

APPENDIX

NOTES FOR FOMC MEETING  
March 27, 1990

Sam Y. Cross

Since your last meeting, the dollar has strengthened. It is now trading 3 percent higher against the German mark and 7 percent higher against the Japanese yen, despite substantial intervention and the fact that interest rate differentials have moved generally unfavorably for the dollar. There has been both a positive and a negative element in the dollar's strength--positive in that investors find the dollar more attractive because the U.S. economy now looks a bit more robust than had been expected, negative in that investors find the yen and the mark less attractive than before because of problems that Japan and Germany face.

On the positive side, data on U.S. business activity released in recent weeks, as well as revisions to fourth quarter GNP, have generally been stronger than anticipated. Comments by Federal Reserve officials reflecting the continuing priority to be attached to reducing inflation, particularly in the context of last week's release of February consumer price figures, have also served to dispel any lingering hopes that the Federal Reserve would soon lower interest rates. In these circumstances, sentiment

towards the dollar has tended to improve in the period since your last meeting.

The more important influences have been on the negative side. The dollar's sizable rise against the yen during the intermeeting period reflected a continued deterioration in sentiment towards that currency. Although the Liberal Democrats maintained control of the Lower House in last month's elections the Japanese political situation is still seen as unsettled, and as limiting the ability of the authorities to respond effectively to changing circumstances. The Japanese monetary officials' prolonged disputes and vacillation over raising the discount rate was seen as a clear example of the political weakness that has developed, and the belated 1 percent increase in the official rate on March 20 did little to repair this impression. Investors, especially Japanese investors, have had their confidence shaken and have responded to this discouraging situation not only in their own financial markets--the Nikkei Dow has declined by 18 percent since the beginning of the year--but also in the exchange markets.

In these circumstances, the Japanese have been most eager to intervene to try to keep the yen from falling, and have strongly urged us to join, including at meetings with the President and Secretary Brady. They are deeply troubled that further declines of the yen may be taken as

confirmation of political weakness or even of a fracturing of the power structure that has held things together so well for so long in Japan. They also worry that a depreciated yen will bring a reversal in Japan's progress towards eliminating its international imbalance. And they are concerned about the possibility that further interest rates increases might further destabilize their stock market, given the already sharp rises in bond yields and the contrast with the stock market when returns are so much lower. In the circumstances the Japanese have relied heavily on intervention, selling during the intermeeting period. In support of these operations, the Desk sold just under \$1 1/2 billion against yen, spread over 11 trading days. The first six days operations were financed jointly by Treasury and the Federal Reserve, but Federal Reserve operations were suspended after March 2. At that time, System currency balances had reached a level which, with anticipated interest receipts, would almost entirely use up our authorized limit of \$21 billion by the time of today's FOMC meeting.

In Germany attention has also focused on political issues and inflationary concerns. When you last met, the mark was benefiting from the view that developments in East Germany would provide major opportunities for the West German economy, notwithstanding possible inflationary pressures, and the mark was trading at its highest levels in almost two years. Then, on February 7, the West German government announced plans for

immediate talks on German monetary union. Market participants quickly focused on the possible inflationary consequences of such a move. Observers noted that monetary union could result in a worrisome increase in the German monetary aggregates, and possibly unleash pent-up demand among East Germans. Moreover, Bundesbank President Poehl's initial doubts and subsequent perfunctory endorsement of monetary union left an impression that the Bundesbank's staunch stand against inflation might be subverted by political imperatives. The German bond market experienced a sharp sell-off during February with the yield on 10-year bonds rising by more than 100 basis points to briefly surpass 9 percent. These conditions weighed on the mark, which traded with a decidedly weaker tone.

In this environment, the Bundesbank has been firmly determined not to allow significant weakening of the mark, which they felt would signal a lack of confidence in their ability to deal with the inflationary pressures. Thus in early March, when the downward pressures against the mark were most acute, the Bundesbank and other European central banks intervened to sell a total of about \$1 billion against marks over four trading days. On March 5 and March 7, the U.S. Treasury also intervened to sell a total of \$200 million against marks, in conjunction with its larger intervention operations against the yen. At that time Treasury officials expressed the view that such dollar sales would help reinforce its efforts to resist upward

pressure on the dollar/yen rate. We in the Fed were concerned that the intervention in marks would be misconstrued as a more generalized effort to reduce the dollar against all currencies. We were unable to convince the Treasury of this view and the Desk intervened for Treasury account. After the initial sale of \$200 million, the Treasury has not pushed for further mark intervention, although there were some other occasions of upward dollar pressure against the mark.

