APPENDIX

FOMC BRIEFING - P.R. FISHER

SEPTEMBER 26, 1995

Before permitting myself to take advantage
of the toys in the ceiling,
and because of the number of topics I need to cover,
I thought I should exhaust the potential of older technologies.
Thus, you should find an outline of my remarks
on the table in front of you,
together with a single page of color charts.

1. **To understand the dollar's sharp sell-off last week, I think it's helpful to distinguish the causes of its initial rally in July and August from the factors that led to its push above 100 yen earlier this month.**

As I discussed at your last meeting,
the dollar's appreciation in July and August,
reflected relative changes in expectations
for each of the G-3 economies, nudged along by regulatory and monetary policy changes in Tokyo & Frankfurt and concerted intervention.

While the dollar moved up a bit
after the Bank of Japan's September 8th rate cut,
the dollar's subsequent rally above 100 yen was
-- to a very great extent --
the result of unusual and aggressive <u>oral</u> intervention
by the Ministry of Finance,
aimed at Japanese portfolio managers,
talking up the benefits of outward investment,
promising a secular change in the dollar's trend,
and raising expectations of supportive fiscal and regulatory policies.

Thus, while the dollar's overall summer rally
against the yen
was vulnerable to a consolidation,
it's extension above 100 yen was particularly vulnerable
to selling on the announcement
of the Japanese fiscal package on September 20th.

The fiscal package, itself, was somewhat larger
and more stimulative than originally expected.
But it was leaked before the fact and, thus,
already in the market.

Moreover, market participants had -- somewhat naively -- come to expect a grand announcement of regulatory changes and banking sector support at the same time as the fiscal package.

The absence of the grand announcement became a good excuse to sell the dollar and we traded down in Tokyo from around 104.60 to 103.60 by the time trading began in New York on the 20th.

What might have stopped as a modest retracement of dollar-yen turned much uglier, for markets and the dollar, when the German mark began to appreciate.

The announcement of the French government's fiscal plans, that same day, triggered a slight firming of the mark -- not because the plans themselves are bad but because they are viewed as politically implausible, as evidenced by the public sector unions subsequent strike call.

The dollar then weakened a bit after the release of the slightly-worse-than-expected U.S. trade deficit for July.

Finally, the mark spiked higher, against a number currencies, following the release of remarks by German Finance Minister Waigel and Bundesbank Council member Jochimsen to the effect, respectively, that Italy and France might well not make it into the first round of European monetary union.

While everyone in the markets understood the limited probability of a number of countries actually meeting the Masstricht criteria by the end of 1997, Waigel's comment transported that future improbability into current markets.

It is noteworthy that the dollar has lost a greater share of its recent rally against the mark than it has against the yen. Thus, the good news may be that the dollar's recovery against the yen is a little less vulnerable than we feared. However, the bad news is that the dollar may continue to be vulnerable to the tensions surrounding European monetary union for the next few years.

2. **Over most of the period, the bond market rallied back to its highest price levels of the year but no further, and then sold off a bit.**

For most of September, the market was seeing all of the components of the soft landing that were so eagerly hoped for last spring:
-- continued growth, somewhat below potential;
-- slightly-better-than-expected inflation numbers;
-- a firming dollar and foreign demand for bonds;
and, a Fed seen as likely to ease before year-end.

At the end of last week,
-- the four-fold increase in the Philadelphia Fed's regional survey of manufacturing activity;
-- the dollar's abrupt sell-off, and
-- outright threats of default out of Washington,
were certainly enough to jolt the market back a bit.

However, given such good initial conditions, I think it's worth asking why, prior to the end of last week, the market couldn't break through the (price) highs established earlier this year.

Most importantly, it has been hard for market participants to get adequate assurance that the economy will not come back more strongly later this year and early in 1996, given the recent production numbers. Indeed, one of the factors that prompted the market to rally as much as it did last spring, was the risk of recession -- which is not now on anyone's radar screen.

Also, the net consequences for the bond market, of the <u>fiscal policy follies</u> are hard to assess.

I think that the prospects for some, unspecified improvement in fiscal policy have been reflected in the market for some time.

