

## APPENDIX

FOMC Notes -- Peter Fisher

SEPTEMBER 27, 1994

Mr. Chairman,

I will be briefly referring to the two pages of color charts handed out this morning.

There are three main points I would like to make about international market developments since your last meeting:

First, market participants are attempting to discern more refined differences in the business cycles of the major industrial countries;

Second, the dollar has traded against the mark and the yen in ranges which reflect the clearing prices between quite divergent views about its prospects; and

Third, Mexican financial markets were stable through the Presidential election and the peso has responded positively to the news that the new "Pacto" includes no change in the speed of the peso's crawling peg to the dollar.

As the summer came to an end, market participants began to ask themselves more focused questions about the different economic conditions of the major countries. Instead of asking only whether a country was in or out of recession, whether its interest rates were headed down or up, they have begun the more intensive process of drawing increasingly refined distinctions among national cyclical conditions and prospects.

I have updated the chart of the quarterly percent change in total-return indices for G-7 bond markets, which I showed you in August. Looking particularly at the latter half of the third quarter, you can see the much greater differentiation among markets that occurred in contrast to most of the rest of the

year. I mention this because I think that, if this process of differentiation continues, we could begin to see greater movement in the major exchange rates than we have had over the past several months.

Dollar-mark is little changed from its level at the time of your last meeting. Its relatively limited range has reflected divergent views over whether short-term differentials will move in the dollar's favor and over how U.S. and European bond market developments will affect the dollar.

With respect to the short end, there are some in the market who think that the Committee will raise rates at this meeting and will ultimately put in 100 basis points before year-end. There are also a number of market participants who expect the Bundesbank to lower official rates by as much as 50 basis points after the October 16th German federal elections. Thus, with overnight rates now virtually identical, there is a plausible view that short-term dollar interest rates could have a 150-basis-point advantage over the mark by Christmas.

However, there are other market participants who expect the Committee to wait to raise rates until November or December and to do so only once this year. It is also thought possible that the Bundesbank will not lower rates again and could even raise them. In this view, the short-end, U.S.-German differential

might only be 50 basis points in the dollar's favor by year-end or could be unchanged.

As indicated on the second page of the charts, the December interest rate futures contracts currently imply a differential of about 60 basis points in the dollar's favor in three-month euro-rates at year-end. However, given the losses sustained in the first half of the year by those who traded dollar-mark on expected shifts in short-term differentials, the current expectations seem to be having less of an impact on dollar-mark as exchange market participants look increasingly at bond market developments.

With respect to the long end, there is one school of thought which asserts that without prompt rate hikes by the Fed, pushing U.S. 10-year yields significantly above comparable German and European ones, the dollar will continue to move lower in the face of our large and growing current account deficit. While there is an obvious logic to the view that the dollar will strengthen WHEN long-term, interest rate differentials are decisively in its favor, a different school of thought notes that, so far this year, the dollar has weakened AS U.S. interest rates HAVE BEEN rising. Indeed, particularly in recent weeks, the dollar has

responded quite positively to price rallies in the bond market and negatively to signs that yields were backing up.

If all this feels like a bit of a muddle, I think that is precisely how -- collectively -- the exchange market feels and why dollar-mark has traded with decreasing conviction and direction.

Dollar-yen's recent range has also reflected contending and divergent views, in this case between those who have thought it might be able to move up to 105 yen and beyond and those who think that it will either continue to grind lower or might yet again drop sharply as a result of the trade talks.

Early in the period the dollar briefly strengthened to above 100 yen. This appeared to reflect the market's perception of improvements in trade-talk rhetoric and in the prospects for the strengthening Japanese economy to absorb more imports. Since then, the dollar traded back and forth around 99 yen until last Tuesday when it came off sharply following the announcement of the worse-than-expected increase in the overall U.S. goods and services deficit. This data release served as a reminder of the sluggishness of trade flows and invigorated the view that, regardless of outcome, the trade talks are unlikely to have a meaningful impact on the bilateral flows between Japan and the U.S. for the foreseeable future.

Over the period, the Bank of Japan intervened purchasing  
dollars against the yen. Of this total,  
the Desk purchased as their agent.

Looking forward to September 30th, the dominant expectation is that the trade talks will result either in modest progress in some sectors or in a papering over of disagreements. While market participants have begun to consider the possibility of some limited sanctions being applied, I think that HOW the September 30th announcement is made is likely to be as important as WHAT is announced. For example, I can imagine an announcement of modest progress and no sanctions, but which is accompanied by extreme, national-competitiveness rhetoric, as having AS negative an impact on dollar-yen as would a calm, business-like announcement of limited sanctions described as intended to reduce the bilateral trade deficit.

Mexican markets fared quite well through the Presidential election and the peso has gained following this past weekend's announcement that the new PACTO contains no change in the rate of the peso's devaluation in its crawling peg to the dollar. Late last week, as the market came to expect the announcement of no change in the peg, the peso strengthened, one-year interest rates fell by over 50 basis points and the stock market gained. Yesterday was a bit choppier: the stock market sold off -- it being at rather lofty levels-- and the peso firmed a bit further,

then sold off, but still closed higher than Friday's close. The peso faced some difficult circumstances this week as a result of the combination of this meeting, the maturity today of a large amount of dollar-indexed Mexican government debt and regular quarter-end demand for dollars. However, from Thursday's close to yesterday's close, the peso was up 0.8 percent.

