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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:** March 20, 1991

FROM: Gary Gillum GPG

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 Houthakker were available for comment this month. Professor Samuelson believes that the quick resolution of the war should boost the economy. Since the Gulf crisis lowered consumer confidence and increased the price of oil, the cessation of hostilities should raise consumer confidence and lower the price of oil. The stock market seems to expect stronger future earnings, because the sharp recovery in stock prices is occurring despite declines in current earnings, productivity, and employment. Despite these favorable signs, Samuelson continues to believe that there is a 40 percent chance that the economy will still be in a recession in the third quarter. Any forecast of the length of a recession will have a large standard error. Coincident and leading indicators have yet to show a recovery and once the recovery begins, the auto and housing industries will continue to be depressed. He believes that policy should remain unchanged until the public reaction to the end of the war is better understood. While the psychological euphoria may promote economic recovery, making further loosening unnecessary, he would not rule out future easing of policy until current data show greater evidence that the recovery has begun.

Professor Houthakker expects a long recession. In his view, the war was not the cause of the recession, so the end of the war should not cause a recovery. He attributes the current economic problems to structural

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imbalances in the economy. The overextension of credit and the precarious position of many banks require a reorganization of our banking system. Mergers of financial institutions to create nationwide banks would provide the greater diversification necessary to prevent the spread of the "credit crunch" currently experienced in many regions of the country. Since Houthakker believes the current recession is due to structural problems rather than monetary policy, he would not try to fine tune the economy. He would not change monetary policy at this time.

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CLASS II -- FOMC

March 1991

SECOND DISTRICT - NEW YORK

FINANCIAL REPORTS - FINANCIAL PANEL

This month we have comments from Charles Lieberman (Manufacturers Hanover), and Scott Pardee (Yamaichi International).[1]

Lieberman: Economic growth is still quite weak, with credit availability problems a significant and continuing risk for the economy. Banks remain cautious about lending and many are still trying to reduce their balance sheet. Clients report that credit remains difficult to obtain and our own corporate finance people are advising clients to sell assets, to retain earnings, and to refinance with longer maturities whenever possible to reduce their vulnerability to difficult negotiations when debt matures. This advice and difficult credit market conditions are encouraging clients to manage business very carefully and to husband cash as much as possible. Of course, this discourages any quick turnaround in the economy.

Anecdotal reports suggest that housing activity is improving, although it remains difficult to assess whether this is merely a seasonal gain, refinancing of higher rate mortgages, or honest rebound in activity. Similar anecdotal reports in the car industry have proven illusory, at least so far. While some

[1]Comments were received by March 18, 1991. Submissions are occasionally cut at the FRB-NY in the interest of concision.

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rebound in activity was expected in the aftermath of the Gulf War victory, there is still no improvement whatsoever. If auto sales remain depressed over the next two 10-day selling periods, we will abandon hope for a quick recovery from recession.

Regarding the manufacturing sector, inventory sales ratios have deteriorated significantly. Order backlogs excluding aircraft are still eroding. Growth in export demand continues to be offset by greater weakness in domestic demand. No recovery is in sight, yet.

Bond market "fears" of recovery have increased interest rates for longer term maturities and significantly steepened the yield curve. Public statements of some Fed officials, who fear inflation either now or in the event of an end to the recession, exacerbate these concerns. There is also some consternation that Fed officials do not share a common view on the economy or on the appropriate course for policy.

Pardee: The Fed should pause to look carefully at the post-war economic indicators before easing monetary policy further. The Fed has already provided the basic elements to promote recovery. Interest rates are down; the yield curve is steeply sloped; and, for those who think it's important, the monetary aggregates are beginning to grow.

There are signs that the recession is beginning to bottom out, as reflected in disparate indicators such as a revival of housing sales and the stock market rally. And, with the war over, households and businesses will catch up on purchases

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postponed over the past seven months and plan ahead for longer-term spending commitments.

At the same time, however, the recession may very well continue. An uptick in housing sales does not automatically translate into a revival of new construction. The extra spending by the families involved in the war effort may be more than offset by the reduced spending by the families who have lost their jobs since last summer. And, the financial system is still dangerously fragile.

In the market, however, the Fed's credibility as an inflation fighter is open to question. Obviously the political pressures on the Fed are intense. Congress is asking Chairman Greenspan to testify entirely too often. Also, the Administration has not helped by repeatedly calling for lower interest rates.

The recent price indicators have been encouraging but not enough to convince investors or the public at large that inflation is under control. The bond market's perverse reaction to the last 25 basis point cut in the Federal funds rate was a clear warning signal that further easing might merely aggravate inflationary expectations and not do much to stimulate longer-term capital formation in the U.S., or anywhere else.