

Meeting of the Federal Open Market Committee

February 9-10, 1988

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., starting on Tuesday, February 9, 1988, at 3:00 p.m., and continuing on Wednesday, February 10, 1988, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Boehne
Mr. Boykin
Mr. Heller
Mr. Johnson
Mr. Keehn
Mr. Kelley
Ms. Seger
Mr. Stern

Messrs. Black, Forrestal, Hoskins, and Parry, Alternate
Members of the Federal Open Market Committee

Messrs. Guffey, Melzer and Morris, Presidents of the
Federal Reserve Banks of Kansas City, St. Louis,
and Boston, respectively

Mr. Kohn, Secretary and Staff Adviser
Mr. Bernard, Assistant Secretary
Mrs. Loney, Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Patrikis,¹ Deputy General Counsel
Mr. Truman, Economist (International)

Messrs. Lang, Lindsey, Prell, Rolnick, Rosenblum, Scheld,
Siegman, and Simpson, Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System
Open Market Account

Mr. Cross, Manager for Foreign Operations, System
Open Market Account

1/ Attended Wednesday session only.

Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Promisel, Senior Associate Director, Division of
International Finance, Board of Governors
Mr. Slifman, Associate Director, Division of Research
and Statistics, Board of Governors
Mr. Gillum,¹ Economist, Division of Monetary Affairs
Board of Governors
Mr. Wascher,¹ Economist, Division of Research and
Statistics, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of
Monetary Affairs, Board of Governors

Messrs. Balbach, Beebe, Broadbush, J. Davis, R. Davis,
and Ms. Tschinkel, Senior Vice Presidents,
Federal Reserve Banks of St. Louis, San Francisco,
Richmond, Cleveland, New York, and Atlanta,
respectively

Messrs. McNees and Cacy, Vice Presidents, Federal Reserve
Banks of Boston and Kansas City, respectively

Mr. Vangel, Assistant Vice President, Federal Reserve
Bank of New York

1/ Attended portion of meeting relating to the Committee's discussion
and action on monetary growth ranges for 1988.

Transcript of Federal Open Market Committee Meeting of
February 9-10, 1988

February 9, 1988--Afternoon Session

[Secretary's Note: The meeting began with approval of the minutes of the meetings of December 15-16, 1987, and January 5, 1988.]

MESSRS. PRELL & TRUMAN. [Statements--see Appendix.]

CHAIRMAN GREENSPAN. Ted, on this alternative C, what are the interest rate movements? 3 percent? 2 percent?

MR. TRUMAN. Yes, [unintelligible].

CHAIRMAN GREENSPAN. Questions for the two gentlemen?

SPEAKER(?). Mike, the pattern of inventories is pretty critical for the forecast and I think you've made an effective case that we are not going to go through what is considered a drastic inventory cycle. But the thing that strikes me is that, really, this is almost the best of all possible worlds in nonfarm inventories where there is basically no cycle. And I wonder if it's more likely that you would have a greater reaction in terms of production than what you've shown, in which case we might have somewhat weaker growth in the first half.

MR. PRELL. As we see this, we don't believe that the overhangs are widespread or that they are very large.

SPEAKER(?). I agree with you.

MR. PRELL. As for automobiles--indeed, the automobile inventory reduction is progressing a bit faster than we had anticipated, since auto sales in January were stronger than we had built into our first-quarter forecast.

SPEAKER(?). Yes.

MR. PRELL. It's conceivable, certainly to the extent that there isn't a response early on to any excessive inventory accumulation, that we could build up a larger problem, which subsequently could give us more of a cycle. [Unintelligible] we'd have an even more dramatic inventory correction earlier in this upswing--and we have been through a number of short-run corrections--and, of course, that's a critical ingredient.

SPEAKER(?). Following up on that inventory question--the distinction between manufacturing inventories and retail inventories. I think what you show here in the charts is consistent with the anecdotal evidence that one picks up. However, there's one area where I, at least, haven't been able to get very much anecdotal evidence. You mentioned it and I've heard it elsewhere. And that is that some of the accumulation in retail inventories was planned--was desired in effect--to beat higher prices for imports. Could you expound on that?

MR. PRELL. Well, I think that's very hard to pin down. And it isn't just prices, but also perhaps in the case of apparel in the

earlier part of last year, the concerns about quota restrictions. The more general issue on prices is whether manufacturers, for example, saw the materials input prices increasing very sharply in some cases, and [since] interest rates looked negative in real terms, whether one saw some effort to accumulate inventories in the manufacturing sector. There was accumulation. It wasn't any faster; in fact, it was slower, than the increase in output. And it's not inconceivable that there could still be some significant desire to build up inventories further. We do have some moderate accumulation of manufacturers' stocks. For example, in the latest purchasing managers' report for January, there is explicit comment to the effect that there was some reaction not only to some shortages of goods and the lengthier delivery times, but also to some anticipatory price increases.

MR. HOSKINS. Mike, I don't know whether this is an appropriate question for you, or maybe for later discussion, but our first monetary policy objective states, essentially, that we want maximum output without a significant acceleration in inflation. One could reverse that and say we want to achieve a deceleration in inflation without significantly damaging employment and output. Did you choose that assumption or are we to discuss that assumption?

MR. PRELL. Well, I suppose that is certainly something fundamental to the Committee's decision-making. I don't think we've misread how the Committee has behaved in terms of putting a significant importance on maintaining growth and avoiding increases in unemployment. In terms of overall resource utilization: to have anything significantly slower than the GNP growth we have would basically bring about some greater degree of slack. It is conjectural whether we have precisely captured the desires of the Committee, but ultimately, we ended up with a forecast that sort of gave you about as much growth as we think you can get without putting enough pressure on the economy to get a real momentum developing in the inflation process.

CHAIRMAN GREENSPAN. [Mr. Morris.]

MR. MORRIS. I have two questions, Mr. Chairman. One, the part of the forecast I have a problem with is business fixed investment. [Given] sustained strength in the manufacturing sector, except maybe in automobiles, the staff is showing the manufacturing industry operating at higher levels of capacity. That is going to produce, unfortunately I think, some price strains as the year goes on. The staff projection shows a deceleration in business fixed investment against last year. Now, I find that hard to reconcile not only with normal cyclical patterns but also with the orders figures for the past four months. The projection has real plant and equipment spending up at a 2.9 percent annual rate and nondefense capital goods up at a 3.5 percent annual rate. These are unusually strong increases; it would lead me to conclude that I should discount the plant and equipment surveys as being a bit out of date and [not] factor in a bigger increase in fixed investment this year.

MR. PRELL. Indeed, the plant and equipment surveys would suggest a stronger year-over-year gain than we have for nominal business fixed investment. Those surveys, as you know, were taken before the stock market [developments] were probably fully assessed. The Commerce surveys overlap that. We think this is consistent with

the general output growth path that we have in terms of the usual accelerator effects. We don't have any particularly favorable developments in the cost of capital. We think there will be areas of significant strength, and I've tried to relate that to those areas of capacity utilization. On the other hand, there are other areas in this economy, if we are right about the overall level and pattern of demand, where the stimulus to investment will not be as great. Obviously, in the financial sector, which is shrinking, they probably are not going to be buying as many computers and other office equipment. Demand for office space may be lower. There are drags in a number of sectors of business fixed investment as we see it: the office area in general, hotels, and probably areas that we have missed in other commercial construction. So we have balanced these divergent elements in what we think is a forecast that is really consistent with historical patterns, given the overall level of growth in final demand and the financial commitments.

CHAIRMAN GREENSPAN. You know, Mike, there is a problem with the new orders series, in the sense that these are orders placed at domestic facilities. And a very big part of the strength is in aircraft orders, a substantial part of which has to be for exports and long forward 1989-1990 deliveries. There's an awful lot of export demand in those numbers as well as, probably, some tilting down in the proportion of imports to domestic purchases. So we probably are getting an upward bias in both the nondefense capital goods shipment figures and the orders figures. I would suspect that when one makes the types of adjustments on exactly those numbers, one comes out very close to where Mike's numbers are coming out.

SPEAKER(?). Well, that may be; but I looked at the only series in the capital goods area, that I know of at least, where they differentiate domestic and foreign orders--in machine tools. You have this very big rise in December in machine tool orders; it's almost entirely in domestic orders.

MR. PRELL. The question is whether this is indicative of what's going on in domestic demands.

CHAIRMAN GREENSPAN. We have no evidence of that. What we get is that there is very strong export demand, orders coming in. We can see it in--

MR. PRELL. I think the Chairman's remarks do raise a very important point on this trade picture. If you look at the nondefense capital goods orders, the average lead time--when you take out the aircraft, which really has enormous backlogs that will keep them in business well into the 1990s--showed very substantial growth in the earlier part of last year. I think we may have shown this in the Greenbook. But then the fourth-quarter increase wasn't really very great. So with that caution--

SPEAKER(?). I'm skeptical about that fourth-quarter number.

MR. PRELL. It's a volatile series from month-to-month. But I think, perhaps in terms of its leading indicator value--and it probably doesn't point very far into the future--that it's one little hint that there may be some moderation in that area.

SPEAKER(?). Isn't the consensus forecast of the P&E probably in excess of 5 percent growth? Most forecasts, that I've seen at least, have much more strength.

MR. PRELL. I'd have to look. But I think our BFI forecast is not much out of line with some of the other major ones. For example, for our 1988 forecast, we have 4.5 percent--[turning to staff] is that an annual average? DRI has 5.1; the Bluechip indicators 5.1. They're comparable; it's a very small difference.

CHAIRMAN GREENSPAN. Questions for Mr. Truman?

SPEAKER(?). Looking at the long-term interest rates in Germany, real long-term rates are unusually high. Is there some--

MR. TRUMAN. Well, I think it's puzzling. If you ask the Germans why they're high, they say that German savers won't accept interest rates that are lower than 6 percent because they assume that the long-term inflation rate will be much higher than it is currently. No matter how you talk your way around that, that's the answer you get back. And it is true that even during the last year, or a couple of years, when [market] interest rates have come down, [rates] have stayed above 6 percent. In fact, this series that we used here slightly understates the movements in rates, because it's an average of all longer-term or under ten-year public authority issues. And some of it is much less than ten years in maturity. So we have some sluggishness in that series. For example, for the ten-year bonds they have outstanding, the rate is above 6 percent, about 6-1/4 percent. It has come down a bit more than that series itself showed recently, but it is still very high. And other than the savings story, some people would point to some critical imperfections and cartelization of the financial markets in Germany; but it's not much of an explanation.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Yes. Since President Hoskins mentioned the monetary policy objectives, I guess I'd like to make even a stronger statement in regard to that. The way you stated it was somewhat different than it's written. The way you stated it was less offensive to me than the way it's written. The way it's written is so contrary to everything I believe about what our job is, that it causes me to wonder: Have I missed something all these two years or have we had this stated before?

MS. SEGER. It's the Employment Act of '46.

MR. ANGELL. Whatever it is, it seems to me that if that's what our objective is, we are always going to be on the edge of a disaster. And I don't know how else to put it. Back on chart 19--and here again I want the Presidents to realize that I'm very impressed with the scholarship of this forecast, and I indicated that to the staff--but I haven't yet seen what happens on chart 19 if we have an unchanged dollar and tighter U.S. monetary policy. Now, I presume that means that money growth is about like it was in 1987. Is that approximately correct?

MR. KOHN. For '88 it would be about the same; but for '89 it would be several percentage points less.

MR. ANGELL. In other words, M2 growth for '88 under this scenario would be 4 percent?

MR. KOHN. Approximately.

MR. ANGELL. And what would it be for '89?

MR. KOHN. One to two percent I guess--in that area.

MR. ANGELL. Oh! I see. That is quite a restrictive path. But what bothers me is the outcome. I disagree with you in regard to the sign of the result in interest rates. It would seem to me, if you adopted a smaller money growth path and if you had the lower real GNP as detailed here, that the fed funds rate might be 2 to 3 percent less than, rather than 2 to 3 percent greater than. Would you comment on that?

SPEAKER(?). I think the exercise involved moving from interest rates to the impacts on the economy and then back to money demand, as measured by standard money demand equations. That is the way it works, and there are lots of ways of cutting this. But, essentially, the slowdown in nominal GNP, which was about 1-1/2 percentage points this year--a little less, 1-1/4--is associated with this kind of interest rate rise on the one hand, and you get the sharp reduction, too, partly because of what Don and his colleagues have been saying for quite a while--because of the considerable interest elasticity in the money numbers.

MR. ANGELL. Well, apparently it's the model. And I guess from time to time that bothers me. The model that you use is not close to the model of the way I would assume the economy works.

MR. KOHN. Ultimately, I think one should differentiate between the short-run simulation that's presented here--where you slow money growth, interest rates go up, and that slows the demand for money and the real economy--and the longer-run effect where you might slow money growth, and ultimately you get the price level down, so that you would have lower inflation and then would come back to the trend rate of growth in the economy. In fact, all these models have that characteristic: that if you slow down money growth, you would come back to, essentially, the trend rate of growth in the economy as a whole. As you may remember in the discussion yesterday [during the staff briefing to the Board], we had that question about the function of economic forecasts as a whole. They have that characteristic. But in the short run, I wouldn't pay much attention to the extent of the tighter monetary policy; but it would give a calibration of what that kind of monetary policy would produce.

MR. ANGELL. I guess that depends upon how soon you expect expectations to be realized. The model that I would be using would have a different chain of events. It would seem to me--

SPEAKER(?). Yes, but just so you could see that in the consumer prices measure here in 1988. If you thought that there was a big expectational component in the rate of inflation, then with slower, or deliberately slower, monetary growth--of course, it is something very difficult to capture in the model--you would get much

less nominal GNP. You would then have some feedback effects; in fact, you would have lower interest rates.

MR. ANGELL. I consider this to be somewhat important, because if I believed that a fast growth rate of the money stock would result in lower interest rates, I would be very inclined to choose such a policy.

SPEAKER(?). In the short run.

MR. PRELL. Governor Angell, let me just say--I don't want to be unduly defensive about this assumption--we aren't making this a normative prescription for the Committee. As I tried to emphasize, we saw the economy and its current position, and looked at this question of how much room for growth there was. But in a sense, to us, the issues in the forecast and in this context are sort of asymmetrical--we were looking at how much room we felt there was to grow without moving the inflation trend much away from what it has been. That's all we were trying to communicate with that assumption.

MR. ANGELL. But you would admit, wouldn't you Mike, that "C" isn't a very pretty picture?

MR. PRELL. Well, for one, I think there is this question of dynamics in expectational effects. I think we always run into this question when we take into account a tighter policy. It always requires higher interest rates in the short run. And you have to get the lower growth to have money balances in line with desired levels, and you could then get some different paths thereafter. But this is our best guess, using our models, of what the difference would be from the forecast we have made. And yet it's not prescriptive; it's just trying to give some sense of the sensitivity of our forecast to the assumptions about exchange rates and monetary growth.

MR. ANGELL. Well, it just seems to me that the sounder money policies that we've had in place tend to result in intermediate-term interest rates coming down and some confidence in regard to this institution. And it seems to me that it's been very beneficial for us and will result in the higher growth path of the monetary aggregates.

SPEAKER(?). The 300 basis points tagged on to that scenario --it really does stretch one's macroeconometric credibility.

MR. PRELL. It certainly wouldn't put rates out of the range of recent years.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I've been in Frank Morris' camp in thinking that expenditures on plant and equipment, along with net exports of goods and services, would be the real driving force in the economy. You pointed out that he may have overlooked the foreign part of that. But that would suggest that one of the two, anyway, increases a good deal. I guess the thing that puzzled me so much in the fourth-quarter figures that were released was the sharp decline in producers' durable equipment. One of our contacts who specializes in watching the computer industry attributed this to the

And he feels

that this is a much weaker pattern of expenditures than we really had. Does that sound sensible?

MR. PRELL. There has been a great deal of commentary on this number. I think we pointed out, perhaps in the Greenbook, that there were subsequent shipments data that on the surface looked stronger than BEA had on this. But the translation, with the limited data they have, is a very complicated one. There are shipments of exports as well as domestic purchases; there are intermediate goods, which shouldn't show up in the end; there are questions about the seasonal patterns and the seasonal adjustment that goes into this because of tax law changes. And the P&E number was dragged down by automobile sales, which are not part of the shipments data. So, it's a very complicated calculation. And I guess, while we certainly expect it to revise to some degree, it isn't clear that we won't still end up with a decline in P&E in the fourth quarter.

MR. BLACK. I guess I still find that hard to believe in view of what I thought was happening. I know you mentioned in the Greenbook that a good part of this was computer equipment. And that's the reason I raise this question about

That is different from the way most of the other computer companies report the figures. I don't know whether there is any truth in what this fellow said or not, but he seemed to know what he was talking about. And it confirmed my suspicions, though I was hoping you could lend some support to that hypothesis.

CHAIRMAN GREENSPAN.

They are concerned about their competitors looking at that Department of Commerce series and I guess there are all sorts of rumors about how serious--

MR. BLACK. This fellow said he talked to
That probably was the exact reason; I hadn't thought about that, which is now [unintelligible]--

SPEAKER(?). Yes, but I thought the decline was 3.8 percent. If I read this one [correctly,] it's 7.2 percent in the fourth quarter. Where did I get that 3.8?

MR. PRELL. The PDE decline was 7 percent. It's 3.6 percent for total BFI for the fourth quarter. I'd just like to emphasize that this seasonal adjustment phenomenon will bounce the numbers around for some time in the future. Under the old depreciation rules, a company could buy something in December and get, I guess, a half year's depreciation. With tax reform, if you pile too much into the fourth quarter for tax purposes, you are penalized. And so the seasonal factors in the last several years--as you may recall, we have seen wild fourth quarter-first quarter swings--were probably beginning to capture that at just the wrong time, when this incentive was eliminated. And that could bounce the numbers around in the future.

SPEAKER(?). That's a good point.

SPEAKER(?). [It could affect the] third-quarter/fourth-quarter swing now, because you have the third quarter up about 2.6 percent.

SPEAKER(?). Yes.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. Well, ever since your briefing yesterday, Mike, I've been trying to figure out why I can't understand your point that when the fourth-quarter GNP numbers came out--which showed weaker consumption spending and greater inventory accumulation than I believe you had forecast--how now that we have those numbers, you can have an upward revision in the forecast for the first half of the year. I must say that the arithmetic still flies right by me. So, maybe you can try once again to convince me of it; I'm sure it's my density today that's doing it.

CHAIRMAN GREENSPAN. The explanation is the [unintelligible] was unsustainable.

SPEAKER(?). It's reversing.

MR. PRELL. We don't exactly go into this with a clean slate each time. There is a certain follow-through from earlier [forecasts]. But I guess we didn't have the feeling that overall production growth was going to tail off quite as fast as we had built in [earlier], just based on the orders trends and the employment data at the end of the year. We had the sense that consumer spending was not falling apart as the year ended. It was looking very weak in the early fall and didn't show much growth at the end of the year, but it didn't seem to be falling apart. We surmised from that, and everything else we could look at, that probably the stock market psychological effects were not as great as we might have feared they would be. This forecast is not a drastic change by any means from our last forecast; we're talking two-tenths of a percent on overall GNP. And there is a certain amount of arithmetic momentum in this. I don't view the change in the first half as being a very great change. As I noted last time, we perceive the slowing in the first half to come about in two ways: either that final demand will be weak and producers will react really fast to that before inventories build up; or that inventories would begin to build up and we'd see some adjustment of production in this process. And we sort of got the second [from the] emerging data; final sales in the fourth quarter were somewhat disappointing. So we have about the same outcome, but there's a slightly different story.

MS. SEGER. A second question--maybe this is for Mr. Truman--involves the assumption about the dollar. What is it likely to do this year? And if that agreement that I thought we struck with the other major nations called for drawing a halt to the dollar's decline, am I supposed to take seriously the forecast of a 10 percent decline in the weighted-average value of the dollar this year, followed by [a decline of] 8 percent next year? I just am not sure how to match that with what I thought the basic objectives were.

MR. TRUMAN. Well, it's a little less than 10 percent, depending where you start out from.

MS. SEGER. Ten from the fourth quarter?

MR. TRUMAN. Yes, but a lot of that you had by the time of the December 22 Greenbook. So the change from the average in January is under 10 percent. That is, in fact, one of the reasons why we presented the last chart here with this middle panel on it. So you'd not think somehow the dollar is really the problem, the way we set it up was to say, this is what the impact would be--you wouldn't see very much difference for 1988. But at a minimum, as I said in my comments, if the dollar is not going to go down, you're not going to get much difference [as may be seen] from that chart. And [if] everybody seems happy with the current account deficit, as we have it, then they're probably going to have less than we thought. Then looking forward to 1989, you might want to have an easier monetary policy--that's what that chart was designed to deal with--where the stronger dollar is brought about not by any difference in the policy assumption but by what the staff sometimes calls a levitation. It's a risky business forecasting exchange rates, and we have to make some sort of assumption. I find it more useful to make an assumption that eventually more price adjustment will have to take place. But there's no reason why it is essential, within the time frame of the forecast, for a lot of adjustment to be in the pipeline. If the world could stand still why [unintelligible] places we are? That's one of the reasons why we have, on the one hand "more moderate" as we have sometimes said in the past, [unintelligible]. On the other hand, we presented this alternative scenario for the four quarters.

