

Meeting of the Federal Open Market Committee  
December 16, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, December 16, 1997, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman  
Mr. McDonough, Vice Chairman  
Mr. Broaddus  
Mr. Ferguson  
Mr. Gramlich  
Mr. Guynn  
Mr. Kelley  
Mr. Moskow  
Mr. Meyer  
Mr. Parry  
Ms. Phillips  
Ms. Rivlin

Messrs. Hoenig, Jordan, and Ms. Minehan, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, McTeer, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis respectively

Mr. Kohn, Secretary and Economist  
Mr. Bernard, Deputy Secretary  
Mr. Coyne, Assistant Secretary  
Mr. Gillum, Assistant Secretary  
Mr. Mattingly, General Counsel  
Mr. Baxter, Deputy General Counsel  
Mr. Prell, Economist  
Mr. Truman, Economist

Messrs. Beebe, Cecchetti, Eisenbeis, Goodfriend, Lindsey, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members,  
Board of Governors

Mr. Ettin, Deputy Director, Division of Research and Statistics,  
Board of Governors

Messrs. Madigan and Simpson, Associate Directors, Divisions of  
Monetary Affairs and Research and Statistics respectively,  
Board of Governors

Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors,  
Division of International Finance, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of  
Monetary Affairs, Board of Governors

Messrs. Connolly and Rives, First Vice Presidents, Federal  
Reserve Banks of Boston and St. Louis respectively

Mses. Browne, Krieger, Messrs. Dewald, Hakkio, Lang, and  
Rosenblum, Senior Vice Presidents, Federal Reserve Banks  
of Boston, New York, St. Louis, Kansas City, Philadelphia,  
and Dallas respectively

Mr. Miller, Vice President, Federal Reserve Bank of Minneapolis

Messrs. Bryan and Evans, Assistant Vice Presidents, Federal  
Reserve Banks of Cleveland and Chicago respectively

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CHAIRMAN GREENSPAN. I would first like to welcome our temporary new Bank representative, LeGrande Rives.

MR. RIVES. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Also, sadly, this is Charlie Siegman's last meeting after several generations of watching the ups and downs of these proceedings. We are going to miss you, Charlie.

MR. SIEGMAN. Thank you very much. On my list of things from the Federal Reserve that I will look back to, this is one of the activities that I will miss very much.

CHAIRMAN GREENSPAN. When all of a sudden we begin to see a hole in the staff analysis, we will infer its cause. [Laughter] Would somebody like to move approval of the minutes of the November 12 meeting?

VICE CHAIRMAN McDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection, they are approved. Mr. Fisher, you have the floor.

MR. FISHER. Thank you, Mr. Chairman. I will be referring to the package of colored charts, which you should find in front of you.<sup>1</sup>

On the first page are charts covering the same information we have shown in the past, but we have changed the source of the data for the current 3-month deposit rates. Traders have persuaded me that the LIBOR fixing provides a better comparison than the Eurodollar series we have been using, so that is a slight change.

Focusing first on U.S. forward rates, there are two points to which I would draw your attention. One is that there has been relatively little net change in these rates since the November meeting, as shown by the red lines, but clearly some compression has occurred as the money market yield curve has become increasingly flatter in the period since October. I think

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<sup>1</sup> Copies of the charts used by Mr. Fisher are appended to this transcript.

the updrift in the solid line, the current dollar LIBOR, reflects a fairly typical year-end phenomenon. I would not attach any significance to that.

Looking at the German forward rates, Mr. Tietmeyer said rather publicly on November 14 what other Bundesbank officials have been saying for some time, namely, that the market should not expect German rates to go up by 120 basis points between now and next May to meet Italian rates halfway, as the market had come to believe was going to happen. In effect, Tietmeyer was saying that the German economy is stronger but not really all that strong. You can see the gentle drift downward in German forward rates. If you look at the solid blue line, the current mark LIBOR, it is quite interesting that the spike in early December parallels the spike in the yen LIBOR, shown in the chart below, at the time of heightened concerns about the Japanese premium. Now, this is interesting for those of us in the money market business, as it were, because the calculations really are quite different. In the British Bankers Association panel for the yen LIBOR fixing, there are eight Japanese banks, whereas in the panels for the dollar and the mark, there are only three and the calculation is done by throwing out the highs and the lows. So, I think the spike in the German money market rates reflects the demand for funds from the Japanese banks. It is not a reflection of the credit premium, as it were, from the demand side but a pushing through of the demand coming from the Japanese banks.

Turning to the Japanese market, we need a little magnification of the bottom panel to see what is going on in Japan. So, if you turn to the second page, I will work through some of the events in the Japanese markets. Three rates are traced in the top panel: the current yen LIBOR 3-month deposit fixing in dark purple, the 9-month forward 3-month yen deposit rate in orange-yellow, and the Japanese overnight call rate in green. In the middle panel, we have plotted the excess reserves in the Japanese banking system. I talked to Bank of Japan officials at some length about their calculation of this measure. It is not quite how we would calculate it, but it is the way they do it. The chart illustrates the heightened generosity that the Bank of Japan was practicing by leaving their market in considerable surplus following the closure of Yamaichi and subsequently in the last few days. The bottom panel has two measures of the Japanese premium in dollar interest rates: the solid line is the difference between the 1-month LIBOR rates at the Bank of Tokyo-Mitsubishi and at Chase, and the dotted line is the Fuji rate minus the Bank of Tokyo-Mitsubishi rate. There was some modest differentiation among Japanese names at the height of the crisis, but clearly the dominant difference may be seen in the comparison between the best Japanese name and Chase as shown in this example.

Going back to the top panel, I would like to draw out two points. One is that in the last few days the Bank of Japan has pushed the overnight call rate down into the 20 basis point range. A Bank of Japan official has told me that "you may call this a temporary easing." I took that to mean that the emphasis was on "you" because they were not going to call it that out loud quite yet. But clearly, they have pushed the overnight call rate down. The gap between the purple line showing the current LIBOR and the orange line does tend to indicate that the current premium is expected to wash out on the other side of the fiscal year. That is, the high premium, high demand for funds coming out of the Japanese banks is thought by the market to be something that will wash out 9-months forward when we get happily to the other side of the Japanese fiscal year-end in March.

Turning to the third page, I thought I would give a little background on events in East Asia. I know Ted Truman will be speaking more about that. The main purpose of these panels is to remind us that this is not just a bad thunderstorm but something more like the 100-year flood. The top panel shows the exchange rate movements since July 1; the middle panel has percent changes in equity indices; and the bottom panel depicts 1-month interest rates. Focusing on the currency panel, I think it's easy to say that the currencies have overshot their fundamental values. But I think it's important to recognize that there is still a very large position overhang weighing on these exchange markets. In effect, a leveraged convergence trade as we would have called it in Europe a few years ago, short dollar or yen external currencies and long internal currencies, was embedded on the balance sheets of businesses throughout the region, and they have not yet completed hedging those exposures. In these thin markets, both bankers and traders have a very hard time thinking of these currencies as having overshot because they are aware of how much more there is yet to hedge that is weighing on the exchange rate.

A second inference I would draw from this page is to note that the downward slope of the foreign exchange and equity values is somewhat steeper than the upward slope in the 1-month interest rates at the bottom. Another point I would note is that so far Taiwan, the red line, has managed to distinguish itself. In the top panel you can see that its currency has declined against the dollar only slightly more than the yen; and in the middle panel, you can see that their equity market has really broken out of the pack.

While looking at this chart overall, I think it is possible that we will look back and see that the end-of-year effect for some of these currencies and values provided something of a nadir for them, given the risk aversion that is generally typical at this time of year. But I think it would be risky to count on a bounceback after the New Year for all of them.

Turning to the fourth page, I have depicted in the top panel both the March Eurodollar contract and the March fed funds futures contract as they have traded throughout the fall. There is relatively little net change in both those series from just prior to the November meeting to today. The middle panel shows the U.S. Treasury constant maturity yields for 30, 10 and 2 years. You can see that we have had a continued decline in bond yields in the 30- and 10-year areas, while the yield on the 2-year note has been more or less flat over that time horizon. Clearly, this is something that is quite difficult to interpret. I think that with the worsening of the Asian crisis, market participants have inferred that there will be no action at this meeting, and more of them have come to adopt the deflationist outlook or at least are taking it more seriously than they did some time ago. While point estimates for inflation have moved down a bit, I think the better explanation is that market participants have shaved off the upside risk in the inflation probability distribution, that is, the risk that inflation will rise over the next six months. That is what is tending to bring down the yield curve in combination with the flight-to-quality, end-of-year effect, making market participants more comfortable about moving their duration out the yield curve in this end-of-year environment.

The last page of charts relates to our open market operations in this period. The top panel covers daily fed funds trading: the blue lines show the daily ranges, the vertical red lines show the standard deviations, and the horizontal red lines indicate the effective rates. The panel at the bottom has the level of free reserves and indicates our daily misses from the projections. I should point out that at the start of the middle period, which included Thanksgiving, we raised the allowance for excess reserves from \$1 billion to \$1.4 billion. The demand for excess reserves clearly has been inching up. I do not want to suggest that this is a precise science, but we are trying to get a handle on how much it has drifted up. I think it will be some while before we are confident that we know where it has settled. We had some volatility around the Thanksgiving holiday and the start of December. As you can see, excess reserves averaged around \$2 billion in that period, and we still had a slightly firm funds rate. We may have slightly overcompensated at the beginning of the current maintenance period, but the market was quite tight. Yesterday was a corporate tax payment date, and we tried to prepare the market for that.

We purchased a total of \$15.6 billion on an outright basis since the last FOMC meeting and a total of \$17.2 billion since early November. The total included a small amount of bills, \$1.5 billion, and those purchases seemed to go quite well. I was trying to leave something of a marker with the market and the Treasury--a notice that we were not forgetting about the bill sector, that we plan to come back to it. In making these permanent

reserve injections, we did change our pattern of operations from last year. A year ago, we left a larger need in the market, but we reverted to our traditional pattern this year by adding a large amount of permanent reserves. That may put us in a position of having to drain reserves to a modest extent toward the end of January when the Christmas demand comes out of the market. At that point, we also will be reaching rather low levels of operating balances, but I think we are ready to handle the effects of being on the drain side at what are likely to be new lows in operating balances.

We had no foreign operations in this period. Mr. Chairman, I will need the Committee's ratification of our domestic operations, and I would be happy to answer any questions.

CHAIRMAN GREENSPAN. The Southeast Asian exchange rate patterns imply, as you say, that a lot of market participants are overshooting the fundamentals in a certain sense. It is difficult to avoid that sort of conclusion. We cannot get a 40 or 50 percent decline in an exchange rate in a short period of time under any realistic assumptions concerning what has changed. Stock prices can do that. They reflect net long positions, and if everyone decides to pull out, stock prices will go to zero. But exchange rates are zero-sum games; one person's rise is another person's decline. So, this exchange rate decrease looks extraordinarily large. You raised a question when you stated that the balance of foreign currency positions is still effectively long in local currencies and short in dollars or perhaps yen. One would assume that forward positions in the currency, if they exist, would be able to pick this up. I have never seen 9-month or 1-year forwards on baht/dollars. Do they exist?

MR. FISHER. They exist. They are quite thinly traded, and I'm not sure how much confidence people put in them, but they are there. They are not the kind of market instruments that one can click on a Reuters page and see.

CHAIRMAN GREENSPAN. But the question is whether they give us at least a partial answer. If we are getting extreme disequilibrium, the deep forward positions ought to be

closer to minus 10 or minus 15 as distinct from minus 40. And if we cannot infer it from these other positions, we could in principle handle the credit risk in this situation--I haven't thought this through--by focusing on the spot rate adjusted for covered interest rate differentials to give us an idea of the forward position. I wonder whether we know anything about the more distant horizon in order to answer the question about overshooting, so to speak, in the adjustment of balances. If indeed those balances are precisely what you say, namely, that they are comprised of long positions in the local currency and short positions in dollars, that imbalance would give us a very significant premium on the forward position vis-à-vis the spot. It would be very interesting to test that if the information is at all available.

MR. TRUMAN. Are you not just as likely to see higher short-term interest rates, so in fact it would go the other way? The forward foreign exchange rates would be more depressed. You use the word position, which is quite different--

CHAIRMAN GREENSPAN. I'm thinking of 2-year forwards, for example.

MR. TRUMAN. I don't think you can find 2-year forwards in these markets. If they existed, they would tend to have higher interest rates and would be more depressed than the current spot rates.

MR. FISHER. I think the problem is that we do not have a time horizon where one ought to find fundamental value. There is not enough confidence in markets that one would want to have a contract with a maturity of that length. That is a long duration exposure to take on a currency that is declining so rapidly now.

CHAIRMAN GREENSPAN. Before the Southeast Asian markets collapsed, we used to talk about the ability of the Koreans to fund long-term debt more readily than short-term,

which goes against everyone's view of the way the world works. Was that true then or was it just an illusion?

MR. FISHER. I don't know. I have not heard that story.

CHAIRMAN GREENSPAN. If it was true, it would be an indication that there is a premium in a longer forward exchange rate. This is a crucial question because the adjustment is either going to implode down to minus 80 percent or it is going to run into downside resistance.

MR. TRUMAN. Peter Fisher may want to comment, but I think it is reasonable to say that many people want to cover their positions. There are a lot of different ways of covering them. Some covering can be done in the spot market; some in the forward market; some through borrowing; and some through lending. How it manifests itself in individual cases may be quite different. If you have thin markets, this continuing activity may be depressing spot exchange rates and you may get some bounceback even though the whole process has not played itself out because basically no one is in a position to provide forward cover.

MR. FISHER. I think what we are seeing is the implosion of the intermediation process in these exchange markets. The exchange markets for the won and the baht have disappeared. There are not a lot of people who are excited about participating in those markets.

CHAIRMAN GREENSPAN. It will be fascinating to watch what happens. It's like the tide coming in for the first time in 20 years, and we find all the junk on the shore that we didn't know existed. This is partly what is going on in the financial system.

VICE CHAIRMAN MCDONOUGH. Also, if and when confidence is restored or when greed overcomes fear, people may suddenly find that they are much better off to keep a lot of those positions that they now want to get out of.

CHAIRMAN GREENSPAN. If this thing turns, it can turn on a dime. The trouble is, it cannot turn on a baht. [Laughter] President Parry, bail me out!

SPEAKER(?). Neither won!

MR. PARRY. A question about Yamaichi: It was closed on the 23rd of November, and I guess they ceased being a primary dealer on December 4th. Could you talk a little about what our financial relationships with them were just before the 23rd and then between the 23rd and the 4th?

MR. FISHER. We had been monitoring their trading exposure to us rather carefully for many, many months. We had an arrangement where if they needed to elevate their demand for financing in our RP operations from the agreed routine amount, they would call Sandy Krieger and give us some advance notice and information to enable us to understand their need. The process of getting a resignation letter from them was really a formality. The lag can be attributed to all the things they had to do other than type out a letter and send it to us, but I think their management understood that was something they would have to do in the course of winding up their affairs. Was that helpful?

MR. PARRY. Yes.

CHAIRMAN GREENSPAN. Anyone else? Would somebody like to move to ratify the Domestic Desk operations?

VICE CHAIRMAN McDONOUGH. Move approval.

CHAIRMAN GREENSPAN. Thank you. Without objection, they are approved. This is a very short agenda. Messrs. Prell and Truman please.

MR. PRELL. Thank you. Anticipating that, as last month, the focus of your interest this morning is on the international side, I will try again to be

brief. I thought, however, that I would offer a few remarks on some of the tougher calls we had to make on the domestic side of our forecast--namely those relating to the outlook for wages, the stock market, and capital spending.

