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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 13, 1992

FROM: Gary Gillum

Enclosed are the Greenbook and the usual information prepared at the Federal Reserve Banks of Boston and New York.

Enclosures

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August 10, 1992

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT

ACADEMIC LEVEL

Professors Houthakker and Samuelson were available for comment. Professor Houthakker expressed concern over the behavior of the monetary aggregates. Slow growth in M2 has made him more pessimistic about the economy. Although he is uncertain about the optimal aggregate to target, he is now leaning toward M1; none of the money numbers instill him with confidence about the economy. He believes, however, that further cuts in the federal funds rate would have only a minimal effect on the economy. Although inflation is lower than expected, so the federal funds rate is higher than it may, at first glance, appear, he sees little room, or use, for the funds rate to fall further. The goal of policy should be to drive down the long end of the market, not the short end. He blames the Treasury for the current slope of the yield curve and advocates substantially reducing the issuance of long-term federal debt. He believes the Fed should call on the Treasury to stop issuing longer maturity bonds and to purchase bonds at the long end.

Professor Samuelson, on the other hand, is convinced that Fed action has been, and still can be, effective. So far, the decline in long-term yields has been significant, and the economy

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would be much worse off now than if previous monetary easing had not forced all rates down. Samuelson also emphasizes that watching exclusively the long end of the term structure misses much of the expansionary effect of monetary policy mortgage lending rates and rates on borrowing for business investment are tied more to the five- to seven- year rates than to the 30 year rates. Not only has monetary policy helped the economy, but room remains for further expansion if it is necessary, he believes.

Samuelson's forecast of third-quarter GDP growth is now closer to 2 percent than the 3 percent he expected six weeks ago. He also sees Fed inaction as potentially triggering expansionary fiscal policy, which would have an adverse effect on investment and the composition of GDP. As a result, he believes the Fed should ease further and continue easing until its forecast growth path converges around a more desirable growth target.

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AUGUST 1992

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT - FINANCIAL PANEL

This month, we have comments from Richard Hoey (The Dreyfus Corporation), David Jones (Aubrey G. Lanston & Co.) and Scott Pardee (Yamaichi International, America, Inc.).[1]

Hoey: The central bank now has a great deal of credibility with respect to its commitment to disinflationary policy. One reason that has not translated into lower long-term interest rates is that the legitimacy of central bank policy is under attack. Neither political officials nor public opinion concur with the central bank's priority on disinflation. Market participants must therefore discount a risk of a future abandonment of disinflationary policy. Near term, however, evidence of downward pressure on the underlying rate of inflation is likely to be persuasive enough to generate somewhat lower long rates. But upward pressures are likely to emerge as demands for economic stimulation intensify.

A mix of monetary and fiscal policies which merely restrains the growth of total demand is unlikely to be politically tolerable. Unless policies to support growth in productive capacity are adopted, public tolerance for non-inflationary policies cannot be sustained. While the pro-cyclical stance of bank regulation in this cycle is restraining the economy, there are

[1]Comments were received by August 7, 1992. Submissions are occasionally cut at the FRBNY in the interest of concision.

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encouraging signs of a virtuous cycle of equity deleveraging through stock market underwritings.

Economic expansion at a low-normal pace with relatively constrained fluctuations in the financial markets appears to be the most likely outlook.

Jones: The U.S. economic recovery continues to stumble alomg in an unusually slow and uneven fashion. In this environment, inflation pressures are well contained. Indeed, the problem is not inflation; it is instead the threat of prolonged sub-par economic growth. The recovery nearly stalled out completely as the second quarter of 1992 came to an end. The unique nature of the current anemic recovery continues to be the dominance of financial problems. These financial woes, which could depress economic activity for several more years, contrast with the more traditional dominant cyclical influences. The following major points are worth noting:

(1) Consumers continue to be extremely cautious and selective. Wary consumers suffer from too much debt, bleak job prospects, the negative wealth effects of declining real estate values and vague uncertainties about their long-term standard of living. Corporate pricing power is weakening in this environment, forcing businesses to emphasize cost control and more permanent worker layoffs.

(2) Housing activity should be given a boost on the heels of the Fed's latest aggressive easing move just as it was temporarily stimulated following the Fed's dramatic easing move last December. However, this boost in housing activity is not likely to last.

(3) For the economy as a whole, desired debt restructuring and retirement efforts appear to be about 65% complete. For individuals, the debt restructuring process may, however, only be

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about 50% complete. Elimination of the debt excesses and the unwinding of asset price inflation of the 1980s is likely to take at least five years beginning with the stock price collapse of 1989 (when the corporate takeover frenzy came to an end) and continuing at least until 1994.

(4) Economic growth will be constrained to a "soft takeoff" pace not exceeding 2% to 2 1/2% for the remainder of this year and possibly all of next year as well. In a situation vaguely reminiscent of the 1930s, debt-strangled individuals and business borrowers remain reluctant to take on new debt, despite the lowest short-term interest rates in more than two decades. Similarly, lenders, especially hard-pressed depository institutions, continue to be extremely reluctant to face the risks inherent in making new loans, despite extremely attractive net interest margins.

(5) On balance, real GDP is expected to accelerate to 2.5% in the third quarter of 1992. Looking ahead to the fourth quarter of this year, the pace of real GDP growth could edge lower to about 2%. There remains the possibility of a "triple dip" slump in real GDP growth to 1% or below in early 1993.

Pardee: This is one of the most dangerous periods for the Federal Reserve I can remember. Politicians from both parties are beating up on the Fed, seeking to make it the scapegoat for their own failings. The Fed's usual friends in the government are being quiet. And no one at the Fed is in a position to fire back at the critics with equal intensity. In the absence of appropriate fiscal policy, the Fed has forced short-term interest rates down to absurdly low levels and has created an enormous amount of liquidity in the banking system which can only come back to haunt us next year when loan demand really begins to pick up.

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For now, the U.S. economy continues to grow at a pace of 2-2 1/2%, with little sign of acceleration. The reasons for the sluggish growth have been set forth accurately, in my view, by Chairman Greenspan and others from The Federal Reserve. In recent weeks, investors are shifting out of short-term instruments, where the rate of return is now nil after inflation, into higher yielding paper, through extending to longer maturities or accepting higher credit risks. Thus long-term interest rates have begun to decline. I think this process will continue until the 30-year bond yield reaches to 7% or so later this year.

The lower long-term interest rates will help hasten the balance sheet restructuring process. But lower interest rates alone will not establish the basis for a more satisfactory economic growth rate, of 3% or more over time. That will require the U.S. government to adopt broader economic policies to improve productivity, and to bring the fiscal deficit finally under control. These are the issues that politicians should be discussing, rather then bashing the Fed.

The employment and unemployment statistics produced by the U.S. government these days are a sorry reed on which to base monetary policy. Even if the unemployment rate rises between now and November, the Fed should continue to look at the whole range of economic indicators. This is a period of slow growth, not a recession, and further monetary ease at this time could easily sow the seeds of inflation in 1993 and after.