

APPENDIX

Notes for FOMC Meeting
November 5, 1991
Margaret L. Greene

For most of the period since your last meeting, the dollar was perceived as trading within a range that has prevailed since mid-summer, even as it traversed the full width of that range. There was no intervention on either side by the United States, and our only operation during the period was the settlement, on October 28, of forward sales of marks by the ESF and Federal Reserve on the program reported previously. Nor was there any intervention by Germany or Japan. Market participants appeared content to buy the dollar when they thought it appeared relatively soft and sell when they thought it looked relatively firm.

The start of the intermeeting period found the dollar near the low end against the mark, at a time when doubts were being expressed that any prospective pickup in U.S. economic activity during the third quarter would be strong enough to launch a sustainable recovery.

Then the dollar moved toward the top of the range. Employment data released early in October were not as weak as expected. Also, talk spread that new approaches were being considered to reinvigorate demand or promote private borrowing so as to enhance the prospects for a U.S. recovery. With market participants sensing that reliance on the traditional tools of monetary policy might be reduced, they revised their expectations about U.S. interest rates and came to believe that interest rate differentials against the dollar might not continue to widen.

By last week, however, the outlook for the dollar had once again turned sour. Sentiment about the U.S. economy deteriorated

sharply, first after data were reported showing a plunge in consumer confidence and again, following new employment data. The talk of tax cuts or other measures subsided and market participants once again believed that monetary policy was going to be called upon to insure continued expansion. This change in perceptions occurred at a time when the Federal Reserve, itself, was seen as being less assured that recovery was on track. Under these circumstances, the dollar fell back to test the lower boundaries of its range. Over the same period, the dollar has eased also against the yen, as that currency has drawn intermittent support from a strengthening of Japan's external position and from uncertainties about international response to that development.

Notwithstanding these fluctuations, market participants were slow to alter their currency management strategies.

At the upper end of the dollar's range few expected the dollar to show persistent strength: The drag being exerted on the dollar of the currently large adverse short-term interest differentials was just too great. Accordingly, Japanese exporters appeared to sell dollars at levels above Y130. And if there were insufficient dollar sellers against the mark at levels much above DM 1.72, market operators felt certain the Bundesbank would be quick to shore up the mark--either by way of monetary policy or exchange market intervention.

At the lower end, corporations and others that needed to buy dollars had been delaying their purchases to take advantage of any attractive opportunity. For those that needed to acquire their dollars before year-end, time was running out. For everyone, betting against the dollar contained risks. There has been a firmly held expectation in the market for at least the past nine months that the

U.S. will emerge from recession at a time when other industrialized countries may be slowing down. In that context, the traditional interest rate advantage for the dollar will be quickly restored. In the meantime, market participants around the world have had over a year to take advantage of the abnormal pattern of interest rate differentials to borrow in the United States and thus lower their borrowing costs, or to invest abroad and thus enhance return. If some event were to occur--be it an event that might signal an end to the interest rate declines in the U.S. or a political uncertainty such as that which developed in the Soviet Union in August, or year-end pressures such as those that emerged last year--the scramble for dollars could be intense. The dollar then might rise to levels that could wipe out the interest differentials these operators expected to realize.

Also, enthusiasm was lacking in the market for other major currencies. With respect to the Japanese yen, the market was transfixed by speculation that the recent decline in market rates in Japan would soon be ratified by a drop in the Bank of Japan's discount rate. While market participants were waiting for this potentially bad news, they were reluctant to move into yen. With respect to the German mark, the magnitude of financial and economic exposure of the German economy to the Soviet Union and uncertainty as to what institution, if any, would service those Soviet obligations cast an important element of doubt about the German currency. With respect to other European currencies, evidence of slowing economic activity and the continuing impact of Germany's tight monetary policy on countries whose currencies are tied to the mark cast a cloud of doubt there, too. Also, a number of countries from Scandinavia to the Far East, were experiencing strains in their financial systems at least partly

driven by sharp drops in real estate prices, and some of those strains might prove to be more severe than those here in the United States.

Under these circumstances, many in the market appeared unwilling to make long-term commitments and were anxious to preserve the liquidity of their portfolios. The preference for shorter-term assets has been reflected in the steep yield curves in many centers. The liquidity of portfolios has made it easier to move funds from one currency to another, giving rise to a heightened responsiveness of exchange rates to actual and expected interest rate moves. There still were market participants that wanted to retain a dollar-based currency exposure, as long as they could obtain a foreign currency yield by investing in the high yielding currencies of Canada and, to a lesser extent Australia and Mexico--countries that have been attracting large inflows of capital.

