Meeting of the Federal Open Market Committee

August 22, 1995

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, August 22, 1995, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Blinder
Mr. Hoenig
Mr. Kelley
Mr. Lindsey
Mr. Melzer
Ms. Minehan
Mr. Moskow
Ms. Phillips
Ms. Yellen

Messrs. Boehne, Jordan, McTeer, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Forrestal, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco, respectively

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

Ms. Browne, Messrs. Davis, Dewald, Hunter, Lindsey, Mishkin, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Madigan, Associate Director, Division of Monetary Affairs, Board of Governors
Mr. Simpson, Associate Director, Division of Research and Statistics, Board of Governors
Ms. Johnson, Assistant Director, Division of International Finance, Board of Governors
Mr. Ramm, 1/ Section Chief, Division of Research and Statistics, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Ms. Strand, First Vice President, Federal Reserve Bank of Minneapolis

Messrs. Beebe, Goodfriend, Rolnick, Rosenblum, Sniderman, Mses. Tschinkel and White, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Richmond, Minneapolis, Dallas, Cleveland, Atlanta, and New York, respectively

Mr. Meyer, Vice President, Federal Reserve Bank of Philadelphia

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1. Attended portion of meeting relating to the Committee's economic discussion.

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CHAIRMAN GREENSPAN. This is the first meeting in our rejuvenated Board Room. The map of the Federal Reserve Districts has been enhanced but not redrawn, so your Districts are what they were; you need not worry about that. However, as in the old James Bond movies, there are a lot of buttons here that you can't see. If I push one in an appropriate manner, you fall through the floor with your chair, and there is a pool down there with sharks and all sorts of other creatures. That is not meant to influence your vote! [Laughter]

MR. BOEHNE. I support your proposal.

MR. BROADDUS. Whatever it is!

MS. MINEHAN. Will this be part of the transcript to be released five years from now? [Laughter]

MR. LINDSEY. It's recorded.

CHAIRMAN GREENSPAN. I don't think there is anything else that has to be discussed with respect to the Board Room. What you see is what you get. We will soon find out if it is a major improvement or just more expense. [Laughter]

We have with us today First Vice President Colleen Strand from the Federal Reserve Bank of Minneapolis. She is attending the meeting for the first time under our new procedures. We welcome her.

Would somebody like to move approval of the minutes?

VICE CHAIRMAN MCDONOUGH. So moved.

MS. MINEHAN. Second.

CHAIRMAN GREENSPAN. The July 5-6 minutes have been moved and approved. We now turn to Peter Fisher for his report on foreign currency and domestic open market operations during the period since the July meeting.

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

CHAIRMAN GREENSPAN. Questions for Peter?

MS. MINEHAN. Peter, in the absence of financial difficulties in Japan, would the U.S. Treasury on its own have supported actions in the market to increase the value of the dollar?

MR. FISHER. You're asking me to put myself inside their minds. I am a little squeamish about doing that.

MS. MINEHAN. I'm not really asking that. I am asking what the driving reason was behind these interventions. Why did the U.S. Treasury perceive that there was a problem with the foreign exchange value of the dollar independent of Japan, which is what Secretary Rubin implied in his comments after the intervention? Or was that a way to make palatable to a variety of different constituencies something that was really done more to help the Japanese situation?

MR. FISHER. I don't see it as an either/or situation. I think the Treasury feels very strongly about the commitment made in the G-7 communique in April that they were seeking an orderly reversal of previous exchange rate moves. At that point, they were referring to the downward movement of the dollar from January through the end of April. When they say they are seeking an orderly reversal, they really mean that. I think the financial sector difficulties in Japan and the weakness of the Japanese economy are an additional reason why the Treasury was concerned about exchange rates when they reached their lows. But I don't think it is really an either/or situation. They would like to see a stronger dollar and now we have a somewhat stronger dollar, though I would note that it is not yet back to the levels of mid-January. I don't think anyone thought the dollar was over-valued in mid-January of 1995. I tried in my remarks to be rather careful to say that the dollar is off its lows and we have had a big move, but it was a bigger move down.

MS. MINEHAN. Yes, but there are two issues here. First, there is a sort of long-term mindset about why you intervene. You intervene to counteract disorderly markets, at least that's the received wisdom coming through the Fed. Second, who really knows the right value of the dollar? There are winners and losers for any value of the dollar. Why would we support strengthening in the absence of a real rout that was damaging to the financial markets?

MR. FISHER. I think the Treasury is looking at the decline of the dollar from January through the spring and seeing that as something that is not positive for U.S. financial markets or the perception of the U.S. economy. It's really the time horizon that is involved here. You can think about disorderly markets as a fifteen minute phenomenon; you can think about them as a 24-hour phenomenon; or you can worry about whether there wasn't a bit of an overshoot on a quarter-by-quarter basis. I think the Treasury's focus has been more on the quarter-by-quarter basis.

MS. MINEHAN. But it seems to me that is a different position than the one that I at least have been led to understand is our position vis-a-vis defending the dollar, to use that old terminology. But second, once the winners and losers have been decided over a period of a week after exchange market instability settles down, it looks as if we are taking actions well after the fact that are detrimental to the people who are seeing this new exchange rate level as not really all that bad. In fact, our firms are more competitive in foreign markets.

MR. FISHER. I think this Treasury has tried to shy away from putting it so pithily. They are trying very hard to shake the image that there is any effort to depreciate ourselves into prosperity. So that would be their rather direct rebuttal to the point you are making. They are trying to shake that image.

MS. MINEHAN. It's just an interesting change, at least to me, in perspective.

MR. SIEGMAN. President Minehan, in addition the Treasury has been seeking opportunities in market conditions where its intervention would have a positive effect and where it might ride a rally where one was already occurring. So they piggybacked on the various measures that the Japanese took with regard to external investments, and they caught the market by surprise on several occasions. And that turns out to be, for the moment at least, a little more effective than just intervening randomly.

MS. MINEHAN. So you think that this is an--

MR. SIEGMAN. They found an opportune time.

MS. MINEHAN. Right, and are they going to try to do this a few times to prove the point that intervention can be successful so that when we have a disorderly market and they do intervene it works? Is that the logic here? Or are they seeking some particular foreign exchange value for the dollar?

MR. FISHER. I am not aware of any exchange rate target or particular objective other than the sense that the dollar was a bit low this spring.

CHAIRMAN GREENSPAN. Let me say that I think the Treasury people are aware that they cannot do this very much more without falling into the trap, where they basically are intervening all the time to no effect. My impression is that this is the end of the series. We have not been behind the Treasury pushing them in this direction, to say the least. They have acknowledged that this is a risky business and that if they prolong it or try to do it too often, the market will come back and bite them. I don't think there is a newfound insight that modest intervention of a few hundred million dollars or a billion dollars or whatever can really move the market. I think the people who make the decisions at the Treasury are aware that the only way we can effectively change the exchange rate through intervention is to catch the market short against our intervention and the reaction is strictly that. By definition, we cannot continuously surprise the market; at some point, it is waiting for us to move and catch us when we move. I think there has been an element of luck here that we should put in the bank and let it draw interest and not try to spend right away.

Any other questions for Peter? If not, would somebody like to move to ratify the foreign currency transactions since the last meeting?

VICE CHAIRMAN MCDONOUGH. So moved.

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Without objection. Would somebody like to move to ratify the domestic open market transactions since the last meeting?

VICE CHAIRMAN MCDONOUGH. So moved.

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Without objection. Let's now move on to the economic situation. Are you going to use the big screens for your presentation?

MR. STOCKTON. I'm not going to inaugurate the screens.

CHAIRMAN GREENSPAN. I'm disappointed. We have new technologies here that enhance the economic outlook, I do believe.

MR. STOCKTON. I'm not sure the screens will enhance the quality of the forecast!

MR. KOHN. More investment in producers durable equipment. [Laughter]

CHAIRMAN GREENSPAN. Dave Stockton has the floor.

MR. STOCKTON. Thank you, Mr. Chairman. [Statement--see Appendix.]

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

CHAIRMAN GREENSPAN. Questions for either gentleman?

MR. FORRESTAL. Dave, you have some fiscal restraint built into your forecast and you just indicated--

CHAIRMAN GREENSPAN. Excuse me; may I just interrupt for a second? Let me request that everyone move their papers away from the microphones, the little disks directly in front of you. I think the system works fine provided we don't block up the microphone system.

MR. FORRESTAL. Your forecast has some fiscal restraint built into it and you also, as you just indicated, have a relatively lower inflation forecast; and yet I notice that your assumed long-term interest rates remain pretty much at their current levels over the forecast horizon. I am a little confused about that. I would have expected some decrease in long-term rates.

MR. STOCKTON. The principal reason we have relatively flat rates over the next year or so is that our forecast is basically balanced. We have the occurrence of fiscal restraint. We also have additional demand crowding in on the net export side and relatively well maintained private domestic demand. In our inflation forecast, the underlying picture is one of flatness, not one of moving lower. So, the underlying view behind the interest rate forecast is our expectation of unchanged longer-term prospects for inflation.

CHAIRMAN GREENSPAN. President Parry?

MR. PARRY. Dave, I would like to ask two questions about labor force developments. As I am sure you know, in the last year or so there has been a lot of volatility in participation rates and in particular a very sharp decline in May and a further decline in June. I wonder if the staff has had any thoughts about what is going on in terms of this volatility of participation rates. Secondly, is it possible that there is somewhat greater elasticity in the participation rate such that the current 5.7 percent unemployment rate may be giving us misleading information about the degree of tightness in labor markets?

MR. STOCKTON. On the first part, we have been less puzzled with respect to the volatility in the participation rate, which has often been volatile in the past. The real question has been the basic flatness that we have had in participation, even as labor markets appeared to improve considerably. To be quite frank, I don't think we have very good stories at this point; one reason is that with the changeover in the CPS, it has been very difficult to interpret the aggregate movements in the participation rate. I don't think we see any particular change in labor force behavior that would suggest that participation is going to absorb more of the fluctuations in demand and therefore leave the unemployment rate as a less important indicator of labor market slack at this point. But one can't rule out that possibility.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I have a couple of questions. First, Charlie, on the international side: With regard to the other industrial nations, as I looked at your projections I couldn't discern the reasons you are expecting improvement in their economic activity. Is that based on the general cyclical notion that those economies have been growing slowly, if at all, so they are bound to do better in the future or is there something more fundamental going on that has led you to believe they are going to do better?

MR. SIEGMAN. It is partly that the slowdown in the first half may well be an aberration with respect to underlying trends and underlying strength in those countries. The German economy felt some impact from the depreciation of the mark, which is now being partially reversed. We anticipate some Japanese policy measures as well, although we have projected a very slow Japanese performance. So, there is a correction for the weakness of the first half that we don't expect will continue.

MR. STERN. Second question: I don't fully understand it, but I gather that BEA is going to use the chain-weighted index to deflate GDP and that will lower previous estimates of real GDP, significantly in some cases. Does that also mean that productivity estimates are going to come down significantly? If so, is that really credible?

