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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 8, 1991

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 Tobin and Samuelson were available for comment. Professor Tobin was pleased that the discount rate had been cut, but believes that further easing is necessary. He sees little evidence of a resurgence in inflation; in fact, prices on some assets such as real estate are still falling and he believes that the bottom of the recession is not evident. With little risk of rising inflation, he would ease further to ensure that output did not drop further. The exact timing of the trough is not important. Even if we have already reached the trough of the recession, the economy can grow rapidly before resources are again fully utilized. The strength of the dollar also argues for further loosening. If exports are to pull the economy out of recession, lower interest rates and therefore a weaker dollar are necessary to increase our competitiveness enough to stimulate exports.

Professor Samuelson also believes that further easing may be necessary. While the leading indicators have turned positive, the coincident indicators provide no evidence that the trough of the recession has been reached. He is not confident that the recent drop in unemployment accurately reflects labor market conditions, especially since critical industries such as auto and

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construction still show no signs of recovery. If the FOMC wants the economy to begin recovering by the middle of this year, and is prepared to tighten if the economy expands too quickly, then the FOMC should ease further. If, instead, the FOMC is serious about achieving price stability and is unwilling to continue with a 4 percent inflation rate, then no further tightening is required. However, choosing the latter would require significant slack in the economy, much as Germany had during the 1980s. Professor Samuelson believes that further reductions in inflation are sufficiently costly, and the risk of an extended recession still sufficiently great, that he would continue easing monetary policy.

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CLASS II--FOMC

MAY 1991

SECOND DISTRICT - NEW YORK

FINANCIAL REPORTS - FINANCIAL PANEL

This month we have comments from Stephen Axilrod (Nikko Securities), Leonard Santow (Griggs & Santow) and Albert Wojnilower (First Boston).[1]

Axilrod: The recent move in the discount rate positions by the Fed is about right for now in a very uncertain situation. The recovery could begin anytime from June to November, with the odds not low on beginning late in the period. Thus, the Fed needs room for further declines in the funds rate, and should take at least the next step to 5 1/2 percent before the next meeting even if the economic data show the recession could be bottoming.

It is difficult to see any strong impulses for recovery at this time within the private economy--which increases the need for supportive actions by the policy authorities. Moreover, the monetary tightness in Japan and Germany is, at the margin, working to offset credit market ease here (on a guess by 10 to 20 basis points in longer-term rates), while also restraining our

[1]Comments were received by May 3, 1991. Submissions are occasionally cut at the FRB-NY in the interest of concision.

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export markets. In that context, it is a bit worrisome that the real overnight money market rate in the U.S. still seems high relative to historical experience with recessions--which may well indicate more monetary or credit restraint than usual for such a period.

Inflation remains a problem, of course, but I assume the Fed will be satisfied with a reduction to a 3 1/4 to 4 percent range, as projected in the policy report to Congress earlier this year. Given the prospective weaker than normal recovery, that may well have already been accomplished.

Santow: The U.S. economy is still declining, but at a slower pace. April was a negative month for real growth, and the same is likely for May. June should be flat and real growth will probably not be evident until either July or August.

There are many who overemphasize what the Fed can do to speed up this process. The problems in the economy cannot be cured by merely easing monetary policy. The more easing the Fed does from this point on, the less likely the chances that the 30-year government bond rate will trade at or below 8 percent.

One item that bears very close watching is the crisis situation developing in the state and local government area. From a financial market perspective, it is not so much the deficits but the inability to roll over maturing debt. The key period is the end of June and early July and the biggest problem area is the state of Massachusetts. There could well be a dumping of lower quality state and local government obligations

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in general before that time, and a major move to buy short-term Treasury paper. Such a crisis would not be good news for those hoping for a meaningful economic recovery.

Wojnilower: Anecdotal information from the housing, furniture, and employment agency sectors tends to corroborate the statistical evidence that the recession is slowing. I have seen no indication, however, of any leveling in the consumer or capital goods sectors (with the possible exception of computers and related industries). The military sector continues to plummet.

I project the current-quarter GNP to show a minor decline, and the second half an anemic recovery on the order of two percent (annual rate).

The recent discount rate reduction is welcome. The Federal Reserve's apparent reluctance to take this action has, however, made market participants more skittish that short rates may be raised promptly if and when the economy starts to recover. This perception is liable to move bond yields higher in anticipation.