Meeting of the Federal Open Market Committee Meeting
August 16, 1994

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, August 16, 1994, at 9:00 a.m.

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

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

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

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

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

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

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

Mr. Madigan, Associate Director, Division of Monetary Affairs, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Bennett, Davis, Dewald, Rosenblum, and Vander Wilt, Senior Vice Presidents, Federal Reserve Banks of New York, Kansas City, St. Louis, Dallas, and Chicago respectively
Messrs. McNees, Meyer, and Sniderman, Vice Presidents, Federal Reserve Banks of Boston, Philadelphia, and Cleveland respectively

Ms. Meulendyke, Assistant Vice President, Federal Reserve Bank of New York
Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

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CHAIRMAN GREENSPAN. Before we get under way today, I want to welcome Governor Janet Yellen who is attending her first Committee meeting.

MS. YELLEN. Thank you.

CHAIRMAN GREENSPAN. She was exposed to her first Board meeting yesterday. You survived that, and I wish you well today.

MS. YELLEN. Thank you; it's good to be here.

CHAIRMAN GREENSPAN. Cathy Minehan is at her first meeting as President of the Boston Bank and we congratulate you.

MS. MINEHAN. Thank you.

CHAIRMAN GREENSPAN. Finally, while Bill Conrad has been here before, this is the first time he is representing the Chicago Bank. So I have many announcements--more than usual for this organization. Let's start by having somebody move to approve the minutes of the July 5-6 meeting.

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Is there a second?

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Without objection. Peter Fisher, would you take us through the foreign operations Desk report?

MR. FISHER. Thank you. [Statement--See Appendix.]

CHAIRMAN GREENSPAN. On that there are two ongoing thoughts that are supposed to be insights into what happened. First is the notion that the moves on the part of those two central banks were suggestive of the fact that declines in European rates had come to an end. The other is that because the public debt/GDP ratio in both countries is exceptionally high, the rise in interest rates was suggestive of the fact that the deficit might be more of a problem. To which of those two, if any, do you subscribe to explain this phenomenon, which scares every central banker I know?

MR. FISHER. I think the market's immediate reaction was more the first of the two you mentioned. I think that the extremity of the reaction, if I can distinguish the fact of the reaction from the extent of the move once it got going, was more of a gnawing anxiety about the general fiscal condition of Europe--of all the European countries put together. But untangling those two anxieties in a relatively short time is quite a problem. I would point out, if you'll forgive me, Mr. Chairman, that the very technical aspects of the announcements were not handled as elegantly as they might have been. The Italian announcement came with 60 seconds left in trading on LIFFE futures. There were many people in London with very bloody fingers trying to cut back their positions. That certainly contributed to the very extreme reaction on that day. Clearly, those two countries are the outliers on the fiscal side in Europe. No one in Europe had been anxious about a general backup in short-term rates beyond the fact that everyone expected the UK to begin raising rates sometime soon. As the market digests what happened and distinguishes the stronger countries from the weaker countries, there may be some improvement, but I wouldn't expect that very soon. The markets may have a hard time digesting and untangling whatever it is the Bundesbank does on Thursday. I think that there is likely to be a period of continued gnawing in European bond markets for several days to come.

CHAIRMAN GREENSPAN. Further questions for Peter?

MR. BLINDER. I have one, Peter; it's sort of in two parts, but they are part of the same question. Markets tend to latch on to things in faddish ways. Something was almost implicit in what you said, and I want to see if you want to make it explicit--it's about the fad that dollar/yen dances to the U.S./Japan trade talks or events, that is, to monthly announcements of the trade figures or to the talks. It was almost implicit in what you said that the market seems to be getting off that fad. Did you mean to say that? And then the second part is related to the looming date, September 30th.

MR. FISHER. I think the market is faddish; I'll agree with you on that. I think there is an opportunity for the market to be less anxious about the trade talks. I'm of the school in interpreting the market's reaction to trade talk announcements that believes the market is biased in its reactions. When the announcements tend to be explicit, mundane, and mechanical, however strongly articulated, e.g. "we are imposing a 60-day deadline," the foreign exchange market, dollar/yen, can shake that off fairly easily. What is harder to interpret is what happens when the announcements come in a setting or context that the overall Japan/U.S. relationship or the overall economic relationship including exchange rates and trade flows is at stake, and that's what is being argued about here or that's why this announcement is being made. That then tends to undermine the confidence in dollar/yen and the confidence that the Administration would stick to a stronger dollar rhetoric. So I think that there is a nuance that the market is really very quick at picking up on, whether the announcements are couched in this broad overall relationship or whether they are couched in the specifics of the trade announcement at hand. I think that on reflection, the end of July announcement by the U.S. side was seen in the mechanical context. The market reacted negatively actually to the Japanese announcement that they would walk away on September 30th if sanctions were imposed. Now, that announcement fell on what probably is the thinnest foreign exchange market in the world, which is New Zealand when Australia is on holiday in early August. [Laughter] The big reaction we got was clearly related to the fact that no one was trading there. Some people stayed in New York Sunday afternoon to sell into it and see what was there. I think everyone then realized that was 60 days away and 60 days is eternity for the foreign exchange markets, so we will worry about that in the period to September. I will say regarding the period to September, what has made me more anxious than anything is seeing a number of members of Congress write a letter to the Administration saying they hoped the Administration would be tough in the trade talks. I think the foreign exchange market could very easily focus on a date, but that is the sort of thing the exchange market can get riled up about. If there were even a modest shift in a few members of Congress choosing to run on a trade issue rather than a health care issue, that could get the foreign exchange market very engrossed in the run-up to that date. I think that could be difficult.

