Federal Open Market Committee
Conference Call
December 30, 1994

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Blinder
Mr. Broaddus
Mr. Jordan
Mr. Kelley
Mr. LaWare
Mr. Lindsey
Mr. Parry
Ms. Yellen

Messrs. Melzer, Ms. Minehan, and Mr. Oltman, Alternate Members of the Federal Open Market Committee

Messrs. McTeer, and Stern, Presidents of the Federal Reserve Banks of Dallas and Minneapolis, respectively

Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Mr. Patrikis, Deputy General Counsel

Messrs. Beebe, Goodfriend, Promisel, Simpson, and Stockton, Associate Economists

Ms. Lovett, Manager for Domestic Operations, System Open Market Account
Mr. Fisher, Manager for Foreign Operations, System Open Market Account

Mr. Wiles, Secretary, Office of the Secretary, Board of Governors
Mr. Madigan, Associate Director, Division of Monetary Affairs, Board of Governors

Messrs. T. Davis, Lang, Rosenblum, and Ms. Tschinkel, Senior Vice Presidents, Federal Reserve Banks of Kansas City, Philadelphia, Dallas, and Atlanta, respectively

Mr. Fieleke, Vice President, Federal Reserve Bank of Boston
Mr. Thornton, Assistant Vice President, Federal Reserve Bank of St. Louis

Transcript of Federal Open Market Committee Conference Call of December 30, 1994

CHAIRMAN GREENSPAN. The purpose of this conference call is to discuss the Mexican situation in which we and the Treasury have been fairly heavily involved during the last few days. The situation is more unstable than I think we would have anticipated under a number of different scenarios. Also, we were all quite surprised at the extent of the peso depreciation following the initiation of the float. The general presumption that a country can somehow have an exchange rate that was being held down a little more than a year ago--a situation in which the Mexican authorities were accumulating dollars to hold down their exchange rate--only to find a year later that it's off by 30 to 40 percent clearly cannot be described in terms of fundamentals. Indeed, nothing of any great fundamental nature apparently has occurred. We are obviously dealing with a highly psychological issue and a very significant amount of international financial volatility.

There are two aspects to how the Mexican government is going to address this issue. One is by far the most important in all respects, the speech by Mexico's president on Monday night describing what changes the Mexican government intends to implement to approach this particular problem. I will shortly call on Charlie Siegman to outline some of the issues that we are aware of. The second aspect, which is something that we are involved with and I want to discuss further, relates to the currency stabilization fund that is being set up.

The crucial question at this stage is whether the speech on Monday will be sufficiently effective to make the issue of a currency stabilization fund moot. The former Minister of Finance, Jaime Serra, came here with Miguel Mancera, the central bank governor, and Guillermo Ortiz who, although we didn't know it at the time, was about to replace Mr. Serra as the Minister of Finance. I guess if we had thought about it, we would have suspected that it was somewhat unusual for Mr. Ortiz to be part of the group, but in retrospect the reason is clear. They came here largely to put forward their views of what should be done, and we spent several hours with them. They left us with pieces of paper, and I think we had a rather fruitful discussion. I will leave it to Charlie to indicate the particular elements of the program they were suggesting.

My concern in all of this is that a nominal speech on Monday night could very well lay an egg, and I would say we would have fairly significant currency turmoil on the following morning largely because the so-called tesobonos they had created had cumulated to a much larger amount than I had thought. One of the more interesting statistics made available to us was that the outstanding maturities of tesobonos, which are issued in pesos but linked to the exchange rate, now cumulate to about $30 billion equivalent. They are running off at a rate of $700 to $900 million a week and are effectively dollar-denominated securities. Consequently, there is significant erosion there and a major problem in the making unless something fundamental is done because the existing quantity of reserves at the Bank of Mexico, which we have not been able to fully tie down, is somewhere between $4 and $5 billion. We don't know if any of that is encumbered, though we are trying to find out. I assume that Bill McDonough is going to tell us the answer. Is that correct, Bill?

VICE CHAIRMAN MCDONOUGH. We have an answer by this time, yes.