In the circumstances, we did not intervene for Federal Reserve account after March 2, pending the review of System foreign currency operations that had earlier been scheduled for today's FOMC meeting, which could provide the Committee with an opportunity for a comprehensive discussion of System foreign currency operations.

To summarize the numbers, Mr. Chairman, during this intermeeting period, the Desk sold a total of \$1480 million against yen and \$200 million against marks. The Treasury financed all of the sales against marks, and all but \$325 million of sales against yen. Accordingly I request the Committee's approval of the System's share, the sale of \$325 million against yen. I would note that our present currency balances are just below the \$21 billion authorized limit, and also that the Treasury has now warehoused \$9 billion of the \$10 billion currently authorized.

PETER D. STERNLIGHT  
FOMC NOTES  
MARCH 27, 1990

Since the early February meeting, the Domestic Desk has sought to maintain steady reserve conditions, associated with seasonal and adjustment borrowing around \$150 million and an expected federal funds rate around 8-1/4 percent. The borrowing allowance abstracted from the special situation borrowing by the Bank of New England, which was classified as adjustment credit through February 20, and then as extended credit. Actual seasonal and adjustment borrowing--again abstracting from Bank of New England early in the period--averaged about \$180 million over the intermeeting period. Daily amounts were typically well below that level but some end-of-reserve-period stringencies boosted the average.

The funds rate was a nearly rock-solid 8-1/4 percent throughout the period--rarely varying by more than 1/16 to either side of that well-entrenched central tendency, again apart from some end-of-reserve-period firmness. Moreover, as the interval progressed, market participants seemed increasingly disposed to stretch out the horizon over which they expect funds to remain at that level.

For the first third of the period, the Desk was still draining reserves to deal with the typical seasonal over-abundance of reserves early in the year. This was handled through several rounds of matched sale-purchase transactions in the market. Then after a few days on the sidelines, the Desk switched gears and turned to meeting reserve needs, initially through outright Treasury bill and note purchases from foreign accounts which totaled \$800 million for the interval, and then through a series of repurchase agreements for customer or System Account. Seasonal needs might have been met to a

greater degree through outright purchases but for the provision of reserves through additional warehousing of \$2 billion of foreign currency for the Treasury, and, in the earlier part of the period, small additional purchases of foreign currency for the System.

Market moves in interest rates were relatively modest on balance over the period, with yields on short- and medium-term issues closing some 5 to 20 basis points higher. At the long end, though, Treasury issues were slightly lower in yield. The markets focused on a variety of factors, including rising rates in overseas financial markets, some sense of a little greater economic strength and greater inflationary pressure at home, but also the rising dollar in foreign exchange markets and particular foreign demand for long-term Treasury zero coupon issues.

Market evaluation of the stronger economic news, notably on employment and retail sales, was tempered by the realization that weather-related or other temporary effects were having a distorting influence. Price data were recognized as having been affected by temporary factors, also. Still, after taking account of these factors, analysts were left with a lessened sense of likelihood of progressive economic weakening after the soft final quarter of '89, and a bit greater sense of the stubbornness of underlying core inflation rates. At the same time, though, notice was taken of the possibility that, unrelated to current monetary policy, some increased restraint on the part of banks and other lenders could have a dampening effect on activity and price pressures.

The predominant monetary policy outlook still called for no change for a good while ahead, but one heard increasingly the possibility expressed that when a change does come, it could just as plausibly be to the firming as to the easing side. Earlier, the

prevalent view was that further easing, while not imminent, was the more likely direction when a change came. Market observers also seemed to be impressed by the firm restatements of the Federal Reserve's determination to see inflation work lower over time, as expressed in the Chairman's congressional testimony and in statements by other Fed officials.

