APPENDIX

September 30, 1991

NOTES FOR FOMC MEETING

Sam Y. Cross

Since your August meeting, there has been no intervention in the foreign exchange market, either by the United States, or by Germany, or Japan. Indeed there has not even been any serious consideration of intervention during the period, which saw the dollar drift down by a little more than 3 percent compared with its levels after things settled down from the attempted coup in the Soviet Union.

As you may recall, just before your last meeting, the dollar spiked upward with the news of the Soviet putsch on August 19 and that event was still influencing exchange rates when you last met. But as evidence accumulated that the attempted right-wing coup would fail, the dollar gave back all those gains. Thereafter, if there was any residual effect of that aborted coup, it was mildly negative for the dollar and positive for the mark. For one thing, the failure removed one major area of concern surrounding the mark insofar as it revealed the strength of public support for more democratic government in the Soviet Union. For another, it was also seen as likely to induce other Western nations to share the burden of assistance for Eastern Europe, and it increased the likelihood of meaningful economic reform.

As far-reaching as those developments in the USSR might be, by far the more immediate factor influencing the dollar during the period was the perception that the U.S. economy still lacked clear signs of vigor, and that U.S. monetary policy would continue to be eased in response. These views seemed to have the greatest impact on dollar exchange rates during the first half of September. Reports showing continuing low growth in the money supply, statements by various officials in the Federal Reserve and elsewhere about the need to address that issue, and the release of the August employment data, in combination prompted the dollar to decline by almost two pfennigs on Friday, September 6. During the following week the dollar continued to decline, with the market anticipating that U.S. producer and consumer price data would show moderating inflation, and would be followed by an easing. Thus when the discount rate was cut on September 13, the move had been very widely expected and discounted, and the dollar did not immediately decline further.

After mid-September, the dollar benefitted from a shift in expectations about German interest rates. Market observers felt increasingly comfortable with the view that the Bundesbank would be unlikely to tighten further following recent favorable news about developments in eastern Germany, and improved monthly inflation data. Nonetheless the Bundesbank remains troubled about the current round of wage negotiations, and quite sensitive to any signs of a nascent wage-price spiral, so that in public comments, Bundesbank officials have continued to make clear their determination to act if necessary to contain such a development.

The dollar did not get the same benefit, however, from expectations of an easing of monetary policy in Japan. Market participants have observed the recent slowing of the Japanese economy and easing of inflationary pressures. They have noted the chorus of calls by a range of government officials for an easing of monetary policy. In these circumstances, many are expecting the BOJ to move soon to reduce the official discount rate. Yet the yen has remained firm against the dollar. To some extent, the exchange rate is benefitting from reduced capital outflows, modest repatriation of funds to shore up capital positions, and expectations of renewed strengthening of Japan's current account position. It is also worth noting that the market may be overestimating the likelihood of an imminent cut in the BOJ's discount rate. The BOJ is telling us there is still room for market rates to go down before there is any meaningful pressure on the discount rate, and appears to be encouraging the continuing decline in short term market rates, without yet moving on the discount rate.

At present, the dollar continues to trade with a soft tone. Market participants are speculating about the timing of the Federal Reserve's next move to ease. Also, President Bush's nuclear arms reduction proposals of last Friday are generally interpreted as confirmation of declining global tensions, further lessening dollar support. Yet up to now, this increased bearish sentiment has not translated into further significant declines, as the possibility of further military action in the Middle East, concerns over the situation in the Soviet Union sparked by Yeltsin's uncertain health, and the strife in Yugoslavia have reminded market participants of the risks of going too short dollars. Should some political event of consequence occur when the market is so overwhelmingly positioned against the dollar, dealers face the risk that the dollar could shoot up sharply, thereby imposing sizable losses on large short dollar positions. It may also be that market participants are cognizant of the fact that the dollar -- though significantly above its lows of last February -- is still at very low levels in an historical context and competitive in terms of purchasing power.

Mr. Chairman, there have been no exchange market operations to request the Committee to approve. I can report that in accordance with arrangements made earlier in the summer, and which I mentioned at your last meeting, forward sales of marks by the ESF and the Federal Reserve to the Bundesbank settled on August 27 and September 27, and a forward sale of yen to the Bank of Japan settled on September 18. Also as previously arranged, the ESF used a portion of its share of the proceeds to further reduce outstanding warehousing on August 22. Thus, during August warehousing was reduced by a total of $2.5 billion, and currencies warehoused by the Federal Reserve for the Treasury currently stand at $2 billion equivalent.

