

APPENDIX

NOTES FOR FOMC MEETING
MARCH 26, 1991

Sam Y. Cross

When you met here in early February, the dollar was in a sharp downturn that had begun with the start of the Gulf war in mid-January. Uncertainty over the war's impact and duration, together with further widening of unfavorable interest rate differentials, was still weighing heavily on the dollar. As dealers sought to establish short-dollar positions and corporates postponed buying the dollar in hopes of getting better rates later, the dollar declined, setting successive historic lows against the mark. Although some investors were beginning to say that the dollar was undervalued in some fundamental sense, the view persisted that the dollar would continue to decline.

In that environment, the Desk entered the market on the day before your last meeting--February 4--and on the six following trading days to support the dollar and to try to develop a sense of base or bottom to the dollar's trading range. The Desk purchased just under \$1.4 billion over those seven days, adapting operating techniques to market conditions. Foreign central

banks cooperated with this effort, purchasing just under \$1.8 billion over the same period. The first day of our operations the dollar got a lift from the intervention, which was highly publicized and, interpreted by market operators as a signal of official concern about market developments. But there remained skepticism that there was any real commitment to stop the dollar's decline. Traders believed that Germany was still desiring mark appreciation to help attract the capital needed to finance unification and that the United States was willing to accept dollar depreciation to help bolster exports. As our operations continued, however--and especially after the European central banks took the initiative to conduct a round of coordinated intervention before the opening of New York trading on February 12--market participants became impressed by the persistence of the operations. They came gradually to the view that the monetary authorities in the major countries could work together effectively and consistently even with differing monetary policies, and that the intervention was serious and not just a U.S. support. Market participants gradually came to question the conviction that the dollar would continue to decline, and the dollar leveled off and started tentatively to move higher.

By then the market's technical position was ripe for the dollar's recovery.

For some time, inter-bank dealers had been establishing short-dollar positions. Also corporate customers had been delaying purchases, hoping to come in at the dollar's bottom, while in many cases buying options to protect against a sudden dollar surge. When a sense of two-way market risk was finally and convincingly restored, dealers quickly began to cover their short-dollar positions and corporates bought to cover their needs. Later, as the dollar moved significantly higher, the option writers had to buy more dollars to keep their positions hedged. Also, investors, sensing that the dollar had been undervalued for some time, began to buy dollars as they reallocated their portfolios to reflect a more positive outlook for the dollar. As a result, once the dollar started to move up, it quickly gained momentum.

After mid-February, sentiment for the dollar gained increasing support from the growing anticipation of a prompt allied victory in the Gulf following Iraq's withdrawal proposal of February 15. The war victory supported the dollar in a number of ways. First, it engendered hope for a resurgence in U.S. consumer confidence and an early economic recovery. Second, there was a presumption that the U.S. economy would get a lift from a surge of contracts to rebuild in Kuwait. And third, reports and rumors circulated that Kuwaiti

assets were being shifted into dollars to finance reconstruction, and also that large financial contributions were being made to the United States by its allies. Market participants were impressed by the potential scale of these transfers of funds into dollars and uncertain how they might affect exchange rates. The Japanese financial contribution, in particular, was a source of uncertainty. Not until the last few days were the mechanisms agreed for the Japanese to make their contribution to the United States and to convert the funds into dollars without going through the exchange market.

Meanwhile, the dollar was also benefitting from a reassessment of the U.S. economy and U.S. interest rates, and the contrast in the outlook relative to Europe and Japan. The market's view was that, for the United States, the bad news was behind us or at least known and discounted, while for Europe and Japan the bad news was yet to come. Even before the resolution of the Gulf War, market participants began to speculate that U.S. interest rates had little room to move lower. The Chairman's Humphrey-Hawkins testimony on February 20 was interpreted in the foreign exchange market as an indication that major interest rate cuts were not imminent, and following the monetary easing on March 8, dealers began to wonder if that had been the last such

move. In contrast, evidence emerged that the economies of Europe and Japan would be slowing down. In Japan, an unexpectedly sharp slowdown in monetary growth led to expectations of a possible cut in the Bank of Japan's discount rate, possibly soon after the Japanese fiscal year end this weekend. In Europe, perceptions of slowing economies were even more widespread, with GNP growth forecasts being revised downward. In a number of European countries, official interest rates have been lowered to reflect this change.

