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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: December 9, 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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CLASS II - FOMC

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT ACADEMIC LEVEL

Professors Houthakker and Tobin were available for comment this month. In retrospect, Houthakker believes that monetary policy became too tight before October 19, aggravating the crash. By allowing interest rates to rise this fall, the Fed invited a stock market correction. Long bond yields in excess of 10 percent were out of line not only with dividend-price yields on stocks but also with reasonable forecasts of inflation. Worries about inflation have been exaggerated in recent months. The evidence of rising inflation has been spotty and not more compelling than the spotty evidence of declining inflation. Since October 19, Houthakker believes the Fed did well by declaring its readiness to support the financial markets, and he agrees with the Fed's subsequent "mopping up" of liquidity in recent weeks. Houthakker believes that, more than anything else, the recent crash exposes the inadequate capital base behind Wall Street and the need for expanding the ranks of specialists and dealers in equity markets. It should be clear that these problems deserve the attention of the Fed as the custodian of monetary policy and as lender of last resort. Regarding next year, Houthakker anticipates moderate growth lead by exports and investment spending. Although inflation may increase slightly early next year, it should decline slightly in the second half.

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Tobin believes the Fed reacted well to October's stock market crash, but he is disappointed to see interest rates rising during the last six weeks. The Fed should return to the policy that it has pursued since the middle of 1984 by accommodating 2 to 3 percent growth. Citing anecdotal evidence that major corporations have raised the hurdle rates of return required on their investments by as much as 4 percentage points, Tobin thinks that the Fed must allow interest rates to fall to sustain growth. Moreover, if the Fed wishes to encourage the effort to reduce the federal government's budget deficit, then the Fed also must be prepared to offset the effects of a contractionary fiscal policy without worrying about the dollar. If the current value of the dollar is too high to be compatible with sustained growth, then the dollar, not the recovery, should be allowed to fall. Of course, a depreciation of the dollar should entail higher prices of imported goods, which is an important part of the mechanism by which the balance of trade adjusts, but this "one-time" adjustment of prices should not be resisted by policy-makers if balance is to be restored. To a degree, this price increase may add temporary momentum to the "wage-price-wage spiral," but we cannot expect to hold forever the benefits we enjoyed when the exchange value of the dollar increased.

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CLASS II - FOMC

DECEMBER 1987

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Richard Hoey (Drexel Burnham Lambert, Inc.), Francis H. Schott (The Equitable Life Assurance Society) and Albert M. Wojnilower (The First Boston Corporation):*

Hoey: The current crisis is a political crisis in the major democracies. The markets are increasingly focused on the institutional breakdown in the decision-making process. There is no sense of movement towards a sensible long-term economic strategy either here or abroad. A key role for the heads of the major central banks is to lead the world's politicians to stave off economic disruption.

The market has a renewed focus on money supply, with slow growth reinforcing concerns about downside risk in real demand following a worldwide shock to confidence. We expect zero real growth and a monetary easing in the first quarter followed by fast growth in the second half. The dollar is expected to fluctuate within a new lower trading range.

Schott: Rapidly cumulating evidence suggests that the economy is riding out the October 19-20 financial storm. Real-growth forecasts for 1988 are again centering in the 2.5 percent range.

Financial markets, however, remain fragile. The stock market, in particular, appears to be focusing on the potential insufficiency of the budget compromise and on a possible early turn toward higher interest rates to fight inflation and dollar weakness.

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*Their views of course are personal, not institutional.

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Reassurance of steadiness in the present monetary policy stance is required. Markets are too jittery to justify an early tightening. Yet, further easing could also prove counterproductive should export-led expansion and the dollar depreciation pose serious risks to the moderate-growth-and-inflation path now foreseen for 1988.

Wojnilower: The economy remains strong. Industry continues to boom and delivery delays to lengthen. Although sales are dull and profit prospects impaired, nothing dramatically adverse has happened.

By contrast, morale and performance in the securities industry continue to deteriorate. It seems unlikely that dealers or investors will consider bullish positions in stocks, bonds or the dollar until the New Year at the earliest.

The United States is experiencing an extraordinary increase in foreign demand in response to a badly undervalued dollar. Since this comes when the economy is virtually at full capacity, the foreign demand has to crowd out domestic demand. The securities and foreign exchange markets may be unable to recover until they sense that overkill of domestic demand has occurred. Thus, whatever fiscal and monetary policymakers do might make things worse. If action there must be, my vote would be for gingerly tightening rather than easing. Fiscal restraint accompanied by monetary ease is liable to produce the worst of all worlds.