APPENDIX

NOTES FOR FOMC MEETING
FOMC MEETING MARCH 23, 1993

William J. McDonough

The Desk did not intervene in the foreign exchange markets since the last meeting of the Committee.

The dollar has been generally unchanged against the Deutsche mark and the remaining ERM currencies, but has weakened about 7 percent against the Japanese yen.

Last Thursday, the dollar reached an all-time low of 115.60 yen at the New York close and was as low as 115.05 in Tokyo today. Although there have been virtually countless statements by Japanese officials regarding the official Japanese attitude on the yen and quite a few statements by officials of other G-7 countries, including our own, the strengthening of the yen probably has more to do with the enormous Japanese trade and current account surpluses and incoming capital flows than all the statements. It is likely that the current account surplus will persist. It is more difficult to judge whether the recent capital flows into Japan are prompted mainly by fiscal-year-end activity by Japanese insurance companies and others or whether it is a more fundamental flow. Market participants continue to have problems figuring out the offsetting outward capital flows needed to make the balance of payments table foot; consequently, they have major problems in guessing exchange rate direction.

The Japanese authorities seem to realize that a gradually appreciating yen is probably unavoidable, but there is very real fear in Tokyo about the effect of a stronger yen on the health of export industries, the only significant source of strength, other than fiscal spending, in a seriously weak economy. This could well lead to a continuing Japanese reluctance to agree to a G-7 policy aimed at strengthening the yen.

In the face of a rather constant dollar/DM rate, there have been a number of developments in Germany in both the fiscal and monetary areas in the context of an economy which is weak and getting weaker. The long-awaited fiscal policy pact between the two major political parties and between the federal and state governments was achieved, but has been dismissed by German newspapers as very small stuff indeed. That leaves the Bundesbank in the awkward position of having to do what it least likes to do, easing interest rates because of its concern about the economy at some risk to its much-cherished credibility if it should be deemed to reward ongoing poor fiscal performance. But the Bundesbank has moved.

Just after the last meeting, the German Central Bank lowered its discount rate from 8.25 percent to 8 percent and the Lombard rate from 9.25 percent to 9 percent. Last Thursday, the discount rate was again dropped by half a percentage point to 7.5 percent. Money market rates have also been brought down, narrowing the interest-rate differential with U.S. rates. Using the three-month rate as the benchmark, the differential has come in by 45 basis points.

The narrowing interest rate differential and the relatively attractive American economic performance, all other things being equal, might well have brought about a strengthening of the dollar. A partial, but not entirely satisfying, explanation for the lack of dollar strength is that the Bundesbank sold about   which it had received in payment of loans made last summer to the central banks of other members of the EMS. The Germans do not consider such sales to be intervention, since they are selling these dollars to buy their own currency which they loaned to the other countries. They do not have a policy goal, they say, of affecting the exchange rate. In the same conversations, they mention that a weaker DM could present policy problems, making further easing of interest rates more difficult. In any case, they have maintained the normal courtesies and have kept us well informed of their intentions and their actual dollar sales.

The French franc has been under pressure from time to time, but has been able to stay within its ERM band against the DM. The first round of elections last Sunday makes it clear that the center-right coalition will be back in power next week. The most prominent leaders of all the major factions within that coalition have stated their support of the strong franc and maintaining its present parity with the DM. There could be some market testing of that conviction this week if any important politicians should sound less convinced – or convincing – and also in the early days of the new government if there is any hint of devaluing immediately and blaming it on the outgoing Socialists.

The new Treasury team is still getting in place, so we have not had any in-depth discussions regarding appropriate levels of official reserves. Therefore, I have nothing new to report on that front.

Notes for FOMC Meeting
March 23, 1993
Joan E. Lovett

Desk operations over the intermeeting period remained geared to achieving reserve conditions associated with a trading area around 3 percent for Federal funds. The borrowing allowance continued at $50 million.

Reserve management was fairly uneventful over the interval. A need to drain reserves at the period's outset was of brief duration and gave way to moderate add needs thereafter. Temporary transactions sufficed through most of the period to adjust reserves in the needed direction and included 3 rounds of MSPs early on and 16 rounds of assorted RPs subsequently. Last week, the normal seasonal buildup in reserve needs began to emerge, and the Desk purchased $3.1 billion of Treasury coupon issues in the market.

The World Trade Center explosion on February 26 had only a mild disruptive impact on the markets in general. The "blizzard of '93" produced substantial amounts of float, notwithstanding which the funds market was strangely firm in its wake. Banks either wanted more excess reserves at the time than the elevated levels already available, or there is a revision yet to come in the reserve data for March 17.

