

APPENDIX

Notes for FOMC Meeting

May 19, 1992

William J. McDonough

Dollar exchange rates from the time of your last meeting until early last week traded comfortably in ranges of 133 to 135 yen and DM 1.63 to 1.68, but then there was a gradual weakening of the dollar leading to a stronger selling bringing the dollar below 130 yen and 1.60 marks, the lowest levels for the period. Market participants are gloomy about Japanese financial markets even though there is growing hope that the stock market may have found its bottom. It is also gloomy about inflationary pressures and political uncertainty in Germany. Overtaking or overwhelming this gloom about the other major currencies, there is an underlying feeling of weakness in the dollar for the first time since January. This seems to be based on a view that the Federal Reserve will loosen in the next month or two and growing confusion about the meaning of presidential election opinion polls.

The downward movement of the dollar against the yen came in three installments. A small move occurred after the G-7 meeting and the mention in the statement that the decline in the yen was not contributing to the adjustment process; the dollar dropped from just over 134 to about 133, in part because the Bank of Japan on instructions from the Ministry of Finance intervened on Monday and Tuesday after the G-7 meeting and sold _____ each day and then _____ later. The second and largest move came

last week, when Under Secretary Mulford talked about the need for a stronger yen during Congressional testimony and as the market became more convinced that the Fed might ease again; the dollar dropped to just under 130. Yesterday, the dollar broke the 129 level, at least in part because of some heavy speculative selling that I will describe in a moment. It is just above 129 this morning.

The dollar weakened against the DM from a high just above 1.67 to about 1.61 between the end of March and last Friday because of widening interest rate differentials and a widely held view that German interest rates might go up and U.S. rates might come down. Again, the dollar slumped further yesterday and broke the 1.60 level. It is just above 1.59 today. This weakness of the dollar happened at a time when Germany was experiencing severe labor unrest and inflationary wage settlements to end the public workers strike and avoid one by the metal workers. Settlements of 5.4% and 5.8% for the two groups are well above productivity growth. This complicates further the severe economic cost of German unification. Directly related to the strains of unification is some political disarray. The German Government managed to look inept in its handling of the public workers strike and following settlement. The junior partner in the coalition, the Free Democrats, made themselves and Chancellor Kohl look weak in handling the succession to Foreign Minister Genscher.

The denting of Germany's political and economic armor made it possible for several other European countries to act more

independently. As the DM weakened somewhat within the Exchange Rate Mechanism of the EMS, the United Kingdom and Ireland reduced short-term interest rates. France reduced reserve requirements and the market believes will follow by reducing short-term rates as well. Nobody has been successful in bringing interest rates below those of Germany, even though the short term rates are converging. German longer term rates, using the 10-year government as a proxy, are still comfortably below those of their neighbors.

The desk did not enter into any intervention in the foreign exchange markets since the last meeting.

In the last few days, we and the market have become aware of a very large long dollar position held by the Bank Negara of Malaysia, the country's central bank and a well-known and very active participant in foreign exchange markets, whose trading and position-taking activities have been a matter of concern to the Federal Reserve in the past. An educated guess from one of their major trading counterparts is that Bank Negara was at least

long as of late last week against Japanese yen, German marks, British pounds and Swiss francs in that order of position size. With the recent weakening of the dollar, there is a very large loss in that position. This became increasingly known by Negara's trading partners and they began to cut back or to trade with Negara, in at least one case, only if Negara sold dollars to reduce its position. These moves forced Negara to look for new counterparties and made its losing hand more visible to the market. We believe that Negara had to dump at least a portion of its

dollars yesterday and that this selling of dollars was an important cause of the dollar weakness, as was the shorting of the dollar by those familiar with Negara's position. Bank Negara's situation is an overhang on the dollar which may take some time to work off. We will continue to monitor this situation closely.