These reassessments of economic and interest rate outlooks were particularly damaging to the German mark. Ever since the Bundesbank last raised its official interest rates on January 31, the market had come to assume German interest rates were at their peak. The German government's proposed tax increases announced in late February were seen as taking some of the pressure off monetary policy for the financing of German unification, while widely expected to dampen economic growth somewhat. The economic outlook in eastern Germany appeared increasingly bleak, manifest in occasional demonstrations by the rising number of unemployed, as well as comments over the past week by Poehl describing German monetary union as a "disaster" and by Finance Minister Waigel that the country was in crisis and

faced its most difficult situation since 1949. The economic and political turmoil in the Soviet Union and elsewhere in Eastern Europe also weighed heavily on the mark throughout the period.

In the past two weeks, the dollar's rally has accelerated, and at times the dollar/mark exchange rate has reached levels over 15 percent above the February lows. In these circumstances, the Bundesbank took the initiative to mount concerted intervention operations to support the mark. The Bundesbank, which had sold _____ in off-market and "troop dollar" operations earlier in the period, sold an additional _____ in these interventions. Other foreign countries have sold \$1536 million, some against marks and some against their own currencies. On the U.S. side, we have not been concerned about present dollar levels, but have come in from time to time at the Bundesbank's request to resist sudden upward moves, in the interest of orderly markets and in a spirit of cooperation with the Germans and our other partners. The Desk entered the market on four occasions, selling a total of \$370 million against marks and \$30 million against Japanese yen.

In other operations, the U.S. Treasury and the BIS established a near-term support facility for the National Bank of Romania. The Romanian authorities drew the full amount of the swap agreement, including the Treasury's share of \$40 million, in early March and repaid in full last week.

Mr. Chairman, I would like to request the Committee's approval of the Desk's operations. Including operations conducted on the two days of your last meeting, the System purchased a total of \$644.5 million against marks, with an equal amount financed by the U.S. Treasury. In mid-March, the System sold dollars in the amount of \$185 million against marks and \$15 million against yen, with equal amounts financed by the U.S. Treasury.

FOMC NOTES
PETER D. STERNLIGHT
WASHINGTON, D.C.
MARCH 26, 1991

Domestic Desk operations were carried out in a comparatively serene money market in the last intermeeting period--a welcome contrast to the turbulence of the previous period which was marked by year-end pressures, early reactions to the cut in reserve requirements and resultant low operating balances, and concern over the fragility of the banking system. Several factors contributed to the calmer atmosphere. Higher seasonal levels of required reserves and lower levels of vault cash meant that, at most times, the reserve balances needed to meet reserve requirements were also sufficient for normal clearing needs for most large banks. Also, there was a steady, though modest, enlargement of required clearing balances--which have risen now by over \$800 million since the reserve requirement cut took effect in mid-December. Further, banks have made some adaptations to help cope with the lower levels of reserves, including reductions of their vault cash and improved internal communications. I like to think that our own Desk has learned to cope better, too. Finally, with some supporting words from the Chairman, banks have felt a bit less reluctant to turn to the discount window to meet late-in-the-day surprises, and without feeling that Fed funds must first be bid up to extraordinarily high levels.

This is not to say that volatility totally disappeared or cannot recur in some greater measure, but until such times as we hit low points again in required reserves or highs in vault cash, the problem should be relatively subdued. In modest doses, a little greater volatility is not all that bad, it seems to me, as it can help promote a bit more flexibility in the background for the execution of operations in response to projected reserve needs.

For the first several weeks of the intermeeting period, the Desk sought to maintain unchanged reserve conditions, which were expected to be associated with adjustment and seasonal borrowing around \$100 million and Fed funds trading in the area of 6 1/4 percent. Actual borrowing exceeded the path allowance, modestly in the February 20 period and more substantially in the March 6 period as a few banks borrowed more readily following Chairman Greenspan's comments on use of the window. Funds averaged just about 6 1/4 and 6 3/8 percent in these two periods, though there was some day-to-day volatility in mid-February when banks were alternately awash with unwanted reserves and then pressed for sufficient funds shortly afterward.