The market paid close attention to rate developments overseas, especially in Germany and Japan, although there was not always a lock-step response to the changes abroad. Responses to exchange rate changes also seemed to be spotty--often being cited as a factor in the U.S. market but not always with great precision or consistency.

A particular factor in the Treasury bill market, where rates rose about 5 to 12 basis points despite rather steady fed funds and dealer financing costs, was the increase in actual and prospective supply from the Treasury as a result of funding RTC working capital needs. Supplies were also enlarged as foreign central banks lightened their bill holdings in order to finance foreign exchange intervention. In yesterday's Treasury bill auctions, the 3- and 6-month issues went at 7.85 and 7.83 percent respectively, up from 7.83 and 7.72 percent just before the last meeting. The coupon equivalent yields on the latest issues were 8.12 and 8.26 percent, closer than usual to the prevailing fed funds rate.

Bucking the trend toward somewhat higher rates, yields on long-term Treasury issues came down by a few basis points over the period. At least in part, this seemed to stem from a particular demand for long-term Treasury zero coupon issues, reportedly from Japanese investors who found the long zeros attractive, under Japanese accounting rules, on swaps out of Japanese government bonds. The long

end of our market also seemed to be helped by the strong dollar and possibly by the sense that the central banks would resist inflation.

Investment grade corporate bonds ended about unchanged to slightly higher in yield, and with some pickup in new issuance as the period progressed. In the case of junk bonds, the story is mixed, with some issues showing little change while a number of others registered an appreciable rise in yields in spotty trading, as the markets coped with the demise of Drexel Burnham--the leading underwriter and market maker in such paper during the 1980s. There was virtually no issuance of new high-yield paper.

More broadly, it can be said that the market coped well with the unwinding of Drexel's operations and positions--a notable achievement given that this was a major player in a variety of markets with pre-bankruptcy balance sheet positions on the order of \$28 billion, and similarly large interest rate swap positions off the books. Contributing to the orderliness of the unwinding were the professionalism of the Drexel personnel, on-the-whole responsible behavior by other financial market participants and a certain amount of constructive monitoring and hand-holding by the regulatory authorities. Drexel's government securities affiliate is almost totally wound down now, and while we went out of our way to affirm their primary dealer status as the liquidation process began, we will shortly be putting out a new primary dealer list which removes their name. Very substantial progress has also been made in winding down other Drexel affiliates, although fair-sized holdings of high-yield bonds remain, and there are still some unresolved questions about certain commodity transactions in one of the unregulated affiliates. As it turned out, only limited use was made of the liberalized authority to lend securities from the System's portfolio during the

liquidation process, but it was useful to have this flexibility available.

Part of our concern while monitoring the unwinding of Drexel was that difficulties could spread to other firms with potentially disruptive systemic consequences. For a couple of weeks rumors did in fact abound in regard to some other U.S. investment banking concerns, with particular focus on those with appreciable junk bond or bridge loan exposure. These firms experienced a more cautious attitude--even a pulling away--by some usual funding sources. Thankfully, the rumors have abated partly with the help of fresh injections of capital or statements of support from well-regarded parent firms, but an atmosphere of increased caution remains.

To be sure, the cautious or even "edgy" atmosphere stems not only from Drexel but also from other developments such as the further reverberations of Bank of New England, and commercial bank real estate exposure more generally. Several major bank holding companies saw their credit ratings reduced during the period, and there was some selective widening of spreads quoted on bank-related debt compared to Treasury paper, especially in the Euro-bond market. On the other hand, the TED spread, which compares Treasury and bank-related paper for very short maturities, and which has sometimes been regarded as a measure of market confidence in bank paper, showed little change, and a couple of major money center banks had rating upgrades.

With respect to primary dealer changes, I should mention that when we put out a new list in a couple of days, in addition to removing Drexel we will be adding Swiss Bank Corporation. That will leave the number of primary dealers at 44, while raising the number of foreign-owned firms to 16.

