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FEDERAL RESERVE SYSTEM
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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee **DATE:** November 10, 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

November 9, 1993

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT

ACADEMIC LEVEL

Professors Samuelson, Houthakker, and Cooper were available for comment this month. Professor Samuelson finds encouragement in the data for the third quarter, making him more optimistic about the current quarter and about 1994. Given the observed strength in the economy, he feels that any tendency to lower interest rates can be put on hold for now. He believes that a good monetary policy will be satisfied with 3% growth, but should feel uneasy if growth slips as low as 2-1/2% for several quarters. On the other hand, monetary policy should entertain tightening if the economy grows at 4% or more for several quarters.

Professor Houthakker saw no great surprises in the recent data, finding them consistent with a slowly growing economy that will exert little, if any, inflationary pressure over the next two years. He suggested that with recent inflation readings of about 2% and short nominal rates at 3 to 3-1/2%, short-term real rates are a bit high given the state of the economy. He also noted that, in part due to the Bundesbank's rate cuts, the dollar is unnecessarily strong and is likely weakening our exports. He thus advocates two possible policy paths. The first would hold

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the funds rate constant, accepting expected real growth of about 2-1/2%. The second, which Prof. Houthakker prefers slightly, would lower the funds rate, perhaps by 1/2 percentage point. He feels that even if this slightly more stimulative monetary policy were to yield economic growth of 3 to 4%, there would still be no immediate danger of sparking inflation.

Professor Cooper suggests that the recent data are consistent with an economy in anemic recovery. He notes that much of the continued U.S. sluggishness may be attributed to weak growth abroad. Consequently, he suggests a "steady as she goes" monetary policy. Tightening would be inappropriate, and further easing would make little difference domestically or abroad.

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CLASS II--FOMC

November 1993

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT - FINANCIAL PANEL

This month, we have comments from Stephen Axilrod (The Nikko Securities Co. International, Inc.), Leonard Santow (Griggs & Santow) and Edward Yardeni (C. J. Lawrence).[1]

Axilrod: The Federal funds rate should remain unchanged over the next several weeks. Inflationary pressures are well repressed for now. While there is some reason to expect stronger price pressures next year, the real side of the economy is not quite vigorous enough to permit any anticipatory tightening by monetary policy at this point, though early next year may be another matter.

Growth in spending thus far this year has been reasonably good, but much of it (and all of the increase in real consumer spending) has been financed by a sharp reduction in the measured personal saving rate. For spending strength to be sustained over the next few months, we will have to see a stronger rise in real disposable income--a likely occurrence

[1]Comments were received by November 5, 1993. Submissions are occasionally cut at the FRBNY in the interest of concision.

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given the greater expansion in production and employment expected for this quarter and which would be sustained early next year if the holiday shopping season turns out well.

If growth in spending holds up, I should think the potential for upward pressures on wages and prices will become more evident, in part because spending will have to be more and more accommodated by domestic output increases. The sharp deterioration in the real trade balance thus far this year, which satisfied 37 percent of the domestic spending over the first nine months, will certainly not continue.

However, there are potential negatives for spending that cloud the policy outlook. For one thing, the personal saving rate is worrisomely low so that a negative shock to the stock market (such as a premature rise of interest rates) could well precipitate substantial consumption cutbacks. For another, one cannot be sure whether next year's greater tax payments will come more out of saving or consumption.

<u>Santow</u>: The psychology of debt market investors has deteriorated recently, and the change is not primarily due to technical or special factors. Market participants believe that an underlying improvement has taken place in the economy, with fourth-quarter real GDP probably coming in at 4 percent, or slightly more. Investors are no longer asking whether the Fed will tighten. Rather, the questions are: When will it occur? and, How many firming moves will take place in 1994?

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The general market perception is that the FOMC will change the directive to err towards the firmer side before the year is out. Moreover, the expectation is for a one-quarter percent firming in the second quarter. These estimates are based on strong GDP numbers, not only in the fourth quarter of 1993, but also in the first half of 1994.

The adverse change in market psychology is not due to any near-term inflation problem. Traders expect inflation to be fairly subdued during the first half of 1994, followed by a modest advance in the second half of the year. However, what does disturb the market on the inflation side is a growing belief that we have clearly seen the bottom of inflation.

It should also be noted that budget and financing problems are not contributing to the market's deteriorating mood. The budget deficit for fiscal-year 1994 is likely to surprise on the low side with expenditures up about 3 percent, receipts advancing about twice that amount, and the deficit coming in at about $220 billion. As for the financing, there is a heavy supply in the two-year-and-under sector, but the rest of the market has no new supply problems. What does worry some market participants is that the bond funds may soon liquidate, and banks will not be the large buyers out on the yield curve that they have been in recent years.

Yardeni: The Fed should continue to hold the Federal funds rate at 3% for now and probably through the end of

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next year. In other words, the members of the FOMC can stay home and call in for messages.

My advice to the Federal Open Market Committee is biased by my forecast. I believe that economic growth will remain on the sluggish side next year: Real GDP should increase between 2.5% and 3% in 1994. Given the recent strength in auto and housing indicators, the odds are increasing that growth might be a bit stronger than I am now predicting.

However, better-than-expected growth is likely to be productivity-led. Unit labor cost growth could be near zero next year. If so, then the CPI inflation is likely to fall to 2% over the next 12 months.

I believe that the end of the Cold War unleashed another powerful disinflationary wave. The resulting dramatic increase in the supply of cheap labor is actually deflationary for labor markets in the major industrial economies. High wages and benefits are under intense cost-control pressures. High-priced workers are losing jobs. Job insecurity is apparent in the U.S., Canada, Europe, and Japan.

In response to job insecurity, consumers are spending more time and money at discount retailers. The discounters are gaining market share and leaning on their vendors to cut costs and boost productivity. The vendors are doing so by hiring cautiously--which compounds job insecurity--and by relying more on high technology.