MR. STOCKTON. We have taken a look at trend productivity estimated by using the new Fisher ideal chain-weighted index, and that suggests that the trend in productivity has basically been constant since about 1980. What one sees as a pickup in trend productivity using 1987-based dollars appears to be a statistical artifact that arises from giving much greater weight in recent years to the growth of computers, and that tends to boost GDP growth rates. We think a chain-weighted index is probably going to be a better measure for judging longer-run trends in the economy because it does not assume that the relative prices of computers today are a good reflection of what they were twenty years ago. But it certainly does raise a question as to whether we have witnessed any improvement in trend productivity. On many occasions people have forecast or thought that trend productivity was in the process of improving only to be disappointed later. This, in some sense, is just another measure that would suggest that perhaps we can't be as optimistic as we might have been on the basis of the fixed-weighted index.

MR. SLIFMAN. Let me add just one other comment that works in the other direction. There are other changes that BEA is considering implementing over the next several years. One in particular that would work the other way would be the inclusion of software as final output. At present, when software is not bundled with the computer, it is counted as an intermediate product. If output of software has been growing faster than other output, that would push up "true" output growth. There are some other things that are service-related where BEA is planning to implement new procedures to try to get a better handle on service output, such as this issue with software. Those things won't be reflected in the next benchmark this December, but they will be reflected in the following benchmark revision. In fact, it may well be that productivity is growing faster and that we just are not measuring output properly.

CHAIRMAN GREENSPAN. There is a major statistical problem. We are all acutely aware that there has been a shift toward increasingly conceptual and impalpable value added and that actual GDP in constant dollars is becoming progressively less visible. All of these intellectual services have historically tended to be written off as expenses in income statements, research and development clearly being the largest and most obvious of these. We are moving toward an economy in which the value added is increasingly software, telecommunications technologies, and various means of conveying value to people without the transference of a physical good; entertainment is the obvious classical case. So, we are getting increasing evidence that we probably are expensing items that really should be capitalized. This is the issue with software. We have all seen, as I think you are aware, a number of industries in which the ratio of stock market value to book value is much higher than one. In fact, in certain industries it is a huge multiple. The trend of market to book value has been rising very dramatically over the years, and I suspect we cannot extract all of that from changing market valuations of stocks in general. What appears to be the case is that an increasing amount of capital expenditures in the classic sense is being misclassified as expenses and that obviously lowers the book value of the firm to well below where it would be if those expenses had more appropriately been capitalized. The stock market is basically telling us that there has indeed been an acceleration of productivity if one properly incorporates in output that which the markets value as output. If in effect there has been a failure to capture all the output that has been occurring, we will indeed show productivity growth that is too low. It is hard to imagine that productivity is moving up only around 1 percent under the new weighting basis with profit margins moving the way they are and with the widespread business restructuring that is occurring. I think the difficulty is not in productivity; I think it is at the Department of Commerce.

MR. PARRY. Didn't the previous Greenbook mention a switch from basing productivity on income to basing it on expenditures as a more realistic way to assess productivity because of the increase in the statistical discrepancy? Doing that will reduce the growth of productivity.

MR. SLIFMAN. Only in the most recent quarters. The statistical discrepancy doesn't have a particular trend to it.

MR. PARRY. Hasn't it gotten wider in recent quarters?

MR. SLIFMAN. In the most recent couple of quarters.

MR. PARRY. That's a factor that is going to work in the same direction as the chain-weighted index.

MR. SLIFMAN. I don't think that's a trend phenomenon.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. Dave, when you outlined the downside and upside risks, you didn't mention what I had guessed you would start with, which was the fiscal situation. If you were doing the Greenbook forecast in a DRI framework, which gives the majority probability forecast, and, say, your alternatives, and you said: here is my forecast with probability P1 and my forecast with probability P2, where P1 and P2 add up to about .3, what would you say about the fiscal situation?

MR. STOCKTON. I am not sure that we have any particular political forecasting acumen that could predict how this fall's budget negotiations are going to unfold. Obviously, our best estimate or highest probability estimate is that some agreement will be reached in the fourth quarter that will avoid the more dire fiscal scenarios that have been mentioned. Clearly, there is a tremendous amount of uncertainty as to what actually will occur.

MR. BLINDER. What I am getting at is this: You have one alternative forecast that has more fiscal contraction, and you have another that has less fiscal contraction.

MR. STOCKTON. Right. I would say that we are still showing less fiscal restraint in our forecast than is embodied in the budget resolution passed in Congress. Therefore, if we end up with almost exactly what that budget resolution shows, we probably would show slightly weaker activity next year than we currently are forecasting. We are not doing that because typically, even when these budget plans have been put on the table, when everything is added up in the end, it usually comes out shy of what was thought when everybody signed the deal. We felt comfortable doing that. But I guess the probability of a tighter fiscal policy than our forecast is somewhat higher than the probability of a looser fiscal policy.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. This gets back to Bob Parry's question about labor force participation rates and volatility. One of the changes that appears to have taken place in the labor market is this greater use of temporary workers or people who have less than permanent attachment to the workforce. I have two questions relating to this: One, is this in any way related to the volatility that we were talking about before? And second, has the Board staff done any studies on this, particularly in relation to whether this growth of temporary workers affects the speed with which firms respond either in expansions or slowdowns in terms of their hiring policies?

MR. STOCKTON. To have an effect on the participation rate, these contingent workers would have to be moved in and out of the labor force. That could actually be occurring; so that could be a factor in some of the additional volatility. I think more typically folks are with some kind of temporary agency and would probably consider themselves to be in the labor market most of the time. But on the margin, there are probably people who can more easily drop in and out of the labor force given the kinds of opportunites that are available. We don't have any studies yet on whether this increasing use of contingent workers is fundamentally changing the dynamics of labor force participation. But we are acquiring data to take a look at this issue of increasing use of contingent workers and temporary help agencies.

MR. MOSKOW. We have two of those firms in our District. We are working with them to get some data as well.

MR. STOCKTON. Our staff has been working with yours.

MR. MOSKOW. Good.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. A quick question: In your answer to one of the earlier questions, you talked about inflation flattening out. I thought I read in the Greenbook that you were really somewhat more optimistic about inflation coming down somewhat. In your projections by quarter, you have a pretty significant decline. Yet, given where we are in the cycle and given where we are with your projections on output, that seemed a little optimistic to me, although I read your rationale. Is there one particular reason why you are foreseeing the improvement?

MR. STOCKTON. In my answer to President Forrestal, I was thinking more in terms of the kind of long-term inflation expectations that might be a factor in determining long-term interest rates rather than the quarterly pattern of our inflation forecast, which does have some deceleration. The deceleration is from a bulge earlier this year that was, in our view, related to some special factors including significant increases in auto finance charges and airfares that are now receding; it also is related to the materials prices and import prices that were rising quite rapidly but now seem to be slowing down significantly. I tried to convey in my remarks that, indeed, in some sense we have been surprised by how well labor costs have performed in a period when, by our assessment, labor markets were tight. I think that has played an important role in our thinking about the prospects for inflation and has underpinned our optimism for the outlook over this particular horizon.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Just following up on that question: I was struck by the fortuitous timing that you have in the Greenbook of the halt, if you will, of the one-time--although it seems to be a long time--decline in costs of benefits due to employer efforts and so forth. I am referring to the coincidence of that with our coming to a point in the cycle where the unemployment rate is such that it should not be causing labor market pressures and pressures on prices. You don't see an upturn in inflation after the downward impact of the drop in benefits costs subsides, which will occur sooner or later. Could you talk a little about that timing? Obviously, you think it is probable because it is part of your forecast. How do you come to that fortuitous timing?

MR. STOCKTON. It wasn't exactly by design that we did that. We reached a point where the unemployment rate had dropped to the 5-1/2 to 5-3/4 percent level and we were expecting to see some pickup in compensation inflation. It just has not occurred. As we indicated in the Greenbook, we don't really see any reason yet for revising significantly lower our estimates of the natural rate in the face of that; in our view that would be giving too much weight in some sense to the recent performance. But as this year has progressed, we have been impressed by the significant slowdown that we saw in health care benefits costs, particularly in the first quarter. We thought perhaps that was just a flukey number and it was going to reverse itself or at least not be occurring with much strength in the second quarter; but, it occurred again. The anecdotal evidence is that some employers really are making significant efforts to make this adjustment. Now, maybe that could go on even longer than in our Greenbook forecast, in which case the inflation outlook beyond our forecast horizon would remain relatively benign. But as we have the forecast now, we have enough slowdown in the economy and inching up of the unemployment rate to rescue us from the possibility of that rate running below the natural rate for a period of time and ever showing through into prices. In some sense, it is like having a favorable supply shock right at the time when you need it the most. That could be. Then the question becomes: Is it a permanent improvement in supply or is it temporary? In some sense our forecast doesn't really have to come down too firmly on that point because the forecast horizon is not long enough for the effect to show through.

MS. MINEHAN. We have this discussion once a month at our directors' table because our chairman is the president and chairman of New England Medical Center and because of the predominance of the health care industry in the First District. For at least the last two years, we have tried to get a handle, both from questioning on our side and from concerns on his side, on how long business efforts to control costs will continue to have an impact in terms of cutting medical costs. It just strikes me that they don't have a handle on it at all. They are being pushed by market forces that have become extremely strong and unavoidable, at least in the First District. I assume that is reflected nationwide.

MR. STOCKTON. That is just one reason for being somewhat cautious in looking ahead and thinking that somehow the entire medical care problem has been licked. There are still some significant issues about what is driving medical care prices and whether we are going through a transition period where employers are able to get a series of one-time improvements. It looked for a time as if the health care inflation problems were behind us. But given that we have not solved the deeper problems there, one suspects that at some point those could come back again.

CHAIRMAN GREENSPAN. Any further questions? If not, would somebody like to start the roundtable? President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. I will start with the District economy, which remains relatively strong and actually shows fewer signs of weakness than it did the last time we met. This firmer tone in the region's economy is evident across a wide range of indicators. The broadest gauge of improvement is that the District's employment levels have in fact leveled off after some earlier declines this spring and are up substantially over a year ago. Manufacturing remains sound. It's not growing significantly but remains sound, with plants operating at relatively high levels of capacity and firms generally satisfied with their inventory levels. The District's construction industry shows signs of improving from this spring's slowdown. We have seen some movement in contracts in the commercial as well as the residential side. Our directors are reporting improving consumer confidence and rising retail sales, and this has been evident this past July. Finally, confirming the overall strength in the District, loans at our banks have resumed growing at a healthy pace after slowing earlier in the summer. Indeed, we see some signs of increased deposit rates as loan and deposit ratios move up, and there seems to be a drive for increased funding at the banks.

There are a couple of weaker spots. The energy industry as you know continues to languish due to low prices. The District's farm economy has been hurt by a poor wheat harvest, especially in Oklahoma and Kansas, and by financial losses in the cattle industry. Despite the overall strength in the economy, wage and price pressures remain subdued; we have seen only spotty movements in prices.

