

APPENDIX

**REPORT TO FOMC  
ON  
FOREIGN EXCHANGE OPERATIONS**

**MARGARET GREENE  
MAY 18, 1993**

Thank you, Mr. Chairman.

In the foreign exchange markets since your last meeting both the U.S. dollar and the German mark have appeared weak whereas the Japanese yen has been relentlessly bid up. The yen reached an all-time high against the dollar at just about Y109 and came close to matching its earlier record against the German mark around Y68 (Y67.70). I will briefly postpone further comments about the yen, as well as of the one intervention operation that took place during this period, in order to comment first on the dollar and the German mark.

The softening tone for the dollar during the period was apparent both in the tendency for dollar exchange rates to decline against all major currencies and in its inability to get any meaningful lift from developments that, in the past, had buoyed the dollar. The dollar sagged from its intermeeting high near the end of March by more than 7 percent against the yen and by 5 percent against the mark to hit its low of the period early in the last week of April. During this decline, the dollar showed little bounce even when, for example, on April 22 the Bundesbank surprised the market by cutting its official interest rates sooner than had been expected. Although there has been some covering of short dollar positions last week and this that pared back the dollar's loss, the dollar posted declines for the period overall of more than 3 percent against the yen and more than ½ percent against the mark.

The softening tone for the dollar reflected a deflation of expectations concerning the strength of economic expansion, uncertainty about the prospects for fiscal repair here, as well as disappointment that interest rate differentials have not moved as quickly as expected in a direction more favorable to the United States. We are being told by market participants that many who had built up positions in dollar-denominated financial assets earlier in the year appear to have grown impatient with the prospect for returns. They feel there are more attractive opportunities either in some of the European markets for capital gains arising from declining interest rates in previously high-yielding fixed income securities, or speculative profits from stock markets in Asia and Latin America.

Meanwhile, the German mark, itself, has been undermined by growing evidence of Germany's deepening recession, widening fiscal deficit, and high labor costs. Against this background, the German mark has actually weakened against most currencies. The easing of the mark has contributed to a general diminishing of strains within the EMS that has permitted other European countries, both within and without the EMS, to rebuild their foreign currency reserves, lower interest rates, or do both. Only a very few currencies failed to strengthen against the mark. Among those that did not are the Spanish peseta and Portuguese escudo, both of which were devalued within the ERM last week, and the U.S. and Canadian dollars.

Turning now to the Japanese yen, the currency's advance that began in February and paused in March, resumed in April. The start of Japan's new fiscal year did not bring, as it has in the past, a burst of new outward investment by Japanese institutions. Instead, the new year opened with Prime Minister Miyazawa conceding that a further appreciation of the yen was probably "unavoidable". Then, in the first days of trading, the markets were rife with reports that

certain Japanese institutions, having waited until their year-end had passed to liquidate positions so as to avoid reporting more losses, were aggressive sellers of some foreign securities. These developments gave the yen a boost toward the Y110 level.

At Y110, the yen would have appreciated 12 percent since the beginning of 1993 and many in Japan were becoming fearful of the effects on Japan's economy of so rapid an appreciation. The Bank of Japan was being seen intervening regularly in the exchange markets to temper the yen's rise. But market participants were doubtful that the Japanese authorities could be effective until other governments signaled they, too, were concerned about the movement in the exchange rate. With a number of high level meetings scheduled to take place both in Tokyo and in Washington during the month, market participants were anxiously awaiting signals whether there would be concerted action to stop the yen's move. Instead, on April 13, Japan's trade data for March were released, highlighting the size of the trade imbalance. Later that week press reports covering a summit meeting between Prime Minister Miyazawa and President Clinton in Washington, focused on the new Administration's tough stance on trade issues. Against this background, markets became concerned that a confrontation between the two economic super powers might be brewing in which the United States would use the exchange rate as a means of creating pressure on the Japanese. The dollar sold off further – hitting its low early in the morning of April 27.

At that point, the U.S. Treasury suggested that the U.S. monetary authorities intervene. Before our usual opening of trading that day, the Desk went in to the market and started to buy dollars against yen. Operating in several rounds during the morning, and assisted by release of reassuring data on consumer confidence, the Desk visibly bought dollars at progressively higher

dollar rates. In total it purchased \$200 million for the U.S. monetary authorities, shared equally between the Federal Reserve and the Treasury, as well as for the Japanese authorities. Later, Secretary Bentsen in Congressional testimony and Under Secretary Summers in a press briefing confirmed that the United States is prepared to intervene in the foreign exchange market. Further, Summers said that "there have been some misperceptions about U.S. exchange rate policy. The Administration believes that exchange rates should reflect fundamentals, and attempts to artificially influence or manipulate exchange rates are inappropriate. Moreover, excessive volatility is counterproductive for growth." The dollar closed that day in New York at Y111.60.

