

APPENDIX

FOMC NOTES  
September 21, 1993

Peter Ryerson Fisher

Mr. Chairman:

Considering the period since your last meeting, there are three questions to be addressed:

First, why did we intervene in dollar-yen on August 19th?

Second, why has the German mark appreciated sharply against the yen and also against the dollar, even as the Bundesbank has lowered interest rates?

And third, why has the dollar remained relatively stable against the yen, trading between 104 and 106 yen for most of the period since August 19th?

On the morning of your last meeting, the dollar reached a record low against the yen of 100.40. The Committee was informed that the Japanese authorities had initiated discussions about the possibility of coordinated action but that the U.S. authorities were reluctant to join such an effort because the prospects for success appeared limited without additional policy actions by Japan and because the advance of the yen appeared to be broad-based and not specifically a dollar problem.

After your meeting, the Japanese authorities made a formal request for coordinated intervention, the Bank of Japan confirmed to the Treasury and the Federal Reserve that it had eased money market conditions, and the dollar appeared to come under pressure. Given the Bank of Japan's actions, the decision was

made to join in a coordinated operation in order, first, to give a supportive response to their adjustment in interest rates, second, out of concern that the movement in dollar-yen had been too rapid and, third, to dispel the market perception that the Administration would welcome further yen appreciation.

From Tuesday morning's low, the dollar recovered to 102.50 yen by early morning trading on the 19th. But the dollar then declined quickly that morning in New York to 101.35 yen following the release of the worse-than-expected increase in the U.S. trade deficit. The dollar also fell sharply against the mark, dropping a pfennig and a half. It was in this setting that the Desk entered the market.

The Desk's initial operation surprised most dealers and the dollar rose from 101.50 to 103.30. The Desk paused for release of Under Secretary Summers' comment expressing concern that further yen appreciation could retard growth in Japan and the world and welcoming the decline in Japanese money market rates. This statement had been planned, in advance, as an integral part of the operation as a way of addressing the market's perception of the Administration's attitude to dollar-yen.

The Desk re-entered the market with the release of Summers' comment but ceased operating when the dollar moved through 104 yen. Market participants continued to cover short positions and

reported on September 3. On that day, the yield on the 30-year bond broke through the 6 percent level -- a level recently regarded as implausibly low. In subsequent days, the bond yield fell even further on the heels of declining prices for gold, oil and other commodities. Ultimately, the yield reached 5-7/8 percent, about 45 basis points below its level at the start of the period, and other rates declined by similar amounts.

Despite the forecasts by some enthusiastic analysts for even lower yields, investors became increasingly skittish about whether the recent price gains could be sustained. In this environment, it did not take much to spark the intense selling that occurred on several days. Although the decline in producer prices provided some support, broad-based selling reemerged after a mildly disappointing CPI number was announced last week. Rates moved back to levels where they may find some support, with the long bond trading somewhat above 6 percent.

The new information on the pace of economic activity has caused many analysts to push back the date when they expect the Fed to tighten policy, and some analysts even talked about a possible easing at some point. In this environment, shorter coupon rates also posted substantial declines. In fact, just after the payroll report, the rate on the two-year Treasury note was some 30 basis points below its level at the time of your last meeting. However, most of the

decline in shorter rates was erased as public statements by some Fed officials and the CPI report were felt to be at odds with any easing move.

Although trading activity has calmed down somewhat from earlier sessions, a nervous tone remains as the market tries to determine appropriate yield levels. Few participants feel certain about the economic outlook and therefore whether current market levels are justified by the fundamentals. Barring major surprises in the data, most observers are looking for a steady monetary policy over the near term. The dominant view remains that the next policy move will be a tightening one, but that it will not come until sometime next year.

Finally, I might note that a few smaller banks lowered their prime lending rate from 6.0 percent to 5.75 percent last week. This move was not followed by any of the largest banks, but Harris Trust and a few smaller banks joined the move last Friday. These were the first changes in bank prime rates since July 1992.