It was against this background that market expectations about Federal Reserve policy changed last week. Many had previously been expecting a 25 basis point easing in the federal funds rate before year-end. They were contemplating the possibility that the dollar would ease on the news before staging a more sustained rise either late in December or early in 1992. The data and comments of last week led market participants to question their assumption that the U.S. would be in a position to lead recovery globally in 1992 and to expect a larger monetary move now. The Bundesbank is also expected to adjust its policy stance soon, by raising its Lombard rate by 25 basis points--perhaps as early as Thursday.

In the past couple of days, exchange rates have moved in accordance with these shifting expectations. The dollar/mark broke below levels that had provided technical resistance for months and the mark gained against other currencies as well. The dollar has weakened

less against the yen, with interest differentials vis-a-vis the yen not expected to worsen much. For the moment, the prospect of a recovery for the dollar this winter does not appear to be ruled out. But expectations are in a state of flux, more easily influenced by disappointment than unexpectedly good news.

Mr. Chairman, as you know, all of the System's reciprocal approved currency arrangements come up for renewal before year-end. At this time we have no changes in the terms and conditions to suggest and would request that the committee approve they be renewed without change.

E. M. Truman
November 5, 1991

Comments on the USSR Financial Situation

Since late August, shortly after the unsuccessful coup in the Soviet Union, representatives of the G-7 countries have been meeting among themselves, with the international financial organizations, and with representatives of the former Soviet Union, to consider the short-term external financial difficulties confronting the USSR and its successor entities. Of course, the external financial problem is only one of many facing the crumbling Soviet Union, but it is one the West might do something about.

The magnitude and implications of the external financial problem are uncertain. The data base is weak, and the disintegration of the Soviet Union has meant that the government's share of reduced export receipts has been sharply reduced. However, the best guess is that the central bodies of the Soviet Union face a foreign exchange shortfall on the order of \$4 billion for the balance of 1992.

As has been amply reported over the past two months, the G-7 has not been able to agree on a common approach to this problem. In Bangkok, the G-7 were able to reach agreement on certain principles that were accepted by Mr. Yavlinsky representing the Soviet Union: (1) introduction of a comprehensive economic reform program, (2) a commitment by the center and the republics to service their external obligations, and (3) the need for full disclosure of Soviet economic and

financial data. [Chairman Greenspan may want to say more about the Bangkok discussions.] Last week in Moscow, representatives of the USSR and 12 of the republics, meeting with the G-7 finance deputies, reached what might be called a provisional and non-operational agreement that the USSR and the republics are jointly and severally liable for the existing debts of the USSR. They also agreed that the Vneshekonombank (known as the VEB) or its legal successor should manage their external debt.

Following this agreement, the G-7 is considering an approach to the Soviet external financial problem that could include five major elements:

First, a so-called deferral of principal payments on debts to Western governments and commercial banks. This would impact primarily on governments and commercial banks in Europe; the term "deferral" is designed, in part, not to interfere in the short run with food credits to the Soviet Union.

Second, the central Soviet financial institutions would stop supporting the five Soviet banks in the west and claims on those banks would, in effect, be folded into the deferral arrangement. Claims of Western commercial banks on these Soviet banks are at most \$2-1/2 billion.

Third, an effort would be made to recapture or rechannel some of the foreign exchange earnings now flowing to enterprises within the former Soviet Union for the use by the VEB in meeting the center's foreign exchange needs, including interest on external debts.

Fourth, Saudi Arabia and South Korea would be encouraged to release loan commitments to the USSR. South Korea apparently took the first step in this direction yesterday.

Fifth, a special credit facility would provide some new money to the Soviet Union.

The idea of a special credit facility backed by gold was first considered in late September when representatives of the VEB approached the BIS concerning a possible financing facility of up to \$2 billion based on a gold swap. If the BIS were to undertake such an operation, it would require backing from its associated central banks and their governments.

Since that initial contact it has become clear that a number of obstacles stand in the way of putting such a facility in place.

First, the amount of gold potentially available for such an operation is substantially less than previously thought. In fact, the size of any such facility is more likely to be on the order of \$1 billion.

Second, under current circumstances the VEB does not have clear legal authority to undertake such an operation.

