APPENDIX

FOMC BRIEFING - P.R. FISHER

DECEMBER 19, 1995

Mr. Chairman,

If I could, I would like to begin with the Mexican swap renewal before turning to the market reports, all of which is reflected in the one page outline of my report which should be in front of you on the table.

As I mentioned at your last meeting, I planned to wait until this meeting to seek the Committee's approval to renew the 3 billion dollar swap line which we have with the Bank of Mexico. You have received a memorandum from Ted Truman setting out some of the background and relevant legislative developments.

The temporary swap arrangement with the Bank of Mexico, initially approved by the Committee last December at 1.5 billion dollars and increased to 3 billion dollars on February 1st, will expire without being renewed.

Our regular, 3 billion dollar swap arrangement with the Bank of Mexico is set to expire on January 31st and it is my recommendation that the Committee approve its renewal at this time and that we set the expiration date of the renewed arrangement to December 13th, 1996, so that it comes up at the same time as our other arrangements.

The regular swap arrangement would be renewed along with the North American Framework Agreement or "NAFA", among the U.S. and Mexican monetary authorities and the Bank of Canada. This Agreement sets out a framework for notifications, drawings and repayments on our respective, bilateral arrangements but does not impose any financial obligations or commitments on the signatories, other than those established in our underlying, bilateral swap arrangements. The NAFA expires on January 31st and would be renewed until December 13th, 1996.

There remains 650 million dollars outstanding on the regular swap arrangement, drawn by the Bank of Mexico, which is due on January 29th. In the event that the Bank of Mexico does not repay this amount by January 29th, the Treasury will reimburse the Federal Reserve for any amount still outstanding.

Given the continued operation of the President's program in support of Mexico, and the political difficulties Canada has just been through with the Quebec referendum -- and may have to go through again in the next few years, I think that renewal of our swap line with the Bank of Mexico along with the NAFA is both appropriate and desirable under the circumstances. I request the Committee's approval to renew them both.

Ted and I would be happy to answer any questions.

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Since your last meeting, the dollar has been quite stable against the Japanese yen and has firmed somewhat against the German mark. The relative stability of the dollar is not, in my view, the result of an absence of factors influencing market sentiment, but rather a consequence of offsetting factors. In particular, the general perception of a moderating U.S. economy occurred against the backdrop of a substantial decline in the Japanese current account surplus and a perceived weakening of the German economy which, in turn, led to increasing expectations for an ease in rates by the Bundesbank, gratified last week.

The dog that did not bark, in this period, was the French franc. The relative stability of the franc during the French labor unrest said more about expectations for the Bundesbank to ease than it did about confidence in the ability of the French government to stay the course of fiscal discipline.

Interest rate markets continued to rally during most of the period, with yields on longer-date Treasuries declining somewhat more than those of Treasury bills. The perceived softening of the economy, the generally good performance of prices, and prospects for fiscal consolidation have each been seen by market participants as providing a basis for an ease in rates by the Committee. But over the last two weeks, futures contracts suggest that the market has lost some of its confidence that the Committee would act at this meeting, with the probability of an ease now around or just under 50 percent.

In the last few days, the bond market has backed up -- particularly yesterday and this morning at the long end -- reflecting market participants' defensive response to the current budget impasse and partial Federal shutdown. However, throughout December, we have confronted a risk that participants in both the bond and stock markets would be tempted to take profits ahead of the year-end. I had thought that they would wait and see the outcome of this meeting before doing so, but the back-and-forth over the budget spooked many into paring back positions in advance of the meeting.

The Fed Funds rate has been a tad firm during the period. Of course, we have aimed to accommodate the market's need for reserves. But on several occasions -- notably our settlement days as well as the concentrated auction and settlement days for Treasury securities -- reserve conditions remained firm.

In particular, on the settlement-Wednesday prior to Thanksgiving the total RP propositions received from dealers was less than we were seeking to do. This, combined with a negative reserve miss, caused Fed Funds to trade briefly as high as 30 percent. Misses will happen. But, as I have mentioned to the Committee before, I am uncomfortable with the tardiness with which we participate in the RP market, which can cause us to have a shortfall in propositions. Particularly since the introduction of daylight overdraft pricing, the RP market has shifted to earlier in the morning. Because of this, and because of my concern, we are beginning to explore the feasibility and the pros and cons of an earlier operating time.

