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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: May 13, 1993

FROM: Gary Gillum GPG

Enclosed are Part II of the Greenbook and the usual information prepared at the Federal Reserve Banks of Boston and New York. Part I of the Greenbook will be distributed with the Bluebook.

Enclosures

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5/10/93

First District - Boston

Special District Report

Academic Level

Professors Paul Samuelson and Ben Friedman were available for comment this month. Professor Samuelson believes that weather conditions were partly to blame for the poor first quarter GDP numbers, but he felt that the complexion of the growth was negative all the same. He pointed out that the decline in defense spending will continue well into the future and that the fall in final sales was more serious than the GDP numbers suggested. Furthermore, Samuelson believes the defeat of the fiscal stimulus package, and a decline in the likelihood that any fiscal stimulus will occur, only increase the need for countercyclical monetary policy. Since he sees no increased inflationary pressures lurking around the corner, Samuelson believes monetary policy should be eased further. The costs of inaction can be high, and with little immediate threat of inflation, the costs of action are low.

As of last month, Professor Friedman approved of monetary policy because he was satisfied with the prevailing view on the economy. The economic data available since then - the first

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quarter GDP numbers, the downturn in leading indicators, the increase in initial claims, to mention a few - may have been sufficiently negative to affect the forecast. Since he defers to the Board staff's superior information about factors that could have distorted the data, such as weather, he gives the following conditional policy recommendation. If the recent bad news is interpreted as an aberration caused by the bad weather, for example, with no effect on last month's forecast path of output growth through the rest of 1993-94, then he sees no reason to change interest rates. If, however, the economy is "weaker than we thought one month ago," then rates should be reduced somewhat. Professor Friedman believes that because inflation is not a pressing issue at this time, the risks of easing slightly are minimal. In fact, concerns about inflation probably should not be raised until growth gets well over 4 percent, which leaves sufficient leeway for further ease.

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CLASS II--FOMC

MAY 1993

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT - FINANCIAL PANEL

This month, we have comments from Richard Hoey (The Dreyfus Corporation), Scott Pardee (Yamaichi International American Inc.) and Albert Wojnilower (First Boston Investment Management Group).[1]

Hoey: The orderly deleveraging of the U.S. economy continues. The equity channel of funding corporations through public purchases of stock mutual funds, reinvested by portfolio managers, continues. The equity channel is a partial substitute for the traditional bank channel as a transmission mechanism for monetary ease and has substantially lowered risk stresses in the financial and industrial sectors.

The economy in the second half of 1993 could be stronger than the first half for a variety of reasons including a large amount of income brought across the tax barrier into spendable personal income if tax rates are lower in 1993 than 1994.

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[1] Comments were received by May 7, 1993. Submissions are occasionally cut at the FRBNY in the interest of concision.

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Concern about long-term inflation persists despite low money and credit growth. The cause of this phenomenon is intentional dollar-bashing by the U.S., energy tax increases, wage tax increases, concerns about protectionism and pressure to weaken central bank independence. The short-term inflation numbers are not the driving source of this concern.

Contraction of the supply of 30-year Treasury bonds with 25-year call protection was rejected by the Treasury in 1981 at a yield of 14%, but adopted in 1993 with yields below 7%. The profit-maximizing corporate sector did the exact opposite and is probably correct that interest rates will move higher over the next several years. Inability or unwillingness to issue long bonds is historically linked with countries which have had great difficulty in controlling either their deficits or their inflation.

Pardee: The economy is growing sluggishly now, but has good momentum and should end the year with a GDP increase of 3% over last year. The economy is giving off mixed signals on inflation, but there seems to be no trend either way. The main policy priority for the U.S. is to complete work on the President's fiscal policy proposal. There is no compelling argument for the Fed to change monetary policy in the near term.

My main concern continues to be the political environment surrounding the Fed. It is possible that the economic situation may change over the months ahead sufficiently such that the Fed may want to tighten monetary policy, only to

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face extensive pressures not to tighten, from the Administration and from the Congressional leadership. Indeed, if the President's fiscal package is passed and the economy is still growing only modestly, then the pressure will be for the Fed to ease, perhaps when the Fed would not be prepared to ease on its own. This is not a new problem, but in the face of heavy political pressures in the past, the Fed has sometimes lost ground, in terms of its credibility in the financial markets and its independence from the rest of government. The credibility can be regained, but it takes years; the independence may be lost forever. And independence may not be lost overnight. It may be whittled away by wily legislators and their staff who take advantage of an acquiescent Administration that has a lot of other problems. I am sure many people in the Fed recognize the problem, but from where I sit the prospects seem ominous. I can only encourage people in the Fed to speak out on the issue, not only as a matter of public information but also to offset the incredible amount of publicity the Fed-bashers seem to be getting these days.

Wojnilower: The economy continues along a steady but slow growth of about 2 1/2% or less, notwithstanding quarterly fluctuations that reflect statistical noise and the short-term ebb and flow of consumer spending. This morning's employment data are consistent with that view. Conditions in the Northeast are somewhat better, due mainly to the revival in the financial

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industry, but this is offset by the weakness on the West Coast which is likely to intensify.

Recent visits to a number of major central banks in West Europe leave an impression of great apprehensiveness as their economies -- with the exception of the U.K. -- persistently and substantially underperform forecasts. The U.K. improvement is attributed by others mainly to the depreciation of sterling. To me as an outside observer, it seems likely that competitive depreciations on the Continent will continue despite the efforts of governments to avoid them.

The market has taken in stride the planned reduction in the Treasury's long-term bond issuance. The Treasury's action was a good one in both concept and execution. Other things equal, the reduction may eventually lower long bond yields by perhaps 15-20 basis points. The marketplace, however, probably will not take it seriously into account until the final quarterly auction in August. After all, the whole stock of long-term bonds turns over almost monthly and November is still very far off. The ultimate interest rate reduction could be larger if the bond issue is being reduced enough to avoid the need for sizable purchases by taxable buyers (as opposed to pension funds, etc).

Lending conditions are easing rapidly and the cyclical aspects of the credit "crunch" are over. Structurally, however, credit availability for middle and small-size firms has been and remains seriously impaired for the long term.