On March 8, in response to signs of continued weakening in the economy, particularly as indicated in that day's employment report for February, the Desk implemented a slightly easier stance, reducing the path borrowing allowance to \$75 million with an expectation that Federal funds would edge down to about 6 percent. The move was communicated to the market by arranging over-the-weekend System RPs when funds were trading at 6 1/4 percent, and the change was quickly perceived by the market. Any lingering

doubts on the part of some observers were put to rest after that weekend as the Desk injected reserves through customer RPs when funds were at 6 1/16 percent. More generally, funds have averaged about 6 to 6 1/8 percent since the March 8 move while borrowing remained a little above par, averaging about \$140 million in the March 20 maintenance period. During part of that period, funds traded a shade under 6 percent and the Desk hesitated to meet projected reserve needs lest the market be misled into thinking a further accommodative step was in train--leading to a fairly firm wind-up to the reserve period. In a technical adjustment last Thursday, the path borrowing allowance was raised to \$125 million, in recognition of the recent slightly greater willingness to use the window for adjustment borrowing, and the early spring stirring of seasonal borrowing. It was still expected that funds would trade around 6 percent.

Reserve needs were met over the period through a combination of outright purchases of bills and notes from foreign accounts and either System or customer RPs on most days. The outright purchases came to nearly \$6.3 billion, including just under \$2.3 billion of bills and \$4 billion of coupon issues. About \$2.4 billion of the coupon issues were bought from a foreign customer that was raising dollars to fund a "Desert Storm" payment to the Treasury; additional sales of securities were undertaken for that account in the market. Incidentally, in connection with another country's Desert Storm payments, the Desk has assisted that country in funding its payment temporarily by arranging reverse repos, but this has all been done with the market. Repurchase

agreements, when made, were typically in a range of about \$2 - 6 billion, but the amount outstanding was increased to \$16 billion on February 28, as reserves were drained by a sharp rise in the Treasury balance at the Fed on the payment date for 2- and 5-year notes. This spike in Treasury balances threatened not only a deep reserve deficiency but also a very low operating balance that undoubtedly would have caused clearing problems.

Market interest rates showed mixed changes over the intermeeting period. Rates on most Treasury issues rose, except for very short maturities where the System's slight easing move was a factor pulling rates down. Further out the maturity spectrum, rates rose in response to a sense that the quick end to hostilities in the Persian Gulf would likely spur the economy. Disappointing price numbers and sales of U.S. securities by foreign official holders added to upward rate pressures, while sustained growth in money weakened one of the earlier reasons for expecting further policy easing. Economic statistics released during the period were seen largely as still pointing to weakness, but much of this was shrugged off as pertinent to the economy prior to the Middle East ceasefire. The System's small easing step, while modestly positive at the short end, was seen as neutral or a bit negative in the intermediate and longer term sectors. Some market participants regarded the weak February employment report and the System's follow-up move as an opportunity to sell, as this could be the last easing move. Others expressed concern or surprise about the move in light of the Chairman's Congressional testimony shortly earlier that was interpreted as more consistent with policy being on hold

for a time. Moreover, a report that same morning pointing to a strengthening in consumer sentiment also soured market reactions.

The disappointment with price numbers was especially acute in mid-March, when both the PPI and CPI measures for February showed large increases for the core ex-food and energy components. Similar bad numbers a month earlier had been regarded largely as temporary aberrations but it became harder to shrug off a second month though analysts pointed out that several one-shot developments again played a role. Most analysts expect the core rate, say of the CPI, to slow to a 3 1/2 - 4 percent annual growth rate over the rest of the year but it's not at all clear that investors believe this or factor it into their interest rate outlook.

In the Treasury bill sector, rates were down 5 or 10 basis points in the 3- and 6-month areas, and down even more for the very shortest maturities but up a few basis points in the year-bill area. Among the diverse forces affecting bills, financing costs came down somewhat along with the funds rate while net outstanding bills declined by about \$6 billion as the Treasury trimmed issuance in response to temporarily enlarged balances. In turn, that temporary cash bulge stemmed from Desert Storm receipts and some slowdown in the pace of RTC resolutions. The Treasury has been taking some pains to trim regular cycle offerings, even though it means they'll have to sell some short-term cash management bills early next month, in order to avoid excessively high balances in late April and early May after the April tax date, which they recognize would give us significant reserve management problems.

In yesterday's regular weekly auctions, the 3- and 6-month issues were sold at average rates of 5.86 and 5.84 percent, respectively, compared with 5.97 and 5.83 percent just before the last meeting.