MR. BLINDER. Thank you.

CHAIRMAN GREENSPAN. Any further questions for Peter? If not, Joan Lovett will you carry us through domestic operations?

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

CHAIRMAN GREENSPAN. Questions for Joan? If not, would somebody like to move to ratify the actions of the Desk since the last meeting?

SPEAKER(?). So move.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Let us move on to the economic situation and Mike Prell.

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

CHAIRMAN GREENSPAN. In looking at the divergence between the permits and the starts in this morning's release, as you know, it could possibly be that we had a significant increase in non-permit single-family starts. Do we have those data yet?

MR. PRELL. No, I don't have information on that. It's very clear the ratio of starts to permits for the single-family sector is extended well beyond the norm. Given the better statistical reliability of the permits series, I think that this argues pretty strongly for starts likely to have been less robust than this report suggests. But we had a level of single-family starts for this quarter in the forecast that would still be below any reasonable adjustment, I think, of that single-family starts rate.

CHAIRMAN GREENSPAN. Any further questions for Mike or, I might say for that matter, for Ted Truman who has no formal remarks to make? President Parry.

MR. PARRY. Mike, in the Greenbook forecast inventory investment comes down to more traditional levels. And I think as a result the inventory/sales ratios, if I remember them from Part II of the Greenbook, also come down. Would you comment on the risks to the assumptions about inventory investment because it seems to me possible at least that we could see more inventory building in the forecast period than is incorporated in what may be a conservative forecast.

MR. PRELL. I think it's a reasonably balanced forecast, given my suspicion that inventory investment in the second quarter may have been overstated. But I wouldn't want to make too big a point of that. The May figures held up very well; they were raised in the revised figures. To date, there hasn't been any evidence there. But we have, in essence, carried through a slightly higher level of the inventory/sales ratio, that having been achieved in the second quarter. We do not have a significant movement; the ratio begins to trail off very slightly in the latter part of 1995. In a sense, at that point we are beginning to get a little improvement in final sales and we begin to see the hint of a restoration of what we think is the secular downward trend in the overall ratio. We have anticipated in this forecast that the adjustment in stock levels relative to sales trends is going to occur in the distribution sector, particularly retailing. We have allowed in effect for a substantial degree of manufacturing inventory accumulation, which is the area where we might have anticipated the upside risk to have existed because of the tightening in supplies and some of the pressures on prices of materials and so on. Certainly, no inventory forecast is without its risks, but I think in this case the balance is not distinctly on one side or the other. We really are not uncomfortable in that respect.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I'm a little puzzled by the projected levels of consumption expenditures and am trying to reconcile them with the relatively high continued levels of housing starts projected in the Greenbook as well as the further increase in light motor vehicle sales to the highest level since 1988. That just doesn't seem consistent to me.

MR. PRELL. A compound question here, I think.

MR. LAWARE. A confounded question, I guess.

MR. PRELL. No.

MR. LAWARE. I'm confounded at any rate.

MR. PRELL. Let me try to be helpful with a few, brief comments. I think if we had to do the single-family housing construction forecast again today, we would still have in essence the kind of pattern we have, with some further erosion of single-family housing construction in the near term and then some firming over the course of 1995--the levels in the two years being pretty comparable and quite decent by historical standards. A fairly high level of existing home sales is also likely over that period. We have seen very strong sales of appliances and furniture. Even through July, the retail sales report shows considerable strength there. We would expect to see some ebbing of that strength and some deceleration in non-motor vehicle consumer durables outlays over the coming quarters. At the same time, we think we've reached a rather low level relative to the plausible trend in motor vehicle sales, in good part because of the shortage of some of the more popular models. We see a substantial ramping up of production going on currently and we are anticipating that sales will move up significantly in the next few months, and then we have a slight upcreep during 1995 with the continued moderate growth of income and employment. Our sense is that there probably is still some element of pent-up demand in the motor vehicles sector, just looking at what has happened to the stock of cars relative to the number of households and the aging in the stock and so on. Our forecast for next year, at just a little over 15 million for light vehicle sales, is certainly not high by the standards that we see in private forecasts and certainly not relative to the hopes of the automobile industry. I think they will have the capacity to supply that many cars and this is not an extraordinarily high level of durables expenditure overall relative to income or GDP. In fact, it's rather moderate in that sense. So I think there is a reasonable rationale for this path.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I have a couple of questions, Mike. The first one has to do with the price forecast. How much of that is empirical as opposed to judgment? I ask because some preliminary work we've done suggests that if you look at capacity measures versus measures of price or wage inflation, they look pretty good into the early 1980s but then the relationship seems to deteriorate rather significantly. I'm curious what you see going on there.