CHAIRMAN GREENSPAN. Hopefully, we'll get some judgment on what those actual numbers are. I would assume that the dollar reserves are virtually all there, but I think it's important for us to find out. The general tone of the meeting, attended on our side by Bill McDonough, myself, Governor Blinder, and Charlie Siegman and Larry Promisel from our staff, was quite cordial, a little nervous-making. Specifically, there were indications from Governor Mancera that he had been particularly concerned about the tesobono issue. The increasingly important and fundamental question is how they have handled it. Yesterday on the phone, I raised the issue with Governor Mancera of whether the speech on Monday could have some favorable surprises for international financial markets. This would be equivalent to what we succeeded in doing with our 75 basis point move in mid-November, which created significant credibility for this institution because it was slightly more than what the market had expected. If President Zedillo's speech on Monday has a few important surprises, I think it may well turn this whole thing around because the weak underlying economic structure that prevailed in 1982 when the Mexican economy last fell into a swoon clearly is not there. The outline of what went on at that meeting is useful, but the details of their recommendations are more interesting. Before Charlie explains that,

I hope to fill you in on what is involved here. Charlie, why don't you give us a rundown of what is in their package as of now.

MR. SIEGMAN. I'll try to be brief and outline the main elements of what they regard as a fairly austere program to restore confidence both in domestic and international markets. They are still developing their program in preparation for the speech, although elements have already been revealed in various public statements. They are aiming for a sizable reduction in the current account from a $31 billion current account deficit before the whole episode of the breakup of the exchange rate regime to a $14 billion current account target. They aim to achieve that through--

CHAIRMAN GREENSPAN. It's the current account deficit target.

MR. SIEGMAN. Yes, the target is to reduce the current account deficit to $14 billion. The policy program that they are considering proposes splitting it, with approximately half derived from exchange rate and wage policy adjustments and half through fiscal adjustment by reductions in real outlays. With this program, they are prepared to accept a very sizable reduction in their growth prospects for 1995. They also expect that because of the changed environment of the exchange rate in particular, inflation will have to rise, but they'd like to contain the rise. They have outlined a set of macroeconomic policies primarily on the fiscal side to lower the fiscal deficit, although from our analysis there's room for further tightening that would help a lot. They will also try to announce a variety of structural changes in the economy, including various aspects of privatization, opening their market more to various forms of competition, and what they regard as confidence-building measures. Although their target objectives are pretty ambitious--to halve the current account deficit within one year and to contain the inflation pass-through--one important feature is to try to create an image that would contrast with past Latin American devaluations, in particular where there were large fiscal deficits combined with loose monetary policy and the pass-through was very rapid and full and had a spiraling effect. They are trying to avoid the price increase spiral, hoping it will only be a level adjustment that will enable them to move to a better economic environment. Whether they succeed or not will depend on the final outcome of their program. That's the broad outline.

One final comment to be made is that the market's view of the evolution of this problem attributes a lot to the way the new Administration has handled it. They are seen as having made plenty of errors, but they started by taking on a very difficult problem where the economy was out of equilibrium. Something had to burst sooner or later and adjustments had to be made. Unfortunately, it came with a dramatic impact. The other point is that they have the dilemma of trying to satisfy two audiences: the domestic audience--relating to the "pacto" to provide assurance that it can be sustained after the adjustments are absorbed--and the external markets. The elements that are necessary or desirable for the external markets are not always the things that the domestic political situation may absorb. This is not to excuse them from holding on and persevering, but they have this double audience dilemma which will affect their final policy decision.

CHAIRMAN GREENSPAN. It's pretty clear that if they don't address the international financial audience primarily, the second audience will be hurt more than anybody. The second issue that arises here is that of the currency stabilization fund. There seems to be a view in the market that these funds work and that the availability of backup resources is taken in some way as a measure of the capability of the government to sustain its currency. I seriously wonder whether the market or the people out there have got this right. It is pretty clear that if at this stage the Mexicans were to run into a severe set of pressures on the peso market and were intervening heavily using, for example, not only what's left of their reserves but to an extent drawing on the existing swap lines, a problem would very rapidly arise. The Mexicans would build up external dollar-denominated debt and raise the probability of their being unable to meet their obligations. Restraint on the movement of capital or on free exchange rates would very rapidly and cumulatively occur, which would exacerbate the selling. In a sense, this process involves a vicious circle unless the sum of the currency stabilization fund is of an extraordinarily large magnitude such that a country can exhaust all of the potential foreign claims and indeed domestic claims that want to move out of the domestic currency very readily.