Michael J. Prell  
September 21, 1993

FOMC Briefing

In broad terms, the current staff forecast looks a good deal like the one we presented at the last meeting of the Committee. We think that growth in the third quarter probably will fall short of our prior expectations. But, we also expect that most of that shortfall will be made up over the remainder of the year and that GDP will expand in 1994 at the same 2-1/2 percent rate projected in the August Greenbook.

However, beneath the superficial stability of the forecast are some revisions that are worthy of note. They help to explain why we still anticipate some pickup in output growth, despite the apparent lackluster performance of the economy recently, and in the face of substantial oncoming fiscal drag.

The first revision is the slightly lower path of the foreign exchange value of the dollar in this forecast. Ted will have more to say on this subject in a few minutes; it will suffice at this point to remark that this change has helped bolster projected net exports and that it is related to a second change in the forecast, namely a further lowering of our projection for U.S. long-term interest rates.

In the last Greenbook, we had anticipated that the 30-year Treasury bond yield would be between 6 to 6-1/4 percent by the beginning of 1994, and that it would generally run in that range through the year. Well, the rate is already there, and at the time we were preparing the current Greenbook forecast, it was below 6 percent. We thought hard about what to do with this feature of the projection,

and concluded that we should lower the range for the T-bond in 1994, to something like 5-1/2 to 5-3/4 percent.

There are two obvious questions raised by this forecast: Number one is, has anything happened that should lead us to think that even lower rates might be needed? Number two is, what Fed policy action, if any, would be needed to bring about those lower rates?

On the former question, I've already hinted at the answer. The recent indications of the strength of the economy have been a little disappointing on balance. And, as we look ahead, the achievement of sustained, moderate growth seems likely to require substantial impetus from the so-called interest-sensitive components of domestic demand--and whether that will be forthcoming at current rate levels is not clear. To be sure, we've been seeing healthy gains in equipment spending, a sector usually thought of as relatively responsive to financing conditions; however, there are now signs of deceleration in PDE. In addition, some of the traditionally interest-sensitive areas of activity continue to be effectively blocked by excess stocks, particularly office and multi-family construction. And others simply have not yet shown the kind of dynamism that probably will be needed to offset the drag from fiscal policy and other negative forces in the economy.

In this regard, the housing sector is one that comes quickly to mind. The data on sales and starts of new homes through July suggested a muted response, at best, to the declines in mortgage rates that had occurred through the spring. In the Greenbook we did anticipate a sharp pickup in housing starts for August, partly as a make-up for the July disruptions. And the figures released this morning have validated that prediction, with single-family starts jumping 11 percent. But we think that, to achieve the further gains

we've projected for coming months, yet lower mortgage rates may be needed. Many potential buyers still must be persuaded to set aside their fears of job loss and, in some markets, their sense that prices are sufficiently weak that it will pay to wait a while longer.

Obviously, it is not easy to divine the interest rate level that will produce a given pace of economic activity, and it is possible that the lags are just proving a bit longer than we anticipated. But, for the sake of argument, let us stipulate that lower long rates might be in order and ask, what monetary policy is called for to achieve those rates? Judging by past patterns of rate behavior embodied in many econometric term structure models, the downtrend in bond yields may have a long way to run--unless there is a substantial backup in short-term rates. The models essentially say that investors' expectations about future rate levels are shaped by the history of short rates; the persistence of low short rates will gradually lower investors' perceptions of what is normal and sustainable, or equivalently it will cause people to give up on their hope that short rates will rise soon and prompt them to shift funds to intermediate- and long-term instruments. This backward-looking model of expectation formation and rate determination may seem simplistic, but I think it does capture some of the psychology that has caused investors who wouldn't touch 7 percent T-bonds earlier this year to gobble them up recently at 6 percent.

How much farther might this process go, if the funds rate remains at 3 percent? Our quarterly model says that T-bond yields could drop below 5 percent by the end of 1994, as the slope of the yield curve moves more in line with the norms of the 1958-83 estimation period. We remain skeptical, and, in effect, we've done little more than nod in the direction of the model prediction. That



said, though, the model has done remarkably well in tracking developments to date; and, if it continues to be right, bond rates will overshoot the decline we've anticipated, unless short rates rise appreciably soon. That possibility obviously forces one to think back to the earlier question of just how low bond yields should be, given the underlying demand tendencies in the economy.