MS. SEGER. I like the idea of alternative scenarios, but looking at these got me thinking about whether or not our assumption was flying in the face of that deal. I have a final question on the estimate for real GNP in the other G-10 countries running below our forecasted real GNP growth in each year--1988 and 1989. That makes me wonder about our export boom, and whether or not that, in fact, can materialize to the extent we are talking about.

MR. TRUMAN. Well, that forecast is only slightly different from the one for this year. And the "export boom" itself is only, essentially, the same as we had in 1987.

MS. SEGER. Well, at one time, you remember, we were lecturing the other countries to speed their economies so that it would help us peddle more of our goods overseas.

MR. TRUMAN. Apart from Japan, it doesn't seem to have helped.

MS. SEGER. We'd better go to Dale Carnegie. Okay, thank you.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. [I want to address] the capital expenditure issues that Frank Morris and Bob Black raised in a different way. Looking at the utilization rates on chart 7, some of these rates are getting pretty high. And I guess the question is: What does history tell us? When do industries, particularly textiles, chemicals, paper, and steel, which are operating at very high levels--and those are averages for each industry, which suggests that some are operating at

higher levels--begin to move? At some point they're going to begin to lose market share. And my experience is that market share is a very sensitive issue; when they hit that point they begin to spend some money. Does history tell us anything about that?

MR. PRELL. Well, I don't think history identifies clear trigger points. Indeed, econometrically, our efforts to identify capacity utilization effects on investment turn up only modest positive results on that score. We tried to look beyond any econometric evidence, and sift through what stories we could find and conversations with people. I think there is something, as I indicated, to the story of some hesitancy on the part of some companies to expand capacity aggressively. But on the other hand, we can also uncover stories that, yes, at some plants operating at high levels of capacity, capacity is being expanded by removing bottlenecks. We are expecting some fairly sizable gains in paper and chemicals.

MR. KEEHN(?). Paper is moving?

MR. PRELL. Yes. Even a couple of years ago there were probably already signs of movement in the paper industry, involving plans for putting more production [capacity] in service.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I'd like to go back to this question on inventories and distribution of business around the world. Assuming there's going to be some sort of an inventory cycle of the type you have forecast, or even greater: Do you have any sense as to what extent we could take comfort that that's going to result in a greater slowing in production abroad than domestically--given that we, of course, are importing a lot more than we used to?

MR. PRELL. This is a very difficult question. We sorted through some of the data and tried to put our finger on how many dollars' worth of imports there are in this inventory overhang. At least arithmetically, that appears to be presently in the retail sector; it doesn't amount to a lot of dollars, as best we can assess. It's probably a small proportion and would not be a significant factor.

MR. TRUMAN. To give you an example, I think one number we came up with was something like \$2 billion plus. If we spread that out over the four quarters, lets say, of 1988, it's well within the noise factor on the monthly trade numbers. So it may be there; in some sense, it is built into the forecast because we have a lower level of imports in general--that's part of the cost of production. But, in the first half of the year, based on what we know now, it's not going to show up decisively in the import numbers. And, therefore, we are not going to set off a mini-cycle in the rest of the world.

MR. STERN. Well, on the other side of it, to what extent is our domestic industry going to benefit from that?

MR. PRELL. We think the domestic industry, on net, is not going to benefit from this. It's a complicated story, but as best we

can tell, it's probably the domestic industry that will experience the greatest negative effect from the inventory accumulation. If you felt that there was the beginning of some shipping [unintelligible] into domestic firms, then the effect is going to be felt more by the domestic firms, even if the inventories on the shelves have a relatively higher import ingredient. So it's very complicated. And I think that, in terms of foreign economic activity, it's probably at most a second-order factor.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. I was going to ask Ted Truman the same question that Governor Seger raised with respect to real growth abroad. I guess Ted has basically answered the question, but if I could take it just a step further: Since this is basically an export-driven forecast, if countries like Germany and France and Italy, particularly Germany, which has not been very responsive to our overtures, were to fall short--I don't mean into recession but short of the growth patterns we expect--is this forecast in serious trouble? I guess I would add that, given the weight of our trade with Japan and Canada, they apparently could carry a lot of it; and I wouldn't expect them to fall very short. But suppose those other countries did, would you expect the forecast to come--

MR. TRUMAN. Well, I wouldn't want to suggest that the difference between 2 percent growth and zero wouldn't have an effect on our forecast. It would be something on the order of [unintelligible]. If you had 1 percent lower growth throughout this period in G-10 countries, we would say it could produce something like \$13 billion, at an annual rate, lower growth of exports in the fourth quarter of 1989. That would be next year against this year. That would have a considerable impact on the forecast. That's relatively small, but it would be noticeable in terms of our output, especially to the extent that in some sense you have so much external stimulus--one thing that the forecast itself doesn't completely recognize. In a sense we have export-led growth here, and some of the income out of that is being driven by that growth, and so you have multiplier effects.

CHAIRMAN GREENSPAN. Can I just address that question? It's an interesting question as to whether this is strictly an export-driven growth forecast. Of course, crucial in the numbers is that full percentage point decline in the saving rate from the first quarter to the fourth--if I've got it right--yes, from 5.3 to 4.3 percent. That implies basically that consumption levels are higher than they would otherwise be. And obviously, it's not a net subtraction from GNP because you have to subtract out the imports that are a part of it. Nonetheless, if you were just to re-estimate this forecast with a flat saving rate, a good deal of that recovery in the second half would just dissolve. The issue I'd like to address, which is very crucial to this question, is how comfortable do you feel with this pattern of your consumption function and the wealth effect on savings and, thus, how comfortable that we are going back to a 4.3 percent saving rate? And is my judgment correct as to what would happen if we don't?

MR. PRELL. Let me address that from the way we started this forecast, rightly or wrongly. If, for example, foreign activity were

to be weaker, and from that we got weaker demand for U.S. production, it would naturally follow that we would tend to have more monetary expansion, and initially at least, a movement to lower interest rates. That would produce some offsetting boost to domestic demand. We haven't needed to do that, in a sense, to get this kind of growth, because we have the assumptions we do about foreign economic activity and the dollar. As we view the saving rate question, I think picking out the first quarter probably overstates what we would perceive to be the movement in consumer behavior. The fourth quarter had a very big increase in farm subsidies, and farm proprietors' income was up very sharply. We think that group tends to have a comparatively low marginal propensity to consume, so that tended to boost the saving rate. We may also have a somewhat similar phenomenon in the first quarter, with a big increase in government transfer funds from the social security COLA increase. Unless that is spent very rapidly, we would tend, in the short run, to have a slightly higher saving rate. I think the potential would be a fairly high marginal propensity--

CHAIRMAN GREENSPAN. [Unintelligible] COLA on social security, you have to assume [the marginal propensity to consume] is about .9.

MR. PRELL. Yes, but I think it's a question of just how quickly that occurs. If one looks at the average saving rate for this year versus the average for last year--let alone what it was in the middle couple of quarters last year versus this year--I think there's a noticeable increase in the saving rate. And it's one that we do view as being generally consistent with the kind of wealth effect that we are building in from the stock market. Crudely, the general model results would suggest that you might get something on the order of a 1 percent higher saving rate for a period of time--well, there would be a gradual adjustment to that. I think we have some reasonable comfort with the range we're showing--tailing off next year, as it came out in our forecast. We can't really provide any particular explanation for it. The saving rate is to some extent a residual in the forecasting process, though it's a check. We don't view it as a really significant movement from what we see in the latter part of this year to the latter part of next year. But if consumers do retrench, and they're a very big segment of the economy, then it would take a substantial offsetting action of some sort to keep the economy on the same track. So, in that sense, it is really crucial.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Mr. Chairman, I think I may be on the wrong [speaker's] list. I don't have any questions, but whenever you want some comments, I'll be happy to be on that list. So I'll pass on the questions.

CHAIRMAN GREENSPAN. Any more questions to staff? Well, in that event, Ed, why don't you begin?

MR. BOEHNE. I have several comments on the regional economy as well as the national economy. As far as the regional economy goes, the Mid-Atlantic area is still operating at very high levels of economic activity. But, if one could measure GNP at the regional level I think one would see a slowdown in growth. Interestingly enough, it's more because of supply constraints than it is because of

demand constraints. Labor markets are very tight. I hear comments, particularly in manufacturing, about slower delivery times for materials. People tell me that the steel industry is not as friendly as it once was: they don't answer their phone as readily; the shipments from steel companies are slower; and in some cases, they aren't filling orders completely. So it does seem to me that there's some slowing, but not for demand reasons, more for supply reasons. I do not sense any excessive concern about inventory buildup.

But having said that about the current situation, I have noticed in the last half a month or so, some definite deterioration in the outlook--again, noticeably in manufacturing. It's hard to say why, when they're essentially complaining that they can't get enough input. I've tried to probe on this--admittedly not with a truly representative sample, but with some people--and it's a kind of a logic that says things are so good now they have to get worse. I guess that's human nature. People tell me that they have seen this kind of situation before where they can't get parts, and demand is strong, and price increases seem to come through, and that that usually is a leading indicator for some downturn. But things seem to be going very well currently.

I suppose on the national economy, I agree with the staff forecast. Actually, I think they've done a really rather commendable job, given the kind of environment that we are in. If I had any differences they'd be a tenth of a point here or there, not worth focusing on. I would like, however, to get at several larger issues in the forecast. I think that the staff has made a reasonable case for reacceleration of economic growth in the second half, and I can buy that. There clearly are risks on either side. But there wasn't a lot of talk about inflation. The emphasis, or the main question now, in current discussions is whether we are going to have a recession or whether we aren't going to have a recession. It seems to me that one could make a case, and a reasonable case at that, that we also have a threat of some accelerating inflation. And one could talk about that in the same context as a recession or no recession.

For example, we are getting more price hikes. I hear this with more frequency now--again particularly from manufacturers, but also from retail people--that their suppliers are simply passing on higher prices with increasing frequency, at least compared to recent years. We know that we have higher import prices, and that has an impact on domestic competition, particularly in my area. But I think it's also true in the national statistics. Labor markets are very tight; and one just gets the sense that we may not be too far from some kind of acceleration in wages. I buy off on the inflation forecast, but I think as we go forward it will pay to give some attention to the inflation question and not just overly focus on this recession/no recession question.

And my final comment is that I think that we are in a period now which is different from most of our experience. In the past we tended to worry about whether the economy would grow faster or more slowly or whether inflation would pick up or not pick up. We have an additional element in this international adjustment process; and we have to give, I think, considerable weight in our policy discussions to that going forward. It just simply has to go forward. I think that this gets me into the discussion for tomorrow, so I'll stop. But

it does seem to me that this is a different element than we have had in the past.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, it appears to me that the Twelfth District is exhibiting modest but steady growth. Currently available information indicates that retailers experienced a 5 percent growth in nominal sales in the final three months of the year versus the same period in 1986. We conducted surveys of retailers about inventory levels and it was a bit surprising to us that they were generally satisfied with their inventory levels; and as many indicated that they had shortages as indicated that they had excessive levels of inventories.

In the auto area, there's no question that at year-end auto dealers had high inventories. But a more recent check at the end of January indicated that that was pretty well rectified. Based upon what we've seen there are few signs, if any, that the Twelfth District had weak consumer spending or excessive inventories. However, there's no question that the numbers for the national level indicated excessive inventories in the fourth quarter. I agree with the staff that we probably are going to see a somewhat unique adjustment to that inventory picture. I think you can make a strong case that there will be a more modest inventory correction. One of the things that I think is interesting is that real P&E expenditures were weak in September and October and actually picked up in November and December. And industrial production actually has been increasing at smaller rates. It would seem to me that this is the beginning of a gradual adjustment and, therefore, the classic type of adjustment in inventories is not likely to occur. Also, it looks to me as though manufacturing inventories are in fairly good shape. With respect to autos, I mentioned the District [situation], but it seems to me that at the national level, auto inventories are not in that bad shape.

When we put this all together, our forecast is for growth in the first half to be about 1 percent or a little less; we have more of an inventory correction than in the staff's forecast, but not what I would consider to be a classic inventory correction. And then, since we think that correction is likely to be completed by midyear, our forecast in the second half is for growth of a little over 3 percent, largely on the strength of that improving net export position. In sum, we have annual fourth-quarter to fourth-quarter growth in GNP which is very little different from the staff forecast. But we do have a pattern of a little more first-half weakness and second-half strength.

CHAIRMAN GREENSPAN. [Mr. Keehn.]

MR. KEEHN. Let me just start by saying that our forecast is really very close to the staff forecast; our contour is terribly parallel. There really are no differences that are worth talking about. Importantly, I certainly view both our forecast and theirs, at least in the growth perspective, as being a very positive outlook--certainly not negative. I think we are making a shift from a consumer-driven economy to greater strength on the manufacturing side. And certainly, the improving trade balance is a part of that. Also, from the Midwestern perspective, no one I talk to senses any emergence

of a recession, as I keep reading about in the Wall Street Journal and the New York Times.

With regard to the District, our growth characteristics are now very much in parallel with the national numbers. Having lagged so long, we are very much on track right now. Just to hit a couple of individual sectors: first, the agricultural part of our District is clearly showing signs of improvement. Land values rose last year, and in the fourth quarter these values stabilized at higher levels; and we've seen a lot of land transactions--enough purchases taking place to give confidence in the numbers. Commodity prices are higher, so the exports are helping that. Farm debt levels are down and, I think, at a much more manageable level. Even the beleaguered equipment manufacturers--and this has really been a very tough industry--are showing signs of light. I'm hearing the first good news out of that group that I've heard for a good many years.

We talked about machine tools a little earlier, but one of our directors operates a very large machine tool company and they are operating at an 80 percent rate; they are enjoying the best quarter that they have had since 1982. The import penetration of machine tools, at least from their perspective, is down significantly and they think the Japanese are on a conscious program to try to curtail their exports to the United States. In the steel industry, I think there has been almost a spectacular turnaround, with the industries--certainly in our area--operating at very, very high levels. Delivery schedules are being lengthened out, and we are hearing increasing comments about price increases, and this time they're sticking. The paper industry--I mentioned that a moment ago as well--is operating at rates over 90 percent, and I am hearing more noise that they're getting into capital expenditures. On the housing side, we have several directors involved in that and they all say that the December numbers were distorted, probably by weather, and certainly are not reflective of a fundamental change in conditions. The auto industry, which has had high inventories, is going to have lower production this quarter, but I think to some extent that's a corporate problem. GM and Chrysler are digging out of very high inventories. Ford is not; in fact, their production schedules in the first quarter are going to be up, not down. So then, as far as growth is concerned, everybody I talked to--though there is a high level of apprehension and concern--certainly does not anticipate, from their own business perspective, anything like a recession.

Let me just conclude by picking up on some of Ed Boehne's comments, because I think they were very appropriate. With regard to inflation, all of the indexes indicate that we are going to continue to experience moderate inflation. But I think some of the stories don't match the indicators; I keep hearing more news and more noise about price increases that are beginning to stick. In the raw materials area, nonferrous metal prices are moving up pretty rapidly. Aluminum and copper--we have talked about those in the past--are much, much higher. Many chemical products that are in short supply [unintelligible]. Also, people that we talked to who buy copper are paying much more. There are definitely higher prices in their production process.

SPEAKERS(?). [Unintelligible--Several speaking at once.]

MR. KEEHN. I mentioned steel a moment ago--one person I talked to said they had an increase in steel prices of 10 percent in January and another 10 percent in February. And some of these prices are beginning to move through into finished products, as market conditions permit. Wage rates are certainly not affected. I think wage rates are continuing to perform very, very well. While the economic outlook seems solid, I must say in regard to the inflationary outlook that I think the risks are on the upside rather than on the downside.

CHAIRMAN GREENSPAN. Mr. Forrestal.

MR. FORRESTAL. As I assess the Sixth District, Mr. Chairman, I would have to conclude that conditions are mixed. From our local contacts we're getting confirmation of things that we are seeing nationally--that is, we have reports of heavy inventory accumulation, particularly at the retail level. There are some indications that wholesalers of consumer goods are starting to use incentives and promotions to generate greater retail orders. On the other hand, some of the manufacturers that we talk to report that they're adding to inventories strictly as a precautionary measure, as delivery times lengthen and capacity pressures intensify in their industries. That's particularly true for paper and textiles, and this of course reflects the improvement in the tradeable goods area. A lot of these manufacturers are also reporting that their uncertainty about the dollar is causing them to hold back on some business fixed investment or capital expenditures. They got burned at the time that the dollar was very high and they're reluctant to go into a lot of expensive business fixed investment at the moment. A lot of the manufacturers are also reporting backlogs of up to six to seven weeks in orders. As for prices, we get spotty information about them, but in general I would say that there's a tendency for price increases to be coming into the marketplace. In agriculture, we're beginning to have more and more good news, particularly because of strong demand for cotton and vegetables. Interestingly, some of the areas of the Sixth District that have been growing rapidly are now beginning to slow. In particular, I find this in the Atlanta metropolitan area where for years I've been reporting to this group that it has been a go-go, boom kind of situation--partly because of construction--but now other sectors are beginning to see a decline. That's also true in south Florida, which had been growing quite well, and part of that slowdown is in the services sector.

Looking at the national economy, we have virtually no difference with the staff forecast. I could go through some very, very slight differences in nuance in some components, but basically we have essentially the same forecast as the Greenbook. On the inflation side, again, we have roughly the same outlook for prices, with perhaps a little more pickup in inflation than the staff toward the end of the year. I'm a little concerned that import prices might move up a little more quickly than the forecast would indicate.

As I look at the national economy and the forecast, Mr. Chairman, I guess I would have to conclude that the risks are probably on the downside, but maybe not very strongly. It's possible, as we heard from the chart show, that consumption may not turn around as quickly as we anticipate. Growth abroad may not be as heavy as we expect and, as I've indicated, some of the regional contacts in my

District are suggesting that capital expenditures may not be quite as strong as we are forecasting. So, we could have some of these shortfalls, and I think perhaps that's where the risk is; but by the same token, I do also agree with the forecast that we are going to see growth picking up in the second half of the year.

I think in terms of policy, the broader issue that I'd like to address is my concern about overreacting to the weakness of the first half and not taking into sufficient account what might happen in the second half. In other words, I'd be concerned about extrapolating the sluggish activity we hear about right now. I share the view of others who have just spoken that weight needs to be given to the inflationary implications for the second half of the year.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. As far as the national economy is concerned, I guess my own view is a little less optimistic than the staff's, mainly because I think the first half is going to be a bit weaker. My intuition is that the inventory correction might be more significant than they're predicting. I also think we probably have not yet seen the effects of the stock market decline. I think that's coming. I also think we are in the midst of this transition that Ed Boehne has referred to--and I don't think that this transition from consumer-led growth to export-led growth needs to go smoothly in each and every quarter. So, I think we have to be prepared for a certain amount of bumpiness as we go forward.

Let me give you my intuition about it all: in talking to people around the District, I'd say they're probably, in general, somewhat more optimistic and more positive than I am, although [not] ebullient. But that has been the tenor, I think, for a while now. Part of the reason is that agriculture is clearly doing better. I won't go through all the reasons for this, but agriculture is doing better and people are starting to observe that that is filtering into mainstreet business in rural communities. Clearly, that will be a reversal of what had been going on for a number of prior years. I think retail sales, in general out our way, have been better than expected. And finally, I just want to report that the major airline in our District indicates that their cargo business has been quite strong both to Europe and to the Orient--unusually strong, I'd say.

CHAIRMAN GREENSPAN. Tom Melzer.

MR. MELZER. In the Eighth District, the fourth-quarter data that we have are all very strong--quite a bit stronger in any number of measures, including employment, construction, income and so forth, than the national data. I guess more importantly, for where we are now in terms of discussing anecdotal information, the sense I get from a major national retailer is that there is some disappointment with their sales performance. There is improvement in relation to last year, but probably not as much as was being targeted. But I don't get the sense of an inventory problem in terms of general merchandise. Where I pick that up is more in talking to people in areas like furniture, consumer durables, appliances. I sense that this is not a problem yet that has spilled back into the production cycle. People have not changed production plans based on this, partly because of order backlog and the like. But in the major appliances area, one

particular manufacturer is about 9 percent behind where they were a year ago. By the same token, that same manufacturer indicated that they're really seeing a lot of raw material price increases coming through, and for the first time since 1984 they're going to try to pass that through with a price increase in their products. So, that reflects some of what we've been hearing elsewhere around the table.

