

Meeting of the Federal Open Market Committee
March 22, 1994

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, March 22, 1994, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Forrestal
Mr. Jordan
Mr. Kelley
Mr. LaWare
Mr. Lindsey
Mr. Parry
Ms. Phillips

Messrs. Hoenig, Keehn, Melzer, and Oltman,
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

Ms. Minehan, First Vice President, Federal Reserve Bank of Boston

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

Messrs. Beebe, J. Davis, Goodfriend, Promisel, Siegman, Simpson, Stockton, and Ms. Tschinkel, Associate Economists

Ms. Lovett, Manager for Domestic Operations, System Open Market Account
Mr. Fisher, Manager for Foreign Operations, System Open Market Account

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

Mr. Madigan, Associate Director, Division of Monetary Affairs, Board of Governors

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

Mr. Bennett, Ms. Browne, Messrs. T. Davis, Dewald, Lang, Rosnick, and Scheld, Senior Vice Presidents, Federal Reserve Banks of New York, Boston, Kansas City, St. Louis, Philadelphia, Minneapolis, and Chicago respectively

Mr. Cox, Vice President, Federal Reserve Bank of Dallas

Mr. Hilton, Manager, Open Market Operations, Federal Reserve Bank of New York

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CHAIRMAN GREENSPAN. Good morning everyone. We welcome Cathy Minehan.

MS. MINEHAN. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. I trust you won't dominate the meeting but if you do, so be it!

MS. MINEHAN. I trust I won't either!

CHAIRMAN GREENSPAN. Would somebody like to move the minutes of the February meeting?

VICE CHAIRMAN McDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection. Peter Fisher.

MR. FISHER. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Peter? I assume that the econometric model that gave you that forecast has a number of linear equations in it. [Laughter]

MR. FISHER. Yes, undoubtedly.

CHAIRMAN GREENSPAN. Would somebody like to move approval of the Desk's foreign exchange transactions since the last meeting?

SPEAKER(?). So move.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection.

MR. LINDSEY. Mr. Chairman, may I just ask one question?

CHAIRMAN GREENSPAN. Sure.

MR. LINDSEY. I'm sorry I didn't do it in a timely fashion. There was some talk in Europe that was critical of the hedge funds of banks for contributing to the instability. Do you think that worsened the situation or had no effect?

MR. FISHER. There were some days on which the criticism of hedge funds or leveraged funds or derivatives worsened the impact. That impact wasn't very long-lived, but there were a few days when comments by officials, especially the ones by unnamed officials allegedly getting tough on hedge funds or derivatives, were counterproductive. I wouldn't put that as a dominant effect but at the margin it was a factor.

CHAIRMAN GREENSPAN. Okay, I'd like to call on Joan Lovett next.

MS. LOVETT. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions? If not, would somebody like to move to ratify the actions of the Desk over the intermeeting period?

VICE CHAIRMAN MCDONOUGH. And to increase the leeway.

CHAIRMAN GREENSPAN. And to increase the temporary leeway.

VICE CHAIRMAN MCDONOUGH. So move.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection, both are approved.
Mr. Truman.

MR. TRUMAN. The subject is the permanent enlargement of the Mexican swap line. I hope the background material that was circulated to you was reasonably comprehensive and comprehensible and that, therefore, I can be brief. As was explained, there are two themes to this discussion. One is the Mexicans' desire for a substantial and permanent enlargement of their current swap lines with the Federal Reserve System and the United States Treasury; those lines are \$700 million and \$300 million respectively. The second is the United States Treasury's desire not only to be responsive to the Mexican request but also to set up a consultative mechanism on macro policy issues among the three NAFTA countries, which makes a certain amount of sense.

Specifically, what is proposed to be put in place, which is now thought would occur sometime in the second half of April, would be a consultative mechanism among the three NAFTA central banks and finance ministries and an announced increase in the swap lines. What is being thought about is for the United States Treasury and the System to increase our combined lines to either \$5 billion or \$6 billion, though I think there is a preference for \$6 billion. The new swap lines would be divided half and half between the System and the Treasury. Activation of those lines, of course, would require consent as is the case at the moment. And normally that consent would have to be linked to our satisfaction with the economic policies and reasonable agreements on repayment. Indeed, it's contemplated that all or most of any drawings would be collateralized. It is contemplated that there would be a parallel, though somewhat smaller, increase in the Bank of Canada's swap line with the Bank of Mexico, though the size has not been decided. The thought is that there would be some staff meetings with the Mexicans and the Canadians over the next month that would refine this proposal and then we would come back to the FOMC for action, probably by telegram. No action is needed today, but it was felt that a discussion would be helpful. As you know, Mexico has been the principal user of our swap network over the past decade or so. The size of the actual swap drawings has often been augmented by special arrangements. A change in the swap line at this point would clearly be linked to NAFTA and to the shift in Mexico, as of the first of April, to an autonomous central bank. It is not, I should emphasize, linked in any way to the recent pressures on the peso. I would be glad to answer any questions.

MR. FORRESTAL. I have two questions, Ted. First, is this proposal contingent in any way on Canada's moving? Second, are these conditions, for example the collateral and consultative apparatus, unique to this arrangement or do the other swap agreements have those as well?

MR. TRUMAN. On the question about Canada, I think it's required that the Canadians come in at some point. They actually do have a swap line now. Whether they will agree on the amount that the Treasury is thinking about, which is C\$1 billion to C\$2 billion or the size that the Mexicans are thinking of, which I was told is C\$3 billion, I think is another matter.

As far as the conditions are concerned, all swap lines have at least implicitly a condition in terms of the Committee being satisfied that any drawing would be supported by the economic policies of the drawing country. So, in that sense it's the same, and I'll come back to that in a minute. As for the collateral, normally we don't have any language to that effect in the actual swap line agreement. The reason for that in this case is that the Treasury has had in the past quite elaborate conditions in its own swap line with Mexico and in its other arrangements relating to outstanding swap lines. My suggestion, or my inclination anyhow, would be essentially to leave our swap line the way it is, except to say that the amount X would be raised to Y. We would rely on provisions of the Treasury's agreement for these conditions. I think that's a cleaner way to do these things. So, in principle there could be, as there has been in the past, activation of one line without activation of the other. But when an activation took place, then one could decide what conditions were warranted. We have over the years--both with Mexico and with other countries in the more distant past--always wanted to make sure that if a country was going to draw, we had some assurance that they would be able to repay us from one source or another. But the details of the conditions specified in advance have varied depending on the circumstances.

MR. FORRESTAL. But I take it these conditions are satisfactory to the Mexican authorities?

MR. TRUMAN. I assume so. We haven't had a full set of discussions, so I can't say that with certainty.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. First, just a small item of clarification. In your memorandum you say Canada's line would be increased to between C\$1 billion and C\$2 billion, but it is already C\$2 billion so I assume--

MR. TRUMAN. No, Canada's line with Mexico would be increased from its current C\$250 million to between C\$1 billion to C\$2 billion.

MR. JORDAN. Okay.

MR. TRUMAN. It hasn't been proposed yet to increase our swap line with Canada.

MR. JORDAN. Our own with Canada?

MR. TRUMAN. Right.

MR. JORDAN. With regard to Mexico, I have very mixed feelings. On the one hand, I have trouble with all the swap lines, their utilization, and the conditions. I'm still not satisfied in my own mind as to what is or is not an appropriate use of swap lines per se. And in that respect there is no reason to treat Mexico as a second class partner versus other countries; they are a very major trading partner of ours and I assume in the spirit of NAFTA there is a sense of bringing them into the big leagues. Now, whether they really ought to be on the same level with the Germans and the Japanese I'm not so sure. On the other hand, when I look at the utilization of our swap lines with Mexico in the past, it's a very troubling pattern. It tends to occur at six-year intervals, including 1976, 1982, and 1988--very questionable utilizations. And now it's 1994 and I would predict that if we do this, the line is going to get used and we are going to have trouble saying no. It might get used with a supplement even if we don't approve a permanent increase and there are going to be some very serious questions about the appropriate use of this facility in that kind of political environment.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. I didn't have a question, but a comment if that's appropriate now. I have a lot of sympathy with what Jerry just said. I think Ted has presented a number of plausible reasons for enlarging this swap. I think the memo that he distributed was very helpful and it showed that this facility has been used constructively on a number of occasions in the past. The drawings generally have been paid back promptly and U.S. taxpayers have not lost anything. So, from that kind of perspective I think we can make a case for increasing the line.

But it seems to me that there are a number of broader issues here that Jerry has alluded to that urgently need attention. The 1951 Treasury/Federal Reserve Accord established the principle that the Fed needs to be meaningfully independent within the government in order to conduct our monetary policy effectively. I think we all know that that independence is indispensable if we are going to be able to discharge our fundamental responsibilities successfully. We also know that this independence is granted only grudgingly and it's under constant scrutiny in the Congress and elsewhere. Consequently, I think we ought to be very reluctant to take any action that might have even the appearance of abusing this independence lest we lose some or all of it.

Now, with all of this in mind, enlarging the swap line with Mexico worries me a great deal. As I understand it, the line was initially established back in 1967 to help deal with balance of payments issues and specifically to help support the then-fixed exchange rate between the peso and the dollar. That rationale no longer exists; in fact, the materials that Ted distributed make it explicit that this facility would not be used for this purpose. So, it seems clear to me that any loan to Mexico in the current circumstances in essence would be a fiscal action of the U.S. government. And fiscal actions--expenditures of the government--are

supposed to be authorized by Congress and Congress is supposed to appropriate the funds. So, whatever the general merits may be of making loans to Mexico, I don't think we should be involved without explicit Congressional authorization, Mr. Chairman. So, I would oppose an increase in the swap line.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. I'd also like to make a comment. I think that one of the functions of the Federal Reserve is to seek monetary stability in a broader framework than just the American economy itself because of the obvious interlinkages of world markets, as we have heard this morning in Peter's and Joan's presentations. I think that has a great deal to do with why we created swap lines with the major trading partners of the United States and countries that in the past have been a very important part of the world's interlinked financial system. Mexico, because of a very much better performance over the last twelve years, has now reached a stage where its economic performance seems to me to justify being included as a major partner of the United States and the other participants in the world economy. It also is a country, being on our border, in which serious financial instability would have a very definite possibility of spreading across the border and creating problems in our own markets. So to me it is appropriate to have the swap line used in times of market instability, which may or may not be related to years in which there is a presidential election, as long as we are careful that it is not used to prop up the value of the Mexican peso when all the fundamentals say that that would be inappropriate. I think it's very consistent with our general responsibilities. So, I don't share the view that it is something that is inconsistent with the role of the central bank and therefore would demand approved funding from the Congress. I think it's just as much a part of the responsibilities of the Federal Reserve as the swap line with Germany is.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Well, I must admit that I can support the recommendation. What concerns me most, however, is its potential use, a concern related to Jerry's. I recall the paragraph in the Maroni memo referring to the fact that in 1988 the swap line was used for window-dressing operations to enhance the announcement of the country's reserves scheduled to be made by the Director General of the Bank of Mexico on August 4 and the President of Mexico on September 1. I think of swap lines as being used to deal with disorderly markets. I think someone who wants to could make a case that perhaps they were being used for political purposes. The kindest light one could put on it is that they were used to prevent the occurrence of disorderly markets, a view with which I'm uncomfortable as well. It's not so much the authority that bothers me; it's the potential in my view for misuse of the Mexican swap.

MR. TRUMAN. Their argument at the time obviously was that announcing a drop in their reserves would cause problems on the financial markets and that was the reason we went along with their request.

MR. PARRY. Hasn't there been a tradition to use swaps to deal with disorderly markets or do we also use them to prevent disorderly markets?

MR. TRUMAN. I think they have been used for both purposes. At times when we have been involved, there have been so-called window-dressing operations. There were some in the 1980s. During the 1982 period they were driven by a slightly different set of considerations that had to do with domestic currency cover concerns. I think it is right to question--and I would put it the other way around--whether central banks

I think it's fair to say, however, that all central banks do this these days though they tend to use other mechanisms to window-dress the reserves rather than central bank swap lines. You could argue that the use of central bank swap lines, which ultimately becomes public, seems much more forthcoming than what has done to manage their reserves over essentially the past 20 years when they have

MR. PARRY. But these Mexican swap lines were used in 1976, 1982, and 1988 as well. The political aspect seems apparent.

MR. TRUMAN. Well, there have been occasions on which they have been drawn other than in Mexican presidential election years. But it is true that those last three have been election years.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I have to admit some ambivalence toward this. I think that to use the swaps, as the memos themselves imply, to influence exchange rate levels is risky business. I do agree with Bill McDonough that they can be used to stabilize markets. My question is about the size of the proposed increase. From the material the rationale for the number that we are shooting toward now, the \$6 billion total, wasn't clear to me other than perhaps that the economies are larger. This is a larger number but it's not necessarily the right number for any particular reason. Is that a fair interpretation?

MR. TRUMAN. That's a fair interpretation. The \$5 billion number was a number that in fact the Mexicans put forward a year ago when they approached us and they had done a rough back-of-the-envelope calculation of the increase in swap lines since the swap network was first established. One can come up with these numbers for various countries in a lot of different ways but it's fair to say that the largest increase in our trade since 1967 has been with Mexico, both globally and bilaterally. That's where the \$5 billion number came from; the \$6 billion number came from the fact that that was the number we contemplated providing last November in the context of NAFTA. So that's the source of those two figures. Neither is based on fine scientific analysis.

CHAIRMAN GREENSPAN. First Vice President Minehan.

MS. MINEHAN. I have a question and a comment. Ted, is it accurate to say that Mexico has been the only country since the early '80s to actually draw on the swap lines?

MR. TRUMAN. Yes.

MS. MINEHAN. So the conditions that we impose on Mexico in some sense do not involve treating them like a second-class citizen; those are the only conditions that are really operative at present in terms of our swap lines.

MR. TRUMAN. Well, we went the same way in the past. The most recent other drawing was in the early '80s by Sweden. And we asked ourselves the same questions at that time, about how long the drawing was going to be outstanding, what the conditions were, and how they would contemplate repaying it. So in that sense we asked the same questions as in the Mexican case.

MS. MINEHAN. I would generally agree with President McDonough that this is a legitimate function of central banks in general. But I would be concerned, to whatever extent we enter into this swap agreement with Mexico, that we do so on a businesslike basis for us. In that regard I'd be a little nervous about relying on the Treasury's collateral. I'm also bothered, as other people have been, by the history of the drawings and the amount of money that seems to go from one source of funds to another source of funds to pay each of them back. And I would be concerned if we didn't take measures on our own in terms of this very substantial expansion of the line with Mexico so that if it were to be drawn upon we would have independent means of securing our own exposure.

MR. TRUMAN. Well, maybe I have not been clear on this. What I was suggesting, just as a matter of convenience, was not that we would rely on the Treasury but that the Treasury could put the conditions in their swap arrangement because they have done that in the past. We have not put such conditions in our agreements in the past, whether it's the \$6 billion line we have with the Bundesbank or any of the other lines. And when it came time for a drawing, then we would draw on those conditions rather than have the lawyers specify all those things in advance and have to rescrabble them when the time came for a drawing. I was speaking just in terms of convenience from our side.

MS. MINEHAN. So you would contemplate that if they ever needed--

MR. TRUMAN. They would have to come and ask to draw on the swap line and we would have to approve it. And at that time we would say, "Well, yes, we will approve it as long as we make these collateral arrangements." That's what I would contemplate rather than pre-specifying those conditions. But we'll do it either way.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I would support the proposal. I think I heard Al Broaddus saying that since the line wouldn't be used to peg the exchange rate then it is likely to be used for some other purpose that would be less legitimate and outside of our scope. However, a crawling peg is a peg when you reach the limit of the crawling peg. And at that point it does become an exchange rate stabilization tool. Also, I would like to associate myself with Jerry Jordan's introductory comments where he pointed out that if we have problems

with swaps, we ought to deal with that as a generic matter and not deal just with the case of Mexico.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. What are the consequences of not approving this request?

MR. TRUMAN. I don't know for certain; that's why we are having this discussion, if I may put it that way. If the weight of opinion in the Committee was against going ahead with this request, I think we would inform the Mexicans and the Treasury in advance so that they didn't embarrass us and themselves--particularly themselves--by announcing something they couldn't deliver on.

I think the consequences would be that the Treasury would go ahead and enlarge its own arrangement, presumably substantially. Whether they would go all the way to \$6 billion and leave us at \$700 million, I don't know. But something like that might happen. And that would affect to some extent, I think, our relations both with Mexico and with the United States Treasury at this point. But it wouldn't be the end of the world.

MR. BOEHNE. Well, there are these two issues. One is the wisdom of swaps in general and how well they've been used. Then there is the question of whether Mexico ought to be treated differently. The \$6 billion is in line with trade flows and various other economic ways of measuring these things. So really it's the second issue of whether Mexico should be treated differently; I think we are not really talking about the wisdom of the overall swap arrangements today. So then my specific question is--and I don't think you really answered the question, Ted--what are the consequences of treating Mexico differently? What are the consequences of nonapproval? I'm not clear in my own mind what those consequences are. I don't come to these discussions on intervention and foreign exchange markets and swaps with any ideological baggage. I just want to know what the practical implications are of our actions or lack of action.