I'd like to
call on Bill McDonough who has been involved in those conversations,
to give an
outline of how that went. Bill.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. It might be helpful for the Committee to see why we decided it would be appropriate to bring the non-NAFTA BIS countries in. As late as the meeting on Monday that the Chairman described when the Mexicans came to Washington, we had evaluated the situation as one in which we should try as much as possible to have the new Mexico, as we call it, not look like the old Mexico of 1982. What has made the new Mexico new was a very good set of domestic financial economic policies with the exception of an exchange rate policy that had resulted in a progressively overvalued currency. Therefore, we thought that the support that was already existent in the swap facility of $6 billion from the United States jointly and equally funded by the Treasury and the Federal Reserve plus a $1 billion Canadian line, which is equal to $0.7 billion U.S., would be adequate and sufficient in bringing in players from the past such as the BIS as a source of pesos. However, as this week has progressed, it became very clear that the marketplace needed some additional source of psychological strength, even though I could not agree more with the Chairman that the market's view about how much this outside support really contributes tends to be exaggerated.

CHAIRMAN GREENSPAN.

There is a case to be made for a significant amount of Congressionally appropriated funds to buy down a very large part of these tesobonos, which is effectively foreign aid. But it's a type of foreign aid that probably would be rather wise for us to engage in. At the moment, I don't see anything remotely like that emerging on the scene. I suspect, however, that it might become a major political issue if we find that the currency turmoil does not simmer down. I might also add that there is a commercial banking package that is being initiated by specifically, and it looks to be several billion dollars in size or at least that is what they are talking about. I don't know at this stage what type of collateral or other arrangements are being contemplated, but from what I have heard, it includes some U.S. banks and Deutschebank as well. That is the general thrust of everything that I think is going on. Charlie?

MR. SIEGMAN. I have one technical point that was being proposed as a supplement to the current framework arrangement. The swap would be temporary, that's underlined, and would have a termination date. Whereas the current $3 billion swap facility is an ongoing one subject to annual renewal, this one would be a supplementary one.

CHAIRMAN GREENSPAN. What maturity?

MR. SIEGMAN. They're talking about one year at most. But the Treasury may even consider a shorter amount of time.

CHAIRMAN GREENSPAN. So this--

VICE CHAIRMAN MCDONOUGH. Could I interrupt for a second, Mr. Chairman? I think it would be more consistent with our conversations with the Mexicans to date if we made this supplementary portion 90 days with a possible extension of 90 days rather than a year.

MR. SIEGMAN. That's possible. That sounds right. The Treasury is groping over the duration because it would be 90 days of drawing ability perhaps--

CHAIRMAN GREENSPAN. In hypothetical terms.

MR. SIEGMAN. --hypothetically for the drawing facility and repayments of 180 days. It has to be in existence longer because it has to be repaid on time in technical terms.

VICE CHAIRMAN MCDONOUGH. They'd have the facility available for 90 days plus 90 days.

MR. SIEGMAN. Right.

VICE CHAIRMAN MCDONOUGH. If they draw on the 179th day and then they have 90 days, there is a possibility of rolling over the drawing for another 90 days. You could wind up to about 359 days. But all our conversations so far have been that the facility would be available for 90 days plus 90 days.

MR. SIEGMAN. Right.

VICE CHAIRMAN MCDONOUGH. I think we ought to stick with that.

CHAIRMAN GREENSPAN. Yes, I--

VICE CHAIRMAN MCDONOUGH. We're giving them more than we've been talking about.

