Meeting of the Federal Open Market Committee
November 15, 1994

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, November 15, 1994, at 9:00 a.m.

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

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

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

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

Messrs. Goodfriend, Lindsey, Mishkin, Promisel, Siegman, and Simpson and Ms. Tschinkel, Associate Economists

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

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

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

Mr. Brayton, Assistant Director, Division of Research and Statistics, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Ms. Pianalto, First Vice President, Federal Reserve Bank of Cleveland
Ms. Browne and Messrs. Davis, Dewald, Lang, Rolnick, Rosenblum, and Vander Wilt, Senior Vice Presidents, Federal Reserve Banks of Boston, Kansas City, St. Louis, Philadelphia, Minneapolis, Dallas, and Chicago respectively
Mr. Judd, Vice President, Federal Reserve Bank of San Francisco
Mr. Guentner, Assistant Vice President, Federal Reserve Bank of New York

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CHAIRMAN GREENSPAN. Good morning, everyone. We ought to congratulate Governor Lindsey who has just returned without mishap from Rumania with an addition to his family.

MR. LINDSEY. Yes!

MS. MINEHAN. Congratulations. [Applause]

CHAIRMAN GREENSPAN. What do you have, a girl?

MS. MINEHAN. A girl?

MR. LINDSEY. A one-year old girl.

MS. MINEHAN. How nice.

CHAIRMAN GREENSPAN. What I have been trying to tell Larry was that he had better learn Rumanian pretty quickly because when she learns to talk if he does not understand Rumanian, he is in trouble!

SPEAKER(?). He's in trouble anyway! [Laughter]

MR. LINDSEY. For now, it is either feed me or change me; that won't always be so.

CHAIRMAN GREENSPAN. I think we'll allow you to move approval of the minutes for the September 27th meeting.

MR. LINDSEY. So move.

CHAIRMAN GREENSPAN. Without objection. You all have before you the Report of Examination of the System Open Market Account that was distributed on November 3rd. Are there any questions relating to that? If not, would somebody like to move its acceptance?

SPEAKER(?). So move.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. After we complete our general monetary policy discussion, I am going to raise some broad issues about our recent intervention in the foreign exchange markets. I will also comment about the alleged increase in central bank participation in the G-7 process. So, after Peter discusses his operations, let's hold off discussion of the broader questions with respect to intervention until later in the meeting. We will have more time then for a general discussion. With that in mind, let me call on Peter Fisher to report on foreign currency operations.

MR. FISHER. [Statement--See Appendix.] Mr. Chairman, I wasn't quite sure how you wanted to proceed. I could take questions on the report, or I could go on and ask for ratification of the operations and renewal of the swap lines. Should I just go on with each of those?

CHAIRMAN GREENSPAN. Why don't you do that? We will then have general questions on all issues but leave the intervention discussion until later.

MR. FISHER. I will need the Committee's ratification of our operations on Wednesday, November 2; we sold $400 million equivalent of Japanese yen and $400 million equivalent of German marks for the System's Account. On November 3, we sold $250 million of yen and $250 million of marks for the System's Account. Thus, over the period we sold $650 million equivalent of each of the two currencies for the System Account.

Mr. Chairman, the System's reciprocal currency arrangements are up for renewal for another year with the exception of our Mexican and Canadian arrangements. I have no changes to suggest in the terms and conditions of the existing swap arrangements and request that the Committee approve their renewal without change.

CHAIRMAN GREENSPAN. Let me just say this. If anyone objects to voting until we have had our discussion on intervention, we can delay the vote. If anybody wants to object, object now and we will just postpone the vote.

MR. BROADDUS. I would appreciate it if the swap vote could be delayed until later.

CHAIRMAN GREENSPAN. That's fine. In fact, there is a certain symmetry in doing that. So why don't we leave that vote until later?

I was a little curious myself as to why the dollar was as strong as it was yesterday. You implied that the reason was because the foreign exchange market expected us to move today. But last week and two weeks ago they expected us to move today. What is the explanation?

MR. FISHER. I admit it is rather hard to fathom. I think it is this combination of foreign demand surprising the dealer community which has for some time now been playing the dollar from the short side. I think the two factors continue to operate together. The surprising election result last Wednesday produced precisely that sequence, that is, the resulting foreign demand for the dollar surprised the U.S. dealer community a bit and the dealers rushed to cover shorts. Monday morning, the same thing seemed to be occurring again. The dealers saw a slightly surprising level of foreign interest in the dollar and the dealer community once again tried to play catch-up with their customers, as best I have been able to understand. There was a rather quick mark-up yesterday. If you look at the charts, it really happened rather quickly. I have not been able to ascertain what in particular was happening at that time.

CHAIRMAN GREENSPAN. Peter, you indicated that you inferred from the market that we are behind the curve in three areas and that we are in striking distance of reaching at least one or more of those curves. Is there any view within the foreign exchange market that puts federal funds numbers on that?

MR. FISHER. The very fact that we are effectively at parity on the funds rate with German rates suggests that any move we make now will give the dollar a cost-of-carry advantage against the mark. One of the things that some people talk about and that I perceive as important is that the foreign exchange market generally is not focusing on that. That is, during the spring, that was the "be-all-and-end-all" of the exchange markets. People talked about the point in time <u>when</u> fed funds <u>would</u> be higher than overnight German rates. I think that that is in effect the sleeper that could catch up with the market. If fed funds were to be trading between 50 and 100 basis points above German overnight rates as we went into year-end, that would begin to shift the whole dynamic of leads and lags in corporate deposits and the like. That again would slightly shift the burden of proof to the speculative community. If they start to lose money by running a short dollar position on cost-of-carry, that will begin to work on their calculations.

CHAIRMAN GREENSPAN. Any other questions?

MR. JORDAN. Peter, your remarks suggested that some traders view intermediate- and long-term U.S. Treasury rates as not being at a high enough level. That differs from a feeling that a policy action by this Committee to increase the funds rate will at least temporarily depress bond prices. Which is it? Are they saying that the level is not yet high enough or are they waiting until that last shoe is dropped so they don't get caught holding an unwanted long position?

MR. FISHER. Let me answer that in a couple of ways. It obviously varies depending on the institution. The point is that the Fed being perceived as behind each of those curves means it is rather hard to justify and means that foreign demand is around the corner. There are extraordinarily high real returns in foreign bond markets, and that is a cause of major concern to our European counterparts. There are incredibly high yields in France at present and German real yields simply calculated are extraordinarily high. That in itself is the problem. One way of looking at the problem is to ask when investors will be prepared to buy our bonds. For example, if there were to be a sense of stability and the sense that a capital gain was available in the intermediate term, that might overcome the lack of a real bond yield advantage for the dollar. I don't mean to suggest that it is a necessary condition for the Fed to be ahead of each and every one of the curves. Rather, the negative sentiment is premised on the fact that, no matter what the analytic frame of mind, one can look at the exchange market and see that the Fed is behind each and every one of the curves. That's been feeding on the market.

CHAIRMAN GREENSPAN. Any further questions? If not, we'll go on to Joan Lovett.

MR. FISHER. Do you want to ratify the foreign operations or do you want to save that for later also?

CHAIRMAN GREENSPAN. We will save that for later on. In other words, until we have the discussion, it would be inappropriate to vote on the ratification. Joan.

MS. LOVETT. Thank you, Mr. Chairman. [Statement--See Appendix.]

CHAIRMAN GREENSPAN. Joan, was that 4.79 percent the federal funds rate average since the last FOMC meeting?

MS. LOVETT. That's right.

CHAIRMAN GREENSPAN. What is it so far this month? Do you remember?

MS. LOVETT. For the month of November?

CHAIRMAN GREENSPAN. The month of November to date.

MS. LOVETT. I don't know the precise average, but it is on the high side, because after its rise at the end of the quarter the rate never really went back down. The last statement week ended on a firm note and it was a holiday on Friday. With expectations of a rate move at this meeting today, the funds rate has been persistently above that average.

CHAIRMAN GREENSPAN. So it would be more than 4.79 percent?

MS. LOVETT. Yes.

CHAIRMAN GREENSPAN. Would it be 4.82, 4.83 percent?

MR. KOHN. The month-to-date effective rate is 4.81 percent, Mr. Chairman.

MS. LOVETT. For November.

CHAIRMAN GREENSPAN. For November, okay.

MR. KOHN. That 5.11 percent futures rate implies 5.34 percent for the remainder of the month.

CHAIRMAN GREENSPAN. Okay. You did my calculations for me, I thank you. Any further questions for Joan? If not, would somebody like to move to ratify the actions of the domestic Desk since the last meeting?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection. Let's now move on to Mike Prell and the staff report on the economic outlook.

MR. PRELL. Thank you, Mr. Chairman. [Statement--See Appendix.]

CHAIRMAN GREENSPAN. Questions for Mike?

MR. BOEHNE. The profile that you have for growth over the next 15 months or so I find somewhat puzzling. The economy has a fair amount of momentum, and yet you have a rather significant falloff in the rate of growth out into next year with a yield curve that is still sloping upward. I think that you would have to have more flattening of the yield curve to get this dramatic a slowdown. That's one piece that is puzzling. The other part of it, even if you are right, is reminiscent of the late 1980s. If you take growth down to 1 to 1-1/2 percent, if it really does get that weak, you open yourself up to any kind of a shock. I'm puzzled on both sides: one, that we will get this amount of slowing with the kind of increase in rates that you talk about; and on the other side, if we actually do end up with this kind of slowing, then you can argue that we are vulnerable on the down side. So I have two opposite concerns.

MR. PRELL. President Boehne, I think the first question is more a forecasting question. The second one perhaps is more a policy question, though there are obviously ingredients of both in the two questions. We hinted in the Greenbook that, in essence, we see the probability distribution as skewed a bit in the direction your first question suggested--that, indeed, the momentum could turn out to be better maintained in the near term and that it might take considerably greater monetary policy tightening in order to generate a quick and significant slackening in growth, bringing the economy below potential and beginning to reverse what we regard as an overshooting in resource utilization. So, I take your point, and while I don't think history would suggest that a moderation in growth requires a total flattening of the yield curve, I would say that perhaps we are a bit optimistic, if you want to view it that way, on that relationship. The Greenbook assumes a reduction in the upward slope, but the latter is still significant. If I had to pick an alternative scenario, I might lean in the direction you are talking about.

As to slow growth and openness to shocks, the economy is always open to a shock that could move it off the projected path by a given amount. When growth is that low, such a shock obviously could move the economy into negative territory. Maybe the psychology of that is different and downward momentum might develop, but I don't think we have a way of coping with that. In fact, in 1989-1990, we did have a period of slow growth. There were some revisions of data which revealed just what the pattern was, and it wasn't until that shock occurred that the economy really tipped into recession. In the absence of that shock, it is conceivable we might have skated by. A period of slow growth does not necessarily mean that the economy is going to slip into a recession.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mike, in your verbal presentation and also in the Greenbook you twice referred to more lenient lending terms by banks as a factor in the strength of the economy. I want to make sure I understand the point. Are you saying that banks are more lenient than one typically would see at this stage of the cycle, or is this just what we typically see? My own discussions with bankers suggest that they are not doing anything unique for this cycle. As a matter of fact, I think that in some respects they are a little more cautious. Are you seeing something exogenous to what our experience has been in the past at this stage of the cycle? If so, how important is it?

MR. PRELL. This is hard to pin down, but my sense is that the credit availability cycle has been out of sync with the normal pattern this time around.

MR. PARRY. A little later?

MR. PRELL. In the sense that, when interest rates were coming down in 1991-1992, we were still seeing the tendency toward tightening of bank credit terms.

MR. PARRY. Right.

MR. PRELL. And, as we have been tightening money market conditions, our loan officers' survey and the preponderance of the anecdotal evidence have suggested that the banks have become increasingly aggressive in their business lending and obviously have been increasingly willing to extend consumer credit as well. We looked back at the responses to that same senior loan officers' survey some years back through a couple of cycles and found that, as we might have expected, during periods of rising interest rates and a flattening term structure, some of which we have had, we generally had a tightening of credit terms; but recently we had a tendency toward an easing in credit terms. So, I think we may be moving in an unusual direction. Be that as it may, we are pretty much convinced that we have been moving in the direction of easier credit availability and that that has tended to work against the effect of the rising interest rates on demand. From the perspective of businesses, it is certainly clear that the credit crunch is no longer there and credit availability is not a concern to firms that want to expand their fixed investment or inventories.

MR. PARRY. I guess I'm a little surprised that in the past we have seen a tightening of terms in the first year of rising interest rates. I would have thought that it would have come later.

MR. PRELL. I don't want to put too fine a point on it, but I think the main point is that this seems to have been an offsetting influence over the past year to the rising market interest rates.

MR. PARRY. I don't think there is any doubt about that. I really wonder if that's unique.

CHAIRMAN GREENSPAN. It is not. There is a bias in the measure of the degree of ease in the loan officers' survey. What is the size of it? Do you remember, Don?

MR. KOHN. The Richmond Fed did a study once that showed that, at least back in the 1970s, it looked like the responses were biased toward showing tightness. Now, the psychology of everything has shifted so radically in the current cycle that I wonder whether that same bias is there.

CHAIRMAN GREENSPAN. The trouble is that if you cumulated the first differences, you got a progressively greater degree of tightening, which at the end of the day should have strangled the total financial system.

MR. KOHN. Right. That was true back in the 1970s when the bias was found.

CHAIRMAN GREENSPAN. In other words, there is no evidence that that has been the case since then?

MR. KOHN. We just don't know.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Mike, I've got two quite different types of questions. The first one has two parts and it is about productivity: What has been going on and what do you foresee going on? In the past four quarters, growth in manufacturing productivity is reported to be something on the order of 6 percent or so, and for the overall economy it is substantially less than that--the rest of the economy only running about 1-1/2 percent. A large part of that is because we define output in such a way that we preclude labor productivity gains, at least for services. Nevertheless, we wind up with some pretty good numbers for these past four quarters. When I look at your forecast for the next year--the first part of the first question is how you read these numbers as to what happened with productivity gains in the manufacturing sector being four times what they have been in the rest of the economy. Is it simply a measurement error in that we don't know how to measure productivity in the rest of the economy and how does that affect judgments about policy? Or do you take those numbers at face value? The second question is, what do you foresee going on in manufacturing and nonmanufacturing productivity to produce the slow growth of under 2 percent in output for four quarters starting next spring?

MR. PRELL. As a technical matter, the productivity numbers for manufacturing that are published along with those for overall productivity growth are in essence based on a separate system in the current period. The recent period is based on industrial production data rather than industry gross product data. Those numbers will be revised. There isn't any reason, though, to think that they are giving a grossly misleading picture. Our assumption is that, indeed, there has been substantial growth in manufacturing productivity. I'm not sure you want to subtract that number from overall nonfarm business sector productivity growth and get the residual for the rest of the economy.

CHAIRMAN GREENSPAN. Actually, Mike, when we separate the GDP into its factory value components, don't we get results that are not all that different from numbers based on industrial production?

MR. PRELL. There's a big gap between the industrial and the nonindustrial sector productivity measures even when we do this exercise.

CHAIRMAN GREENSPAN. Okay.

MR. PRELL. Maybe that isn't actually true; maybe there is an inaccuracy in the measurement of output. It would be affecting the GDP numbers. It also would be affecting our estimates of potential output growth. It is in fact neutral in terms of assessing what the output gap might be. All the measures are commensurately affected. As to the pattern we have going forward, we do have a deceleration of productivity growth. This is a normal accompaniment to a significant deceleration in output growth. We believe that we are somewhat above the cyclically-adjusted trend line and that deceleration normally occurs in mid-expansion. As we move to fuller resource utilization, the expansion will be slowing; there will be some tendency to move back toward that trend line. Historically, the economy has moved below it during recessionary periods, but we don't have a recession in our projection period. In essence, we have a somewhat below-trend growth of nonfarm business productivity over the next year or so and then we move back toward that trend. Basically, looking at the growth of productivity in the 1990s, we don't see any real evidence that our assumption for some time now of about 1.4 percent trend growth in nonfarm business productivity is off the mark. The data seem to be conforming to that in terms of the normal cyclical pattern.

MR. JORDAN. Just as a comment on it, I'm not hearing anything that suggests to me that businesses--manufacturing or others --foresee fewer opportunities for productivity improvements in the next year or two than they have had in the last couple of years. What produces this quite dramatic slowing of productivity? I think this is troubling.

The second question is more involved--sorry about this. When I pair up what has happened in the last four quarters and your projection out to mid-1995, it looks like a pattern that says, because output has grown faster than projected, say, at this time a year ago and also faster than some ideas about potential, what we have to do is give it back so that, in the end, we wind up at the same level of output and employment as we would have otherwise. Another way of looking at this same situation is to pair up this last year with the prior year. Instead of matching off a year in the future, match off a year in the past. We went through a period in 1992 and much of 1993 of downward revisions in forecasts--staff, Blue Chip, everybody else; the forecasting errors were on the down side in relation to expectations about what the economy was capable of doing. If you do that matching up of 1993 and 1994, the level today comes out about where you would have projected it two years ago. Then, if you don't have to give anything back in the future, the question is what is happening to growth in the future.

