

## APPENDIX

NOTES FOR FOMC MEETING

July 2, 1991

Sam Y. Cross

When you met here in mid-May the dollar had entered a period of temporary stability. The exuberance of the dollar's recovery in February and March had faded in light of uncertainties about the timing and strength of the anticipated U. S. economic recovery and the dollar was fluctuating with no clear trend. Since then, however, the dollar ratcheted up another notch, and rose by about 5 to 6 percent on average in the intermeeting period, though the rise was nearly 8 percent against the mark and less than 1 percent against the yen. Sentiment toward the dollar remains positive; July has started out with further upward movement and there is a widespread view in the market that the dollar still has upside potential.

The latest boost in sentiment began in late May. A series of economic data, starting with housing and personal income, persuaded many market participants that the U. S. recovery was, in fact, underway and might also be more robust than previously foreseen. Soon thereafter, the dollar received further reinforcement from political and economic uncertainty in Germany, particularly following a state election victory by the opposition Social Democrats in early June. Although market participants were wary how the monetary authorities might respond to the dollar's renewed rise, they bid the dollar up, especially against the mark, during the first half of June.

As the dollar rose, market participants recognized that the rally might be causing problems for Germany and to a lesser degree Japan.

Throughout the spring, German officials had pointed to the need for a strong mark to assist the financing of unification. It was feared that, in both Germany and Japan, currency weakness might force the central banks to maintain tighter monetary conditions than were appropriate for purely domestic considerations. The market was watching for evidence that the authorities in those countries might try to forestall such moves by intervening to contain the dollar's rise and by seeking cooperation from the United States and others in those intervention efforts.

In fact, the Bundesbank did initiate a round of coordinated intervention with most other European central banks and the Bank of Japan on June 10. Although the United States did not join, these operations and expectations of similar ones later on served to dampen the dollar's upward momentum at times. By mid-June talk had begun to spread that the G-7 Finance Ministers and Central Bank Governors would meet prior to the July summit to arrange a major effort to cap the dollar's rise. So when such a meeting was announced for June 23, the dollar retreated sharply before steadying.

Nevertheless, underlying sentiment towards the dollar continued to be bolstered by prospects of near-term recovery in the U.S. economy. As a result, when the initial market interpretation of the G-7 communique was that it offered no new initiative to the dollar, at first the dollar rose. But, almost immediately, interpretive comments by a number of officials--from France, Japan, and Britain--caused the market to reevaluate its skepticism about the likelihood of coordinated G-7 intervention. Also, reports began to circulate that the

Bundesbank was selling U.S. Treasury securities. Market gurus speculated that the German central bank was either building its war chest for a major intervention or, alternatively, that it was preparing to buy back accumulated mark reserves from the Federal Reserve and the Treasury so that the United States would then be in a position to conduct large-scale intervention. In these circumstances, the dollar gave back most of its gains in the past week or so since the G-7 meeting.

Other developments last week also tended to weigh on other currencies and thereby helped add to the dollar's attractiveness. With respect to the German mark, uncertainty that a controversial withholding tax might be reimposed resurfaced last Thursday when the German High Court set a deadline for more effective taxation of investment income. This led to a sharp sell-off in all mark assets and a broad decline of the mark against other currencies. Also, the reemergence of turmoil in Yugoslavia supported the dollar and weighed on the mark, reflecting Germany's economic exposure to that nation.

The yen has generally been somewhat less weak than the mark. Nevertheless, the latest securities scandals have at times made market participants uneasy about foreign investors' reaction, and have led to some sapping of the yen's strength in the exchange markets as well as to renewed weakness in Japan's equity market. Yesterday, the Bank of Japan lowered its official discount rate one-half percentage point, to 5-1/2 percent. Although the timing of the move had not been widely expected, talk of a lowering of Japanese interest rates had been around for months and the stock market decline of recent days was seen by many as likely to argue for an earlier monetary policy action.

The U.S. monetary authorities intervened on only one occasion during the period; that was in late May when Sweden announced its decision to link the krona to the ECU. The change in Sweden's exchange rate regime had balance sheet implications for a lot of Swedish institutions that had borrowed dollars. With the announcement coming out late in Europe on a Friday, the dollar/mark market was the only one still open to absorb the hedging operations these institutions needed to do, and the rush to hedge prompted a temporary but sharp rise in the dollar against the mark. These pressures were met by substantial intervention by the Bundesbank and the Swedish Riksbank. The Desk sold \$50 million in cooperation with that effort.

The only other operation during the period is one we have already reported--the off-market currency exchange with the Bundesbank. As you know, we agreed to exchange, at market rates, DM 10 billion for approximately \$5.5 billion, with the Federal Reserve exchanging DM 6 billion and the Treasury DM 4 billion. These exchanges are to occur in installments, the first of which was for DM 4 billion, which settled on June 27, and the remaining six are each for DM 1 billion and will occur on agreed dates over the next six months. Entering this arrangement immediately reduced the Federal Reserve's exposure, or net open position, by the full DM 6 billion. The exchange produced for the Federal Reserve a realized profit of \$103.4 million on the first transaction and an estimated \$139 million more on the remaining six transactions.

Mr. Chairman, I would like to request the Committee's approval of the operations of the period.

July 1, 1991

FOMC MEETING NOTES  
JULY 2 - 3, 1991

JOAN E. LOVETT

Desk operations during the intermeeting period were geared to maintaining unchanged reserve conditions, expected to be associated with Federal funds trading in the area of 5 3/4 percent. The borrowing allowance was raised for technical reasons in light of normal springtime increases in seasonal use. The allowance was raised in four steps by a total of \$125 million, bringing it to \$325 million. Actual borrowing ran a bit above the allowance over the first three periods, reflecting occasional use of the adjustment facility by larger banks. For the period in progress, it is running considerably higher in the early days in part because of reserve shortages at quarter-end.

The funds rate was reasonably steady throughout the intermeeting period, averaging pretty close to the 5 3/4 percent central point. The quarter-end saw relatively mild rate pressure, but skimpy reserve balances led to a firming by the close which has carried into the early days of this week.

Reserve management was pretty uneventful during the first two maintenance periods. Rising reserve needs were anticipated and were met through a combination of outright purchases and RPs, mostly of the customer variety. The purchases came to \$3.6 billion, including about \$1.1 billion of bills and notes purchased from foreign accounts and \$2.5 billion of bills

purchased in the market on May 29. The market generally expected a stable Fed policy stance but, near the outset of the period, a soft funds rate in conjunction with a weaker durable goods report generated some market discussion which the Desk dampened with a round of MSPs.

Reserve needs were much more uncertain in the third period, which was characterized by large revisions to the outlook moving through the period. Uncertainty about the timing and magnitude of June tax payments to the Treasury was the key difficulty. Many market analysts appeared to be having similar difficulty and, consequently, anticipated Desk operations on either side of the market depending on these flows. In fact, we drained reserves twice and added on three occasions, acting when the weight of the estimates and reserve market conditions suggested the need. The operations added on balance.

The period in progress showed a fairly sizable reserve need, and our early actions were designed to start meeting it as well as to assure sufficient clearing balances over the quarter-end weekend. However, market demand for these reserves was not there at the time as most participants apparently felt adequately positioned. Thus, dealers terminated early the bulk of the 4-day RPs we had arranged and gave us only meager propositions when we tried to replace them. As a result, clearing balances over the quarter-end weekend were skimpy, and we got \$1.5 billion of

borrowing. Given current and prospective needs, we again began supplementing our RPs with outright purchases from foreign accounts over recent days, buying a total of about \$300 million in the period underway.

Following your last meeting, market interest rates were, on the whole, generally steady over the remainder of May. Data at month's end soon gave rise to rumblings about an earlier-than-expected recovery, and the surprise increase in May NFP announced in early June put a focus on both an earlier and potentially stronger rebound. Market rates rose a solid 20 to 35 basis points by mid-June as the new outlook was factored in and, except for very short maturities, the increases came pretty much across the yield curve. Following the employment report, a fairly steady stream of data added to the notion that the economy had begun up the path to recovery, as did remarks by Federal Reserve officials.

Having discounted the recovery early on, differing views about its strength and sustainability caused some trimming in rates on Treasury issues over the balance of June. Market views on this score are divided. Some see a healthy though not vigorous rebound, and others still look for anemic growth or downside risks. Supporting arguments for each case have left participants in a guarded mode. The "standard" consensus probably calls for real growth around 3 percent over

articles on the health of the banking system and periodic drops in equity prices here and abroad acted at times to suppress the rate rise. The Treasury issued a net of \$24 billion in bills during the period. The auction held yesterday--for a record \$20.8 billion--brought average issuing rates of 5.59 and 5.71 percent, respectively, on new 3- and 6-month issues, compared with rates of 5.50 and 5.63 percent just prior to your last meeting.

Private short-term rates also rose by about 10 to 25 basis points. For most of the period, quality spreads widened only a little. The default by Columbia Gas System on some maturing CP elicited a fairly muted response in the paper of other issuers, apparently because its particular financial difficulties were deemed specific to the company. Despite the focus on the banking system, quality spreads there were also fairly quiescent--in fact modestly narrower--until late in the period. The ease with which this market slipped the other way suggests that the recent stability was tentative. The Wells Fargo announcement on June 25 caught the market off-guard and aroused fresh concerns about asset quality more broadly. Rumors of various banking problems surfaced over the remainder of the week. The so-called "TED" spread widened out by 9 basis points on the last week, with downward pressure on longer-term BHC debt and equity prices resuming.

After adjusting higher through mid-June, intermediate and longer Treasury maturities settled into a trading range. The long bond approached 8 5/8 percent briefly but receded back to around 8 1/2 percent thereafter. The Treasury raised some \$18 billion of new cash in this sector during the period. It appears that Treasury net marketable borrowing came in pretty close to the \$40 billion second quarter estimate provided by the Treasury at the time of the May refunding. Associated cash balances look to have finished the quarter about \$9 billion higher.

The Treasury's May 2-year note auction commanded a fair amount of market attention early on and again more recently. In that auction, as you recall, a few bidders stepped ahead of the market talk, spurring reports of concentrated holdings and fears of shortages. When the issue subsequently began to rise in price in both the cash and financing markets, cries of "foul ball" were heard from some participants. Others at the time seemed to feel that this was the byproduct of trading strategies that the market should be able to take in stride, so long as it did not pose a threat to the process going forward.

Market discussion of the matter seemed to fade when the issue began to move back toward more normal alignment on the yield curve, though it remained relatively expensive in financing markets. However, concern resurfaced later in June as the market

approached another auction of 2-year notes. Most participants were fearful of setting up pre-auction short positions given the prior experience. The normal spread between the outstanding and when-issued security widened out going into the auction and it has moved even further over recent days. Given the caution, the auction came a little behind immediate pre-auction when-issued trading. Meanwhile, the Treasury has been reviewing its auction procedures with a view to probable change amid signs of discomfort with the auction process.

On the whole, rates on intermediate and longer Treasury coupon issues ended the period about 15 to 20 basis points higher. In the 2-year area, rates were roughly 10 basis points lower to 10 basis points higher though there was a flare-up in volatility there today for reasons that are not entirely clear.

Finally, in other markets, corporate spreads remained quite tight despite sizable new issuance throughout the period. There is currently some debate in the market about whether such narrow spreads can be maintained. The municipal calendar was also large, in part reflecting heavy issuance of short-term notes going into the June 30 fiscal year-end of many states. A number of these entities are struggling with severe budget problems which placed some upward pressure on their yields. The Bridgeport bankruptcy filing generated little fallout.

Michael J. Prell  
July 2, 1991

CHART SHOW PRESENTATION -- DOMESTIC ECONOMIC OUTLOOK

As you know, recent data have been almost uniformly positive, providing strong evidence of a turn in the economy. Chart 1 displays the Commerce Department's composite indexes of economic indicators. The leading indicators, in the top panel, have risen every month since January, and according to our LEI-based probability model, we can be highly confident now that a recovery is in train.

The coincident indicators, in the bottom panel, have begun to confirm the upturn, flattening out in April and edging up in May. This suggests that the trough month probably will be March or April, and I've used April and the second quarter in these and subsequent charts.

Of course, all this leaves some important questions unanswered--notably, what the character of the ensuing expansion will be and what it will bring in terms of inflation and the U.S. external position. Chart 2 begins the examination of these questions.

The top panel shows four-quarter percent changes in real GNP. It is apparent that the expansion we've projected for the next year and a half is more subdued than most of the prior upswings plotted. It is tempting to say, simply, that mild recessions, such as that we just experienced, naturally beget mild upturns. In fact, the correlation is quite good, but, given that it is based on a small sample, one might not want to depend on it. In any event, I know that

you would feel deprived if you did not have the benefit of our insightful--or at least lengthy--analysis of the forecast.

We see three major factors underlying the turnaround in the economy. The first two of these are basically the reversal of the negative forces unleashed by the Gulf crisis last summer: namely, the jump in oil prices and the sudden plunge in consumer and business confidence regarding economic prospects. The third factor is the interest rate decline fostered by the System and the easing in financial market conditions more generally, reflected in narrowing risk premia and improved access to the capital markets for many financial and nonfinancial firms.

Of these three influences, the monetary stimulus is perhaps the most difficult to assess, for the indicators in this area are rather ambiguous. For example, although interest rates have come down in recent quarters, they've not declined as much as in some other recessions, especially at the long end of the maturity spectrum. This could mean that the monetary impulse has been less, or perhaps that the expected returns on capital have held up better. Looking at the monetary aggregates, M2 hasn't accelerated the way it did in past recessions, but, of course, we no longer have the deposit rate ceilings that played such a big part in the past and there have been notable changes in patterns of intermediation that may be accommodating the flow of funds to investors with little adverse effect on aggregate demand. And then there is the rise in the dollar this year, which might suggest a restrained monetary policy, but may reflect, importantly, an elevation of expectations regarding U.S.

economic performance. Sifting through all of this, we conclude that the economy currently is benefitting from an expansionary monetary impulse, but probably one of lesser magnitude than those in some other cycles.

There are, to be sure, some other, sectoral considerations that distinguish this upturn from earlier ones, and these are reflected in the table at the bottom of the page. The table shows the contributions of various expenditure categories to the projected increase in real GNP, comparing the current upswing to those that began in 1961, 1970, 1975, and 1982. In light of the uncertainty about which quarter the NBER eventually will select as the latest trough, I've shown calculations based on both the first and second quarters of this year. As it turns out, it doesn't matter much which of those two quarters is used--the picture is fundamentally the same.

I'd offer the following observations on these data:

(1) The first-year GNP increase we've projected is smaller than the 5-1/2 percent average of the prior upturns; only the upturn after 1970, at 3.2 percent, fell short of the 6 percent mark.

(2) Inventory investment, the next-to-last line, is likely to provide its usual boost to production; aggressive destocking has laid the groundwork for a sizable swing in inventory investment, even while businesses maintain a tight hold on ratios of stocks to sales.

(3) As the memo item indicates, it is final sales that account for the smaller gain in GNP this time.

(4) Consumption, construction and government purchases all look to be areas of subpar contribution, while we think that exports

will make a relatively healthy contribution to GNP over the coming year.

I'll be exploring those relatively weak components of domestic demand in the next few charts, and Ted will be addressing the outlook for the external sector.

Turning to chart 3, a basic premise of our forecast is that the personal saving rate is so low now that it would be unreasonable to anticipate that consumer spending will outstrip the growth of disposable income. The saving rate was 3.6 percent in May, according to last week's release, and it edges up to just 4 percent in our projection.