The Canadian dollar has also strengthened, following the much narrower-than-feared victory of the Quebec separatist bloc in the provincial elections, which reduced prospects for the success of a separatist referendum. With the Canadian dollar up over one and a half percent since September 12th, the Bank of Canada acted last Wednesday to maintain its existing mix of monetary conditions through money market operations indicating a 25-basis-point reduction in its target range for call money rates.

Mr. Chairman we had no intervention operations during the period. However, we have distributed a memorandum on certain changes that are planned for the investment of Deutsche mark reserves. I would be happy to answer questions perhaps first on my report and second on the memorandum.

# CHART 1

## Quarterly Percent Changes of G-7 Total Return Bond Indices

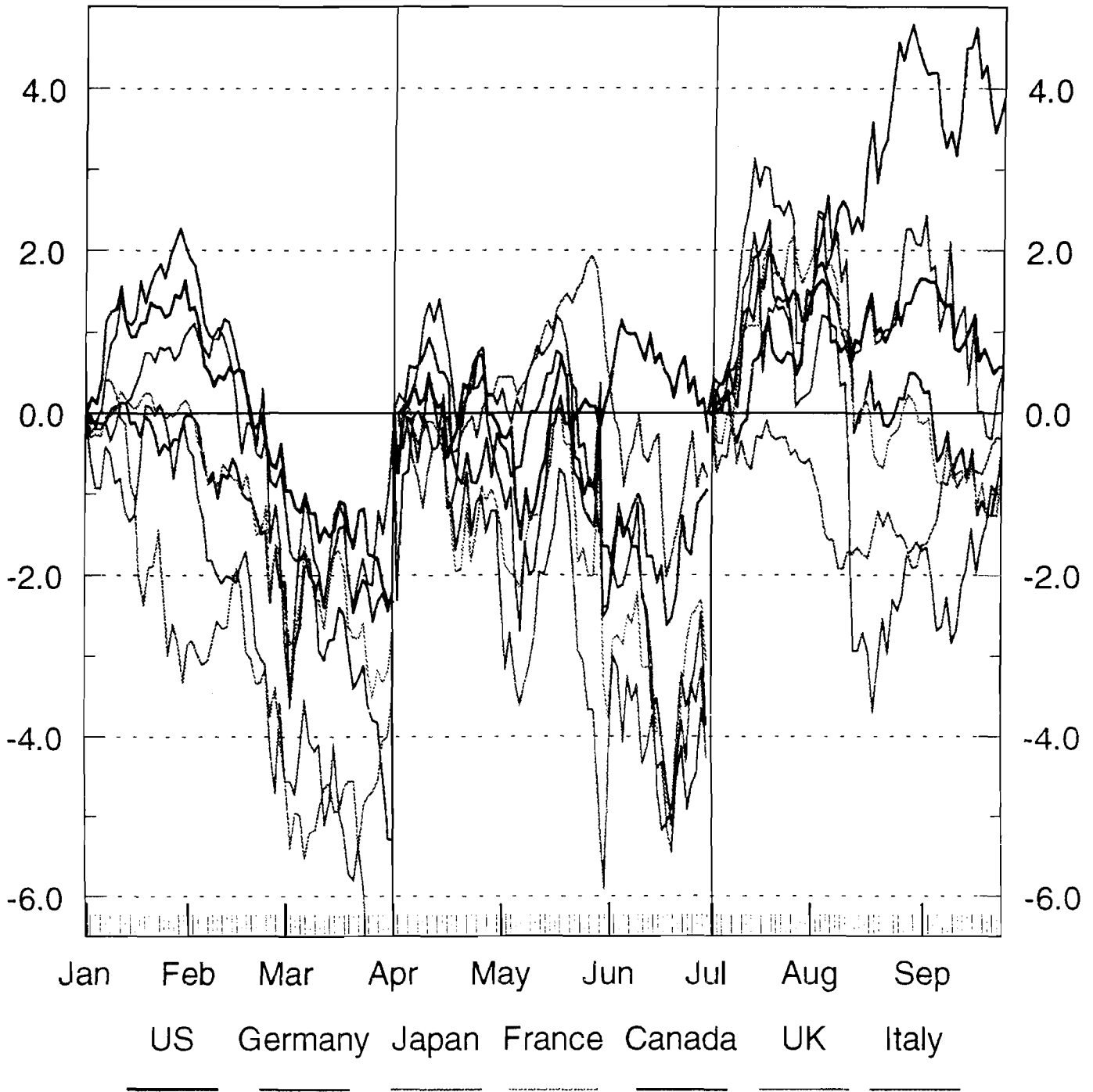
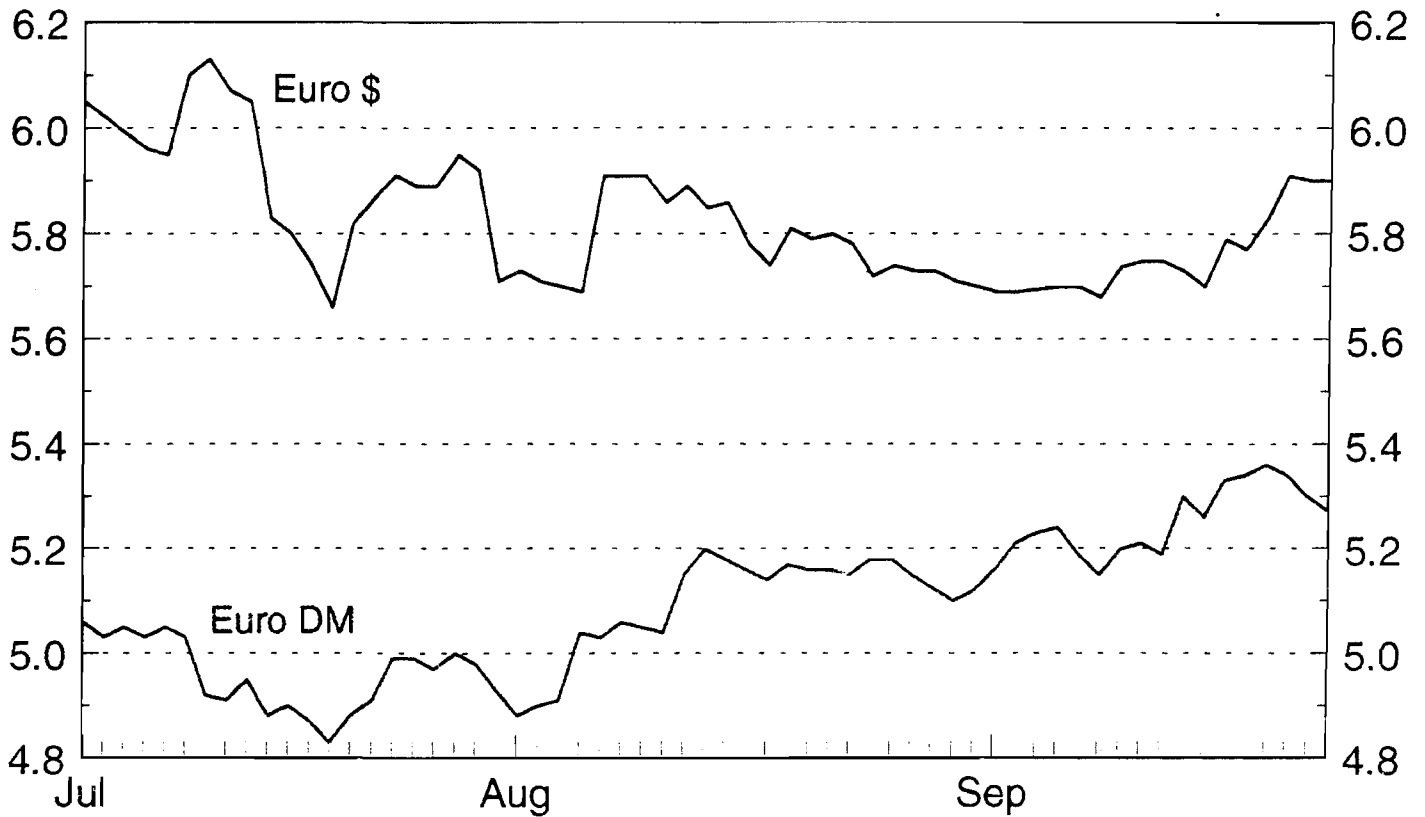