We utilized the new, "installment plan" approach to outright purchases, buying 4.6 billion dollars of coupon securities on four separate occasions: Thursday and Friday, November 30th and December 1st and Tuesday and Wednesday, December 5th and 6th. We gave the dealers a half hour to submit propositions and we were able get responses back to them in between 10 and 20 minutes, compared with the 45 minutes to an hour which it took us to respond under our previous approach. We are pleased with this improvement and several dealers have even given us the compliment of saying that we have taken the profit opportunity out of coupon passes.

Mr. Chairman, there were no foreign exchange intervention operations during the period. I will need the Committee's ratification of the Desk's domestic operations during the period. I would be happy to answer any questions.

Michael J. Prell
December 19, 1995

FOMC BRIEFING

The shutdown of the Commerce Department has resulted in the postponement of today's scheduled statistical releases, and the fiscal battle remains unresolved. So, having no hot news to report, I want simply to underscore a few key points about the Greenbook forecast as it stands. Being naturally argumentative, I'm going to focus particularly on some differences we have with notions that have been expressed frequently around this table recently and that may have a direct bearing on your policy decision today.

Point 1: While a good many retailers and manufacturers are saying that business has been disappointing of late, it is far from clear that the economic expansion has run out of steam. In fact, payrolls have continued to grow roughly in line with the labor force in recent months, and total hours worked look to be up considerably this quarter. On the spending side, overall retail sales rebounded quite sharply last month; the volume of mortgage applications and some other indicators suggest that housing demand may be strengthening again; and business fixed investment still appears to be increasing briskly on the whole, paced by the computer sector. And, despite uneven economic performance abroad, the signs are that export demand has remained healthy. Inventory investment probably has been running above a sustainable rate; however, there are few indications of significant overhangs of undesired stocks, and so there's no reason to think that a jarring adjustment lays ahead.

Basically, I think we must recognize that, when the economy is growing only moderately on average, there is no reason to expect that factory employment will be rising or that reports on sales and orders will be uniformly upbeat. Moreover, growth will not be absolutely steady. You'll recall that things looked rather bleak this past spring, and then activity--at least as measured--picked up smartly once again.

Point 2: We see little indication that monetary policy is too tight to accommodate moderate growth in demand going forward. To be sure, real short-term interest rates are above their postwar averages. But that observation doesn't take one very far. Real rate levels--assuming they can even be measured with some accuracy--are an extremely ambiguous indicator of monetary conditions. In the short run, high real rates can reflect either restrictive policy or strong investment demand. Certainly, at the present time, whether one looks at the rise in stock prices this year, at the behavior of the dollar on exchange markets, or at the availability of credit, it is hard to find evidence of financial constraint. And, if one examines the composition of growth in the second half of this year, it is not a pattern that suggests the cost of capital is weighing heavily on demand.

Point 3: We also find it difficult to subscribe to the view that there are serious financial head winds coming from balance sheet conditions. Business finances have, if anything, been improving. Corporate balance sheets are strong, and the major issue for some firms is how to deal with shareholder complaints that their cash reserves are excessive. For households, the picture admittedly is more mixed. Debt burdens are up, and so are loan delinquency rates. But, on the other side of the ledger, there has been a huge increase in wealth as a result of this year's rally in the securities markets. Even if a large share of assets is now held in less liquid forms such as 401(k) accounts, people are well aware of the growth of their nest-eggs. At the margin, this should make them more willing to spend out of their current income. Our forecast actually has made little allowance for such an effect, partly on the thought that--especially with bond yields backing up--the ratio of wealth to income might well give up some of its gain. But, unless yesterday's stock market decline is repeated many times over, I'd place the potential influence of the household financial position among the upside risks to our forecast, not the downside.

Point 4: Although I cannot say exactly what the outcome of the current budget debate will be, it does appear unlikely that the economy will be subjected to a crushing fiscal blow. Looking at where the two sides are now, it is probable that--if there is a compromise--the degree of fiscal restraint in the next few years will be similar to what has prevailed for a while now as a result of a succession of deficit-reduction efforts. Admittedly, this new package may involve some special twists, what with the proposed changes in entitlement programs and the shifting of responsibilities to the state level. But, analyzed from a conventional macro perspective, the oncoming fiscal shock does not loom especially large when one considers all of the possible sources of variation in the growth of demand over our projection period.