At the national level, we concur with the general assessment that the inventory correction is for the most part behind us and that the economy will be rebounding as we go forward. Looking out over the remainder of this year and into next year, I anticipate a pickup in activity, as does the Greenbook, to the 2 to 2-1/2 percent growth range. Factors contributing to this pickup are continued strength in consumption and business fixed investment and a modest turnaround in residential construction.

On the inflation side, I am not as optimistic as the Greenbook. While we are reasonably confident that inflation will be capped at the 3 or 3-1/4 percent level, I do not expect core inflation to move much below 3 percent, if at all. With most measures of the economy still operating at or above capacity and likely to do so for some time, I think the fundamentals indicate that price pressures will remain firm. I will stop with that comment.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. For the most part, Mr. Chairman, changes in our outlook for the economy parallel those in the Greenbook, so I am going to focus my comments on developments in the Seventh District. Overall, it appears that District economic growth increased in the early stages of the third quarter. The inventory correction that slowed growth in the second quarter appears to be nearing completion in several industries, notably appliances and steel. Recent reports from the appliances industry point to a pickup in shipments to dealers and a sizable reduction in factory inventories. These reports were also consistent with increasing production levels in July and early August. In the steel industry, District output climbed relatively sharply in the first half of August. Orders seemed to be flowing in at a good rate. Customers had built up inventories late last year in anticipation of price increases, but stocks now seem to have been worked down to more normal levels. Most steel markets have remained fundamentally healthy, especially those linked to construction activity.

In the automobile industry, some progress has been made in addressing the inventory overhang, but the July drop in sales may have raised some concern that additional production cutbacks will be needed. Automakers we have talked to tend to attribute the July drop in light vehicle sales to temporary factors including reduced fleet sales, shortages of some popular models related to model changeovers, and a drop in Japanese luxury car sales. Through the first two weeks of August, showroom traffic is up and sales rates are showing marked increases over July with reports ranging from a 14.6 to 14.8 million unit rate for August; that's for the first two weeks. At this point, only Chrysler has extensive incentives on 1995 models, but at least one other manufacturer is expected to follow in coming months. Inventories have not been a problem in the heavy duty truck market where production has been at capacity for some time. However, there have been some significant changes in this industry over the past month or so. In June and July, order cancellations for heavy duty trucks jumped to their highest levels since the early 1980s. Incoming orders have slowed somewhat from earlier in the year, but backlogs remain nearly as large as last year's record output level. Order cancellations are causing production slots to open in the fourth quarter and some producers are responding by trimming production plans and overtime. However, major adjustments to production schedules are not expected until early next year.

While reports were mixed, most retailers in the District reported stronger sales growth in June and July than earlier in the second quarter. As expected, air conditioner sales have been quite robust, but sales gains in June and July were broadly distributed across a wide variety of durable goods categories. So far in August, retailers report that hard good sales remain strong but some sales have been hurt by the hot weather, particularly back-to-school and fall fashions as well as home building and remodeling merchandise. Retail inventories generally seem to be back near desired levels even for apparel stocks, and some retailers now expect to be adding to stocks over the balance of 1995. Reports from District realtors point to a significant strengthening in existing home sales during June and July. Homebuilders remain optimistic, but we have not yet had reports of a strong revival in building activity, partly due to the weather and partly due to the remaining inventory of new homes for sale.

Crop conditions vary widely across District states, with crops in Iowa, Wisconsin, and Michigan regarded as above normal and those in Illinois and Indiana below normal. Due to late plantings, the corn crop in most areas is not as far along as usual, but warm temperatures have permitted some catch-up. The hot weather was not beneficial for poultry and livestock production, which was temporarily curtailed.

Labor markets in the District remain relatively tight, but slowing economic growth has tempered demand for workers. The average unemployment rate in the five District states has drifted higher this year, but it remains below the national average in every state. Help wanted advertising in the region has slipped a bit. There are still areas, though, within the District experiencing labor shortages. One Iowa contact, for example, noted that he needs to import workers from South Dakota and Missouri.

Reports on prices have been mixed but generally continue to indicate receding inflationary pressures, mainly in input prices. Plastic resin prices have actually fallen in recent months. Paper prices are still rising, causing concern for catalog retailers and other District firms. However, the rate of increase in paper prices seems to be diminishing. Steel scrap prices recently rose, climbing to their highest level in four years, but this probably reflects strong demand for scrap-based steels going into construction markets. Price index components of the various District purchasing managers' reports continued to move lower through July. Our early receipt of the Chicago purchasing managers' report for August, which I caution is confidential until it is released on August 31st, indicates further moderation in price increases. The overall Chicago purchasing managers' index shows a modest decline in manufacturing activity, with the index moving down to 49.3 in August from 49.7 in July. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, economic growth in the Twelfth District accelerated a bit in early summer after slowing earlier this year. A pickup in California is evident from strengthening retail sales, faster job growth, and a falling unemployment rate. Employment gains have been particularly large among California's manufacturers of semiconductors and other electronic components. Growth in high-technology industries also is spurring employment gains in the Pacific Northwest. In Oregon, much of the strength is also at manufacturers of electronic components and other electronic equipment. In the state of Washington, employment in the software industry continues to expand rapidly from a high level. Farther inland in the District, economic activity in states such as Nevada and Utah is growing fast and construction continues to boom. Excluding these fast growing intermountain states, the District construction sector had weakened in early 1995, but more recently employment growth and residential permit activity have picked up.

Turning to the outlook for the national economy, I guess I have a pretty rosy scenario in mind, which is probably a good reason for suspicion. Although real GDP growth virtually halted in the second quarter, I believe its composition bodes well for the future. The modest sustained rate of increase in final sales was encouraging. In addition, it seems clear that firms made progress in working off the inventory overhang that had built up in the first quarter. This development in combination with continued modest growth in final sales sets the stage for resumption of real GDP growth in coming quarters, perhaps to the 2 to 2-1/2 percent range.

Finally, the recent slowdown in real GDP growth should help nip in the bud any potential surge in inflation. It should help eliminate excess demands in labor and product markets that otherwise might have boosted inflation next year. In addition, our model suggests that the so-called speed effects on inflation of swings in the economy will restrain inflation, perhaps by 1/2 percent in 1996. Overall, I would expect to see CPI inflation come in at around 2-3/4 percent next year.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. Overall, the New England economy can be characterized as moving sideways. It is not declining as it did earlier in the spring and summer, but it is not moving up markedly either. As in the past, there is considerable variation in employment growth among the states, with the northern states down through Massachusetts doing much better than the Rhode Island and Connecticut region. In fact, I think I reported in the past that Connecticut had barely inched out of its recession lows. Actually, even though the economy is not doing well there, it is doing better than Rhode Island, which is on a downward trend. As an offset to this, unemployment rates in the region are below what they were a year ago, although there are some labor force participation issues in this assessment. Consumer confidence has improved; price pressures are modest overall. Things are, as I said, moving sideways.

Looking at bank lending, our growth in bank loans had been below that of the nation as a whole. We are now running at about the nation's rate of increase. I think that is more reflective of the fact that bank lending nationwide has slowed and we have come into line with that. I don't think much has changed in the First District.

We don't have any large firms anymore that drive the First District economy. When you look at it, there tend to be more similarities among firms of roughly equal size than there are among firms of different size within similar industry categories. Our larger industries seem to be tremendously affected by downsizing, by defense industry contraction and all of that, and they tend to drive the headlines and some elements of consumer confidence. The small industries tend to be where the growth in output and jobs is occurring. We get very different impressions of what is going on when we look at the data, which tend to show relatively sluggish business activity, versus what we pick up anecdotally when we talk to business people. We have a small business advisory council. These people tell us that New England is booming. Now, it may be that we selected the right people or the right people agreed to join our council. They are finding it difficult to hire the workers that they need; they see price pressures that they can't pass on; they see a lot of competition; they see more economic growth than we do in the numbers for the District or what we read in the newspapers. The latter probably reflect more of the impact of the large industries. So, we are seeing something that people have commented on as a national trend. People in New England like to think that things happening in New England precede what is going to happen in the nation. That's really the dominance of small industries in terms of the economic pattern of the District.

On the national side, we see the economy very much the way the Greenbook sees it. If we were going to quibble, we would quibble about the optimism on the external side and we would quibble a bit about the downward trend in the inflation forecast. I personally was very happy to see the revision in this Greenbook versus the last one in terms of the uptick in GDP for the remainder of the year. We continue to believe that there are forces working in the economy that are going to produce more growth than the Committee certainly expected at the last meeting. I was happy to see the Greenbook reflecting that this time. In our view the Greenbook forecast--as you pointed out, Dave--seems the perfect definition of a soft landing. This also led us to concerns about where the risks are and the probability of ever landing where the Greenbook is forecasting. We evaluated the likelihood of that pretty much the same way you did. We were struck, as you seem to be, by the apparent balance in those risks, even though the risks are sizable on either side and there isn't a high probability of hitting the forecast on the head. So, we would assess the balancing of the risks the same way you do, and I think that is probably enough to say prior to our policy discussion.

CHAIRMAN GREENSPAN. Thank you. President Boehne.

MR. BOEHNE. Thank you, Mr. Chairman. Most of the recent anecdotal and statistical information suggests that economic growth is resuming in the Philadelphia District. Manufacturing, which has been a major drag, appears to be bottoming out and the outlook is positive. Retailers report the usual summer slowdown, but the underlying trend is favorable and retailers are upbeat about the fall. Bankers continue to report that consumer lending is rising. Auto dealers are maintaining positive sales trends, although extensive incentives are underpinning the sales rate. Residential sales have picked up in response to falling mortgage rates as well as effective price reductions by builders. There are some indications that the pricing of office buildings may be firming, although prices are low and vacancy rates are only steady at high levels. The employment situation is mixed, with the jobless rate still high in parts of southern New Jersey and the old industrial and mining regions of Pennsylvania. Other parts of Pennsylvania and Delaware have tighter labor markets. Wage and price pressures remain contained.

On the national level, the inventory adjustment appears to be proceeding reasonably well. Final demand appears to be holding up and inflationary pressures appear to be subsiding. There are always risks to any outlook as has been pointed out, and there can always be surprises. At this point, however, the outlook is favorable for sustainable growth and further progress toward reducing inflation over time.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, after a brief pause earlier in the year, the expansion in the Sixth District has resumed. We see broad-based growth continuing for some time to come and this is partly due to continued migration to the region. This is a trend that shows very little signs of abating, and it is supporting economic performance that I suspect is stronger than in the nation as a whole. Our contacts in the District, including our directors, report that retail sales rebounded in July. Apparel is doing fairly well and household items, particularly those relating to home sales, are doing well also. The exception is auto sales, which are mixed. Manufacturers have begun using incentives to clear out end-of-year models. Tourism has improved markedly in comparison to last year. The increasing publicity being given to the Olympic games in 1996 is generating interest generally throughout the District, but perhaps more importantly there has been a return of European visitors to Florida.