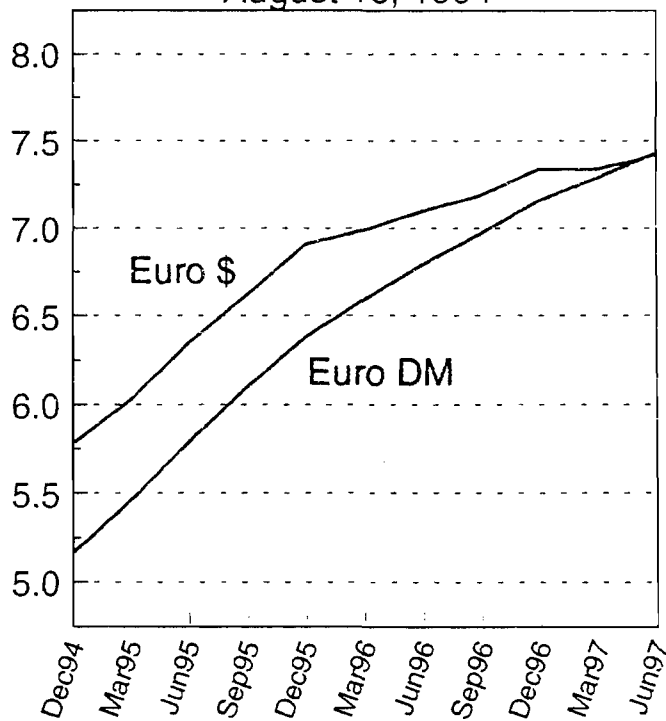
CHART 2

Interest Rates Implied by Prices of December 1994  
3-Month Eurodeposit Futures Contracts