Third, provisions in existing loan and debt arrangements most likely preclude a formal pledging of gold by the VEB.

Fourth, political decisions in the West as well in the Soviet Union are necessary before trying to set up such a facility.

If a gold-backed facility were established, the Federal Reserve or the Treasury or both might be asked to backstop the

BIS. The Federal Reserve does have the legal authority to deal in gold. However, I would emphasize at this point the obstacles to putting any such facility in place.

It is also possible that a facility might be backed or backstopped by other Soviet assets. In this case, it is even more unlikely that the Federal Reserve would be involved for its own account.

I would emphasize that the approach that I have outlined is essentially hypothetical. Finally despite the fact that one can read newspaper reports on G-7 thinking, I also would emphasize the sensitive nature of these discussions.

**Notes for FOMC Meeting
Peter D. Sternlight
Washington, D.C.
November 5, 1991**

Through most of the recent intermeeting period, the Domestic Desk sought to maintain the degree of reserve pressure in force since before the last meeting, consistent with an expected Federal funds rate around 5 1/4 percent. Late in the period, a slightly easier stance was adopted in light of evidence of flagging business and consumer confidence and indicators of a weakening pace of recovery. The easing step began to emerge on October 30, the final day of a reserve maintenance period, during a Committee consultation call to discuss possible easing moves, as the Desk--in consultation with the Chairman--refrained from draining a remaining over-abundance of reserves. The market interpreted the Desk's inaction as a probable, but not conclusive, signal of an easing step. Market convictions strengthened over the next few days as Desk actions were seen as consistent with the presumed new central tendency for funds of around 5 percent.

The path borrowing allowance was cut by \$150 million during the period to \$175 million; \$25 million of the cut was associated with the easing step formally incorporated on October 31, while the rest represented a series of reductions in the allowance for seasonal borrowing, typical of the slide in such borrowing at this time of year. Borrowings and funds rates

closely paralleled expectations, with actual borrowing around \$285 million and \$210 million in the two full maintenance periods, and funds rates averaging 5.24 and 5.17 percent in those periods. By the end of the intermeeting period, funds were trading around 5 percent, with many market participants anticipating that a further reduction was likely in the near term.

Desk operations were mainly of a temporary nature, although near the end of the period the Desk began to meet longer-run reserve needs through a \$2 billion purchase of bills in the market and about \$400 million of Treasury issues bought from foreign accounts. On a number of days, the Desk drained reserves through short-term matched sale-purchase transactions. These were done not only to meet technical needs to drain reserves but also to head off market interpretations, at times, that the System might be leaning to an easier policy. (As noted, on October 30, the Desk intentionally did not drain a projected over-abundance of reserves at a time when the funds rate was softening, leading to widespread speculation that an easing step was at hand.) On a few occasions the Desk provided reserves through customer-related or System repurchase agreements--most notably on October 31, when payment for new Treasury issues temporarily swelled the Treasury balance far beyond the capacity of commercial banks to hold such balances. Facing a prospective reserve deficiency on the order of \$12 billion for October 31, the Desk announced its intention the previous afternoon to

arrange overnight repos the next morning--and nearly \$9 billion was done.

The Treasury yield curve steepened appreciably during the intermeeting period. Short- and intermediate-term rates, say out to 5 years, declined about 15 to 35 basis points, responding to indications of soft business conditions, mixed but on balance encouraging signs regarding inflation, and related anticipations of (or reactions to) policy easing moves. Yesterday's bill auctions went at 4.74 and 4.80 percent for the 3- and 6-month issues, down from the 5.11 and 5.14 percent rates just before the last meeting that already reflected some anticipation of easing moves at that time. Meantime, the Treasury raised close to \$20 billion in the bill sector, including the issues bid for yesterday. It would appear that the short-term market has fully priced in the move in the funds rate down to 5 percent, and has partially discounted perhaps a further 1/4 percent decline. Rates on some private short-term paper such as CDs and commercial paper are down even a bit more--by about 35 to 50 basis points--and a couple of mid-sized regional banks have cut their prime rates by 1/4 percent to 7 3/4 percent.