MR. PRELL. Well, we have at least 59 varieties of, or is it 57, I don't know, [Laughter]--57 varieties. The number has crept up over the years, of econometric models. So, we probably can encompass a pretty wide range of outcomes, given the conditioning assumptions of the degree of slack in labor and product markets, the acceleration or deceleration in activity, the signs we have seen of materials' cost rising, the implications of exchange rate changes for import prices, and so on. Our models have not done that poorly in capturing the general trend of things. Our analysis is that we are generally in the ball park of the natural rate, I think our forecast looks quite plausible. We have sort of a stabilization of the core inflation rate. One could say that there might be some offsetting influences here of abatement of the speed effects and the pressures on materials prices that we've had recently and some of the shifts in the influence of the exchange rate. I think this is not hard to justify at all in terms of a pretty wide variety of econometric models, but a significant element of judgment has gone into this. As I indicated, we simply do perceive a leveling out of things that have occurred in the last several months, the last few quarters. We foresee a generally stable labor market and level of industrial capacity utilization if the economy slackens as we have forecast. And so the broad macro conditions are sort of stable in this picture.

MR. STERN. My second question--as I understand the forecast, you have long-term interest rates coming down next year, is that right? [Mr. Prell: Yes.] How much precedent is there for a decline in long rates like that in circumstances where you have stable short-term rates and a continuing expansion? Obviously, we had some periods in the 1980s when long-term rates came down in the middle of the expansion but short-term rates were declining through at least some of that period as I recall. So I'm trying to look for history and my memory isn't that good about all that.

MR. PRELL. I think you probably cited one period in which we could find it in the 1980s, but I'd have to reexamine that record. I'm not sure what precedent one would look for: What we are anticipating in this forecast is a moderation of economic expansion that extends this cyclical upswing with inflation not picking up at all. We think that the implied real rates of interest, given the kind of inflation expectations that presumably could prevail in 1995 with the continuation of 3 percent inflation, are fairly ample by historical standards. Even with the nominal rate decline we have, these real rates might be regarded as generous by historical standards. Some might say it poses the possibility of a downside risk. We think that there is probably still an element of extra liquidity premium in the market--some trepidation on the part of investors. People who had been throwing money into bond mutual funds with abandon until a few months ago are perhaps a little more cautious now. I think we can get a combination of some reduction in the inflation premium and some reduction in the liquidity premium that is probably still embedded in the long rates. The yield curve would still have an upward slope of some significance and certainly wouldn't look strange in that regard.

MR. KOHN. Of course, we did have a period in the second half of 1988 and early 1989 in which short-term rates were moving up smartly and long-term rates were doing nothing.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Mike, I'm interested in your confidence levels for various parts of the forecast. Where are the surprises likely to be? If one starts a year ago, in your assessment in August and September as to the year ahead, at that point one of the things you talked about was a middling expansion and maintenance of the low interest rates necessary to support it. You were more optimistic about long rates coming down than was the marketplace. Your forecast for growth wasn't that much different in real terms than the Blue Chip or others, but you had more confidence on inflation and long rates. What's happened since is that we had a lot more real growth, a lot more employment growth, and a much different structure of interest rates, yet your inflation forecast has come out very close. What happened to inflation in between has been very close to what you were saying a year ago it was going to be even though the other circumstances associated with that inflation didn't obtain. If you now project out a year from now, what in your thinking is the most likely vulnerability of the forecast and where do you think the surprises are going to be--on the real side or the inflation side?

