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

TO: Federal Open Market Committee DATE: October 28, 1987

FROM: Rosemary Loney

Enclosed are the greenbook and supplementary information prepared at the Federal Reserve Banks of Boston and New York.

Enclosures

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CLASS II - FOMC

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professor Samuelson was the only respondent available for comment this month. Professor Samuelson feels the Federal Reserve should receive a good grade for dealing with a serious brush fire. When a crisis occurs, an accommodative monetary policy is the appropriate reaction. As a result of the financial instability, the FOMC should err on the side of ease for the next several meetings. While there have been problems in the United States, he expects more severe repercussions abroad, where many firms will be forced into bankruptcy as a result in the decline in worldwide stock markets. While the market is frequently considered a precursor of future events, he does not believe that the drop in the stock market necessarily indicates a future recession. Three weeks ago all indicators were pointing towards a rapidly growing economy. He believes that fears of Federal Reserve tightening and a balance of trade problem made worse by rapid growth triggered the drop in stock prices. The drop in stock prices became a rout as a classic stock bubble burst. Although financial bubbles have burst before there is unfortunately no theory on the duration of bubbles, either up or down. We need not be preoccupied with what triggered the drop, because if the bubble had not been pricked now, some other event would have made investors realize that stock prices were not sustainable. While a move towards fiscal austerity accompanied by incremental easier monetary policy would be reassuring to market participants, it would not be a guarantee against a further slide.

Professor Samuelson would not compare the current drop in stock prices to the crash in 1929. The depression was caused by bank failures and widespread bankruptcies rather than the drop in stock prices. With the government protections currently in place, there is little fear that events could spiral into another depression. However, the probability of a recession has increased. Three weeks ago he would have put the odds against having a recession in 1988 at 3 to 1. If the Dow Jones average remains near 1750 he would put the odds against having a recession at 2 to 1. Any further declines would increase the probability of a recession. The increased probability of a recession is due to the likely reduction in consumption, particularly for luxury items, and the increase in the cost of capital which should discourage investment, particularly for venture capital which relies on equity financing. His best estimate for real GNP for next year has dropped from close to three percent if he had been asked three weeks ago to 1.5 to 2 percent now. While the Federal Reserve needs an accommodative monetary policy, the goal should not be to return stock prices to their previous level. There was nothing intrinsic about a Dow Jones average at 2500. There is also nothing intrinsic about the current level of the dollar. However, until financial markets become more stable, lowering the dollar should not be a higher priority.

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

NOVEMBER 1987

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from David M. Jones (Aubrey G. Lanston & Co., Inc.), Leonard J. Santow (Griggs & Santow, Inc.) and Francis H. Schott (The Equitable Life Assurance Society):*

Jones: The spectacular stock price plunge on Black Monday, October 19, is the dominant influence on the near-term financial outlook. The Fed's easing that followed helped stock prices recover some lost ground and should help cushion the real sector of the economy. Further ahead, the Fed's easing actions are likely to weaken the dollar and eventually (perhaps as soon as in the first quarter of 1988) exert upward pressure on longer term U.S. interest rates.

On balance, it seems unlikely that the stock price decline will have more than a moderate impact on overall real GNP growth. There is likely to be some flattening in consumer spending and housing activity, but there is also likely to be a contrasting strengthening in business capital spending, owing to increasing profits and a rising capacity utilization rate. A modestly declining trade deficit should also add some strength. Real GNP growth is likely to be pushed no lower than a 2 - 3 percent growth rate in the final quarter of this year and perhaps through the first half of next. The collapse in stock prices could temper inflation psychology as well.

Santow: An economic forecast made as recently as Friday, October 16, is no longer valid because of the stock market debacle. Real GNP for the

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* Their views of course are personal, not institutional.

fourth quarter could now come in at only 1 percent to 2 percent and the first quarter of 1988 could be even weaker. Consumer spending on big ticket items will be adversely affected and the timing could not be worse with the start of the new auto model year and the holiday season upcoming. Corporations will also cut back on plant and equipment outlays, although this will take until the first half of 1988 to show up in a meaningful way. Inflation under these circumstances is not a pressing short-term problem.

The ugly events in the equity market and its adverse effect on economic activity require a bold Fed initiative to indicate control of the situation. The discount rate should be reduced 1 percent and the funds rate target should be cut to between 6 percent and 6 1/2 percent. At the same time this announcement is made, the Administration should announce support of the dollar at approximately current levels and a desire to reduce the budget deficit by more than $23 billion through a combination of expenditure reductions and tax increases.

Schott: Financial market disturbance is likely to subside, partly because of well judged official liquidity-strenghtening measures, partly because institutional investors are on the verge of a major bargain-hunting exercise.

The hope for an agreed budget-improving compromise must be fulfilled. The dollar should be permitted to decline somewhat at the earliest opportunity to strengthen belief in eventual reduction of the U.S. trade deficit.