

APPENDIX

Notes for FOMC Meeting

August 18, 1992

William J. McDonough

Since the Committee's last meeting June 30, the dollar has weakened significantly against the European currencies as interest rate differentials became even greater. The desk intervened on three calendar days for the Treasury and the Federal Reserve when we considered markets to be disorderly.

As of June 30, our discount rate was at 3.5%; the Bundesbank's was at 8% and the Bank of Japan's was at 3.75%. When the Federal Reserve lowered the discount rate to 3% on July 2 and the Federal funds rate to 3.25%, the dollar weakened against the European currencies and also against the Japanese yen.

Against the yen, the dollar moved down to 123.50, the inter-meeting low, right after the cuts. Then weakness in the Japanese economy and persistent weakness in the stock market spilled over into the foreign exchange markets and the yen gradually weakened. The Bank of Japan cut its official discount rate by 50 basis points to 3.25% on July 27. The yen has been trading for some weeks in the area of about 126 to 128 to the dollar. The Bank of Japan has intervened on a number of occasions to support the yen by selling dollars, largely motivated by a view that a weaker yen both

contributes to and is caused by stock-market weakness. Dollar sales in July and August have reached

After our discount rate cut on July 2, the dollar slid fairly steadily downward against the German mark and other European currencies mainly because of greater interest rate differentials.

At the start of the G-7 Summit in Munich, the dollar had dropped to DM1.51. The dollar weakness was worsened by the Summit Meeting communique in which no mention was made of exchange rates, thus indicating no official concern about the weakness of the dollar. As the Summit broke up, a number of officials, including American, made remarks which were rightly or wrongly interpreted as condoning or perhaps even welcoming a further fall in the dollar.

As of July 15, the dollar closed in New York at DM1.4813. On Thursday, July 16, the Bundesbank increased its discount rate by 75 basis points to 8.75%. The Germans claimed to have tried to bridge the gap between the domestic need to combat inflation and way-above-target money growth and the adverse international effect of raising market interest rates and undermining both growth and the currencies of its partners in the European Community. Raising the discount rate, they explained, did not directly affect market rates, where the key rate is the Lombard rate, which they left unchanged. Nonetheless, there was immediate strain within the European Monetary System as the weaker currencies, especially the Italian lira and the British pound, strained against the lower limits of the rate mechanism. And the dollar's slide quickened. On Friday, July 17, the dollar was at about DM1.47 in mid-afternoon

in Europe. Largely because of the effect of the strengthening DM on their own currencies, the French and the British began talking up joint action. We did not respond because we saw the problem as a European one; nor did we see the market as disorderly.

However, in the European morning of Monday, July 20, the dollar began to drop rapidly, reaching a low of 1.4470. This movement and a strong market sentiment that there was virtually no limit on the upside for the mark and no lower limit for the dollar gave us what I think must be considered a disorderly market. At a minimum, leaving it untouched would have brought about a large overshoot in the FX market and, in my view, almost certainly a serious weakness in the U.S. Government securities market as foreigners sold dollar assets. After full consultation with the Treasury, the Federal Reserve organized a coordinated intervention with all of the major central banks of Europe and with the Bank of Canada. For their own reasons as cited a moment ago, most of the Europeans were highly enthusiastic. The Germans demanded more persuasion and would not have joined if not invited by the Federal Reserve.

The total amount of the intervention was a purchase of
of which \$170 million was by the United States,
equally divided between the Federal Reserve and the Treasury. We started at just after ten in the morning in New York, meaning after four in the afternoon on the European continent and three in London.

The market was not only surprised by the fact of the

coordinated intervention in light of the view of what had appeared official lack of interest, but was hit very hard by the force of the intervention as the European central banks entered their markets just as they were closing. We at the Fed bought \$100 million in that first wave and then reenforced the effectiveness of the operation over the next several hours by buying an additional \$70 million dollars. At the time of our last purchase, timed just before the Chicago exchanges closed, the dollar had climbed from DM1.4520 when the first intervention began to DM1.4920. The dollar then strengthened further to DM1.4970 before the close for the day and to above DM1.50 a week later.

That intervention was clearly very successful. Why? The market was completely surprised. The interbank market was short and the intervention caused a panic short-covering. Perhaps more importantly, longer-term investors who had seen relative value in U.S. debt and equities markets were reassured by the official action and moved aggressively into dollar assets, both fixed income and equity.

The dollar settled into a trading range between DM1.47 and 1.49 over the next several weeks.