MR. PRELL. I suppose I should have thought ahead to this kind of question; it comes up frequently. I don't really have any clearcut answer jumping into my mind at this point. I think there are risks that one could identify in every sector and I could identify them as having potential on both the upside and downside. So I don't think there is any key number here. On the inflation--sort of the Phillips curve--side of things given the outlook path, we certainly are somewhat at sea still about what the unemployment rate truly is right now. There is still, because of the change of surveys, an unusual degree of uncertainty about the seasonal [unintelligible] labor force participation would change radically from where it is now. We noted that we tried to come to grips with the news that we've seen recently, but that news involves a lot of interpretation. And so even given an output path, the degree of labor market slack that that implies is uncertain. Looking back at the recent experience and maybe leaning toward a slight degree of pessimism, one could argue that things really began to firm--the end of the deceleration in wages, the lack of evident further deceleration in core CPI--earlier this year, before we got the drop in unemployment that we've seen recently. This might suggest that more pessimistic views of where the NAIRU is, such as those embodied in the famous Kansas City Fed estimates, might be correct and that one could see some pressure emerging fairly promptly that we don't have in our forecast.

On the other hand, as I said, the range of estimates we could come up with in this regard certainly embodies NAIRUs that would be below what we perceive the current level of unemployment to be and thus might give us a little more room to run. We've got a sustained strong investment pattern. We think that makes sense, but it is on the strong side perhaps of what some models would suggest. There is uncertainty about inventories, and certainly in the near term, if there were enthusiasm about building stocks because of concerns about supplies and price increases, that could give some impetus. We are continuing to see the evolution of the recoveries abroad, and in that kind of dynamic one could be off the mark in gauging just what impetus we are going to get one way or the other there. Given our own experience in the United States and maybe once things settle down, one could see a sequence of surprises in a positive direction. On housing, as we saw this morning, we've been surprised; and so we could be right or wrong there. I don't feel that this is, on balance, far out of line with the Blue Chip consensus in the sense that they have more growth and more inflation. They have higher nominal short-term interest rates, I think, ultimately perhaps. But again, that is also consistent with more inflation. So there is not a glaring inconsistency of our view with a lot of the private forecasts.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. Mike, I have just a simple question about the news since the last Greenbook. You mentioned that June and July payroll employment came in stronger than you expected. Do you happen to recall what was built into the previous Greenbook for June and July?

MR. PRELL. My recollection is that we were anticipating that the increase in the latest month would have been 50,000 or so less.

MR. BLINDER. July?

MR. PRELL. Right.

MR. BLINDER. Including the 30,000 rise in the bias adjustment? If I'm not mistaken, the bias adjustment changed from Q2 to Q3.

MR. PRELL. Without an explicit view about the bias adjustment. I think the bigger surprise was in June where we got a whopping increase in employment, and we were, as I recall, anticipating something again more in the 200,000 area. So I think, we have had a substantial upside surprise for those two months.

MR. BLINDER. Say, more than 150,000 jobs or something?

MR. PRELL. I think that is the order of magnitude.

MR. BLINDER. Okay, thanks.

CHAIRMAN GREENSPAN. Any further questions for Mike or Ted? If not, would somebody like to start the round table?

MR. BROADDUS. Mr. Chairman, the reports we have been getting on the District suggest that overall economic activity in our region is still growing at a healthy pace. My personal sense is that there may have been some moderation in the rate of expansion in our region from earlier this year, but not much and there may not have been any at all in some areas. Some parts of the District, particularly central and western North Carolina and northwestern South Carolina can only be described as booming in my view. Moreover, some of the recent commentary we are getting suggests that the northern part of the District and the West Virginia economy, which had been lagging behind the Carolinas earlier in the expansion, are now catching up. At our board meeting last week, directors from both Maryland and West Virginia gave particularly bullish reports on conditions in their respective state economies. In this regard, I might say that the adverse effects of cutbacks in defense spending, which of course are concentrated primarily in the northern part of the District, while not negligible by any means, seem to have been somewhat less severe than might have been expected earlier. Residential construction is off somewhat in the District as elsewhere, although there are still areas of very robust growth in housing, again especially in North Carolina. Offsetting at least some of the softening we are seeing in residential activity, there is a real surge in commercial real estate activity. Leasing is strong and in many District markets vacancy rates are down and there are a number of sizable new construction projects under way. Elsewhere, activity in manufacturing, retail, and the services sector continues to expand, according to the reports we have, although again perhaps at a somewhat more moderate pace than a few months ago. On the baseball front, we have bad news and good news in our District. The bad news is that somebody has estimated that the state of Maryland will lose about $3 million in business for every Orioles game that is not played. The good news is that the Richmond Braves are still playing. And if anybody needs tickets, let me know and I'll see what I can do!