These actions appear to have had a reassuring effect on markets. Although since that time trading in dollar/yen has been limited because of holidays in Japan, the dollar has traded rather narrowly around Y111.50. Japanese investors continue to be cautious about investing abroad and to be somewhat more interested than before in channeling whatever foreign investments they make into Europe. But the steadying of Japan's stock market index, the Nikkei, around 20,000 and signs of modest improvement in economic conditions both at home and abroad appear slowly to be rebuilding some confidence about the future. Trading housings in Japan and their bankers are approaching the exchange markets with a cautious attitude, not sure which way the yen might go if, indeed, economic fundamentals are given a change to show through.

OPEN MARKET DOMESTIC DESK OPERATIONS

FOMC MEETING

MAY 18, 1993

William J. McDonough

Monetary policy was unchanged throughout the intermeeting period and the Desk sought to maintain the degree of pressure on reserves consistent with Federal funds trading in the area around 3 percent. The borrowing allowance was raised twice for technical reasons and is now at \$100 million, with the allowance for excess reserves held at \$1 billion.

Actual management of reserves was complicated by the Treasury balance being frequently lower than either the Federal Reserve or Treasury forecasters thought it would be as individual non-withheld tax payments fell well below estimates.

The Desk met much of the expected seasonal needs with a purchase of about \$5 billion of coupon issues in the market on April 14. We met the rest of the reserve shortages with temporary operations. On one occasion, the first Friday in May when the April employment data were released, Federal funds were quite soft and trading at 2-13/16 to 2-7/8%. In order to make it clear that monetary policy had not been changed, we protested that rate by doing a small matched sales operation.

We bracketed the 3% funds rate in the various maintenance periods, but came close to it for the whole intermeeting period with an average of 2.98%.

The quarter end on March 31 was quite uneventful. Although it was their fiscal year end, Japanese banks followed their performance of December 31 and were essentially invisible in the Federal funds and other short-term money markets.

In the Treasury market, there has been considerable price movement within about the same trading ranges which existed at the last meeting. At this juncture, market participants foresee two-year note swings of about 20 basis points around an axis of 4%, the ten-year staying fairly close to 6% and the thirty-year bond in a range from 6.75% to something just above 7%. After the unexpectedly high price numbers of last week, yields are towards the upper end of those ranges, but still within them. Turnover is relatively light.

Seeking to distinguish between investors on one side and more active market participants, such as hedge funds, and dealers on the other, the investors such as pension funds, investment managers and financial institutions for their own accounts were substantial net buyers of securities from November until March, enlarging their portfolios and doing some extending of durations. Since about mid-March, these investors have been by and large sitting and watching, neither buying more nor selling. Recent net purchases have been the result of defeasance of municipal issues, parking of funds in the shorter maturities by bond mutual funds as the managers wait for clearer market trends, and some buying by European and Middle Eastern investors. The Desk's coupon pass also took up some supply. The demand from these sources has been about enough to make it possible for the dealers to underwrite the auctions,

including the quarterly refunding last week, and take care of customer sales and stay essentially flat or perhaps even a little short. Consequently, we do not see a major overhang of supply on the market.

Normally you would say that is a description of a market which would sit in the trading range until new information of sufficient perceived importance brought about a breakout in either direction. And that is pretty much how I see it, with one caveat, which I will precede by an additional caveat that I am trying to describe a market and not make a forecast. Market news has been more a source of pessimism than optimism recently, especially price data. So it will take more good news to lead to a breakout on the positive side to higher prices and lower yields than it will take bad news to have the market drop and yields go up.

What kind of good news would it take? Enough good price data to convince the market that inflation is not a threat or enough positive movement in the fiscal area to restore faith that the new administration has both the desire and the skills to get deficit reduction legislation enacted. Bad economic news might well not lead to higher bond prices, since international capital flows into the United States would become even smaller and could reverse if remaining optimism about our economy should disappear.

Since I think it would take less bad news than good to lead to a breakout, negative developments must be closely watched. Additional bad news on prices, especially one more month of bad PPI and CPI data, might well have a strong market reaction. Political developments are both harder to forecast and the market reaction to



them more difficult to call. Any series of developments within the beltway that could lead to a market view entitled "Gridlock and Tax and Spend Are Here To Stay" would be highly likely to bring about upward movement in market interest rates.