MR. TRUMAN. I'm sorry I didn't answer your question. I'm not sure what you mean when you say "treat Mexico differently." If you mean by turning down their request, there have been a number of countries over the years whose requests, either to join the swap network or to enlarge existing swap lines have been turned down. So nonapproval of their request would not be unprecedented from that standpoint, though in most cases the countries that were turned down were discouraged before they had gone very far into the process. But it would obviously have adverse implications at least in the short term for our relations with the Bank of Mexico--and I think it is not irrelevant in that regard that the Bank is now entering into a new status--and also would have some adverse implications for our participation with the Treasury and the Canadian authorities on the macroeconomic policy coordination process. I can't speak for the Treasury, but my guess is that they would be less inclined to pursue the arrangements they are now contemplating if we were to back down. We do have a long-standing relationship with Mexico and they have called upon us in the past for assistance. There have been some debates about whether it has been appropriate, but it's fair to say that the Federal Reserve has taken the lead in many cases in helping

Mexico over the past 20 years. So, nonapproval would really have some implications for our relations with that country and that central bank.

MR. BOEHNE. What are the consequences of something less than \$6 billion?

MR. TRUMAN. It's doable but I'm not sure it's worth arguing about, if I may put it that way.

MR. BOEHNE. All right.

CHAIRMAN GREENSPAN. Let me just add a point here. When Treasury approached us, we toned them down a good deal; we set up a lot of road blocks in periods when they wanted to move. And we have that capability of restraining actions which I think this Committee, myself included, feels uncomfortable with. If we decide that we want to disengage, we will lose whatever power in that area we have to influence the system, and that has pluses and minuses to it. Obviously, we can't acquiescence in a system that is inappropriate. But there is an interesting tradeoff here, which I think we have to be aware of, when one asks what the consequences are. I think one of the consequences if we pull away from this is that there will be a set of policies in this area that we would find less agreeable. It would be worse for the country. It might be better for the Federal Reserve; that's a possibility. But I think we have to keep that in mind. I'm not saying that anytime somebody comes up with one of these proposals we should dive in. I feel increasingly uncomfortable because my inclinations, frankly, are similar to much of what I just heard. But there is a lot riding on how this whole thing comes out. If we say no, there will be both pluses and minuses I might add.

MR. BOEHNE. So this is really the price of admission to a bigger show?

CHAIRMAN GREENSPAN. It's a partial price, I would say. We have never been in a position with this Treasury of essentially thwarting something about which they feel strongly. Basically Secretary Bentsen, I think, feels very strongly about this; he was an ardent supporter of NAFTA. It is his belief that American interests in the international financial arena rest to a large extent on our extending those interests throughout Latin America and enhancing America's international trade position through a NAFTA-type agreement in that part of the world. This is part and parcel of that operation. And in many ways if we pull away, I think we lose a good deal of influence in trying to determine how that all comes out. There is a limit. I'm not saying we should merely do what the Treasury says because in fact if we had done what the Treasury probably had in mind before we put our hands up, I think we would have been acquiescing in a very loose policy. One second, Bob Parry is first.

MR. PARRY. I certainly would not favor disengagement and I don't have problems with the numbers that are being proposed. Is it feasible to have an agreement among the Treasury, Mexico, and us--and for that matter others with whom we have swap arrangements--that the swaps would be used to deal with disorderly markets? I would feel much more comfortable.

MR. TRUMAN. Well, let me make two points. This Treasury certainly agrees that we do not want to get engaged in using the swap line to peg the exchange rate. That's point number one. Therefore, in the circumstances, we are dealing essentially with pressures on the exchange rate, which as President McTeer explained, can exist even with a crawling peg or a floating exchange rate. We ourselves drew on swap lines in the late 1970s when we were operating with floating exchange rates because we were intervening. Presumably the discussions, including the ongoing discussions associated with the consultative mechanism, are designed not to surprise ourselves, so to speak, when these things come up. On the question of window-dressing itself, I think it is fair to say that it's a little difficult--particularly for me speaking as an outsider--to bind all future members of the FOMC. But I think it would be perfectly appropriate, based upon this discussion, to convey to the Mexicans in the staff level talks that we are going to have in the next few weeks that there is extreme reluctance to use the swap line for window-dressing purposes. And, therefore, since they have to come and ask our permission to begin with, they should know in advance that that's an even harder sell, if I may put it that way, than dealing with more garden variety disorderly markets.

MR. PARRY. That's helpful to me.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I guess I'm somewhat confused because the comments around the table seem to address different parts of this issue. Are we discussing the merits of swaps, period? Are we discussing the merits of any swap line with Mexico? Are we discussing just a request for an increase in the swap line with Mexico? Or are we discussing the use of the swap with Mexico? Or all of the above? It sounds like all of the above to me. But it seems to me that this discussion may be long overdue if we have a whole array of these arrangements in place with various countries, so perhaps we should be trying to delineate or define better what our standards are for engaging in swaps. That's point number one. And point number two is then insuring that any swap arrangement meets those criteria.

I certainly have great trouble with the use of the swap either for pegging exchange rates or for window-dressing purposes. I think that's inappropriate. On the other hand, it seems to me that Mexico has, within certain limits, handled the previous drawings quite responsibly even though there may be some question about the purpose of one or two of them. They handled them responsibly in terms of their meeting the conditions of the swap, if I have the right impression. So, if we are going to focus on the use of the swap line, accepting that swaps are appropriate in certain cases, then maybe what we need to do is to define what we regard as an acceptable use of the swap. We have heard all the things we don't think are acceptable. What is an acceptable use of the swap other than to address disorderly markets? That is not a question, I guess, but rather a general statement of my confusion.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN McDONOUGH. To continue Governor LaWare's train of thought, it would appear that at some stage we may need a greater

and deeper philosophical discussion of swaps. But that isn't really what we should be talking about today, it seems to me. We do have swap facilities. Also, we are not discussing whether we should have a swap facility with Mexico; we have one. So the only question before us is to give the Board's staff advice on how to proceed in the discussions. As Ted pointed out in his opening remarks, he's not asking for a vote; all he's asking for is some guidance. I am very much in sympathy with what the Chairman said about the role of the Federal Reserve among the American monetary authorities--the Treasury and ourselves--that it is important for us to continue to have the very positive influence that we have had. And having participated in that responsibility myself, I think we have used it very wisely and constructively both at the level of the Chairman and the governors and Ted and the New York Bank when it has been involved. I think it would be very unfortunate if the Federal Reserve were not involved at this particular time given what is soon to be an important event in Mexican history. And that is that in a country in which the power of the government is almost unmatched anywhere in the world, they have decided to have a truly independent central bank. That's a major structural reform which it seems to me that we as the central bank of the United States should be supporting by responding to a request which in any case appears to be reasonable.

As for what purpose swaps should be used, again I'd suggest that we look at the record of the American monetary authorities, which is very tough-minded and very good. Ted has been a kind of permanent feature for many years and anybody who thinks he has been a pussycat in these matters would be very confused. Our experience with the present Treasury so far is that they seem to have a rather serious, sensible attitude toward international cooperation on monetary matters. The difficulty with saying swaps can be used for X, Y, and Z is that nobody can define a disorderly market. You know one when you see one, but they take on various forms. I think our conversation has been very good in reminding Ted of the views of the Committee, which he probably already knew and shared anyway. It reminds us all that the view of the Committee, in my phraseology, is that the swap facilities should be used wisely and well. But figuring out exactly what that means is best done at the moment that a request comes in, which also in my view supports the Federal Reserve's traditional position that instead of putting a lot of conditionality into the agreement we should establish the conditionality and the whole financial arrangements in light of what's going on at the time of the request. Then we can be very tough-minded; we can be very specific and demand what's appropriate at that time, which is very, very difficult to anticipate in advance.

CHAIRMAN GREENSPAN. President Parry, quick question?

MR. PARRY. Yes, point of clarification. You are quite correct that it's sometimes difficult to define what is a disorderly market, and everybody would agree that we should give the authorities the judgment on that issue. But the issue is whether the authorities should attempt to prevent what might turn out to be a disorderly market versus dealing with a disorderly market.

VICE CHAIRMAN McDONOUGH. Sure. Just a very brief response: I think where honest people could differ is if we were moving toward what we were very certain was going to become a disorderly market very

quickly--for example, if we and the other central bank involved knew that the reserves were really moving out. Then we'd have to decide whether use of the swap line was appropriate. We wouldn't want to fight the market and defend an artificial exchange rate. But we might be inclined at least to entertain a request for a drawing on the swap facility. I'm not sure the answer ought to be "yes." It may very well be that the answer is "no."

MR. PARRY. I hope so.

VICE CHAIRMAN McDONOUGH. But since disorderly markets are so hard to define, to have the combination of, say, Summers and Truman raise their hands and say this is a disorderly market and then we debate whether they are right or not is not something I think we want to get into.

CHAIRMAN GREENSPAN. You know, this is a much more profound issue about the nature of the Federal Reserve System than I think we realize. It really gets to the issue the Vice Chairman was raising earlier as to what type of institution we want to be. And I sensed this whole philosophical debate in the discussion we have been in the process of going through dealing with the issue of supervision and regulation and a consolidated bank regulatory system. I think one can make a very strong argument for the central bank as a narrow institution that basically maintains strictly central banking operations. In that narrow sense, it's not obvious to me that we would be involved in swaps and it's not obvious to me that we would be involved in currency intervention. We would restrict ourselves strictly to domestic monetary policy--and this gets to this other issue--with an add-on of other functions like supervision and regulation and the like.

What this question is really all about is the stance of the central bank in a broader context, in other words a role in which we do get involved in issues which are in many aspects at the Treasury's lead. If we want to influence those or want to affect them, it's obvious if we try to do that, as we indeed have been doing, that we run into certain types of questions about the nature of central banking per se. I think the issues that are being raised here are quite legitimate. They are not issues that relate directly to this narrow question, however. They really are fundamental to the nature of what type of central bank we wish to be. And there are strong arguments on both sides. I have seen the influence of this institution in this Administration and in previous ones and I would hate to give it up. I think we are a force for good. And if we decided to pull in our horns, I think we would be doing a disservice to the nation. I fully recognize the concerns that have been expressed today, and I'm as uncomfortable as any of you. And unlike Ed Boehne, I do carry intellectual baggage into this discussion. I'm afraid my views are more like those of Presidents Jordan and Broaddus than anything else, but I do recognize that there are other issues involved. Anyway, President Broaddus.

MR. BROADDUS. Well, I was simply going to say that going forward we need to keep in mind that there is a tradeoff between the good we can do with a somewhat broader function and our independence. I think we always need to have that in front of us. But the other point is that as a Committee we need to take a fundamental look at

some of these basic philosophical issues. The problem I have with the current proposal is that it's difficult to disentangle the proposal from the broader issues. If we do this now, then it's going to be somewhat more difficult subsequently, at an early date, to look at the broader issues because the current proposal takes us down a particular path. That bothers me.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. The questions I had in mind have been largely answered by your remarks just now and by Bill's remarks before, putting this matter into a broader context. I think your remarks are extremely important. The reason is that the way we conduct ourselves this year with regard to this issue and how that's viewed when it gets scrutinized by others could tell us a lot about whether this is or is not a desirable thing to do. We need to know if it is accepted on Capitol Hill, at the Treasury, and by others subsequently.

One other comment is that I'd be very careful about going too far with the linkage of the timing of this with other developments. I think NAFTA was a wonderful development, as I'm sure everybody else does, and what the Mexicans are going to do on April 1st I think is terrific. But I wouldn't want to link this too closely to that because I don't know whether Costa Rica or Chile or who will be next in line or when. But to say that joining the free trade agreement and broadening participation in this sort of thing means that as soon as they make the central bank independent they can join the swap club is not a message we want out there.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, I am in general very supportive of your comments, and I have the exact concerns that you and my colleagues have. But two points came up in this discussion that troubled me. The first is the use of the phrase "this Treasury."

CHAIRMAN GREENSPAN.

MR. LINDSEY. Well, if I read this morning's paper correctly,

CHAIRMAN GREENSPAN. What did you see in the paper this morning?

MR. LINDSEY. Apparently there was some talk in the Washington wire or one of those columns that he's going to be out but

that Mr. Altman will not be the successor, Mr. Rubin will be. That's just part of it. Is that malicious gossip?

CHAIRMAN GREENSPAN. That's U.S. news.

MR. LINDSEY. That's U.S. news. It has nothing to do with the point except that I want to make certain that we are clear in our own minds that we are not making a deal with "this Treasury," "this Secretary of the Treasury," "this Deputy Secretary of the Treasury," or "this anything." So we should not cloud our judgment because we will be in bed with other Treasuries and other Secretaries of the Treasury as well.

Parallel to that is the phrase that was unmentioned and that is "this Mexican government," which is very much like "this Treasury" except that it is much more volatile than "this Treasury." "This Mexican government" may very well be replaced and we don't know who the replacement is going to be.

So before we jump on board with our very warm and legitimate feelings toward "this Treasury" and "this Mexican government" we ought to realize that's not who we are really signing on with.

The other question I had--this is actually a question rather than a statement or speech or whatever--is how do we say "no"? What I've felt very reassured about is double bullet two on page 3 of the memo and that is that drawings on the Federal Reserve swap line would continue to require the agreement of the FOMC. I assume, therefore, that when these unstable market conditions occur the Chairman would call a conference call and we would discuss it and vote on it as needed. Is that correct?

MR. TRUMAN. Yes, although it depends on the circumstances; but yes in principle. In the past that's how things have happened and I would expect no matter who is the Chairman that's how things would be done.

MR. LINDSEY. Well, this Chairman will be with us a long time.

MR. TRUMAN. We are not always perfect at this, but in the past efforts have been made by the staff, particularly in the case of Mexico because the Mexican swap line has been more actively used than the others, to keep the Committee informed about developments and to try to anticipate possible requests. There have been discussions and consultations with the Committee when there have been approaches to us. Maybe I shouldn't mention it, but the recently released transcripts included a conference call in October of 1988 about a special swap arrangement which in the end never was implemented, but that was discussed extensively by the Committee at that time. And I would presume that that's the way things would happen in the future.

MR. LINDSEY. Well, I think the real question to ask is how hard do you think it would be under real live circumstances for us to say "no"? Say, for example, we are coming up on two weeks before the Mexican election and there is a legitimate run on the peso--a

disorderly market because it looks as if someone else is going to win or whatever. That is a real live case. It's hard to separate out the politics from the economics. And if we have a disorderly market, could this FOMC easily say "no"?

MR. TRUMAN. Well, I think it would be difficult to say "no" if they came to us, as they have in the past, and asked for a special arrangement, too. Obviously, you would confront a slightly different situation if they have a \$6 billion--in our case \$3 billion--swap line with us; it may be slightly more difficult to say "no" to an actual drawing than it would be to set up some special arrangement. But we can say "no." In 1982, for example, we said "no" repeatedly. We were dealing with a set of circumstances which were quite different from what one would hope to see today or in the near future. But we repeatedly said "no." We did allow them to have a few window-dressing operations, but that was part of a strategy that set out to get them in the position so they would go to the International Monetary Fund and they would change their policies.

So I think the Committee and the Chairman of the Committee would have to make those decisions as they came to them. In some sense, you'd have to make those decisions anyhow. We can't disengage from Mexico; I think that's the point that President McTeer made basically. Mexico is there, and we are going to have to deal with its central bank and all its problems regardless, because we are neighbors and have to share largely the same space.

CHAIRMAN GREENSPAN. President McTeer. And I hope you have the last word because we are running up against time.

MR. MCTEER. I have just a fairly narrow question. This says we are considering a substantial enlargement of the Federal Reserve and Treasury swap lines with Mexico. We are the central bank, the Treasury is the finance ministry, and Mexico is a country. I see in the footnote, though, that the swap line is with the Bank of Mexico and with the Mexicans. Is it central bank to central bank--

MR. TRUMAN. In our case it is central bank to central bank and will remain that way. In the Treasury's case, currently it is the Treasury using the Federal Reserve Bank of New York as its agent with both their treasury and the central bank of Mexico. I assume they will continue that practice, but that's a question the Treasury has to address. But as far as we are concerned, the only issue that would come back to the Committee would be whether to enlarge our swap line with the Bank of Mexico from \$700 million to X.

MR. MCTEER. Along the lines Larry was getting at, I think it's reassuring that we are dealing with the central bank rather than the government or the treasury.

CHAIRMAN GREENSPAN. Does anyone else want to have the ultimate last word? Let's then move on to our economic discussion and Messrs. Prell and Truman.

MR. PRELL. Ted will begin.

MR. PARRY. This is out of order!

MR. PRELL. We switched.

MR. TRUMAN. [Statement--see Appendix.]

MR. PRELL. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for either gentleman?

MR. JORDAN. I attended my first meeting of this Committee two years ago at the March meeting. Over those two years I've been tracking the migration of the staff forecasts on nominal and real GDP, prices, and so on meeting to meeting. And at my first meeting in March of 1992, the projections for 1993 that the staff had at that time were for lower inflation than is now forecast for 1995. We started getting forecasts of inflation for 1994 in August of 1993 and through March of 1994 the forecasts for 1994 were below the current forecasts for 1995. And now I look at the forecast that we have for 1995 and this trend of inflation in the out years revising upward worries me. If it's causal, then maybe I ought to leave the Committee and these forecasts will go back down again!