In your framework, when you talk about inflation, you rely on excess demand. I puzzle over what is producing this idea of excess demand. Nominal GDP growth really has not accelerated that much. In fact, it looks the same for the last four quarters as it looked in 1992. To put it into terms that I feel more comfortable with, I try to reconcile your forecast with what I think is going on with money and the desire to hold money balances. At least conceptually, I can make equivalent an excess-demand-for-output model and an excess-supply-of-money model. How well that can be done depends on what is going on in asset markets. But conceptually, we can make the two the same. A year ago at this time, I said that the opportunity cost model for narrow money, M1, or for the monetary base, was tracking very well; nothing had gone wrong. We had had two years of double-digit growth of M1 and the base. At that point a year ago, we had four options for the year ahead: One was that the relationship would break down; we don't want to make monetary policy on the idea of the relationship breaking down, so put that one aside. That left three possibilities. One was a further sharp decline in interest rates. It would have taken a 20-25 percent decline in interest rates from where we were a year ago to make the opportunity cost model hold up, given the kind of money growth we were getting and the forecast you had. At that time, you thought that there was some possibility of further declines in bond yields and that the funds rate would stay at about 3 percent. I actually would have leaned on the side of thinking that if inflation psychology improved, bond yields could have too. I do remember the Chairman saying he would have been shorting the bond market. Of course, I probably would have been buying! That improvement didn't happen. So that left the other two possibilities: Either nominal GDP growth doubled, shot up to about 10 or 12 percent, or M1 growth and base growth collapsed. What we got was a combination of the two with a small increase of 1 percent in nominal GDP growth and mostly a drop in money growth--M1 and the base. The opportunity cost model still fit.

So here we are now and as I look ahead, we've got four options: One is that the relationship breaks down; hold that aside. Second, I can come at it one of two ways. I can look at your Greenbook forecast and the Prell path of policy and ask if this is reasonable for interest rates and money growth if the model still works. That would say to me that if interest rates remained at today's level and your Greenbook forecast was right, M1 growth would decline a little over the next year--1 percentage point or so if the relationship holds. Or, if your fed funds recommendations are correct, that implies that M1 growth has to drop about 6 percentage points in absolute level in the next year for your nominal GDP forecast to be correct. Is that reasonable? What's going on in the demand for money balances for the velocity to have to increase about 10 percent?

MR. PRELL. I don't think I can work my way through all the history you gave on the forecast. But I think the first statement you made about giving back the extra growth that we had recently is fundamentally correct. That extra growth, as we assess it, resulted in an overshooting of sustainable levels of resource utilization--levels that would be consistent with at least stability in inflation as opposed to accelerating prices. We tried to devise a scenario in which, within a reasonable period of time, we move back to and slightly above the NAIRU to damp the incipient inflationary process. I think that is an apt characterization of how this scenario is designed.

I hope Don has some thoughts on the M1 velocity story. It is not something we focused on, frankly, in designing the forecast. We didn't give any attention to M1. M1 is an endogenous byproduct in this forecast just like many other variables. There can't conceivably be any tension in our thinking about the money and income relationship. It is whatever it is, and we don't have an M1 target range that we need to worry about violating, so that doesn't arise as a side constraint, and we think the broader aggregates will remain at growth rates that are compatible with the 1995 ranges and any reasonable extensions.

MR. KOHN. In fact, you're right, President Jordan, in the sense that the M1 that we have been getting for the last two years or so has been pretty much on the M1 demand curve. But that aggregate, of course, is very interest elastic. We are predicting even slower growth next year than the 2 percent that we have for this year and another hefty increase in velocity. I have to admit that our models suggest that if the same relationships hold, M1 might even drop next year consistent with the Greenbook GDP and interest rates. We have projected essentially no growth. We don't have the drop built in, but I couldn't rule out the possibility that we could get the Greenbook

GDP and a decline in M1. It would be right on the model and not a surprise.

MR. JORDAN. If the money demand relation still holds on M1 and you get a 5 or 6 percent drop in the absolute level of M1, what does that do to your M2? Unless you've got non-M1 components of M2 starting to take off suddenly--

MR. KOHN. We do have opportunity costs narrowing over the latter half of next year, and we do have M2 picking up then. We see those costs rising in the first half of the year when we expect very damped growth in M2. As you can see in your Bluebook, we have built in declines through March. We do have a bit stronger growth built in for next year partly because some of the special factors, like the reduction of demand deposits stemming from the fade out of mortgage refinancings, will not be there. So, we do have a little strengthening next year as things come a little more into line with our models. In fact our models for M2, based on the same interest rates and the same incomes, predict much stronger growth in M2 next year than this year. We trimmed it by a percentage point or two, so we only have 2 percent growth.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. An opposite question to President Boehne's: I was interested in the reference in the Greenbook to the cessation of speed effects that brings about the moderation of CPI increases in the last part of 1995. I wondered whether you had any estimates of what that CPI figure might be absent speed effect changes? Did you look at it that way?

MR. PRELL. I don't think we can do a precise dissection. One of the things we've pointed out in the Greenbook is that in looking at the acceleration--I don't want to overstate this--what we are talking about in essence in the core CPI number is that we are going to get pretty much .3 increase a month rather than a mixture of .2 and .3 a month.

MS. MINEHAN. Yes, right.

MR. PRELL. Whether we'll be able to perceive this month-by-month isn't entirely clear. But we see this as involving a mix of things that are sort of overlapping. We have had an exchange rate depreciation. We have seen raw materials prices increase. Some of those raw materials are internationally traded and are imported in some instances. We have seen rapid growth of output recently, and econometrically, while it is not always a particularly robust result--you can tinker with your models and get large or small effects--that mere increase in resource utilization can produce in these models some increase in markups, and when things taper off we see some stabilizing and a return to the trend. I really can't parse these things out with any great precision. Some set of these factors we think will give a little bit faster rise in prices in the near term than would be dictated simply by the margin of slack in the economy, which we would see as only adding maybe a couple of tenths to underlying inflation over the coming year, no more than that.

MS. MINEHAN. So you think it is more the special factors that are pushing the increase in prices to 3.8 and 3.6 percent rather than any uptrend?

MR. PRELL. Right. We have a timing question here. It is hard to say but we think that we might get a little more of the price increase announcements at the beginning of the year.

MS. MINEHAN. Yes.

MR. PRELL. So, there is a considerable amount of guesswork involved here. But, yes, I think it is these speed effects or the exchange rate effects on import prices and so on that are giving the bulge. However, if we did not eliminate the excess pressures on resources during 1995, as we have in this forecast, the risk would be that wages would begin to reflect more fully the higher price increases, inflationary expectations would take hold, and we would begin to build that higher track into the trend. That's why we felt it important to try to indicate what kind of interest rate path would lead to this slackening fairly promptly.

MS. MINEHAN. Looking at the other side, you have a declining impact from inventories, but certainly a smooth one. Do you care to comment on that?

MR. PRELL. Reality will never be that smooth!

MS. MINEHAN. That's what we thought too!

MR. PRELL. That's one of the risks we noted in the Greenbook.

MS. MINEHAN. Right.

MR. PRELL. An inventory adjustment could come more quickly: If final demand were to taper off and be perceived to have tapered off early next year, perhaps the inventory adjustment would be sharper. That could move us much closer to zero or even conceivably negative GDP growth for a quarter, but inventories might then come back if final demand is still growing moderately. So, they are certainly a potential source of volatility in the numbers and of some greater cyclical variation.

MS. MINEHAN. Finally, have you looked at the price effect when the ARMs that were issued this year kick in next year? The teaser rates this year have been very low. Some of these ARMs have new provisions to extend the maturity, but a good portion of them will kick in next year.

MR. PRELL. It is going to be a factor affecting the cash flow of many households, but it is not a huge effect. It is less huge than one might have expected because what we've observed this year is that a substantial proportion of the ARMs originated this year have fixed rates for 5 or 10 years. This is something of an innovation in this cycle. We are not going to have any adjustment on those and there is a 2 percentage point limit on those shorter-term ARMs. So, this is not going to produce a drastic income shock in 1995.

MS. MINEHAN. Thank you.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. Mike, I want to ask you a question about the projection for the automobile market, which in the Greenbook is peaking this quarter at about 15-1/2 million light vehicles--cars and trucks--and then declining very modestly, almost trivially. In the Greenbook, short-term interest rates are up 150 basis points more. In addition, it is been a notable feature of this episode, I think, that auto loan rates have gone up only about half--or less--as much as market rates. The first part of the question has to do with what this implies about the future of auto loan rates and for the responsiveness of purchases to auto loan rates. Furthermore, as I look at the real disposable income forecast, it is also peaking this quarter. Then, in the first three quarters of 1995, while the auto industry is barely showing a dent in sales, real disposable income growth rates are going to 2.2, 0.9, and 1.7 percent. The question is how do you square that circle? What's going on with autos in this forecast?

MR. PRELL. I think we have a forecast that is middle-of-the-road. [Laughter]

MR. BLINDER. That's the question; why is it in the middle!

MR. PRELL. A view that is certainly held in the industry is that there is considerable pent-up demand that could buoy sales of automobiles and light trucks but such demand really has not been fully seen yet because of capacity constraints. We think there is some element of truth to that story. On the other hand, it is true that, to date, we have had a very moderate response of auto loan rates to the increase that has occurred in market rates. Prospectively, one would expect that gap to close, and in addition we have assumed some further rise in market rates. I must say that the rise in rates is most pronounced at the very short end of the market, and the sort of intermediate-term rates that we typically compare to auto loan rates would not be going up as much. We get some flattening in the yield curve here. So, in our thinking, there is some further increase in auto loan rates, but maybe not as dramatic as one might think by adding the rise in the funds rate to the gap that seems to exist now between market rates and auto loan rates. Arguably, that sort of normal interest rate response could produce a weaker automobile market than we have. I think we are somewhere in between, but I would grant you that the interest rate picture might constitute a downside risk.

CHAIRMAN GREENSPAN. I just want to mention that the scrappage model that was developed by my former colleagues at Townsend-Greenspan is closely consistent with the numbers that we are getting from the income model. I meant to show it to you; I have a copy. As Mike said, there is an implicit scrappage demand element here that seems to be running stronger than the income flows are declining. I understand that the short-term interest rate elasticity of the demand for motor vehicles is something like several hundred thousand units per percentage point in the loan rate.

MR. PRELL. I think that's fair. One also could argue that we do not have as large an interest rate response here as we could have. Again, as President Boehne suggested in his original question, it is possible that we have not put in enough of an increase in interest rates to get the damping of aggregate demand in the Greenbook forecast.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I had Governor Blinder's question. But I had another one on profits. You have a very sharp deceleration in profit growth in the forecast, and I have a cause and effect question about that. The cause question is whether the deceleration is due to a narrowing of margins. You were mentioning earlier your perception of the PPI and the changes there. Secondly, on the effects side, I am surprised that given a very sharp deceleration in the outlook for profits, you have real business fixed investment holding up as well as it is at very high levels. Could you also give me on the effects side your perception of what this means for equity markets?

MR. PRELL. Equity markets clearly have been buoyed, in the face of rising bond yields this year, by surprisingly favorable earnings reports. Our anticipation would be that those reports will not be pleasant surprises in 1995. That suggests some vulnerability to the stock market, at least in the early part of the year before the significant bond market rally that we anticipate occurs. This pattern of flattening profits and diminishing profit share is quite consistent with the cyclical pattern of profits moving with the acceleration and deceleration of output--moving with the growth of productivity in a sense. As we go forward, as was noted earlier, we do have a considerable slackening in productivity. We see some pressure coming, as wages accelerate and productivity flattens out, toward certainly weakening profit margins--maybe not a pronounced plunge but some pressure on them.

MR. LINDSEY. And the effect on investment?

MR. PRELL. We think that investment has been benefiting to some degree from strong profitability and ample cash flows. As we go forward, cash flow does flatten out. We do get a growing nonfinancial corporate financing gap, and we do see that as an element that will be damping business fixed investment. Recall that you are probably looking at real numbers that are inflated to some degree by the computer deflator. You get rapid growth in real computer purchases with a zero nominal increase. That's basically what we have in our forecast for the next two years. We still think this is a climate in which business investment in computers will be fairly robust. On the nonresidential structure side, we anticipate a pretty solid uptrend. There are lags in this process. Permits have been rising noticeably recently. We think the uptrend at this point is unlikely to be reversed in the near term by the further rise in interest rates. That's giving some underpinnings to this advance, and BFI along with exports are a couple of the sectors against which we are working in reducing the growth of other elements of private domestic demand.

CHAIRMAN GREENSPAN. You will also remember that you are looking at outlays, not appropriations. The relationship is closer between cash flow or profit margins and appropriations. You can view outlays as sort of a distributed lag against the appropriations data. It is a quite considerable lag.

MR. LINDSEY. So that would begin with 1997?

CHAIRMAN GREENSPAN. Yes. President Stern.

MR. STERN. Mike, as I recall when the household survey was changed by the Labor Department, a lot of people anticipated that at some point there would be a significant bump up in the unemployment rate, which has not materialized. Is that simply because it has been swamped by employment gains or what is the explanation for that?

MR. PRELL. In all likelihood, the parallel survey that was conducted prior to the first of this year misled the Labor Department. It showed that the unemployment rate would be 1/2 percentage point higher with the new survey. The evidence from the survey that was conducted afterwards using the old relationships to other series such as the unemployment insurance data and payroll employment series suggests that somehow or other that parallel survey was misleading--perhaps a fluke statistically--and that the gap between the old and the new series is probably very small, maybe no more than .1 with another upward estimate of .1 for the change in census population controls.

MR. STERN. Thank you.

CHAIRMAN GREENSPAN. Any further questions for Mike? Vice Chairman McDonough, did you have a question?

VICE CHAIRMAN MCDONOUGH. No questions.

CHAIRMAN GREENSPAN. Okay. Do you want to start our tour de table?

VICE CHAIRMAN MCDONOUGH. Whenever you are ready.

CHAIRMAN GREENSPAN. Okay. You can start off.

VICE CHAIRMAN MCDONOUGH. Let me begin, Mr. Chairman, with just a brief remark about the goings on in the Second District. The New York State economy is continuing to grow but at a slightly slower rate than that of the nation. The major source of strength is the consumer. Retail sales have been strong and the sales of existing houses have been quite high. Needless to say, there is great uncertainty about the fiscal future of the state. The new governor inherits a $4 billion hole in a 1995 budget of $34 billion, but he continues to promise to cut taxes. New York City dwellers wonder about how well the city will fare given the dynamics of the recent campaign. So, I think any investment decisions in which the state tax burden is an issue will almost certainly be put on hold.

The banks in the District are lending very aggressively, and that seems to reflect a combination of two things. Regional banks both inside and outside the Second District seem to be trying to increase market share. Secondly, the money center banks that in some cases have had a considerable reduction, modest in others, of their trading income seem to be somewhat more aggressive in lending in order to improve their earnings. The spreads are sufficiently low now that it is not clear to me that they are getting an adequate return on capital from such activity. There is no question in my view that their lending standards, as evidenced by the covenants being required of their borrowers, are slipping excessively.

Switching to the national economy, the question we have been asking ourselves is: What do we know that we didn't know at the last meeting of this Committee? Well, the first thing we know is that current and recent GDP and employment growth are even stronger than my colleagues at the New York Bank and I thought would be the case at the time of the last meeting. That is the case both as regards the third quarter, which came in stronger, and our view of the current quarter, which we have ratcheted up even more. Second, we believe that even if inventory investment slows enough so that it becomes a modest drag on the economy, real growth will stay above 3 percent through most of 1995. We do not have growth slowing in 1995 and 1996 as much as the Greenbook does. Third, the interest-sensitive areas are in fact major contributors to growth and show very little response to higher interest rates, even though one must state, of course, that the full effect of the tightening to date has not yet been felt. Automobile sales are strong, and if General Motors could straighten out some of its production problems, they would be even stronger. Housing is robust. The fourth thing we think we know now that we didn't know then is that the surge in average hourly earnings in October of 0.7 percent is not traceable to unusual factors. The Bureau of Labor Statistics' announcement of a pending major upward revision in payroll employment means that the help that we thought we would get from productivity is much lower, causing an upward revision in the trend of labor costs. Fifth, even though medical costs were beginning to be better behaved before the health care debate of the last 18 months, we do not think that the improvement in medical costs and therefore the cost of benefits to employers will continue to be a help in controlling inflation. Sixth, the rate of unemployment in our view is below the NAIRU, which we think is 6 percent, give or take 0.1. We could be wrong. Since unemployment is now below 6 percent and the CPI is rather well behaved, the question could be asked, is God kinder and has the NAIRU become lower? We don't think so. History in the late 1970s and in the late 1980s gives us a lesson, we believe. At those times there was hope that the NAIRU would come down. Certainly in the late 1980s it was thought that it would come down somewhere within a range of 5 to 5-1/2 percent. Unfortunately. those hopes turned out to be ill founded. I think that what was overlooked is that monetary policy works with a considerable lag and inflation, when it starts, doesn't leap out of its cave; it starts rather slowly and almost imperceptibly.

In the meantime, have the financial markets given us any new information? The first thing that I think we should all pay no attention to is the zigs and zags of the financial markets from one day to the next as they absorb the most recent data and as 35-year old bond dealers make profound remarks to the media. What I think the market is telling us is that inflationary expectations are high and that our tightening to date has not reduced those expectations. One can look at a variety of places on the yield curve to measure inflationary expectations or look at consumer surveys and so on. We find the spread between 3-year and 1-year Treasuries a very helpful indicator in large part because it covers just the period during which monetary policy should have its effect initially on inflationary expectations. That spread has jumped around because of the volatility of markets this year, but on average it has stayed quite steadily around 85 basis points despite the choppiness. It has not improved; it has not narrowed as a result of the tightening since the 4th of February.