Notes for FOMC Meeting
Peter D. Sternlight
October 1, 1991

For several weeks following the Committee's August 20 meeting, the Domestic Trading Desk sought to maintain the existing degree of reserve availability, consistent with federal funds trading in the area of 5-1/2 percent. In the first half of September, the path borrowing allowance was reduced in two technical steps, by a total of $75 million to $300 million, to keep pace with an abatement of seasonal borrowing. Then, on September 13, the Federal Reserve lowered the discount rate from 5-1/2 to 5 percent and, as reviewed in an FOMC conference call that morning, it was envisioned that half of that reduction would pass through to the federal funds rate--paring the expected rate to 5-1/4 percent. Consistent with the restoration of a small spread in the expected funds rate over the discount rate, the borrowing allowance was boosted by $25 million to $325 million.

Actual funds rates and borrowings were fairly close to expectations. In the first few weeks of the period, funds averaged about 5.60 percent, while seasonal and adjustment borrowing was largely in a $350-$400 million range, boosted somewhat by temporary special situation borrowing and some tightness at the end of the August 21 reserve period. In the weeks since the discount rate change, funds have traded largely in a 5-1/4 to 5-3/8 percent range while borrowing has centered around $310-350 million. Yesterday, some quarter-end firmness showed through and funds were largely around 5-1/2 percent.

There were sizable reserve needs during the period, reflecting reductions in the Systems foreign exchange holdings, a paydown of extended credit, and after the mid-September tax date a bulge in Treasury deposits. The level of Treasury deposits was often a source of major uncertainty and projection error, especially in the latter part of the period when heavy outpayments by RTC and FSLIC did not always occur precisely as expected. The Desk met reserve needs with a $3.5 billion outright purchase of bills in the market in late August and a series of outright purchases of bills and notes from foreign accounts that totaled a little over $2 billion for the period. In addition, on most days the Desk arranged System or customer-related repurchase agreements. The extent of the small easing step on September 13 was readily conveyed to the market that day through the execution of a sizable round of customer-related repos at a time when the funds rate had just edged off to 5-1/4 percent apparently in anticipation of the System's presumed new posture.

Yields on most fixed income securities declined over the intermeeting period, responding to the sense of sluggish recovery, weak money growth and subdued inflation. The mid-September policy easing was thoroughly expected by the time it came, but was welcomed as confirmation of what had already been built into market pricing. Toward the end of the period, the market began to build up anticipations of a further easing step--perhaps not to be seen immediately but likely to unfold in coming weeks.

In the Treasury bill area, rate declines were very modest over the period, as these rates had dropped sharply just before the last meeting in a knee-jerk response to the uncertainties about the Soviet coup attempt then underway. When the coup failed, bill rates backed up, but then they worked lower again to end the period just a bit below where they started. In yesterday's 3- and 6-month bill auctions the average rates were 5.11 and 5.14 percent, compared with 5.17 and 5.23 percent just before the last meeting, which was the day the coup attempt began. The Treasury has continued to raise money in this sector--just over $20 billion during the period.

Yields on intermediate and longer-term Treasury coupon issues were down about 25 to 40 basis points over the period. Early on, there was some back-up in rates as participants responded to the sharp jump reported for new durable goods orders and leading indicators for July. The lost ground was more than regained by the time the discount rate was cut in mid-September as the August employment report was seen as weak and the market was impressed by the weakness in broad money measures, weak retail sales, and a better-than-expected PPI. The August CPI was slightly disappointing but not enough to dim sentiment. The Treasury also raised money in the coupon sector--a net of nearly $19 billion for the period. The rate decline for longer maturities brought the 30-year yield down to about 7.80 percent--the lowest since December 1989,

Treasury auctions proceeded smoothly, even robustly, despite concerns that adverse effects might develop in the wake of the Salomon Brothers revelations and investigations. In particular, there had been concern that some major participants in recent previous auctions might shun the process, and that a diminution of so-called "pre-auction" talk among dealers and customers might lead to a greater diffusion of pricing ideas with consequent "tails" in the bidding. There were indeed fewer mammoth-sized bids either from dealers or customers, but there has been plenty of broad-based dealer and customer demand--perhaps owing in good measure to the generally favorable market sentiment. To be sure, bidding for longer maturities, especially if it occurred in a less friendly market environment, could present more of a challenge.