In trying to understand this and how you make assumptions about policy that go into putting together the forecasts, Mike, you've said in the past that you try to read what the Committee is saying and thinking with regard to its objective, in order to try and ascertain a policy consistent with achieving that objective. So I went back through last year's Greenbooks to review the comments with regard to inflation, and what caused me to do this was something that was missing from this Greenbook. Beginning in March of 1993 the Greenbook's statements with regard to inflation were as follows: "we expect it to slow over the forecast period;" in May of 1993, "resumption of disinflationary progress;" in June, "lead to some further disinflation;" in August, "tempering inflation expectations and downward pressure on wages and price inflation;" in September, "disinflation trends reemerged;" in November, "further progress reducing core inflation;" in December, "progress toward price stability;" and in January of 1994, "movement over time toward price stability." None of that type of phrase appeared in this one. In fact this one, very pointedly I thought, shifted instead to "holding on a track consistent with containment of inflationary pressures." Is that a deliberate, very significant shift, or maybe a new reading of what this Committee has as its objectives?

MR. PRELL. Well, as I noted, I think we have provided a baseline against which you can apply your own objectives. As I said, if you accepted the structure of our forecast but didn't accept the implied result for inflation, it would logically lead you to say that the monetary policy assumption made wasn't sufficiently stringent. As to the strategy we applied, I think we could plausibly have read the forecasts that have been made and the statements that have been enunciated by members of this Committee as suggesting that we would have given you something useful if we had put in, in terms of our analysis, a tighter monetary policy and therefore a somewhat slower growth and lower inflation result over the next two years. In the

present circumstance, I think we have put in a tightening of monetary policy that does not seem grossly at odds with the kinds of signals we pick up from statements that have been made and the degree of aggressiveness with which you've moved at this point. We have given you an alternative that is perhaps more comparable to what many outside forecasts that you might look at embody at this point in terms of the increment to short rates. That's a hard call to make. It's hard to say what people are thinking just today.

As to the changes in our forecasts over time, I think what happened basically is that we made some mistakes. Sometimes we made mistakes, in a sense, in our policy assumptions; the Committee didn't do what we anticipated. I would have to admit, too, that we have had some upside growth surprises over time. But perhaps even more important, at certain junctures we didn't anticipate how much unemployment would decline for a given amount of growth. And what we find ourselves with today is what we think is less slack than we might have anticipated in those earlier forecasts and less downward pressure on the inflation rate. So we are not anticipating, without very sharp constraint on aggregate demand, that we'll get to the low 2 percent inflation range within the next year or so. That was perhaps a complicated answer, but you've raised a whole bunch of questions.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I'd like to ask a question about unemployment that I don't think is related to that excellent memo that deals with some of the problems with the new series. It may be a bit related to your answer to Jerry. Looking at the unemployment rate and the amount of slack implied in labor markets, it looks as though you have either a new Okun's Law relationship relative to your previous forecasts or some kind of an intercept change that resulted from observing where the first quarter's unemployment rate is. Real growth, if you compare the two forecasts, is less than it was in the prior forecast and the unemployment rate is also a fair amount less. Is that just an intercept change or some conclusion that Okun's Law is operating in a different way?

MR. PRELL. I think you've put your finger on what is a significant question and, if we had wrestled with it for a while longer, perhaps we might have come to a different conclusion. You've highlighted the key point, and that is that we have taken seriously our view of what has happened recently--I mean the drop in unemployment--not seeing clear evidence that it is just a fluke. And we essentially used this as a jumping off point in this Okun's Law assessment. If one used a different jumping off point for that kind of simulation, it is arguable that perhaps the unemployment rate path could be a couple of tenths higher than what we have. But this is always difficult. It goes back to the very problem that I mentioned in responding to President Jordan's question. It has proven very difficult in recent years to get a fix on that Okun's Law relationship and where we are in terms of cyclical or trend behavior of labor force participation in particular. So I think there is a significant area of uncertainty in this whole relationship.

MR. PARRY. And when you do that, does that raise any questions or issues about one's view of NAIRU?

MR. PRELL. No, I think this is separable. But again, going into this deeply, one gets into questions of labor market structure and behavior. It's not entirely separable from those features of the economic system that relate to how much pressure we get on wages and prices at given measured levels of unemployment.

MR. PARRY. Well, to the extent that the NAIRU doesn't change, it clearly has significant implications.

MR. PRELL. Well, all things equal, if we held to our assumption of the NAIRU of 6-1/2 percent or a shade less and we had unemployment at 6.8 percent, and looked at those numbers very, very finely, that would be enough slack, presumably, to give us some modest edging off in the inflation rate over the coming year or two.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mike, I note that in the forecast there is a roll-back at the long end of about 1/2 percentage point, but suppose that doesn't happen. How would that change your forecast?

MR. PRELL. My life is flashing before me in the transcripts of the meetings that were released recently where we got into extended discussions of these sorts of hypothetical cases. It's a fair question; it was back then, too. [Laughter] I think we made some significant mistakes in our assessments of what the term structure would do a few years ago. It depends, obviously, on what circumstance gave rise to that. If it were in essence a decidedly greater degree of risk aversion on the part of investors who have been burned recently and are demanding a much larger term premium, all other things equal, it would make capital more costly to firms who wanted to buy equipment and so on. And I think it would tend to damp aggregate economic activity relative to our current projection. If it were a reflection of underlying stronger demands for capital based on higher expected returns, then I think in a sense it could be the bond market vigilantes keeping things under some control. Whether on net we would have a higher GDP outcome or not, I don't know. But it would be a different situation.

MR. LINDSEY. Let's assume the first; could you quantify it at all? How sensitive is the forecast--

MR. PRELL. I think 1/2 percentage point at the long end, even perhaps modifying the rather strong interest-sensitivities in our model, is non-negligible in terms of economic impact. So I think we are talking about potentially a few tenths on GDP over the next year.

CHAIRMAN GREENSPAN. Any further questions? If not, who would like to start the tour de table?

MR. FORRESTAL. I'll jump in first, Mr. Chairman. In the Atlanta District, economic activity continues to look quite positive. Retail sales, for example, have shown very good gains in both February as well as in early March. Businesses are reporting increased traffic and the expectation is that the rest of March will be equally good. In fact, they are reporting their expectation that the rest of the

year will continue to be good. Home furnishings and durable goods sales continue to be strong year over year, although they are not quite as strong as they were at the end of last year. But even with these good sales, businesses are continuing to keep their inventories quite lean. Tourism has picked up in the region with central Florida being the beneficiary of most of it, although I would note that we have had record crowds at Mardi Gras this year in New Orleans and that convention activity has been at record levels. That's boosting hotel occupancy rates as well as the retail sector. And as I've been reporting for several months now, District casino activity continues to grow and the states are the beneficiaries of that as their Treasuries are continuing to grow.

Looking at the production area, our manufacturers' survey for February reported increases in production and shipments, but the expectations for six months out were not quite as optimistic as they had been. It's only marginally lower. Pent-up demand for new cars is stimulating production for automobile suppliers, although I have to report that the Saturn factory near Nashville announced some production cutbacks. But I think that's probably more related to that particular line of car than a reflection of cutbacks generally in the automobile sector because, as I've said, the demand for new cars is certainly stimulating production. Building products producers say that they are beginning to reach capacity constraints because of strong residential building.

In real estate, single-family sales remain quite strong and inventories are very, very tight in many areas. Building costs continue to climb, as both building materials prices and wages of subcontractors have increased, although most builders have been able to pass along most of these cost increases. In the Gulf of Mexico, the rig count jumped to 132 in February; that's compared to 95 a year ago and 119 at the time of the last FOMC meeting. That's actually the highest level in almost two years and it's almost entirely associated with gas production. Commercial real estate is also improving but gradually. Absorption and occupancy rates are slowly rising. And we find that concessions for office space are almost nonexistent now in the District. New construction is fairly limited to retail and build-to-suit as well as public works activities. In the financial area, commercial loan demand is showing some signs of picking up, and residential mortgage demand continues to fuel the real estate lending. And it's not just refinancing, it's actual originations.

Employment in the District continues to outpace the national average. Wage pressures continue to be evident only in construction, although we are hearing some reports of pressures beginning outside of the construction area. Manufacturers are reporting some more price pressures for raw materials, although they are not expecting those price pressures to continue over the next six months. The producers of building products and furniture continue to report increasing raw materials and finished goods prices. And lumber prices remain quite volatile, with cost-of-lumber adjustments now a common feature of new residential building contracts. Retailers didn't report any price pressures from their suppliers and none of the contacts that we talked to plan to raise prices in the near future.

In conversations with business people over the last four or five weeks together with reports from our directors, I would say that

the attitude is quite positive and very bullish throughout the entire District. And those who are doing business nationally and internationally are equally bullish about prospects not only for demand but for inflation as well.

As we look at the national situation, our forecast for real GDP growth is stronger than the Greenbook's, although as we get further out in the forecast horizon in 1995, it begins to come down closer to the Greenbook forecast. The reason for the difference is that we think the momentum that was generated in the fourth quarter, and perhaps a little in this quarter, will take a little longer to play out than the Greenbook assumes. Our forecast for inflation is, in spite of that higher growth, a little lower but the CPI in our forecast picks up later in the forecast horizon. I think the risks to our forecast are, frankly, on the down side and I tend to look at the Greenbook forecast as representing sort of a lower bound of where we ought to be. So both in terms of the District and the nation, I think we are in reasonably in good shape.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. The tenor of the Third District's economy has changed during the last several months. Economic growth now resembles the type of growth typical of an expansion rather than the lackluster performance that we have been experiencing in the mid-Atlantic region. Manufacturing is clearly strong in the District, with much of the strength of the fourth quarter carrying over into the first quarter, and expectations seem very positive for the remainder of the year. New orders are up; steel and auto production schedules are strong. One major railroader told me that his company is running flat out and adding locomotives and crews as fast as possible. And for the first time I heard from a sheet steel maker that they plan a significant increase in their inventories because they are concerned about the reliability of deliveries.

Residential real estate sales remain strong and industrial properties are selling well. Although commercial real estate remains soft in Philadelphia, it has become very strong in the suburbs, with a noticeable improvement in south Jersey. I would say that strength is coming on sooner than most of us had thought. One of the major real estate firms told me that they are hiring additional commercial real estate agents and not all that long ago they were laying them off and didn't expect to be hiring them back for some time. And there is sufficient demand to warrant new commercial construction in the suburbs starting, I would say, within the next year or two.

As for retail sales, autos and other big ticket items are selling well. Where there is still a note of caution is with smaller retailers and smaller items. They clearly have been hurt by weather. Their feeling is that their sales will pick up, but there is a natural worry because their expenses have been continuing and they haven't been selling. They feel pretty good, but they'll feel better when the customers start coming back in when the snow melts.

Labor markets clearly have strengthened in the District. I see more help wanted signs in retail stores than I've seen for a while. But there are few, if any, signs of wage pressures developing. On the price side, I have not seen any general price pressures

although most business people tell me that the demand is strengthening to the point now that they think there may be some opportunities for price increases in the next few months. They always talk about how long it has been since they've had a price increase and their optimism for getting one to stick, I think, has increased. One can sort of see it in their eyes!

As far as the national economy goes, there are always uncertainties in these kinds of forecasts. There have been very few meetings where somebody has said, here it is, the economy is either going to go down or up and there isn't any doubt about it. There are always risks. I think our job is to assess those risks. My sense is that the greater risk to sustainable growth is too much strength rather than too little demand. I feel that way for several reasons. The most important thing in any economic expansion is not pinpointing this item or that item, it's the cumulative momentum that carries us from one quarter to the next. And I think that momentum is very well entrenched. We also have a highly stimulative monetary policy. Most of the drags to demand that we have been trying to get over in recent years are largely behind us. And there seems to be an attitudinal change now which looks at sales and other data as a sign that things are going to get better rather than worse. I think that psychology is an important part of this momentum.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, in terms of the District, there is no question that the underlying level of economic activity has been and remains strong. And despite the miserable weather that we have had in the Midwest most sectors, with the obvious exception of housing construction, have come through very, very well.

There is little that I can add to what you already know about the automotive sector. The second-quarter production schedules have been set preliminarily at 9 percent over last year. This increase would be even greater except that some of the manufacturers are dealing with capacity constraints with some of their better selling models. Still, the production increase in the second quarter will be less than in the first quarter, as Mike has pointed out. Therefore, the automotive industry's contribution to the second-quarter GDP will be lower than was the case in the first quarter. The capacity issue in the automotive industry, though, is an interesting shift from an industry that for years has been experiencing plant shutdowns and layoffs. Now in some cases, they are struggling to keep up with consumer demand, which of course is particularly the case for light trucks. To address their problem Chrysler, for example, has announced a \$1.8 billion capital investment program. And we are told that it's very likely that this program will be larger as they get further into it. Given what Chrysler has been through over the last 10 or 15 years, it seems almost incredible that they are now the industry's star profit performer. I must say that for the auto industry, all the way through from the manufacturers to the suppliers to the dealers, attitudes at this point are really very positive. The heavy truck business has only gotten better, and Class 8 sales estimates for 1994 have been increased to 185,000 units. The current order flow is the highest that they've had in 15 years and it's potentially a record year for some of the major manufacturers.

The steel industry is running essentially flat out even though the current capacity utilization number is 93 percent. That number is somewhat misleading; several companies are really producing at what they feel is their capacity limit. Some of the major customers of the steel industry, and the auto companies are a specific example, have become concerned about the ability of the industry to meet their demand. Ironically, steel imports this year will increase and likely significantly, but a large part of the increase will come from the domestic companies that will be purchasing foreign semi-finished products to meet domestic demand. There is another increase in steel prices coming this summer. Some while ago, U.S. Steel announced a 2 percent increase that was scheduled for midyear. It kind of hung out there for a while and others didn't join it; but now it looks as if the others will support that price increase.

Retail sales have remained on the strong side. To the amazement of one retailer I've talked to, their comparable store sales in February were 17 percent higher than last year, with good demand for higher-priced items. They also worry about the ability of their suppliers to deliver, and in several instances the suppliers for this particular company are adding to their capacity.

Despite this very strong level of economic activity I just don't sense that the price pressures are quite as heavy as I might have expected. Major companies, particularly those that buy under contract, are continuing to push their suppliers very hard and they are continuing to get results from this. Labor contracts continue to be very restrained, and wage increases are easily dealt with by productivity improvements, which continue to be very impressive. Having said that, there clearly are signs that in many cases prices have at least stabilized and that some are showing slight upticks. That's particularly true, of course, for steel-related products. But while prices in the manufacturing sector may be firming, these increases have been offset by moderations in the service sector. So I think, net, our outlook for inflation continues to be a constructive one.

With regard to the national economy, our forecast is very much in line with the staff forecast. And I think at this point the risks, if any, are as Ed Boehne has just suggested--namely that perhaps the numbers will come in higher than our current expectation.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. In our District, we certainly have not seen any significant weakening in business conditions recently, aside from some temporary setbacks which seem clearly to be related to the weather. Business is basically good across all sectors and I think it's fair to say that most of the people we have contact with, our directors and others, are reasonably optimistic about their prospects for the remainder of the year. So the overall picture generally is pretty good and I won't belabor that.

In contrast to some of the other comments we have heard, I think the major, most striking development in our region has been the increasing number of reports of rising prices and increased concern about inflation generally. We see that in our directors' meetings; we hear that from some of our other contacts.

as some of you know,

and consequently he has contact with a number of industries that he rents to, in addition to his direct contacts with the construction industry. He's a well informed and I think generally perceptive observer of short-run economic developments.

a couple of weeks ago, he emphasized the fact that suppliers that he has contact with across a broad range of industries are indicating that they are seeing price increases in a range of 3 to 5 percent for a number of industrial supplies and materials, and moreover that these price increases are now, for the first time in this cycle, really sticking. Some other directors and some of our other business contacts are telling us that they are seeing increased prices for steel, plastics, and corrugated paper, and for the first time in a long time, some of our directors are telling us that they are raising their own prices in a broad range of industries from textiles to trucking. So we see a little less favorable news on the inflation front in our region than some others have noted.

With respect to the national picture, let me make just a couple of comments about the staff projections and analysis. I have mainly two points. First, I have some trouble with the downward revision in projected real GDP. Projected real GDP growth for the first half has been reduced in this Greenbook from an annual rate of 3.5 percent to 2.8 percent, and for the year as a whole from 3 percent to 2.7 percent. These are significant reductions. I recognize that these reductions are predicated to some extent on a now more rapid tightening in policy than was assumed in some of the earlier projections. But my feeling is that we are still more likely to get something like 3 percent growth for the year as a whole. I was especially struck, Mike, by the projections for consumer spending, for which I think you have a projected growth rate for the first quarter of 2-1/2 percent and something like 2-1/4 percent for the year as a whole. We just don't see that happening. If I calculated correctly, even if we don't get any change in real consumer spending in February and March, we would still have a rate of growth in the first quarter of 3.6 percent at an annual rate.

