APPENDIX

Notes for FOMC Meeting
November 3, 1987

Sam Y. Cross

Movements in dollar exchange rates during the intermeeting period largely coincided with shifting assessments of the interest rate and exchange rate policies of the United States and other Group of Seven countries.

During the early part of the intermeeting period, the dollar traded in a narrow range, comfortably above the lows of last spring. Interest differentials favorable to the dollar continued to widen, encouraging investors to maintain funds in dollar-denominated assets. The Group of Seven at its Washington meeting reaffirmed the Louvre accord commitment to foster exchange rate stability, and subsequent comments by Chancellor Lawson and Secretary Baker were interpreted as suggesting that the major industrial nations were moving towards greater management of exchange rates. Market participants felt that the Louvre understandings were pretty solid, and that interest rates would be used if necessary to sustain exchange rates at near their then current levels.

At the same time, however, German short-term interest rates began to rise in late September. At first, the firming had little impact on the dollar/mark rate because even larger interest rate increases were taking place in the United States. Then, when the August trade data indicated that the trade adjustment was still disappointingly slow, U.S. interest rates rose markedly across all maturities. Soon thereafter, comments by Secretary Baker, followed by explanatory remarks of an unidentified senior administration official, signalled displeasure with interest rate trends in Germany, and there were press reports suggesting that the target range for the dollar would be lowered, or even that cooperation among the G-7 countries was breaking down. The dollar moved down abruptly against the mark to around DM 1.77 on the weekend of October 17.

The next Monday, as turbulence erupted in stock markets around the world, market participants looked for some coordinated official response. When news came out later that day that Secretary Baker and German officials had met in Frankfurt, the dollar bounced back to trade above DM 1.80. After the Bundesbank took a step to contain upward pressure on German short-term interest rates, market participants believed that cooperation was being restored, and that the authorities would seek to limit exchange rate movements, at least for the time being.

Thus, fluctuations in dollar exchange rates were relatively modest in the first several days after "Black Monday". The dollar appeared to benefit initially from its traditional role as a safe haven during times of chaos and fear. Although many investors who withdrew from equities markets in the various financial centers apparently moved into domestic fixed-income markets in the same centers, there were substantial flows into the U.S. Treasury market. At that time market professionals were reluctant to position aggressively and corporate participants remained cautious, owing to increased concern over counterparty credit risk as well as to fears of possible abrupt and unpredictable exchange rate movements. As foreign exchange trading moved to the sidelines, flows into the U.S. Treasury market continued. In these circumstances, and with the Federal Reserve's assurances that it would provide adequate liquidity to the U.S. financial system necessary to calm the equity and other markets, there was a decline in short-term dollar interest rates.

Meanwhile, German and Japanese authorities also provided short-term liquidity assistance to their domestic markets by way of open-market and other operations. Short-term interest rates there also declined, but by amounts one-half to two-thirds the decline of comparable U.S. rates. As a result, there was a sharp narrowing--by at times as much as 100 basis points--in differentials between the dollar and mark three-month Euro deposit rates in the first week or so after the stock market fall. Thus, in late October, with less support from favorable interest differentials, and a feeling any accommodative monetary policy moves abroad would be less vigorous than in the United States, the dollar became more vulnerable. At that time, following a spate of press commentary, to the effect that the Louvre agreement was falling apart, or that the United States was again welcoming a lower dollar, heavy selling pressures re-emerged. By the end of October, the press was carrying an increasingly strident public debate on the advisability of a continued U.S. commitment to that part of the Louvre accord calling for exchange rate stability.

As this selling pressure intensified, the United States intervened in the foreign exchange market, in concert with other central banks. These operations were aimed at providing some stability to the market and resisting downward pressure on the dollar, but they did not stop the dollar from declining, at times abruptly.

All of the U.S. intervention activity for the period has taken place since last Monday. The Desk bought a total of $425 million against the sale of German marks and $105 million against Japanese yen. The total amount of $530 million was shared between the Treasury and the Federal Reserve, with the Treasury covering all of the yen sales and the Fed providing a somewhat larger amount of marks. The Fed's total was $260 million.

