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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: September 15, 1993
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Enclosed are the Greenbook and the usual information prepared at the Federal Reserve Banks of Boston and New York.

Enclosures

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

9/13/93

First District - Boston
Special District Report
Academic Level

Professors Friedman and Tobin were available for comment this month. Professor Friedman was optimistic about the second half of 1993 before the previous meeting of the FOMC and remains so now. Recent news has not altered his belief that the economy will pick up in the second half of this year. Yet, although the revisions in GDP have reduced the gap, Professor Friedman does not believe these revisions were large enough to significantly increase the threat of rising inflation. Being relatively optimistic about the current course of the economy, and the low level of inflationary pressure, Professor Friedman believes that monetary policy should maintain its present course.

Even with the recent revisions Professor Tobin believes there is room for policy to maneuver. He states that monetary policy almost always faces some risk of aggravating inflationary pressures but currently feels that the downside risk of continued sluggish growth is greater than the risk of re-igniting

inflation. He sees little evidence that inflationary pressures have begun to accelerate but plenty of evidence that the economy remains weak. One reason the economy has stagnated is that restrictive fiscal policy, both current and future, is having a contractionary effect on the economy now. Since real rates should be negative when demand is weak, and demand is currently weak, Professor Tobin believes monetary policy should be eased. Furthermore, he emphasizes that because the FOMC meets so frequently, nothing done at this next meeting is irrevocable; if a more circumspect course is indicated in the future, there will be enough time to react.

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

SEPTEMBER 1993

SECOND DISTRICT - NEW YORK
FINANCIAL REPORT - FINANCIAL PANEL

This month, we have comments from Henry Kaufman (Henry Kaufman & Company, Inc.), Charles Lieberman (Chemical Securities, Inc.) and Albert Wojnilower (First Boston Investment Management Group).¹

Kaufman: The American economy will continue to move ahead at a moderate pace. Structural impediments that are handicapping the economy will probably diminish measurably by the end of next year. In the meantime, restructuring will remain in force, intensive price competition and pressure on organized labor will hold inflation to moderate proportions, and the tepid pace of economic activity in most industrial countries will limit U.S. exports.

Much of these developments are already reflected in the American bond market. The bond market has also benefitted from the huge purchases by bond mutual funds and by the elimination of the 30-year bond in the November refunding. Moreover, the massive refinancing of mortgages has induced institutional efforts to switch from these obligations into traditional call-protected bonds. It probably is also causing some problems for those

¹Comments were received by September 10, 1993. Submissions are occasionally cut at the FRBNY in the interest of concision.

mortgage market participants who have applied hedging and arbitraging techniques. Unless the economy really deteriorates, it would seem that gains in bond prices will at best be modest from here on.

Lieberman: Economic growth should improve to a 3.5 percent rate in the second half of 1993. Although the trade sector will remain a significant drag on domestic activity, due to recessionary conditions overseas, a rebuilding of auto stocks and ongoing strength in consumer spending should maintain growth on a solid upward trajectory. It now appears likely that inflation will begin to worsen by sometime in the second half of 1994.

The contractionary impact of the upcoming tax hike on gasoline has been more than offset by lower oil prices. While lower oil prices are typically unambiguously positive, that is not the case at the moment. A decline in crude oil prices, which acts just like a drop in excise taxes, is expansionary. That is inappropriate today, because it will strengthen growth and hasten the return of inflation.

In our judgement, payroll employment is understating domestic growth. More businesses are using their workforce more intensively, rather than hiring new employees. This behavior shows up clearly as a lengthening of the workweek, which has increased enough to more than offset the weakness in job growth. A second effect of this unusual behavior is to create new business opportunities for smaller firms, as larger firms outsource work. Small firms must be hiring actively, since individuals are

reporting increased employment in the household survey. The same inconsistency between hiring in the establishment and household surveys "explains" the more rapid growth of spending than personal income. Income is estimated from the payroll data, while consumer spending reflects consumer perception of their income. These inconsistencies are likely to be resolved with the next round of benchmark revisions in the summer of 1994, which should raise estimates of payroll employment, GDP, and personal income.

Wojnilower: The surprising decline in payroll employment announced on Labor Day eve precipitated a catharsis of bullish bond market sentiment at a time when bonds were already "scarce" because of the reduction in future supply. The greater price volatility promised by reduced supply has made the market still more enticing to hedge funds (of which there are dozens or even hundreds trying to imitate or outdo the Quantum Fund), and enhances the impact of Federal Reserve bond purchases. My earlier estimate of about a 15-20 basis point reduction in bond yields due to supply reduction is apparently too low. Even with this morning's tobacco price surprise, however, I judge the bond market to have overshot and would guess that 30-year Treasury yields will be averaging above rather than below 6 percent in the months immediately ahead.

Labor market indicators other than payroll (household survey employment, workweek, wage rates, claims for unemployment insurance, help wanted ads) are stronger. So are the "anecdotal" that I hear, although these are local and, even if accurate, may not offset the weakness in California. The lower bond yields more

than countervail any modest negative economic impact from higher Federal taxes and medical-plan uncertainties. I project 2-1/2 percent GDP growth for the next 12-18 months, which would further reduce the unemployment rate and lift capacity utilization.

The FOMC has suffered, in my opinion, an unnecessary loss of stature by announcing its intention to raise rates without actually doing so, and by volunteering public forecasts of GDP and inflation appraisals that were substantially above the consensus and indeed much too high. Based on forty-plus years of experience, I assert confidently that, reputationally, publishing frequent short-term forecasts is a no-win game. Also, "threatening" to change rates via the directive but failing to do so reduces respect for the institution.