Until last week, most market participants and observers thought that Federal Reserve policy was on hold and would remain so, with the next move either up or down depending on economic developments. After the price data, believers in a Fed ease in the near future have essentially disappeared. Some now believe that any policy change is likely to be a tightening. However, a very large majority feel that the Federal Reserve will hold monetary policy steady.

To conclude, all of the Treasury auctions since April 29 have been conducted using the TAAPS automated bidding system and it has functioned very well, including permitting a shortening of the time between the close of bidding and the Treasury announcement of the results by about fifteen minutes.

Market reaction to the Treasury decision to shorten the maturity of its debt issuance by cutting the 30-year bond back to two issues a year and eliminating the 7-year note has been muted, with little price action.

Michael J. Prell  
May 18, 1993

### FOMC Briefing

Events since the last meeting would seem to pose a multiple-choice question that goes something like this: The economy is (a) running out of juice and in need of another recharge from monetary policy; (b) in the early stages of an upturn in inflation, calling for a dose of monetary tightening; (c) neither of the above; or (d) both of the above. Choice d--both of the above--is the kind of policy quandary one wouldn't expect to encounter in the absence of an obvious, adverse supply shock like the oil price jump of 1990. But more on that later.

Right now, I want to start by addressing the question of whether the economy is in the process of lapsing into another period of seriously subpar growth. My answer is that it is possible, but not likely. Moreover, the risks with respect to the Greenbook growth path seem to me reasonably balanced.

It's easy to overstate the degree to which activity has deteriorated of late. We came out of 1992 with a burst of growth and a surge in confidence that left the impression that the economy had gotten past the choppy water of the earlier recovery phase and had smoother sailing ahead. Against this backdrop, the performance of the economy thus far this year seems more disappointing than it might have otherwise. The facts are that employment grew moderately in the first quarter, and--unless there is a negative surprise in tomorrow's merchandise trade data for March--it looks like real GDP may have grown at more than a 2 percent annual rate. With production-worker hours in April above the first-quarter average, and the unemployment

rate stable, output evidently was still trending upward as the spring began.

To be sure, this doesn't guarantee that the economy will grow fast enough in the coming months to maintain or raise the level of resource utilization in the economy. Let me, therefore, focus briefly on a couple of concerns that we identified in developing our forecast.

An obvious one is the recent sizable increase in inventories. We had expected that inventory investment would turn up in the first quarter, as businesses built their stocks in response to the increase in activity. But, some of the accumulation that occurred seemingly was unplanned. A good part of the run-up occurred in motor vehicles, where sales fell well short of production levels--especially in March, when the bad weather depressed purchases. Since mid-March, though, the average pace of auto sales has been much improved, and stocks have been trimmed to comfortable levels. Outside of autos, reports from retailers also indicate that weather disrupted shopping in March and a good part of April, and there seems to be no great concern about clearing out the inventory overhang. All told, we should expect a substantial step-down in inventory investment this quarter; but that process is already well underway and built into our forecast.

Obviously, the adjustment would hit production harder if consumer spending were to remain as lethargic as it was on average over the first four months of the year. With hindsight, the reasons for the weakness are, of course, completely clear. Spending had moved way ahead of any reasonable trend in the latter part of 1992, and something of a breather was almost inevitable. The waning of the post-election consumer euphoria may have exaggerated the slowdown. It's also conceivable that President Bush's lowering of withholding schedules heightened the dimensions of the fluctuation, giving people

extra cash last year and then reducing their purchasing power in the past few months when they normally would have received refunds. To be sure, they should have known about this earlier and smoothed their spending; but tax withholding behavior has never been consistent with the notion that everyone is so alert and rational. These stories suggest that a good part of the recent sluggishness in consumer demand was attributable to transitory drags that should be abating now. But they don't imply that we can expect consumers to bootstrap themselves up at this juncture; rather, the prospects for a renewed growth of consumption would appear to depend on the existence of some other engine of income creation.

Fortunately, developments in several sectors appear favorable for growth of output and employment in the coming months. First, the influence of low mortgage rates should come to the fore once we get beyond the weather and lumber problems of recent months; the 6.7 percent April increase in housing starts reported this morning is exactly the initial installment we anticipated. Second, defense spending plunged below trend in the first quarter, and some firming is likely in the near term. Third, the anticipated firming of activity in Japan and Continental Europe should help solidify demand for our exports before too long. Fourth, nonresidential construction appears to be bottoming out. And, last--but by no means least--we seem to be in the midst of a minor boom in equipment investment. Firms have the cash flow, and they are spending it on equipment that will allow them to improve their products and to operate more efficiently. Innovations in computers and other high-tech areas are causing rapid obsolescence of existing machinery.