Before that, however, just a few words on this morning's statistics: The CPI--total and core--increased just 0.1 percent in November. The twelve-month changes were 1.8 percent for the total CPI and 2.2 percent for the core--the total a tenth below our Q4/Q4 forecast and the core right on it.

Housing starts rose slightly further last month. We had expected a dropback. Most of the upside surprise was in the lower value multifamily segment, which held at a high level. For what it's worth, I am told that this may be the result of a new seasonal pattern related to efforts to qualify for tax breaks on low-income housing projects. We'll have to look into that further. Single-family starts were up a little, but permits were down, so this more important segment looks broadly in line with our prediction of flatness.

Now back to my main theme, some of the tougher issues in the projection. The first I noted was the outlook for wages. As you know, we have forecast that wages and total compensation will decelerate slightly in the next year, in the face of continued low unemployment. We certainly are not arguing that the labor market is not tight. We have heard the anecdotes and read the surveys, as you have, and we are persuaded that finding and retaining qualified workers is a major problem for employers. While many firms continue to report that they will do just about anything they can to avoid raising their wage bills--including even forgoing expansion opportunities--wage increases have been creeping up for a while now.

My gut tells me that the pressure is building in this labor market pot to where the lid could blow off. But, for better or worse, our forecast has not been shaped by this visceral sensation. In particular, we have given major weight to the observations that wages are rather inertial and that they can be significantly affected by perceived trends in prices. And, at this point, workers and employers are looking at very low inflation over the past year, and they should be seeing more of the same for a while longer, given conditions in goods markets. The net result in our forecast is still a hefty further rise in real wages and a marked increase in the labor share of the income pie--but not an upward wage-price spiral.

Another tough call relates to the stock market outlook. As you know, in light of our reassessment of the prospects for inflation, we have eliminated our prior assumption of an increase in the federal funds rate. We

had viewed that tightening as an important trigger for a marked downturn in the market in the first half of next year. The question before us, then, was whether disappointing corporate earnings alone could be expected to produce a significant correction before long. Our answer was yes, but that the decline will likely be more gradual and smaller overall--about 15 percent from yesterday's close by early 1999. Question marks remain, however.

To date, individual companies or industries have been punished for bad earnings announcements, but this seemingly has occasioned merely a rotation to other sectors by determined equity investors. So, could the market shrug off the negative news we are forecasting? Perhaps, at least for a while. Certainly, on our numbers, aggregate year-on-year profit comparisons will not begin to look really poor until next summer or fall.

That said, though, I think there is the distinct possibility that, once the deterioration of profits comes clearly into view, the market could develop even more downward momentum than we have anticipated. I would note that we are currently projecting a low for the Wilshire 5000 in 1999 that would only take it back to where it was this spring and leave price-earnings multiples at historically high levels. A combination of revised earnings expectations and any further increase in the equity premium from what probably has occurred recently would point to a much more sizable decline, unless interest rates were to fall appreciably at the same time.

Finally, a few thoughts on the outlook for business investment. This is a sizable sector and one that has provided a lot of propulsion for the expansion to date. We have forecast a significant deceleration in capital spending, and while this gets a little circular, it fits well with our predictions of rising equity capital costs and decelerating output. However, most of the indications at this point are that investment plans are very strong going into 1998. For example, the semi-annual survey of the National Association of Purchasing Managers indicated that manufacturers are expecting to increase their capital expenditures next year by 15 percent--an even greater increment than they reported for this year. The NFIB's November survey of small firms also showed extremely upbeat investment plans.

These surveys underscore the risk that investment will, yet again, prove stronger than we have gauged. But, there is some reason to doubt their predictive power in the present case. For one thing, even if the surveys are merely a few weeks old, they may still be providing pretty stale readings. Just looking at how our own changing perception of the international outlook has altered our GDP projection over the past few weeks, it seems reasonable to think that businesses are also reassessing their plans and that many of them will be trimming their investment budgets. If we are wrong,

that does raise the question of whether this capital spending boom won't come to a more jarring end sometime down the road, with firms finding themselves with excess capacity and experiencing a deeper hit to profits.

So, to sum up, we think we have provided a realistic baseline forecast, but there is still plenty to puzzle over--and perhaps to worry about from a policy standpoint. On that comforting note, let me now turn the floor over to Ted, who has been doing a lot of worrying lately.

MR. TRUMAN. Our message about the international economy and the external sector of the U.S. economy is straightforward and easily summarized: We have a weaker outlook for net exports, primarily as a consequence of the further deterioration of economic and financial conditions in Asia. While I am tempted to stop at this point and turn to questions, there may be a bit more that I usefully can add. It is true that we are again projecting slower global growth, in particular in Asia. We also are projecting a stronger dollar and lower oil prices; the first is associated to a considerable degree, though not entirely, with Asian developments, but those developments have only marginally affected our view of oil prices. Finally, we have updated our worse-case scenario, and I will say a few words about our current thinking on that subject.

With respect to the current quarter, we have very little hard data on U.S. international transactions; trade data for October will not be released until Thursday. However, we have written down a small negative contribution of net exports to GDP growth this quarter, in contrast with a small positive contribution in the November Greenbook. This estimate is based primarily upon three considerations: first, our assessment of the third-quarter data that revealed somewhat weaker exports than we had anticipated; second, a judgment that the unexpected strength in our exports during the first half of this year was coming largely from an accelerator effect on exports of capital goods that has waned with the Asian crisis; and third, anecdotal information, for example, from the Beige Book and the supplementary reports received from Reserve Banks about the apparent negative effects of the Asian crisis on trade flows this quarter. The anecdotal information, in turn, is consistent with our prior assessment that the first-round effects of the Asian crisis on our trade will be felt sooner rather than later.

Turning to our forecasts for 1998 and 1999, our aggregate projection of growth in the rest of the world, weighted by U.S. nonagricultural exports, is now 2-1/2 percent next year and 3-1/4 percent the following year, compared with a trend rate of around 4 percent. Most of the downward adjustment is for the developing economies in Asia, where we anticipate greater near-term

weakness and a more protracted return to trend. We have also marked down slightly further our growth forecast for Japan, while that for the other industrial economies is essentially unchanged.

Our outlook for Japan and the other industrial countries has been affected by our revised view of dollar exchange rates. As Peter Fisher has reported, the dollar strengthened against both the yen and the continental European currencies during the intermeeting period. We attribute the yen's weakness to continuing question marks hanging over the Japanese economy and financial system--questions marks that we do not expect will be removed by the announcement, now postponed until tomorrow, of yet another package of policy measures. Because we do not expect underlying conditions in Japan to improve immediately or dramatically and because we anticipate that the effects of Asian developments will prevent a further substantial expansion of the Japanese external surpluses in the aggregate, we have incorporated into our projection only a slight appreciation of the yen/dollar rate from its recent level. Compared with our September projection, we now have the yen more than 15 percent weaker at the end of 1999.

With respect to continental Europe, we are no longer expecting a further increase in German official interest rates prior to the start of monetary union, and the market appears to be gradually coming around to the same conclusion. This has contributed to the weakness of the DM and its associated currencies, and we expect that recent lower exchange rates against the dollar will persist, on balance, over the forecast period. We also anticipate in our forecast that sterling will depreciate somewhat against the dollar as U.K. economic growth and interest rates ease but that the Canadian dollar will strengthen somewhat as interest rates continue to rise in Canada.

With respect to the currencies of non-G-10 countries, in particular in the Asian region, our crystal ball is murkier. The Asian currencies, except for those of China and Hong Kong, have declined substantially further over the intermeeting period. We are not expecting further depreciation, on balance, from the current highly depressed levels, nor are we expecting a recovery. To borrow a term from the politics of 1884, I would characterize this as a mugwump position with regard to the nominal exchange rates of these economies--our mug is on one side of the fence and our wump is on the other. However, real dollar exchange rates of these countries should appreciate somewhat due to inflation rates that in many cases will approach or exceed double digits.

The net result of these assumptions is that the dollar is stronger in both real and nominal terms throughout the forecast period against both G-10 and

non-G-10 currencies, with an associated negative impact on our outlook for net exports.

Turning to oil prices, we have reduced our assumption about the price of imported oil by about \$2 per barrel in 1998 and 1999. Our revised assumption is based on the substantial increase in official OPEC quotas (which has led us to boost our projection of OPEC production by 900,000 barrels per day in 1998), the easing--at least for the moment--of tensions with Iraq and Iran, and the slowing of global growth, especially in Asia. The market appears to have adopted a more cautious interpretation of these developments. Although futures prices have declined, the implied downward adjustment in import prices over the forecast period is about half the size embodied in our assumption. We believe that the difference reflects primarily continuing concerns about the availability of supply from Iraq and, perhaps, a different assumption about the increase in actual OPEC production--in particular by Kuwait, Saudi Arabia, and the United Arab Emirates--under the new quotas.

In terms of our overall forecast, lower oil prices, of course, imply lower U.S. inflation. The principal impact on our external forecast is with respect to the nominal balances: Our assumption of lower oil import prices translates into a projected reduction in the value of U.S. oil imports in 1998 and 1999 of about \$7 billion a year compared with the November Greenbook. Lower oil prices have only marginal effects on net exports in real terms, boosting real imports slightly.

In total, the estimated drag from the external sector in the December Greenbook is about 0.9 percentage point over the four quarters of 1998 and 0.4 percentage point during 1999. As a rough approximation, the drag from net exports would be a bit less than half this amount in the absence of the effects of the Asian crisis and the weaker outlook for Japan and the yen, using the September Greenbook as the basis for comparison. I would caution, however, that it becomes increasingly difficult to disentangle causes and effects in successive forecasts. For example, in the case of effects that are transmitted through third countries, establishing the counterfactual assumption is problematic. As an illustration, in the November and December Greenbooks, we've assumed progressively more moderate trajectories for monetary policies in the major foreign industrial countries as well as in the United States, and these assumptions have affected our thinking about the path for the dollar. No doubt some, but probably not all, of these adjustments can and should be attributed to the generally weaker global outlook and in particular to the effects of the Asian crisis, but it is increasingly tenuous to try to separate out how much is due to developments in Asia and how much is due to other underlying factors.

Some of the same qualifications apply to the interpretation of alternative scenarios. For this meeting, we have updated and circulated to the Committee a "worse case" scenario for the global economy in which the already seriously affected Asian economies experience deeper and more prolonged recessions and less recovery in their real exchange rates. In this scenario, the crisis also spreads in a major way to China and Hong Kong, and it impacts with greater ferocity on Latin America, Eastern Europe, and the countries in the area of the former Soviet Union. On our assumptions, such a worse case would further reduce the growth rate of U.S. real GDP by about a half percentage point next year and about a quarter point in 1999, compared with the Greenbook forecast, with comparable effects on other industrial economies. An important qualification to this analysis is that it assumes that the authorities, in particular those in the major industrial countries, would respond under the hypothesized circumstances by taking appropriate countercyclical actions, primarily in the area of monetary policy--that is, they would lower interest rates. As I noted earlier, in preparing our Greenbook forecasts, we have already incorporated assumptions that go in this direction; we are no longer assuming much monetary tightening. It is another matter, some might argue, to assume that policymakers will act aggressively and on a timely basis to damp a global slowdown in growth that is having differential effects on their economies. Policymakers in Europe, preoccupied with the transition to monetary union, might be less than poised to take prompt, decisive action. On the other hand, this alternative scenario is one that combines both lower inflation and lower growth, which would facilitate easing action, at least in the area of monetary policy.

Although our revised worse case scenario is possible, and you might even see it in February as our base case, I do not believe at this point that this scenario is the most likely outcome. No doubt, Asian financial markets and economies will continue to experience substantial downs and ups for some months, but my view of the situation is one of optimism combined with realism. I am optimistic that the political leaders in Asia, on balance, are acting and will continue to act constructively to stabilize their economies and financial systems and that the support they receive from the international financial community will help to bridge the gap until confidence in their policies and underlying economies returns. On the other hand, it is clear that the crisis is not over, and there is plenty of scope for additional errors or negative surprises.

Mr. Chairman, I will conclude our presentation on that note.

CHAIRMAN GREENSPAN. Thank you. Questions for either gentleman?

MR. BROADDUS. Ted, on the worse case scenario, do you have any sense of what probability you would put on that given what you know now?

MR. TRUMAN. I am never quite sure how to answer those questions about probabilities, but I would guess a fifth or something like that. How seriously should we take that scenario? I would say moderately seriously. This is not a meltdown scenario because it assumes that action will be taken by others to prevent a meltdown.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. I was going to ask Al's question, but I will ask a follow-up. Is there a better case?

MR. TRUMAN. Yes, I think there is. That's partly because we are in December and this crisis has been going on for some time. As Peter said, we have the sense of a flood rather than a severe rainstorm. The psychology is pretty gloomy, though one might say it has been slightly less gloomy in the last couple of days. It is slightly less so only with respect to Korea, not with respect to any of the other countries. But there is a scenario in which we could have a rebound in that situation. For example, their exchange rates could move back up in nominal terms--we are assuming essentially that they will not--and the global economies could pick up faster than we anticipate. I think this scenario is equally likely, though I would argue that it is not completely symmetrical. I think a better case would be associated with a series of the right policy steps in the right order, rather than two steps forward and one step back as is often the case in these situations.

MR. MOSKOW. When you say it is not symmetrical, do you mean the better case has a lower probability?

MR. TRUMAN. No, I would say the better case has the same probability, but it probably is not as good as the worse case is bad. We have a somewhat skewed distribution in that regard.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Ted, I have a question about China and Hong Kong. In early 1994, China abolished its official foreign exchange rate, and I guess that produced a depreciation of about 40 percent in their currency. That obviously had an adverse impact on the relative competitive position of Southeast Asian countries. The real appreciation of the Southeast Asian and Chinese currencies since early 1994 and the problems in their banking systems led last summer to depreciation of their currencies and related capital outflows. We now have China's relative position very adversely affected by foreign exchange developments. What adjustment is likely to occur in China and Hong Kong? China's currency is not convertible but I guess there could be capital flight out of Hong Kong. In fact, we could get a depreciation of both currencies. It seems to me there is the possibility of a rather significant adjustment in these areas, and we do not seem to be focusing on that.

MR. TRUMAN. That possibility certainly is incorporated in the worse case scenario we have laid out, though the effect may not be as big as some would argue it could be. Let me go back to one of your premises. Although there was a 40 percent adjustment in China's official exchange rate in 1994, most of China's trade--some 80 percent of it--was already being conducted at the unofficial exchange rate. So, although the sign certainly was right, we, unlike some commentators, do not think the depreciation was a major cause of all these developments. Moreover it came in early 1994, not in 1997. The Chinese financial system is very weak and has

many of the same problems, if not worse, as the financial systems in these other economies. The important difference is that the Chinese financial system is not as integrated into the world financial system so it is not a major source of external weakness. It may be a source of internal weakness, but one can debate that point. Clearly, it is not the same source of external weakness that we find in some of these other countries.

