1/2% and assume a growth rate of only 1% in the first quarter of 1984, the economy declines by more than 1% in the second quarter of 1984 and shows very little real growth in the final two quarters of this year.

Obviously, these rates of change and the timing of the change cannot be taken as absolute results in the real world. A decline of about 1%, as shown in Forecast II, is sufficiently ambiguous as to allow for no decline or a very moderate rise in real GNP. On the other hand, in Forecast III, a decline of more than 1% is much less ambiguous but may also be taken to mean -- at best -- no change in real GNP.

Similarly, the precise timing of the slowdown is difficult to capture. Velocity, which proved to be so elusive during 1982-83, has been moving back towards track in the quarter just ended and it's assumed that we will have a further increase in velocity in the first quarter of this year. But the volatile behavior of money growth raises the probability of a decline in velocity as the volatile behavior of the economy increases uncertainty and thus the demand for money balances at some point during 1984. This will occur as policymakers respond to clear evidence of the economic stall by shifting to an expansionary monetary policy. The influence of that monetary expansion will thus be delayed by the decline in velocity caused by volatile monetary policy.

Monetary policymakers may at least implicitly be assuming that the money multiplier will rise in the first quarter of the year. If this happens and the money supply grows by 5% or more, it would appear from the model that a decline in the economy would be avoided -- but just barely.

On the other hand, those who are concerned that the Federal Reserve has gone too far in allowing the rise in money supply to slow down are implicitly assuming that either the multiplier will not rise in the first quarter or that it will not rise sufficiently to lift the growth of the money supply to a rate that will avoid an outright economic decline and a very weak performance through the second half of 1984. The assumptions of those holding views on either side of this issue, including Federal Reserve officials, are couched in uncertainties and very little precise knowledge about short-term changes in the monetary base multiplier.

The higher inflation rate in these forecasts -- between 6% and 6.5% in 1984 -- is due to the very high money growth in 1982 and the first half of 1983 and the pace of economic recovery which we expect will continue through the first quarter of 1984. The rise in inflation will be an element in producing the decline -- and determining the size of the decline -- in the real economy. Most economic forecasts and the expectations of most businessmen and people in the financial markets assume continued good economic growth, say around 4.5% in real terms but 10% to 11% in nominal terms. Most businesses look at nominal performance. Hence, a 5% to 6% price rise is implicitly built into expectations.

As monetary policy has programmed a much larger-than-expected slowdown in nominal GNP, prices will not adjust fast enough to prevent that slowdown from squeezing real output and possibly causing a decline. The rise in the inflation rate may be less than projected by the model but it will certainly be higher than in 1983. Inflation expectations are expressed by businessmen in terms of optimism, length of the order book, operating rates, etc. It would be a mistake to assume that the much better-than-expected economic recovery in 1983 has not caused such "inflation expectations" to rise.

Despite the relatively surprising success in reducing inflation in 1982-83, it should be recognized that long-term success will only be achieved by a more even- handed monetary policy and, hence, a more stable, albeit gradually slower, rise in nominal GNP performance. The risk is clear: If the economy, to the surprise of most people, declines in 1984, the Federal Reserve will turn with a sense of urgency to an expansionary track and thus risk a repeat of the volatility that is so damaging to the achievement of a rational economic policy.

Conclusion

It would appear that in the very least, the Federal Reserve has programmed a very significant slowdown -- close to a stall -- in economic growth at some point during the first three quarters of 1984. Thus the risk is high that if the money growth remains relatively flat for another three months or more, an outright decline in real economic activity will occur.

It cannot be overly emphasized that the present predicament is a result of the exceptionally high growth in the money supply from mid-1982 to mid-1983. The risk of imposing an excessive monetary shock on the economy in coming off that high growth rate is clearly very large. Put more simply, the economy cannot avoid great volatility if the money supply is highly volatile. The degree of monetary restraint in terms of its ultimate effect on nominal GNP growth is currently underestimated by a marketplace which normally measures monetary restraint in terms of movements in interest rates. Moreover, it is illogical and hazardous to assume that changes in the character and content of M1, the random behavior of money velocity, and the base multiplier, will somehow improve the conduct of monetary policy or make wide discretionary swings in the rate of growth of money less relevant to the performance of the economy.

As a footnote to this outlook, it's perhaps important to recognize that the sharp slowdown in economic growth or outright decline will be blamed on the large federal deficits and not on monetary policy. It is fashionable at this time to believe that the large deficits will terminate recovery. Consequently, monetary policy by and large will not be held responsible in the public mind for the poor performance of real GNP.

FORECAST I

	1983		1984			
M1 (adjusted)	8.4	3.5	5.0	7.0	8.0	8.0
Final Sales annual rate of change	8.4	7.5	11.0	7.5	11.5	11.7
Real Final Sales 72$ annual rate of change	5.1	2.7	4.1	1.3	4.8	5.0
Chg Bus Inventory 72$	3.8	10.8	9.9	10.4	9.3	12.2
Nominal GNP annual rate of change	11.5	9.6	10.8	7.8	11.2	12.5
Real GNP 72$ annual rate of change	7.6	4.5	3.9	1.4	4.4	5.7
GNP Deflator annual rate of change	3.6	4.9	6.7	6.3	6.5	6.5
Unemployment Rate	9.4	8.9	8.7	8.5	8.4	8.0

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FORECAST II

	1983		1984			
M1 (adjusted)	8.4	3.5	1.0	4.0	4.0	4.0
Final Sales annual rate of change	8.4	7.5	9.9	5.2	8.3	7.7
Real Final Sales 72$ annual rate of change	5.1	2.6	3.2	-0.9	1.8	1.4
Chg Bus Inventory 72$	3.8	10.8	9.9	9.5	6.3	6.6
Nominal GNP annual rate of change	11.5	9.6	9.8	5.2	7.4	7.8
Real GNP 72$ annual rate of change	7.6	4.5	2.9	-1.0	0.9	1.5
GNP Deflator annual rate of change	3.6	4.9	6.7	6.3	6.4	6.2
Unemployment Rate	9.4	8.9	8.8	8.8	8.9	9.0

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FORECAST III

	1983		1984			
M1 (adjusted)	8.4	2.5	1.0	4.0	4.0	4.0
Final Sales annual rate of change	8.4	7.3	9.5	4.9	8.1	7.6
Real Final Sales 72$ annual rate of change	5.1	2.4	2.8	-1.2	1.6	1.4
Chg Bus Inventory 72$	3.8	10.8	9.7	8.9	5.6	5.9
Nominal GNP annual rate of change	11.5	9.4	9.3	4.8	7.2	7.8
Real GNP 72$ annual rate of change	7.6	4.3	2.5	-1.4	0.8	1.5
GNP Deflator annual rate of change	3.6	4.9	6.7	6.3	6.3	6.2
Unemployment Rate	9.4	9.0	8.8	8.9	9.0	9.1

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