

## APPENDIX

Notes for FOMC Meeting

March 31, 1992

William J. McDonough

Since your last meeting, foreign exchange markets have been rather volatile with a tendency towards a stronger dollar. Although off its highs of the period, the dollar is up about four percent against the mark and six percent against the yen.

The dollar sagged just after the last meeting because of a poor report on January employment on February 7. But then better news began to appear about the prospects for the real economy, and the dollar appreciated against the mark and other European currencies to reach a high of DM 1.6860 on March 20, before settling back to the DM 1.65 level, apparently largely on profit taking on the long-dollar positions which had been established.

The inter-meeting history of the dollar/yen relationship involved even more politics than economics at the Tokyo end. There is no question that the Japanese economy is weak, especially by recent standards of strong and sustained growth. Real GNP declined by 0.2 percent in the fourth quarter. Consumer demand is slowing and business confidence seems low. The Nikkei fell below the psychologically important 20,000 level. There was much talk about capital ratio problems for the major Japanese banks. New information about financial scandals involving the major securities firms hit the market.

Governor Mieno was under virtually constant heat to help things out by lowering the official discount rate, including a threat by a kingmaker in the Liberal Democratic Party that Mieno be fired if necessary to get the rate cut. Governor Mieno stared down his attackers and held onto his post, and the official discount rate remains at 4.5 percent. It seems likely that the rate will be reduced, and perhaps even very soon, but it also seems that this will happen at the Governor's timing.

In the midst of this economic weakness, the Japanese monetary authorities tried to strengthen the yen, mainly in the hope that a stronger yen would attract foreign capital to the Tokyo stock market. The Japanese authorities asked for American cooperation in this effort. On February 17, the Desk authorized the Bank of Japan to sell \$100 million against yen, all for the account of the U.S. Treasury, as part of a joint intervention. After consultation with the Chairman, and he with the Treasury, it was decided that the Federal Reserve would not participate. We felt that the intervention was at a yen rate that could not be sustained.

On February 20, the Japanese authorities once again asked the Treasury to provide at least token support for their intervention. The Desk again authorized the Bank of Japan to include the American authorities in intervention for the sale of \$50 million, shared equally by the Federal Reserve and the Treasury. The Japanese authorities sold a total of  
on these two days.

Regarding our own \$25 million participation, the only intervention for the period, I believe it is fair to say that we were seeking to calm disorderly markets. But we did recognize that the Japanese were trying to stop a market movement that was too strong to be slowed down much, never mind halted. After this second round on February 20, it became completely clear to us that further intervention was not likely to be useful and might even be counterproductive. We believe that conversations with the Treasury by the Chairman and others of us from the Fed helped the Treasury reach the same conclusion.

After this experience, and after the G-7 Deputies meeting at which no decision could be reached to support the yen, the Japanese authorities no longer asked for U.S. support, but did spend an additional \_\_\_\_\_ in largely ineffective intervention before they too acknowledged that could not fight the market and withdrew.

The Swiss National Bank had to intervene very heavily in March to resist strong downward pressure on the Swiss franc. This pressure resulted from an effort by Switzerland to strengthen its economy by easing interest rates at a time when German rates remained firm. The Swiss got away with holding policy steady when Germany and virtually all other EMS countries raised rates in late December. One reason the Swiss franc held firm may be because Japanese borrowers came to the market around that time to buy the currency in order to redeem Swiss franc-denominated securities they had issued some time ago. But when the Swiss authorities tempted the devil, and the market, by actually reducing rates in

late January--a reduction which widened differentials with German rates by roughly 75 basis points--the exchange rate was hit hard. Despite intervention totalling over                      worth of dollars and marks, and a narrowing of the interest rate differential with Germany by 100 basis points, the Swiss just barely held their own, let alone recouping the franc's losses against either the dollar or the mark. This episode serves as a reminder, especially to those in Europe, that domestic policy must be carried out within limitations set by the policies of other countries.

The path of the dollar between now and the next meeting appears to me to depend above all on how the market views the recovery of the U.S. economy. The stronger it sees the recovery, the higher it will take the dollar. At the same time, the two other major financial powers have difficulties which could contribute to weakness in their currencies. Germany continues to see inflationary wage settlements, and it is ever more obvious that the cost of the restructuring of former East Germany is a heavier burden than West Germany had anticipated. Japan is politically unsettled and experiencing continuing political and economic scandals. The country appears to be having trouble coping with unaccustomed economic weakness. Accidents can happen in those circumstances, the timing of which one cannot predict, but the possibility is indeed present.