In addition to U.S. intervention, there have been heavy dollar purchases by others since last week. The Bank of Japan has bought about   for yen. The Bundesbank has bought almost   for marks, and other Europeans bought about   for marks. In addition the U.K. and other European countries have bought very large amounts of dollars for their own currencies.

In the meantime, with the sharp rise of the mark against the dollar, strains within the European Monetary System (EMS) re-emerged. While the Louvre accord was viewed as in place and the exchange rate structure reliable, the higher yielding currencies within the EMS had benefited from the atmosphere of stability.

Once this atmosphere was shaken, the perceived exchange risk for these currencies increased enormously and they declined against the mark even though they rose against the dollar. In particular, the French franc moved down within the EMS band as both foreign speculators and French companies sold francs in anticipation of an imminent realignment. In addition to the dollar intervention in the past ten days, there have been very heavy sales of German marks -- about DM 12 billion last week by France and others, in response to EMS pressures.

Thus we close this period with the dollar down around 6 percent since the last Committee meeting, despite substantial intervention. The mood is extremely bearish, with the news media filled with reports of official interest in a lower dollar.

In closing, Mr. Chairman, I recommend that the Committee approve the intervention undertaken during the period. In addition, I would like to seek the Committee's approval for renewing the Federal Reserve swap agreements with other central banks and the BIS, all of which come up for renewal in December. Aside from the swap drawings by Mexico, these facilities have not been drawn on for several years, either by the Federal Reserve or any of the counterparties. Although they cannot be drawn except by reciprocal agreement, of course, it is important to keep these facilities in place and available in case of need. I recommend that the Committee authorize their extension for a further period of one year, without substantial change.

PETER D. STERNLIGHT

NOTES FOR FOMC MEETING

NOVEMBER 3, 1987

The latest intermeeting period saw a dramatic shift in the financial market climate following a record drop in equity market prices on October 19. Up to that point, the Domestic Trading Desk was seeking to implement the policy adopted at the September meeting of the Committee, aiming for reserve pressures associated with $600 million of adjustment and seasonal borrowing at the discount window. In line with the Committee's September discussion we sought to bring about those reserve pressures, which entailed a slight firming in comparison with conditions prevailing before the September meeting, in a relatively unobtrusive fashion. In fact, the market's perception and reaction became somewhat accentuated because of pressures associated with the September quarter-end, debt limit disruptions to Treasury financing, a significant computer problem at the New York Fed, and a market sense that policy was edging firmer in key foreign countries as well as in the U.S. Borrowing rose from $470 million in the period ending just a day after the September meeting to $726 million in the first full period of the new intermeeting interval--i.e., the period ended October 7. About $100 million of that borrowing appeared to be attributable to special factors, particularly the New York computer problem, and market participants had a sense of this, but they were left with a feeling that some slight policy firming might well be taking place. The average funds rate edged up in that period to 7.50 percent from about 7-1/4 in the two previous periods--a bit more of a move than we had anticipated in conjunction with the sought-for reserve pressures.

Fresh pains were taken in the next period to avoid confirming market anticipations of a firmer move than was actually sought--although we were conscious that it could be misleading to dispel market ideas that there had been any move at all. Borrowing fell back to $525 million in that period and would have been even lower but for an unexpected bulge on the October 21 settlement date, reflecting a miss in projections and some maldistribution of reserves. Indeed, by the time of that next settlement date, the Desk's posture had already shifted to one of essentially accommodating the economy's liquidity needs in the wake of the extraordinary stock market plunge on October 19. Fed funds again averaged about 7-1/2 percent in the period, with a 7-5/8 percent first week offset by a 7-3/8 second week as market participants were already gaining a sense of greater accommodation.