That having been said, there certainly is scope for continuing capital flight from China. I know some analysts, including colleagues on my staff, who estimate that capital flight on the order of \$10 billion a year probably is occurring today from Mainland China. It is disguised in the trade account and so forth and there are errors and omissions in the data. There certainly is plenty of money in that economy and there always are ways of getting it out, though that may require some patience. In my view, the Chinese authorities have taken a fairly responsible and nuanced position to date with regard to the yuan. In fact, at the meetings this week in Kuala Lumpur they basically said that they were not going to devalue their exchange rate, but they also indicated that they were not going to go out of their way to help neighboring nations financially any more than they already were. As you know, they have a fairly comfortable international reserve position of well over \$130 billion--the latest number that I remember seeing. So, there is a risk there. Setting aside the Chairman's view about the possibility of a downward limit to declines in other Asian exchange rates, which seems to be right to me, there is a point at which the competitive pressures on China and the different competitive pressures on Hong Kong would be felt. Therefore, I think we cannot rule out the possibility that that pair of dominoes, to use an old metaphor, could affect other Asian economies and likely have a secondary ripple effect on the United States and other parts of the world. That

is a risk, though if I were to assess the risks, I think there is a higher probability of a problem in Brazil associated in the short run with a spread of the Asian disease and a lower probability of a problem in Mainland China and Hong Kong.

MR. PARRY. It seems to me that, without getting into specific probabilities, if one were constructing another worse case, Brazil would be an interesting dimension to add to it.

MR. TRUMAN. It is in this scenario; it just may not be in the outline that we sent to you. We assumed that the Hong Kong peg goes and, as I remember, that economic growth in China drops from essentially 4 or 5 percent to zero or close to it next year and similarly in Hong Kong. That aspect of the scenario could be worse, if you want to put it that way, and in some sense it is just illustrative of what would be happening. Any of these developments could be augmented by 25 or even 50 percent without much argument from me.

MR. PARRY. Okay, thank you.

CHAIRMAN GREENSPAN. Any further questions for these two gentlemen? If not, do you want to start the go-around?

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. I will not comment to any degree on the economy of the Second District, which actually is a little better than it was at the time of our last meeting, nor on the national economy because we agree essentially with the viewpoint of the Greenbook. Since I have spent a little more than four decades on the international side of things, I thought I would devote some comments to my feel for the political and economic situation in the world. My views are not significantly dissimilar from those that have just been shared.

It seems to me that the world economy is walking along a rather narrow ridge. To the right, we have a pleasantly upward sloping meadow and to the left, a rather large precipice. The forecast essentially has the world economy continuing to walk successfully along that ridge. It is not very likely to begin to enter the meadow and experience better conditions nor is it likely to fall into the precipice. What are the dangers? If we look at the three economies in Asia that already are in the hands of the International Monetary Fund--Korea, Thailand, and Indonesia--we see that even though they are very different in many ways, they all have command economies in which resources are allocated by politicians and bureaucrats and not by the marketplace. The tool that the politicians and bureaucrats have used to allocate resources has been the financial system, and the financial systems in all these countries are extremely weak. The process of allocating resources by politicians and bureaucrats through the banking system means that a country does not produce good bankers and it does not produce good bank supervisors.

However, the leaders of these countries have had very long records of success. Accordingly, it is very difficult for them to believe that the leadership they have provided, which has taken advantage of some very real virtues--such as very high saving rates and tremendous investment in education that have created a dedicated, hardworking, and well-educated labor force--has suddenly become wrong. They really were not wrong during that long period of success. What they miss is that the world has changed, just as a number of years ago the leaders of the Soviet Union missed that the world had changed.

The command economy simply does not work today in a more integrated world with very rapid technological developments. That means that the leaders in those countries do not understand, either emotionally or intellectually, how the new economy in which they must

operate now functions. This is where there is a great deal of confusion that leads to equating these Southeast Asian situations with that of Mexico in 1994 and 1995. The differences are that Mexico has had political leadership that very deeply understands how a market economy behaves; it has had the good luck of having a president who is an outstanding economist and understands markets very well and, after a short adjustment period, it has had an outstanding finance minister who also understands very well how markets work; it has a much better, more market-oriented entrepreneurial sector and a population that sadly has had many centuries of experience with hardship and thus has the ability to adjust to this new hardship with patience. Therefore, the Mexican economy, with some very creative help from the United States and the International Monetary Fund, improved rather quickly. It began to turn upward in March and April of 1995, within months after the rescue package was put into effect. I do not think that we can have great confidence that the same favorable outcomes will prevail in Korea, Thailand, and Indonesia.

Among the other countries in Southeast Asia, Malaysia certainly has a very similar economy, but I think it is involved in an advanced exercise in denial. Even countries that have managed themselves particularly well, Hong Kong and Singapore, are being battered, as the Singapore dollar was today, by people who view them as command economies. They have been much better managed, certainly in the case of Singapore with a very high degree of integrity at the official level, but they are still regarded as command economies that may have the same problem in adjusting to the real world.

The Chinese leadership, as Ted Truman suggested, has thus far behaved extremely well. Overnight, the spokesman for Jiang Zemin, the chairman and president, said that they

would not devalue their currency. Their vice premier for economic management, Zhu Rongji, who is generally deemed to be the premier-to-be, provides very effective leadership especially considering that he has lived all of his life in a command economy that is still under Communist Party leadership. He understands rather well how the world economy works. One can hope that China will not add to the problems by making some unfortunate policy mistakes. As President Parry suggested in his questions, the temptations certainly are there.

The major command economy in Asia is that of Japan. It is after all the Japanese model that Korea followed. Japan basically has the same structural problem: Resources are allocated by bureaucrats and politicians.

one has to hope that certain steps will be taken that recognize that the way they have been managing their economy may have been grand for a while, but it no longer works.

If we were to have a continuing contagion from Asia, I think it is very likely, again as suggested by President Parry in his question and Ted Truman in his answer, that the next country about which one would have to worry is Brazil. The Brazilian real is overvalued in the exchange markets; the banking sector is extremely weak; and the political system is not functioning well except when there is a feeling among the politicians that they are about to be infected by Asia. After some improvement in facing reality a couple of weeks ago when the Asian flu seemed particularly virulent, there appears to have been a return to politics as usual. Fortunately, Brazil has a very good government team at the levels of the president, the finance minister, and the central bank governor. Argentina continues to do well, but because of its Mercosur involvement, it would not be able to withstand a shock from Brazil.

If we look at Europe, there were dire warnings at the recent BIS meeting of the dangers from Russia. Every central bank governor took us aside--Alice Rivlin, Ted Truman, Peter Fisher, and me--and said they hoped we were not concentrating so much on Asia and on our own hemisphere that we were unaware of how precarious the Russian economic situation was. That situation is exacerbated somewhat by the most recent illness of President Yeltsen. The leadership that we normally share with Europe is adversely affected, though one should not overstate this, by the fact that they are heading into the most crucial six-month period for the creation of the euro. The concentration of European political and economic leaders is very much focused on their own affairs and that of the United Kingdom. Even though the United Kingdom is going to be an "out" initially, though an "in" later, it also is going to concentrate on European economic affairs by the historical accident that its prime minister is the president of the European Union for the first six months of next year.

Therefore, it would appear that we have a world that is not likely to slide into the precipice, but that risk is very considerable. In my view, what would bring about such a slide would be the implosion of the financial systems in some of the Asian countries, as happened in a number of well-developed economies in the 1930s. That is not likely to happen but it remains a possibility.

There is a positive side. As we have been suggesting, markets probably have overreacted in relation to fundamentals. I think it is less likely but not at all impossible that, if the Asian financial systems do not implode, the markets would decide that the risk is behind us. Markets participants might decide that there are some very good buying opportunities and that there could be a recovery. The latter probably would be accompanied by a certain amount of

euphoria, which could have us entering the meadow that I described. There might be a very big question, if that happened, about the degree of realism that would accompany the euphoria and whether we would be preparing ourselves for an even more difficult situation a year or two down the path.

In the middle of all this, the United States should continue to do rather well, as Mike Prell and Ted Truman have suggested and certainly the New York Bank agrees. Therefore, I think we, the central bank of the United States, are in the very fortunate position of being able to pursue our primary long-term goals of sustained economic growth and price stability. However, I believe there is a tactical aspect relating to what I have described as the precipice on the left. Tactically, I think we should maintain an extremely flexible view of what we need to do, and that approach should characterize at least our operating view of our responsibilities in the coming months. Thank you.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, the pace of economic growth in the Twelfth Federal Reserve District remained solid in recent months, although down slightly from its trend during the first half of the year. Despite the slowdown, economic activity is expanding more rapidly in most District states than in the nation as a whole. Employment growth in the District continues to outpace growth in the labor force, pushing unemployment rates down and creating very tight labor markets, particularly in urban areas. The District-wide unemployment rate fell nearly 1 percentage point over the last twelve months.

The generally positive outlook in the District is tempered by reports of tight labor markets, shipping bottlenecks, and recent problems in East Asia. In several areas in the District,

competition for employees has become so fierce that employers reportedly are converting temporary part-time jobs to permanent full-time jobs in an effort to attract workers. Shipping bottlenecks associated with the Union Pacific rail scheduling problems reportedly have caused delays in deliveries of both final and intermediate goods, with the most affected sector apparently being agriculture.

Initial reports from District states indicate that recent developments in East Asia have reduced the demand for exports of some commodities, primarily raw and processed agricultural goods and lumber and wood products. At this early stage, other vulnerable industries such as high-tech equipment reportedly have not been greatly affected, although we recently heard that Microsoft is talking about some weakness as a result of problems in Asia. Data on merchandise exports indicate that in percentage terms the Twelfth District exports about twice as much of its estimated gross product to East Asia as does the United States as a whole. Thus, the effects of recent developments in East Asia on economic growth likely will be larger in the Twelfth District than in the nation.

Turning to the national economy, the data certainly indicate that real GDP growth remains robust in the current quarter and that inflation continues subdued. But traditional macro models strongly suggest that growth will slow next year. We expect real GDP growth of just above 2 percent in 1998. Our pure model forecast actually showed a more pronounced slowdown than this, but we boosted it a bit to reflect the effect of a possible favorable productivity shock. Just to mention very briefly a couple of the factors behind the projected slowdown: First, the dollar's appreciation over the last year and the projected slowing in foreign demand in 1998 certainly should reduce demand for U.S. products. Of course, both of these

factors are being reinforced by recent developments in Asia. In addition, real short-term interest rates appear to have been nudged up by recent declines in expected inflation. I must add, however, that there is plenty of room for skepticism about whether a slowdown this big will actually occur next year. Traditional models have been incorrectly predicting slower growth for the past year and a half. As I mentioned, it is quite possible that economic activity is being boosted to some extent by a positive productivity shock, but it is certainly too soon to tell how much of an effect this factor may be having or how long it may last.

With regard to inflation, we have reduced our forecast since the November meeting. Certainly, the continued appreciation of the dollar will help to hold down prices. Secondly, the results of the last Philadelphia Fed survey of inflation expectations were impressive. The sizable drop in long-term expectations provides an important confirmation of the evidence that we have seen from the inflation-indexed Treasury bond market. And third, recent productivity data have been encouraging, and it may be reasonable to build in a modest reduction in future inflation from faster productivity gains. There is, of course, one major factor that goes in the opposite direction. The unemployment rate has continued to fall and is now well below the natural rate.

Given all these considerations, we expect that price inflation will hold steady in 1998 and 1999 at about this year's rate. At our last meeting, it seemed more likely that there would be some upward tilt to inflation. I must add, however, that the risk to this forecast may be skewed to the upside. If economic activity does not slow as much as we expect, labor markets could tighten further and add upward pressure on inflation. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, economic conditions in the Seventh District are quite similar for the most part to what I reported at our last meeting, but the Asian situation has left a sense of greater uncertainty about the outlook. In terms of consumer spending, retailers have used the terms "sluggish" and "soft" to describe recent sales trends. That may be partly due to what has become a bimodal holiday sales season, with sales relatively stronger around Thanksgiving and the week before Christmas but weaker in-between. While it is possible that we will see the same pattern this year, at least one large retailer in our District has trimmed expectations for industry sales from a rise of 4 to 7 percent to one of 2 to 3 percent.

Light vehicle sales this month seem to be tracking around the 15 million unit rate according to our contact at the Big Three who also noted that incentives are a very important factor in maintaining sales at this level. Overall manufacturing output in the District has been expanding at about the same pace as in the nation, but trends are mixed across industries. Demand for heavy trucks has been very strong, with order books filled through the middle of next year. One truck manufacturer believes that there has been some double ordering, although cancellation rates have been low thus far. A number of District industries including steel, cement, gypsum board, container board, and housing have not experienced as much strength as seen nationally.

In terms of any impact from the Southeast Asian situation, it is still too soon to know all the direct effects on the region, let alone the indirect effects. On the export side, the Seventh District is likely to be directly affected less than the nation as a whole because the Southeast Asian countries account for a smaller share of our export markets, a flip side of the situation in the Twelfth District that Bob Parry was describing. Contacts in the food equipment, paper, and

plastic laminate industries already have seen some reduction in export orders to Asia, but they also note that business has been good in Europe. Depreciating foreign currencies and slow economic growth in several Asian markets may account for part of the sluggishness in our corn exports, but an increased supply from China, Eastern Europe, and the former Soviet Union may be a more critical factor there.

On the other side of the trade equation, auto and steel imports could rise as Asian producers attempt to find replacement markets in the United States for their products, and that would affect our region relatively more than the United States as a whole. One of our directors in the steel industry believes that steel imports will surge and that the quality of selected categories of imports will be quite high relative to the more common imports from Eastern Europe. Steel and auto industry contacts said that they were moving ahead with plans to accelerate their cost-cutting measures substantially over the next year, perhaps spurred in part by prospects of more intense import competition. As I have been reporting for some time now, labor markets are very tight in our District, with the unemployment rate at or below 4 percent since May, and we continue to hear many anecdotes of various ways that firms are dealing with worker shortages.

Turning to the national outlook, my view at the last several meetings has been similar to that expressed in past Greenbooks. GDP growth and inflation could only be contained by policy tightening in 1998. The question now is whether the deteriorating international situation will have the major consequences for the U.S. economy that the current Greenbook envisions. Of course it could, but I don't see the balance of risks pointing in that direction. Considering the strength of the underlying domestic economy, we tend to think that real GDP growth in 1998

will be closer to 2-1/2 percent than to the 1.7 percent rate in the Greenbook. Our figure factors in a substantial degree of pessimism based on the Asian crisis. Net exports subtract about 0.7 percentage point from 1998 GDP growth in our projection. Combined with some further collateral effects on U.S. financial markets, this takes us to the 2-1/2 percent forecast. This is not a worse case scenario; it is our best guess given the information to date. Regarding prices, I, too, am concerned that the favorable inflation shocks that we anticipate from the international situation in 1998 will be transitory and their reversal will have to be addressed later at a time when action will be more difficult. In summary, I see the upside risks for 1998 to be substantially greater than the Greenbook portrays.

**CHAIRMAN GREENSPAN.** President Broaddus.

**MR. BROADDUS.** Thank you, Mr. Chairman. Overall, it appears that aggregate demand remains relatively strong in our region, although reports are a little more mixed than they were a month ago. Regarding a couple of the details, general retail and service-sector activity picked up sharply in November according to our latest monthly survey. However, we also heard a number of reports of weaker auto sales over the course of the last several weeks, and recent anecdotal reports indicate that housing may be softening a little from a very high level. Commercial real estate activity, in contrast, appears to remain very strong, especially in the Washington area but generally around the District as a whole. Elsewhere, manufacturing activity moderated in November according to our survey, but there is some evidence of a firming in this sector so far in December. Labor markets--what can I say? They are at least as tight as they have been in our region, perhaps even a little tighter than they were if that's possible. We have reports of record-breaking job vacancy backlogs at a number of temp agencies. Labor shortages

apparently are resulting in some buildup in wage pressures in at least some sectors of the regional economy, especially construction and retail. Typically, seasonal workers earn the minimum wage on average during the holiday season. They are now making \$6.00 an hour or even more in some cases.