As has been the case for some time now, the Federal funds market continued to show a distinct intra-maintenance period pattern: softer in the first week or so and firmer over the last few days. Both we and the market have learned to work with this pattern. For the full intermeeting period, the effective Federal funds rate averaged 3.02 percent. Adjustment and seasonal borrowing came in at $60 million.

The next few weeks should be challenging ones as April tax flows are expected to be particularly hard to predict this year and as debt ceiling constraints may emerge in early April. In the meantime, the March quarter-end is next week. The calendar itself suggests some pressure as the date falls on a reserve period settlement Wednesday when two Treasury notes are settling. It is also the end of the Japanese fiscal year. Thus far, however, reports indicate quiescent conditions. Rates in the 4 1/2 - 5 percent range have been paid, mostly by Japanese banks, but appetites are reportedly pretty mild.

In the Treasury market, an explosive rally was set off early in the period that brought yields down to levels not seen in nearly two decades. President Clinton's Congressional address on February 17 provided the initial trigger as investors appeared convinced that significant reductions in the budget deficit are possible. The plan was considered by some to present a "win-win" opportunity for the bond market as the proposed tax increases would both reduce the deficit and provide a restraining effect on the economy and prices.

The initial downshift in yields unleashed successive waves of demand across the yield curve that became self-reinforcing for a time. Heightened prepayment risk on mortgage-backed securities prompted demand for Treasuries, and municipal refunding operations prompted heavy defeasance buying. This demand pressed on the market, pushing Treasury yields down further and provoking fresh rounds of buying. Overseas demand also picked up. By early March, yields on Treasury coupon issues were down 40 to 60 basis points from levels prevailing at the time of your last meeting. The bond yield briefly touched a low of 6.72 percent, and the record amounts of corporate issues that flooded the market were readily absorbed at roughly unchanged yield spreads. News of the stronger-than-expected employment data gave the market pause. Furthermore, expectations of low inflation, a key factor in the move to lower bond yields, were brought into question by some disappointing reports on prices at the wholesale and consumer levels. Against this background, the market's ardor cooled over the balance of the period. Overall, yields on Treasury coupon issues ended the period 30 to 35 basis points lower.

At this juncture, views on the likely direction of long-term rates are mixed. A marked acceleration in inflation is not anticipated, but prospects for further moderation are being questioned, as is the likelihood of a drop below 3 percent in the CPI. Some participants look at well-contained labor costs and say there is still room for inflation and bond rates to edge down. Others, however, see vulnerabilities on the upside as the budget proposals work their way through the Congress. Convictions don't appear particularly strong either way given that the extent of the recent rally caught many dealers by surprise. This has produced a somewhat skittish background climate. A trading range for the long bond of 6 1/2 - 7 1/4 percent covers the gamut of views. The Fed is expected to be an observer over the next few months. Economic conditions are not seen as warranting a change in policy in either direction for some time to come.

I should mention that one of the primary dealers, reached a settlement agreement with the SEC on matters that included a violation of Treasury bidding rules in connection with the Salomon affair. We suspended our trading relationship for a one-month period, beginning March 1. Treasury restricted the firm's ability to bid for customers in its auctions for a three-month period.

Michael J. Prell
March 23, 1993

FOMC Briefing

I hope that the small size of the revisions in the staff output forecast since the last meeting will not be misinterpreted. It doesn't mean that everything has gone as anticipated, or that we've been hibernating since the winter weather hit. In fact, there have been a number of surprises, and we've been working hard to divine the implications of developments in fiscal policy and other areas.

In terms of the incoming economic indicators, the pluses and minuses have pretty much balanced out, leaving our first-quarter GDP forecast little changed, in the neighborhood of 3 percent. Last month's unexpected jump in employment looks to be in good part a statistical catch-up; jobless claims and other evidence suggest that labor demand actually is still growing at a quite moderate pace. As we expected, real consumer spending appears to have flattened out a bit early this year; however, owing to an upward revision to December sales, the quarterly average advance may still outstrip our prior forecast, perhaps exceeding a 3 percent annual rate. Orders data suggest that equipment investment may also come in stronger than we anticipated, with growth into the double-digit range. The information on net exports has been about neutral relative to our prior forecast, but housing starts have been disappointingly weak, and our guess is that inventory investment also will come in weaker this quarter--given the decline in stocks in January.

In none of these cases, however, did the incoming data seem to warrant a major change in our basic view of the trends in the individual sector or in the economy as a whole. The challenges we faced in developing the current forecast arose more from the problem of assessing the implications of changes in several environmental factors. Prominent on the list were the introduction of the Administration's fiscal program, the continuing weakness of activity in the major foreign industrial economies, and the recent movements of interest rates and exchange rates.

