BOARD OF GOVERNORS
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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: December 7, 1988

FROM: Gary Gillum GG

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 Houthakker, Tobin and Cooper were available for comment this month. Professor Houthakker continues to see no acceleration of inflation or wages. He expects inflation of 5 percent through 1989, assuming no major changes in OPEC's pricing of oil. He does not view the current growth in GNP as excessive, and without further signs of increased inflation, he would keep the federal funds between 8.5 percent and 9 percent. Pushing the federal funds rate above 9 percent would be a mistake unless inflation increases.

Professor Tobin believes that the Federal Reserve should keep the economy growing at 2.5 percent. While it may be necessary to tighten for domestic reasons, monetary policy should not be used to set a value for the dollar. A policy to prevent a further decline in the dollar may require higher interest rates than are justified by the domestic economy. He approves of the cautious monetary policy that the Federal Reserve has been following. While the federal funds rate could trade slightly higher, policy's main focus should be to avoid a recession.

Professor Cooper believes the signals in the economy are too mixed to justify a change in policy. While the increase in employment was large, the civilian unemployment rate also rose, indicating that the labor force grew faster than expected. While capacity utilization is high, prices and wages have not been accelerating. Industries with high capacity utilization, such as the paper industry, have recently rescinded announced price increases. Factors that indicate the economy is not growing too fast include moderate wage contract settlements, lower materials prices (such as sensitive materials prices in the leading indicators), and a stable unemployment rate. The Federal Reserve should carefully monitor the economy for signs of overheating, but given the currently mixed signals, Professor Cooper would maintain the federal funds rate in its current range.

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SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Dick Hoey (Drexel Burnham Lambert), David Jones (Aubrey G. Lanston & Co. Inc.) and Henry Kaufman (Henry Kaufman & Company, Inc.)*

Hoey: The intention of *ex ante monetary policy* appears to have been to grow the economy slightly below trend to restrain any rise in inflation risk. *Ex poste monetary policy* has, however, been accommodative of above-trend economic growth and rising inflation risk for the last two years. Monetary policy has been disinflationary in intent and inflationary in effect.

Secular disinflation is now conventional wisdom as long-term inflation expectations have broken to new lows. However, we believe that the battle against inflation has already been lost for this cycle: full-scale recession appears likely in 1990 in the aftermath of accelerating wage inflation in 1989.

We expect new dollar lows whether or not a budget deal is cut. Past U.S. actions have badly damaged foreign confidence.

* Comments were received December 2, 1988.

Jones: The outlook is for accelerating price-wage pressures, rising interest rates, and a temporarily stable but skittish dollar over the remainder of this year and through the early months of 1989. The surge in November employment suggests that real GNP growth could be as high as 3.5% in the final quarter. In the first quarter of 1989, real GNP growth is expected to moderate slightly to a 2.5-3.0% pace, after subtracting the drought's impact.

This excessive pace of economic growth raises the threat of a wage-price spiral. Actually, tightening labor market conditions already appear to be resulting in a moderate but steady acceleration in wage rates. Adding to inflationary pressures will be the surge in oil prices following OPEC's recent agreement on production quotas. On balance, consumer prices are projected to increase 5.5-6.0% in 1989 (December-over-December).

Against this background, the Federal Reserve is almost certain to soon begin a new series of steps to tighten reserve pressures through open market operations. In addition, it is possible that these tightening efforts will be accompanied by discount rate increases. Specifically the Fed might increase the discount rate to 7% in late December; the Fed might then follow this move with a further discount rate hike to 7 1/2% sometime in the first quarter.

Kaufman: The American economy is continuing to move to a higher level of resource utilization and will probably not reach a cyclical economic climax next year. This will contribute to a moderate lift in the rate of inflation, with consumer prices reaching the 5 1/2 to 6% range sometime in 1989. Moreover, neither the U.S. budget nor trade deficit problem will diminish sufficiently to calm financial markets. The continued economic expansion in the U.S. will make it difficult to lower the trade deficit very much from hereon. And the limited flexibility in the new President's posture towards the budget problem suggests only modest progress towards a budget deficit reduction following long periods of negotiations. As a consequence, financial market volatility will heighten with both long and short-term interest rates drifting irregularly higher.