Turning to the national picture, I have to say that I found the abrupt revisions in the Greenbook projections surprising, at least their extent. Actually, this month's real growth and inflation forecasts are not all that different from last month's. But in this Greenbook, the moderation in the rate of real GDP growth and the containment of inflation take place without any tightening of monetary policy. In the November Greenbook, a significant tightening was assumed to occur over the course of 1998. I understand, of course, that this change reflects the potential negative fallout of Asian problems on the U.S. economy, but it is not at all clear to me from the discussion in the Greenbook that in terms of the most likely outcome recent developments have changed the outlook as substantially as the projections indicate.

Let me make four observations about this very quickly. First, at our November meeting I expressed concern that the widespread view in financial markets that Fed policy was on hold, at least for the time being, was preventing long-term interest rates from playing their usual automatic stabilizer role. In my view, the market reaction to the November employment reports was very strong evidence for this point of view and this concern. That report was much stronger than expected. The strength was across the board, and the report included an hourly increase in wages that was well above any reasonable projection of productivity gains. The markets hardly reacted at all. It appears now that the markets think the only thing that will make us react is a fairly substantial jump in CPI inflation. With labor markets as tight as they are, I

think this absence of the usual stabilizer mechanism coming from long-term interest rates is a significant upside risk in the outlook, and I believe that needs to be given considerable weight along with whatever weight we give to the Asian problem.

Second, a key element in the Greenbook's new projections is the estimate that the Asian crisis will double the decline in U.S. net exports in 1998 from what was projected in the November Greenbook and that net exports will reduce real GDP growth by about one percentage point next year. I don't know exactly how that estimate was arrived at. More importantly, I do not have a clear sense of what the staff would say about the confidence interval around that estimate. I think it would be helpful to know that, given the extent of the changes in the projections, although Ted's answer to my question helps to put a little more of a quantitative dimension on it. The basic point is that net exports clearly present downside risks, but we need to be careful not to overstate them when weighing them against other risks that we face in the outlook. For all of the talk about globalization, the U.S. economy is still self-contained to a very considerable extent.

Third, the flip side of the prospective widening of the U.S. current account deficit is a widening capital account surplus. The Asian crisis, as I think we all know, has redirected capital flows away from emerging economies back toward industrial economies, especially the U.S. economy. This is certainly part of the reason for the recent declines in bond rates in U.S. markets, and I think it has helped to increase loanable funds at banks. In short, the capital reflow that is occurring has some of the effects of an easing of monetary policy. I don't think the Greenbook mentions this, and I wonder whether the projections take account of it.

Finally, while the appreciation of the dollar obviously will reduce export demand, that effect will be partially offset by the restraining effects of the dollar's appreciation on prices. The better inflation performance will bolster real wage gains in the U.S. economy and probably increase household confidence that those wage gains will continue. That could well keep consumption expenditures on an above-trend path and add further to the tightness in labor markets.

In short, while events in Asia obviously are serious and present significant downside risks, the upside risks that were in the outlook before the Asian crisis emerged have not disappeared. We should not discount them in our assessment of the outlook. Thank you.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Thank you, Mr. Chairman. The economy in the Philadelphia District is operating at a high level, with most sectors doing well. Labor markets, as elsewhere, are very tight, but inflation remains subdued despite some upward pressures on compensation. We talk about the tight labor markets, but business people are doing a lot more than talking about it. They are being rather creative in terms of attracting people who ordinarily would not be available to work. For example, along some of the main arteries in the Philadelphia region, we see large signs advertising job opportunities at ABC company or XYZ company. Local theaters advertise jobs in their film clips. Instead of just getting previews of the next film, the moviegoer gets a film clip about working for specific companies. Flyers about available jobs are being distributed at senior citizens' meetings and in grocery stores. I am told that serious consideration has been given in some schools to sending flyers home with school children to invite their parents or other caretakers to call a number or come to a particular place to discuss available

jobs. The subways, buses, and taxis also are getting advertising from employers. So, business is responding to this labor scarcity and is exercising some flexibility in terms of enticing unemployed people to accept jobs. Clearly, there are limits to this process, but I think those limits are being pushed back.

In the consumer spending area, holiday retail sales seem to be doing reasonably well overall. However, one can get quite a mixed message depending on whom one talks to. Competition is fierce, and the patterns of retail sales are changing. Sales through the TV medium and catalogue sales are taking away some business from traditional retailers. The large malls with the more established stores seem to be doing well, whereas the big box retail stores and strip malls tend to be having a tougher time. We can get any story we want depending on whom we talk to on any given day, but if we put it all together, I think we come away with a sense that holiday sales are doing reasonably well.

The commercial real estate market continues to tighten and office vacancy rates are dropping. Home builders and real estate agents report that demand for both new and existing homes is quite healthy. At this point, manufacturers report some moderation in demand and output, but they do not point in particular to the Asian situation, although they may well do so over the next several weeks.

We in the Fed and other central banks focus on inflation and the goal of price stability. Being a good central banker, I always warn people of the risks of inflation and the virtues of price stability. When I finish that talk, the first question I get now concerns what I think about deflation. In my view, this deflation talk is not something one can just dismiss. That's mainly because it is coming from fairly sensible people, the same people who told us not to worry a

whole lot about inflation in 1996 and 1997 when we insisted that there was a big problem. In part, I believe these comments are reflecting the fierce competition that businesses face, and they also reflect the fact that most businesses find deflation harmful. I think they would rather have a little inflation than a little deflation. Nonetheless, while we do not have to buy into it and we want to be sure to keep it in perspective, this is something that we ought not to dismiss out of hand as coming from people who are ill-informed.

On the international side I want to compliment President McDonough on his analysis. It was a very insightful analysis of what is happening and I appreciate very much having it.

As far as the national economy goes, we are in an enviable position in terms of underlying demand in the economy, in terms of job creation, and in terms of benign inflation. There clearly are risks and we have talked about those risks for months. I think we need to be flexible both in our assessment of where the risks lie and what monetary policy might or might not have to do over the next 12 months or so.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. The Sixth District economy continues to expand at a moderate rate. Tourism remains a real strength for us, with flights to Florida already booked up earlier and faster than last year and with above-average attendance at tourist attractions for the holiday period. In particular, the influx of tourists from Latin America is reportedly boosting retail sales in south Florida. Hotels, car rental companies, cruise lines--all indicate that current and advanced bookings are strong. Similar patterns prevail along the Mississippi and the Gulf Coast. Production and new manufacturing orders have declined somewhat recently in our area, according to both anecdotal evidence as well as our December

regional manufacturing survey. However, expectations are for a pickup in both production and new orders looking six months out. Not unexpectedly, orders for textiles and apparel are reported to be declining. Also, the rig count in the Gulf slipped back a tad in the last month.

The picture for housing has changed very little since the last FOMC meeting. Home sales remain mixed, and housing inventories are reported to be in good shape. Single-family home construction has been essentially flat and multifamily construction has begun to slacken. Occupancy rates are expected to stabilize by the first of the year. As was the case at the time of our last meeting, commercial real estate markets remain healthy, as evidenced by increases in both occupancy and rental rates. However, the industrial real estate sector has shown some signs of a slowdown. Overall, both developers and real estate agents remain optimistic about the period immediately ahead.

With regard to the now familiar story that everybody is talking about, labor markets in our area remain tight. Reports of wage increases have been occurring with some greater frequency recently. In certain hot areas like Atlanta, finders fees are being offered to employees who recruit family and friends. Overall, however, prices generally are remaining steady. There are scattered reports, some coming from our District manufacturing survey, of a slight rise in materials prices.

The impact of Asian problems on our region does not appear to have been great to date. Like President Parry, we have reports of citrus shipments, mainly grapefruit, that are either being cancelled or are down considerably, especially to Japan. Port contacts in both Miami and New Orleans report some decline in the overall volume of shipments to Asia, while the port of Savannah indicates a slight reduction in shipments of wood pulp. The big Georgia Pacific

Company states that it has seen some slowing in shipments of pulp and paper to the Pacific rim, but the company had expected a seasonal slowdown in any case.

As for the national economy, the consumer sector is a little stronger than we expected at the time of the last FOMC meeting. Because of the deepening difficulties in Asia, the foreign sector has been a bit weaker than we anticipated. Business investment spending has been maintained at strong levels longer than we had forecast. I continue to be heartened by the good balance we continue to see in the economy and the fact that inflation remains moderate and is showing a slight downward trend.

Four developments have led us to modify our projections: the stronger-than-expected November employment report, the decline in energy prices, the surprising upward revisions to rates of growth in industrial capacity, and the view that the weakness in Asian economies may be greater than initially was thought. As a result, we project the consumer sector to be somewhat stronger, the international trade sector somewhat weaker, and capacity utilization somewhat lower, with inflation marginally more subdued in the near term. Both our judgmental forecast and our VAR policy model suggest that real GDP growth will be a bit smoother than that reflected in the Greenbook, with near-term growth being somewhat lower and longer-term growth somewhat stronger but with an inflation path closer to the Greenbook alternative with no stock market decline. Indeed, our VAR model, which does not consider the effects of the Asian flu, implies that if one wanted to hold the rate of inflation at about current levels, a small temporary increase in the federal funds rate would be necessary sometime next year. Considering that to be a warning signal and in light of my desire not to lose the gains we have had in bringing inflation to its current level, I regard the likely drag that the Asian problems

imply for the economy as equivalent to a slight policy tightening, but with a more immediate short-run impact on the real economy, an outcome that seems desirable at this time. Projected results should take some of the heat off both production and labor markets and may even have the desirable effect of taking inflation down another notch. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. The economy in the Dallas District continues to grow considerably faster than the nation's. Growth has remained broad-based through all segments of the private sector. The strongest employment growth has been in oil and gas extraction, followed by the finance, insurance, and real estate sectors. The only industry running at or beyond full capacity is oil and gas drilling, where supplies of all key inputs have constrained activity. A few meetings ago, I mentioned that some oil companies were going as far as Great Britain to find machinists. More recently, we have heard reports of a company recruiting welders from India. In spite of the somewhat bearish outlook for oil prices over the next year or two, most companies expect to remain profitable and are trying to expand exploration and production.

All sectors of the real estate market remain quite strong, especially the industrial and office markets. Both the Dallas and Houston office markets have had falling vacancy rates and steeply rising rents throughout 1997. In Dallas, it is expected that over 11 million square feet of office space will become available next year. That is the equivalent of about 15 Dallas Fed buildings. In Houston, plans for the construction of the first downtown office tower since 1986 have just been announced. Class A space in Houston's central business district is now about 90 percent occupied. Prices of existing homes in Texas are up 3 percent year over year, with some metropolitan markets such as Dallas showing gains of more than double that. The president of

the largest single-family real estate agency in Dallas told us that October and November were the two best months in the firm's history, and she expects December to be the same. Normally, they would be practically shut down at the end of the year for the holidays, but demand has been making that impossible this year.

Not all sectors are this robust. Employment has been weak in the apparel industry, and the announcement by Levi Strauss that it will close three El Paso plants has increased the level of concern in that community. More recently, Hasbro also announced a plant closing in El Paso that, together with the big decline in wages in Southeast Asia, has begun to undermine some of the confidence that had been returning to the border economy. The last year has not been such a good one for our manufacturers of semiconductors, electronic equipment, and instruments. While they are anticipating a better year in 1998, recent financial turmoil in Asia has damped near-term prospects.

At our board meeting last week, our director from the retailing industry reported that Christmas sales were about on track so far this season and that retailers were expecting a "ho-ho" year rather than a "ho-hum" or a "bah-humbug" year. Labor markets remain extremely tight. Sizable wage increases are reported for highly skilled technical workers. Salaries have soared as much as \$20,000 in the last year for workers such as software engineers, though the more typical increases have been in the \$7,000 to \$10,000 range. The greater the shortage, the more extraordinary are the measures taken to find workers. For example, Intel is building a chip factory in Fort Worth and is reported to have mailed letters to 14,000 engineers working at competing companies with offers of a week-long trip to Hawaii for two if they joined Intel. One telecommunications company has been helping Asian students to get visas after graduate school.

Consequently, 11 percent of their workforce of 2,500 is Asian. The company also has begun recruiting in Canada. Another large Dallas-based firm offers telecommuting to engineers who wish to live in Austin and work in Dallas. To increase the future supply of engineers, a number of leading telecommunications companies including Motorola, Southwestern Bell, AT&T, and Texas Instruments have joined forces with several leading Texas universities to form the Texas Telecommunications Consortium, which will fund research and educational programs.

Turning to the national economic outlook, it is clear that the risks have shifted considerably since the November meeting. The Greenbook does a good job of reflecting this increased uncertainty, both on the downside and the upside. The so-called "worse case" scenario is a highly plausible and unnerving one. We must be concerned that a serious slowing of world economic growth would imperil the ability and willingness of countries in Latin America, Eastern Europe, and Asia to continue their transition to more democratic, market-based economies.

This seems to be a time that calls for economic diplomacy on our part and an excellent time not to "rock the boat." Against the backdrop of continued disinflation stemming from lower energy prices, a stronger dollar, and plenty of domestic and worldwide industrial capacity, the inflation risks seem small indeed and may be shifting rapidly toward the other end of the spectrum.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, the New England region continues its recent trend of solid growth, low unemployment relative to that for the nation, tight labor markets, but only moderate price and wage pressures. There are exceptions in specific job categories where

workers are in extremely short supply, especially in information technology and engineering. Like Atlanta, the First District is experiencing a boom in tourism. We, too, have some large manufacturers who are concerned about deflation as in the Philadelphia region. But my sense is that their concern reflects a long period of very strong competition within their industries rather than any real expectation that the economy will experience broad-based reductions in prices and wages.

While it has been a short period since our last meeting, we have seen a change in attitudes regarding the sustainability of this favorable economic situation. On the one hand, there is the Asian crisis, which will both limit the exports of some of New England's fastest growing companies and increase domestic competition because of lower import prices. However, we also are told that some New England companies outsource production to Southeast Asia and may now be getting cheaper components, thereby keeping costs lower than would otherwise be the case.

The other area that has called into question the sustainability of the regional expansion is speculative commercial real estate construction. I have been reporting for some time that while the Boston commercial real estate market was very tight, with only small amounts of contiguous Class A space available, there also were no reports of plans for major building projects or much new building under way except for that related to the Artery Project going through the center of the city. That has now changed. Senior city officials told me recently that plans have been submitted for 40 new hotels in Boston proper. We also have reports of 11.3 million square feet of speculative office space being proposed for construction in the greater Boston area within the next 12 to 18 months. At current absorption rates, this additional office space will take about four years to fill. Commercial loan data support stories of an increase in

construction plans. First District loans are growing at better than twice the national rate, with real estate lending at our two largest banks leading the way at over three times the national pace. Commercial real estate lending is seen as a growth opportunity for the first time since the late 1980s, raising regulatory as well as economic concerns. We understand that a Systemwide effort is under way to investigate lower lending standards of banks. We would suggest that some follow-up be done on commercial real estate lending as well, as we are doing in the First District.

Finally, one of our directors, the chairman of State Street, sounded a warning of a different nature at our last meeting. As you know, State Street has extensive and highly mission-critical information technology systems. As a result, it has been a leader in century date change planning. Recently, State Street was asked to speak to eight very large European banks to discuss Year 2000 problems and ways to work together to solve them.

Our director believes it would be helpful and in the national interest if the Federal Reserve were to raise this issue more forcefully.