Mr. Chairman, I have reported to the Committee, as did Mr. Cross before me, our discussions with the Bundesbank regarding a reduction in our overall reserves. We have

now reached the agreement described in the memorandum I sent to the Committee last week. We have agreed with the Bundesbank to sell, just as we did last year, a total of DM 10 billion in off-market transactions with the Bundesbank, involving one spot and a series of forward transactions, all taking place this year. Of that DM 10 billion, DM 6 billion will be from the account of the Federal Reserve and will bring the Fed's holdings down to approximately DM 20 billion. The remaining DM 4 billion will be from the account of the Treasury's Exchange Stabilization Fund and will bring the ESF's mark holdings down to about DM 12 billion.

We have also agreed to change

this has been  
one factor prompting us to consider other modifications to the mark portfolio.

As a first step, we have agreed to move DM 6 billion of the U.S. official holdings to the Bank for International Settlements, where they will be invested in six-month instruments. The first tranche of DM 2 billion has already been moved, all for the account of the Fed. We are discussing with the Treasury their possible participation in

the remaining DM 4 billion. The shift to the BIS will improve our earnings significantly and

In addition, we are studying the merit of placing some of our mark reserves in maturities longer than the 12-month maximum permitted under the present Authorization. If, as I think we will conclude, that appears to be a good thing to do, we will return to the Committee for further discussion and a request to revise the Authorization.

Mr. Chairman, the sale of DM 6 billion and agreement that it not be counted against the \$1.5 billion limit on the change in the overall open position between meetings needs the clearance of the Committee.

And, Mr. Chairman, perhaps you would entertain a motion to approve the February 20 transaction in which the desk sold \$25 million against yen for the account of the Federal Reserve.

Notes for Peter D. Sternlight  
FOMC Meeting  
Washington, D.C.  
March 31, 1992

Since the Committee's meeting in early February the Domestic Desk has sought to maintain unchanged reserve conditions, associated with Federal funds continuing to trade around 4 percent. The assumed path level of borrowing was raised by \$25 million, to \$100 million, following the February meeting in a technical move to accommodate recently higher levels of adjustment borrowing and in anticipation of a modest increase in seasonal borrowing.

Average Fed funds rates turned out quite close to the expected 4 percent level. At times, the rate sagged a little below that level, causing us to delay injecting reserves that the projections called for. On a couple of occasions, the slippage in the funds rate was sufficient that we entered the market to drain reserves overtly--even when projections suggested no overabundance--thus going out of our way to avoid generating speculation of possible easing moves. In the latter part of the interval, when market sentiment was leaning further away from any likelihood of an easing step, we felt we could be a little more tolerant of softer-than-expected money market conditions--but we still did not want to be very venturesome in this regard. We did go so far as to arrange some customer RPs on one occasion when funds were trading a hair below the rate of choice.

Reasons for the tendency toward softness in the funds market are not entirely clear. Except in the very early part of the intermeeting period, it did not appear to be a result of imminent expectations of easing. To some degree it may have stemmed from a desire by banks to avoid accumulating excesses that might be hard to work off in the closing days of a period without risking an overdraft. On occasion, the resultant delays in our own actions to inject reserves led to elevated funds rates at the end of reserve periods--in one instance a small amount traded as high as 35 percent. Taking the whole period, though, the average effective funds rate was 4.01 percent.

Borrowing tended to come in fairly persistently below the path level, typically ranging around \$50-75 million, though it did climb to nearly \$ 1/2 billion at the end of the reserve period that saw the very high closing funds rates. Seasonal borrowing did edge up a little, though by less than had been anticipated, perhaps constrained by the new pricing arrangement.

Reserve needs were moderate to fairly sizable over the period, and were met through a combination of outright purchases and temporary injections. Ordinarily, the needs emerging at this time of year would have called for greater reliance on outright purchases, but the reduction in reserve requirement ratios announced February 18, scheduled to take effect this Thursday with a release of some \$ 9 billion of reserves, changed the prospective pattern of needs. The delay in making sizable outright purchases also fit in conveniently with the plan to have some discussion at

this meeting of the long-run composition of the System's portfolio. Even so we did buy about \$3 billion of Treasury issues from foreign accounts over the period, including nearly \$2 1/2 billion in fairly short-term coupon issues and the rest in bills.