I suppose I should really stop there, but I think that the Greenbook and Mike's presentation place the stance of monetary policy rather front and center. At the last meeting, we decided that it was appropriate to have an asymmetric directive, which the world will know about this Friday. That meant that we were ready during the intermeeting period, when we didn't know all those new things that we think we now know, to increase the fed funds rate and perhaps the discount rate by 50 basis points. We think that because of all the additional information available since the last meeting, such a move would no longer be adequate. It could in fact increase inflationary expectations not because young bond dealers would raise questions, but because sensible people could question the resoluteness of this Committee. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, New England continues to recover gradually. But there is a distinction to be drawn between the incoming labor market data and other indicators, so I'll try to frame my comments about New England along those two lines. Unlike most of the rest of the country, New England has not yet recovered the jobs lost in the last recession and is not expected to do so until late 1998 at best. There is a continued lull in growth that I commented on at the last meeting, and it is hardly as welcome in New England as it might be for the country as a whole. Payroll employment declined in five of the six New England states in September, putting the region's establishment job count slightly below its July level. But it is still nearly 2 percent over a year earlier. Massachusetts and New Hampshire continue to reflect the strongest growth rates among the six states, and Connecticut still bumps along on the bottom. The September job decline for the region was concentrated in manufacturing unfortunately, but all the major industry categories except construction and government recorded declines. Unemployment rose noticeably in the region in October, also in contrast to the national scene. Prices and wages seem to be rising somewhat more slowly in the region than in the nation, and the residential real estate markets are definitely slowing.

To round out this rather downbeat picture, trends in defense-related business also show deterioration relative to the national picture. For example, prime defense contract awards to New England companies during the first half of 1994 were lower than at any time since 1980 and 35 percent below their 1989 peak. Defense-related employment continues to decline and in some states the decline is nearly twice the national pace and probably accounts for a healthy share of the manufacturing job losses I noted earlier.

Moving from the labor market data to other indicators, however, consumer confidence, help wanted advertising, and retail sales all show continued improvement in New England. Retailers contacted for the Beigebook, especially those selling hard goods, were upbeat about recent activity and the near-term outlook. I must admit that every business group I meet with seems to be much more positive than the incoming labor data would make me believe. More than 50 percent of any group I have talked to in the past month or two are contemplating hiring people over the next 12 months and out into the future; they are seeing escalating input prices and are seriously considering raising prices in response to these escalating prices, probably along the lines of the January price increases that were mentioned in the Greenbook.

In sum, New England faces considerable sectoral challenges--defense, the computer industry, health care--which tend to drag down the data. But there are sources of growth and ebullience emerging.

On the national scene, we agree with the Greenbook's inference that the economic expansion has overshot. We expect employment costs as measured by the ECI to turn up soon, and we agree that near-term inflation prospects are not optimal. I've covered our concerns about the Greenbook in the questions that I had for Mike, but overall we don't find a lot to complain about. We seem to be slightly further behind the curve than I would have liked at this point and the longer we wait and fail to slow the economy, the greater the chance that rates will need to be significantly higher. If we don't increase rates at this meeting, I see a real chance of causing the boom-bust cycle that we have been trying to avoid. I think the risks are on the up side, and I think we have to move sharply and fast to curb those risks. I'm in agreement with President McDonough that that move should take place at this meeting.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, as I have been reporting for several meetings now, the Southeast economy is sustaining a broad-based expansion, although we have seen a little slowing of growth recently. There really hasn't been very much change in the situation in the Sixth District since the last meeting, so I'm not going to repeat a lot of the detail that I have given at the last couple of meetings. Let me hit just a couple of highlights.

Retail sales rebounded in October after a somewhat lower September. Retailers are expecting strong increases, in some cases even record increases, in sales over the holidays. According to our latest manufacturing survey, activity was not quite as robust in October, but an increasing proportion of respondents expect production and shipments to be higher six months out. Single-family home sales slowed in most of the District last month, dropping below strong levels seen a year ago. On the other hand, multifamily real estate markets continue to improve throughout the District, and that has been going on for a while. Commercial real estate markets clearly have hit bottom and are beginning to move up. We are beginning to hear some reports of speculative building in that sector, particularly in Atlanta. Bank loans overall are growing modestly for the first time this year, although I find it interesting that consumer loans are flat in the District. Employment growth picked up a little in the third quarter with services, trade, construction, and durables manufacturing showing the best gains. More reports of wage and price pressures are coming in than before. The wage pressures are concentrated for the most part in a few localities and in a few areas. Respondents in our manufacturing survey are reporting pressures on prices of inputs and finished goods, and they are expecting to be able to pass those through later on. Again, although retailers have held the line so far, prices are expected to increase as new shipments come in after the first of the year.

In sum, the situation in the Sixth District is not very different from what it was at the time of the September meeting. There is momentum and the expansion is moving along at a quite good and sustainable level.

Now with respect to the national economy, I must say that I was quite surprised at the extent of tightening assumed in the Greenbook and the resultant low level of GDP growth for three or four quarters in the range of 1 to 1.8 percent. As President Boehne indicated, I think this is flirting with recession even in the absence of shocks to the economy. There is very little margin for error. In the short term, our forecast does show the economy starting to decelerate a little sooner than the Greenbook, but in the longer term even though we have some deceleration, we show stronger growth with lower unemployment and a somewhat higher inflation rate. I think that it is going to take less tightening than envisioned in the Greenbook to cause inflation in the current expansion to peak at a level that is well below the one that we had in the last cycle. Our forecast assumes that a rise in inflation can be viewed as a cyclical phenomenon and not necessarily the start of a trend. But that being said, our view is a little more optimistic and it may not be the correct view; it may be unrealistic. The risk, in my judgment, is on the up side, and we need to remain vigilant to inflation. I think that the cost of underestimating price pressures can be very high. Perhaps I've tipped my hand as to what I would want to do, so I won't go any further at this point. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. The economy in the Dallas District continues to show moderate to strong growth across the board. Virtually every sector seems to be expanding with the exception of livestock production. At our board of directors meeting last Thursday, the reports were uniformly upbeat. Every region within the District reported positive news. The only negative reports were scattered slowdowns in single-family housing construction, but even these reports noted strong gains in other construction activity such as apartment, shopping center, and industrial construction. Our Beigebook contacts and numerous other reports from around the District noted a significant boost in both price and wage pressures over the last several weeks. This represents a sea change from previous reports, and if this is a start of a new trend, it implies serious consequences for monetary policy. More and more industries are reporting reaching or approaching capacity limitations as well as a newfound ability to pass on some of their higher input costs to the next stage of production or consumption.

The national economy, as best as we can tell, is showing the same early signs of overheating as the Eleventh District. Various resource constraints rather than demand conditions seem to be the major factor determining the growth of output. Although the statistical measures of price and wage inflation have yet to show an upward trend, we can't help but notice that the Beigebook reports from around the nation indicate a pickup in price and wage pressures that may suggest a red alert for the Federal Reserve. As I look at the national economy, the Greenbook seems to have the current state of affairs about right, but I expect that the staff forecast may have underestimated the strong forward momentum in the economy as we go into 1995. The risks to the forecast both with respect to growth and to inflationary pressures seem to be that we have underestimated the underlying strength of the economy.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, the economic recovery in California appears to be taking hold while conditions in the rest of the District generally remain strong. Abstracting from month-to-month volatility, the California unemployment rate has fallen about 1 percentage point since the first quarter of the year, although it remains about 2 percentage points above the national rate. In the rest of the District, state employment growth has outpaced the national rate in Arizona, Idaho, Nevada, Oregon, and Utah. Contacts in District states other than California and Hawaii generally indicate that regional wages are accelerating. Labor markets are regarded as especially tight for construction workers, computer programmers, as well as banking and retail sales personnel. Consumer prices have been fairly weak in California in large part because of weak housing prices. More recently, housing sales in the state have picked up noticeably, and many of our contacts expect a pickup in housing cost inflation.

Turning to the national economy, real GDP growth has continued to be surprisingly strong, showing no signs so far of falling below the potential rate of growth. As a result, as already has been mentioned, tight labor and product markets have become noticeably tighter since our last meeting. Moreover, at present levels of interest rates, I would expect to see further robust economic growth and declines in the unemployment rate in the remainder of this year and in 1995. Under these circumstances, it has become increasingly clear that inflation would be on an upward trajectory in the years ahead without a substantially tighter stance of policy.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, the Tenth District remains strong, and the strength is spread generally across all our states. Activity is robust in most of our key industries, although there may be some signs of a slowdown in single-family housing; that has yet to be determined. Our farm income has weakened in 1994. The current data show that the number of payroll jobs in the District increased by about 3 percent in September over a year earlier, about the same as the nation. I should note, though, that New Mexico had job growth in the neighborhood of 5 percent and only Kansas and Wyoming added jobs at a rate less than the nation, although not a whole lot less. Manufacturing continues to improve with most of the strength in the durable goods industry. The District's key automobile assembly plants have completed their model changeovers. They have told us that they expect gradually restored production toward capacity levels. In general aviation, aircraft production, another of our key durable goods industries, improved in the third quarter with billings up significantly over the second quarter and over a year ago. Energy activity improved just slightly in October, but farm income is down due to poor livestock prices, and that will be offset just slightly by the record harvest that we expect or are having. As we have been seeing for the past few months, construction remains robust across the District. But as I said, there are some signs of slowdown in the housing permits area. Anecdotal reports point to some shortages in labor, and that includes unskilled labor in our area. Upward pressure on wages appears to be increasing. Loan growth in our District continues to be strong although slightly less than last summer; it was extremely robust last summer.

Turning to the national economy, my view is that the economy has considerable momentum. Domestic spending remains strong; export growth is trending upward. With the exception of housing, it is difficult to see any immediate signs of a slowdown. Indeed, activity appears to be picking up in several industries, particularly manufacturing. At current interest rates, I would expect real GDP growth to remain above potential for at least the next three quarters. As a result, with the economy already at more than full employment, an upturn in inflation seems inevitable. We already are seeing inflationary pressures, not just at the early stages of production but at the final stages as well. As Bill McDonough said, inflation starts out very slowly, and that is what we are seeing. On a year-over-year basis, virtually all the price indices as well as the employment cost index and average hourly earnings have either bottomed out or are showing increases in recent months. So, it seems to me that the issue before us now is not whether inflation will be picking up, but how much and over what time horizon.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Anecdotal reports suggest that the Philadelphia District is catching up to some extent with the rest of the nation. Manufacturing in particular is showing strength and the outlook is positive. Steel and auto products are notably brisk. Retailers generally report a pickup in sales, especially in apparel and appliances, and the mood is upbeat about holiday sales. Realtors say home sales are strong in the Philadelphia area but uneven in the rest of the District. The supply of homes is high, however, and selling prices have been steady. Commercial real estate activity varies a great deal around the District from weak in south Jersey to strong in some parts of central Pennsylvania. There is a pickup in the Philadelphia area, especially in the Pennsylvania suburbs. Lending activity is on an upswing around most of the District and lending terms are easing, but I don't think we ought to be surprised at that; that's typical. Bad loans are made in good times, and there is a bandwagon effect that human nature just cannot resist despite changes in legislation, better supervision, and so forth. There are no general signs of price pressures, although I hear more reports about tightness in skilled labor markets and the demand for professional-type jobs. Some manufacturers seem more confident about selected price increases sticking, but most still talk about tough competition holding prices down. All in all, the District economy is less of a laggard and the tone is better, although feelings of insecurity are just below the surface and sometimes on the surface, depending on who is doing the talking.

At the national level, we are seeing what we have seen before. Once the economy gets going, we tend to underestimate the strength of its forward momentum and the level of interest rates needed to achieve moderate growth with subdued inflation. Now fortunately, if we have fallen behind the curve, we are not all that far behind. With timely actions going forward, we have a good chance of keeping inflationary pressures in check and the expansion on track.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, my comments will be very similar to many of the others you have heard already. With respect to the District, last week I attended a meeting of leading business people in Virginia who advise the governor on revenue estimates. This group includes the CEOs of most of the state's large corporations--a couple of major railroads, a major aluminum producer with worldwide operations, some banks, a big shipbuilder, and a big trucking company. I was really struck by the uniformly bullish commentary at that meeting, not only about the state economy but about regional and national economic prospects as well. Several of these people said explicitly that they were planning major capital outlays in the near future based on these expectations. A number of them said explicitly that they thought the consensus national economic forecast, which had been summarized for them at this meeting as calling for GDP growth of about 2-1/2 percent next year, might be too low. It was a very bullish meeting.

The tone of our board meeting in Richmond last Thursday was similar. All of the directors were optimistic about conditions both in their local areas and in their respective businesses. Consumer spending appears to be especially robust in our region. Retailers are expecting a good Christmas. There is what I would describe as a gradual revival of commercial construction in the District. The main negative factor is still the reduction in defense expenditures. But even places like Norfolk, Virginia, and Charleston, South Carolina, where there had been projections of a big negative impact, are not seeing that--I guess because of the strength of the general economy. In spite of this strong growth, we have seen only scattered reports of actual price increases for final goods and services in recent weeks at least. But a number of our directors at the meeting last week, especially those who have contacts in the manufacturing sector, said they expected a number of their suppliers to put price increases in place, perhaps fairly substantial increases, at the end of the year. Several of them said they would expect to pass at least some of these increases along in their own prices.

Nationally, I thought the staff did a very fine job of sizing up the current situation in this month's Greenbook. I guess it is fair to say that Mike and his people are still calling for a fairly soft landing. I think that's appropriate, but I would make three points. First, I think it is worth noting that the landing in this Greenbook seems to me to be less soft than that in the September Greenbook, which if I remember correctly was slightly less soft than that in August. I think there is a lesson for us somewhere in this pattern. As I recall, the Greenbook states explicitly at one point that the risk of error is on the up side toward the situation where we move back into some kind of boom-bust pattern; that's something we have seen so often in earlier postwar cycles. The second point I would make about the Greenbook is that, as you know, the current projection is predicated on a significant further move toward restraint in monetary policy over the next several months. Finally, even with this further tightening, the Greenbook is still calling for a 3 percent inflation rate; we are not really getting any reduction in inflation. So even with this outcome, we are still going to be some distance from full price stability.

On the inflation score, I think it is fair to say that many business people with whom I have contact and probably more financial market people now expect a moderate increase in the inflation rate next year to about 3-1/2 percent. I've spoken to a number of people who are expecting something more. I would say that this increase in inflation expectations is clearly at least part of the explanation of what is going on in bond markets and foreign exchange markets. The behavior in these markets suggests to me that we probably have lost some additional credibility over the last several weeks. I agree with Bill and Cathy and others who have said that we are in a position now where we need to make another decisive move in order to shore up our credibility and convince the public that we are still serious about our goals.

In this regard, Mr. Chairman, I would like to repeat something I said at the September meeting. I think that inflation expectations currently are especially sensitive to incoming short-run economic data and to indications of monetary and other economic policy changes precisely because we don't really have a clear, step-by-step strategy to meet our longer-run goals. I think we would be well served by explicit multiyear inflation targets that we would announce publicly. If we took this approach, I think it would relieve some of the pressure on us, in a situation like the current one, to make a strong move to reinforce and shore up our credibility. If we were to do something like this, we obviously would need to talk about it a bit. But I think it would increase our operational flexibility in the short run, and it would reduce the risk that at some point we might do some damage to the economic expansion. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. With regard to the District economy, there is not a lot new to report; it remains strong. Manufacturing is robust. Materials prices are going up. Employment is high throughout the District. In some of the metropolitan areas, the reports we are getting are that everybody who wants to work is working. What seems to be restraining some further job growth in those areas is housing shortages; businesses would attract more labor from the rural areas in the region or maybe from outside the District, but there is no housing in some of these places. Despite that, there are no widespread reports of wage or price pressures, at the retail level at least. What wage pressures there are seem to be concentrated mostly at the lower end of the pay scales. I think that is because of the difficulty of retaining workers there; they have so many easy opportunities to move out and up. Elsewhere in the District, the agricultural situation is mixed. It is a good year for crops, though prices are not entirely favorable. It has been tough in the livestock industry at least outside the dairy sector. Since they are coming off about 7 good years, I'm not sure there are any real problems emerging there. We did hear some reports from our Advisory Council members about interest rates starting to bite in the housing and furniture markets. It is hard to know exactly what to make of that in light of the national statistics that seem better. But however that may be, it is clear that the paper industry has bounced back.

With regard to the national economy, I don't have a lot to add to what has already been said. When we go through our translation process that takes the labor market data, in this case for October, and turns them into a GDP estimate for the fourth quarter, we get about 4-1/2 percent growth in real terms at an annual rate. In some sense, that's neither here nor there, of course. It's history, but it does tell us something about the underlying momentum of the economy, which I do think is quite positive and quite strong. There is always the danger of extrapolating the latest reading. On the other hand, as several people have already commented, it seems to me our experience over the years has been that once momentum starts to build in terms of real growth, it tends to go on for quite some time and it probably takes more restraint than we usually anticipate, at least early in the game, to avoid an acceleration of inflation or indeed to make progress in reducing the rate of inflation.

Finally, let me comment on the suggestion that Al Broaddus just made. I may come out at a somewhat different place than he did, but I do think that the suggestion to consider the implications of longer-run inflation targets may be a constructive one.

CHAIRMAN GREENSPAN. That's a legislative issue.

MR. STERN. Well, you certainly wouldn't want to do it without considerable political support. I agree with that.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. National economic activity is much stronger than earlier forecasts anticipated. Employment grew twice as fast as the labor force from January to October. There was a large rise in hours worked in both September and October, including an extraordinary amount of overtime. Wage pressures are building. Average hourly earnings surged in October; for the past four months, this measure of wages has risen at a 4.4 percent annual rate, up sharply from only 1.3 percent in the first five months of 1994. Such reflections of tight labor market conditions are signs of prospective inflationary pressures.

Strong credit demands also reveal the strength of economic activity and nominal spending. Growth in business loans at commercial banks nationwide and in the Eighth District has been rapid throughout this year. Since spring, banks have reduced their holdings of securities and have bid aggressively for time deposits to accommodate loan demand. Nonfinancial firms have also increased issuance of commercial paper since September, corroborating the increased demand for credit by businesses. The large inventory accumulation in the second quarter was followed by a larger accumulation in the third quarter. Those forecasters who had expected a substantial slowing in real growth following a large buildup in inventories in the second quarter seem to have guessed wrong. Nevertheless, inventory-to-sales ratios remain very low by historical comparisons, so low in fact that many firms are concerned about both deteriorating vendor performance and the prospect of continued acceleration in sensitive materials prices.