Turning to the national scene, we had prepared our own forecast prior to receiving the Greenbook. Our assessment for GDP growth in 1998 was in the area of 2.8 percent, following growth of about 4 percent in the fourth quarter of 1997. We had unemployment trending down by year-end 1998 and the core CPI trending up, even after adjustments were made for measurement changes. Obviously, in terms of broad trends this is quite different from the Greenbook scenario though it is in line with several private forecasts. In preparing this forecast,

we incorporated between .50 and .75 percentage point of negative impact on GDP as a result of the Asian crisis and a few tenths more reflecting our expectations of a general slowdown in the domestic economy. The result is that we had projected a bit less of a slowdown in GDP growth than the Greenbook.

When I looked at the Greenbook forecast this weekend to assess the progressively gloomier Asian prospects, I could accept the Greenbook estimates of the effects of the external situation. However, I am more agnostic about the impact of smaller additions to inventories and the gradual decline in stock market prices, both of which contribute to a Greenbook GDP outlook that is well below our forecast in Boston. Inventory and stock market levels are difficult to project, and I worry that they are expected to play such an important role in reining in the domestic economy. I believe there is a good probability of growth being stronger, unemployment levels more stable, and pressure on prices greater than is evident in the Greenbook, though I do agree that the Asian situation is a wild card.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. The District economy continues to grow at a healthy pace as usual. I will not dwell on much of that in detail; it is not an unfamiliar story. We recently had a couple of meetings with business leaders, and I would say the general information gleaned at those meetings indicated no major surprises. Business people are uniformly positive about the 1998 outlook. Construction is a particularly bright sector. They clearly expect economic growth to continue. All in all, I would say the forecast is generally favorable. It is also clear now, at least in our region, that wage pressures have become pervasive both geographically and by job and skill categories. It is very, very hard to find workers, and

there are more reports of larger wage increases. Some business people believe that they can offset the higher wages with productivity improvements or other actions. Some say that they expect profit margins to be squeezed in 1998 and presumably beyond. That was the general thrust of the commentary at those meetings. All in all, the District economy continues to perform very nicely.

As far as the national economy is concerned, my view is that the risks are on the downside at this stage. But in making that statement, I would not start with the current Greenbook forecast. If we compare that forecast with, say, that in the September Greenbook, we do not have any tightening of policy in the current Greenbook in contrast to the staff assumption in September. While I certainly recognize that Asia and its repercussions represent a significant shock that was not anticipated in September, we also have had more sustained aggregate demand than was anticipated. We now have tighter labor markets. We have an economy that displays a good deal of momentum. So, if I were going to write down a baseline forecast based on all of this, I would put in more real growth and more inflation than is in the Greenbook.

Against that background, I think the risks are on the downside. I say that because if the Greenbook is right that there will be no appreciable acceleration in inflation, and if I am right that wage pressures are now pervasive, which is pretty well baked in the cake, then it seems to me that the implications or at least the risks for profit margins, stock prices, and ultimately real activity are on the downside.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. The economy in the Kansas City District continues to do well. Reports from our directors and other contacts suggest a healthy business

environment throughout the region. Manufacturing activity remains strong, especially in our durable goods sector. Our manufacturing employment has grown about 1.6 percent over the past year, and that is quite a bit higher than the national average. Our most recent survey of manufacturers found that production, shipments, and new orders are all increasing at least moderately. District exports of manufactured goods to Asia represented less than 3 percent of our total shipments in 1996, so we don't think there will be a strong direct effect on District manufacturing from developments in that part of the world. Retailers reported higher sales last month and expect a very robust holiday season across the District. Our regional farm economy continues to do well.

As strong as this District report is, there are some signs of slowing. Construction activity has been flat, as are indicators of future construction activity. Housing permits grew at a rate of only 2 percent in October, down from a 13 percent rate the month before. The value of total construction contracts fell 6 percent in October, resuming a downward trend from earlier in the year. District energy activity has edged down somewhat for three consecutive months. Actually, the rig count in our District is now only about 1 percent higher than it was a year ago. Business loan activity is only modest throughout the District.

Labor markets, though, remain tight in most of the District, and reports of wage pressures have become more common in the last couple of months. However, there is still no evidence that these pressures are showing through to prices. The District's unemployment rate remains a full percentage point below the national average. Almost all the firms we have contacted are reporting labor shortages, and a substantial majority say they are raising wages and benefits in an effort to attract and retain workers. The labor shortages are especially severe for

some skilled positions. As one rather frustrated Kansas City employer said, he now feels very much like the owner of a sports team in his efforts to set salaries for data processing workers. He is being told to negotiate with the workers' agents, and he is only half joking about that. But, as I said, the higher wages are not enabling firms to raise prices.

On the national front, like others, I expect to see strong economic growth for this quarter followed by a slowing toward trend over the next year. This slowing is caused in part by the restraint on some economic activities in the United States stemming from the Asian financial crisis. However, domestic economic fundamentals remain quite healthy, and I think they will keep the economy growing at a pace around trend through next year. At this point, I expect inflation to remain modest over the next year or two despite the tight labor markets, partly because the appreciation of the dollar will keep import prices down for a while. I think the downward revisions in the utilization rate of manufacturing capacity also suggest less price pressure than we might have thought previously. Inflation continues to be low and stable, and inflation expectations remain subdued and are declining at the moment. Low inflation and inflation expectations in fact may help damp future wage demands as we face these tight labor markets.

Finally, although I recognize the upside risks and I believe they are real for both the growth forecast and the price environment, I do not see any evidence, at least not any overwhelming evidence, that action is required at this time. Thank you.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. I think it was brave of the staff to produce a Greenbook forecast at all. The increased uncertainty about world events in the short interval between meetings certainly

has widened our confidence intervals quite a lot, even though we don't know exactly what our confidence intervals are!

My own hunches are that the domestic economy may prove stronger and more resilient than the Greenbook suggests, and others around the table have voiced that feeling. I sense that we now have some momentum in wage increases, especially at the low end of the wage spectrum, and I'm not sure that declining inflation matters that much for wage increases. We may have achieved the Chairman's definition of price stability: It occurs when inflation does not play into business and consumer calculations. I also am more skeptical than the staff that the minimum wage has had a lot to do with the wage increases that we have seen. I'm more inclined to attribute the increases to tight labor markets. If that is true, the absence of another minimum wage increase going forward will not have as much of a restraining effect as the staff seems to anticipate. I also think we could see health cost increases adding more to labor costs than the Greenbook predicts, though we have not seen that happen yet. Especially with somewhat higher wages, consumer spending may prove stronger than is projected in the Greenbook. I am a little skeptical of a significant negative wealth effect if the stock market does what we all hope it will do, namely, reflect real earnings prospects company by company and drift down at a moderate rate. That kind of outcome may not have a major negative wealth effect. There also may be a little more momentum in business investment than the staff is estimating. I would not expect, however, that a slightly stronger economy would give us significantly higher inflation. Cheaper imports, including the flood of goods we will be getting from Asia, are certainly going to hold down price increases, and productivity growth may hold up a little better than the Greenbook suggests.

I, too, am mystified by the deflation question that we get every time we make a speech. I have concluded, unlike Ed Boehne, that the question should not be taken too seriously. That's because when I ask those who pose the question what they really mean by it, I often do not get a very good answer. They may have in mind something they read on the front page of the Wall Street Journal that sounds like a good question to ask a speaker from the Federal Reserve. The prospect that prices actually will go down in the face of what we normally see as continuing strength in the economy strikes me as bizarre.

On the foreign front I, too, thought Bill McDonough's analysis was extremely cogent.

I spent a week in Europe listening to the remarks of Japanese finance ministry and central bank officials concerning what they are going to do about their economy. The explanations were not reassuring. One of our European colleagues asked me if I thought they didn't understand the problem or if they just didn't have the political will to do what was needed. I said that I did not know. But, there is still a great deal of uncertainty about whether they can come to grips with their problem. There are, of course, possibilities that we could fall off the precipice internationally or even conceivably domestically if an international rout had a sudden effect on the U.S. stock market and consumer confidence, the kind of Gulf War phenomenon that nobody expected but that did happen. I think that is unlikely. On balance, I am not that far from the Greenbook forecast, although my confidence interval on anything that might be said about the next few weeks is very wide.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. What a difference a month makes! The stock market has recovered from its 500 point decline. The economy seems to be marching ahead. We have an incredible labor market and generally benign aggregate inflation, although there is quite a split between inflation rates in the goods and the services sectors. Services inflation, largely affected by wages, more than offsets price stability or deflation in the commodity and goods sectors. I think that managing in this dichotomous situation is going to be a challenge for monetary policy. So far, demand and growth are holding up quite well this quarter. We even hear debates about how to spend the federal surplus.

Under normal conditions, we would expect the current momentum to carry the economy forward at a rather high level of activity well into 1998. However, the depth of the Asian problems is still unknown. What is certain is that no one can say that the Asian turmoil has bottomed out or that the situation in that part of the world is under control. I expect that the upcoming debates about funding the IMF and the use of the Exchange Stabilization Fund will not shore up confidence in contemplated solutions. In the near term, the apparent inability or unwillingness to make changes, particularly in Korea and Japan, makes the prognosis somewhere between uncertain and grim. The terms "denial," "haven't got a clue," and "no political will" seem to crop up continually in assessments of the Asian economies. The high Asian saving rates, the culture or Asian way of doing business, and their economic growth history appear to be dulling corrective response actions.

In the United States, we see only the beginnings of an awareness of the potential problem and its effects on U.S. economic activity. Firms are now starting to assess sales forecasts, profit outlooks, and related investment plans. In any case, a widening of the U.S. trade

and current account deficits is certain. More generally, we have been expecting slower growth to occur in the United States. We may be seeing some very tentative signs of developments that could lead eventually to a slowdown. As mentioned, net exports clearly will be diminished by the Asian flu and by the strength of the dollar. Labor shortages may directly curtail expansion plans in some cases. In other cases, firms that are unable to raise prices to pass on higher labor costs may find that expansion or investment plans simply will not pencil out. Profits seem to be coming under pressure. Classic bottlenecks also are showing up, for example, in transportation. In short, the staff forecast of a reduced rate of business fixed investment makes sense. Although the fundamentals remain reasonably strong in terms of current cash flows and sales as well as the cost of capital, the risk to investment has risen considerably. The flattening of the yield curve is another indicator that some slowdown is likely. Inflationary expectations appear to have abated. Looking at the stock market volatility, I am hoping that it is reflecting a fundamental reassessment of prospects by investors.

Turning to inflation and productivity, despite press debate on the subject, the productivity picture appears to be getting a bit clearer. We have seen some improved statistics recently. There is some recognition of improvement by economists. More attention is now being directed to trying to understand what is going on in different sectors of the economy. Capacity increases help to explain the performance of inflation to some extent. We may now be witnessing some of the benefits of a low inflation or stable price environment: persisting economic growth, strong balance sheets, and sufficient confidence in forecasts to carry low inventories and make capital investments.

In sum, international uncertainty has heightened, but the U.S. economy is doing quite well for the moment. It is better to be facing this higher-risk international situation with a U.S. economy that is not fragile.

**CHAIRMAN GREENSPAN.** Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. As we meet today, both international and domestic developments give us obvious food for thought. I believe, as others do, that our watchwords at this point should perhaps be a "cautious" and maybe even a "nervous" wait-and-see stance. The trend of the domestic economy, as others have said, is clearly quite strong. The latest figures indicate continued tightness in some sectors of the labor market, particularly in the area of information technology. I also am impressed by indications of declining labor underutilization, which suggest that there are fewer people, at least domestically, who can be pulled into the labor markets by the creative solutions that others have mentioned. I am not an expert on how an employer can pull in workers internationally, but the need to attract such workers may increase. There is also some obvious strength in industrial production. The recent numbers indicate quite clearly a widespread increase in production activity. There is a large backlog of unfilled orders suggesting some continued strength in manufacturing output.

I also see evidence pointing to some moderation. If we look at the real adjusted orders measures, we see an indication of possible slowing in growth, admittedly at still very high levels of activity. While we are observing tightness in the labor market, I continue to believe that the evidence indicates an increase in productivity above the anemic 1 percent trend that we have seen thus far. It is quite clear that some capital deepening has occurred. We should continue to watch that. Obviously, there have been changes in capacity utilization measurements that

indicate some room for continued output growth without taxing productive resources. Others have already talked about recent indications of some slowing in inflationary pressures stemming from lower oil prices, which I think will continue to be important.

With respect to financial markets, it is clear that credit conditions are not overly tight. In addition, some of the evidence that President Minehan referred to with respect to investments in Boston, discussions with other bankers, and even this morning's American Banker continue to indicate some loosening of lending standards. We should be mindful of that as we go forward.

Finally, with respect to the international situation I, too, commend the analysis that we heard earlier with respect to international markets. The major issue we are dealing with there is that the recovery periods of these countries and the potential impact on U.S. prices and export demand are still very unclear. At the time of the previous Greenbook forecast, I believed that the actual outcome might end up being closer to the so-called "worse case" scenario than to the Greenbook forecast. This time, I am more convinced of that. The anecdotal evidence, at least, suggests that the Greenbook forecast as it stands now is about right. Secondly, we should also consider our own financial markets. A number of different forces evidently are driving them, but it is clear that we have declining inflation expectations, which we should continue to keep in mind. The financial markets apparently do not perceive that monetary policy is behind the curve in terms of fostering our price stability goal. I do think the dichotomy between goods inflation and services inflation will start to come more into play going forward, but at this point neither of them is pressing us to do anything dramatically different.

In summary, there are some clear stresses, particularly in parts of the labor market. There are signs of a pickup in wage-induced inflation, but there also is room to believe that

productivity gains will preclude significant wage pressures. I will admit that there are few clear signs of moderation in economic growth or price pressures. And, finally, I think the staff has the likely impact of Asia on our economy about right in the Greenbook, and I commend them for that. I conclude that this is a period to wait and see. In my view, any other posture risks upsetting a fairly complex economic and financial system that is looking for a new equilibrium.

Thank you.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. The forecast to which policy must respond is now being shaped by three powerful forces. The first is the strong cyclical upturn over the last two years. The second is the diverse set of factors--some combination of temporary influences and longer-lasting structural changes--that have restrained inflation and resulted in a virtual disconnect between the real sector and the wage/price sector. The new ingredient, also threatening to be a powerful player in its own right, is the Asian turmoil. In terms of monetary policy, we mainly have watched as the first two forces have battled to a near draw. We have remained alert and asymmetric to be sure, but mostly unmoved. Our inaction has been rewarded with exceptional macroeconomic performance. However, the further decline in the unemployment rate over the past two months and the evidence of growth at a pace still well above trend in this quarter have begun, in my judgment, to tilt the balance toward policy action to lean against the cyclical winds, notwithstanding the continued excellent inflation performance.

Simply put, an economy growing at a pace near 4 percent and operating at a 4.6 percent unemployment rate deserves to have a little sand thrown into its wheels. The Asian crisis will throw a heap of sand into the wheels of the economy. This should, in my judgment

substitute for at least part of any monetary policy tightening that otherwise might have been appropriate. This suggests the use of a comparison. How much monetary tightening would be required to yield the same slowing in growth over the next two years as the staff now expects from the Asian turmoil? Between the September and the December Greenbooks, the forecast for growth over 1998 was revised downward by almost a full percentage point and over 1999 by 1/2 percentage point. The September forecast in this comparison is adjusted to reflect the same monetary policy assumptions as in December. The effect of the Asian turmoil with allowance for a multiplier effect accounts for most of this revision. We can compare this effect with that of a 100 basis point tightening over 1998 as shown in the December Greenbook. This tightening is estimated to slow growth 0.3 percentage point over 1998 and 0.7 percentage point over 1999. The dynamics of the two shocks are quite different. Nevertheless, this comparison suggests that the effects of the Asian turmoil might easily match or exceed the outer end of any monetary policy tightening we might have contemplated over the next year. That is a lot of sand to throw into the wheels of the economy. The dynamics of the response to the Asian crisis are more front loaded, and that may be even better suited to policy objectives at the moment than a policy tightening.