Let me turn now to the inflation outlook. We have lowered our forecast for consumer price inflation a couple of tenths of a percent, relative to the August Greenbook paths. The recent news in this area has generally been good: The PPI and CPI have, on average, been in line with or below our expectations, commodity prices have been soft, and inflation expectations seem to be headed in the right direction. Basically, these developments have bolstered our confidence that our analysis of the basic tendencies has been on the right track and so we've reduced the hedges in our price forecast a bit, so to speak. As we noted in the Greenbook, the headline CPI readings may not look quite so good for a while later this year and early in 1994, owing to food, energy, and seasonal adjustment problems--but we're projecting that core CPI inflation, which was 3-1/4 percent over the past twelve months, will have edged below 3 percent, year on year, by the end of 1994.

E.M. Truman  
September 21, 1993

FOMC Presentation -- International Developments

As Mike has noted, in this Greenbook projection we lowered somewhat our projected path for the foreign exchange value of the dollar. The adjustment was in two steps. First, we recognized the recent decline of the dollar on average, which appears to have been loosely related to the relative decline in U.S. long-term interest rates. Second, although we think the dollar will tend to appreciate over the next year as interest rates abroad decline relative to dollar rates, it may not reach the previously projected level because of the further downward adjustment in U.S. long-term interest rates that Mike has described.

Taken by itself, this revised projection for the dollar would have strengthened somewhat our outlook for real net exports of goods and services. However, it was small enough that it was essentially washed out by other small changes in our forecast. Thus, real net exports of goods and services are expected to be a continuing negative factor in U.S. real GDP over the next six quarters, but less than over the past six quarters because of a projected acceleration in our exports as foreign growth picks up.

Meanwhile, data on the July trade deficit, released on Thursday after the Greenbook forecast had been completed, were close enough to our expectations not to cause us to alter our basic outlook. The deficit of \$124 billion at an annual rate

(census basis), though smaller than the deficit in June, was only slightly larger than we had anticipated. With the bulk of the disappointment in the area of non-ag, non-computer exports, however, these data might best be viewed as suggesting a slightly greater downward risk to our forecast.

Since much of that risk is associated with uncertainties about growth abroad, especially in the major industrial countries, a few additional comments may be in order. First, our fundamental outlook for this year and next has not changed since the late spring: on average, growth has picked up modestly this year, and we are projecting an additional rise next year, but actual growth will continue to fall short of potential. Recent downward revisions in forecasts by international organizations -- the IMF and the OECD -- have brought those organizations' forecasts into closer agreement with our basic projection of a weak recovery abroad. Second, growth of real GDP in the major foreign industrial countries was a bit stronger over the first half of this year than we previously estimated. However, much of the surprise was in inventories, for example, in western Germany and Canada. As a consequence, we have lowered slightly our projection for growth on average in the second half, leaving the year as a whole about unchanged. Third, we have slightly revised our assumption about the pace at which the continental European monetary authorities will allow short-term interest rates to decline. It would appear that the French monetary authorities will be more cautious than we had thought they would be in the near term about using the room to maneuver provided by the wider

ERM margins. We also have delayed some of the decline in German short-term interest rates that we had been assuming, leaving the total additional decline by the middle of next year unchanged at about 200 basis points from the current level.

That completes our presentation.

September 21, 1993

FOMC Briefing  
Donald L. Kohn

There would seem to be little in the incoming data or the outlook to push the Committee away from its apparently comfortable perch at a 3 percent funds rate at this time. However, on the basis that three percent is not a new constant of monetary policy, I thought it would be useful to review briefly the rationales for current, tighter and easier funds rates, as background for considering possible changes in the months ahead.

