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

TO: Federal Open Market Committee **DATE:** June 27, 1990

FROM: Gary Gillum GG

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

6/25/90

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT

ACADEMIC LEVEL

Professors Samuelson and Houthakker were available for comment this month. Professor Samuelson believes that GNP growth over the past several quarters is only slightly below potential growth. The poor performances in the automotive and housing sectors, as well as any possible credit crunch, have clearly been inadequate to produce the recession many have anticipated. Low unemployment, robust growth in final demand, and a low probability of recession as measured by the Stock and Watson indicator all suggest that a downturn is unlikely in the near future. Although he warns that weaknesses in the economy have a tendency to occur rapidly, he is not worried now about an impending recession.

Professor Samuelson is concerned that the core rate of inflation is beginning to accelerate. Because "slugflation" is preferred to "stagflation," he believes that output growth slightly below potential GNP is currently optimal. Slight increases in unemployment may be necessary to stabilize inflation. Given the relative strength in real GNP and the current indications of accelerating inflation, he advocates continued firmness in monetary policy.

Professor Houthakker believes that the April and May inflation figures reveal the stability of the core inflation rate; the first-quarter inflation acceleration was merely an aberration. Although the danger of rising inflation persists, it is not a problem that demands immediate action. He concurs, however, in the long-run objective of price level stability, yet he believes that the achievement of this goal is infeasible in light of current US fiscal policy. Only after fiscal discipline has been restored should the Federal Reserve embark on a path toward zero inflation.

Professor Houthakker further emphasizes the dollar's role in facilitating the Federal Reserve's fight against inflation. He advocates using the exchange rate to help stabilize the price level. The Federal Reserve's task of fighting inflation has been complicated this past year by the depreciation of the trade-weighted dollar. Although the appreciation of the dollar vis-a-vis the yen has mitigated much of the inflationary pressure from the dollar's depreciation against the European currencies, he fears any further depreciation will be inflationary. A stronger dollar, in the long run, will ease the Federal Reserve's job of decreasing inflation.

The current strength in GNP and final demand clearly indicates to Professor Houthakker that the probability of a downturn is low. In fact, he believes that no recession will occur this year. Given strong output growth and stable inflation, Professor Houthakker urges monetary policy to remain steady.

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

June 1990

SECOND DISTRICT - NEW YORK

FINANCIAL REPORTS - FINANCIAL PANEL

This month we have comments from Stephen Axilrod (Nikko Securities Co.), Scott Pardee (Yamaichi International Inc.).*

Axilrod: It is difficult to find any source of dynamism within the U.S. economy under current monetary and fiscal conditions. Consumer and real estate markets are clearly weak. Manufacturing may well be bottoming out. However, the upside remains limited by a less than scintillating outlook for profits--with exports and production abroad the most likely sustaining source.

The lack of dynamism is a great advantage in containing inflation and is, indeed, a sign that inflation is being contained. The policy question is how much more, if any, monetary pressure needs to be exerted at this point--which depends on, among other things, how quickly the Fed wishes to bring inflation down, after two years of upcreep.

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*Comments were received June 25, 1990. Submissions are occasionally cut at the FRB-NY in the interest of concision.

All things considered, it is not a good idea at this time to try to bring inflation down too fast--which implies limits to the monetary restraint that should be tolerated. The risk of a significant recession could become relatively high if money growth (and associated credit availability) remain as constrained as in the past two months--a constraint that could partly be an unintended result of the FOMC's open market methodology at a time when banks and other depositary institutions tightened lending standards and perhaps therefore also became less willing borrowers in the overnight money market.

However that may be, I would still ease pressures on the money market a bit at this time in view of the overall economic situation, and would continue doing so as long as money growth (taken collectively) is near or below the bottom of long-run target ranges. The pace of any easing, however, should continue to lag disinflationary adjustments in financial and product markets until it is clear that inflation will not re-accelerate.

Pardee: I lean towards ease. Economic growth is slow and may slow further, looking at consumption expenditures, housing, corporate profits, and capital goods expenditures. Money and credit growth have stalled. Inflation is still a problem, but some key prices are coming down. A modest move to reduce short-term interest rates is not likely to damage the Fed's credibility as an inflation fighter. I would move the Federal Funds rate to 8 percent now and be prepared to move it to as low as 7 1/2 percent by mid-August.

I am increasingly disturbed by the Fed's pegging of the Federal Funds rate. It gives no scope for free market forces to influence the price of reserves. It has created the situation whereby a change in the Funds rate by the Fed, even by a measly 25 basis points, has taken on the signaling force that discount rate changes used to have. Meanwhile, the market tends to wind up like a spring, and to over-react to small moves. Also, to the extent that the Fed's fixing of the Funds rate masks an underlying disequilibrium in the Funds market, once the Fed decides to change to a new fixed Funds rate, it may ultimately have to move by a bigger jump (or in more quick small steps cumulating to a bigger jump) if it wants to reach the equilibrium level.