My contacts in the Eighth District indicate that increases in inventories have largely been planned in anticipation of strong sales, including retailers who ended the last Christmas shopping season with largely empty shelves. Overall, employment in the Eighth District remains robust and the District unemployment rate hovers near its lowest levels since August 1974. This September, the District unemployment rate was 4.7 percent compared with the 5.8 percent rate for the nation in October. In recent contacts with business executives and directors in the Eighth District, the consensus was that wage pressures are building, especially for unskilled workers and construction workers. I have been hearing these reports and have mentioned them here for some time, but I'm hearing more and more reports of actual increases in wages. Furthermore, contacts report price pressures from rising costs of raw materials from both domestic and foreign sources. Prices of imported goods, which had been an important factor in holding down inflation until recently, rose at a 6.9 percent annual rate in the past two quarters after falling over the previous two quarters.

Finally, looking ahead, I am troubled by the Greenbook forecast, which shows that among G-7 countries only Italy and the United Kingdom have a higher inflation outlook for 1996 than the United States. Thus, it is not surprising that we seem to lack credibility with respect to price stability, and this is indeed costly in current circumstances. Picking up on what Al Broaddus said, I feel that it may be time for us to consider setting a specific inflation target that looks out into the future. I think, and this point was made as well, that it could make our job considerably easier in circumstances like the present--with upward cyclical inflationary pressures--if people were willing to look out to a longer-range target and that added to credibility.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, economic activity on balance in the Seventh District appears to be a bit stronger than at the time of our September meeting. Retail sales and manufacturing output have strengthened, and overall housing activity through September held up better than might have been expected given the rise in mortgage interest rates. One cautionary note is that new single-family home sales in the Midwest have been weaker than national trends. Contacts in the manufacturing sector continue to report robust activity, and several are now beginning to report gains from higher levels of exports. Looking ahead to next year, a number of manufacturers anticipate that growth will slow in their domestic markets, but this slowdown could be offset by continuing increases in exports. Similar to the Board staff, we estimate that the auto sector will contribute about 1/2 percentage point to real GDP growth in the current quarter, despite the fact that the auto industry is still struggling to address several model changeover and parts shortage problems. We also expect about the same contribution to real GDP growth in the first quarter of 1995.

Indicators of consumer activity in the District are quite robust. Regional income growth has been above the national average. Retail sales have improved, with sales in Michigan and Wisconsin up more than 12 percent in the third quarter, which is well above the 7-1/2 percent national figure. More recent reports from two major retail chains indicate that sales in early November were very good and that it would not be a surprise if holiday sales exceeded earlier expectations. In general, retailers throughout the District are quite optimistic about the holiday season and have been adding to inventories. Consumer confidence remains high and well above the national average, but it has flattened out in recent months due to a decline in the expectations component.

In the agricultural sector, harvests of corn and soybeans will set new records in the District and the nation. Cattle and hog supplies are also running at historically high levels. These developments have led to lower prices to date, and prices are expected to remain low throughout 1995 in those areas. The banner corn and soybean harvests have taxed the capacity of the grain storage and transportation facilities, but these bottlenecks, which are common in years of big crops, are already starting to ease.

Examples of Seventh District industries operating at or near capacity are numerous, including motor vehicles, steel, appliances, construction, agricultural equipment, office furniture, and railroad car loadings. Steel price increases appear to be in the 6 to 8 percent range, and significant increases are reported for other commodities such as chemicals and paper products. Although manufacturers continue to resist supplier price hikes, conditions seem generally more conducive to such increases. Some manufacturers can offset these increases with productivity improvements; others cannot and will increase prices of their products to consumers.

District employment growth has been quite good. In almost all of our states, unemployment rates are below the national average, including a 5.1 percent rate in Michigan after many years of significantly higher unemployment rates in that state. We are increasingly hearing of labor shortages at the low and high ends of the skills' spectrum from retailers having difficulty filling entry-level positions to manufacturers reporting a futile search for engineers and designers. I visited Detroit recently, and it is clear that the help wanted signs are out in Detroit. I learned that one large retailer is trying to attract new employees by putting help wanted advertisings in the monthly bills that they send to their customers. Despite these shortages, few manufacturers or retailers have reported any significant upward pressure on wages of permanent positions. However, as I mentioned at the last meeting, temporary help firms have reported higher wage increases of about 5 percent.

On balance, Mr. Chairman, we concur with the Greenbook assessment that the economy is now past the point of full noninflationary utilization of productive resources.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. With regard to the national picture, I'd like to associate my comments with the very eloquent analysis of President McDonough; he was right on target. With regard to the staff forecast, I would only add the issue of timing. We do not know in what quarter the economy will slow down, but we do know that it will slow down. I think the point about forecasting increasingly hard landings is a good lesson for us. As a side note on hard landings, if anyone really wants to experience a hard landing I recommend Rumanian Air. [Laughter]

At the last meeting, I set aside my normal reservations and favored an asymmetric directive because I perceived the possible need for foreign exchange intervention. I specifically recommended that, if we had that intervention, it be accompanied at that time by a 50 basis point increase in rates. Frankly, I think that had we done that at the time, the move would have been both appropriate and, I would add, sufficient. Why did we have the intervention? It wasn't because of volatility or disorderly markets. It wasn't a signal of policy change at the time. The word that was most commonly used was a "bridge." A bridge to what? At the time, cynics in the market and a few of the press reports guessed it was a bridge to the election. I hope and trust that that was not the case, and no one knew what the outcome would be anyway. I think the other option was that it was a bridge to what we are about to do today. If so, if we are bridging to a 50 basis point move, which everyone anticipates, then it would be like building a bridge to the middle of the river, which is actually another thing they do in Rumania, [Laughter] but so much for that. The key is that I think markets will probably think we are all wet if we do. [Laughter]

MS. MINEHAN. Oh heavens!

CHAIRMAN GREENSPAN. You are in great shape today!

MR. LINDSEY. That is what happens when you are awakened at 2:00 and 4:00 in the morning by a one-year old! The other part of my trip, I had both our bureaucracy and the Rumanian bureaucracy prepare a serendipitous schedule. The first part of the week I was in Paris and I was able to go on from there after meetings. I think both in meetings and also in private meetings I had with and with folks at there was a strong sense that U.S. policy is behind the curve. I can only second what Peter mentioned about the perception that we are behind and that therefore a big increase would be coming. Of course, diplomats always talk about it a little circumspectly. My favorite description was by one of the Europeans that monetary policy was behind the curve in non-European OECD economies. [Laughter] I don't think they were talking about the Australians and New Zealanders, but here we are. The bottom line is that while I certainly do not believe in the tail wagging the dog, and I certainly don't think that foreign exchange concerns should drive our long-run policy, I do think that given what the folks around the table have said about the strength of the economy, the issue is not whether to move but when. Frankly, I think our intervention really boxed us in a corner, and I don't think that the 50 basis point option is still there. So, I would join others in recommending that we do something more than that.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mr. Chairman, the Greenbook outlook for dramatically increased short-term rates and a marked slowing in the rate of economic growth accompanied by rising inflation and increased unemployment is not a particularly appealing one. It would be much more attractive if the inflation projection was one that reflected greater progress toward stable prices. An even more unpleasant vision is the one that would emerge if further significant restraint were not put in place. In spite of recent declines in consumer confidence as measured by the Michigan survey, consumer confidence remains at a high level and may be further enhanced by the election results. I suspect that the current momentum in the economy may be significantly stronger than previously expected and may in fact produce a stronger GDP performance in 1995 than that projected in the Greenbook. It is hard for me to accept the idea that we can't get an inflation rate significantly below 3 percent. If the monetary policy inherent in the Greenbook forecast can't produce a better result, then perhaps we should be considering monetary policy alternatives that would make better progress toward stable prices even at the short-term cost of unemployment marginally above the NAIRU. The signal effect of greater restraint may in fact wring out some of the inflation expectations in the markets, which are inherent in current bond prices.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, it seems to me the situation is unequivocal. At this point in the morning, I have very little to add that's useful. Virtually every bit of information that we have gotten and certainly the reports around the table this morning have indicated that we have an extremely strong expansion. It may be accelerating. I don't expect this, but if somehow nothing were done, I think we probably could get rather quickly into a runaway boom situation. The inflation teakettle isn't whistling yet, but I think the temperature inside of it is rising rather markedly. There is no need to go back over any data; we are all familiar with them. As far as I'm concerned, the only question before the house is in the next part of the meeting. That is, what is the best way to deal with this situation?

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you. The momentum of the real economy certainly seems to be stronger in all sectors than was anticipated earlier. I think that the revisions we have seen recently in a number of forecasts and, for example, the recent benchmark revision in the employment level, demonstrate that there was more momentum than we earlier thought. This may well carry the economy forward at an even stronger pace than we had anticipated. It is carrying forward into consumer confidence. All of the spending indicators are showing considerable strength, even housing. We would have expected more of a downturn than we have seen in the interest-sensitive parts of the economy. The outlook in industrial production is for continued strength. Autos and light trucks alone probably will sustain us for a while. The real economy is showing more strength than we had predicted a couple of meetings ago; essentially, the second-half slowdown that was anticipated never occurred.

Turning to the financial markets, I think that they generally are functioning quite well; the currency markets may be a bit hard to read. We should look to some of the lessons that the financial markets are trying to suggest to us. Even though the lecturing that we are getting is coming from 35-year olds, these 35-year olds still are voting with dollars. I think that there is something to be learned there. The markets are not as volatile as they were earlier in the year. There is more depth. There are more varied expectations on market direction and financing needs. Some people have expressed disappointment in the stock market, but we may well look back on this in coming years as being one of the most orderly corrections that we have seen in quite a while. The cost of capital has increased, both for equity and debt financing. But it does not appear to be inhibiting investment either by households or in the business sector. Banks are now providing capital that earlier was being provided directly by the stock and the bond markets. It seems to me that we have had a relatively smooth transition from credit crunch to the direct issue market and to bank financing. The financial markets generally are functioning quite well. The fact that we haven't had a major accident, I think, is significant.

On the inflation side, some people have suggested that we are getting closer to the point where we should see more increases in final consumer prices. But in fact, we have seen increased pressure in the CPI for the third quarter. We are well above a 3 percent rate at current levels, and I would hope that our goals would be better than 3 percent. I'd associate myself with Al Broaddus' comments about starting to look at some kind of monitoring range for inflation, particularly one with a long-term outlook. I think that we are not giving as clear signals as we might with respect to what we think inflation should be. I guess I'm getting a little tired of seeing all these analysts say that inflation is under control when in fact it is above 3 percent.

In sum, I think that some of the previous uncertainties that we saw in the economy appear to have been resolved in favor of economic strength. Productivity increases have resumed. The markets have been reasonably steady. The elections are over except for the State of Maryland. We still do have some downside risks. Health insurance still is going to be an uncertainty. I suspect the solutions are likely to change now, but the problem is still there. The new Congress may yet create unimagined new challenges for us. I think we are going to have to start factoring in such things as tax cuts and perhaps increases in defense spending. What is this going to be doing for the Federal deficit? The monetary aggregates remain surprisingly weak, so I count this as one of the remaining uncertainties. I hope that productivity, efficient capacity use or even more capacity will permit higher growth with no inflation, but I think that's fairly wishful thinking. Perhaps the NAIRU is lower than we had thought, but again that may well be wishful thinking. On balance, the risk seems to be for continued economic momentum at least in the near term. I think we'll see inflation pressures increasingly evident.

CHAIRMAN GREENSPAN. Thank you. President Jordan.

MR. JORDAN. I'll say very little about the District. In my District contacts, I raised two questions that I thought were of some use in the period since the last meeting. One was about labor market conditions and the persistent comment about shortages, tightness, especially for unskilled, semi-skilled workers and so on. I asked what they were doing about it, and the general response was "hiring bonuses," with the exception of the construction industry. That industry is willing to raise offering wages; others industries are not going to let higher wages go into the cost structure. I asked them how they are responding to current retention requirements and again the answer was bonuses--one-time payments to retain workers that they are not willing to build into the cost structure. In response to a question about the outlook for passing through cost increases to higher prices, respondents, especially retailers and various consumer products companies, simply said "impossible." I noted in the supplement to the Greenbook that the Michigan survey of consumer sentiment indicated that household appraisals of car and appliance buying conditions deteriorated in early November. I think that bears watching, especially in this post-election period. Small businesses that I asked about their outlook for the next year versus their outlook for 1994 at this time last year were more optimistic last year than they are this year looking a year ahead. That was before the election. I have no idea what the election did to their optimism. Also, the Michigan survey shows the mean and median values of expected inflation declining over the next five years to their lowest levels since 1990. So, we may not be as far behind the inflation psychology curve with real people as financial market indicators would suggest.

On the national economy, as shown in the Greenbook, we have had four good quarters averaging 4 percent growth, and I have no reason to disagree with the staff projection that this quarter also will have 4 percent growth. That comes after approximately eight quarters of subpar performance. We had a rebound effect after the Gulf war in the spring and summer of 1991, and the economy then tended to go flat. The staff forecasts overstated the economy's growth after that for about two years. I don't view those two years as having been a result of the inadequacies of aggregate demand, but rather the real shock effects of a variety of depressants in various sectors and industries that were preventing the economy from performing very well. Therefore, I don't view the last four or five quarters of good growth as being the result of pump-priming stimulus to aggregate demand by our monetary policy or fiscal policy or anything else. Rather, I see them as the result of the dissipation of those earlier depressants. In that sense, I view this growth in output and employment as having been a good thing, a make-up for the earlier subpar performance.

I don't view that growth as being a precursor to future inflation because I don't view it as having been fostered by excessive money creation. The subject of inflation to me is still the subject of the purchasing power of money. I don't see that the growth of output and employment reduces the purchasing power of money. I do think it would be helpful, as Al Broaddus was suggesting, for us to have credible, multiyear objectives and to seek a legislative mandate for achieving our price objectives. In part, the reason is the problem that we now have with inflation psychology. Here is where our own words cause us a problem. If we talk about the purchasing power of money as having something to do with the NAIRU and potential output or something, then I think that we have no choice but to continue raising the funds rate and create some unemployment and some perceived slack. The last time this Committee went through a tightening period in 1988 and 1989, it was being guided by the opportunity cost relationships of broad money and the P* model, which seemed to be serving the Committee fairly well including the behavior of the stock of money--we got about 5 percent M2 growth in that period. We don't have that now. The Committee lost confidence in staff estimates of the demand for money balances or the supply of things; we just didn't know what to make of that and we all fell into a pattern of thinking that we know a lot more about aggregate supply of goods and services and labor and aggregate demand for labor and output and how to influence demand for labor and output than I think we have reason to know. I don't think that we have reason to have more confidence in our ability to know what is really going on out there in terms of productivity, consumption, and investment patterns than we do about money supply and money demand. There appeared since our last meeting a very good article in Business Week magazine on this problem of the quality of the economic statistics that we use to guide ourselves. There was nothing new in that article for those of us in this business, but I think it was very helpful to have that in the public forum saying that there are a lot of very serious quality problems in those numbers. We better be careful and not rely on them too much in deciding what to do about monetary policy. We have been in a pattern since last spring where every time we come back, we need another 50 basis points to get to neutral. Now the staff is at 6-1/4 percent. I know where it is going to be in December; it will be at 6-3/4 percent and then in February at 7-1/4 percent--just extrapolating the trend. At some point we have to have a different rule that says, enough is enough and let's coast for a while. I'm not soft on inflation. I want to go to price level stability. But I also don't want to make the mistake of continuing to tighten too much, precipitating a downturn because I know what will happen. This means we will go completely the other way and set the stage for more inflation.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Since our last meeting, the evidence has continued to accumulate that there is enough momentum in aggregate demand to carry the economy past potential output. We have yet to see much slowdown in the interest-sensitive sectors, and it may well be that easier lending terms have offset somewhat the impact of higher interest rates. The news on the international side of yet further upward revisions in foreign GDP growth reinforces the view that the economy will overshoot the NAIRU with potentially inflationary consequences. The recent decline in the dollar exacerbates this concern, although fortunately the dollar has risen a bit against both the mark and the yen since the Greenbook was put to bed. The amount of slack in the economy, however it is measured, clearly has diminished. I think that the performance of wages and prices accords quite well with the predictions of a Phillips curve model in which the economy is currently in the vicinity of the natural rate. So there are few surprises there. It is not surprising that we are seeing some early warning signs of rising inflation, including business reports that there will be price increases after the first of the year and anecdotes about rising wages to retain and attract qualified employees. I think the staff's inflation forecast that the CPI will rise to 3-1/2 percent in the first half of 1995 is quite reasonable based on historic experience. It is difficult, though, to construct a scenario in which inflation over the next year would rise by a lot more than the staff forecast. So, I think there is limited upside risk of an inflation rate increase over the next year or so. The key question, of course, is whether and how quickly this modest rise in core inflation may become embedded in inflationary expectations, feeding back into wage and price formation. I think there is risk here unless aggregate demand is restrained.

Now, what concerns me most in connection with the Greenbook forecast is that the assumed further tightening of 150 basis points entails considerable downside risk to the economy that will be concentrated in 1996. In light of the current strength in the interest-sensitive sectors, it is tempting to conclude that the monetary tightening we have had so far isn't producing and will not produce the slowdown we desire. But the time honored view among economists is that monetary policy operates with long lags. I consider this view to be supported by considerable empirical evidence. If so, there is a real risk of a hard landing, instead of a soft landing, if we are too impatient and overract. Demand may be strong now because monetary conditions were so easy until last spring. The tightening is really quite recent and its impact most likely has not yet been fully felt. Indeed, as President Jordan noted in his comments, the November Michigan survey suggests a sharp deterioration in household appraisals of buying conditions for houses and significant declines in willingness to use credit and savings. The October survey suggested that some of the current strength in housing may stem from the belief that interest rates are on the rise, so it is better to buy now than later.