I won't take the time to repeat all that we've said about these matters in the Greenbook or in our briefings. I'll just highlight a few key conclusions. First, on the question of fiscal policy, you'll recall that, in previous Greenbooks, we had been attempting to abstract from the near certainty that there would be a new program. In doing so, we had found some comfort in the notion that any program that would be forthcoming would likely have only small macro effects over the forecast period. On our current analysis, it looks like that approach didn't take us far off track: The net direct effects of the stimulus and deficit-reduction components look to be close to a wash through 1994. That conclusion holds even if you toss in the quarter point or so of additional decline in bond yields that we have built into the current forecast, in light of the recent market rally.

Meanwhile, the continuing weakness of most of the major foreign industrial economies, in combination with a somewhat higher path for the dollar, has had a small, but significant negative effect on projected U.S. GDP growth. We still anticipate that activity overseas will accelerate later this year, encouraged by further monetary policy easing in general and fiscal stimulus in Japan; however, U.S. exports are expected to grow more slowly in this forecast through 1994.

Turning briefly now to some of the risks in our forecast, I should emphasize once again the uncertainty attending the analysis of the fiscal program. Setting aside the possibility that the package may yet change by the time the legislative process is completed, there are facets to the current plan for which there is little or no precedent, and for which the effects will depend considerably on expectational behaviors that are difficult to predict. It is my judgment, though, that the forecast risks associated with the fiscal picture are two-sided, and that they are not so great as to dominate all the other questions about the trends in the economy.

One of those other questions clearly brought to the fore by recent news is the realism of our forecast of slowing inflation. As you know, the half percent increases in the CPI ex. food and energy in January and February were appreciably larger than we had projected. To be sure, the downtrend in "core" inflation over the past couple of years has been far from even, and we've had our forecasts jerked around at times by what proved to be over-reactions to unexpectedly high or low short-run variations. But that experience does not itself provide grounds for discounting entirely the recent movement in the price index. The pickup has, after all, followed what seems to have been a considerable quickening of the economic expansion, and in a circumstance where market conditions seem to have provided some materials producers and other firms with the closest thing to pricing leverage they've seen in a while. As you know, I've been looking over my shoulder for some time at the price forecasts of private analysts, and it would be reasonable to ask whether the recent data are not evidence that they were right after all in predicting a firming of inflation.

Obviously, we have not yet thrown in the towel on price deceleration. Indeed, even the quarter percentage point we've tacked onto the 1993 and 1994 core inflation rates overstates the fundamental shift in our view; some of the addition to next year's rate simply reflects new assumptions about the minimum wage and energy taxes.

The limited size of the adjustment to our forecast is based on the following observations: First, while we may have taken too literally the relatively low readings on the core CPI trend in late 1992, the recent bulge seems to involve partly the same sort of coincidence of seasonal adjustment problems and one-time price jumps that we've seen previously--indeed, in the first quarters of the past few years. Second, not only does the surge in some materials and intermediate goods prices look to be attributable to special, possibly transitory, factors, but, even if it were to reflect a broader, ongoing tightening of supply-demand conditions at the earlier stages of processing, the direct implications for finished goods prices would be minor. There have been bigger increases in materials prices in other cyclical upturns, without an immediate acceleration in the prices of consumer goods and services. Third, and last, it does not appear that a labor market with 7 percent unemployment is producing inflationary pressures at this time: there is no sign that wages are accelerating, and unit labor cost increases are probably still being substantially damped by productivity improvement.

This is not to say that I'm going to stop worrying. Even if, in effect, we've got the short-run Phillips curve relation right, it would not take a huge overshoot of our output growth forecast to create circumstances in which inflationary pressures could soon be significantly more intense than we're anticipating. On the other hand, though, I think it is only fair to recognize an opposing risk in the outlook--namely, that continuing corporate restructuring and productivity improvement could mean that real GDP growth at the pace we've projected would create less inflationary pressure on resources.

March 23, 1993

FOMC Briefing
David E. Lindsey

Again, the surface message of the incoming information on the monetary aggregates is greatly at odds with the preponderance of economic indicators. The monetary aggregates have come in still weaker than our projection in early February, while the economic information in hand as filtered by the greenbook points to continued moderate economic expansion and price pressures that are stronger, though only a little, than previously thought. Looking further ahead, one crucial issue is how the various crosscurrents stirred up by the fiscal package will, on net, alter current economic trends. In this regard, the staff's longer-term outlook has not changed much since the February meeting, as Mike has noted.

My sense is that financial market participants by now also expect sustained moderate economic growth, though they seem to have reached this conclusion by a somewhat different chain of reasoning than the staff's. Through the election, markets were much more pessimistic about future fiscal restraint than was the staff. Hence, markets were more surprised than the staff by the extent of deficit reduction in the President's proposals and its accompanying contractionary effects on aggregate demand after 1993. The markets also had built in rising short- and long-term interest rates going forward, whereas the staff had projected fairly stable short-rates and declining long rates all along. Thus, the ensuing rally of intermediate- and long-term security prices, although compressed in time relative to the staff forecast, was a considerably bigger surprise to investors.