The next questions are whether the staff may have overestimated the spillover from the Asian crisis or underestimated the momentum in the economy in the absence of an Asian shock. The reality is that there is a great deal of uncertainty about the dimension of the Asian turmoil. First, the situation has not stabilized in the region. Second, it is very difficult to predict the effect of the crisis on growth in that region. And third, the degree of spillover to other developing economies remains in question.

The good news is that we may not have to wait long to grade this forecast. The staff expects the effect of the Asian turmoil on the United States to occur very quickly. It may be hinted at in a downward revision to the forecast for net exports and the less favorable mix between inventory investment and final sales now projected for the fourth quarter. It will be clear for all to see, according to the staff, in the halving of growth in the first quarter relative to the fourth quarter. Nevertheless, most of the data we are likely to see between now and the next meeting will be dominated by the monthly data for November and December and the NIPA data for the fourth quarter. These data will more likely, in my judgment, signal momentum rather than slowdown. So, we are likely to have to be patient and wait for the data that will come out after our next meeting to see more clearly the effects of the Asian turmoil.

The degree of the slowdown will, of course, dictate the nature of the challenge monetary policy will face going forward. The staff forecast, now close to where private sector consensus forecasts have been for some time, presents one vision, a remarkably graceful version of what I would call a reverse soft landing. We begin from an economy already operating beyond its point of sustainable capacity, with the prospect of a slow progressive updrift in inflation. Growth slows immediately to below trend where it remains over the next two years, ending 1999 close to NAIRU. Inflation is restrained over the interval by a variety of factors; it rises only modestly, and the cumulative increase is limited by the return toward NAIRU by the end of the period. This scenario allows monetary policy to remain on hold and permits the economy to move into the year 2000 near full employment and with inflation still low. Maybe! But given the more balanced risks going forward, I certainly cannot rule out that the next move might be toward ease if the Asian shock turns out to be even greater than is now projected.

Let me offer an alternative that I believe is at least as likely as the staff forecast. This is a forecast that already has been presented today by Presidents Moskow, Broaddus, and Minehan. The economy slows only to trend. The unemployment rate stabilizes near its current level, having declined by 1/2 percentage point recently without any response from us, and inflation begins to edge upward over time. This would be a challenge for monetary policy--to tighten into an economy that already has slowed to trend when the updrift of inflation is still only a forecast. It is a challenge I believe we may still face. Certainly, as Presidents McDonough and Boehne have noted, flexibility should be our key word, both in respect to the outlook and to demands on monetary policy going forward.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. At our November meeting, at least some of us were thinking hard about tightening policy in the face of very strong economic growth, but we were deterred from doing so by the problems of Asia. The Asian turbulence, the severity of which was and still is difficult to judge, introduced major uncertainties, and we felt it unwise to stir that bubbling pot further with a shift in policy. Basically, I believe that constraint still holds. The domestic economy still looks quite strong, with what has come to be a rather standard array of driving factors. Those factors still seem to shift about but not to weaken on balance. Inflation, of course, remains dormant at this time. However, we do face some important changes. The Asian concerns have intensified substantially, and their likely impact on our GDP appears to be growing. I, for one, would bet that the news is likely to get worse before the crisis is over. For the domestic economy, the Greenbook and many analysts see a slowing in prospect that goes well beyond the Asia impact. It is driven by reductions in rates of growth in

investments by businesses and households and a slowing in inventory accumulation. To make this bet, I would ask for somewhat better odds, but there is a good probability of such an outcome.

So, I find myself once again favoring a "steady as she goes policy" but with these added thoughts. Number one, upside risks seem to me to have moderated a bit while, number two, significant downside concerns have now emerged. Taken together, while quite substantial in both directions, those risks seem roughly in balance. This is indeed a remarkable time. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. Last week we held a joint meeting of our three boards of directors. I had asked our directors to come to the meeting to convey their own views and those of other companies or organizations with which they confer. I asked them in particular to compare how 1997 was now finishing in relation to their expectations a year ago and then to characterize their outlook for 1998. The word I wrote down afterwards in summarizing all of this was one that Governors Phillips and Ferguson already have used this morning, "dichotomy." It was quite obvious that the economic evaluations were similar to the story of the blind man and the elephant in that the economy looks and feels differently to different people. Clearly, for firms in some sectors, such as metals and energy and those that compete with imports or are engaged in exports, the year 1997 was disappointing and the prospects for 1998 are not as good as previously anticipated. In other areas, retailers and especially importers say that business conditions are terrific and can only get better. One director reported that a real

estate developer who operates in Ohio and Kentucky said that his industry was starting to experience the super boom of the century.

My concerns are more along the lines of what Cathy Minehan and Gary Stern indicated earlier about where some of the risks lie. A realtor said that activity cannot increase in 1998 because his firm barely could handle all the work that was available in 1997 and it has no capacity to handle more transactions. Construction, at least in our region, cannot grow very much simply because there are no additional workers to be found. A union director said that employment in every segment of construction could increase if workers were available, but he does not expect to be able to find them and he anticipates that employment will be close to the current level a year from now. He said that even though union contracts are going to increase worker compensation only about 4 percent in 1998, nonunion compensation is rising much more rapidly. He indicated that the unions are trying to recruit and retain members by offering them more training and a focus on lifetime considerations because they cannot keep up with the competition for workers on the basis of compensation alone. A new problem for the unions is how to stop subcontractors on a site from pirating employees from other subcontractors. The unions could provide some discipline if the subcontractors were both union employers, but otherwise there really was no discipline left on projects. Most directors said that they and other people they talk to were concerned about the cost of attracting additional workers. One director commented that to keep employees under current conditions, an employer did not give them a raise within the current pay grade but jumped them two grade levels. Another argued that it was impossible to discipline workers because of the hot job market. If an employer tried to tell a worker that there were policies about showing up on time or the length of the lunch hour, the

worker simply left and went someplace else. There is no accountability. The paradox for our region of the country is that employment growth is so slow. We probably will report employment growth of about 0.6 percent this year in Ohio. The increase is so low because people are going elsewhere or there is not enough labor force growth.

On the national and international situation, I remember a meeting with my directors about six months ago and hearing them talk about how great the U.S. economy was. I said, yes, but the paradox is that the rest of the world is a mess. We spent quite a bit of time talking about the rest of the world. Oddly enough, the foreign economies have gotten worse and are likely to get worse yet. So, again the word "dichotomy" seems to fit the international context. The U.S. economy is doing very well while much of the rest of the world is very troubled. This is not the first time that that has happened; we have been in that situation before.

While we all recognize the problems that exporting and some import-competing firms are having, people generally are optimistic about the next year or two. Americans are getting richer. This is a period of prosperity. Last week in preparing for the directors' meeting, I looked at the Blue Chip forecast that had just come out for December. It had some special questions because of the Far East. Consistently, every participant in the forecast revised down their forecast of real growth and inflation because of what was happening in Southeast Asia. How is it possible that we are worse off in the sense of anticipating slower growth and simultaneously better off with low inflation, higher real incomes, and wealth rising at a faster rate? Everybody agrees that net capital inflows are going to be even larger than they were before. That word "dichotomy" has to be applied to asset prices as well as to goods prices. Some Board members referred earlier to the dichotomy between the prices of services and the prices of goods. That

clearly is the case, but the notion of dichotomy also has to be applied in the case of asset prices because we would not say that we have had deflation if we think in terms of what has happened in the stock market in the last three years.

When I get that question about deflation, I usually remind the audience that in the early 1990s we had a lot of people, including some reputable economists, writing about asset deflation because of what they saw happening in commercial real estate. They were not referring to deflation at all; they were simply talking about the prices of certain types of manufactured goods that were falling, as was the case in the 1920s. I was reading some material about the operations of the FOMC in the early 1930s. This involved a discussion of the concern about the international situation in Britain, Germany, and Japan. As we know, some countries turned to militarism because they experienced a depression while we enjoyed a boom in the 1920s. I decided to go back and look at A Monetary History of the United States, written by Friedman and Schwartz. They say at one point that U.S. monetary policy was too restrictive for goods prices and too expansionary for asset prices. That observation may strike some as somewhat curious. I think that it's a useful reminder of what can go wrong if we are too narrow in thinking about words like "inflation" or "deflation." When people use the term "deflation" today to refer to the price changes of certain types of manufactured goods caused by foreign competition, innovations, product enhancements, productivity gains, or some combination of those factors, that does raise some questions. What do they mean by the word "inflation?" Clearly, it cannot refer simply to the current prices of goods, whether domestically produced or imported. We have to think in terms of the present price of future consumption.

Three years ago, Mexican officials said that their monetary policies were not inflationary as conventionally measured in terms of peso goods prices or peso wages in 1994. That was too narrow a way to think about it. One would not have found warning signs of the problems in Southeast Asia by looking at prices of goods available in the marketplace in these Southeast Asian economies or wages paid in domestic currencies. That is not where the problem was manifested any more than it was where one would have found the problem in the 1920s in the United States, when the wholesale price index fell and the CPI rose at a 1 percent rate, or in Japan in the 1980s, when wholesale prices fell and the CPI did not increase at all. But that did not mean that they did not have a problem.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. At the last meeting, I felt that from the standpoint of domestic considerations alone, it was time to raise the funds rate. I was dissuaded from actually voting to do so by the worrisome situation in Southeast Asia. While I still favor no change this month, my reasoning has changed. On the one hand, events in Southeast Asia have become much more worrisome. Last month's worse case scenario has now become the best guess scenario, and this month's worse case scenario has gotten quite bad indeed. The impact of the Southeast Asian crisis on the U.S. economy already generates all the demand restraint that anybody should want. More tightening, I think, would not be called for. Moreover, there is still the question of what I will call international leadership. The United States does not want to be taking monetary actions that will drive up the dollar and drive down Asian currencies any more than at present or actions that reduce the growth in overall world demand any more than at present.

Domestically, too, conditions have changed. While the economy may still be on the inflationary side of the NAIRU, that is not quite as clear to me. Recently, the Board revised its capacity utilization figures showing much more productive capacity than was apparent earlier. Evidently, the respondents to the survey do not feel that much capacity tightness, and the overall utilization rate is now close to its historical average. It is not clear whether the state of demand is best measured by labor market statistics or by the capacity statistics. Indeed, the capacity statistics seem to be explaining price and wage changes better at present. Moreover, other leading indicators of price increases, such as commodity prices, gold prices, and term-structure spreads, are remarkably quiescent. All that refers to where the economy is now. If the staff is right and we are looking at a weakening economy as we peer ahead, it may be even less wise to be tightening now. Hence, I would favor no change in current policy.

Several speakers around the table used the word "flexibility" and I think that is a very good word for the present time. It is frankly quite hard for me to know where the predominant risks are, whether they are up or down. Thank you.

**CHAIRMAN GREENSPAN.** President McTeer, you wanted to add a few points.

**MR. MCTEER.** I will not insist on doing it before the break unless you want to do that. I want to follow up on the Vice Chairman's parable of the meadow and the precipice.

**CHAIRMAN GREENSPAN.** Better to do it now.

**MR. MCTEER.** Okay. He did not mention the role of the IMF, and I thought I would ask him about that and you, Mr. Chairman, as well. I know that the IMF does a lot to promote movement toward market mechanisms in command economies, and they do a lot to bring government policymakers out of an attitude of denial. But it also seems that IMF officials

promote a lot of austerity wherever they go. They have a root canal theory of the way to get out of difficult situations by canceling projects and so forth. If one watches CNN frequently, one sees a lot of Asian people on the street talking about how they are going to do their patriotic duty and stop spending money. It seems to me that there is a psychology that presupposes that the way out of this problem situation is to stop spending. It is hard to save your way to prosperity in an environment of collapsing aggregate demand. I wonder what we really think about the role of the IMF in all of this.

CHAIRMAN GREENSPAN. I think the IMF has pulled back a good deal from some of its previous statements. In addition, there has been a lot of talk suggesting that implicit in the IMF agreement with Korea is a 3 percent growth limit. Such a limit does not exist. There is a series of recommendations with respect to policy, which essentially rest on the issue of disbanding the dirigiste-type of activities, the command economies that the Vice Chair was talking about, and a series of other types of deregulatory, market-opening type initiatives from which the IMF forecasts that the growth would be 3 percent. But there is no directive on the issue of growth.

The interest rate issue is also noteworthy. I think there is a recognition that when we have a degree of instability in exchange rates, which suggests very rapid changes in expectations, small increases in the annual rate of interest are going to be overwhelmed by changes in exchange rates. You will recall that in 1992 the Swedes tried to curb a run on their exchange rate by raising their overnight interest rate to 500 percent. They discovered that when they divided that rate by 365, the daily interest rate was small relative to the fluctuations they were experiencing in their exchange rates. I believe that lesson is understood by the IMF at this stage.

The issue really is not about raising interest rates for the purpose of affecting the exchange rate. It is essentially a balancing of market forces and an effort to keep the money supply from growing too fast and potentially engendering undermining inflationary pressures.

So, I do question the IMF and their tendency to use language relating to this Southeast Asian set of actions that sounds very similar to that used to describe actions taken to counter the inflationary, government-debt type of problems in Latin America to which that language was applicable. Fortunately, when we look at the details of what the IMF is doing in Southeast Asia, it turns out to be significantly less than kind of issue. The IMF is dealing with a different regime from that associated with the problems in Latin America.

MR. MCTEER. Thank you.

CHAIRMAN GREENSPAN. First Vice President Rives, do you want to add anything to our discussions?

MR. RIVES. Nothing that has not already been said, Mr. Chairman. Thank you.

CHAIRMAN GREENSPAN. Then, let us break for coffee.

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

MR. KOHN. Thank you, Mr. Chairman. The Committee's decisions at this meeting, with respect both to its immediate posture in reserve markets and to the symmetry or asymmetry in its directive, entail weighing actual evidence of strong domestic economic activity against the prospective effects on the U.S. economy of financial and economic developments abroad and the possible interaction of any Federal Reserve action with conditions in foreign markets.

Incoming data have indicated on balance that the U.S. economy has continued to grow at an unsustainable pace. Labor markets have tightened further and give more suggestions of mounting pressure on wages. While there are hints on the spending side of some slackening in demand, this

could well be another brief pause in inherently noisy statistics; judging from continuing low levels of initial claims, employers have not yet trimmed their hiring in response to actual or prospective softening of growth in sales. Moreover, with the important exception of the dollar, financial market conditions remain at least as accommodative as those that have been associated with persistent rapid expansion this year. In fact, bond yields are noticeably lower than they have been for some time--including rates on corporate bonds despite a slight rise in risk premia. Although much of the decline in longer-term interest rates since earlier this year is probably accounted for by lower inflation expectations, real bond rates likely are no higher than they were over recent quarters, and they could be lower. Equity prices remain near the much higher levels reached over the spring and summer, holding down the cost of capital and boosting wealth. And we see no signs of additional caution by banks and other lenders in advancing credit. The ample availability of credit and liquidity is reflected in robust growth of late in broad measures of money. In the staff forecast, although the economy slows substantially, the level of output remains beyond its estimated long-run potential, and the resulting updrift in underlying inflation begins to emerge in the second half of next year. Taken by themselves, these circumstances might suggest serious consideration be given to firming policy.