In other short-term rates, CDs and commercial paper came off about 1/8 of 1 percent. Possibly quarter-end factors are holding these rates a snip higher than they might be otherwise, but in general the quarter-end does not seem to be a matter of much concern at this point--certainly nothing like the recent year-end or even the end of September last year. A big difference is the calmer behavior of Japanese institutions, which we hear may reflect their more confident outlook on meeting capital standards in light of the better performance of the Japanese stock market recently.

In the Treasury coupon sector, rates were up a fairly uniform 30 to 40 basis points, with some of the larger increases centered in the 5-year area where Treasury cash raising has been sizable. The Treasury raised about \$30 billion in the coupon sector over the intermeeting period, of which almost \$19 billion was in the quarterly refunding that settled February 15 but for which the announcement and most of the auctions came in the previous period.

With bills slightly lower in yield and coupon issues somewhat higher, the already steepening yield curve became even a bit steeper, from a coupon equivalent of 6.05 percent for 3-month bills to a 30-year bond yield around 8.35 percent. I'm not sure what a steep or steepening yield curve is telling us, but it does seem consistent with the view one hears expressed that a business recovery, while not yet apparent, is expected to emerge within the

next few months. Not many market participants look for a really vigorous recovery, though, and rather few have factored in anything resembling a firming of policy for at least the next several months. Indeed, while most observers look for no change in policy stance in the near term, there are some who anticipate a further possible easing step or two if news on the economy remains quite sluggish and inflation signs abate. For a short time after the latest move down in the funds rate, there was some anticipation that the discount rate would "have to move" just on technical grounds, but market participants now seem to be largely disabused of this notion.

Finally, I'd like to note that there has been some appreciable abatement--though certainly not a disappearance--of credit quality concerns during the past month or so. This shows up, for example, in the rate spreads in the corporate market. Rates on high quality corporate debt were steady to just slightly higher while those on Treasury issues rose, thus narrowing the spread somewhat. More notably, rates on a number of lower graded issues came down substantially, shrinking spreads against Treasuries quite sharply. One particular area of smaller spreads is that of bank holding company debt. While still wide compared, say, with a year ago, these spreads have narrowed in some cases by 1 to 3 percentage points from their recent peaks. Moreover, some major bank holding companies have been able to issue intermediate or even moderately long term paper in recent weeks, an option that seemed unavailable just a short time ago. Again, I would stress that concerns have not disappeared, just abated.

Michael J. Prell
March 26, 1991

FOMC BRIEFING -- DOMESTIC ECONOMIC OUTLOOK

As you know, the staff's forecast for this meeting has a lot in common with the one that we presented last month. Basically, it still is our judgment that the most likely path for the economy is a quick end to the recession and a stronger expansion over the remainder of the year than most other forecasters have projected.

Our confidence in that prediction has not, on balance, been greatly enhanced or diminished by the information we've received over the past several weeks. Very clearly, there has been some bad news, most notably the indications that the labor market and industrial production were considerably weaker through February than we had anticipated. In addition, downward revisions to the December and January retail sales figures point to another decidedly weak quarterly average for consumer spending and a somewhat heavier inventory position than we had expected in the January Greenbook. All told, these data forced us to lower our projection of first-quarter GNP growth by about a percentage point.

Moreover, these developments imply a certain negative momentum as the quarter draws to a close, in part because of the resultant loss of household income. We also were impressed by the anecdotal evidence indicating that manufacturers' orders were still weak. Under the circumstances, we felt it appropriate also to lower our forecast of second-quarter growth by a percentage point.

Even so, our projection still indicates that this recession will end up being milder than most other postwar contractions. This brings me to the good news of recent weeks. In essence, a variety of things have begun to move in the favorable directions we had been anticipating. On the real side, retail sales, housing starts, and existing home sales all bounced up last month.

To be sure, given the volatility of these numbers, and the fact that the jumps last month only offset previous big declines, they are scarcely decisive. But, there have been some changes in the economic backdrop that encourage one to think that the upticks in the data will not prove to have been false starts.

The early and successful conclusion of the military conflict in the Gulf clearly has given a boost to confidence. Consumer sentiment as measured by the Michigan Survey Research Center has moved back to the levels prevailing before the Iraqi invasion, mainly on the strength of greater optimism about the business outlook. Consumers say that they think it is a much better time to buy durables and houses; that thought doesn't appear to have translated into significantly higher car sales through mid-March, but there is fairly persuasive anecdotal evidence that residential real estate is moving. Furthermore, given the Saudi's unwillingness to accept deep output cuts, oil prices appear likely to run even lower than we had assumed earlier, implying more of a near-term lift to purchasing power.