Leeway

Mr. Chairman, although the Committee just voted at the last meeting to increase the standard intermeeting leeway for changes in outright holdings of government securities, it is projected that the upcoming intermeeting interval will need an even bigger allowance for change, essentially because of prospectively higher Treasury balances after the April tax date. Some estimates place the maximum need for additional reserves as high as \$20 billion. Other estimates are considerably lower, closer to around \$10 billion, and in any event it is not necessary or desirable to meet the whole need with outright purchases. To provide a reasonable cushion for flexible management, I recommend that the standard leeway now set at \$8 billion be enlarged for the upcoming intermeeting period to \$12 billion. If the need works out toward the high side of the projected range, the additional reserves probably can be provided through repurchase agreements which do not count against the leeway.

Michael J. Prell  
March 27, 1990

FOMC BRIEFING -- ECONOMIC OUTLOOK

I suspect that most of you sensed, as you read the Greenbook, that the staff found it exceptionally difficult to read the economic tea leaves in this forecasting round. Mother Nature and the Big Three automakers seem to have led a conspiracy to make the monthly data on business activity even noisier than they usually are. Moreover, lurking in the background is the credit crunch story, whose ultimate importance remains very hard to judge.

In the end, despite all the obvious uncertainties, we felt there were sufficient grounds to make a few noteworthy changes in our projections.

First off, we've raised the near-term level of economic activity. The Commerce Department revised fourth-quarter GNP upward by a small amount. Significantly, the mix of expenditures was altered, with final sales being strengthened, and inventories being lowered--a change in composition that tends to have positive implications for activity in subsequent months. With respect to the current quarter, the huge increases in payroll employment in January and February may be a bit suspect, especially the size of the gains in service sector jobs. But a temporary jump in construction employment would seem plausible in light of the warm weather and the stability of the unemployment rate supports the notion that overall labor demand was indeed quite firm. We therefore feel reasonably comfortable in raising our prediction of real GNP growth in the first quarter to a 2 percent annual rate.

The second change in the forecast I want to mention is the sizable hike in the inflation rate for the current quarter. At this juncture, this is little more than a matter of arithmetic: it would take a substantial retreat in the March CPI to undo the damage done to our previous first-quarter projection by the January and February data. More important for the outlook, however, we've interpreted the recent price developments as involving something more than transitory weather effects. On the energy side, the underlying supply-demand balance in the world oil market looks to be somewhat tighter than anticipated in previous projections, and we've raised our assumption for petroleum prices about a dollar a barrel. For food, new fruit and vegetable crops should reverse much of the recent surge in prices, but the inflation trend for food prices overall looks a shade higher. And, finally, while there are lots of special stories about individual items, the pace of inflation for the CPI excluding food and energy has been faster in recent months than we had anticipated; in an environment of higher aggregate demand than previously expected, and with profit margins having been squeezed, we've thought it reasonable not to project a full offset in coming quarters to the upside surprise of January-February.

The higher level of activity, the lower unemployment rate, and the stronger price pressures have led us to the third notable change in the forecast--namely, the expectation that somewhat greater monetary restraint may be needed in coming months to temper growth in aggregate demand through 1991 and to set the stage for a renewed slowing of the underlying trend of inflation. As you know, we've built into the forecast a rise in the federal funds rate of one percentage point,

occurring toward the end of this year and the beginning of 1991. Long rates also are expected to move up, about half a point. Under these circumstances, as Ted will discuss shortly, the dollar is anticipated to depreciate even less than in the last forecast.

I won't take the time to recite all the other details of the recent data, or of our forecast. I would just note that last Friday's advance durable goods report was consistent with our expectation that shipments of nondefense capital goods to U.S. and foreign customers will be reasonably robust in the current quarter, but that manufacturing activity will remain sluggish in the next few months.

Perhaps what might be more useful would be for me to take just a couple of minutes to highlight some of the risks and uncertainties we perceive from the domestic side. One of these, which we didn't address directly in the Greenbook, is the question of how slow GNP growth will have to be in order to open up some additional slack in the labor markets. According to the existing GNP estimates, growth of drought-adjusted output of 2 percent last year was sufficient to hold the unemployment rate steady. Given our assumption that the underlying trend of potential output growth is on the order of 2-1/2 to 2-3/4 percent, the unemployment rate should have edged upward. Recognizing the short-run variability in that relation and the possibility of data revisions, we've chosen in effect to ignore last year's disparity for the time being. But we shall be watching carefully for any further signs that labor force participation rates are leveling off or that underlying productivity trends are weaker than we've been assuming.