Pursuing that more accommodative approach, the borrowing level built into the path for next reserve period--the one ending tomorrow--was reduced to $500 million and then $450 million. But these were more notional changes than binding targets or expectations, as the thrust of the Desk's operational approach has been to provide significant liquidity to relieve the turbulence and tension in the wake of the financial market upheaval. At the same time, it was not meant to be a totally unlimited flood of reserves--we have sought to relate our provisions to the standard framework though in quite flexible fashion. Thus, we have been making a generous allowance for what we believe to be substantially enlarged excess reserve desires. So far in this period, through Sunday, borrowing has averaged a little over $300 million while Fed funds averaged about 6-7/8 percent.

Early in the period, the postponement of a Treasury bill auction because of debt ceiling constraints forced the System to run off a $3.7 billion holding of Treasury bills. This was partly offset by outright purchases of about $1.4 billion of bills and notes from foreign accounts in varying day-to-day amounts. Meantime, except for a few days in early October, the Desk has arranged repurchase agreements for its own or customer accounts each business day. From October 15 through 30, the repos done each day were for the Federal Reserve's own account. Yesterday we arranged a moderate volume of customer repos. Total System repos over the period came to $102 billion while another $20 billion was done for customer account. On several occasions the Desk entered the market an hour or more earlier than usual to underscore its intention to provide liquidity, and on one occasion we notified dealers the previous afternoon that System repos would be arranged the following morning.

Through about mid-October, most interest rates pushed higher, responding, at least in part, to perceptions or expectations of firmer monetary policies in the U.S. and some other major countries. Expectations of discount rate increases in the U.S. and abroad were widespread, while official comments to the effect that inflation fears were overblown seemed to have little calming effect. Reported inflation rates remained moderate while business news continued to suggest a moderate to somewhat strengthening pace of advance. More unsettling to the markets, it seemed, was the continuing prospect that the dollar would be under downward pressure in coming months, given the discouragingly high international payments deficit. There was particular disappointment in the reported trade deficit for August, published October 14, showing a much smaller than expected narrowing from the July record. A further point of concern was the sense of lessened international cooperation in dealing with world financial problems. Some satisfaction was taken in the Congress's passage of Gramm-Rudman budget deficit restraints (along with action to lift the debt ceiling), and with the President's willingness, after a little delay, to sign the measure, but a good deal of skepticism soon returned as to how meaningful the budget reduction plans would prove to be. Indicative of the broad upward rate move, the yield on 30-year Treasury bonds pushed above 10.40 percent by mid-October, compared with 9.62 just before the last meeting. The 3-month bill rate had climbed to about 7.30 percent compared with about 6.50 before the last meeting. Banks generally raised their prime rates by 1/2 percentage point to 9-1/4 percent in early October and several banks posted a further 1/2 percent rise toward mid-month.

All of these developments were part of the background for the dramatic stock market collapse on October 19. It should be noted, though, that the stock market had already lost ground through September and early October, with the popular DJ index off 17-1/2 percent from its late August high through October 16. The 500 point plunge on the 19th (a further 22-1/2 percent drop) saw extremely heavy trading--about double the previous record volume for a day--and noticeably changed the economic and financial climate. Not only were estimates on the economic growth outlook revised significantly lower but also there were widespread concerns about the very functioning of the financial system as worries developed that steep losses would disable major market participants.

In the changed market environment, aided as well by the Federal Reserve's statements and actions with respect to liquidity, market rates fell sharply and more than reversed the rise earlier in the period. Government securities benefited not only from a sense of more accommodative monetary policy and a softer economic outlook, but also from a flight to quality as many investors switched from equities to fixed income issues, and within the fixed income area to higher grade securities. Earlier in the period, as noted, concern that the dollar would weaken was a significant negative for the bond market. Later, when the dollar _did_ decline appreciably, the effect on the bond market was relatively muted--apparently because in the changed environment a softer dollar was deemed less likely to produce an immediate policy tightening. Some dollar-bond market linkage does remain, however, if only because a weaker dollar is seen as discouraging foreign participation in our market.