For longer intermediate Treasuries the rate changes were mixed--up or down just a few basis points--while at the very long end rates were actually up about 10-15 basis points for the intermeeting period. While these sectors were also affected by the soft business news and at times by policy move prospects, there were some countervailing currents as well. Notably, the

long Treasury market seemed to experience sharp disappointment in the September CPI report in mid-October, which seemed to suggest stubborn core inflation--though market participants felt better when the third quarter GNP deflators were reported. Some strength in oil and other commodity prices was also sobering. Moreover, around mid-period a rash of talk about tax-cut proposals to stimulate the economy sent shivers through the market. Supply considerations also played a role--on one side there were intermittent reports of substantial Japanese account selling of long-term Treasury zeros, and indeed reconstitution activity at the Fed did pick up; at the same time the market was encountering increased actual and prospective supply from the Treasury, culminating with the \$38 billion mid-November refunding for which bidding begins today. Counting the nearly \$18 billion to be raised in these immediately upcoming auctions of 3, 10, and 30 year issues, the Treasury will have raised close to \$34 billion in the coupon sector since your last meeting. The market did not take great comfort from the Treasury's announcement that it was expecting to raise about \$76 billion in the current quarter. While down from the previous quarter's staggering record of \$103 billion, the amount is still huge and much of the abatement merely reflects a lesser pace of deposit insurance payments following the end of the fiscal year and the failure of Congress thus far to extend the RTC funding authority. The small net rise in bond yields over the period leaves the 30-year issue at about a 7.95 percent yield.

Gauging the likely reaction in the long market to further possible policy easing is always a tricky business. As in the short end, one senses that bond market participants have already factored in the decline to a 5 percent funds rate "and then some." Many seem to anticipate a discount rate cut, though some are troubled at how the timing of such a move might mesh with commitments to be made in coming days in the Treasury's quarterly financing. It would be my sense that, given the more bearish view of the economy and predominantly more confident view on inflation, the long end could be reasonably accepting of further easing, though one should not look for an enthusiastic reaction. There could, of course be an adverse reaction to moves that the market senses were an overdose of ease, especially if it came with any hint of bending to political pressures.

The financial markets remain sensitive to individual name problems, though in some instances the recent period has seen some improvement in name acceptance. A number of bank holding companies announced fairly good third-quarter earnings and their stock prices and quoted rate spreads over Treasuries have fared better. One exception was Citicorp, which posted a large third-quarter loss and suspended its common stock dividend. Its stock price fell and yield spreads widened--though generally only to levels modestly above those of some other major money center banks. Late in the period there were unfounded rumors of Citibank experiencing funding difficulties and having to use the discount window. Downgradings were reported not only for

Citicorp but also for Continental, SecPac and First Interstate, but there did not seem to be very drastic or lasting spread changes on their paper. Chrysler Financial's spreads improved after the auto company reported a smaller than expected third-quarter loss--though its spreads remain very high. Salomon Brothers' stock price improved appreciably over the period and the spreads on its debt issues narrowed substantially in the wake of third-quarter earnings that held up well despite a \$200 million reserve provision for potential liabilities growing out of its misdeeds. The firm nonetheless remains quite apprehensive as to what further shoes may drop--either from official quarters, private lawsuits, or defections of their own staff.

Statement on Leeway

Mr. Chairman, projections for the next intermeeting period point to seasonal reserve needs that could just about exhaust the standard \$8 billion leeway. The needs arise largely from expected increases in currency in circulation and required reserves. To be on the safe side, I recommend a \$2 billion temporary increase in the intermeeting leeway to a total of \$10 billion for the forthcoming period.

Michael J. Prell
November 5, 1991

FOMC BRIEFING -- DOMESTIC ECONOMIC OUTLOOK

As you know, there are some notable changes in the staff forecast prepared for this meeting. Not only have we slashed the projected growth rates for GNP in the near term, but we've also deviated in a modest way from our recent practice of assuming that the federal funds rate would remain at the currently prevailing level. Prior to last week's easing action, we took as our assumption that the funds rate would be cut to 4-3/4 percent in the near term and held there through the forecast period.

In a sense, the size of the revision to our forecast overstates the extent of the change in our thinking. As you'll recall, I've emphasized in recent briefings that we felt there was an unusually thick downside tail to the probability distribution associated with our forecasts. That said, however, I would have to concede that, like many other analysts, we have become more troubled by what we see happening--or perhaps more the point, not happening--in this economy. Thus, while this mark-down of our forecast effectively captures some of the risks we perceived earlier, I would scarcely argue that the economy could not still turn out significantly weaker than we've indicated.

