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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: March 23, 1988

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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 Samuelson and Tobin were available for comment this month. Professor Samuelson believes that economic growth will slow in the first half of 1988, but not by nearly as much as forecasters had been predicting. The large inventories from last quarter have been reduced without substantial cuts in production and the recent decline in the unemployment rate indicates that the probability of a recession anytime soon is quite low. Wage settlements have been quite moderate considering the tightness in labor markets. While there are no immediate signs of inflation, the economy is close enough to full employment to warrant some precautionary tightening before the middle of the year. If it's politically difficult to tighten at the end of an election year, some "snugging" of interest rates would be appropriate.

Professor Samuelson is disturbed by press reports that the Federal Reserve was now focusing on daily financial variables. He believes that the Federal Reserve should set a goal for real GNP growth and inflation for a 6 to 18 month horizon. If the real economy and inflation are following the path that the Federal Reserve desires, fluctuations in these volatile series should not necessitate a change in monetary policy.

Professor Tobin sees no evidence that the underlying rate of inflation is increasing. If we were close to full employment, growth in wages and unit labor costs would be rising. The restrained wage growth and the absence of serious bottlenecks indicates that we still have some excess capacity. In addition, external factors such as lower oil prices and a stable dollar should continue to have a favorable effect on inflation. Even if the dollar should depreciate further, it should not be resisted by the Federal Reserve. Relative price changes are necessary to correct the trade balance and would only be a problem if they are incorporated into wage contracts. Since the economy is improving without serious inflationary pressure, there is no need to change policy at this time.

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CLASS II-FOMC

MARCH 1988

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Richard B. Hoey (Drexel Burnham Lambert), and Henry Kaufman (Salomon Brothers Inc.).*

Hoey: We continue to expect 4% to 5% real GNP growth in the second half of 1988 as nearly all segments of the U.S. economy are likely to contribute to positive growth.

Ten-year inflation expectations dropped 17 basis points from 5.32% in January to 5.15% in March. The Decision-Makers Real Yield (ten-year government bond yields minus ten-year inflation expectations) remains near 3%. With 12-month inflation expectations at 4.34%, short-term real yields have dropped to slightly more than 2%.

We believe that there will be a shift in market focus over the next few months from the monthly trade numbers to measures of inflation and fundamental determinants of inflation. The focus on monetary growth among U.S. portfolio managers is fading as the recession expected by some of those who focus on M-1 growth has not materialized. Foreign portfolio managers are expecting quick fiscal tightening after the U.S. election and would be deeply disappointed if it does not occur.

* Their views of course are personal, not institutional.

The great debate among portfolio managers is between those who perceive secular structural disinflation linked to financial fragility versus those who perceive a cyclical tightening of the supply/demand balance in the weak currency industrial country, the U.S. We believe that the thesis of continued expansion and intensifying U.S. inflationary pressure is the correct one for the next 18 months, with the structural disinflationary arguments likely to be most relevant in the full-scale recession we expect in 1990.

Kaufman: Sentiment in the financial markets has shifted this month from initial concern about the fragility of the economic expansion to some concern about a higher rate of inflation as the better than generally expected improvement in the economy continues to push against capacity constraints. The fixed income markets rallied only moderately following the surprisingly good trade data and the very good monthly news on inflation. In contrast, the markets set back sharply with the release of the strong employment data and the latest improvement in housing activity.

The near term financial fundamentals for the markets actually remained quite good. This is especially because of the sharply reduced financing needs of the U.S. Treasury during the second quarter of the calendar year. Moreover, with corporate cash generation likely to be good for the very near term, new issuance of bonds by corporations will only occur in volume when financing terms are attractive. In the meantime, the stock market will continue to be bolstered by improved earnings and a substantial volume of share retirement through mergers and acquisitions.