At the March 31 meeting, the Committee gave its clearance to the Federal Reserve's participation in the sale of DM10 billion from our reserves, DM6 billion for account of the Federal Reserve and DM4 billion from the Exchange Stabilization Fund. We have reached agreement on that sale and are working out the mechanics with the Treasury on their participation. The DM sale is being done as last year in an off-market transaction with the Bundesbank, but at market rates. The DM4 billion spot transaction should be done in the fairly near future and the forward sales set for a series of maturities ending in December. This action will reduce the total reserves in DM by the entire amount of DM10 billion to approximately \$20.9 billion equivalent at current exchange rates. We also have total reserves of \$17.3 billion equivalent in Japanese yen, \$580 million in Swiss francs and about \$100 million in other currencies. After the DM sale, therefore, we will have total reserves in foreign currencies equal to just under \$39 billion.

The Committee will also recall its clearing our plan to sell interest on our reserves as it is earned. We will begin discussions with the Treasury regarding their participation in interest sales.

The Bundesbank's Vice President, Hans Tietmeyer, asked me if we would entertain the idea of entering into another sale of DM10 billion, to take place concurrent with the remaining part of the transaction I have just described or perhaps running into the early part of 1993. If we would do so, it would bring U.S. official reserves down to about \$14.7 billion equivalent in DM and \$32.7 billion equivalent overall. Before pursuing this matter, which I have brought to the Chairman's attention through Mr. Truman, with the Treasury or entering into any detailed negotiations with the Bundesbank, I would like to request general guidance from the Committee. If you wish to pursue this German idea, I will develop a specific proposal for the Committee's consideration at a future meeting. At that time, we should also consider the currency composition of our reserves.

Notes for Peter D. Sternlight
FOMC Meeting
Washington, DC
May 18, 1992

For about the first week of the past intermeeting period, the domestic Trading Desk sought to hold reserve conditions unchanged from those prevailing just prior to the March 31 meeting, consistent with federal funds continuing to trade around 4 percent. Then, on April 9, against a background of persistent and significant weakness in the broad monetary aggregates, along with indications of relatively meager economic expansion and abating inflationary tendencies, the Desk implemented a slight easing of reserve conditions, expecting federal funds to soften to 3-3/4 percent.

The allowance for seasonal and adjustment borrowing began the period at \$100 million, and then was reduced to \$75 million to go with the modest easing move on April 9. The allowance was returned to \$100 million on April 30 in a technical adjustment associated with a modest pick-up in seasonal borrowing.

The Desk coped with some greater-than-usual uncertainties in managing reserves during the period, as the reduction in required reserve ratios was folded in on April 2, with its hard-to-foresee impact on excess reserve levels, and as Treasury balances proved difficult to predict in the days following the April tax date. At first, we made allowance for a large bulge in excess reserves in the immediate wake of the reserve requirement reduction, as had occurred when requirements were cut at the end of 1990--but this added allowance proved to be unnecessary in the initial phase of the cut this time. On the other hand, the reserve requirement reduction may be leading to some elevated demands for excess reserves in the current maintenance period, as required balances are reaching a

seasonal low point and perhaps impinging on the reserve levels needed for clearing purposes. Exacerbating the problem of predicting Treasury balances in the latter half of April, many banks seemed reluctant to permit any build-up of excess reserves, perhaps out of concern that excesses could not be worked off without risking end-of-day overdrafts, and this contributed to lower-than-desired funds rates on a number of days in April. A desire to avoid the build-up of excesses also occurred in the first half of May, when hopes of another Fed easing provided an additional reason to avoid building excesses--leading eventually to a sharp tightening of reserve conditions and bulge in borrowing at the end of the May 13 reserve period.

On average, funds were close to the expected 4 percent level in the first week of the intermeeting period, but sagged to around 3-1/2 to 3-5/8 percent for the next few weeks when the expected rate was 3-3/4 percent. In the two weeks ended May 13, the average rose to 3.80 percent, with the help of a sharp firming on the final day. In the opening days of the current maintenance period, with the adequacy of daily clearing balances a question, the average has been a higher-than-desired 3.95 percent.