Our point forecast in the Greenbook was for real GNP growth of just over 1 percent this quarter and only fractionally more in the first quarter of next year. The news received since the Greenbook went to press would lead us to lower the near-term forecast still further, but only slightly at this point.

Thursday's report on manufacturers' inventories showed an unexpected and fairly sizable accumulation in September; however, a

couple of considerations lead us to discount this as a negative relative to our already weak output projection. First, a dissection of the figures suggests that there were some flukey elements in the accumulation and that there has not been a broad backing up of stocks at the factory level. Second, the deceleration in manufacturing activity through October--which was incorporated in our forecast of fourth-quarter GNP--may well indicate that the correction of any incipient inventory imbalances is already well under way.

The second major piece of news received late last week was the October labor market report. The surprise for us was the size of the decline in the workweek, which left aggregate private production worker hours in October even with the third-quarter average, rather than slightly above it, as we had expected. However, given the erratic behavior of the workweek figures over the past year or so, we'd extract only a mildly negative signal from this movement.

It may be that even this is too negative a reading of the data on labor utilization and that what really is happening is that widespread efforts to cut costs are yielding productivity improvements sufficient to translate weak hours into appreciable output gains. Unfortunately, in this process, labor income is depressed, and the net effect in the short run probably is a further drag on final demand, which already looks to be rather soft. The housing recovery appears to have faltered as people worry about their jobs; commercial construction remains in a nose dive with no end in sight; and government spending is headed down, led by defense cuts. The recent orders data do hint at a firming of demand for some types of business equipment, and we think that exports should accelerate somewhat after their abrupt slowing this summer, but it doesn't appear likely that these sectors can generate enough employment and income to keep consumer spending on a healthy growth path. And what is perhaps

especially worrisome at this juncture are the signs that consumers are so spooked that they might just sit on any income gains--something that hasn't happened to date, judging by the behavior of the personal saving rate.

We've noted many times that sentiment surveys usually don't help a lot in forecasting, but the anxiety level revealed by the Conference Board survey for October and in many other public opinion polls is stunning. Having seen the contraction in activity last fall in the wake of a sharp drop in sentiment, we didn't think we should ignore the recent pattern. At a minimum, these reports can't do much to inspire businesses to raise their production plans.

The obvious question we faced in developing this forecast is why the recovery apparently has failed thus far to take hold in a solid way. The corollary question is whether the limited policy action we have assumed--or, in the extreme, whether any monetary action--would be enough to turn the tide. I don't think there are clear-cut answers to these questions, but I shall offer a few conjectures.

In addressing the question of what explains the disappointing performance of the economy, one is faced with a list of candidates longer than can be dealt with in the time I have this morning. In the Greenbook, we mentioned just two of the usual suspects--namely, the real estate bust and the credit crunch. The building boom of the Eighties not only left us with a supply of income properties that will take years to absorb, but it left financial institutions with a serious loan loss problem that has impaired their willingness and ability to perform their traditional intermediation function. We've long known about these phenomena, but it is conceivable we've underestimated their effects.

We didn't mention in the Greenbook the often-cited problem of high corporate and household debt burdens, partly because the experience in postwar cycles argues for some skepticism about the extent to which debt in itself inhibits spending. But it could be that, in the aftermath of the extraordinary leveraging efforts of the last decade, more firms are cash-constrained today than was true in earlier upturns. And in the household sector, survey and anecdotal evidence points to a broad feeling of financial stress. No doubt the bursting of the speculative bubble in home prices has left many people feeling much less wealthy. And the failures of depository institutions and life insurance companies surely don't engender a sense of well-being. If people were unable to see on their own how bad-off they are, they surely would be saved from ignorance by the daily drumbeat of statements by politicians and pundits about the failures of the U.S. economy.

With all of these negatives, and the widespread sense that government has neither the formula nor the wherewithal to address the problems of the day, it perhaps shouldn't be surprising that "animal spirits" are not a big plus in the current picture. But does this mean that monetary policy has been "pushing on a string" to date and that, if stimulus is needed to produce acceptable growth, further easing steps would be futile? In my judgment, that would be the wrong conclusion. Moreover, I believe that, should stimulus be required, it probably would be more desirable to attempt to provide it through monetary policy than to tinker with the tax code in ways that might recreate uneconomic distortions or undermine the revenue base.

