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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:** August 15, 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 Houthakker and Samuelson were available for comment this month. Professor Samuelson believes the Fed should ease policy in order to limit the anxiety due to the conflict with Iraq. Even before the oil crisis, revisions to the national accounts had shifted the course of the economy more toward recession, away from a good soft landing. Although we do not know how serious the crisis will become, we do know that we are poorer than we were last month. The Fed should ease because the sanctity of the price level cannot be regarded the same after the oil crisis, and it does little good to experience an unnecessary recession in industries other than those tied directly to oil consumption.

Even though the Fed should ease policy, it should be aware of two constraints. First, the trade-off between unemployment and inflation is now more acute. With too much ease, the oil crisis can initiate a relatively rapid increase in the rate of inflation. Without a restoration of oil production, increases in domestic prices and wages cannot reduce the real price of oil; consequently, if policy is too lenient, oil prices and domestic prices would tend to chase each other in an upward spiral. Second, with the threat of stagflation, slower growth abroad, and higher interest rates abroad, the Fed may be able to reduce domestic short-term interest rates, but not real long-term interest rates. The Fed acted just right in 1987, and something like that is needed now: policy should be eased enough to mitigate anxieties and the consequences of the crisis at hand; then the Fed should tighten policy later when it is sure the problem is safely behind us.

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Professor Houthakker does not believe the recent events in the Middle East are sufficient reason for easing policy, but he does believe the recent revisions to the national accounts are sufficiently disturbing to warrant another reduction of the federal funds rate. The current oil crisis does not closely resemble those of 1973 or 1979. Even the recent increase in oil prices, which was an exaggerated reaction to the relatively modest reduction in net world production, does not represent a huge increase in the real price of oil from its average over the past two years. Nevertheless, the Fed should ease its policy slightly because the rate of growth of real GNP as reported in the national accounts has been reduced significantly, indicating that monetary policy has in effect been tighter than we had thought. The case for easing policy is reinforced by the relatively slow growth of M1 and M2 in recent months. An increase in the real price of oil should not necessarily deter this easing, because the Fed cannot do much to reverse the consequences of this event.

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

August 1990

SECOND DISTRICT - NEW YORK

FINANCIAL REPORTS - FINANCIAL PANEL

This month we have comments from Richard Hoey (Barclays Bank), Charles Lieberman (Manufacturers Hanover), Albert Wojnilower (First Boston).*

Hoey: We believe that the U.S. economy has already moved into recession. This primarily reflects the workings of a credit risk cycle rather than an intentional policy cycle. First, there is a reduced willingness to supply credit to risky borrowers. Second, there is a reduced willingness to demand credit.

There is a risk of severe rather than moderate recession if the oil price shock worsens the risk crunch. We are concerned about a "petrodollar recycling bust" as financial intermediaries have limited willingness or ability to lend to vulnerable oil consumers. Monetary policy has engaged [in] successful damage control to date, balancing the risk of credit

*Comments were received August 10, 1990. Submissions are occasionally cut at the FRB-NY in the interest of concision.

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deflation and wage inflation. Policy predictability has been a major stabilizing factor. Long-term inflation expectations near 4.25 percent remain at the low end of the recent range but have not broken to the downside.

While long-term expected real yields at about 4.5 percent are high relative to past U.S. real yields and conditions in the real estate market, they are not high relative to competing real yields in Germany and Japan. With monetary policy shifts likely to drift towards ease in the U.S. and possibly towards further tightening in Germany and Japan, the dollar should remain in a persistent downtrend. A gradual downdrift will help cushion the severity of the recession if a confidence crisis in the dollar can be avoided.

Lieberman: Economic growth had turned marginal even before the latest events in the Middle East threatened the economy. The unemployment rate is grossly understated, and I fully expect it to rise sharply in the coming months. A surge to 6% by the fall is quite possible. Our rough estimates suggest that a $10 increase in oil prices would reduce real GNP by about 1%. This might be enough to tip the economy into recession, if one is not already underway.

The outlook for "core" inflation had been gradually improving, even as the events in the Middle East now ensure that actual inflation measures will spike upward temporarily. But the surge in oil prices [is] not likely to pass through to "core" inflation because of the sluggish state of the economy.

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The market's perspective on Fed policy has shifted radically over the past few weeks. Sentiment has swung from surprise and disappointment that the Fed would ease policy under Administration pressure to expectations of easing in the near future and actual concern that the Fed has refrained from doing so. It seems unreasonable for the Fed to offset higher oil prices by keeping monetary policy tight to squeeze the domestic economy, and thereby risk a possible recession.

Wojnilower: The new Middle East crisis is prompting a general downward revision of economic prospects among business firms. (This is separate from the downward revision in the full-employment growth rate of 1 to 1-1/2 percent implied by the newly revised GNP statistics.) For my own part, I am guessing that real GNP will remain about unchanged for the fourth quarter of 1990 and first of 1991. Resumption of modest growth later in 1991 depends, in my judgment, on a cessation of oil price rises and supply disruptions, avoidance of (excise) tax increases that aggravate the rise in the cost of living, and a somewhat more accommodative monetary policy to cushion asset price declines.

Recent increases in government bond yields reflect, primarily, the market's disappointment that the Federal funds rate has not been lowered further and, secondarily, rises in bond yields abroad. Fears of heightened inflation are roughly counterbalanced by the conviction (already widely held by market participants even before the oil crisis) that a recession is under way.