While the threats of default contributed to yields backing up last week, the uncertainty associated with the wide range of plausible outcomes of the various "train wreck" scenarios may also be making it more difficult for prices to settle in at any one point.

3. **In domestic operations:**

during the period,
we used temporary operations,
supplemented with purchases from foreign accounts,
to manage reserve conditions.

Last week, we faced several days of large deficiencies,
and low operating balances,
as a consequence of high Treasury balances
resulting from quarterly tax receipts.

On Tuesday, I decided to operate earlier than normal,
in order to improve our prospects
of receiving a sufficient volume of propositions,
to meet our need.

I mention this for two reasons:

-- First, our flexibility in doing this
was certainly enhanced by the Committee's
policy of announcing changes in policy.

-- Second, our need to operate early,
in order to have adequate assurance
that we will have sufficient collateral,
reflects the fact that the financing market
has been shifting to earlier in the day,
leaving our current operating time
as something of an afterthought to the rp market.

In the context of the thoughtful annex to the Bluebook,
on the possible impact of sweep accounts
on reserve balances,
Don and I will be considering a number of ideas
to ensure that the Desk can continue
effectively carrying out the Committee's directives.

In the upcoming period, the fiscal "train wreck" may create
some challenges for the desk.

A partial shutdown of the government, after October 1st,
would be likely to make it more difficult to forecast
the Treasury balance.

Any likely adjustments
to the Treasury's auction calendar
through early November,
would have minimal impact on the portfolio.

Even the cancellation of the 2-and 5-year auctions
at the end of October,
would have little impact on SOMA,
because of our low holdings of these issues.

Given the $37 billion of maturing securities and
and $27 billion of interest payments,
all on November 15th,
no one expects the Treasury to be able to make it beyond
mid-November.

In contingency planning,
for a possible default by the Treasury,
we -- like other market participants --
face a number of uncertainties.

We are still unsure whether it will be possible
to transfer matured and unpaid Treasury securities
over the book-entry wire;

Assuming that some means could be found to transfer
and settle these securities
we will have to consider
whether we will accept them
in our RP operations,
and, if so, what the appropriate haircut should be.

Given the likely breakdown of payment flows
that would result from a Treasury default,
we would expect
demand for excess reserves to rise sharply.

4. Portfolio review:

Mr. Chairman, I had hoped to provide the Committee
with an initial report
on our review of the portfolio's **maturity** structure
in time for the Committee to have a preliminary discussion
at the November 15th meeting.

However, I am afraid that I will need some more time,
and I hope to be able to come to the Committee
in either December or January.

5. Mexican Swap Renewal

While we had no foreign operations during the period,
I would like to inform the Committee
that we have an expectation
that the Mexican authorities will repay
half of each of the outstanding one billion dollars
on the System's and the ESF's short-term swaps
(500 million each)
by the time of the swaps next maturity date on October 30th.

We would then roll-over the remaining 500 million each
on the System's and the ESF's swaps
until their final maturity in January,
when we expect them to be repaid in full.

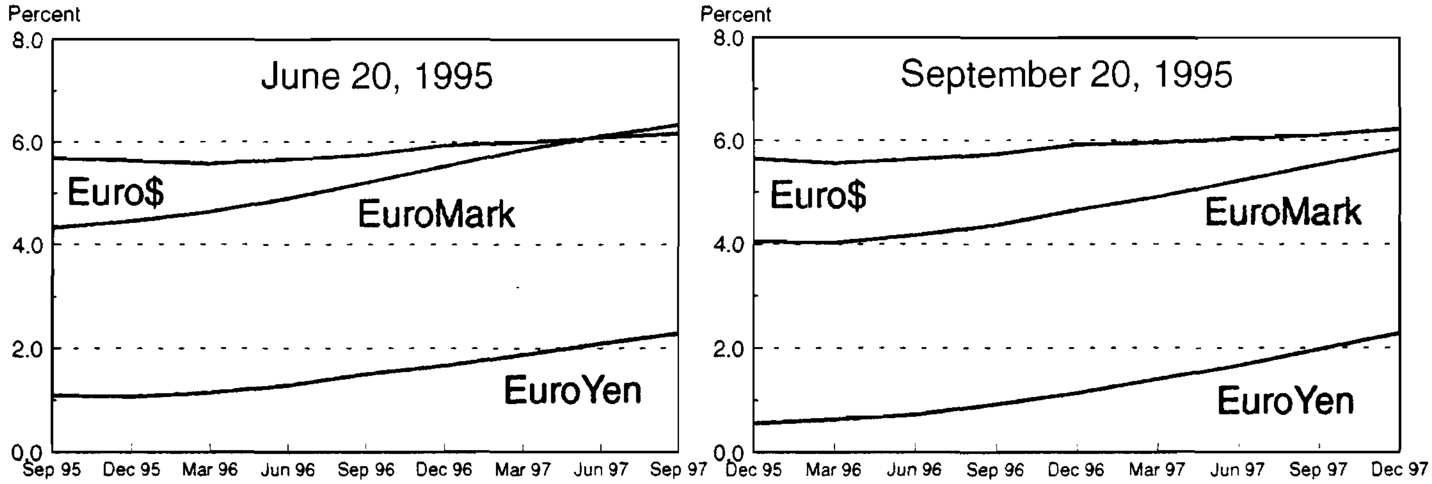
There remains 10.5 billion dollars outstanding
on the ESF's medium-term facility.