In other markets, yields on investment grade corporates and municipals declined over the period, but not by as much as on Treasury issues. Short-term private instrument yields fell a modest 5-20 basis points, but the prime rate came down a full 1/2 percentage point just after the discount rate reduction.

Yield spreads on the paper of several bank holding companies widened over the period, notably including Continental which announced a restructuring that included the relinquishment of its primary dealer role. S&P downgraded Continental debt. Citicorp also sustained a widening yield spread following reports that it took a large loan charge-off against incorrectly valued assets on a mortgage-backed deal, and comments by their chairman that real estate problems will likely linger for it and other financial institutions for many years. There was also a sharp widening in spreads on Chrysler Financial's issues to as much as 11 percentage points over Treasuries, as investors were concerned about the parent company's cash flow and the financial unit's greater reliance on bank lines as they have lost effective access to the bond market.

Much attention, of course, has focused on the prospects for Salomon Brothers as official investigations proceed and the Federal Reserve weighs the firm's primary dealer status. The firm has operated in a defensive posture, shrinking the total balance sheet on the order of 25-30 percent since the announcements of wrongdoing and major changes of management. More than half of its commercial paper has run off. While some financing sources and trading partners have pulled away, and the firm has suffered downgradings from major rating agencies, day-to-day financing has not been a serious problem. The firm has substantial amounts of high quality assets that can still be put out on repos, and they have not had to pay up sharply for financing. Still, the firm is deeply concerned about the outcome of investigations and lawsuits, and of course, any decision on primary dealer status. Since the scandal was first reported, the spread on Salomon's intermediate-term notes over Treasuries has widened by about 230 basis points--and at its worst the widening was by nearly 300 basis points. Meantime, the firm's stock is off by over 30 percent.

Michael J. Prell
October 1, 1991

FOMC BRIEFING -- DOMESTIC ECONOMIC OUTLOOK

I want to focus this morning on two key issues regarding the prospects for the economy. The first is whether the incipient recovery can be sustained over the next few quarters without additional exogenous stimulation. The second is whether it is reasonable to expect that core inflation will drop significantly below 4 percent over the next year, given our growth forecast. While the staff's forecast continues to offer affirmative answers to both of these questions, it can hardly be said that the information that has come to us over the past six weeks has done much to resolve the uncertainties that attend the outlook.

With regard to the real side, the anecdotal evidence has, as I see it, continued to have a decidedly negative cast to it. Although yesterday's Wall Street Journal described a recent Conference Board survey of business executives that was rather upbeat, there is no shortage of bleak reports from individual firms. And there certainly hasn't been a rising tide of confidence among households in recent months; opinion polls reveal that the vast majority of people perceive no improvement in the economy. Perhaps all this should not be surprising: layoffs still are numerous, unemployment remains high, and many businesses have yet to approach their pre-recession levels of output or profitability.

Arrayed against this negative sentiment, though, is a substantial amount of statistical evidence that the moderate upswing in activity that most of us predicted is on course. To be sure, given the inherent noisiness of most of the data series--as well as the tepidness of the overall growth--the patterns are not clear-cut.

Indeed, it would not be at all difficult to construct a more negative case out of some of the recent zigs and zags in the monthly time series. But it is the staff's view that the odds at this point favor a continuation of the recovery rather than a stall-out or a second dip.

What is the basis for this judgment? An important consideration is that we believe we've already built into our Greenbook scenario allowances for a lot of the negative factors in the economic environment. Our projection includes a further sharp decline in the level of commercial construction activity. It also incorporates the drags stemming from increased taxes and weak defense and state and local spending. And we think that we have made due allowance for the financial stresses in the system, although admittedly this is an influence much less susceptible to straightforward quantification. For what it's worth, our flow of funds forecast provides what I think is a plausible picture of how the limited growth in spending that we've projected can be financed without heavy reliance on banks and other troubled intermediaries.