At the close August 6, the dollar was at DM1.4770. On the morning of August 7, the July employment numbers came out at what appeared to be about market expectations. Nonetheless, the dollar drifted lower, but in a rather orderly way. However, after Europe had closed and further readings of the employment numbers became quite bearish, the market became one-way and the dollar started

dropping quickly with no apparent market support. Again, we believed that the market was disorderly and the American authorities intervened and purchased \$300 million, evenly divided between the Treasury and the Federal Reserve. With Europe closed, only Canada could join in the intervention and did so; the Bank of Canada purchased Both of us sold German marks. The fall of the dollar was stopped. We began intervening at DM1.4670. The dollar reached an intraday high of DM1.4780; we finished intervening at the New York close with the dollar at DM1.4675. There is really no clear way to guesstimate what the rate would have been in the absence of intervention, but my sense is that it would have been significantly lower by Monday morning.

The Treasury was convinced and we agreed that this episode of intervention would demand a second segment to convince the market that the European central banks were also still involved. That second episode took place on Tuesday, August 11. The American authorities purchased another \$300 million against DM's, again evenly split between the Federal Reserve and Treasury. We were again joined by Canada, Germany and 14 other European central banks, who bought an additional Intervention began at DM1.4635 and the dollar reached a high of DM1.4780 in what looked initially like a quite successful operation. Ill-advised remarks by a Belgian central banker and a confusing statement by a Bundesbank director who had not been involved in their discussions with us knocked the dollar back by a pfennig. Moments thereafter, obviously by pure chance, the screens carried headlines from a

speech by Secretary Brady in which he called for lower interest rates. That put in question in the minds of confused market participants what the official U.S. attitude on the dollar really is. We ended the day at DM1.4670.

Major differences between the apparent success of these two intervention episodes from a technical point of view are that we surprised the market the first time, but not the second. On July 20, the interbank market was short dollars. When we intervened again, the interbank market was still somewhat long dollars, eliminating the short-cover rally possibility.

The foreign exchange market moves mainly on changes in capital flows. Our market sources who see what longer-term investors are doing tell us that there is a considerable appetite for dollar assets by investors who look at relative values and find some American debt and equity instruments quite attractive, producing demand for dollars. On the other side, short-term-oriented capital market participants mainly look at interest-rate differentials. They find it much more attractive to be long Deutsche marks where market rates are about 9.75%--and might go higher--than to be long dollars and earning much lower interest rates which they believe could go still lower. Just how the tug-of-war between these conflicting forces will play out is uncertain and tends to make the market volatile.

Another source of volatility for the dollar is that a significant part of the strength of the Deutsche mark is a result of speculative moves out of weaker European currencies in fear of

a realignment of the Exchange Rate Mechanism. These movements strengthen the mark against the other European currencies, but have a spillover effect on the dollar. This problem will last until and if the European currencies' relative values are changed.

German authorities tried last week to break the bond between a strong mark and a weak dollar. On Thursday, Economics Minister Moellman said that the strong mark was hurting German export industry competitiveness. On last Friday, Bundesbank Vice President Tietmeyer, with whom we have been in frequent contact, took advantage of a television interview to say that he usually didn't comment on exchange rates, but that "we certainly are not interested in a weak dollar". That remark was worth almost a pfennig and helped the dollar to end last week at about 1.4670.

Mister Chairman, we will need a motion to approve the purchase of \$385 million on behalf of the Federal Reserve System since the last meeting.

Notes for FOMC Meeting
August 18, 1992
Peter D. Sternlight

Reserve pressures in the domestic money market were lowered on July 2, shortly after your last meeting and following a particularly glum employment report. The discount rate was cut by 50 basis points to 3 percent and the full amount of the cut was passed through to the reserves market where Fed funds were expected to trade in the area of 3-1/4 percent. Domestic Desk operations then sought to maintain this degree of pressure over the balance of the intermeeting period. The borrowing allowance was initially kept at \$225 million to reflect the unchanged spread between the discount rate and the funds rate. An upward adjustment of \$25 million was made in late July to accommodate increased seasonal use, and the allowance has been held at \$250 million since.

Adjustment borrowing was heavy on the July 8 settlement day at \$1.7 billion, when the funds rate rose to 20 percent. Reserve forecasts were on the mark (after some earlier swings) but banks apparently wanted more excess reserves than anticipated. We were having difficulty estimating required reserves at the time and this may have been true for the banks as well. Excluding that bulge, adjustment and seasonal borrowing has averaged about \$235 million for the intermeeting period through the last weekend.

