

APPENDIX

Notes for FOMC Meeting
December 17, 1991
Margaret L. Greene

Since your last meeting, the dollar has been caught in a tug of war between two opposing forces. The deepening gloom over prospects for economic recovery, as well as concern about the ensuing political pressure, exerted downward pressure against the dollar throughout the period. At the same time, anxieties about the disintegration of the USSR gave rise to spasms of demand for dollars that sometimes pushed the currency up and otherwise kept alive the risk of loss for those tempted to aggressively sell the dollar short.

Overall, the negative force proved to be the more dominant. But the extent that the dollar declined against individual currencies depended on developments abroad. Against the yen, the decline was only 1-1/2 percent. The Japanese currency itself was undermined by concern about a slowing expansion, problems with Japan's financial markets and banking structure, and the likelihood of further interest rate cuts there. The decline of the dollar against the German mark was, by contrast, more than 4-1/4 percent.

In fact, the strengthening of the German mark overall, amid a reawakening of the perception of exchange rate risk, is probably the most important development of the exchange markets during the intermeeting period.

The heightened awareness of exchange rate risk was precipitated by developments in a rather remote place, Finland. For about a month to mid-November, the Finnish authorities had been trying to resist pressures against their currency that reflected, among other things, severe recession, the loss of its major export markets in the USSR and Eastern Europe and fractious wage negotiations. The authorities had intervened and, as their foreign currency sales

approached equivalent, talk spread that the country had run out of reserves. On November 14, the currency succumbed to market pressures and the next day, the Finnish authorities set a new peg for the markka against the ECU, effectively devaluing the Finnish currency by 12.3 percent.

The market was awed by the size of the pressures that flared up around such a thinly traded currency. The magnitude of the flows demonstrated the extent investors around the world had been diversifying in the past several years in order to enhance yield when interest rates in traditional markets had declined. The episode also brought into question the ability of authorities to resist market pressures.

After being surprised by the drop in the Finnish markka, international investors sought to shift the currency composition of their portfolios toward the German mark. The 8-1/4 percent yield available on 10-year German government securities, for example, came to look like a reasonable return. Investors were willing to forego the additional 3 to 4 percentage points being offered in some of the other, so-called "high-yielding" currencies of Europe, which suddenly was perceived as scant compensation for an overnight devaluation. The approach of the European Summit at Maastricht only added to the sense of uncertainty. Although market participants were reasonably sure that none of the EMS countries would be going into the discussion of European Monetary Union seeing a change in parity for their currency, the possibility existed that, either for political reasons or in response to market pressures, an EMS realignment might occur.

The impact of these uncertainties on EMS currencies was uneven. Pressures within the EMS focused on those currencies thought to be most exposed, such as sterling, the Italian lira and the French

franc. Intervention in support of these currencies came to nearly \$9 billion equivalent.

But outside the EMS, the Swedish krona--a currency, like the Finnish markka, recently pegged to the ECU unilaterally--got caught up in a maelstrom of selling pressures. During November and early December, the Swedish Riksbank sold equivalent of foreign currencies, mostly German marks to support its currency. The Riksbank raised interest rates 1 percent on November 26 to show the market the government's determination to maintain the currency's exchange rate. But rumors of devaluation spread and, within a week, the Riksbank had to hike its official lending rate again--this time by another 6 percentage points to 17.5 percent--to stabilize market conditions.

In the past week or so, the pressures among the European currencies appear to have subsided somewhat. Sweden's strong monetary move has succeeded in attracting reflows. The Riksbank has bought back nearly all of the foreign currency it had previously sold and has scaled back its official lending rate 2-1/2 percentage points to 14 percent. The Maastricht Summit is over, there was no realignment, and

the German mark is seen as having little to gain from the agreements on European Monetary and Political Union.