The rationale for my assertion that monetary policy is not impotent rests in part on the fact that there has been some response to the decline in interest rates to date. The most obvious is the substantial upturn in homebuilding since last winter. It may be that

the level of activity has been restrained by other factors, but I think it is safe to say that the drop in mortgage rates has raised demand relative to what it otherwise would have been. I would venture the assertion that--despite the stickiness of many administered loan rates--lower borrowing costs have strengthened other types of spending too, although the effects are more difficult to discern.

It is important to note also that declines in interest rates affect aggregate demand indirectly through channels other than borrowing costs. For example, the drop in rates almost certainly muted the upturn in the dollar earlier this year and contributed to the recent softening, thereby bolstering demand for U.S. goods. And lower returns on fixed income investments have helped to push stock prices to new highs even as a disappointing recovery held down corporate earnings; higher stock prices have buttressed household wealth and aided corporate financial restructuring. Note that these interest rate effects do not depend on the willingness or ability of intermediaries to lend.

It may well be that the dislocations in sectors like commercial construction have made interest rate changes less effective than in some other upturns; and in today's more fluid financial markets, the responses may not be as sharp as they were in the days when a cyclical easing moved rates back below Regulation Q and usury ceilings. But that is not the same as saying that rate movements have no effect at all. And, in assessing the current situation, we also must consider that real rates are not especially low by postwar standards. The performance of the economy does not suggest that this is solely a matter of strong demand for capital; rather, monetary policy here, and possibly in some countries abroad, may be tighter than is consistent with vibrant recovery in the present circumstances.

We have built only a modest further easing into our forecast, in the belief that it, in combination with the lagged effects of the interest rate declines to date, will prove adequate to produce a significant reacceleration in activity next year. But it should be noted that our forecast shows the economy operating well short of capacity for some time--and on the weak side of the Committee's expectations last July. If the Committee were to wish to spur growth so as to achieve, say, the central tendency range of 6-1/4 to 6-1/2 percent for the jobless rate in the fourth quarter of 1992, it might well require a reduction in the funds rate to somewhere between 3 and 4 percent over the next several months. The risk in such a sharp move is that the System would be perceived as losing sight of the disinflation objective--and, indeed, the resultant stronger growth would mean slower progress toward price stability. But the tendency for the financial markets to interpret Fed behavior negatively likely would be mitigated to the extent that money and credit growth is still slow and the economy still weak. Of course, if aggregate demand should prove weaker than anticipated in our forecast, a reduction of rates on this scale might be required simply to achieve the more modest growth path we've described in the Greenbook.

November 5, 1991

FOMC Briefing
David E. Lindsey

The expansion of M2 and M3 so far this year remains quite sluggish, as their resumption of growth in October only kept them around the lower bounds of their ranges. The behavior of these aggregates has been especially weak on balance since the spring, when they were around their midpoints. October's meager growth did not quite restore M2 to its level of June, and M3 remains nearly \$30 billion below its May peak.

Over the next two months, we continue to expect that M2 and M3 will expand, but stay near their lower bounds. Growth of the broader aggregates in October about matched our expectations at the last FOMC meeting. And the prospects for growth of M2 and M3 over the rest of the year are little different now than in the previous bluebook. Under current conditions, we still foresee M2 remaining on a 3 percent growth track through year-end. By itself, the sizable downward revision to fourth-quarter spending in the staff forecast would argue for a slower pace for M2. But the depressing influence of weaker spending should be about offset by two stimulative influences that we didn't foresee five weeks ago. One is last week's easing of monetary policy. Another is the prospect that, owing to legislative delays, RTC resolution activity will remain light through year-end. Even with the lessened RTC activity, our forecast of M3 growth for November and December has been lowered, but only by a half a point to a 1 percent rate, the same growth rate as seen last month.

Growth of the broader aggregates this year has been stimulated by the sizable declines in short-rates since last fall. But

other forces apparently have been strong enough to pull annual money growth below the downward-revised projection for nominal GNP growth of 3-1/2 percent for this year. To my mind, while our explanations for such weak money growth are not fully satisfying, we have a better grasp of how those forces have depressed money growth than we do of what they mean for future spending. As a result, the message from the slowdown in money growth for future economic activity is difficult to discern. For example, commercial bank lending restraint, partly related to actual and potential hits to capital, particularly from commercial real estate, clearly has lessened their need for retail deposits, as well as managed liabilities. But the extent of the contractionary effect on spending of such credit restraint has been hard to assess.