Finally in terms of the [national] forecast, I would say our forecast is quite a bit different in the sense that we are looking for much slower real growth and modestly higher inflation than the central tendency. To some extent, I think that's influenced by our assumption of a monetary policy roughly consistent with last year's. This was based on a model using 5 percent money growth. What that shows in 1988 is what I would call a reasonable economic performance on a longer-term basis--in the 2 to 2-1/2 percent area real [GNP]--and maybe 4 to 4-1/2 percent in prices. What our model, and interpretations of it, would tend to indicate is that trying to respond to the short-term weakness that shows up with very strong money growth here would have very little effect in the short run; really a lot of it would pass through into prices looking out into late 1988 and early 1989. I share the view that has been expressed in terms of recognizing the constraint that the external adjustment process puts on policy, and perhaps to some extent, the desirability of accepting slower real growth than might have been accepted, say, a year or two ago.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, it doesn't look as if we have that many differences for the year as a whole with the Board staff's forecast. We are sort of in the same camp--which probably makes you very nervous, Mike. But I think what's coming out in this discussion is that the shape or the profile is probably more important for policy than taking the year as a whole. Several people have indicated that they think the weakness in the first half, as a result of the inventory correction, may be greater than the staff is projecting. Most of my colleagues at Richmond share that feeling. My feeling is that the staff has it about right. But I think that, in either case, there's a distinct risk that we can have more strength in the latter part of the year than people in general have been thinking--in view of the turnaround in the aggregates, the shape of the decline in interest rates, and also the obvious strength in the industrial sector. So I think this is something we ought to bear very closely in mind as we address the policy issue because we may have a short-term problem, from the policy standpoint, that is quite different from what we may have later in the year. And that will influence what I will say later on with regard to the various alternatives.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, I think the Eleventh District, in many ways mirrors the national economy, although the plane that we are on is lower than the plane where the national economy is now. We have had a little improvement, although I think that our uncertainty remains, and if anything, may be increasing a little. Our employment gains continue at slightly less than the national rate. Our construction sector remains the weakest sector and that's really no surprise. Just as an example: for the whole state of Texas in

December, we had permits issued for 100 apartment units, which is pretty much next to nothing.

MR. JOHNSON. Did you need them?

MR. BOYKIN. However, our manufacturing continues to show signs of improvement, and that's mostly related to the lower dollar, of course. Construction-related and energy-related manufacturing are exceptions. We think our principal vulnerability is to national recession more so than to the possibility of lower energy prices. Anecdotally, with regard to perceptions and attitudes--which I think do get to be important, certainly at the margin--in terms of how you're going to [unintelligible] concerned with the condition of our financial institutions, which remains somewhat of a drag. I've had two or three business people visit with me from our small business advisory group, and they are concerned because they don't feel that our financial institutions are in a position to meet their credit needs. This is a drag in terms of the credit that they need to move along. I think in many ways our business people are more optimistic, but the timidity of the financial people to make loans is a real concern. And then the question is: What do we do about it? You talk to the bankers and, of course, they will tell you that there aren't any good loans out there. There is just not any loan demand.

The Southwest plan that we've been reading about--that the Federal Home Loan Bank has to try to do something with savings and loans that are in trouble, a large portion being in Texas--I think is being greeted with mixed views. I guess we are coming to the point, or at least I am in my own thinking, [that I'd like to see] any plan as long as something would happen as opposed to just talking about it. Now, in talking with savings and loan people and with other investors who have proposals pending to try to become involved in this, they say it's extremely difficult to get anything to happen. The fact is that they think there seems to be a pretty heavy overlay of politics when it gets to the Washington level, with respect to getting some of this restructuring done. But I think sooner is much better than later. There is a mixed view on whether, if we get a restructuring plan working, it will reduce the effects of the premiums that it costs to fund, which is not only hurting the savings and loans, but certainly also the banks. I think hopefully it will help; it certainly will not hurt. Real estate, which I've reported on, we read about. But in visiting with a chairman of savings and loan association, his judgment is that there is at least \$100 billion of really troubled real estate in Texas, if you really face up to it. Now that's one person's [view].

MS. SEGER. That's pretty big.

MR. BOYKIN. Even in Texas. And it's a lot bigger than it used to be.

SPEAKER(?). That's book value, right?

CHAIRMAN GREENSPAN. How much of that is directly owned by a financial institution or de facto owned with those [unintelligible] paper?

MR. BOYKIN. A lot of it. And I don't know whether I said this a while ago or not, if I did forgive me--but this same individual told me that his institution owns 10,000 apartments and they just reassessed their loan portfolio and they're getting ready to own another 10,000. You know, that says--

SPEAKER(?). But who put those 100 building permits in?

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. However, it's always difficult to follow the Eleventh District. Over the years, we in the Tenth District have lagged the national economy, both in personal income as well as employment growth, generally throughout the cycle. That's true again this time. However, there is some optimism it seems to me, given [developments in] two or three primary sectors of our economy. For example, in agriculture, which has already been spoken of here, land prices are up; commodity prices are up; and exports appear to be very vigorous and have taken with them the red meat prices, particularly for cattle and hogs. The farmers have recovered from a very low level of activity and they're feeling very good, even in the middle of the winter with cold weather. I think an important observation, which Gary Stern made, is that there are some real paybacks to the agricultural banks--their outstanding agricultural credit--and that is flowing back into main streets of these small communities. Although that sector is not totally reviving, there is some optimism appearing there. On the other hand, in the energy sector, apparently because of the lack of any substantive agreement among OPEC members to control supply, what we saw as an uptick early in 1987 in drilling exploration activity has dropped off again in the Tenth District. People are simply not willing to commit to financing another hole--to put down another hole to discover whether there is any more resource there. One of the bright spots, as mentioned earlier, is in the aircraft orders that have been booked, which impacted our District rather significantly through Boeing, Beech, and other aircraft manufacturers. It has given some real hope for an uptick in that sector. Commercial construction is winding down in our District. It should have wound down in Denver, Oklahoma City, and Tulsa two years ago, and as a result, there are high vacancy rates there. But by and large it's being pretty well managed.

On the national level, as far as the forecast is concerned, I have no disagreement with the Greenbook. My staff would be a bit more pessimistic than I personally, but the Board staff's forecast is right on, as far as I'm concerned. And I'd like to echo those comments that have already been made that we don't become overzealous in the first half of the year, or at least the first quarter, in working off the inventories, if indeed that be the case--jockeying monetary policy around to try to accommodate an unforeseen event. I'll talk a little more about that tomorrow.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I guess my main difference with the staff forecast involves the inventory situation. Because I am more pessimistic about whether or not the current levels are considered excessive or right on, that makes me have a different point of view about what's going to happen to them. I think that there's going to

be a lot more worked off in the first quarter, and also some in the second quarter, so I have a significantly weaker first half. In fact, my personal view is that we are going to have a down quarter in this present period. Therefore, because I have a lot slower first half, I also have been the proud possessor of the low end of the range [of the members' forecasts] for the whole year, but this isn't my only difference. I also think that housing is going to be somewhat weaker in the first half. Also some kinds of construction such as office buildings and shopping centers, those sorts of things, I think are going to be weaker than maybe is implied by the forecast. I think that we have to be paying careful attention to this. Whether or not we will see what's coming in time to adjust, I think, is certainly an open question.

In connection with an earlier comment about why these businesses aren't expanding their capacity, I had two interesting conversations this week. One was with the chairman of the board of a large chemical company and one was with the chairman of the board of a large paper company down In each case, the main point they made about lack of willingness to commit to a major new project is that there is all this uncertainty about what's going to happen about public policy. They think people down here operate like whirling dervishes--you know, they can't keep policy stabilized for very long. It's impossible for them to plan. They have questions about what's going to happen to fiscal policy. You get a cut for a couple of years; then you get tax reform--they're still trying to figure out what it really means. Based on how they read the deficit numbers, they are assuming that we will probably get a tax hike; and because corporate America is not very popular, they think they will get a big part of that bill passed on to them. It's just very, very difficult for them to plan. They also have concerns about where interest rates are going. They're not talking about whether they're too high or too low, but just about the volatility; and it makes it tough for them to do the arithmetic.

And finally, in looking at the foreign exchange markets, here again the volatility makes life tough for them. They are not assuming that the dollar is going to stay where it is over the next few years. A number of them were really burned in the late '70s and the early '80s, when they had expanded dramatically based on assumptions of strong future growth. And then just as the plants were coming on stream, the growth evaporated. So they were badly injured and, at least according to my sources, they don't want to get into that predicament again. That doesn't suggest that they're not doing certain kinds of capital spending, because they are; it's much more targeted to specific kinds of products and toward specific production problems, with a big emphasis on getting productivity improvements, rather than--I think the term is [unintelligible] expansion. So, for what it's worth, I thought I would pass that along. Thank you.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Just very briefly, the Fourth District is very similar to what the reports were with respect to Philadelphia and Chicago. We are strong in terms of steel and chemicals and capital goods. And, despite a certain amount of probing around for difficulties there, we're having a lot of trouble finding any. To answer Ed's question about why people are so nervous, even though

things are so good: it's probably because we're always calling them up asking them what's wrong. There's a problem every week, and they think I know something.

SPEAKER(?). You can talk to [unintelligible].

SPEAKER(?). You can create a recession.

MR. HOSKINS. Yes, all by myself! The only exception, really, is in the state of Ohio, where we had a full percentage point rise in the unemployment rate in the last couple of months. And, from what we can tell, that's entirely associated with autos and the buildup there. As for the financial forecast, I wouldn't quibble with the staff's projection.

CHAIRMAN GREENSPAN. President Morris.

MR. MORRIS. Mr. Chairman, our forecast is higher than the staff forecast in both real GNP and inflation, primarily because we think that capital spending is going to be higher this year than they're projecting. I think we have a data system in the United States that is pretty oriented toward the idea that the United States is an island--here we sit not knowing how much of this increase in inventories is imported goods and how much is domestic. The conclusion [with respect to one's forecast] obviously is very different. But we don't know.

SPEAKER(?). I think Mike Prell knows but he won't tell us.

MR. MORRIS. There's also this issue that was stressed earlier--that we don't know how much of the durable goods orders are from domestic origins and how much from foreign. It seems to me that we, as an institution that works on these data--perhaps you [Mr. Chairman] might use your good offices to try to see if we could expand this kind of differentiation in the data, because I think we are going to need it in the future.

CHAIRMAN GREENSPAN. You know, we used to have export orders. Ted, didn't we have export orders?

MR. TRUMAN. Yes. The problem, as with many of these series, was that the series got to be so bad and unrelated to anything that you thought they were predicting. There was a big powwow--in the early '80s, I think--to figure out what to do with them. The advice of the staff at the time was either improve them or throw them out.

SPEAKER(?). They did the latter?

MR. TRUMAN. [Yes.]

MR. MORRIS. But I think that was at a time when it wasn't really as important to us to have these data as it is now. The Germans and Europeans in general seem to be able to generate numbers like this.

MR. TRUMAN. It was one of those series that just did not have enough--

MR. MORRIS. I was kind of [unintelligible] by that as a proposition. The occupancy rate of the New Hampshire hotels is 100 percent this week because all of the national press and many political people have invaded the state. The vacancy rate will start to grow next week and they will again be thinking about whether we are going to get enough snow to bring the skiers up to New Hampshire. But for the moment it's booming and you couldn't get a hotel room in New Hampshire. As I've indicated before, we have had a downtrend in manufacturing employment in New England since December 1984, reflecting a mini-recession in our computer industry. That downturn has ended. October-November show the first increases in manufacturing employment in New England in our computer industry since the end of '84. Given that our unemployment rate is 3 percent, I think the only question is: Where are they going to find the labor to generate a further increase in employment? I had thought for a while that perhaps a slowdown in defense contracting might spin off some skilled labor that the high-tech industry could use; but I've been disabused of this notion by our defense industry people who point out that what's happening in the Pentagon now is that they're focusing on slowing down the increase in the number of what they call, in Pentagonese, platforms--ships, aircraft, and so on--and focusing on increasing the electronic capabilities of existing platforms. We're not much on platforms except for nuclear submarines, which are made in Connecticut. Our primary defense product is defense electronics and the outlook for that has not been impacted at all by the slowdown in real defense spending in general. In our area we are still having an office building boom. [I saw] a big sign saying 75 percent committed. I inquired as to whether that could possibly be true and I was told it really is.

SPEAKER(?). Boykin needs to know about that.

MR. BLACK. [Unintelligible] now 75 percent of the developers are committed.

MR. MORRIS. My concern is: When is Boston going to turn into a Dallas or a Houston? It has to happen sometime, but it appears that it's still some time off.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. As far as the forecast goes, our forecast again is virtually identical with the staff forecast, so there's nothing to talk about there. On the anecdotal side, the commentary that we hear--whether it's from people on our small business advisory council or on our board of directors or people in between--is generally, with some exceptions, along the lines of the kind of thing Ed Boehne was talking about before. But even at this last meeting of the small business group, I guess it was two weeks ago, I was amazed. These guys were talking about their steel shipments being on quotas in upstate New York. And that's--

CHAIRMAN GREENSPAN. It would have to be. They shut down the whole industry.

VICE CHAIRMAN CORRIGAN. Well, that's true. I'll come back to that in a minute. But again, the broad thrust is in the direction of the kind of comments that Ed Boehne referred to earlier. That has

influenced my own thinking, at least at the margin, in the direction of not being overly preoccupied about the prospect of a weak first quarter or a weak first half. I should add that, on I guess it was Thursday or Friday, I took a poll of a couple dozen economists in the Bank, and I asked them whether any of them foresaw a recession. And every one of them said no; and that's when I got worried.

MS. SEGER. Did they call the last one?

VICE CHAIRMAN CORRIGAN. They haven't been around long enough!

MS. SEGER. [Unintelligible].

VICE CHAIRMAN CORRIGAN. That was a tongue-in-cheek remark, Martha. I even said that myself: "That's when I got worried." But what I'm really worried about is not the first quarter or first half. What I'm worried about, as I've said before, is the intermediate-term problem we have in terms of winding down the external deficits, with all that that implies, without ending up with a serious inflationary problem on our hands. I think all the risks in the intermediate term are on the side of more inflation, not less. And I can't find a way to approximate a transition out of those external deficits that does not leave me with that conviction--that the risks over the intermediate term are on the side of more, rather than less, inflation. To complicate the problem, from where we stand right now, in order to achieve that transition, under the very best of circumstances we have the equivalent of \$4 to \$5 billion of unfunded external liabilities in the form of the cumulative changes in the current account deficit that are going to occur, almost without a doubt. So, that's where my concerns are. I think the risks of a recession in the near term are there; and we have to guard prudently against that. But I think we have to keep our eye on the longer-term problem and the longer-term adjustment, because I don't know of any surer way to end up with a really nasty recession than to make the mistake on the side of ending up with more inflation and not less. So, I'm powerfully influenced by those longer-term considerations.

CHAIRMAN GREENSPAN. Longer-term, you're talking 9 to 18 months?

VICE CHAIRMAN CORRIGAN. I'm talking even longer than that--perhaps a period of as much as two or three years.

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. I largely agree with the staff forecast for the first half of 1988, but I do have a couple of doubts on the bounce-back, and the basis for the bounce-back, in the second half. Just to review a few of those things: the government [sector forecast] for the year as a whole is a -1.3; consumption is slow; residential structures are flat; business investment is 1 to 1-1/2 percent; and export growth--which is the driving engine of the economy at the present time--is slowing significantly. For instance, if you compare: there was 23.8 percent growth in the third quarter of 1987 and only 12.8 percent growth is forecasted for the third quarter of 1988 which, after all, is the opening quarter for that second half bounce-back. So, I really don't think that the forces that are going to generate

that bounce-back in the second half will be in place. First of all, as the Chairman mentioned already, much of the forecast is based on a drop in the saving rate--something that we really don't want to see, for the reasons that Jerry Corrigan just mentioned. Second, once that first-quarter or first-half slowdown hits, I think there will be a lot of businessmen who will be revising their own forecasts, and then their investment decisions, for the second half. Third, the leading indicators, although they're not all that reliable, have been solidly down for the last three months. And, finally, nobody has mentioned--Martha Seger was skirting around the issue, I think--political uncertainties. Let me do it anyhow. As we get close to the election, the political uncertainties and the new programs that will be discussed--on the tax side, on the federal government spending side, and in general--will also not be exactly forces that will lead to rejuvenation of investment spending before the election. So, plans will get postponed; that's something that we have experienced in [election] years before. Overall for the second half, I would see a weaker economy than the staff sees, and most of the risks there will be on the downside. I'll leave it at that.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. The staff forecast, it seems to me, is in the ballpark, although I have very little confidence in our ability to see quarter-by-quarter. That is, I would tend to look at what happens for the year, and appraise that. The staff probably does better than I would in regard to calling these quarter-by-quarter changes; anytime I try I can't get it right. I think there are some extreme circumstances that make forecasting much more difficult, and some of them have been mentioned. We have had sectors of the economy in and out of recession; now we have a dramatic switch in the net exports area at the same time that, clearly, consumer spending is altering its path--the data we have in regard to the use of cash rather than plastic tend to indicate a different kind of behavior. It seems to me that the Chairman's point on the saving rate--that a 1 percent difference there is a large number and makes a lot of difference--should be emphasized. I think there are many, many special difficulties.

I would point out that I did have a chance to go to an area I thought would have the most dismal [economic conditions] in the United States, so I decided, with Bob Forrestal's permission, to visit the branch at New Orleans. I was really quite surprised, Frank, to hear the number of stories about firms that are headquartered in your region that are locating plants in that region. And I guess that's what we would come to expect, given the labor market conditions there versus labor market conditions in your area. So, I think it's very hard to know how the expansion areas match out; I think we have to be careful to watch it on a week-by-week basis. But I don't think that we should let ourselves get scared by those who use some rules of thumb to tell us about when recessions occur.

I think I'll mention commodity prices so that I don't have my reputation damaged in that regard. The precious metals make up a part of what we call reflective indices on commodity prices--that is, they tend to reflect more quickly changing scarcities in money. And there's no question that we had some indication there that would seem to me to call for less extreme slow growth in the monetary aggregates,

growth path. So it seems to me that it would be more appropriate for us to target growth above the 3.5 percent or 4 percent range of M2 last year. But I would point out to you that even though industrial metals seem to have gone through their cycle, we do have some evidence of upward price movements in the nonoil portions of our experimental index, which is designed to measure the flow-through effects. That includes a lot of food and fiber, and my concern is that wage rates seem to be more sensitive to discretionary food and fiber prices than they probably are to many other prices. I'm becoming worried that we have been in a period of exchange rate adjustment, with some import price increases, for long enough that it's going to be very difficult for us to go much longer without having a permanently higher inflation rate--one that's just not acceptable. It seems to me that it is important for us to be on guard in that regard.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, sir. I share with many others the view that the staff forecast is a very good one. Not only is the forecast good, but I think it's a very attractive path for the economy. I like it a lot. I'd like to just freeze dry it and put it on a shelf and consider it a record. I hope it will happen very close to that way. But, of course, what we are talking about is where the risks lie in [potential] deviations from the forecast, and I'm not as confident as some seem to be that they're on the high side. I'm a little more concerned about the low side. I had a list here I was going to run that was very similar to Governor Heller's and I won't repeat all of that. I do think that we should keep in mind that the factors that are going to give us a stronger second half, if we get it, depend to a very substantial degree on interest rates at least as low as we have and probably lower. And, if we don't get it, I'm not sure whether some of the other indicators that we see that could take us toward weakness won't gather strength. I have concern about the weakness, the extended weakness, of the aggregates. I think I was pretty comfortable, and maybe complacent about it, for a long time in view of the fact that they had run high in 1985 and 1986 and it seemed to me to be a reasonable catch-up period. But now I'm beginning to get more concerned about it, particularly the weakness we had at the tail end of 1987. It came back, as everyone knows, in January. Now, I may be premature on this, but I'm a little concerned that they're beginning to fall back again, and I would worry if that started to happen.

Another key thing in keeping the economy going reasonably well and achieving this transition that we need to achieve is to keep this export growth going. I think that's going to be harder to do as we go along. We may have gotten through the easier part of it. Unless I'm mistaken, it seems to me that this path would take us to what looks like a surplus, ex-oil, by the end of the forecasting period in 1989. Ted, you may want to correct me on that. At any rate, we're going to be either in surplus, ex-oil, or close to it; and I'm not sure that the rest of the world is going to let us get there without some disruption along the way. It's a little harder for me to see a lower dollar and that strong a real trade pattern. I'm afraid that something's going to have to give there, and I'm not exactly sure what it's going to be. But my concern is that it would be on the side of weakening the economy somewhat. Given the straws in the wind and the difficulty of achieving that level of continued export growth over

many more quarters out in the future, I fear that the risks may indeed be somewhat more on the weak side rather than on the strong side.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. I've been sitting here, choosing to be last because I feel sort of jet lagged. I just got back--well, Jerry did too, and he was very articulate, so--

VICE CHAIRMAN CORRIGAN. That's because I got the earlier flight.

