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

STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: December 16, 1992

FROM: Gary Gillum GPG

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

12/11/92

FIRST DISTRICT - BOSTON

SPECIAL DISTRICT REPORT

ACADEMIC LEVEL

Professors Samuelson and Houthakker were available for comment this month. Professor Samuelson believes the economic news from October and November presents a slightly better picture for the future, even though the 3.9% third-quarter GDP growth rate cannot be projected to future quarters. Furthermore, recent price and cost data suggest that the inflation outlook is rather favorable. The improved outlook suggests that any Clinton fiscal stimulus should be guarded in both timing and size, although a deliberately austere short-run fiscal policy is not warranted, either.

On the other hand, there is still no lack of elbow room for Fed policy. This is an ideal time for a little incremental monetary stimulus, both in its own right and as a strategic move to head off fiscal stimulus proposals that might be too large. Given the inflation outlook, the target for real GDP growth should be moved up toward 4% for a few years to make up for the normal growth surge that was missing from the early stage of this recovery, with the stimulus coming primarily from monetary policy. Professor Samuelson would not mind having the value of the dollar decline somewhat. The strengthening of the dollar associated with the ECU breakup reminds him of the early years of the Reagan Administration, when the dollar got overly strong for reasons other than fundamentals and played havoc with our trade position.

Professor Houthakker believes the recovery is well under way. At this time there is no justification for a reduction in the discount rate. While he is not yet suggesting a tightening of monetary policy, he believes the Fed may

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have to consider a gradual movement toward more restrictive policy over the next three to six months as the recovery progresses. Operationally, a federal funds target somewhat above 3%, with a 3% minimum, would be appropriate. Professor Houthakker is concerned that the use of the dollar as a safe haven could place undue upward pressure on its value. While this is not yet a problem, he would be uncomfortable with a value much above 1.60 DM.

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CLASS II-FOMC

DECEMBER 1992

SECOND DISTRICT - NEW YORK

FINANCIAL REPORT - FINANCIAL PANEL

This month, we have comments from Richard Hoey (The Dreyfus Corporation), Scott Pardee (Yamaichi International, America, Inc.) and Albert Wojnilower (First Boston Asset Management).[1]

Hoey: The adjustment to numerous structural problems is going well: bank solvency is improving, debt-to-income ratios are improving, the defense slowdown is being absorbed and a strong stock market with ample equity financing is reliquifying the corporate sector by providing permanent capital and increasing the market-value net worth of many companies.

Sustained economic expansion has begun and should persist for many years.

Inflation optimism is well founded for 1993, but not necessarily in the longer term. World recession, Russian commodity sales and a shortened list of credit-worthy borrowers are temporary phenomena. Political support for disinflationary policy has weakened. However, if NAFTA and GATT proceed, odds are that the long-term underlying rate of inflation can remain near a basic 4% trend.

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[1]Comments were received by December 14, 1992. Submissions are occasionally cut at the FRBNY in the interest of concision.

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In the absence of a serious reform of "money politics," plans for long-term deficit reduction have minimal credibility. Increased government involvement in the economy will raise the payoff to successful execution of "money politics" by various interests. Only institutional reform of the decision-making process would provide credibility to plans for improvement in the structural budget deficit.

Pardee: The 50 miles-an-hour head winds that Chairman Greenspan talked of some time ago have now eased to about 20 miles-an-hour. The winds are still there. Long-term interest rates are too high. Many major U.S. companies are still downsizing. The banking system is still shaky. The U.S. current account deficit is widening. These impediments to growth are likely to continue well into 1993. But growth there is. The Fed's accommodative monetary policy at long last seems to be taking effect. It is still too early to forecast an era of good feeling, but 3% growth for 1993 now seems likely, with a pop in growth to a 5% annual rate in, say, the second quarter.

There is no compelling reason for the Fed to change policy now, but if the economy does begin to expand rapidly there will be a time for some modest tightening of monetary policy probably in the second quarter of 1993. In that context, my concern is that the new administration and Congress are being advised by many people who argue that inflation is no longer a problem. Indeed, some believe that a 3% inflation rate is a good

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thing, to grease the wheels of the economy. But 3% is still too high, especially for the millions of retirees and other people living on fixed incomes, and for U.S. companies seeking to compete in global markets. Helmut Schlesinger and Yasushi Mieno are leading the fight against inflation in their countries, in the intellectual arena as well as in the day-to-day policy decisions. It will be the job of the Fed to set the record straight in the U.S.

Wojnilower: Just as the pessimism as respects the economic outlook was much overdone during the summer, so, it seems to me, the current optimism also is liable to be excessive. I look for GDP growth not much over 2%, with more or less stable unemployment.

It should be noted, however, that the contraction in New York City has finally given way to recovery. The upswing in the securities industry is the main reason for the turnaround.

A note on the bond market. During the run-up in rates after mid-September, yields on intermediate (especially three-to-five year maturities) surged as much as a full percentage point, much more than other yields. The rise in rates was widely attributed to expectations that Pres.-elect Clinton would introduce an expansionary fiscal policy. Why this should have affected intermediate yields more than others is difficult to rationalize.

Although they do not become effective until June, we may be seeing the initial impact of the new interest-rate-risk capital standards for banks. These place a substantial (and unprecedented)

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capital "haircut" on the investment of short-term funds in over three-year securities. Whether or not this explains the recent yield anomaly, the new regulations may profoundly alter the "maturity-transformation" behavior of the banking system and need to be closely analyzed for their possible monetary and macroeconomic consequences.