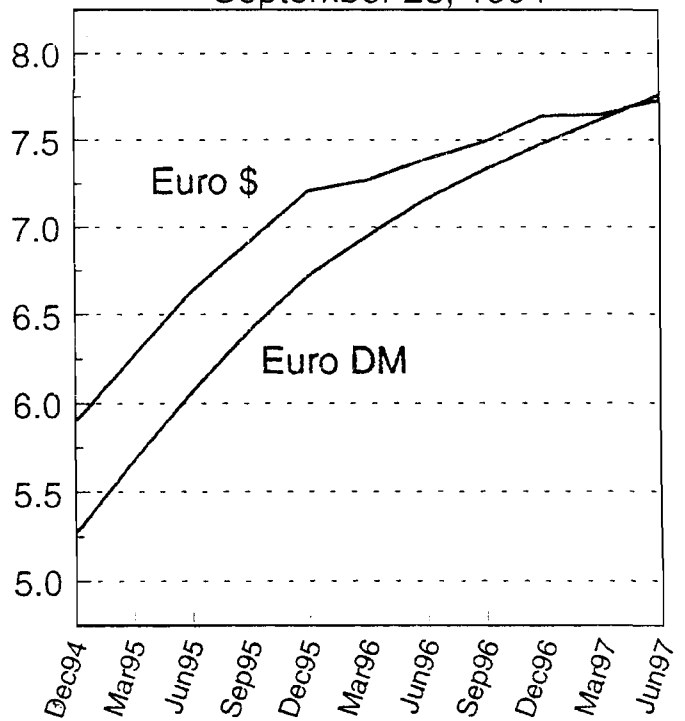


Interest Rates Implied by Prices of Series of  
3-Month Eurodeposit Futures Contracts

August 16, 1994



September 23, 1994



Notes for FOMC Meeting  
September 27, 1994  
Joan E. Lovett

During the intermeeting period, we sought to maintain the firmer degree of reserve pressure adopted at your August 16 meeting, with Federal funds expected to trade around 4 3/4 percent. The borrowing allowance was left unchanged at that time because the full 50 basis point hike in the discount rate, also approved that day, was allowed to show through fully to the reserves market. The allowance was lifted by \$50 million in two steps early in the interval and later cut back by \$25 million, in each case to accommodate movements in seasonal demands. It now stands at \$475 million. Adjustment borrowing was generally very light and averaged just \$35 million.

The sizable reserve shortages we faced at the start of the intermeeting period were expected to deepen further in September, first as a result of high levels of currency and required reserves around the Labor Day holiday, and later when inflows around the September 15 corporate and individual nonwithheld tax date would lift the Treasury's Fed balance.

To help address the largest expected reserve shortages, we resumed purchasing securities from foreign accounts, acquiring about \$900 million of Treasury bills from this source in the early days of the period. We then purchased about \$4 1/2 billion of Treasury coupon issues in the market on August 30.

Temporary operations met the balance of remaining reserve needs. We arranged a total of seven multiday System operations and five overnight RPs, most of which were customer-related. The larger multiday operations came in the first full maintenance period ahead of the coupon pass. Much smaller-sized RPs were generally arranged in subsequent periods.

Our market entries in the current maintenance period--which ends tomorrow--have been particularly light. The earlier outright purchases, cumulative downward revisions to currency, and a Treasury balance that never quite reached the higher levels that were first anticipated for mid-September left the reserve estimates in this period close to path or even showing a modest surplus. Consequently, we have entered the market on just two occasions during this period, arranging a modest volume of customer RPs. The revisions to currency growth were a surprise: the growth rate for the two months ending in September was an estimated 6 1/2 percent, about 1 1/2 percentage points below the New York staff's mid-August forecast and about 5 percentage points below the average rate for the first seven months of the year. Data are available only for August and suggest that the slower growth then was not due to a weakening of foreign demand.

The effective funds rate often traded with a slightly soft cast over the interval, partly reflecting a general absence of large reserve deficiencies on most days. Since your last meeting, the effective rate has averaged 4.71 percent.

In the securities markets, interest rates were buffeted by shifting perceptions about the economic outlook, the pace of inflation, and the immediacy of Fed policy actions. Investor participation in the market was sometimes very light, but was interspersed with bouts of intense activity on some days. The policy moves announced in August were viewed favorably. Very short-term rates immediately backed up to reflect the tighter reserve conditions, but yields on Treasury coupons dropped 5 to 10 basis points that day. Since then, however, these yields have worked their way higher in erratic fashion, rising a net 20 to 40 basis points, accompanied by some steepening in the yield curve.

Over the first several weeks after the August meeting, movements in yields generally backed and filled within established trading ranges. The data released during this time provided a somewhat mixed picture of the economy, which contributed to some volatility in rates, best illustrated by the gyrations that followed the release of the August payroll data in early September when the market both gained and lost ground on the same day.

