

## APPENDIX

FOMC NOTES - PRF  
MARCH 26, 1996

Mr. Chairman:

Since your last meeting, U.S. interest rates have backed up sharply; foreign -- and particularly German -- interest rates have also backed up, and the dollar has been quite stable. Of these three developments, the most difficult to understand is the rise in German long-term rates.

U.S. interest rates backed up in two distinct steps.

First, in the Chairman's Humphrey-Hawkins testimony market participants failed to find a confirmation of their own expectations of further easing. Second, with the March 8th release of the strong non-farm payrolls data, market participants were jolted into a recognition of a much more balanced outlook for the economy and a corresponding balance of risks for the direction of short-term rates.

As a consequence, from mid-February to mid-March, the yield on the Two-Year Note increased by over 80 basis points, moving from around 40 basis points under the Funds rate, on February 13th, to a comparable amount over the Funds rate in recent days. In my view, this principally reflects the reintroduction of an uncertainty premium for the direction of interest rates and the realignment of term-premiums to those normally associated with a stable or slightly rising rate environment.

Turning to Europe, there are a number of plausible, but few compelling, explanations for the backup in German long-term rates. Despite the widespread perception of a weak German economy, 10-year rates have backed up 50 basis points since the end of January. This has been attributed to: anxieties about the outlook for German fiscal policy; a premium for European Monetary Union; and above-target growth in German M3.

The backup in German yields has also been attributed to Germany's greater dependence on foreign capital and, thus, as reflecting a greater impact of U.S. rates than is observed in other European markets. While there is something in this, particularly evident after the March 8th U.S. non-farm payrolls release, it does not explain why the rise in German yields began in late January, before the U.S. bond market began backing up.

The German mark and German bunds have been the darlings of international investors for several years and some paring back of overweight positions in Germany was inevitable. This process has

been evident over recent months in the improved performance of other European bond markets and in the gradual strengthening of other European currencies against the mark.

Whatever the cause or causes, the backup in German bund yields is seen as further curtailing German growth prospects and as forestalling the Bundesbank's ability to ease, where the strong M3 data alone probably would not.

During the past two months, the dollar has been remarkably stable, on net declining less than one percent against the mark and closing unchanged against the yen, but really trading in ranges against them both. In this same period, in the run-up to the Japanese fiscal year-end on March 31st, in 1993 the dollar fell by .2 and 7.9 percent against the mark and the yen, respectively; in 1994 by 3.5 and 5.3 percent, and in 1995 by 10 and 13 percent.

Against this recurring, seasonal pattern, the dollar's stability owes a great deal to the improved U.S. outlook, the gloomy German outlook, and the gently improving Japanese outlook coupled with Japan's declining external surplus.

However, the dollar's stability also owes a great deal to the our intervention by the Japanese monetary authorities between February 20th and 28th. While it may not be our style, it directly removed the pressure of positions and also impressed the Japanese institutional community and the speculative community with the Japanese authorities' resolve to prevent the yen from strengthening prior to the fiscal year-end.

In the Fed Funds market, as mentioned in the Bluebook and as described in the Desk's written report, over the course of several recent maintenance periods we experienced somewhat greater variability in the funds rate around the target than has been typical. This may reflect the impact of sweep accounts but could also reflect a number of other factors.

While the effective average funds rate has been 5.27 percent over the intermeeting period, this average masks a noticeable variability in the daily effective funds rates within each of the three most-recent, completed maintenance periods.

In the last few years, low demand for excess reserves early in maintenance periods, followed by rising demand at the end to meet period requirements, has been a fairly typical pattern, usually interrupted only by days of heavy payment flows, such as for the settlement of Treasury auctions. In the recent maintenance periods, however, the skewness in demand toward the last day has become even more accentuated.

This could reflect the relatively low level of required operating balances as a consequence of sweep accounts. Banks whose required reserves are only slightly above their desired working balances might prefer to focus, during the maintenance period, on the level of their working balances and then to meet their residual reserve requirements only at the close of the period. We have heard from several funds market participants, who have initiated sweep programs, that they have altered the pattern of their buying and selling activities in the funds market.

However, this is the time of year when we shift from a seasonal pattern of draining reserves to growing add needs and this shift itself creates its own imbalances. Also, from year-to-year, there have been pronounced shifts in banks' demand for reserves on the last day of maintenance periods, and we may just be experiencing an acute episode of this.

Over the coming maintenance periods, we expect growing needs to add reserves and face some uncertainty over the size of these needs because of the introduction of the new 100 dollar bill. However, we believe that the current 8 billion dollar leeway will be adequate.

We had no foreign exchange intervention operations during the period, but we did begin our program of investing Deutsche mark reserves in repurchase agreements on German government securities.

Let me also briefly mention work we are doing in two areas.

First, we are preparing a proposal, for the Committee's consideration, to remove the one-year remaining maturity constraint on the System's foreign currency investments and to replace it with an average duration constraint which would permit us to invest a portion of the System's foreign currency reserves in the more-liquid sectors of the German and Japanese government securities markets.