Again citing the 30-year Treasury bond, that yield plummeted from over 10.40 percent in mid-October to around 9-1/8 percent by the period's end, and for a time the yield fell below 9 percent. The 3-month bill, a particularly favorite storm shelter, plunged from 7.30 to below 5 percent at one point. As the stock market turbulence abated and prices recovered somewhat, the flight to quality also subsided, and 3-month bills closed yesterday around 5.65 percent while the newly auctioned 3-month issue was around 5.80 this morning.

The few banks that had raised their prime rate to 9-3/4 at mid-October quickly reversed that move, and later in the month banks generally lowered their prime rate 1/4 percent to 9 percent. One bank went back down to 8-3/4 yesterday. In the corporate market, rates had moved up along with Treasury rates early in the period, but the subsequent decline has been less steep, thus widening the yield spread of higher grade corporates to Treasuries by some 20-50 basis points, depending on maturity and quality. Lower grade corporate issues were hit particularly hard, first by the rate rise and then by the stock market plunge, and remain in quite feeble condition. Tax-exempts also showed less of a yield decline than Treasury issues after mid-October.

This sector was also jolted by announced cutbacks in market participation by some major underwriting firms.

In addition to providing substantial day-to-day liquidity to the market, the Federal Reserve has also assisted the Treasury market by relaxing some of the constraints on our temporary lending of Treasury securities. With Committee approval, we suspended the per issue and per dealer limits on the amount of loans as well as the requirement that loans not be made to facilitate a short sale. Loans, of course, continue to be collateralized by Treasury issues of greater market value. Use of the liberalized lending program has in fact been relatively moderate, largely because the System has only modest holdings of the issues in tightest supply. Given continued supply shortages and nervousness in the market about the volume of fails, I believe it is useful to continue the more liberal lending rules for a while longer. Apart from the lending, we have also sought to alleviate market concerns--and our own concerns--about ongoing market development with a more comprehensive and timely monitoring of exposures in the when-issued market for Treasuries. This refers to the increased exposures incurred in volatile markets in trading securities a number of days in advance of delivery, including trades through the brokers' market. We are also monitoring the fail situation more closely in certain particularly scarce issues, and are working with the dealer community to explore possibilities for reducing outstanding delivery "fails" through some sort of netting procedures.

Finally, we've been encouraging market participants to free up scarce issues and have sought to encourage banks and other major lenders of funds or securities not to act too hastily in pulling back from customary counterparty relationships--asking them to keep in mind the functioning of the system as a whole as well as their own prudential concerns. Obviously, it's a delicate line to walk!

We have, of course, been closely monitoring the financial health of dealers, and keeping in close touch with such official regulators as the SEC, NASD, CFTC, NY Stock Exchange and Treasury. A number of firms have incurred losses in the recent period, but at least among primary dealers we're not at present aware of life-threatening losses. Some of the more significant ones have been publicly reported. Generally, they related to the equity market activity of diversified firms. A few small firms--not including any primary dealers--have closed up or substantially contracted operations.

Returning finally to current market views on monetary policy, as might be expected there is a fairly wide range now, both as to where we are and where we might be headed. Some participants had looked for more dramatic and overt easing moves in the immediate wake of the stock market plunge, but that view seems to be fading now as people wait a clearer fix on the broad economic effects. The current more accommodative stance is seen by some as likely to lead to a funds rate settling in around 7 percent; others, perhaps a majority, would expect rates more consistently somewhat below than above that level. Only a few, I think, look for rates significantly lower, and few see any early return to the higher rates of several weeks ago, although some voices express concern about longer-run consequences of too much ad hoc liquidity. A consensus, I suppose, is that the situation is still seen as fluid, with traditional "objectives" either in abeyance or subject to short run change as the market situation evolves.

FOMC BRIEFING -- THE ECONOMIC OUTLOOK

MICHAEL J. PRELL

NOVEMBER 3, 1987

As you know, all of the data received since the last Committee meeting relate to the performance of the economy prior to the recent financial upheaval. Those data were in broad conformity with the pattern of developments anticipated by our previous forecast: output was growing briskly, paced by strong real exports and domestic capital spending; price inflation was below the first-half rate, while wage inflation was showing the first tentative signs of picking up.