But the heightened sense of exchange rate risk is not completely dispelled. Partly as a result, the trend to lower interest rates in the European countries other than Germany is seen as having been stalled if not reversed. Many of these countries had been attempting to earn the respect of the market place--not only by bringing down their domestic inflation but also by tying their currency in some way to the mark--so as to squeeze the exchange rate risk out of nominal domestic interest rates. For much of the year before these events, European interest rates in these countries had been moving lower, offsetting to some extent the upward move of German rates. Now, EMS central banks are perceived as having to be alert to the need to use short-term interest rates to deflect exchange rate pressures suggesting that the scope for further convergence of interest rates may be limited. At the same time, the monetary authorities in Germany's neighboring countries are growing concerned that their efforts to maintain anti-inflationary discipline in their own countries may be undermined by the cost-push pressures so evident today in Germany. They, therefore, are no longer putting pressure on the Bundesbank to refrain from tightening monetary policy further. On both counts these central banks seem reconciled to the prospect of keeping their own interest rates firm, even in the face of slowing growth.

Outside the EMS, those currencies that had previously benefitted from high yields and large-scale capital inflows have also weakened considerably during the intermeeting period. Two of these currencies, the Canadian dollar and the Australian dollar, have been

hit by reportedly heavy liquidation of investments by Japanese investors.

Looking forward, it is hard to know how much of the speculative juices unleashed in November will stay active or how much the lessons of the episode will affect investor behavior. Once trading resumes in the new year, the perception of increased foreign exchange risk could impel fund managers to seek higher returns or react more swiftly to any signs of exchange market disturbance. Thus, at a time when we are being reminded to "Remember Pearl Harbor," the international fund managers may be responding to the refrain, "Remember the Finnish Markka."

In closing this part of my report on foreign exchange market developments, Mr. Chairman, I request approval of the sale of \$200 million equivalent marks to the Swedish Riksbank.

I would also like to report to you on our discussions with the Bundesbank regarding the possibility of altering the double-forward investment facility provided for the investment of the bulk of the U.S. authorities' Deutsche mark reserves. Mr. Cross explained to you earlier this fall how the current arrangement exposes the Bundesbank to losses as a result of a maturity mismatch on its balance sheet. I believe he informed you that we are working with the Bundesbank to establish a new pricing arrangement for the facility which would reflect the Bundesbank's need to minimize its exposure to losses and still meet U.S. authorities' desire to receive a market-related rate of return.

It had been our understanding that the Bundesbank wanted to have the issue settled by year-end. We, therefore, hoped to be able to reach agreement on a new pricing mechanism by now, so that you could have considered it at the same time as the annual renewal of the

swap line with the Bundesbank. We have presented several alternative proposals to the Bundesbank since early fall, but they have not been as quick as we had expected in responding. In any case, work on this project is underway.

To date, we have received confirmation of renewal on all of the System's reciprocal swap arrangement with the exception of those of the central banks of Germany, Italy and the Netherlands. We expect all three will be renewed by their December 28 maturity dates. Additionally, the Treasury anticipates that its swap arrangements with Germany and Mexico will be renewed by their January maturities.

In one of the System's swap arrangements that still has not been renewed -- that with the Netherlands bank -- a change in the interest rate provision would be desirable. The Dutch central bank has asked that we make one modification to use the Dutch interbank offered rate, in place of an obsolete Netherlands Treasury paper rate, in determining the forward rate on swap drawings initiated by the Federal Reserve. Mr. Chairman, I request approval for that amendment.

Notes for FOMC Meeting
Peter D. Sternlight
December 17, 1991

Domestic Desk operations since the last meeting of the Committee, on November 5, effected two small easing steps in policy. The first was taken on November 6, carrying out the Committee's decision at the previous day's meeting. It entailed a reduction in the expected Federal funds rate from 5 to $4 \frac{3}{4}$ percent, and was implemented in conjunction with a $\frac{1}{2}$ percentage point reduction in the discount rate, from 5 to $4 \frac{1}{2}$ percent. The extent of the move was conveyed to the market by arranging customer-related repos that morning at a time when the prevailing funds rate had already moved to $4 \frac{3}{4}$ percent in the immediate wake of the announced discount rate cut.

The second easing step was taken a month later, on December 6, the day of a particularly weak employment report. The move was made against the background of that report, other evidence of slack economic activity, a sense of abating inflation and still-slow (though improving) growth in broad money aggregates. The expected Federal funds rate was reduced by a further $\frac{1}{4}$ percent to $4 \frac{1}{2}$ percent. This move, too, was readily conveyed to the market by executing customer-related repos, as the prevailing Fed funds rate that morning had slipped to $4 \frac{1}{2}$ percent in widespread anticipation of the System's move. Indeed, had there not been a decision to take an easing step, we

would have had to drain reserves that day--despite the projected add-need for the period--in order not to mislead market participants.