Reserve management was fairly uneventful thereafter. Reserve needs in the next two maintenance periods were modest and were met

with temporary reserve injections. The bulk of these came in the latter part of each period as banks continued to prefer holding low levels of excess reserves early in the period, and this contributed to softer money market conditions at that time.

In the maintenance period now underway, the Desk has begun supplementing its temporary reserve injections with outright purchases of securities from foreign accounts, given sizable prospective reserve needs ahead. We have purchased about \$300 million of notes and bills outright, though there were also some offsetting redemptions of agency issues totalling around \$100 million. Larger seasonal reserve needs emerge in September and very likely we will be making sizable outright purchases then.

Since July 2, Federal funds have averaged fairly close to their expected level, coming in at 3.23 percent through the past weekend. Yesterday, there was considerable trading in the 3-1/2 percent area as a reserve need for the current period was showing through, exacerbated by pressures related to the large Treasury financing settlement.

The markets rallied across the board on July 2 following the unexpectedly weak employment report for June and the Fed's subsequent policy actions. The report seemed to solidify the view that the economy was in for a slow growth pattern for some time to come, with attendant beneficial effects on inflation. Bill rates were down by 30 to 35 basis points that day, the prime rate was cut by 50 basis points to 6 percent and Treasury coupon yields fell by 15 to 25 basis points.

Data over the remainder of the period were supportive of this slow growth view--including a labor market report for July that registered some reversal of the June downturn but basically remained consistent with a sluggish economic picture. Subsequent price index reports continued on the benign side. Against this background, yields continued to work lower. Investors who heretofore had limited themselves to relatively short-term maturity segments felt more comfortable extending out along the yield curve, while the further yield declines at the short end provided additional incentive to stretch out a bit. Some participants viewed the improvement in inflation as cyclical and "parked" funds in shorter and intermediate maturities pending the inevitable rise in rates. Others became more inclined to believe favorable forecasts of a longer-term retreat on the inflation front and yields on the 30-year bond breached successively lower levels. Demand for Treasury issues also emanated from occasional bouts of pressure on world equity markets and from weakness in the market for mortgage-backed securities. The drop in interest rates had prompted fears of heavy mortgage prepayments, causing investors to swap out of these instruments and into Treasuries as a defensive measure and to maintain the duration of their portfolios.

The market generally looked for some backup in yields as the Treasury's midquarter refunding approached but this did not happen. Tepid news on the economy and declining commodity prices--the CRB dropped to six year lows--kept prices relatively firm leading up to each of the auctions. The Treasury's \$36 billion package was

identical in size and composition to the February and May offerings, except that it offered all new issues rather than reopenings of the long bond issue. The auctions proceeded smoothly at the lower yields prevailing but prices fell sharply right after the 30-year bond sale was completed. Participants were already skittish about the distribution of these issues at lower yields when reports of Secretary Baker's comments about seeking lower taxes in a second Bush administration seemed to sensitize market worries about deficits in years to come. Prices subsequently recovered somewhat but the episode was sobering. The 10- and 30-year issues remained under water (that is, below issue price) on yesterday's settlement date.

The Treasury raised \$34.5 billion of new cash in the coupon sector during the period, including \$15.8 billion at the refunding. Yields on coupon issues due out to about 5 years ended about 60 to 70 basis points lower, with 5- to 10-year yields down about 50 to 60 basis points. Rates in the 30-year area were lower by about 35 basis points. A more moderate \$12 billion was raised in the bill sector where rates came down some 50 to 60 basis points. Yesterday's three- and six-month bills were sold at average issuing rates of 3.10 and 3.18 percent compared with 3.59 and 3.66 percent just prior to your last meeting. Issuance was sizable in other segments of the capital markets as lower rates spurred corporations and municipalities to refund existing debt.

As to the near-term outlook, participants still see some room for further declines in interest rates. The market leans somewhat toward the likelihood of another easing move by the Fed, though not an

immediate one. Recent weakness of the dollar in the foreign exchange market is cited as a reason for at least a little delay in a further move, while some observers note that the Fed might be reluctant to act in the immediate time frame of a major political convention. Many seem to feel that if there are weak economic data for August, which would become available in early September, that could well be the catalyst for an easing move. Some participants seem to contemplate levels around 7 percent for the long bond by year-end, although the Baker incident serves as a reminder that political uncertainty and campaign rhetoric could make for a bumpy ride ahead.