But all that now is history. In approaching the task of putting together a forecast for this meeting, I was inclined to lament those earlier times when we described the outlook as being "clouded by unusual uncertainties." One clearly is well advised to save such phrases for when they are truly needed.

After initially questioning whether a quantitative forecast would be sensible in the present circumstances, we decided that we should take a stab at it, if only to offer a reference point for your discussions. It seemed reasonable to assume that the drop in stock prices would have a negative effect of <u>some</u> magnitude on aggregate demand, and we sought to adjust our previous projection on that basis.

The result was a forecast of real GNP growth of about 2 percent at an annual rate over the next five quarters, a little more than 1/2 point below our previous projection. At the same time, the projected pickup in inflation has been moderated by about a quarter point, with the 1988 rise in GNP prices now put at 4-1/4 percent.

The adjustment to the forecast would have been considerably larger had we not assumed that monetary policy will cushion the shock from the stock market plunge. Our projection now includes a decline in short-term interest rates of around a percentage point over the next six months, rather than the rise of comparable magnitude contained in the previous forecast. Moreover, our presumption that this easing action will not be matched abroad led us to lower somewhat further our path for the dollar, thereby providing a little added boost to net exports. Just how far the dollar might fall--and how fast--in these circumstances was, to be sure, a key uncertainty in the outlook; the events of the past few days seem to be resolving those uncertainties on the side of faster.

Pinning down the effects of stock price movements on demand isn't an easy matter. Conventional econometric models like those used here at the Board, rooted in the life-cycle theory of consumption, suggest that as household net worth falls relative to income, the personal saving rate should tend to rise. Translated into numbers, our model says a $1 drop in stock market wealth will cut around a nickel from consumer spending.

Some skepticism has been expressed about such results because a sizable portion of household stock holdings are indirect--through pension funds, for example--and because direct holdings are highly concentrated. But that concentration doesn't rule out a substantial effect on spending, so long as the wealthy do adjust their lifestyles to their financial resources. And the events of recent years probably have, if anything, heightened people's awareness of the potential implications of changes in the value of their indirect holdings; I have in mind the publicity about pension funding and the increasing use of defined contribution pension plans, 401(k)s, and so on. In this regard, you may have noted the reports of an episode last Friday, that illustrates the subtle ways in which the stock market drop could affect the economy, even on the supply side. Lockheed Aircraft evidently experienced hundreds of early retirements, because Friday was the last day employees could cash out their thrift plan holdings based on a September 30 valuation.

And even if the effects of the stock market on a large part of the population are primarily psychological, the magnitude of the recent drop and the heavy media attention to its international scope must raise the odds of significant adverse shock effect. National surveys taken late last month did in fact point to a sudden drop in household confidence in the business outlook. I suspect, also, that even if the market recovers moderately in the coming year, as we've assumed, shareholders will respond to the recent experience by applying a greater mental haircut to their stock portfolios when they gauge their permanent wealth.

Our forecast is, in this context, a moderate one, in that we have assumed that the August stock market highs were not fully incorporated in consumer expectations. And, while we have projected a relatively prompt response of demand to the stock plunge, we have not assumed that the effects are magnified by any extraordinary psychological damage.

It is lower consumption, especially on discretionary purchases of autos and other durables, that accounts for the major share of the reduction in the forecasted level of GNP, especially in the next several months. In time, business capital spending takes a hit, too; this primarily reflects the "accelerator" influence flowing from weaker consumer demand, for lower interest rates offset the financing cost effect of the lower stock price path. State and local revenue losses put a small dent in government spending, while housing is buoyed by the reduction in mortgage rates. As I noted earlier, real net exports also look a bit better, partly because of the exchange rate effect on U.S. competitiveness, but also because of the effect of weaker domestic demand on the volume of imports.