Point 5: Whether it is through fiscal policy or otherwise, aggregate demand probably <u>must</u> be held to a moderate path if an upturn in inflation is to be avoided. To be sure, a pickup in the growth of the labor force or of productivity could create some extra room for expansion, but at this point the economy's resources appear, in the aggregate, to be fully employed. In this regard, the proof of the pudding is in the eating--that is, in how wages and prices behave. And when one looks at their behavior, it is arguable that we've have been rather optimistic in our assessment of the inflation risks.

For example, in gauging wage trends, we've discounted the upward drift in the rate of increase in average hourly earnings and the recent proliferation of reports of strains in the labor market. Instead, we've continued to emphasize the more favorable trends in the employment cost indexes through the September reading and the anecdotal evidence that employers still have the upper hand in most wage setting.

On the price side, we've given little weight to the acceleration of the core PPI and we've discounted the significance of the apparent pickup in core CPI inflation this year versus last. On the latter score, I perhaps should note parenthetically that the technical changes instituted by the BLS this past January were expected to shave a hair off the CPI increase. In any event, in assessing the underlying trends, we have judged that core CPI increases have been boosted temporarily this year by the earlier surge in materials prices and by the depreciation of the dollar that contributed to a rise in import prices. With those adversities behind us, we're hopeful that core CPI inflation will slow a bit in 1996 relative to 1995.

As I noted at the last meeting, it's conceivable that we are wearing rose colored glasses and are in danger of repeating the error of the late 1980s, when inflation did not pick up on schedule and we became overly optimistic about the sustainable levels of resource utilization. Although one still hears that competitive forces are causing businesses to eschew price increases and that the economy is less prone to inflation than it used to be, that is hard to square with the fact that prices are still rising, let alone with how inflation seems, at the very least, to have leveled out in the past year or so. Under the circumstances, we can see no compelling case for anticipating a further diminution in trend inflation unless the economy is permitted a period of sluggishness and some easing of resource pressures.

TABLES DISTRIBUTED BY GOVERNOR LINDSEY

Table 1

Group		% of Dividends	% of Household	% of After Tax A.G.I.	% of Disposable Personal Income
1	Zero Dividends	0.0	79.8	63.6	65.6
2	L.T. $1,000 Div.	4.4	12.7	18.2	18.6
3	$1,000-$10,000 Div.	29.9	6.3	11.4	10.4
4	Over $10,000 Div L.T. $200,000 A.G.I.	35.7	1.0	1.9	1.5
5	Over $10,000 Div. G.T. $200,000 A.G.I.	29.9	0.2	4.9	3.9

Table 2

Let's assume a $50 billion increment to consumption (1% of personal outlays) proportional to stock market gains proxied by dividends

<table>
<tr><th>Group</th><th>Total Change in Consumption (Billion)</th><th>Per Household ($)</th><th colspan="2">As Percent of Disposable Personal Income (%)</th></tr>
<tr><td>1</td><td>0</td><td>0</td><td colspan="2">0</td></tr>
<tr><td>2</td><td>2.2</td><td>151</td><td colspan="2">0.24</td></tr>
<tr><td>3</td><td>15.0</td><td>2,092</td><td colspan="2">2.88</td></tr>
<tr><td>4</td><td>17.8</td><td>14,049</td><td>23.8</td><td rowspan="2">12.1</td></tr>
<tr><td>5</td><td>15.0</td><td>65,048</td><td>7.7</td></tr>
</table>

December 19, 1995

FOMC Briefing
Donald L. Kohn

The structure of market interest rates and the commentary of FOMC members and market observers would seem to suggest that the question facing the Committee at this meeting is whether or not to ease policy. The market has built in about a half-point worth of decrease in the federal funds rate over the next few months, though, as Peter noted, a little less than 50-50 odds on smaller action today. Keeping policy unchanged at this meeting would lead to some disappointment and a backup in rates--though probably quite limited since the market still would be anticipating an ease before long. Holding the funds rate at 5-3/4 percent over a longer period would be associated with a further rise in intermediate- and longer-term rates, though probably still of fairly moderate dimensions compared with the movements we've seen in the last two years, since the yield curve doesn't seem to have much more built into it than the near-term 50 basis point reduction. Nonetheless, reductions in the federal funds rate in line with market expectations would tend to keep costs of capital-market finance closer to the lower levels that have evolved this year.