One is given at least slight pause in this cautious assessment when one looks back at late 1982. Then, too, the saving rate was low by the standards of prior years and household debt burdens were historically high. Indeed, as you can see in the middle panels, at the end of the '82 recession, consumers themselves were reporting an unwillingness to use savings or to borrow for major purchases rather similar to what they are saying today. Yet spending proceeded to vastly outstrip income growth in the ensuing expansion. In contrast to 1982, however, we are starting at a lower saving rate and, as shown in the bottom panel, we are coming off a period of extraordinary accumulation of durable goods, rather than a deep recession in which an appreciable pent-up demand developed.

Our judgment is that the current concerns about financial stress in the household sector probably are, once again, overdone, but

that, unless there is a surge in household wealth like that in the 1980s, consumption is unlikely to outpace income growth.

In search of that income growth, then, let me turn to the construction sector--which is treated in your next chart. In past expansions, private construction activity--in particular, homebuilding--provided substantial impetus to job and income growth in the first year. The thrust probably will be considerably less impressive this time. Housing starts and sales have picked up in recent months and should increase further. But we see a couple of limiting factors on the supply side of the market. The first of these is illustrated in the top panel, which shows the remarkable rise in the number of vacant housing units during the past decade. A testament to the potency of builder optimism and lender profligacy, the existing overhang of unoccupied units is likely to damp prices and new construction in a good many markets. The other negative supply factor is the marked shift in credit availability for land acquisition and development, even in the single-family sector; we continue to think the problem here is often overstated, but we don't think it is non-existent. Many smaller, less well capitalized builders undoubtedly are encountering some difficulty in finding financing even for sound projects.

There is, of course, a similar problem in the nonresidential construction sector. As the middle panel shows, contracts for private nonresidential building--the solid line--have been trending downward for a while and construction activity has a considerable way to go to catch up. In past expansions, nonresidential construction has lagged

the general business upturn by a few quarters, but in this instance we expect that it may be at least a couple of years before construction turns around. Justifiably, in terms of the damage it has been doing to financial institutions, the commercial real estate bust has been the focus of much attention. The bottom left panel indicates that office vacancy rates remain very high, and with prices and rents remaining soft, lenders are likely to be preoccupied for some time with managing their losses and with avoiding new exposures. Other commercial properties also appear to be in ample supply; although the imbalance probably is less serious than that for offices, a significant upturn in building probably will be slow in coming. All that said, though, the panel at the right is intended to provide a reminder that these sectors represent rather small parts of the economy: investment in office and other commercial structures is less than a percent of GNP. In sum, as far as construction activity is concerned, it is residential--not nonresidential--building that is likely to be the important story in terms of subpar impetus to economic expansion over the coming year.

I've mentioned financial concerns with respect to both the household and business sector. While there clearly are some strains in the financial markets that will linger for a while, we don't believe that they represent a serious impediment to expansion--at least not to the kind of moderate upswing we're projecting. The top panel of chart 5 shows our projection of borrowing, scaled by nominal GNP. As you can see, we believe that the projected level of spending can be financed with still low rates of credit growth. The middle

panel reveals one reason why we don't anticipate heavy borrowing by businesses: namely, we believe that firms will not be engaging in the kind of leveraging that produced massive net share retirements--the red line--in the 1980s. Similarly, in the household sector, with real after-tax interest rates high on consumer loans, with asset values not providing the same support for expanded borrowing, and with the pressure less intense to buy new big-ticket durables, we expect borrowing to pick up only a bit in the period ahead. We believe that these private credit needs and those of the government sector can be met without undue strain on financial intermediaries.

Speaking of the government sector, chart 6 focuses on the federal component. The top panel compares federal purchases in this cycle versus other recent cycles. Notably, purchases are expected to be weaker in the coming year--the solid red line--than in any other expansion with the exception of that following the 1970 recession--the dashed red line. Interestingly, that too was a period of military retrenchment and, as I noted earlier, of relatively weak economic recovery.

The middle panel shows our measure of the impetus being delivered to aggregate demand by discretionary fiscal policy action. The budget agreement reached last year implies significant restraint during this recovery. This is a considerable departure from the experience in some earlier cycles, when there were tax cuts, social security benefit hikes, or other stimulative actions as the economy pulled out of the recession.

This difference is visible in the unified budget figures, shown below. When one strips out the foreign contributions to the Defense Cooperation Account and the effects of deposit insurance, the widening of the unified deficit this fiscal year is fairly mild--and in significant part explained by Desert Storm outlays.

Like the federal government, states and localities are facing significant budgetary constraints at present. The top panel of chart 7 shows that the operating and capital account deficit of the state and local sector has become very deep over the past few years. This gap has developed in a different way than did those in the past. The persistent gaps of the 1960s reflected heavy infrastructure investment, largely financed by federal grants or borrowing rather than by taxation; as you can see in the bottom panel, structures outlays have been trending upward once again in the past decade, but they don't loom as large relative to the overall size of the sector's expenditures as they did in the '60s. The deficits in the mid-'70s and early '80s were basically transitory phenomena related to cyclical shortfalls in revenues. But the recent deficit emerged during a period of economic expansion, and reflects in large measure a structural problem of tax limitations and growing demands for services. The pressures have been exacerbated by the imposition on states and localities of burdens mandated by federal initiatives--without commensurate grants.

In any event, these units are now responding in a variety of ways to the fiscal imbalance. We are seeing both higher taxes--some of which are adding directly to measured inflation--and spending

cutbacks. In many cases, those spending cutbacks are from very ambitious plans, and so they don't imply large absolute declines. And they often are in transfer payments or in compensation rates--neither of which is directly reflected in the GNP component, real purchases of goods and services. Nonetheless, we anticipate enough layoffs and construction postponements to produce a relatively weak contribution to economic expansion from state and local purchases.

Chart 8 summarizes the inflation outlook associated with our projection of a moderate expansion. The top panel shows our forecast that, as usual, much of the initial increase in output will be achieved through increases in labor productivity. Thus, as indicated in the middle panel, unemployment will be slow to drop off and is expected to remain well above 6 percent through next year.

The red shaded areas in the middle and bottom panels highlight periods when the actual unemployment rate has been above the nonaccelerating inflation rate of unemployment, or NAIRU. Not surprisingly, given that this estimate of the NAIRU is derived from the observed relation of unemployment and inflation, you can see that these periods have generally witnessed decelerations of consumer prices. Because we anticipate that the slack in the labor market will remain significant, and pressures on plant capacity modest, we expect to see inflation trending downward through 1992.

Ted will now continue the briefing.

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E. M. Truman  
July 2, 1991

Chart Show Presentation -- International Developments

Chart 9 summarizes the staff's outlook for the U.S. external accounts. The major factors affecting that outlook are presented in the box at the top of the chart.

The principal factor is the recovery of U.S. domestic demand which will stimulate demand for imports. At the same time, we expect a moderate pickup in growth on average in the major foreign industrial countries. This will help to support U.S. recovery.

On the negative side for domestic growth, we are projecting that most of the recent strength of the dollar will persist over the forecast period. On our weighted-average basis, with the rise today, the dollar has risen close to 6 percent since the May Committee meeting. We continue to think that some of the influences tending to push the dollar up are temporary, and that the dollar will drift off a bit from its recent highs. However, we are now projecting that the dollar will average about 5 percent higher over the forecast period than in the May Greenbook. This tends to restrain the domestic expansion as well as inflation.

A neutral element in our outlook is the assumption that oil prices will remain near current levels. This is based on our belief that Saudi Arabia will adjust its production to

avoid any substantial price fluctuations, especially as Iraq and Kuwait resume exporting.

The lower panel summarizes the effects of these various factors on our projection of U.S. external balances. As the red line indicates, real net exports of goods and services will make a small negative net contribution to U.S. real GNP over the forecast period -- about 20 billion 1982 dollars over the seven quarters from the first quarter of this year through the end of next year. Meanwhile, the current account is projected to settle down to a deficit of about \$45 billion by the fourth quarter of this year after the contributions to the Defense Cooperation Account are no longer coming in. Next year, the deficit should widen to somewhat more than \$50 billion. However, compared with several years ago, deficits of this size would be a substantial improvement both in absolute terms and as a percentage of GNP.

The next chart summarizes recent developments with respect to exchange rates and interest rates. As is shown by the red line in the top panel, the dollar through June on average had appreciated about 15 percent in real, or price-adjusted, terms since its low of February [July 2 about 2 percent above June average]. On this basis, the dollar was only about 3 percent above its average value since February 1987, the post-Louvre period. Roughly the same relationship holds for the Deutschmark and the yen; however, in nominal terms against the DM, the rate today is essentially the same as at the Louvre meeting [183.05 compared with 153.65 for the yen].

The dollar's rise over the first half of 1991 appears to have been fueled by the quick and successful end of the Gulf War and, more recently, by prospects of a stronger U.S. recovery than earlier anticipated. At the same time, special factors have affected some of the other currencies. Political factors within Germany and in the Soviet Union and, more recently, Yugoslavia have weighed on the DM along with a growing sense that the Bundesbank is constrained not to move aggressively against incipient inflation forces in that country. Thus, as is shown in the box at the left in the middle panel, so far this year through the end of June, the dollar appreciated 21 percent against the DM, but only 3 percent against the yen, and it depreciated slightly against the Canadian dollar.

The black line in the upper panel indicates that U.S. real long-term interest rates have risen relative to rates abroad this year. It is clear from the box at the right in the middle panel and the charts in the lower panel that, while U.S. short-term interest rates have fallen more than rates abroad, U.S. long-term rates have risen somewhat at the same time that rates abroad have tended to decline. Developments since last Friday have tended to reinforce these trends in long-term rates. Such a shift in the structure of interest rates is consistent with the expectation of a recovery in the U.S. economy, the likelihood that U.S. interest rates will be higher at some point in the future (particularly relative to foreign rates), and, therefore, the strengthening of the dollar that we have seen.

Cyclical patterns abroad vary considerably from country to country. The top panels of Chart 11 illustrate the very different patterns of industrial production in the major industrial economies. Production in Japan and Germany is still expanding at quite rapid rates on a year-over-year basis. As is suggested by the data on consumer prices presented in the middle panels, these countries still face what for them is high inflation.

Meanwhile, Canada and the United Kingdom remain in recession, though we think that the Canadian economy may be pulling out of its decline. Data on consumer price inflation in these two countries are distorted by a number of special factors: In Canada, by the introduction of the Goods and Services Tax and, in the United Kingdom, by the removal of the influence of rising mortgage interest rates and the poll tax. Nevertheless, enough slack has opened up in both economies that inflation pressures are receding. Production is weak in France and Italy, pressures on capacity have been reduced, and unemployment is rising. As a consequence, there has been a further narrowing of the gap between inflation in these countries and inflation in Germany. Indeed, the inflation gap between France and Germany essentially has been eliminated.

As is summarized in the box at the bottom of the page, we anticipate that growth will be slowing in Germany and Japan over the balance of this year following very strong first quarters. Inflation remains a concern for the authorities in these countries.

Meanwhile, we think we can detect tentative signs of pickup in some of the weaker economies.

Against this background, we expect that monetary policies will remain cautious, but interest rates may decline further in some countries as inflation eases. We expect that fiscal policy in Germany will become somewhat tighter after the expansion this year, assuming policy is not paralyzed by the political process. Fiscal policies are likely to be on the contractionary side on average in the other countries.

The next chart summarizes our projection for growth and inflation abroad. The upper left panel shows that foreign growth, weighted by shares in U.S. nonagricultural exports, slowed during 1990. Growth in the first half of this year remained at about the same weak rate as in the second half of last year. We are projecting a recovery toward 3 percent over the second half of this year -- a bit less pronounced than the projected recovery of the U.S. economy -- and a further rise to near 3-1/2 percent next year -- somewhat stronger than U.S. growth. As can be seen in the box at the right, the major foreign industrial countries -- the G-6 countries -- account for most of the pickup in foreign growth on average.

The middle panel provides greater detail on our forecasts for the G-6 countries. While economic activity in Germany and Japan has held up well on balance through the first half of this year, we expect that reported real GNP actually declined in the second quarter. After this pause, growth is projected to be moderate in the second half, followed by somewhat

more rapid expansion next year. Growth slowed in France and Italy at the end of last year and in the first half of this year partly under the influence of higher oil prices and a decline in confidence. Both factors have now turned around, and we are expecting a modest pickup in the second half of the year and in 1992.

From the standpoint of our non-agricultural exports, Canada and the United Kingdom are important markets; Canada is our largest market, and the United Kingdom is our fourth largest after Japan and Mexico. We anticipate that the recessions in Canada and the United Kingdom will come to end in the second half of the year, if they have not already, and this should provide a boost to demand for U.S. exports. In Canada, in particular, orders, retail sales, and housing starts are pointing to a pickup. In the United Kingdom, the story is more of a bottoming out and a recovery of confidence. Growth in these countries next year should be respectable but not buoyant, that is, a bit less than the estimated growth of potential output.

Partly as a consequence of the projected moderate recovery and expansion in the G-6 countries other than Germany and Japan, inflation is expected to decline substantially in these countries, as is shown in the lower left panel of the chart. However, some of this improvement is a statistical artifact associated with special one-time factors, such as the Goods and Services Tax in Canada, that will not be present in 1992. Nevertheless, the gap between underlying inflation in these countries and the average rate in Japan and Germany is

projected to narrow substantially. As is shown in the box at the right, the gap between U.S. inflation and the average for all of the G-6 should be fairly small.

Chart 13 summarizes various influences on two important components of the outlook for our external accounts: nonagricultural exports and non-oil imports. Using our econometric model, we have tried to decompose the sources of expansion and contraction affecting these broad categories of merchandise trade. In the case of nonagricultural exports, the top panel, the striped bars show that these exports have been expanding, and are expected to continue to expand, at annual rates of 30 to 40 billion 1982 dollars. As is shown by the red bars, foreign growth over the second half of 1990 and the first half of 1991 has made a very modest contribution to that growth, but in the forecast period, the contribution will increase substantially. Meanwhile, relative price effects, which include not only the dollar's performance but the also behavior of prices and costs here and abroad, have been and will be important in 1991, but will decline in significance next year.

Turning to non-oil imports, the lower panel, the turn in U.S. growth, the red bars, is the dominant factor producing the swing in non-oil imports. While relative prices were less of a positive factor boosting imports in the first half of this year, compared with 1990, they do not have a major influence in our outlook for non-oil imports.

My last chart considers the external sector as the transmission mechanism from the rest of the world to the U.S.

economy. In particular, it addresses the influence of the dollar's rise since February, and the possible consequences of continued weak growth on average abroad. To construct the alternative scenarios presented in the chart, we employed the staff's econometric models and used as a baseline the Greenbook forecast extended through 1993, with M2 growth at 5-1/2 percent and U.S. real GNP growth at 2-1/2 percent.

In the first alternative, we assumed the dollar remained at its February level, almost 15 percent lower than what is built into the current Greenbook forecast. However, the federal funds rate is unchanged from the assumption underlying the baseline. By itself, the February Dollar scenario would imply somewhat higher growth of real GNP this year and substantially higher growth in 1992 and 1993. In contrast with the baseline, the lower level of the dollar is sustained, and its effects tend to cumulate. By the end of 1992, the unemployment rate would be back at 5-1/2 percent, and it drops below 4-1/2 percent by the end of 1993. Not surprisingly, the inflation of GNP prices picks up noticeably by 1993.

One curious feature of this scenario is that foreign growth is higher on average in 1993 than in the baseline. The reason is that relative to our baseline forecast, the Canadian dollar appreciates only slightly against the U.S. dollar but depreciates against the non-dollar currencies; this tends to stimulate the Canadian economy as does the faster U.S. growth. Moreover, we have assumed that interest rates in Canada track interest rates in the United States; as a consequence, they

decline in real terms along with U.S. rates, which also stimulates the Canadian economy. Higher growth in Canada outweighs lower growth in Japan, Germany and the rest of European countries compared with the baseline forecast.