Second, and probably more fundamentally, we have some concerns about the Greenbook's discussion of the recent behavior of long-term interest rates and the interpretation of that movement. Over the last five months, the 30-year bond rate has risen about 120 basis points, with corresponding increases in other long rates. That's one of the largest movements in long rates in such a brief period since the end of the 1981-82 recession. In my view it strongly suggests that inflation expectations have risen by more than a marginal amount. And I think that interpretation is widely shared by financial market participants, as evidenced by their comments reported in the press and in market newsletters. The Greenbook, in some contrast, at least in some of the sections of Part I seems to dismiss or at least de-emphasize this inflation expectations interpretation of the recent backup in long rates. It seems to offer two alternative scenarios. The first is that the rise in rates may reflect, at least in part, higher actual and expected real short-term rates down the road because of the stronger economy and the reaction to our action back in early February. But over at least the last six weeks or so since we took that policy action, some long- and intermediate-term rates have risen significantly more than short rates. I guess that

would imply on this explanation that expected real short rates way down the road have increased, and I just think it's unlikely that the economic news and policy developments have increased expected real short rates 20 or 30 years out in the future. So I don't think that explanation can account for a great deal of the significant backup in the longest maturity rates. The second explanation, if I understand it correctly, is that the rise in bond rates may have little to do with economic fundamentals such as inflation expectations and may have resulted primarily instead from what, for lack of a better term, I'd have to refer to as irrational market behavior--some kind of bandwagon effect with overshooting to use the term I think you used. That may well be true; I wouldn't deny that. But it's a hard argument to get your arms around because it's really more a psychological argument than an economic argument. So it seems risky to me, to put it mildly, to dismiss or de-emphasize at least the possibility that the reason for one of the biggest backups in long rates in a long time has to do with inflation expectations or some worsening in those expectations. In any event, I think this question of how to interpret this move in bond rates is one we need to give some weight to when we get to our policy discussion later in the meeting.

MR. PRELL. Chairman Greenspan, could I inject a couple of points of clarification here?

CHAIRMAN GREENSPAN. Sure.

MR. PRELL. One, for what it's worth, the level of GDP is about the same in this forecast as in the last. As currently estimated, we got more growth in the fourth quarter than we anticipated and, in essence, the lower growth rates simply offset that surprise. The second point is one of arithmetic on consumption in the first quarter. We don't know what will happen in March; we don't even know for sure what happened in January and February at this point. But in your calculation I think you were probably using the currently published estimates of real PCE for January.

MR. BROADDUS. Right.

MR. PRELL. The retail sales revisions for January were dramatic, and they would substantially lower the number one gets doing the same February/March arithmetic. So that's the key explanation for why we have as seemingly low a number as we have. On the interest rate story, I think you did touch upon the various elements in our thinking, but you went a step further in describing what has happened, covering things we didn't say explicitly in the Greenbook. You referred to the 120 basis point rise in long rates since October. I guess basically we find it hard to believe that circumstances have changed in such a way as to raise intermediate- or long-term inflation expectations by anything approaching 120 basis points. We don't find evidence in the surveys of that kind of movement; we don't see evidence in other asset prices and so on that really suggests that big a move. But we don't rule out at all--I suggested this I think in my comments--the distinct likelihood that an elevation of inflation concerns did play a role in the recent backup of rates, particularly since early February. Basically what we said is that, given our expectations about what kind of news will be coming forth over the next several months, there will be some allaying of those concerns,

and thus a part of the backing down in rates is due to some reduction in those inflation expectations.

MR. BROADDUS. Well, that's fair. The point I was addressing particularly in the Greenbook as distinct from what you said this morning--I think the emphasis was a little different--is that you had a statement saying "we are inclined to think that the emergence of a large inflation premium per se can explain relatively little of the recent surprise in bond yields." That's what struck me when I read the Greenbook and that's really what I was addressing.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, information we received about the Twelfth District's economy since the last meeting suggests that the economy has strengthened, although I would point out that California's economy continues to lag. The District outside of California is experiencing very strong growth. District employment growth outside of California was 4.1 percent between January 1993 and January 1994. Nevada, Utah, Idaho, and Arizona all ranked in the top five states in employment growth during the last year, and strength in these states is widespread and is absent only from the mining industry. Construction is very strong outside of California, with double-digit construction employment growth in most states. Moreover, strong permits and nonresidential awards suggest that activity will continue in the months ahead.

California continues to show mixed signals. Payroll employment declined again in February. Employment is off about 1.2 percent in the past year and since July of 1990 it is down 644,000. But it appears that real estate conditions are improving somewhat. Residential sales in California were up 20 percent in January from the level of a year ago, which could have something to do with weather. Contacts also report more multiple offers for housing in many parts of the state. And the commercial real estate picture is improving, with stabilizing rents and slight declines in vacancy rates reported. There are a few prominent forecasters that people follow for California. One is UCLA and the other one is Salomon Brothers. Both of them recently have revised upward their forecasts for the state, predicting that economic recovery will begin in the second half of the year primarily as a result of the improved picture with regard to real estate and also the infusion of earthquake relief funds.

Turning to the national economy, I agree with the Greenbook forecast as far as GDP is concerned, with it averaging approximately 2-1/2 percent over this year and next. It's worth emphasizing, of course, that this forecast assumes a rise in short-term rates from current levels. The strong growth that we saw in the last half of the year has all but eliminated the gap between actual and potential GDP, as mentioned by Mike Prell, and has brought unemployment close to most estimates of the natural rate. The further growth projected for this year would seem very likely to eliminate any gap that might remain.

It seems, as Ed Boehne and others said, that there are few downside risks to this forecast and conceivably there could be some upside risks. The Greenbook and the financial markets presume a significant increase in short-term interest rates this year but, even if these come about, I wouldn't expect to see any further progress in

bringing inflation down. Therefore, my expectation for CPI inflation over the forecast period is very similar to the Greenbook average of approximately 3 percent.

CHAIRMAN GREENSPAN. First Vice President Minehan.

MS. MINEHAN. Well, I have a somewhat less bullish report than the rest of you. But it's also a little less bearish than has been the usual case for the First District. Sizable data revisions and recent data trends suggest that the New England economy is doing better than most observers, including ourselves, recently thought. Upward revisions to the payroll employment numbers were substantial and now show that the region began a gradual recovery in the summer of 1992 or about a year earlier than the originally published data had shown. Services are the most notable source of employment growth. Service jobs in the region now exceed their pre-recession peak by about 6-1/2 percent. Other indicators--unemployment rates, help wanted advertising, housing permits--are consistent with a gradual economic recovery in the region. After a very severe recession, New England's recovery finally seems to be tracking the nation's. Now despite the net increase in overall employment, large employers in a number of industries continue to announce layoffs, and manufacturing employment continues to decline. The shrinkage in defense spending is hurting the region. The computer companies are still struggling. Interestingly, however, the region is benefiting somewhat from the strong performance of the U.S. auto makers despite having no assembly plants. Companies making various rubber, metal, and textile products have seen increased demand from the auto industry. Most manufacturers have ambitious capital spending plans, but few if any have plans to resume hiring.

Although a few First District manufacturers report scattered increases in input prices, selling prices are not going up. Competition is intense in almost every industry, so there is no automatic passthrough of higher costs. In addition, companies appear to be using technology more intensively to improve productivity. And the products they sell also may be more durable and last for longer periods before replacement is needed than before. One major dealer of heavy trucks reported that it is common now for truck trade-ins to occur after 600,000 to 700,000 miles owing to improvements in technology and durability versus trade-ins at about 250,000 to 300,000 miles less than a decade ago. Severe weather has depressed retail sales and construction in New England but manufacturers and manufacturing hours were generally unaffected.

On the national side, we see a deceleration from the pace in the latter part of 1993 similar to the Greenbook. At issue here is how much slack does the economy have before it reaches a point where inflationary pressures increase considerably and how fast will it move to that point. As the staff noted in one of their briefing papers, reasonable people can differ on the amount of labor market slack, and at the margin we do. Our view is that the NAIRU is perhaps 25 basis points lower than the Board staff estimate or at the low end of the range. We also see the growth rate of potential GDP as slightly higher, so we come out with an estimate of a higher capacity for growth than the Greenbook. On the issue of how fast the economy will close the gap, we have been impressed by the amount of longer-end interest rate movement that has occurred since February and the

constraining effect that has. On the other hand, our estimates of the future drags from the external sector are less than those of the Greenbook and we see somewhat stronger consumer durable goods expenditures and state and local spending and perhaps higher inventory investment. These forecasts of slightly greater speed are marginal, however, and we are in complete agreement with the Greenbook assessment that there is no near-term threat of rising inflation.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Our reports on the Ninth District have been positive for a long period of time now and nothing has really changed. In fact, it appears that there has been a further step-up in activity pretty much across the board both by region and by sector. Attitudes are positive; employment has continued to increase; expectations about 1994 for the most part are positive, and this is a continuation of what has been going on for quite some time. If we are looking for negatives, one thing that has become more pronounced in recent months is that the phenomenon of Canadian shoppers coming across the border to spend their money has diminished, in part because of changes in the exchange rate and in part because of changes in Canadian policies that have made that more difficult and more expensive. One other factor that is of some interest relates to housing activity. We have had brisk sales for quite some time now and we are getting reports from realtors both in the major cities and in some of the smaller cities as well that the problem they face is a lack of supply of unsold homes. That ought to augur well for construction going forward. So the news in the District certainly remains positive and if anything has improved even further.

With regard to the national economy, our model, although its structure is quite a bit different from the one that underpins the Greenbook forecast, produces a forecast that's really quite similar. My own view is at least a little more optimistic about the pace of real growth, which is to say that I think we might do a little better than those two forecasts. But I think the more salient features of the outlook have to do with the lack of disinflation, the lack of further progress in bringing the rate of inflation down both in our forecast and in the Greenbook forecast, given the monetary policy assumption.

On this question of slack, we have done some analysis of the past several years that confirms my impression that the labor force at least for a time in the 1980s grew more rapidly than might have been expected. Participation rates rose; the rate of increase in participation rates appeared to be above trend at least for some time. That's not a situation that is, of course, sustainable forever, so it does not particularly surprise me that we are getting slower growth in participation rates now. And if all of that holds together, I think it does tell us something about how much slack or how much capacity we can expect from the economy going forward. If one wanted to be a little more optimistic about all of that, one would factor in the international situation because it does appear that there is a good deal more slack elsewhere in the world, certainly in the other industrial economies, than there appears to be here at the moment. Despite all this and despite the strength in the regional economy, while there may be a minor increase in reports of greater wage or price pressures, there is nothing very broadly based or very

significant there yet, at least as far as the anecdotal information that we are picking up is concerned. There may be a smattering of it but there is nothing that leads me to believe we have seen any significant change in that arena at this stage.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Before commenting on the District, I want to report on the presentation I heard yesterday on small businesses. I think most of you know the National Federation of Small Businesses has over 600,000 members. I normally don't pay too much attention to their surveys, which they do once a month, but I was struck by the extraordinary upward movement in a number of indicators recently. Most of the indicators started to turn either in July or by October and they have moved quite sharply. As an indication of the thinking of these small businesses the levels are quite impressive: Planned capital outlays are the highest since 1989 and 1990; job openings are the highest since 1989; plans to hire are the highest since 1990; and plans to raise prices are the highest since 1991. With regard to the general outlook for business conditions, the response chosen was that now is as good a time as any since early 1990. I have no idea about the statistical reliability of that survey, but I thought it was so upbeat across the board that it was notable.

Turning to the District, everything there also tends to be uniformly positive; in fact, it would be hard to find something that stands out in our District that is of a negative nature. What is interesting to me is what is not there. A year ago, I was still hearing, and I think many of you were hearing, a lot of talk about anemic recovery, sluggish pace, use of the term "recovery" more than "expansion," and worry about its sustainability. That's completely absent in the commentary I'm hearing now. The talk is more about how much more up side there is. There was another question in the small business survey about various concerns the firms had: taxes, regulations, and so on. A couple of years ago one of the highest concerns was demand for their products, and that has pretty much dropped out of what is being reported now. And that's consistent with what I'm hearing in the District. In the Greenbook, it was said that motor vehicles production would add 1-1/2 percentage points to growth in the first quarter, but that that stepped-up production is transitory and would be fully reversed in the second quarter. That's not what we are hearing in our District. The auto companies in Ohio and our part of Kentucky are not indicating in their reports to us that a drop-off is imminent. Maybe that has something to do with seasonality; I don't know.

On the national level, I have the same kinds of concerns that Al Broaddus expressed about the use of higher real interest rates both in the Greenbook and in Mike's presentation. To say that we are counting on higher real interest rates to damp aggregate demand and then try to talk about what we mean by these higher real interest rates just doesn't square with past experience. Normally, we wouldn't expect in partial analysis a steeper yield curve to be associated with a less expansionary monetary policy. In fact, the contrary. We normally would expect that as an expansion matures, the yield curve would naturally flatten and very often invert before we get to the end of the expansion. To say that we have moved to a much steeper yield curve recently and, therefore, policy is more restrictive, I think

needs more explanation. If we say that the run-up in interest rates is too big to be explained by an upward revision of inflation expectations over 10 years to 30 years, we have a similar problem of saying that the expected real return to real productive capital over the next two to three decades has been revised up by 80 to 100 basis points. So what we wind up with is that we are using the term real rate to include things other than real rates of return to real productive capital, mainly risk. And we really ought to make three separate distinctions there: the inflation premium, what really is a real rate in one sense, and what is simply a risk premium that may be fostered by people's concerns about policies, political developments, and whatever else. And that's a different way of looking at things than you were telling us.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. The Second District is mirroring what Cathy Minehan said about the First District. It has begun to participate in the economic recovery, led by very strong exports, especially to Canada, and what you are all very familiar with, the strong performance of the financial sector. So wages are beginning to move up. General economic performance is doing rather well and the feel of the District is considerably better.

Regarding the national scene, our forecast has somewhat higher growth and somewhat, but not very much, higher inflation than the Greenbook. My main concern, to borrow a notion from Ed Boehne, is whether there is anything around that could break the momentum of this recovery, and therefore have even the Greenbook forecast wind up being a bit optimistic. I think there are two possibilities. I certainly would not label them as probabilities but I think we need to be attentive to them. There has been considerable concern about what would happen if all the people who have moved from bank deposits into mutual funds of various types were to become sufficiently nervous that they started pulling their money out of the funds. What would that do to markets? I think perhaps a more likely event would be not that they would pull their money out of markets but that as they got their reports on what really happened to them in February and so far in March, which by and large they haven't received yet, they would become aware that they are not as well off as they thought they were and therefore they would become less likely to spend. We could have a diminution in consumption as a result.

The other possibility, and I certainly do not wish to be alarmist, is a major problem in the financial markets. I think we were quite fortunate in that the financial markets, which were very, very rocky in the first days of March, settled down rather quickly. But we were working the phones at least as actively with the money center banks in New York and with the central banks of Europe--specifically including the Bank of England, the Banque de France, and the Bundesbank--as we ever have in earlier better known episodes of financial problems. An indication of what was going on is that rumors began to spread very rapidly in London on the Wednesday of that week, the 1st of March, about possible very large losses at two money center banks, J P Morgan and Bankers Trust. As a result, on the New York Stock Exchange that morning neither stock could be opened. Eventually Morgan could be opened. In the case of Bankers Trust, the chairman had to make a public statement that his corporation was profitable for

the year to date. I remind you that this is a bank that has a AA rating and had a 26 percent return on equity in 1993. It may be that the good news is that the rumors were about two banks that are perhaps most skilled at funding themselves and therefore can handle adversity with unusual ability. But these kinds of rumors were there. And let's remind ourselves that in our ongoing concern about derivatives and the lack of transparency that goes with them, the thing we have been most concerned about is exactly that--that we could have a rumor, well founded or ill founded, about a major market participant and that it would spiral into a liquidity problem. That danger was there. It was resolved and resolved with almost no publicity, which is the best of all worlds. But certainly if we have more market turbulence and this kind of thing is repeated and is not resolved quite so quickly or quite so quietly, it could be enough to shake people's confidence to the point that spending would be less, capital investment would be less, and we would have a lower track for the economy.

My own conclusion is that even though one always operates with some degree of concern about where the economy really is going, I personally have much greater uncertainty about whether the economy will perform about in line with the Greenbook forecast; yes, it could be a bit stronger but it is not at all impossible that it could be somewhat weaker. And, therefore, in my own notions of what that tells me about policy, it is that a certain amount of caution should emanate from the uncertainty. Thank you.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. The national economy, as we all know, has been expanding rapidly and that's a phenomenon we would expect to see continue on a path above that shown in the Greenbook. For example, industrial production over the last three months ending in February grew at an 8.4 percent annual rate; payroll employment grew at a 1.6 percent rate from November to February which was in line with the growth over the previous nine months; and the unemployment rate, adjusted for changes in measurement, seems to have declined in an amount about equal to 1 percentage point over the last year.

