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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: August 10, 1988

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

Enclosures

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

I.1

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Houthakker and Samuelson were available for comment this month. Houthakker notes that the economy and economic policy have been behaving just about as he had expected. He expected real growth to continue near its recent pace and inflation to accelerate somewhat. But this is not sufficient reason to slam on the brakes and risk a recession. The increase in inflation is mainly the lagged impact of earlier declines in the dollar. It will take time for the impact of earlier tightening to be felt. Houthakker believes monetary policy has tightened enough for the time being.

Professor Samuelson has been surprised by the Fed's slowness in tightening policy. Above-trend growth continues at home and abroad. Wages have started to respond to tighter markets. He recalls similar circumstances in 1972, when a reluctance to tighten policy earlier contributed to the need for a more drastic tightening later. The reaction of financial markets to continued, gradual tightening now would surely be more favorable than financial markets' reaction to a major tightening later, should "events force the Fed's hand." Concerns about stabilizing the dollar should not compromise the more fundamental goals of continued real growth and inflation stabilization.

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

August 1988

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Richard Hoey (Drexel Burnham Lambert, Inc.), Henry Kaufman (Henry Kaufman & Company, Inc.), and Leonard Santow (Griggs & Santow, Inc.).*

Hoey: We expect a rise in long-term Treasury bond yields towards 12% by late 1989 or early 1990, followed by a sharp decline in a 1990 recession. Three assumptions underly our forecast: (1) a long economic cycle lasting through 1988 and 1989, (2) no major collapse of oil prices and (3) a reversal in the dollar from its recent rally to new lows in 1989 below the December 1987 low. We are now in the sixth consecutive year of above-trend economic growth in the U.S. The result has been cumulative capacity tightening in both the goods and labor markets, which should result in an acceleration in inflation in 1989 into the 6% to 8% range.

We perceive monetary gradualism in the U.S. as a return to the tradition of the 1950's, 60's and 70's in response to volatile monetary velocity and financial fragility.

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*Their views of course are personal, not institutional. Comments were received on August 5, 1988.

Others perceive it as politically motivated. If above-trend economic growth persists in the U.S., as I anticipate, the credibility and legitimacy of the central bank is likely to come under attack.

The dollar rally was caused by a front-loaded improvement in the trade deficit leveraged by a short squeeze and hot money flows. New lows in the dollar are likely in 1989 due to (1) a stall in the improvement in the trade and current account deficit, (2) accelerating U.S. inflation, and (3) minimal reduction in the cyclically adjusted deficit.

Kaufman: The financial markets have behaved exceedingly well considering the undertow of significant economic growth and the likely consequences for inflation and monetary policy. To a large extent, this current financial behavior reflects the recent strength of the dollar which has encouraged purchases of American financial assets by foreigners, the expectation that near-term monetary tightening will at best be very moderate, and the strong technical position in the bond markets due importantly to the likely absence of a long bond in the upcoming U.S. Treasury financing. Nevertheless, continued economic growth pressing against resource capacity will continue to tilt inflation upward, increasing the financing requirements of the business sector and widening the inflation differential between the U.S. and our key foreign competitors. As a consequence, the current tranquility in the financial markets will probably be a brief interlude.

Santow: Real GNP in the second half of the year is likely to grow between 3 and 3 1/2 percent, if current Fed policy remains unchanged. In the third quarter, strength is likely to come from consumption, nondefense government spending, and fixed investment. The inflation rate is likely to edge higher between now and year-end, with monthly CPI increases averaging 0.4 percent, or a touch higher.

The economic and inflation picture should put moderate upward pressure on interest rates. This situation is offset in part by technical factors such as short dealer positions and considerable investment funds on the sidelines. Look for the Japanese to take down approximately half of the 10-year note in the refunding because of the recent strength of the dollar, a 4 percent-plus yield advantage over the comparable Japanese issue, no long bond in the refunding, and the availability of substantial investible funds.