Overall, the U.S. current account deficit at the end of 1993 is somewhat more than half its size in the baseline.

In assessing this alternative scenario, it is interesting to recall that the interest rate assumption that went along with the lower dollar exchange rates in the staff's judgmental forecast back in February was higher than what we now are assuming -- the federal funds rate was about 100 basis points higher. The level of U.S. economic activity projected in February for the fourth quarter of 1992 was almost exactly the same as we are now projecting.

We tried a modification of the February Dollar scenario in our econometric models. In it, the dollar remained at its February level, but the federal funds rate was adjusted to leave the path of U.S. real GNP essentially the same as in the baseline forecast. Our models suggest that to achieve this result, the federal funds rate today would have to be about 130 basis points higher now and increase about another 20 basis points or so over the course of 1992. Given all the factors that can affect our forecasts, this correspondence of judgmental and model-based results is remarkably close. In essence, it can be said that the decline in the funds rate has offset the unexpected strength of the dollar.

The second alternative scenario hypothesizes continued weak foreign growth. We manipulated the demand side of the models to ensure that foreign growth, weighted by U.S. nonagricultural exports, remains at about 1-1/2 percent -- roughly the rate that prevailed over the second half of 1990 and the first half of 1991. Again, the federal funds rate was unchanged from the baseline.

Such a scenario of weak foreign growth has little effect on the growth of U.S. real GNP this year, but it would chop off about 3/4 of a percentage point next year, and almost twice that much in 1993. As a consequence, the performance of GNP prices is considerably better than in the baseline. However, the current balance deteriorates substantially.

To compensate for the lower foreign growth, the models suggested that the funds rate would have to be about 50 basis points lower over the second half of this year and roughly 100 basis points lower by the end of next year.

I would caution the Committee that this second scenario is rather extreme. While we do not have perfect foresight about the foreign outlook, and it certainly could be somewhat weaker in the short term, we believe the chances are very small of sustained weakness on the scale assumed for purposes of constructing this alternative.

On that reassuring note, I'll turn our presentation back to Mike Prell.

Michael J. Prell  
July 2, 1991

CHART SHOW PRESENTATION -- CONCLUSION

The final exhibit summarizes the forecasts you provided last week. There doesn't appear to be vast disagreement among you: all of you project a moderate upturn in activity, declining unemployment, and inflation moving below the recent trend by next year. Whether there was as much consistency in the assumptions you made regarding policy will, of course, become clearer in the discussion ahead.

Because the law requires that we report on how our objectives relate to the Administration's economic forecast, I've shown their current numbers--which are those from February. The Mid-session budget review is due later this month, and it will include new numbers. My sense is that the changes will be small, perhaps mainly a reduction in the forecast of inflation, bringing it closer to your central tendency.

STRICTLY CONFIDENTIAL (FR) CLASS I-FOMC

*Material for*

*Staff Presentation to the  
Federal Open Market Committee*

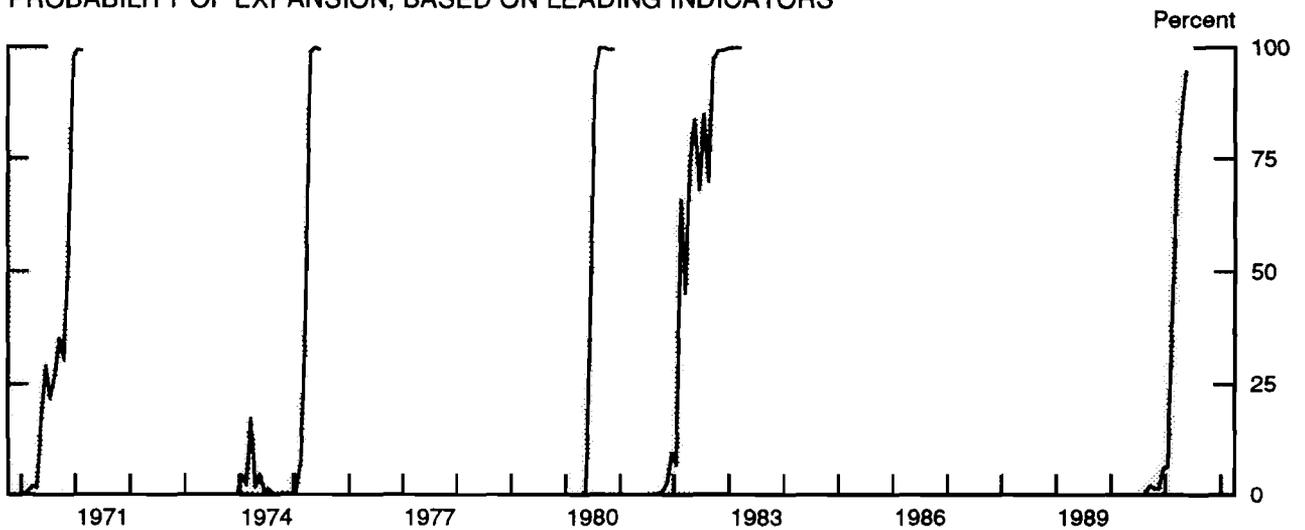
*July 2, 1991*

Chart 1

COMPOSITE INDEX OF LEADING ECONOMIC INDICATORS



PROBABILITY OF EXPANSION, BASED ON LEADING INDICATORS \*



\*Each observation represents the probability that an expansion has begun or will begin during the next three months.

INDEX OF COINCIDENT INDICATORS

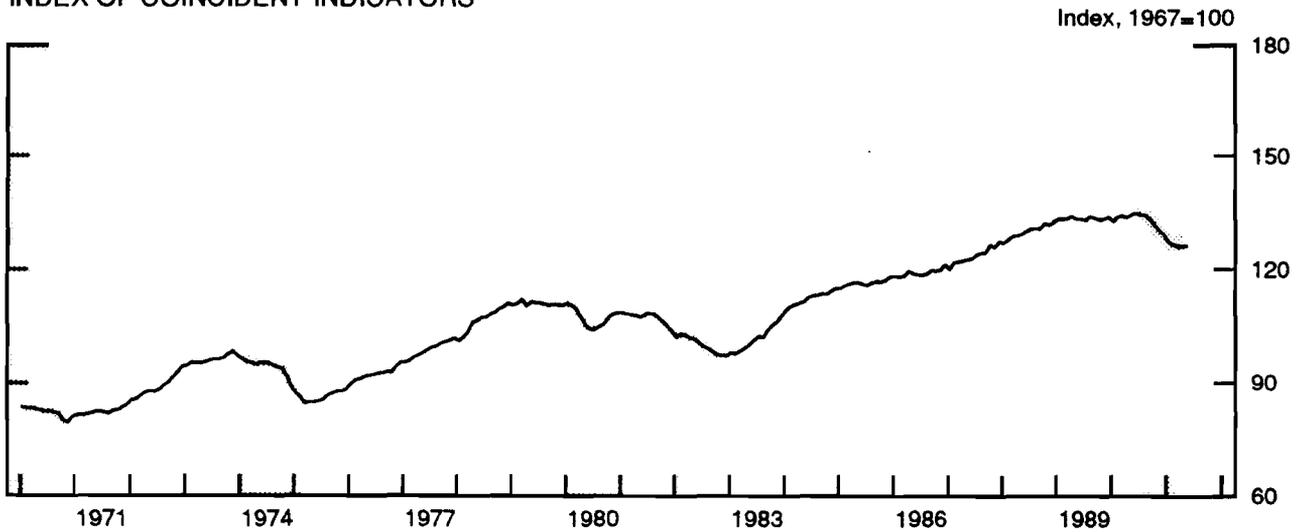
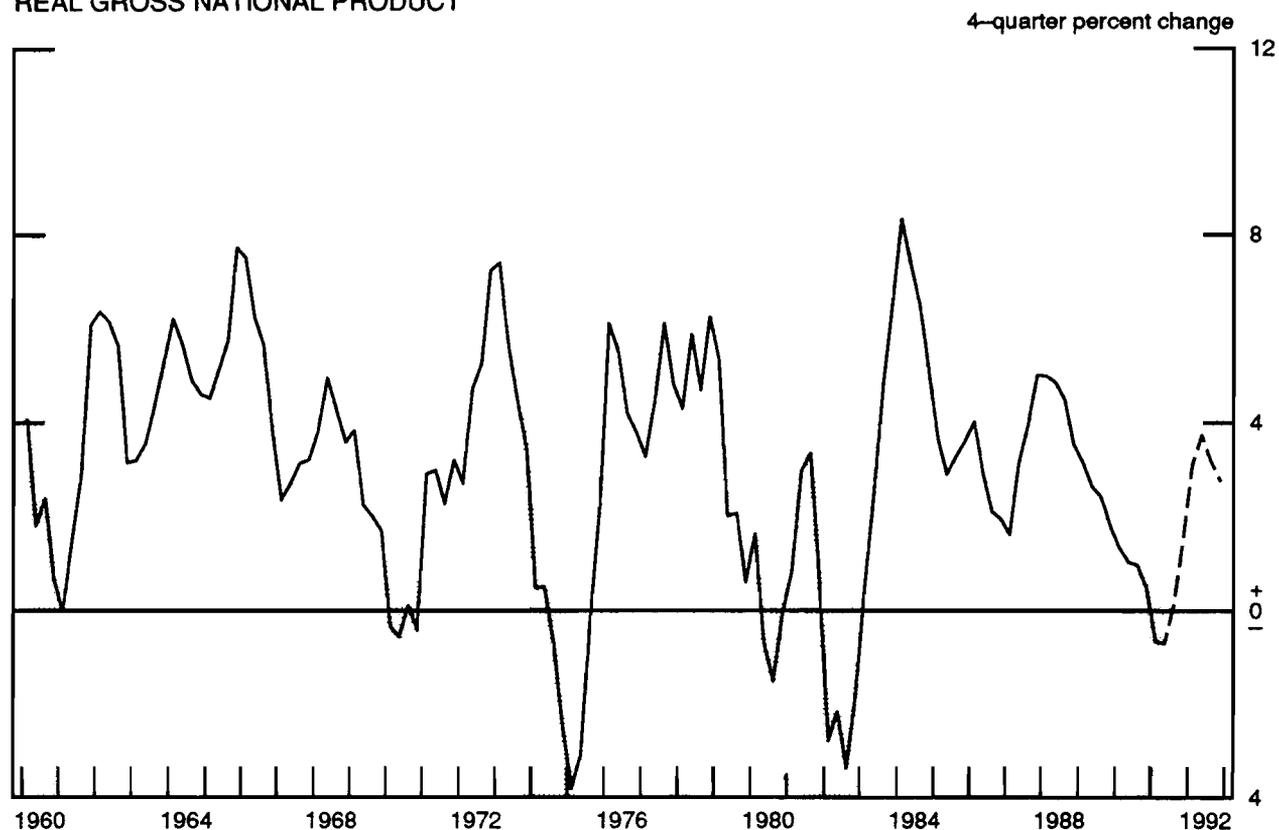


Chart 2

REAL GROSS NATIONAL PRODUCT



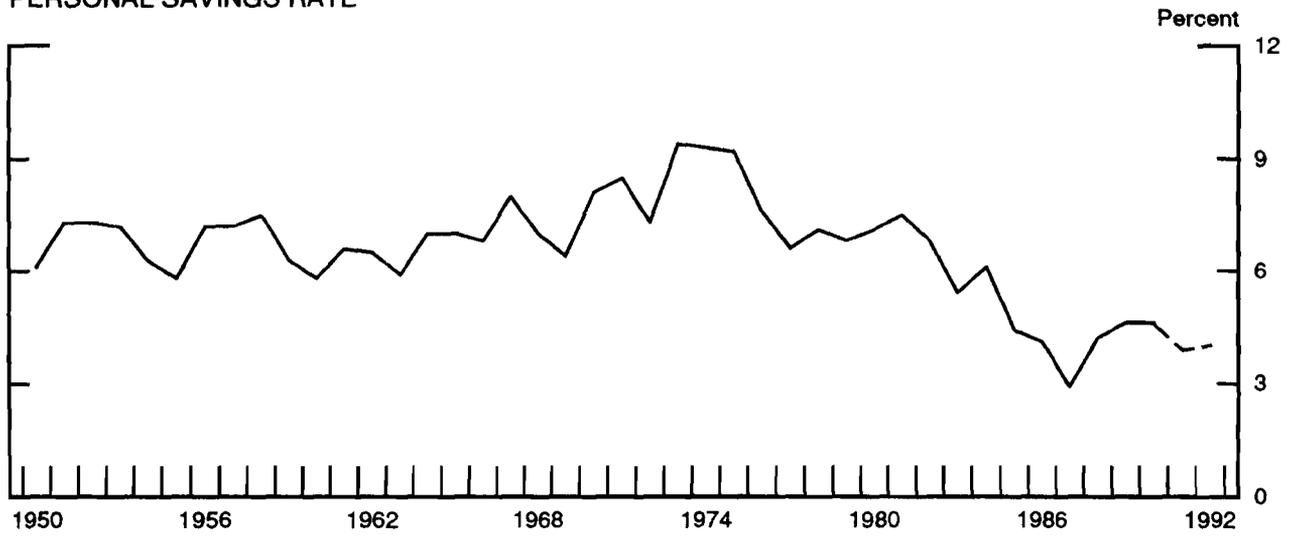
Contributions to Real GNP Growth in the First Year of Expansion  
(percentage points)

	Current Cycle		Average of Four Earlier Cycles*
	91:Q1 Trough	91:Q2 Trough	
GNP	3.2	3.7	5.5
Personal consumption	1.8	1.7	3.2
Producers' durable equipment	.4	.6	.6
Construction	.1	.2	1.1
Government purchases (ex. CCC)	-.1	-.2	.4
Exports of goods and services	.7	1.1	.2
Imports of goods and services	-1.0	-1.1	-1.2
Inventories (incl. CCC)	1.3	1.5	1.4
MEMO: Final sales (ex. CCC)	1.9	2.2	4.2

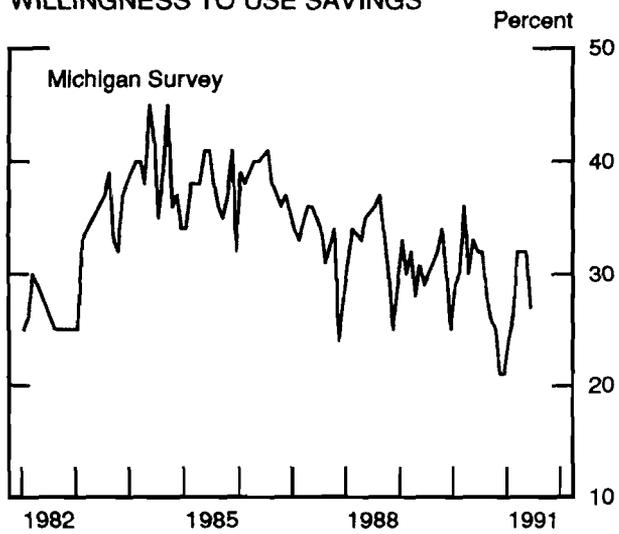
\* 1961, 1970, 1975 and 1982.