6. Ratification of Operations:

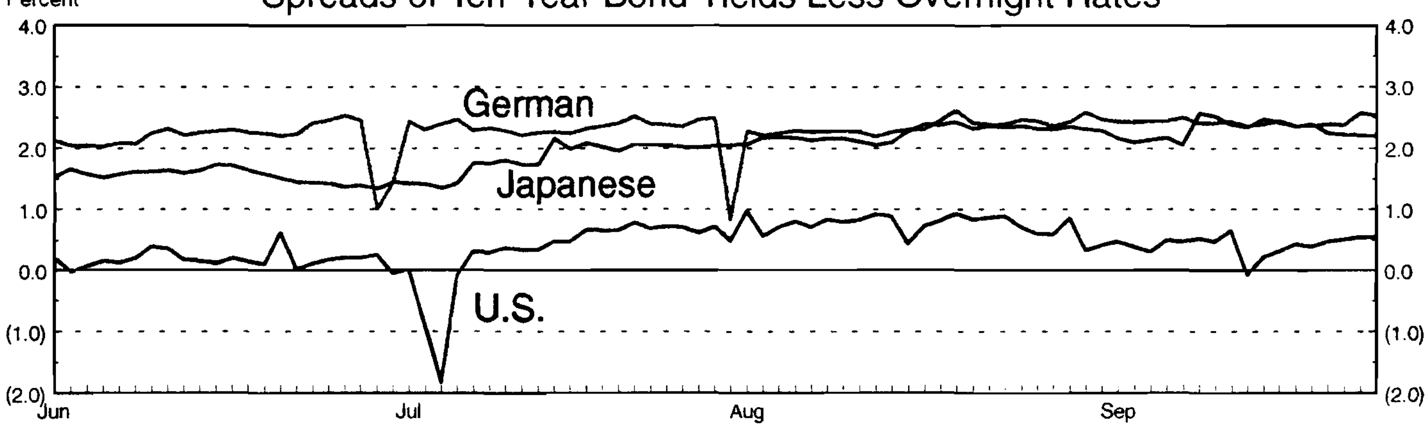
Mr. Chairman, I will need the Committee's ratification for our operations during the period.

I would be happy to answer any questions.