Our manufacturing survey released just about a week ago showed gains in output but not gains in shipments during July. As a result of this, inventories of finished goods appear to have risen, but the expectational elements in that survey were quite positive. Business has been particularly strong for manufacturers of electronics, medical equipment, and heavy duty trucks. Weakness again is evident in autos and related goods as well as the District's apparel and textile plants, which continue to suffer from import competition. Defense is also weak in the District. Sales of paper and paper products have been good, but industry representatives express concern about prospects for the continuation of that good growth.

Sales of single-family homes improved in July and rose to levels above those of a year ago in many areas. Inventories of homes for sale appear tight at the moment; and new home construction, while rising, is still somewhat below last year's level. Multifamily markets are also doing quite well, which I think is in contrast with the rest of the country. Occupancy and rental rates are rising, although this is probably going to be moderated in 1996 by new units coming on line. Commercial construction is also doing quite well and we are beginning to see some speculative office and industrial projects coming on line. Again related to the Olympics, we are seeing a lot of building activity, particularly in Atlanta.

On the banking side, bankers are reporting moderate growth in loan demand and very, very strong competition. That competition unfortunately is reflected in credit terms as well as in price. Business loans have been moderate so far this year, but the demand seems to be decelerating. Consumer loans are mixed and lenders are somewhat disappointed with the demand for refinancing.

Wage pressures in the District remain in check, almost throughout the District. Skilled workers are still in high demand in a few places, but reports of labor shortages have diminished quite a lot in the last few months. Product prices also seem to be in check with the exception of some pressure in the pulp and paper and the chemical sectors.

With respect to the national economy, our forecast is very close to the Greenbook for the balance of this year, but we do show a little greater strength and somewhat more inflation. Our forecast does not have any adjustment for fiscal policy changes, so I believe the differences between our two forecasts are consistent. I think that the outlook is reasonably good for continued growth and moderate inflation. But with the uncertainty surrounding fiscal policy and with the continued softness in the economies of our trading partners abroad, there is some risk of deviation from both of those forecasts.

But at this point, I think the risks are about balanced. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. The Eleventh District continues to show modest overall growth with a noticeable flattening of employment growth in New Mexico and Louisiana being offset by slightly improving employment in Texas. High-tech industries like electronics, semiconductors, computers, and communications services, which are increasingly important in the Eleventh District, continue to be an important source of regional growth. Our contacts in real estate are voicing a renewed sense of optimism particularly in single-family construction, which is believed to finally have hit bottom. However, we are beginning to hear of some fears of overbuilding of apartments, particularly in the Dallas area, and banks in the District have indicated that concerns about apartment overbuilding have led them to tighten standards for apartment construction loans. Retail sales have improved somewhat in most parts of the Eleventh District in recent months, with the notable exception of the cities along the Mexican border where conditions continue to deteriorate. Most of our peso-sensitive manufacturing industries have been showing flat or declining employment, with electronics and electronic equipment as I previously mentioned being the exception. Electronics have benefitted from strong worldwide demand, and our contacts have indicated that prices have been falling at a slower rate than previously, which has added somewhat to inflationary pressures. We continue to hear scattered reports of tight labor markets but little about wage pressures.

On the national scene, we really have no significant quibbles with the Greenbook. The only bit of inside information I have to share with you is that up through the middle of August, sales of nationwide have been weaker than expected. They have maintained unit sales, but have done so only by cutting prices. The weakest areas are in the Northeast and the Southwest.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. At our board meeting a couple of weeks ago, Mr. Chairman, one of our directors summed up his comments on the local economic situation by saying that things were not as good as they had been, presumably back in 1994, but they were better than most people had expected when the economy began to slow earlier this year. I think that remark fairly characterizes the general sentiment not only in his area but pretty much across our whole District. I read that remark as offering some confirmation for your remark in your Humphrey-Hawkins testimony that we may be past the point of maximum risk in the slowdown. I think it offers some support for the staff forecast--maybe it raises the probability from zero to three or four percent or something like that! [Laughter]

There really has not been much change in conditions overall in our region since the last FOMC meeting. The economy in the District continues to grow at a subdued pace, but it is growing. As I have mentioned at previous meetings, we still have some pockets of very strong activity, especially in central North Carolina. To a large extent that is because a number of businesses from other parts of the country have been relocating recently to that area. In any case, we have been told that the market for office space is extremely tight in places like Raleigh-Durham and Charlotte and that the supply of both skilled and unskilled labor is quite tight in that region. The South Carolina and Virginia economies for the most part are also pretty strong, and even West Virginia is doing pretty well overall, I think in part because of some relocations from other parts of the country.

The main problem in our District I guess is the opposite from your situation, Cathy. The northern part of our area, the Maryland economy, is quite sluggish and, of course, the general economic situation here in the District of Columbia is very bleak because of current and prospective job losses. One anecdotal comment we heard might be of some interest. We are in touch with an automobile dealer in Maryland who is active not only in his own market but in one of the national dealers associations and he gets good information about the industry generally. He told us recently that auto dealers had been surprised and burned three times so far this year--in January, April, and now July. Because of that he thinks that dealers are going to approach the new model year with considerable caution and only order the minimum number of cars, what they need to represent the new models to the public. If that turns out to be right, it could offer some confirmation to your projection, Dave, that the cutback in assemblies may extend through the third quarter and maybe shave a point or so off GDP growth in that period.

More generally, the staff's near-term projections for the national economy are certainly reasonable. They seem to me to be closely in line with the private consensus projections. Like most other people, I think the risks are pretty balanced on the up side and the down side. Back in the spring, as you may recall, we in Richmond were especially concerned about the downside risks in the outlook. We are less concerned about them now, but I think we need to keep in mind that they are still there. It seems to me the key is the automobile sector. If the weakness we have seen in auto sales were to persist, that could extend the period of slow job growth, revive concerns about job security, and put a lid on aggregate demand. But there are also upside risks, and I think they are more pronounced now than they were earlier this year with the strengthening in the economy that seems to be suggested by some of the recent data. The main upside risk as I see it is that once we get past the inventory correction, assuming no unanticipated negative shocks, the economy could be operating at close to full capacity in a number of key industries and labor markets. In that kind of situation with a recession having been dodged, people may have an enhanced view of job security. If we were to get a situation like that, the favorable wage picture that we have been looking at in a period of relatively low unemployment could begin to dissipate. The recent upward adjustment in bond rates may be reflecting that kind of concern at least to some extent and maybe to a considerable extent.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. As in the nation as a whole, the Eighth District has experienced some slowing relative to 1994. That was expected because the District economy had been growing faster than could be sustained. The District unemployment rate was 4.7 percent in June, holding at about a percentage point below the national figure. Recent reports show growth in personal incomes in District states centered in the 4 to 5 percent range. Job growth has continued, though at a slower pace. Conversations with our directors and other District business leaders indicate that the District is generally operating at a high level. In fact, forecasts of reduced auto production at the national level are not reflected in the Eighth District. The models produced in our District are popular, and the auto companies are expanding capacity. Third-quarter motor vehicle production is expected to be 3.6 percent above the level in the second quarter and 13.8 percent above the level in the third quarter of last year. Loan demand continues to be strong, and District banks have increased loan portfolios by about 15 percent over the last year. There has been an increase in the issuance of building permits, suggesting that the District is sharing in the nationwide rebound in the demand for housing. Many of the business people I have met have reported pockets of labor shortages, especially for entry-level workers but for some skilled workers as well. Nonetheless, as others have mentioned, the labor market information has been mixed. On the one hand, there have been some suggestions that wage pressures are continuing to build. On the other, there has been a moderate reduction of both overtime and employment of temporary workers.

I remain concerned about the outlook for inflation and our inflation credibility. When I look at the pattern of inflation expectations--for example, there is a table on CPI inflation expectations in part II of the Greenbook that I think is quite interesting--I see that expectations for future inflation continue to exceed current inflation. Even the Administration's mid-session review of the 1996 budget assumes that consumer price inflation will continue in excess of 3 percent through the year 2005. This month the Blue Chip consensus reported expectations that the CPI would rise 3.3 percent at an annual rate in the third quarter, 3.4 percent in the fourth quarter, and 3.4 percent in 1996, fourth quarter over fourth quarter. It is clear that the prevalent view is that inflation will continue in the 3 to 4 percent range, which is less optimistic than the view expressed by the staff. Even the lower bound of a 3 to 4 percent inflation range is certainly not price stability as I see it.

I am also worried that we, as well as the financial press and others, are focusing too much on news reports about real economic activity. By continually focusing on labor market reports, factory orders, consumer sentiment surveys, and other real series, we undermine our position that the best policy to promote long-term growth and full employment is to achieve and maintain price stability. Our words lose their force when we act on uncertain news about real activity in the presence of expectations for inflation as high as they are. The decline in bond prices since July 6, which Al mentioned a minute ago, indicates that not everyone expects that the modest acceleration in inflation that has occurred this past year will be capped and that inflation will turn down. All said, I am concerned about actual inflation and the high level of inflation expectations that are embedded in forecasts and in longer-term interest rates.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. A general characterization of the District economy, I would say, is the feeling that it is as good as it gets. Certainly for the state of Ohio and for the part of Kentucky in our District, people would say that these are the best times that anyone can recall, and they would have a hard time imagining it improving over that. That would not be the case in western Pennsylvania where we have a number of counties that are still considered to have high unemployment and sluggish growth. But I think the sense of optimism and confidence about the future is really extraordinary. Yet, I don't see it being accompanied by the kind of imbalances or any kind of excesses or speculation that would worry me. The mood I get from our small business advisory council, our small bank advisory council, our board of directors, and the business people that I talk to is one of a calm confidence that this is sustainable. Near term, Cleveland in particular is looking forward to the Rock and Roll Hall of Fame opening on Labor Day. They consider it to be a bigger event than the Atlanta Olympics [Laughter] followed very shortly by the all-Ohio World Series. [Laughter] We have been sold out of baseball seats for over a month now; it is really extraordinary.

MS. MINEHAN. We take exception to the idea of an all-Ohio World Series. [Laughter]

MR. JORDAN. The industry- and sector-specific comments that we hear would not be significantly different from what Mike Moskow is reporting from the Great Lakes region. So, I am not going to go through them. But I will relay a couple of anecdotal reports of note related to motor vehicles and specifically trucks. One director commented that he had seen a very welcome reduction in the amount of overtime. With some relief, the companies--auto suppliers and assemblers--feel that they will have fewer problems with labor now that they are able to cut back on the amount of overtime. Talking to business people about their efforts at hiring, it has been very interesting to hear their comments about the lack of what they call unskilled workers and how much they are having to pay in order to attract unskilled people for entry-level positions. One company that makes rubber products related to motor vehicles said that the nice thing about today's technology is that they can hire people who don't know anything at all and still afford to pay them $8 an hour even though they are unskilled in his view. This says that there is something about the productivity of these people that is not consistent with usual notions about productivity. If he thinks they have no skills and yet they are worth $8 an hour because of technology, that is a different way of thinking about what the labor market is contributing. One of our small business people in the Columbus area said that people who are not working today in that area are people who don't want to work. Bonuses are being paid and firms are competing for unskilled or trainable workers. Another general comment from directors and advisory people is how much they are spending on training and how they achieve better results by competing for workers by offering training programs rather than by raising benefits or bidding up the wage structure.