Borrowing levels have varied in a range of about \$50 to \$150 million for full maintenance periods, running to the low side when the funds rate sagged and bulging when conditions veered to the firm side. There was a particular bulge at the end of the May 13 period when we restrained our injections of reserves to avoid appearing overly aggressive at a time when the market was on the lookout for an easing move.

The Desk undertook no outright transactions during the period. Moderate reserve needs were met with System or customer

repurchase agreements. This permitted needs to be addressed flexibly in a period of uncertain reserve forecasts and uncertain bank behavior in response to the lower levels of reserve balances. Particular care was taken to avoid injecting more reserves than banks wanted at the time, lest market participants misconstrue our moves as leaning toward a more accommodative posture than was intended. Even so, we skirted on the edge of being misunderstood on the occasion noted earlier--May 13--when a large technical reserve need was projected, and funds were trading a shade over the desired rate; we thought our overnight injection of reserves was unaggressive but some market observers thought otherwise because the skimpiness of propositions caused us to stop at a lower rate than they had been estimating. Later that day, when funds climbed to 20 percent, the doubters were largely persuaded that no easing move had been intended. On a couple of other occasions, very small scale matched-sale purchase transactions were executed in the market essentially to disabuse participants of the notion that an easier policy was being fostered.

Looking ahead, we face some sizable and lasting needs for additional reserves in coming weeks, and we would expect to address this through a combination of bill and coupon purchases along the lines of the discussion at the last meeting.

Market yields on Treasury issues generally declined over the intermeeting period--by a net of about 15 to 65 basis points--but this did not occur in a smooth progression and there was a mixture of factors at work that could lead to differing judgments about future prospects. The steepest declines were in the two-to three-year coupon issues, on the order of 55 to 65 basis points. This area benefitted from a reaching out for yield as bills and

other shorter issues sank in yield, partly a result of the Fed's early April easing, and as information on the economy suggested no strong recovery momentum. In March, there had been some shift toward a view that the next policy move, while not imminent, was perhaps more likely to be toward the firming rather than easing side. By early April, anticipation of an easing step began to emerge though the timing of the System's move was somewhat of a surprise. Following the move, a mix of uneven economic data and mostly weak data on money supply kept expectations alive for a further easing step--though with much ebb and flow of expectations in response to each report on the economy, inflation, or money growth.

In the bill area, rates came down about 45-50 basis points, or somewhat more than the System's perceived reduction of 25 basis points in the expected fed funds rate. As noted, market sentiment moved from a neutral or even slightly bearish stance regarding monetary policy prospects to a view that another easing move is distinctly possible against the backdrop of slow economic growth, laggard M2 and subdued inflation. Bill supplies showed little net change over the period. Heavy maturities of cash management bills shortly after the April tax date were nearly offset by sizable increases in regular cycle issues and a \$10 billion sale of new short cash management bills to mature June 18. In yesterday's regular 3- and 6-month bill auctions, the new issues were at 3.61 and 3.71 percent respectively, compared with 4.08 and 4.19 percent just before the last meeting.

Intermediate and longer term coupon issues also responded to the flow of information on the economy and money growth, but in addition gave weight to concerns about new issue supply and

recurrent worries that System easing might be overdone, with adverse consequences for inflation. The System's April 9 easing got a mixed review in the long-term market and then the intermediate and long markets became quite heavy later in April as the Treasury's mid-quarter financing approached.

By the time the auctions arrived, in early May, sentiment was better again and all three issues found decent support-- especially the 10-year notes. By the end of the period, the new securities were trading at respectable premiums over their auction levels. For example, the twice re-opened long bond was trading around 7.80 percent, down from the 8.0 percent auction levels and a high yield point during the period of 8.11 percent. The yield had been about 7.95 percent at the time of your last meeting. Net over the period, the Treasury raised about \$28 1/2 billion in the Treasury coupon sector.