MR. SIEGMAN. President McDonough is exactly right. The access to the facility would be limited to a very short time period, but the concept of a facility on the books would technically have to extend for up to one year. We have had two precedents for this. In 1982 and 1989 under different circumstances, we enlarged temporarily our existing swap of $700 million with Mexico by adding a supplementary facility of $325 million in 1982 and a supplementary facility of $125 million in 1989. This would not be the first time it has been done.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I hate to continue a technical debate, but the terms of the facility remain in place until the final repayment is made. But if you say that the facility is available for a year, then we're talking about a potential year and a half. That is six months longer than anything that we have been encouraged to believe. We can fix that up.

MR. SIEGMAN. We can fix that up.

VICE CHAIRMAN MCDONOUGH. I think we may be confusing the Committee.

MR. SIEGMAN. I think there's no disagreement.

CHAIRMAN GREENSPAN. No, I think this is a technical issue based on previous actions on the part of this Committee, and we will just stay with standard practice on the assumption that the Committee goes along with this initiative. Peter Fisher, could you bring us up to date on what's been going on in the peso markets today?

MR. FISHER. Yes, I'd be happy to. Today the peso has traded between 5 and 5.20. It's original devaluation, for point of reference, was to a level of 4, and the weakest level was 5.85. In the last couple of days, it has strengthened to a high of about 4.75. That really was on quite a bit of leakage of expectations for what the official package would be and what the Mexican government policies would be. It is back down now around the 5 to 5.20 level. I should say that the peso market for most of this week has been extraordinarily thin. There's an exchange rate suspended in the air. Indicative prices move a great deal more than actual volume. Those who were trying to sell in the initial wake of the action, the original devaluation and then float, realized how narrow the door was and how little money was coming in on the other side. They have more or less suspended any attempts to sell or get out of the pesos. Earlier this week they had a tesobono auction in which $750 million worth of peso instruments were coming due; they redeemed only $28 million of this amount. It was simply an auction that nobody came to. Their overnight rate today is about 30 percent, and at one point this week, the Bank of Mexico had to raise its overdraft penalty substantially to make sure that it was still an effective penalty over the market rate. They have an auction on Tuesday coming up for value next Thursday. They have $650 million worth of tesobonos running off next week and they hope to auction $500 million on Tuesday. I think that is what they total this week. The worst indication we had was the one-month dollar/peso auction volatility at a level of 150 percent. It was 40 percent following the initial devaluation and 6 percent two months ago, to give you a sense of the thinness of a market that has no one on the other side. There are high hopes in the market that the other side will materialize with the new year. One of the risks next week is not only the expectation of official action, but the extent of expectations of a deeper two-way market, which may or may not materialize.

CHAIRMAN GREENSPAN. Are there any questions for anybody here?

MR. LINDSEY. Alan, this is Larry Lindsey. I just was wondering if we have any estimates of how much the current devaluation will shrink their current account deficit.

MR. SIEGMAN. The estimates that we have, using conventional relationships and based on the level of imports to Mexico, are that for a 30 percent devaluation, imports would fall approximately $30 billion over three years. On the export side, a 30 percent devaluation would approximately increase non-oil exports by $18 billion from the current level.

CHAIRMAN GREENSPAN. They would swing to a large trade surplus.

MR. SIEGMAN. Yes, a large trade surplus. And the current account would be similarly affected. Now, that's all dependent on other associated policies they adopt in order to get that impact such as the degree of reduction in real output. Our analysts looked at the program that the Mexicans presented and thought that the turnaround, with all the feedback effects that the Mexicans were proposing from $30 billion or so to $14 billion, was realistic for the current account.

SPEAKER(?). Thank you.

CHAIRMAN GREENSPAN. Other questions?

MR. SIEGMAN. And that was based on 4.50 exchange rate.

MR. PARRY. This is Bob Parry. Two questions. The first one is whether Canada is doing anything more on this. Secondly, the amounts I think you said were 6 to 9, right? We'd be going from $6 billion to $9 billion?

CHAIRMAN GREENSPAN. That's correct.

MR. PARRY. If we are looking for the symbolic effects, why wasn't a number like 10 chosen in which case, we'd have 10 here and 5 in Europe? I'm just curious.

CHAIRMAN GREENSPAN. Basically, because Treasury thought that 9 was the right number

MR. PARRY. Thank you. I think I understand it better now.

MR. SIEGMAN.
We have not spoken to the Canadians yet and are waiting until we know what the FOMC decides.