Yields broke out decisively on the upside in mid-September as the evidence seemed to tilt toward a visible quickening of price pressures. Steep losses on two consecutive Fridays brought yields to new highs for the year. To many analysts, the August PPI report was a first glimpse of higher inflation rates in a broad-based measure which some of the more

leading price indicators had been hinting at previously. Then, the industrial production and capacity utilization reports released a week later were taken as a sign that some strains were already being placed on operating capacity in the manufacturing sector, and yields surged higher across the yield curve with the current bond yield moving above 7 3/4 percent. Most analysts now seem confident that, after a pause in the current quarter, economic activity will resume at a pace into next year that will maintain some upward pressure on inflation, although views diverge on where these forces will peak in the current cycle.

The financial markets did not have to absorb a significant amount of new supply this intermeeting period, either from the Treasury or in other sectors. The Treasury paid down a substantial amount of bills, about \$19 billion, mostly when several cash management bills came due last Thursday. The expected reinvestment demand associated with these maturing bills and a desire to stay defensive in the current market climate helped keep short-term rates in check until last week, when the market actively began to revise its near-term rate outlook. Net issuance of coupon securities was also fairly moderate, about \$15 billion altogether, which does not include the two-year notes that will be sold early this afternoon or tomorrow's five-year offering.

A reassessment of policy prospects has accompanied the changing perceptions about the economy over the past few weeks. Many analysts believe that Fed tightening to date will not suffice to bring growth to a non-inflationary pace, and that policy will eventually reach a greater degree of restraint than they previously thought. There is also a fairly general consensus that the next policy step, whenever it comes, will take the form of a 50 basis point hike in rates, although the possibility of a smaller move is not entirely ruled out.

While the perception remains that rates are headed higher, and that a Fed move is possible sooner than expected only a few weeks ago, views are split on the need for immediate action. One camp holds that the Fed must move without delay to prevent price pressures from building further, and that not acting now would court the emergence of an inflation psychology. Others feel that the case for an immediate move is not conclusive and that there is an acceptable risk to holding off, awaiting some confirmation of the economy's momentum in upcoming reports or until the November meeting. Current market surveys would probably place the majority in the second camp. I would be happy to answer any questions you may have.

Michael J. Prell  
September 27, 1994

FOMC BRIEFING

It is with more than a little chagrin that I find myself having to report to you, once again, that we have raised our forecast of near-term economic growth. Moreover, the surprising momentum of activity suggests to us that money market rates may still be well short of the level needed to hold inflation in check.

Admittedly, it is not yet certain that our previous forecast of a sharper second-half deceleration in activity was wrong. Indeed, in the early part of the intermeeting period, the incoming indicators seemed to support our thesis. Notably, durable goods orders dropped appreciably in July, and production worker hours slipped a bit in August. It looked for a while like third-quarter GDP growth might even fall short of the last Greenbook forecast.

But the scales quickly tipped back in the other direction. Sales of light vehicles surged in August as production picked up smartly: this pattern provided validation for the story that the earlier slump in sales owed importantly to supply problems. Next, the report on non-auto retail sales revealed not only a healthy advance in spending in August, but upward revisions to prior months. All of this seemed to fit with the fairly buoyant sentiment evidenced in household surveys, in the face of a continuing rise in interest rates that many analysts had thought would damage confidence.

The industrial production data for August clearly argued against much slackening in the pace of expansion over the summer months. Not only did overall production rise an estimated 0.7 percent, but manufacturing output soared a full percentage point.

With upward revisions to each of the prior three months as well, it now looks like factory output will rise almost 7 percent, at an annual rate, in the third quarter.

Meanwhile, initial claims for jobless benefits have remained near their lowest levels of this expansion, suggesting that the September labor market report will reveal a sustained strong pace of payroll growth.

If these data were not enough to call into question our notion that the negative effects of higher interest rates on aggregate demand were about to manifest themselves more clearly, the figures on housing permits and starts released last week certainly did. The report showed that single-family building in August was at virtually the same level as had prevailed since the spring. We still see some signs of softening in this sector in other indicators, but the starts data did seem to require some upward adjustment of our forecast of residential investment.

Given these developments--and also the prospect of a steeper rise in auto assemblies than we had anticipated earlier (barring a strike)--we decided to elevate our fourth-quarter GDP forecast a half point, to 2-3/4 percent. In doing so, we recognized the risk that we could be giving up on a good idea just before it's proven correct--always a hazard in forecasting, especially because the timing of monetary policy effects is hard to pin down. But, that said, we perceive the risk of overshooting our revised near-term forecast to be at least as great as that of falling short.

In arriving at that conclusion, we asked ourselves whether there were any reasons we could identify for why the rise in interest rates might be having a relatively muted effect on aggregate demand. One answer to that question may be that the normal financial



transmission mechanisms have not been working as one might anticipate. The dollar has depreciated since the beginning of the year; the stock market has given up rather little of what appeared to be an awfully rich valuation earlier this year; and bank credit availability has been improving, possibly substantially. Moreover, it is arguable that the rise in bond yields has been at least in part a reflection of heightened inflation expectations--limiting the rise in the real cost of capital.

It's also possible that we've underestimated some of the forces buttressing demand at given interest rate levels. For instance, it could be that the pent-up demand for single-family homes is greater than we judged. Consequently, to achieve the anticipated degree of demand restraint through the housing sector, it may take a further deterioration in affordability measures--perhaps including a further rise in short rates that makes it less attractive to use ARMs to circumvent the higher initial cost of fixed-rate loans.