Clearly, there was an improvement of sentiment regarding the long term market in the latter part of the recent period. To be sure, the long market tended to improve when new information came out suggesting less strength in the economy, weakness in money growth, etc.--the same type of events that was also stimulating the shorter market and generating speculation about further policy easing. Less clear is whether the long market was reacting positively to the possibility of policy easing or just to the prospect of slower growth with perhaps an unchanged policy. Based on conversations with various market participants, I come away with at least a doubt as to whether further easing would be well-received right now in the bond market. My guess is that to have much confidence in it being so regarded there would have to be some greater evidence of faltering recovery than is currently at hand.

Leeway

Mr. Chairman, over the next intermeeting period, movements in required reserves, currency and other reserve factors--possibly including the impact of foreign currency operations--are projected to call for substantial reserve additions. We might just squeak through on the standard \$8 billion intermeeting leeway for changes in outright holdings, but to provide a more comfortable cushion, I recommend that the Committee provide a temporary \$2 billion addition to the leeway, to run through the next regular meeting date.

Michael J. Prell
May 19, 1992

FOMC BRIEFING -- DOMESTIC ECONOMIC OUTLOOK

I think there's an old joke to the effect that "Forecasting wouldn't be so tough if you didn't have to predict the future." Unfortunately, insofar as the behavior of the U.S. economy is concerned, the past currently seems to be shrouded in as much mystery as the future.

You may recall that, last fall, we predicted a slight decline in real GDP over the fourth and first quarters, basically on the premise that there would be a contraction in manufacturing to clean up the inventory imbalances that had emerged. In the event, industrial output did fall as we predicted, but GDP, after little change in the fourth quarter, evidently increased--perhaps quite substantially--in the first quarter. As a result, we're left with a puzzling picture in which domestic goods production and imports seemingly fail to account for all of the goods sold, and in which the increase in profits (or in the statistical discrepancy) that is needed to balance the income and expenditure sides of the ledger seems awfully large.

Be that as it may, there appears to be ample evidence to support the conclusion that the economy has grown appreciably since January. The issue before us is just how strong the upward thrust in aggregate demand is at this juncture. Obviously, the judgment we've offered is that the thrust probably is enough to sustain moderate growth in activity over the coming months, without a further easing of the funds rate.

The Greenbook provided a summary of our forecast, so I'd like to highlight just a few of the key questions we confronted, and how we answered them:

(1) Is it possible that the first quarter was the real thing and that the recent large increases in employment, as measured in the household survey, are an indication that we're belatedly experiencing the kind of surge in business activity that has typified cyclical recoveries?

Our answer: Possible, but not probable. There still is a set of unusual economic and financial adversities that argue against a powerful acceleration in activity in the near term. And while the payroll survey may be missing something, it seems unlikely that labor demand has been increasing as much as is indicated by the household numbers. Other indicators--including unemployment insurance claims and the perceptions of job availability reported in surveys--generally are more consistent with modest gains in employment.

(2) Isn't the first-quarter drop in the saving rate unsustainable, and thus isn't it unreasonable to think that consumer spending will keep pace with income in coming quarters?

This is, to say the least, an area of uncertainty. But, as I pointed out in the chart show in February, one of the upside risks to our GDP forecast at that time was that we might see the sort of decline in the saving rate that had occurred in the early phases of some other expansions and thus get more of a push from consumer spending than we were anticipating. As Monday morning quarterbacks, we can lay out a case for a lower level of the saving rate than we had in our prior forecasts, noting the rise in the stock market, the progress that has been made by many households in reducing their debt-servicing burdens, and other favorable factors. On the other hand, a nihilistic view would

be that measurement of the saving rate is so problematic that it is always inadvisable to make a lot of its currently estimated level. With a blend of these thoughts--and with an allowance for some pent-up demand, especially for autos--we've concluded that it's reasonable to expect that consumption will grow essentially apace with income through next year.

(3) Has the housing recovery fizzled?