This view, namely that there remains restraint in the pipeline, seems consistent to me with the Greenbook forecast because, given the lags of monetary policy, the Greenbook's projected slowdown in 1995 must primarily be related to the interest rate increases that already have occurred, along with other factors, and can't be related primarily to the assumed further tightening of 150 basis points. The staff forecast implicitly assumes that we already have enough restraint to slow growth in 1995 by enough to bring unemployment back to the natural rate by the end of 1995. In that case, the argument for an additional 150 basis points of restraint rests on the staff's assumption that without that restraint, demand would rebound strongly in 1996. Now, that view may be correct, but the logic of why there would be this strong rebound in demand in 1996 without the 150 basis points of additional restraint does not seem compelling to me. I think there is a distinct possibility that that much extra restraint would represent overkill and that the overkill would make itself felt in 1996. In addition, I would point out that the Greenbook forecast assumes that the tightening is going to have relatively little additional effect on long-term rates. While I'm not a good forecaster of movements in long-term rates, certainly that assumption has proven incorrect thus far. I conclude that the degree of tightening assumed in the Greenbook poses a serious risk of a hard landing in 1996, although in the absence of some further tightening, I think there would be an unacceptable risk that inflation would accelerate.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. Until about three minutes ago I thought that, even though I was speaking last, I would have some things to say that had not been said before. But that is less true now than it was a few minutes ago. Let me start at the point where Janet Yellen left off. I thought it was a remarkable feature of the Greenbook projections that we could put in another 150 basis points of tightening at the short end and get almost nothing--10 basis points or something like that--at the long end. Now, that is not impossible; nobody can rule that out. But given the history of 1994, I think it takes a certain amount of guts to project that. I commend the staff for having that much guts; it is more than I have. I'm not as worried about the 35-year old bond traders that Bill is worried about as I am about the 25-year old bond traders who will be on it very quickly. Furthermore, if in fact long rates don't move at all, we won't get a lot of tightening out of this additional 150 basis points. I don't doubt that GDP, sales, etc., are growing briskly and that the level of resource utilization, including labor utilization, is pretty near and maybe right at or even a little beyond capacity. I also don't doubt that growth in the second half of 1994 now looks higher than we thought in August and certainly higher than we thought in July. So I'm persuaded that there is a strong likelihood of a small overshoot--we may indeed already have had a small overshoot--and that probably some more monetary tightening is indicated. Nevertheless, as we whip ourselves up into a frenzy here, I think we should remember a few things. The first is that the staff's 4.1 percent forecast for the current quarter is well above the consensus, as Mike mentioned. Now it is true, as Mike also mentioned, that the early indications for this quarter are quite strong, but let's also remember that, as we sit here now, we know very little about October and nothing at all about November and December. Also, there are, as Jerry Jordan and Janet Yellen mentioned, a few, small contra-indications--no indication that the economy is about to slump, absolutely not--but a few contra-indications.

Much more important than the next quarter is the longer-term outlook, and that is what I really want to focus on. I am thinking about, roughly speaking, the broad picture of the economy and monetary policy over a four-year period comprised of the last two years and the next two years. As Janet mentioned a few minutes ago--and as Ed Boehne and Bob Forrestal mentioned earlier--there is a sharp tail-off in the Greenbook forecast between now and the second or third quarters of 1995. The real GDP growth numbers starting with the current quarter are: 4.1, 2.5, 1.4, and 1.0 percent. Given the lags, that does not have anything to do with any subsequent tightenings from here forward. Therefore, it can come from only three places. It could be factors having nothing to do with monetary policy, and that's possible. But I think we have all agreed that there is considerable forward momentum in this economy and, if anything is slowing it down, it is monetary policy. I think that's a very strong consensus around this table; and I share it. The second candidate is, of course, the 175 basis point increase that we have already put into the system and the huge run-up in long-term rates that has come along with that. Thirdly, something that has barely been mentioned up to now, though I guess Janet Yellen touched on it, is the wearing off of the monetary ease that the FOMC put into the system ending in September 1992. It was a very substantial dose of monetary ease. That factor is virtually ignored in all public discussions and in most of the discussions inside the FOMC to date. But everything we know about the effects of monetary policy says that monetary ease put into the system in strong doses in 1991 and 1992 should have its maximum effects on real GDP growth in 1993 and 1994--and now come the important words--<u>and then wither away</u>. You do not permanently raise the level of GDP by putting the economy on a monetary high. We push it up a hill and then it comes down of its own accord. I don't think there is much dispute about that.

Now, there is a lot of dispute about the numbers. I had the staff run its econometric model of the economy, the MPS model, to try to quantify that. Nobody has to believe these numbers, but I don't know where else to get numbers other than trying to put this policy through an econometric model. According to our staff model, the impact of all the changes in monetary policy from mid-1990 to date, including the easings from mid-1990 to September 1992, the subsequent period when short-term interest rates were held constant, and then the tightening this year up to now should have done the following to GDP: added about .7 percentage point to the 1992 growth rate; about 1-1/4 percentage points to the 1993 growth rate; almost 1-1/2 percentage points to the 1994 growth rate; about 3/4 percentage point to the 1995 growth rate coming down the hill; and 0--coincidentally it happens to be 0--to the 1996 growth rate. What I want to focus your attention on is the estimate of the swing in the monetary impulse on the growth of demand from 1994 to 1996 of about 1-1/2 percentage points.

The same model says that, if we follow the Greenbook's recommended increase in the next few months of another 150 basis points in the funds rate--and by the way, if long rates respond as they historically do and not by next to nothing--then we will chip a tiny bit off the 1995 growth rate--a very, very small amount--and about a percentage point off the 1996 growth rate. If we add those two together, we are talking about a swing from monetary policy from both the end of the expansionary stimulus and the move to contraction of about 2-1/2 percentage points, from about plus 1-1/2 percent in 1994 to about minus 1 percent in 1996. That's a big number. I think that with all the focus on the upside risks, which are certainly greater right now--I don't by any means see imminent risks that this economy is about to head downhill--we should remember that we are in this business for longer than a quarter and longer than a year. And as we go out a couple of years into the future, there is a substantial downside risk. At some point, all these higher interest rates are going to hurt autos more, I think, than is indicated in the staff forecast. They are going to hurt housing; that might be right around the corner. Who knows? I believe they are going to put a damper on business fixed investment, which is growing strongly throughout this Greenbook forecast.

One last comment about stopping momentum: There is forward momentum in this economy. It is not going to be stopped by putting a rock in the road. I don't dispute that at all. I just want to close by putting some perspective on what a 325 basis point increase in fed funds within a year means--that's 175 to date and, if we do another 150 by February, that will make 325 basis points in a year. Only once since 1984 has the Federal Reserve tightened by this much within a year. That period, which has been discussed around this table a couple of times, was between March 1988 and February 1989 while the economy was in the midst of quite a large overshoot of capacity. If you look at the previous 30 years, and leave out the very exciting episodes between 1979 and 1982 when 325 basis points in the funds rate was hardly worth talking about--there were many moves of 325 basis points in that period--there are only two other episodes in the previous 30 years from 1954 to 1984. One was in 1969 and the other was in 1972-73, both with inflation rising considerably. As a result, the real federal funds rate rose considerably less than 325 basis points. But here we are talking about the vast majority of the projected 325 basis points being on the real rate. The moral of the story to me is that a 325 basis point swing, which is being contemplated here, is not trivial; it is very strong medicine. It is enough to stop an economy with considerable momentum, although there is also an amount of momentum that even 325 basis points would be insufficient to stop. It is therefore not to be prescribed lightly.

CHAIRMAN GREENSPAN. Thank you. With that, why don't we adjourn for coffee?

[Coffee break]

MR. KOHN. Mr. Chairman, as I think Governor Lindsey already remarked, the decision facing the Committee at this meeting would seem to be not whether to raise interest rates but by how much.

CHAIRMAN GREENSPAN. Let me tell you this. I thought that the two great remarks made previously were: One, Governor Lindsey's half bridge; and, two, Governor Kelley's teakettle. They have brought the theoretical structure of monetary policy forward immensely. [Laughter]

MR. KOHN. The teakettle is probably a better metaphor than the automobile metaphor we so often use--steering back and forth and tapping on the brakes. (Statement--See Appendix.)

CHAIRMAN GREENSPAN. Questions for Don? If not, let me get started. I must say the discussion this morning has been one of the best discussions I have heard around this table in quite a long while. I certainly don't have much to add to it. Let me just say, however, that inventories in my view are going to be the crucial area that will determine to a large extent how much momentum this economy has in it. It is not that inventories per se will engender the total gross national product, but as you recall when inventory investment is high, gross domestic product is high, disposable income is high, consumption expenditures are high, and we get a very significant multiplier from that phenomenon.

We can't look at inventories independently of final sales nor the reverse because they are clearly interrelated. We don't have data much beyond August and part of September, but there is a good deal of indication that inventory investment has not slowed in any appreciable manner in the fourth quarter. I must say to you, I would not be surprised to find that fourth-quarter inventory investment turns out to be higher than it was in the third quarter. First, we have a very robust rate of increase in commercial loans. Commercial loans, with or without commercial paper and with or without the merger adjustments that we make, have been a reasonably good indicator of book value inventory changes. If one looks at those data through the last week for which information is available, there is no evidence of any slowdown. If we postulate, which I think the data will support, that inventory investment in September was significant when the industrial production index was unchanged from the August level, it seems quite noncredible that the increase in industrial production of .7 percent that we published today for the month of October did not create an acceleration in inventory investment in October. This is consistent with the data on loans and, I must say, it is consistent with the indications that vendor performance continues to deteriorate.

This is important because inventory levels, as has been indicated, are still quite low by any objective measure. This is especially the case if we use what I think is more important in business-cycle forecasting analysis, namely, inventories at factory value as distinct from including the trade markups that we get in these data. Inventory factory value as a ratio to consumption, for example, is still low, and indeed it has not shown the level of uptick that we have seen in the data where there has been a disproportionate amount of retail inventory accumulation with a very large trade markup element in it.

This says in effect that even though accumulation is quite large at this moment, that is, production levels are quite a bit above consumption levels, we are going to need quite a long period of that type of accumulation before the economy slides off. While it is quite plausible that inventory investment may begin to slow over the next month or two, I find that quite unlikely. It is more likely that this investment will proceed for a while with some momentum. That is one of the reasons why the notion in the Greenbook that the upside risks are larger than the downside risks in the forecast strikes me as plausible. That is not to say, however, that what we are looking at is a runaway boom. The reason is that when inventory investment builds up rapidly, even though the levels of inventories may be low, it is difficult to sustain very large inventory investments that result in significant increases in inventory/sales ratios or inventory/consumption ratios. At some point after we have gone through this inventory surge that I think may be in front of us--it may not all be behind us but it may be in the period immediately ahead--we are going to see that buildup slide off and the economy's growth slow down quite appreciably. That's what the history is. I think that the expectation that we will get very strong final demand rests in large part on how we view this pattern as unfolding.

Clearly, producers' durable investment is moving strongly. As Governor Lindsey pointed out, it does depend on what the profit numbers look like. To date, there is no evidence that profits are deteriorating. Indeed, we are still in a mode where Wall Street analysts are underpredicting the profits that are coming out. So, while I do think we are likely to get some slide in profit margins, right now those margins show no signs of declining. History tells us that when we are in this type of inventory environment with profit margins still strong, the decline--I might even say the slowing--is still an appreciable way off. That is, we are still an appreciable distance away from any actual decline in the economy short of one induced by a financial problem, in other words short of a crack in the financial system which I'll get to shortly. History tells us that the economy just continues to move until it wears itself out.

As a consequence, the general discussion around here, which is somewhat skeptical of the economy's slowing down very dramatically, strikes a familiar chord with me. I'm not sure, however, that I would dismiss the comments made by Governors Yellen and Blinder with respect to the pattern of monetary impetus because there is no doubt that that is a very relevant consideration. You can very readily, as President Jordan points out, get yourself into a notion where all you have to do is keep jacking rates up and finally you get it right. The trouble is that the process of getting it right historically has led finally to our knocking the economy off its perch.

I don't think that policymaking right now is very difficult. I think it is going to become exceptionally difficult when the expansion starts to slow, unit costs no longer get distributed over rapidly rising output, and price pressures begin to emerge as Governor Kelley's teakettle starts to whistle. We will be looking at a situation in which the growth rate of the economy is slowing down, while inflation is picking up. This is in the context, as President Forrestal raised it, of a cyclical rise at the end of a cycle, which is really the quite relevant consideration. We are going to be in a position where we are going to see the economy slowing and the actual inflation data picking up. And we are going to have to be able at that point to recognize that that's the tail end and continuing to ratchet rates up would be a mistake. But we are nowhere near that point as far as I can see at this particular stage.

I think that we are behind the curve, and that it would be plausible, as I infer from what is going on around here, to move rates up more than 50 basis points because markets have built in something close to 60. I think that creating a mild surprise would be of significant value; creating a very strong surprise on the up side would be more risky because the stock market, in my judgment, is still a little rich although off its price/earnings ratios of a while back. I would not want to argue that we couldn't break it down very easily. However, what bothers me about doing only 50 basis points is that even though the markets are saying that that is what we probably are going to do, I think we have to distinguish between what they are forecasting we are going to do based on our past behavior and what they think we ought to do. I suspect that while the majority think we are going to do 50, the vast majority will think that that is not enough and they will immediately price an additional 50 or more basis points in the December forward contracts. In my judgment, we would be risking--a low probability risk but a potentially very large outcome if it were to happen--a run on the dollar, a run on the bond market, and a significant decline in stock prices. This would be on top of a $750 billion paper loss as a consequence of the declines in bond and stock prices earlier this year. We would find out what a wealth effect can do to economic activity in a way that would make us really quite uncomfortable. So, I think that we have to be very careful at this stage and be certain that we are ahead of general expectations. I think we can do that with 75 basis points.

I don't know what that will imply about what we do in December. I think it puts December somewhere between no change and 50 basis points. I'm not sure I can say at this moment that I fully buy into the Greenbook's projection of where the funds rate should be. That will depend on how the markets behave. I would argue that at this point we should give serious thought to 75 basis points. If we do that, I think we can go to a symmetric directive. If we choose to do 50, I would argue that we should at least retain an asymmetric directive, but I must tell you that 50 makes me a little nervous. No, I take that back: it makes me very nervous and I would be disinclined to go in that direction.

MR. FORRESTAL. Mr. Chairman, you haven't mentioned the discount rate.

CHAIRMAN GREENSPAN. As I judge the Board's general view, a recommendation to increase the discount rate by 75 basis points would be approved. Implicit in that would be a recommendation that the full 75 basis points gets passed into the funds rate. The Board will be discussing the discount rate after this meeting. President McTeer.

MR. MCTEER. Mr. Chairman, in my opinion strong action is warranted today, but I don't think we should prejudge future actions. I, for one, particularly don't want to commit today to a series of increases that add up to 150 basis points and that will result in a hard landing as depicted in the Greenbook. So, I would support your recommendation for 75 basis points. I also believe that part of the justification for such an increase has to do with the weakness of the dollar in the foreign exchange markets, and I think it would be helpful if that is cited as one of the reasons for the action today.

As we go forward from today, I would bear some cautions in mind. One is that we shouldn't forget the lag. When we started tightening in February we were doing it for anticipated inflation reasons, not for current reasons and that still applies today. We can't fight today's inflation with today's policy. Another point to keep in mind is that policy already has tightened considerably more than the 1-3/4 point increase in the fed funds rate, both in terms of long-term interest rates and particularly in terms of the sharp slowdown in all the monetary aggregates so far this year; even the aggregates adjusted for stock fund increases have slowed considerably. I just think we should keep that in mind.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, I agree with your analysis and your recommendation. I also agree with the points that Governors Yellen and Blinder made earlier. I hope that we won't go 150 basis points, because I think your analysis was on the money. The question I have to ask myself is how best to avoid that. I think the best way is by going 75 today. Frankly, I think if we go 50 today, we are going to be locked into doing 50 in December. I agree we can't prejudge the next meeting, but I support 75 today in the hope--and I must say the expectation--that December will be 0.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I'm in full agreement with your recommendation, Mr. Chairman. My comments earlier were fairly strong and I'd like to put them in context. First, I agree with the comments that both Governors Yellen and Blinder made that monetary policy lags being what they are, we won't see the full effects of what we have done already and certainly what we may do today until 1995 and early 1996. However, I do believe that the labor markets and other data we have gotten today continue to indicate that we have overshot. I fear, along with Governor Lindsey, that if we move too slowly, underlying growth rates, which we have consistently underestimated all year, will cause significant overshooting. In that case, we might find it necessary to pull even harder on the monetary reins, perhaps in the aggregate moving the full 150 basis points or more, and create a real hard landing. Thus, I believe we should move now, move more strongly than the 50 basis points everyone expects, go to the 75 you have recommended, and I wouldn't care to predict anything about December. I'm hopeful that we will be able to rein in the strong economy and achieve a better and softer landing.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, since our last meeting, the economy certainly has shown considerable momentum and labor and product markets now appear to be extremely tight. I feel that if we don't act strongly, it seems likely that the economy will substantially overshoot its potential and that inflation will take on a rising trend. It seems clear that interest rates need to be raised considerably above current levels, and therefore I support your recommendation of a 75 basis point increase in the federal funds rate. Moreover, I would not be surprised if a further tightening in policy is necessary in December. Therefore, my preference would be for asymmetric language toward tightening in the directive. I would not want the press release to imply that there would be a pause in further action. While I am at it, since I am making suggestions, I would find any mention of the dollar as a rationale for the change a mistake.

CHAIRMAN GREENSPAN. I must say I personally agree with both of those recommendations. President Forrestal.