Further, on a good many days the Desk arranged either System or customer repurchase agreements, including a few instances of nonwithdrawable RPs when we wanted to gain better assurance that the reserves would stay out there for at least a couple of days. For several days at the start of the period, and then on a few intermittent occasions later, we entered the market to drain reserves through matched sale/purchase transactions--responding in part, as noted earlier, to unacceptably soft money market conditions rather than to projected reserve excesses. The draining actions early in the interval were against a background of temporarily revived market anticipations of further policy easing, following the weak employment report for January.

Yields on most fixed income securities rose a net of about 10 to 45 basis points in choppy and sometimes illiquid trading over the intermeeting period. The sharpest increases were in the short-to-intermediate range, about 1 to 5 years in maturity, causing the yield curve to flatten somewhat. The upward rate move continued a tendency that began early in the new year, abated somewhat in late February and then resumed more noticeably in March. The rate rise reflected a combination of more upbeat reports on the economy and a relentless outpouring of supply as the

Treasury moved to finance record deficits and other borrowers also tapped the market.

By the time of your early February meeting most market participants had pared down their expectations of further near-term policy easing--a process that had contributed to the rate rise in January. Then some weak January statistics, especially the employment report, revived anticipations of possible easing steps for a time. This was followed by stronger economic reports in early March, virtually snuffing out anticipations of near-term easing. Indeed, based on market rate relationships, an appreciable firming of policy within the next few months seemed to be priced in, although market participants disavowed such an explicit view. Within the past week or so, there has been more of a "trading range" apparent in the market, with a number of reports of decent investor buying as rates reached levels deemed reasonably attractive against a setting where the economy is seen as likely advancing but not really buoyant. But there are also "down days" when Treasury supplies loom ominously and participants anticipating a stronger economy can't seem to get out of one another's way.

The predominant view now is that policy is likely to be on hold for some months ahead, with perhaps more likelihood that the next move could be on the firming rather than easing side--but in any event not imminent. There is little anticipation of a resurgence of inflation, but also not a lot of confidence that there will be much further improvement on this front--a factor that tends to impede prospects for bringing long rates down. Long rates

are probably also held up by underlying supply and demand considerations--the never-ending supply from Treasury, competing supply from other domestic issuers, and diminished prospects for demand from overseas, especially Japan. The market experienced a bit of relief as it became evident that there was little likelihood of the Administration and Congress agreeing on a fiscal stimulus package.

Rates backed up only modestly in the bill area, as continuing low financing rates, anchored by the steady funds rate, were a stabilizing factor. Three- and six-month bills were auctioned yesterday at average rates of 4.08 and 4.19 percent, respectively, up from 3.86 and 3.93 percent just before the last meeting. The Treasury meantime raised about \$30 billion in the bill market, including \$14 billion of cash management bills to be repaid next month, but not including a hefty \$22 billion cash management bill just announced yesterday also for repayment next month.

Rates on 2 to 5-year Treasury issues pushed up by a net of about 35-45 basis points, while at the long end the rise was about 12-15 basis points. This left the active 30-year issue close to 8.00 percent and on a number of occasions the yield pushed above that level. The Treasury raised a substantial \$38 billion in the coupon market over the intermeeting period. Some \$16 billion of that amount was raised in the mid-February refunding, which met only lukewarm interest. There was better

interest in the monthly 2 and 5-year offerings, though at rates that had to move smartly higher to attract investors.

Debt issuance was also high in the corporate market, although the pace was less than in the opening weeks of the year. This abatement permitted some digestion of recent issues to take place, and in turn this relieved some scarcity situations in the Treasury market as short positions in certain Treasury issues had been widely used to hedge corporate or mortgage-backed securities during their distribution phase. This meant that several Treasury issues which had been in strong demand recently to make deliveries against short sales, gradually became more readily available in the market. A tight shortage continued in the case of recently issued 7-year notes, however, causing us to collect more statistical information about this issue from dealers and hold a number of conversations with market participants as part of our stepped up market surveillance efforts. At this point, we're inclined to the view that this issue was on special in the financing market essentially from "natural causes."