DStockton
8/18/92
FOMC Briefing

As you know from reading the Greenbook, we have adjusted down our outlook for near-term activity. But, perhaps, more notable are the revisions that we've made in our forecasts of unemployment and inflation: The projected path for the unemployment rate is higher and for wage and price inflation lower than was projected in the June Greenbook.

The labor market reports of the past two months have weighed heavily in our thinking about near-term activity. Apart from hiring related to an expanded federally funded summer jobs program, payroll employment was little changed, on net, over June and July. Coupled with a slight decline in the workweek, aggregate production worker hours in July were a bit below their second-quarter average. Moreover, recent readings on initial claims provide no hints of any improvement in labor market conditions. Consequently, we expect to achieve our projected 1-3/4 percent increase in real GDP in the current quarter the same way that we have every other quarter of this recovery--with virtually no increase in hours worked and a healthy gain in productivity.

The industrial sector has shown less vigor than earlier in the spring, but activity still appears to be on an uptrend. Total IP increased 0.4 percent in July, reversing June's decline. New orders for manufactured goods have looked strong in recent months, and with few signs of any emerging inventory problems, we see support for moderate increases in IP over the remainder of the quarter.

Data on the spending side have been a mixed bag. Real retail sales--outside of auto dealers and building materials and supply stores--were up 0.6 percent in July, to a level 2-1/4 percent at an annual rate above the second-quarter average. This actually was a tad stronger than we were anticipating, but we stuck with a forecast of subdued consumer spending in the current quarter. Sales of new motor vehicles have been softer in the wake of the June surge. And, surveys continue to reveal a considerable skittishness among consumers that is probably rooted in uncertain employment prospects and very meager gains in income.

New bookings for capital equipment have looked very solid of late. Computer purchases continue to show exceptional strength, driven by substantial price cuts and the introduction of new products. But even apart from computers, orders and shipments of other capital goods have increased briskly in recent months.

The decline in interest rates last month spurred a sharp rise in mortgage applications for new purchases, according to the Mortgage Bankers Association. However, in the absence of much anecdotal information of a step-up in building, we took a relatively cautious approach in the projection. That caution appears to have been more than warranted, judging by this morning's figures on housing starts. Single-family starts fell 4 percent to 960,000 units in July. In contrast, permits, which are more reliable statistically, inched up, but only to about their second-quarter average. In the multifamily sector, starts remained at 160,000 units. Given the positive indications regarding mortgage activity, builder assessments of demand, and consumer attitudes toward homebuying, we'd expect future data to show gains in sales and starts. But the quarter is off to an

even weaker start than we had expected, and a jump in activity similar to that seen earlier in the year certainly seems unlikely.

With respect to the external sector, the recent trade figures have been somewhat disappointing, as has the incoming information on activity abroad. Consequently, we are not looking for exports and imports, on net, to exert much influence on domestic activity in the near term. But Ted will have more to say on this front in a few minutes.

Adding up the pluses and minuses of the data we actually have in hand, it is difficult to discern any perceptible change in the pace of underlying activity. If that's the case, it seems reasonable to ask at this juncture whether we view the expansion as having sufficient strength to reduce slack in labor markets in coming months. In the Greenbook, we have answered "yes" to this question. But, one would have to admit, it's a close call.

There are two issues that warrant consideration here. The first concerns the supply of labor. As I discussed in last month's chart show, the sharp rebound in the participation rate in the first half of the year erased the surprising shortfall that had developed over the previous year and a half. Seasonal adjustment problems appear to us to have exaggerated a bit the increase in the unemployment rate this summer. And, as we look forward, we are expecting much smaller increases in the labor force than occurred between January and July. The second issue is the strength of labor demand. With growth in real GDP not anticipated to move above potential until later this year, we're not expecting much help here in the near term. Taken together, these supply and demand considerations lead us to expect a slight decline in the unemployment rate to 7-1/2

percent by the fall. But any reasonable confidence band would have to include the possibility of increases in the months ahead.

As we move into 1993, the odds appear better for an acceleration of activity that will lead to a gradual fall in the unemployment rate. Declining long-term interest rates, a lower dollar, and improved balance sheets continue to underlie our projected pickup in activity. Given the events of the past year, one could wonder whether this is a shaky foundation upon which to rest the forecast. It probably is, but there are reasons for expecting these financial market developments to provide support for a step-up in activity in coming quarters.