Similarly, households no doubt have reallocated financial portfolios from retail deposits to capital market instruments. But does such behavior signify basically benign financial portfolio shifts? That is, does the allure of longer-term instruments stem from their justifiably high rates of return in light of prospects for stronger spending and credit demands in future years? Or do attractive long-term returns to investors actually represent costs of capital to borrowers that are too high in real terms to sustain an adequate economic expansion over time?

As yet another example, the process of deleveraging by households and businesses is restraining the expansion both of debt liabilities and monetary assets. But is this ongoing process a phenomenon affecting mainly financial entries on balance sheets? Or are strained balance sheets also significantly retarding business outlays on capital goods? And are existing debt burdens and higher tax-adjusted

consumer credit rates also appreciably restraining household spending on durables?

To the extent that some of these forces are going to hold down future spending, then sluggish money growth does point to weak economic performance down the road. Even so, an assessment of that economic outlook, and the appropriate policy response, still must rest on judgments about forces at work that go well beyond the monetary aggregates per se.

Today's policy decision, of course, will affect future money growth along with economic activity and inflation. For example, any policy easing decided on today would raise the odds that the aggregates would end the year within their ranges. But, given where we are in the year, this effect would be modest, and the bulk of the impact would be felt in 1992. Indeed, when we prepared the previous blue-book, we concluded that the near-term sensitivity of M2 to changes in short-term interest rates was lower than we had previously thought. We did so in recognition of the heightened importance of partially offsetting movements in the the yield curve. By the same token, the bulk of the effect of any current policy easing on output and prices also would be felt next year, especially later in the year.

The staff forecast, which assumes another 1/4 point easing fairly soon in the funds rate and a stable rate thereafter, embodies an increase in nominal GNP growth next year to 6-1/4 percent, up from a 3-1/2 percent rate both in the current quarter and for 1991 as a whole. We also predict that, in these circumstances, M2 would grow at the 4-1/2 percent midpoint of its tentative range for 1992. Such growth would involve a further abatement of the massive downward shifts in M2 demand seen earlier this year.

The staff forecast thus offers a benchmark for assessing alternatives A and B in the bluebook, since it essentially lies midway between them. Admittedly, looking at today's policy decision in this way may accord too much significance to a 1/4 point deviation of the funds rate one way or another from the path assumed by the staff. And looking at it this way also abstracts from future policy adjustments up or down that surely will be made as economic conditions evolve unexpectedly over time.

That said, alternative B would seem attractive if the staff forecast were viewed as too pessimistic about the outlook for economic activity or M2 growth. This alternative also would gain appeal if the degree of disinflation embodied in the greenbook projection were seen as too small to be acceptable. Alternative B could continue to incorporate an asymmetry toward ease, so that further information confirming that economic activity really is on the weak side could still elicit additional easing. But any such action presumably would be taken well beyond the Treasury's mid-quarter refunding that starts today, thus avoiding a policy move during the bidding process.

Alternative A, on the other hand, could be preferred on the thought that the downward revisions to the near-term outlook for the real economy in this greenbook may not have gone far enough. For example, it could be argued that the staff forecast might not have incorporated enough of the recent deterioration in public confidence and of the spate of gloomy anecdotal reports on spending and production. Or, alternative A could be justified if the staff forecast, while viewed as plausible given its assumed pattern for the funds rate, were seen as showing unacceptably slow economic growth next year. On either view, adequate economic performance may require more

of a jump start--which might be fostered by the publicity surrounding, as well as the spending incentives associated with, a 1/2 point cut in the discount rate to 4-1/2 percent that was fully passed through to the funds rate.

An intermediate alternative--opting for a 1/4 percentage point drop in the funds rate to 4-3/4 percent, as assumed in the staff forecast--might also be considered. That middle course could seem appropriate if the staff forecast were judged to be an outcome not only likely to result from such a policy move but also about the best economic performance possible under the circumstances. After all, once the economy gets beyond a couple of weak quarters, real growth is projected to pick up largely spontaneously to a more reasonable pace. This alternative could be implemented through a further reduction of the borrowing allowance of \$25 million, or, more consistent with past practice, a 1/2 point cut in the discount rate combined with only a partial pass-through to the funds rate. This middle course seems to be the one most nearly built into the structure of market interest rates at present, and likely would generate the least reaction in securities prices. Were the Committee to decide to delay implementing this option until after the bidding in the mid-quarter refunding was over, say on Friday, this feature may represent something of an advantage, because the surprise element for market participants would be minimized.