But developments overseas provide the important counterweight to those at home. The dollar is higher against a broad array of currencies, as Ted discussed. Appreciation against the Asian currencies transmits a portion of the negative spending shocks those economies are experiencing to the United States. Demands from Asia for our exports are further damped by lower incomes there and possibly by financing problems that will also constrain their ability to import until confidence in their financial systems returns. And the dollar has risen against the currencies of industrial economies of Europe, putting even more downward pressure on demand and prices in the United States. Lower oil prices will reduce near-term inflation, though they will also boost aggregate demand. Changes in the level of the dollar and oil prices can leave a more lasting imprint on inflation by reducing inflation expectations a little. Altogether, these influences will override any increases in underlying inflation pressures in the next few quarters and could well help to keep inflation relatively subdued over a longer period without policy tightening, as now embodied in the staff forecast.

By the way the financial markets have shaken off incoming data, it appears that investors have placed much more weight on the potential effects of weakness abroad than on current pressures on resources at home. Not only have long-term rates fallen half a percentage point since the

turmoil intensified in October, but commodity prices have dropped substantially in reaction to the stronger dollar and prospects for weaker global demand. However, markets do not seem to be anticipating that problems abroad will on balance weaken U.S. economic performance substantially. The resilience of equity markets indicates that, aside from companies with high Asian exposures, investors do not see the foreign difficulties as exerting enough restraint on demand and prices in the United States to impair earnings prospects materially. Some of the decline in long-term interest rates, probably impossible to quantify, is associated with a flight to quality. Even allowing for such distortions, however, the flatness of the yield curve suggests that market participants expect short-term rates to remain near current levels well into the future, implying that they do not anticipate inflation pressures--or economic weakness--that would require much action on your part.

Notwithstanding the assessment of the markets and the staff, the Committee still may view policy as somewhat more accommodative than desirable at this level of labor utilization. It could be concerned that the staff and the markets have overestimated the impact of foreign difficulties on the United States. Or the Committee could view as inconsistent with its own long-run goals the upturn of inflation in the staff forecast or level of inflation expectations still embodied in long-term market interest rates. Nonetheless, there would seem to be reasons to consider postponing a corresponding tightening action. One reason would be the effect any tightening might have on global markets. To be sure, several countries have tightened policy since the problems intensified in October, including the United Kingdom, Canada, and Sweden. But their combined GDPs do not approach that of the United States and, more importantly, their currencies do not play the lynch-pin role of the dollar, which is, among other things, the currency of denomination for many of the debts of troubled Asian countries. By itself, a 25 basis point increase in short-term dollar rates would not add appreciably to the burdens of these borrowers, whose principal problems center around doubts they can roll over their debts. But higher rates and the associated strengthening of the dollar would not make their task any easier. And, unexpected tightening in tender markets does risk an outsized response, here and abroad, especially if markets extrapolate further policy action.

In addition, the cost of waiting for economic and market conditions to become clearer could be viewed as rather small, even if foreign and U.S. economies turn out to be stronger than the staff expects. With inflation already low and declining and with inflation expectations, by some measures, still above actual inflation, these expectations are unlikely to turn around very quickly. Moreover, some of the influences that will be

restraining prices in the near term should persist in any event. The dollar is unlikely to roll back soon all of its recent increases, even if foreign markets begin to recover, because the level of demand overseas will remain depressed. And oil prices should be held down for some time by greater OPEC production and smaller world demand, even if not by as much as the staff is forecasting. It might be important to firm policy promptly if growth in the United States appeared to be continuing at a rapid enough pace to tighten labor markets further, but in the current circumstances it seems unlikely that the Committee would find itself seriously "behind the curve," in the sense of chasing rising inflation expectations, if it waited until it had additional information on foreign markets and the domestic outlook.

There is always a temptation to await more evidence on the state of the economy, and the inertia this can impart to policymaking can lead to policy errors that end up creating or accentuating business cycles. However, the range of possible outcomes for the economy would appear especially large at this time, given conflicting signals from data and projections and the fluid state of foreign markets and economies. Among those outcomes is the possibility that problems abroad could exert sufficient restraint on the U.S. economy to warrant monetary policy easing. This possibility is what led us to reintroduce an easing alternative in the Bluebook after a prolonged absence. In that regard, some outside economists have marked down their forecasts for the United States by more than Board staff owing to these events. And, even if the staff's baseline is the best modal forecast, the Committee might perceive some odds--albeit small--of an even worse market disruption that could spread further and feed back more forcefully on the U.S. economy and financial markets. In something like the "worse case" scenario presented by Ted, it would be important for you to ease to cushion the effects on the United States and other economies, as was assumed in that exercise. And the worse case did not encompass a freeze up of markets and credit availability in affected countries, which could constrain their imports even more for a time.

If the Committee, like the market and the staff, now sees a more balanced set of risks going forward, including the possibility of needing to ease, it might want to reconsider the asymmetry in its directive. Retaining the current asymmetry could be justified on the grounds that in a fundamental sense the balance of risks remains tilted toward higher inflation. Persistent strength in domestic demand is likely to keep the economy producing beyond most estimates of its potential for some time. At some point, escalating labor costs should begin to pressure prices, and the sooner this situation is addressed, the less disruptive will be the correction. Moreover, of course, the Committee could ease its policy stance from an asymmetric directive toward tightening if circumstances changed

enough. But the Committee may view the odds on tightening over the intermediate term as having receded considerably, especially with price increases likely to be damped for a while. And it might want to put some weight on the original purpose of the sentences in question--that is, possible policy actions over the intermeeting period--if it considers there to be some potential that a worsening situation would call for a prompt response. If the Committee shares these perspectives, symmetry might better represent the contingencies it sees confronting policy.

CHAIRMAN GREENSPAN. Thank you. Questions for Don? If not, let me warn of our talking about the "worst" case or "worst" around-the-world scenario because everyone here can contemplate a case, which is far more negative than the so-called "worst" case.

MS. RIVLIN. Ted Truman, to his credit, did not say "worst" case. He referred to a "worse" case.

MR. TRUMAN. This time we did it right; we did not call it "worst!" [Laughter]

CHAIRMAN GREENSPAN. Oh, "worse" case. Sorry about that. There is a "worst" case, but I don't even want to contemplate it.

There is not terribly much I can add with the exception of one area that I think has not been fully addressed in our deliberations today. We are looking at a November CPI increase of 0.1 percent. In prior months, the changes in the CPI and the PPI clearly exhibited a receding trend in the rate of inflation, no matter how these measures are affected by technical adjustments. In fact, we have been observing that trend for quite a long period of time in the context of still rising profit margins, as best we can judge the latter from the most recent data.

A distinctive feature of the Greenbook forecasts in the last two or three years, which it has shared with other forecasts, has been the projection that profit margins would begin to fall immediately from the base period of the forecasts. This is important because arithmetically, as we all know, if prices are not changing and profit margins are rising, unit costs are going

nowhere. As we saw in the third-quarter profit data for nonfinancial corporations, that was indeed the case. We do not have such data for the fourth quarter as yet, but the presumption that unit cost increases are low and productivity is accelerating seems rather difficult to support considering the size of the increase in the hours input, adjusted or otherwise for hours of self-employed workers, in the available data for the fourth quarter. It will be difficult to get a significant increase in productivity in the fourth quarter with the data we already have seen for October and November unless the December hours numbers truly collapse. Indeed, some softening is implicit in the Greenbook because there appears to be a very substantial aberration in the 400,000 plus increase in the payroll employment number for November. In particular, the seasonal adjustments are dubious, not to mention the hours figures, as was explained in Part II of the Greenbook.

Leaving aside the measurement problems, there is no way of getting around the fact that, on average, productivity has been accelerating over the past several quarters. We can argue at great length about how businesses are managing their operations. Obviously, if the technological capabilities are not there, the potential real rates of return on facilities are not achievable. I don't care how assiduously businesses try to contain costs. If they don't have the necessary underlying infrastructure, they will not be able to do so. But they have succeeded in doing so, and the reason, as we have discussed on numerous occasions in the past, is that the opportunities to improve profits clearly have been expanding. I don't know what the real gains in underlying productivity will turn out to be in the fourth quarter. I don't know what they will be in the first, second, third, and fourth quarters of next year. I do know that the current Greenbook does the same thing it did last time, namely, it takes the growth of so-called total

factor productivity--the residual in the decomposition of labor productivity growth--and turns it significantly negative. The staff forecast of a pickup in capital deepening implies a full percentage point slowing in output per hour between 1997 and 1998 from what it would be if total factor productivity growth were held at its 1997 pace and another quarter percentage point slowing for 1999. I don't think any of us knows what that number can or should be. All I can tell you is that we keep getting reams of ever lower CPI readings that seem outrageous in the context of clearly accelerating wages and an ever-tighter labor market in which employers are running out of people they can hire. Yet, prices are just locked in. Indeed, as Don Kohn pointed out, if we look at the underlying price structure, we see falling prices. The Journal of Commerce industrial price index, which every deflationist and every bear uses to make this case, does indeed show prices going down significantly. That is noteworthy because this is not a particularly biased commodity price index. It may well be the best among comparable indexes.

Something very different is happening. I think the only way we can explain it is from the output per hour side. Unfortunately, that is where our data are weakest. The behavior of inflation suggests to me that potential output is a lot higher than we tend to assume. Leaving aside the mismeasurement of prices, the notion that we are on the brink of a major acceleration of inflationary pressures is correct arithmetically if we assume a stable rate of growth in productivity. It is not correct if we leave open the potential for an acceleration in productivity. The price data are telling us that the hypothesis that productivity is accelerating cannot be dismissed unless the profit figures we are looking at are all wrong. I am merely indicating that there is something quite unusual going on here, and we have been aware of this for a considerable period of time. As I have argued many times in the past and despite the latest set of

employment data, employment cannot increase indefinitely at the rate it has been increasing. Leaving the Phillips curve aside, leaving NAIRUs aside, leaving everything aside, I do not know how one can put negative people in an equation and then run it out. At some point, something has to give. We cannot increase productivity merely by an act of will. There are upside limits, so that if effective demand continues to grow as it has, there is no question that inflationary pressures have to emerge. To paraphrase St. Augustine, yes, but not yet.

VICE CHAIRMAN McDONOUGH. He said, "God, make me pure, but not yet."

CHAIRMAN GREENSPAN. I didn't want to say the first part of that! [Laughter] There is something going on here that we have not observed in decades, and maybe decades is too short an interval. I was startled by this morning's CPI report. We cannot keep getting such numbers and continue to say that inflation is about to rise. As we keep projecting a higher rate of inflation, it keeps going down, and there has to be an admission at some point that something different is affecting prices. The growing recognition of that is the reason why markets are reacting as they are to incoming economic information. That is why the big November surge of 400,000 in payroll employment had only a very slight market impact. I don't think the surge affected policy expectations and economic forecasts. The markets are responding to something that they perceive as important. We don't know fully what it is; we do not have any data; and we probably will not for a while.

As I said last time, I do not deny that the Asian problem is a crucial issue with respect to policy. But I think it is a mistake to say that we should be moving at this stage, absent the Asian difficulties. That is at least a debatable issue. I probably would come out in favor of moving if for no other reason than that this economy has been undergoing a powerful surge and

we could not do much to harm it by moving rates up 25 basis points. It is very hard to make the case that we have tight money when the housing market is behaving as well as it is, including the starts figures, granted the seasonal factors, that came out this morning. So, we have experienced unusual developments, which get compounded by the Asian situation. The Asian problem is a fascinating one for macroeconomic evaluation because, as those of you who have been involved in building models know, there is virtually no way that we can infer a very large impact on the American economy from the Asian developments in light of our fairly limited trade connections. We cannot get a very large number using the existing model structure because the latter in effect has coefficients that essentially reflect the level of confidence that has existed over the period for which we are fitting the model. We have to bring in a confidence-deterioration factor as an exogenous variable to get a different result. It is very difficult to infer it in any material sense.

In theory, we can get virtually any impact we want if we remember that what we mean by psychology is the degree to which people withdraw or reach out. In effect, it is a time preference type of issue. When people get frightened, they disengage or pull back from whatever they are doing. If they are involved in markets and are net long, then disengaging means that prices go down. If they are net short, prices go up. In most markets, participants are net long. There are very few historical periods like the Northern Pacific panic early in this century when everyone decided that there were more shorts than there were stocks outstanding. That led to a panic and everybody ran for cover; they disengaged. If people disengage enough, the payments system begins to freeze up, intermediation is curtailed, and all forms of lending contract. There is no downside in any model that is structured to pick this up, but a huge

implosion can nonetheless occur. I don't think any econometric model would have picked up the 1929-1932 debacle without a major exogenous evaluation of how human beings behave.

There is something going on out there, and I ask myself where its impact is being felt. Can it be on consumer confidence in the United States? I would say, hardly. There is no evidence of it; that would require a far greater disturbance. We are just beginning to see reports on the Asian crisis on the front pages of our newspapers. It is still not in our mindset; it is not significantly affecting attitudes. Is bank lending pulling back here? I do not see any evidence of that whatever. A significant pullback cannot be based on the notion that there are a lot of losses on loans to Southeast Asia, because our financial institutions have not lent that much to borrowers in that part of the world. Even if they lost 90 percent of those loans, it would not be a big deal.

The only place a material effect can occur is in the combination of asset prices and capital investments. For example, one can envisage a significant change in the equity premium in the American stock market. The calculations that people are currently making have the equity premium at the low end of normal ranges with very significant further increases in earnings embodied in the relationship. At any realistic earnings forecast, stock prices will be substantially overvalued. It is conceivable that we could get a significant implosion here. I believe the odds are small but not zero. What that essentially does is to create a high level of uncertainty, as the Vice Chair was mentioning. It gives us the much wider ranges of uncertainty that Governor Rivlin referred to. A lot of us were gradually becoming concerned about the range of possibilities, not the probabilities but the tails of the various types of distributions, which very clearly seem to be getting more extended.

It is useful to think in terms of the Vice Chair's analogy about the meadow on the right and the ditch on the left. Some of the market changes in Asia have been overdone. If financial conditions there stabilize, the economies in that region could very easily recover, putting us back in much the same place that we were in the sense that our economy would still be experiencing quite strong demand. There would be some lessening of export demand because it is very unlikely, given the trauma they have experienced, that the Asian economies will suddenly return to 8, 9, or 10 percent rates of economic growth. If they achieve 2, 3, or 4 percent rates for a while, that is not going to be a bad outcome. They have been subjected to a tremendous shock, and economies do not recover from that sort of shock readily. It is going to take a while for them to recover. But that is not the critical issue. The issue is whether their economic performance will be severely negative or whether these countries just will not be the Asian tigers that they once were.

As I indicated before, the IMF is facing a different type of model in its efforts to address the Asian situation. It is not clear that the problems are going to be resolved readily. I do not think the issue here is one of propping up a number of institutions. I believe there is a fundamental flaw in the Asian economic model that is only becoming apparent now as their technologies move closer to the cutting edge of technologies in the world and they begin to run into problems because government-directed investment cannot work in highly sophisticated economies. I do not think they believe that. They have had an extraordinary run for three decades. You cannot tell a Korean cabinet minister that what they have been doing is wrong.

you can do a lot of things to get them to say things that sound more

forthcoming; but you do not change a people's view of how the world works in a matter of two or three weeks.

