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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee **DATE:** August 14, 1991

FROM: Gary Gillum GPG

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

Enclosures

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

8/12/91

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT

ACADEMIC LEVEL

Professors Houthakker and Samuelson were available for comment this month. Professor Houthakker is very concerned about the slow growth in M2. Although he believes the recent restructuring in the financial sector has changed the velocity of M2, he still sees its poor performance as a strong indicator of underlying weakness in the economy. Because of this change in the velocity of M2, Houthakker has not abandoned his concerns about inflation in the long run. He believes, however, that the weakness in the real sector is sufficient to ensure that there will be little danger of aggravating inflation over the next two years.

Houthakker is very skeptical that the economy is now out of the recession. Another year or two of zero or slightly negative growth is likely. In fact, the possibility of a much larger increase in the unemployment rate should not be overlooked. As a result, Houthakker believes the recent easing by the Federal Reserve was insufficient. Although aware of the dangers of aggravating inflation on the way out of the recession, he believes that both the M2 numbers and the performance in the real economy suggest that the Fed should ease further.

Although Professor Samuelson agrees that the performance of M2 suggests the weakness of the economy, he does not believe that M2 is the most important indicator of future economic activity. Velocity is too variable to predicate policy on this indicator alone; in fact, Samuelson postulates that the apparent recent increase in M2 velocity can be explained, in part, by a decline in the competitive position of bank depository instruments. On the other hand, he emphasized that the Federal Reserve should not hesitate now about increasing the growth rate in M2 above its steady state level since slack in the real economy ensures that this temporary increase would not turn into inflation later.

Other indicators in the economy Samuelson finds more troubling. For example, both housing starts and auto production have not approached historically healthy levels. Thus, he believes most forecasters are still overestimating the size of the expansion. In fact, he places the odds of a double dip at around 25 percent and the odds of a limp recovery, with no distinct bottom, at higher than that. He is adamant that a limp recovery is nearly as undesirable as a double dip. Samuelson, therefore, fully supports the easing last week. Although he is content with the current monetary stance, he believes the discount rate should be brought into historical line with the federal funds rate and warns that the Fed should be ready to ease quickly at any new sign of continued stagnation.

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

AUGUST 1991

SECOND DISTRICT - NEW YORK

FINANCIAL REPORTS - FINANCIAL PANEL

This month, we have comments from Richard Hoey (The Dreyfus Corporation), David Jones (Aubrey G. Lanston & Co.) and Leonard Santow (Griggs & Santow).[1]

Hoey: The most likely case is that the economy is making a gradual rounding bottom. The main risk is a sudden crack in public confidence if declining commercial real estate prices create a 19th century bank run at the insurance companies.

Inflation expectations appear stable with a good chance of a downward drift. Policy focus on M-2 confuses the market since few in the market believe in the stability or forecastability of money velocity anymore. Some analysts are suspicious that for some policymakers outside the central bank, focus on M-2 is an excuse for activist demand management policies motivated in some cases by the political calendar.

Easing moves have been appropriate but Fed credibility would be even stronger if these moves were clearly linked to evidence of reduced inflation risk rather than being solely identified with evidence of weak demand growth. To the extent that the Fed

[1]Comments were received by August 9, 1991. Submissions are occasionally cut at the FRB-NY in the interest of concision.

encourages the view that it is responsible for the speed of economic growth, outside pressure to raise that implied real growth target can become intense. By timing the policy moves to the real sector data rather than the inflation data, the central bank may unintentionally convey a reduced emphasis on inflation.

Jones: The U.S. economy appears to be headed for a weak and uneven recovery in the second half of 1991. Moreover, it is possible that the economy could experience a second period of recession (double dip) in the first half of 1992. The unusual prospective "double dip" shape of the current recession stems from the fact that it is primarily "financial" by nature (for the first time since the 1930s) rather than reflecting real sector (inventory) imbalances. The current recession reflects a dangerously overleveraged economy that has been brought to its knees by a bank-induced credit crunch.

There are emerging new and ominous financial dangers that threaten to depress consumer confidence, borrowing, and spending. Most dangerous are mounting insurance company failures threatening individuals' life savings and annuities, protected only by scattered and inadequate State insurance funds. More recently, questions have been raised concerning the Securities Investor Protection Corp.(SIPC) coverage of individual's brokerage accounts in failed brokerage firms. Quite simply, more threats are currently posed to individuals' personal financial holdings than at any time since the Great Depression.

Meanwhile, the lender "crunch" on the supply of private credit continues unabated. Due to a toughening in lender credit standards, including a doubling of collateral requirements and net worth standards for individual borrowers, the leasing business has been severely curtailed. Moreover, for the few borrowers that still qualify, it now takes a week or more to process the financing documents, compared with only 24 hours before the credit crunch.

These forces point to an all-out and disorderly credit contraction and asset price deflation. In these circumstances, massive additional Federal government expenditures will be required to bail out failing financial institutions. Signs of prolonged economic weakness are already evident in unusually depressed service sector employment. Also signalling weak demand pressures and potential deflationary forces are slumping commodities prices.

Federal Reserve easing actions are less effective and take longer to work in a "financial" recession than in an "inventory" recession. For example, bank borrowers have seen little interest rate relief as bad-loan plagued banks seek wider net interest margins. Additional measures will be required, perhaps including a delay in the implementation of the BIS risk-based capital requirements. Also, greater fiscal stimulus, including tax cuts, may be required. Currently, many State and local governments are working in the opposite direction towards greater fiscal restraint.

<u>Santow:</u> The July employment figures are not a true reflection of what is happening in the economy. The economic picture is brighter than the numbers suggest. In particular, there is a major seasonal adjustment problem in hours worked, the hourly earnings rate, and weekly earnings. The first month of every quarter is unduly weak, and the following two months unduly strong. The sharp declines in July are likely to be reversed in August and September. Real GNP in the third quarter will probably show a 2 percent growth rate.

M-2 and M3 are being hurt by a combination of factors. Investors are not satisfied with a 6 percent rate of return and are buying bond funds and intermediate governments. This reach for yield is evident throughout the debt markets in the narrowing of the yield spreads between governments and corporates and governments and mortgage-backed securities. Because of these crosscurrents, it is almost impossible to determine what is a proper growth rate for any of the monetary aggregates.

The state and local government economic picture continues to deteriorate, although not as rapidly as earlier in the year. From a financial market perspective, the situation is better than it was several months ago. Most state and local governments have passed their budgets and are now in the process of implementing expenditure reduction and tax increase programs. The spending cutbacks are now showing up in cutbacks in state and local government employment and are a major limitation on the strength of the U.S. economic recovery.