A lot of financial indicators also are consistent with an upturn in activity. As Peter and Sam noted, the stock and bond markets and the foreign exchange market all seem to have responded

recently to elevated expectations of prospects for U.S. economic activity. And, while I would be among the last to attach great weight to the zigs and zags in the monetary aggregates, the acceleration of the "Ms" certainly is not a negative sign. Even the credit supply adversities appear to have lessened, with risk premia on corporate securities narrowing and banks regaining some access to the capital markets.

In sum, it appears that we are at a juncture where greater consumer confidence and lower costs of capital should turn the economy upward soon. As we suggested in the Greenbook, history suggests that, if the turn is indeed at hand, then there is a significant risk that the dynamics of the process will produce a considerably more forceful upswing than we have projected.

But, as we also noted, there are downside risks to the forecast as well. In the near term, for example, it is conceivable that businesses will be so cautious about stepping up orders that cutbacks in payrolls will extend even further than we've projected; the result would be a loss of personal income that could override the recent improvement in sentiment and restrain consumer spending. Looking farther down the road, another obvious concern would be that the economy will not get the anticipated impetus from export demand over the next year or so. We addressed that question in the chart show last month, and Charles will be taking another look at it momentarily, in the context of the recent surge in the dollar.

Before that, however, I'd like to conclude with just a few words about the inflation outlook. The recent news in this regard

obviously has been mixed. The recession has put a damper on wage increases, and the sharp drop in energy prices has produced some good overall PPI and CPI numbers. But the increases in the PPI and CPI ex food and energy thus far this year have been disappointing. One is always a bit leery about telling "special factors" stories, especially when the list gets as long as it has been of late. However, we believe that there is good reason for discounting the recent figures heavily, owing among other things to identifiable tax effects and seasonal adjustment problems, not to mention simply the implausibility of the enormous run-up in out-of-town lodging prices in the CPI.

Our assessment is that we should continue to anticipate a significant reduction in the underlying trend of price increase this year, but the recent index readings do underscore the point that the momentum of the inflationary process is not easy to reverse and that the current and projected degree of slack in the economy is modest by comparison with past recessions. It would not take a recovery very much stronger than we have projected to virtually eliminate that slack by next year and, in that event, progress toward price stability likely would be rather meager.

Charles...

C. Siegman
March 26, 1991

FOMC Presentation -- International Developments

Sam Cross already reported in detail on the extraordinary appreciation of the dollar that has occurred over the intermeeting period. In light of this development, I will comment on the staff's forecast for the dollar over the projection horizon.

Taking into account the very sharp appreciation of the dollar in recent weeks, in the current Greenbook forecast we have adjusted the path of the dollar by nearly 5 percentage points above the path assumed in the January Greenbook. However, we assume that the value of the dollar will retrace some of its more recent gains and then remain unchanged on average in terms of the G-10 currencies.

Factors cited by Sam provide some reasons for the recent strength of the dollar over the past month. In the staff's view, once the euphoria associated with the Gulf war victory recedes, market participants will again focus on fundamental economic factors that affect exchange rates. On the whole, these fundamentals have changed somewhat over the past month, but not enough to offer a full explanation of why the dollar, which was under considerable strain only seven weeks ago, has risen so sharply since.

We have revised down somewhat our forecast for average growth in foreign countries for this year. However, it remains in the 2-1/4 to 2-3/4 range over the next two years -- as

strong or stronger than last year. With inflation rates abroad expected to recede somewhat on average over the forecast period, we see some likelihood that monetary policies will allow foreign short-term interest rates to decline a bit, but not by more than we saw previously and, importantly, not by more than is already reflected in the term structure of foreign interest rates and in the value of the dollar. The extent of the recent appreciation of the dollar substantially exceeds the response we would expect to the limited change in interest differentials that has already occurred and that is implied by the staff assumption regarding the paths of U.S. and foreign interest rates.

The forecast for the current account balance shows a somewhat greater narrowing between the U.S. deficit and the surpluses of Germany and Japan than was projected in the previous forecast. The U.S. recorded current account for the first half of this year will show a dramatic improvement -- in fact, moving into temporary surplus. This will be primarily due to the inclusion of cash grants from foreign governments to support the Desert Shield/Storm effort. These transfers do not go through foreign exchange markets, and, therefore, should not affect exchange rates. Excluding these transfers, the U.S. current account, while improving considerably from 1990 levels, nevertheless is expected to remain in deficit by close to \$50 billion by the end of the forecast period. In contrast, the current account surpluses of Germany and Japan, excluding their financial contributions related to the Gulf war, come down from

recent highs, but still are expected to remain in the range of \$25 to \$30 billion in 1992.

