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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee **DATE:** May 11, 1989

FROM: Gary Gillum GFG

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

Enclosures

5/9/89

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Samuelson and Houthakker were available for comment this month. Professor Samuelson does not want the Federal Reserve to change policy until more information is available on the condition of the economy. Over the past six months he has been concerned that monetary policy has not been tight enough to reach a "soft landing." However, now the data are mixed. On the one hand, he thinks inflation may be increasing. The 3 percent growth in drought-adjusted real GNP for the first quarter is not sustainable. This rapid growth may be continuing into the second quarter as measured by the robust forecast in the purchasing agents' survey. Furthermore, new wage contracts, such as the agreement made by Bethlehem Steel, show no evidence that wage pressures are moderating. On the other hand, the slower rate of growth of payroll employment and the higher unemployment rate for the month of April, indicate that the growth of real GNP may be falling sufficiently to avoid further tightening of monetary policy. Professor Samuelson would not raise rates unless there is evidence that growth has not slowed to a sustainable 2 to 2.5 percent growth rate. If the economy were to grow faster than capacity he would tighten further, regardless of the impact on the exchange rate. He would not subordinate domestic well-being to exchange rate stability.

Professor Houthakker also would wait before making any changes in monetary policy. He does not believe that the higher civilian unemployment rate of 5.3 percent is conclusive evidence that the rate of growth of real GNP is falling, since he believes that the seasonals may have inflated the number because of the Easter holiday. While real GNP grew at 3 percent last quarter, which he believes is above capacity, the slow growth in the money aggregates should be sufficient to avoid further increases in the inflation rate. Professor Houthakker is not concerned about recent appreciation of the dollar since he believes the dollar fell too far last year. Moderate appreciation should not be resisted.

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

May 1989

SECOND DISTRICT -- NEW YORK

FINANCIAL REPORT -- FINANCIAL PANEL

This month we have comments from Stephen Axilrod (Nikko Securities, Inc.), Richard Hoey (Drexel Burnham Lambert) and David Jones (Lanston & Co.).*

Axilrod: The foreign exchange market is giving the Federal Reserve more breathing room to assess domestic economic conditions. The pressures to fight inflation have been shifted, to a small degree, more onto other major industrial countries because of the recent tendency for the dollar to rise toward the upper end (interpreted fuzzily of course) of its tolerance range. Responses of these countries have been mixed, however, and inflation has accelerated in the major countries outside the U.S. -- and by and large by more than the acceleration in the U.S. That would seem to argue that these countries may be forced before long to take action that limits the Fed's breathing room.

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*Comments were received May 5, 1989.

However that works out, there is reason for the Fed to take advantage of the situation and hold policy unchanged for a while more. The very moderate money supply growth over the past year does weigh in against further tightening in present circumstances when viewed in conjunction with a relatively strong dollar on exchange markets and the possibility of slower domestic spending. At the same time, there is no reason at all to ease. The domestic spending potential--given, among other things, the good stock market and more than adequate liquidity viewed historically--remains excessive for current resource availability, and more upward wage pressures are still a clear threat.

Hoey: Long-term rates have declined since the fall of 1988 even as short-term rates have risen due to three factors. High real yields, pervasive confidence in secular disinflation and Treasury supply/demand scarcity. Confidence in secular disinflation is high with 10-year inflation expectations up only slightly from the December 1988 low at 4.56%. Confidence in secular disinflation is as high today as confidence in secularly accelerating inflation was high in 1980-1981. There has been a supply squeeze in long Treasury paper, exacerbated by a recent bout of speculation that zero coupons would be bought from the market for the thrift bailout. We expect an erosion of all three supports for long bonds over the course of the next several quarters.

We view the cyclical circumstances as classically late cycle. The economy is at overfull employment and the logic of wage acceleration is powerful. The markets are comforted by more subdued growth but the lagged effect of six and one-half years of growth is that the most likely case is <u>accelerating inflation without boom</u>. The market believes that if there is no boom, there will be no inflation acceleration. We believe that until the next full-scale recession, the trend of underlying inflation will be upward.

The thesis that the money supply slowdown is symptomatic of tight liquidity is challenged by post-Crash highs in the stock market, industrial prices near their highs despite recent strength in the dollar and continued availability of credit to low-rated borrowers.

<u>Fed policy is stalled on the threshold of an escape from gradualism</u>. Despite slowdown sentiment, this economy has yet to record a quarter of below-trend GNP growth (ex drought). Capacity utilization has tightened and inflation accelerated throughout the world, with 98% of OECD GNP in countries whose 12-month inflation rate has accelerated over the last year.

<u>Jones</u>: The U.S. economy is entering a possibly prolonged period of stagflation. Real GNP growth is turning more sluggish in 1989, compared with 1988, but this slowing in real economic activity does not appear to be sufficient to hold in check rising wage and price pressures. As a result, wage

costs and price pressures are expected to gradually but persistently accelerate this year and perhaps next. In contrast, the GNP deflator is likely to accelerate to 5.4% this year up from 4.3% last year (fourth quarter-to-fourth quarter). The important point is that the contrasting trends of slowing real economic activity and accelerating inflationary pressures are each <u>moderate</u> and therefore likely to continue for some time.

Faced with the prospect of U.S. stagflation, the Federal Reserve is likely to maintain a stable policy stance over the near-term. However, foreign central banks (including the Bank of Japan) are likely to continue to tighten over the near-term in an effort to counter accelerating inflationary pressures. Later in 1989, rising U.S. inflationary pressures, including rising import prices are likely to trigger further Federal Reserve tightening steps.