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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: November 12, 1992

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

Enclosures

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CLASS II - FOMC

11/9/92

FIRST DISTRICT - BOSTON
SPECIAL DISTRICT REPORT
ACADEMIC LEVEL

Professors Hendrik Houthakker and Benjamin Friedman were available for comment this month. Professor Houthakker believes recent data indicate some improvement in the economic situation, although the improvement is not spectacular. While he anticipates a greater rate of GDP growth, the unemployment rate will decline very slowly. The recent substantial appreciation of the dollar is a concern. While the current level of the dollar does not present a danger, continued appreciation would at some point become a problem for our export performance.

Monetary policy is basically on the right track. No further stimulus is necessary at this time. While some fiscal policy stimulus would be appropriate, a Clinton administration fiscal stimulus package that is at all sizable would place the Fed in a difficult position with respect to its policies to eliminate inflation. In fact, Professor Houthakker believes the recent increase in long-term interest rates reflects an increased fear of inflation on the part of investors.

Professor Friedman attributes the recent increase in long-term interest rates to two possible factors. First, it reflects the long-term prospects for budget deficit reduction, in particular a concern that fiscal policy will increase the deficit. Thus, long-term rates reflect the probability that when the economy does get back to full employment, short-term real interest rates will be high. Second, it may reflect a concern by participants in the bond market about a return to higher inflation rates. Given that the recent news provides little reason to be more nervous on the inflation front, he places much more of the emphasis on the prospects for future short-term interest rates at full employment.

Professor Friedman would favor still lower short-term interest rates. While the short-term real interest rate is now lower than one or two years ago, monetary policy still is not all that easy when placed in historical perspective. A zero short-term real rate is roughly the average rate for the thirty-year period prior to the Reagan administration. The Fed should not get into an anticipatory game by adjusting monetary policy to reflect what fiscal policy might or might not be six months hence. Thus, he would not be reluctant to reduce short-term rates now because of concerns about a fiscal expansion that might be legislated in the future. While it is too early now for monetary policy to be reacting to prospects for changes in fiscal policy by the Clinton administration, it would be appropriate to take the new fiscal policy program into account in the spring or summer, after the nature and magnitude of the new fiscal policy stimulus are clear.

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

NOVEMBER 1992

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT - FINANCIAL PANEL

This month, we have comments from David M. Jones (Aubrey G. Lanston & Co.), Henry Kaufman (Henry Kaufman & Company, Inc.) and Edward Yardeni (C. J. Lawrence).[1]

Jones: Recently, there have been some hints that the slow pace of economic expansion may quicken slightly in the closing weeks of 1992, especially with election uncertainties behind us. To be sure, the latest data are mixed. Nevertheless, there have been some encouraging signs.

In the favorable interest rate environment that prevailed through early September of this year, individuals and businesses continued the necessary task of restructuring their heavy debt burdens. These debt restructuring efforts should be completed within the next 6 to 12 months, thus helping set the stage for stronger economic growth.

On balance, assuming a front-loaded, confidence-building dose of Clinton Administration fiscal stimulus, real GDP should grow at a 2 to 2 1/2% pace in the first half of 1993 and then accelerate modestly to 2 1/2 to 3% in the second half of next year. In the first half of 1994, real GDP growth should accelerate

[1]Comments were received by November 6, 1992. Submissions are occasionally cut at the FRBNY in the interest of concision.

further to 3 to 3 1/2%, followed by a further pick-up to 3 1/2 to 4% in the second half of 1994.

The new Clinton Administration is likely to promptly launch an aggressive policy of fiscal stimulus. It will be largely formulated in a first 100-day honeymoon with Congress. The plan for sharply increased public spending on infrastructure, education and job training, perhaps along with health care reforms, is likely to be front-loaded with aid to State and local Governments that goes beyond Clinton's original economic plan.

The relationship between fiscal and monetary policies in a new Clinton Administration is likely to be the reverse of that in the preceding Bush Administration. Specifically, the Clinton Administration will view fiscal policy as the dominant economic policy instrument with monetary policy typically playing only a secondary role. Thus, in the boldest experiment in fiscal activism in decades, the Clinton Administration will likely first seek to jump-start the economy mainly with additional new public works spending programs, which almost certainly will initially add to the already huge deficit, followed by a longer-term effort to trim the deficit, perhaps spanning 10 years.

<u>Kaufman</u>: The American economic recovery continues to be hampered by a series of unusual impediments. Exports, which have accounted for much of this year's increase in real GNP are found to turn lackluster in view of the weakening economic tendencies in the rest of the industrial world. Employment growth will be hindered by the continuation of corporate restructuring and the increasing

outsourcing capacity of American business. Indeed, the latter is not just an American phenomenon but will be increasingly evident in other industrial countries. Concurrently, while the debt overhang has diminished, this financial problem has not been relieved enough to bring about willing institutional lenders.

Against this backdrop, any flattening of the yield curve through increases in short-term rates or a steepening of the yield curve through increases in intermediate and long-term interest rates will be highly detrimental to the American economy. Interest-rate-sensitive sectors, such as housing, would be affected adversely. The rise in intermediate and long-term interest rates will induce portfolio losses at financial institutions, many of which are still trying to write off loans and to increase their capital positions. Moreover, higher interest rates anywhere along the curve may well induce lower equity prices, thus reducing significantly the rebuilding of equity capital at financial institutions and business corporations.

The current and prospective economic situation requires additional monetary accommodation to encourage further financial rehabilitation which remains the prerequisite for a stronger economic rebound in the future.

<u>Yardeni:</u> For more than a year and half, we argued that the economic recovery would be subpar. We believed that lower and lower interest rates were necessary to keep the economy growing. The normal recovery mechanism was not clicking into gear. The

recovery was not self-sustaining. It was sustained by several cuts in the Federal funds rate and the discount rate.

Pessimistic forecasters claimed that the Fed was "pushing on a string." We claimed that the Fed was "pushing on jello." The economy would move forward in response to the Fed's pushing, but progress would be slow and several sectors would be left behind.

Now, for the first time in more than a year and a half, we see some tentative signs that the normal business cycle recovery mechanism is finally in gear. In other words, it is possible that economic growth is finally self-sustaining. If so, then further easing by the Fed is not necessary.

If the economy still needs to be pushed, odds are that fiscal policy will take the initiative given the more activist approach of the Clinton Administration. In this weak-economy scenario, our preference would be more monetary, rather than fiscal, stimulus. We would encourage the Fed to work out a deal with the new Administration: In the event that the economy remains weak, fiscal policy will remain unchanged and the Fed will lower interest rates by another 100 to 200 basis points, as needed.