I think it's fair to characterize the current stance of policy as accommodative, in the sense that the 3 percent nominal funds rate implies a roughly zero real rate, and is low enough not to impede downward adjustments of real and nominal long-term rates in markets, with associated declines in the foreign exchange value of the dollar. Indeed, the three percent funds rate already has been putting downward pressure on real longer-term rates, though the effects may have been damped to an extent by expectations that the Federal Reserve was likely to tighten policy. Savers have moved into capital market investments as low short-term rates persist and as the pace of economic activity and inflation have fallen short of expectations, pushing off anticipated increases in the federal funds rate. The staff forecast, as Mike noted, assumes a continuation of the 3 percent rate and further declines in long-term rates--in real as well as nominal terms--serving to offset the continued contractionary influence of fiscal policy, cautious private spending, and weak economies abroad.

It seems unlikely that 3 percent will remain exactly the right federal funds rate for years on end, exerting just the correct degree of pressure on long-term interest rates to keep the economy expanding at a moderate rate and inflation pressures in check. Alternative B and the staff forecast may be characterized as a "wait and see" policy, appropriate so long as moderate growth seems in store, and until some of the uncertainties about which way to move sort themselves out. Long-term real rates are already low, but the response of the economy to recent declines in rates remains uncertain, as do the effects on aggregate demand of atypical exogenous forces, including a sustained period of fiscal retrenchment, which could necessitate a prolonged period of unusually depressed real rates. Adding to uncertainty and perhaps arguing for delay in taking any action are the somewhat disparate signals being given off by labor market data, which have shown modest and dwindling levels of excess capacity, and information on expenditures that have suggested more damped demands that could keep the economy below its potential for a considerable period.

Although the stance of monetary policy is already accommodative, and a tightening in real terms seems inevitable at some point, the possibility that the next action might need to be in an easing direction can not be ruled out. An easing would nudge real interest rates and exchange rates down even faster. Such an action might be appropriate if the FOMC thought the economy were in danger of faltering, falling below a growth track that in the greenbook is already only just sufficient to keep unemployment from rising. Action to reduce rates in such circumstances would be needed especially if markets were not themselves reducing rates sufficiently.

say because participants had unduly optimistic views of aggregate demand. An easing in these circumstances would risk a flare-up of inflation expectations, though such a response ought to be temporary once data began to justify the FOMC's action. Faster disinflation than anticipated also might suggest a need to ease policy, because it would raise real short-term interest rates sooner and by more than appropriate, especially if the disinflation resulted from shortfalls in demand and rising slack in the economy, rather than shifting expectations.

On the other hand, if inflation does not decline significantly, at some point the current federal funds rate may well threaten to pull long-term rates to levels too low to be consistent with sustainable expansion--necessitating a tightening of policy. Long-term real rates have already fallen considerably, to their lowest levels in years, and stock prices are high relative to earnings and dividends. Both should be bolstering demand in the period ahead.

The question is when do such rates become too low, with potential adverse consequences for the macro economy and the disinflation process. The odds on such an outcome would seem to be enhanced to the extent that the decline in rates was a product of not-entirely-rational pursuit of yield by investors, egged on by low short-term rates. It's too early to assess the effects on spending of recent rate declines. Previous falls in real rates appear to have been sufficient mainly to cushion the effect on demand of various restraining influences. They have induced a substantial amount of financial market restructuring, including the substitution of

equity for debt and long-term debt for short-term debt. These latter types of activities have positive implications for spending, but they are indirect and longer-term. Stronger and more direct effects would work through demands for real assets and might be seen in increases in the prices and quantities of those assets. Consequently, one might look for persistent strength in real estate, commodity and other asset prices and increases in inventories or spending on interest-sensitive goods for evidence that low real rates were having a marked affect on spending and with subsequent implications for price pressures more generally.

In addition to incoming data on prices and spending, financial flows--both money and credit--may provide some signs that policy needs to be altered. To be sure, these flows have been especially difficult to read in the current expansion, but a distinct change, either way, in trends of credit or money growth might be one indication that interest rates were inappropriate. Recent data show no such indication; growth of credit and broad money seem to have been little stronger over the spring and summer, but generally remains quite subdued. For example, overall borrowing by households and businesses has picked up in recent months, but debt growth is still below that of spending. Moreover, some strength in borrowing and spending by these sectors is essential to maintaining a moderate expansion when government spending is declining.