Peter D. Sternlight

Comments on System Portfolio Management

(For March 31, 1992 FOMC)

The paper on the composition of the System's portfolio distributed to the Committee on March 6, was prepared as background for possible Committee discussion, particularly in light of comments at recent Congressional hearings regarding the possibility of greater System participation in longer term issues. Given the concerns about the behavior of long-term rates and the recurring suggestions that perhaps the Fed could play a role in lowering those rates by lengthening its own portfolio, I thought it would be useful to describe what has been the Account Management's approach to the composition of the portfolio in recent years.

In summary, we've tried to have a fairly neutral posture vis-a-vis the shape of the yield curve. A major objective has been to ensure that, while meeting the FOMC's reserve growth objectives for current monetary policy, we also maintain a highly liquid portfolio capable of handling various contingencies that might call for large cuts in holdings in compressed time frames. A second objective has been to stay in touch with various sectors of the Treasury market through at least occasional participation in the intermediate and longer maturity areas. A further aim has been to avoid building up exceptionally large holdings of particular issues.

I believe that our occasional purchases outside the short-term area add some liquidity to the intermediate and longer markets, and

perhaps contribute modestly to rates in those sectors being a little lower than they might be absent our participation. But these purchases have not been pushed to the point of deliberately seeking to shape or twist the yield curve by materially affecting the balance of supplies in different sectors.

In my view, there is considerable doubt whether we could effectively alter the shape of the curve unless we operated on so massive a scale as to jeopardize our liquidity objectives and undermine the Treasury's efforts to maintain or increase the average maturity of the debt in the hands of the private sector. Moreover, an acknowledged policy of seeking to affect the shape of the curve, say by bringing longer rates down appreciably, would almost certainly subject the Fed to enormous pressure to do more than we might think is prudent.

Within the framework of maintaining essentially the neutral policy that has been followed in recent years, I think there is room to be a touch more forthcoming toward the long end of the market-- but this is more a matter of fine-tuning than of significant restructuring toward longer term issues. In the past year, the proportion of the portfolio in Treasury issues due within a year has crept up just past 60 percent compared with a shade under that level in the preceding few years. And the average maturity of our Treasury holdings has slipped just under 40 months, working down from a range of about 50-55 months in the early 1980s. This could make us comfortable doing a bit more in the longer end--but there should be no illusion that doing a bit more will work wonders in regard to long term rates. Indeed, there is a risk that a

noticeable effort in this direction could seem to promise more than it would deliver--and then end up being counterproductive.

Typically, the Desk makes outright purchases in the market when it faces sizable and sustained needs for additional reserves. Current projections, taking account of the about-to-be implemented reduction in reserve requirements, look toward moderate needs in April and May, and then a substantially expanded need in early June. I believe it would be consistent with the approach outlined in my paper to use both the bill and coupon sectors in meeting these upcoming needs, including some purchases out in the intermediate and longer term areas.

Michael J. Prell  
March 31, 1992

FOMC BRIEFING -- DOMESTIC ECONOMIC OUTLOOK

There have been some notable surprises in the data we've received since the last meeting--and they've generally pointed to stronger than expected activity in the quarter ending today. Nonetheless, the staff is not yet ready to declare that a solid, self-sustaining economic upswing is assured. We may be suffering from the "once burned, twice shy" syndrome, but it seems to us that there still are enough uncertainties and straight-out negatives in the picture to warrant considerable caution. Thus, while we might be on the verge of something a bit more akin to the traditional cyclical pop--albeit rather belated--a repetition of last year's experience can't be ruled out either. In the circumstances, the Greenbook projection of moderate growth over coming quarters might be viewed as simply splitting this wide difference, but we believe that it constitutes a reasonable shot at the most likely outcome under the assumption of an unchanged funds rate.

The big story since the last meeting is the surge in demand from the household sector. Although the official statistics for January and February look to us too good to be true, there are many other reports supporting the notion that consumers did in fact do some serious shopping. The question is, was this a flash in the pan--perhaps reflecting the effects of unusually warm weather and some bargain-hunting after a very weak Christmas season--or will we continue to see at least moderate gains in spending in coming months?

I think there are some fundamental factors in place that could be bolstering spending at this point--namely, lower interest rates, higher asset prices, reduced debt-service burdens, and some pent-up

demand. There has even been an improvement in consumer sentiment of late, though just how durable that will prove remains to be seen. The surveys from late February and March didn't show that a lot of people perceived themselves to be better off now, only that they were more hopeful things would get better in the months ahead.