MR. JOHNSON. Yes, you did get a little earlier flight. So, I'm not sure I can really get into some of the detail. I don't think I need to, because I think all sides of the issue have been discussed. I think the forecast is a perfectly plausible scenario, and I think it's well done and carefully detailed. But, as with any forecast, its problem is that it's just a forecast and who knows what's going to happen six months to a year out. My general feeling is that the fundamentals are basically good. You don't see the kind of forces at work right now, it seems to me, that would lead to the kind of classic inventory correction that some people get hysterical about. I agree with Bob Parry that you just don't see the kind of price pressures out of whack at this stage that would lead to some serious continuing deterioration. But at the same time, I think you also have to look at the evidence that's before you and get the best reading you can from it. After listening to all this, what I worry about a little I guess, is that we're going to work ourselves into some sort of macho chest beating--that we've got to hang tough through this--and ignore some of the conditions that seem to be developing. I think a lot of what we are seeing has to do with the psychology that develops. I agree with what Bob Heller says, that you may get what looks like a temporary inventory correction underway, but if a very negative psychology builds on top of that it can continue, and who knows what will happen. I just don't want us to be asleep at the switch. Our short-term function is to try and make sure that we keep things on track. I agree with what Jerry said--there has to be an external adjustment to get that [outcome] and we can't let aggregate demand surge on us and waylay the trend that is developing now. But at the same time, we can't afford a plunge in real spending. I think our whole scenario hangs very fragilely on the saving rate/consumption issue and how real income develops. So there is a lot of risk to this scenario. If we are not asleep at the switch, I think chances are we will get on the other side of this inventory situation, and the fundamentals will remain good, and we can keep things going at a modest rate without inflationary pressures. I agree with what Jerry said--that the long-run view has to be oriented towards keeping our eye on the inflation situation. I think in the long run that's always the case, especially when the expansion is this mature. I don't want us to fall asleep here.

CHAIRMAN GREENSPAN. You're sitting here with jet lag. That wasn't too bad. If I were actually doing the forecast in great detail, I'd come out very close to where the staff comes out. The trouble I have with it is that the structure of the economy at this stage is really quite different from anything I've ever seen. We are seeing an extraordinary imbalance--where we're getting terrific export numbers, tremendous pressures coming in the industrial area, and a

sort of mediocre, but not particularly negative, retail market. With respect to the inventory data, although I'm not especially concerned, I have a suspicion that there are more imports in those numbers than any of us suspect. In any event, it's basically in the retail area where, in effect, you're looking at the physical volumes; it should be marked down to factory values; you start doing that and the aggregate physical relationships don't look all that bad.

The real problem with the forecast is--I never recall a forecast where you fine tune from 4 percent down to 1 percent, then back to 3 percent; it happens that way. Although I could say that the staff forecast is, in a sense, the most likely scenario, I think the big surprise is likely to be that the first half will not be as weak as we suspect. And if, in fact, that demand is out there in the second half, it also will move up. It will move up because inventories will accumulate while we'll find the capital goods markets behaving. I just am terribly skeptical of a forecast that has a dip and then turns back up, when we can barely [predict] the direction when we are heading in a straight line. So I must say that I'm uncomfortable with the outlook, yet there's just no question that there is nothing in the order books that appears weak. I have never seen a situation such as this in which the order books are as unequivocally solid as they are at this stage. Yet, the copper price decline strikes me as an indication that there is something weakening there; the aluminum price rises have sort of stalled; steel scrap prices are looking a little shabby in a certain sense. It's a funny outlook and I just can't for the life of me get a firm hold or a comfortable feeling. So, I come out [with a view] that in many respects sort of averages those of the Vice Chairman of the Board and the Vice Chairman of this Committee. I guess that's where I come out, although I'm not sure you're averageable, gentlemen.

It's getting a little late and I think we have come to a normal breaking point. Are there any other things of relevance, looking at my agenda, prior to getting to the aggregates side [of the discussion]? If not, let's adjourn until early in the morning.

[Meeting recessed]

February 10, 1988--Morning Session

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

CHAIRMAN GREENSPAN. Thank you, Mr. Kohn. Any questions of Mr. Kohn?

MR. JOHNSON. Have you actually tried to project the aggregates off of the Greenbook forecast--just to see what it looks like with respect to those ranges?

MR. KOHN. That's exactly what we did; that's what our 6 percent--

MR. JOHNSON. Okay, that's where those ranges come from.

MR. KOHN. To be very up front about this, what we do is take the Greenbook forecast and the interest rates implied and see what money growth is implied by that. Then there's an iterative process of coming together with the money [growth] and the Greenbook forecast. But, in theory, it's all consistent. There's an effort to make it consistent.

MR. JOHNSON. Looking at the forecast, you sort of have a U-shape in interest rates and you'd think you'd get almost a mirror image in the aggregates.

MR. KOHN. Well, the problem--

MR. JOHNSON. And so it almost looks like a nonlinear target we have to accommodate that--

MR. KOHN. No one's talking about targeting aggregates, I think--quarter-by-quarter, in any case.

MR. JOHNSON. True.

MR. KOHN. And we do have a situation in which we see money growth relatively strong and velocity falling in the first part of the year because of the decline in rates. It's not so much in the first half; nearly all of the decline is behind us relative to our forecast. But given the lags in this process, what's left over from October 20th on, in terms of interest rates, would affect M2 growth, particularly over the first half of 1988. And then most of the increase in interest rates we have forecast for the second half of 1988 would have some impact on M2 in the second half of 1988, though it's mostly crystallized with the impact into 1989. But the whole movement of opportunity costs isn't very large, given these lags over, say, the second half of 1987 to the second half of 1988 and we have to--

MR. JOHNSON. So the ranges would accommodate these?

MR. KOHN. Absolutely; yes.

MR. PARRY. '89 slows down, correct?

MR. KOHN. That's right.

MR. PARRY. What was the number for M2?

MR. KOHN. We assumed 5 percent M2 growth for '89.

MR. PARRY. Fourth quarter-to-fourth quarter?

MR. BLACK. Don, what did you say for M1 for '88?

MR. KOHN. That would be about 5 percent.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. Are you ready to have some comments now?

CHAIRMAN GREENSPAN. Well, let's first make sure the questions are behind us.

MS. SEGER. I just have one.

CHAIRMAN GREENSPAN. Go ahead.

MS. SEGER. In regard to the width of the band, if there is all this uncertainty, the honest way to present that--if I remember from Stat 101--is to have the band of uncertainty identified. And if we really think we cannot target within these 3 percentage point ranges, I think it would be more honest to bump the range out a point than to be below the bottom or exceed the top, because then you could explain it as indicative of the uncertainty rather than some sort of policy message.

MR. KOHN. I guess the question the Committee would have to answer is whether the uncertainty is greater now than it has been over the last 12 or 13 years that ranges have been given. They've been three points almost uniformly throughout that period. And I was arguing that with regard to the interest sensitivity, one source of uncertainty is that we don't know what's going to happen with the real economy, how interest rates are going to move, and then what money growth is consistent with what you want to happen. From that perspective, I think there probably is a little more uncertainty now than there was, say, in the '70s or the early '80s. Or perhaps we now realize the degree of uncertainty. Our experiments suggest that the interest elasticity of M2 is a little higher now than it was 5, 6, 7 years ago.

MS. SEGER. Well, starting with 1984, it seems to me that people either have been suffering from an undershoot--or rather, two years of overshoot followed by last year's undershoot. Now, that's not going back to the '70s; but certainly, given recent history, it occurs to me that maybe you would get less trouble with the financial market participants if we put this up front.

CHAIRMAN GREENSPAN. Anybody else have questions?

MR. PARRY. Yes, one more. Part of the answer to Governor Johnson's question is the fact that you also have a pattern in income as well; and since they have opposite signs, in effect, it takes out a little of the pattern--

MR. JOHNSON. You're right.

CHAIRMAN GREENSPAN. What I'd like to do, if it's feasible, is see if we can get a judgment before your general commentary on whether anybody feels strongly that we should reinstitute official targets for M1 or M1A or anything at this particular stage. If there are no strong feelings about it, then I would say that you ought to encompass whatever remarks you want to make in a generic commentary. What I hear is that there is no strong change in view and I will assume that to be the case at this stage, unless it gets altered.

Vice Chairman.

VICE CHAIRMAN CORRIGAN. As I look at the 1988 policy horizon, it seems to me that the most important thing is to do all we can to try to satisfy ourselves that the economy is on the right trajectory that will work in the direction of resolving some of those longer-term problems of an external nature that I spoke of yesterday. When I look at the staff's forecast or the central tendency of the FOMC Committee members' forecasts, it seems to me that both have the virtue of being on the right trajectory, in the broader sense of the word trajectory. And in that sense, I don't have great difficulty at all with an outcome that would resemble either the central tendency or the staff forecast.

But as Don Kohn said, we ought to think then about the risks to that kind of an outcome. On the downside, there are two or three things that pop into my mind. One is the saving rate that was talked about yesterday. In that area, again, consistent with this trajectory argument, I think that we should not resist--indeed, we should welcome--a mild and modest updrift in the saving rate. That is one of the things that has to happen as a part of this larger adjustment process. On the other hand, clearly, if the saving rate were to take a leap up, that, in turn, would imply a pattern of consumption spending that could well be associated with a recession. But I ask myself what could produce a leap in the saving rate rather than a drift. And the generic answer I get is something that shakes confidence. And of the things that enter my mind that can shake confidence, the one that still rings loudly is the financial sector--not necessarily the stock market in the first instance but some kind of further disruption on the financial side. Clearly, there is a risk there.

Another risk is that the trade deficit may not come down. We could be confronting that situation as early as Friday if we get a bad trade number in these next series of numbers. Obviously, in that case, the likely chain of events is the dollar, interest rates, and then stock prices. You've got the same kind of Catch-22. The irony, of course, is that if the trade deficit is going to come down it's going to have to come down in the context in which we have at least slower-than-typical rates of increase in consumer spending. So, there is a clear risk there.

There's another kind of financial risk, and that is some kind of a shock--whether its origins are in Latin America or the unexpected demise of a major financial house or something of that nature. So there clearly are risks. And the common denominator of them, at least as I think about it, is not that I see great potential structural weaknesses in spending, but these risks one way or another end up on

the financial side. The initial event might vary from one case to another but somehow you always end up there.

But I also see risks, and I may be an outlier on this, on the other side altogether--risks that the economy could be stronger than the central tendency or the staff forecast. It doesn't take much in terms of stronger, and not a lot stronger, consumer spending, and certainly not much in terms of stronger business fixed investment spending, to alter that outlook on the other side. In that context, I believe that there is virtually no margin on the upside, because we are that close, in my judgment, to a situation in which the inflationary implications of all of that could be very distasteful, very quickly.

Now in some sense, the policy dilemma that is most acute to me is in the immediate context. When I try to balance those risks, I come to the conclusion, Mr. Chairman, that in the very near term--and by that I mean next week, I suppose--that the balance of the risks is probably on the downside. But out over the year as a whole, I think they're on the upside. And that makes for a very difficult set of policy choices. It certainly means that, while we have to be sensitive to those risks, we can't overreact either way. Indeed, I think from a financial market point of view, if we were to act in a way that led the markets to conclude that we were on vacation, we'd have the various financial disruptions that we are trying to avoid in the first place. Where that brings me, in terms of policy for 1988, is to a comment that Governor Kelley made at the end of the discussion yesterday. I think he said he'd like to freeze dry, or something to that effect, the staff forecast--a forecast that, in round numbers, implies something like 6 percent growth in nominal GNP--and I agree with that. In that context, my preference on the aggregates is alternative III. I have a small preference, very small, for a monitoring range for M1. But the key thing about alternative III is that the midpoint is 6 percent on M2 and M3. That, in turn, implies 0 velocity growth for the year as a whole. It seems to me that from the point of view of your testimony, and the body English that gets put on policy for the year as a whole, that by saying we are assuming 0 velocity, in effect, that casts the right kinds of vibes and it also leaves the Committee with some flexibility over the year. I think that gives us some latitude to respond to any velocity other than 0. But again, I think it also has the added cosmetic value of being good grist for the testimony. So, I'm for alternative III.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Well, I do think that monetary growth targets are important, and I would like to have them even if the law didn't require them. There are conditions that exist or occur during a year that are unforeseen that may warrant from time to time accepting growth outside the target ranges. But I think the advantage of targets is that they do, in a sense, hold us accountable for those deviations--that is, whenever we have faster growth than the targets, if it turns out to be a policy mistake, it seems to me we have to bear that responsibility. And there isn't any question that we are somewhat on the line right now because M2 has grown outside the target ranges. Our year-over-year growth rate bottomed out for M2 at 3 percent--that is before the revisions. The numbers showed 3 percent in the week of January 11th; and 3 percent is quite a way below the 5

percent. It seems to me that it is important, as we go through this period of adjustment of exchange rates--which we know brings pressure on import prices--to make it clear to everyone that our long-run objective is to get to price level stability. We know what we experienced with the rebound in oil prices; there is no question that we couldn't keep the rate of inflation at a long-run desired level while going through that adjustment. But it seems to me that we should have these target ranges, and the Chairman's testimony concerning them should make clear our long-run objective of price stability. It seems to me that we ought not to have M2 growth as low this second year as we did the first year. In some ways I think to miss two years in a row, or to plan to miss two years in a row, on the downside becomes somewhat unacceptable. That is, we have had an experience of a year in which certain commodity price pressures and exchange rate pressures and conditions in financial markets caused us to believe on a week-to-week basis that monetary policy needed not to be eased in order to achieve those growth rate targets. But I think now we ought to say to ourselves in the second year: What bottom on the target range can we go with, where we really do mean that we expect to ease if we go below it? And that bottom of 5 percent, frankly, is too high for me to feel comfortable pledging that I would want to ease if we were at 4-1/2--even though financial markets might be somewhat under an adjustment problem, exchange markets might have a problem, and inflationary fears might be there. I guess I don't want to put myself in that position of pledging myself to ease under that condition. So, I would prefer alternative III. Frankly, as many of my colleagues know, I've been flirting somewhat with even 4 to 7 percent as the proper range. But I do believe that there are uncertain conditions on the other side and it might be helpful to have a somewhat higher boundary. So I would join the Vice Chairman in being willing to go with alternative III.

Now, I did do some playing around with the year-end adjustment problem. From time-to-time I have been concerned that seasonal adjustments at year-end give us a last-quarter base that seems to be somewhat out of kilter. And I think as a long-run policy I would be happier basing on the last 6 months of the year and beginning our cone on October 1 rather than basing on the fourth quarter and beginning the cone on November 15th. That would have the subtle tendency, of course, to cause the cone to be wider, and by year's end that extra width would be about \$11 billion. But it would still give us the narrower 3 percentage point range that we have talked about. I've kind of flirted with [the view that] maybe 4 to 8 percent ought to be right, because that would give us a 6 percent midpoint; but anything that gives us some move in that direction I could go with. So, I guess I'll summarize by saying alternative III.

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. I could go along with alternative III as well, but the problem that I really have is with the path, as Governor Angell already started to address. First of all, I think it is very clear that last year, as Governor Angell pointed out, we consistently undershot our short-term targets. We undershot the various targets that we established by 1 percent for the lowest undershoot and 3.9 percent for the maximum undershoot. I think it's very important that we don't do that again this year, because we are getting in the danger zone on the downside. So, I hope that we draw the bottom half of that

target cone--the lower band--with a very thick pencil and with the intention not to go through it on the bottom side.

As far as the base is concerned, I think we again had very special factors at the end of this year, which were very different from the special factors that we had at the end of last year. I think the reasons detailed in the Bluebook, in exhaustive detail, are very compelling indeed. So I have a lot of sympathy for what Governor Angell is saying about changing the base period around somewhat. In particular, if you look at the chart for M2, for instance, you see that for the proposed parallel bands for 1988 the upper limits are an exact continuation of the bottom part of last year. So we're saying that we are lowering ourselves permanently down for one reason only--and that's the accident that January 1st happens. If we had two-year targets, we would now be in a position where we would say, "Well, we have an awful lot of catching up to do." Or if the [target] year had begun in midyear, we would have started out, let's say, in June--that's the time where the point of my argument is better--then again we would be at the bottom end of the cone and we would probably be arguing that we should be moving more towards the middle of the cone. To ratify permanently the very temporary factors that were in effect at the end of last year, I think, would be a mistake. And I would support the new target ranges only with the proviso of rebasing.

On how to rebase, I think there are two options open to us. One would be to go to the bottom end of last year's target cone--that's roughly where the solid line and the dashed line intersect on the graph--and start this year's target cone there. So, we would be working with an area of some overlap instead of zero overlap between last year and this year. The other alternative--one that may be a compromise to what Governor Angell is suggesting--is to base towards the second half of 1987, taking a midpoint there. Eyeballing it, you can see that you are getting a bit of an overlap at least, instead of virtually zero overlap. So, with a rebasing proposal along one or the other line, I'd be happy to go along.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, let me say at the outset that I think that our course for policy at the moment--of using discretionary policy rather than a slavish adherence to any of the aggregates or to any other intermediate target--is quite appropriate. And I don't particularly worry greatly if we miss those targets in any given year if the circumstance requiring that miss is evident to us. On the other hand, we are required by the law, as we all know, to set these targets. And I think we need to set them as realistically as possible so as to avoid, if we can, any shortfall or overshoot in M2 or M3.

I said yesterday that I thought that the risks to the economy were on the downside, and I do believe that. But I think that it's a very, very delicate balance. As has been suggested earlier, I think there are also risks on the upside in the economy. I'm prepared to believe my own staff's forecast, which places nominal GNP at 5-1/2 percent. That suggests to me that the midpoint for the range is somewhat lower than the 5 to 8 percent that we set in July, and even a little lower than that suggested by the Bluebook in alternative III. So, I would like to propose a wider band--recognizing that this is not traditional and perhaps doesn't have any precedent. But I would think

that a range of 4 to 8 percent would be appropriate, given the interest rate elasticity of M2. And I think this kind of a range would give us the flexibility to adjust our policy as the year goes along and we can measure where those risks really lie. At the moment, it seems to me that we hardly have any room with the 5 to 8 percent for any shortfall in M2 growth. The reason that I would not drop the whole range is that I think by doing that, people would tend to think that this is a tightening of policy. While we have gotten away from the monetary aggregates to some extent, I think that in the climate this year perhaps more attention is going to be paid to where we set M2 and M3. And I think your testimony is going to take on even more importance than it usually does. I wouldn't like to give an implication of tightening, and by keeping 8 percent at the top, I think we might avoid or at least mitigate some of that suggestion of tightening. Now, 4-1/2 to 7 percent would be acceptable to me, but my preference would be 4 to 8 percent, recognizing some of the risks of that wider range that Don Kohn has already indicated.

I don't know if you want to talk about M3, but I would like to keep the range at 5 to 8 percent because I think this, too, would damp any implication that we are tightening. Or, if you adopted 4 to 8 percent for M2 and 5 to 8 percent for M3, the implication of tightening based on the lower M2 range would be damped if you kept M3 at 5 to 8 percent. So, in summary, targeting on nominal GNP and using the 6 as the midpoint of the 4 to 8 percent range for M2, I think, would give us the kind of flexibility we need on the downside, without giving any implication of tightening to the market. So I would prefer a 4 to 8 percent range for M2 and 5 to 8 percent for M3.

CHAIRMAN GREENSPAN. President Morris.

MR. MORRIS. Mr. Chairman, I would go for alternative III, but for different reasons than have been expressed. I don't see the near-term downside risks that Mr. Corrigan talked about. I looked at those new orders figures for December, and not only were they exceptionally strong, but the fact that they were that strong two months after the stock market crash suggests to me that our manufacturing sector is really going to be on a roll in the first half of this year. And that is highly likely to generate higher spending on plant and equipment than the staff forecast is indicating. So, I think by the time we reach midyear, our problem of softness in the economy is going to be way behind us and our concern is going to be the price pressures generated by a manufacturing sector that is really booming. And I think having a slightly lower upside limit on the aggregates might be very helpful for us in that kind of a situation.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Well, as I indicated yesterday, Mr. Chairman, I was very close to Frank Morris and very close to Jerry. I suppose at this point I'm a little closer to Frank in that I'm not as sure as my colleagues in Richmond are that we will have the weakness in the first part of the year. But I think there is a distinct risk that by the end of the year the economy will really be rolling and there may be stronger upward pressure on prices and wages than most people are now expecting. That would put us in a very difficult situation, and a dangerous one I think, given the advanced stage of the expansion. So, my feeling is that reducing the risks of that kind of scenario playing

itself out ought to be one of the principal goals, if not the principal goal, of long-run policy. So I would opt for alternative III. Ordinarily, I think the Bluebook tends to favor the middle alternative, but I thought this time, Don, you did an excellent job in defending alternative III with your 6 percent midpoint. If the economy should be a little weaker in the first part of the year, then the 7-1/2 percent limit ought to be enough to accommodate that and also some downdrift in interest rates. But I think more importantly, dropping the range a full percentage point rather than just 1/2 of a percentage point, as we tentatively decided in July, would send a strong, and I think a very reassuring, signal to the markets and the public that the System is looking beyond the immediate softness in business activity towards the potentially more serious threat of excessive and rapid inflation later on. And if we voted for that, I think you could make that point very strongly in your testimony. I know you'd get some flack on that from some members of Congress, but I think that would be muted by the recent strength in the aggregates and the significant drop in interest rates. I think, in the end, we'd be a whole lot better off from the standpoint of political pressure, if M2 growth didn't come out in the lower half of the range but somewhere near the midpoint. And I think we have a better chance to do that with alternative III than with alternative II.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I would also favor alternative III. I think it conveys the right message to financial markets. One thing we might consider is to have the range for M3 slightly [unintelligible]; the elasticities are such that you probably will get stronger growth of M3 than M2. With regard to the base question, I would be opposed to the suggestions of Governors Angell and Heller and instead I would prefer the Kohn cone.