Nationally, it seems to us that the economy is still quite strong and we don't think either the apparent softening in consumer spending in the second quarter or the recent slowing in residential construction poses a significant threat to the expansion at this point, given what we know now. Deceleration in housing--I guess there is some question now with the data this morning as to how much deceleration is actually going on, but clearly there is some and that is not unusual I would argue for this stage of the business cycle and probably reflects the satisfaction of pent-up demand to some degree as well as the increase in mortgage rates. And the slowing in growth of real consumer spending, after all, follows three consecutive quarters of very robust growth in consumer outlays; and it seems clear now, as Mike Prell said, that at least some of this weakness reflects supply constraints, especially with respect to domestic automobiles. Moreover, the latest reports on consumer sentiment suggest that consumers are not backing off in any big way. As Mike said, the continued strong gains in jobs presumably are going to support growth in income and spending in the period ahead.

Against this background, the Greenbook forecast certainly seems reasonable to us. Our guess is that nominal GDP may grow somewhat more rapidly in the second half of this year than the 4.7 percent annual rate of increase that the staff is projecting. Looking ahead to 1995, the key number as far as I'm concerned is the staff forecast of a 3 percent inflation rate next year. As we all know that forecast is predicated on the assumption that the Committee will move short-term interest rates up on an order of magnitude of perhaps a point by early next year. I think the staff is right in assuming that some additional restraint of this order is going to be necessary to contain inflation going forward, and personally I think it's important to begin that process now.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Thank you, Mr. Chairman. Economic activity in the Sixth District is expanding moderately and we continue to outperform the nation as a whole. The contacts that we have had since the last meeting indicate that their businesses really are doing quite well and there is very clearly an attitude of optimism both among the business people and the consumers that we have talked to. I think this optimism is borne out and confirmed by the numbers. For example, retail sales rebounded in both June and July and they are expected to remain healthy. Apparel, which had been weak for awhile, has been especially strong and again is expected to remain so. On the other side, sales of durables are beginning to moderate. We have not heard of any unexpected inventory buildup in the retail area. As a matter of fact, some retailers are telling us that they plan to add to their inventory stock. On the manufacturing side, we did have a tapering off over the summer, but this appears to be seasonal in nature. The contacts in our survey have indicated some optimism about orders as well as production six months from now. Inventories here also appear to be in line with the desires of manufacturers, and several contacts plan increases in their stocks of materials over the next several months. In the energy sector we are seeing better activity, particularly in Louisiana. The rig count was up from 127 to 136 in the month of May. We did have some tapering off also in single-family housing, but this has been affected by unusually wet weather. We do think that there will be a continued deceleration in this area. We have had some unexpected strength in multifamily housing in the District. There has been a lot of in-migration to the Southeast, and rental markets have tightened in many areas and rents are rising. On the commercial side, absorption is reducing inventories of space and effective lease costs are moving up. Tourism remains a strong point in the local economy.

Since the last meeting, Mr. Chairman, I've spoken to several groups of business people around the District and there are two themes that seem to emerge from those meetings. The first is that most of them are reporting some input price pressures and, for the first time in a long time, I've heard that now to some extent they are able to pass those price increases through. The second theme is that they are experiencing labor shortages, not only for skilled people but for semi-skilled and unskilled. In our District at least, it's across the board and some firms are actually paying signup bonuses even for unskilled people. I thought that only applied to baseball and football players, but in fact clerks are getting them as well! As an aside, their problem with labor is exacerbated by the fact that as many as 50 percent of the applicants fail the drug test that the firms are giving. That is in spite of the fact that the firms have notices up on the premises that they will test for drugs--

CHAIRMAN GREENSPAN. That suggests that the literacy rate isn't very high!

MR. FORRESTAL. This may be unique to our District, I don't know; but certainly it's been reported almost universally among the people that I've talked to. It hasn't translated so far into a lot of wage increases, but I'm sure that will come. Just a word on the floods: The damages from the floods in south Georgia and a few parts of Florida and Alabama appear to be on the order of magnitude of about $750 million, that is about $250 million less than was originally thought. The estimate assumes rebuilding and replacing all damaged property and infrastructure but it does not include an allowance for lost business activity. Most of the losses were in the agricultural area. The flooding, of course, was extensive and it created many hardships for the people involved, but the economic impacts were quite limited because of the sparse populations in the areas affected.

With respect to the national economy, I think that things are moving along at a fairly reasonable rate. Our forecast hasn't changed very much since the last meeting. We continue to differ with the Greenbook on two counts. Except for the very near term, we have somewhat stronger growth for the forecast horizon than does the Greenbook. And our inflation forecast in line with the GDP forecast is somewhat higher as well. We see inflation creeping up by the end of 1995 to the 3-1/2 percent level. In general, as I just indicated, Mr. Chairman, I'm really quite pleased with the outlook. Of course, our forecast also assumes some tightening of policy as well. If we can emerge from this current expansion with a somewhat lower cyclical peak in the inflation rate and we can successfully avert a recession, I'd be quite satisfied. Thank you.

CHAIRMAN GREENSPAN. President Parry.