Chart 3

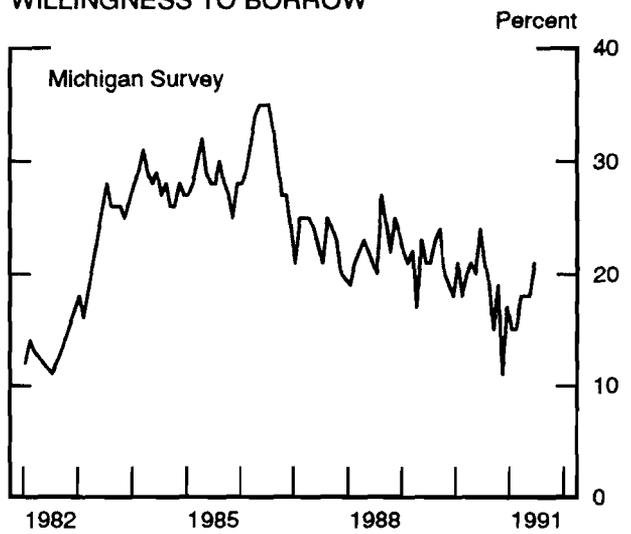
PERSONAL SAVINGS RATE



WILLINGNESS TO USE SAVINGS



WILLINGNESS TO BORROW



PER HOUSEHOLD EXPENDITURE ON DURABLES

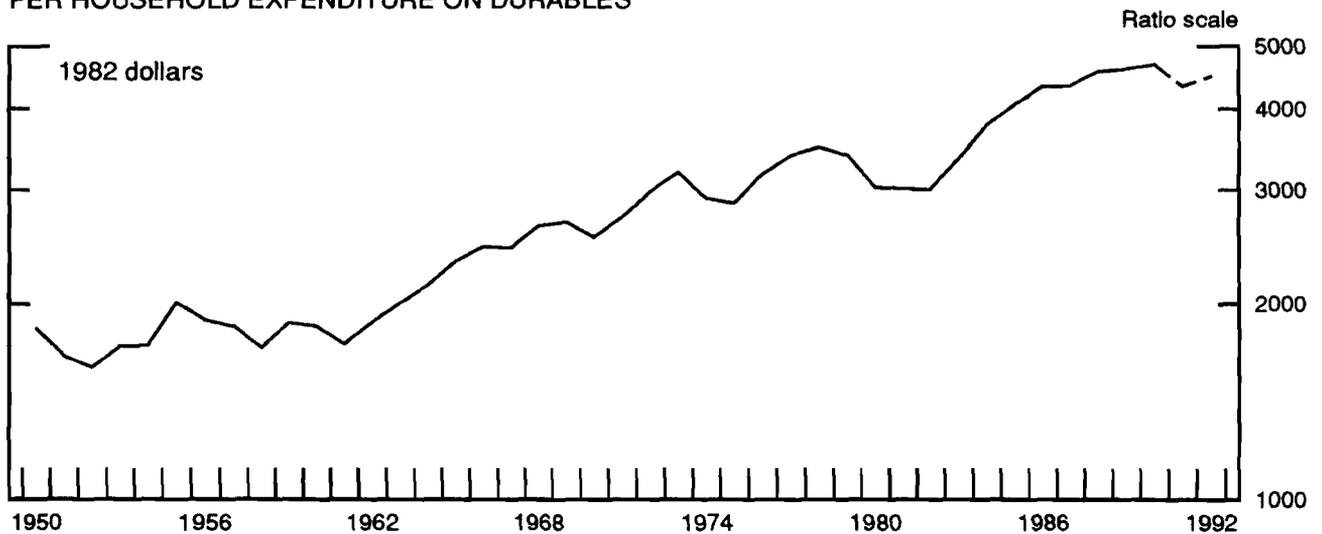
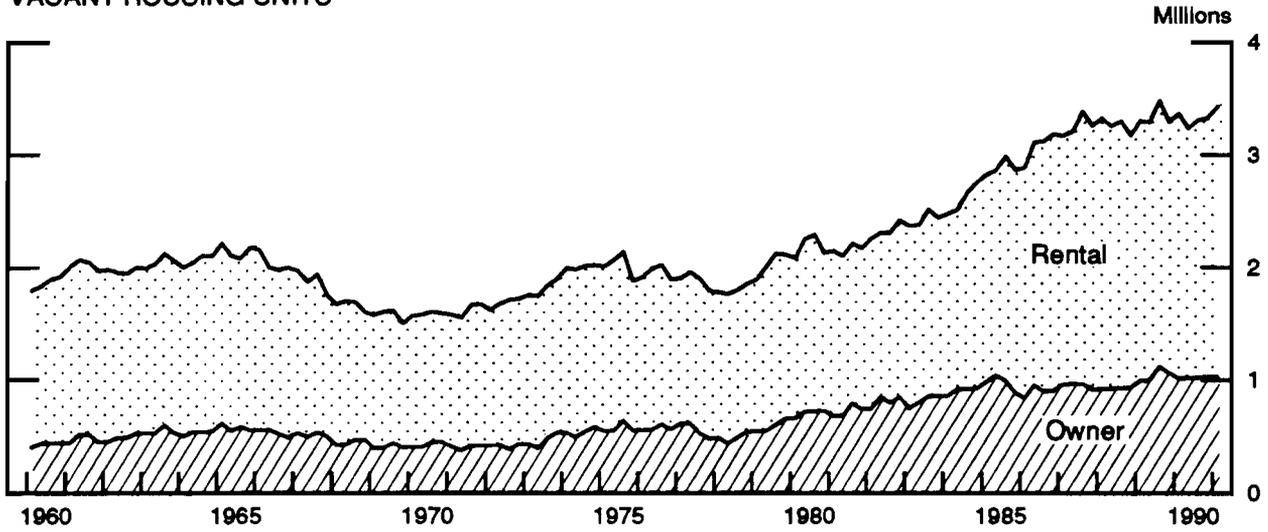
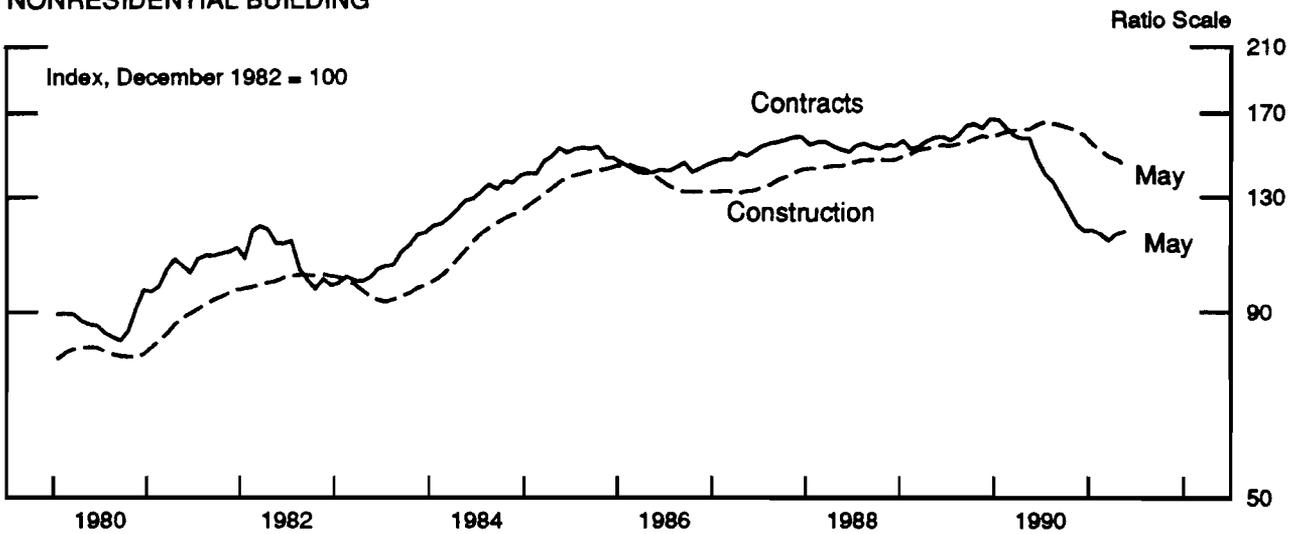


Chart 4

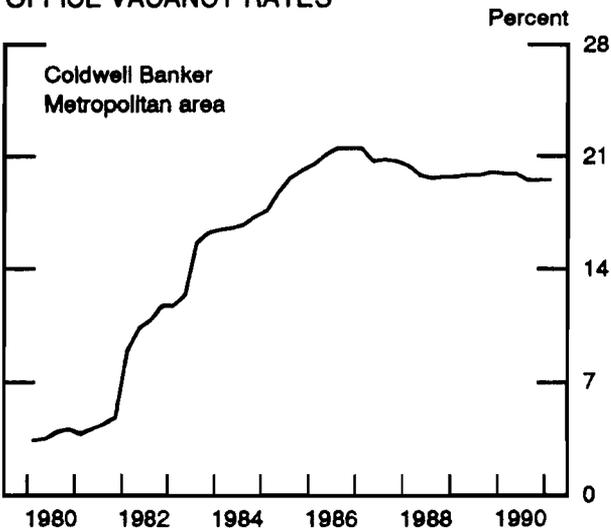
VACANT HOUSING UNITS



NONRESIDENTIAL BUILDING



OFFICE VACANCY RATES

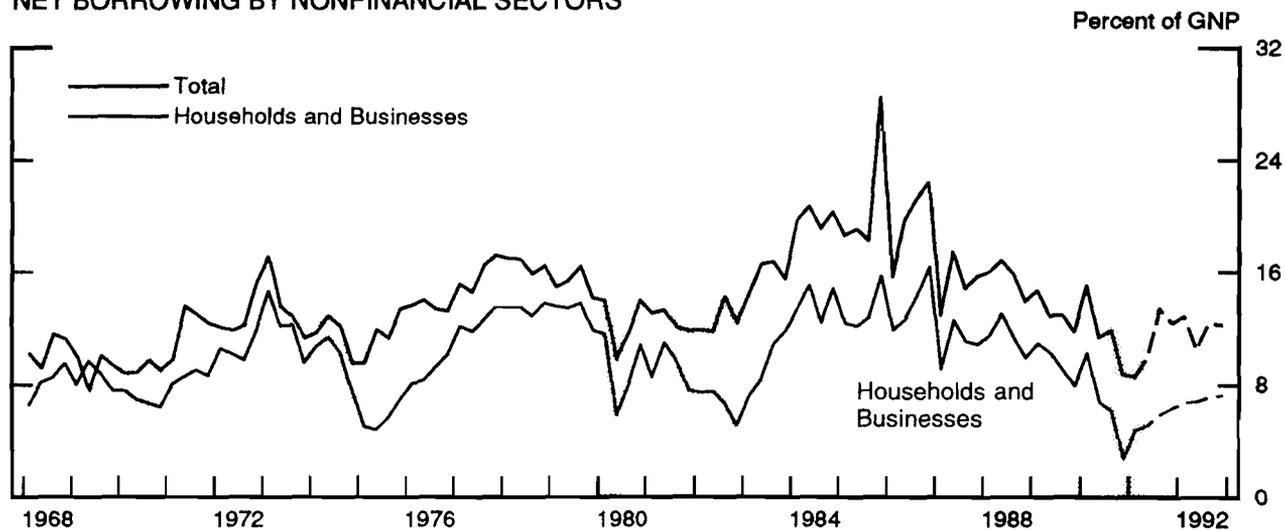


NONRESIDENTIAL STRUCTURES—1990

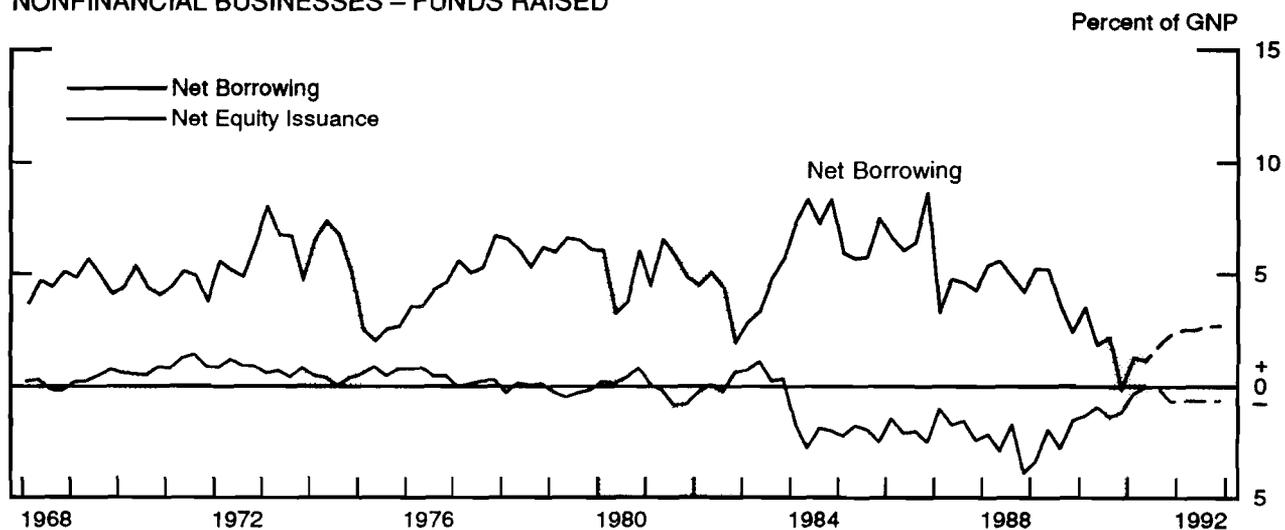
	1982 dollars
Total	121
Office	19
Other commercial	22
Industrial	17
Institutional	20
Drilling and mining	17
Utilities and other	26