Given these changes over the intermeeting period in underlying economic factors affecting relative currency values, we felt that it would be premature to regard the current level of exchange rates as representing rates that necessarily will prevail over the forecast period.

Nevertheless, what if, contrary to our assumption, the recent strength of the dollar persists and even intensifies? It would be useful to provide the Committee with an estimate of the impact of an arbitrary 10 percent appreciation of the dollar against G-10 countries relative to the values for the dollar assumed in this Greenbook forecast, based on the staff's econometric model. This would put the dollar at 1.70 DM and 145 yen, and weighted average of the dollar of 93.5. As you know, the model is useful in providing rough orders of magnitude of effects rather than in predicting their precise time patterns.

As a first approximation, the staff's model suggests that a sustained 10 percent appreciation of the dollar, assuming the staff's current policy assumptions for M2, would reduce the growth rate of real GNP by about a quarter of a percentage point over the four quarters of 1991 and by a further half a percentage point in 1992. The impact on real GNP involves a reduction of real net exports of goods and services, erasing about three quarters of the contribution from net exports to real GNP that is being projected in the current

Greenbook forecast. With regard to prices, a 10 percent appreciation would lower the U.S. CPI by a quarter of a percentage point over the four quarters of 1991, with a further one-half percentage point reduction in 1992.

In order to offset the impact of a 10 percent appreciation on real GNP and bring the economy back on track by the end of next year, the staff's model suggests that U.S. short-term interest would need to decline by about 100-125 basis points by the end of 1992, depending on the pace of offsetting the impact on GNP.

Mr. Chairman, that concludes our presentation.

March 26, 1991

FOMC Policy Briefing
Donald L. Kohn

As Mike noted, a variety of financial variables seem supportive of the general outlook of the staff forecast in pointing to at least a moderate rebound in activity in the not-too-distant future. I want to develop this theme in two ways. First, by discussing the dramatic turnaround in the money supply. And second, by looking at the interactions of market expectations with potential Committee actions and strategies.

Money stock growth over the last two months has been a good bit more than the staff projected judgmentally, and even a little more than the models predicted. The expansion of M2 presumably is primarily a response to the sizable declines in market interest rates since last fall and associated decreases in the opportunity costs of holding M2, as M2 deposit rates, as usual, lag the adjustment in money market rates. Under alternative B, the staff is projecting continued fairly robust growth in M2 over the second quarter--at a 5-1/2 percent pace--leaving it in the upper half of its target range. Over coming months, M2 should continue to be boosted by previous declines in interest rates, though less so than in the last few months, and by the projected pickup in income growth.

What might be the implications of the recent and projected strengthening of money growth?

First, the surge in M2 growth probably represents, in part, some return of confidence in depositories--or at least indicates that the erosion probably has ceased; growing concerns about deposit safety likely

had been one factor holding down money growth over previous months. Deposit inflows have coincided with narrowing spreads of bank debt over Treasury securities and increases in bank equity prices. The turnaround in confidence might reflect an apparent stabilization in some real estate markets, the failure of additional unanticipated banking problems to materialize, and more visible efforts to shore up the deposit insurance system. Such a development may well have been a critical condition for an economic rebound, and so the acceleration in M2 is encouraging in this regard.

Second, the strength in money may give us some comfort that current income is not falling substantially short of expectations. Though contemporaneous velocities can vary over a wide range, and we have seen major shifts in money demand relative to income, the M2 growth rates seem largely explainable with observed interest rates and greenbook income projections. This contrasts to some extent to the situation last year, when unexpected weakness in money last spring and again last fall were one sign that the economy might be softer than estimated.

Third, collateral evidence suggests that the behavior of M2 may not as yet indicate a significant loosening of credit availability by banks, though conditions probably are stabilizing. Although bank credit has strengthened in February and early March, growth remains moderate after taking account of some special factors, such as acquisitions of real estate loans in the process of taking over failed thrifts, and rebooking of loans from foreign branches. Continued sluggish expansion of bank and other credit through the first quarter is not surprising in light of the effects of recession on demands for funds. The very high level of the

prime rate relative to market rates--indeed an increase in that spread-- suggests continued supply side credit restraint, as do bank responses to a recent, abbreviated, survey of bank lending practices.

