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

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: February 3, 1988

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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FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Samuelson and Houthakker were available for comment this month. In light of the preliminary fourth quarter GNP data, Samuelson believes that the consensus real growth forecasts for the first half of 1988 will be reduced. He expects a short growth recession followed by 2 1/2% real GNP growth in the second half of the year. As the recent shocks continue working their way through the system, people are scared. Thus, the Federal Reserve should attempt to keep the money markets calm. The Federal Reserve currently has an unusual opportunity, due to the changing velocity of money, to be more expansionary without seeming rash and should use this opportunity to ease slightly. In addition, there is currently no rational fear of a noticeable worsening of the inflation rate. With respect to the exchange rate, given the lack of substantial improvement in the nominal deficit, we may still need a further decline of the dollar. This is not the time to have a strong reversal in the value of the dollar.

Professor Houthakker was disappointed with the preliminary fourth quarter GNP data which were worse than he had expected. If the large inventory accumulation is repeated next quarter then a recession is quite likely. However, it is too early to say whether monetary policy should attempt to head off a recession. While there is some room for expansionary policy, there is not yet a real case for a large stimulus. In any case, the Fed should not allow interest rates to increase.

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The inflation outlook remains fairly good. While some import prices have increased with the decline in the dollar, these price increases have not been as great as expected. Although the influence of the lower dollar on prices is still working its way through the system, policymakers should not be concerned as import prices must go up to decrease the trade deficit.

Houthakker believes the November trade figures are not a fluke as many have suggested. However, even if the trade deficit deteriorates in the next few months, he would resist a further fall in the dollar because it is already substantially undervalued by any purchasing power criteria. Because some central banks have above normal dollar holdings that they may wish to eliminate, any rise in the dollar will quite likely be held in check.

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JANUARY 1988

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

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

Jones: Three key factors point to a depressed economic performance in early 1988. (1) An unexpectedly large and mostly involuntary build-up in business inventories in the final quarter of 1987. (2) An unexpectedly sharp decline in December housing starts. (3) A jump in state initial unemployment claims. This economic weakness, combined with sluggish monetary growth, could cause the Fed to react by easing reserve pressures and pushing money market rates lower over the near term.

However, longer-term interest rates could reverse course and move higher during the remaining three quarters of 1988. The culprit could be the threat of another dollar plunge owing in part to expected Fed easing and in part to Washington's inability to make adequate progress in reducing the "twin" deficits. Also, rising inflationary expectations are likely.

*Their views of course are personal, not institutional.

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On the plus side for the economy, personal consumer spending has not shown any major ill-effects from the October 19 stock market crash. This is evidenced by a rebound in monthly personal consumer expenditures. On balance, real GNP is expected to show no change in the first quarter. Real GNP growth should resume a 2-3% pace in the remaining quarters of 1988, reflecting the boost from a declining trade deficit and stepped-up business spending on new plant and equipment. On the inflation front, the danger, despite some recent easing in commodity prices, is that the GNP deflator might accelerate to a 4.3% pace in 1988.

<u>Santow</u>: While the economy has lost some momentum, it is far from clear that substantial economic weakness is around the corner. Real GNP in the first quarter is likely to show 1 to 2 percent growth, but this will understate underlying economic strength as the fourth quarter of 1987 overstated it. The monetary aggregate picture is far from clear and does not seem to reflect economic activity. The Ms appear to have improved noticeably in January. The dollar picture has stabilized, although much, of course, will depend upon the December trade data. On the basis of these three factors, no change in policy would seem called for at the February FOMC meeting.

<u>Schott:</u> Real GNP in 1988 is likely to grow at around 2.5%. Improved net exports and strong business capital spending should offset slow growth in consumer spending and some inventory correction in the first half.

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Financial markets sense a possible easing of Federal Reserve policy, and institutional investors are chasing fixed-dollar instruments at currently available rates. The previously expected tightening of policy because of gradually rising inflation has been put off, in investor minds, until late 1988. These new expectations are reinforced by a somewhat stronger U.S. dollar externally. I do not perceive the need for an overt change in Federal policy in either direction.