Chart 5

### NET BORROWING BY NONFINANCIAL SECTORS



### NONFINANCIAL BUSINESSES – FUNDS RAISED



### HOUSEHOLDS – FUNDS RAISED

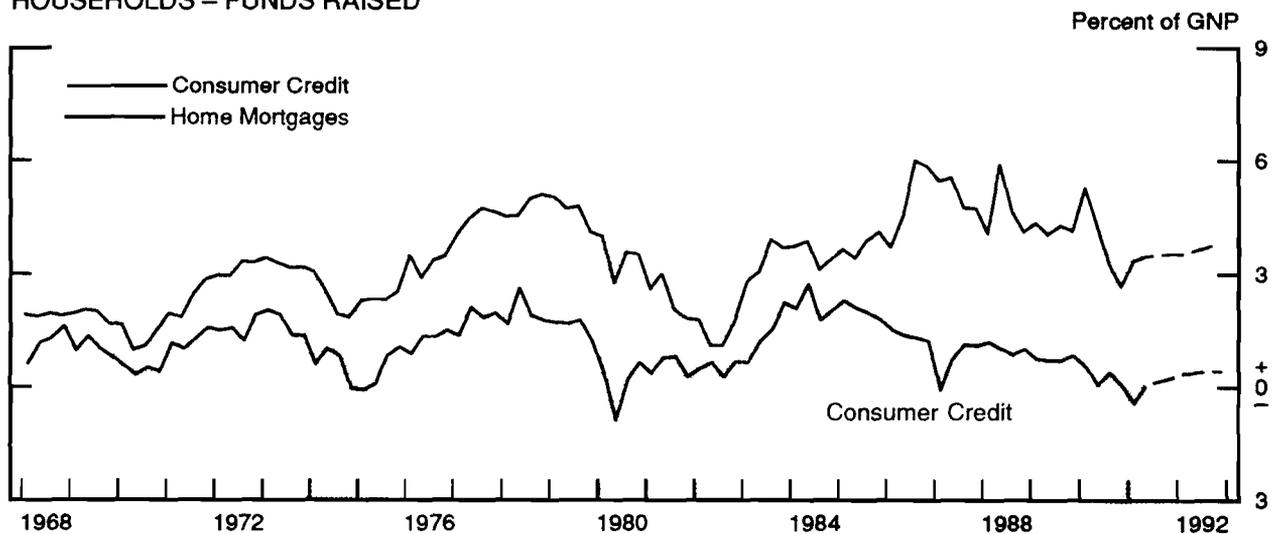
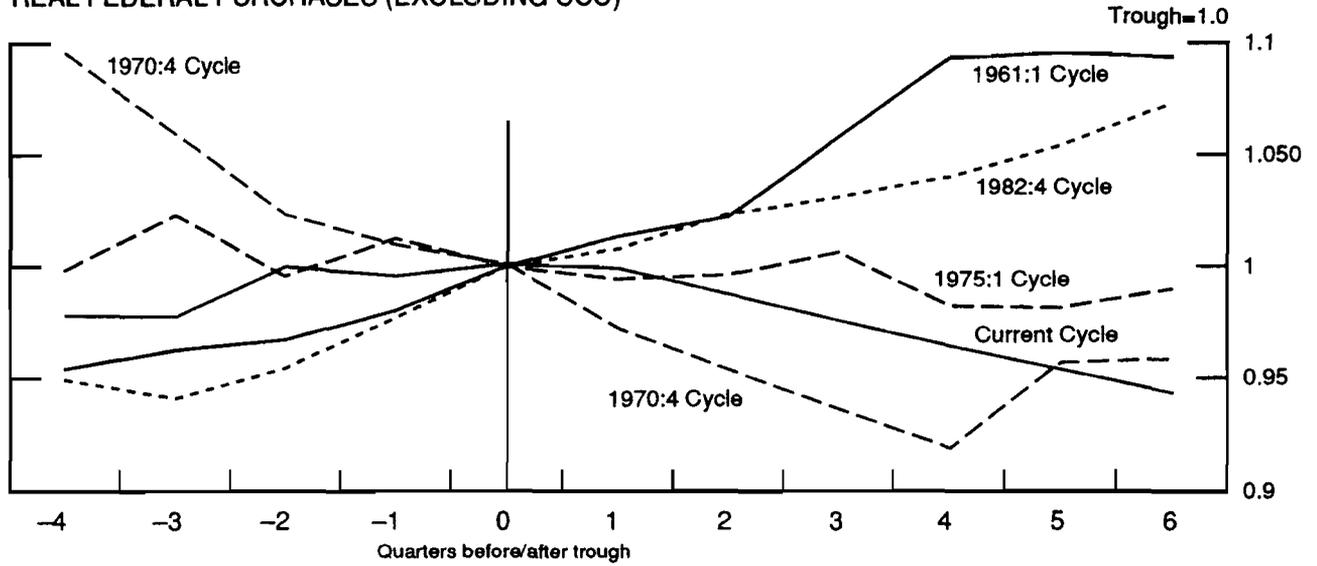
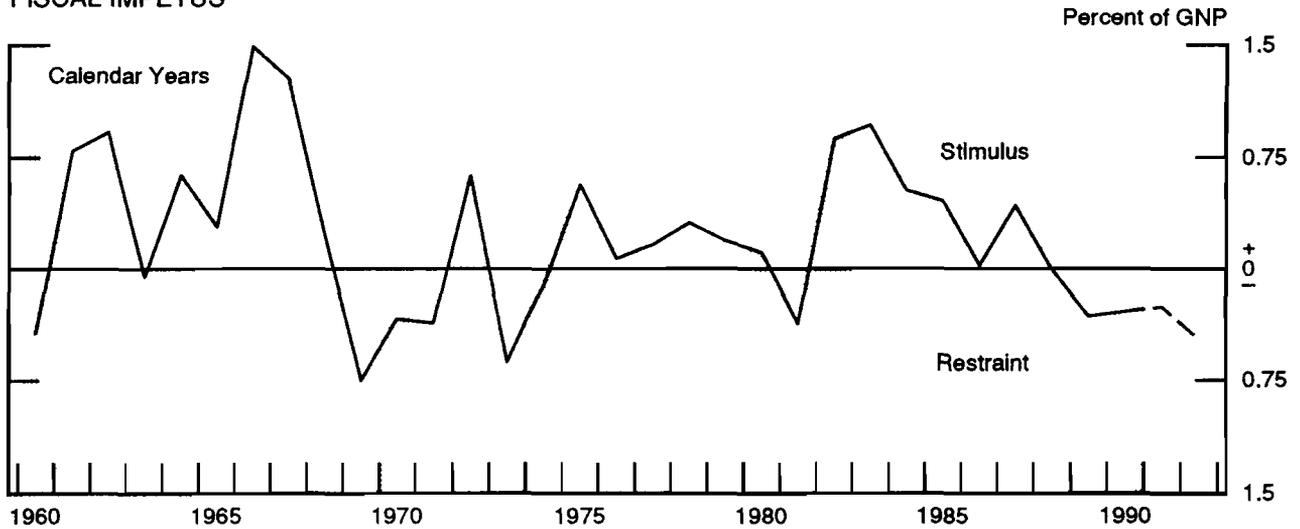


Chart 6

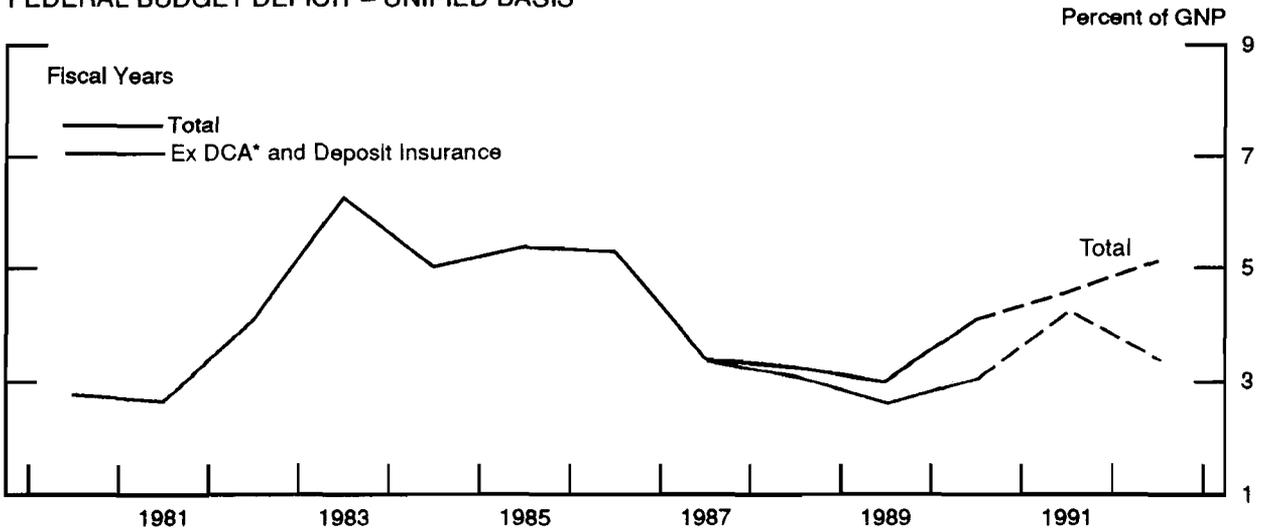
REAL FEDERAL PURCHASES (EXCLUDING CCC)



FISCAL IMPETUS



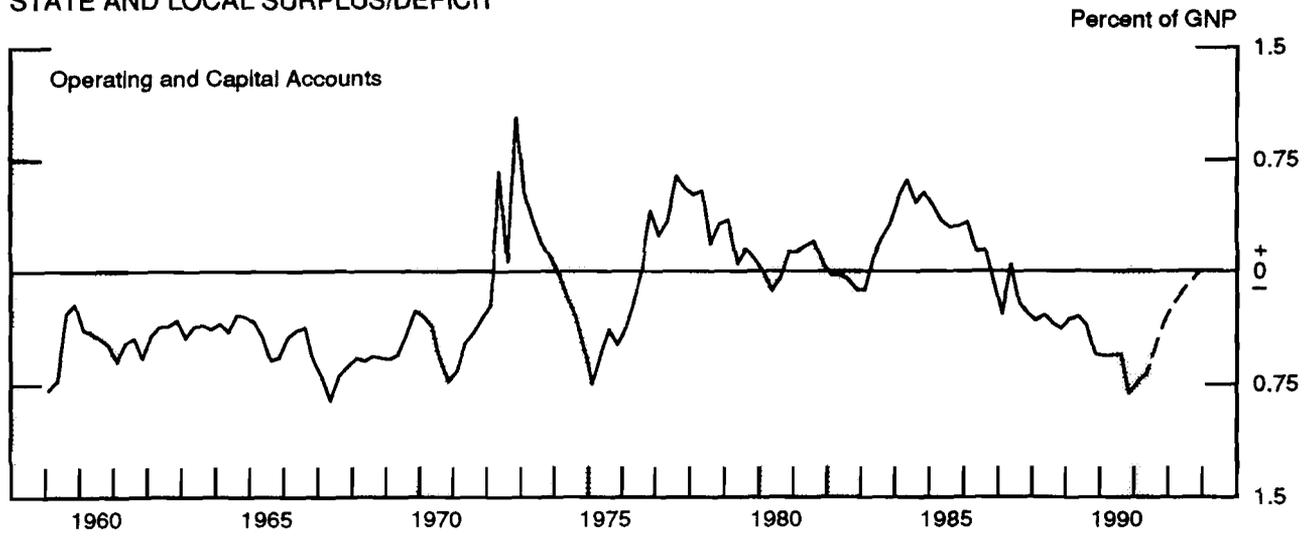
FEDERAL BUDGET DEFICIT – UNIFIED BASIS



\*Defense Cooperation Account

Chart 7

### STATE AND LOCAL SURPLUS/DEFICIT



### STATE AND LOCAL GOVERNMENT REAL PURCHASES

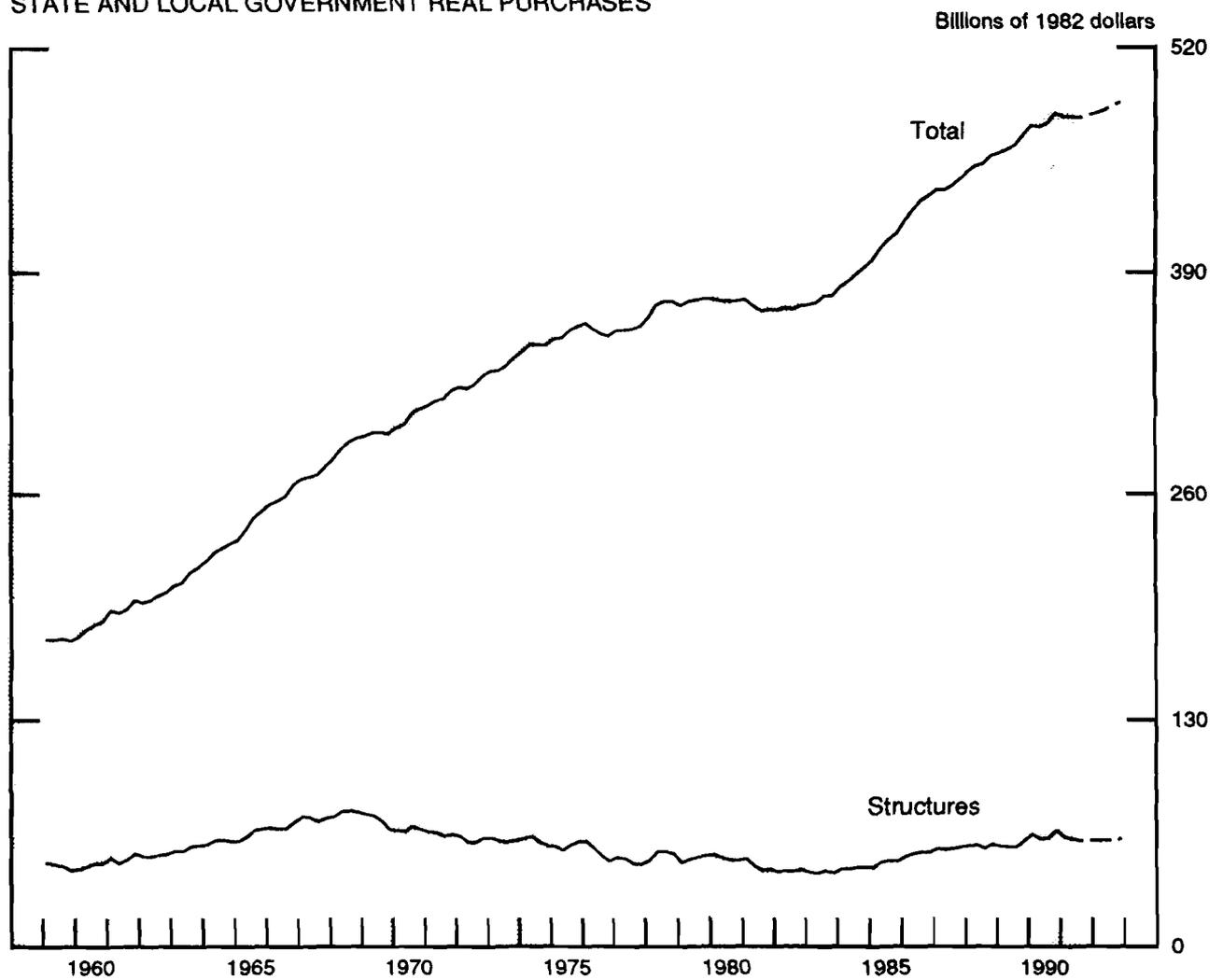
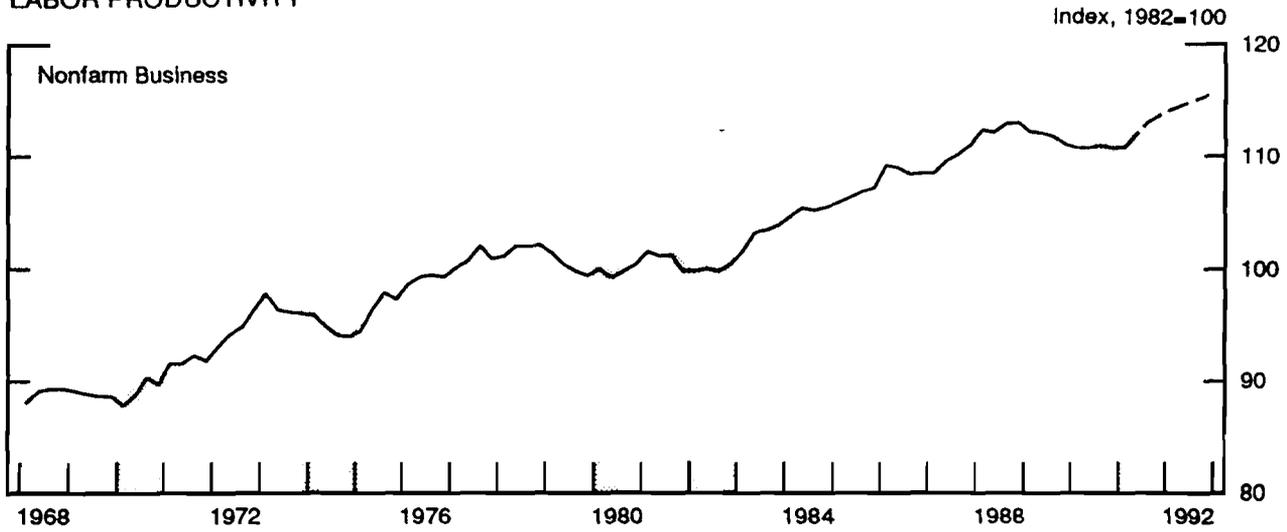
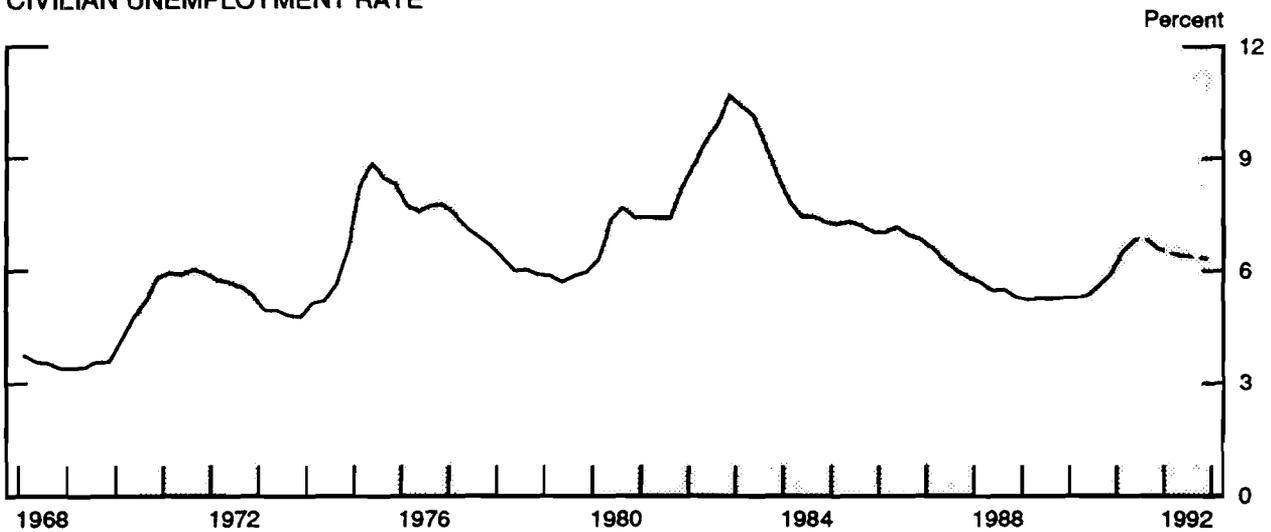