CHAIRMAN GREENSPAN. How do you spell that?

MR. PARRY. Two different ways.

CHAIRMAN GREENSPAN. In which order? President Stern.

MR. STERN. However we may decide to tilt policy in the short run, it seems to me that in the longer term we have to keep our eye on the price stability goal. And I think achievement of that is consistent with some of Mike Prell's language that we touched upon yesterday; in other words, I think that's how you do achieve maximum sustainable growth in employment and output. In the current setting, what I'd like to achieve is a certain continuity in policy at this point. And I'd also like to facilitate this transition or adjustment that's occurring in the economy that we have discussed--or at least not take steps to retard that adjustment by trying to bolster domestic demand. All of those considerations lead me to alternative III, which I think works in the direction of price stability and all that goes with it over time. I think it provides ample room for growth in the economy in terms of the outlook that we discussed yesterday at some length; I also think it is consistent with this transition or adjustment that needs to occur. I might also note that--well, this has been covered and I won't dwell on it--the midpoint is consistent, I gather, with the Greenbook forecast. Moreover, while it's a little hard to go through all these numbers with the revisions and so forth,

as I look at growth of M2 and M3 over the last two- or three-year period, on average, they've grown about 7-1/2 percent or maybe a touch more. It seems to me, at this point in time, that we would not want to have acceleration beyond that kind of rate of growth. So, I come out in the alternative III camp as well.

MR. JOHNSON. Gary, are you assuming a stable demand for money? I mean, you have some assumption.

MR. STERN. I'm assuming I don't know any less about it today than I knew about it in the past; let me put it that way.

MR. JOHNSON. But what you're saying is that the uncertainty is symmetric around zero velocity.

MR. STERN. Yes, that's right. I think you might argue, although I'm not about to press it, that last year's shortfall is history now and we can't do anything about it. I'm not sure you want to have much of an acceleration from that.

VICE CHAIRMAN CORRIGAN. So far it is.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I would favor the 4 to 8 percent alternative; I'd go with alternative II but I would widen M2 to 4 to 8 percent. I think the half a point reduction that we already have in the preliminary numbers sends the right long-term signal. I think a further reduction now would, in a sense, almost be confusing. People perceive the thrust of policy to be in the opposite direction and I think that would be a potentially destabilizing signal. I think everybody knows from my comments over a long period of time that I've felt just as strongly as Jerry and others about the long-run inflationary risks, but I think that might be confusing. I think the 4 percent lower band on M2 recognizes Jerry's concern; it actually gives us the latitude to move further in that direction than alternative III would if we had to. And I don't think the widening of the ranges from 3 percentage points to 4 percentage points is really a problem. I don't think anybody perceives us to be targeting monetary aggregates anyway; we certainly don't. We take an economic forecast and then pick [monetary growth] numbers that we think are roughly consistent; and if they don't work out, fine. So, I don't think that violates anything in terms of what I perceive we're doing here and what I think the outside world thinks we're doing. So, that's where I come out.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Well, I think all of us agree on what the basic policy challenge is and that is to balance the short-run risks of weakness with the long-run risks of inflation and the need to keep the external adjustment process moving forward. Given the looseness in the aggregates and the way we have treated those aggregates the last several years, substantively, I don't think it makes a lot of difference whether we have alternative I, II, or III, as far as trying to play this balancing game. It seems to me that which of these you choose has to do more with the message that you want to send out than the economic or policy substance of what these alternatives mean. I

think the message is important; and I would like to send out a balanced message. I would like for the country to know that we are concerned about the current weakness but I also want to underscore these longer-term concerns. And I think alternative II sends out that balanced message. If we tended to loosen a little, as we have done in the short run the last couple of weeks, and then we send out a message that we are tightening as in alternative III, I think that's a confusing message. I think that when you're sending out messages, you want to keep the messages as simple as possible. At the same time, if we reverted to alternative I, I think that sends out the wrong message too. So, I would think that in the testimony you want to strike this balance, and to me, alternative II sends out that message.

Now the other issue, having to do with the width of the range, I think also is a substantive versus message kind of issue. If we were to be totally intellectually honest, I think we'd have a very wide range, or we might not even have these [ranges for the] aggregates. But we have them, and we have generally stuck to a 3 percentage point range. We have tried to widen them in the past and that tends to send a message that we don't have any discipline up here or that we are somehow losing that discipline. I don't think that's the kind of message we want to send, and so I would--again, not that 5 to 8 percent is substantively better than 4 to 8 percent--just think in terms of a message and keep it at 3 points.

As far as the issue of rebasing, I think we have to be careful that we don't rebase on an ad hoc basis. If you go back to 1985 and 1986, we overshot the targets and we didn't rebase in those years. Now if we rebase this time when we undershot, I think it sends a message that we rebase when it suits us in terms of easing money and we don't rebase when it means tighter money. Interestingly, if you take a longer-term perspective on M2, if we had rebased for the last two years, we would be just about where we are now. In other words, the undershoot of last year just about compensates for the overshoot of the prior year. So, I would not rebase in 1988 for those reasons.

MR. MELZER. I forgot to say that I wouldn't rebase either. Sorry to interrupt.

CHAIRMAN GREENSPAN. If we had rebased back to 1984 we'd still be in the cone.

SPEAKER(?). Right.

VICE CHAIRMAN CORRIGAN. The Kohn cone too.

CHAIRMAN GREENSPAN. Kohn's cone. President Hoskins.

MR. HOSKINS. I think the long-term targeting process is really your chance, and our chance, to make a more clear statement about what we think we can control over time. I think over time we can control nominal variables and not real variables. And I think what we want to signal to the markets and the public is this commitment to bring on price stability. I think you do that by continuing to march the aggregate ranges down. In that context, I think we should have some fairly firm statements about our consensus on inflation, and I'd prefer to see some time horizon attached to that price stability goal.

In terms of the specific targets this time, I would want to choose alternative III, if not even slightly lower than that. I think, as the staff correctly points out, the forecast will fit any of these ranges. And I think, as Ed indicated, this will send the right message to our public.

In terms of the rebasing issue, it's an old one that has come up many times before in terms of base drift. At least eight years ago we chose, at that time, not to adjust our misses. Ed was indicating that it seemed to be somewhat random; in those days, it seemed to be biased in one direction. I think if we are going to want to adjust for base drift, then we ought to do it in a consistent fashion. That would mean something like picking the midpoint of the target range every year and starting the base over again--starting the cone from that midpoint regardless of where we came out. I'm not recommending that. I guess I'd just as soon go with the randomness in our misses and start from scratch each time. But I would not move the base around. My last point is that I would concur with Jerry that we ought to put M1 into a monitoring range; but--and this may be premature to our later discussion--I'd also toss the monetary base in there as a monitoring range.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Without going back over yesterday's conversation, it does seem to me that it's important to remember that the economic record over the past few years, and that certainly includes the last year, has been pretty good. And I think the outlook for this year is also positive. In terms of the risks, they're about equal on the upside and the downside. And I think we have a very good shot at coming in about on the forecast. The risks, as I see them and as I suggested yesterday, really are more on the inflationary front; I do sense some buildup of the inflationary pressure. In addressing the aggregates question, I think it's important to bear that in mind.

Now, despite Don's very articulate and, I think, clear explanation of the opportunities this year with regard to the aggregates, I think we are continuing in a period of reasonable uncertainty and it's terribly difficult to forecast just how this is going to come out. Therefore, I think we ought to try and establish ranges that deal with those very tough uncertainties. If I were to choose one of these specific alternatives, I would choose alternative III, largely for the reasons that have already been said. But I must say, given the uncertainty, I'd have a preference for the 4 to 8 percent range that Bob Forrestal suggested. I think it does provide for the uncertainties and also deals with the consistency of our message of trying to achieve price stability. So, I'd have a preference for 4 to 8 percent but certainly could be persuaded to accept alternative III. I would not establish a monitoring range for M1; I think the uncertainty there is still too high to do that. And I would not be in favor of rebasing either. I think if we begin to move the base around to suit our requirements, that's a rather awkward message; I'd not be in favor of rebasing.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I guess, like a couple of others who have sat around this table too long, I'm maybe getting

jaded. Let me first say that setting ranges is legally necessary to have some constraining effect on the Committee and monetary policy. Therefore, I accept that as being something very good. But listening to the discussion around the table brings to mind what I believe was a statement in the Bluebook: that the staff forecast falls in any one of these three [alternatives]. You're talking about a difference of 1/2 of a percentage point in the midpoint from one to the other. And it's minutia. The fact of the matter is that any one of them will fit.

So, I think Ed Boehne is right. As the Bard said, "all the world's a stage" and I think that's what we're doing here today. That is, [the issue] is what kind of message you give as you testify regarding the intention of the Federal Reserve in the period ahead with respect to economic growth and inflation. My own view is that since we already established alternative II in July, we probably don't know much more about what's ahead now than we did in July with respect to a decision on these aggregate ranges. Going on a holiday as Jerry suggested, or at least the Federal Reserve doing nothing very dramatic, seems to me to be a very good thing to happen in the period ahead. I would reestablish the ranges of alternative II; I think you can do anything you want to with them. I think they serve the purpose; and the message that you give in testimony is the more important one.

I would not rebase; we've been through that many, many times in the past with a great deal of consternation by Congress and others about what they thought we were rebasing. And I don't think we ought to get into that kind of controversy. As a result, I could accept the widening of the range to 4 to 8 percent; but to avoid any ripples I'd do 5 to 8 percent--alternative II straight down the line.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Well, Mr. Chairman my speech was just made basically by Roger and others. I would favor alternative II--not the substance but the appearance of it--and hope we make the best translation from the substance. It does reflect a march down--maybe not at the pace some would argue for--but it's a half a point less than what we had for 1987, and it's consistent with our direction in reducing the ranges, at least. If you go to alternative III, as Tom Melzer said, I wonder if that's not a bit of a conflicting signal versus what we generally are perceived to be doing, which might lead to some confusion. Alternative II permits us, I think, to do whatever it is that we need to do. And it would reflect, to me at least, a continuing commitment to guarding against inflation. So, I would stay just where we put it tentatively. I would not rebase either.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. I was impressed with what Gary Stern said a while ago: that whatever tilt we may make in the short run--and we'll discuss that a little later--it's important to keep our eye on inflation in the longer run. And I think that that's the message we want to project. That being the case, I can be very comfortable with alternative III. I would like to see us maintain as much discipline as we can to hold our own feet to the fire and stay within whatever ranges we set. Of course, we have to have the capability of going outside the ranges if that's appropriate.

Part of my reasoning is that I would like to see us stay within whatever ranges we set and, if we're going to make a serious effort to do that, then I like the idea of being a little on the lower side with a 4-1/2 percent low instead of the 5 percent low.

Apparently this argument about rebasing has been around for a while--it's new to me being new to this sort of consideration--but I must say that it makes a lot of sense to me. I don't know what formal work has been done on that issue in years past, but I would urge that at least we review it and seriously consider it. I'd be a little leery of doing it ad hoc right here at the table without some further consideration, but I am impressed with the force of that argument, and I'd like to see it pursued a little. I would agree that we have fought the battle of getting away from trying to be forced into projecting M1; we don't have to do it and I think there is still so much variability there that we should not go back to doing it. So, the sum of this is that I would go with alternative number III.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. I don't feel that strongly about any of these particular ranges. I feel a little like Roger Guffey and others who have spoken on this issue. However, I think there are signal issues, credibility points, that have to be made. I do think, if we're going to be credible on our view of the long-term inflation picture, that through the midpoint of whatever range we establish for M2--I say M2 because I prefer not setting a monitoring range for M1, given my view that it has too many problems--we have to demonstrate that we are moving towards price stability, or a nominal GNP that's consistent with price stability. So I am in favor of continually ratcheting down that midpoint. It seems to me that the fact that we even establish a range means that we are trying to embody the uncertainties, in terms of all the things that can affect the aggregate; otherwise, we'd just have a line. And so the ranges have to be somewhat credible to encompass what we think are the uncertainties. And if we fall outside those ranges, it means that we weren't even certain about the uncertainties. And that creates some problems. My own personal view is that to encompass all the uncertainties we have to have a range that's wider than any that are here. And I think that gives us a political credibility problem, to some extent, in their presentation. I'm not really against the narrow range, even though I don't think it embodies all the uncertainties that we could face. We would look kind of silly announcing a range that admitted the uncertainty that I think we are really faced with. So I guess I don't really mind whether we have alternative II or alternative III; I'm sort of indifferent [between the two]. I guess if I were going to be honest with myself, alternative II would be a little better; it allows a wider range and ratchets down the middle from last year. But I'm comfortable with alternative III; I wouldn't resist that.

On the basing issue, there are some implications from the base. I think Governor Heller and Governor Angell made some important points. But I think all of this can be handled in the language of the testimony and how we present this. If we don't handle it carefully, we could give the message that the short-term implication of our target range setting is a tightening of policy. That could conflict with what we might be trying to do in the short run and create some

confusion. So, it seems to me that if we're going to go with alternative III, we have to be very careful about how we explain it when the Chairman testifies on this, because there could be some confusion about what we're actually doing in the short term and what this target might imply. So I think the basing issue is important. I think what Governors Heller and Angell pointed out is that we could take care of some of those concerns by rebasing. I think you could also take care of those concerns with the right kind of language in the presentation. I don't really have any strong preference for either, as long as we take care of it. I think probably it's better to handle it in the language rather than to try and explain a rebasing--although I have some sentiment for maybe trying to normalize those last two months of the fourth quarter, November and December, which none of us can explain very well, and building the base off of some more normalized trend pattern in the fourth quarter rather than letting those last two months so affect the average. But I don't feel that strongly; we can easily explain that in the presentation. I think one way that you do that is by these tunnels that are built around the cone at the beginning of the year. You've got these dotted lines that look like parallel lines building off of the cone, so that we are even saying we are not taking the Kohn cone too seriously at the beginning of the year--that's why we have these parallel lines because there can be some variation early. I guess that can all be fit into the language. And as long as we do that, I'm comfortable.

CHAIRMAN GREENSPAN. Because of November to December?

MR. JOHNSON. Right.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. Last July I dissented when a proposal was made to cut the ranges back by a half [percentage point], not because I didn't want them cut, but because I thought we were firing our ammo too soon. I felt that if we kept them the same, 5-1/2 to 8-1/2 percent, then we'd get a crack at them now, when we could do what was appropriate in the context of this period. I think that was the appropriate way to go and, consequently, I am willing to go with a cut now, down to what's being called alternative II, I believe. But I would like to go with a wider band, in keeping with what I said to Don Kohn about the uncertainties. I just think that we are misleading people when we suggest that we can get it within a 3-point range. If I thought we could, that's one thing; but at least many times we can't.

So, I would go along with Messrs. Forrestal and Melzer: alternative II, with maybe a 4 to 8 percent range for M2 but staying with 5 to 8 percent for M3, so as to phase this in. I still believe that the risk is on the downside. Also, I think there are people out in the real world who think there are some downside risks and [this Committee] ought to be really, really concerned about doing anything with these ranges--even though, admittedly, they're longer-term ranges. It would send a message to business people or money market or capital market participants that suggests a tightening. Even though they might be reading it wrong, I would hate to have that happen, because right now I think that the mood is that we are easing. I was just reading some money market commentary this morning and they think the Fed eased yesterday when the fed funds rate went to 6-1/4 percent. If we send out a message when the Chairman testifies next week that we

are tightening. I'd like to crawl into a fox hole, because I don't want to be around when the flak flies. Anyway, that's sort of where I'm coming from in general.

On the rebasing, I've been in favor of rebasing all along. In keeping with Mr. Kelley's comments, I think we really ought to look at this. And if we go to rebasing, we should do it come hell or high water, good times and bad--stick with it and not send the message that if it suits us we'll rebase, and if it doesn't we won't. I think this is the time, though--and the chart here shows it--that it would make a significant difference whether we go with an average of where we thought we were going to be in the fourth quarter or where we actually were. Also, if you don't rebase and then go to the lower ranges specified in alternative III, I think that could really give us problems. On the monitoring question, I don't have a strong view on that; if you want to monitor M1 that's fine; if you don't that's okay with me too.

CHAIRMAN GREENSPAN. One thing about this meeting which I think is pretty important is that we have to find the mechanism by which we are perceived to be in a general consensus. The reason I say that is that it's fairly obvious that the Administration is beginning to wind down. There are elections coming up and we are turning out to be the only people who are minding the store. The one thing I would particularly like, if we could find a way to do it this time, is to find a way in which we can accommodate each other in a manner in which we can speak with a single voice. I don't know whether or not that's going to be feasible, listening to what I've been hearing. And it's certainly a problem when one is dealing concurrently with the issues of both short-term monetary policy and intermediate- or long-term basing questions.

In my mind, when I look at this particular outlook, as I sort of indicated in my views yesterday, it's very difficult to find the inventory weakness, or inventory recession, out there. The reason, essentially, is that if we actually had meaningful inventory overhang, we'd already see it in the order books. It just strikes me as not the way the system functions--to have order books under strain and concurrently have a notion that there is an inventory overhang. Every inventory recession that I've ever experienced--and I've seen an awful lot of them--was signaled first in the order books before anything else. This tells me, at least, that whatever the problems are out there, that's not one of them. However, I must say that I pretty much agree with what Jerry Corrigan has been saying--namely, that if there is a problem out there, it's in the financial area. And I must say to you that I'm bothered by this. We had a major shock in October and we seem to have temporarily come out of it. But the stock market, by anybody's measure, is not low; it's hanging up there. While a lot of the yield spread abnormalities have come down, it is still a very unstable situation. What's concerning me is that there is a vulnerability out there which is continuing to heal but is not healed yet. And I'm basically concerned, in a way which in fact Governor Seger raised, that if we were to indicate that we were tightening, the shock to the markets I think would break the stock market and create some real problems. Yet one can easily argue that we can break the market by being too easy or too tight. I think it is a very narrow cone--spelled "c-o-n-e"--that we are going through at the moment. And the impression I get is that the markets, at this particular stage,

are taking the little softness we have imparted with a good deal of equanimity. Bond markets have been behaving well; the exchange rates have been behaving surprisingly well; and there is a sense in which the markets are willing to accept somewhat lower real rates at this stage; and I think they may for a while.

The other side of the problem is that if we are not dealing with any particular slowdown here, then the question largely is what then begins to emerge. And I suspect that what we have is a very tough policy problem, because I think there are short-term risks in the sense that I think the markets need more time for healing--meaning they need some general softness in the short end of the money market. But it's fairly apparent also, if the general views around this table are correct about the longer term--and I must say, I subscribe pretty much to what everyone has been saying about fears of inflation--that we have to make certain that, if we choose to be a little accommodative in the short run, we don't send the message that that's our longer-term view.

The message question is the real issue; because if anyone can tell me that the monetary aggregates are locked in a very sensible way into the economy--it requires a great deal of finesse and I will [unintelligible] it. There has been more data mining with the monetary aggregates in the last two years than I've seen with any other set of data in my whole life. And whenever you get to that, you know that there's nothing there. We can expand away or we can contract, but I don't think it matters. As a number of you mentioned --I think Ed did--it doesn't really matter. I think the crucial question, during this particular period for the Federal Reserve System, is to communicate to the markets what our philosophy of the outlook is and basically how we should function.

So I must say, and we'll get to this I assume a little later, I would be more inclined to be somewhat more accommodative in the short run--in a sense picking up what seems to be the desire, if not the willingness, of the markets to perceive a somewhat lower rate structure here, even if only at the margin. But we need to be very careful that that is not extended in anybody's mind to a point where they will figure that we are not minding the store. As a consequence of all of this, what I would like to do, and I'm not sure we can effectively do it, is to hear everybody's short-term views before we actually vote on the target ranges, because I suspect we can't really separate these two positions. They're part of a single monetary philosophy package and I'm not sure that independent votes on one and then the other essentially capture the type of consensus which I hope we may be able to marshal.

