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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: June 24, 1992

FROM: Gary Gillum GPG

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

Enclosures

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

June 23, 1992

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT

ACADEMIC LEVEL

Professors Tobin, Houthakker, and Samuelson were reached for comment. Professor Tobin foresees more of the same anemic recovery for the rest of the year; with luck, GDP will grow at 3 percent in the second half of 1992. As a result, he emphasizes, the risk of igniting inflation is low.

In the longer run, Tobin believes real GDP growth of about 5 percent in 1993 will be required in order to reduce the current slack in the economy. Even with this amount of growth, the underutilized capacity in the economy will prevent any increase in inflation. In fact, he believes price-level stability is an inappropriate long-run goal for monetary policy. The sacrifice in lost output to reach zero inflation would be too great. And even if the economy could costlessly move to a stable price-level, price level stability is not an appropriate policy goal, for three reasons: (1) the change in the price-level is a poor measure of the change in purchasing power (due to changes in productivity and quality); (2) when it is necessary to decrease real wages it might be less costly to do so with inflation rather than nominal wage changes; and (3) the economy occasionally needs real interest rates temporarily to be negative. Accordingly, Tobin believes further ease in monetary policy is needed now.

Professor Houthakker is slightly more optimistic about the economy. It may not be booming, but it is not collapsing either. Industrial production and the trade balance are sources of strength for the economy and the performance of M1 is satisfactory. He believes the appropriate target for real growth in 1993 should be slightly above 3 percent. At that rate of growth, there will be no inflationary pressure. The long-run target of Fed policy should be "price stability with stable real growth," implying that trade-offs must sometimes be made between the two. As a result, Houthakker feels that current monetary policy is about right.

Professor Samuelson sees final sales increasing at about a 2 percent rate through the second half of 1992, with GDP increasing at about 3 percent. His major concern is the apparent fragility of the financial markets, brought on by the slow recovery and worldwide market fluctuations. The current political situation, with the possibility of a three-way tie in the Presidential elections, can only further unsettle these markets. As a result Samuelson believes the Fed should aim for growth of about 3.5 percent in the next year and 2.75 percent thereafter. Although all central banks should espouse a zero inflation goal, he believes an attempt to reach that goal by 1995 would force the economy into recession. Because of the risks from unstable markets and the current slack of the economy, Professor Samuelson believes current monetary policy should be eased slightly.

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

JUNE 1992

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT - FINANCIAL PANEL

This month, we have comments from Charles Lieberman (Chemical Securities Inc.). Albert Wojnilower (First Boston Company) and Edward Yardeni (C.J. Lawrence, Inc.).[1]

Lieberman: A sluggish recovery appears to be underway, although it is too weak to be sure that it can be sustained without relapsing into recession. Therefore, inflation pressures should continue to decline.

Job growth averaging 85,000 monthly over four months makes an adequate case for recovery, although this pace is extraordinarily slow. The initial impetus for recovery already appears to be spent. The sharp gain in housing and consumer spending of the first quarter of 1992 is unlikely to be repeated in the second. Growth in consumer spending has already slowed, since income growth is not particularly robust, nor is it likely to strengthen as long as job growth is weak. Housing has been hurt by the rise in mortgage rates and shifting demographics that do not support a sizeable gain in starts from the current 1.25 million level. Merchandise trade improvements have slowed as well.

[1]Comments were received by June 19, 1992. Submissions are occasionally cut at the FRB-NY in the interest of concision.

Only some inventory restocking is capable of providing another burst in demand at this delicate stage, but this does not appear likely. Manufacturers have done a remarkable job of boosting output without hiring additional labor. Instead, a longer work week and increased productivity have been sufficient to meet production needs. Manufacturing employment has fallen slightly since January. In contrast, all of the 350,000 rise in payroll employment has come in the "other" services category and in state and local government, which gives the recovery a very narrow base.

The slow pace of recovery implies that the economy could easily lapse into recession and is unprepared for any adverse shocks. At least a few more months of data are needed to ensure that the expansion will be sustainable. But, the risks remain entirely to the downside.

Wojnilower: Confidence is now widespread that economic recovery will continue--and that it will continue to be modest. The better performance and sentiment is clearly more pronounced in manufacturing than in wholesale or retail business. Business loan demand is said to be reviving slightly, but no mitigation of lending policies is reported. My personal impression is, however, that locally the credit doors for small business may now be ajar, but that home-mortgage loan standards may still be tightening.

Bond market participants hold the paradoxical view that the rally in prices is due to strong expectations of a lower Federal funds rate--but that the price gains will be lost if and when the rate actually were to drop. Little or no attention is (yet) being paid to the election campaign or other political developments; for example, prices rallied strongly immediately following news that the balanced-budget amendment had failed. Foreign exchange market participants, in contrast, believe that election uncertainty is and will be weighing down the dollar.

My own GDP forecast, for what it is worth, is for 2 - 2 1/2% growth from 4Q91 to 4Q92, and less than that in the first half of 1993.

Yardeni: The Federal Reserve should lower the federal funds rate and cut the discount rate to sustain the current economic recovery. While the recovery may very well continue with interest rates remaining at their current levels, I believe that there is a significant 25% chance of a Triple Dip.

The recent rebound in autos comes just as new home sales and nonauto retail sales show signs of slowing. If it were not for the rebound in autos, the economy most likely would be headed for a "triple dip" this summer. Instead, the most likely scenario remains the Slow Go. I give it a 75% probability. I give 25% odds to No Go and 0% to Go Go.

As the economy continues to recover, workers are returning to the labor force seeking jobs. The risk is that jobs remain scarce because employers remain cautious. Their caution is justified because consumers continue to prefer paying off their debts rather than purchasing goods and services. The disappointing job market triggers another dip in consumer confidence and spending.