Clearly, the possible results of the alternative paths for interest rates need to be judged relative to the

Committee's longer-run objectives and the strategies for achieving them. In that regard, President Stern at the last meeting asked whether the Committee shouldn't discuss what the members meant by an "opportunistic" disinflation strategy and its implications compared with a "deliberate" strategy for achieving price stability. In a subsequent conversation, he and I agreed that the issue might best be addressed in a concrete situation, and that, if possible, I would do so at this meeting.

Because different people may have different definitions of these strategies in mind, especially when it comes to opportunism, the logical place to start is to define terms. To help in this regard, I've distributed a handout, the first page of which outlines some key elements I've extracted from the discussions at the FOMC and with my colleagues.

Both strategies start from the premise that price stability is the appropriate primary long-term goal of policy. The deliberate policy seeks to make steady progress toward this goal. The only way to ensure such progress is to keep some slack in the economy so as to put downward pressure on inflation in labor and product markets. Hence, the deliberate strategy would be earmarked by a persistent tendency for the unemployment rate to exceed NAIRU so long as the economy was not at price stability, albeit by varying degrees depending on the amount of inflation and the Committee's desired trajectory to price stability. A Taylor Rule is an example of a deliberate disinflation strategy.

Under the opportunistic strategy, the policy approach depends on the level of inflation. If inflation is high, an opportunistic strategy will induce some output loss, just as under a deliberate strategy, to bring inflation down. Probably the most recent example of this was in 1988-89, when inflation seemed to be in the process of rising above the 4-to 5-percent range that had predominated through the 1980s, and the Committee tightened with a view to raising the unemployment rate above the natural rate to reverse the acceleration in prices.

The contrast between the two strategies arises in situations like the present, when inflation is low and steady but not at the Committee's long-run goal. Under these circumstances, the opportunistic strategy attempts to hold the line against any increases in inflation and may need to accept some output shortfall to do so in the case of adverse supply shocks. But otherwise the opportunistic strategy attempts to keep the economy producing at its potential. In effect, it waits for unanticipated developments to produce further disinflation, accepting the reductions in inflation such developments bring, but always attempting to keep the economy at, or return it to, its potential.

What kinds of developments could produce disinflation under this strategy? One might be an unforeseen shortfall in demand--the unintended and unanticipated recession many of you refer to when discussing the next leg of disinflation. Note that under the opportunistic strategy, the Committee would try to correct for the shortfall in demand, pushing the economy back to--but not beyond--potential, thereby accepting the lost output but also cementing in the lower level of inflation that resulted. One of the difficult issues in thinking about the economic rationale behind the opportunistic strategy is the justification for accepting, in effect, by accident a loss of output the Committee was unwilling to seek deliberately.

Another class of unexpected developments that should produce lower inflation come as favorable supply shocks. These can take a number of forms, including a surprise decrease in inflation expectations or a reduction in the NAIRU. The former will produce lower inflation while the economy is producing at potential. Disinflation from the latter comes, as in the case of demand shortfalls, from lags in policy--both the recognition lag and the time it takes for corrective action to take effect. During that period, output is below the new higher level of potential, and inflation is damped. The key is that the opportunistic policy takes the effects of these developments in disinflation, and doesn't try to boost output beyond potential to realize their benefits in a temporary boost to output.

How might these concepts map into your current policy choices? I've attempted to systematize examination of this issue in the two matrices on the next page. The top panel has the two strategies arrayed against two views of the economy. The top row assumes the view of aggregate demand and the inflation process underlying the Greenbook forecast. The second row encompasses the views that might be underlying the recent downward tilt of the yield curve or forecasts that look for a decrease in the federal funds rate, which I've labeled disinflation pressures. I'll go through the table row by row, but one thing to notice is that for any given set of underlying economic conditions, the opportunistic strategy calls for one notch easier policy than the deliberate approach; this is the policy manifestation of the opportunistic strategy keeping output at potential while the deliberate strategy lives with some slack at moderate inflation rates.

As you know, in the Greenbook forecast, holding the funds rate at 5-3/4 percent and allowing other rates to back up a bit is consistent with the economy operating in the neighborhood of its potential and inflation as measured by core CPI running around 3 percent. This is completely consistent with an opportunistic strategy. Inflation is not so high as to mandate tightening, nor is the behavior of output relative to its potential suggesting ease if the staff's assessment of demand and price pressures is about on track. Under these circumstances, however, pursuit of a <u>deliberate</u> disinflation strategy would seem to call for consideration of an increase in the federal funds rate to turn inflation down in coming years.