We have seen reasonably clear evidence in recent quarters that movements in mortgage interest rates are capable of influencing housing demand. Some of the quickening in the pace of capital equipment spending that has occurred this year likely reflects the favorable effects that lower interest rates have had on internal cash flows and the cost of external finance. And, balance sheet adjustments both in the business and household sectors clearly have been aided by lower interest rates. All of these tendencies should be reinforced by the recent drop in long-term rates as well as the further decline that we have projected to occur over the next year and a half. Moreover, the lower projected level of the dollar and improving activity abroad should provide a boost to exports. We expect only some of this impetus to activity to be dissipated by continuing fiscal restraint.

An obvious downside risk to the projection is that it might take longer for balance sheet corrections to proceed to a point that spending picks up appreciably. The revised NIPA data now show the saving rate to have moved up fairly steadily since 1990, in a pattern

more consistent with some unusual and persistent restraint on spending, given household income and wealth. We have the saving rate flattening out in the second half of the year. With interest rates assumed to remain low, our projection of consumption and saving is consistent with a decline in debt service burdens by the end of next year to levels that last prevailed in the early 1980s. Of course, we have no evidence to suggest that those levels are what households will find satisfactory, and it's possible that the saving rate could continue to move higher next year, implying greater restraint on household spending and aggregate activity.

As we indicated at the last meeting, conditions are lining up solidly in support of continued disinflation. And, the incoming news since then has been uniformly favorable. The employment cost index for the second quarter showed hourly compensation up just 2-1/2 percent at an annual rate--well below the 4 percent readings in the previous three quarters. Although some of the slowing reflected what is almost certainly a transitory decline in pension contributions, we view the ECI data, taken as a whole, as signalling an even lower trend in labor costs than we had projected previously. In combination with the higher path forecasted for the unemployment rate, we now see hourly compensation inflation dropping from the 3-3/4 percent pace of the past year to 3-1/4 percent in 1993--about 1/4 percentage point below our previous projection.

We have also marked down our price projection, especially in the near term. In the current quarter, the CPI is projected to increase 2-3/4 percent at an annual rate, more than a percentage point less than the June projection. Favorable developments in the food and energy areas account for the bulk of the downward revision. But, we've also had small pleasant surprises on consumer prices other than

food and energy. Over the past twelve months, the CPI ex food and energy has risen 3-3/4 percent. With the considerable degree of slack in product markets and further slowing in underlying labor costs, we are expecting this measure to drop below 3 percent by the end of next year. We would have shown even greater progress in our projection except that with the lower dollar, import prices have gone from being a slightly beneficial factor in the inflation outlook to a roughly neutral influence. Moreover, state and local governments look to be even deeper in the hole than we had previously thought and are expected to be under pressure to resort to large increases in sales and excise taxes in 1993. That said, the underlying inflation trends look very favorable.

I'll now turn the floor over to Ted, who will bring you up to date on the international situation.

E.M. Truman
August 18, 1992

FOMC Presentation -- External Outlook

I will complete our presentation of the staff forecast by reviewing three principal sources of change to our outlook for the external sector: recent developments in merchandise trade, the lower dollar, and weaker growth in the major foreign industrial countries.

We were again disappointed by the data on U.S. merchandise trade in May that were released about a month ago. We now estimate that nonagricultural exports were about \$11 billion at an annual rate below our expectations in the second quarter. The shortfall partly reflects slower-than-expected growth abroad. However, we also appear to have misjudged somewhat the strong performance of U.S. exports last year. It appears to have been more heavily dependent than we had thought on special factors, such as rebuilding in the wake of the Gulf War and the surge in investment demand in Latin America. With respect to the forecast, we basically have assumed that most of the correction for 1991 is behind us.

Not all of the recent news on merchandise trade has been negative. Exports of computers and accessories have held up well, even as imports in the same category have surged. The near-term outlook for the volume of agricultural exports, especially of soybeans and corn, has improved somewhat, although prices are lower. Finally, we have scaled back the projected bulge in prices of imported petroleum and products in response to

lower spot and futures prices, evidence that Saudi Arabia has continued to produce more than 8 million barrels per day, and Kuwait's increased production.