In that regard, the sustainability of appreciable growth in consumer spending may hinge on our seeing some meaningful increases in employment and labor income before very long. The continued high level of initial claims for jobless benefits suggests that the February jump in payrolls was fluky. If our forecast is right, it will be a couple more months before there is a meaningful upturn in hiring.

In theory, consumers could continue to drive the expansion by stepping up their spending further relative to their income; however, we think that at least a good part of the near-term impetus to activity will have to come from elsewhere. We are looking to rising residential construction and a swing in inventory investment.

On the housing front, the recent signs have been quite favorable. Although, as you know, we've found reason to discount the dimension of the February rise in single-family starts, things obviously have picked up in that segment of the market. The back-up in mortgage rates is a worry, but affordability indexes still don't look bad and consumers still say this is a good time to buy. The February level of starts may well have been above-trend, but we believe the trend is pointing upward at present and that home construction will be creating jobs in the coming months.

Inventories, as so often, are a murky area. Looking, however, at the apparent divergence in the first quarter between domestic final sales and manufacturing output, we are left with the inference that either net exports or inventories fell substantially. What limited

evidence we have to date suggests that the inventory story is probably the key to reconciling the spending and production data; indeed, one of the identifiable downside risks to our first-quarter GDP estimate is that there could have been an even more pronounced reversal of the late-1991 inventory build-up than we've written down. Be that as it may, we expect manufacturers to benefit from a reduced rate of inventory liquidation in the coming months. The February orders data gave no hint that anything was in progress, but the more recent anecdotal reports have been a little encouraging and so have the surveys of manufacturing firms.

All of this doesn't tell us much about the path of the economy beyond the next few months, which of course is central to your policy decision. Essentially, in the revision of our forecast, the recent good news is reflected in faster growth in the first half of this year, but this is gradually offset through somewhat slower growth thereafter. We still perceive the troubled commercial real estate sector and constricted defense and state and local spending as drags on aggregate demand. But, in addition, the unanticipated further back-ups in long-term interest rates and in the dollar have argued against a more robust forecast.

I should note that much of the rise this year in bond yields occurred prior to the last Greenbook, and thus was not news for this forecast round. But, in any event, it is worth emphasizing that the implications of the rate increase are far from clear-cut. In particular, to the extent that it reflects an anticipation that the economy will be stronger than earlier thought, with the consequences that expected returns on investment may be higher or inflationary tendencies greater, the inhibition to borrowing and spending may not be substantial. That consideration, in combination with my persistence in

believing that bond yields will fall over the next year, has minimized the direct damage to domestic demand in this forecast.

The exchange rate story has some similar aspects, and is to some extent intertwined with the interest rate picture. The appreciation of the dollar probably owes at least in part to the pull of higher U.S. interest rates and to the perception that the U.S. economy is looking better while the economies of other major industrial countries have continued to lag. The incoming news on foreign activity has been disappointing, and the sluggishness abroad likely is hurting our exports currently. A pickup later this year should bolster U.S. exports, but because we have anticipated that the dollar will remain somewhat above the path in our previous forecast, the external sector is now, on net, a slightly more negative ingredient in GDP growth over the projection period.

In sum, our forecast of GDP growth is little changed--although it is a bit more front-loaded. Our forecast of the slack in labor and product markets is also about the same as that laid out in last month's chart show. The recent news on inflation has, if anything, reinforced our belief that wage and price trends are moving in a favorable direction. Our expectation that the disinflation process will be sustained through 1993 still does not appear to be widely shared among professional forecasters--or, it would appear, among bond traders--but certainly the survey evidence on inflation expectations among consumers suggests that, whatever it is that is still bugging people, it isn't a heightened fear of price increases: the Michigan survey for March showed about as low a mean 12-month price-increase expectation as has been recorded in the fifteen years they've been calculating the series.

E.M.Truman  
March 31, 1992

FOMC Presentation -- International Developments

I have three additional comments on the international outlook.