With regard to health care, some of our directors in that industry--including health goods and other health-related activities such as a managed care company in the Dayton area that is adding new members at double-digit rates--describe an industry that is so grossly mismanaged that any organization, even one like the Post Office, could improve the administration of hospitals and clinics. I asked them how long the opportunities for improvement can go on, and they said the introduction of better administration and technology could take until well into the next century.

Turning to the national economy, the productivity numbers that we see have interested me for some time. Early this year or late last year, I saw Board staff projections of productivity that I thought were simply too low. But since I also don't think that the output numbers mean much, it's hard for me to get too concerned about the productivity numbers. The fact that those numbers are consistently coming in so much stronger than people expected may tell us something about the different nature of this expansion. That is, it is not a demand-led expansion fostered by monetary and fiscal stimulus, but rather it is the dividend from a gradual improvement in the credibility of our commitment to price stability so that people are putting more into those things that improve efficiency or what we would call productivity. To test that idea, I have been asking directors and advisory council members whether, if they were told that they could not increase their prices for the rest of this century, the cost increases they would have to incur--labor, benefits, raw materials, and so on--would put them out of business. Almost all say, yes, we can make it. But some go so far as to say that such a price outlook is the reality. said that he is operating above capacity but he has not had a price increase in two years. I asked him why he didn't raise his prices. He said it is impossible to do so; he can rely on rising productivity. He is increasing his work force and training it, and he is adding technology. I believe we have made a lot of progress on what I think of as the issue of inflation--people's ability to compensate for cost increases without raising output prices. We are seeing the benefits of that in rising standards of living.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. The District economy remains healthy and activity generally has picked up over the summer. That pickup has been reasonably widespread across industries and regions of the District. There have been some further gains in employment. At the same time, labor does remain in relatively scarce supply. That combination is interesting because it still has not translated into anything resembling a broad-based acceleration of wages or even growing wage pressures. One interesting anecdote bearing on this--and I would not argue that this is a widespread development at this point--came from a fairly large employer in our District who indicated that he was having a lot of trouble finding workers. He said he has gone to outsourcing some of his back office activities; he has contracted with a firm in Maine to do some of this work. Apparently, labor is more readily available there and he can get the work done at a reasonable rate. As I said, I am not suggesting that such outsourcing is widespread, but we may see more of it as time goes on.

One exception to this general picture of economic health is the livestock industry; a second is manufacturing. For whatever reason, manufacturers in our District feel business is soft and they are not optimistic. They believe they are going to be cutting output further for some time. I think that's a reasonable generalization of their views.

With regard to the national economy, I am certainly in general agreement with the contours of the Greenbook foreast. The major surprise to me has been that things seem to be working out so well, and certainly a bit better than I might have expected a month or two ago. I think we are moving toward a foundation for a resumption of sound economic growth. I anticipate that wage and price pressures will remain relatively restrained. That is based in part on what I see going on in the economy in terms of the difficulty of raising prices and the reluctance to raise wages or other forms of compensation. I don't see anything that is going to come along soon to disturb that. So, I think we are in pretty good shape.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, I want to take up Governor Blinder's question and Dave Stockton's answer regarding the risks in fiscal policy. This should not surprise you at all because fiscal policy is what I have talked about all year. I would like to start off with two observations. The first has to do with the level of deficit reduction we are talking about. Now, there are a lot of ways of looking at budgets, and the word baseline has a lot of meanings. I like to think of baseline as being what we would be spending if we adjusted for inflation and demographic changes without changing the law. That number is $20 billion higher than the baseline that the staff is using. So, when the Greenbook refers to a $30 billion deficit reduction from the baseline, we are really talking about a $50 billion reduction from what I think of as a current services baseline. When we talk about the House and Senate budget resolutions, which have a $50 billion budget deficit reduction, we are really talking about a $70 billion reduction. These are numbers that we have to keep in mind because we are talking about more "real" money than we might think, to use Senator Dirksen's phrase. Second, when we look back at this, I think we are going to be happy that the second-quarter pause happened in the second quarter and not in the fourth quarter or the first quarter of 1996 because I think the fiscal contraction we are going to have coupled with random events such as an inventory correction, if those happen coincidentally, would lead to much worse problems than we thought. I agree with Dave Stockton that we don't have any particular expertise on the fiscal side. I don't think anyone has any real insight into how this process is going to work out. But I decided to be cynical about it. I decided that our elected representatives may have something on their minds other than purely the national interest. So I talked to pollsters and political advisers of both parties, actually most of them are independent. I asked them for some poll numbers so that you could see exactly what they are seeing and you can make your judgments accordingly.

The first thing you hear when talking to anyone is the importance of Perot voters. One only had to watch the parade to Dallas to understand how important they are. So, I am going to focus on Perot voters. They have been called the radical center--I don't know if that's the right phrase. Demographically, they are more middle class than most voters: 37 percent of them had incomes in the $40,000 to $80,000 range versus 28 percent for all voters. They are also less religious than other voters; 47 percent admitted not going to church at least monthly versus 38 percent of all other voters, and the percent of voters that go weekly was well below that for the general public. Those are important characteristics to keep in mind. They are also decidedly more anti-government than Republican voters, and this is where it becomes interesting. When asked if the federal government has too much power, Democrats thought yes, 63 to 24;

Republicans said yes, 79 to 17; Perot voters replied yes, 88 to 9. A pre Ruby Ridge question was: Would you actively resist the government if you thought it was threatening your rights? "Actively resist" is a pretty strong phrase. Perot voters said yes, 57 to 34. Do you think the government is your partner or your opponent in your pursuit of the American dream? Perot voters said it was their opponent, 71 to 23. Does government hurt or help people like you? Democrats split about evenly. Republicans said "hurt," 50 to 36, and Perot voters said "hurt," 51 to 24. How about the welfare state? There were two choices: government is there to take care of people who can't take care of themselves; or groups like the Salvation Army and/or the United Way would do a better job. Democrats like the government, 48 to 39; Republicans like the private sector, 61 to 25; Perot voters like the private sector, 67 to 18. Do we even need the federal government to provide a social safety net? Democrats said yes, 53 to 33; Republicans said no, 60 to 36; Perot voters said no, 68 to 24.

In all these questions, the Perot voters are to the right of the Republican voters. They are even more so in the case of regulations. Do regulations cause significant job losses? Perot voters agreed, 71 to 24, more than the Republicans. Does it increase the cost of things we buy? The Perot voters said yes, 83 to 12, more than among the Republicans. And this is something that maybe the Fed should keep in mind: How much trust do you have in regulators to act in the interest of most Americans? The split was a great deal or a fair amount versus not very much or none. Among Perot voters the largest category was none, and they were negative, 54 to 16. On the key spending issue of Medicare, the choice was: Would you want to tinker--to which most people said yes--leave it alone, or completely redesign. The public in general split 21/20 on leaving alone versus completely redesigning. Perot voters were for completely redesigning, 30 to 14. When given the choice of reforming Medicare to control costs or using money allocated for tax cuts for the rich to maintain the current Medicare system, they split 3 to 1 in favor of reform over using tax cuts for the rich. Those are the numbers that the Republicans in Congress in particular are focusing on since these voters are the ones that gave them the majority. Perot voters in 1992 split evenly among the parties; they went 2 to 1 for the Republicans in the last election.

The first conclusion of the pollsters and analysts is that the Republicans think they have to deliver on budget cuts to keep these voters. The second is that the decline in the Republican numbers since January is more a result of the budget-cutting process slowing down than their doing the wrong thing. Independents, for example, were asked whether Congress was stalling or going too fast. They said stalling, by 43 to 30. Third, GOP freshmen are by far the most Perot-like. Secretary Rubin spoke to the freshman class to try to talk them out of not approving the debt ceiling. He came away shocked; that was the word I was given. There are now 160 members of the House of Representatives who have signed their names to something that says they will not raise the debt ceiling unless there is a balanced budget resolution with it. People in both parties gave me a flat prediction that a debt ceiling bill will not pass the House of Representatives unless there is also a balanced budget resolution to go with it. Fourth, specific bureaucratic cuts are not going to be reduced. They are, as the numbers suggested, even more popular among Perot voters than among Republican voters. Finally, shutting down the government is perceived as posing very little risk. You might get a sense of that by looking at the vote on the bill to limit the authority to use the Exchange Stabilization Fund that the House passed by over 100 votes.

The Democrats' constituency is best served by saying that there is no problem, and that is in fact the case. Remember, the Democrats we are talking about are the survivors and they don't need to go after the Perot voters. Gephardt says that there is no problem, for example, on Medicare and he is in fact angry that the President said there was. When you look at the Democratic voters, you get a sense that they really have to hold their base if they are going to be re-elected. For example, 47 percent of the attendees of the last Democratic national convention were government employees. The largest group of those were teachers. As a result there is an incentive not to cooperate in the process, which is going to be important both at the beginning and at the end.

What we should expect in September, I was told by the pundits, is a series of filibusters in the Senate over the appropriations bills. If the Senate cannot act and we don't have appropriations bills, the President can blame the Congress, and that is the opening for him. I was told that one of the reasons for Bradley's defection was that he became so fed up with this mess. What Clinton is hoping to do is not so much get the Perot voters as to have them not like the Republicans. The way to do that is to have Congress not produce the appropriations bills, and that is the strategy. The path of least resistance, according to the party leaders I talk to, is to have something like the GOP level of budget cuts because they are not going to get anything else through the House. But to achieve presidential victories on issues such as abortion, where we already have seen some, especially if Medicare cuts are incorporated into the process, the President may have to compromise with the Republicans and get the Democrats in the Congress to go along. They would not. The final result may be that a bill will have a lot of difficulty passing because there is no bipartisan support for a compromise. The final caution in all this is that if a reconcilation bill is vetoed, all the deals that were cut in getting the appropriations process are nullified. You have to start the process all over again. A veto of the reconciliation bill probably means that it is going to take weeks and weeks and weeks and not a matter of hours or days to get a second deal through. All that makes me very depressed, but it seems to me that we are probably going to get much larger deficit reductions in the form of spending cuts than the Greenbook is calling for, and I think that should be a factor in our thinking.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The recently released data show no clear-cut trend in the Second District's economy. In the real estate sector, our contacts reported declines in existing home sales and home prices in the Greater New York City metropolitan area in July and August to date. In June, permits for construction of single-family houses in the District fell below year-ago levels for the fourth consecutive month. Unemployment rates rose in both New York and New Jersey in July, but the payroll reports were mixed. New Jersey reported moderate, broad-based job growth while New York reported a contraction reflecting a decline in government employment. On the more positive side, tax collection data suggested some underlying strength in personal income and retail sales.

The considerable concern and pessimism regarding the international situation that I mentioned at the last Committee meeting has been lessened but only a little. It has been lessened slightly because the Japanese have made some rather modest steps to encourage economic growth and a more rational flow of capital from their financial institutions. Much more needs to be done, however. European growth is weak as demonstrated especially by recent German data. In our own hemisphere, the major countries--Mexico, Brazil, Argentina, and Canada--are working through very difficult macro-economic situations, and that is likely to continue. So, we need to continue to look at the United States domestic economy against the background of a rather weak international environment.