Whatever the case--whether it is the lesser financial restraint or the greater underlying demand--we simply do not yet see the evidence of a decisive slowing in this expansion. Under the circumstances, we concluded that--while we do still anticipate meaningful lagged effects of the earlier rate increases--we should assume a greater monetary policy tightening than in our previous projection. So, we added 50 basis points to the 50 basis points of additional funds rate increase already assumed in our last forecast. Expecting that the dollar will not depreciate further and that credit supply conditions will not continue to ease, we think that this may suffice to produce the slackening of aggregate demand growth that we believe essential if inflation is to be held in check.

Let me turn now to the issue of the inflation outlook. We've raised our forecast for price increases through next year for two reasons. The first is that the level of output is higher in this projection than in the last, until the latter part of 1995. This, in itself, would imply a higher level of resource utilization and thus greater potential inflationary pressure. But, in the case of the manufacturing sector, the tensions are compounded by the upward revisions to prior levels of factory utilization. At 84.3 percent now, the rate is within a point of the 1989 peak and considerably above levels that in the past have been associated with accelerating prices.

In fact, we could be said to be discounting the importance of this observation in our forecast; a Phillips-curve type model using capacity utilization rather than unemployment as the slack variable would point to a greater pickup in inflation than we have written down. Given the wide standard error attending any such econometric prediction, this normally wouldn't cause much anxiety; but in a period when the meaning of the unemployment rate has been obscured by the revision to the household survey, this gives one a little pause.

As it is, the run-up in capacity utilization is one of the factors behind our forecast of roughly 3-1/2 percent core CPI inflation through the first part of 1995. We believe that the rise in utilization is a key factor explaining the ongoing surge in industrial materials prices, which is likely to be passed through to finished goods prices--at least to some degree--in the near term. As activity slows and capacity utilization ebbs a tad next year, we expect that the rise in materials prices will taper off.

As you know, we've also identified the pass-through of higher crude oil prices and firmer non-oil import prices as giving some

impetus to inflation in the near term. And, with labor markets fairly taut, there likely will be some tendency for the acceleration of prices to feed through to wages, thus raising unit labor costs and giving some momentum to higher core inflation in the latter part of 1995. This is why we've presented a forecast that produces subpar growth for a time and a slight increase in unemployment: We wanted to present the Committee with a baseline forecast that did not involve a reversal of the disinflationary trend of the past decade.

If I may attempt to anticipate a question, our quarterly model says that, starting from the Greenbook forecast, the difference between our funds rate path and holding the rate at 4-3/4 is, by 1996, the difference between a minimal downward tilt to inflation versus a slight upward tilt. But this really is putting far too fine a point on what such models can tell one. And this exercise doesn't answer the question of whether our Greenbook forecast is broadly correct and a substantial further policy tightening truly is needed to moderate aggregate demand.

I would say that such a view is implicit in the market yield curve as well as in the analyses of most private forecasters. Of course, they, and we, have been wrong before, and it is possible that we are all being misled by a tendency to look at the much greater size of past funds rate upswings in gauging what it might take to rein in a cyclical expansion. As I've noted previously, that could be a misleading standard, given that fiscal policy is relatively restrictive this time, and that we've had a disproportionate rise in bond yields. Moreover, past major upswings in rates typically culminated in recessions--which is not our current design. However, on the other side of this ledger, as I've noted this morning, is the observation that we have not had in the current episode much

reinforcement of the money market tightening in other aspects of the financial environment--at least not yet.

On that point, let me turn the floor over to Ted for some comments on how the dollar and other aspects of the external sector fit into the picture.

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E.M.Truman  
September 27, 1994

FOMC Presentation -- International Developments

I would like to add three comments about the external sector to amplify Mike's presentation.

First, the outlook for economic growth abroad has improved substantially. Since the beginning of the year, we have added more than a percentage point to our projection of 1994 average growth abroad as well as to growth in the foreign G-7 countries. Information received since the August FOMC meeting about growth in foreign industrial countries during the second quarter and initial indications about the third quarter have reinforced our tendency to mark up our forecasts. In the case of Japan, second-quarter GDP, contrary to the general expectation, dropped 1.6 percent at an annual rate. However, it is instructive that there was essentially no reaction in financial markets or in public commentary to these data. The reason may be that information received on business sentiment, orders, and consumer demand during the third quarter suggest that the Japanese economy most likely has turned the corner.

In our forecast, aggregate foreign growth averages a shade under four percent in 1994 and 1995. Given the large output gaps in most foreign industrial countries, such an outlook hardly amounts to a boom, but growth abroad is a definite upside risk to our overall outlook.

Second, let me try to explain our forecast for the dollar. Sentiment toward the dollar continued to be somewhat

bearish during the intermeeting period primarily under the influence of continuing concern about U.S. inflation. Notwithstanding the further slight depreciation of the dollar, we have not changed our projection for the dollar: we expect the dollar to appreciate by a couple of percentage points from its current level and to remain around that level for the balance of the forecast period. Our reasoning involves several considerations.