Disinflation, the second line, might arise from optimism on the inflation outlook at high levels of resource utilization or pessimism on the path of real output at current nominal and real interest rates. Under either of these circumstances, holding the funds rate at current levels would at some point in the future tend to push the economy below its potential. Under a deliberate disinflation strategy, lower right cell, you still would not ease, unless you thought the odds on a major shortfall in output were sizable. But an opportunistic approach with this economic outlook would suggest scope to consider easing to keep output at potential--though how aggressively might depend on the reasons for the expected shortfall.

Some of the possible reasons for disinflation pressures are given in the lower matrix, along with potential policy responses in terms of the federal funds rate. If an ease under an opportunistic strategy were contemplated on the basis of the surprisingly good news on inflation over the last few quarters, there are several possibilities, with different implications. The lower inflation results could be temporary--just the normal noise in a very uncertain set of relationships, with little effect on inflation going forward. In this case, inflation could well come back, and easing would risk leaving the real funds rate unduly low.

A second possibility is that inflation and inflation expectations have dropped permanently, but not because underlying relationships have changed, but rather because, for example, people have become convinced that the Federal Reserve is determined not to allow inflation to pick up, and this increase in your credibility induced them to back out their anticipation of a rise in inflation in this business cycle. This circumstance might call for a reduction in the nominal funds rate to keep the real funds rates at the level you previously thought appropriate.

The third possibility is that underlying relationships have changed so as to permit the economy to produce at higher levels of potential without engendering inflationary pressures; that is, the NAIRU has fallen--and by more than the staff has built into its forecast. This situation would call for a more sizable decline in nominal rates over time to effect a decline in real rates that would be needed to allow the economy to produce at its higher potential. A similar analysis and response would pertain to a judgment that for a given potential, demand might be excessively weak at current nominal and real funds rates.

A number of aspects of this analysis could be read as counselling caution with regard to the extent of any easing going forward, even under the opportunistic strategy. For one, the economy is about at its potential now, and policy under that strategy would be careful not to push the economy past its potential; whatever disinflation might be in the pipeline would be accepted. For another, there are obvious problems sorting out the reasons for any disinflation pressures, and considerable further information will be needed to judge whether, for example, the NAIRU has shifted down further than now recognized; meanwhile aggressive ease could risk reducing the funds rate to below its equilibrium level.

Finally, and unrelated to the strategy chosen, is the situation in financial markets. Markets are not likely to react very much to a 25 basis point easing, but there is some risk that bond and stock markets could run up noticeably if they project additional Federal Reserve easing actions, for example once a budget agreement is reached. If the Committee and the Board wished to reduce the odds on such an outcome, they might consider two aspects of how any easing is shaped. One might be to key the announcement and subsequent commentary by Committee members primarily to the past behavior of inflation rather than developing weakness in activity or future declines in inflation. And second, to forego an associated decrease in the discount rate. The distinction between actions with and without discount rate moves has become minimal, but leaving the discount rate unchanged still might help reinforce a message of caution if the Committee wanted to send one.

Opportunistic versus Deliberate Disinflation Strategies for Monetary Policy

1. Both policies start from the premise that price stability is the appropriate long-run goal of monetary policy.

2. The deliberate strategy seeks to make progress toward price stability, no matter whether current inflation is high or low, by keeping output below potential.

3. The opportunistic strategy takes a different approach depending on the level of inflation.

    a. When inflation is high, an opportunistic strategy (like a deliberate strategy) will induce and tolerate some output loss in order to make progress against inflation.

    b. When inflation is low (but still above the long-run target), an opportunistic policy will:

        i. attempt to hold the line against <u>increases</u> in inflation (accepting output losses in the event of adverse supply developments);

        ii. accept <u>reductions</u> in inflation due to:

        - an unforeseen shortfall of demand; or

        - a favorable supply development (for example, a spontaneous reduction in inflation expectations, or an unexpected reduction in the natural rate of unemployment),

        while attempting to hold output at potential.

MONETARY POLICY MATRIX

	Opportunistic Strategy	Deliberate Strategy
Greenbook Economic Conditions	unchanged	tighten
Disinflation Pressures	ease	unchanged

Source of Disinflation	temporary inflation shock	permanent drop in inflation expectations	positive supply shock or negative demand shock
Policy Response	no response	reduce nominal rates leave real rates unchanged	reduce nominal and real rates