I view the movements in exchange rates since our last meeting as positive in that the dollar was weaker than it needed to be to make the United States a very formidable exporter, and the strength of the Japanese yen was a major source of concern, then and now, about the basic financial stability of that country, especially its banking sector. But I think the present exchange rate levels, given the current fundamentals, are more rational and more likely to lead to economic growth in Japan and Germany. And as I said earlier, I believe the United States dollar is still at a level that makes us quite attractive. I think that all or most of these exchange rate moves would have happened if we had not intervened. As Peter Fisher and others have suggested, the success of the intervention had a great deal to do with the fact that the market was moving in that direction anyway. You never know whether all of this would have happened if we had just stayed home and relaxed, but it is important that we not get confused into thinking that we can have exchange rates where we would like them to be rather than where market forces say they will be. I certainly support the Chairman's wish to have everybody decide that it is nice that we were successful; we were lucky three times; and now let's cool it.

Domestically, we think, as all of you have suggested, that the economy is bouncing back very much along the lines that we and others have been forecasting for the last several months. We think the downside risk has been reduced considerably and that the risks to the forecast are now rather well balanced. Signs of strength: Single-family housing starts are up 11 percent in May and June; nonauto retail sales are strong; consumer confidence is strong; and the stock market is quite robust. On the other hand, auto sales are weak and, as has been suggested, could continue to have an adverse effect on the economy in the fourth quarter. Employment is growing but not very strongly. Our forecast and the Greenbook's are very similar in terms of real GDP and the unemployment rate. We are slightly less sanguine on inflation but just slightly less. We had been considerably more concerned or at least we had a higher forecast of inflation than did the Greenbook until now; we have been revising our inflation forecast down. I think it's easy to get confused about how much better the price data look because used car prices early in the year pushed core inflation higher than it should have been and are now making core inflation look a little too good. If you take car prices out of core inflation, it slows from around 3-1/2 percent in the first quarter to about 3 percent in July.

CHAIRMAN GREENSPAN. Used cars only or total?

VICE CHAIRMAN MCDONOUGH. Prices for both. I really applaud the approach of the Greenbook. I think we have to be careful, especially in New York, not to fight the tape and to accept the fact that price performance is in fact better than we had thought it would be. On the other hand, it's a little early to declare victory, and therefore I applaud the decision of the authors of the Greenbook not to say that the NAIRU is coming down from the 5.9 percent level. I think it would be very nice if we could conclude sometime in the future that that has happened, but I believe it is smart not to reach that conclusion quite yet. Thank you.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. There is no doubt that the Greenbook is not exactly correct. It never is; it can't be and it's not expected to be. But that said, I think the staff did an exceptionally good job this time around in assessing what I see as a very tricky period. I find the economy that they project to be highly credible. I also think that it's a very acceptable one at this time but not permanently. By not permanently I mean that over the longer term we still have to keep the inflation rate on a secular downward path. We are not at price level stability yet, and we are still determined to get there.

What do I mean by acceptable at this time? Well, I think there are many very big questions out there whose answers are going to have to unfold over the coming months. Virtually every one on my list has been discussed this morning, and it's rather awesome. After all the rhetoric runs its course, what is really going to be the deficit reduction that we are going to have to deal with? Second, has the NAIRU changed and if so by how much? Third, have productivity trends really improved as many think? If we are on a higher trend, how much higher and is it a sustainable one? Fourth, a lot of the good results that we are getting now, I don't know how much, has to do with the so-called traumatized worker. How long is the American workforce going to remain quiescent without the compensation increases that it thinks it should get? When employment is as strong as it is right now, I don't think we can depend on having permanently favorable results in that area. This has been a rather big key to the present happy macro situation where we have a high capacity utilization rate and a relatively low inflation rate. We all feel rather good about that. Fifth, will households continue to take on more debt? That obviously is the key to consumer spending. Consumer debt is rising again toward its all-time high of several years ago. We all know that in many past years we had a much lower level of consumer debt than we are carrying now. One has to wonder if people are going to want to return, at least partially, to those standards of prior years. Then, of course, there is the matter of whether or not we are overstating inflation and if so by how much. That was a very interesting but not particularly critical question when we were at higher levels of inflation, but as we begin to move into the zone that could be considered price level stability, that question starts to become very important indeed.

The answers to all these questions, and more I am sure, are going to have everything to do with shaping monetary policy as we go along into the future. How is it going to shape up? I certainly don't know, but the point is that for now it seems to me that we have a good balance in the economy and we are moving toward an appropriate degree of momentum. That puts us in good shape to await the unfolding answers to some of these critical questions and in a pretty good position, I would hope, to be able to react appropriately as those answers start to become available.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. The inventory correction appears to be running its course and the adverse follow-on effects that we talked about at the last meeting do not appear to be about to beset us. The economy could well be set to resume its growth path at potential. Many of the areas of strength in the economy have been mentioned. Both consumer and business spending have resumed. The housing market has shown some renewed vigor. Employment still is fairly strong, although the unemployment rate did tick up last month and there has been some discussion about the volatility of the participation rates. The wealth effects of a stronger stock market may support continued spending. The flip side of a strong stock market is that we have a fairly low cost of capital, and that bodes well for continued investment spending. Corporate profits have been holding up reasonably well, and there appears to be a continued commitment to improvement in productivity.

In view of this rather optimistic scenario, I have been trying to assess the downside risks, the clouds and uncertainties on the horizon. Larry has talked extensively about the fiscal impact on the economy of dealing with the deficit, particularly since it appears that there is considerable interest in seriously addressing it this fall. It's very hard to know what, if any, effects there will be from a train wreck. I think we'll see a lot of national attention focused on Washington as we approach the November showdown.

There also has been considerable discussion today about the labor market. Although the unemployment rate is historically low, it is difficult to assess the longer-term impacts of the re-engineering binge that has been going on in the private sector and in some parts of the public sector. A lot of displaced people are now employed, but they may see their new jobs as temporary. On the positive side, this does suggest that there may be more flexibility in the labor market than is implied by the 5.7 percent unemployment rate. This may help explain the dichotomy that we seem to be seeing between labor shortages and the fact that there don't seem to be many upward wage pressures. This uncertainty in the labor market or lack of confidence among workers may well contribute to consumer spending vulnerability. This vulnerability may be exacerbated by the fact that a lot of consumers have taken on more debt in the last year and a half. On the supply side, the auto market may not provide the same kind of growth impetus that it has in the past. We have heard some mixed reports around the table today about the auto market. Pent-up demand has probably been worked off. The ownership holding period for autos appears to be longer. Some of that is due to the improved durability of autos, but it also may be simply that people can't afford the higher sticker prices. Income constraints may start to hold down auto sales in the future and not provide the same kind of impulse that we have had in the past. Of course, foreign competition may become more of a factor as the impact of the dollar is felt.

On the inflation side, I do think that most of the recent data are supportive of the hypothesis advanced at the last meeting that the uptick in the first half of the year was really due to temporary cyclical pressures. It is somewhat discouraging that the outlook for inflation still seems to be in the vicinity of 3 percent, indicating that we have some distance to go.

In sum, the economic reports that have come in since the last meeting have been encouraging. The inventory correction appears to have been more the proverbial air pocket on the way to the soft landing. The financial markets seem reasonably consistent with this outlook. The stock market has paused but it didn't tank. The slope of the yield curve has steepened, implying that the risk of recession is somewhat less. Yield spreads have not widened, implying that there may be some lessening of concerns about asset quality in the markets. Credit demand appears reasonably strong. So, it seems to me that a growth outlook reasonably close to potential is quite likely and that the risks are more balanced.

CHAIRMAN GREENSPAN. Thank you. Governor Blinder.

MR. BLINDER. Thank you, Mr. Chairman. After all the praise that the staff forecast has received, I am tempted to start by saying that I think they have it all wrong. But I don't actually, so I won't. I don't have any major quarrels with the Greenbook. I could differ with it a little bit here and there, but those differences are too small to bother anybody with. Like many people, starting with Dave Stockton, I am troubled by the fact that it's a bit too good to be true. We know it's not going to come in quite that well, but that is in no sense a criticism of the forecast; you make your best guess.

A notable feature of the Greenbook forecast exercise, which various people have indirectly remarked upon but I'd like to make explicit, is that we have been seeing a successive writing down of the staff forecast as I have observed at past meetings. That has now stopped. I think the staff has stopped writing down its forecast, as I have, for good reasons. Bob Parry mentioned several of them, and I won't repeat what he said about the composition of the GDP in the second quarter; that's much more important than the tea leaves that we get from week to week.

However, as you could probably tell from the question that I posed to Dave, I have some fear that all of us are going to be revising our forecasts down again after the fiscal dust settles, whenever it settles. We don't know what the dust is going to look like, and we don't know when it is going to settle. But when I think about the various scenarios, I have a much harder time thinking about the economy coming out better at the end, or in the middle, of the process than I do about it coming out worse. I just find it extremely difficult to conceptualize a scenario that takes us through this train wreck and has us coming out on the other side with stronger aggregate demand than we had when we went in. There are two reasons for that. One is the aggregate demand effect, which Larry Lindsey was emphasizing. But we also ought not to forget about the potential impact of this thing, whatever it is, on financial markets. The foreign exchange markets, the domestic bond market, and the stock market could truly be rattled by this event. Now, of course, none of us can predict what is going to happen. I am just emphasizing this because I think it now ought to be at the front of our screens, not at the back. Two or three FOMC meetings ago it was at the back of our screens, and now I think it really needs to be at the front.

The last thing I'd like to call attention to is a subtle, barely noticeable, feature of the Greenbook forecast. You have to look closely to see it. But I think it's important for the long run--not at all important for the short run--and also sensible. In this forecast, there is a small GDP gap at the forecast horizon, which happens to be the fourth quarter of 1996. GDP is below potential by just a hair more than it is now, according to the staff's estimates. It's not a very big gap, about .4 percent of GDP. That's a small number, much less than forecasting errors for a six-quarter horizon. But it's also about twice the estimate of the overshoot of capacity that we had at the end of 1994 and the beginning of 1995, which was minute. Much more important for the long run--and the reason I bring it up--is that, if we look at the details of the forecast, that gap is slowly widening over time. That is to say, GDP is growing just a tad below potential. If we extrapolated that path into 1997 and 1998--after all, year-end 1996 is a very short time horizon for monetary policy--we would be looking at a path with a slight upward tilt to the unemployment rate and a slight downward tilt to the inflation rate, neither of which is showing yet in the Greenbook forecast. They go together, of course.

I said I thought this was a sensible, though very subtle, feature of the forecast. It's exactly what one would expect if the real interest rate is above the equilibrium real interest rate--which, I think, is what we believed at the last FOMC meeting and what I still believe. If that is the case, the gap between potential and actual GDP, or between the natural rate and the unemployment rate, or between 3 percent and the inflation rate, will grow bigger as we go forward--and at an accelerating rate since this thing feeds on itself.