Well, the March figures on new home sales and other indications of a drop-off in real estate transactions did cause us to lower our forecast of housing starts substantially. This morning's report showed total starts in April down sharply, with the single-family component at just a 963,000 annual rate--off more than 10 percent from a downward-revised March figure. This is even weaker than we had expected, and it points to the direct loss of a couple of tenths on GDP growth in the current quarter. In seeking to divine the underlying trends, however, it is worth noting that, despite what might have been in part a payback for the extra activity pulled into the first quarter by transitory factors, single-family starts and permits remained in April above their fourth-quarter levels. Moreover, indicators of builder and buyer sentiment, as well as affordability measures, suggest that it would not be unduly optimistic to look for modest gains in activity in coming months--and more if the recent easing in mortgage rates is extended.

(4) The orders data and anecdotal reports suggest that equipment demand may indeed be firming, but isn't the Greenbook forecast of an abatement in the decline of nonresidential construction overly optimistic, especially in light of the Olympia & York bankruptcy?

A few thoughts are relevant here. First, nonresidential construction is a small enough sector that, even were it to continue declining at the recent pace, the difference relative to our projection

would not be critical in GDP terms. Second, we do anticipate that the plunge in office and hotel construction will continue; it is other categories that we see firming in the near future, and this forecast appears to have a reasonable foundation in the available data on contracts and permits. Finally, we have recognized that the financial damage from the commercial real estate debacle is still not behind us, and that it is one reason why we expect that there will be only a gradual easing of the credit supply constraints that have been afflicting the economy.

(5) If the amount of inventory liquidation in the first quarter evidently was far less than the BEA estimated, doesn't that bode ill for near-term production?

Two answers are in order, one statistical, one economic. On the statistical side, the Greenbook forecast of GDP growth is, in effect, based on our estimate of the actual inventory change in the first quarter, not the BEA's number. As for economics, all other things equal, a lower level of stocks at the end of the first quarter would have been a plus for the outlook. Be that as it may, however, our assessment is that, with a few exceptions, inventories are in pretty good shape. Thus, we foresee only a small liquidation of stocks in the current quarter--and the reduced run-off implies a moderate positive contribution to GDP.

(6) Isn't there a significant risk that export demand will be weaker than we've projected, given the softness of economies abroad?

There is a risk, but it appears limited. Export demand has held up quite well to date in the face of flagging growth in the major industrial economies--thanks to strong sales to Asian and Latin American countries. Much of the relatively moderate growth in exports we've forecast should be accounted for by these same countries, which seem to

be expanding at a good clip; we're anticipating only a gradual recovery in Europe, Japan, and Canada.

(7) OK, let us stipulate that the Greenbook forecast for real GDP growth is exactly right; can we be sure that the inflation forecast is, too?

We found this to be one of the toughest questions of all, because, looking at the recent data from the Employment Cost and Consumer Price Indexes, the progress of the disinflation process seemed uncertain. Just to cite one example, the CPI, excluding food and energy, rose 3.9 percent over the past 12 months, at a 4.1 percent annual rate over the past six months, and at a 4.8 percent rate over the past three months--scarcely a picture of slowing inflation. Under the circumstances, it is not difficult to see why, as I've noted before, most private forecasters are anticipating no further progress toward price stability over the next year or so, as the economy expands.

However, recognizing the way sales tax increases, energy cost pass-throughs, import price swings, seasonal adjustment problems, etc., have buffeted the numbers over the past year, we have chosen at this juncture to alter our assessment of the underlying trends only a little. And, in light of the projected slack in the economy, we still are expecting to see "core CPI" inflation drift down to the low 3s by late 1993--just a few tenths above our prior forecast. But, as someone once said, stay tuned. We're approaching inflation territory that we've not been in, except briefly, for a long time, and we can't be sure how things will work.

May 19, 1992

FOMC Briefing
Donald L. Kohn

A prominent feature of the intermeeting period has been the weakness in broad measures of money. The drop in money evident in the preliminary data, which were relayed to the FOMC at the last meeting, was confirmed by more complete information and extended into subsequent weeks. That decline, coming on top of slower growth than desired in both money and income in 1991, and occurring in the context of indications that the current expansion remained moderate, prompted a slight easing in reserve market pressures some time after the last Committee meeting. Data becoming available over the balance of the intermeeting period suggest something of a rebound in broad money, but only by enough to leave both aggregates near the lower ends of their annual growth cones. Moreover, we project continued expansion of M2 and M3 that will just keep them at the lower ends of their ranges over May and June. While broad money is only one of many factors to be taken account of in policy decisions, the recent and projected behavior of the aggregates does at least raise questions about whether short-term interest rates are appropriately positioned to promote adequate economic expansion.