Fourth, with regard to future income growth, actual and predicted strength in M2 seems consistent with a rebound in the economy, but does not yet seem indicative of so strong an expansion in future nominal income as to produce an upsurge in inflation pressures. At some point, money growth sustained at high levels might point in that direction and weigh on the side of tightening policy. Indeed, such growth could provide a useful signal, and rationale, should tightening become necessary later this year or in 1992 to head off inflation pressures anticipated as the economy approached effective capacity. The surge of the last few months, however, just brings M2 back to the midpoint of its range, and while it would be in the upper half under alternative B in the staff forecast, such growth follows a shortfall last year; June-over-June, M2 growth under alternative B would still be only 4 percent. Moreover, some of this growth is being reflected in declines in velocity.

As I noted previously, the strength in M2 seems mostly to be a reflection of the decrease in short-term interest rates since last fall, and judgments about the implications of M2 growth can not be divorced from judgments about the implications of those declines in rates. A drop in nominal rates, by itself, has no necessary carry-through to real rates, especially in a period like that of the last eight months of volatile inflation and inflation expectations. Real short-term rates would seem also to have fallen since last summer, since inflation expectations have not been revised down by the 1-1/2 to 2 percentage points decrease in

nominal rates. Whether real long-term rates have also declined is less evident. Despite the drop in short-term rates, nominal long-term rates are only a little lower than they were last July, and it seems unlikely that inflation expectations have moved appreciably away from the underlying trend of prices evident for several years. Nonetheless, the greenbook forecast implicitly views these rates low enough to encourage expansion, and so do the financial markets. Indeed, real long-term Treasury rates would appear to have risen over the intermeeting period because of the strength in spending expected by the market. The rise in the dollar and continued softness of commodities markets suggested that the backup in nominal bond yields was weighted toward real rates, and not a resurgence of inflation concerns. That the higher rates accompanied a steepening of the yield curve along with increases in stock prices indicated that they were a product of expected strength in the economy, not anticipation of tighter monetary policy. Judging from the structure of rates, the rebound in the economy is not predicated on a significant further easing of policy.

If market participants are correct in their assessment of aggregate demand, and if they have built into their expectations a course for monetary policy consistent with the Committee's objectives, these changes in bond and stock prices and in foreign exchange rates etc. should be constructive and stabilizing. Dilemmas for the Committee would arise if it saw either the developing economic situation or the ultimate outcome in terms of inflation in a different light. In particular, if the Committee saw policy as not yet positioned to assure an adequate economic recovery, easing policy, as under alternative A, at a time when markets already

were expecting a rebound in the economy and little long-run progress in inflation, could provoke a strong market reaction, potentially including a backup in bond yields as well as a substantial decline of the dollar. Neither of these events would short-circuit the Committee's intention to better assure a satisfactory expansion. The dollar decline might be particularly welcome if its recent strength were one reason the Committee were concerned about the outlook. And the increase in bond yields would involve a rise in nominal, not real rates. Eventually, as data confirming the Committee's judgment become available, bond markets would reverse. The risk is that the near-term loss in credibility and in predictability of Federal Reserve policy might not be immediately recouped. Still, delaying action until the market expectations were more conducive would risk a greater shortfall in economic performance.

If the Committee believed that the odds favored a satisfactory outcome at the current federal funds rate, so that alternative B was its option, it still would be faced with choosing an approach to intermeeting adjustments. Retaining an asymmetrical directive would acknowledge that easing was more likely than tightening over the intermeeting period, and that available information on economic and financial conditions did not yet warrant a judgment that the risks of undershooting and overshooting the Committee's desired path for output and prices were evenly distributed.

A symmetrical directive would seem to reflect a view that recent information, including the behavior of financial variables, did now suggest a better balancing of risks around the Committee's objectives. Such a directive need not mean that the Committee saw a distinct possibility of

tightening over the intermeeting period, or ruled out further significant easing. The period ahead is likely to present policy with the difficult combination of further weakening in current indicators even as a trough in activity and subsequent expansion is projected. A symmetrical directive would be consistent with the view that this might be a good time to wait for fairly definitive evidence that the current economy was on a substantially weaker track than expected, or that the upturn would be delayed or insufficiently robust before undertaking additional ease.