Another area of uncertainty--one that certainly is not new--centers on wage and price behavior. Although we have raised our forecast of prices, some analysts would argue that we are being optimistic and that the recent news is evidence that, at current levels of resource utilization, tendencies toward a pickup in inflation are stronger. We noted in the Greenbook one particular concern in this regard, centering on the outlook for wages. All other things equal, one might have boosted the wage forecast for this year by an amount closer to the hike in our price forecast--which was four-tenths of a percent for the CPI. However, we added only one tenth to our projection of compensation. This reflected, in part, our judgment that there has been no discernible deterioration in wage trends recently, despite the tighter than anticipated labor market conditions. Again, I would suggest that this is something that warrants close monitoring, and by the May meeting we shall at least have the full complement of labor cost data for the first quarter and monthly wage figures through April.

One might interpret my remarks as suggesting some bias in the risks--toward the inflationary side. However, there are some offsetting considerations. Perhaps the most obvious is the "credit crunch" issue. There is plenty of smoke to attract our attention here, but, unfortunately, there is little basis for assessing the intensity of the fire beneath it. I can't quantify it, but I would say that we've made allowance in our projection for only a small restrictive effect of the shift in credit supply conditions on aggregate demand. If the effects on spending are larger, then interest rates--at least those on risk-free assets--would not have to be so high to produce the same GNP outcome.

Interest rates also would not have been as high as they are in this forecast if it were not anticipated that the external sector will be providing some added impetus to domestic activity by next year. Ted has some remarks on that subject.

E.M.Truman  
March 27, 1990

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FOMC Presentation on International Developments

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In preparing the external component of the latest staff forecast, we have been influenced by a number of factors.

First, our assessment of economic developments in central Europe has led us to raise our outlook for growth abroad; everything else being the same, this has a positive influence on our forecast for U.S. exports. I will return to this topic in a moment.

Second, as Mike noted, developments in world oil markets, in particular increased demand from the industrial countries and reduced supply from the centrally planned economies, have induced us to raise our assumption about oil prices by about a dollar a barrel for the balance of the forecast period.

Third, new data on U.S. international transactions in the fourth quarter of 1989, especially in the area of net investment income, showed a substantial improvement. Most of this improvement we think will persist and give us a brighter current account outlook for 1990 and 1991 than we had previously.

Fourth, the projected higher level of dollar interest rates, against the background of a somewhat better underlying outlook for our external accounts, has led us to reduce our projection of the dollar's depreciation in terms of the other G-10 currencies. Indeed, in this forecast the dollar's real

depreciation over the eight quarters starting from the fourth quarter of last year has been cut almost in half.

On balance, our assessment of these factors has yielded little change in the expected contribution of the external sector to U.S. growth over the forecast period: That is, essentially no net contribution to GNP for the balance of this year followed by a substantial positive contribution in 1991. The influence on the forecast of more growth abroad is roughly offset by the effects of the stronger dollar. At the same time, the impact on U.S. inflation of higher oil prices and more inflation abroad largely, but not entirely, offsets the influence of a relatively stronger dollar. Finally, we now are projecting by the end of the forecast period a current account deficit that narrows to around \$70 billion at an annual rate.

With a view to adding further to Mike's list of risks in the forecast, aside from the familiar uncertainties associated with exchange rates and oil prices, I'd like to expand briefly on our assessment of growth, inflation and policies abroad; we focussed our analysis for this forecast on the accelerated pace of developments in Central Europe over the past six months, recognizing that our judgments can hardly be definitive.

We believe that the West German economy will receive a substantial fiscal stimulus over the next year and a half -- perhaps, as much as one percent or more of GDP -- in connection with the process of German economic and monetary union. The revitalization of the East German economy, especially a sharp acceleration of investment expenditures, will add further to demand in West Germany and pull in imports from outside the two

Germanys. We envision a similar, but much slower, process of economic change in the rest of Eastern Europe. On balance, anticipation of these developments has contributed to a higher worldwide level of real interest rates by heightening uncertainty as well as by raising expected returns to investment.

