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

TO: Federal Open Market Committee DATE: September 17, 1986

FROM: Rosemary Loney

Enclosed are the greenbook, and special reports from the Boston and New York Banks summarizing the views of outside economists about the economic outlook.

Enclosures

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FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Houthakker and Samuelson were available for comment this month. Professor Houthakker expects modest economic growth to continue. While there is no immediate risk of inflation, he believes that rising commodity prices, the devaluation of the dollar, and higher wage settlements in the service sector will cause somewhat higher inflation towards the end of next year. He is not disturbed by the continuing trade deficit, since it takes up to two years for the full effect of the drop in the dollar to occur. While he supports the recent drop in the discount rate, at this time there is no need to lower rates further.

Professor Samuelson feels that the Federal Reserve should not be unduely concerned about inflation at this time. While some commodity prices, such as platinum and gold, have recently surged, they have very little macroeconomic effects. While there is some concern that oil prices and wages in service industries are increasing, inflation will be between 4 and 5 percent for 1987. Rather than concentrate on inflation, he feels that policy should be oriented towards the real economy. He feels that the rate of growth of real GNP will be between 2 and 3.5 percent over the next two quarters, and the goal of the Federal Reserve should be to maintain real growth at least at 3 percent a year. While it is hard to justify lower interest rates now, if evidence indicates that real growth is below 2.5 percent, a further reduction of short-term interest rates may be necessary.

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

SEPTEMBER 1986

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Richard Hoey (Drexel Burnham Lambert, Inc.), Leonard J. Santow (Griggs and Santow, Inc.) and Albert Wojnilower (First Boston Corp.):*

Hoey: The two most likely forecasts for the U.S. economy are moderate stagnation (2 percent real growth trend) and moderate reacceleration (3.5 percent real growth trend). The latter is most likely. The cyclical low in inflation has probably occurred, but the surge in inflation expectations is largely in the minds of short-term traders. The dollar price of gold lagged the dollar price of the yen and the DM due to world commodity deflation. When an ebbing of that deflation coincided with South Africa fears and the Japanese gold coin, gold began a partial catch-up with the yen and DM.

The recent steepening of the yield curve is fundamentally appropriate. The violent short squeeze on the 9.25 percent Treasury bonds in April 1986 flattened the curve excessively at that time. Speculators overpaid for the call protection feature of Treasury bonds. Budget skepticism is rising and fears persist in the United States that the American policy of weakening the dollar will erode foreign interest in maturity extension. Expectations of lower short-term rates weakened as signs of a rebound in the economy and inflation emerged. Fast monetary growth is unintelligible but worrisome, especially since it is occurring worldwide.

Real yields are high against recent inflation experience. But measured against long-term inflation expectations, long-term real yields are near their lows for the decade. Short-term real yields are still high against current inflation and against near-term inflation expectation.

*Their views of course are personal, not institutional.

Santow: The economic numbers in the summer often have surprising swings. In this regard, the most questionable is the three-month decline in the unemployment rate by 1/2 percent. This does not square with most other employment data. The September unemployment figure, and the other September employment data, should give us a much better handle on where the economy is heading. Since these figures are not available until one and a half weeks after the September 23 FOMC meeting, it makes sense to follow an unchanged policy at that meeting.

Wojnilower: It appears there has been little change in the underlying economic situation since early 1986. Despite all the statistical and other noise, the economy seems to remain on or about a 2 1/2 percent growth track.

The September 11 drop in the stock market was triggered, I believe, by the SEC's ruling that major firms would, as it were, have to display their cards at 3:30 on September 19 and let everybody else lay against them for half an hour. The underlying weakness in the market reflects tax reform effects and concern that interest rates have reached a low. Whenever there is doubt about the continuation of the worldwide down trend in interest rates, securities prices will fall until the economic outlook is impaired sufficiently to make the forecast of declining interest rates credible again.