MR. FORRESTAL. I came into the meeting, Mr. Chairman, with a slight preference for a 50 basis point rise, but having heard the discussion around the table and your analysis, I am strongly in support of the 75 basis points. As I said earlier, I think that the 150 basis point increase suggested in the Greenbook is too much. I hope we can keep an open mind on that issue.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I agree with your recommendation completely. I am convinced that the sooner we move on this, the less we will have to move later. I am not at all inclined to say that we have to look to a 150 basis point increase at any time. Right now the 75 is before us; I think that it is a wise move. I also think we should make as little comment about this as possible, in line with what Bob Parry is saying in terms of the dollar or whether we should pause. I think it would handicap us needlessly.

CHAIRMAN GREENSPAN. I think that the preliminary view would be a statement that is pretty bland and promises nothing and doesn't mention the dollar. President Broaddus.

MR. BROADDUS. I support your recommendation, Mr. Chairman, and I would associate myself with both of Bob Parry's recommendations and yours.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I support your recommendation.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I support your recommendation also, Alan, based on what I have heard about emerging inflationary pressures and also the importance of credibility and the fact that if we have credibility, it will reduce the long-term cost of keeping inflation and inflation expectations under control.

Just a couple of comments on things that came up after my earlier comments. One is on the slow money growth. That's something that would ordinarily trouble me. I think I mentioned last time or the meeting before that in view of the very large monetary stimulus from 1991 through 1993, I am not as concerned as I would otherwise be. It is very difficult to evaluate when the effects of that stimulus will all be played out. I applaud Alan Blinder for trying to put numbers on it. I think we all know that if it were that easy to put numbers on the effects of monetary policy actions, we probably could be much more precise in setting policy. But it still is helpful in a directional sense to try to understand those things.

With respect to stop/go monetary policies and the risk of putting things over the edge here, unfortunately we don't have, in my view, a lot of inflation credibility. The time to correct this stop/go phenomenon and try to look through current developments is when we are in a "go" phase. In other words, I think it is much easier to correct by not driving the funds rate too low or stimulating the aggregates too much when trying to foster a recovery. If we try to fix it at this stage, because of presumptions about an inflationary bias of Fed actions, it really becomes very difficult to do that and maintain credibility. I agree with what you said before. At some point, we are going to reach a very difficult juncture, and we will have to make some tough judgments. But I think we are far from that point right now.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Earlier in the year when we knew that we had to begin to tighten, I think there was a case on real sector grounds that we probably should have moved by more than we did. I think you argued rather persuasively, Mr. Chairman, that we had a bubble in financial markets and that we had to deflate that rather slowly. Otherwise we could take a big hit. In hindsight, I think that was wise. We may have a similar bubble now in the nonfinancial sector of the economy. Sentiment and the outlook for the economy have improved. Inventories, as you have noted, are a positive influence on the economy. However, while we talked a lot today about financial markets and the foreign exchange markets, we talked very little about sentiment in the nonfinancial part of the economy. We run a risk with the 75 basis points of making a pretty big hole in that nonfinancial bubble out there. It is going to hit those in the nonfinancial part of the economy with a big bang; they are going to be quite surprised; they are going to think that either we know something that they don't know or that this move is going to bring about a significantly slower 1995. My own preference would be to go 1/2. If we had to go another 1/2 in December, I would go another 1/2. But just as we had to be careful about deflating the financial bubble earlier in the year, we have to be careful about deflating the nonfinancial bubble at this point.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I don't know whether or not 150 basis points is ultimately needed. It seems to me that that is fairly large, particularly in view of the monetary aggregates. I wouldn't want to prejudge. I do support 75 basis points, symmetric. It strikes me that 50 is not enough. I think the markets would be immediately looking for the next move, and we would be in that treadmill situation. A move of 100 basis points would be too much of a jolt. I do think we have to be alert to the question that has been raised about how much tightening is left in the pipeline and alert to the potential effects of the tightening in the pipeline. But we also have to be alert to the possibility that if momentum is greater than we thought, that pipeline may be getting flooded out.

CHAIRMAN GREENSPAN. Monetary policy insights by analogy are getting to be legend!

MS. PHILLIPS. I resisted analogies in my original comments, but I couldn't this time around!

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I support your recommendation with considerable enthusiasm. The New York Bank has had a recommendation in since November 3 for a 75 basis point increase in the discount rate. I am very pleased with that piece of it. I think 50 would be too little and 100, for the reasons that Ed Boehne suggested, would be dangerous on the high side. I believe that the symmetry is as important a part of your recommendation as the number. Janet Yellen's eloquent explanation put into economics what had been in the lining of my stomach and therefore was very helpful. But I do think deciding what we do in December at that time rather than prejudging it in any way now is very appropriate.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I can support 75 and symmetry at this meeting. Regarding outside expectations of what we are going to be doing, though, it looks to me like we are in a trap. Former Governor Angell was in Cleveland a couple of weeks ago giving a speech, and he said we will be at 7.75 percent on the funds rate a year from now. We have this world of traders and Fed watchers, whether they are 25 or 35, that seem to be persuaded like many people that growth reduces the purchasing power of money. As long as that is the perception, any output growth above around 2-1/2 percent or unemployment rate below something like the NAIRU is going to have these people calling for another 50, another 100, basis point increase. At some point we have to ignore them.

CHAIRMAN GREENSPAN. As I interpret them, I think the comments around this table support that. Governor Kelley.

MR. KELLEY. Mr. Chairman, I have had in mind an intermediate target, if not a final target, of about 100 basis points. The question was when and how to get there. I have been holding out hope that perhaps we would not have to go too much further than that. My preference would have been to do this in stately 50 basis point steps. I think that's the more elegant way to proceed. But I am afraid that that has been taken off the table. Your analysis for the 75 is persuasive, and I would no longer be that comfortable with 50. I also would favor symmetry.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. As I mentioned, it seems clear to me that some tightening of policy is needed to prevent inflation from accelerating, but I have strong doubts about the need for an additional 150 basis points. My guess is that it will take 75 to get the job done, and I can live with 75 basis points today. But on balance, I guess I would agree with Ed Boehne, and I would favor 50 today. I share his concerns. As Don mentioned, it worries me that in the absence of an announcement of the type we issued in August, 75 can backfire. Instead of simply flattening the yield curve and our seeing very little effect on long-term rates, a rise of this magnitude may raise market expectations both about the risks of inflation--because we are so concerned about it--and market expectations about the ultimate expected tightening that we intend here. I am concerned about the possibility that bond yields could rise more than the Greenbook forecast, which could provoke a stock market reaction. My own preference would be for 50 today, but I can live with 75 as well.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I also support your recommendation for 75 basis points on tactical grounds because it seems to me that the markets have been discomfited by our failure to respond recently. I don't think that that has done our credibility any good. I would reiterate, though, a couple of the dangers that other people have mentioned. At some point, there is a danger of overkill. I don't know whether 150 basis points in total is going to turn out to be too much or too little. On fundamentals, I think there might be something to be said for buying a little time to see when the presumably lagged effects of previous tightenings start to bite, or if they do. But because of the state of the markets and market expectations, my view is, as I stated, that 75 is fine for now.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I support the recommendation. Quite frankly, I came into the meeting thinking that a series of 50 basis point increases would be preferable for the reasons that Mike Kelley enunciated. I also felt that, coming from a business background, it is preferable for people in business to see us moving in a progression that gives a certain logic to the direction we are moving. I think this facilitates longer-term planning in business and makes it easier to operate in that type of environment. But I was persuaded by the discussion here today. I thought that Governor Blinder's and Governor Yellen's comments and their cautions were very helpful, and I think we should keep these in mind in the future. I do think that the mild surprise that was mentioned, at least in terms of the financial markets, will be useful now in sending a positive signal.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. I think all of us have experienced the following: You go into a hotel room and the room is too cold. You turn the thermostat up a notch. You go in the shower. When you come out, it is still a little too cold. You turn the thermostat up another notch. You then go to sleep, but wake up at 2:30 in the morning in a sweat in your bed. The classic mistake of monetary policy--and I am not talking only about the United States and I am not even talking only about the postwar period--is overdoing it. Overdoing it in either direction. The classic reason for this error, though not the only reason, is impatience in waiting for the lagged effects of what already has been done. It is very, very frustrating to wait just as it is difficult to keep our fingers off that thermostat when we are still cold.

Furthermore, one thing we know about the hazards of fine-tuning is that we really can't do fine-tuning. That means that when we are close to target we should be very wary of oversteering. I think that with 3 percent inflation and the economy right about at capacity we are in an awfully good position, and so we should be extremely wary about oversteering. I fear that doing 75 today rather than 50 may send us down an oversteering path. I want to be clear--it is not that I think a total of 75 more is going to clobber the economy into the ground. But it provides the setting and the jumping off point for where we go from here.

On strict macroeconomics grounds, a difference of 25 basis points today--between doing 50 and 75--is no big deal. You can barely detect it. The issue to me is the signal we send--the signal we send to the markets, the signal we send to people running businesses, who are thinking about their sales and therefore their inventories for the near-term future, and the signal we send to consumers about their expected near-term incomes. And this, as you know Mr. Chairman, is where I differ from your assessment.

I think the signal we send out by doing 75 today, although I can see that we are going to do 75 today, is that the Federal Reserve is more scared about inflation than the people out there thought we were yesterday, and that the Federal Reserve signs on to the Wall Street indictment that we are behind the curve. That will be correct because the FOMC does sign on to that view. Thirdly, we will signal that there is much more to come. I do not believe the market expectation after tomorrow will be only 75 more. I don't believe that for a minute. I believe Wayne Angell's 7.75 percent federal funds rate will be raised, not lowered, as a result of what we do today. Finally, I think it sends a signal that I find very unfortunate: that we can be led around by the markets. I don't want to send any of those signals. I'd rather follow the Kelley strategy. A confident, patient--stately did you say, Mike?

MR. KELLEY. Elegant.

MR. BLINDER. Elegant, that is, moving with thought and planning in increments of, say, 50 as necessary and as a central bank that is not behind the curve, that is not panicked by an inflation which is likely to tick up 1/4 point or 1/2 point or something like that, but as a central bank that is willing to prescribe moderately strong doses at intervals if the need is there. I think Don described it in his opening statement as taking a reasonably routine step and then waiting to see what happens.

I am worried for a number of reasons, as Ed Boehne is, about the signal that 75 sends. Don mentioned--I just want to underscore this--that the Greenspan Fed has never once moved the fed funds rate by 75 basis points in either direction. Not once. When this Fed has erred, it has been on the side of caution. When I was on the outside as a citizen, I always thought that was good idea. I would rather see my Federal Reserve err on the cautious side in either direction, and now that I am on the inside, I still think the same. This Federal

Reserve, under our current Chairman's leadership, has only once changed the discount rate by an amount greater than 50 basis points. This will be the first 75. The 75 now will make it--

CHAIRMAN GREENSPAN. More than 50 basis points in the funds rate?

MR. BLINDER. No, the discount rate. There was a 100 basis point change in the discount rate.

CHAIRMAN GREENSPAN. I am sorry, that's right.

MR. BLINDER. A 75 basis point increase now will add up to 175 basis points within a 6-month period, if you go back and add the other 50s. Since 1984, tightening has proceeded that quickly only once--in the period that I mentioned earlier between March 1988 and February 1989. There are several 6-month periods you can find within that period to get that pace of tightening.

Fourthly, I think this will be like feeding red meat to the bond market lions. They will chew it up and they will ask for more. A Federal Reserve that did 25, 25, 25, 50, 50, 75 does not look to an outside observer like it is about to stop. I think we will create what are already strong expectations that we are not about to stop. We will create, rather than diminish, expectations of more near-term tightening to come--with the potential that has for markets, especially the stock market. That's at the top of my worries about the surprise that will be created.

My personal preference is strongly for 50, for reasons similar to those Ed Boehne mentioned. The difference, of course, is that I have to vote. I thought hard about whether I should dissent on this matter, and I did not decide until last night. I finally decided that I won't, but I want to say why because it leads to a conclusion. I won't dissent because, as I said, the macroeconomic difference of doing another 25 basis points today is really quite small. Secondly, nobody really knows about market psychology. I don't pretend that I know. I said what I believe will happen--that this will be received adversely--but I certainly could be wrong. Finally, I think it is better to show a united Federal Reserve against the criticism that we are surely going to get for this move. But I just want to say right now that unless we receive some really surprising news between now and December 20th, I am not going to be prepared to go further on December 20th.

CHAIRMAN GREENSPAN. Okay, I propose that we move 75 with symmetric language.

SPEAKER(?). We may need a need a new word to describe 75 basis points in the opening sentence of the operational paragraph.

SPEAKER(?). "A lot"! [Laughter]

SPEAKER(?). "Substantially"?

MR. KOHN. I think it could be "increase significantly." The announcement will make it very clear what the Committee has in mind.

CHAIRMAN GREENSPAN. Yes, "increase significantly" instead of "increase somewhat," which seems clearly inappropriate.

SPEAKER(?). Just say "increase?"

SEVERAL MEMBERS. "Significantly."

MR. BERNARD. The proposed directive language is as follows: "In the implementation of policy for the immediate future, the Committee seeks to increase significantly the existing degree of pressure on reserve positions, taking account of a possible increase in the discount rate. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint or somewhat lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with modest growth in M2 and M3 over coming months."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
Governor Blinder	Yes
President Broaddus	Yes
President Forrestal	Yes
President Jordan	Yes
Governor Kelley	Yes
Governor LaWare	Yes
Governor Lindsey	Yes
President Parry	Yes
Governor Phillips	Yes
Governor Yellen	Yes

CHAIRMAN GREENSPAN. I'd like to adjourn this meeting for just 5 minutes so the Board of Governors can go next door and take up the discount rate question. Then we can come back and Peter will have the floor to answer questions after I make some brief comments.

[Recess]

Secretary's note: The Bank presidents were informed that the Board members at their meeting in the Chairman's office had approved an increase of 75 basis points in the discount rate, effective immediately for those Reserve Banks with pending increases of that amount.

CHAIRMAN GREENSPAN. I want to raise a couple of issues following up on what Peter Fisher said earlier and just open up the discussion to general comments. First of all, I understand that there were some questions about statements coming out of Madrid to the effect that the central banks would be playing an enhanced role in the G-7 process. What that basically comes down to is nothing more than the central bank deputies being involved with the finance ministry deputies in formulating the agenda for the meetings, and that actually is pretty much what was being done in any event. We central bankers have not in any way materially increased our interface with the G-7. Indeed, as best I can judge, and I may have indicated this before, there seems to be more concurrence in those discussions among the governors on the one hand and the finance ministers on the other rather than there being country positions. So long as that continues, I think that the central banks will have a very effective and important role in the G-7 process. Should it turn out at some point that we get involved in the politics of the finance ministers, then I think we had better give this very significant second thought. There is no evidence of that and certainly nothing of that sort was indicated or implied in the notion of increased central bank activities with the G-7. So, nothing has changed in any material way.

On the issue of intervention, we had some fairly interesting discussions earlier and I would like to lay some thoughts on the table that have certain implications for the future. I might add that, interestingly, my view about the way intervention works is something that Hans Tietmeyer and I happen to agree on. I am not necessarily speaking for the Bundesbank, but I am pretty sure that they would not be in severe disagreement on this issue.

First of all, I think there is a view in the financial marketplace that intervention is far more effective than it actually can be. The analogy I like to use is that irrespective of what people in the markets believe, we can set the federal funds rate wherever we wish to place it, and market trading, market activities of all sorts have no effect. There are people in the foreign exchange markets who believe that we as central bankers have the capability of doing the same thing to the exchange rate. A number of French financial officials clearly do believe that. A lot of commentators on the periphery believe that we central banks can fix rates where we choose. The truth of the matter that I think all of us have acutely recognized is that that "ain't the case."

As a consequence, if we were to announce what we are going to do with exchange rates in the way that we announce what we will do in the federal funds market, inevitably the financial community would be disappointed. The reason I say that is their belief that we can do more than we can; and when we do only what we can, they will necessarily be disappointed.

We have all concluded that the only way we can have an effect in the exchange markets on a short-term basis--because nobody believes that sterilized intervention can have any long-term effect--is to catch the markets by surprise. If in effect we catch them in a short position, it is very obvious that we can create a run-up in the exchange rate and indeed that has occurred on many occasions. There have been numerous occasions when we failed, when for one reason or another we either misjudged that the market didn't expect us to act or we felt that we had to act even though the market knew we were going to act in order to "show the flag" as the Treasury likes to say on occasion.

I think the important point, however, is that we succeed some of the time because, if we create a presumption that we might intervene, we establish an atmosphere on the part of a lot of traders, who wish to take short overnight positions against the dollar, that they should be a little cautious. Indeed, it does seem to be the case that when we have, in a sense, a dull but nonetheless a Damocles Sword hanging over the markets, that often will deter individuals from raiding our currency.

While I think we all to a greater or lesser extent believe in efficient markets, the truth of the matter is that sometimes they are not. There are periods when we get a confluence of forces driving down the exchange rate. Such a development may at times lead to market conditions that cannot readily be viewed as involving the functioning of truly efficient markets.

When we were negotiating with Treasury officials, who were concerned about the exchange rate weakness that Peter was discussing, their initial choice was to do a full blown, multiday intervention, multilaterally. We argued that we started off with one-day shots unilaterally, then one-day shots multilaterally, and now they were proposing multiday shots, multilaterally, and one had to ask where we would go from there. The argument that we put on the table was to mix it up because if the argument is that we cannot effectively do anything unless there is a surprise, we have to create some surprises. So, what we agreed to in this instance was that we would intervene unilaterally but would do so two days in a row. As Peter points out, there were some positive effects there. I don't know whether we stemmed the dollar's decline effectively, but clearly one has to chalk up certainly the first day as a success. The second day was actually, somewhat to my surprise, a mild success.

