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

TO: Federal Open Market Committee **DATE:** August 16, 1989

FROM: Gary Gillum GPG

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

8/11/89

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Samuelson and Houthakker were available for comment this month. Professor Samuelson believes the risks have shifted toward recession and away from accelerating inflation over the last two months. He points to the purchasing managers' reports, the Business Week indexes, and the slow growth of drought-adjusted real GNP. He regards the second thoughts associated with the July employment report "remarkable, even comical." He finds recent price behavior consistent with the forecast of decelerating inflation in 1990 contained in the Chairman's July Congressional testimony. Consequently, further easing now poses little danger unless the central goal of monetary policy is to achieve a steady deceleration of inflation. Samuelson believes the Fed has no mandate to roll back inflation from its existing, fairly modest rate. He would favor slight easing--the inflationary consequences of any weakening of the dollar should not be of concern in a period of weak price pressures.

Professor Houthakker believes it is not yet time to change course and thus views the recent easing of monetary policy with mild alarm. The Fed should steer a course that does not "at all costs" avoid a recession. At this time a relatively restrictive policy of near-zero monetary growth is appropriate, even though it will likely increase the probability of a recession. Although a recession in 1990 may already be inevitable owing to the previous tightness in monetary policy, he believes that inflation is still creeping upwards. The continuation of restrictive policy is necessary to return us to a more reasonable rate of inflation from its current excessive level. If a recession does occur in 1990, it will not be a major one. And, a mild recession might have a salutary effect by providing a needed correction following the long expansion. The danger lies in the fiscal paralysis associated with the budget deficit. The Fed will not be able to rely on assistance from the fiscal branch and, worse still, given that state governments have increased taxes in the face of revenue shortfalls, Prof. Houthakker is concerned that a similar response might occur at the federal level.

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

August 1989

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Richard Hoey (Drexel Burnham Lambert), Scott Pardee (Yamaichi International) and Albert Wojnilower (First Boston Corporation).*

Hoey: Short-term sentiment in the markets has capitulated to the disinflationary "soft landing" thesis, shifting away from the "recession now" thesis. We have a third view--that recession will be avoided in 1989 but will begin in the second half of 1990. We expect a pattern of slowdown, rebound, recession. We expect a market-led rise in interest rates in late 1989 and early 1990 in response to economic rebound, dollar weakness, and renewed inflation fears. We do believe that the slowdown of 1989 will mute the magnitude of the 1990-1991 recession we still expect.

While the pace of Fed easing is generating only a slow reliquification of the domestic banking system, it is also inviting intense foreign portfolio inflows into the U.S. With the early phases of Fed easing generating capital gains in

*Comments were received August 11, 1989.

bonds and stocks, the drag on the dollar from tighter yield spreads is temporarily muted by portfolio inflows. We believe the dollar will be more vulnerable once the virtuous cycle of capital gains and portfolio inflows runs its course over the next several months.

The probability that the U.S. economic adjustment can be spread over two years (early 1989 to early 1991) decreases the odds of disorderly adjustment by vulnerable enterprises as necessary restructuring can occur sequentially rather than at one concentrated point in time.

Pardee: I think that the Federal Reserve should continue its step-by-step reduction in the Federal Funds rate, one or two steps more over the near term.

Businesses and consumers are still in an uncertain stage of choosing between being cautious and being outright defensive. The yield curve has taken various shapes over recent weeks but it is still essentially inverted, especially with reference to the Federal Funds rate, which suggests that monetary policy is still restrictive. An additional decline of 25-50 basis points in the Federal Funds rate would help restore a more normal yield curve. The discount rate should be left alone.

Inflation signals are mixed. Price and wage indicators which respond to short-term pressures have been improving, while those which move more gradually are not. The short-term indicators thus suggest that there is some scope for further easing; the longer-term indicators suggest that the easing must be gradual.

The dollar is firm in the foreign exchange markets. Traders and investors are sensitive to the recent narrowing of favorable interest rate differentials for the dollar vis-a-vis the German mark and the Japanese yen, but this concern is only one of many factors now affecting the exchange markets. Again, a further modest gradual decline of the Federal Funds rate would be tolerable.

Wojnilower: The slowing of business has been due mainly to a reversal, at the beginning of the year, of speculative inventory purchasing and accumulation at the manufacturing and wholesale levels. The effects were compounded by an auto inventory sales problem resulting from overproduction and overselling in late 1988.

These restraining influences have now largely spent their thrust, in my judgment. Much of the impact, in any event, fell on imports rather than domestic output. Domestic aggregate demand is likely to revive significantly over the balance of the year. The markets for the dollar and dollar denominated bonds and stocks have retained their underlying sense of invincibility and are likely for some time to remain supportive of the growth in demand.