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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: May 11, 1994
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Enclosed are Part II of the Greenbook and information prepared at the Federal Reserve Bank of Boston. There is no special report from the Federal Reserve Bank of New York. Part I of the Greenbook will be distributed with the Bluebook.

Enclosures

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May 10, 1994

FIRST DISTRICT - BOSTON
SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Friedman and Samuelson were available for comment this month. Professor Friedman feels that monetary policy is on the right track. The short-term rates that prevailed at the beginning of this year were too low relative to ongoing inflation to be consistent with an economy that attains, but does not overshoot, full employment. The current strength in the economy will move us near enough and fast enough toward full employment that an anticipatory increase in short-term real rates is appropriate.

Professor Friedman notes that trying to understand the recent poor performance of the long bond market is difficult but important. He suggests that if the FOMC believed that the bond market would improve with a Fed tightening, that was a mistake. Such a belief would fly in the face of the historical record of short-term fluctuations in the bond market. While there must be some long-run sense to the prediction that sustained higher short rates will eventually bring inflation down, and long rates with it, the bond market has never worked that way in the short run.

Finally, Professor Friedman points out that, with the introduction of new derivative instruments, the structure of

leverage in the long market is considerably different now than it has been. He believes that the resulting increase in leverage may have amplified the response of long rates to short rate movements. It will be important to understand the effect of derivatives on bond market leverage when assessing the impact of policy actions on the long bond market.

Professor Samuelson notes first that he does not believe that the Fed should feel constrained to arrive at and announce policy actions only at FOMC meetings. With current communications technology, there is no reason that decisions can not be made by conference call (for example) during the inter-meeting period.

He feels that the financial markets are expecting another one-quarter point increase at, but not before, the next FOMC meeting. The appropriateness of that expectation should be judged not just by the latest signals from a basket of inflation indicators, but by the consensus estimate of real growth over the next few quarters. He suggests that an acceptable goal for the growth in real final sales would be about 3 percent, on average, over the next year.

Professor Samuelson found the first quarter GDP number surprising; the 0.9 percent growth in real final sales was particularly weak. If careful analysis of the GDP release suggests that this is an unbiased estimate of first quarter activity, then an additional one-quarter point increase in short rates would not be required. If, on the other hand, the first-quarter weakness in the GDP report can be "explained away," then

increasing rates an additional one-quarter point would be appropriate. He feels that neither action--tightening or standing pat--would be a crucial mistake.

He cautions against interpreting movements in the long-term bond rates as changes in inflation expectations. The bond markets respond to a variety of factors, not just inflation conditions. He notes that even in the absence of inflationary pressures, the bond markets might well be bearish if real growth appears to be surprisingly strong.

Finally, Professor Samuelson believes that auto sales account for much of the current strength in the economy. Favorable leasing terms may have tapped a new layer of demand for autos. However, he suggests that the current strength in auto demand is making up for past weakness, and subtracting from future strength, and thus should not be viewed as a sustainable source of strength. This argues, he feels, for a monetary policy that proceeds with caution, not locked in to higher rates, until the outlook for real growth becomes clearer.