In the Eighth District, we would expect economic performance in the first quarter to be affected somewhat adversely by unusual winter storms, especially in the southern and eastern parts of the District. But, nonetheless, District activity and employment have grown faster than in the nation as a whole over the past year and especially in the most recent three-month period for which we have data--ending in January. So, obviously, the full effects of those storms wouldn't be reflected in that data yet. Employment reports recently have been dominated by expansion in industries as diverse as appliances, finance, poultry processing, trucking, bicycles, and autos. Particularly noteworthy are double-digit annual rates of growth in employment during the most recent three months; this would be in the electrical and transportation equipment industries and in construction. Recent announcements that Chrysler will reopen an old plant in the St. Louis area and that Ford will expand its production line also in St. Louis, along with the previously announced 1995 plant reopening by GM, indicate a dramatic resurgence in investment and employment in the transportation sector over the next few years.

The continuing strong performance of the District and of the national economy as well reinforce my concerns about the inflation outlook. Over the past five months both consumer and producer prices have accelerated from their pace over the previous five months. Producer prices for finished goods, for example, increased at a 1.6 percent annual rate since September 1993 following a 2.7 percent rate of decrease over the previous five months. Consumer prices accelerated from a 1.8 percent to a 2.7 percent rate over the same period. In addition, and that's why I mentioned industrial production and employment trends earlier, I think the potential for bottlenecks and price pressures is growing. Capacity utilization has reached the level recorded at the previous cyclical peak in July 1990, and labor market conditions adjusted for recent changes in survey methods are rapidly approaching the degree of tightness that existed at that time as well.

Not surprisingly, I think inflationary expectations have also increased, as reflected in the 25 basis point upward shift in the yield curve following our last meeting. This was on top of a 50 basis point steepening that had already occurred between October, when long rates touched their lows, and our February meeting. One final note on this score would be the question: Is a significant increase in inflationary expectations plausible when price levels were declining as recently as last year? And my answer would be, "you bet." If you look at the postwar period, there essentially have been nine periods of declining inflation. And in the four quarters following those nine periods, the average increase in inflation rates over those four-quarter periods was 2.2 percentage points. So it's not at all implausible, given what's going on now, that there are significantly higher expectations with respect to inflation.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Eleventh District employment growth has been greater than the national average for some time, but so far this year it has been below the national average. I suspect that that's because much of the country is recovering from recession while the Eleventh District is just recovering from sluggish growth. On the other hand, hours worked in manufacturing in the District continue to be at record levels; the weekly figure is 43.2 right now. In addition to a weaker rubber band effect in the Eleventh District, low energy prices and the absence of a major automobile manufacturing sector probably have something to do with our relative weakness. We apparently don't benefit from manufacturing of automobiles and we don't have a parts industry like the Boston District does.

The actual pickup in major economic activity from NAFTA still seems to be in the future, although there is a lot of activity going on with companies positioning themselves to do more trade and new entrepreneurial start-ups trying to figure out how to trade. There is some confusion on just how to do it and some lag in the ability of public authorities to teach people about the proper paperwork and so forth. All indications are that NAFTA trade is going to be a very big deal soon. You probably heard that Dallas was chosen as the Labor Secretariat location for NAFTA, a good right-to-work state getting that honor.

Construction of homes has been fairly strong in the District, creating some shortages of building materials, particularly bricks but also glass and other materials, and some shortages of skilled construction workers; we have reports of some upward pressure on building materials prices and on blue collar wages relative to white collar wages. As for news from board meetings, I guess the most significant news I'll admit is that the Houston Board, which perennially is our most negative board in terms of its assessment of local economic activity, reportedly had a very upbeat board meeting last week. They are talking about a lot of new strengths in the Houston economy, which has been the weakest major metropolitan area in the District. Loan demand has picked up considerably and the larger banks are reportedly seeking loans very aggressively. A couple of weeks ago we had a meeting of our Advisory Council on Small Business and Agriculture and

--used to report that when he tried to get a loan from a bank it was not "no," it was "hell no." He now reports that it's not "yes," it's "hell yes." [Laughter] If you're looking for potential weaknesses in the economy, I would just offer the possibility that a lot of people refinanced their house in 1992 and 1993 and when income tax time comes there may be some negative surprises for them in the next month.

With respect to the national economy, I have no comment on the Greenbook except that it contains more "blue" than usual.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. To begin with our District, I will tell you that it's growing at a strong pace now. Recent employment numbers show a growth rate for the District as a whole above 3 percent. This is showing up in manufacturing not only of nondurables, which I've reported on before, but of durables as well, reflecting our auto industry and our aircraft industry, which for our region has shown some expansion. Construction in the region generally is very strong. I spoke with

in the Kansas City region just last week, and he indicated that the activity prospectively for the next 90 days is as high as he's ever seen it, higher than the 1985-1986 period. As a result of that, they are seeing some strains in terms of getting access to labor, but not necessarily in wages yet, and also in materials.

Agriculture is stable; there is a tradeoff between some increases in price in the grain side which is in effect hurting the cattle side to some degree. Energy in our District is still modest, with oil being a negative but natural gas being a positive, and there has been some drilling activity as a result of that. Banks financially are strong and are also seeing an increase in demand for loans. And their attitude toward making loans I would say is very positive. Just to talk a little bit about prices in the region, we are not seeing systematic increases yet in the data. Land prices are increasing but at a rate only slightly above the inflation rate in the last survey that we did, and the same is true in some of the labor markets. However, on the anecdotal side, I'm getting increasing information that some price pressures are beginning to emerge. The same that I talked to said that they are seeing materials prices move up sharply. He quoted a figure as

high as 15 percent in some of the materials that they were bidding for. In land prices, I've reported at other meetings that in the rural areas of Nebraska, Kansas, and Wyoming we have seen land prices move up. In some cases, we have seen them rise sharply and the impetus is not from outside buyers but from neighboring operations trying to expand. So we are beginning to see that.

On the national level, we continue to view the outlook as we did at the last meeting in that we see inflationary pressures that are increasing more rapidly than shown in the Greenbook--not by a lot but I think by enough to matter. We see that widening as we go out into 1995. There are three reasons for that in our judgment. Number one, generally we expect growth in GDP to be above that in the Greenbook. Secondly, we see the unemployment rate coming down more than the Greenbook; the difference is small but combined with faster GDP growth it's important. And finally, as you know, we view the natural rate of unemployment as being somewhat higher than the Greenbook. So the combination of all those factors, in our minds, adds up prospectively to the emergence of significant inflationary pressures. Thank you.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. As was said early on, our job here, of course, is to assess risks. And I think most of what we have heard today has been centered around the risks that we see in the upside direction. I certainly can't disagree that that is probably the most likely scenario, but I would like to inject a couple more notes of caution into that if I may. I don't disagree that these risks are probably the most compelling argument. But I do think there are good reasons not to assume overly confidently that that's the only scenario. I think there is a probability that's considerably above zero that we may be a good deal further away from this full utilization flash point than we think we are.

First of all, the Greenbook forecast points to a considerable slowing in the real economy. It describes the consumer as neutral going forward from here. I'm not sure what that means, but I agree with it. [Laughter] I have spoken before about the very heavy debt load that consumers have; as of now it's all still there. And as Bill McDonough mentioned a few minutes ago, we may have some nasty shocks in the wealth effect area that people are about to find out about. Indeed, going forward from here, I think almost all of the major sectors are projected to slow. After this quarter, unemployment ceases to go down in the Greenbook projection and capacity utilization stops going up. I find it hard to ascribe very much of that in 1994 to the effects of a slowly rising federal funds rate, though there may be some effect at the margin. Now, more slowing is projected for 1995, and I can associate that a bit more with a rising funds rate. In short, that projection just doesn't look anything like a runaway boom to me.

The foreign economies, particularly the G-7 countries, have a very slow recovery under way, if indeed it is under way. And the projection is that their under-utilization gap never does close at all over the forecast period, and their inflation stays low and indeed gets lower as time goes on. This tells me that our net exports are going to be a continued heavy drag; there is going to be continued heavy pressure for other economies to export to the United States at

very attractive prices, and I think that implies a rather strong pricing discipline on our own domestic producers. I'm not sure the International Finance staff here would agree with that; I think they believe that effect is more limited, and historically I'm sure that they are correct. But in the foreseeable future, I think foreign competition will continue to have a strong disciplinary effect on prices in the United States.

In the area of productivity and unit labor costs, we have recently been seeing a rate of growth in unit labor costs that has been substantially below the inflation rate. In 1993 it was .9 percent. The Greenbook projects that to jump a lot next year to 2.9 percent, which would be very adverse if it happened. But even if it does happen to that extent, I still don't see 2.9 percent as being an inflationary flash point. But is it going to happen? The reason given for that very adverse development is that productivity has been running much better than trend, and it's got to get weaker in order to come back to trend. That just might be a tad academic. It may be that the folks out there in the real world who are fighting to make a living may not realize that they've been performing way above trend; they may feel they have to keep it up in order to survive. [Laughter] My impression is that they are doing that. So it's possible that we will continue to see a substantial improvement in productivity that may be more secular than cyclical, as the case may be.

Interest rates cut both ways. On the one hand, I would certainly agree that real rates are low and stimulative, and that's a very important point. But on the other hand, this 70 to 100, maybe 120 basis point increase in long rates that we have seen, however you want to measure it, is a powerful restraint. We can talk all day about whether they are real increases or not real increases and to what extent one way or the other. But the fact of the matter is that it's a large increase and it points to very substantial restraint right now. The Greenbook projects that long rates are going to come back down in association with a rise in the short rates; that's happened before and conditions may exist today where it will happen again. But it's hardly a cinch bet. That could be an important constraint.

Finally, there is the matter of inflation trends themselves; they are still improving. Three years into an expansion, the 12-month change in the core CPI last month, the latest figure, was the best we have had in a long time. I realize, of course, that when we talk about trends we're looking backward and we need to look forward. One reason that these trends have been looking so good in the face of an expansion has been the fact that we have had a weak recovery, but then one reason the recovery has been weak is because there was a weak recession before it; we started out at pretty good levels. Trends change slowly most of the time. The first thing they've got to do is to stop moving in the direction they are already moving, and in this case they haven't yet. Then later they may reverse. Certainly, there is evidence that that's going to begin to happen. The last time we met I used the phrase "there is dust on the horizon." Certainly, some prices are rising; there is no doubt about it. Maybe this trend will reverse faster than trends usually do, but I don't think it is completely insignificant that so far that is just not happening. The trends are still in the direction of slowly declining inflation. Over the previous 12 months, the PPI change was almost flat. The core CPI

last month, as I mentioned, was the lowest it has been in a long time, at 2.8 percent and on a downward trend so far.

Is there danger that we are going to get behind the curve or alternatively, if we do move now, that we could conceivably choke off the expansion? I seriously doubt both of those. But I do think it's possible that we have a situation here where the economy, at least for a while, is behaving in some new ways. It could be that if we are not being pushed hard right now to move--if we are not in danger of getting behind the curve--that it might be worth keeping our powder dry for a little while to see how some of this plays out. Thank you.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. That's a nice sequence and I'd like to associate myself with a lot of what Governor Kelley just said. I want to add to that my perplexity about the projected relationships between four elements of the forecast. The first is the presumed direction of policy and the trajectory of interest rates associated with that policy. The second element is GDP in the context of that policy and in the context of what we presume to be potential for the economy. In its effort to tie all of that into the projection for the CPI, the staff has come up with a projection for the balance of 1994 and well into 1995 that has the CPI running at a higher rate than it did in 1993 and 1992 and the GDP running at a lower growth rate than in 1993 and 1992--in fact tracking very close to what we presume to be the potential for the economy. Those things don't make much sense to me. Either the staff has underestimated GDP and it is going to come out higher than projected and therefore the CPI numbers are more reasonable, or it has underprojected the CPI. If it is the former, then the question that I would raise is whether we have the right monetary policy. If in fact we are projecting a monetary policy involving rates that are rising gradually to a certain level with the result that the economy is growing at a relatively sluggish rate and there is no projected progress against inflation, then clearly, given the stated objective of stable prices, do we have the right policy? I don't have the answer to that at the moment, but in the context of some of the things that Governor Kelley was saying, I just don't feel comfortable with the conclusions that one seems to be forced to draw from those projections.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you. There has been a lot of discussion about where we are right now with respect to the real economy. It does appear, no matter how we measure things and how January and February actually come in, that the economic strength is broad-based. And as part of that strength, we are seeing strong productivity improvement, which really bodes very well for strength in housing and in household spending. Certainly, the labor markets are a bit difficult to read right now given the changes in the survey method. But even with that difficulty, it does appear that there is some improvement in the labor markets. We are even getting some improvement with respect to the deficit. There hasn't been much discussion of the deficit recently; in fact, I don't think anybody has even mentioned it today but that's something one should chalk up in the positive column. Moreover, the capability for financing growth seems to be continuing to strengthen. Certainly, there is uncertainty

in the secondary markets, both the bond and the stock markets, but the overall cost of capital remains relatively low. Banks are in a strong position to finance further expansion.

In terms of the outlook, I certainly can't disagree with the notion that whether we characterize this as an expansion or a recovery, it is sustainable and it may well be at or above potential. Perhaps somewhat like Mike Kelley, I've been asking myself whether or not this is a picture that's too good to be true. I do think that there are some checks on potential runaway growth. Maybe this is the proverbial soft landing that Mike Prell referred to. Re-engineering is definitely entrenched in corporate culture. The focus is on cost savings and improved productivity. There is a flip side, of course, with respect to job quality. Even though we are seeing job growth, the question remains as to what kind of quality there is. So in a sense that is a check on growth. We have a low saving rate; Larry Lindsey has spoken about that recently. I have a hard time believing that current household consumption levels can remain at the same rate given the income growth rates that we have seen recently. There is a continued international drag; with our trading partners being weaker, we are certainly the ones that are leading this growth.

With respect to inflation, certainly the recent history is excellent, but again we have to focus on the future. It's hard to know when there is a problem with respect to when are we shifting from disinflation to either a flattening or an increasing trend. Certainly we can look to some of the underlying price series, including commodity prices. While commodity price run-ups are not sufficient to cause CPI increases, they would be necessary. So, while the increases we are seeing may not work their way into the CPI eventually, I certainly think it's a signal that should put us on alert. There are some vulnerabilities with respect to future price movements. Low crop carryovers this spring make food prices quite vulnerable to whatever is experienced with respect to the 1994 harvest. Oil prices have been obviously benign. They have been the very thing that has kept our recent inflation performance very good. I guess I have a healthy skepticism. Maybe I stood in some of those oil lines too long to be comfortable with declining oil prices. We are still not sure how the health care reform movement is going to shake out. The economy has been running ahead of potential, and if it continues at that same pace, eventually at some point we are going to see price pressures. We already are hearing some anecdotal discussions of bottlenecks and supply shortages. So I think there are some vulnerabilities even though price increases haven't yet shown up in the inflation statistics.

In terms of assessing the risks to the economy, I guess I come to the conclusion--and maybe it's because I've spent a lot of my life in the markets--that perhaps the markets themselves may be one of the sources of vulnerability. I think they are undergoing a great deal of sorting out right now. Market adjustments are not instantaneous, though if everybody heads for the door at the same time, we could get a massive movement. But given the very complicated sets of portfolios now in markets--and I don't mean just hedge funds or pension funds or financial institutions, but portfolios throughout even the manufacturing sector--I think the price movements that one can get as interest rates change may be somewhat exacerbated when it occurs. The steepness of the yield curve in fact may be exacerbating

the problem. We were going through a shift in expectations with long rates coming down; maybe the decline overshot last fall; I don't know that we are ever going to know that fully. But the process was under way last fall and long rates were shifting down. When the Fed tightened, to use a bad analogy, that threw a monkey wrench into the gears of the market system and participants are having figure it out and work out a new direction. Part of the problem is that it is not clear what unwinding of portfolios and adjustments are being made. Sometimes we get mixed signals because portfolio positions are very, very complicated. The markets themselves I think are certainly a reflection of this changing, shifting portfolio adjustment process that is occurring. This whole process is compounded by other kinds of uncertainties, domestic/political uncertainties, Korea, potential trade wars with Japan and China, and trading partner weaknesses. For me the bottom line is that the markets don't need any more uncertainty with which to deal. So whatever we do, we shouldn't let the markets get in the way of economic recovery or expansion, however we characterize it.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, I think we have heard today a very optimistic view outside of New York and Washington and a very pessimistic view from those of us in New York and Washington. I hope it's natural for people in Washington to be pessimistic; you just have to live here and watch it. [Laughter] But I've decided that everyone is right. I think the reason comes down to the fact that the real after tax return to riskless saving is negative. And that is our problem. The natural response to that situation is that people first of all go into durables and housing, as they have been doing. Indeed, I think the last time that the rush into real assets was as great was probably 1979 when the real after tax return to riskless savings was also probably as negative or more negative than it is now. The other things people do are to take on more risks, avoid the tax man, and go abroad for new opportunities.

I just want to throw out a few fun facts. In 1993 the rise in the dollar value of the Hong Kong stock exchange was almost half the rise in the dollar value of the New York stock exchange. Hong Kong is an emerging market and they have lots of reasons to be optimistic about China, but the fact that it grows half as much in dollar terms I think suggests that people are running overseas in search of higher returns. I'm a little more concerned when I see that the rise in the value of the Bangkok stock exchange was \$51 billion compared to \$432 billion in the NYSE and that the Ankara stock exchange--I wonder what percentage of the American people could identify Ankara on a map of the world--was \$42 billion, almost a tenth of the increase in the value of New York stock exchange stocks.