CHAIRMAN GREENSPAN. Yes, I thought we would approach the Canadians after this meeting.

MR. PARRY. Okay, thank you.

MR. LAWARE. This is John LaWare.

Unless they are willing to flesh that out in the speech on Monday, it doesn't seem to me that the markets are going to be reassured at all. Alan, you referred to favorable surprises. None of what Charlie was talking about sounded very surprising to me.

CHAIRMAN GREENSPAN. Precisely.

the basic purpose was to recommend to Messrs. Ortiz and Mancera to include in the speech a series of issues that we would interpret to be something of a surprise and that the markets would not expect. We were focusing largely on the fiscal area. At the moment, there is a drafting group at the Treasury and the Fed trying to put together a listing of that sort to make available to the Mexicans.

MR. LAWARE. I see, thank you. Bill McDonough, I think you indicated that you did have some idea

Could you clarify that?

VICE CHAIRMAN MCDONOUGH.

CHAIRMAN GREENSPAN. Really?

VICE CHAIRMAN MCDONOUGH.

CHAIRMAN GREENSPAN.

VICE CHAIRMAN MCDONOUGH.

CHAIRMAN GREENSPAN.

VICE CHAIRMAN MCDONOUGH. I share that view, Alan.

MR. LAWARE. One more question, Alan.

CHAIRMAN GREENSPAN.

MR. LAWARE. Thank you.

MS. MINEHAN. This is Cathy. Just to clarify what you just said, Alan.

CHAIRMAN GREENSPAN.

MS. MINEHAN.

CHAIRMAN GREENSPAN.

MS. MINEHAN. Right. Coming to the broader issues of what they are going to do in Mexico: Did you get a sense that they had confidence in the kinds of agreements that I gather they're working on with labor unions and others within the economy to put the kind of lid on wages and prices that they may need to control inflation?

CHAIRMAN GREENSPAN. It's difficult to say, Cathy. They clearly were fessing up to a significant decline in real wages as a consequence of the program that they are initiating.

MS. MINEHAN. Thanks.

CHAIRMAN GREENSPAN. They did not convey, at least as best I could judge, a view that they would run into trouble on that. Now, they obviously have to be nervous about it, but they did not convey that to us.

MS. MINEHAN. Given that at least a torch for this fire was income inequality in one of the areas in Mexico, you've got to wonder about austerity programs that are only going to exacerbate that potentially in other regions.

CHAIRMAN GREENSPAN. There is no question that that has to be a very major conflicting factor in their judgment.

MR. BROADDUS. Mr. Chairman, this is Al Broaddus. Could I ask when the additional swap facility will be announced? Is that going to be announced after the speech on Monday?

CHAIRMAN GREENSPAN. Assuming we get all of this put together, I would assume that that would be in the speech.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, they definitely do plan to include in the speech, as we understand it, anything that they have available in the way of international support, though probably not in a lot of detail. Assuming they don't get leaked in the meantime, the details would be more likely in the form of a briefing by the new finance minister probably right after the speech or the next morning.

MS. MINEHAN. This is Cathy again. Peter Fisher, in your assessment of where the peso is, given all the information that has been in the Times and The Wall Street Journal about the negotiations and in some detail and given the announcement of the resigning of one finance minister and another taking over, it sounds as though--now, maybe it's just because the markets are so thin--none of that has produced the kind of stabilizing, improving impact that you would have expected.

MR. FISHER. I think actually a little bit on the contrary. The peso has gotten all the way down to 5.85--

MS. MINEHAN. All right.

MR. FISHER. --and bounced back to 4.75 on all that leakage. I think it would be doing well to trade through next Tuesday around the 5 level. Now one would hope to see it do better than that but fear that it could be worse. One would rather see it firm to 4, 4.50 on the news next week; that would be ideal. If it stayed at these levels, I think that would still be pretty good news.

MS. MINEHAN. A lot of what we heard today had been heard by the relevant people well before today.

MR. FISHER. Yes, the markets were discounting a lot of it yesterday and some of it the day before.

MS. MINEHAN. All right.