The first easing move was accompanied by no net change in the path borrowing allowance, as a \$25 million increase associated with the re-emergence of a positive spread between the expected funds rate and the discount rate was offset by an equal downward technical adjustment to allow for ongoing declines in seasonal borrowing. The second policy move was accompanied by a \$25 million cut in the borrowing allowance and there were three other downward technical adjustments of \$25 million each to parallel the receding level of seasonal borrowing. For the whole period, the path borrowing allowance was reduced by \$100 million to \$75 million.

Over most of the period, borrowing ran a little below the path allowance as adjustment borrowing remained particularly light except for a bulge at the end of the December 11 reserve period. Funds rates hewed fairly closely to the expected level, averaging a shade to the higher side, but with soft rates on a number of days tending to inhibit the Desk's ability to meet projected reserve needs lest the market misconstrue the Desk's action as still further easing steps. This was notably the case on the December 11 settlement date when a large reserve need was foreseen but the funds rate only grudgingly crept up to the desired 4 1/2 percent level by late morning. With the market seemingly thirsty for evidence of further ease, the Desk felt

constrained to do no more than a moderate reserve provision, recognizing that a sharp tightening might well occur late in the day. As it turned out, funds softened for a time that afternoon, touching a low of 4 percent, but then tightened and climbed as high as 15 percent, while borrowing jumped to about \$600 million on the day.

Typical late-year reserve needs dominated the period, related to currency outflows and increased required reserves, punctuated further at times by some unexpectedly high Treasury balances. The bulk of the need was met with outright purchases, including nearly \$5 billion of bills and notes purchased from foreign accounts and \$2.3 billion of coupon issues bought in the market--the System's first market purchase of coupon issues since April 1989. While the total outright purchase of \$7.2 billion were thus substantial, it did not prove necessary to use the enlarged leeway provided by the Committee.

Outright purchases were supplemented on most days either by multi-day System repurchase agreements, or customer-related repos. There were no matched sale-purchase transactions in the market, and just one modest redemption of an agency issue.

Looking ahead, repurchase agreements likely will be used heavily to meet seasonal needs through year-end, while outright purchases are probably about over for the year, as we enter soon after year-end into a period of substantial seasonal reserve absorption.

It may be noted, though, that net outright purchases so

far this year add up to a record \$31.4 billion, including \$20.2 billion of bills and \$11.3 billion of coupon-bearing issues--the latter mainly bought from foreign accounts. The exceptionally large outright purchases reflected needs stemming chiefly from large increases in currency in circulation, and the need to replace reserves absorbed by the declines in foreign currency holdings.

Yields declined across a broad front during the recent intermeeting period--with the larger declines weighted as usual toward shorter maturities, so that an already steep yield curve steepened further. The declines stemmed from increasing market perceptions that the economy's pick-up beginning toward mid-year, while never very strong, recently has lost what little momentum it had. Most market participants see the current quarter and the next quarter or two as essentially flat while a resumption of significant growth is not expected before about the middle of next year.

Each easing step by the Fed has been widely anticipated and promptly followed by expectations of further steps to come, though some observers are expressing the views that we could, or should, now be nearing the end of the line for easing moves. A widely held current consensus would look for a further 1/2 point discount rate cut and a reduction in the funds rate by at least 1/4 point between now and year-end. Market observers seem to have been particularly impressed by the weakness in various confidence measures and the sour mood in the

business community as many lay-offs are announced. Inflation news is recognized as mixed, but most commentators express confidence that core rates are slowly abating.

Responding to actual easing moves and anticipations of moves, Treasury bill rates came down by about 50 to 65 basis points in the recent period. Yesterday's 3- and 6-month auctions saw average rates of 4.14 and 4.19 percent, compared with 4.74 and 4.80 percent just before the early November meeting. The Treasury raised about \$2 1/2 billion, net, in the bill sector over the interval. Private short-term rates also fell, including the bank's prime rate which was reduced 1/2 point shortly after the early November discount rate cut.