Some of the surprising weakness in money since the last Committee meeting owes to temporary factors, whose

effects were not fully anticipated in the staff's forecast. Foremost on that list was the shortfall in nonwithheld tax collections for April 15, which came in below last year's depressed level, rather than appreciably above it as was expected. Lower tax payments imply less need to build balances in advance, which would have reduced money growth in March and through much of April. They also imply a smaller volume of clearings against money balances in late April and early May than might be embodied in the seasonals, and indeed we are seeing some substantial increases in seasonally adjusted money in early May. I should note that the partial data available this morning for the weeks of May 11 and 18 generally confirm the May growth rate of 1-1/2 percent for M2 and 1-1/4 percent for M3 given in the blue-book. Other temporary factors we may not have given sufficient weight to might include the disruption to depositor relationships of a surge in RTC activity around quarter-end when its funding expired, and the effects on demand for M2 assets of the backup in intermediate and long-term market rates from mid-January through March. The effect of these latter two factors, like those of depressed tax payments, should be fading or reversing. But the tepid rebound in money thus far suggests that underlying money growth has been quite sluggish as well.

Another influence damping money growth may be the more moderate expansion of spending now anticipated for the

second quarter--relative to projections at the time of the last meeting, and relative to the first quarter after taking account of expected revisions. But the behavior of past and current spending is not sufficient to explain all of the weakness in broad money. We anticipate two quarters of appreciable increases in the velocity of broad money in the first half of 1992--a period in which opportunity costs have been fairly steady on a quarterly average basis.

Allowing for the effects of both income and temporary special factors, it still seems likely that a major portion of the weakness in M2 growth this year reflects further downward shifts in demand for M2 assets at given levels of income and opportunity costs. We have been observing such shifts since the middle of 1990, calibrated against the projections of our standard model of M2 demand. Incentives to channel savings away from M2 and into other assets or debt repayment continue to be given by an unusually steep yield curve, especially unattractive rates on intermediate- and longer-term retail time deposits, the disruptive effects of RTC activity, and the sluggish downward adjustment of borrowing costs for households and businesses who ordinarily rely on banks for credit.

Unlike some downward shifts in money demand, the factors causing the shortfalls of recent years have not been entirely benign. They evidence a redirection of credit flows away from depository institutions resulting from

factors that may feed back on spending. Widening margins and tightening lending terms at depository institutions have implied higher borrowing costs than ordinarily would be associated by the level of market interest rates. Moreover, borrowers, themselves, have come to recognize that debt embodies some costs beyond interest rates or other credit terms--including the extra risk of more highly leveraged positions--that they had not anticipated ex ante, adding impetus to the incentives to use cash flows to save and deleverage rather than spend. And, elevated long-term rates may be discouraging spending to a degree, as well as diverting savings to bond markets.

The possible association between weak money and weak spending, even in the face of downward shifts in money demand, seemed most evident in the second half of last year. Slow money growth in that period turned out to be symptomatic that monetary policy was too tight to foster the kind of economic expansion the Committee desired. We do not anticipate a similar outcome this year. We believe that the slow growth in money underway in the first half of 1992, which has been very similar to the rate of expansion of money in 1991, will instead be consistent with the more rapid increase in nominal GDP than last year now forecast in the greenbook.