On the asset side of spending sectors' balance sheets, conventional measures of broad money growth continue sluggish. Shifts into very liquid money assets persist, as indicated by strength in M1, reserves and the monetary base. But these shifts seem to be related importantly to low time-and-savings-deposit rates compared



with returns on NOW accounts, to the accumulation of demand deposits in the process of refinancing mortgages, and to demand for currency overseas. M2 has been growing at around a 2 percent pace in recent months, and the staff expects expansion at around this rate through year-end under alternative B. This would represent only a small acceleration from the one percent pace of the first half of the year, and would leave this aggregate only a little above the downward revised lower end of its range. Flows into bond and stock mutual funds appear to have been especially heavy of late, and expansion of M2+ has been further boosted by the arithmetic effects of capital gains in stock and bond markets. Together, these factors have pushed growth of M2+ to above that of nominal income, though most of the overage is accounted for by capital gains. Such gains, by boosting wealth, should stimulate spending, but by a small fraction of the gains themselves.

In sum, Mr. Chairman, as I noted at the outset, little in the recent data or staff forecast would argue forcefully for moving monetary policy at this time from its current position. I have tried to review some of the circumstances and indicators that could suggest a need for action in the future.

Notes for FOMC Meeting  
September 21, 1993  
Betsy B. White

Desk operations during the intermeeting period continued to foster reserve conditions associated with Federal funds trading in the area of 3 percent. The borrowing allowance was held at \$250 million, as the seasonal component of borrowing moved within a fairly narrow range. Adjustment borrowing continued to be very low on most days, although it did jump on two occasions owing to operational problems at two large banks. The Federal funds rate was mostly well behaved, and averaged 3.02 percent over the intermeeting period.

The Desk faced a substantial reserve shortage over the period, especially during the second half of the interval. To address this reserve need, we bought \$4.0 billion of Treasury notes and bonds in the market for delivery on September 2. This was our third coupon pass of the year and it brought the average maturity of our holdings to just over 38 months, about two months longer than at the beginning of the year. The Desk acknowledged some relative scarcities at the longer end of the market and tilted its purchases somewhat more toward shorter maturities than in other recent coupon passes. As an aside, the current Treasury long bond has consistently commanded an unusually large premium because of investor concerns that the issue could become scarce under the Treasury's new auction cycle. As a result, many traders are using the older bond

as the benchmark for pricing corporate debt. In addition to our coupon pass, we bought outright about \$900 million of securities from foreign accounts.

The balance of the reserve need was met using temporary operations. The Desk again made frequent use of fixed-term multi-day system RPs to address the fairly certain and evenly distributed reserve shortages that occurred in the early part of each of the first two maintenance periods. Withdrawable multi-day operations, overnight customer RPs and System RPs were used at other times or to supplement the fixed operations.

In the Treasury market, yields on most intermediate- and long-term securities have fallen an additional 25 to 30 basis points or so on balance since your last meeting. Shorter-term yields posted more modest net declines, causing the coupon yield curve to flatten a further 15 basis points or so.

Intermediate- and long-dated Treasury securities continued to be supported by flows out of mortgage-backed securities, buying linked to municipal defeasance programs, and investors' continued stretch for yield. Also, a light auction schedule and, for a time, spillover demand from the futures market provided support.

Data on economic activity released during the interval were collectively disappointing, especially the surprising decline in August nonfarm payrolls

the dollar reached a high of 106.75 before closing just below 106.

During the operation it became apparent that the market was even shorter dollars than had been anticipated. In addition, the dollar's upward movement was accentuated by the unsuccessful effort of at least one speculative fund to continue to sell dollars into the initial phases of the operation, only to find themselves overwhelmed by other dealers' short covering and, thus, forced to cover their position at higher levels.

On the 19th, the Desk purchased 165 million dollars, evenly split between the System and the Treasury and an additional

on behalf of the Japanese authorities.