Chart 8

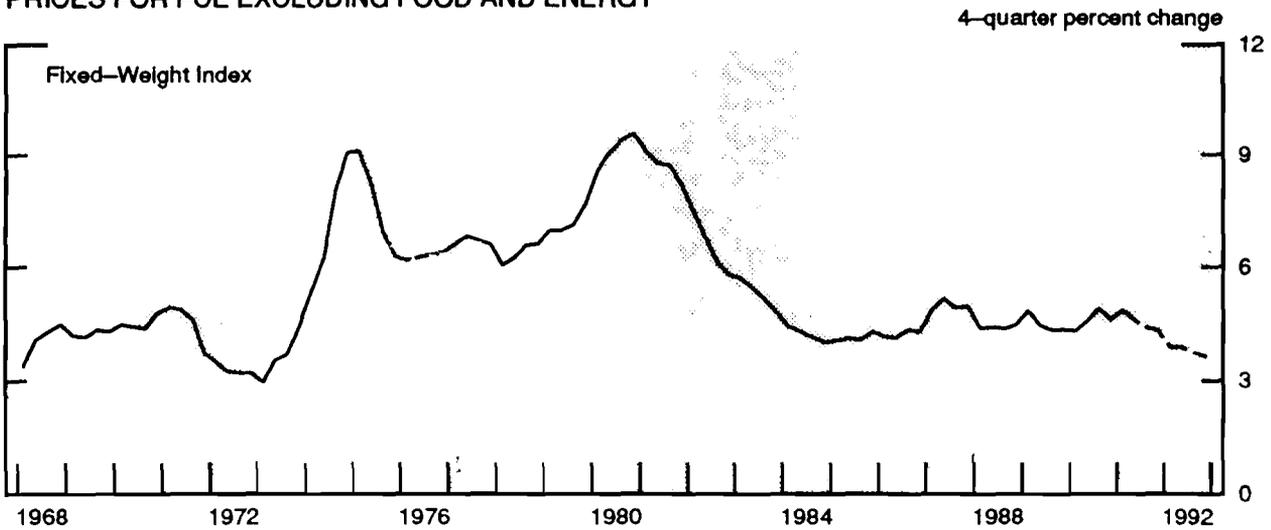
### LABOR PRODUCTIVITY



### CIVILIAN UNEMPLOYMENT RATE\*



### PRICES FOR PCE EXCLUDING FOOD AND ENERGY\*



\*Shading indicates periods when unemployment rate exceeds NAIRU.

U.S. External Accounts

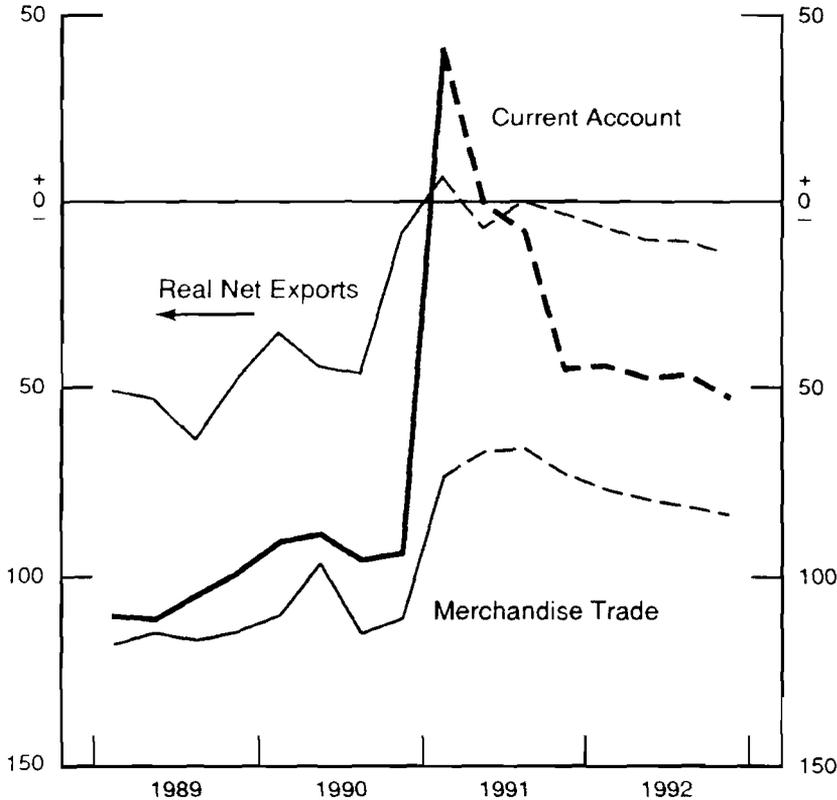
**MAJOR FACTORS AFFECTING THE EXTERNAL SECTOR**

- Recovery of U.S. domestic demand.
- Moderate pickup in growth on average in the major foreign industrial countries.
- Recent strength of the dollar persists.
- Oil prices remain near current levels.

**EXTERNAL BALANCES**

Billions of 1982 dollars, SAAR

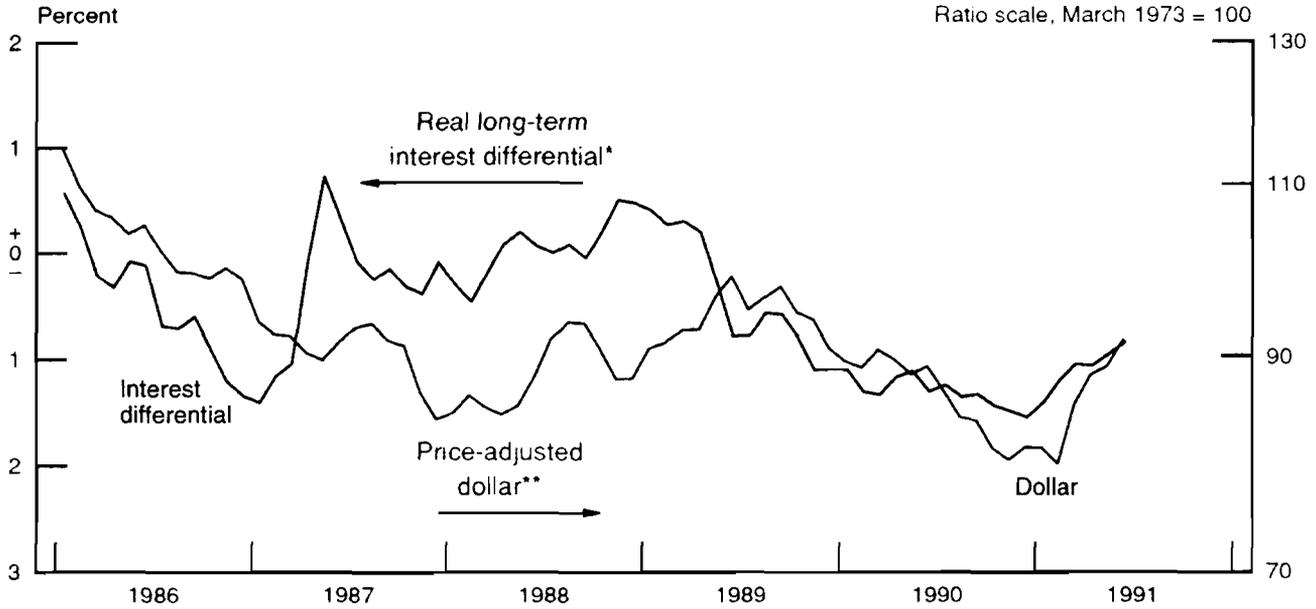
Billions of dollars, SAAR



Billions of dollars  
annual rate, Q4

	1990	1991	1992
Merchandise Trade	-111	-73	-84
Current Account	-94	-45	-52
Real Net Exports	-9	-4	-14

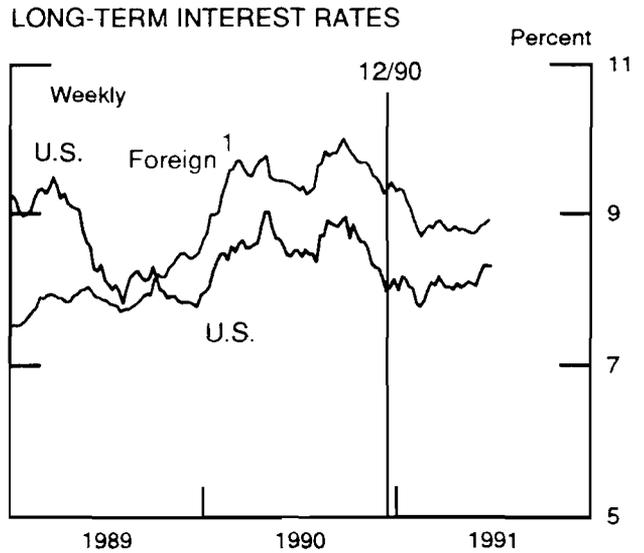
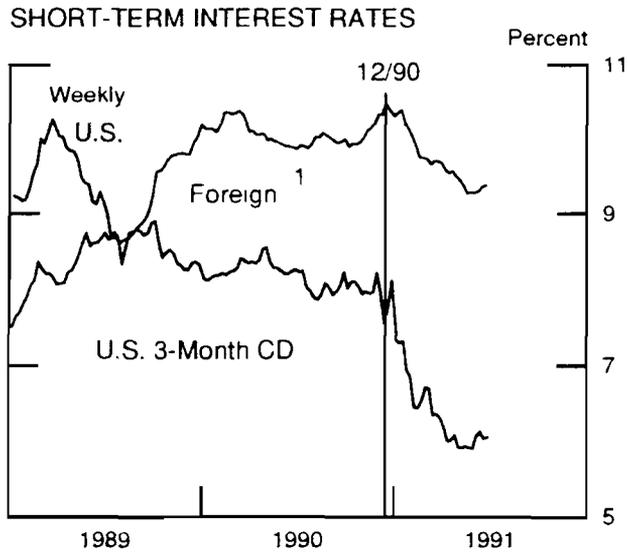
### THE DOLLAR AND THE INTEREST DIFFERENTIAL



- \* Difference between rates on long-term U.S. government bonds and a weighted average of foreign G-10 long-term government or public authority bond rates, adjusted for expected inflation.
- \*\* Weighted average against foreign G-10 countries, adjusted by relative consumer prices.

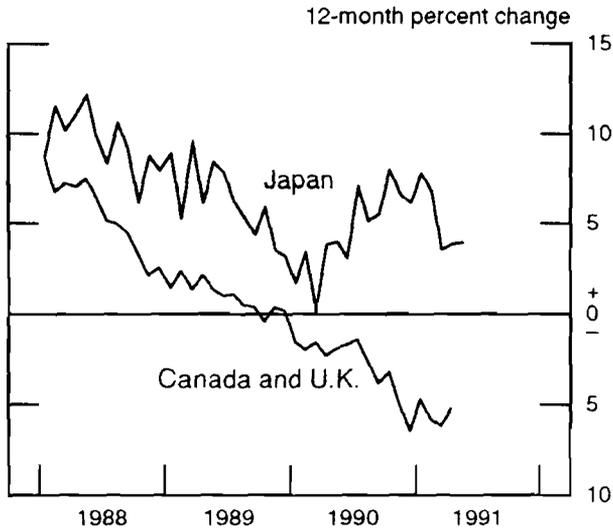
Nominal Dollar Exchange Rates	
	Percent change 12/90 to 6/28/91
Deutschemark	21
Pound Sterling	19
Yen	3
Canadian Dollar	-2
S. Korean Won	1
Taiwan Dollar	0

Nominal Interest Rates Percent		
	Change 12/90 to 6/28/91	Level 6/28/91
<b>Three-month</b>		
Germany	-0.17	9.00
Japan	-0.35	7.92
U.S.	-1.76	6.06
<b>Long-term</b>		
Germany	-0.28	8.50
Japan	0.04	6.78
U.S.	0.16	8.24