MR. PRELL. Mr. Chairman, may I simply improve upon my answer to Governor Blinder? In the latest data, there were upward revisions to April and May payrolls from what we were aware of at the time of the June Greenbook, a total of about 100,000. The increment to what we were expecting in June and July is about 150,000. So the total increment we have had is considerably larger than what I suggested. But the June-July increment is about 150,000.

MR. BLINDER. Thanks.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, trends in the Twelfth District economy are little changed since our last meeting. Employment has grown 1 percent during the past year with strong gains in many parts of the region offset by flat conditions in California. Idaho, Nevada, and Utah remain the three fastest growing states in the nation in terms of employment. Moreover, Arizona and the Pacific Northwest states are reporting year-over-year employment gains ranging from 2 to 4 percent.

Unfortunately, California's economy still shows few signs of growth. Employment in the state has risen only .1 percent on an annualized basis since December, and July's level was off .5 percent from a year earlier. Moreover, the change from a declining economy in 1993 to a flat economy in 1994 has followed a pattern that does not suggest an imminent rebound. The flattening is due more to a cessation of large employment losses in areas such as construction, wholesale trade, and local government rather than to rising strength in other industries. In fact, there is only one sector, business services, that has shown consistent growth. Meanwhile, defense-related industries, banking, and communications continue to experience substantial job losses.

As I'm sure you know, we are at the current time suffering from many fires throughout the District. It's a little early to estimate what the impacts are likely to be. I don't think there will be major impacts in dollar terms, but we are just entering the fire season, so it is something to keep a watch on.

Turning to the national economy, our outlook differs somewhat from the Greenbook for the latter half of this year. We actually have a little more of a slowdown than was incorporated in the Greenbook for the second half because of the effects of the tightening moves so far, and also as a result of a decline in the amount of inventory investment. However at present levels of short-term interest rates, we clearly would see a strong bounceback in real GDP growth next year.

Even with slower growth in the near term, I have significant concerns about the longer-term inflation outlook. Although estimates of slack are subject, as we all know, to considerable uncertainty, it seems likely that most if not all of the unused capacity in labor and product markets has been used up. That point certainly was emphasized in the Greenbook. Given the present stance of policy, we are running a substantial risk that the future trend of inflation will be in an upward direction. Inflation accelerates in 1995 in the Blue Chip consensus and in both the structural and vector auto-regressive models used by our staff. In our structural model, a significant rise in the funds rate in 1996 is required through the nominal income policy rule that is built into our structural model. Thank you.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, the Tenth District continues to grow at a very healthy pace. Construction activity remains strong, although perhaps somewhat slower than the boom environment we saw just a few months ago. Manufacturing continues to improve, especially in durable goods, and we have seen continued employment growth there. Oil activity appears to be strengthening due to the firming in prices; that is no surprise. The agricultural sector will be okay, as record yields in a couple of the crops will be offsetting the lower prices that are expected. And the cattle market has strengthened as well. From what we see, our economy in the region should continue to be strong going forward.

I want to share with you some data and anecdotal information that we have on bank activity in our District. We have seen some increased interest in the use of the discount window in the last several weeks. For all District banks, loan-to-deposit ratios have increased from about 56 percent in March to an estimate of about 65 percent in June. At banks that inquired about borrowing, loan-to-deposit ratios have increased from around 60 percent to almost 75 percent. So we are seeing some liquidity interest there. This reflects loan growth of about 14 percent in our District. The reason given by banks for this growth is very strong loan demand across the board, not just in agriculture. It's interesting that this also is true of our larger banks; some of the smaller banks that have come and asked us about borrowing have indicated that their upstream banks have been less willing to lend to them because of their own liquidity needs associated with outside lending, which is reflected in their increase in loan-to-deposit ratios as well. This is supported to some extent by the fact that deposit growth in our banks, on which they rely heavily, has grown at about half the rate of that for loans. Also, both the larger and smaller banks around the District report that they have eased their credit standards, that the loan demand is there, and that the banks want to make loans. We see some heavy competition throughout the District for loans. So the banking environment has changed, I think rather dramatically, in the last two years.

