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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: July 1, 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 Samuelson and Tobin were available for comment this month. Samuelson finds no convincing reasons to change monetary policy -- no signs of either recession or accelerating core inflation. The Fed should take advantage of this pleasant pause and adopt a "wait and see" attitude. The higher price increases earlier this year were due mainly to OPEC and special "micro" situations rather than generalized excess demand. The drop in the dollar will have a "self-limiting," once-and-for-all impact. Despite a definite improvement in the constant-dollar balance of trade, it is unclear that the current dollar balance has turned the J curve corner.

Professor Tobin reiterated his position that a further decline in dollar is both desirable and probably inevitable. Further increases in short-term interest rates would risk a recession, which would not solve our trade problems but would swell the federal deficit. An increase in import prices is part of the international adjustment process and should not be interpreted as a change in the underlying inflation rate but rather as a reversal of the temporary gains in the early 1980s. Tobin is skeptical that the "natural rate" of unemployment can be estimated precisely. The absence of shortages, bottlenecks, generalized capacity constraints, and wage pressures all suggest that the aggregate economy has more room to expand.

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In light of the frequency of velocity surprises in all financial aggregates, Tobin believes the monetary policy debate should focus on the desired path of current dollar GNP. He urged taking the GNP projections "seriously," recognizing the important link between the expected outlook and the policy chosen.

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CLASS II - FOMC

JULY 1987

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Richard B. Hoey (Drexel Burnham Lambert, Inc.), David Jones (Aubrey G. Lanston & Co., Inc.) and Francis Schott (Equitable Life Assurance Society):*

Hoey: While the long-term cyclical trend of both inflation and interest rates is upward, we expect a more neutral 8% to 9% trading range in long-term Treasury bonds for the balance of 1987, given:

(1) A pause in the primary dollar bear market for two or three quarters, (2) the depressed pace of wage inflation so far in this cycle, (3) only moderate strength in the U.S. economy, (4) demand for long-term credit reflects price-sensitive voluntary credit demand rather than price-insensitive involuntary credit demand, (5) weak inflation and low nominal yields abroad, (6) the decline in the top marginal tax rate, (7) the spread of ten-year government bond yields above ten-year inflation expectations is now near 3%, up from 1.8% in March 1987 which was a classic sell signal, (8) the strong odds that U.S. budget deficits for fiscal 1987 and fiscal 1988 will come in below current consensus expectations of $183 billion and $170 billion, and (9) the ratio of bulls to bears in the bond market has shifted by more than seven-fold, from a 3.8 to 1 bullish predominance in December 1986 to 0.5 to 1 ratio of bulls to bears in our May 1987 survey.

Real rates are not high enough to threaten the expansion. The rise in short-term nominal rates merely paralleled the rise in short-term inflation and the rise in long-term rates reflected a rebound in unsustainably depressed expected real rates.

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* Their views of course are personal, not institutional.

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Jones: The pace of real GNP growth is likely to accelerate to 3.3% in the second half of 1987, and to perhaps as much as 4.0% in the first half of 1988. A sharp acceleration in inflationary pressures is to be expected, which the GNP deflator (fourth quarter-over-fourth quarter) moving up 4.9% in 1987 and then faster in the first half of 1988. Longer-term interest rates are likely to push upward and the yield curve is expected to steepen.

Behind this outlook: (1) the industrial sector and exports are smoothly taking over the leadership of the expansion, (2) consumer spending on nondurable goods and services is likely to hold up well, (3) business spending on new plant and equipment is likely to pick up sharply in coming months reflecting higher profits and the declining cost of equity capital, (4) a major tightening in labor market conditions is likely to lead to cumulative increases in wage costs and prices later this year, (5) private foreign investor demand for U.S. bonds will continue to weaken reflecting declining real U.S. interest rates relative to foreign real interest rates, (6) Federal Reserve policy will be frozen into a period of inaction in the second half of 1987, (7) no Federal fiscal miracles are likely.

Schott: Financial markets have now recognized that interest rate increases are likely to be limited in view of less--than robust economic growth and are by and large expecting a period of stability. However, foreign visitors and keen domestic observers alike are increasingly questioning the structural stability of the U.S. financial system because of the erosive effect of thrift insolvencies and foreign--funds--dependent budget deficit financing.