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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: May 13, 1987

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 Tobin, Houthakker, and Samuelson were available for comment this month. Professor Tobin believes attempts designed to defend the dollar are "misguided" and that actions already undertaken should be abandoned. When there is a serious imbalance in trade flows, depreciation of the dollar is the market mechanism for correcting this problem. Intervention in the currency markets without fundamental changes in the economic policies of the United States and its trading partners will not prevent a further drop in the dollar. He does not believe that raising short-term rates to defend the dollar is a good policy. Higher interest rates risk pushing a weak economy into a recession. Causing a recession to defend the dollar would have several undesirable effects. As well as hurting the domestic economy, our trading partners who are already experiencing difficulties, could face severe recessions. A recession would also have harmful effects on the federal deficit and our ability to control problems with third world debt. It is unreasonable to inflict damage on the economy to prevent a one shot change in the price level resulting from the depreciation of the dollar.

Professor Tobin believes that a relative change in import prices will not cause a serious problem with continuing inflation. While import prices will cause a temporary increase in indexes such as the CPI, this should only cause concern if it appears in wage settlements. Both unit labor costs and compensation have been very low, so inflation is not likely to be a serious problem anytime in the immediate future. We are currently "paying back" the lower inflation we experienced when the dollar was appreciating. Commodity price increases are a "side show" that shouldn't influence monetary policy decisions. While they have risen, they are still recovering from all-time lows. The higher interest rates are primarily reflecting tighter monetary policy. To the extent that they reflect increased inflationary expectations, these expectations will be revised as investors realize that inflation is not a problem. Since a lower dollar will not create a continuing inflation, the

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Federal Reserve should stop focusing on the dollar and bring the federal funds rate back to 6 percent.

Professor Houthakker is concerned about the depreciation of the dollar. Actions taken by the Federal Reserve to prevent the dollar from falling further are justified. Continued depreciation in the dollar will result in further inflation at home and discourage foreign investors from investing in the United States. The dollar depreciation is already showing up in the CPI, and further drops in the dollar could cause the CPI to stay at 6 percent. The April drop in the unemployment rate is inconsistent with fears of a recession. The economy is strong and can sustain higher interest rates. The federal funds rate should trade at 7 percent to prevent further drops in the dollar.

Professor Samuelson believes that monetary policy is following an "ill formulated international goal" that does not serve domestic goals. When the state of the economy is shown to be too strong, the Federal Reserve should tighten. That is not the case currently. A policy of a "slow and orderly decline" of the dollar is disastrous, for it provides a one way bet for speculators in the currency markets. If the dollar needs to fall, it should fall fast. Furthermore, if investors expect a gradual decline in the dollar it can cause Treasury rates to rise. This will occur if investors require a premium to compensate them for likely declines in the dollar. While there are definite costs to defending the dollar, there are few gains. If the dollar dropped below current levels there would be little harm to the domestic economy. While the CPI has risen, a dollar depreciation and higher import prices are necessary for the trade balance to improve. However, a dollar depreciation cannot cause inflation to continue once the dollar has stabilized at its equilibrium level. Wages and compensation are showing no indication of a serious increase in inflation and the real final sales number reported for the first quarter is not very strong. If the economy starts to overheat, monetary policy should tighten, but the economy is not overheating at this time.

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MAY 1987

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Henry Kaufman (Salomon Brothers, Inc.), Donald E. Maude (Midland Montagu Capital Markets) and Donald B. Riefler (Morgan Guaranty Trust Co.):*

Kaufman: The U.S. economy should continue to move along at a sluggish pace in the second half of the year with real growth at an annual rate of 2 1/2 percent or so and consumer prices moving into the 4 1/2 percent to 5 percent range by year-end. The financial markets will probably do reasonably well whenever the dollar stabilizes in the FOREX markets and weaken significantly when the dollar is under pressure. The de-coupling between stock prices and bond prices should persist as the equity market will benefit from improvement in corporate earnings, the expectation of no imminent reversal in the direction of economic activity, and the likelihood that monetary restraint will continue to be imposed reluctantly and with considerable moderation.

Maude: The large inventory buildup during the first quarter of this year suggests that the pace of economic expansion over the second and third quarters will decelerate from the 4.3 percent clip to about 1.0 percent in the spring and about 2.0 percent during the summer. This pace of growth would suggest that--once the dollar shows some signs of sustained stability--a more accommodative monetary posture would be appropriate. In its

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*Their views of course are personal, not institutional.

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absence the risks of no growth--or negative growth--early next year would increase. This would especially seem true, given the recent spike in rates.

With regard to the markets, participants are now completely fixated on the course of the dollar in the foreign exchange markets. This is not a reflection of their concern about the inflationary implications of a falling dollar, however. More importantly, it represents the fear that a weakening dollar will force the Fed to firm policy further. At present, inflationary psychology is being driven by the recent rises in commodity prices. Also, at present, money supply growth represents little importance to market participants. And while the budget deficit is still a factor in market thinking, it too has taken a back seat to the foreign exchange markets.

Riefler: Inflation expectations are rising despite continuing good fundamentals in the cost structure. It is important that the Fed respond by reassuring the markets as to its willingness to raise interest rates. This conceivably could require a dramatic move at some point in time.

Considering the relatively low level of short-term rates that have developed over the last couple of years, this could be achieved without bringing rates to a level that would create lasting damage to the economy.