Finally, I think there is a reasonable probability that the gap between the equilibrium rate and the real short-term interest rate implied in the Greenbook path is bigger than in the Greenbook forecast for two reasons, both of which have been mentioned. One is that the fiscal contraction is bigger than in the Greenbook path and that lowers the equilibrium rate. The other is the possibility that the NAIRU is actually below the number that is being used in the Greenbook, as has been mentioned several times. We don't know that that is the case. Dave is absolutely right; I was quite happy with the way he characterized it. But I think the odds that the NAIRU is higher than the staff number look extremely small compared to the odds that it is lower. If that's the case, the divergence between the equilibrium real rate and the actual real rate will grow faster than an extrapolation of the Greenbook would presume. Thank you.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Thank you, Mr. Chairman. I think the news that has accumulated during the intermeeting period is almost entirely favorable with respect to the outlook, both for real performance and for inflation over the forecast horizon. While I, too, would like to find a reason to disagree with the Greenbook, I find myself in substantial agreement with the Greenbook's assessment of the data. Most important to my way of thinking is that we now have mounting evidence that the inventory adjustment under way is proceeding more rapidly and with substantially less disruption of growth in final sales than I had been fearing. The continued strength of consumption and investment spending in the face of the inventory adjustment, coupled with strong evidence of a rebound in residential construction, substantially mitigates what I had thought was one of the most serious downside risks. At this stage, as David emphasized, substantial risks to the outlook for real growth remain, but I agree that they are much more balanced than they seemed to me in July. As David also indicated, it's possible to argue that there remains enough momentum in aggregate demand to potentially rekindle inflationary pressures. In that regard, I would simply point out that we have had a significant backup in interest rates since our last meeting, coupled with a significant appreciation of the dollar. I think that those two forces are working to restrain this upside risk.

At our last meeting, Mr. Chairman, you argued that the present level of the real funds rate is above the neutral or equilibrium level that is needed for stable growth with a continuing secular downtrend in the rate of inflation. The Bluebook for the July meeting reinforced the conclusion that, particularly with projected fiscal contraction, this neutral real funds rate would be declining gradually over time. I certainly agreed with that conclusion then and I continue, as Governor Blinder emphasized, to think that eventually the real funds rate is going to need to decline to keep the economy on track beyond the forecast horizon. I agree with Governor Blinder's explanation that if we were to go beyond the six quarters in the Greenbook, we would see initially a mild shortfall in growth below what is needed to keep the economy operating at potential and then the gap would begin to widen. It's in that sense that a decline in the real funds rate is eventually going to be needed to keep the economy on track. Nevertheless, over the forecast horizon I think that the outlook has definitely improved.

On the inflation front, the news has also been quite favorable. Recent readings on producer and consumer prices along with the appreciation of the dollar have lessened the concern that the uptick in inflation that we saw in the first half of the year could presage a higher inflation trend. And as David Stockton emphasized, the continued moderation in the growth of benefit costs and compensation is a favorable factor in the inflation outlook. It may be too soon to break out the champagne, but it seems quite likely to me that we will succeed in capping the inflation rate in this cycle and preserving the gains that have been made on the inflation front in the 1991 recession and the ensuing recovery.

CHAIRMAN GREENSPAN. Thank you. I assume we have coffee available at this stage.

MR. BERNARD. It's available.

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn, you have the floor.

MR. KOHN. Thank you, Mr. Chairman. As it turns out, my comments begin where the last two commentors left off. I'll be organizing my comments this morning around the real federal funds rate. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Is there a particular reason why you use a one-year forward expectation of the price index deflator with overnight funds?

MR. KOHN. First of all, I don't know what the overnight inflation expectation is. To make a guess about inflation over the short run, it's pretty reasonable to assume that people would look at inflation in the recent past, so we use a one-year backward-looking inflation measure. It does not give a significantly different result from the Philadelphia Fed's one-year ahead inflation measure. We don't have any shorter measure of inflation expectations. I do think that if folks are trying to guess at what inflation is going to be over the next few months, those guesses are not all that different from their guesses about inflation over the next year or what inflation was over the last year. But I'd be the first to admit that our measures of expectations are highly imperfect. I took a little comfort from the fact that both the backward-looking and the forward-looking measures gave roughly the same answers, though I think the forward-looking measures are--

CHAIRMAN GREENSPAN. Except now, if you use a two- or three-month moving average, won't you get virtually a full percentage point higher?

MR. KOHN. A full percentage point? I guess if you use the three-month moving average.

CHAIRMAN GREENSPAN. What has the inflation rate been in the last three months?

MR. KOHN. I would say 2-3/4 percent if I were going to guess. This has 3.1 percent built in. I am using the last 12 months.

CHAIRMAN GREENSPAN. I understand that. You are not using the core rate; you are using the total CPI, is that right?

MR. KOHN. Yes.

MR. STOCKTON. The total CPI has averaged about .2 a month for the last three months.

MR. KOHN. That's closer to a 2-1/2 percent rate, so it would be about 1/2 point perhaps.

CHAIRMAN GREENSPAN. Any other questions for Don?

MR. LINDSEY. Suppose your objective was to maintain nominal GDP in calendar 1996, and suppose on November 7th we got protracted, torturous messes on Capitol Hill and in the bond market. Suppose we got a contraction of government spending somewhere around 3/4 percent of GDP, and again it was messy in the bond market. Which would be more effective as far as influencing nominal GDP in 1996: to have a sharp cut in the fed funds rate at that time or to have gradual reductions leading up to it?

MR. KOHN. The premise of the question is that somehow on a given day you knew the size of the shock and it was huge relative to GDP. So there was no uncertainty going forward about how long the shock would persist and what its size would be.

MR. LINDSEY. The issue is resolved on that date.

MR. KOHN. My first thought is that if the issue is resolved, you know what the resolution is and where things are going, and everybody else knows--this isn't some inside information the Fed has--I don't know why you wouldn't reduce your rates right away rather than gradually. I'm not sure I see the advantage of gradualism in the case of an identified shock whose effects I am quite confident that I know, provided that the rest of the world sees the situation the same way so they don't misinterpret your policy actions. Governor Blinder was shaking his head "no."

MR. BLINDER. I thought the question was whether to move in advance. Isn't that what you just said, Larry? You got the right answer but not to the question that you asked. [Laughter]

MR. KOHN. If I knew now that this was going to happen--is that the question?

MR. LINDSEY. If you knew now that this was going to happen and the objective was the same. Maybe, Governor Blinder, you can help me out in phrasing my question. You are right; I don't think Don answered my question.

CHAIRMAN GREENSPAN. Am I grading these papers? [Laughter]

MR. LINDSEY. No, I'd rather he grade the papers. If that was what was going to happen, would it be more useful to wait until the event and have a sharp reduction on that day or to have a reduction sooner than the event?

MR. KOHN. If I knew what was going to happen but the markets didn't?

MR. LINDSEY. Right.

MR. KOHN. That's the key because, as I think Mr. Simpson demonstrated last time, if the markets know what will happen they will take bond yields down and that acts basically as an automatic stabilizer. It doesn't matter quite so much how the Fed validates it. Eventually you have to validate it, but the timing of our moves is not so important. If you knew today that there was going to be a major contraction beginning on November 7th, you would have to proceed somewhat gingerly because there would be a problem if the markets didn't know it. They wouldn't know how to interpret what you were doing even if you stated what you were doing. If they didn't believe you, there could be a potentially adverse effect on inflation expectations or a lot of confusion and volatility in the markets. So, you have set up a very difficult problem where the central bank does have inside information, while the rest of the economy doesn't have it and might or might not believe the central bank if it provided that inside information. So, I think you would have to proceed very cautiously in that kind of situation.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Just a quick comment and a quick question. The comment is that I noticed some changes in the way the Bluebook was constructed and the way you presented some of the information, which I thought was useful and constructive, Don. The question I had: We have had a significant backup in long-term interest rates over the intermeeting period, 35 basis points at the long end of the yield curve. There wasn't a whole lot of discussion about that. I interpret that backup as being in part, and maybe largely, a change in inflation expectations and psychology in the market, albeit a short-term one. It's hard for me to see how real rates would move that quickly. Much of this took place in a very short period of time--shortly after the data began to come in stronger. Do you see it that way?

MR. KOHN. I would say, President Broaddus, that I see it as much more of a mixture, perhaps with a little more emphasis on the real rates but not exclusively the real rates. That is, I think the information that hit us and the market over the intermeeting period was that real growth was stronger at those old interest rates than we had been expecting. In classroom jargon, the IS curve was out a bit further than we thought. That to me would suggest that in fact real interest rates need to be higher over the business cycle to keep the economy at its potential. If you look at the pattern of forward rates, a lot of the bulge in forward rates over the intermeeting period is at business cycle frequencies of three, four, five years. At the same time, I think we probably can never settle this because we don't have inflation-indexed bonds. Given that the economy was stronger, I think it's logical that inflation expectations might have been revised up at least a little, but I would put much more emphasis on the real side than on inflation expectations.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Don, first of all I wanted to comment that I really appreciated the remarks you made with respect to the Bluebook. I must say that I read the discussion of real rates in the Bluebook and got a headache! I think what really bothered me about it is that I view real rates, like any other real variables, as something we can't influence in the long run as well as something that we can't observe. So we are describing policy actions in terms of something we can't affect and something we can't see. That's why I got the headache. Now, there is an easy solution to that: get inflation down to zero, keep it there, and we won't have to worry about it. We have just cut short rates 25 basis points and have seen long-term nominal rates go up 35 to 40 basis points. In that light I was going to note, particularly with regard to a policy option such as alternative A, that it is incomprehensible to me that we somehow could cut short rates again based on our forecast of inflation, which the market doesn't know about, and keep real interest rates in general from rising, let alone foster lower real rates. This is very similar to the example you were giving in response to Larry's question. The Greenbook inflation forecast is not supported by most other forecasts and many surveys of longer-term expectations. Real rates, as you suggested in your remarks, are a helpful thing to look at over longer periods of time, but I don't know what to make of the analysis of a short-run policy option based on what would happen to real rates, particularly to real rates across the yield curve.

MR. KOHN. I don't think I can help your headache. [Laughter] I can try to explain what I was thinking about. I think that the Federal Reserve can affect real rates by changing the federal funds rate, real and nominal, since the two are about the same because inflation expectations don't change in the near term. I think expectations about what the Fed will do with interest rates do have an effect on real rates, at least through the intermediate part of the term structure. I believe that's the primary channel of Federal Reserve policy to the economy. In 1979, 1980, 1981 this institution raised real rates to very, very high levels and had a major effect on economic activity. Those real rates rose at short- and long-term maturities in order to put slack in the economy and reduce inflation. So, I think the Federal Reserve can affect real rates, at least over a business cycle. I agree that in the long run productivity and thrift determine the long-run real interest rate. The premise of our meeting here and making policy changes is that in the short run we can affect real rates and lean against business cycles. Perhaps we don't do a perfect job all the time, but I think the evidence of the last 15 years shows that we have done a pretty good job on at least a few occasions in smoothing through these cycles by changing real rates.