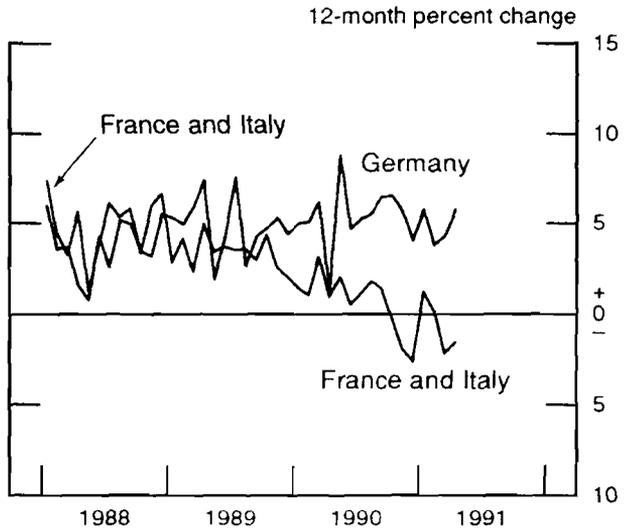


1 Multilateral trade-weighted average for foreign G 10 countries.

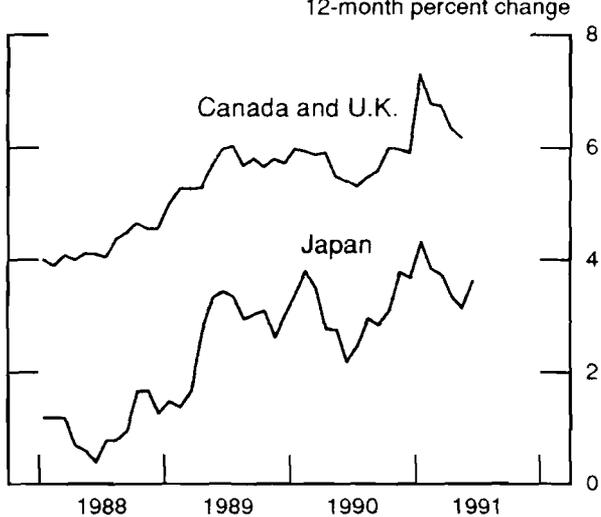
**INDUSTRIAL PRODUCTION\***



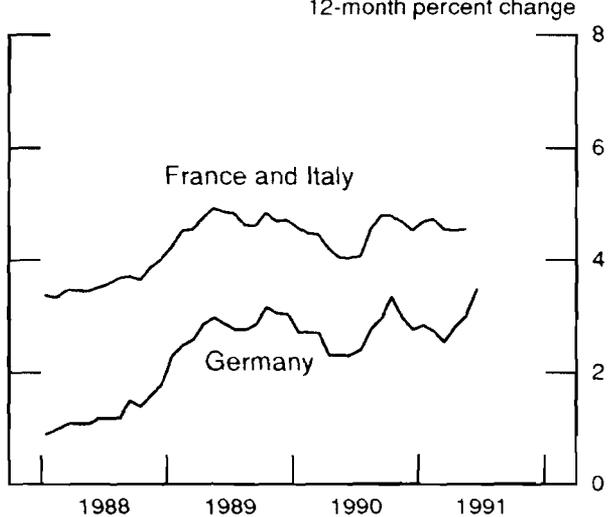
**INDUSTRIAL PRODUCTION\***



**CONSUMER PRICES\***



**CONSUMER PRICES\***

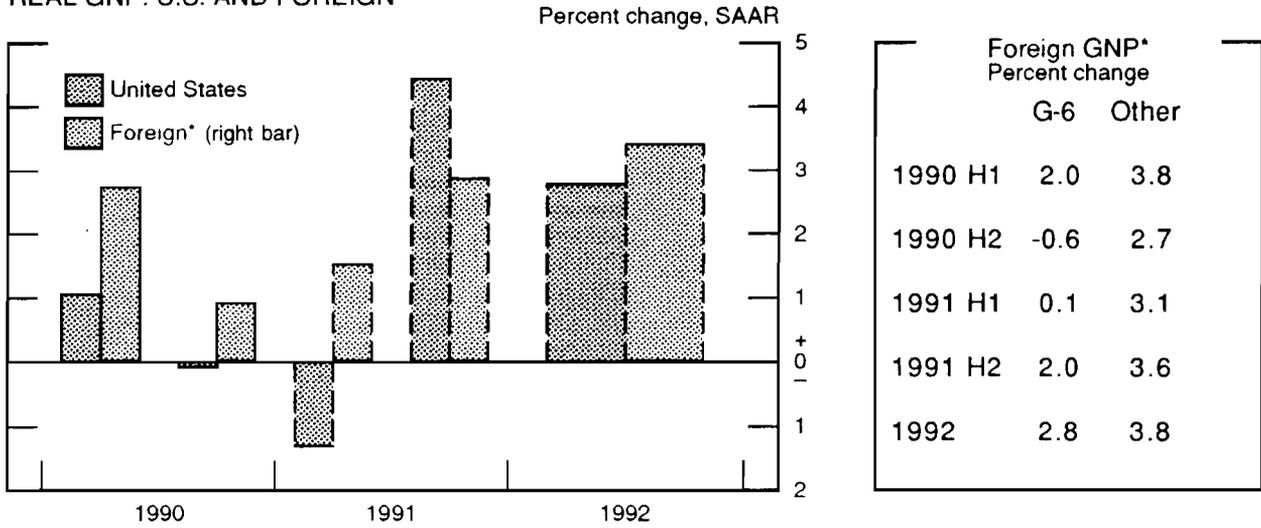


**ECONOMIC POLICY ABROAD**

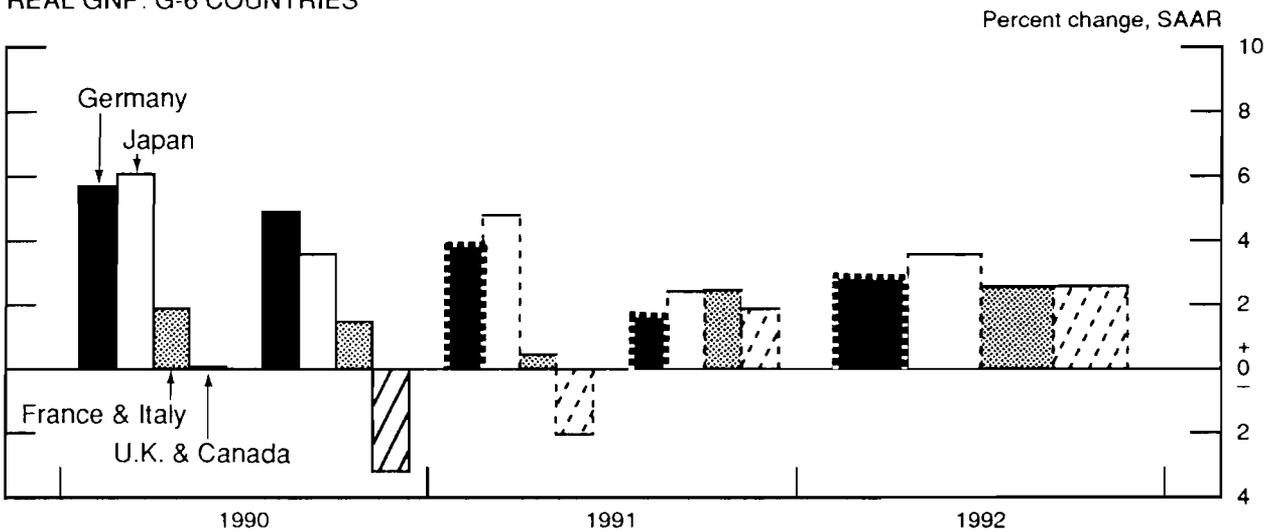
- Growth slowing in Japan and Germany following very strong first quarters, but inflation concerns remain.
- Tentative signs of pickup in some weaker economies.
- Monetary policy cautious, but interest rates may decline further in some countries as inflation eases.
- Fiscal policy in Germany tighter following expansion this year; policies slightly contractionary on average in other countries.

\* Averages weighted by bilateral shares in U.S. non-agricultural exports

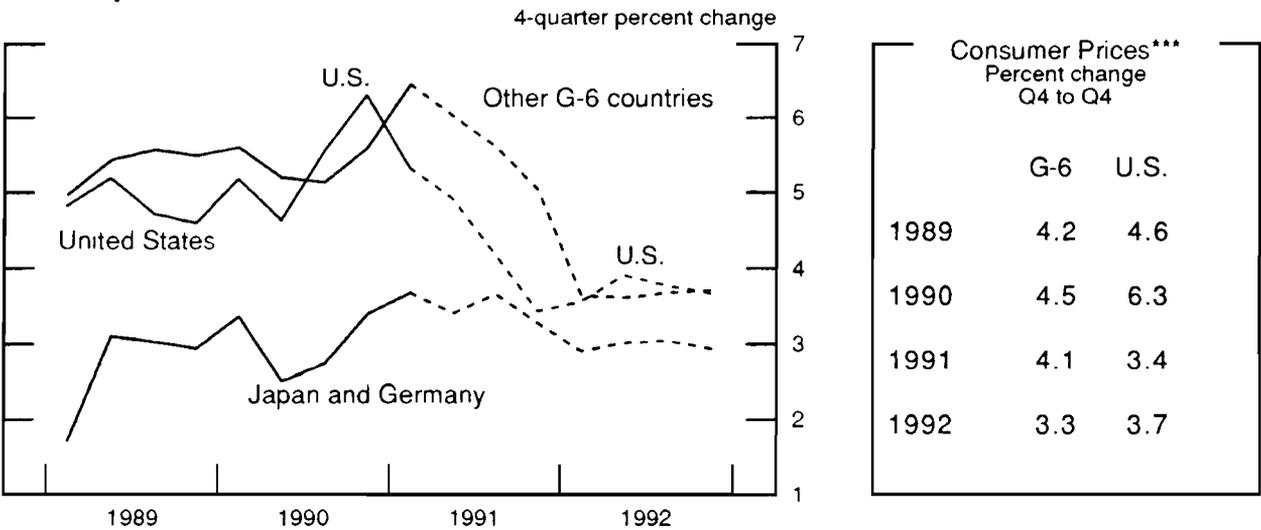
REAL GNP: U.S. AND FOREIGN



REAL GNP: G-6 COUNTRIES\*\*



CONSUMER PRICES: U.S. AND G-6 COUNTRIES\*\*\*



\* Average of 22 industrial and 8 developing countries weighted by bilateral shares in U.S. non-agricultural exports

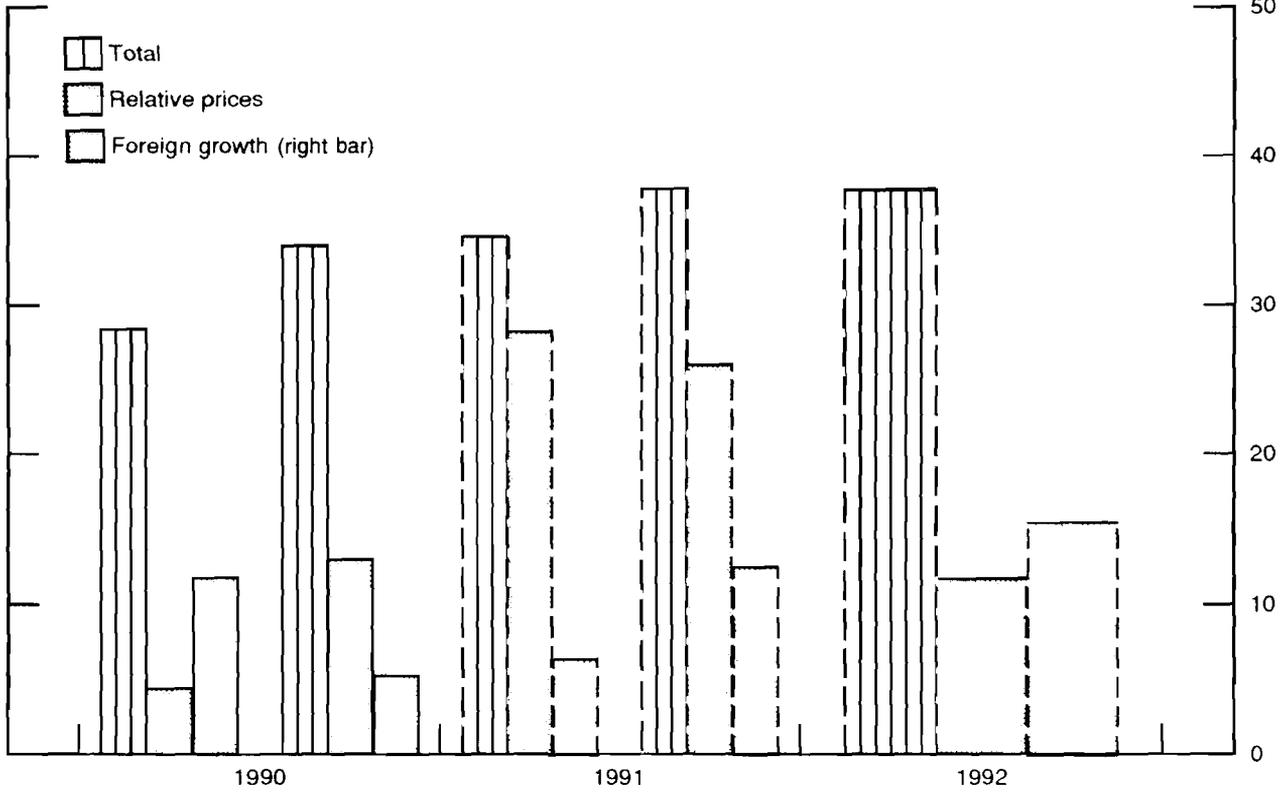
\*\* Averages weighted by bilateral shares in U.S. non-agricultural exports

\*\*\* Average using U.S. bilateral non-oil import weights

Chart 13

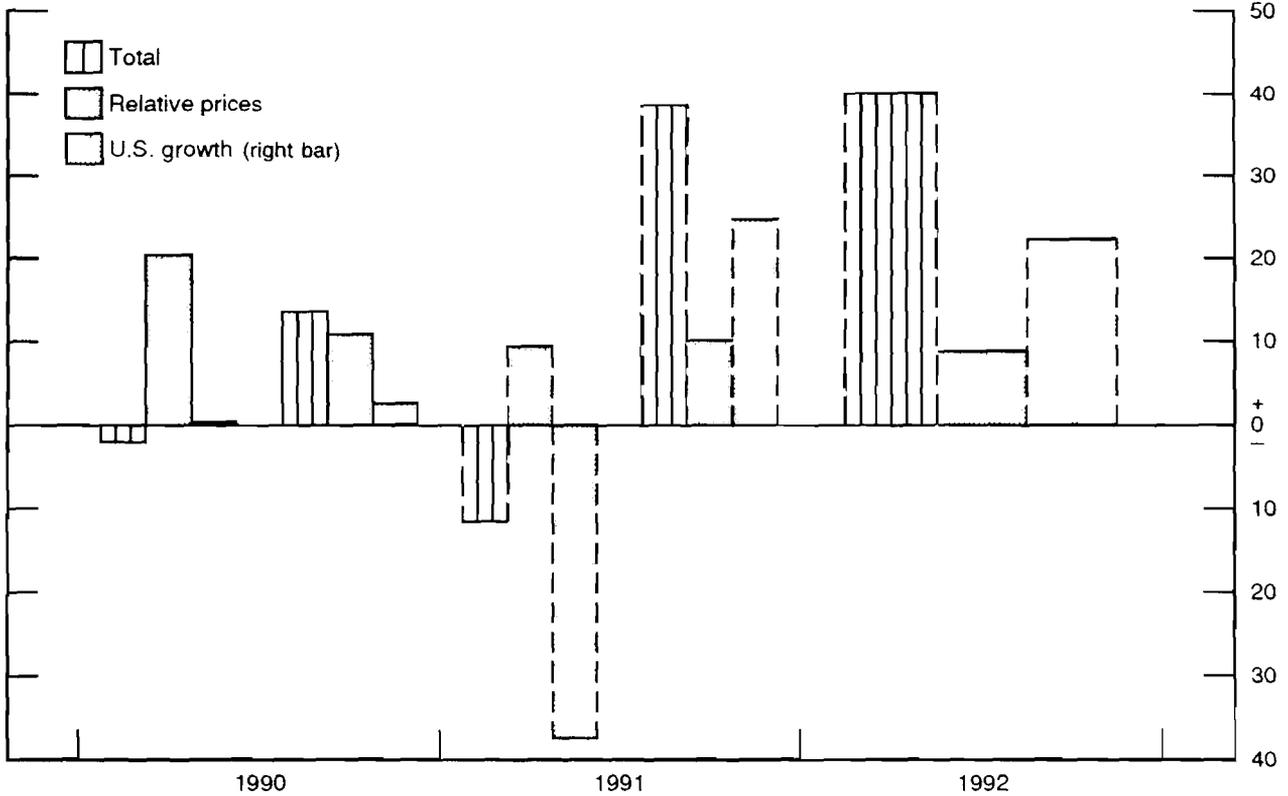
FACTORS AFFECTING NONAGRICULTURAL EXPORTS

Change, billions of 1982 dollars, SAAR



FACTORS AFFECTING NON-OIL IMPORTS

Change, billions of 1982 dollars, SAAR



## Alternative Scenarios

Baseline:	Greenbook forecast extended through 1993; M2 growth at 5-1/2 percent in 1992 and 1993.
February Dollar:	Dollar at the level projected in February, almost 15 percent below level now projected; federal funds rate unchanged from baseline.
Weak Foreign Growth:	Foreign growth remains at about 1-1/2 percent; federal funds rate unchanged from baseline.