First, our assumption about the near-term course of short-term dollar interest rates coincides fairly closely to market expectations, but we see much less tightening in foreign monetary policies than the market expects. In the case of Germany, for example, the futures market is projecting that three-month interest rates will rise by 100 basis points by June of next year while we think they will be unchanged. We think it is likely that the financial markets have over-estimated the strength of the recovery abroad. As implicit projections of growth abroad are revised down, dollar assets should look relatively more attractive. In addition, for those who believe along with Fred Bergsten that for the past seven years we have been operating an exchange rate regime of de facto target zones, I would note that the dollar is about five percent below its average value for the period since the Louvre meeting in early 1987: our forecast implies some regression toward the mean.

The dollar's depreciation so far this year has been a surprise. It has vitiated one of the normal channels of restraint on the U.S. economy exerted by higher interest rates.

Moreover, further weakness in the dollar cannot be ruled out. Thus, the dollar is an additional upside risk to our forecast of growth and inflation.

My third point concerns our forecast that the external sector of the U.S. economy ceased to be a negative factor for GDP growth in the third quarter. You might ask how we square this projection with July's near-record deficit on trade in goods and services that was announced last week. Part of the explanation can be traced to the influence of special factors in July such as a temporary drop in aircraft deliveries. Our implicit projection for the deficit in August and September is about \$1-1/2 billion lower. The remainder of the explanation for the third quarter involves the difference between the balance in nominal terms and the balance in real terms. Because of such factors as the spike in oil prices during the summer and the boost to prices of non-oil imports from the dollar's depreciation, in nominal terms we are projecting a \$5 billion deterioration of the third-quarter deficit while in real terms we estimate a \$5 billion improvement.

For the remainder of the forecast period, our projection for the U.S. external sector relies on the influence of three basic factors: faster growth abroad, a slowing of growth in this country, and the influence of the decline in the dollar on balance so far this year. As a consequence, real net exports of goods and services are projected to be about neutral in their contribution to U.S. real GDP over the next six quarters; this would amount to about \$30 billion less real restraint by the fourth quarter of next year than we were projecting in January --

equal to a bit more than half a percentage point on the level of projected real GDP in that quarter.

Mr. Chairman, I have reached the end of my written comments.



September 27, 1994

FOMC Briefing  
Donald L. Kohn

As Mike has discussed, the incoming data may be seen as suggesting that the Committee may not have the luxury of a more or less automatic "no-change" decision that it perhaps anticipated after the last meeting. The persistent strength of aggregate demand and higher level of resource utilization raise questions about whether policy is yet positioned to head off increasing inflation--much less make progress toward the longer-run goal of price stability.

The answer in the Greenbook was no--that a considerable further tightening is likely to be necessary to accomplish the Committee's objectives. In evaluating this outlook it may be important to keep in mind that the tightening assumed over the next few quarters is about in line with market expectations for this period. As a consequence, the rise in short-term rates is not thought likely to produce major changes in longer-term interest rates or the weighted average exchange value of the dollar--two key variables in the transmission of monetary policy. In these circumstances, however, a failure to tighten in line with market expectations could well lead to a lower dollar and lower long-term real rates (though perhaps not nominal rates), effectively moving these two important influences on

aggregate demand in a stimulative direction relative to their current values as well as to the staff forecast.

That would not be a concern if markets have overshoot--if long-term real rates have moved up excessively, building in more policy tightening than will prove to be appropriate; certainly it would not be the first time that capital markets over-reacted and miscalculated. In fact, extending the forecast horizon, the Greenbook projection does assume that aggregate demand will be softer and inflation less than built into the markets, producing a decline in long-term rates later in 1995.

But evidence of actual or expected overshooting is not yet obvious. Real rates have risen, but they are not unusually high by historical standards, and have not shown through substantially in interest-sensitive spending. Moreover, other financial or related markets--such as those for commodities, equities or private debt instruments--do not show signs that market participants see the increases in real interest rates as significantly inhibiting activity. And, in contrast to some other tightening episodes, the dollar has fallen. These market responses themselves inhibit some of the usual channels through which policy affects the economy. Credit markets have tended to react to incoming data suggesting strength in spending or the potential for inflation by building in additional Federal Reserve tightening. That may in part be simply their reading of

your reaction function, but if markets sensed that you were likely to over tighten, one might expect that a hump in the term structure and its imbedded forward rates would emerge, and none is evident.

As to the near-term, the staff forecast does not necessarily assume tightening at this meeting, and market views on what might happen today are mixed. The key task for the Committee would seem to be assessing if the evidence that has accumulated since the last meeting points strongly enough to the need for immediate action. In making that determination, the Committee may find reason to demand a heavier burden from that evidence than for previous tightenings this year. For one, the funds rate was increased a full 50 basis points just six weeks ago. The magnitude of that action was intended to be somewhat pre-emptive--to allow a period of policy rest to evaluate the results of earlier moves. Moreover, this intention was conveyed to markets in a statement that held out the distinct possibility of at least a short hiatus in policy changes, creating market expectations to that effect. The credibility of future statements of that sort could be impaired unless the reasons for overriding its implied commitment are perceived as compelling. Second, with another tightening--especially one of 50 basis points--Federal Reserve policy could be seen as in a new place. Previous tightenings this year, even including the August action, can be interpreted as moving

interest rates broadly into line with historical experience for periods of stable inflation rates. A 50 basis point action would push real short-term interest rates toward the upper end, if not above what many have characterized as policy neutrality. The FOMC might want especially clear indications that the economy were not moving onto a sustainable growth track or that prices had already accelerated before moving policy into what might be perceived as a posture of restraint.

