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BOARD OF GOVERNORS
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FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: June 22, 1988

FROM: Normand Bernard N.B.

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

Enclosures

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# FIRST DISTRICT - BOSTON

## SPECIAL DISTRICT REPORT
## ACADEMIC LEVEL

Professors Samuelson and Tobin were available for comment this month. Professor Samuelson believes the strength in the economy indicated by recent economic data increases the odds that the economy may be in danger of overheating. Particular industries with especially high capacity utilization rates could become bottlenecks. In addition, strong growth in Japan and other industrial countries should be of concern, since strength abroad is likely to lead to strength here. Higher farm prices will result from the midwestern drought. To the extent people mistake one-shot price increases for the onset of continuing inflation, the consequences of this shock should be taken seriously.

Professor Samuelson believes there should be no strong stepping on the brakes. Rather, the Fed should permit markets to tighten on their own with only slight help from the Fed. The growth in export industries should not be hindered. Profits and relative prices should be allowed to rise in export industries as an incentive to increase capacity in those industries in order to regain their lost shares of world production. Rather than responding to sectoral price increases related to strong foreign demand pressing against capacity limits, the Fed should apply monetary restraint only when aggregate demand exceeds aggregate supply overall and produces general increases in prices.

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Professor Tobin believes there is no direct evidence that the economy is overheating at this time, although each month of declining unemployment rates and increasing capacity utilization should make the Fed more cautious. With unit labor cost growth still moderate, there is no sign of "misbehavior" in labor markets. We must be willing to accept one-shot increases in import prices as the cost of improving our trade performance. Such price increases should not be taken as a sign of continuing inflation unless they trigger an inflationary wage-price spiral. Since there is no sign of such a spiral at this time, the Fed should not apply the brakes but continue to allow slow economic growth. The Fed must watch carefully as we gradually substitute aggregate demand from the import-export sector for aggregate demand from the government sector. If the trade deficit improves faster than the budget deficit, the Fed may need to apply the brakes.

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CLASS II--FOMC

June 1988

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Scott E. Pardee (Yamaichi International), David Jones (Aubrey G. Lanston & Co.), and Francis Schott (Equitable Life).

Pardee: The U.S. economy is growing reasonably strongly, with no sign of generalized overheating or early recession. The economy is, however, receiving substantial stimulus from the continuing fiscal deficit, a build-up in business spending, and an improvement in the foreign trade balance. Prices of key commodities have risen and public concern over a possible increase in inflation dominates the stock, bond and foreign exchange markets.

The Federal Reserve has moved gingerly to tighten bank reserve positions, and this has helped somewhat. I believe, however, that the inflationary threat here and abroad is much more serious than can be headed off by the modest moves taken so far and that an early hike in the discount rate is warranted. In addition, I would allow the dollar to rise should it come into substantial demand. A rising dollar now

*Their views of course are personal, not institutional. Comments were received on June 17, 1988.

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would help restore confidence in our currency around the world. It would also give foreign central banks some leeway to deal with incipient inflationary pressures by absorbing excess liquidity in their own markets and raising their own interest rates. Such moves by the Federal Reserve and foreign central banks should of course be coordinated.

Jones: The outlook is for interest rates to hold near current levels over the next month or two. Operating as a favorable influence to pull bond rates lower is the firm dollar. Also serving as a favorable near-term influence on the bond market is the likelihood that real GNP growth will slow to perhaps 2.5% in the second quarter. This slowing in economic activity stems in part from a moderation in consumer spending. Contrasting strength is likely to continue to be evident in export-driven industrial production and employment. Moreover, business capital spending is likely to strengthen further this year.

Because of the welcomed expected slowing in the second quarter's GNP growth, the Federal Reserve is likely to maintain an unchanged policy, at least over the near-term. Looking further ahead, however, interest rates are likely to resume their uptrend by late summer. Influences operating to push rates higher are likely to include accelerating inflationary pressures, reflecting both higher food costs and demand-pull inflation in basic industries experiencing sharply increasing capacity utilization rates. At the same time, growing skilled labor shortages could eventually trigger increased wage demands.

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Adding to upward pressure on global interest rates in the second half of this year are expected anti-inflation tightening moves by major foreign central banks. Against this background, further moderate Federal Reserve tightening steps in the second half of this year are expected.

Schott: The economy is hovering on the brink of overheating as strong exports and business investment strain capacity. However, moderate consumer spending and significant real estate and energy weak spots leave legitimate doubt about the actual presence of overheating.

Such doubt hardly exists however concerning the strong likelihood of a significant worsening of the inflation figures. Hourly earnings, international commodity and domestic agricultural prices are pushing the inflation rate upward.

Should credit markets be permitted to tighten gradually there need not be any concern with the availability of institutional funds for business investment. This is still a buyer's market.