



BOARD OF GOVERNORS
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FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551-0001

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee

DATE: March 16, 1994

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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 tomorrow.

Enclosures

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

March 15, 1994

FIRST DISTRICT - BOSTON
SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Houthakker and Tobin were available for comments this month. Professor Houthakker believes that both domestic and international conditions argue for no tightening of monetary policy at this time. He fears that further tightening would threaten to choke off the recovery. He believes that commodity prices such as gold prices are not useful indicators of inflation; instead, he would rely on the CPI and wage data. With recent increases in productivity as measured by output/hour, and no apparent increases in the inflation rate using wage or price data, he views the threat of increasing inflationary pressures as minimal. He is also concerned that further tightening would slow down the already weak recovery of our trading partners.

Professor Tobin also believes that monetary policy should remain unchanged. He finds no evidence in the wage and price data of increases in the inflation rate. During any recovery, he expects some sectors to improve their profit margins as demand increases, but changes in relative prices of some sectors should not be interpreted as general price increases. While estimating the natural rate of unemployment is difficult, the evidence in

the job vacancy and unemployment data is consistent with continued slack in the labor markets. He views the increases in interest rates since February 4th as reflections of concern about future Federal Reserve tightening rather than incipient signs of inflation.

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

March 1994

SECOND DISTRICT - NEW YORK
FINANCIAL PANEL

This month, we have comments from Henry Kaufman (Henry Kaufman & Company, Inc.), Charles Lieberman (Chemical Securities, Inc.) and Edward Yardeni (C. J. Lawrence Deutsche Bank Securities).¹

Kaufman: The recent rise in interest rates is unlikely to deter the forward momentum in the American economy. This is because key sectors of the economy now have sufficient financial strength to withstand the higher interest rate levels. In addition, the prevailing level of interest rates is still sufficient to support continued economic growth.

In the initial step-up of short-term interest rates, the yield curve, however, has not flattened, even though traditional theory tends to suggest such an event. As interest rates continue to rise during the current business expansion, a genuine flattening and then an inversion of the curve is highly unlikely. This is because financial markets are less segmented today than years ago, many market participants have a greater near-term orientation in

¹Comments were received by March 11, 1994. Submissions are occasionally cut at the FRBNY in the interest of concision.

their portfolio practices, and more banks and other institutional investors must mark their assets to market rather than maintaining them on their books at cost. Also, the likely behavior of mutual funds will resist a flattening tendency. Consequently, changes in financial asset values will become an increasingly important consideration in the implementation of monetary policy as the current economic expansion matures.

Lieberman: Economic growth should continue on a solid growth path that takes the unemployment rate through the 6% "full employment" level (on the old basis) by summer. As the economy approaches full employment the outlook for inflation is growing less favorable. By year end we expect consumer inflation to be moving into the 3 1/2-4% range. Thus, we think the Fed's modest rate hike on February 4 was entirely appropriate. Furthermore, we anticipate that the Fed will continue to tighten monetary policy this year, gradually at first, moving the federal funds rate up to 4 3/4-5% by year end.

The labor market is already fairly healthy and some modest upward pressure on wage rates could begin at any time. Moreover, we expect that labor markets will tighten more rapidly this year than the FOMC anticipated in its economic forecasts presented to Congress in the Humphrey-Hawkins report. We continue to expect that the economy will grow at an average rate of 3 1/2-4% rate in the first half of this year.

Yardeni: The Federal Reserve's new approach to monetary policy is flawed, confusing, and probably contributed greatly to

the recent turmoil in the global bond markets. Undoubtedly, the U.S. monetary authorities did not expect that bond yields would soar all around the world after they raised the federal funds rate by a quarter of a point to 3.25% on February 4. They probably believed that their preemptive move against reflation would lower inflationary expectations and lower bond yields.

What went wrong? Some critics say the Fed should have tightened sooner. Others say the rate hike should have been greater. The problem is not one of timing or magnitude. Rather, the Fed has adopted a new approach to monetary policy which relies too heavily on questionable economic indicators and intuition.

Most upsetting to the financial markets, is that the Fed no longer puts much weight on the actual inflation news. It is quite likely that the Fed's action and Mr. Greenspan's recent testimony revived inflationary concerns that were not there.

Fed Chairman Alan Greenspan confused financial market participants by suggesting that the Fed now targets real interest rates rather than nominal interest rates or the money supply.

One solution ... is to have the Federal Reserve adopt a Real Interest Targeting Approach (RITA). The monetary authorities could declare that the federal funds rate will be set at a level that is 50 basis points above the year-over-year change in the CPI. So the rate would be set at 3% today. If the inflation rate falls to 2%, the federal funds rate would drop to 2.5%. If inflation moves up to 3%, the funds rate would move up to 3.5%.

Every six months, the Fed could reassess the real interest rate spread. If inflation is not contained between 2% and 3% by a 50 basis point spread, the Fed could raise it to 100 basis points. If the goal is price stability, i.e., zero inflation, the initial spread could be set at 100 rather than 50.

This approach directly targets actual inflation rate as the one variable that is the Fed's top responsibility. It eliminates the need to rely on intuition to gauge the degree to which monetary policy is accommodative, neutral, or restrictive. Once the inflation goal has been declared, the approach is either working or it is not. If it is not working, the spread can be "fine tuned" as described above. Admittedly, RITA involves some learning by doing. But the goal and the process would be clear and straightforward. Investors would be less confused and more confident that the Fed has an approach that within a reasonable period of time can hit the announced inflation target.