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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: June 30, 1993

FROM: Gary Gillum

Enclosed are the Greenbook and the usual 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 the new economic data make monetary policy decisions easier. The bulk of the macro data suggests that the average rate of growth of real GDP probably will not exceed 3 percent over the next three to four quarters, and may be only slightly above 2 percent. At this stage of the recovery, our goal for real growth should exceed 2 percent. With 2 percent growth, the rate of inflation probably will not rise because of macro considerations. However, this does not rule out increases in prices resulting from sources such as legislative and regulatory changes. But Fed policy considerations should not be focussed on the micro increments to prices that are one-time events. Rather, the Fed should be concerned primarily with inflation which tends to build up and persist.

Professor Samuelson does not believe the Fed needs to reassure the bond market of the Fed's resolve to fight inflation. Much of the skittishness in the bond market is associated with the fear that the Fed is predisposed to raise interest rates given any excuse. Because of this predisposition, many bond market participants expect short-term rates to rise this summer and they expect both long-term and short-term rates to rise in the fall. Rising interest rates during this year would reduce real growth and could even end the recovery. It would be a mistake for monetary policy to be too tight. The only defense to pursuing such a policy would be to ensure an economy soft enough to achieve price stability by the middle of the decade. But there is

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no mandate from the electorate for a policy that would introduce sufficient slack in the economy to achieve this goal over such a short horizon.

Professor Houthakker believes the recent data make clear that the economy is still struggling, with its performance weaker than he had expected. Perhaps it is a temporary aberration associated with the weather, faulty seasonal adjustments, or some shifting of economic activity back into the fourth quarter. It is also possible that the advent of the Clinton administration and the confusing signals out of Washington have reduced growth so far this year. In any case, Houthakker sees neither cause for alarm nor cause for a change in policy. Monetary policy is basically on the right track. Given that there is no danger of an acceleration in the inflation rate, there is no need for monetary tightening. The idea of a preemptive strike against inflation, as reported in the press, is misguided. If specific reasons existed for expecting higher inflation, then a preemptive strike might be warranted. But no such evidence exists at this time. For the Fed to take drastic measures to show its concern regarding inflation would not be consistent with rational policymaking and would likely harm an already weak economy.

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CLASS II--FOMC

JUNE 28, 1993

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT - FINANCIAL PANEL

This month, we have comments from Stephen Axilrod (Nikko Securities International, NY), Charles Lieberman (Chemical Securities Inc.) and Leonard Santow (Griggs & Santow)[1]

Axilrod: There is little reason to change the Federal funds rate at this moment. Economic activity does not appear to be growing close to an unsustainable pace, and there are disturbing signs here and there of uncertainties holding back business spending. Inflation now appears more subdued, following the unexpected and unacceptable (if continued) accelerated pace of the first four months of the year.

On the more crucial question of future inflation, I see no market evidence that inflationary expectations have worsened and also no sign that the Fed's anti-inflation credibility has been seriously eroded.

It is probably true enough that the market continues to

[1] Comments were received by June 25, 1993. Submissions are occasionally cut at the FRBNY in the interest of concision.

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expect more inflation than the Fed ultimately would like to see. However, I do not believe behavior of the yield curve or of the level of intermediate and long-term interest rates in recent months suggests that market participants believe inflation is in danger of getting out of hand.

As to whether the directive's operating instructions should be symmetric or asymmetric, the main argument for asymmetry turns on whether such a directive was adopted at the last meeting. If it was, market confusion and misunderstanding about the Fed's intentions might result from shifting back to symmetry at this point.

Nonetheless, although the domestic economy still seems to be in reasonably good shape, I am beginning to fear that the U.S. may implement a deflationary budget package before there is sufficient expansion in Europe and Japan to provide an adequate countervailing economic force for us and for the industrial world as a whole. A symmetric directive by the FOMC would have the virtue of recognizing that both deflationary and inflationary forces are still loose in the world.

On balance, I would suggest a symmetric directive. I would not contemplate any easing at all in the intermeeting period, but the odds on needing to tighten over that interval strikes me as much less than fifty-fifty (more like one in four).

<u>Lieberman:</u> The economy continues to grow at a moderate pace of about 3%, with virtually all of the job gains coming in the service sector. We expect this to continue, since the near term

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outlook for manufacturing remains quite weak.

The economy appears to be on a trajectory that should gradually reduce unemployment. We estimate that the underlying demographic growth in the labor force adds about 140,000 potential workers monthly. Therefore, the current growth rate is sufficient to absorb this ongoing inflow and, also, to gradually reduce unemployment. The manufacturing sector is not participating in this process, however. Growth in demand can be satisfied by gains in productivity without additions to the work force. In fact, the productivity gains are so large that this sector can satisfy its moderate rise in demand with fewer workers.

In contrast, growth in employment in the service sector has improved to the pace seen during the middle of the previous expansion, about 200,000 monthly, which should prove sustainable. Once benchmark revisions to income, savings and other data are reported, we expect a more coherent image of a solid, moderate growth economy.

The pace of expansion is not strong enough to produce inflation pressures in the immediate future, although such pressure will mount once the labor market tightens up. We do not expect the economy to approach full employment, defined at around 5 1/2%, until late 1994, at the earliest.

Santow: The economy in the second quarter will show 2 to 2 1/2 percent real growth, and the third quarter will not be

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much better. Many businesses are sitting on the fence waiting to see what the budget legislation will bring. They will not be happy with the results because the package is long on tax increases and short on investment stimulation. Individuals will also be unhappy with the results because it means less take-home pay. Neither group believes the budget package will mean a noticeable improvement in the budget deficit, and they will be correct.

Inflation is currently running at 3 to 4 percent, and is not likely to change for the rest of this year. For the first half of next year, the story is not likely to be much different.

A preemptive rise in the current funds rate in order to combat inflation is of questionable value. A rise of one-quarter or one-half percent in the funds target will have virtually no impact on the inflation rate. Moveover, once an increase in the funds target is implemented, and the inflation picture does not improve, the Fed could find itself in the position of having to continue to ratchet up the funds rate to maintain credibility, with little in the way of results to show for it.