On the more positive side, unless one is strongly inclined to focus entirely on the empty portion of the recent glass of statistical indicators, there are favorable trends emerging in the data for a number of sectors. For example, despite all of the talk of weak consumer demand, real consumer outlays have been trending upward since February, and the slight decline in August still left the level well above the second-quarter average. Moreover, the latest data on motor vehicle sales suggest that September will see a good bounceback from the August decline. Neither the sentiment measures nor the figures on household saving and financial health would suggest that we should look for spending to outstrip income in the coming months, but consumers have been providing support to this recovery and, barring some new adverse shock, it seems unlikely that they will retire from the scene.

Before leaving the household sector, I should take note of the developments in the residential real estate market. Housing starts actually came in a little higher in July and August than we had expected, but declines in permits and sales suggest that the recovery in homebuilding might have been losing steam this summer. However, mortgage rates have come down quite a bit recently, appreciably enhancing affordability. Thus, we think it likely that the uptrend in housing starts will soon be reestablished--although, until there is more consistent employment and income growth, that uptrend is likely to be a very gradual one.

Meanwhile, in the business sector, orders for durable goods fell off some in August, but from a vastly improved July level. The upswing in orders since the early spring has been mirrored in a string of healthy increases in industrial production, and, with motor vehicle assemblies rebounding very strongly from an August dip, it appears that we are likely to see another large gain in IP in September. This pattern is suggested as well by the various surveys of purchasing managers, which have been flashing clear recovery signals in recent months.

Looking at the nondefense capital goods component of the durables figures, we can also see hints of a firming in spending on business equipment. The revised second-quarter GNP data show real equipment outlays to have increased at a 6 percent annual rate, an upward revision based on a higher estimate of aircraft purchases. The flat trend of computer orders should translate into hefty gains in real outlays in the near term, and the orders pattern for industrial equipment seems to point to a bottoming out in that category. Thus, we expect to see continued gains in equipment spending over the second half.

The last positive element I'll note is the inventory situation. Businesses have continued to trim inventories at a pace greater than we anticipated, and thus stocks look even leaner at this point than we had predicted. We could be surprised yet again, but we think that--barring another severe shock to business confidence--it is most likely that we'll be getting a moderate impetus from an abatement of destocking over the next several months.

All in all, then, many of the familiar elements of cyclical recovery would appear to be at work, and we think they will continue to override the unusual drags on aggregate demand we are experiencing in this episode. The risks in the outlook may well be somewhat asymmetric to the downside, but we don't view them as totally one-way: As has happened in the past, this recovery could yet surprise us on the upside, as some other forecasters are predicting.

I'd like to turn briefly, now, to the inflation outlook. If you examine the most recent poll of the Blue Chip forecasters, from early September, our projection of real output growth stands well up in their distribution. Yet our forecast of inflation, with the CPI increasing 3.6 percent in 1992, is a shade below the average. Most of those who have lower inflation forecasts have appreciably more subdued expectations for output as well. Is there a justification for our relative optimism? I think so, but I also would have to grant that I have some concerns.

First, on why we may be differing from the Blue Chip consensus: As I read and listen to many private analysts, I perceive a couple of major points in their arguments for less favorable inflation outlook. One is that the amount of slack in the economy isn't all that great, and the other is the thought that, once the economy has been growing for a while, inflation is likely to turn up--even if some slack remains. Our analysis of history suggests that, with the unemployment rate at 6-1/2 percent plus, we have an appreciable amount of slack and that disinflationary pressures should be substantial. Admittedly, the restructuring occurring in many industries could cause frictions in the labor market that raise the natural rate, but we don't think this is greatly affecting the situation. As to the conflict between growth and disinflation, the econometrics certainly can't be said to rule out the possibility that, once sales and jobs are perceived to be on a solid growth path, progress in lowering wage and price inflation may become more difficult to achieve, but our reading of history suggests that the existence of slack is the more important force.