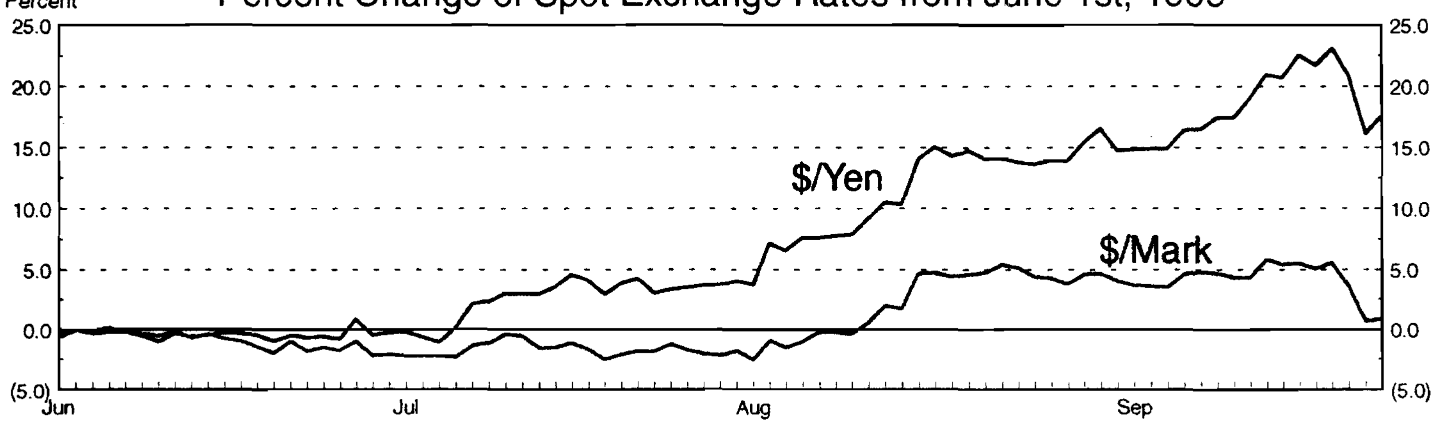
Yields Implied by 3-Month Futures Contracts



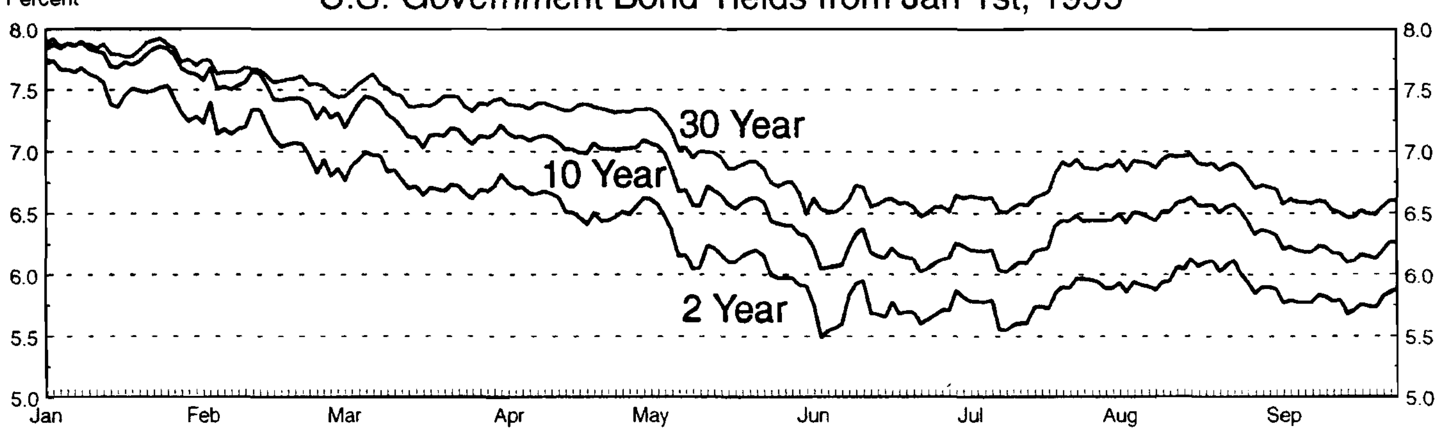
Spreads of Ten-Year Bond Yields Less Overnight Rates



Percent Change of Spot Exchange Rates from June 1st, 1995



U.S. Government Bond Yields from Jan 1st, 1995



Michael J. Prell
September 26, 1995

FOMC BRIEFING

The forecast we've prepared for this meeting could reasonably be characterized as singularly unexciting. Not only are the changes from the last time almost imperceptible, but our projections for output growth and inflation look so flat as to suggest that the economy--or at least the staff--is in a state of suspended animation. In fact, though, we believe that some important dynamics will be playing out in the economy over the next year or two. It's just that, at this point, we don't know nearly enough to try to anticipate the wiggles that inevitably will occur.