With regard to alternative A, I believe that if you were to lower the nominal funds rate, you would have an effect on real interest rates at least through the intermediate-maturity spectrum. People would change their idea of what this Committee was going to do with interest rates. What would happen to nominal rates is a bigger question and one that we debated amongst ourselves in writing that particular paragraph. That is, if our policy was not credible, if people thought that lowering these interest rates would simply provoke more inflation, then nominal intermediate- and long-term rates might very well do nothing, in which case the inflation expectations part would rise even though the real rate was lower, or these nominal rates might even rise. My view in the end was that the FOMC has a lot of credibility and that if the Committee lowered rates and in particular if you said that you lowered rates because you had an optimistic view on inflation, that would carry some weight in the market at least for a while. If I remember the paragraph, it would only be if the incoming data failed to confirm the Committee's expectations that rates would then back up. But I agree it's entirely a guess as to where inflation expectations will come out if you do that.

MR. MELZER. I thought it particularly difficult in the context of our most recent experience to make that argument. Let me just leave it there.

CHAIRMAN GREENSPAN. Tom, there is no question that you are right on the longer-term rate spectrum, but if hypothetically we just squeezed reserves out of the system, two things would happen: The nominal rate would go up and the inflation rate would go down, and the real rate would have to go up. But I think that is not true in the longer run, which is where we can't affect it.

MR. MELZER. It's not true in the longer run. I get troubled when we start extending that out the yield curve and making judgments as to how it affects the long end of the curve.

CHAIRMAN GREENSPAN. I think it is not true in the long run, and it is not true in a long-term forecast of the real funds rate, if I may put it that way. But for a short-term forecast of the real funds rate, I think Don is exactly right on that.

MR. MELZER. In terms of the funds rate, yes. What troubles me is going out the yield curve and making a general application.

CHAIRMAN GREENSPAN. Or a long-term projection of the real overnight rate--in other words, what the funds rate is going to be three years or ten years from now.

MR. MELZER. Sure.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. Don, I want to ask you a question that came up when I scribbled my notes last night, notes which were much less extensive than yours. I was thinking about the difference between the real Treasury bill rate, or any interest rate that really matters to somebody, and the real fed funds rate, which doesn't matter to anybody but us and a few banks that trade fed funds. If I am not mistaken, when we looked at this a while back, it was somewhat puzzling that nominal fed funds rates were higher than Treasury bill rates on average over long periods of time. Is that right?

MR. KOHN. Yes, but there are two differences. One is the taxation. Treasury bills aren't subject to state income tax. People often use a New York resident as the marginal holder, so it's a nontrivial tax rate like 10 percent. The second point is that one is the obligation of someone who hasn't defaulted--at least until a few weeks from now--and the other is a private rate. There is a different risk premium.

MS. MINEHAN. Yes.

MR. BLINDER. Different risk?

SPEAKER(?). Sure.

MR. BLINDER. Yes, but that goes the other way.

CHAIRMAN GREENSPAN. No.

MR. KOHN. Fed funds rates are higher than bill rates because banks are riskier than the government.

MR. BLINDER. I am sorry. Am I right that the average gap over a very long time is in the range of 75 basis points with fed funds higher?

MR. PARRY. That's too high.

MR. KOHN. That sounds too high to me as well. Dave is saying 50 basis points. In the Financial Indicators package there is a one-year real funds rate; I don't know whether that's helpful in terms of the point you are getting at.

MR. PARRY. He's talking about the two nominal effective yield curves?

MR. KOHN. Yes. The difference is about 30 basis points now and it looks like the average may be about 50 to 75 basis points. It was low for a long time.

MR. BLINDER. What I was getting at is this: On the question of the real rate relative to historic averages, I think you get a little stronger case that it's on the high side if you look at, say, Treasury bills.

MR. KOHN. Treasury bills?

MR. BLINDER. I think that's more correct than if you look at funds.

MR. KOHN. I will have it plotted and distributed to the Committee.

CHAIRMAN GREENSPAN. Anything else? At the last meeting and at the Humphrey-Hawkins testimony, as Governor Yellen suggested, I indicated that the maximum risk of a short-term recession was probably past. Indeed, the data that have emerged since then have increased the probability that the risks of recession have eased. A significant part of this is unquestionably the fact that we are not seeing a weakening in final demand despite all the evidence that clearly points to a far more rapid pace of inventory adjustment than we had contemplated at the last meeting. The lead times are continuing to fall and the inventory adjustment process is still going on. It may be a bit premature to presume that the adjustment is complete at this stage or approaching completion. There is no question that we are beginning to see order patterns that are stabilizing, but the adjustment has been too quick and the timeframe too short for us to believe that we are through it as yet. I would not be surprised to see industrial production sagging for a number of weeks or a month or so before we work our way through this. Nonetheless, I think the evidence clearly is emerging that the underlying structural weakness that concerned us is dissipating. The evidence of much stronger growth in output is lacking but, as I think Dave Stockton said, the probabilities of that occurring have gone up. Indeed, while the anecdotal evidence around this room has pointed with surprising unanimity to a pause, the Districts are doing better now as we go from one to another than they were three months ago. I think that probably reflects the fact that the economy is coming back and growing at a faster pace, but real pressure on the up side seems a good distance away, judging from all of the numbers we have at this particular stage. When we look at the individual company data and the anecdotal data on orders, it is clear that conditions are improving overall, but it is a mixed bag. It is not the straightforward universal strength that the economy exhibited in the latter part of 1994.

Whatever forecast we are looking at, I think a smooth pattern is not going to be the actual outcome. Our forecasts are going to be tested by the fiscal crunch we are all talking about. It is not self-evident to me that the crunch will involve a major contraction in federal spending. I think there are two sides to this issue. First of all, it is pretty obvious that if the debt limit blocks spending--and indeed, as Larry Lindsey said, the chance of getting a debt limit extension through the House without a balanced budget in place is very small--we will have a dramatic shutting down of the government. I am inclined to the view that, when push comes to shove, we are going to get consecutive one-week extensions of the debt limit rather than allowing it to push the economy down. And the ambiguity with respect to the question of how appropriated but unspent funds are employed in various authorization bills, when there is indeed no authorization for the period after September 30, leads me to conclude that the rate of reduction in discretionary spending will be modest in the short term. We will get very significant cutbacks in certain budgets, but overall, if entitlement spending continues as indeed it does in this particular context, the contraction in spending will be modest in the early stages. It would be severe if a debt limit is allowed to go into effect.

If in this process we end up with a very sharp reduction in federal spending, the fiscal drag issue will arise, especially if it is presumed that the decline in expenditures will be temporary. Under those conditions we will not get offsetting pressure from falling long-term yields, but we will get a contractionary effect from a reduction in incomes. That will require very difficult policy judgments on our part because I don't recall any historical precedent telling us how all this works. It may well be that everyone will see the decline in income as temporary and hence the saving rate will collapse but expenditures will not. Nominal GDP will stand up except for the effects of liquidity constraints, of which there have to be some. But there is no doubt that until we get a sense of that, we will not be quite sure where it will come out.

There is also the distinct possibility--although hopefully at this stage it is a very small probability--that we will run into a situation in which the outlook is for materially less budget deficit reduction. If the outlook for substantial deficit reduction does not look as likely as it does now, markets are going to react very adversely. We will get a significant rise in long-term rates because very clearly there is sizable deficit reduction embodied in the long-term rate structure. If that were to happen, the stock market would come down very dramatically. Therefore, it is possible that this fiscal outlook can create negative real effects on the economy if the budget deficit reduction is too much or if it is too little. It is very difficult to know what the probability distribution looks like.

The one thing that is clear is that the budget process is now moving forward to some form of crunch. It just is not conceivable at this stage, at least as I see it, that there can be a resolution before October 1st. I find it highly unlikely that continuing resolutions will simply be adopted as they have in the past. Some variations of continuing resolutions and debt limit extensions may occur, but they are surely not going to apply universally. That means that there will be some impact of an order of magnitude and a nature that I don't think we can get a sense of at this particular stage. We can judge that better after Labor Day as we begin to see whether in fact there are going to be filibusters on the appropriations bills in the Senate. If we don't get appropriations bills, we can be certain that we will not get majority votes for continuing resolutions. Therefore, there will be no budget and no legal authority to spend. In the Budget Act that was passed around five years ago, Congress narrowed very significantly the ability of the President to define threats to life and property as reasons to invoke expenditures to protect them.

So, we have emerging an extraordinary set of events that belies the tranquility of the Greenbook forecast. It is not terribly clear precisely how the fourth quarter is going to come out. The one thing I am absolutely certain of is that it is not going to look like the Greenbook forecast. However, I would not know which numbers have a higher probability of being realized because I think that the Greenbook forecast may be the maximum likelihood estimate. But then who knows what the distribution looks like on each side of that forecast?

I conclude from all of this that we don't know how the budget debate will be resolved. We will have another shot at it at our next FOMC meeting, which fortuitously occurs just before October 1st. I think we will know a good deal more about how things are evolving at that stage. As a consequence and in the context of our discussion in July, I agree with Don Kohn that the real federal funds rate is a good starting point to get a sense of where we are. Other things equal, that rate is probably somewhat higher than we are likely to want it to be somewhere down the track or over the longer run, with "down the track" being on the other side of the fiscal train wreck, to keep this analogy going. In the immediate period ahead, it strikes me that the general outlook is extraordinarily benevolent and one that I view at the moment as pointing to no change in policy. That is, "B" and symmetrical seems to me the most sensible approach until the next meeting. By the next meeting, I suspect that we are going to have to make a number of contingent decisions. I will be very surprised if we do not have several telephone conference calls in the month of October as this budget situation evolves because there will have to be coordination between the Treasury and ourselves to ascertain what is going on and to take measures that, to whatever extent possible, will mitigate the secondary consequences of this fiscal process that will loom ever larger as we move into the fourth quarter. Tom.

MR. HOENIG. Mr. Chairman, I support your policy proposal.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I support your policy proposal.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. As do I, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. As do I, Mr. Chairman.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. As do I, Mr. Chairman.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I support your proposal.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Ditto, Mr. Chairman.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. The same.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I support it, Alan.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I support it as well.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Me, too.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I agree.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I also.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. I support your proposal, too.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. I support it, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. So do I.

CHAIRMAN GREENSPAN. Have I run out of people? We'll have lunch earlier than usual! [Laughter]

SPEAKER(?). It's those sharks!

CHAIRMAN GREENSPAN. Why don't you read the relevant language?

MR. BERNARD. I'll be reading from page 14 in the Bluebook: "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, slightly greater reserve restraint or slightly lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with more moderate 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 Hoenig	Yes
Governor Kelley	Yes
Governor Lindsey	Yes
President Melzer	Yes
President Minehan	Yes
President Moskow	Yes
Governor Phillips	Yes
Governor Yellen	Yes

CHAIRMAN GREENSPAN. Our next meeting is on September 26 and I think we'll have a very interesting meeting. We adjourn for lunch.

END OF MEETING