Let me just say that as best I can judge, and obviously I can't read peoples' minds, I don't think that the issue was the upcoming election at that point. It is possible; I obviously can't argue against that, but Larry Summers' recommendations were wholly consistent with his previous positions. In my judgment they had no bearing on whether or not there was an election coming up. That issue did come up in the news media, and I must say that I find no evidence or basis to support the media speculation.

Larry Summers, and it is possible the Secretary at this stage, is still concerned about the dollar and thinks that we should be doing something more. I believe they would like to see how the outcome of this meeting gets reflected in the market, but they still would like at least to discuss the issue of doing a multilateral, multiday type of intervention. We said we would be glad to discuss that with them. We have made no specific commitments, but I think it is important for the Committee to know that that issue is on the table and it will be discussed. It is important to know what the Committee, which authorizes the actions on the part of the Fed in this regard, has to say on this question before we go into discussions with the Treasury. But before we go to anything else, I do think we owe Peter a chance to answer some questions after which we are going to have to take several votes for the record. Now, let me open the floor to questions to Peter. [Pause] I do not believe that silence!

VICE CHAIRMAN MCDONOUGH. I have a question.

CHAIRMAN GREENSPAN. Why didn't you ask him before!

VICE CHAIRMAN MCDONOUGH. Was the second-day success the result of the sheer brilliance of the operation? Just say yes. [Laughter]

MR. FISHER. This is kind of the reverse of a beating-your-wife question!

VICE CHAIRMAN MCDONOUGH. Just say "yes;" that's enough!

MR. FISHER. Yes! I'll mention one thing, Mr. Chairman, that relates to the commentary earlier by Governor Lindsey. Maybe this will inspire questions from those who are reluctant to dig in. I recognize in your comment the idea that intervention takes place and it seems to box in the Committee; the bridge had better go somewhere. I think both in the way you pose that and in other remarks at previous meetings, one has to say "compared to what?" We don't always have the counter-factual of what would have happened had we not intervened. I think the hypothesis I worked with and why I thought it was a good idea to intervene was the risk of an extreme event--that in early November the dollar could have dropped another 3 percent rather quickly. The range could have dropped to the mid-140s on the mark and to 94 to 96 dollar/yen. The market would have interpreted that move as entirely related to the inaction of the Fed. I think the Committee could then have found itself at this meeting in a very different kind of box, one that you would have liked a lot less. It would be a box that is much harder to get out of, one that was similar to the box in which the Committee found itself in July where to do anything plausible or reasonable on interest rates would have looked very bad from an exchange market point of view because it was not going to be adequate. That is, the reasonable change in fed funds for domestic policy purposes would look like a sop to the exchange market. That is not a counter-factual thing one can put one's hands around, but one has to think of what the counter-factual is to devise recommendations --whether the risks are leading one to think it is a good idea to intervene versus not.

MR. LINDSEY. There are two counter-factuals: One would be not intervening and having something happen at this meeting; the other would be intervening coupled with a monetary policy change at the time. That's one you did not mention; that's in fact the one I recommended. Had we done that, I think we would have been in a much better position; we would have been at 50 instead of 75. I think we would have signaled a policy change that is at least intellectually consistent with what we all believe.

CHAIRMAN GREENSPAN. As I have done in the past, let me argue against the use of monetary policy to achieve exchange market objectives. I am not necessarily referring to this particular instance, but this is something I think we have to be aware of. Often when we have a weak currency, we are looking at significant portfolio adjustments. Often we are looking at correct or incorrect views of differential rates of return between two currencies, not only in interest rates but also real estate, the stock market, all of those things. What history seems to tell us, especially if we look at something that may be an extreme example here--the breakdown of the EMS--is that the types of expected differential rates of return are something like maybe 10 basis points a week. That's 500 basis points or more at an annual rate. I am concerned that if we run into one of those situations and we hit it with 50 basis points and it turns out that we needed 300 basis points, the central bank is caught in the dilemma of whether or not to keep moving the rate. I must say that it is tough to envisage our doing that because then we would basically subvert domestic policy to the exchange rate, which I think none of us, yourself included, wants to get involved with. I am not saying that if we had done 50 basis points, that that might not have an effect if in fact the expected differential rate of return between, say, the deutschemark and the dollar was only a few basis points. Yes, it would have worked, but I'd be terribly worried since we have almost no way of making that judgment. We have to worry basically about getting ourselves into that process and finding it very difficult to extricate ourselves once we are there. So it is a high risk operation.

MR. LINDSEY. There is no question that we have no way of making that judgment; that's what markets are for. That's why I think it is inappropriate for us to take on the job of guessing at some point that the market is oversold and now is the time to plunge in. The Sword of Damocles would hang. I agree that markets are not always rational. When those players who behave irrationally are punished by losing money, the people who hold the Damocles Sword and wield it effectively are rewarded by making money. That's how those markets work. We are putting ourselves in that position. So my first choice would be for us not to intervene. But I think we have to think about this from a public choice perspective. Right now, it is absolutely costless for the Treasury to decide to play with what former Vice Chairman Mullins used to call that "little toy in the closet." We all wrote papers saying we should never use it, but when we get in the position of having it, we just can't stop ourselves from using it. If we are going to intervene, I think that we gain two advantages by having our general posture be that the intervention be coupled with a monetary policy change: One, it is at least intellectually consistent; the intervention may work, but then again it may not work. But secondly, it creates a price for the Treasury.

CHAIRMAN GREENSPAN. Let me just say that I don't deny that there should be a relationship. It is just that if it is tying monetary policy directly to the exchange rate, it locks us in. To have it in parallel paths or somehow related, I think the answer is obviously yes.

MR. LINDSEY. Let's not admit it to the world. But when the phone rings in your office, if you have behind you the view of this Committee that a monetary policy change will ultimately accompany an intervention, you will have a weapon supporting you in the view that I think you really hold, and that is that intervention should be used rarely if at all.

MR. BLINDER. We don't have to exercise it.

MR. LINDSEY. We don't, but I think we should have that as the Chairman's weapon.

CHAIRMAN GREENSPAN. Other comments, questions?

MR. LAWARE. Are we saying that dollar/yen is an interest rate phenomenon?

CHAIRMAN GREENSPAN. Differential rates of return. In other words, if most of the exchange rate moves these days against the dollar are the result of portfolio shifts rather than, say, current account deficits or flows, then the question is why do people change portfolios? And the answer is that the risk-adjusted rate of return is perceived to be better in one currency versus another.

MR. PARRY. There may be times when what you want to do for monetary policy purposes is consistent with what the Treasury wants to do to affect the exchange rate. I have difficulty relating that to what Governor Lindsey said. It sounds like he wanted a tool for all time for you to put in the closet, and I don't understand that. This Committee will have a view about what is appropriate monetary policy. It may be that today it would be consistent with what the Treasury may want to do, and that's good for today.

MR. LINDSEY. In point of fact, we had a view; we stated it in our asymmetric directive. It was quite clear what this Committee wanted to do. It was quite clear that that was consistent with an appropriate action if an intervention occurred. And I will stipulate that the Committee's view may vary from time to time.

MR. PARRY. Right.

MR. LINDSEY. My precise recommendation at the last meeting was that because foreign exchange markets were likely to be unstable, that we go asymmetric and have a 50 basis point move as our explicit price for intervention. I think that was quite appropriate. I think that that would be the right kind of message for us to send in the current environment if a multilateral move or any kind of intervention were to come up in the intermeeting period.

MR. PARRY. So the trip factor would be a request for intervention. When we have asymmetry, what we are assuming is that we or the Chairman will be looking at a set of data that will lead him perhaps to request a rate increase. Are you saying that there is one development we are going to focus on and that is a request from the Treasury to intervene?

MR. LINDSEY. There may be other reasons to adjust monetary policy, but it should be clear that there is a price associated with intervention. There is a monetary policy change that accompanies our intervention.

MR. BROADDUS. I wonder if I could put another alternative on the table--that we not intervene at all. I realize that there are many people on the Committee who would disagree with that because they think that, at least in a limited way, intervention may be useful from time to time, and I certainly respect those views. But I have to tell you that I personally have very serious reservations about the wisdom of our continuing to intervene. Whether we renew the swap lines is relevant to this discussion, because in many ways the swap lines facilitate these operations and make them more convenient. I'll be brief here, but if I could just go through the way I see this at the risk of some repetition. As you said, Mr. Chairman, it is now widely agreed that sterilized intervention doesn't have any sustained impact on exchange rates unless it sends a signal that we are going to follow it up with a monetary policy action. This implies, for me at least, and this is really the heart of the matter, that it is not really possible for the Fed to maintain a truly independent monetary policy for an extended period of time while following the Treasury's lead on foreign exchange policy. Now, of course, in reality the way I see this is that we have maintained our independence by not making a commitment to follow interventions with monetary policy actions. But that's not a perfect situation either. I think it is a problem because of the possibility that these operations will not be successful. Of course, back in June we had an operation I think most people would agree was not successful. That really bothers me from the standpoint of credibility because when we participate in an operation like this and it is not successful, we get associated with that result. Specifically, we lose credibility. It is adverse for us from the standpoint of public perceptions about the central bank and what we can do. I think that can reduce our effectiveness over time in conducting monetary policy generally. It is an important issue; it is a broad issue. Again, I would respectfully submit that we ought to consider withdrawing from these kinds of operations, maybe not immediately but gradually in some way. This is a side point: If we did that, we would not need swap arrangements. Frankly, I would oppose renewing the swap arrangements this morning. Let me say that I am not opposed to or saying that the U.S. Government should never intervene in foreign exchange markets. I am simply saying that I don't think we should participate except perhaps as the Treasury's agent.

CHAIRMAN GREENSPAN. You are raising an interesting question. The dilemma we have is that if we withdraw and act strictly as an agent, we then lose any voice in altering or casting the structure of the policy that they would like to implement. The points you are making, Al, are quite to the point; I don't disagree with that. The question that we have to trade off here is, do we wish to remove ourselves from any influence on how these things are done? In my experience, because we are involved in the discussions, we have headed off a lot of actions that I think would have been detrimental, more so than what we have done. There is unquestionably the problem that we are not the final voice on that; legally they are. Nonetheless, we do have a de facto veto if we wish to use it, and the reason we do is because we participate in those discussions. We have to choose whether we want to lose what is in my judgment a very valuable asset in tempering what the Treasury Department does. It is not a simple tradeoff. If you are asking me, do I disagree with the way you have put it? I personally don't. I think that the question really gets down to, are we as a nation better off with our participating in these deliberations, granted at some cost to the Federal Reserve? I have argued that, yes, looking at it from the national point of view as distinct from the Federal Reserve itself, I think we are better off. That's the way I come out, and it is one of the reasons I have supported this type of operation.

MR. BROADDUS. Well, again, I just worry about the credibility effect. I think there is a negative there and I guess I see the tradeoff differently. Obviously, I have no personal experience in this and I respect your views. But is it the case that we would have no influence whatever in these discussions if we were not participating directly?

CHAIRMAN GREENSPAN. Yes, ultimately, I would say, if we decided to bow out. In other words, you can't be half in or out. Either we are acting as an order taker, which is strictly as the agent of the Treasury, or we get involved in the discussion. We either have to cut our participation completely and have Peter act as an order taker with no conversation except what he might say as a broker--don't do it now; the market is closed. [Laughter]

SPEAKER(?). If the System is not participating in these operations, that's going to have some effect in itself on the way the Treasury views the operations--

CHAIRMAN GREENSPAN.

MR. TRUMAN. I think that is the point, President Broaddus. Ultimately, we can and have declined to participate. There have been occasions--I am referring to a long period of time--when we have declined to participate. The suggestion that we are not going to participate can be a significant brake on the enthusiasm of the Treasury--of all the Treasuries that I have had anything to do with over the years--partly because the norm for the last decade or so has been that almost all operations are joint and all are on a 50/50 basis since we have roughly the same amount of reserves. If you said, Peter is just their agent, the quality of our advice would probably be unchanged, but the consequences of ignoring it would be substantially reduced compared to current circumstances where ultimately it becomes known via the Manager's reports whether the Federal Reserve was part of the operation.

MR. LAWARE. Al, I would argue that we can't withdraw from it completely because part of our statutory responsibility is the stability of the financial system. I can envision a situation where the foreign currency markets were so disorderly that they were a threat to the financial stability of the country. I think that to take us completely out of that would be a mistake. Now, the problem is how to define a disorderly market; who makes the decision whether it is disorderly; or whether, in fact, for whatever purpose, we are trying to peg or stop a decline in a rate relationship. But I don't think we can get out of it completely. I would like to see us, as a matter of internal policy, limit our participation to those situations where we have a disorderly market and where we define what is a disorderly market.

CHAIRMAN GREENSPAN. That's practically what we try to do.

MR. LAWARE. Yes.

MR. BROADDUS. I guess I think if we are out of these operations, there is less chance of disorderly markets. [Laughter]

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. I think we have to talk as a practical matter about how we would go about this disengagement. At the present time, the Federal Reserve Bank of New York operates as the agent for the U.S. monetary authorities, which means the Federal Reserve and the Treasury. The way the conversations take place is that the Desk, Peter and his colleagues, are the technical advisors.

Typically, the people at the Treasury talk with Ted; they talk with me; they talk with the Chairman; and sometimes they talk with other members of the Board as well. They get our advice and they pay a great deal of attention to our advice. It is very, very rare that if we really say you should not do it that they do it. The last time we didn't participate in an intervention was in February 1992. The fact that we have that threat can give us some additional leverage with them, although I think it is not something that one would wisely use very often.

If the Federal Reserve were to decide to disengage itself from being part of the U.S. monetary authorities for foreign exchange purposes, we would have to announce that to the world. We can't just let it slip out. That would impress me as saying that the Federal Reserve--at the risk of some backslapping to this wonderful institution, it is a part of the U.S. public sector that is universally highly regarded outside of our country, sometimes even more than the Administration of the day--would be seen by the world as retreating into a kind of Fortress America. That, I think, would be a terrible signal to give. It would be a great disservice to the American people and a great disservice to financial stability in the world. Our ability to have these operations done at sensible times and in a sensible way is very great, which obviously brings upon the Federal Reserve in general and the Chairman in particular an additional amount of responsibility. It is a serious burden, but I think one that we really have no choice but to accept and carry forward. There is no question that if we undid the swap lines, it would be mainly a signal to the world. We haven't drawn on the swap lines since the 1970s, if I remember correctly. They are much more symbolic than real. But if we wanted to say to the rest of the world that we are beginning a retreat into Fortress America, it would naturally be through the swap lines. It is the classic case of the dog that didn't bark in the night. When we renew the swap lines, it is such a routine matter that nobody pays any attention. If we didn't renew the swap lines, it would create an international hoopla of very considerable seriousness and, I think, a very negative one.

CHAIRMAN GREENSPAN. We haven't used the swap lines. Indeed, all the intervention that has taken place has been profit-taking, because we have been selling off our deutschemark and yen reserves. President Jordan.

MR. JORDAN. Mr. Chairman, this to me is an exceedingly difficult issue and not one that this central bank or any central bank in today's world can solve by itself, whether by any unilateral declaration by us or even all the central banks. Both your initial remarks and your response to Al's comment, I think, highlight what the problem is. Since August 1971, this country has not had a policy toward its currency; it has had a sequence of policies, and sometimes they are consistent internally and sometimes externally. Therein lies the problem. It is not just the traders who don't know that sterilized intervention cannot produce results inconsistent with domestic monetary policy, but sometimes members of executive and legislative branches of the government, ours and other governments around the world, don't know that. The hazard comes from having the power to do these things in the context of outside expectations, that we do not share, that they will work. I remember being told that when President Nixon was confronted by his advisors--some of the outside people--about the issue of wage/price controls, he said: I don't believe in controls; I know they won't work; and you don't believe in controls; you know they won't work; but the people don't know that. And so we got controls.

In the late 1970s, we had a policy toward the currency externally that was inconsistent with what at least I would want for domestic monetary policy. Earlier in the 1970s, as we were thrashing around for a policy, the Open Market Committee had a number of debates on the issue. At one point, Arthur Burns made what I thought at the time was a pretty effective argument, that the only way to be certain that you absolutely have to intervene is to declare you are never going to intervene and you will get some asymmetric bets in the foreign exchange markets. If you want to be in a position where you don't have to intervene in this institutional setting, you have to declare that you are willing to intervene massively and often to burn speculation and so on. It reminds me of Charlie Coombs' beartrap arguments. In the early 1980s, the Treasury tried out the idea of declaring unilaterally that we would never intervene. However people viewed that experience, the Treasury Department abruptly changed our currency policy at the beginning of 1985 in association with the Plaza Accord and the Louvre Accord and all of that. It is troubling to me that nothing has changed institutionally. In going forward, we can again find ourselves in a position with an executive or a legislative branch view that we can or should have a policy toward our currency in the international markets that is incompatible with what this Committee thinks is appropriate for domestic markets. We ought to attack that policy issue as something that our government in its totality needs to address.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I think that if we were to withdraw in that way, it would create a wound that could very easily be opened at almost any time. It would indicate a continuing disarray in U.S. financial management to any serious observer, official or private. I think it could have very deleterious consequences in an ongoing way and in ways that would be impossible to foresee. There would always be a question about where U.S. policy was and where the Federal Reserve was relative to the Treasury. Furthermore, I think that frankly it would be a display of unseemly arrogance if the central bank were to walk away from its Treasury in that manner, essentially being seen as thumbing its nose at the government or maybe holding its nose. I just don't think that that would sit well with other governments; I don't think it would sit well with the Congress. We see ourselves as wanting to be independent in managing monetary policy for very good reasons, and I don't want to poison the well for the wrong reasons. I am afraid that would do it.