In the interest of time, I won't recapitulate the current-quarter accounting discussed in the Greenbook. Suffice it to say that, sifting through all of the available information, we think that a GDP growth rate in the vicinity of 2 to 2-1/2 percent is a reasonable call. My sense is that most outside analysts see it about the same way.

The bigger question is where the economy is headed from here. Doing the proverbial two-handed economist one better, I'll offer three quite different, yet plausible, answers. At one end of the spectrum is a scenario in which the economy quickly returns to a pace of expansion brisk enough to elevate resource utilization significantly--say, real GDP rising at 3 percent or more.

Analysts holding this view tend to point to one or more of the following factors as driving the economy away from a more moderate path: First, it is argued, financial conditions are, on balance, stimulative. To be sure, real short-term interest rates are above longer-term averages, but they aren't high by the standards of the past decade. And, moreover, long-term rates have come down appreciably this year, providing obvious lift to the housing market and making other household and business capital outlays less costly as well. If anything, the economy is awash with liquidity, as indicated by the aggressive lending behavior of banks and other intermediaries and the run-up in stock prices.

Second, the degree of fiscal restraint in the offing is much less than what we've assumed in the Greenbook. Any deficit-reduction package that is passed will be considerably back-loaded, and there will be liberal use of smoke and mirrors, so that the fiscal drag actually imposed on the economy will be less than the budget numbers might suggest.

Third, U.S. producers are in a strong competitive position internationally, and especially now that some of our major trading partners have moved to get their economies on more solid growth tracks, our net exports will soon turn upward.

Finally, as an extra added attraction, if the factors I've just listed do result in a fairly buoyant final demand picture, businesses will need to stock up accordingly and thus inventory investment may provide some lift to activity.

The implication of this analysis is that the Fed is going to have to tighten soon, or else inflation will gather speed over the coming year.

At the other end of the spectrum is a view that we are headed for a period of quite subdued growth in activity--not a recession, but perceptibly short of the 2-1/4 percent kind of expansion we've described in the Greenbook for the next few quarters.

The argument goes something like this. The current economic expansion is enervated: households are up to their ears in durables and debts, and business capital spending is already at such a high level that further sizable increases cannot be justified in terms of reasonable capacity growth. Furthermore, the federal budget not only is being slashed, but there are unprecedented programmatic changes that could be seriously disruptive to activity. The Japanese economy will remain bogged down for a while, and Mexico isn't going to recover soon, either; consequently, our trade deficit will continue to suffer. The stock market is overvalued and overdue for a setback, which will have adverse effects on wealth and the cost of equity capital. And, of course, short-term interest rates are unduly high, especially in an environment in which real rates will be moving up as the softening economy pushes inflation down.

The policy implication is that, unless you wish to seize upon this as the opportunity to achieve that next significant notch down in the inflation rate, it would be appropriate to ease money market conditions appreciably in the near future.

The Greenbook forecast sits between these scenarios. However, I should emphasize that we didn't just split the difference between the two to arrive at our projection. Rather, we see something along the lines of our projection as constituting the mode of the probability distribution--the most likely of the alternatives, conditional on our monetary and fiscal assumptions. Of course, we're not saying you should take seriously each and every decimal place in the projection tables. Indeed, we'd vigorously warn against it. But we do believe that it would be a reasonable premise for your policy decision today to anticipate that, without a significant change in the funds rate, growth would average just a little below trend over the next several quarters and that inflation would be essentially stable.

The simple logic of our output forecast is that, in the near term, the boost to final demand from this year's capital market rally is offsetting most of the drag from the inventory adjustment that is underway. As we move through 1996, the financial impetus from this year's stock and bond rallies wanes in force and the assumed fiscal restraint takes hold; these forces are only partially offset by the completion of the inventory adjustment and a diminution in the negative contribution from net exports.

This kind of outlook for activity suggests that resource utilization rates can be expected to ease a bit in the months ahead. At least, this is so if the labor force resumes a mild uptrend, as we've predicted, and if all this manufacturing investment we're witnessing is in fact raising plant capacity at a brisk clip. This still leaves open some questions about the inflation picture, however. Dave Stockton noted last time that there might be a case for more optimism about where, in conventional Phillips curve terms, the natural rate of unemployment is. The latest price index readings certainly have not weakened that case: Notably, they have largely reversed the deterioration in the trend of core CPI inflation that occurred earlier this year--despite the fact that the unemployment rate has remained in the 5-1/2 to 5-3/4 percent range.