First, with respect to the current quarter, we have only one month of trade data and some preliminary indicators for February. Stronger than expected non-oil imports in the fourth quarter -- especially of consumer goods -- we thought would be followed by a correction this quarter. However, consumer expenditures recently have been stronger than expected. As a result, we are left with a bit of a puzzle concerning the extent to which the process of adjustment will actually show up in lower imports or just faster inventory liquidation. We are projecting that non-oil imports have declined a bit this quarter, and the decrease reported for January helped to confirm this view. In addition, the relatively mild weather contributed to lower than normal oil imports in January and February. These two factors more than offset weaker exports in the first quarter -- the result of slower-than-expected growth abroad. The consequence is a positive contribution to U.S. growth -- a somewhat larger contribution than was anticipated in the January outlook.

Second, economic activity in the major foreign industrial countries -- the other G-7 countries -- has continued to underperform our projections. Real GNP is estimated to have declined on average in the fourth quarter on a U.S.-export-weighted basis, falling short of our previous forecast by about

one percent at an annual rate, and helping to explain the shortfall in our projection of exports for that quarter. We expect real GNP in these countries to be about flat on average this quarter and project a slow recovery in the second quarter, followed by somewhat more rapid growth after midyear -- in the 3 percent range.

The rationale behind the projected pickup in growth is that interest rates have declined significantly in several countries -- Japan, Canada, the United Kingdom -- and fiscal policy has eased modestly in some as well -- Japan, the United Kingdom, and France. At the same time, balance-sheet problems, where they existed, are now closer to resolution, and special factors retarding consumer demand in Germany will be reversed at midyear. However, the scope for stimulative policy actions in the other G-7 countries, with the exception of Japan, is limited. This is one reason why we are projecting a very moderate recovery -- one that eliminates essentially no slack over the projection horizon.

We believe that the effects of weaker economic activity abroad are largely contemporaneous. On this basis, our weaker outlook for near-term growth abroad has trimmed about 1/4 percent from the growth of real GDP at an annual rate over the first half of 1992. However, for the second half of this year and beyond, despite the weaker level of economic activity now projected, we have roughly the same growth rate. Consequently, the contribution of foreign economic expansion to the growth of U.S.

exports and real GDP after midyear should be about the same as in the January forecast.

Of course, our foreign outlook contains some downside risks. However, I believe the risks are balanced for the forecast period as a whole. In this connection, you may have read recently that the IMF's latest forecasts for the G-7 countries again have been marked down. However, the IMF's forecast of growth for the other G-7 countries this year that has been reported in the press is more than one percent higher on average than the staff's. Moreover, further downward revisions in the IMF's outlook that will be released next month are likely still to leave their projections above ours. I report this comparison not to support the staff forecast, rather to warn against automatically adjusting our forecast for the IMF's revisions when they hit your screens over the next four weeks.

Third, as Mike has noted, we have raised the projected level of the dollar. The increase is about 3-1/2 percent, largely reflecting the dollar's appreciation since the last FOMC meeting. This appreciation was consistent with relative increases in U.S. long-term real interest rates over the first quarter, increases that now have been built into our assumptions about the path of interest rates over the forecast period. For your information, we estimate that our higher projected path for the dollar by itself removes one or two tenths from U.S. real growth this year and a bit more next year.

That concludes our report.

March 31, 1992

FOMC Briefing  
Donald L. Kohn

Although much of the real data since the last meeting has been stronger than expected, raising hopes for a period of solid economic growth, financial indicators of the transmission of monetary policy to the economy and prices continue to send mixed signals.

On one side, a number of indicators are sufficiently different from a year ago to support the notion that the recent pickup in the economy will in fact be sustained, in contrast to the situation last spring and summer. For example, the level of interest rates, long as well as short-term, is lower than a year ago, with short-term rates down significantly in real terms. And the dollar remains below its elevated level of last summer. The lower level of interest rates has contributed to a reduction in financial pressures, by encouraging balance sheet restructuring and reducing debt servicing burdens. Both borrowers and lenders are in better shape to support additional spending now than they were one year ago. Also responding to the lower level of interest rates, narrow money growth has accelerated considerably. Although M1 growth never faltered in the same fashion as M2 and M3 last summer, at an average of 14 percent over the fourth quarter of 1991 and first quarter of 1992, it has been substantially faster recently than the 5-7 percent growth rates of the first 3 quarters of 1991.