The question is just how much additional employment and labor income these activities and the associated multiplier effects will

generate. To date in this expansion, productivity gains have accounted disproportionately for increases in output. But, while productivity improvement is great for profits, profits appear to provide a less potent and reliable impetus to household spending in the short run than do wages. So job growth is clearly important.

As I'm sure you're all aware, most business managers are expressing little enthusiasm for hiring, in part because of their concerns that this administration will promote policies that add to the effective cost of labor. Be that as it may, employment has been growing along with productivity during the past year. And because a good deal of labor shedding already has occurred, our forecast anticipates a shift in the productivity-employment mix over the coming quarters, with smaller, but still healthy, increases in productivity and solid, if unspectacular, job growth.

In sum, though growth in GDP has slowed discernibly in recent months, it has not yet stalled out. Looking ahead, our analysis is that--even with a good deal of fiscal drag--activity should reaccelerate, not decelerate, owing in part to the favorable financial environment.

Of course, the ability of the System to maintain a "friendly" monetary stance, as traders put it, hinges on the prospects for inflation--the second issue I raised at the outset. The recent news on inflation has, as you know, been less than encouraging. I won't recite all the details, of which you are well aware. Given the volatility and imprecision of the compensation and price indexes, we would caution against putting a great deal of weight on their shorter-term variations. But even the longer trends in the various series have come to pose a very serious challenge to our belief that

inflation would slow appreciably further in the present economic environment.

In response, we have backtracked still further from our earlier, more optimistic projections that put core inflation in the low 2s by the end of 1994. However, in what some would--and no doubt will--characterize as a triumph of hope over recent experience, we still are predicting some slowing in the trend over the projection period. The notion that inflation tends to slow when there is significant slack and the economy isn't growing rapidly is a fairly compelling one--one that has proved very serviceable over the years.

In arriving at our forecast, we have asked ourselves how one might reconcile--especially within the scope of our standard analytical model--the current apparent coincidence of relatively high unemployment and quickening inflation. Two possibilities come to mind. One is that inflation expectations may not be moving down in step with actual inflation. As we noted in the Greenbook, the Michigan survey would seem to suggest that people have viewed the 3 percent inflation of the past couple of years as a temporary dip. Bond yields seemingly are saying the same thing. Reasons for this view are not hard to find: if nothing else, everyone knows that inflation has eventually picked up in each cyclical expansion. While it is difficult to pin down with precision the influence of these expectations on wage and price decisions, there can be no doubt that they do matter.

The second possibility that comes to mind as an explanation for recent developments is that the restructuring that has been going on in the economy has reduced effective productive capacity and created more structural unemployment than we thought. This is, in terms of my initial remarks, the adverse supply shock story.

We've actually been leaning a bit in this direction for some time now, especially in regard to the labor market implications of the deep cutbacks in the defense sector. We've implicitly been using a NAIRU somewhat above what econometric results would suggest. But, at this point, the notion that 7 percent unemployment today implies an overly tight labor market is a little hard to swallow. It certainly wasn't evident just a few years ago, in the latter half of the 1980s, and the structural changes since then, while significant, don't seem that dramatic.

In terms of industrial capacity, restructuring clearly has in some cases involved a good deal of consolidation and downsizing; we hope that the recent revisions to our measures of capacity utilization--which raised the rate noticeably--captured these changes, but I would be the last to argue for the absolute precision of our concepts or measurements in that regard. It seems more likely to me, though, that, rather than it being simply a matter of the level per se, it was the sharp increase in utilization over the latter half of 1992 and the expectations of continuing strong sales growth that caused firms to think that the time was finally ripe to mark up their prices. On this analysis, the softening of demand and the remaining slack in capacity should lead to an abatement of the price increases in the coming months.

Even tossing in the costs added by various government regulations, I would hesitate to rely entirely on a capacity constraint explanation for the recent inflation developments. But I also would be uncomfortable dismissing the possibility that it is an important element in the story.

In arriving at our forecast, we've tried to blend in all of these considerations. Because it is, in the end, a highly judgmental

assessment, one can scarcely be confident of the precise quantification. But for what it's worth, our judgment is that the odds favor the restoration of some downward trend in inflation in the months ahead--unless the economy is appreciably stronger than we perceive it to be.