Turning to the dollar, on a weighted average basis in terms of the currencies of the other G-10 countries, it is about 2-1/2 percent below the level at the end of June and 5 percent below the level that we were then projecting would prevail for the rest of 1992 and for 1993. Since the end of June, dollar interest rates have declined, Japanese and Canadian rates have declined by as much or more, and European rates have firmed a bit. In the context of projected continued slow U.S. growth this year, declining U.S. nominal long-term rates through next year, and only moderate declines in European interest rates in 1993, we adopted a forecast for the dollar through the end of 1993 that is essentially unchanged from the average level that has prevailed since mid-July. This projection implies that the dollar will remain for an extended period very close to the bottom of the range that has prevailed over the past five years. There are risks on both sides of this forecast. They may be tilted toward the downside in the near term, as U.S. economic activity takes time to strengthen convincingly, and perhaps on the upside later on when that strengthening occurs.

By itself, a foreign exchange value of the dollar that is about 5 percent lower than in the last Greenbook would tend to boost U.S. exports of goods and services and restrain U.S. imports. However, recent developments and indicators have also led us to mark down our forecast for economic activity in the

major foreign industrial countries. Growth in the other G-7 countries is now projected to average about 1-1/2 percent this year and about 2-1/2 percent next year, with growth for the rest of the world as a whole about a percentage point higher each year. The most significant adjustments to our forecasts have been for Japan, the United Kingdom and Canada.

In Japan, we now anticipate that the growth of real GNP will not exceed two percent at an annual rate until the third quarter of 1993 because of continuing balance-sheet problems and cautious macroeconomic policies. This implies a fiscal year growth rate of about 1 percent, compared with the official forecast of 3-1/2 percent. In the United Kingdom, we now think that the recession continued into the second quarter, and we have scaled back the recovery that is expected to emerge this quarter. Balance-sheet problems, an uncompetitive exchange rate, and high real interest rates continue to cloud the near-term U.K. outlook. In Canada, we now also see a more anemic expansion than we were previously projecting, in part, because of our weaker U.S. outlook. For the continental European countries, downward adjustments to our growth outlook have been minor.

We continue to project a moderate pickup in growth in the major foreign industrial countries in 1993. It is based on three main factors: First, interest rates have come down in some countries, and we expect reductions in rates in all countries during the forecast period. Second, we are counting on a fiscal stimulus in Japan on the order of 1-1/2 percent of GNP (though this figure involves some overstatement), and we don't expect to

see much tightening of fiscal policy in any of the other countries, with the exception of Germany and, depending on your baseline, Italy. Third, those sectors of foreign economies with balance-sheet problems are healing, and in due course improving conditions should contribute to real economic activity.

Nevertheless, we now have a very weak outlook for economic activity in the major foreign industrial countries. To provide some perspective, the growth rate of real GDP in the foreign G-7 countries averaged less than 2 percent from the first quarter of 1990 through the first quarter of 1992 and is not now projected to move significantly above the 2-percent rate until around the middle of next year. Such a period of prolonged weakness or slow growth in these countries as a group would be comparable with the 1974-75 period following the first oil shock and the 1981-83 period of slow growth. Moreover, at this point, the expected sources of stimulus that I have outlined are somewhat less dramatic than in either earlier period. The developing countries of Asia and Latin America provide the only evidence of strong growth in the global context, and one might ask how long such growth can continue if growth in the industrial countries does not pick up. Yesterday's news about slower-than-expected growth in Mexico during the first five months of this year may be symptomatic.

Pulling together these various elements, we are projecting that the performance of the external sector during the second half of this year will be essentially neutral in terms of the contribution of real net exports of goods and services to

U.S. real GDP. However, in part because of the bulge in oil prices that is already in the pipeline, nominal monthly trade deficits are expected to average closer to \$8-1/2 billion during the third and fourth quarters, compared with \$7-plus billion in the second quarter. Adjusted for the disappointing results for Q2, our outlook for the remainder of 1992 does not differ much from our previous projection.

Next year, the lower dollar and the pickup in foreign growth combine to impart a modest positive tilt to our outlook for real net exports. The influence of the lower dollar outweighs the effects of a reduced level of economic activity abroad. We expect the current account deficit will be about \$60 billion at an annual rate in the fourth quarter of this year and that it will decline to about \$45 billion by the fourth quarter of next year.

Mr. Chairman, we will now try to answer the Committee's questions.