In addition, there are risks of rising nominal interest rates abroad owing to greater inflation. Our assumption is that the Bundesbank will follow a relatively accommodative monetary policy. This should contribute to a higher overall level of inflation and tend to push up the level of nominal longer-term interest rates in Germany. The impact on other countries is more problematic; a rather robust result in most large-scale econometric models is that changes in monetary policy in one country, in an environment of floating exchange rates, has little net effect on other economies. However, it is more difficult to assess the longer-term implications of a possible loss of Europe's monetary anchor.

In Japan, the combination of higher interest rates and a weaker yen has caused us to expect lower growth and more rapid inflation. We also have lowered our outlook for growth in Canada in light of the stubborn persistence of inflation in that country. On balance, over the past six months, we have added about a full percentage point on average to the level of economic activity in the foreign industrial countries by the end of the forecast period, and an equivalent amount to the average level of consumer prices.

Mr. Chairman, that concludes our report.

March 27, 1990

FOMC Briefing  
Donald L. Kohn

As Peter noted, markets are expecting the Committee to maintain the System's current stance in reserve markets at this meeting--and indeed seem to be looking for only minor changes in policy for some time to come, judging from the relatively flat yield curve. In a sense, they have already adjusted for the surprising strength in incoming data through the upward movement in bond yields earlier this year. And this increase, together with the strength of the dollar and the reduction in credit availability, apparently are seen as sufficient to contain inflation pressures within a range markets think the Federal Reserve will tolerate. In a sense, the market is at odds with the greenbook forecast, which, as Mike discussed, put an upward tilt into the path of interest rates over the forecast horizon--although that discrepancy may rest as much on the perceived long-run goals of policy as on an assessment of the underlying forces.

To be sure, bond yields, the dollar and changing credit standards were taken into account in constructing the greenbook forecast. But, in light of their importance to the outlook for aggregate demand and price pressures, as background for Committee consideration of its policy decision it might be useful to review recent developments in these areas in some greater detail.

Bond yields were covered extensively at the last meeting. As I already mentioned, the increases since late last year seemed largely to be an endogenous response to the prospects for stronger economic activity

than had previously been expected, rather than a lock step movement with foreign rates. The stronger outlook arose both from a re-evaluation of domestic demand in the U.S. and, secondarily, from the likely pull on our resources of the changes occurring in Europe. As a consequence, the higher rates would not be expected to weaken the U.S. economy unduly, unless the market's assessment of underlying demands was mistaken.

Events over the most recent intermeeting period have not contradicted this analysis. Nominal interest rates in other countries have risen substantially further over the last month or so--but this time importantly out of concern about potential increases in their inflation rates. And, U.S. rates did not follow. Moreover, the dollar has been firm, in contrast to the earlier period when the draw of increased real returns on European investments appeared to put downward pressure on the dollar. The more recent upward pressure on the dollar seems to reflect concerns that real returns abroad may fall as foreign monetary policy fails to keep pace with inflation pressures, rather than a rise in real rates here. The continued increase of equity prices in the United States is consistent with a relatively benign domestic real rate environment. In the context of possible upward revisions in expected inflation abroad, the rise in the dollar probably is larger in nominal than in real terms; if this is the case, it would be serving more to help insulate our price level from greater price pressure abroad. than to damping real net exports.

With respect to tightening credit standards, it is important to delineate the information we have, while at the same time acknowledging that the situation may be evolving rapidly and could show up in our data

only with a lag. Bank survey results, beige book reports, yield spreads on junk bonds, and reports from the commercial paper market all indicate that riskier borrowers are having problems finding credit. In particular, lending for corporate restructuring as well as for certain types of real estate transactions is more expensive, carries more stringent nonrate terms, and is generally less available. On the other hand, the credit squeeze apparently has not extended to investment-grade borrowers. Bank survey responses indicate a continued willingness to lend to such borrowers for nonmerger purposes. Spreads among investment grade yields or between such yields and government securities are unusually low--and inconsistent with past behavior prior to recessions, when they generally had begun to widen. Moreover, spreads between residential mortgage and Treasury rates have even narrowed a bit since late last year, indicating a continuing flow of funds to this market despite thrift cutbacks.