So, having said that, I guess we could take a break now and then get to the short-term discussion. And then what I'd like to do is see if we can find a way--if not by voting in a single package, then some way other way--that we could agree that none of us is [totally] comfortable with the end result but all of us, or most of us, hopefully, can at least feel as though it's accommodatable. Having said that, I think the doughnuts are there. Are they there? The problem is they're not; we have to try to filibuster for 10 more minutes.

MR. KOHN. I could filibuster for you.

CHAIRMAN GREENSPAN. You can filibuster.

MR. KOHN. Or you can have the Managers' reports, as Peter and Sam just pointed out.

CHAIRMAN GREENSPAN. That's not a filibuster, that's substance.

MR. KOHN. This is only substance--

MR. BLACK. What's wrong with a longer-than-usual coffee break?

MR. KELLEY. The major problem is that the coffee hasn't arrived.

MR. BLACK. Well, there are other things to do out there.

MR. JOHNSON. You mean you've had a lot of coffee this morning.

MR. BLACK. The reason--

CHAIRMAN GREENSPAN. I think you have, and as a result, I think we will adjourn on that note.

[Coffee break]

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

CHAIRMAN GREENSPAN. Would somebody like to move the ratification of the Manager's transactions?

MS. SEGER. I'll move it.

VICE CHAIRMAN CORRIGAN. I'll move.

CHAIRMAN GREENSPAN. Approved without objection. Mr. Sternlight.

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

CHAIRMAN GREENSPAN. Thank you. I'm sort of working this in reverse, but let me ask for a motion to ratify Peter Sternlight's transactions and then I'll ask for questions of both.

MS. SEGER. I will move that.

VICE CHAIRMAN CORRIGAN. I will second.

CHAIRMAN GREENSPAN. [Approved without objection.] Are there any questions for either of our Managers?

MR. HOSKINS. I'd like to know what the procedure is for formally changing the borrowings target.

MR. STERNLIGHT. Well, on this occasion, there were discussions that I had with the Chairman and the Vice Chairman of the

Board. And there's a kind of continuing dialogue I have with Mr. Kohn or whoever is sitting in his chair--he happened to be away during some of the time we were having these discussions. But it came out of discussions and communications between our domestic Desk and the Chairman, essentially.

MR. MELZER. Peter, did I understand you correctly? In the early part of your report I believe you said that the continued sensitivity in approaching open market operations most recently was largely due to the shift in policy and the uncertainties that surrounded that, not to any other factors.

MR. STERNLIGHT. I said we were getting away from that great sensitivity and moving toward the borrowing objective, as January proceeded.

MR. MELZER. Right.

MR. STERNLIGHT. I think that there had to be some moving back from that approach when we were putting in place this slightly easier stance, just to put across the fact that that modification of the stance was occurring.

MR. MELZER. Yes.

MR. FORRESTAL. Sam, what kind of trade number is the market looking for on Friday? Have you heard any possibility?

MR. CROSS. Well, they're talking about \$13-1/2 billion. They probably have very little basis for knowing, just like everybody else; but the fact remains that they tend to get these numbers in their minds, and if it comes out better or worse than their expectations, it has an effect. That's the latest commentary, although it has varied from yesterday when we were hearing numbers anywhere from \$11 billion to \$14 billion or more. Then Mr. Yeutter made some comments yesterday, which seemed to have taken a little of the bloom off the rose, that it's on the low side. And so, today, they seem to be talking about levels of around \$13-1/2 billion.

MR. PARRY. The Money Market Services range is \$11 to \$16 billion in the survey they do.

MR. FORRESTAL. I saw that.

CHAIRMAN GREENSPAN. Well, the higher the expectation, the better.

MR. FORRESTAL. Yes.

MR. CROSS. Yes. Accordingly, we haven't been hearing as many high numbers as I would like to hear.

MR. FORRESTAL. \$13-1/2 billion seems to be low.

CHAIRMAN GREENSPAN. Any other questions for either of the Managers? I'm sorry, Governor Angell.

MR. ANGELL. Peter, I guess it seems to me that there's some appearance at the Desk that when we need to drain [reserves] and we are perceived to need to drain, we are still somewhat more interest rate sensitive about draining earlier in the period. It seems to me that's conveying to the market that we still continue to have a more narrow interest rate tolerance. Would you comment on that?

MR. STERNLIGHT. Well, as I mentioned, in this period when we needed to drain--which was also coming when we were putting in place this slightly more accommodative stance--we proceeded in what I call a gingerly manner, sometimes deferring for a day or so the actual draining operations, waiting to see more evidence of the availability of the reserves that we thought were there before going in to mop them up.

MR. ANGELL. I guess it would seem to me that when we had that change from \$300 million to \$250 million, that would have given a little more opportunity for us to make another step towards more emphasis upon the borrowing target and a little less concern about interest rates. That didn't seem to show through to me; and I think it didn't show through to a lot of the marketplace.

MR. JOHNSON. Part of that was because borrowing was averaging about \$150 million, as Peter said. It was hard for it to show through.

MR. ANGELL. Well, I understand that. But we knew earlier in the period that we needed to drain, and it seemed to me we didn't drain because of the fed funds rate. It seems to me that that continues to have the market's attention and that doesn't seem quite in keeping with what I understood we were expecting to do on that as we ended out this intermeeting period. I thought, as we got away from the first of the year, we had thought that adjustment process--

CHAIRMAN GREENSPAN. You know, you're talking about a \$50 million difference. When you're draining a huge amount, with expectations that the appropriate amount is in a range that is much larger than anything remotely near the total borrowing requirement, it's a very tough operational procedure to conduct.

MR. ANGELL. I know, but I'm concerned that the markets may exaggerate what it is that we have done--that there might appear to be a slight tightening. Interest rates may be running a little lower this week than we would expect, midpointwise, because of that surplus; and it seems to me that we now run the risk of having people think we have snugged back up after this meeting, which I think is unfortunate.

CHAIRMAN GREENSPAN. Yes, I would suspect that [such a reaction] probably has become a likely prospect.

MR. ANGELL. Well, I just want to indicate some slight difference [of opinion] with regard to how that was done.

MR. MORRIS. Well, you didn't get much of a bond market response to the 6-1/4 percent fed funds rate yesterday.

MR. JOHNSON. It was well acknowledged that there was a wire problem, wasn't it? I saw a couple of reports about a wire problem.

MR. STERNLIGHT. The procedures for the commentary on--

MR. JOHNSON. Because the funds rate actually got down to 4 percent.

MR. STERNLIGHT. There was a big range of trading yesterday. And in the morning yesterday we did go in and drain a lot of reserves; we took out \$5 billion.

MR. ANGELL. I know. It's so late in the period.

MR. STERNLIGHT. Right. It was late in the period.

MR. ANGELL. What I'm saying is we waited so late in the period.

MR. STERNLIGHT. Right. Funds softened afterwards and they got as low as 1 percent late in the day yesterday. I don't yet have the effective rate but I think it was around 6 percent. I didn't see any reference to wire problems.

MR. JOHNSON. You didn't? I thought there were references but I'm--

MR. STERNLIGHT. Maybe I just didn't see it. Today funds are again around 6 percent or a shade under. We're going to be draining some additional reserves. For one thing, it has been very hard to evaluate the demand for excess reserves, which we think is high in this period, although we're not sure from day-to-day just how high. Also, we are getting daily revisions in the amount of required reserves. It has just been a difficult period to operate in. But I readily acknowledge that we projected a draining job but were hesitant in meeting it because we wanted to let some of that softening show through. But, wanting something to show through, you always run the risk that more shows than you want to have show. I don't see any way to avoid it; there are some risks on both sides of that coin.

CHAIRMAN GREENSPAN. But I think the key here is that the markets did not react to that. I think that's the crucial question. If they had, then I think you would have had a problem. I watched that all day long; the exchange rate was absolutely solid and the bond market was hardly moving. It was as though they were off on vacation. So the markets didn't take any view of that, as far as I could see. Any further questions to the Managers?

VICE CHAIRMAN CORRIGAN. I just want to pick up on what I thought was a very important comment Peter made in the middle of his remarks about the search for this elusive mechanism in relationship that's going to make everybody happy every day. That's just not going to happen. Just to take a piece of it: On a slow day, the federal funds market turns over \$400 or \$500 billion. The list of various things that could introduce slippage and errors into those relationships is vast.

MR. JOHNSON. You hit on the key point, Jerry, which is errors and slippage--and that's what causes the variations.

VICE CHAIRMAN CORRIGAN. But you can't have a monetary policy that is so fine-tuned that it attempts to overcome every one of those dozens of things that can take place in the market.

MR. JOHNSON. Well, you can overcome those things; it depends on what your objective is.

VICE CHAIRMAN CORRIGAN. I don't think you can overcome them no matter what your objective is.

MR. JOHNSON. Yes, I think you could reduce the range substantially.

VICE CHAIRMAN CORRIGAN. The range of what?

MR. JOHNSON. Well, it depends on what your objective is. If your objective is a borrowing number--

VICE CHAIRMAN CORRIGAN. I don't care what your objective is.

MR. JOHNSON. Well,--

VICE CHAIRMAN CORRIGAN. If your objective is the federal funds rate--

MR. JOHNSON. Oh, there's no doubt that that range could be reduced substantially.

MR. ANGELL. Jerry, if your objective is the federal funds rate--

VICE CHAIRMAN CORRIGAN. Mine isn't.

MR. ANGELL. I know; mine isn't either. But if it is, I think you can pinpoint it, if that's your objective.

VICE CHAIRMAN CORRIGAN. I don't.

MR. ANGELL. My goodness! We sure did in the '70s.

VICE CHAIRMAN CORRIGAN. Again, those were different days. Just take the computer problems and the frequency with which they occur. I guarantee you that that alone is an important source of day-to-day variability in the federal funds rate.

MR. ANGELL. Well, Jerry, I just don't understand. If the Desk has the message that it's below, buy and sell fed funds.

VICE CHAIRMAN CORRIGAN. It depends what time the computers go down.

MR. ANGELL. No, I'm saying if the Desk has the objective of buying and selling 1/8th of a point off of the fed funds target, that's going to be realized.

VICE CHAIRMAN CORRIGAN. That means--

MR. ANGELL. Now, I don't agree with wanting to do that; I'm just saying I agree with Manley that it can be done.

VICE CHAIRMAN CORRIGAN. I don't think you can do it.

MR. JOHNSON. It just depends on--

CHAIRMAN GREENSPAN. Heavens, I haven't heard this conversation since Economics 101!

VICE CHAIRMAN CORRIGAN. That's about what it is, too.

CHAIRMAN GREENSPAN. Peter is very quiet.

MR. PARRY. Mr. Chairman--

CHAIRMAN GREENSPAN. Let Jerry finish.

VICE CHAIRMAN CORRIGAN. I really don't think it is desirable or possible to build that kind of precision into the day-to-day conduct of monetary policy.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Mr. Chairman, with regard to Lee Hoskins' question about changing the borrowing target--I don't want to focus on whether or not reducing the target \$50 million was right or not right for the long-run best interests of the economy--but I am concerned that it was done in such a way that it did not take into consideration the decision made by this Committee and the directive that was issued [when the Committee consulted in early January]. There are four kinds of developments in that directive that permit you [as Chairman] to move the borrowing target and I think that decision is left principally in your hands. I think there was no evidence--at least it certainly wasn't clear in Kansas City that there was incoming evidence from the fourth-quarter numbers, for example--for the borrowing target to be adjusted down \$50 million for the next two-week period. It seems to me that decision was outside the confines of the directive itself. I raise this without trying to make any other issue out of it. But it seems to me it is an important issue that we have to keep in mind.

CHAIRMAN GREENSPAN. Yes, I'm responsible; and let me tell you my reasons and why I thought it was within the scope of the directive. First of all, there was increasing evidence from the initial claims figures that the economy was slowing down very dramatically. And this was subsequently confirmed by the January unemployment data. Secondly, and of considerable significance, was increasing evidence that the exchange rate was being stabilized. Thirdly, the markets were coming down on their own at that particular time--clearly trying to seek a somewhat lower market rate level. The combination of those three factors, coupled with the nature of the directive, made it important in my judgment that we move in a somewhat marginal direction. The issue was discussed as to whether or not an FOMC telephone meeting should be called under those conditions. The general judgment was that it was not appropriate. The issue was raised. If there is any sensitivity in this group that in the future we should--if that is communicated--I think it would be incumbent upon

us to, in fact, go to a telephone conference. It was a close call. And if it's the consensus of this group that in the future we should, then I'd find it, as a result of your request, [appropriate] to do so.

MR. GUFFEY. In my view, it's particularly important, given the background of the political pressure that had come from the Treasury people and so forth, that such a decision be a broader-based decision. I understand the flexibility that you must have, Mr. Chairman, and that the Desk must have. This is a structural issue and I only want to raise it.

CHAIRMAN GREENSPAN. Yes, I appreciate that. And I must tell you that I resented those calls that were being made by the Treasury and I told them. And I must tell you that the Secretary of the Treasury was very upset when he heard about them and did not like them. I communicated in a manner which I hope will shut that nuisance off, because I thought it was most inappropriate. And I can't believe the insensitivity of the people involved in doing what they were doing. That's the reason I asked you earlier on, by all means, to let me know if we failed to shut the valve down. I'll just have to use a sledge hammer. Any other questions to the Managers? If not, then, Mr. Kohn.

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

CHAIRMAN GREENSPAN. Thank you, Mr. Kohn. Questions for Mr. Kohn?

MR. BLACK. Don, I didn't see any mention of your borrowing targets under any of these alternatives [in the Bluebook].

MR. KOHN. In the first paragraph on page 13, under the short-run alternatives, we associated alternative B with \$250 million and with funds trading of 6-1/2 to 6-3/4 percent--around the range we expected them to have been trading in the last week.

MR. BLACK. I'm sorry, I remember having seen that. I was just looking for it in a different place and couldn't find it.

MR. KOHN. We changed the place this time; maybe that will--

MR. BLACK. That threw me off.

MR. KOHN. Originality doesn't always pay off.

MR. BLACK. And I've even got it underlined so I have no excuse for not having remembered exactly what you had. I thought that's probably what it was, but I just wanted to make sure.

MS. SEGER. Should we be paying any attention to the structure of rates? It seems to me that the long rates have dropped dramatically in the last couple of months, as have private short-term rates. The fed funds rate has dropped a bit, but it certainly hasn't kept up with the others. And, of course, the discount rate has remained stuck. Should we be looking at this as a factor or condition?

MR. KOHN. I'd make a couple of points on that. One is that the drop in private short-term rates, particularly since the last FOMC meeting, very importantly reflected the passing of the year-end pressures. We had a huge decline in those rates in the first week of January and I don't think that had anything to do with the economy or monetary policy or expectations or anything like that.

MS. SEGER. How about going back, though, to the October--

MR. KOHN. I think that the decline in bond yields does reflect a weaker outlook for the economy and expectations that interest rates will not be rising as much as people previously thought over the coming year. But, as I remarked in my briefing, the yield curve still is really pretty flat. I think there is an expectation that we will be easing perhaps even further in the very near term, but there is something of an upward slope beyond that. When you get out a little, it does slope upward a bit; and I think that reflects expectations that there is enough strength in the economy that we won't be seeing declining rates. We don't have a classic situation--a sharp downward slope in the yield curve and tight monetary policy, or anything like that. It still has an upward sort of curve. I look at those things as an indication, at least, of what the market is thinking and what they're expecting. Then you can measure that against our expectations. President Keehn's Bank published an article on indicators of monetary policy, which shows that spread, I think, as an important indicator--

CHAIRMAN GREENSPAN. [Unintelligible] spread has edged up in this period. That's just suggestive of some expectation in the market that the economy will turn flat.

MR. KOHN. I was really concentrating on the short-long kind of scenario.

CHAIRMAN GREENSPAN. Yes. I mean they're giving slightly different signals. Governor Kelley.

MR. KELLEY. May I come back, Don, just one second to Bob Black's question about just what alternative B means? On page 13 it does indeed say it's associated with borrowing of \$250 million. On page 14, in paragraph 16, it says that "Alternative B contemplates a continuation of reserve conditions now expected to prevail after the recent slight easing." Now, when we get over to [the directive] language, which we're going to look at in just a minute, it says that alternative B "would maintain the existing degree of pressure on reserve positions." And I guess I would like to know how that would be defined. Would that be defined as the \$250 million or would that be defined as what, in fact, has been happening here in recent days, more like \$150 million to \$200 million?

MR. KOHN. Peter can give his views also, but I guess I would still be tempted to think that \$250 million was more a center of gravity for this kind of funds rate range. But I would also be ready to adjust that informally, as Mr. Sternlight has done through the intermeeting period, if it looked like it was inconsistent with the Committee's expectations. I think one week, or even two weeks, of low borrowing is not necessarily indicative that the whole thing has slipped; but it's something that would have to be watched very

carefully. So, if you started by writing down \$250 million, and it persistently came in under that but was consistent with funds trading in the range you expected, we could take it down as a technical adjustment. But I'm not sure that we would have to do it right off.

MR. KELLEY. Then, if we were to say that we were going to maintain the existing degree of pressure, that wouldn't necessarily mean that we were going to, in fact, tighten from what we have been doing?

MR. KOHN. Well, I think it means tightening in terms of the borrowing objective you write in the reserve path [relative to recent actual borrowing]. But I think that other sentence in there gives Mr. Sternlight the flexibility to fall short of that if market conditions dictate. Open market operations should not produce that effect.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I was surprised that the implication of alternative A is that it could be implemented solely through open market operations. In other words, it has a borrowing assumption of \$100 million--I guess I had in my mind that frictional borrowing was somewhat higher than that.

MR. KOHN. Well, so did I until recent weeks when it has been coming in lower. I think it's a close call, President Melzer. We have seen, as people have pointed out, in the last few days some periods in which the funds rate has been fairly close to the discount rate. Often that gives rise to an expectation that the discount rate is going to be reduced; and often those periods are periods in which a discount rate reduction is a step away. But I guess the idea of the \$100 million was to suggest that it probably is possible to get the funds rate down to just a tick above the discount rate using open market operations. Whether that sets into motion expectations about the discount rate I think is another question; and whether a \$100 million borrowing is what you would do it with or not, I don't know. But it does get tricky in this area. I agree that it's an important question.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Is it time for comments? I don't have any questions.

CHAIRMAN GREENSPAN. No, still questions. Questions?

MR. BOYKIN. Don, as I read the write-up, alternative A would accommodate a discount rate reduction. My question is, technically, would alternative B accommodate a discount rate reduction?

MR. KOHN. Well, it would depend on a combination. Alternative B implies funds trading in a 6-1/2 to 6-3/4 percent area, in terms of the money forecast. If you were to reduce the discount rate, presumably that would take funds down with it, and that would be more like alternative A.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. My question has been answered, or at least an answer was attempted.

MR. BLACK. You want to identify it? It wasn't on the agenda.

MR. KOHN. I think it was the alternative A, \$100 million--

MR. BOEHNE. Right.

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. Don, if I follow my earlier desire to somehow or other ignore the November and December artificially low figures-- looking at the table on page 14 [of the Bluebook], there are growth rates from November to March and December to March. If I calculate a growth rate from October to March--I've been doing it here on the back of the envelope--is 5.7 percent about right for alternative A and 5.4 percent for alternative B?

MR. KOHN. I don't know--you're talking about M2?

MR. HELLER. M2.

MR. KOHN. Yes; it's the right direction. It would be something lower than the 6-1/2 percent and 7 percent for the [November to March period], and it sounds approximately correct but--

CHAIRMAN GREENSPAN. Any more questions? If not, let's go to comments. President Parry.

MR. PARRY. Mr. Chairman, our analysis and that in the Greenbook suggest to me that policy should not be eased beyond the actions taken two weeks ago. The sharp slowdown during this half of the year is related to the inventory buildup and should be corrected by midyear. A further rate decline wouldn't have much effect on this correction, and it actually would primarily impact the second half of the year when the economy is really expected to bounce back. Moreover, if I accepted the much smaller inventory pattern of the staff's forecast and the statement I guess that you made yesterday that the inventory correction could be even less than that expected by the Board's staff, it would seem to me that any further easing at this point could be something of a mistake. Also--

CHAIRMAN GREENSPAN. Unless you're using it for something else.

MR. PARRY. Excuse me?

CHAIRMAN GREENSPAN. Unless you're using it for insurance.

MR. PARRY. Perhaps. Also, a growth rate of 2 percent or slightly higher in 1988 as a whole is acceptable, in my view, given the rapid growth of the economy last year and also given that the economy has entered the range of full employment. Therefore, I'd favor alternative B. Of course, if greater weakness did begin to show

up in the statistics, we could always make a change toward an easier policy before the next regular meeting.

SPEAKER(?). Maybe not.