If there is a big flood of IMF money into Asia, I think we will find that they are going to continue doing whatever they did before. They are going to behave the way they think they ought to, which is what got them into trouble. Injecting a lot of IMF money would just prolong the problem situation, but I don't believe that is going to happen. I think that there has been a considerable increase of realism in the IMF. I do not anticipate a crisis, but I do not expect a quick recovery. The problem is going to be with us for a good while, and I think it is going to have generally negative effects, the extent of which I do not have any way to evaluate.

I have gone on longer than I expected. Where I come out on policy is that I continue to believe that we will have to move rates up at some point. I see that as the most probable next move. This assumes that the Asian problem will diminish and that the tremendous underlying thrust that we have in our economy eventually will run into limits stemming from productivity constraints. But if we focus on the very short run, it strikes me that the probability of our having to move in the next month or two is exceptionally low, given the price numbers we have been looking at. The only move that we might make in this period, if we move at all, might be to lower rates as a consequence of some substantial asset deflation, a prospect that has a low probability.

Accordingly, I would be marginally in favor of alternative B symmetric this time. On the basis of the price indexes for the last couple of months, that probably is the right policy until we see some evidence, not necessarily of consumer prices, but at least of commodity prices or the prices of intermediate goods starting to move or some evidence of declines in profit margins.

All of these developments will precede an acceleration of the CPI, but we are seeing none of that, and it is going to take several months for anything like that to emerge. I think the market, in looking at central bank policy, probably is saying that the Fed will not move until we see some pressure on prices. It is not sufficient evidence to argue that the economy is running hot, that the labor markets are very tight, and that there is evidence that wages are accelerating. That is necessary evidence, but it certainly is not sufficient for a policy move unless one argues that productivity is not accelerating, that profit margins are not expanding, and that the total unit costs structure is beginning to exert greater pressure on prices that we are able to observe. As far as I can see, none of that is occurring. So, I would argue for "B" symmetric. Other members may feel that we should remain asymmetric. I could live with that without any difficulty. Vice Chair.

VICE CHAIRMAN McDONOUGH. Mr. Chairman, I think that "B" is the right call and that it is a clearer choice than the intermeeting adjustment decision. I agree with you that, absent the international events, this might be a rather good opportunity for a 25 basis point move that could do very little harm in present circumstances and probably some good toward achieving our goal of price stability. But given the international considerations, I believe such a move would be very ill-advised at this time. The financial markets are thin, both because the markets in Asia are very thin and our normally much more liquid markets are becoming thinner as we get closer to the end of the year. So, this is not a good time for a policy move, which clearly would be a great surprise in the financial markets.

I believe I have become something of a resident theologian on the meaning of symmetry and asymmetry. We have been using asymmetry since the May meeting essentially to

indicate that the central bank of the United States remembers that its primary responsibility is to foster sustained economic growth through price stability and that the balance of risks has been in the direction of rising inflation even though there has been no evidence in the inflation numbers to that effect. However, I think the international situation currently demands that we be flexible enough to respond as appropriate to unanticipated developments, so that signaling our general anti-inflation intent with a bias in the intermeeting adjustment instruction is not desirable at this point. We may wish to return to asymmetry at some later date. I certainly do not think we have reached a point where we would want an asymmetric directive toward easing. That would have to be based on the assumption of an international crisis that we are not in fact assuming. On the other hand, I also think a tightening move would not be appropriate at this time. In my view, there is almost a zero possibility that we would tighten between now and the next meeting. Therefore, the best choice is to move to symmetry, largely to avoid an emotional or intellectual bias that might make us feel that we could not respond appropriately to any critical development. With that interpretation of what symmetry means, I believe that "B" symmetric is the right judgment.

**CHAIRMAN GREENSPAN.** President Minehan.

**MS. MINEHAN.** In thinking about the current situation, I ask myself, where are the risks to the forecast? Last month, I was more negative than the staff on the Asian situation, but my sense now is that the Greenbook has it about right, although there certainly is a lot of uncertainty about potential developments in Asia. It is possible, of course, that a "worse case" situation could materialize. The Asian situation could get worse, spread to Latin America, affect Hong Kong and in turn China more significantly, and the contagion could develop into a

worldwide downturn. On the other hand, it is also possible that, given the strength of the current data, domestic growth could fail to slow sufficiently despite retarding external effects, feeding into a cycle of more intense wage and price pressures and ultimately into higher inflation. To me, these risks seem fairly balanced right now, but I think the costs of being wrong are not balanced.

If, in fact, international developments occur along the lines of the Greenbook forecast or even get worse, we will not be in such a bad situation if we do nothing now. Monetary policy is not overly tight. We have inflows of capital to the United States that are reducing interest rates. We have low inflationary expectations. There is not a lot to be lost in waiting in that case. On the other hand, if resource use is tighter than we think and economic growth is stronger than projected in the Greenbook, we could be waiting too long. Wage inflation could get embedded. It would then cost more to root it out, and it could cost more at a time when the strength of the U.S. economy is more rather than less important to the worldwide situation. In thinking about these alternative costs, I conclude that the right decision is probably not to do anything now. The underlying situation is too uncertain in Asia. I also believe that it would be desirable to see the price data stabilize, if not tick up, before we move on the inflationary front. But because I think the costs of being wrong in the direction of greater inflation are more significant than if we are wrong in the other direction, I would have a slight preference for staying with the asymmetric directive. I would interpret symmetry and asymmetry a little more broadly than simply looking at what is likely to happen over the next several weeks.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, in view of the situation in Asia, I certainly would recommend against a change in rates at the present time. So, I would support alternative B. I have a slight preference at this point for asymmetry because I do not think the distribution of likely outcomes with regard to inflation is unbiased. In my view, it is biased toward higher inflation, but in the short run--at least in the very short run--it may be less biased than it was in the past. Therefore, I would not object to symmetry.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. My policy preference today, Mr. Chairman, takes account of the new Greenbook projection, which assumes no action on our part and has the growth of employment barely getting down to a sustainable trend over the projection horizon. Given that forecast and for the reasons I outlined earlier today, I still think there is a significant upside risk in the projection, even taking account of Asia. I mentioned a number of things earlier, and one of them was my concern about the impact of rising real wages on consumption. Some of the comments around the table have reinforced that point for me.

I recognize, of course, that there are arguments for not moving at this point. There are clear reasons for lying low. Don Kohn laid them out well, and you summarized them also, Mr. Chairman. But I continue to believe that there are considerable risks to delaying action further. Cathy Minehan mentioned some of those. Weighing the reasonably hard information we have about current U.S. economic conditions against the softer projections, I still think, stubbornly no doubt, that a modest 1/4 point increase in the funds rate today would be a prudent step for us to take. It is a form of cheap insurance. In my view, not only would a small rate increase today better position policy for unanticipated strength in the economy if domestic demand should fail

to slow, but it would signal that we are prepared to take whatever actions we need going forward to contain inflation. That in itself would help longer-term interest rates resume their role as automatic stabilizers.

Let me make one final comment about flexibility. A lot of people have used the word flexibility today. I know I am shifting the context a little here, but flexibility certainly does not apply to our management of the funds rate. Over much of the last year, that rate has been parked at 5-1/2 percent. That is not the way one would expect short-term interest rates to behave in an adjusting, fluid economy. I worry that we may be introducing inflexibility by the way we are dealing with this policy instrument.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. I would support your recommendation on the "B" alternative, and I certainly would not disagree with you on symmetry. I will tell you that I, like others, remain concerned about the tight labor markets and the possible effects they may have on inflation, but I do not conclude that monetary policy has necessarily been overly accommodative. I say that partly because, as has been noted, the real fed funds rate has been above its long-run average. I know that average should not be equated to the real long-term equilibrium rate, but still it has been relatively high. I would also mention that while M2 growth has been above the upper bound of the Committee's range, it has not been substantially above that range and it is projected to moderate. As I mentioned earlier, the utilization of manufacturing capacity is near its long-term average after the latest revisions. Perhaps most importantly, as you also noted, inflation has been quite stable. Core inflation has been stable or declining, pipeline inflation is basically nonexistent, and various measures of short-term and

long-term inflation expectations are stable or declining. Long-term rates have fallen in this environment. So, I do not think that right now we are in a position to change monetary policy. Thank you.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I support your recommendation of "B" symmetric. There is no pressure to act now. It seems to me that there is time to see how things play out. Given the shape of the yield curve, the recent inflation experience, and the inflation outlook, I have to question the direction and timing of the next move. This seems to me to be an argument for removing the asymmetry from the directive.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I support your recommendation for "B." I think the case for staying where we are is overwhelming today. The issue of symmetry is a more marginal decision, and I don't have strong feelings about it one way or the other. In my view, the major case for removing the asymmetry is that symmetry is probably a more accurate description of where policy is. Now and then, I think we ought to be accurate. [Laughter]

MS. MINEHAN. Not to mention transparent.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, the economy is quite strong currently, but I believe the situation in Asia is likely to be a key restraining factor going forward. I agree that no one knows for sure exactly how severe the Asian problems will be and how they will play out. In his comments, Ted Truman did not rule out the possibility of a better case. It was not the best possible case, but it was a better case. So, there is another side to this in that adverse

developments in Asia may not be as severe as we now tend to anticipate. I agree that we should be cautious until more of the uncertainty is resolved. While I do not favor changing policy at this time, I do think that the risks are tilted to the upside. So, I would personally favor retaining the asymmetric directive, Mr. Chairman, although I could live with your recommendation for going back to a balanced directive.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, I support the recommendation for no change this morning. After trying to sort out the crosscurrents we have discussed in the last three and a half hours, I still have the sense that the Asian shock represents something of a substitute for a modest policy move. I, too, could support a symmetric directive, but on balance I would be a little more comfortable with an asymmetric directive for a while longer to make sure that the strength in the domestic economy is not overwhelming the drag we are getting from international developments. But, again, I can support a "B" symmetric directive.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I support your recommendation both in terms of alternative B and a symmetric directive. I do so principally because I believe there is more than enough uncertainty to go around. We do not know how severe the Asian problem is going to be. We do not know how far it is going to spread. We really do not know what it means for the United States in terms of quantifying it. In light of all that, it seems to me that no change in policy and a fair amount of flexibility are appropriate at this point.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. I, too, support the "B" symmetric. I don't think there is any case for moving rates down. Were it not for the Asian problem, one could make a case for moving rates up, but I'm not sure I would be totally persuaded by that case, given the CPI and the productivity information. But we do have the Asian problem and we do not know how severe its effects will be. So, it seems to me that "B" symmetric is the right thing to do.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. I, too, concur with your "B" symmetric proposal. I agree particularly with what President Stern has said. We are in an era of significant uncertainty, and I think it is important to signal to the markets that as a responsible central bank we are prepared to be flexible in our effort to address whatever challenges may emerge. I also recognize that this is an intermeeting approach, and we will have a chance to rethink this in the near future.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. After our action to increase the funds rate last March, we had a debate at the May meeting concerning the desirability of a further increase--whether we should drop the other shoe. In an environment of decelerating real growth as evidenced by an assortment of measures, related expectations of a fairly soft second quarter, and slowing money growth, we decided against raising the funds rate another notch. That decision was partly conditioned on an expectation that growth in employment, real output, and other measures was going to be a lot slower in the second half of the year in the context of fairly benign money growth. That did not happen in the third quarter, but at the September meeting we were still looking for much slower money and economic growth in the fourth quarter. So, we decided not to tighten policy then either. My guess is that if we had been focusing on nominal spending growth last May or

any of the other measures of demand people want to focus on, such as real output growth, employment growth, the unemployment rate, or various measures indicating capacity pressures in the economy, we probably would have raised rates at that time and we probably would be glad today that we did. We would not have financed so much demand over the past six months that induced a lot more imports and enabled the Asians to get themselves into a deeper hole. However, of the various reasons for not acting now, I think the Far East crisis is among the better reasons.

**CHAIRMAN GREENSPAN.** Governor Kelley.

**MR. KELLEY.** Mr. Chairman, as I said earlier, I think this is a remarkable time in the sense that we face very substantial risks, both up and down. This leads me to support strongly your proposal for a "B" symmetric directive. But there is another interesting reason for symmetry this time. It relates to some asymmetries that I see in terms of the time frames within which these different sets of risks might present themselves. The downside risks primarily revolve around the Asian situation, and if that situation blows up and forces some kind of policy easing move, that is liable to happen reasonably soon and probably fairly dramatically. On the other hand, the upside risks that have been with us for a long time are liable to emerge over the longer term and more slowly. As a consequence, we would have a better opportunity to respond if that is the way to go. So, the short-term risks seem to me to be more on the downside, and we presently have an asymmetric directive toward tightening. I would prefer not to face the prospect, should it emerge, of going all the way from an asymmetric directive toward tightening to an easing move in an intermeeting period. If we were to adopt a symmetric directive now, I

believe we would then be very well positioned to respond to whatever might emerge as time goes on, whenever it might emerge. Thank you.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. Given the expected effects and uncertainty related to the Asian turmoil, I agree that we should hold policy unchanged today. Because the risks are better balanced, I also support a move to a symmetric directive. It is, as President Boehne suggested, likely to be a much better description of our intermeeting posture. I believe a symmetric directive has the advantage of signaling our flexibility to respond quickly to a worse case scenario, should it materialize, without changing our view that the next move is still likely to be in a policy tightening direction. Thank you.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I supported a symmetric directive before Governor Kelley talked about the relative timing of the various risks, and I support such a directive even more after hearing his comments. It is doubtful that we will have to ease in the near future, but it certainly would be embarrassing to ease with an asymmetric directive toward tightening. So, I support your recommendation.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. I am for "B" with symmetry. I say that both from an international standpoint and a domestic standpoint. The one thing that gives me pause is that if we wait to see evidence of inflation, given that there are lags in monetary policy, it could be too late. I think that is a cost that we need to keep in mind, but I still conclude, given the current data on the

economy and the international situation, that "B" with symmetry is the most logical course of action.

CHAIRMAN GREENSPAN. First Vice President Rives, do you want to add anything to this discussion?

MR. RIVES. Thank you, Mr. Chairman. Real GDP growth through the first three quarters is above most estimates of potential growth. Fourth-quarter estimates and forecasts are sharply higher than they were earlier in the year. Personal spending and credit growth are expected to end the year on a high note. The broad monetary aggregates, M2 and M3, are growing at or above the announced target ranges. On balance, it appears that the surprisingly low rate of inflation in 1997 may give way to higher inflation in 1998 and beyond. Nevertheless, continued turmoil in the Asian markets argues for a steady policy prescription at this meeting. In my view, the FOMC continues to face the challenge of when and how to lock in recent gains on inflation. We would support "B" asymmetric.

CHAIRMAN GREENSPAN. There seems to be a very substantial majority for "B" and a modest majority for symmetry. Would you read the directive in that context?

MR. BERNARD. The directive is on page 14 of the Bluebook: "In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5-1/2 percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a slightly higher federal funds rate or a slightly lower federal funds rate might be

acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the growth of M2 and M3 over coming months."

CHAIRMAN GREENSPAN. Would you call the roll on that directive?

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Broaddus	No
Governor Ferguson	Yes
Governor Gramlich	Yes
President Guynn	Yes
Governor Kelley	Yes
Governor Meyer	Yes
President Moskow	Yes
President Parry	Yes
Governor Phillips	Yes
Governor Rivlin	Yes

CHAIRMAN GREENSPAN. Thank you. Our next meeting is--

MR. BERNARD. February 3rd and 4th.

CHAIRMAN GREENSPAN. February 3rd and 4th. The lunch to bid farewell to our colleague from St. Louis is scheduled to begin in about three minutes.

END OF MEETING