Home equity loans and mortgages in general because of their tax favored status have reached levels that clearly suggest that the funds are being used for consumption purposes and not simply for buying new homes. They may also be used to fund tax sheltered investments, which have also reached new record shares of total saving. In addition, at the end of the year margin debt hit a level as a ratio to disposable personal income not seen since the month after the Chairman joined the Board of Governors, and we know what happened shortly after that! Margin debt fell precipitously, we know

that. Again, people are reaching for risk; it is also a tax favored method of borrowing because up to a limit it is tax deductible. I think, therefore, that we can have a booming economy and at the same time have the very high risk situation that Bill McDonough talked about and that my colleagues on the Board just discussed. Both are true. The answer, I think, is to raise the real after tax return to riskless saving. My preference for how to do that would be largely in the fiscal policy area, but I'm not going to hold my breath. So, although I'm leaping to the next agenda topic, I would go for what we can do.

CHAIRMAN GREENSPAN. Let's keep this coffee break a little shorter than usual.

[Coffee break]

MR. KOHN. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Don?

MR. JORDAN. Don, in the early part of your remarks, you made reference to the credibility of the Committee's commitment to, you used the word, "contain" inflation, and later in your remarks you said, "to contain inflationary pressures or to reduce them further, if that is your objective." So, again, you were using the words that Mike used earlier in his remarks about containing inflation, and I don't know what happened to the rhetoric about the objective of reducing inflation, a route moving toward price stability. If it's the staff's interpretation that this Committee has changed its long-term objective based on what we submitted in the February meeting, then I think maybe in our May meeting we ought to schedule a discussion as to what are the long-term objectives of this Committee to give you guidance as to what kind of policy input we need.

MR. KOHN. I'm not sure I can add very much to what Mike said in response to your previous question except to say that my words in regard to alternative C were meant to suggest that strong action--50 basis points now and likely considerably more down the road--would probably be more consistent with getting inflation down than the more gradual, though not very gradual, path in the staff forecast. I think it's the same issue. In effect, the staff forecast has inflation leveling out at 3 percent. In the judgment of the staff, given our assessment of spending and inflation pressures, stronger action may be needed to bring inflation down. And that's what I tried to convey--

MR. JORDAN. Did I read too much into your expression "or to reduce further, if that is the Committee's objective"? It sounds to me as if you are doubting that that is our objective.

MR. KOHN. I was just suggesting that that's the alternative you ought to consider if you really want to bring inflation down and make measurable progress. That would be one reason for looking at alternative C.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Recently, growth rates of the narrow measures of money have slowed and the broad measures, if you adjust them for stock

and bond flows, have slowed. The only measure that has accelerated has been the monetary base and that's entirely in currency. Where is the currency going?

MR. KOHN. We don't have current data on that. We do have a sense that the flows overseas are large. I don't think we have a good fix on where they are going, especially since where they might go initially--suppose they went to Switzerland or something like that--doesn't indicate what the final destinations might be.

MR. MCTEER. In the last couple of months, interest rates have risen a good bit and all the monetary aggregates that count in this country have slowed. Would you say we have had a significant tightening already?

MR. KOHN. I tried to suggest that some of the slowing might be in response to the rise in interest rates, though ordinarily we would think that it would take longer. On M3 in particular, we have these institution-only money funds that are very sensitive to small changes in interest rates, and we think that accounts for a substantial part of the minus 7-3/4 percent M3 in February. On M2 and on M1, I think we have a somewhat different phenomenon. A lot of that is in the mortgage prepayments and, in fact, they have come off, as you know, as mortgage rates have risen since last October. That has a temporarily depressing effect on M1 deposits, which we expect to come back. So if anything, I would think that M1 has dipped below its longer-term trend or what we might expect over the longer run and might come back a little. But with higher interest rates, we would certainly expect M1 in particular to slow substantially from the 10 percent plus pace of the last few years. That would be our analysis. M2 is more questionable. We think that M2 does respond at least for a while to higher interest rates, but then we have questions about the effects of higher interest rates on the flows to the stock and the bond funds. So the effect of higher interest rates, particularly if accompanied by rising bond yields and capital losses, on people's preferences for M2 versus bond and stock funds may muddy those waters. But we would expect higher rates to damp M2 growth a little, at least for a time.

MR. MCTEER. It sounds as if you're saying the signals are jammed.

MR. KOHN. Right.

CHAIRMAN GREENSPAN. If nobody else has questions, why don't I get started. I'd like to take a minute to put the current period in some historical perspective. We have had extraordinary financial turmoil, and it's worthwhile to go back in time and see where it came from and where it's likely to go. My impression is that we are looking at the aftermath of the 1987 stock market crash, which is the first and perhaps the only major stock market crash in history that actually was beneficial to the economy. In other words, it appeared to me in retrospect that the crash stripped out a high degree of overheating and sort of got right to the edge of where the overheating got into the muscle of the economy and stopped. We came out of it with a very shaken environment but one which recovered relatively quickly. As a consequence of that, from the 1987 stock market crash on, all the key risk spreads started to narrow. We saw it in, say,

the rates on six-month commercial paper versus the Treasury bill rate; we saw it in BAA corporates versus Treasuries. The only abnormality is the junk bond trend which was affected by the emergence of that market. But there has been a general decline in those risk premiums, which has led increasingly to the view implicit in the market that there is a risk-free environment and one that incorporates, as we have noted previously, extraordinary rates of return on stocks and bonds. Those returns not only have been significantly higher than average but remarkably stable. There has been very little volatility in the stock market until recently. And as a consequence of that, we saw the emergence of a huge mutual funds industry, which was able to promise above average yields and stable yields. I don't know the size of the industry now--\$2 trillion or something like that--but it has become the major player in the marketplace.

Everything we know about markets is that abnormal rates of return, especially those built on capital gains, cannot persist. Indeed, the closest example of this in recent times was the pre-September 1992 hedging, or I should say investments, in a number of European currencies. You will recall that the Swedish kronor was yielding significantly more than most money market instruments and the deutschemark. So everyone figured that the kronor was locked into the deutschemark, and investors took positions in the Swedish kronor at high interest rates, hedged it in the deutschemark/dollar market, and got blown apart. This sort of led to the beginnings of the ERM falling apart.

I think we are looking at something not terribly significantly different in this current situation. Prior to our move on February 4th, the market had drifted into a state of somnambulance at low risk premiums, and there were steady upward price pressures. While we all recognized at the time that the stock market was a little dicey and we were worried about the mutual funds, I don't think we were aware of the apparent underlying speculative elements involved in the markets on a worldwide basis that I think our February move unearthed. I think it was a wakeup call which basically got everyone to look up and say: How long can this go on? And if our wakeup call had not occurred on February 4th, there would have been another wakeup call coming some other time within days, weeks, or months. I believe we in effect dislodged a brick from an edifice when it was vulnerable to being hit by something. What actually eventually hit it was the Philadelphia Federal Reserve's February publication. That morning the CPI came out at zero and the bond market took off; it rose to 6.39 percent on the 30-year bond, which was 10 basis points above its level before we moved, and by the end of the day the Philadelphia Fed index for February came out, it closed at 6.54 percent. Now, it wasn't the Philadelphia Federal Reserve index itself that moved the market; that was a catalyst. The way we knew that is that when the March index came out and the index turned around, the bond market tried to rally and it rallied for about 10 minutes and got its head cut off. So really, these are secondary catalysts to a far more fundamental restructuring that's going on. Views of the market structure are undergoing a major review at this stage and portfolios are undergoing dramatic changes. We have seen some increase in yield spreads but they are still quite low by any historic standard, which suggests to me that the adjustment process in the capital markets, in the portfolios of pension funds, mutual funds, and individual households, still has a long way to go. I'm not saying that means that interest

rates have to adjust; I mean that portfolios are out of kilter and are still being adjusted.

When we moved on February 4th, I think our expectation was that we would prick the bubble in the equity markets. What in fact occurred is that, as evidence of the dramatic shift in the economic outlook began to emerge after we moved and long-term rates began to move up and hence the discount factor on stocks began to move up, we were also clearly getting a major upward increase in expectations of corporate earnings. While the stock market went down after our actions on February 4th, it has gone down really quite marginally on net over this period. So what has occurred is that while this capital gains bubble in all financial assets had to come down, instead of the decline being concentrated in the stock area, it shifted over into the bond area. But the effects are the same. These are major capital losses, which have required very dramatic changes in actions and activities on the part of individuals and institutions. I believe there was a view that the capital gains in the bond markets were largely permanent because the economy was perceived as coming off a relatively high fourth quarter but would begin to ease at a somewhat faster pace, and it didn't do that. And this development created a very significant shift as to where the capital losses occurred, although it may not have significantly altered what the actual possible losses overall would have been, combining the stock and the bond markets.

With the improved economic outlook, risk premiums have remained quite low. And the reason they are continuing quite low is that the risk to the economy is not perceived to be a crucial one. So even though we had some pickup--for example the risk spreads of the six-month commercial paper vis-a-vis the bill rate have gone up moderately--it's the first rise in a long time and the spread is still basically low.

There is a very strong view, which is reflected around this table, of a very solid economic outlook. Indeed, I'm hard pressed to remember when the outlook itself looked as unequivocally expansionary as it does today. We are always able to find reasons why it's going to cave, and there are lots of different figures we can adduce. The only real danger to this economic outlook, as I see it right now, is the financial structure. And that, as I think the Vice Chairman said, has a low probability of inducing a downturn. But if the financial system were to be ruptured, it would not be terribly difficult to bring the economy down very quickly. If you want precedents for that, I suggest that you merely go back and read the business annals that go back 50 or 100 years. They show economic conditions looking absolutely terrific three weeks before the roof caves in. So the outlook is one thing; history I think has to temper it. Nonetheless, there is no doubt about the very strong underlying forces in the economy.

The one area, as I think I said at the February meeting, that has potential upside risks is the inventory situation, which continues to be fairly tight. I think the lead times are probably just now beginning to move out. Somebody here mentioned steel mill inventories picking up; I've heard some of that myself. We are beginning to get the first signs that the inventory numbers may be moving up, and if

that's the case, that would maintain a higher level of economic growth than I think we otherwise would have gotten.

There is no question that we have cut the tail of the probability distribution for the economic outlook, even though in a modal sense the outlook itself is not all that much higher than it was six months ago so far as 1994 is concerned. There was a good deal of concern six months ago that the economy might fade very fast. The truth of the matter is that it has not. And in the event, even though the modal expectation hasn't changed, the probability distribution has changed, and I think that's a major factor that has moved into the bond market and the whole constellation of interest rates.

I thought the most interesting aspect of the discussion around this table today was some element of surprise--and I don't know how to phrase it but it involves almost everyone with the exception of Al Broaddus. Everyone is concerned about a pickup in inflation, tightness and stringency picking up, and the fact that commodity prices are moving, but there is no apparent acceleration in wages or final goods prices.

This raises a very interesting issue that we ought to think about. I don't know where it leads us, but a year or so ago I raised a question about the absence of financial tinder--meaning credit, debt, and money supply--in the economy, even as the economy was picking up and we were beginning to see some shrinkage in excess capacity. But a year or so ago, we had soft inflation and excess capacity. Looking strictly at what the data show to date, the inflation rate, if anything, is somewhat less than we had expected. We have very detailed data for January and February, or more exactly probably half-way through February. We have very detailed data on daily spot prices of a lot of things. And we have some data from purchasing managers' reports which have never been terribly useful with respect to inflation. We have very clearly seen some pickup in underlying commodity prices; we have seen very little evidence of accelerating inflation in any of the data on final prices. Even the February CPI, in which the core rate was up .3 percent, is not a clear indicator. I'm not inclined to pick pieces of it and isolate them, but there was a .6 percent increase in owners' equivalent rent, which was way above average. If you bring that down to average, that takes off another tenth of a percentage point.

The reason I raise this question is that we have an economy which doesn't look like anything that we have experienced in the last 30 years. In the last 30 years, when we saw a tightening of slack in the system, we also saw a pickup in credit demands and we had inflation. That, however, has not been the universal experience in this country. If we go back to the 1920s, there were several periods of significant tightness in markets but no significant credit expansion and no inflation; that was also the experience even in the 1950s. I raise this issue because we are pretty far along in this business cycle. So why is inflation not showing its head a little more? Now, the next set of numbers may come out and I'll be sorry I said this, but the earlier experience raises the question: Is it automatically the case that when the economy is tightening up that inflation takes hold?

I would submit that looking at the simple short-run Phillips curve, which is what we are doing, without a credit variable in it, may be misspecifying the process in question. As we all know, the shrinkage of credit has basically reflected balance sheet strain in the latter part of the 1980s and has at the same time been associated with extraordinary weakness in all of the aggregates. To be sure, there has been a pickup in credit--in loans and debt, but from very low levels and the numbers do not support, at least historically, any significant inflation pickup. I must say that I find this whole process very puzzling, because it does not seem likely to me that it can continue in this way. I'm sort of waiting for the credit numbers to really begin to move, for the patterns to begin to look like those I have found so familiar, being a business forecaster for a number of decades.

There is something different going on. I don't know yet what it means, but there are two facts that coincide with one another that at least should raise our awareness. One is that we are not yet getting final demand price increases, and it may very well be that we are getting extraordinary productivity increases that are keeping unit labor costs down and the competitive pressures there. That is why, of course, commodity prices, which are clearly going up, are not working their way through the system in a direct manner. This is the type of situation where we are looking at a credit picture and a lack of inflation that is more reminiscent of the '20s than of the last 30 years. And that is something we ought to keep in mind, because if we are basically going to presume that there is an automatic relationship, I think there is at least a question as to whether that is true. I'm not sure that really affects what policy should be because I don't think there is any question that at some point and in some manner, if we have accommodative monetary policy at the central bank, credit has to become excessive and it has to become inflationary or all of our concepts about how the monetary system works will have to go into a radical revision, which I can't at this stage even remotely contemplate.

Where this leaves me, putting the inflation issue aside for the moment, is that I think we have to restore policy to neutrality as fast as we can. What I really have in mind here is to eliminate the excess degree of accommodation, which I assume is basically feasible. If we were dealing strictly with the economic outlook as it stands now, there is no doubt in my mind that this economy could absorb a very large increase in interest rates without a problem. The difficulty I have is that I don't think the financial system can take a very large increase without a break in its tensile strength--which we strained significantly the last time but did not break. It's a risk, frankly, that I think we should be quite concerned about.

So, we have the issue of, one, moving as fast as we can and two, doing it in a manner that doesn't break the markets. But as I see our objectives here, there is another characteristic as well. One of the elements that I think we have all been observing with respect to the markets--and one of the reasons why there has been such a level of instability in the markets--is that when we were perceived as moving on the basis of economic data, the markets had a certain sense of what it was we were doing. Now, Jerry Jordan doesn't like that approach to policy and I have considerable sympathy for his point of view, but it did give the marketplace a semblance of knowing what we

were doing. Now they are worried that they don't know when we are going to move, so we have this Sword of Damocles hanging over the market. They don't know whether we are going to move in 2 days, 5 days, or 12 days; they have no basis to judge and they are understandably nervous. So the question is, having very consciously and purposely tried to break the bubble and upset the markets in order to sort of break the cocoon of capital gains speculation, we are now in a position--having done that and in a sense succeeded perhaps more than we had intended--to try to restore some degree of confidence in the System. And that means we have to find a way, if at all possible, to move toward a policy stance from which we will not be perceived as about to move again in any short period of time.

That essentially leaves us, as far as I can see, with two options: moving the funds rate up 25 basis points or 50 basis points. I don't think we have an option, incidentally, of doing nothing. There is no case that I feel comfortable with for doing nothing, so I would frankly reject "B." But leaving that option aside, I do think we have an interesting choice. A 50 basis point increase would move the funds rate to 3-3/4 percent. In my judgment that would not be perceived of as neutrality or where we ultimately have to be. My own view is that eventually we have to be at 4 to 4-1/2 percent. The question is not whether, but when. If we were to move 50 basis points, I think we would create far more instability than we realize, largely because a half point is not enough to remove the question of where we ultimately are going. I think there is a certain advantage in doing 25 basis points because the markets, having seen two moves in a row of 25 basis points at a meeting, will tend almost surely to expect that the next move will be at the next meeting--or at least I think the probability of that occurring is probably higher than 50/50. If that is the case and the markets perceive that--and they perceive we are going to 4 percent by midyear, moving only at meetings--then we have effectively removed the Damocles Sword because our action becomes predictable with respect to timing as well as with respect to dimension. My own impression, if we decide to move in that direction, is that the last move we might want to make--say, for example, the funds rate was at 3-3/4 percent and we decided 4-1/4 percent might be neutrality--is that perhaps we should add 50 basis points at that point. That would ring the gong as the end and we could in effect withdraw from the race, provided that during this period rising inflationary pressures did not actually start to become real as distinct from prospective.