CHAIRMAN GREENSPAN. Do you have a borrowing assumption? What number do you indicate?

MR. PARRY. \$250 million.

CHAIRMAN GREENSPAN. \$250 million. Governor Johnson.

MR. JOHNSON. Let me ask: Are we just concentrating on the short-term issue or are we going to try to combine the whole thing at this point in the comments?

CHAIRMAN GREENSPAN. You know, that's a good question. Bob, would you reiterate in that context your longer-run targets as well?

MR. PARRY. Right. I was in favor of alternative B in the short term; and then for the long term, 4-1/2 to 7-1/2 percent, which is, I think, alternative III.

MR. JOHNSON. My view is that we have to be very careful in terms of the short-term direction of policy. It's clear to me, having just come back from the BIS meeting, that the international situation would be too sensitive to [want to] trigger a discount rate reduction. I think there's a much larger international implication from a move like that--not to say that forces which might require such a move might not develop over the next few weeks, if things looked more serious than what we anticipate. I think under more serious economic conditions the international community could probably absorb something like that. But right now we certainly don't have enough information, I think, to imply that. I think also that we have to be sensitive to the international situation when we consider the short-term course of policy.

So, my views, in terms of open market operations in the short run, don't imply a move on the discount rate unless some future developments point towards more weakening. But when I say that, I still think that some slight tone of easing is necessary. But I think that can be done without creating the expectation of a discount rate reduction, mainly because I think that the markets perceive that we are sensitive to the international situation and that we have been sensitive to the dollar. And as a matter of fact, I've already seen a number of reports indicating that the Fed would not be likely to trigger a discount rate reduction because of international considerations. And I think that's sort of the right tone in the market. At the same time, it seems to me the market already has absorbed quite well--as the Chairman and others have pointed out--some expectations of a modest easing. What they've actually absorbed is not totally clear yet, because there's still a bit of uncertainty as to where we are.

But I guess my preference is somewhere in between "B" and "A", although closer to "B". What I'm thinking is that I would prefer something centered around a policy consistent with a 6-1/2 percent funds rate, maybe even a hint lower than that. Alternative B is

associated with \$250 million of borrowing; I guess I could accept \$200 million of borrowing as something consistent with my view, although I'm not very confident in the borrowing number as projecting what I want. I could accept the \$200 million number, given that Don has described open market operations in the Bluebook as somewhat sensitive between the borrowing number and money market conditions, and that seems appropriate to me. So, I guess that's where I come out on the short run--trying to avoid the implication of a discount rate reduction, although it may not be totally possible to do that. Given a move like I'm suggesting, which is only just a slight move away from where we already are, I'm not even sure the markets would know the difference from where we already are and what I'm suggesting, because things haven't totally settled. So I would go with something like a \$200 million borrowing number, which is a tad below what is described as "B", with the kind of language on operations that Don implied in the Bluebook.

In terms of the long run, as I said, I really don't have much of a preference between alternative II and alternative III, mainly because they're both centered on about the same point. But alternative II has a slightly wider range associated with it, which is a little more consistent with my view about the uncertainties in terms of an M2 target. I guess somebody else mentioned 4 to 8 percent instead of 5 to 8 percent, which is in alternative II, and that gets even closer to what I think is the right answer. So I guess my preference would be something like a 4 to 8 percent M2 target range and a \$200 million borrowing number. And I think that somehow satisfies my concerns about the short term and the long term.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I would prefer alternative B on the short run, with a \$250 million borrowings target. Basically, my feeling is that there clearly has been a significant change in the thrust of policy, no matter how you want to look at it. Interest rates, in terms of fed funds, are down 100 basis points from where they were in late September-early October. And a dramatic shift now shows through, for a month anyway, in the growth of reserves and the monetary base. So I would say, let's let that work. I don't think any more easing is called for at this stage. Secondly, and I guess perhaps more importantly, we already decided to make a move back to more normal applications of the borrowings target and I think, as Governor Angell suggested, we ought to take advantage of these stable conditions and complete that move now. I understand what Peter said about the need to be sensitive in the short run--letting the policy change show through--and I think that is appropriate. But I think now we can move back and we ought to get that done. I really think that the markets had become quite accustomed to dealing with that, and the fluctuations you got in the funds rate tended to be on the last day of a two-week statement period. I just don't think that's a problem in terms of conditions. So I would move back to that now. I would indicate in the directive that we were doing that--I wouldn't have language in there in terms of continued flexibility. If there were agreement about that, we might even have to deal with that lead-in phrase "taking account of conditions in financial markets" on line 108. The other thing I would do in the directive is, in the lead-in I think we'd have to say maintain--or whatever we're going to do--maintain/increase/decrease "the degree of pressure sought in recent

days." I think it should be worded in that fashion probably; to me that usually conveys that there has been an intermeeting movement. Finally, I take heart in the stability in the foreign exchange markets, as you do Mr. Chairman, and I think there is some significance to it. I take heart in that, but I don't want to do anything to test it. I think we ought to take it and be happy we got it, but not press our luck on testing it in any fashion.

MR. JOHNSON. Can I ask a question about what you said in talking about going more strictly to the borrowing number? I just want to ask Peter: My understanding is that for the last few weeks borrowing has been averaging about \$150 million; and I think the implication of what you're saying is that a continuation of that trend definitely implies a much higher funds rate, even in current conditions. I don't know if you want to clarify that.

MR. MELZER. Well, I'm not sure I necessarily agree with that.

MR. STERNLIGHT. Well, the borrowing has been about \$150 million in the last two weeks and in the previous reserve period it was \$175 million, I guess. But with the \$150 million some [unintelligible] were weak.

CHAIRMAN GREENSPAN. Well, the facts of the case are that the borrowing/funds rate relationship is not back to normal.

MR. MELZER. I guess I can believe that there never will be such a thing as normal--where it's a totally stable, predictable, relationship. All I'm saying is that in some of these cases where we have missed, one of the reasons it might have run low--and I think this was said before--is that we have been unwilling to force it toward the end of the [reserve maintenance] period. And I'm just saying that a spike of a billion or two billion of borrowing on the last day of the two-week statement period generally is not going to be disruptive. My understanding is that \$250 million is roughly consistent, even under present conditions, with a 6-1/2 to 6-3/4 percent funds rate. And I would be quite comfortable with that.

CHAIRMAN GREENSPAN. You know, Tom, I'm only raising the point that it has not been kicking back and forth, but it has been persistently under--implying that there's still some disinclination to move to the discount window--a certain historic relationship with the funds rate/discount rate relationship. That's all I'm saying. I'm making a statistical point; you're raising an operational question.

MR. JOHNSON. Well, you may be right. All it may mean is a big spike on the settlement date, Wednesday. But it still implies a significant funds rate spike on or around the settlement day; and the maintenance period average would be considerably above what we are used to. Maybe that wouldn't disrupt the market, but it will certainly change the tone of things.

CHAIRMAN GREENSPAN. President Forrestal.

MR. PARRY. What was his long-term?

CHAIRMAN GREENSPAN. Tom? Long-term?

MR. MELZER. Oh! My long-term is alternative II, but I'd do 4 to 8 percent for M2.

CHAIRMAN GREENSPAN. Mr. Forrestal.

MR. FORRESTAL. For the short term, Mr. Chairman, I would prefer alternative B with a borrowing target of \$250 million. Now I realize on the basis of this recent discussion that we have some operational problems; but we do have a target now of \$250 million, associated with a funds rate of 6-1/2 percent, and that's where I'd leave that target. And I base that judgment on the forecast. I think we are in an environment of a sluggish first half and the forecast indicates acceleration in the second half of the year. I think the mistake we could make at the moment would be to overreact to that sluggishness now. There's not anything we can do about it anyway; and I think it would be a procyclical kind of policy stance if we were to overreact to the sluggishness now, which would show up in the second half. So I don't think that easing is called for.

However, there are risks, as we all have indicated, and a lot of uncertainties. So, I would be extra vigilant and extra sensitive to changes in the economic situation. For that reason, I would prefer an asymmetric directive which would be biased towards ease if we see some continued weakening in the economy showing up in the second quarter and into the second half. So, I'd favor alternative B with borrowing of \$250 million. For the long term, I continue to favor the 4 to 8 percent range for M2 that I indicated earlier, with a 5 to 8 percent range for M3.

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. As I said before, in contrast to many of the members, I don't feel that the second-half strength is a foregone conclusion. It's not in the bag and the risks are still there that it will not come about. As far as the short-term monetary growth is concerned, I see January mainly as a bounce-back after the very weak November and December numbers. If you take the number from October to March, as has been just supplied by Don Kohn, our current targets only imply 5-3/4 percent M2 growth under alternative A and only 5-1/2 percent growth under alternative B. So there would be very slow growth, indeed, compared at least with the numbers that we see in front of us here--the 8 percent number that's the implied growth [under alternative B] from December to March. So I see both "A" and "B" as pretty restrictive policies. I certainly would favor somewhere in between--I'd say right on the line between "A" and "B"--with a borrowing target just as it exists right now, maintain continuing pressure. And following Peter Sternlight, I'd say continuing pressure is \$150 million and the trading range for federal funds probably would then be 6-3/8 to 6-1/2 percent, broadly.

CHAIRMAN GREENSPAN. So you're saying \$150 million borrowing assumption?

MR. HELLER. Existing borrowing, existing pressure--so it would be \$150 million.

CHAIRMAN GREENSPAN. Well, let's make sure we are all talking about the same thing. Don interprets existing pressure as \$250 million.

MR. HELLER. Well, I interpret it--

MR. KOHN. With room for downward adjustments.

CHAIRMAN GREENSPAN. What?

MR. KOHN. With room for some downward adjustments if it looks like this weakness is persisting. But I wouldn't take the first 11 or 12 days of this maintenance period--

MR. JOHNSON. Don's language sort of says \$250 million but with some room to adjust according to money market conditions. So--

MR. HELLER. Well, I was going more with Peter Sternlight's number of \$150 million. That's the actual number, and the actual pressure existing right now, and I want to maintain that actual pressure.

MR. JOHNSON. Even if it means a lower funds rate, at some point, than what you're saying, 6-3/8 percent?

MR. HELLER. Yes. If it goes down to 6-1/4 percent, that's fine.

MR. PARRY. What about long term?

MR. HELLER. As I said earlier, I'm still in favor of rebasing, with a 4-1/2 to 7-1/2 percent range; or 4 to 8 percent is also fine with me. I really don't have a strong feeling on that as much as the rebasing.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, I share the questions that are arising as to just where we are, but for the short term I am in favor of maintaining the existing degree of pressure, and I think that's alternative B. I also would share Tom's view that we ought to be moving back to a borrowings level, on a basis that's consistent with what Peter can produce; and, therefore, I'm leaning toward a borrowing level of \$250 million. Of the three alternatives for the longer term, I'd be in favor of using the ranges stated in alternative III; but I would have a preference, as I said earlier, for a broader range of 4 to 8 percent. And I think that that broader range would be appropriate both for M2 and M3.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I favor alternative B with a \$250 million borrowing, which I interpret as being essentially where we are now, after the recent easing. I would have a symmetrical directive. I also agree wholeheartedly with Manley on his views about the discount rate. It seems to me that whatever marginal adjustments we make in monetary policy ought to be done through open market operations and that we ought to avoid a change in the discount rate for the reasons

that he stated rather well. However, my alternative B and \$250 million borrowing are predicated on the current discount rate. If the circumstances should arise over the coming weeks that there might be a change in the discount rate, then I think one would have to revisit open market operations. I don't think that we ought necessarily to let a discount rate change automatically change open market operations. It seems to me that while they obviously work together, they are separate decisions; and a change in one shouldn't automatically lead to a change in the other.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I'm generally in favor of alternative B, with one slight modification that I'll get to in a moment. But I think, as several people have mentioned, that we should work a little harder than we have, at least, at achieving the borrowing objective--however we specify it. In light of that, and in light of what I've seen going on in the markets lately and the relationship between the funds rate/discount rate spread and borrowings, I think I would favor a borrowing target probably in the neighborhood of \$200 million rather than \$250 million. If we worked to achieve that, I wouldn't be surprised if the funds rate might drop below 6-1/2 percent on occasion; but on occasion, it might also rise to, or maybe even above, 6-3/4 percent. I wouldn't try to prejudge or pinpoint that to a great extent.

As far as the long run is concerned, I am where I was before; that is, it seems to me that given all the circumstances, alternative III is the preferable one. I don't see a conflict between the short-run stance of policy and the long-run objective package. As I read Don's numbers, those things look like they fit perfectly. They don't seem to be at all that much variance. We are not very good at forecasting monetary aggregate growth month-to-month or quarter-to-quarter anyway. So, I think you could convey a message about both the short-run needs and concerns about the economy as well as the long-run objective of policy with that combination.

CHAIRMAN GREENSPAN. You're arguing for a wider potential range; would you be willing to accept 4 to 8 then?

MR. STERN. I guess I'm not in favor of a wider potential range. I'm not sure I see particularly what it buys us. I'm not violently opposed to it, but--

CHAIRMAN GREENSPAN. It does, I guess, send a message that we haven't concluded that the money numbers have been locked back into the economy in the way in which they were historically.

MR. STERN. But that has been the case for some time, and for M2 and M3 we kept these 3-point ranges, regardless.

CHAIRMAN GREENSPAN. With some cost.

MR. STERN. Well, I don't see any problem with that. I think one of the values of the ranges is that when you hit the limits, you've got to stop and think and assess the situation: Do you want to permit the aggregates to go outside on the high side or the low side, or don't you? It seems to me that's one of the virtues of the ranges.

And we may decide to let them go, but at least we will have given some healthy analysis to the question.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I would favor "B", but I'd like to see the average level of the federal funds rate near the lower end of this projected 6-1/2 to 6-3/4 percent range. I think there's a good chance that the relationship between the level of borrowing and the federal funds rate is going to continue to surprise us from time-to-time in the weeks ahead. So, I'd like to maintain this flexibility in the operating procedures that we have, and retain the sentence that's on lines 103 to 107 of the directive in this form.

As far as the long run is concerned, I would stick with alternative III. The statement that I'm really trying to make is that I think there is uncertainty in the economy now. We have to be accommodative and make sure that that doesn't become serious. But my suspicion is that it's not going to be all that bad. So we want to be careful in the long run not to waken fears that we have thrown in the towel on the inflation issue, yet at the same time show sensitivity to the weakness that has been evident recently.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. Having sat here for two days reminds me what a difficult job this is at the minimum wage. Even at \$4 an hour, the higher minimum wage, we'd still be--. But more seriously, I think one of the most difficult jobs that economic forecasters have is predicting turning points. I sort of remember that from school and I also remember it, having lived a long time and through a number of business cycle turns. I think policymakers also have a difficult time doing that--even identifying that the turn has occurred after the fact. I just want to make sure that we are looking at every single thing here, and we have looked at a lot, certainly. And we're very, very sensitive to the notion that there might be a bomb placed somewhere in this. It's just this feeling of unease I have, I guess, that I would like to concentrate on. I'll also repeat that I think there are risks on the downside both in this half of the year and my friend Governor Heller has convinced me that the bounce-back [in the second half] isn't assured either. So that makes me doubly concerned. I'd like to convey that feeling of risk and uncertainty and of having to watch carefully how we proceed.

If I had to choose among the alternatives as stated, it would probably be alternative A. If we can come up with something that's sort of a marriage between "A" and "B", then I could certainly vote for that. But I am not convinced that the bankers are back to normal if they ever were normal. I know a lot of them, and I had a feeling that those scars were going to remain for a while and I think they are remaining. Therefore, I think it's more realistic to put a number in the borrowing path that, in fact, reflects what's going on--which is Bob Heller's \$150 million. I think that's what their behavior is really suggesting. I think if we force the \$250 million, we would put quite a bit of upward pressure on fed funds rates. I'm willing to go with maintaining the current degree of pressure, but I don't think the \$250 million would produce that. Instead of putting all the latitude

on the Desk, I would rather give us a little vote in the process and let us suggest that maybe it go down to around \$150 million.

On the longer term, I would vote for alternative II with the broader band for M2--4 to 8 percent rather than 5 to 8 percent, and 5 to 8 percent for M3. A main concern I have is how these numbers will be received by the financial markets when they are announced. Right at this moment I would be very sensitive about sending any message that we are tightening or even considering a tightening. And I think one way to prevent that is to keep the upper end of this band where it has been. So that's what I would vote for; I'm not sure that's specified exactly as an alternative.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I'm also in the camp that feels that the risks this year are more on the soft side. I agree with Governor Heller in that I don't think this second half is in the bag and I would be fearful of anything that looked like a tightening. I'm really quite comfortable with the slight easing that has occurred so far. At this meeting I would like to come out with a configuration that would essentially leave us there. I'm not exactly sure what would accomplish that. I think if we have \$250 million as a borrowing target and take that seriously, it might result in what would appear to be a tightening, which I would not be comfortable with. So, I think I favor a \$150 million to \$200 million borrowing target and alternative B with some asymmetric language on the easing side. And for the longer term, I agree that we must maintain our posture against inflation. For that reason, I would stay with alternative III in order to maintain that message in the market.

CHAIRMAN GREENSPAN. Could you read that as 4 to 8 percent?

MR. KELLEY. I could read that as 4 to 8 percent, yes sir.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, for the short term, I favor alternative B, and the \$250 million borrowing assumption, with the understanding that it would be interpreted as Don explained. In the longer term, my preference would be to remain with alternative II as specified--that is, 5 to 8 percent on M2. I could accept 4 to 8 percent if that's where the majority was. It does seem to me that maintaining the 8 percent on the top side still represents a downward move of a half a point [from the range for 1987], which indicates that we continue to be concerned about inflation. If you throw in another half a point on top--which, in effect, would knock a full point off--that might be, in my judgment, a little overkill in showing our determination.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Mr. Chairman, I would opt in the short run for alternative B with the existing borrowing target of \$250 million. I'm concerned about trying to hit a target below that--and I'm talking about the \$100, \$150, or \$200 million--simply because I think there is a frictional level of borrowing where we lose control, particularly if you get seasonal borrowing as \$50, \$70, or \$100 million of that \$100

million borrowing target. I think you take a real risk: if things do not come in as you want in the first quarter and you choose to move against a recession, then you have to do a discount rate decrease. And I think the implications of that for the dollar are very great, as Governor Johnson has pointed out. As a result, I would stay right where we are with the borrowing target of \$250 million. On the long run, I favor alternative II with a 5 to 8 percent range for M2; I could accept the 4 to 8 percent range. I agree with the point made by Bob Boykin that we have already gone down a half of a percentage point from the targets set for 1987 and if you do another half point, you give the view that you went on the low side. That's something I don't want to do.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. You spoke earlier, Mr. Chairman, about the need to try to come out of this with a point of view that could command some support. I'm tempted to say, looking at this little score card here, that you were clairvoyant in anticipating that that might not be the easiest thing to do. Let me first say what is my preference and then what I guess I would regard as acceptable. My preference on the short run is a straight plain vanilla alternative B; and on the long run, a straight plain vanilla alternative III. In the short run, I could associate myself with Gary Stern's approach, which would have "B" with a little tilt toward "A"--\$200 million borrowing but with the expectation that on the borrowing we'd work toward--I'll come back to that in a minute.

On the long term, again, I could accept 4 to 8 percent. I have three kinds of problems here. One is a little uneasiness about the thrust of policy, let's say, that I can accept. Two is, that if the conduct of policy in the days and weeks ahead were strongly to prejudice the discount rate question--in a context in which the economic outlook, or the exchange market, or whatever, is not different in a material way from what it is right now--I would have real trouble at that point. Even so, we have to go carefully here, at least until we get the trade number. If that trade number turns out to be a real bummer, even the kind of finessing we're trying to do here is going to backfire.

CHAIRMAN GREENSPAN. Well, there is no finessing under those conditions.

VICE CHAIRMAN CORRIGAN. I think it is extremely important, at least for the foreseeable future and barring some material change, to try to conduct operations in a way that is not prejudicial to the discount rate. My third point--calling a spade a spade--is that now we are running policy off the federal funds rate and I think that's a mistake.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. I share your view, Mr. Chairman, that the financial markets do have some fragility to them. Given the circumstances we are in, I think it's rather dangerous to be in a position of tightening credit at all. I'm not comfortable with even a small step towards tightening. That's why I believe what we've done has been not so well thought out, because I think we have set

ourselves up in the circumstance in which we are apt to find it necessary to tighten--and tighten after the fact--and that poses a dangerous problem. I don't mean to be insensitive to the problems that we have had and I don't want to make too much over little, but when we have hardly any opportunity to go in the other direction, every step we lose on the downside gets to be, I think, rather significant.