	<u>1991</u>	<u>1992</u>	<u>1993</u>
Percent change, Q4 to Q4			
Real GNP, U.S.			
Baseline	1-1/2	2-3/4	2-1/2
February Dollar	2-1/2	4-1/4	5
Weak Foreign Growth	1-1/2	2	1
GNP Prices			
Baseline	4	3-1/2	3-1/4
February Dollar	4-1/2	4-1/2	5
Weak Foreign Growth	4	3-1/4	2-1/2
Real GNP, Foreign *			
Baseline	2-1/4	3-1/2	3-1/2
February Dollar	2-1/4	3-1/4	4
Weak Foreign Growth	1-1/2	1-1/2	1-1/2
Q4 Level, \$ billions			
Current Account			
Baseline	-45	-52	-56
February Dollar	-37	-20	-32
Weak Foreign Growth	-48	-73	-95

\* Average of 22 industrial and 8 developing countries weighted by bilateral shares in U.S. non-agricultural exports.

**ECONOMIC PROJECTIONS FOR 1991**

	<b>FOMC</b>			
	Range	Central Tendency	Administration	Staff
----- Percent change, Q4 to Q4-----				
Nominal GNP	3-3/4 to 5-3/4	4-1/2 to 5-1/4	5.3	5.3
previous estimate	3-1/2 to 5-1/2	3-3/4 to 5-1/4	5.3	5.9
Real GNP	1/2 to 1-1/2	3/4 to 1	0.9	1.5
previous estimate	-1/2 to 1-1/2	3/4 to 1-1/2	0.9	1.9
CPI	3 to 4-1/2	3-1/4 to 3-3/4	4.3	3.4
previous estimate	3 to 4-1/2	3-1/4 to 4	4.3	3.9
-----Average level, Q4, percent-----				
Unemployment rate	6-1/2 to 7	6-3/4 to 7	6.7	6.6
previous estimate	6-1/2 to 7-1/2	6-1/2 to 7	6.7	6.1

**ECONOMIC PROJECTIONS FOR 1992**

	<b>FOMC</b>			
	Range	Central Tendency	Administration	Staff
----- Percent change, Q4 to Q4-----				
Nominal GNP	4 to 6-3/4	5-1/2 to 6-1/2	7.5	6.1
Real GNP	2 to 3-1/2	2-1/4 to 3-1/4	3.6	2.8
CPI	2-1/2 to 4-1/4	3 to 4	3.9	3.7
-----Average level, Q4, percent-----				
Unemployment rate	6 to 6-3/4	6-1/4 to 6-1/2	6.6	6.3

July 2, 1991

**LONG-RUN RANGES**

Donald L. Kohn

At this meeting the Committee is called on to review its long-run ranges for money and debt for this year and to set ranges on a provisional basis for 1992.

The choice of ranges can be thought of as conditional on three basic considerations: the objectives of policy, the underlying forces and risks in the economy as they bear on reaching these objectives, and the relationship of money growth to a given path of spending and income.

The first set of considerations is addressed in the simulations of alternative strategies in the bluebook, whose results are given on page 9. The strategies represent three fundamental approaches to policy in the next few years: one that emphasizes increases in output and declines in unemployment (Strategy III), one that puts stress on consolidating recent gains on inflation and moving close to price stability in 5 years (Strategy II) and one that takes something of a middle road by making gradual progress on both inflation and unemployment (the baseline strategy I); Strategy IV is a variant of the baseline, which emphasizes output early on and prices somewhat later.

The possible outcomes that different strategies can produce depend importantly on the starting point for the economy, including any developments already built in for the near term, more or less independent of the monetary policy path followed in the months immediately ahead. In that regard, we are starting from a condition of slack in the economy, and consequently can expect a near-term deceleration of inflation under any

approach. The degree of slack is not especially large compared to past recessions, however, and could be reduced by the near-term bounceback in activity.

This situation has several consequences illustrated in the simulations. First, if policy attempts to push unemployment down rapidly and significantly, as in Strategy III, progress in reducing inflation will be very limited, and could be reversed in a few years unless the additional ease were offset after only a few quarters, as in Strategy IV. Second, because the existing degree of slack is modest, any drop in unemployment will allow only fairly modest progress on inflation. Strategy II, aimed at approaching price stability over 5 years, entails very small declines in unemployment now and an increase later; of course, these latter results do not embody credibility effects, which might allow significant declines in both inflation and unemployment after this strategy had been in place for a time.

The tendency for inflation to persist also implies the need for policy to accommodate some pickup in nominal GNP growth in 1992 relative to the last few years if unemployment is to be reduced. Indeed, one could characterize the tighter strategy as one that holds down money growth to resist any such near-term pickup, and enforces decelerating nominal GNP growth from 1993 on. The easier strategy is accomplished by raising nominal GNP growth to about 7 percent in 1992 and keeping it there; the baseline increases nominal GNP growth to 6 percent in 1992, then gradually reduces it thereafter.

The path for money that can accommodate the Committee's objectives for prices and output depends on an assessment of the second and

third sets of considerations--the underlying forces working on spending and prices, and the underlying relationships of money to spending. With regard to the former, as Mike and Ted detailed, the staff forecast sees essentially flat nominal short-term interest rates producing gradually declining unemployment and inflation rates. The continued improvement in price performance occurs because the level of real rates implied by the nominal rates is sufficiently high, given all the damping forces Mike discussed, to keep the economy from rebounding all the way to its potential; that configuration has been extended in the baseline forecast. Obviously, a weaker economy would imply the need for lower interest rates to meet any set of objectives, and a stronger economy higher interest rates. Changing interest rates, in turn, by influencing opportunity costs and velocity, would affect the money growth needed to achieve the Committee's objectives. In this regard, the money ranges should give sufficient scope to deal with potential deviations from expectations; the choice of ranges itself can convey some sense of how the Committee sees the risks, as well as how, in the context of its objectives, it would react to particular types of unexpected developments.

What money goes with a particular path for spending depends not only on the associated movements of interest rates, but also any changes in underlying relationships of money to income. While unexpectedly sluggish money growth has presaged shortfalls in nominal spending over the past year, the full extent of the weakness in money has not been reflected in nominal GNP, at least based on historical patterns. Velocity has declined over the last three quarters, but not by as much as would be expected when effects of the drop in interest rates are taken into account.

The reasons for this remain something of a mystery. They probably involve the declining importance of depositories in the intermediation process--a secular trend, arising from technological change and fuller pricing of the safety net, that has been accentuated and compressed in time by the current travails of both banks and thrifts. These developments have affected the supply side of the market for M2 by damping depositories appetites for funds and the demand side through concern over the safety and liquidity of deposits and through the availability of other saving vehicles.

In projecting money growth relative to nominal income and interest rates, the staff has assumed that the unusual strength in velocity will not be reversed, and indeed that there will be further shortfalls in M2 growth relative to growth in income, but the size of these additional shortfalls and associated increases in velocity will gradually decrease. Depositories are expected to become more willing and better able to supply credit as the expansion helps to reduce anticipated loan losses, bolstering their access to capital markets and improving the appetite both of depositories and of depositors for deposits.

This analysis leads us to project 5-1/2 percent growth of M2 for the remainder of 1991 and for 1992, consistent with the greenbook forecast of nominal income and interest rates. Such growth would represent an acceleration from the pace of recent years. As noted above, in the absence of an unexpectedly sharp slowing of inflation, somewhat greater nominal GNP expansion would seem to be needed to reduce the unemployment rate. Even with the more rapid money growth, this projection still implies an increase in velocity, especially in the second half of this year, but to a lesser extent in 1992 as well. Several outside commentators have

noted that such an increase in the first part of an expansion would be unusual. In the staff forecast this behavior of velocity has its origin in several aspects of the current situation that differentiate it from past cycles. First is the assumed further downward shift in money demand, or upward shift in velocity. Second is relatively damped downward trajectory of rates in the months leading up to this trough, giving less impetus to money demand--and depressing velocity less--early in this recovery. Third is the decontrol of deposit rates; this is the first recovery we have experienced without any vestige of Regulation Q holding deposit rates below equilibriums or effects of its staged lifting. In fact, the staff expects some, small, further reductions in deposit offering rates in coming months that will raise M2 opportunity costs and contribute to higher velocity.

Against this background, there seems little reason to revise the ranges for 1991 now in place. M2 and M3 are now in the middle portions of their ranges, and under the staff forecast are expected to stay there. In these circumstances, even if the Committee desired a different outcome than the staff forecast, or had questions about the assessment of the economy, prices or money demand underlying that forecast, the resultant adjustments to policy most likely could be accommodated within the current money ranges. Your own forecasts of nominal GNP for the year fall a little short of those of the staff, but, assuming your forecasts were not built on appreciable changes in interest rates, are likely also to involve money growth in the middle portion of the range, considering that the staff projection was for M2 a bit above its midpoint. Moreover, given the factors expected to be boosting M2 velocity in coming quarters, growth

around the midpoint in 1991 would seem to be compatible with a policy that was on track to produce the 6 percent nominal GNP growth both you and the staff have projected for 1992. In these circumstances, growth of money--at least M2--approaching the outer edges of the existing ranges this year likely would signal the need to take a hard look at the thrust of policy relative to the Committee's objectives.

The growth of debt so far this year is at the lower end of its range, but is expected to move higher over the second half with the pick up in the economy. A failure of debt to strengthen might signal a problem, such as intensifying restraints on credit supplies, that could affect the performance of the economy. Reducing the debt range at this time could be read as connoting complacency about these kinds of developments in credit markets. On the demand side, desired debt-to-income ratios may well be shifting down as a consequence of wider interest spreads at intermediaries and problems encountered by borrowers over the past year in servicing high debt levels, but such shifts are of uncertain size and duration and should be encompassed within the range.

Alternative ranges for money and debt growth for 1992 are given on page 18 of the bluebook. Alternative I, which would raise the ranges from those in effect this year, would be most consistent with the staff forecast for M2. Raising the ranges would seem to signal that priority was being placed on assuring a fairly robust recovery. The higher upper end of the range would give sufficient room to move against any weakness in the economy should it re-emerge, for example, once the surge from the inventory adjustment is completed. If further reductions in interest

rates were needed, the increase in velocity envisioned in the staff forecast would be far less likely. Scope for greater M2 growth would also prove necessary if the recent downward shifts in M2 demand stopped, or especially if they began to reverse. At the same time, the higher range, by potentially accommodating very strong GNP growth, also could be read as connoting less concern about maintaining the downward tilt to inflation in 1992 and beyond.

Alternative II would carry over the current ranges on a provisional basis. Although M3 and debt are projected to grow in the middle of the alternative II ranges in the staff forecast, M2 growth at 5-1/2 percent would be in the upper half of its alternative II range, implying greater scope to run a tighter than an easier policy and higher probability that increases rather than decreases in rates might be needed to hit the ranges. The Committee might want such a bias toward tightening if it were concerned about the potential for inadvertently building in undesired inflation pressures by delaying a needed tightening as the expansion moved out of its initial stages and resource utilization rose. The failure to ratchet down the range as in a number of recent years could be justified by a desire for stronger nominal GNP growth than in the recession and immediate pre-recession years, recognizing that such growth is still likely to be compatible with lower inflation. The central tendency of your own projections is for 6 percent nominal GNP in 1992, the strongest since 1988, with inflation generally below 4 percent and probably headed lower given a 6-1/4 to 6-1/2 percent unemployment rate projected for the end of 1992; if there were little or no increase in velocity, such an outcome

would require M2 very close to the top of the alternative II range. Simply carrying over the ranges might also make sense and be explainable in the context of uncertainty about the evolution of the financial system, and its implications for the relationship between money and GNP growth, accentuated at this time not only by the fragile state of many banks and thrifts but also by a pending bill that could affect attitudes toward deposits in ways that are difficult to predict.

Finally, the Committee could reduce the ranges further, as in Alternative III. Such a step would emphasize the Committee's commitment to price stability. The lower ranges imply that the Committee envisions a prompt reaction to any tendency for nominal GNP to exceed its projections, and would tend to constrain and delay any easings undertaken if the economy falls short. Such a course might be seen as potentially compromising the possibilities for a significant recovery over the next year or so, but it would also consolidate recent gains in inflation and keep policy on track to make substantial further progress toward price stability, with attendant longer-run benefits.

July 3, 1991

**SHORT-RUN POLICY BRIEFING**

Donald L. Kohn

With the trough of the cycle now tentatively marked as April, the next meeting of the FOMC will occur in the fourth month after the trough. On occasion in the past, the initial rise in the federal funds rate has occurred by that time in the cycle--though, to be sure, easing also occurred past this point, and past cycles may not provide the ideal model for current policy. The staff forecast, of course, does not envision such an increase this time around, given the other restraining influences discussed yesterday, including the milder degree of policy easing put in place during the recession.

Markets clearly expect some upward movement of interest rates--perhaps not over the next month or so, but probably by yearend. Looking at the entire yield curve, the slope is as steep as in the initial stages of any expansion, even those following more aggressive policy easings. This tilt, and its steepening over recent months, likely does not reflect concerns about a flare-up of inflation, judging from the the appreciating dollar and subdued behavior of commodity prices. But the persistence of high long-term rates in the face of an appreciating dollar and substantial declines in short-term rates could be read as indicating an enduring skepticism about whether lasting progress on inflation can be sustained through an expansion. By implication, markets must be seeing the rise in short-term rates built into the yield curve as an upward movement of real rates necessary to keep inflation from accelerating.

While these expectations might argue for the Committee to be especially alert to the possibility of needing to raise rates over coming

months, certain financial flow variables, especially those associated with depositories, continue to flash warning signals about the possibilities of weak expansion. To date, bank credit has been anemic--weaker in fact over the past few months than it was in the first quarter. Growth in total bank credit is usually a leading indicator of business cycle expansions, though business loans often lag the cycle trough. Partial data for June suggest another month of flat bank credit, after allowing for the effects of banks buying thrifts, and further decreases in business loans. While the behavior of loans appears to be mostly a question of declining demand for short-term credit, supply conditions remain tight. Often, the spread of the prime rate over the federal funds rate has begun to narrow appreciably by this point; some times this narrowing has resulted from an initial upward movement of the federal funds rate, but on occasion it has also reflected decreases in the prime in the early stages of expansion. While some banks are reported to be seeking lending outlets a bit more aggressively, that lending seems to be targetted only at the highest quality borrowers. Renewed skittishness in markets for bank debt and equity in the last week may impart a continuing element of caution to bank behavior, even as the economy rebounds.

The fall-off in bank credit in the second quarter has been accompanied by a marked slowdown in M2 growth as well. The moderation in M2 growth in the last few months has appeared to represent not weakness in contemporaneous income or spending, but rather a continuation of the velocity shifts of the past year. Those shifts in turn seem to have their origin in the rerouting of credit flows around depository institutions and, to an extent some portfolio shifts by money holders into capital

market instruments, in response to declining yields on M2 assets and the steeper yield curve. The implications of the slowdown in money for future spending depends in large measure on the interpretation of these two phenomena. The portfolio shifts, themselves, seem innocuous, since they do not directly affect spending or wealth. But if they indicate a high level of real long-term rates, weak money may be telling us something about incentives to spend. Similarly, damped credit growth at depositories may simply be a measure of the ready availability of other sources of funds. But if it also connotes banks and thrifts continuing to hold credit conditions quite tight, effective real rates to borrowers may remain high, with implications for spending and growth.

Even with the unchanged funds rates of alternative B, the staff does have a pickup in M2 growth forecast over coming months in association with the strengthening economy, as we discussed earlier in the meeting. Uncertainties about the relationship of M2 to spending over one or two quarters suggest the need to react to any deviations from expectations with care. Nonetheless, continued sluggish money growth, with M2 becoming entrenched in the lower part of its range, might indicate that policy was not fostering the financial conditions needed to sustain moderate recovery, and at least would provide an important counterweight to the expectations of tightening built into the yield curve.