Shorter-term Treasury coupon issues were also down sharply in yield--with declines of about 60 to 65 basis points out to three years. The five to ten-year yields were down about 25-45 basis points as buyers reached out in maturity to capture dwindling rates of return. The long end came off by a more modest 10 to 15 basis points--a somewhat grudging move that reflected concerns that budgetary discipline might be weakened in the effort to provide greater fiscal stimulus to the economy. Continuing reports of Japanese selling of long Treasury zeros and whole bonds were also a factor holding up longer rates. Some observers also sensed concern that confidence in declining inflation was not as robust as might be needed to produce more meaningful rate declines. Meantime, the long Treasury market got some periodic bursts of support when Secretary Brady commented to

Congressional committees that the Treasury was looking at the possibility of reducing its reliance on long bonds in financing the deficit.

In all, the Treasury raised about \$32 billion in the coupon market. The bulk of this, nearly \$19 billion, was raised in the November refunding auctions, which were just getting under way the day of the last Committee meeting. In those refunding auctions the bidding interest was rather weak for the 3-year issue, and not much better for the 10-year, but then quite strong for the 30-year apparently because rates had temporarily backed up to the appealing 8 percent level. All three of the new issues later moved to sizable premiums over their auction prices in the market's subsequent downward rate moves.

Rate declines in the Treasury market were roughly paralleled in the corporate market, encouraging a heavy volume of new issuance including a moderate volume of below investment grade securities. Issuance of tax exempts was also heavy although their rates showed little change over the period. New issue activity can be expected to taper off in these markets through year-end. Much of the new issuance, to be sure, is related to debt restructuring rather than net new borrowing.

A final note: as of this point, there seems to be little evidence of generalized year-end pressure facing the financial markets--a welcome contrast with last year when such pressures were quite intense. While certain individual firms are

under strain and are having to aim for scaled-down balance sheets, they appear to be the exception.

Michael J. Prell
December 17, 1991

FOMC BRIEFING -- DOMESTIC ECONOMIC OUTLOOK

Shortly after the last FOMC meeting, incoming information led us to conclude that the economy probably was turning down again. In essence, it looked like the downside risks to which we had been pointing were in fact materializing. Unfortunately, subsequent data have, on the whole, supported that initial assessment.

Central to the change in the near-term outlook was the negative news received in mid-November on retail sales and inventories. The initial readings on sales through October suggested the distinct possibility of a decline this quarter in overall real consumer outlays. And data on retail inventories through September indicated a build-up that we had not foreseen. Although it appeared that a significant portion of this accumulation was accounted for by imports, we felt that a good part of the ensuing adjustment in stocks would come at the expense of domestic producers.

After the Greenbook was published last week, we received another month's worth of retail trade data, and they suggest that things may be going a bit more poorly than we had anticipated. Sales for November were soft, and those for prior months were revised down considerably, indicating a still weaker fourth-quarter spending pace. Meanwhile, inventories continued to accumulate on retailers' shelves in October. I don't want to make a lot of the differences from our expectations in these preliminary reports; the main point is simply that the latest numbers have reinforced the basic message of our forecast: namely, that weak employment and income and diminished confidence have dealt a blow to consumer demand and to overall economic activity.

This is not to say that the economy has collapsed. On average, aggregate production worker hours in October and November matched the third-quarter level, as the workweek of those still employed remained firm; as we noted in the Greenbook, if one believed that productivity is being improved, then there would be reason to hope that output will be up in the current quarter. Of course, if that output should end up in undesired inventories, it would not bode well for early 1992. An important positive for the near term is the fact that single-family housing starts jumped in October and held that gain in November, according to the figures released this morning; this suggests that the lower mortgage rates may be sustaining the recovery in residential construction in the face of all the negatives in the economic environment. And our most current indicator of activity--the weekly figures on initial claims for unemployment compensation--exhibited only a mild deterioration through the end of November. It may be worth noting in this regard that many of the payroll cuts that have been announced recently have pretty long fuses; they may be affecting consumer confidence--and political debate--today, but the actual job losses will not occur for some time.

