MINUTES
CABINET COUNCIL ON ECONOMIC AFFAIRS

June 21, 1984
8:45 a.m.
Roosevelt Room

Attendees: Messrs. Regan, Baldrige, Porter, Wallis, Abrams, Ballentine, Ford, Lyng, Poole, Sprinkel, McManus, Herrington, Chapman, Cicconi, Fitzwater, Gibson, Johnson, Neal, Platt, and Li, Ms. McLaughlin and Ms. Risque.

1. Financial Market Developments

The Cabinet Council considered a report from the Working Group on Financial Market Developments. Mr. Poole presented a paper on interest rates, stock prices, and monetary policy. The market has revised upward its expectations of future levels of interest rates, as evidenced by the behavior in the futures markets for Treasury bills and bonds. Moreover, investors seem concerned about the fact that recessions are always accompanied by stock market declines. However, he added, there are numerous cases of market declines that were not followed by recessions.

Interest rates usually change because of new information that alters expectations about the future. New items of information that have influenced the market's assessment of interest rates between January and May 1984 include:

- Stronger economic growth than anticipated;
- Rising concern about inflation because of the strength of the economy;
- Market concerns that the Administration and the Congress will pressure the Federal Reserve to pursue a more inflationary monetary policy; and
- Fears of banking instability.

Mr. Poole noted that since the budget outlook has not changed significantly since January, and in fact will probably be slightly better than initially anticipated, interest rates probably did not rise in response to the Federal budget deficits although the prospective deficits could have interacted with other factors.

Mr. Poole reviewed the sharp increase in interest rates prior to the 1980 election. Between June and November 1980, reported M1 growth exceeded market expectations 16 times out of the 23 money stock reports. Interest rates usually increased in reaction to

those surprises. In general, attempts by the Federal Reserve to lower interest rates by increasing the money stock proved ineffective. When the Fed reported money stock increases, interest rates usually rose in anticipation of higher future inflation.

Mr. Poole offered several observations of current interest rate projections for the second half of 1984:

- The market's best guess is that both short-term and long-term interest rates will rise.
- The prevailing view in the financial press that bond yields can only rise is erroneous.
- The importance of long-term expectations in determining interest rates cannot be overestimated.
- Any unexpected increases in money growth during the remainder of this year are very likely to produce rising interest rates, as occurred in late 1980.

Mr. Ballentine presented a paper reviewing the relationship between money growth and inflation. He emphasized two major points:

- Short-term money growth data are highly unreliable and often are revised significantly.
- Long-term money growth data are more reliable and are better indicators of future inflation.

Monthly fluctuations in M1 growth explain only about 1 percent of the monthly fluctuations in inflation, while quarterly M1 fluctuations explain about 10 percent, four-quarter M1 fluctuations explain about 45 percent, and eight-quarter M1 fluctations explain about 75 percent of their respective inflation variations.

For the Administration's inflation forecast to be realized, the currently high money growth must slow dramatically or the historical relationship between long-term money growth and inflation must no longer hold.

Mr. Sprinkel presented a paper providing an outlook on inflation. He noted that since early February, there has been a 150-200 basis point increase in interest rates. The rise in rates can be attributed to strong private credit demand and, according to some monetarists, the recent high money growth.

Mr. Sprinkel observed that many market participants fear that high M1 growth will lead to higher inflation because of the historical relationship between M1 growth and inflation. However, M1 currently includes super-NOW accounts, which were not included in the past.

The markets currently need assurance that both the Federal Reserve and the Administration are committed to a non-inflationary monetary policy.

The Council's discussion focused on the effects that changes in velocity have had on economic growth. Some Council members observed that if the stock market believed the Federal budget deficit will decline significantly, it would react favorably.