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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: December 15, 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

December 14, 1993

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT

ACADEMIC LEVEL

Professors Friedman, Samuelson, and Tobin were available for comment this month. Professor Friedman feels that the economy has strengthened since his last contribution to this report, and that the recovery looks more robust. He suggests that it would be quite difficult at this point to make a case for lowering the funds rate. As we move into the first half of 1994, Friedman thinks that the FOMC will have to think seriously about raising the funds rate, not because he sees any resurgence in inflation, but because the utilization rates of both capital and labor have risen. He notes that the case for having policy as stimulative as it is currently, with zero short-term real rates, was based on the desire to raise utilization rates. With the unemployment rate approaching 6 percent, and capacity utilization rates rising into the mid-80s, that desire is likely to be fulfilled. He suggests that the FOMC will want to be ahead of the curve--will want to move in advance of full utilization--rather than behind it. He also points out that an increase in the funds rate does not necessarily constitute a "tight" policy; with short real rates at zero, one could increase the funds rate and not have a tight policy.

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Professor Samuelson noted that the tone of the average forecaster has turned notably more optimistic in the fourth quarter. It is virtually taken for granted that we will see 4 percent growth in the fourth quarter of this year. There is also talk among forecasters that 94:I growth will be lower than 93:IV, but Samuelson feels that there is considerably more uncertainty about 94:I performance.

Professor Samuelson believes that if the current policy stance is evenly poised between loosening and tightening, then with this predicted strength, it would be defensible to return to a stance biased in favor of tightening. If such a stance were adopted, Professor Samuelson suggests that the Fed should simultaneously reassure the public that the Fed would not act so precipitously as to cut the recovery short. Looking ahead a bit, if the economy were to grow at 4 percent for two or three quarters, Professor Samuelson would characterize this as healthy, but not overheated.

Professor Samuelson notes further that the downscaling undertaken in many sectors of the economy has yielded improvements in productivity, possibly lowering the natural rate of unemployment, and thus allowing a more prolonged expansion.

Professor Tobin counsels for holding rates where they are. He suggests waiting to see if the expansion that appears to be occurring in the current quarter will amount to anything and extend significantly into next year. Given the extremely good behavior of inflation, and given the false start that the economy showed in the fourth quarter of last year, he feels that it would

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be premature for the Fed to raise the funds rate at this time.

Professor Tobin sees no evidence that the non-inflation-accelerating rate of unemployment has increased from the historically accepted 5 to 6 percent range. He finds few signs that "re-structuring" in the labor markets is impeding declines in unemployment. He cites the apparent shift in the Beveridge curve--there are fewer job vacancies at this level of unemployment than has been observed in previous recoveries--as evidence against an unusual degree of restructuring in the labor markets.

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CLASS II--FOMC

December 1993

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT - FINANCIAL PANEL

This month, we have comments from David Jones (Aubrey G. Lanston & Co.), Charles Lieberman (Chemical Securities Inc.) and Scott Pardee (Yamaichi).[1]

Jones: Real economic activity is accelerating in the current quarter and the increased momentum is likely to carry over into early 1994.

This stepped-up pace of economic activity is likely to sharply boost industrial capacity utilization rates. Further monthly increases could produce bottlenecks and rising price pressures, especially in light of extensive corporate downsizing, which in many industries is resulting in the contraction of productive capacity. In particular, demand pressures are currently boosting commodity prices for such items as timber, copper and steel scrap. Moreover, growing inflation expectations are reflected in the rising price of gold. At the same time, the unemployment rate is likely to decline further.

To be sure, there are still some major structural depressants on the economy including defense cutbacks, debt restructuring and corporate downsizing. But, most importantly,

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

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these negative forces are not restraining the 33 month old expansion as much in 1993 as they did in 1992, and their impact will likely diminish further in 1994. An apparent weakening in OPEC's resolve has recently led to sharp declines in oil prices, thereby temporarily lessening the threat of renewed inflationary pressures.

Nevertheless, the cyclical forces of pent-up consumer demand, spurred by earlier sharp declines in interest rates, seem to be winning out. On balance, I look for real GDP (fourth-quarter-over-fourth-quarter) to accelerate to about 3.3% in 1994. On the inflation front, consumer prices are expected to accelerate to a 3.2% pace (December-over-December) in 1994 from an estimated 2.8% increase for the comparable period in 1993.

In 1994, Clinton Administration policies are likely to add to business costs. In sum, these higher costs are likely to reinforce the moderate acceleration in price pressures next year.

Lieberman: Our analysis suggests that fourth quarter economic growth will be unusually high, but the economy will enjoy quite a bit of momentum as it enters the new year. We look for real GDP growth of around 3% in the first half of the year and 3 1/2% in the second half. Most critically, we believe rather strongly that the data significantly understate the vigor of the expansion. The level of employment could be, and in our judgment is, understated by more than 250,000 workers.

Indeed, every available measure of the labor market now looks very healthy. Help-wanted advertising is picking up.

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Initial claims for unemployment insurance are still trending down and are at a very low level, particularly in proportion to the size of today's workforce. Diffusion indexes of employment gains indicate that job creation is becoming more broad-based. And record levels of the workweek and overtime point to continued improvement in the labor markets in the months ahead.

The understatement of payroll employment implies that personal income (and the savings rate) is also understated. This means that the rapid rise in spending, which appears to exceed growth in income, may be entirely financed out of income rather than by drawing down on the savings rate. Indeed, why would consumer spending consistently pace income growth as long as it has this year, in an environment in which individuals are expressing a high degree of caution and pessimism, unless they actually were seeing better income trends than are apparent in the official reports? Carrying this logic to its ultimate conclusion, stronger income growth implies that the rise in spending may be well financed and, therefore, sustainable.

Stimulative monetary policy no longer seems appropriate to us, now that the economy is on a sustainable growth path and fast approaching fully employed but noninflationary levels of resource utilization. So, sometime early next year we expect Fed policy to begin to shift back to a more neutral stance--neutral in our minds being a federal funds rate somewhere between 4% and 5% at this juncture. We expect fiscal restraint next year to dampen only slightly the pace of growth, as much of the burden of higher taxes

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will be placed on high-income earners who we think will respond by dipping into saving rather than cutting their spending.

Pardee: The Fed should raise the federal funds rate by 50 basis points, to 3 1/2%, promptly.

- The momentum of economic growth is now firmly established.
- Excess capacity in manufacturing and the labor market is now being absorbed at a pace that will create inflationary bottlenecks in 1994-95.
- Inflation, while modest by recent experience, is still above the longer-term objectives of 1-2% set forth by Fed leaders over the years.
- The narrow money aggregates show that the Fed's policy is still accommodative: the Fed's provision of reserves is holding the Federal funds rate from rising in response to market forces.
- Real short-term interest rates are still zero or only slightly positive, a good idea when economic growth is sluggish but a bad idea once momentum picks up.

Years ago, William McChesney Martin said that it is the job of the Fed to take away the punch bowl just when the party begins to swing. These days, the party's host is responsible for the sobriety of the guests from the outset.

Congress, the Administration, and the public at large should be made to recognize that a modest move now, however controversial it may be, may forestall the need for a major move later on, in the midst of much greater economic and political tensions.