Weighing all of the evidence, we came up with a forecast of just a small dip in economic activity into the winter months, followed by moderate growth thereafter. For the near term, our projection reflects importantly the judgment that the existing inventory imbalance is small and that the necessary production adjustment is already under way--as suggested by the decline in manufacturing output last month. We also believe the immediate downside risks to final demand are limited relative to our already weak projection. If nothing else, we don't see much risk of another dive in auto sales and production like that which played so large a part in the economic contraction a year ago.

Perhaps the bigger issue with respect to the forecast is the projected upturn in activity starting next spring. To a considerable degree, that upturn is simply the result of inventories ceasing to decline--a significant plus for real GDP after the substantial liquidation in the first quarter. But, as the experience this year shows, any ensuing recovery is going to be weak and unsustainable unless there is also a solid pickup in final demand, supported by growth in employment and income. The recent faltering of the expansion has forced us to re-examine our view of the forces influencing final demand, and we have reached a few tentative conclusions.

First, in retrospect, those who had argued that, once the inventory cycle that occurred during the Gulf crisis was over, we'd still have a very soft economy, held down by longer-term problems, had it right. I might quibble with their reasoning in some instances, but the factors that we had thought all along would result in a sluggish recovery clearly have proven more powerful and more persistent than we anticipated. Among other things, we may not have appreciated the dynamics of the interaction among the stock adjustment processes that are taking place. We knew, for example, that the financial sector had too many buildings and too many people in them, but we didn't anticipate--at least not fully--how the commercial real estate bust would intensify the pressures on that sector and vice versa.

In general, we probably did not make adequate allowance for the demand-reducing effects of the structural adjustments occurring in such industries as computers, airlines, and retail and wholesale trade, where firms--in some cases under the stress imposed by excessive leverage--are finally confronting the technological and competitive pressures that have been mounting for years. Slashing payrolls is the order of the day, and in the process, labor income is

being destroyed. And, though blue-collar and low-skill workers have experienced the greatest increases in unemployment, the media seem to have given disproportionate attention to the white-collar and professional layoffs--thereby helping to broaden the sense of insecurity among the populace. The fact that many households see themselves as financially overextended only adds to the contractionary consequences.

Finally, as best we can judge, changes in financial markets and the grossly outsized stocks of physical capital in some sectors probably have dulled the effects of interest rate reductions to a greater degree than we anticipated. Monetary policy isn't pushing on a string, but it is having to work harder to get a given spending response.

The upshot of this analysis is that we think that aggregate demand is going to tend to be weaker, for longer than we previously had been expecting. This is reflected in the fact that real GDP is appreciably lower all the way through 1993 in the current Greenbook forecast than in our last projection--even though interest rates and the dollar exchange rate are a shade lower. Output does not regain its 1990 peak level until the third quarter of next year--a relatively long period of depressed output--and the expansion that follows is mild.

The fact that our forecast contains such a tepid economic performance overall might suggest that we are not being wildly optimistic about the outlook; but it of course does not guarantee that growth will resume, as scheduled, in the second quarter of next year. The Greenbook basically projects that the declines in interest rates that have occurred thus far, plus the anticipated further decline in long-term yields, will bolster housing demand and that consumer spending in general will pick up by next spring as the job losses

associated with the near-term inventory correction abate. It's almost a case of *deja vu* all over again, with a repetition of the 1991 upswing--but we expect the upturn will be sustained this time, given that the real adjustments will have progressed further in a number of troubled sectors, that some pent-up demand for cars and other consumer goods will have developed, and that many businesses and households will have reduced their debt burdens further.

Obviously, we would not want to put too fine a point on the timing and initial strength of the upturn, given the many uncertainties in our analysis. If nothing else, we have no way of predicting what the fiscal authorities will do, and events abroad, which Ted will discuss in a moment, also present some risks. In our view, however, it is reasonable to anticipate moderate growth over the next two years, without any additional easing of money market conditions. I would characterize the risks of this projection as being better balanced--more symmetric--than has been true for a while.