Since the election, the extent of the rally has been remarkable. The Treasury long bond rate has declined nearly 1 percentage point and the Treasury one year forward rate three years out has fallen about 1-1/2 percentage points. Despite the recent upturn in inflation readings, and accompanying market jitters, a portion of these reductions likely represents a further downward adjustment in inflation expectations. Investors' expectations of inflation in the mid-1990s seem to have come closer to the staff view. An even larger share of these nominal rate declines probably has reflected falling real rates, prompted by perceptions of reduced future federal credit demands <u>and</u> associated restraint on overall real spending. However, investors also realize that the drop in real interest rates itself will work to counter over time the depressing effects of fiscal restraint on aggregate demand by encouraging more private spending.

In effect, investor perceptions of the future <u>natural</u> real interest rate, consistent with full employment, have dropped appreciably in reaction to the fiscal program, but the sharp declines in actual real rates may have been of about the same size, thus serving as an approximate offset to potential future spending weakness. Market participants accordingly seem to be left with an outlook similar to the staff's that sustained moderate real economic growth is the most likely outcome in coming years. To be sure, the market's inflation outlook likely is still more pessimistic than is the staff's, but our best guess is that as time passes, the further unwinding of inflation expectations will be accompanied by additional declines in nominal long rates, leaving long-term real rates little changed and still consistent with the economy's gradual approach to full employment.

The risks to monetary policy looking ahead will continue to involve either a possible stalling of the economic expansion or a possible sustained reversal of the disinflationary trend of the past couple of years. While neither of these outcomes can be ruled out, neither appears to represent a clear and present danger, judging by the Committee's earlier discussion. Thus, the Committee's short-run policy choice today would seem to involve an assessment of whether or not either one of these risks of untoward developments down the road appears sufficiently serious to warrant tilting the directive away from its current symmetry or even changing the stance of operating policy.

The staff's interpretation of recent monetary behavior implies that the monetary aggregates are basically silent on this question. We interpret <u>some</u> of the recent weakness of M2 as arising from purely temporary factors, such as seasonal distortions and a lull in prepayments of mortgage-backed securities, both of which are soon to be reversed. We see <u>another part</u> of the weakness in M2 as representing a marked and continuing uptrend in underlying velocity--that is, measured abstracting from effects of the temporary factors on M2. And <u>the rest</u> of the recent M2 weakness involves an <u>acceleration</u> in the first quarter of this year in underlying velocity growth. We have attributed this pickup in underlying velocity growth to a first-quarter intensification of some of the influences that have been at work for some time in rechanneling credit intermediation away from depositories and depressing money relative to spending.

The particular sources of this recent boost to velocity growth, however, seem rather benign for future spending. Specifically, the cessation of bank credit expansion this year is partly related to further paydowns of bank business loans from the proceeds of record issuance of corporate debt and equity. Refinancing has left corporations, if anything, with stronger balance sheets. Banks' own issuance of subordinated debt and equity, while depressing their need for deposit funding, has further improved bank balance sheet structures, along with their capacity to make loans. And record inflows to bond and stock mutual funds represent, on the other side of the coin, a reduction in the public's desired holdings of money balances that yield relatively low returns.

In coming quarters, we see these influences diminishing in force, but still remaining strong enough to sustain further increases in velocity. Thus, we view the current and projected levels of the broader monetary aggregates that are below the lower bounds of their annual ranges as fully consistent with the greenbook's forecast for the economy. It follows that we do not interpret the recent money stock decline in and of itself as a warning signal of renewed economic contraction.

Finally, Mr. Chairman, I'd like to mention the two options for the sentence in the directive regarding monetary growth given in the bluebook. The first, included in the operating paragraph on page 12, would specify explicitly the Committee's expectations of numerical growth rates for M2 and M3 over coming months, as was standard practice prior to the February meeting.

The second option, on page 13, instead would retain a qualitative characterization of expected money behavior, similar to the general approach adopted at the February meeting. This sentence could be seen as more compatible with the Committee's evident deemphasis of money growth relative to specific expectations in setting operating policy. This sentence also could be viewed as "holding the place" until more experience clarifies the likely future reliability of the aggregates as policy guides. As it happens, the wording of the alternative sentence, which refers to "a resumption of moderate growth in the broader monetary aggregates over the second quarter," would apply to the staff's money projections under all three policy alternatives, A, B, or C. In this sense, the Committee's decision whether or not to adopt this second sentence can be logically separated from its more substantive decision about short-run operating policy.