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

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: October 26, 1988

FROM: Gary Gillum GTG

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

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

A new respondent, Professor Richard Cooper of Harvard, and Professor Samuelson were available for comment this month. Professor Cooper believes that the CPI is likely to increase between 4 and 5 percent in 1989. Recent movements in the CPI can largely be attributed to changes in energy and food prices, which are temporary shocks, and apparel prices, which are affected by import controls. The underlying rate of inflation seems unchanged because of continued moderate increases in wage settlements. Unit labor costs are unlikely to grow sharply over the next six months because of high productivity growth in the manufacturing sector. Professor Cooper believes we are still seeing the delayed effects of past drops in the dollar and he expects gradual improvements in our trade deficit, so he does not expect the dollar to drop much further.

Professor Samuelson expects the CPI to rise between 4.5 and 5.25 percent over the next six months. While he has been surprised that wage increases are not accelerating nationwide, he expects to see wages rise faster next year as a result of the low unemployment rate. On the east coast, where unemployment is particularly low, wage increases are accelerating. Nonunion wages, rather than union wages, are likely to increase first with demand-pull inflation. However, as long as the economy grows slowly, he would leave monetary policy unchanged. If the Federal Reserve has evidence that real GNP is growing by more than 2.75 percent, some further tightening would be necessary.

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

October 1988

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Scott Pardee (Yamaichi International), Francis Schott (Equitable Life) and Albert Wojnilower (First Boston).*

Pardee: I see no compelling reason for the Federal Reserve to change monetary policy now. The U.S. economy is still growing. But it is not growing as rapidly as it was. Consumer expenditures have turned flat, many farm communities are suffering, the "oil patch" faces a loss of income as a result of the renewed drop in oil prices, and real estate prices have leveled off or are falling in many populous states suggesting that housing construction will also slow down. A recession is not in sight, since few industries seem to have production bottlenecks and inventories remain well under control. Inflation is still serious, however. The current inflation rate is too high to avoid generating significant wage pressures. The latest oil price drop may only be temporary.

*Their views are personal, not institutional. Comments were received October 21, 1988.

Internationally, compared with our industrial country trading partners, the U.S. price performance is poor. We run the risk of falling into a vicious circle of rising prices at home and a falling dollar in the exchange market. The U.K., whose inflation rate is comparable to ours, is engaged in a classic monetary squeeze precisely to fight inflation at home and defend the pound sterling internationally. Even no change in monetary policy is a strong statement. In the U.S., there is a renewed chorus of voices urging a further depreciation of the dollar--a policy which would only add a further twist to such a vicious circle. The trade deficit will not be solved by abasing our currency. I believe that the Federal Reserve has little practical choice but to maintain its lonely fight against inflation until the next president and Congress find a way to significantly reduce the budget deficit. In the meantime, let us not abandon the G-7 effort to stabilize the dollar against other major currencies.

<u>Schott</u>: There is inconclusive evidence of a slowdown in the economy's rate of growth during the late summer and early fall. Consumer spending has turned sluggish but business investment remains strong.

The immediate inflation danger has lessened because of oil price weakness and an improved agricultural outlook. But wage and total cost pressures still point upward.

The present Federal Reserve stance--interpreted by the market as firm but not overly restrictive--is precisely right under these circumstances. Ample institutional funds are available to finance business investment at current interest rates.

Wojnilower: The consensus of the financial markets is that the economy is slowing from the demand side, that inflation is not and will not become a problem and that there will be no recession. In response, domestic participants have been taking stock and bond prices up. Foreign participants are buyers on a surprising scale, considering that over $20 billion in NIT stock is being issued in Japan.

In my view, the apparent showing of industrial demand is a transitory ebbing of euphoric buying. For perhaps the fourth time since this economic expansion began in 1982, the anticipation of shortages and sharply rising prices is being frustrated by increases in imports. My limited client contacts do not indicate any slacking of final demand, and I judge real final nonfarm US output to be continuing to grow at a closer to 4 than 3 percent.

The fact that bond and stock prices are continuing to rise in the face of higher federal funds rates, as they have been doing for months, means that the credit markets remain strongly expansionary in their impact on the economy. They may well remain so while the sense of abundance in product markets persists (even though prices in most of these markets are rising a little faster now than before). The speculative oil market may exert an undue influence on market perceptions in this regard.