However, standard market yield spreads may not be a reliable indicator of a reduction in credit availability from banks to smaller businesses, who don't have alternative market source of funds. Bank survey evidence suggests that the spread of rates on smaller business loans over federal funds is fairly high, but did not widen between November and February and remains within the range of spreads that has prevailed in recent years. Banks have indicated that they are tightening nonprice credit terms for riskier businesses, which may disproportionately include small businesses. However, from the business side, a survey done in January of smaller businesses showed no increased perception of reduced credit availability.

From a quantitative perspective, credit flows slowed last year, but do not seem to have decelerated further outside of the areas already identified as facing credit constraints. A substantial weakening in bank business lending late last year and early 1990 appeared to reflect primarily a cutback in merger-related lending, as well as the effects of lagging reduction in bank prime rates. Excluding this lending, and taking account of commercial paper issuance as well, short-term business borrowing has been quite sluggish in the first few months of 1990, but this simply continued a trend that had been in place all of 1989. The debt of all private nonfinancial borrowers is estimated on the basis of very partial data to be growing in the first quarter at about the pace of last year, also abstracting from the ups and downs of merger financing. Still, the steadiness of debt growth may be misleading. Any cutback in credit availability, might be reflected first in commitments, and only later in flows. Perhaps for this reason, bank credit flows do not seem to be good leading indicators of business activity.

On the other side of the public's balance sheet, increases in M2 have been fairly robust, and are expected to moderate only slightly in the months ahead. This aggregate grew along the 7 percent upper end of its long-run range in the first quarter, coming in only a little below Committee expectations. With the slight slowing in M2 growth we are projecting over the coming three months under alternative B, this aggregate in June would be 6-1/2 percent, at an annual rate, above its fourth quarter average. The slowing is premised on less rapid nominal GNP growth and only modest narrowing of the unusually wide opportunity costs for holding deposits that have opened up recently. M3 growth is expected to pick up a

little from its recent depressed pace, but to stay within the lower half of its range.

Several developments could shift the demand for money relative to income and interest rates in coming months, complicating interpretation of these indicators. One is the tax season. Frequently, the months of the second quarter see pronounced swings in monetary data as the tax paying or clearing process does not coincide with the patterns built into our seasonals. We doubt that people will be as surprised this year as they evidently were last by the size of their tax payments, so we have projected smooth monthly growth rates. Yet, tax payments are expected to be quite high again this year, and whether anticipated or not, could result in a greater drawdown of liquid balances than we have predicted. Another source of uncertainty is the RTC. We have assumed a major increase in activity by this organization--resolving institutions and replacing high cost funds. Yet we have not built in anything like the numbers publicly announced. Higher levels of activity would tend to depress M3, as borrowing by the Treasury to carry thrift assets replaces deposits and RPs in M3. It could affect M2 as well, to the extent thrifts became even less of a factor competing for funds, and banks find themselves even more flush with cash, with greater incentives to hold down retail deposit rates.

However the Committee interprets all the economic and financial evidence, the market is not expecting any changes in the stance of monetary policy, as I already noted. An unchanged stance makes sense should the Committee perceive the balance of risks about evenly distributed in terms of the longer-run outlook for the economy and prices relative to a desired path, recognizing that in the short-run such a path might involve

both modest growth and continued fairly strong price increases, given the position of the economy. An unchanged and balanced directive might be considered an appropriate holding action in light of difficulties in sorting out weather and other special effects in first quarter data from underlying forces acting on the economy, and in assessing the credit supply situation. In addition, a steady monetary policy in the U.S. in the near term might provide an appropriate background against which to work through volatile conditions in foreign financial markets and discussions associated with the international coordination process.

However, steady policy would not be appropriate if it were seen as clearly at odds with the appropriate course for the economy. Concern that the level of real rates, tightening credit conditions, and fragile financial conditions could undermine the expansion might argue for a downward tilt in the directive, if not an actual easing of policy. On the other hand, a sense that the current course risked insufficient restraint on inflation pressures and a lack of progress toward price stability over time would weight toward consideration of a tighter policy at this time, or for an upward tilt in the directive. Any tilt would mark a shift from the current balanced language in the directive and would not only guide policy until the next meeting, but would acknowledge, in a way that eventually will be made public, the Committee's assessment of the balance of risks and priorities and the likely next step in policy.