As you know, we have projected that the core CPI will continue to rise at a pace just under 3 percent over coming quarters, even though we are anticipating that the jobless rate will remain below 6 percent until late next year. While such a pattern might suggest that, in effect, the natural rate is closer to 5-1/2 percent than to 6, we still view this as a matter too close to call.

Basically, we see the economy as operating in the neighborhood of full employment of labor and capital, but with some special factors working to moderate price pressures in the short run. Certainly, speed effects are no problem; to the contrary, we think it likely that the widening of markups that has been occurring will abate. The likelihood of this happening is enhanced by the prospect that, despite the dollar's recent backsliding on exchange markets, import prices will rise less rapidly than they did earlier this year. And, while there may be some tendency for compensation increases to creep upward--partly because cuts in medical benefit costs probably will be harder to come by--we suspect that the continuing restructuring of corporate America will keep workers sufficiently insecure that they won't exert very much inflationary pressure.

None of these factors would be expected to improve the short-run inflation-unemployment trade-off permanently, but in our forecast they don't have to: By 1997, resource utilization rates have eased to the point that a gradual disinflationary trend can continue without the benefit of special influences. In sum, the Greenbook projection suggests that maintenance of the current federal funds rate for a while longer is likely to be consistent with a gentle, patient approach to the goal of price stability.

E.M. Truman
September 26, 1995

FOMC Presentation -- International Developments

As a complement to Mike Prell's presentation, I thought it might be useful to add a few comments about the external sector.

We raised our projection for the dollar in the Greenbook, after leaving it unchanged since March. In light of the dollar's strength over the previous month or so, we raised the dollar's path by about 2-1/2 percent, as indexed by the G-10 weighted average. The ink was not dry on the forecast before the dollar came under substantial downward pressure from a number of factors, as Peter has discussed, including the U.S. trade data that were released on Greenbook day, the Japanese fiscal package that was announced the same day, and the financial turmoil in Europe. I will turn to each of these developments in a minute, but first I thought I would comment about our projection for the dollar and its implications for our forecast.

We had expected all along that the dollar would recover somewhat. Partly for that reason, the staff forecast never has envisaged a very large contribution to U.S. real GDP from the external sector. This is in contrast with some of the private forecasts that were predicting that the dollar's weakness would produce a large external stimulus. In fact, our forecast has not differed much from those of private forecasters who pay particular attention to the external sector. The reason is that even as the dollar was declining, growth abroad was weakening, with roughly offsetting effects on net exports. Nevertheless, if the dollar now should remain around its current lower level, closer to its projected level in the last few Greenbooks, we estimate that the impact on real net exports would be about $10 billion by the fourth quarter of 1996, moving from a slight negative contribution to real GDP to a slight plus over the four quarters of next year.

With respect to the July data on trade in goods and services that were released last Wednesday, they were very much in line with our thinking. We anticipated some deterioration based on our assessment that the seasonal adjustment of the trade data appears to be incomplete. This phenomenon produces relatively strong exports in the fourth quarter and relatively weak exports in the first and third quarters, especially in July. Nevertheless, the release of the data apparently resonated in the market, combined with other factors, including Fred Bergsten's comments about the dollar's strength undermining improvement in our trade balance.

The release of the long-awaited Japanese fiscal package on Wednesday also appeared to disappoint the market, though as Peter has suggested this may have been a case of buying on the rumor and selling on the news. The fundamental question is how we now should evaluate Japanese economic and financial developments. Our answer is that we are somewhat encouraged. The monetary and fiscal steps by the Japanese authorities over the past several months suggest that they are more determined to do what they can to bring about a sustained recovery in the Japanese economy. At the same time, they appear to be making progress with respect to strengthening the financial system, notwithstanding or, perhaps, as evidenced by, today's announcement of losses by Daiwa. These policy actions, along with the unexpectedly strong second-quarter GDP data and the substantially weaker yen, have led us to move up our forecast of Japanese growth somewhat. However, I would stress that even with this improved outlook, growth only barely reaches our current estimate of potential -- about 2-1/2 percent -- over the next two years. We anticipate that the financial headwinds in Japan will continue to blow with considerable fury. Thus, we still have a rather conservative forecast.