The lower output path results, in our projection, in a small backup in the unemployment rate. It is primarily that development that explains the trimming in the wage inflation forecast. It is conceivable that, if economic uncertainties are perceived to be heightened, it will give employers some enhanced leverage in dealing with wage demands; however, real wages already have been considerably eroded and are likely to continue to be by rising import prices, so we are still looking for an acceleration in nominal wages in the year ahead. The price picture could worsen relative to our projection if the current deficit reduction effort puts heavy weight on excise taxes, but at this point we have no special insights into how that exercise between the Congress and the President will turn out. This is, of course, a disturbing uncertainty in a number of respects, when one considers how much attention has been focused here and abroad on the outcome of those deliberations. We've in essence assumed that a way will be found to avoid the Gramm-Rudman sequester, and that total deficit reducing actions for FY 1988--including asset sales--will somewhat exceed the required $23 billion. I suppose I'd have to characterize us as agnostic on the question of whether a major multi-year package will be assembled, but a failure to achieve that probably would not come as a shock to a skeptical financial community.

FOMC Briefing
Donald L. Kohn
November 3, 1987

The stock market collapse has created a number of uncertainties for monetary policy. Chief among them are those discussed by Mike--that is what will be the effect on spending and inflation from the stock price decline. On the financial side, interest rates and money and credit flows are likely to be affected by shifting demands for liquidity and safety, potentially distorting a number of the usual indicators of the underlying thrust of policy and its interaction with the economy. And the dollar and its relationship to domestic financial developments may also be affected by the consequences of the equity market decline.

This state of financial markets will be a key factor influencing these indicators and the response of the real economy, as well as bearing directly on the conduct of policy. In preparing background materials for this meeting, the staff's working hypothesis was that the functioning of these markets would continue to return more toward normal, with the most extreme fears and reactions that produced outsized price movements and extraordinary transactions volumes abating further. However, some residual volitility and caution would remain, reflecting a heightened sensitivity of market participants to incoming information about the economy, markets, and their counterparties, and the fundamental price movements in the stock and bond markets would not be reversed. For interest rates, this is seen as implying the same realignment of rates, with yield spreads between government and private instruments narrowing, though not to the levels of last summer; under the current conditions assumption of alternative B this narrowing probably would be accomplished largely by a rise in Treasury yields, especially at the short end, as an unchanged federal funds rate tended to anchor interest rates to private borrowers.

The outlook for money growth in these circumstances is subject to a number of cross currents. Amonq the usual factors affecting money demand, market interest rates have declined, and with deposit offering rates likely to lag as usual, opportunity costs are expected to remain appreciably below levels earlier in the fall. This would have its largest impact on flows into M1 and other liquid components, potentially boosting their growth quite substantially as the effects of earlier increases in opportunity costs fade. On the other hand, slower income growth and a decline in wealth should act over time to depress demands for money.

In addition, two special factors related to recent market developments may be augmenting demands for money, at least temporarily. One of these is the effect on transactions balances of the surge in financial transactions. Ordinarily the turnover in stock and bond markets--even when very high--would not be expected to affect transactions balances, qiven the sophistication of those involved. The jump in demand deposits in the second half of October coincided with the price movements themselves, suqgesting that it may have geen generated in part by margin payments rather than only by needs at settlement, which routinely occurs with some lag. In our projections, demand deposits related to this factor drop off rather quickly, damping growth of M2 as well as M1 in November and December but with little net effect on money growth measured from September to December--the period used in bluebook specifications. The second factor is the impact of any increase in demands for liquidity and safety. So far, there is only limited evidence of such a shift. Currency demands have been strong. In addition, assets of money market mutual funds rose sharply in the week the market plunged, but it may be too soon to tell whether this is the precursor of further subsequent large increases or only temporarily related to one-time transfers from stock mutual funds. A much smaller increase in the funds was registered in the week after the crash. In the bluebook paths we have allowed for some unusual demands for liquidity. The 6 percent growth of M2 in the fourth quarter under alternative B is around one percentage point more than would be predicted by money demand models. Reflecting transaction effects during October on M1 growth, the projected expansion of the aggregate on a quarterly average basis is even stronger relative to the econometric results.