Perhaps my greatest concern about our seemingly optimistic inflation forecast derives simply from the difficulty in reading the price figures we have in hand to discern what the trends to date are. If one looks to the CPI ex food and energy for a rough guide to the trends in core inflation, for example, one sees that this measure rose 4.6 percent in the year ended this August, after having accelerated to 5.5 percent in the year ended August 1990. This suggests that there already is a distinct disinflationary trend in process as a result of the recession. A 3-3/4 percent increase in these prices in 1992, our current forecast, looks quite reasonable. But when I look closely at the composition of the price deceleration to date, I find some rather disconcerting elements. First, in contradiction to what most people would anticipate, the commodities component of the core CPI actually has increased faster than in the previous year, and the deceleration is more than accounted for by the services component. Second, within the services component, the bulk of the slowing is accounted for by a reversal of what seemed like an inexplicably high rate of increase in owners' equivalent rents last year. These patterns raise some question in my mind as to whether some flukes of measurement might be distorting the trends and whether the probability distribution around our inflation forecast might not be skewed somewhat toward the high side.

Mr. Promisel will now add a few words about the role of the external sector in our forecast.

Larry J. Promisel

BRIEFING FOR FOMC, OCTOBER 1, 1991

I would like to review some of the international statistics released since the last meeting that bear on our view of the prospects for U.S. exports and imports.

With respect first to exports, we have seen some surprises in terms of foreign demand. Most notably, data showed that GDP in Canada rose at about a 5 percent annual rate, following four quarters of decline. Canadian exports were especially strong, but final domestic demand grew 6 percent, as well. Inventories dropped sharply.

We had thought that Japanese GNP had fallen back slightly in the second quarter following the 11 percent annual growth rate in the first quarter. But GNP was reported to have increased at a 2 percent annual rate in the second quarter, with the growth of domestic demand slowing only from about 5 percent to about 4 percent. The main factor behind the slowing of overall growth in the second quarter was a decline in exports at more than a 10 percent rate -- some part of which seems to have been a seasonal adjustment problem.

In contrast, in Germany, GNP did fall back as anticipated, following its first-quarter surge. Growth in the rest of Europe on average was pretty much in line with our expectations, that is, it remained subdued -- perhaps a little more strength than some had feared in France, but also not the recovery in the United Kingdom that some had hoped for.

Adding all that together, using U.S. nonagricultural export weights, the <u>level</u> of GNP in major foreign industrial countries was 1/2 percent higher in the second quarter (not annual rate) than we had previously estimated (and also 1/2 percent higher than in the first quarter). However, this development does not significantly alter our forecast for U.S. exports. The higher level of foreign demand enables us to explain more easily the strength of nonagricultural exports in the second quarter, when they rose 4 percent in real terms (not annual rate). The higher level of foreign demand itself does not in our view have significant implications for the future growth of U.S. exports.

Moreover, those second-quarter statistics on foreign activity, coupled with fragmentary indicators for the third quarter, have not caused us to revise upward our forecast for growth of GNP in the foreign industrial countries. We continue to forecast growth at an average annual rate of about 2 1/2 percent from the second quarter of 1991 to the end of 1992 -- somewhat higher when account is taken of forecast growth in major developing countries, as well. For the near term, this average results from some expected sluggishness in activity in Japan and Germany offset by strength elsewhere. The second-quarter data reduce to some extent our perception of the degree of downside risk, particularly for this year.

On the import side, we were impressed by the strength in the quantity of U.S. nonoil imports in July, following their 3 1/2 percent rise (not annual rate) in the second quarter. Very tentative indicators suggest to us that a good deal of the July increase will be sustained in August, implying at least as large an increase in nonoil imports in the third quarter as in the second. We have assumed that most of the stronger imports reflects some combination of the strengthening of U.S. final demand and a planned buildup of inventories of imported goods. Some portion of the notable increase in imports of computers in the second quarter and in July seems to have represented a one-time shift in the level of such imports related to the imposition of a high tariff on U.S. imports of active matrix liquid crystal displays, used in advanced laptop computers. We have revised upward by about 3 percent the path of nonoil imports, leaving the growth rate from the third quarter about the same as in the August forecast.

In terms of real net exports, the basic thrust of our forecast remains about unchanged. A positive contribution to U.S. GNP growth that we had anticipated for the third quarter has disappeared. On the other hand, the subsequent path of real net exports is a little less negative than we had previously forecast, largely reflecting a slight lowering of the path for the exchange value of the dollar. We continue to expect that the change in net exports will be an essentially neutral element in the growth of GNP over the projection period, with an anticipated strong growth in exports being offset by strong growth in imports.