During the following week, the Bank of Japan purchased

bringing the total purchased by the Japanese authorities over the period to

The most pronounced movement in major exchange rates, over the period, has been the appreciation of the mark by 8.4 percent against the yen and by 4.9 percent against the dollar.

The Bundesbank has lowered interest rates less, and less quickly, than had been expected. The Japanese economy is now widely perceived to be in much worse condition. And there has been some reduction in expectations for a tightening of monetary

policy by the Federal Reserve. These changes are reflected in the widening of interest rate differentials in favor of the mark over the period. As a result, long-yen and long-dollar positions against the mark, built up during the European crisis in late July and maintained into August in the hope that interest rate differentials would move in the opposite direction, have been unwound over the period.

On August 26th, the Bundesbank Council surprised the markets by not lowering interest rates. German banks were caught short of funds at the end of the reserve period and money market conditions tightened appreciably. When the Council did announce a reduction of 50 basis points in its Discount and Lombard rates on September 9th, markets were again surprised, this time by the smaller-than-expected 10 basis point reduction in its market repo rate. Reflecting upon these surprises, market participants have come to recognize that the widening of the margins within the European Exchange Rate Mechanism has significantly reduced external pressures on the Bundesbank to ease policy. At the same time, the improved perception of the German economy -- as reflected in the 0.5 percent increase in West German GDP for the second quarter -- seems to be reducing domestic pressures on the Bundesbank to ease.

The dollar declined through 1.67 marks following the Bundesbank's inaction on August 26th. During the following week

the dollar's downward trend continued as conditions remained tight in German money markets and as market participants discussed the risk of dollar sales and mark purchases by European central banks needing to repay their debts from July's interventions. Then on Friday, September 3rd, on the release of the weaker-than-expected U.S. non-farm payrolls, the dollar dropped through 1.64 and 1.62 marks. The dollar was unable to recover above 1.62 after the Bundesbank Council lowered rates on September 9th, and fell below 1.60.

The dollar has since traded in a range back and forth across 1.60 and was off a bit following this morning's release of German M3 for August showing a slight decline. While this was much better than had been originally expected, because of the inflows caused by ERM interventions, in the last few days the market had come to expect a sharper deceleration and, on the M3 announcement the mark firmed slightly across the board.

There appear to be three reasons for the dollar's relative stability against the yen.

First, there has been a perceived increase in the risk of dollar-supportive intervention by the U.S. authorities.

Second, the fact of the Desk's operation, coupled with Under

Secretary Summers' comment, created an impression of a "deal" between the Clinton administration and the Hosokawa government on trade issues. This impression was reinforced by the conspicuous absence of comments by U.S. officials' talking up the yen and by Japanese officials' comments expressing a willingness to consider numeric targets for Japan's trade surplus.

Third, the reduction in publicly-expressed friction on trade and exchange rates gave market participants the opportunity to focus on the weakness in the Japanese economy. Evidence of this has been seen in continued weak business sentiment, deteriorating corporate profits, and in the 0.4 percent decline in second quarter GDP. As a consequence, this morning's long-expected cut in the Bank of Japan's Official Discount Rate was increasingly anticipated less as a device to avoid further yen appreciation and more as a necessary supplement to the Government's efforts to stimulate the domestic economy.

With last Thursday's announcement of the Japanese Government's 58 billion dollar stimulus package, political factors again appear to be affecting the dollar-yen exchange rate. U.S. official comments have been mixed -- ranging from disappointment to faint praise.

This morning's 75 basis point reduction in the Bank of Japan's ODR was reported, in advance, by a Japanese news

organization and the dollar moved up to 104.50 yesterday in New York trading, but moved little on the actual announcement. However, by this morning the dollar was trading around 105.50 as the European markets digested the rate cut and following the release of an early afternoon edition of the Nikkei newspaper indicating that the U.S. authorities would take part in coordinated intervention if the yen appreciated.

Over the coming days, particularly in the run-up to the Clinton-Hosakowa meeting, political comments and indications of official attitudes are likely to dictate the direction of dollar-yen.

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Mr. Chairman, we will need a motion to approve the System's 82.5 million dollar participation in the intervention operation of August 19th.