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

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: January 25, 1995

FROM: Gary Gillum GPG

Enclosed are the Greenbook and information prepared at the Federal Reserve Bank of Boston.

Enclosures

January 23, 1995

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT

ACADEMIC LEVEL

Professors Samuelson and Tobin were available for comments this month. Professor Samuelson believes that we are below the NAIRU, a condition likely to result in upward pressure on wages next year. Even in geographical regions that have not led the recovery, such as New England, the help wanted signs have increased and the labor market appears quite tight. Furthermore, he expects real GDP growth between 3.5 and 4.0 percent in the fourth quarter of 1994, and growth in the first quarter of 1995 to be faster than can be sustained without creating further pressures on the labor market. However, some of this growth will reflect problems with seasonals, with the unusually warm winter distorting the normal seasonal correction in areas such as residential investment. With the economy growing faster than is sustainable at present interest rates, he advocates adopting a tighter policy at the upcoming FOMC meeting.

Professor Samuelson advocates an increase of 25 or 50 basis points in the federal funds rate, with further increases should the data indicate continued inflationary pressure. Moreover, movements should not be constrained to FOMC meetings. Instead, rates should be raised whenever appropriate. This would allow for more frequent, but smaller, increases in the federal funds rate. He would oppose a 75 basis point increase in the federal funds rate at this time, because it would signal to markets that the Federal Reserve would prefer to err on the side of excessive tightness. Furthermore, excessive tightening could trigger sufficient instability in foreign markets, such as Latin America, to make a soft landing quite difficult to achieve.

Professor Tobin notes that inflation has been moderate and that a great deal of uncertainty remains about the current level of the NAIRU, but we may well be below the NAIRU. While any tightening is not without risk, he would advocate some tightening at this time. His preferred strategy would be to raise the discount rate while leaving the federal funds rate unchanged at this time. This would be intended to signal the Federal Reserve's concern with the possibility of rising inflation, while reserving the option to raise the federal funds rate should we receive greater evidence of higher inflation. Domestic concerns should be the primary determinant in the deliberation, although the problems in Latin America suggest caution should be exercised in any further tightening of policy.