These factors, together with the incoming data on the economy, may be behind the apparent market expectation of a fairly robust rebound in the economy. That expectation can be read in elevated stock prices and price earnings ratios, and in a record upward

slope to the yield curve--noticeably greater than it was last year. Indeed, the structure of interest rates seems to be pricing in an appreciable increase in money market rates beginning in the second half of the year, signalling that market participants now view the next Federal Reserve action as more likely to be a tightening than an easing.

But there are several cautionary signs as well. One set concerns the back-up in interest and exchange rates. With nominal interest rates rising and inflation expectations abating, real long-term interest rates now appear to have increased back to the levels of earlier last year. As Mike noted, it's difficult to view the rise in rates as a negative development on balance, to the extent it reflects greater optimism about the economy--assuming those making the spending decisions have the same set of expectations as those buying bonds and other dollar denominated financial assets. On the other hand, the increase and level of interest plus exchange rates may be based on a misreading of the strength going forward of underlying demands in the economy, and, given the lags and complex interaction between changes in interest rates and their affects on spending, the self-correction of these rates may not be rapid enough to insulate the economy. Moreover, a portion of the backup in rates may represent a sense that monetary policy will be firmer than previously thought rather than expectations of a stronger economy alone, a notion supported by the bond market reactions to some public statements of Federal Reserve officials related to the stance of policy. And higher dollar exchange rates reflect in part weakness abroad.

Finally, measures of growth of broad money and credit remain unusually subdued. The data outside the federal sector are sparse,

but credit flows in the first quarter seem to have been very sluggish. Bank credit growth, for which the data are more complete and current, has slowed; no major loan category has shown a pattern of sustained acceleration, and business loans have been especially weak. Expansion of M2 and M3, after picking up in February, has dropped back in March. Even so, over the two months, money growth is not much different than we had expected when the Committee met in early February. And both weak money and weak credit can coexist with healthy economic expansion for a time if spenders are drawing on assets to finance purchases, and also relying on issuance of equity. Still, stronger growth in both sides of the balance sheet would lend some assurance that borrowers and lenders had become more comfortable with balance-sheet structures and were prepared to spend.

Balancing these and other factors, the greenbook forecast is based on the unchanged money market conditions of alternative B. That combination of income and interest rates is expected to be consistent with a fairly slow growth of M2--at a 3-1/2 percent rate from March to June. Money growth over the next few months can be especially volatile owing to flows related to tax payments, although at this time we have no reason to believe that such flows will impart an unusual pattern to money holdings this year. Our M2 projection does take into account the effect of recent increases in market interest rates on the growth of M2, as well as the waning or reversal of some of the special factors--like accelerated refunds and higher mortgage refinancing. Partly as a result, we are anticipating an increase in M2 velocity in the second quarter. In effect, many of the same forces that gave us unchanged velocity despite declines in interest rates in 1990 and 1991 are expected to give us rising velocity once rates stabilize, or even

begin to edge lower, as may be possible under alternative B. For 1992, we are projecting M2 growth of 4 percent, and a velocity increase of 1-1/2 percent. In effect, the staff is assuming that some of the relatively slow growth of M2 will not show through to GDP.

And on the other side, we are discounting the unusually rapid increases in M1. We are projecting a slowing in this aggregate, but to a still rapid growth rate of 11 percent over the March-to-June period. Some of the recent increases in M1 seem to be a function of special factors, such as the greater volume of mortgage refinancing. More generally, we have not placed great weight on this aggregate because its velocity has been so variable over the last decade. The increase in V1 variability seems to relate importantly to the introduction of nationwide NOW accounts. Rates on these accounts are fairly stable, while those on retail time deposits tend to vary with market interest rates. The result is sizable flows between the two instruments in response to relatively small changes in market interest rates. This phenomenon, coupled with the substantial effects of interest rate changes on compensating balance requirements, has made demand for M1 very interest sensitive. Moreover, uncertainty surrounding the degree of interest sensitivity also has been considerable, as household and business cash management practices and methods of compensating banks for services evolve. As a consequence, M1's velocity has been highly variable, and this aggregate has not proven to be a very reliable indicator of future GDP growth. In a general way, robust M1 growth probably can be viewed as an indicator of stronger growth of nominal GDP, and a sharp slowdown in the narrow aggregate to very sluggish or negative growth would be cause for concern, but there would seem to be a very wide confidence interval

around the relationship of the degree of M1 strength or weakness and the ensuing behavior of nominal GDP.

