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

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee **DATE:** May 9, 1990

FROM: Gary Gillum GPG

Enclosed are the greenbook and supplementary information prepared at the Federal Reserve Banks of Boston and New York.

Enclosures

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CLASS II - FOMC

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Samuelson and Houthakker were available for comment this month. Professor Samuelson is concerned that the core rate of inflation is gradually accelerating. With unemployment remaining between 5 and 5.5 percent, he has been surprised that pressure on prices has not been greater. However, the higher than expected first-quarter increases in the CPI and the GNP deflator, while influenced by special factors, indicate to him that the economy is probably below the "natural" rate of unemployment. Thus, because of domestic factors, a tighter monetary policy should be followed. However, he fears that a tighter monetary policy would strengthen the dollar relative to the yen, which would have adverse effects on our balance of trade and might increase protectionist sentiment. Professor Samuelson would be willing to reverse policy as soon as the inflation rate was no longer accelerating.

Professor Houthakker is also concerned that the core rate of inflation is accelerating. He believes that the core rate of inflation, which had been between 4.5 and 5 percent, is now over 5 percent. The dollar depreciation over the past several years has been one reason for the acceleration of inflation. The Federal Reserve should not focus on particular exchange rates,

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First District - Boston

such as the yen or the mark, but should be concerned with the trade-weighted index. He expects that the dollar will appreciate, which will reduce some of the inflationary pressures. However, he believes tightening will still be necessary to reduce the inflation rate. If the Federal Reserve is serious about decreasing the inflation rate, a moderate recession may be necessary. Without more slack in the economy, inflation will continue to ratchet up.

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CLASS II -- FOMC

May 1990

SECOND DISTRICT - NEW YORK

FINANCIAL REPORTS - FINANCIAL PANEL

This month we have comments from Charles Lieberman (Manufacturers Hanover), Francis Schott (Equitable Life), and Albert Wojnilower (First Boston Corp.).*

Schott: The economy has been stronger and inflation worse in early 1990 than expected by most observers at the beginning of the year. The financial markets are uncomfortably aware of these facts and are also significantly impacted by high-yield bond market problems and large Treasury borrowing requirements. The redevelopment of Central and Eastern Europe places a burden on Western capital markets. The full extent of this burden is only beginning to be perceived.

Under these circumstances, the Federal Reserve might wish to reemphasize in word and action its dedication to price stability as its basic objective. Inflation fears have the

*Comments were received May 4, 1990. Submissions are occasionally cut at the FRB-NY in the interest of concision.

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potential of driving up long-term interest rates if the stability of short-term rates is perceived as a lack of response to increasing inflation.

Wojnilower: After many months during which the economic and price indicators gave misleading impressions of economic weakness and disinflation, recently (at least until this morning's employment report), they have been overstating the strengthening that is occurring. All the same, however, there is a palpable change of climate. Anecdotal reports from manufacturers are that "business has stopped getting worse" and (nonauto) retail reports are upbeat. New York and New England, however, remain in a downtilt. The income and employment contraction in the financial services industry is far from over.

I have heard no new reports of undue examiner zeal since my return from three weeks in the Far East at the end of March. A week of intensive talks in Tokyo during the worst of the stock price decline gave no indication that Japanese business was intending to trim its optimistic sails. In our financial markets here, institutional investors generally were cautiously bullish on both bonds and stocks, even before this morning's employment figures.

Lieberman: The modest rise of jobs in April washes out all of the strength previously implied by the employment reports for January and February, conveying a perspective of moderate growth. March and April were overly weak because January and February were overly strong. The only reasonable approach is to take the four months together to discern the

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underlying trend, which implies only moderate growth. Removing the census workers suggests that average monthly job gains in the first four months of 1990 were about 180,000. Since underlying labor force growth averages about 140,000 monthly, the current rate of expansion no longer seems excessive nor does it appear to be accelerating in a worrisome way. Inflation may not increase, but it is also unlikely to decline. Therefore, I would characterize growth as acceptable and inflation as high but stable, implying no need to alter policy at the present time.

Looking out over the balance of the year, the economic expansion does not appear to be at risk. If manufacturing improves gradually in response to gains from exports, economic growth should rise. Even so, underlying growth is unlikely to accelerate quickly. Economic growth is very close to the Fed's soft landing objective. And, the market seems reasonably priced for the risks as they now stand.