Even if you share that view, it obviously does not preclude consideration of the potential risks and rewards of alternative courses of action. One factor that I presume might influence your thinking on that score is the outlook for inflation. Our judgment is that a disinflationary process is well in train, and that further progress would be made toward price stability even if the economy were to be, for a while, significantly stronger than we've projected. Looking at the core CPI as a rough measure of the underlying price trend, we have seen the 12-month increase lingering at 4-1/2 percent recently. But that number is still reflecting the earlier effects of tax increases and energy price pass-throughs, and we expect to see considerably lower year-on-year changes within a few months. And, given the slack in labor markets and in productive capacity more generally, we expect disinflation to continue even as the economy

picks up, with the rate of consumer price increase dropping to 3 percent in 1993.

Something at least close to that rate probably would be attainable even if the economy were to grow 3 percent over the coming year, instead of the 2 percent we've predicted--but unless activity began to decelerate thereafter, possibly encouraged by a tightening of policy, the prospects of extending the disinflation trend beyond 1993 likely would be dimmed.

Edwin M. Truman
December 17, 1991

FOMC Presentation -- International Developments

Turning to the external sector of the U.S. economy, the surprisingly sharp decline in net exports during the third quarter reflected an unusually rapid expansion of imports more than a retrenchment of exports; exports were still expanding at an annual rate of more than five percent. As Mike just indicated, we suspect that a good deal of the bulge in imports -- much of which was in consumer goods, autos, and oil -- went into domestic inventories. The likely rebalancing of these inventories could knock as much as \$5 to \$6 billion, at an annual rate, off the level of imports during the next two quarters. Such an adjustment, along with the weaker near-term outlook for domestic demand that Mike has just outlined, has led us to project a decline in real imports before the winter is over. Thereafter, we expect imports to expand significantly as domestic demand recovers.

We have had less cause to alter the projected path of exports. Reports on export orders point to continued expansion in the export sector, at least through the fourth quarter. Our relative optimism about exports has been tempered to some extent by recent signs of continued sluggishness in economic activity in major foreign industrial countries, and we have marked down -- by about 1/2 percent -- the level of overall foreign economic activity by the fourth quarter of next year.

While the weakening of our outlook for foreign growth has tended to damp our projection for U.S. exports, developments in foreign exchange markets have worked in the opposite direction to brighten export prospects. Our models tell us that the dollar's lower level compared

with the November Greenbook roughly offsets the effects on exports of the weaker outlook for growth abroad.

In sum, with the growth of imports revised down significantly in the near term, and with the outlook for exports revised down only slightly, we expect net exports to make a significant positive contribution to GDP during the fourth quarter and the first quarter. Moreover, we are projecting small additional positive contributions through the rest of 1992.

Three principal risks to our outlook for the external sector are the dollar, oil prices, and foreign economic activity.

Although the dollar has fallen recently, the decline has not reversed all of the increase over the first half of the year -- an increase that seemed to reflect post-Gulf War euphoria. The dollar is above its level at the end of 1990; however, we estimate that the differential in long-term real interest rates, which we think is a major influence on the dollar, has moved against the dollar on balance over the course of the year. This raises the possibility that the dollar could fall further, contrary to our current projection, particularly in the near term as news of weakness in the U.S. economy continues to pour in.

This risk to our outlook for real net exports, therefore, is positive in terms of economic activity. A further depreciation of the dollar below the path we have projected would add to the growth of net exports over the year ahead. For example, a five percent decline in the average foreign exchange value of the dollar in the first quarter that extended through the forecast period would add somewhat more than 1/4 percent to real GDP by the fourth quarter of next year.

Developments in world oil markets could pose another possible positive risk to the outlook. We have assumed that spot oil prices will remain about unchanged from their recent levels as Kuwait and Iraq production come back on stream gradually over the next two years. However, significant downward pressure on oil prices could emerge (in the near term at least) if production in Kuwait and Iraq recovered more rapidly while Saudi Arabia continued producing at or near capacity. Downward pressure on oil prices also could emerge because of sluggish growth in global demand -- acting as a kind of automatic stabilizer.

A third risk to the outlook, and one that is negative, concerns the outlook for foreign economic activity. The extent of slowing in real growth abroad during 1991 has surprised us -- our current estimate of real growth on average in the foreign industrial countries is about 1 percent less than we projected at the time of the February FOMC meeting. The largest revisions have been for growth in western Germany and in the United Kingdom.