Why? For one, unlike last year, we are in fact observing increases in velocity, suggesting that the ongoing

shifts in money demand are not being accompanied by further downward shifts in demands for goods and services. Sluggish money growth seems less an indication of underlying financial distress. Both borrowers and lenders are in better financial condition than they were at this time last year. For many financial intermediaries, capital and earnings have been improved and, as a consequence, we can see stirrings of a renewed willingness to extend credit. In open markets tighter quality spreads imply better availability and terms of credit. Borrowers are facing reduced debt servicing burdens, and the urge to cut back on spending to bolster balance sheets should be waning. Moreover, the easing of monetary policy since last summer has provided important offsets to the restraining effects of financial stress-- including lower nominal and real short-term interest rates, a reduced exchange rate, and higher stock prices. Recent declines in long-term interest rates also are hopeful signs. They suggest more reasonable expectations for the economy and inflation, reducing the danger that financial market participants overestimating the underlying strength of demand and price pressures had unduly pushed up interest rates and undercut even a moderate expansion.

Still, there are reasons for caution about the slow expansion in money and credit. We don't understand all the forces at work and can not rule out the possibility that financial conditions may still be too restrictive to support

further moderate economic expansion. The staff is forecasting some pickup in money growth in May and June from the extreme weakness of the last few months consistent with the greenbook economic forecast. Still, this acceleration represents only a return to an underlying growth path along the lower ends of the Committee's annual target ranges for M2, M3, and debt.

A desire to gain some better assurance of a pickup in money growth, or a judgment that growth of money around the lower ends of the ranges--or other factors in the current circumstances--suggested a significant risk to achieving a reasonable path for spending would argue in favor of alternative A or perhaps a somewhat lesser easing of policy. Even money growth well down in the lower half of the ranges in a setting in which economic expansion is not very robust may raise questions about the adequacy of monetary stimulus. Especially if there were doubts about the strength of the economy, further reductions in short-term interest rates might be seen as embodying little threat to the basic downward tilt to inflation for a considerable period--one long enough to allow ample time for a subsequent tightening, should that prove necessary.

To what extent nominal long-term rates would decline in response to a further reduction in money market rates is difficult to determine. The steeply sloped yield

curve suggests that markets do not have built in the possibility of simultaneous moderate growth and disinflation. Moreover, the level of long-term rates as well as market commentary may indicate some uncertainty about the Federal Reserve's priorities and intentions with respect to inflation. Perhaps this is not surprising, since we have been trying to walk something of a fine line in putting emphasis on stimulating the economy since last fall, while continuing to insist on our commitment to long-run price stability. Depending on the circumstances, an easing has the potential to raise inflation expectations for a time, or at least to reduce near-term credibility for our price stability objective. Unchanged, or even higher, nominal long-term rates as a result probably would not undercut the basic stimulative effect of an easing, since real rates likely still would be lower, and if the policy judgment were correct, eventually market expectations would catch up to the underlying reality of disinflation. Still, even a temporary increase in long-term rates and setbacks to inflation expectations would constitute a less conducive environment for balance sheet restructuring.

If there were concern about market reaction, and weak money and credit were seen as acceptable provided the economy was clearly moving ahead, alternative B might be preferred. This alternative would also allow time for more data after the tax season to determine the underlying trend

of money. The risk is being caught in the lags--finding too late that monetary signals were meaningful and having to ease even further than if timely action had been taken. Given questions about velocities, however, risking such a course may be viewed as difficult to avoid absent aggressive easing. And, it may be desirable if there is value in gaining credibility for our inflation objectives. With some odds on easing built into the market, the unchanged stance of alternative B, if maintained over the intermeeting period, might put some upward pressure on short-term interest rates and exchange rates. If desired, concerns about a lack of a pickup in money and credit could be embodied in an asymmetrical directive, with the understanding that further, persistent, shortfalls would prompt easing actions, especially if incoming data on the economy and prices suggested moderation. In this circumstance, there would be much less danger of an adverse reaction in price expectations, and the response of bond markets to an eventual easing move is more likely to be positive.

Finally, Mr. Chairman, I should note that the bluebook gave some alternative language for the specification of money growth in the directive. This language would emphasize the resumption of monetary growth expected in May and June rather than the very slow or no expansion of the March-to-June period.