Finally on the European situation, we have seen over the past week the influence of developments that we may not have fully appreciated: changing prospects for EMU. We have factored into our outlooks for the individual European countries judgments about the influence of the Maastricht criteria on fiscal policies, we have only partial convergence of long-term interest rates within Europe over our forecast period, but we have implicitly assumed that EMU will blast off on schedule on January 1, 1999. However, we have not been explicit about which countries will be part of the crew, or what kind of mess the rocket will leave behind even if it succeeds in reaching orbit. What I am suggesting by my use of yet another transportation metaphor in discussing EMU is that it is a source of uncertainty. Based on events over the past week, considerable uncertainty about EMU is likely to prevail over the next several years and to add to volatility in European interest rates and in intra-European and dollar exchange rates in the process. The net influence on growth is likely to be negative, and this may be a downside risk to our forecast.

Thank you, Mr. Chairman, that concludes our comments.

September 26, 1995

FOMC Briefing
Donald L. Kohn

As noted in the greenbook, the staff forecast is based on an assumption that there will be no significant economic disruptions stemming directly from the current budget debate. Given the uncertainties surrounding the negotiations, however, it may be worth discussing the issue briefly.

The first key date of interest is in just five days, on October 1, when annual appropriations expire. News stories suggest a strong possibility of a continuing resolution to allow these activities to be carried on at some, albeit reduced, level, at least for a time after October 1. In the absence of such a resolution, or following its expiration, the overall effects on aggregate demand of a lapse in annual appropriations still should not be large, even if it persists for several weeks. Spending under most entitlements and to protect life and property would continue. The remainder amounts to only about .15 percent of GDP each week, at an annual rate. Moreover, multiplier effects from the cut in spending should be small as government employees draw on savings to maintain consumption--though the size of the knock-on effects could increase over time as some employees exhaust their liquid assets or become concerned about the nature of an eventual settlement. Ultimately, employees would be called back to work and spending would resume, perhaps even with a temporary boost from some catch up in deferred purchases. There is probably little monetary policy can or should do about such a brief mild shock. Indeed, attempts to offset the shock would likely be inflationary, given the lags in the effect of policy and the fact that government workers, even while laid off, are unlikely to make themselves available to produce goods and services in the private sector.

The second stage of the confrontation will be about the debt limit. The staff currently estimates that without an increase in borrowing authority--and without resorting to extraordinary measures, such as a drawdown of trust funds--the Treasury will be unable to meet its obligations by no later than November 15--the date of the next scheduled FOMC meeting. In one sense, the macro effects of default would be less than with an appropriations lapse, since the government would continue to incur obligations--it would just take a little longer for the obligors to get paid. But the failure to meet obligations promptly could have disruptive effects on the financial markets and on the liquidity of individual transactors counting on payments. The extent of the disruption might depend on how the government handles a number of technical issues that would have a bearing on the intensity of liquidity pressures. The markets' reaction will be affected as well by the perceived impact of the impasse on the eventual size of the deficit reduction package. The odds on a significant disruption with broad implications for markets and even spending are small--but not zero. However, there may be a self-limiting aspect to the situation; the worse the problems created by a debt ceiling impasse, the sooner the political process may be likely to deal with it. Permanent effects from default also are hard to predict, outside some risk premium on Treasury debt.

Thus, the confrontational process of reaching agreement on the federal budget is not, by itself, likely to give rise to developments that would dictate a change in the basic policy stance of the Committee. Of course, the outcome of the process could be a fiscal policy that differs substantially from that now embodied in the staff forecast--or in the expectations of markets, which themselves may be subject to considerable volatility as participants handicap the outcome. Moreover, as Peter noted, reserve management could be complicated by either an appropriations lapse or a debt ceiling crisis; the latter in particular might dictate a more flexible provision of credit through open market operations and the discount window to meet highly variable demands for reserves as planned payments and receipts are unexpectedly delayed.

