BOARD OF GOVERNORS
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FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: August 12, 1987

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

Enclosures

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CLASS II - FOMC

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT ACADEMIC LEVEL

Professors Houthakker and Samuelson were available for comment this month. Professor Houthakker sees no evidence of any notable change in overall economic activity as the economy continues along the modest growth path of the past three years. Labor markets in general have not tightened appreciably, although very sharp regional differences are apparent (e.g., the tightness in New England) reflecting a lack of sufficient labor mobility. Fiscal policy is still quite stimulative, although much of the stimulus has been leaking abroad. While net exports should strengthen further, the change will not be dramatic. Exchange rates, by themselves, cannot turn around the trade deficit. Until substantial progress is made in reducing the budget deficit, the trade deficit will not disappear.

Professor Houthakker still maintains his January forecast that inflation will remain below 5 percent this year. Because unit labor costs are rising very slowly, he does not foresee a further increase in inflation on the horizon. However, because the effects of the decline in the exchange rate are still cumulating, further increases in import prices should occur. Unless the Mideast conflict escalates, the recent oil price rise should now be over for the most part.

Although the dollar has rebounded somewhat, a further decline in the dollar is possible. We should give the current level of the exchange rate a chance to work on the trade balance. Thus, it is probably desirable to prevent a further noticeable decline in the dollar over the next year until the current exchange rate is allowed to show its effects on the trade deficit.

Professor Samuelson does not yet see any convincing signs of weakness in overall effective demand nor of further increases in the inflation rate. While specific prices (such as metals) have shown strength, it does not appear that the wage cost spiral has been re-established. Despite the current strength of the dollar, he foresees the dollar resuming its decline and would not look with trepidation at such a decline.

The snugging up by the Fed has had no disastrous results. If GNP growth weakens to the 1-2 percent range, the Fed should act to offset the slowdown. But, present evidence does not justify a swing to an easier monetary policy.

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

AUGUST 1987

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Leonard J. Santow (Griggs & Santow, Inc.) and Albert M. Wojnilower (The First Boston Corporation):*

Santow: The economy in the second half of the year is likely to be stronger than the consensus forecast. While third quarter real GNP will probably grow by only 2-3 percent because of little inventory accumulation, the fourth quarter is likely to snap back to almost 4 percent real growth. The deflator in the third quarter would probably be 4-4 1/2 percent and in the fourth quarter 4 1/2-5 percent. These estimates assume no basic change in monetary policy.

The indicators used to support this relatively strong economic performance are: new orders published by the Purchasing Managers, factory overtime released by the Commerce Department, paperboard capacity utilization published by the American Paper Institute and industrial material prices released by the Journal of Commerce.

The foregoing analysis suggests that the current state of monetary policy is reasonable. However, if there is to be any shading of policy one way or the other it should be towards the firming side.

* Their views of course are personal, not institutional.

Wojnilower: Recent business contacts tend to confirm the statistics: strength and optimism on the industrial side, based primarily on growth in foreign demand; lackluster performance and a bit of apprehensiveness in the retail sector.

On the financial side, buying attention (including a major foreign component) remains centered on equities. Since market participants see little prospect of circumstances that could lead to an easing of monetary policy anywhere in the major countries, bonds are viewed as unattractive.