August 18, 1992

FOMC Briefing
Donald L. Kohn

The greenbook forecast, as Dave has discussed, sees a strengthening economy, though along a lower track than in June and consequently with higher unemployment and lower inflation. Expansion of real and nominal GDP in 1992 now is projected to fall short of the central tendencies of the Committee members' most recent forecasts, but to be within the range of forecasts for 1993, leaving the unemployment rate at the end of 1993 at the upper end of Committee members' central tendency; CPI inflation, though reduced in the staff forecast, is projected still to be within the range of Committee forecasts in both 1992 and 1993. In light of this overall outlook, the issue facing the Committee at this meeting would seem to be whether short-term interest rates have been reduced enough to produce an economic outcome consistent with the Committee's broad objectives. To clarify some of the issues associated with this decision, I thought it might be most helpful simply to review the arguments first for leaving the federal funds rate where it is, alternative B, and second for moving it lower, as under alternative A. To a considerable extent, this involves looking at recent developments in the financial sector from two different angles.

Obviously, a strong reason for choosing alternative B would be that you found the staff forecast both the most likely outcome and a satisfactory one as well. That forecast assumes an unchanged federal funds rate through the coming intermeeting period and beyond. The ease in early July along with the significant declines in long-term interest rates imply significant stimulus "in the pipeline".

Short-term real rates, around zero, are clearly below long-run equilibrium levels. Moreover, the recent drop in long-term nominal rates seems at least partly to be accounted for by a decline in real rates, judging from the depreciation of the dollar and the stability of the stock market in the face of disappointing economic news. To be sure, the drop in real long-term rates reflects less optimistic views of underlying demands in the economy. But if, as a result, the expectations built into the yield curve are now more realistic, the endogenous decline in real rates may be more likely to support reasonable expansion. In any event, should the expected pickup in real growth fail to materialize, the Committee could ease later--and a predilection in that direction could be indicated by a tilt toward ease in the directive.

Some of the decrease in nominal interest rates seems also to have represented a decline in inflation expectations, and a reason for keeping the stance of policy unchanged would be to encourage further gains on inflation and a continued downtrend in those expectations. To date, expectations about the level of interest rates, and by implication inflation, past the next several years do not seem to have fallen below the range that has prevailed for some time. In the context of residual concerns about prices beyond the next few years, an easing that seemed to connote substantially reduced emphasis by the Federal Reserve on inflation objectives could be seen as risking an unsettling drop in the dollar that might feed back adversely on U.S. securities markets.

Declines or sluggish expansion of the broad money aggregates might also be seen as no bar to keeping the federal funds rate unchanged if other factors pointed toward adequate growth in spending. A good deal of the weakness in money reflects the essentially healthy

process of strengthening balance sheets. Household debt repayment continues unabated and declines in long-term interest rates have steered borrowers even more away from banks and into capital markets. On the saver side, in large measure, time deposits are being exchanged for mutual funds shares, which, though riskier, are also more accessible for spending. The result ought to be continued substantial increases in M2 and M3 velocity. As for other monetary measures, the drop in M1 and reserves was brief, and narrow aggregates resumed rapid growth in July.

A final reason for choosing alternative B might be a view that while the greenbook outcome might not be particularly attractive, there is little the Federal Reserve can or should do about it. A period of sluggish expansion could be seen as the inevitable byproduct of conservative spending habits inherent in the balance sheet restructuring process. In this interpretation, declines in short-term rates, as were seen in the last few years, are helpful in some respects--for example, by boosting intermediary profits--but their power to promote greater spending in the current environment is limited. Especially aggressive easing might be more effective in promoting borrowing and spending for a time, but only by raising real asset prices by truncating or reversing progress toward price stability, delaying the inevitable adjustment.

A contrary view, that easier policy might well provide some stimulus to the economy without necessarily derailing progress toward price stability, would open the door to consideration of alternative A or some lesser easing of policy. Encouragement on the inflation side might be taken from recent readings on the degree of slack in the economy. The revisions to GDP indicating an average rather than a shallow recession, along with the unemployment rate remaining near

7-3/4 percent in July, could suggest somewhat stronger disinflation pressures than thought likely several months ago. Moreover, lower expectations of inflation, at least for the next few years, seem to have become more firmly entrenched in financial markets over recent weeks. In such an environment, further Federal Reserve easing would be less likely to deflect the inflation rate from a downward path, or to raise questions about the Federal Reserve's intentions. Consequently, nominal as well as real long-term rates might decline further in response to lower short-term rates. In these conditions, easier policy would speed balance sheet restructuring, providing some impetus to spending even if direct responses to lower interest through the usual channels were muted. Moreover, the dollar would fall, stimulating production in the United States; with inflation expectations damped, the odds on a destabilizing flight from dollar assets, while not zero, might be viewed as acceptably small.