I might note, finally, that our forecast makes little reference to the remarkable and historic events unfolding in the Soviet Union. While the Soviet Union is a large geographic region, and ultimately should play an important role in the world economy, it is symptomatic of the Soviet Union's isolation from the West over the past 70 years that, barring some kind of major further disruption to its oil production, what happens to that economy is not likely to have a significant direct impact on the U.S. or world economy over anything like the projection period. However, we cannot exclude the possibility of an indirect influence through financial markets of political developments in the former Soviet Union.

Mr. Chairman, that concludes our report.

September 30, 1991

FOMC Briefing
Donald L. Kohn

As Mike noted, the issue for policy at this time seems to be whether additional monetary policy stimulus is needed to achieve something like the Committee's objective for a sustained moderate expansion accompanied by declining inflation. With regard to developments in financial markets, since the last meeting, we have seen continued anemic flows of money and private credit, along with declining interest rates all along the yield curve. This combination of sluggish flows and falling interest rates is potentially troubling, since the most obvious explanation is downward shifts in demand associated with a weak economy, thereby weighing in the side of the need for additional ease. Alternatively, however, weak money and credit may primarily reflect balance sheet restructuring with minimal implications for aggregate demand, and the declines in interest rates may simply reflect market anticipation and then digestion of the policy easing combined with the belated recognition by bond holders that inflation is not likely to accelerate appreciably in the next few years.

In the interests of truth in labeling, let me begin by noting that the staff has no new insights that will clearly sort among competing explanations for the extraordinary weakness in financial flows or draw obvious implications. Still, the phenomena are so striking and potentially important--partly because the Committee does have publicly announced ranges for money and credit--it might be worthwhile reviewing the outlines of the issues as background for the Committee's decision.

One way to look at the restructuring argument is to view a great deal of what is going on today as an unwinding of some of the financial developments that occurred in the expansion of the 1980s. Those years saw an unusually rapid expansion of debt relative to income or net worth. On the household side this involved a simultaneous build-up of financial assets; for businesses it arose importantly from a substitution of debt for equity. Today's sluggish flows are consistent with both assets and liabilities being reined in relative to income and with the cessation of borrowing to retire equity. Under these circumstances, slow growth of credit and money need not necessarily indicate damped expansion of income or downward shifts in demands for goods and services--only that spending is being financed more by drawing on financial assets than by taking on new debt, and that some old debt is being repaid out of existing assets and new equity.

In addition, the borrowing that is occurring is being concentrated in instruments whose rates are fixed over the longer term. This is the case not only for businesses issuing large volumes of bonds, but for households as well who are showing a distinct preference for fixed-rate mortgages despite the much lower current rates on floating rate instruments. This shift, along with the greater emphasis on equity financing, implies that what funds flows there are have tended to bypass depository intermediaries, so that money stock measures, which concentrate on the liabilities of these intermediaries, are especially depressed. In effect, through purchases of bond funds and other capital market instruments, households are meeting the demands for long-term funds.

The shifts toward lower borrowing levels and longer maturity debt have been overlaid on the phasing down of a major intermediary class--the thrifts--whose liabilities are among those counted as "money". It is probably not mere happenstance that the recent run of shortfalls in money relative to expectations began around mid-year 1990, when the RTC first became active, and that the major surprise in the third quarter of this year coincided with a marked step-up in RTC activity. The channels for the influence of RTC activity on M2 are not obvious. But the disruption of depositor relationships from closing thrifts may accelerate portfolio reallocations outside of M2, as would the termination of brokered deposits at these institutions.

To a considerable extent, these restructuring processes may not be having adverse effects on the economy--indeed, they may be quite healthy for the longer-run strength of the financial system and the ability of nonfinancial sectors to fund future spending. However, from some other perspectives the impulses behind the restructuring and the associated weakness in money and credit may not be entirely benign. Over the past year or so, shortfalls in money growth <u>have</u> been accompanied by slower than expected expansion of the economy. Some of the balance sheet restructuring has been prompted by difficulties at financial intermediaries, even apart from the special case of the thrifts. Those difficulties have been reflected in cutbacks in credit supplies and widening margins of lending over borrowing rates, which have contributed to the propensity to use M2 to finance purchases or pay down debt. The widening intermediation spread, though bolstering the income of the owners of the intermediaries, raises the effective cost of spending financed by borrowing. Moreover, some of the demands for longer-term credit, which themselves may have tended to keep longer-term interest rates relatively elevated, may also reflect concerns about the future availability of funds from banks or in the commercial paper market. To an extent, therefore, the weakness in money and credit probably has signified greater tightness in effective financial conditions than might be indexed by the federal funds rate. Still, there is highly unlikely to be a one for one correspondence between shortfalls in growth of money and credit and in income or spending.