Our current outlook is for slow growth in the foreign industrial countries during this quarter and next -- 1-1/2 percent on average at an annual rate. Growth is expected to pick up by the second half of 1992 to 2-3/4 percent.

This outlook contains considerable uncertainty, and many of the risks to the forecast appear to be negative. The rebound in activity forecast for 1992 in several of the major foreign countries -- Japan, the United Kingdom, and Canada in particular -- depends importantly on the effects of monetary easing that is already in place. Should these effects come more slowly or be offset by other factors, a significantly weaker foreign outcome could result.

For Japan, the weakened condition of financial institutions and the potential for renewed declines in stock and land prices are downside risks. Investment spending, which had been very strong, could be further diminished by lack of available credit. A decline in household spending could occur should further drops in asset prices or a rise in unemployment cause consumer confidence to fall.

We have estimated the effects on our outlook for the U.S. external sector of a "worst case" scenario in which there is little or no growth abroad in the near term and only a weak recovery in 1992, producing growth over the four quarters of next year about one percent lower than we are now projecting. Our model simulation suggests that such a scenario would chop almost 3/4 of a percentage point from the level of U.S. real GDP by the fourth quarter of 1992.

While I could point to some upside risks to our forecast for growth abroad, those risks seem less likely on balance than the risks on the downside. Moreover, my sense is that policy makers in the foreign industrial countries, with the possible exception of Japan, are not in a position, or do not have the inclination, to counter aggressively any downside risks.

That completes our presentation, Mr. Chairman.

December 17, 1991

FOMC BRIEFING
Donald L. Kohn

The weakness currently evident in the economy is a reflection, at least in part, of monetary policies followed in earlier quarters this year, as they have interacted with more subdued demands for goods and services than had been expected. In response to indicators that demands were falling short of expectations, monetary policy has eased appreciably over the last few months. These actions will have only minor effects in the near term, but they do provide a reasonable basis for expecting a strengthening in activity next spring and summer. The issue presented at this meeting is whether the actions taken over the last few months have been sufficient to tilt the odds far enough in favor of getting a rebound of the dimensions desired by the Committee.

The decline in the federal funds rate of 125 basis points since July is showing up in a number of financial indicators, and in this regard the situation differs somewhat from that prevailing in the summer. The drop appears to have outpaced any fall in near-term inflation expectations, so that real short-term rates also have registered significant declines, to their lowest levels since 1980. Nominal long-term rates have moved down noticeably as well, though the extent to which this has shown through to real rates perhaps is more questionable. The drop in interest rates has affected the exchange market, where the dollar also has fallen appreciably in both nominal and real terms since midyear.

The reductions in nominal short-term interest rates are having their effects on the monetary aggregates. M2 and M3 have resumed

growing in the fourth quarter, after declining in the third. Their growth is not especially robust, but decreases in short-term rates have offset weaker income, so that expansion of the aggregates is in line with expectations at the beginning of October. M1 has accelerated markedly--to a 12-1/2 percent rate from September to December. Credit flows, outside the Federal government, remain very sluggish, but do not appear to have slowed further, despite the deceleration of nominal spending since the second quarter. Moreover, credit standards at banks seem to have stabilized, and these institutions have been about matching Federal Reserve easing moves with prime rate reductions--in contrast with earlier this year when the spread of the prime over market rates widened as the federal funds rate fell.

Perhaps because the easing actions over the last few months have been seen as eventually effective in supporting the economy, the worsening near-term economic prospects have had a muted impact on longer-term security prices. The yield curve remains unusually steeply upward sloped, still suggesting an expected rise in short-term rates at some point in the future; stock prices have only edged off record levels and price-earnings ratios are elevated; and risk premiums in private securities markets and between private and Treasury securities are very low.