I think this talk about borrowing targets and then the fed funds rate, frankly, has become a kind of zigzag step which never ends. I vote with the majority and I end up losing. And, Governor Johnson, I just have to congratulate you--I mean you voted in the minority and you've won! And I just want to admit that to you; it was really very, very well done. I hope everyone understands the sensitivity that I have at this point. I would not make any moves other than what I thought was exactly right for the U.S. economy and the world economy. I think we are running some severe risks of other factors blowing up and I don't understand why that is good from any perspective. In the spirit of wanting to go along, I'll try to go along. But I would like some assurance that we are not going to just keep doing this, Mr. Chairman.

On the long term, my first choice is alternative III, but I can go with 4 to 8 percent. I can go with "B", if that's not easing from our present position. And I would like to have us mention the borrowing targets in the directive. I'd like the borrowing target to go in the directive. I would like either to lose with the fed funds targeting issue and have it be fed funds, or I'd like to win, Mr. Chairman, and have borrowing be in the directive. And if we can work in that spirit of cooperation, I'll try to cooperate.

CHAIRMAN GREENSPAN. What's your borrowing number?

MR. ANGELL. My borrowing preference is \$250 million; that's the deal we made. We talked about going from \$300 million to \$250 million and we did it. And then I see the Desk operating in such a way that it puts us in jeopardy--having to tighten to go to what I agreed to do. I seem impatient and I'm sorry.

CHAIRMAN GREENSPAN. Sorry we didn't record that.

VICE CHAIRMAN CORRIGAN. We did!

MR. ANGELL. But I want everyone to know I do understand they are just differences in opinion and not--

CHAIRMAN GREENSPAN. Look, you're raising an issue which I think is right at the cutting edge of the policy operations. And this issue has to be resolved at some point in a satisfactory manner because, in a sense, it is a disruptive issue with respect to this Committee. And I--

MR. JOHNSON. Yes--

CHAIRMAN GREENSPAN. Quiet. It may well be appropriate to find another vehicle--maybe a luncheon discussion--in which we start from scratch, go through lists, and then at some point get a really formal decision, so we are not, in your judgment, unable to get firm

positions on this. My own impression is that it's not a bad idea to put it on the luncheon agenda next time around. We can't have this continuous discussion going on without having the Committee bring forth its judgment of precisely how this issue is going to be resolved--and not let it be at the discretion of either Mr. Sternlight, myself, or anyone else around here. Without objection, I think we'll put it on the luncheon agenda for next time.

MR. JOHNSON. Mr. Chairman, may I say one little word on this?

CHAIRMAN GREENSPAN. One.

MR. JOHNSON. I sympathize completely with what Governor Angell is saying, although somehow I don't feel I've won. But I do agree this has to get resolved. We can't go on arguing over what operational policy ought to be. It has to get clarified and then once it's clarified, I'm totally satisfied joining whatever team that turns out to be; I'll work within those rules. But right now we are in a confusing period. It's one of those times when I'm not sure it's clear. But it has to be clear at some point.

CHAIRMAN GREENSPAN. President Morris.

MR. MORRIS. Mr. Chairman, I agree with Mr. Corrigan that we tackle our policy as if we are controlling the funds rate. I don't feel upset by this, however. I think there are only two things we can control--the funds rate or the rate of growth in reserves. And what we have found in recent years is that there is no stable relationship between the rate of growth in reserves and the objectives of this Committee. So let's face it: that leaves us only with making judgments with respect to interest rates. Even though we find it's difficult to follow, because of the experience of the 1970s, I think it's much better to face it than to build sand castles based somehow on relationships between borrowing levels and our objectives. I served on this Committee when Bill Martin was Chairman. For 19 years he controlled monetary policy through monitoring the federal funds rate [or other money market rates]. And that 19 years was a period of extremely successful monetary policy. I think the idea that we cannot have a successful policy controlling the funds rate is simply wrong. I think we have a lot of history to suggest that we can. So, I don't share Jerry's concern about calling a spade a spade.

Therefore, my recommended policy would be alternative B, by which I mean that we keep the federal funds rate around 6-5/8 percent--I think that's what Don described--until such time as we think it ought to be moved lower or higher. As far as the long-term range, Mr. Chairman, I would prefer alternative III; but as a practical matter I see absolutely no difference between alternative II and alternative III and I'd follow your discretion as to which one you think would be politically superior, because from my experience, a half of one percent over a year is nothing that we ought to quarrel about.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. I guess we could get to work toward our luncheon discussion if we wanted to consider a penalty discount rate;

that ought to reduce the concern over borrowings. I think Frank Morris raised a good point. We haven't been willing to address the rate of growth in reserves, because while we may be able to control that, we haven't liked the outcomes. That may be because we have been uncomfortable with the relationship between money and the economy. That's a longwinded way of saying that it's still a pretty confusing scenario in my own mind. I would tend to favor alternative B in the short run, ensuring that the growth in the monetary aggregates continues; I would err on the side of making sure that growth is continued. In terms of the longer term, I would stick with alternative III.

CHAIRMAN GREENSPAN. I think that there seems to be a very general consensus about willingness to accept 4 to 8 percent for M2 by a large majority, if not all, of the voting members. But it's not clear to me exactly how everyone comes out on M3. Don, do you have any recommendation on that?

MR. KOHN. Well, my thought on the matter was that you could retain the 5 to 8 percent M3 range. We are projecting growth around 6-1/2 percent, so--

CHAIRMAN GREENSPAN. You're talking about M3?

MR. KOHN. For M3, right. So, 5 to 8 percent would encompass that, but 4-1/2 to 7-1/2 percent is also close. As I think President Parry and some others mentioned, we have on occasion in the past--though not for the last several years--had M3 ranges that were slightly higher than M2 ranges. So, it's not without precedence.

MR. PARRY. I have one question about that. If you had the 4 to 8 percent range for M2 and 5 to 8 percent for M3--we really don't want to make a distinction between the two in terms of uncertainties. The 4 to 8 percent is fine; I like it because the midpoint is 6 percent. But in talking this out, given the uncertainties, I'm not that confident about implying that you have greater certainty about M3 than M2. That's the only problem I see having two different ranges.

CHAIRMAN GREENSPAN. Would the rest of you like to speak to that? Does anybody have any objection to keeping them the same?

MR. HELLER. Deciding now, 4 to 8 percent for both?

CHAIRMAN GREENSPAN. 4 to 8 percent for both.

MR. BOEHNE. I think if we change one, we ought to change both.

CHAIRMAN GREENSPAN. So, I sense you'd say 4 to 8 percent on both?

MR. BOEHNE. Yes.

SPEAKER(?). That's fine.

CHAIRMAN GREENSPAN. If that is acceptable, why don't you [Mr. Bernard] read the paragraph for the long-term objectives as it would read under those conditions.

MR. BERNARD. "The Federal Open Market Committee seeks monetary and financial conditions that will foster reasonable price stability over time, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives, the Committee at this meeting established growth ranges of 4 to 8 percent for both M2 and M3, measured from the fourth quarter of 1987 to the fourth quarter of 1988." Then we need something for debt. "The monitoring range for growth in total domestic nonfinancial debt was set at __ to __ percent for the year."

CHAIRMAN GREENSPAN. What do you recommend, Don?

MR. KOHN. We had 7-1/2 to 10-1/2 percent, but if you're widening the ranges for M2 and M3, I don't know--

MR. HELLER. 7 to 11 percent then.

VICE CHAIRMAN CORRIGAN. 7 to 11 percent is fine.

CHAIRMAN GREENSPAN. 7 to 11 percent?

MR. BERNARD. So, nonfinancial debt is set at 7 to 11 percent for the year. And then moving on to M1, for which I gather we have no range, the language there would be: "With respect to M1 the Committee again decided not to establish a specific target for 1988. The behavior of this aggregate in relation to economic activity and prices has become very sensitive to changes in interest rates, among other factors, as evidenced by sharp swings in its velocity in recent years. Consequently, the appropriateness of changes in M1 this year will continue to be evaluated in the light of the behavior of its velocity, developments in the economy and financial markets, and the nature of emerging price pressures."

CHAIRMAN GREENSPAN. Anybody have any objection to the M1 language that's here? If not, can we now go to a vote?

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Boehne	Yes
President Boykin	Yes
Governor Heller	Yes
Governor Johnson	Yes
President Keehn	Yes
Governor Kelley	Yes
Governor Seger	Yes
President Stern	Yes

CHAIRMAN GREENSPAN. On the remainder of the directive, it's a little more difficult to read, but let me tell you what I tabulate. Everyone is on "B" straight, or with a slight movement towards "A", with Governor Seger at "A" or somewhere between "A" and "B". The distribution of the borrowings objectives is: \$250 million (4); \$200 million (4); \$150 to \$200 million (1); and \$150 million (2). I would read the mode, at this point, as represented by \$200. And that implies a funds rate of roughly 6-1/2 percent, as I understand it.

Does anybody read the voting members of this Committee differently from that? That's the tabulation I got. I would interpret this to be maintaining the pressure in recent days, with some slightly asymmetrical language towards ease if one can find such language in here. My impression, however, is that the instructions to the Desk are reasonably clear in the sense that everyone has indicated--there are differences within a relatively narrow range, I think, but they are not as great as they might be. Anybody have any comments or statements on anything?

MR. ANGELL. I think I could compromise at \$200 million if we can be symmetric. But to go to \$200 million and then also be asymmetric--

CHAIRMAN GREENSPAN. No, no, I didn't mean that. I'm sorry, you're quite right. The question is how we interpret "A" and "B". What we have to do is take \$200 million symmetrically.

SPEAKER(?). Symmetrically?

CHAIRMAN GREENSPAN. Yes. Now if one can find the language for that--

MR. BOEHNE. And this is on the assumption of a 6 percent discount rate?

CHAIRMAN GREENSPAN. Yes.

MR. STERN. What about the language in here with regard to flexibility? Would we be likely to retain that or would we pull that?

CHAIRMAN GREENSPAN. What's the view of the Committee?

VICE CHAIRMAN CORRIGAN. Could I just say a further word on this, but hopefully without getting into a debate or a long discussion? I don't think the question of the operating tactics of monetary policy on a day-to-day basis comes down to what will work or what won't work. I think it's true you can make almost anything work. The question that I think is important is preserving for the Committee, and for you as Chairman, an appropriate degree of flexibility. We are not clairvoyant; we cannot anticipate every situation that arises. We have to have the kind of flexibility to do things that need to be done. So, from my point of view, it's not so much a technical question as to what produces the best statistical result and the highest R square. It's a question of what preserves the maximum flexibility for the Committee as a whole, and for you as Chairman, to be able to guide policy in a manner that's consistent with the thrust of the Committee's wishes but incorporates the kinds of flexibility that are often needed. So, Mr. Chairman, that's how I see the issue.

CHAIRMAN GREENSPAN. I don't think anyone disagrees with that. I think the problem gets back to a language question.

VICE CHAIRMAN CORRIGAN. Right.

CHAIRMAN GREENSPAN. If we assume the Bluebook's and Don Kohn's estimates of "B" being \$250 million, then if you use "B" with

no [change in the] borrowing target, implicitly, it becomes "B" with a slight tilt towards ease. If we use \$200 million as the borrowing target then it's symmetrical. The question is what is conveyed in the directive when published. I don't think this is a problem for Peter Sternlight; I think we have made it clear for him. The question is what is the appropriate language to communicate to the public, upon publication, what our particular position is. I would entertain some discussion from the Committee on what's the right way.

MR. HELLER. May I ask a question? What are the numbers you're penciling in for the M growths?

CHAIRMAN GREENSPAN. I'm sorry, for the--

MR. HELLER. Monetary Ms?

CHAIRMAN GREENSPAN. In the short term?

MR. HELLER. Right.

CHAIRMAN GREENSPAN. It's the right question to ask since we have changed the long term; and it's a most interesting issue. Alternative B is basically 6-1/2 percent [M2 growth], but I would read it as somewhat lower in view of what we did with the longer term. I would read it as 6-1/4 percent growth myself.

MR. PARRY. No, I think you'd go the other way.

MR. HELLER. No, not if you're lowering--the old borrowing target implicit in "B" was \$250 million, right? So--

MR. PARRY. But I think there's enough uncertainty--

MR. HELLER. You shouldn't have a little--

MR. PARRY. Bob, there's enough uncertainty associated with the relationship that one can be comfortable with the 6-1/2 percent.

MR. HELLER. 6-1/2 percent, yes.

MR. ANGELL. Let's not argue about that.

MR. BOEHNE. I would suggest, what about 6 to 7 percent?
Okay?

CHAIRMAN GREENSPAN. Put it that way--yes, I feel comfortable with that.

VICE CHAIRMAN CORRIGAN. Yes, especially if Don thinks that the numbers are coming in a little higher anyway.

MR. KOHN. They may be up there already.

MR. JOHNSON. That's fine.

CHAIRMAN GREENSPAN. Yes, 6 to 7 percent.

MR. BOEHNE. 6 to 7 percent for both M2 and M3.

SPEAKER(?). Okay.

MR. MELZER. I think what ought to be conveyed to the market is that one easing took place here. They're going to see that. Just today we had a period ending that way; they're going to see that low borrowings number; there are already feelings around that some easing has taken place. I think one thing that the directive ought to convey is that there was one step; I don't think you want to somehow in the language create the impression that a step was taken and then a subsequent step was taken today.

MR. PARRY. I share that [view].

MR. BOEHNE. I agree with that; it ought to be right up in the front sentence.

MR. PARRY. I think that's right; how do you do it then?

CHAIRMAN GREENSPAN. In fact, that would convey far more than this result.

MR. ANGELL. Well, I thought we were taking a position that we are not easing today; we are maintaining existing conditions.

MR. BOEHNE. No, you would say "to maintain the slightly easier" --

MR. ANGELL. It's just that I think--apparently most think--that the \$200 million borrowings is consistent with the existing conditions.

MR. BOEHNE. But you would say that you would maintain the slightly easier degree of pressures sought in recent days.

MS. SEGER. Would you say confirm the easing?

MR. BOEHNE. That captures it.

CHAIRMAN GREENSPAN. Oh no, that strikes me as--

MR. JOHNSON. Maintain the slightly--

MR. BOEHNE. Put "the slightly easier degree of pressure on reserve positions sought in recent days".

MR. FORRESTAL. We have used that same language before.

MR. BOEHNE. That says we are maintaining what we have done in the last couple of weeks, which I think would capture what we have agreed to.

MR. ANGELL. Yes.

MR. KOHN. It's a slightly reduced pressure.

MR. BOEHNE. All right, slightly reduced pressure.

MR. PARRY. Of recent days.

MR. BOEHNE. Of recent days.

MR. KOHN. Sought in recent days.

MR. PARRY. Right.

MR. ANGELL. I guess I want to second a little what President Corrigan said in regard to the degree of flexibility. I'm perfectly open to having alterations in policy when the data show something different. I'm very open to that.

VICE CHAIRMAN CORRIGAN. If you took Ed's language and put 6 to 7 percent in for the aggregates that--

CHAIRMAN GREENSPAN. That's why I like [it], if it's true.

VICE CHAIRMAN CORRIGAN. Yes.

CHAIRMAN GREENSPAN. It's the right tone. Anybody have any further comments on this?

MS. SEGER. What we end up doing, though, is never voting for a policy change in this Committee. I was thinking of last April when a snugging was taking place that we never voted on; but at the end of April we sort of confirmed the tightening that had occurred. But we never actually voted at the FOMC meeting on a policy to tighten. I was not opposed to doing it, but it just seems to me that there is a difference between our voting to ease, or whatever, and voting for no change with a tilt one way or the other--in which case the Desk can change the policy.

CHAIRMAN GREENSPAN. But remember that the Committee can always reverse the Desk.

MS. SEGER. Uh-huh.

CHAIRMAN GREENSPAN. In other words, this Committee has the ability any time it meets to reverse whatever the Desk is doing. So, in a sense, the acquiescence to the Desk's change is effectively a vote of this Committee to change policy.

MR. BOEHNE. I think what we're seeing here is the calling of a spade a spade. The more you conduct policy focusing on the federal funds rate, the more frequent Committee meetings you need. And in the days when we were literally focusing on the federal funds rate there were Open Market Committee meetings every three weeks or so. The more we moved away from the federal funds rate to reserves--

CHAIRMAN GREENSPAN. That's--

MR. BOEHNE. We've spread it [the intermeeting interval] out.

MR. JOHNSON. I disagree with that. If you vote on the funds rate why would you ever have to have another Committee meeting?

MR. BOEHNE. I think the reason is that you don't have any flexibility to take account of changes that could come in. You can't just absolutely fix interest rates for six weeks at a time.

CHAIRMAN GREENSPAN. Well I know--

MR. JOHNSON. You could set a range.

MR. BOEHNE. You could set a range, and then if you set a range, somebody has to have the authority to go back and forth. I think we generally have given the Chairman a great deal of flexibility within the range that was set. One can quarrel with that procedure, but it seems to me that the Chairman acted completely within the framework of the directive that we passed last time--a directive that gave him the flexibility to move up and down given certain sets of conditions. You may or may not like his decision, or you may or may not have done it the way he did it; you may want to rein him in, or you may want to give him more flexibility. But I think that we have to blame ourselves--not the Chairman for using the flexibility that we gave him.

CHAIRMAN GREENSPAN. I suggest that the issue of the frequency of meetings of the FOMC also be on the agenda as part of this review. I think I'm hearing, as I've come into this place in the last six months, that something is happening to the operational procedures in the System and that it would probably be useful to have a thoroughgoing review and decision on the part of the Committee as to what form of surveillance the Committee chooses to adopt. And the frequency of meetings is not an insignificant question. Do you have enough to read something [Mr. Bernard]?

MR. BERNARD. Yes, I think so. "In the implementation of policy for the immediate future, the Committee seeks to maintain the slightly reduced degree of pressure on reserve positions sought in recent days." And then I'm not sure about the next sentence--whether or not that stays in.

CHAIRMAN GREENSPAN. Which one?

MR. BERNARD. "The Committee agrees that the current more normal approach to open market operations remains appropriate."

MR. HELLER. How about "the current approach remains appropriate."

MR. BERNARD. Current--

MR. HELLER. You mean before that you were less normal.

MS. SEGER. But I thought we were hearing it isn't back to normal.

MR. HELLER. Well, it's a public statement.

MR. JOHNSON. But if you read the rest of the sentence, the more normal implies more normal since right after the stock market [crash]. And I agree that it's probably a little more normal than it was then--

MR. HELLER. Yes, but that says the current approach remains appropriate.

MR. JOHNSON. You can do it either way.

MS. SEGER. Or less normal.

CHAIRMAN GREENSPAN. I think the bracketed sentence captures what is going on in the markets.

MR. BOEHNE. I think so too.

MR. MELZER. If it doesn't, we have a problem with the last policy record.

CHAIRMAN GREENSPAN. Why don't you read--

MR. BERNARD. "The Committee agrees that the current more normal approach to open market operations remains appropriate; still sensitive conditions in financial markets and uncertainties in the economic outlook may continue to call for some flexibility in operations."

CHAIRMAN GREENSPAN. Anybody object to that sentence then?

SEVERAL(?). No.

MR. BERNARD. "Taking account of conditions in financial markets, somewhat lesser reserve restraint or somewhat greater reserve restraint would be acceptable depending on the strength of the business expansion, indications of inflationary pressures, developments in foreign exchange markets, as well as the behavior of the monetary aggregates. The contemplated reserve conditions are expected to be consistent with growth in both M2 and M3 over the period from November through March at annual rates of 6 to 7 percent. Over the same period, growth in M1 is expected to remain relatively limited. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of"--we had 4 to 8 percent.

MS. SEGER. 6-1/4 to 6-1/2 percent.

VICE CHAIRMAN CORRIGAN. You're calling a spade a spade.

MR. BLACK. Consistent.

MS. SEGER. That's trying to be on this side.

MR. BOEHNE. You at least would pass a lie detector.

MR. BERNARD. A range of 4 to 8 percent.

MR. KOHN. Mr. Chairman--

CHAIRMAN GREENSPAN. Let me also state that implicit--

MR. KOHN. I'm sorry--something jumped off the page at me as Norm was reading. "Growth in M1 is expected to remain relatively limited"--we have 6 percent.

MR. BLACK. Yes, I had the same problem.

MR. KOHN. That may or may not be relatively limited, that's--

MR. BOEHNE. Relatively moderate.

CHAIRMAN GREENSPAN. Do we want that sentence at all?

MR. HELLER. Just scratch it.

CHAIRMAN GREENSPAN. Also implicit, but not stated, is the understanding that should conditions arise in which the Board moves the discount rate in either direction, I think an FOMC meeting at that point is immediately appropriate--a discussion of policy is immediately on the table. I think that's all I have to say on that issue. Can we go to a vote?

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Boehne	Yes
President Boykin	Yes
Governor Heller	Yes
Governor Johnson	Yes
President Keehn	Yes
Governor Kelley	Yes
Governor Seger	Yes
President Stern	Yes

MR. BOEHNE. My congratulations to you, Mr. Chairman. You have performed a miracle.

CHAIRMAN GREENSPAN. I don't know where it came from.

END OF MEETING