So, I must say at this point, having struggled with this issue for quite a long time and having given considerable thought to trying to convince myself that 50 basis points might be the best move, I come out thinking that while 50 basis points has a very good logical argument for it, it's too soon. It doesn't quite get us there and I'm not sure that it gains the advantages that we would want. My own inclination at this stage--I may sound a lot surer about what I think ought to be done than I am because we know the markets are very tricky--is to do 25 basis points today, but go asymmetric because the chances of our lowering rates in the intermeeting period ought to be zero.

There is the possibility that the numbers may turn out to be a lot stronger than we are projecting--remember that the Greenbook has industrial production effectively slowing in March. In fact, the

weekly data results for March point to a decline, not a rise, so there is also the possibility that this expansion could slow and ratify the Greenbook projection. If that in fact turns out to be the case and we get a removal of any significant pressures, then we have the opportunity of maintaining a slow pace in moving up into a neutral policy area because that has been our program all along; this had nothing to do with inflationary pressures. If, however, wholly independently of our process of going to neutrality, we begin to see that this economy is not slowing--or more specifically, if we see that inventories are really beginning to move up, because that's where I think the vulnerability is--then we will have a second set of decisions to make. We would still have the path to neutrality to implement, which as far as I'm concerned we have to get to, but we would have an added factor on top of that--an additional tightening superimposed on our move to neutrality because, in effect, we would be seeing an economy that is actually beginning to heat up. My own guess is we are not going to see the economy heat up until the funds rate gets to 4 percent, meaning that I think we have enough time to move meeting by meeting, which gets us to a 4 percent federal funds rate at midyear. Then I think we will be in a far better position.

That's the way I came out. I took a lot longer to discuss this than usual because I've been thinking about it longer--productively or otherwise, I'm not sure. But I lay it out as it seems to me and frankly am very interested in any counter-arguments or issues that people would like to raise, not only with respect to the policy but with respect to all the pieces. Where I come out really depends on this evaluation of the outlook because what concerns me at the moment is not the economy; the economy looks terrific to me. I'm worried that we could break the back of this financial system and find out in retrospect not only that this situation has the negative characteristics of some of the data of the 1920s, but we could also find out that the experience of the 1987 stock market crash, which was benevolent, is not something that is likely to be replicated. Ed.

MR. BOEHNE. Well, I think the case for a less accommodative policy today is quite persuasive. We did press hard on the monetary accelerator to get the economy moving, and now as the economy approaches cruising speed we have to ease off the accelerator to avoid having to slam on the brakes down the road. The real issue--the major issue as you point out, Mr. Chairman--is how much to move. I prefer a 1/2 percentage point increase in the federal funds rate compared to 1/4 because I think we have some distance to go to get to a neutral policy, and it's better to cover that distance earlier rather than later. Also, I think a 1/4 point increase is so small, given where the economy is, that it will set off almost immediate speculation about the next move. So we will just repeat what we have gone through in recent weeks. I think a more decisive 1/2 point increase can reduce uncertainty, especially if accompanied by an appropriate announcement.

Now, there are always risks to decisive action. One risk is that we might be overestimating the strength of the economy, and a less accommodative monetary policy might damp its growth too much. Given the underlying strength that we see, that appears to me to be a small risk, and the best protection against that kind of risk is a willingness on our part to reverse course if need be. I think the greater risk is that we may have gone too slowly in raising rates for

this stage of the economic recovery. Historically, waiting too long to adjust rates has been a greater risk, and I think it's the one that we need to be especially sensitive to in this current environment. I am sensitive to the financial risks that you point out, but I must say that in one form or another that has been the argument around the table for not moving in the past when we should have moved. It also may be that this point is significantly different from other points historically, but my guess is that if we push on this economy, we will get inflation and we will end the growth. So one can come up with lots of arguments, some subtle, some not. I think the important thing is to stick to the basics and go to the heart of the matter. We have an economy that is telling us that we need a less accommodative monetary policy, and in my view we ought to move in that direction decisively. It's surprising, but when people do things decisively, they end up getting better results than if they try to outsmart themselves and consider all the angles in the curve. So, I think we ought to go to the heart of the matter.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I think that robust growth in real GDP in recent quarters has sharply diminished the slack in both labor and product markets. And if growth does not slow as much as anticipated, we could be facing significant upward pressures on inflation. Despite the action taken at the last meeting, the real federal funds rate still appears to be, in my view, unsustainably low. I think those who favor moving toward a neutral policy stance should therefore support a significant increase in the federal funds rate. Even if a neutral stance were to require a real funds rate of only 1 percent, we would still need a large increase in the nominal rate to reach that level. Those who favor such things as nominal income targeting rules should also support a significant increase in the federal funds rate. We have looked at various nominal income rules, and they suggest that we fell behind the curve at the last meeting and that we now need a large increase to catch up. And finally, financial markets appear in my view to be expecting significant increases in interest rates over the next six months. Thus, I feel that a 50 basis point increase is needed. An increase of 25 basis points would probably not be sufficient to prevent an increase in inflation and certainly would not be sufficient to make further progress in reducing inflation. Therefore, my first preference would be Bluebook alternative C. However, since I believe that whether we do things today or a couple of weeks later doesn't make all that much difference in terms of impact on the economy, I certainly could accept 25 basis points today if we had asymmetric language to the up side and at least the possibility that a move could come prior to the next meeting.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Let me just say that I agree 100 percent with Ed Boehne. He said it very well; he really reflected my position completely. I have just a couple of comments. Again, as I suggested earlier, despite the good news on current inflation at this juncture, we can see clear signs that an inflationary psychology is building, and I think that's reflected most clearly in bond rates. You mentioned historical perspective. From an historical perspective, I would like to suggest that the hallmark of our monetary policy strategy in the 1980s was that when these kinds of episodes occurred

and we got into this type of situation, we reacted. My own view is that maybe not all, but a significant part, of the substantial progress we made in that decade in bringing inflation rates down from close to 14 percent to close to 3 percent currently, reflects that strategy, and I would be reluctant to abandon it. Moreover, if one looks at that period in some detail, when we were willing to move more aggressively--and I would say that included the spring and summer of '83 and the spring and summer of '84--we got pretty good results and rather quick results with respect to inflationary psychology and bond rates. In contrast, when we have moved more slowly, such as in the early months of 1987, the results have not been as favorable. So, against that background, I think we need to move aggressively now to deal with this growing inflationary psychology. I have a very strong preference for alternative C. Are there risks in doing that? Yes, there are. But my own feeling is the same as Ed Boehne's--that the risks are at least as great in not taking this action; I think there is a good chance that we would be seen as too cautious and too tentative.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, I think I'm with you with a modification. We definitely want to send a signal to the market, and I think that there are two ways of doing that. One, which is not an option before us, is to go to a number that is a credible--a round number that people would say is the natural rate. One might contemplate a 75 basis point increase to 4 percent. I'm not recommending that, but one could suggest that. It would be clear to market participants that we had stopped. Going to 3.75 percent in my mind doesn't indicate anything. It doesn't suggest that we are going to stop at 4 percent; it doesn't suggest we are going to stop at 4-1/4 percent; it doesn't suggest that we are going to stop at 4-1/2 percent. It does suggest that we have another increase coming down the road. Since I don't think a 75 basis point move is credible and I don't think 50 basis points sends the signal of certainty, I found your suggestion of 25 basis points probably preferable. But where I disagree is on the asymmetric directive because the great benefit of a move at this meeting with the intent that we are probably going to move at the next meeting and at the meeting after that is precisely to remove this uncertainty that we are going to move on some odd Thursday in April, which is one of the things that was spooking the market last month. So, while I have no disagreement at all that we want to get there as quickly as possible, in my mind a move of 25 basis points now, 25 in May and 25 on July 5th seems to be a pattern that will get us there in splendid time. No one can accuse us of upsetting the markets, and we will establish more certainty in the market that we are headed to a fixed point that is higher than I think we would achieve with 50 basis points. So I would vote for 25, symmetric.

CHAIRMAN GREENSPAN. Let me just respond to that because I have great sympathy for the point you are making. Ideally, we should be symmetric for exactly the reasons that you state. The problem that I have with it is that I'm thinking of two separate potential monetary policy paths, which may be additive. In other words, if the situation is evolving in a relatively stable manner, then the symmetric language reinforces the fact that we are moving only at particular times. The probability of our easing is very small, and I think we can probably handle the problem that you raise in the way the minutes are written.

In other words, the minutes could reflect our thinking that the asymmetry is not a break from this pattern but a wholly different option in the event that our evaluation is inappropriate. That's the way I would look at it.

MR. LINDSEY. But the minutes won't be seen until after the next meeting.

CHAIRMAN GREENSPAN. That's true, but nobody will know the directive was asymmetric until they see the minutes.

MR. LINDSEY. I know, so what we are talking about is how we are going to look in the future?

CHAIRMAN GREENSPAN. Let me put it this way. As far as I'm concerned, the asymmetry is there only in the event that the economy or inflation begin to look much stronger than we at the moment anticipate. Now, if that occurs, one other possibility is that we can leave the directive symmetric and decide to go with a conference call. That's another possibility.

MR. LINDSEY. I would prefer that. It's more internally consistent.

CHAIRMAN GREENSPAN. That's the equivalent, as far as I'm concerned. In fact, we are in such an important period of the expansion that I think the more we talk with each other, the better off we are. I find consultation frankly quite useful. President Jordan.

MR. JORDAN. Thank you. With regard to the early part of your remarks, I agree very much that we need to think differently about what influences the purchasing power of money. It has never made sense to me to think that growth per se reduces the purchasing power of money. That's really a phenomenon of the last few decades, when we got into this notion of demand management, which I have increasing trouble with as the way to think about how monetary policy or fiscal policy influence the purchasing power of money. Of course, I have a lot of problems with Phillips curves and gap or slack type models. When we think about individual sectors of the economy, agriculture being the most notable, if we have a spontaneous increase in output--what we would call bumper crops or economists would call an exogenous increase--that reduces prices of agricultural products. That's true, really, with most sectors of the economy. Otherwise we call it a productivity increase--something we can't explain is called a productivity increase. That's the nature of a capitalist system; that's what you would expect to happen in the market economy. That is, the inherent resiliency to expand, removing the depressing forces, does not mean per se that the purchasing power of money should erode at a faster rate.

That view says to me that we don't want asymmetry if there is a possibility that asymmetry would trigger an action related to growth because it would characterize this Committee as basically not liking growth. We see the economy growing fast, and therefore we are going to react against that; I have a lot of problem with that. I thought Mike Kelley's remark about caution in interpreting where we are was very useful; it's very worthwhile to think about that. Mistakes are

made in conducting monetary policy. Occasionally, somebody has to say "Oops." We know that's going to happen; policy mistakes will be made. So it comes down to a question of which mistakes we find most easy to correct or least damaging to the economy once we realize that we have made a mistake. That's similar to the comments that Ed Boehne was making about where the risks are. If we assume that the economy is on a satisfactory path now, a gliding path toward some notion of its capacity and inflation is not accelerating and later we find out we were wrong, that is a very costly thing to correct. Whereas if we assume that we have stayed too easy too long and we need to move very quickly to get to this ideal neutral policy stance, and we find out we were wrong, that's a relatively easier thing for us to correct, politically and in other ways.

In a world where we do not have monetary aggregates to guide us as to the thrust of monetary policy actions, we are kind of groping around just trying to characterize where the stance is. I don't know where neutral is. But if I were out in the northern part of Gary Stern's District, I wouldn't know where the border between Canada and the United States is. For that matter if I were in a sailboat in the middle of Lake Erie, I wouldn't know where the border is located. But that doesn't mean that it's not a very useful idea to think that there is a border there. And it's a useful idea to think that there is such a thing as a neutral policy stance. I feel very strongly that we are nowhere near a neutral stance and that we ought to be aggressive in moving toward it. The only way I would be comfortable with 25 basis points is if I were assured that it was going to be accompanied by an action of the Board on the discount rate. Absent that, I think it would be a mistake to go 25 basis points at this time. And I think it would be a mistake to go to asymmetric in any case.

CHAIRMAN GREENSPAN. First Vice President Minehan.

MS. MINEHAN. Well, maybe you stand where you sit on these issues. Being in the First District and not being surrounded by signs that are as optimistic as those that give rise to the optimism in the other Districts, we at the Boston Bank have had a lot of arguments in getting ready for this Committee meeting. But they tended to be more about moving up 25 basis points versus doing nothing. I think we could buy into 25 basis points. We think that would be more smoothing to the markets and would be expected as opposed to a stronger move that might not be expected. We also believe that with higher rates there is the possibility of a weaker economy than the Greenbook projects, and we would not like that to occur. So by and large we would be in favor of the 25 basis point increase. We would also be in favor of a symmetric directive or a conference call if we want to make a change.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, from our point of view, in terms of the evidence we have seen, there is a very good economic case for a move of 50 basis points now. I think we need to get to the higher level sooner rather than later. Based on listening to your remarks on the markets, however, I'm inclined to go with Governor Lindsey's proposal. If we are trying to bring some certainty to the markets, I think an asymmetric directive would be wrong because when it is read after the May meeting, it would reintroduce uncertainty in the period

between that meeting and the July meeting. Such a directive means that we might do something between meetings and I think it would confuse people. So, I would favor a symmetric directive to go with the 25 basis points. And if the numbers on the economy differ from our expectations, we can have a conference call and make the decision at that time.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, as we try to make a policy decision, I suppose all of us to some extent are guided by the forecasts. As I look at the Atlanta forecast, I see very rapid growth for 1994, much stronger than the Greenbook, and inflation at the end of 1995 at clearly unacceptable levels. But as I said in my opening remarks, I don't think that's the likely outcome. I think growth is probably going to come out somewhere between the Greenbook and the Atlanta forecasts. But there is some reasonable probability that the Greenbook forecast could materialize. And, therefore, some caution is needed in that regard. I think gradualism has served us very well on the down side. I would also add that I don't view a 1/4 point increase as very insignificant at this level of interest rates; it really means something in the market. In my judgment, a gradual approach will create greater stability than otherwise. I also am very persuaded by your remarks about the financial markets. I remember very well at the last meeting, when there was an expression of interest on the part of some to move 50 basis points, that your language was in effect: "If we do that, we are going to crack the markets." We did 25 basis points and I think we came very close to cracking the markets. Now, I'm not saying that would happen again at 50 basis points, but I think we run that risk and I don't think that's a risk we should take.

Therefore, I think the 25 basis points is clearly appropriate in this particular environment. The market is expecting something greater over the course of the next several months, so I don't think it's necessary to meet those expectations at this particular point. When I came into the meeting, I was more in favor of a symmetric directive and I still would lean in that direction, but I can certainly support asymmetry. In sum, I think 25 basis points is the way we should go.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I too believe that rates are too stimulative and I think we ought to seek a neutral policy stance, wherever that turns out to be. I also believe that the robust expansion hypothesis is probably the most likely, however robust may be defined. And certainly both of those points suggest that the funds rate should be moved up. On the subject of timing, I do not believe that the real economy requires a tightening move at this point but I think the markets probably do; so I can go with 25 basis points. I do find the 25 basis points argument compelling and I'd have real trouble with a move of 50 basis points. As far as asymmetry goes, I don't think for the traditional reasons that that is the best idea on its merits, but I also agree with Larry Lindsey's suggestion that it would be confusing. However, I will not dissent over that.

CHAIRMAN GREENSPAN. But you would prefer symmetry?

MR. KELLEY. I would prefer symmetry.

CHAIRMAN GREENSPAN. Okay. President Keehn.