CHAIRMAN GREENSPAN. Any further questions from anybody?

MR. MELZER. Alan, just quickly, this is Tom Melzer. In terms of the relevant size, with this supplementary amount we are agreeing to I guess $4-1/2 billion, which is somewhere in the area of the permanent lines for Japan and Germany. I don't know what the precedent is for supplementary lines, whether there are any precedential issues. I put a lot of weight on what was said earlier about our ability to demand adequate collateralization and that obviously is the key point in terms of protecting ourselves here. But are there any inferences from precedents for what we might be creating for the future?

CHAIRMAN GREENSPAN. You know in one respect, Tom,

The thing that's going to come out of all of this, I think, is an increasing awareness of the problems that will befall developing countries that endeavor to obtain reflected credibility by locking into an exchange rate and trying to hold it. One of the reasons for considerable concern in this instance, as you all know, is that Argentina has put it into its constitution. The problems that emerge as a consequence of that are not readily resolved by swap agreements. My own impression of where we will be going later on with all of this is probably to review the whole concept. Now, I don't think that that's immediate or necessary at the moment. But I do think that we have to figure out what purpose all of these arrangements should be designed to serve.

MR. MELZER. Thank you.

MR. BROADDUS. Mr. Chairman, this is Al Broaddus. I would certainly agree with the last point you made. Let me just say that I have the same concern that I've had with this kind of proposal in the past. Specifically, I'm worried because even if we get this package--we get the speech and we have the enlarged facility--it is not at all clear to me, and I'm sure it is not at all clear to anyone, that it is going to do the job. If that were our only choice, that would be something we could swallow, but what worries me is we are a party to it. We are now adding to our Federal Reserve commitment and I am worried about that from the standpoint of our credibility. So my view on this is very similar to my view on earlier proposals.

CHAIRMAN GREENSPAN. Okay. Are there any other questions or comments?

MR. BLINDER. This is Alan Blinder speaking. I would like to ask Peter: Do you know a ballpark figure for the trading volume on the worst day--I forget which day it was--when Mexico burned through $4 or $5 billion of reserves?

CHAIRMAN GREENSPAN. Probably $4 or $5 billion.

MR. FISHER. I'm sorry, but I don't have a precise notion of the overall trading volume the day they lost $4 billion in reserves.

CHAIRMAN GREENSPAN. My own impression is that it was $3.5 billion in volume. The peso was moving so fast that half of it was lost without any transactions.

MS. MINEHAN. I'm sorry to keep jumping in here with other questions, but there was some reference in the Times this morning to the Treasury using the Exchange Stabilization Fund instead of going to Congress to ask for more direct foreign aid. Is that likely to be a major issue when Congress gets back and are we likely--not that it would be a reason to not do this--to come under some pressure as well from Congress for the use of our facility?

CHAIRMAN GREENSPAN. The basic reason why I insist that we do not commit ourselves to uncollateralized exposure is precisely that, Cathy. I think that if the Treasury were to choose to do that, that is their call, they are part of the Administration. But ultimately, I have a suspicion that we may see Congressionally appropriated funds involved here.

MS. MINEHAN. Yes, it's important enough I would think.

CHAIRMAN GREENSPAN. Any further comments or questions? I would like someone to move on the $1-1/2 billion supplementary facility.

SPEAKER(?). Move it.

CHAIRMAN GREENSPAN. Is there a second?

MS. YELLEN. Second.

CHAIRMAN GREENSPAN. We better call the roll because I know we have at least one dissent.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
Governor Blinder	Yes
President Broaddus	No
President Jordan	Yes
Governor Kelley	Yes
Governor LaWare	Yes
Governor Lindsey	Yes
President Melzer	Yes
President Parry	Yes
Governor Yellen	Yes

CHAIRMAN GREENSPAN. Thank you very much everybody. I hope that we do not have to have a post-mortem of the negative type in the next few days in trying to explain what has gone wrong over and above everything else. But we will certainly endeavor to keep everyone informed as to what we are learning. We will either do it through individual conversations with the members of the FOMC or, if it's more convenient, in another session such as this.

I wish you all a happy New Year and will see you all in the new year.

END OF SESSION