However, the Committee might see reasons for the budget confrontation to affect the near-term tactics of policy. For one, the range of possible outcomes for fiscal policy might appear wider than usual right now but likely to diminish appreciably in the next few months, which could add weight to arguments for a "wait and see" position under alternative B. In addition, people will be looking carefully for how monetary policy might respond to emerging fiscal policy. An easing, in particular, might risk being misinterpreted, and adding uncertainty about policy intentions to markets already displaying considerable skittishness and tendencies toward downward pressure on the dollar. If an easing were undertaken because of reasons not directly related to fiscal policy, the Committee might want to be careful it had a clear, credible case for such action, which it could enunciate. However, if the Committee felt it already had such a case, there might be something to be said for acting at this time rather than delaying for more data, since perceived impediments to policy actions are likely to become larger not smaller after October 1, and a period of "even keel" through the budget battle could be lengthy.

In the context of the staff forecast, the case for easing would be made primarily on the grounds that the

Committee was not seeking the slightly restrictive policy stance implied by an unchanged nominal funds rate in that forecast, with the associated gradual opening up of an output gap. Such a case would be even stronger to the extent you judged the risks on economic growth to be weighted toward the downside, so that lower real short-term interest rates were needed to avoid a noticeable shortfall in aggregate demand, or you judged the underlying inflation picture to be more favorable, arguing for a reduction in the nominal funds rate. Markets have built in some odds of easing by early next year, though perhaps a subsequent upward tilt to rates. The staff forecast sees no change in long-term rates, as disappointment on the steady funds rate is offset by a more restrictive fiscal policy than markets now seem to anticipate. Nonetheless, the staff outlook does imply persistence of an unusually flat slope of the yield curve, perhaps suggesting some risk of a small backup over time in intermediate and long-term rates in the absence of an ease, which would add to restraint.

The staff forecast has a slight downward tilt to inflation under an unchanged funds rate. Alternative C would produce a more noticeable disinflation after a while. This alternative was not named for "Connie", but it might be useful to consider it and alternative policy strategies against the background of the proposed legislation, in part as prelude to your later discussion.

Alternative C can be seen as a step in a strategy that would achieve price stability by running a restrictive monetary policy--one that deliberately creates slack in the economy to put downward pressure on inflation. An alternative is the "opportunistic" strategy many of you have discussed in the context of getting from low inflation to price stability. As this strategy has most frequently been described, the Federal Reserve does not seek to raise the unemployment rate above the natural rate, but effectively leans harder against shocks to the economy that would increase inflation than those that would decrease it. The resulting pattern would be one of successively lower inflation rates at cycle peaks and troughs. This strategy has interesting implications for how the Federal Reserve would report under the Mack bill, which asks for an estimate of the time it will take to get to price stability; it's not clear that Senator Mack has an answer like "two recessions" in mind.

The simplest economic models do not provide a basis for choosing between the Alternative C tight money strategy and the "opportunistic" strategy to achieve price stability. In such models, the two approaches give the same answer for the output loss associated with getting to price stability.

That loss does not depend on whether a shortfall in demand occurs because of high interest rates or because of, for example, tightening fiscal policy that is not offset by easier monetary policy. A similar observation holds in these models with regard to supply shocks. A drop in oil prices, for example, may be used to move to lower inflation under an opportunistic strategy, but it could just as well be taken in the form of a transitory gain in output, leaving inflation where it was.

The world is far more complex than these models, of course, and there are many more possible strategies than the two we have been discussing, especially when you factor in the subtleties and uncertainties of making policy in the "real world". The legislation does instruct you "to take into account any potential effects on employment and output in complying with the goal of price stability." This sentence clearly applies to the current transition period to price stability and possibly also to subsequent episodes when prices deviate from stability. In that regard, the Committee may see its job as damping the variance of output on the way to price stability, leaning hard against large shortfalls in employment as well as overshoots. And it may find that the speed of adjustment affects sacrifice ratios in complicated ways that influence the choice of policy strategies.

Restrictive monetary policy, as in alternative C, is a strategy for attaining price stability--and one that has the attractive features of being explicit in its intent and more certain in its execution than more complex strategies. But it clearly is not the only possible path. Nonetheless, it is interesting to think about today's policy choice in the context of the bill, and the bill in the context of policy choices today and subsequently.