MR. LINDSEY. I am very sympathetic to that point of view. I don't think that in practice we could withdraw. On the other hand, I also know that we have a Treasury that likes to intervene more than we would like it to intervene. What I would like to do is give you, Mr. Chairman, an extra weapon to say "no." The only extra weapon that I can think of, the only extra bargaining chip that we can give you, given that I don't think we can do what Al wants and given that we are intervening too much, is the implicit threat that we will view the price of exchange rate intervention as being an interest rate change.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I used to comfort myself with the observation that since sterilized intervention really didn't affect anything, it probably really wouldn't harm anything either, a sort of a no-harm-no-foul kind of rule. But I have come to the conclusion that sterilized intervention does have some cost. Al just cited the credibility issue. Also, I am observing that this Committee has a lot of discomfort with these operations. I don't know where that goes beyond what we are already doing in the sense that we probably ought to keep these operations to a minimum to the extent we can, unless we believe that for monetary policy reasons we are going to do some unsterilized intervention; that's a different story. Also, I would say that I think this discussion is helpful. More communication about what we are doing and why would be helpful. When we do get involved in intervention, it is very hard from time to time to understand exactly what prompted it on that occasion when it didn't prompt it on other occasions. Sometimes, there doesn't seem to be any particular pattern or rationale. I would certainly feel more comfortable with it all if I knew what it was about the circumstances in question that prompted the action.

CHAIRMAN GREENSPAN. I want to call on Ted because Ted has been around here in this area longer than all of us put together. I am curious as to how he would respond to this.

MR. TRUMAN. On the communications question?

CHAIRMAN GREENSPAN. No, on this general broad issue--the principles, which you infer, that various Treasuries have employed over the years.

MR. TRUMAN. I think President Jordan is absolutely right. In a sense, we are suffering from the fact that various Treasuries have had a sequence of ad hoc or at least temporary policies for our currency. I think that relates both to the international value and the domestic value. Those two things are bound up and are inherent in the discussion that we had earlier this morning about whether the foreign exchange value of the dollar in part should be an overt target for monetary policy. Given the current way things are structured in the U.S. government, it is difficult to predict where a particular Treasury or Administration will be on this matter. Administrations do change and it is, unfortunately I think, an area where personalities, or maybe I should say philosophies, matter to a somewhat surprising degree. The evidence on the effectiveness of intervention is mixed, but I think the academic profession would say today that the pendulum has swung back somewhat on the question of the effectiveness of sterilized intervention, and not just through the signaling channels connected to monetary policy but also the signaling channels connected to other policies. I think it is fair to say that, as on many other issues in economics, experts lie all along the spectrum. [Laughter] I think that's right. I have felt that over the years the Federal Reserve has on balance been a very positive force in trying to modulate the excesses of various Administrations. It has not always been easy and often the Federal Reserve has found itself leaning to one side of the boat because the Administration or particular people in control of the Administration were leaning to the other side of the boat. This has involved a certain amount of moving from one side to the other, though I think the basic objective has been to make sure that if the instrument is used, it is used sensibly, not overused, and one does not exaggerate its effectiveness or ineffectiveness.

To comment if I may on Governor Lindsey's price message, that is certainly in one set of circumstances something we do and have done implicitly in one form or another. There is another side to it, if I may go back to the late 1970s. The way I saw the heavy intervention in that period, which was promoted by the Administration at the time, was that that was the device which in the end was needed to convince the Administration that what they saw as bitter medicine had to be taken in October 1979; it was necessary. It took 18 months to convince the various people in the Administration, as well as maybe some people within the Federal Reserve, that that was necessary. It is difficult to come to the question of disorderly markets narrowly defined. I don't want to get into this. I think you might not want to use monetary policy, so that it would be only a club in the closet under the right circumstances. I think the various German and other officials who have been involved with us have used it that way.

One further comment: I haven't gone back and checked the record precisely, so I apologize if I go back and find that I am mistaken. I would not characterize this Administration as being particularly trigger-happy in this regard. They have intervened relatively few times. Aside from the Administration in the period of the early 1980s, they are probably the least active. The one difference of strategy that the current Administration has followed, consistent with what the Chairman has said and probably not accidentally, is that when they wanted to operate, they have wanted to operate in significant volume to get the market's attention. Governor Mullins commented at one point that one could view intervention to some extent as a type of circuit breaker in the market. If you hit the market hard enough, it forces the market to stop under some circumstances and it gives the market the opportunity to stop and say: Do they know something we don't know, which could be monetary policy or a variety of other things? In order to do that, you need the right scale of circuit breaker to get their attention. I think this Administration has tended to be much more deliberate in its policy of wanting to operate on a larger scale. But in terms of the number of days of operations, they have tended to be toward the lower end of recent experience. We are less than two years into the Administration and all this could change, but that's something I wanted to point out.

MR. JORDAN. I have a reservation about Larry's suggestion about the linkage of a visible domestic policy action tied with intervention promoted by the Treasury. That's because of the asymmetry that would be involved if we were to get into a world where confidence shifts around and capital flows were starting to put some very substantial upward pressure on the U.S. dollar. If we had a Treasury that decided they wanted to rebuild the cookie jar or the war chest, I certainly would not want to couple cuts in the fed funds rate with their mandates to intervene in the opposition direction.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I am sure it is no secret to the Committee that this kind of a debate

They know very well that there is not wild-eyed enthusiasm for intervention on this Committee. In fact, that they know that is a very helpful tool for us. We don't need that you are describing; it is already there.

MR. BROADDUS. Can I just make one very quick final comment, and I appreciate you letting me make my other comments earlier, Mr. Chairman. Let me just say that I am not a Fortress America guy. I don't want to be arrogant, but for me one of the highest priorities we have is always to protect our independence in the conduct of monetary policy. My only concern here is that intervention activities threaten that at least to a degree, and it is very, very difficult to fine-tune it. That's the key point from my standpoint. I hope that that will be very much in our minds going forward with all these operations.

CHAIRMAN GREENSPAN.

I have certainly heard all the arguments here and I must say that I have great sympathy. My own view is that I wish Treasury wouldn't do it and I wish we wouldn't do it. I think that would solve a lot of problems because I am not convinced that that's the way to stabilize our nation's currency. I don't deny that there are occasions where intervention actually does stabilize the market. The trouble is I can think of situations where intervention destabilizes it. I am not sure that one can argue that there is a net advantage to intervention. Nonetheless, we do have very practical difficulties, which I think a number of people around this table have indicated. This far along in the process, post-1971, we would create some very extraordinary events if we were to endeavor unilaterally to pull away from this sort of activity. So we are going to be involved in it and as a consequence, we are going to need Committee authority on occasion. I'd like Ted to raise the issues that are involved here in the event, for example, that we get into these discussions with the Treasury and they come up with something that we find not fully unreasonable. That's an odd way of putting it, but that's the way it comes out and I will ask Ted to outline some of the issues.

MR. TRUMAN. Maybe I'll just add one footnote to the history before I pick up on your comment. After 1971, of course, we did not intervene for quite an extended period of time--March 1971 to July 1973. It was Arthur Burns and President Hayes who essentially prevailed upon the Treasury to take that small instrument out of the closet. It may have been a big mistake but that was what happened. That's just one example of where, for better or for worse, this Committee at that time found itself quite supportive of intervention because it was a question of caring about our currency, at least that's how it was perceived. As Governor Blinder said earlier in the monetary policy discussion, we are dealing in an area where we can sometimes prejudge perceptions with great confidence.

As the Chairman said, the Treasury has talked about a multinational, multiday operation that would be relatively small in scale at least by historical standards, but where we might operate successively for 3 to 5 days. We might imagine the U.S. authorities thinking in terms of a budget, if I may put it that way, of $6 billion of sales, half of which would come from the System and half would come from the Treasury under normal procedures. If we did that, we would as a technical matter have to come to the Committee for clearance to increase the limit on the change in the System's overall open position during the intermeeting period. The limit is now set at $1-1/2 billion. The clearance would be for a larger reduction in our overall open position. The clearance is needed regardless of the direction we are going. We would raise that--up to, say, $3 billion so that we could accommodate this type of operation. I guess the only procedural matter would be that if events over the next few weeks lead the Chairman to think that that is the right thing to do, we would come to you to get your clearance. This is not, as technical matter, a vote; it is a procedure that is partly designed to meet, though maybe imperfectly, the Committee's desire--a desire reiterated by President Stern earlier--to have some degree of communication about what we are doing, maybe not why we are doing it. It may provide opportunities to ask why we are doing it, as has happened in some of our conference calls. It is a mechanism that has been set up both to keep this Committee informed and to review these matters. After it is all over, you can review whether it was a success or failure or why it was a success or failure. Procedurally, it does put everything on the table.

CHAIRMAN GREENSPAN. Yes, let me raise one additional issue here. You may recall that in an earlier discussion, you were looking for ways to restrict the size of our operations. You wanted to try to disgorge some of our foreign exchange reserves. When we intervene in support of the dollar, we are moving in that direction. We are squeezing down our capability of acting and squeezing down the whole operation. I am not sure the Treasury thinks this way, but there really is an asymmetry here whereby we should be more resistant about actions in which we are buying foreign currencies to support them because that expands our reserves. Whereas were we to do anything to support the dollar, even if it failed, we would accomplish something--namely we would reduce our foreign exchange reserves.

SPEAKER(?). And at a profit.

CHAIRMAN GREENSPAN. Yes, at a profit. Governor Lindsey.

MR. LINDSEY. It sounds to me that you are saying that we are acting in order to restrain our ability to act, and I am not sure that that makes a lot of sense. Ted referred to opportunities to discuss proposed operations in conference calls. Now, one of the great beauties of the U.S. Constitution, which makes our foreign policy adversaries furious, is the Senate's right to say "no." My real question for Ted is: Do we have the right to say "no"? If we had that right, in other words if actual vote approval of this Committee were required, the sticks in the closets would be quite numerous and that might be quite an appropriate move. If it is just to notify us and have us ask questions, I think that's a different issue.

MR. TRUMAN. This is obviously a matter for the Committee to decide. The historical antecedents of the procedural instructions were in fact to provide greater restraint on our interventions than had existed. For example, on the domestic side there is a limit on the intermeeting change in the System's overall holdings of U. S. government and Federal agency securities, but that limit is very substantial and is occasionally raised. On the foreign side, the procedural instructions are written the way they are because it is also judged that in some circumstances--given the international nature of these discussions since they don't just involve the United States Treasury but often at least two or three other central banks--they should provide the Chairman with some degree of flexibility to act on behalf of the Committee as long as it is consistent with the foreign currency authorization and the foreign currency directive. We have subsequent discussions and provide a way for the Committee to be informed--in contrast to the situation that existed before 1976 where there could be very large operations and, unless the Committee members kept score as they went along, they wouldn't know how much had been bought and sold until the next Committee meeting. The existing procedural instructions are designed that way, but you can change them. On balance, I think they work pretty well, but obviously there has been a range of views on all the issues in that respect. I think one of the purposes of having this discussion was in fact, as the Vice Chairman said, in order to give the Chairman some basis to have further discussions of this with the Treasury and other central banks.

MR. MELZER. Alan, just getting back to what you said earlier, my worst fear about what I just heard was that it may work the first time [Laughter] and give some people confidence that that can be a substitute for getting the fundamentals right. I'd just pick up on something you said earlier. Maybe the secret is to keep some variety in here. I'd hate to see us get into a mode where there was some perception that it would be appropriate just because it worked once. The markets are so much bigger than we and all the other central banks put together are. Once it becomes known as a mode of operation and the surprise element is gone, I don't think it could work on a sustained basis.

CHAIRMAN GREENSPAN. I think that's absolutely right. Peter Fisher.

MR. FISHER. I just wanted to add a footnote to your comment, Mr. Chairman, about taking the profits on the long position. One of the things that people in the market do focus on is that the accumulation of reserves since the late 1980s implies asymmetry in the U.S. appetite for intervention. That is, we are more prepared to hold down the value of our currency than we are to defend it. That in itself is a major market negative among the analysts who look at our behavior. That's not a particular reason to intervene on any day or for any kind of operation, but it is a reflection of the negative market sentiment about the U.S. authorities in general.

CHAIRMAN GREENSPAN. Any further questions, comments? Yes, Tom.

MR. HOENIG. I don't have a question. In terms of this conversation and where it has drifted, I am not quite sure what we are deciding here, but--

MS. MINEHAN. Yes.

MR. HOENIG. What I understand, Mr. Chairman, is that we have been operating in a very restricted way in the sense that if there is a disorderly market or some other fundamental development, you and others come together knowing that this Committee is generally reluctant to intervene. But it depends on circumstances and the proposed intervention is thought through pretty carefully. I assume that's how we are talking about going forward from here. If it is, I feel comfortable with that. If we are talking about changing to large, multiday operations for different reasons than this limited context, then I would have trouble with that.

CHAIRMAN GREENSPAN. No, I think that's right. I agree with that. My own personal belief, I think, is probably fairly representative of this Committee. If anything, I might be more, if I may put it this way, on the hawkish side in this question. But I recognize that we have very important responsibilities. I think it is crucially important for the Federal Reserve as an institution to be a player here. I think basically that is what Governor LaWare and Governor Kelley were saying.

MR. TRUMAN. Let me come back to where you started the discussion with one question that has been kicking around for weeks--whether we should do something not routinely larger but nonroutinely larger in the interest of varying the tactics. I see some heads going this way around the table but, of course, that's one risk. I think the other view of this matter has emphasized that one risk we see is if we do it once, it might become a bad habit. But depending on how the market reacts to developments over the next several days or weeks, a possibility is that we might have an operation that is a little larger in scale and a little bit more sustained as a way of varying the pattern of behavior but not necessarily something that would become a new pattern. I just wanted to make it clear that--

CHAIRMAN GREENSPAN. Let me put it this way. If it is done, it would be a one-shot thing because if we ever try to do it a second time, it would fail. That is what would happen.

VICE CHAIRMAN MCDONOUGH. Nothing is more sure than that.

MS. MINEHAN. It would be in the face of disorderly markets, right, Ted?

MR. TRUMAN. I think I have been around too long to be able to give you a precise definition of what is a disorderly market.

MR. MINEHAN. I know you can't, but we wouldn't just do it to prove we could do it.

MR. TRUMAN. Let me try to do what I just said I can't do. Disorder to some extent is in the eyes of the beholder. Sometimes we have a situation where the dollar is weaker than the fundamentals would justify. Sometimes the weakness has to do with market conditions. Both situations have been used. Although I know there are preferences for being more precise, there also are preferences for being less precise.

MS. MINEHAN. I think there is a distinction to be drawn. I thought the November 2nd and 3rd interventions were helpful because of the perception of disorderliness in terms of the Administration's back-and-forth approach to the dollar. I think it was helpful in terms of the country's credibility that we did intervene and that the intervention was successful.

MR. TRUMAN. Certainly, it was successful! [Laughter]

MS. MINEHAN. That's true. The reason may be, as you said, that it came at a surprise moment and that contributed to the success. I would worry if in the absence of a surprise--well, I don't know how one can know this except after the fact.

MR. TRUMAN. Not to put words in your mouth, we could be capricious or appear to be capricious about why we are operating. We ought to have some sense of what we are trying to accomplish and why we were trying to do it even though it is not always very well articulated.

CHAIRMAN GREENSPAN. We will all starve if we don't stop this discussion!

MR. FISHER. We need two votes.

CHAIRMAN GREENSPAN. Whatever you have to say, say it in half the time. I think President Jordan has the floor.

MR. JORDAN. On this issue of how the intervention is perceived, the Federal Reserve does not issue statements at the time foreign currency actions are undertaken. My feeling about intervention would be significantly influenced by what is said, and I hope that your contribution is significant not only in terms of what is done, when, and how much, but also what is said about it. I don't have any problem with taking the capital gains from our previous efforts to short the dollar against foreign currencies. I am not very happy about the capital gains we are going to take because the only way a central bank can avoid taking a loss on foreign currency assets is if its domestic policies have not produced stability and its currency has depreciated. We have accumulated big capital gains, and I am willing to cover our shorts, take our gains, and limit our options to do that again in the future, I hope!

CHAIRMAN GREENSPAN. Peter, you have a comment?

MR. FISHER. It was really my two votes that I was after, Mr. Chairman.

CHAIRMAN GREENSPAN. We need a vote right now on the issue of ratifying the actions of the Desk. Let me emphasize that the issue of ratification is strictly the question of whether the Manager had the legal authority to undertake the transactions. We are not discussing the philosophy here. I would like to raise that question and would somebody move for approval.

VICE CHAIRMAN MCDONOUGH. Move approval.

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Are there any objections? If not, consider it passed. Now we have another question on the swaps, which is a one-year extension. Just repeat quickly what the issue is.

MR. TRUMAN. Reread your recommendations.

MR. FISHER. We have most of our reciprocal currency swap agreements up for renewal; those with Mexico and Canada come up at a different time now.

MR. TRUMAN. They will come up a year from now.

MR. FISHER. Yes, a year from now.

CHAIRMAN GREENSPAN. I suggest that we take a formal vote on that.

MR. FISHER. What we have now is no change in the terms and conditions of the existing swaps with Austria, the United Kingdom, Japan, Norway, Sweden, Switzerland, the Bank for International Settlements, the Belgian National Bank, the Danish National Bank, the Bank of France, the Bundesbank, the Bank of Italy, and the Netherlands Bank. These are all swap lines that have been in place for many years. I have no changes to recommend. I seek the Committee's approval for their renewal without change.

MR. BOEHNE(?). Move approval.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Would you read the roll.

MR. BERNARD:

Chairman Greenspan	Approve
Vice Chairman McDonough	Approve
Governor Blinder	Approve
President Broaddus	No
President Forrestal	Approve
President Jordan	Approve
Governor Kelley	Approve
Governor LaWare	Approve
Governor Lindsey	Approve
President Parry	Approve
Governor Phillips	Approve
Governor Yellen	Approve

CHAIRMAN GREENSPAN. Would somebody like to move that we go to lunch? [Laughter]

SPEAKER(?). No objection.

END OF MEETING