MR. KEEHN. Well, it is a tough call. I can't remember a time that the call has been tougher than it is right now. I can come up with good arguments, at least in my own mind, for and against either 25 or 50 basis points. But on reflecting, I do come down agreeing that at this time the 25 basis point move is the appropriate thing to do. I would not be in favor of asymmetric language. I would be in favor of symmetric language, not because I disagree with the direction of policy--I think we will be moving again--but because I'd rather not make it such a regular thing that the moves are going to be dependent on the timing of meetings of the Federal Open Market Committee. I would be opposed to establishing that kind of pattern. Moreover, I'm just in general opposed to asymmetric language. We had a very bad experience with asymmetric language last spring and, therefore, I'd prefer to leave the language symmetric. I do think that the economy is going through a very dynamic phase and that we should keep in pretty current contact as we go through this period. Therefore, I'd be in favor of 25 basis points now with symmetric language but an understanding that probably we would have a phone call before the next meeting and might make a change at that point.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. As most people have already stated, it certainly seems appropriate to act now. How far we ought to go and how fast we ought to try to get there, are the difficult questions. My best judgment is that we'll be at this for some time; it may well be that the funds rate has to go to 4 percent or more by the time we are done. But I don't have a strong conviction about how far we will need to go. As to the timing issue, it seems to me that we are probably going to be at this until we are either more confident than we are today that we have established an environment for renewed disinflation or until we actually see renewed disinflation. It may surprise us and occur earlier or something else may happen that changes our view about appropriate policy. But having said all that, I think we should bear in mind, and I'm certainly willing to be humble about all this, that the confidence interval around any forecast is very wide. And I think that argues for caution. So, I'm comfortable with your 1/4 point recommendation now. I think that is the appropriate magnitude. And I would prefer a symmetric directive with the understanding that if we need a conference call, we can have one.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. As I've expressed before, my view is that monetary policy has been in a very stimulative posture over the last three years and, like Al Broaddus, I think the quicker we get to neutrality, the better off everyone is going to be. I think the cumulative effects of that policy stance are being reflected already in rising prices and certainly in rising inflationary expectations. My own judgment is that we reacted too cautiously to these developments at our last meeting, and that contributed to uncertainty in financial markets and has resulted in higher long-term interest rates than we otherwise might have seen. I'm not saying that they would have gone down, but I'm not so sure they would have gone up as

much, and I think 25 basis points at this stage runs the risk of the same sort of reaction. Accordingly, I favor moving more aggressively at this meeting to an increased degree of reserve restraint through a 50 basis point increase in the funds rate. And were it up to me, I might even be inclined to underscore that with a 50 basis point increase in the discount rate and basically underline our resolve to contain inflationary pressures and eventually resume progress toward price stability.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I favor 25 basis points, prefer symmetric, and would urge you to consider announcing our decision.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I certainly think it's appropriate to tighten. For me the question is how to get there as fast as possible but without causing disruption in the markets. It seems important to me that the Fed not add to the uncertainty. So for that reason, I can certainly go along with 1/4 point increases. But I'd underline your suggestion of emphasizing in some very constructive way when we are finished the tightening process. We do not want to get into a precedent-setting mode because I think when we were easing it was important to be able to do it at the right time. So I would prefer not to establish a precedent of just taking action at meetings. I'm not sure what asymmetric language adds. To me it may well increase the uncertainty. So, I'd be more inclined not to have asymmetric language.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mr. Chairman, not to be facetious, but the 25 basis point approach sounds to me a bit like taking down that Sword of Damocles and inflicting the death of a thousand cuts on the economy. It dies slowly in anticipation of the next strike. Instinctively, I would prefer in the best of all worlds a 50 basis point move for the simple reason that if we are wrong and the economy is moving faster than we thought, we would be seen as having been a little ahead of the curve, and we could still move further. That to me is preferable to making a move in between meetings in reaction to something that's published in the press. If we are wrong on the other side and if the economy is significantly weaker, then we can stop at 50 basis points; we won't need additional moves perhaps. Or we don't have to stop at the 50 points; we can add another 25 if necessary. On the other hand, I have great respect for your analysis of the market risks involved in a 50 basis point move, and I will reluctantly agree to the 25 basis points with symmetric language. That's all.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN McDONOUGH. Mr. Chairman, I must admit that I have been absolutely certain about the need for a move of both 50 basis points and 25 basis points at least as frequently as daily in the last several weeks. But I've come to the conclusion that your recommendation on the change is the safer course of action for us and sufficiently bold to maintain our credentials. If the Greenbook forecast is accurate and if it should materialize quickly as

projected, I think it would be good for us to give ourselves the opportunity to see how the economy is evolving, which also leads me to the 25 basis point increase. Even though every bit of my stomach lining says we are heading toward a funds rate of 4 percent or higher, I don't have any concern about waiting past this meeting. So I very much prefer the 25 basis points just for economic reasons.

The reaction to our 25 basis point increase at the last meeting, as Peter and Joan pointed out, was added to enormously by the various other developments that they mentioned. There is a tendency for financial analysts and maybe ourselves to think that we caused it all, but we certainly were the first to get things moving. So I think we got a good deal more market effect and a good deal more tightening out of 25 basis points than we had in mind when we met on the 4th of February. As regards the market effect, I don't think we normally should be deciding monetary policy based on trying to fine-tune the markets unless one is convinced, as I am now, that the downside weakness to the economy could come from a crack in the market. As I said earlier and as you quoted me, I think that's not very probable, but I think the risk is significant enough that it's worth taking seriously. Therefore, since I cannot anticipate exactly what the reaction of the market would be to 50 basis points and since we had such an overreaction the last time, I think we are better off to avoid a risk where the risk/reward ratio is very difficult to calculate.

As regards symmetry or asymmetry, your reasoning for the asymmetric directive in a way introduces a new use of the asymmetric directive, or at least it's new to me. I think it could be explained with Don Kohn's usual verbal skills in the minutes, so it is something that I could live with. Left to my own devices, I would prefer symmetric; but if you prefer asymmetric, I would support you on it.

CHAIRMAN GREENSPAN. Let me just say that I've been back and forth on this symmetric/asymmetric issue and, as far as I'm concerned, a conference call serves exactly the same purpose. Indeed, it might actually be preferable because we do gain benefits from having the symmetric language in the minutes. So I will support symmetric as well and would propose 25 basis points and symmetric language. Would you read the directive.

MR. BERNARD. "In the implementation of policy for the immediate future, the Committee seeks to increase slightly the existing degree of pressure on reserve positions. 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, slightly greater reserve restraint or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over the first half of 1994."

MR. LINDSEY. Mr. Chairman, I know we are somewhat bound by tradition, but there is a sentence that we really don't need about slightly more or slightly less reserve restraint during the intermeeting period. Why don't we just drop it? That'll take care of your observation that in fact it's slightly less probable that an easing is going to happen. It's the same as being symmetric.

MS. PHILLIPS. That probably will cause problems in the markets.

MR. LINDSEY. Okay.

CHAIRMAN GREENSPAN. The only problem is if we change the directive, is that we don't know the consequences of doing that. So let's not.

MR. LINDSEY. All right.

CHAIRMAN GREENSPAN. But it's an interesting question. Let's review that in the intermeeting period. Do you want to read the--

MR. BERNARD. Yes, Mr. Chairman in the sentence that was circulated on the trade deficit, there was a slight mathematical error made where instead of saying somewhat larger than the average of the fourth quarter, it's supposed to say slightly smaller. [Laughter]

Speaker(?). A slight error!

MR. TRUMAN. The trade deficit on goods and services was slightly smaller in January--I made the mistake.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Broaddus	No
President Forrestal	Yes
President Jordan	No
Governor Kelley	Yes
Governor LaWare	Yes
Governor Lindsey	Yes
President Parry	Yes
Governor Phillips	Yes

CHAIRMAN GREENSPAN. We still have the question of the announcement, and I call on Don Kohn to discuss that.

MR. KOHN. I'll try to be brief, Mr. Chairman. Drawing on the work of the subcommittee, Messrs. Boehne, Kelley, and Melzer considered a couple of options for announcing the decisions of the Federal Open Market Committee. What they hit on finally was that the best bet was to announce changes in our instrument settings much as we did last time but just say what we did. That is, in this case we could say, using the wording proposed by Joe Coyne: "The Federal Reserve decided today to increase slightly the degree of pressure on reserve positions. This action by the Federal Open Market Committee is expected to be associated with a small increase in short-term money market interest rates." The thought was that this sort of announcement could be coupled with additional explanations if the Committee thought that was necessary in unusual situations, but the important thing was to get out the fact that we acted.

One option that the subcommittee thought about was releasing the whole directive, but that has some disadvantages. That would involve releasing the symmetries and asymmetries right away and whatever is left of that symmetry/asymmetry flexibility would

certainly go away because knowledge of that decision does move markets. So the Committee might be less likely to adopt asymmetries. On balance, the subcommittee thought it was a good idea just to release the decision. The reception from the public was good last time. The Fed looked and was more open. We in effect ran an experiment that worked pretty well from that perspective.

I think there is one minor note of hesitancy. The Committee looked at this about a year ago, or maybe a little over a year ago, and rejected this announcement option. The Committee was concerned at that time that it would lose some flexibility. There were two instruments: the discount rate, which rang the gong; and open market operations, which didn't. The February 4th experience, although there were a lot of special things involved, does suggest the possibility that there might be stronger reactions to announced moves both in the markets and in the public which could complicate the implementation of open market operations from time to time. So there is concern about loss of flexibility. But in thinking about this, the balance of the costs and benefits in the view of the subcommittee had shifted toward the notion of announcing changes in instrument settings when the FOMC decided on those changes.

There are also a couple of technical issues. One is when to announce. The thought was that the best approach would be to set a more or less fixed time on the afternoon of the day the Committee met; that would be this afternoon. It should be early enough to allow trading on the news in the markets but late enough so that the markets wouldn't sit around wondering how long the Committee had met. That is, we would have a reasonable prospect of being finished our work before the usual announcement time. We wouldn't want the usual announcement time to go by and have the Committee still thinking about its decision, but people assuming that the decision was for policy to remain unchanged. So the time should be late enough so that you would finish the meeting but early enough to be traded in the market, somewhere around 2:15 p.m. to 2:30 p.m. seems about right to Bill McDonough and to me. What to announce I think I've already covered. The subcommittee did not think a decision for no change had to be announced; only changes would be announced. And as I noted, the subcommittee thought that an explanation such as we had last time would be the exception rather than the rule. That would help maintain a bit of a difference between a discount rate action and open market operations. I invite any of the subcommittee members to comment.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, I have no problem at all with anything Don said as far as the statement and when to announce it are concerned. But this Committee is going to be considering other issues regarding our openness in the months ahead. And I don't see any advantage to the Committee in separating this issue, which is a pro-openness stand from other issues that may incline us toward less openness if we are in fact going to be producing a package down the road. So, I would suggest that the Committee not act on Don's proposal today. But it is certainly in the power of the Chairman to make any announcement he wishes. My personal advice to him would be to go ahead and make the announcement. But I think an announcement by the Committee would be committing ourselves to a pro-openness move

that would be a card we would permanently lose in the future for issues on which we might not be as open.

CHAIRMAN GREENSPAN. You're just suggesting that it would be in the form of a provisional statement similar to the last time.

MR. LINDSEY. Or that you make the statement.

CHAIRMAN GREENSPAN. Meaning in other words that it's not an irrevocable decision of the Committee but of the Chairman?

MR. LINDSEY. That is correct. Yes.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Alan, I wanted to make a couple of comments. First of all, I favor announcing our actions promptly whether they are taken at meetings or between meetings. My preference would be to make this change when we act on the other disclosure issues that Larry Lindsey talked about, although I can accept separating them. I do think that there is the possibility that announcing our actions promptly can have some adverse impact on the deliberative process. But in the current climate I think the benefit of providing more information to the public outweighs whatever that cost is. Obviously, that's a difficult measurement issue.

With respect to what should be released, and maybe I misunderstood a little what we discussed in the subcommittee, I personally would favor releasing only a statement with respect to an increased or decreased degree of pressure on reserve positions. I think any statement with respect to the impact on short-term market rates, in effect, is something that will be decoded. In other words, we will be using different adjectives to describe what we think the effect on money market interest rates is going to be and then we'll be de facto announcing our targets. "Small" will mean 25 basis points; "moderate" will mean 50 basis points. I don't know what more than 50 would mean; that doesn't seem very likely!

MR. PARRY. The same thing could happen with the term "reserve restraint." In saying a slight change, the "slight" may equivocate--

MR. MELZER. Yes.

CHAIRMAN GREENSPAN. Tom, let me just say that that's an interesting issue, but that's a very major question and I would hate to have that decision made at today's meeting. I almost prefer to stay with Governor Lindsey's suggestion and then when we get to the final decisions make that judgment.

MR. MELZER. Okay. I'm just expressing some views at this point. The other point I would make is that I'm not sure I agree with what Larry Lindsey was saying. We are doing something here that, if it's done well and announced properly, will have a very positive public effect. Our practice is going to lock us into that because my sense is we won't get back to these other disclosure issues for some months, and there may be other actions to announce in the meantime. So, our provisional behavior is in effect going to set the precedent

and lock us into a policy, and it will be anti-climatic when we announce it. Personally, I think we can get much more mileage out of announcing the fact that this decision has been made and just get it done. In effect, we are trading it away anyway, so why not announce it and try to get some public relations benefit out of it. The other thing I would say in such an announcement is that we continue to have our disclosure practices under review, because I think there are some other disclosure issues that in due course need to be reviewed.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, I'm not against disclosure but I would repeat what I said last time, which is that we have not really had an opportunity in this Committee to discuss this fully. There are a number of issues surrounding this disclosure matter. Tom has just brought up one of them; there are others. So from a procedural standpoint alone, I think we need an opportunity to discuss this further. If we announce it today, I think we're going to be locked into doing it. We said the announcement last time wasn't going to be precedential. If we do it twice, I think we are going to be locked in.

On more substantive grounds, we haven't really taken into account the effect of this disclosure on the discount rate, the effect on our directors. There is a whole host of things that I think we really need to take into account in a more systematic way. So I would be strongly opposed to doing anything today. I think we ought to revert to our normal practice of not disclosing our decision and let the markets pick this up and then deal as soon as we can with this issue together with the other disclosure issues, as Governor Lindsey has indicated.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I would have said substantially what Bob Forrestal said.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. I have a very strong preference to make an announcement in some form. On this particular afternoon, whether it's the Chairman or whether it's the Committee making the announcement has mainly the significance that if the Chairman does it, it doesn't lock the Committee into having made a decision to do it. So I think that actually has some merit. I have long had what Ernie Patrikis after consultation with Virgil Mattingly assures me is not a legal concern but an ethical concern; and that is, if we go into the market the way we have done it for years and we "announce" a very significant policy move by our operations in the open market, the pros with whom we deal know it before anybody else does. It may be a minute or two before, but that gives them a market advantage, which I don't like. To me it's an ethical matter, which I take quite seriously. That doesn't mean--unlike in the case of the chairman of a well known committee--that my ethics are necessarily the law of nature. But that's where I come down on the issue. I would prefer that we announce our decision and I think it's probably better on this occasion if the Chairman does it rather than the Committee.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I support the subcommittee's recommendation. And I think the latter part of Tom Melzer's remarks are right on. We could say that this is twice in a row, that it's not permanent and it's just not a precedent, and that we have still have a card to play and we might not do this in the future. Nobody would believe it.

CHAIRMAN GREENSPAN. No, I don't think Larry is saying anyone will believe it. I think what he has in mind is that it's useful when we intend to have a whole package to put it all together. That's what I think his--

MR. JORDAN. Are we going to have that package by May? Otherwise, we are going to be faced with maybe three meetings in a row of saying that this is a temporary procedure and it's not--

CHAIRMAN GREENSPAN. Well, that's a good point. And the answer is possibly.

MR. JORDAN. It's eight weeks until the next FOMC meeting. It's the longest period we experience between meetings.

CHAIRMAN GREENSPAN. I would say we have a good shot at it by May. In fact, precisely for that reason it would be useful. President McTeer.

MR. MCTEER. One of the benefits of an immediate announcement is that it eliminates any perception of leaks, so I would suggest that we always do it at the end of the meeting rather than have a hiatus.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. I would favor announcing it now.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. I'm very much in favor of announcing it. Whether it's an announcement from the Chairman or the Committee I think is immaterial. If we do it today, which I think we should, we will have established a precedent and we will have to continue. But I think it's a constructive change.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I think we should announce it on the merits of the case. The time is here to do that. As far as today is concerned, I would be uncomfortable holding this decision overnight and letting it be announced in the traditional way of Desk action tomorrow. I think that would be a mistake. I am in favor of letting it be your announcement rather than the Committee's for the reasons that Governor Lindsey and President McDonough discussed.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I agree with what Governor Kelley just said.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. I support the subcommittee's recommendation. I think we have in a sense committed ourselves to this and I think Bill McDonough's point is well taken. We should get decisions out to the market and the public as soon as we are making them, so I support announcing.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I would favor the announcement.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Well, this was a very wise subcommittee and I want to concur with its recommendations. [Laughter]

CHAIRMAN GREENSPAN. Who is the chairman of that subcommittee?

MR. KELLEY. The chairman departed the scene!

CHAIRMAN GREENSPAN. Is that everybody? Jerry, you said yes to announcing. Is that right?

MR. JORDAN. Yes.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Can I ask: Is there an auction today? Are we talking about announcing today?

VICE CHAIRMAN MCDONOUGH. There was; it's over.

MS. LOVETT. It's over.

MS. PHILLIPS. The auction is over. Okay, I'd announce.

VICE CHAIRMAN MCDONOUGH. That's part of the timing issue--to get it out after the auctions are over.

CHAIRMAN GREENSPAN. Ms. Minehan.

MS. MINEHAN. I must say I am impressed by President Forrestal's comments. I would like to see the disclosure decisions as a package and I would not like to see us committed to announcing every time. But in general I think announcement is not a bad thing.

CHAIRMAN GREENSPAN. Well, let me make the following request. I don't deny that it will appear precedential. In fact, I think it's naive to believe that if we announce today that it's not going to come out that way. We do have a marginal value in my doing it and then making it official at the time we do everything else. It's not that it's a big deal, but it's a bigger package to announce and it probably is wise to do that. Unless there is strong objection, that's what I think I'd like to do.

MR. MELZER. I don't have a strong objection, Alan. How would Joe Coyne respond to inquiries of "What does this mean?" There are bound to be some requests; what's the answer?

CHAIRMAN GREENSPAN. He would basically say the Committee itself has not come to a final conclusion.

MR. MELZER. It is still considering disclosure issues?

CHAIRMAN GREENSPAN. This will be part of a broader package. Okay our next meeting is--

MR. BERNARD. May 17th.

CHAIRMAN GREENSPAN. May the 17th; this really is a long intermeeting period.

END OF MEETING