On the national front, we like others, see GDP growth going forward above its potential if we leave policy unchanged and we also see the inflation rate pushing up well above 3 percent next year. So basically, we are in agreement with the staff's forecast and see some increasing pressures in the future.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, the New England economy continues to grow. June employment was about 2 percent above the year-earlier level, and the regional unemployment rate is about the same as the national average, with rates in several states well below the national figure. Looking at the region, there are big differences state to state. Massachusetts and New Hampshire are growing above national rates while Connecticut bumps along not growing much at all, at least in terms of employment. Job growth has been concentrated in the services industry, especially business services. Construction and wholesale/retail trade also have been expanding reasonably strongly. Services jobs are commonly characterized in highly pejorative terms, at least in the First District. And this pattern of recovery has left many consumers and businesses skeptical that the recovery is for real. Even more sophisticated observers of the regional economy who recognize the high quality of many services jobs find themselves frustrated at their inability to determine what is driving the expansion of these services industries. In constrast to historical experience, manufacturing employment in New England has fallen during this recovery. In the last few months, however, the job decline seems to have ended and our informal conversations with regional manufacturers have had an increasingly positive tone. Firms are seeing some materials cost pressures and, for the first time in a long while, some companies are passing these price increases along. Retail sales are fairly strong, though the environment is highly promotional and margins are flat. Inventories are said to be lean. Our little contribution to the inventory story here is that one major catalog dealer just ran out of the items that everybody wanted this summer. This really puts them in quite an embarrassing position since they sell themselves largely on their ability to deliver things in a certain short period of time. The one area that is showing signs of slowing is housing. Contacts report that sales agreements have fallen during June and July in response to higher interest rates. Statistics on sales and construction still look quite good, but of course they reflect decisions that were made some months ago.

On the subject of the national economy, based on the strength of the employment data over the last several weeks, we think that the economy may well be stronger in the near term than the Greenbook forecast. We would expect to see some overshooting of even our estimate of the NAIRU in the short run as a result of that, and we would expect also to see the GDP numbers for the second quarter at 4 percent or better when they are finally revised. That could mean stronger third-quarter numbers. Over the longer term, we have a little different view than the Greenbook forecast, particularly since the Greenbook incorporates a degree of tightening that we are not quite comfortable with. We are interested, Mike, in whether you ran any numbers on what a somewhat slower rate of tightening might produce next year in the way of inflation and GDP growth. I am looking, for example, at the DRI forecasts, which tend to have less monetary tightening, somewhat similar if not lower GDP growth, and just about the same inflation numbers built into them.

MR. PRELL. I think DRI is perhaps in the lower part of the spectrum right now.

MS. MINEHAN. Yes.

MR. PRELL. I think they have about a half percentage point increase in the funds rate in the second half of this year and nothing after that.

MS. MINEHAN. Yes, they actually have rates backing off, I think.

MR. PRELL. Right, I think they have some modest easing next year and bond yields come down a bit more than in our forecast, and yet they have somewhat weaker growth over the next six quarters. In terms of what a more gradual rate increase would produce if one used our quarterly model, the distinctions, as I hinted in my remarks, would be modest.

MS. MINEHAN. Too short of a period of time perhaps?

MR. PRELL. Well, we are talking about rather small differences. A 1 percentage point change in the funds rate done immediately according to our quarterly model will only take several tenths off GDP growth by the second half of 1995. And it only means a couple of tenths or so on the CPI. So, if you simply select a more gradual rise, the differences are going to be even smaller. I guess what we are suggesting is that, in our judgment, the tilt begins to be most likely in an upward direction in terms of inflation right now, that is, given that we feel we are essentially at full employment.

MS. MINEHAN. Yes, and I think we would agree with that.

MR. PRELL. Faster growth will mean some additional tightening and the probability at least of an upward tilt, but only very gradually; it's a question of degree.

CHAIRMAN GREENSPAN. Okay, President Boehne.

MR. BOEHNE. Thank you, Mr. Chairman. The Philadelphia District economy continues to grow modestly, although still less than the nation as a whole. Retailing, bank lending, and manufacturing reflect this general assessment. Employment growth in fact has strengthened some in the District. The perception, however, is still one that jobs are hard to get, and high profile layoffs are a major contributor to this perception. There is a fairly widespread feeling that the second half will be slower than the first. There is also some anxiety about how much slower. There is in addition some of the skepticism that Cathy has picked up about the durability of the expansion. Our survey of manufacturing is picking up stronger price pressures, particularly in the metals area. More generally, however, wage and price pressures remain largely contained with most firms still emphasizing cost containment to stay competitive.