May 18, 1993

FOMC Briefing  
David E. Lindsey

The economic situation surrounding the Committee's short-run policy decision is somewhat less favorable than at the last meeting. The outlook for real activity seems somewhat weaker than before, enough so that the unemployment rate does not even begin to edge lower until next year in the staff forecast. At the same time, inflation seems to be running stronger than previously anticipated, and we have revised up somewhat our projection of inflation through next year. Put another way, the intermediate-term tradeoff between resource utilization and inflation currently seems less favorable.

Assuming the staff projection embodies the most likely outcome if the stance of monetary policy is kept unchanged, an assessment of the appropriate policy response would partly depend on the relative weighting of goals for output versus inflation over the intermediate-term. Obviously, a heavy relative weight on either goal would lend support for an immediate policy move, or at least a tilt in the policy directive. An in-between monetary policy approach, by contrast, might involve accepting the less favorable outlook for both real output and inflation, and keeping the current policy stance. Such an approach implicitly gives comparable weight to economic growth and inflation performance. Under this approach, a policy change aimed at improving either output or inflation would be viewed as likely to produce an unacceptable worsening in the other measure. Since the outlook for both measures is already not very satisfying, the cost of worsening either one could be seen as greater than the associated benefit of improving the performance of the other.

Considering the risks to the greenbook forecast adds another dimension to deliberations about near-term policy. Substantial concern about the likelihood of either an imminent further slowing in economic growth or a decisive upside breakout of inflation would justify a pre-emptive policy strike now. As Mike noted, the odds on either outcome do not seem high. A cessation of economic growth or a new recession would require a complete dissipation of the economy's modest but evident forward momentum. On the other hand, a major sustained jump in inflation would have to overcome whatever restraining effects the present slack in resource use would provide. These considerations would support a "wait and see" attitude, at least for a little longer, though with a bias in the directive. In this case, a policy reaction would await more conclusive evidence pointing toward either outcome.

As a somewhat less extreme possibility, you might see a more realistic risk to the staff's inflation outlook to be a series of worrisome but not clearly outsized price increases, producing a "creeping acceleration" in inflation trends. This concern also might argue for alternative B with a bias toward tightening that embodies special attention to new wage and price and other associated information. As noted in the bluebook, initially keeping the funds rate at 3 percent would likely induce no immediate market reaction. While market participants seem to view the next policy move as somewhat more likely to be a tightening than an easing, few seem to anticipate any move at this FOMC meeting. As the intermeeting period progresses with an unchanged funds rate, bond yields likely would continue to trade around current levels, rather than edging back down, if wage and price news comes in just a little worse than the staff anticipated. This lack of reaction

would stem from the market's somewhat more pessimistic inflation outlook than the staff's. But if the incoming inflation readings are more noticeably worse than the staff projects, then bond rates would be much more likely to move up. Under those conditions, an absence of a Federal Reserve tightening action would begin to undercut the credibility of the Federal Reserve's antiinflationary resolve.

What added insight the recent monetary data provide for policy deliberations is not at all clear. Shorter-term gyrations in the monetary aggregates, and even their underlying trends, have become increasingly difficult to interpret. The staff has kept unchanged its projections of broad money over the year associated with a 3 percent federal funds rate. We still have 1-1/4 percent growth in M2 and flat M3, in both cases below the lower bounds of their annual ranges. Our thinking reflects a balancing of new considerations. On the one hand, the remarkable early-May bulge in the monetary aggregates has raised their starting points for the rest of the year. From the fourth quarter through the week of May 10, M2 has grown 3/4 percentage point faster than we had predicted in the March bluebook. Because our estimate of the net depressing effect of temporary factors on M2 growth over that period is about the same as before, our estimate of underlying M2 growth from the fourth quarter to early May likewise has been revised up by about 3/4 percentage point. On the other hand, the staff has revised down its projection for bank credit expansion over 1993 by 3/4 percentage point, and, as noted earlier, also has revised down nominal GDP growth over this year by the same amount. After weighing these revisions against each other, we left our projections for this year's growth of the broader monetary aggregates unchanged.

Over the very near term, we foresee some initial unwinding of the two-week bulge in M2 and M3 through the end of May, before expansion resumes thereafter. This pattern produces the month-average growth rates shown in this bluebook. Under the three policy alternatives, growth rates from March to June would range from 3-1/2 to 4 percent for M2 and 3 to 3-1/2 percent for M3. These rates seemed to qualify as "appreciable growth," especially compared with recent quarters. This language is proposed in the last sentence in the operating paragraph of the directive to characterize the expected behavior of the broader monetary aggregates over the second quarter.