If easing were thought to be a potentially effective option, such a move might be considered if the Committee found the staff outlook a likely result but not satisfactory given the lower path for output now projected, or if the risks to the outlook seemed tilted noticeably to the downside. Dave and Ted covered a number of such risks. In addition, fiscal policy uncertainties in this political season arising from new, or newly credible, proposals to stimulate the economy could pose a particularly difficult challenge for monetary policy. The immediate response of long-term rates to the possibility of higher budget deficits, as in recent days, would tend to restrain activity. However, the tax or spending actions themselves are unlikely to be approved before well into next year, and to be implemented substantially after approval.

Moreover, the shift in inflation psychology that may be underway, while a major accomplishment of the patient monetary policy over the last few years, also could be seen as providing support for consideration of another reduction in the federal funds rate at some point. If inflation expectations are ebbing, a steady nominal federal funds rate implies a rising real interest rate. Of course the real funds rate already is below equilibrium levels and the nominal federal funds rate was just lowered, but this action was taken in the context of information suggesting that real rates were still too high. Evidence on inflation expectations is mostly indirect, and recent surveys as well as the behavior of the long end of the yield curve do not suggest a sharp break in expectations. Still the slide of gold and flattening of industrial commodity prices along with the drop in intermediate-term yields may portend a change in attitudes toward future inflation. As inflation and inflation expectations move lower, the Federal Reserve will need to be careful that its decisions on where to place short-term nominal interest rates do not imply higher real rates than is consistent with the kind of trajectory for the economy and prices the Committee is comfortable with. Especially until the 50 MPH headwinds begin to abate significantly, relatively low real short-term interest rates may continue to be needed to avoid greater disinflationary pressures than the Committee desires.

In that regard, the continued weakness of the broad monetary aggregates might be viewed as indicative that those headwinds are still blowing at gale force. Shortfalls in monetary growth now expected for the third and fourth quarters relative to the last FOMC meeting reflect the weaker path of income and overall demands for credit now projected, as well as a further bypassing of the depository sector. Bank loans have continued to decline, with weakness in both

household and business credit. Our senior loan officer survey suggested that this was not a function of any tightening of loan terms and standards--but it also failed to reveal a significant easing of business lending terms or widespread willingness to seek lending opportunities, even by well-capitalized institutions. Loan demand remains extraordinarily weak for an expansion as businesses and households continue to retrench. Toward the end of July money growth began to strengthen a little, which we are interpreting as a response to the policy easing at the beginning of the month. But we expect M2 growth at only about a 2 percent pace over the balance of the year, with a substantial portion of this increase representing the influence of "special factors", including mortgage prepayments and the undoing of the First Union reserve requirement scam. We have structured our forecast of money under alternative B to be consistent with the greenbook outlook for activity and prices, but if that outlook is considered unsatisfactory, so too should the associated money path. Even growth along a 2 percent path may be viewed as a downside risk to the forecast, if the increases in velocity were considered to be unrealistic. Our projection implies an even greater increase in velocity in the second half of the year than the first, especially after taking account of the special factors. The specifications for alternative A do embody slightly faster growth of money. We have trimmed our estimates of the response of M2 to lower interest rates substantially over the past year or so. Still, the first quarter of this year and perhaps the developing acceleration in August seem to suggest some pickup when rates decline. Particularly if declines in long-term rates accompany decreases in the federal funds rate, we would be likely to see an acceleration of money growth under alternative A, albeit to a still-anemic pace.

The subject of money growth brings me to my final topic--the last sentence of the directive. As the Committee will remember only too well, concern about this sentence and dissatisfaction with a staff suggestion to replace it delayed lunch last time. Similar sentences giving some quantification of expected or acceptable money growth have been in the operational portion of the directive since the last half of the 1970s. In theory, such sentences ought to be keyed, at least implicitly, to the Committee's long-run ranges. Since the Committee has told Congress that it has considerable doubts about what money growth would be consistent with its objectives for the economy and prices, such congruence may no longer be necessary. On pages 13 and 14 of the bluebook the staff has offered four possible alternatives. The first contains the usual language, with expected money paths updated through September, as has been the practice at previous August meetings. The second retains the same format, but includes growth through December as perhaps better reflecting actions that might be taken at today's meeting. The third and fourth alternatives attempt to explain why the Committee is settling for growth below its long-run range; in the third alternative the quantification is retained, the fourth has a more general reference to a pickup in the aggregates. Choice of the last would probably be interpreted by the markets as a further down weighting of money in considering changes in the stance of policy, although it would not rule out some response to especially weak money--for example, continued declines.