Looking ahead, this story of "on the one hand", "on the other", doesn't provide much guidance for policy. The approach the Committee has followed so far has been to give the behavior in money and credit heavy, but not a dominant, weight in policy decisions. This suggests sufficient doubts about the significance of particular growth rates for money and credit to deter acting on them alone, but sufficient worries to prompt unusually rapid responses when other indicators also tend to point toward weaker than desired track for the economy.

In the context of the continuing weakness in money and credit, this approach might still call for alternative B, with asymmetrical wording toward ease on intermeeting adjustments. The unchanged conditions of alternative B would be appropriate if the Committee were of the view that recent easing most likely had been adequate to assure satisfactory expansion of the economy. The asymmetry toward ease would connote that the Committee was more concerned that the lack of money and credit growth meant that financial markets might be tighter and the economy might be on a weaker path than desirable. Such judgments are complicated by the recognition that the easing actions of August and September have not yet had an opportunity to affect economic or financial data.

There are at least some reasons to believe the recent declines in interest rates have a significant real component that will bolster the economy ahead. Real rates are impossible to measure with confidence, but a weakish dollar, especially against the yen given declines in interest rates in Japan, and at least a fairly level stock market in the face of widely expressed doubts about the strength of the economy, suggest some declines in real rates. While markets may have built in some expectation of future easing, that appears to be a relatively recent phenomenon, while the stock market stability and dollar weakness are not. A sense that appreciable stimulus from past easings was in train might argue for a more balanced approach to incoming data over the intermeeting period--that is, a symmetrical directive.

The recent declines in nominal rates also should help to buoy money growth, although the fairly prompt adjustment of small time deposit rates and the effects of even greater "sticker shock" by time deposit holders will limit the drop in opportunity costs and their effects. Nonetheless, we are projecting some strengthening in M2 under alternative B, to a 3 percent pace from September to December, leaving this aggregate at the lower end of its range. The pickup reflects in part stronger nominal GNP growth projected for the fourth quarter. More important, however, we are assuming that some of the unusual weakness in money growth seen in the third quarter abates. To the extent the unusual weakness reflected a rethinking of portfolio allocation, those M2 holders with very liquid assets have already had a chance to act on their impulses.

The three percent projection leaves M2 just at the lower bound of its growth range in the fourth quarter--a convenient, but not deliberate aspect of the projection. If the Committee were of the view that slower money growth were an unavoidable by-product of appropriately gauged policies in reserve markets, it is under no obligation under the law to achieve those targets. The law does call for explanations of the reasons for revisions to or deviations from plans in subsequent reports to Congress. In the past, we have occasionally notified Congress when we have made major changes in targets, but we have not followed a consistent practice of giving warning of misses, even when they appeared inevitable some time before year-end.

If the sluggish performance of money and credit was of considerable concern to the Committee, or significant weight was being placed on recent softer indicators and suggestions of eroding business and consumer confidence, then an immediate easing, as under alternative A, would be appropriate. Such a policy would be consistent with a somewhat more activist stance by the Federal Reserve to assure an adequate expansion of the money stock and the economy, but raises the odds that a tightening might be needed at some point to keep price pressures on a downward trajectory.

There is some question about the extent to which lower interest rates would in fact boost money growth, especially if the decline in rates were at the same time to steepen the yield curve. Bowing in this direction, the staff trimmed the difference between money growth under bluebook alternatives A and B. Nonetheless, it is our judgment that the effects of lower market rates on the opportunity costs of holding liquid deposits, whose rates are unlikely to change very much, will more than offset the negative effects of a steeper yield curve, other things equal. Given the response of liquid deposits to an easing, lower rates will almost certainly involve faster growth of M1 and reserves. In any case, in the short run it would be easier to defend and explain any shortfall from target if the Committee had actively eased reserve conditions to hit the range.