But restraint may in fact be needed if the response of spending to higher rates is damped, or exogenous factors are pushing on aggregate demand. And, there are potential risks from demanding too clear a signal from the evidence, especially in an economy operating around its potential. In particular, if price pressures are building, delay can complicate the future conduct of policy and possibly adversely affect the performance of the economy. Prompt action can reduce the levels that nominal and even real rates will eventually have to reach to achieve a given inflation objective in a specific time frame. Smoother rate paths should be associated with smoother paths for the economy and fewer strains on the private sector, including financial intermediaries. The cost of waiting could be particularly severe, if it were feared that inflation expectations might adjust higher more readily than they adjust lower from current inflation levels, which are at the lower end of

experience over the past 30 years. The recent behavior of financial markets does suggest a certain predilection for expectations to rise, and if inflation itself accelerated for any period, those expectations could become more general in labor and product markets. In light of these potential difficulties, if the FOMC were reasonably confident that the economy is not in the process of slowing to a sustainable path and that inflation pressures are building, it might give serious consideration to overcoming any inertia from the August announcement and tightening policy promptly--as under alternatives C or D in the bluebook. In such circumstances, the benefits of prompt action might outweigh any costs in the form of reduced credibility for future attempts by the Committee to pre-commit its policy stance very far ahead.

However, if the Committee sees the data as not yet sufficient to indicate the need for further tightening, keeping reserve market conditions unchanged, as under alternative B, would be appropriate. The substantial size of the moves earlier this year and uncertainty about the timing of their effects on the economy, together with an absence of a clear sustained acceleration in broad measures of costs and prices, might be seen as arguing for waiting for additional information before taking an additional step. Indeed, if there were considerable restraint still in the pipeline, or more scope for more vigorous expansion without additional

inflation pressures than the staff had foreseen, then substantial additional action might not be needed. Given the lags in policy effects, continuing to tighten until data suggest weakness will ultimately result in policy overshooting.

Certainly the behavior of money and credit do not suggest a building inflation problem. After the spurt in July, all money measures weakened in August, and data for the first half of September suggest little growth in any of the aggregates this month. For the year, M2 and M3 continue on the anemic growth paths of 1992 and 1993, while M1 has decelerated substantially, resulting in a decline in bank reserves and an appreciable moderation in the expansion of the monetary base. We believe the recent weakness of money growth--as well as sluggish growth for the year--reflects a natural reaction by depositors to widening opportunity costs--rather than any signal of a slowing in nominal spending. The puzzle is why banks have been so laggard in raising deposit rates, especially since it is not a symptom of credit restraint or lack of lending opportunities. Apparently they believe wholesale funds and sales from bloated securities portfolios will be less expensive than raising the funding cost of their retail deposit base.

Moreover, the expansion of credit remains moderate, with no sign of any overall acceleration that might signal a strengthening of a "borrow and spend" psychology. Borrowing

by nonfederal sectors picked up early last year, but has shown few signs of accelerating since then, despite more aggressive lending by banks. To be sure, household debt growth has been rapid, but business borrowing, while more concentrated at the short end, remains moderate. Borrowing by state and local and federal governments has decelerated, indicating a lack of demand impetus from these sectors, and constraining overall debt growth to 5 percent or less in recent months, down marginally from earlier this year.

If the Committee were to keep policy on hold at this meeting it would need to consider how to react to incoming data. If the risks of higher inflation were considered sufficiently worsening, the Committee might want to react promptly, between meetings, to signs that growth was strong or price pressures were mounting. In this case, it might consider an asymmetrical directive, tilted toward tightening.

There was considerable discussion of the meaning of an asymmetrical directive at the July meeting. As President Boehne and Governor Kelley noted at that time, the asymmetry provisions may be necessarily vague, and efforts to pin down their meaning could be counterproductive. Such a directive was first used in the early 1980s, when the Committee shifted from automatic changes in reserve conditions keyed to M1 to more discretionary changes. In this regime, the asymmetry afforded an element of flexibility and direction for

between-meeting moves. The Committee has resisted spelling out the meaning of asymmetry in any formula. Sometimes members have emphasized the signals it sends to financial markets when it is published, but the directive has had operational significance; indeed, its value as a signal to markets would soon deteriorate if it did not. In general, the asymmetrical directive signalled that the Committee sees an imbalance in the risks to meeting its objectives going forward, or in the costs from missing to one particular side. As a consequence, it had wanted to respond more quickly and perhaps more forcefully to evidence becoming available between meetings suggesting the need to move in one particular direction than it would under a symmetrical directive. Members have used the policy discussion to try to spell out the nature of the information they thought was critical, but responses have rarely been tied to one particular statistic. Intermeeting changes are far from inevitable under an asymmetrical directive, but they are more likely. From 1987 on, about 30 percent of symmetrical directives have been followed by intermeeting changes, and 60 percent of asymmetrical directives.