Alternative C, or a bias toward tightening, might be preferred if the Committee were to place significant emphasis on M1 growth and the associated expansion of reserves and the base as foreshadowing a much stronger economy and price pressure than is contained in the staff forecast. Aside from M1, a potential need for tightening at some point in the future, as for example, is expected by the market in the second half of the year, might be signalled in financial markets by a pronounced acceleration of M2 toward the upper end of its range or a rise in long-term interest rates and declines in the exchange rate in the context of a flow of reasonably encouraging economic data.

On the other hand, more weight to the negative indicators would seem to argue for alternative A, or at least a predilection toward ease. The market apparently has not put much weight on the negative indicators, and an immediate ease risks an adverse effect on inflation expectations. An easing would reduce real interest and exchange rates, with stimulative effects on the economy; however, its immediate effects on nominal long-term rates is difficult to predict. Over the intermeeting period, an easing taken once market expectations had begun to shift would have more favorable effects on bond rates. When looking for signs that an easing might be needed, in addition to weaker economic data, a tendency for M2 to fall short of expectations, dropping toward the lower end of its range, might be considered an indication that interest rates indeed were too high and credit too restrained to support a sustained expansion. In effect, given a reasonable range for possible velocity outcomes at stable market

interest rates, M2 growth of 2-1/2 or 3 percent would seem to argue that there was a significant risk of a shortfall from the greenbook GDP. Further increases in the exchange rate, especially resulting from additional weakness abroad, would also weigh on the side of countervailing measures here in the United States.

Of course, easing could be undertaken under a symmetrical, as well as an asymmetrical, directive. And adoption of a symmetrical directive would be a signal that the Committee was of the view that the risks were more evenly balanced, and that chances of the next move being a tightening were equal to those that it would be an easing. However, if the risks were thought to be asymmetrical, or the costs of a shortfall to outweigh those of an overshoot of expectations at this juncture, the Committee could signal a desire to react more readily to signs of potential weakness by retaining an asymmetrical directive.



THE SECRETARY OF THE TREASURY

WASHINGTON

March 20, 1992

The Honorable Alan Greenspan  
Chairman, Board of Governors  
Federal Reserve System  
20th Street and Constitution Avenue, N.W.  
Washington, DC 20551

Dear Alan:

We have considered the proposals concerning the warehousing facility contained in the January 22, 1992 memorandum to Treasury staff, taking into account our understanding that the FOMC decided at its February 4-5 meeting to renew the facility at a level of \$5 billion.

The ESF's dollar balances have fluctuated widely in recent years, largely as a result of intervention operations but also in reflection of bridge loans and transactions in Special Drawing Rights. The present level is sufficient to meet the ESF's immediate operational needs. But there is no guarantee that a \$5 billion warehousing facility would be sufficient in the future, and Treasury would intend to request an increase if the need arises. Accordingly, I am prepared to accept the proposals to adjust the terms and conditions of warehousing transactions, and to undertake advance repurchase of the remaining \$2 billion equivalent of warehoused foreign currency provided that we could expect that the FOMC would consider positively such a request, based on a favorable recommendation from the Chairman.

I understand that you could not guarantee FOMC approval but would appreciate your confirmation that our expectation outlined above is reasonable.

Sincerely,

A handwritten signature in cursive script that reads "Nicholas F. Brady".

Nicholas F. Brady



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

ALAN GREENSPAN  
CHAIRMAN

March 24, 1992

The Honorable Nicholas F. Brady  
Secretary of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

Dear Nick:

Thank you for your letter of March 20 concerning the Federal Reserve's \$5 billion warehousing facility in favor of the Exchange Stabilization Fund and the U.S. Treasury. I welcome your intention to undertake an advance repurchase of the remaining \$2 billion equivalent of foreign currency currently outstanding on the facility. I also welcome your acceptance of the proposals to adjust the terms and conditions of such transactions in the future.

I recognize that the Treasury may feel the need to increase the size of the warehousing facility in the future, as has happened in the past, beyond its present \$5 billion. I would strongly support an increase under a wide variety of possible circumstances. I am confident that the FOMC would give full, careful and expeditious consideration to any reasonable proposal. Needless to say, as you note, I cannot guarantee in advance the Committee's approval of any proposal.

Sincerely,

A handwritten signature in cursive script, appearing to read "Alan", written in dark ink.