Second, in response to the Chairman's request, we are preparing materials to serve as background to a Committee discussion of the maturity structure and liquidity management of the domestic portfolio.

When these materials have been completed, and as the Committee's agenda permits, we will be bringing up each of these subjects.

Mr. Chairman, I will need the Committee's ratification for the Desk's domestic operations. I will be happy to answer any questions.

Michael J. Prell  
March 26, 1996

FOMC BRIEFING

It's been an exciting intermeeting period for data buffs. Not only did we get a multitude of numbers, but--owing mainly to the effects of the January blizzard--they were a wild array to boot. And, the statistical roller coaster ride isn't over: For example, in coming weeks, the figures on initial claims and industrial production will be reflecting the GM strike.

Cutting through all this noise and finding the underlying trends obviously isn't easy. As you know from the Greenbook, it's our judgment that the economy is basically on a track paralleling the growth of potential output--roughly 2 percent per year. One might say that we've arrived at this conclusion almost by default: That is, we simply don't see any current or prospective macro imbalances that would cause a significant deviation from the 2 percent trend.

Last year, there was such an imbalance, one that we identified early on--namely, an unsustainably high rate of inventory investment. And as businesses struggled to gear down their inventory accumulation to align stocks with the more moderate growth of sales, it chopped about 3/4 of a percentage point off of GDP growth. In addition, the Mexican crisis clipped off a few more tenths of a point.

But that was then, and this is now. Not only did businesses go a long way toward making the needed inventory adjustment late last year, but the GM strike probably largely completed the task this quarter. Moreover, the Mexican economy has turned upward, aiding our net exports.

Meanwhile, domestic final demand has continued to exhibit considerable vitality. Although the storms disrupted shipments of

nondefense capital goods, new orders rose considerably in January. Retail sales rose appreciably in February, and we hear that motor vehicle sales have been brisk again this month. Housing starts shrugged off the blizzard in January and rose further in February.

The recent backup in rates obviously is not a plus for homebuilding, but mortgage affordability is still excellent by historical standards. Indeed, financial conditions overall don't appear to be a barrier to decent growth. First, it's difficult enough to judge where real interest rates actually are, let alone where they should be. But, as Don will be discussing further, current rates are not especially high by the standards of recent years; and longer-term real rates have come down over the past year or so, even with the recent backup. Second, credit is readily available and likely to remain that way; among other things, bank capital is ample, and the reported narrowing of rate spreads suggests that competition for loans is still intense. Third, the rise in the stock market has reduced the cost of equity capital and boosted household net worth.

Meanwhile, on the fiscal front, the odds still seem to be against a balanced-budget agreement. And, without one, incremental fiscal restraint likely will be minimal in coming quarters.

Finally, the modest appreciation of the dollar since last summer may begin to weigh on our trade position, but economic recovery evidently has taken hold in Japan and expansion should resume in Europe--so the external sector should be no worse than a minor drag on U.S. activity in coming quarters.

All told, then, we see an environment that is generally consistent with moderate growth. To be sure, as always, the uncertainties attending the outlook are substantial. But we believe

that the risks surrounding our forecast are reasonably balanced. In the interest of time, I won't explore all of the risks we've identified. I do want to take a couple of minutes, however, to comment on a few items that may be on your minds in light of the latest headlines.

First, yesterday's Wall Street Journal had two stories on capital spending, one of them focused on computers. While the stock market didn't take too kindly to the notion that spending might be decelerating, this was scarcely news to us. In fact, when you look at the predictions for computer sales that were cited, they actually point to stronger, not weaker, growth in real outlays than we've forecast--given the plummeting deflator.

Second, yesterday's Journal had a fascinating account of the outcome of the GM strike, with a marked difference of opinion between the company and the union about what had been agreed to. We're still trying to sort out this story. However, the mere fact of the conflict--and the clear threat of repeats in coming months--could be a sign that workers are starting to demand something of value in return for accepting modest compensation increases in a time of corporate prosperity. If the outcome is either greater wage acceleration than we've forecast, or lower productivity as a consequence of job guarantees, it obviously would not be good news for the inflation outlook. As it is, the aggregate markup of prices over unit labor costs fell last year. Our price forecast is predicated on the thought that there is still some cushion to absorb higher wages, but that cushion has shrunk.

Third, there is the alarm about so-called "mad cow" disease. It isn't clear what is going to happen in terms of herd slaughter, but

presumably this is not good news for meat supplies. Yesterday, though, cattle futures prices actually declined on the Mercantile Exchange. British cattle herds are only about 1 percent of the world total. This fact, along with the possibilities for substitution across meat products, suggests that what we probably should continue to focus more on the grain-livestock nexus that we discussed in the Greenbook.



March 26, 1996

FOMC Briefing  
Donald L. Kohn

As background for your policy discussion I thought it would be useful to look at a key development in financial markets over the intermeeting period--the rise in long-term interest rates. At the last few Committee meetings, a number of you were concerned that policy was to the restrictive side, and that its effects would be felt in part through a backup in longer-term rates if the Committee did not validate the easing expectations built into the yield curve. Hence, interpreting the rise in long-term rates in the face of policy ease would seem to be an important consideration in how you proceed in the future--that is, your perception of the current stance of policy and the weight of the evidence you might require to tighten or ease.

