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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: September 16, 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

Professor Tobin and Houthakker were available for comment this month. Professor Tobin believes that while the recent interest rate increases may have been politically necessary, the domestic economy does not require a tighter monetary policy. Although the unemployment rate is lower than it has been in the recent past, there is still excess capacity in the economy. The Federal Reserve needs to be concerned with overheating if the unemployment rate falls below the natural rate, but there is no evidence that we are there yet. Tightening ought to be avoided until there is a sustained increase in the inflation rate. Recent changes in prices indicate temporary adjustments in relative prices rather than a sustained increase in the inflation rate. Oil prices are stabilizing and import prices are not filtering into wages. A falling dollar and rising import prices are necessary to restore the balance of trade and should not be resisted. As long as domestic inflation remains well behaved, a restrictive monetary policy is not justified.

Professor Houthakker believes that while some regions of the country have reached full employment, the country as a whole has not. It would be ill-advised to adopt national policies that assume full employment when many regions of the country still have substantial excess capacity. It is worth risking some inflation to provide greater growth for those regions that are

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still depressed. While earlier in the year Professor Houthakker was concerned about inflation, the danger of inflation no longer seems as acute as he once thought. The modest growth in wages and the producer price index, and his belief that the natural rate of unemployment may be as low as five percent, indicate that inflation is not a problem. While he is surprised by how steep the yield curve has become, the Fed should not increase short rates because long rates are high. As it becomes apparent to market participants that inflation is under control, the long rates should come down. Embarking on a policy of higher interest rates is not justified given the favorable outlook for inflation.

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CLASS II - FOMC

SEPTEMBER 1987

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Richard Hoey (Drexel Burnham Lambert, Inc.), Donald Maude (Midland Montagu Capital Markets) and Donald B. Riefler (Morgan Guaranty Trust Company):*

Hoey: The plunge in bond prices in recent weeks reflects not only cyclical pressures, but also a recognition that the structural current account deficit will remain high, implying that the dollar will decline sooner or later. Structural fiscal policy reforms have not been adopted here and abroad so that exchange rates and interest rates must absorb the resulting pressure. We continue to believe that the dollar index will ultimately decline 50 percent from its highs of February 26, 1985, implying an additional 15 percent decline.

Fears of a further dollar decline adversely affected expectations of (1) inflation, (2) future Fed policy, and (3) future currency losses by foreigners. Fear of currency losses could calm down again if a new and lower trading range for the dollar is defined at a more defensible level. The precondition for a controlled retreat of the dollar rather than a free fall is that defenses of the dollar be successful at a sequence of lower lows separated in time. A committed defense that fails could be the signal for a destructive free fall.

Inflation expectations are rising but only gradually. Between December 1986 and August 1987, ten year inflation expectations rose 60 basis points to 5.53 percent, the highest level since December 1984.

Maude: Exchange rate developments and market perceptions about the Fed's anti-inflationary resolve under the chairmanship of Alan Greenspan will, to a large degree, influence the near-term direction of long-term interest rates. At

*Their views of course are personal, not institutional.

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present, the verdict is still out. The 1/2 percent increase in the discount rate did not do much to impress the markets. However, it did tend to sustain anti-inflation credibility since it came at a time when the inflation data remain relatively restrained, the broader monetary aggregates seem to be weak and the pace of economic activity is not as strong as the published GNP numbers seem to imply.

At present, given the still wide spread between a 7 1/8 percent Fed funds rate "center of gravity" on the assumption of an unchanged discount window borrowing target of roughly $500 million and the 6.0 percent discount rate, another increase of 1/2 percent probably would not pose a threat to the economic expansion. However, it should be kept in mind that the housing sector becomes more vulnerable with each ratchet upward in the prime rate—especially with regard to variable rate mortgages tied to it.

Riefler: Analysis indicates that the real 30 day Commercial Paper rate (actual rate less inflation expectations) averaged around 4 percent during the disinflationary period of 1983-1985 with the exception of a spike in the middle of 1984. Since the middle of 1986, however, the real Commercial Paper rate has been in the 2 1/2 percent area. A return to a 4 percent real rate or 8 percent to 8 1/2 percent nominal rate may be appropriate to reassure the market that the disinflationary trend is still intact.