However, these market conditions appear to embody expectations of a slight further easing in monetary policy over the near-term. As a consequence, keeping federal funds rates unchanged, as under alternative B, is likely to produce some modest upward pressure on other interest rates for a time, with the subsequent movement of interest rates depending on the implications of incoming data for the strength of credit demands and future policy moves. The flat federal funds rate of alternative B, as Mike noted, is the assumption behind

the greenbook forecast. Choosing this alternative would seem appropriate if that outlook were thought to be acceptable, and the risks fairly evenly balanced. Living with moderately high rates of unemployment for a time, as in the greenbook, would help to put inflation on a downward trajectory toward price stability over coming years. Progress in bringing inflation below the 4 to 5 percent range prevailing over the 1980's has been limited so far, and the level of longer-term interest rates implies deeply rooted market skepticism about any lasting reduction in the underlying rate of inflation. While additional easing at this time need not deflect inflation from a gradual downward path, it would tend to make such a path less certain, and probably would at least postpone any change in market attitudes.

Alternative B would also be justified by a judgment that there was a significant risk that the greenbook is too pessimistic on the outlook for the economy. If the economy does turn out to be materially stronger than anticipated, further easing at this time might well require a prompt and significant tightening to keep inflation rates tilted down, given the small gap between the unemployment rate and the natural rate compared to some prior recessions, and the lags from monetary policy to the economy. Reversing policy in a timely fashion may be especially difficult when there has already been one false start to the recovery, and when money growth is less likely to signal a need for restraint owing to structural adjustments in the depository sector that are likely to continue to depress money relative to income.

Alternative A, or some more modest easing of policy, would be a more preferable choice were the greenbook forecast seen as likely, but involving an unacceptable degree of slack in reserve utilization, or the Committee saw the risks or costs of the outcome for the economy

more heavily weighted toward a shortfall from projections. In effect, the Committee would be judging that real interest and exchange rates had not yet fallen to levels that gave sufficient assurance of achieving its intermediate-term objectives for the real economy, given the forces holding back expansion.

To a considerable extent, those forces are working through the financial system, and lower interest rates will help to alleviate them--for example, by reducing debt service burdens of borrowers and making them more creditworthy, and by bolstering the profits of some intermediaries, like many banks whose liabilities reprice more often than their assets, enhancing their ability to raise capital. In any case, lower market interest rates will encourage borrowing and spending by those with access to securities markets, buoy asset values by reducing capitalization rates, and stimulate net exports through a decline in dollar exchange rates. Easing action in the United States and downward pressures on the dollar might give scope for a few countries to follow suit, damping the drop in the dollar but bolstering activity more broadly.

Prospective paths for broad money growth could be seen as weighing on the side of a further reduction in short-term interest rates. In the bluebook, the November-to-March growth of M2 under alternative B remains at 3 percent, well entrenched in the lower half of the tentative range for next year, and shows little sign of accelerating. In fact, our estimate of M2 growth consistent with a flat funds rate and greenbook income for all of 1992 is only 3-1/2 percent. The relation of money to income has been fraught with uncertainties in recent years, but unexpected shortfalls in money have preceded unanticipated weakness in income. If the Committee wished to assure itself of stronger nominal income, it may want to foster a more

substantial pickup in M2 from 1991 to 1992. Under the lower rates of alternative A, M2 growth through March would average 3-3/4 percent, and this aggregate would be growing at around a 4-1/2 percent rate by March. With the extra push from higher income associated with lower interest rates kicking in later in the year, we would project M2 growth for 1992 at around the 4-1/2 percent middle of its tentative range under alternative A. Given some further upward move in velocity, as credit flows continue to by-pass intermediaries and depositors reach for yield, 4-1/2 percent M2 growth for 1992 might be consistent with 5-1/2 percent expansion of nominal GDP, somewhat above the 5 percent nominal GDP growth in the greenbook forecast.

To be sure, a further ease at this time would raise the odds of an eventual need for policy to raise short-term interest rates. If the underlying demands for goods and services are not significantly stronger than embodied in the greenbook forecast, such a reversal probably would not be needed for some time. A major fiscal stimulus early next year could be a factor that would tend to boost demand more than anticipated. However, the outcome of the political process now considering fiscal action is impossible to predict, and how it might be affected by the course of monetary policy imponderable. In these circumstances, the greenbook assumption of no change in fiscal policy may be the only practical and responsible presumption for monetary policy. Even with an expansive fiscal policy, so long as the Committee stood willing to raise interest rates when needed, alternative A or some easing of policy need not derail the trend toward lower inflation. It is this disinflation trend, rather than any short-term variation in interest rates, that is key to encouraging sound, lasting balance sheet restructuring.