An important question is the extent to which the increase was in real rates or in inflation expectations. Most of the rise appeared to come about from news on actual and prospective strength of aggregate demand--a less-weak economy and fading hopes for long-term fiscal consolidation. Both of these imply upward revisions to the expected path of real interest rates over coming years that was needed to keep the economy growing at its potential, lending credence to the view that the bulk of the increase was in the real component of rates. New information bearing on both spending and budgetary policy became available throughout the

period, so it is difficult to assess their relative contributions to the rise in rates, which might be important in assessing its sustainability and appropriateness. More than one-third of the approximately 60 basis point increase in the 30-year Treasury rate was triggered by the employment report. And, looking at forward rates, by far the largest upward movement came in the intermediate-term sector out to about five years--suggesting that a re-evaluation of the strength of the current expansion predominated, rather than bleaker prospects for longer-run deficit reduction. But longer-term forward rates also increased appreciably--about 40 basis points.

While the moderate rise in distant forward rates likely was at least partly deficit related, it might also suggest the possibility that long-term inflation expectations have not been entirely dormant. In particular, several developments over the period could have been perceived as reducing any chances that inflation might decline, even if they didn't necessarily raise the odds that it would increase. Such a revision to the distribution of possible outcomes would be consistent, for example, with stronger aggregate demand, especially as it interacts with the Committee's opportunistic disinflation strategy; in effect, an opportunity for an inadvertent decrease in inflation has disappeared. In that context, moreover, not only the Federal Reserve, but many other major central banks have

eased recently, and central banks as a whole may be viewed as becoming more aggressive in moving against potential economic weakness; several countries in which policy was eased are already effectively at price stability, but in others, such as the United States and the U.K., buying insurance against shortfalls in growth would tend to make further gains on inflation less likely. Finally, relatively stable rates of increase in labor compensation and prices in recent data would seem to be inconsistent with the hypothesis that the economy could experience disinflationary pressures even at high levels of resource utilization.

Presuming that most of the rise in rates is real, has the bond market over reacted to a confusing and volatile set of indicators, inadvertently placing an excessive drag on spending? A number of market observers apparently think so. Well over half the primary dealer economists surveyed last Thursday expected policy to ease before the end of the year. To be sure, their firms and customers don't seem to be betting a great deal of money on these predictions, since easing is not built into the yield curve or futures market quotes. Nonetheless, these economists still see policy as restrictive, perhaps judging from the real short-term rate, which remains slightly above long-term averages. Presumably, if the Committee shared the concerns of these economists, it would be looking for early signs that high rates were constraining spending unduly or that other factors,

such as household financial stress, were affecting credit demand or supply. Starting from the premise that policy might be insufficiently accommodative, and taking account of the lags in the effects of policy, the need to act promptly to head off a shortfall in the economy might lead you to require relatively less evidence of potential weakness or disinflation to motivate an ease, and relatively more evidence of economic strength or additional price pressures to key a tightening, even if this tilt weren't embodied in an asymmetric directive.

Of course, from the perspective of the staff forecast, the rise in rates seems to be largely an appropriate, endogenous response to changed market perceptions of the economy, and does not indicate restrictive financial conditions. Aggregate demand, in level terms, has come in close to staff expectations, maybe even a tad stronger when looking at final sales. Nominal long-term rates are near the level that had been expected eventually to prevail, though they got there sooner than anticipated. Looking forward, the slope of the yield curve from three months to thirty years is about at its average for the last 30 years, suggesting that the markets too now see little change in rates and presumably little reason in terms of any alteration in inflation pressures to adjust policy.

Supporting this outlook, the real long-term rate, for example the A-rated corporate bond yield plotted in the

Financial Indicators package, is around the level that over the last 15 years has been consistent with stable inflation. The stock market clearly has not interpreted the rise in rates as portending subpar expansion. And the monetary aggregates have accelerated--even M1 in March--despite continued robust flows into stock and bond mutual funds. Without trying to put too fine a point on it, such flows do seem broadly consistent with ample liquidity for spenders and lending capacity at depositories.

In the staff forecast, with higher interest rates failing to damp demand significantly, and the economy already operating with essentially no slack in resource utilization, there would seem to be greater risks that inflation would rise than it would fall. If the Committee were somewhat surprised by the strength in aggregate demand in recent months, and the lack of weakness was confirmed by further data so that the balance of risks did appear to be close to the staff forecast, the Committee at some point down the road might want to consider tilting its potential responses to incoming data more towards a possible firming of policy. That is, it might be readier to tighten in response to unexpected strength in demand or greater inflation, especially relative to the staff forecast, than to ease on the basis of incoming information suggesting a moderation in growth. Indeed slow growth might be welcomed, in a limited amount, to provide better assurance that inflation would not edge higher.