Under our usual operating procedures, any shifts in demands for money deriving from financial transactions or liquidity preferences would be accommodated by the Desk, as would seem appropriate. That is, increased demands for reserves associated with higher money balances would be automatically met through open market operations to keep borrowing at a given level. This would also insulate the federal funds market, unless the increase in liquidity demands also affected attitudes toward the discount window.

Judgments about the level of borrowing or the federal funds rate at which such an accommodation might occur depend importantly on an assessment of the economy and risks in the outlook following the the developments of recent weeks.

Alternative B would retain the easing that has occurred since the stock market collapse with borrowing of $450 million and federal funds trading expected to center just below 7 percent. The decline in rates relative to several weeks ago can be seen as at least an initial step in adapting policy to the damping of spending and fall in inflation expectations that seem likely to have resulted from recent events. Given all the uncertainties about the outlook, alternative B could be viewed as a holding action, pending receipt of additional information about the economy and financial markets.

If the Committee felt the risks were on the side of weakness in the economy, this could be accommodated through a tilt toward ease in the language concerning the intermeeting adjustments. A need for such ease might be signaled in financial markets by further sharp declines in stock prices or long-term rates or even weakness in money growth, as well as by incoming economic and price data.

If the recessionary risks to the economy or structural risks to financial markets were considered to be sufficiently large, a further easing at this time as under alternative A, might be considered appropriate. In some respects this alternative is consistent with the staff GNP forecast, which, as Mike has noted, presumes a further noticeable easing at some point. While any additional easing might put further pressure on the dollar, the repercussions of this for inflation expectations or the bond markets would be muted if market participants also saw the outlook as weak, with little sign of price pressures. The current term structure of interest rates does not suggest strong expectations of an easing of policy, but one suspects that market expectations are not very firmly held these days, and the response to further ease will very much depend on the surrounding circumstances.

Alternative C in the bluebook involves only a slight tightening of policy, leaving borrowing below where it was after the last FOMC meeting. While even a mild tightening at this time might seem difficult to contemplate, the possibility that such a move might have to be considered at some point over the intermeeting period cannot be ruled out, if for example there were a general flight from dollar assets, and indications of significant inflationary pressures arising therefrom. Of course, this possibility could be dealt with by retaining a tightening option in the language on intermeeting adjustments.

In any case, the uncertainties involved not only with the economic outlook, but with interpreting developments in financial flows and markets would seem to call for some degree of continued flexibility in the implementation of policy over coming weeks. Recently, such operations have been keyed toward a fairly open-ended provision of liquidity, with reference at least as much to the federal funds rate and market conditions, especially in the RP market, as to the formal borrowing objectives. This has been necessary in a crisis period in which the underlying demands for liquidity in markets has been uncertain and in which markets needed clear signals about policy intentions. A characteristic of borrowing objectives is that they can be a little ambiguous in their implications for interest rates. Operating under such an objective, the level of the federal funds rate may be affected not only by borrowing, but by changes in the willingnesss of depository institutions to be seen at the discount window, and by temporary shifts in market expectations, in demands for short-term funding, or in unanticipated changes in desires to hold excess reserves. In more usual times, changes in the funds rate may have important information for the Federal Reerve about underlying market forces or expectations, which is lost when markets realize we are trying to control interest rate. Those forces frequently have, in effect, moved the rate in a stabilizing direction, anticipating the next move in policy. Focussing on the funds rate can impart rigidity and inertia to the conduct of policy.

Market conditions remain quite sensitive, and among the uncertainties is the relationship between borrowing and the federal funds rate. But as conditions stabalize and that relationship clarifies, the Committee may want to consider how and under what conditions it wants to return to its previous approach to policy implementation.

Variant I of the directive also attempts to take into account explicitly the possible need for flexibility in meeting liquidity needs and conducting policy over the intermeeting period, along with the possibility of more frequent consultations in such circumstances. At the same time, it would allow for a transition back toward more normal operating procedures if market conditions warranted.