E.M.Truman  
March 27, 1990

Introductory Comments on  
Task Force on System Foreign Currency Operations

Sam and I have no desire to add to the pile of words that have been assembled for you by the Task Force on System Foreign Currency Operations, and we see no need to do so, since we hope the Task Force papers speak for themselves. However, we thought it might be useful briefly to review the procedures we followed in putting together the material and to provide a few introductory comments.

With respect to procedures, our aim was to put together a comprehensive review of U.S. experience with respect to foreign currency operations over the past three decades with an emphasis on System operations. Our objective in the 11 papers before you and in our overview memorandum was to provide a consistent treatment of the various topics; it was not to produce complete convergence or consensus. We recognized from the start that there are some differences in interpretation of history, policy and economic analysis in this area, and we knew we were not going to settle those differences. Our objective was to assemble a reasonably faithful record that would assist the Committee in its deliberations on these issues in the future.

Although our focus was retrospective, I believe that certain themes usefully can be highlighted.

First, I was struck in the Task Force papers by both the elements of consistency and the elements of change in the

institutional context of System operations in foreign currencies. The basic relationship between the Federal Reserve and the Treasury has been remarkably constant, but the structure and functioning of the international monetary system has evolved in many important respects since 1962.

The final authority to determine U.S. exchange rate policy lies with the Treasury. However, the System has cooperated with the Treasury in the formulation and implementation of that policy throughout the years, prior to and following the breakdown of the Bretton Woods system, the adoption of floating exchange rates, and the disenchantment with what some see as the adverse consequences of floating exchange rates. In recent years, the Federal Reserve's cooperation with the Treasury has included an involvement along with other major central banks in a search within the G-7 process for greater exchange rate stability and increased cooperation on economic policies.

I believe that the Federal Reserve's cooperation with the Treasury in exchange rate matters, on the whole, has served the System's and the nation's interest. However, I also recognize the existence of differences of view on the appropriate role of central banks in this area, both in the abstract and for the Federal Reserve. Indeed, in the wake of events since the Task Force was formed, this has become a central issue for the Committee.

Second, over the years the influence of concerns about dollar exchange rates on Federal Reserve monetary policy has varied, but the potential influences always have been there. I

would not deny the risk that exchange rate considerations could dominate Federal Reserve monetary policy discussions, and they may have done so in the past. However, based on the Task Force's review of our own experience and that of other countries, my conclusion is that the probability that such considerations will distort decisions is not increased by the active involvement of the central bank in foreign currency operations.

Third, differences in view and interpretation about the role of exchange rates, the effectiveness of intervention, and the implications for monetary policy are inevitable. They can be traced to philosophical, policy and methodological differences as well as to the failure of the economics profession to reach a broad consensus on some of these issues. Moreover, such differences are likely to persist.

Fourth, while U.S. exchange rate policy is evolutionary, I suspect that U.S. intervention in exchange markets will continue for some time to be conducted under the rubric of "countering disorderly market conditions", interpreted elastically. It is an open question whether, in the future, U.S. exchange rate policy retains the ad hoc flavor of much of the floating rate period or will evolve in the direction of target zones for exchange rates or in the direction of broader objectives such as fostering conditions for greater exchange rate stability. It follows that it is also an open question how often U.S. intervention will be aimed at directing or guiding dollar exchange rates, as opposed to resisting changes in rates. Issues for the Federal Reserve involve the implications of such choices

for monetary policy and how this institution most effectively can influence U.S. policy on these matters.

Finally, the Task Force's papers underscore the important role over the years of accountability -- to the Committee, to Congress, and to the public -- in the Federal Reserve's foreign currency operations. I hope that these papers have contributed to that record.

Sam Cross will now complete our introductory comments.

[Secretary's Note: There is no record of a statement by Mr. Cross at this point. The staff's recollection is that Mr. Cross commented that he had nothing further to add.]