The national economy, while slowing, in my judgment is still growing solidly. The growth in employment plus strength in equipment spending and a stronger outlook for exports are major pluses. Negatives or question marks are in construction and inventories. On balance, while slower-paced growth is likely, the risks do seem to be more on the up side than the down side. Likewise for future inflation, the risks also seem to be more on the up side than the down side. The capacity utilization relationships, I think, point toward a skewed upside risk for inflation, and also the signs in the pipeline--commodity prices, prices paid, prices received--and the attitude in some industries that one can indeed pass along some cost increases, I think, are blinking caution at this point.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. With respect to the national economy, I think the view that GDP might slow to a sustainable pace without further timely Fed action has been resolved in the negative. Employment growth continues to be strong, retail sales held up well in the second quarter, and inventories remain low relative to sales. At the same time, there is increasing evidence of inflation not only in the narrow areas that Ed mentioned, but I think in the broader measures of wages and prices as well. For example, the implicit GDP deflator rose by about 2.8 percent at an annual rate in the first half of 1994 compared to 1.2 percent in the last half of 1993, which is a marked increase indeed. Looking ahead, for what it's worth, the Greenbook expects the CPI to rise at a 4 percent rate in the third quarter and the employment cost index at a 4-1/2 percent rate, albeit there are some special factors affecting the latter index. Such increases, should they materialize, will not go unnoticed in the current environment where there are increasing concerns about price pressures. Accordingly, as I have felt for some time, the risks are clearly on the side of rising inflation. I would also note that the recent increases in bank credit are striking, with business and consumer loans up at annual rates in July of 17 and 23 percent respectively, and that is a trend that has been building for some time. Growth of the broad aggregates has picked up as well, suggesting money and credit conditions that are quite consistent with rising demand and inflation.

With respect to the District, activity continues to expand at a solid pace, albeit more slowly than nationally in contrast to earlier in the expansion when we were outpacing the nation. A significant sector evidencing weakness recently has been transportation equipment. However, following their annual two-week shutdowns during July, the District's major auto plants have resumed production at or above June levels. While production is slated to slow again later in the year, this is attributed to model changeovers or plant refurbishings and modernizations. Recent declines in sales, according to industry sources, result from exceedingly low inventories in certain models, not from slowing demand. It seems to me that the pricing behavior of auto companies confirms this view. Housing activity remains at relatively high levels in the District, with many areas reporting shortages of housing for sale and rising prices. Commercial real estate activity continues to improve. In Memphis, for example, the office vacancy rate is at a 6-year low, and industrial construction is headed toward a 10-year peak. Crops are generally in good condition throughout the District, with record or near-record cotton and rice crops in some District states. Thank you.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. The Eleventh District economy is essentially unchanged from my last few reports. The tone in our directors' meetings is essentially unchanged. The tone of our Beigebook respondents is slightly stronger this time than it has been recently. Price pressures in the District seem to be concentrated in construction-related materials, paper and packaging products, and very little price pressure is noticeable in retail stores.

On important national issues, our economists tell me that we are at full employment, that the inventory buildup is largely voluntary, that the slow growth in the monetary aggregates that we have been having is largely benign, and that the risk in the forecast is on the upside rather than the down side both for real growth and for inflation. On the weakness in retail sales that we have had in the past few months, I might mention that one national retailer based in Dallas reports that in the last few weeks, particularly in the pre-school season, their sales have been excellent; they have been above expectations. They also report that price increases are hard to come by. I give you an early warning, at a couple of our board meetings, our banker directors, who all tend to be representatives of smaller banks in our District--[Laughter]. Well, it's a long story, and hopefully the story is not repeating, but what they are reporting is that competition for loans is getting very aggressive and the large banks are so aggressive on pricing and credit standards, that they wonder if they aren't making some loans that should not be made.

CHAIRMAN GREENSPAN. Are they just wondering or do they know for sure?

SPEAKER(?). Bet on it.

MS. MINEHAN. We have had the same reports in the First District. It seems odd that bankers should be telling the media that they are making loans that they shouldn't be making.

MR. BOEHNE. But it's a bank down the street; they are not doing it; it's a bank down the street.

MS. MINEHAN. No, they even are saying that they are leaning over backwards because of the competition.

CHAIRMAN GREENSPAN. Listen, any banker who doesn't make some loans he should not have made is not doing his job. The only trick is to figure out which of those that he has made are in that category.

MR. LAWARE. Present company excepted please!

CHAIRMAN GREENSPAN. Doubtless.

MS. PHILLIPS. Diversify.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. The Ninth District economy continues to be robust. The strength remains broadly based whether you look at manufacturing, construction, natural resources, or to get the demand side, consumer spending and so forth. Both the objective measures of activity and the anecdotal evidence, I think, are consistent with the kind of performance we saw in the national economy in the first half and suggest to me that we will see pretty good strength continuing in the second half of this year as well. Jobs are plentiful in many, many areas both geographically and across different industries and skills. I'm struck by--business people are usually anxious to share their problems when they come across a Federal Reserve official, but they haven't had a lot of problems to share apparently. There are two exceptions to this generally positive picture. One is that some of the wheat producing areas have a problem with too much moisture and that may affect things there and may back up into the condition of some of their lenders as well. And home sales have slowed a bit, particularly in the Twin Cities, but that has to be put in the context of having come off two very strong years of home sales in the metropolitan area.

CHAIRMAN GREENSPAN. Do you expect problems in the spring wheat crop to be serious?

MR. STERN. In parts of North Dakota and Minnesota where they have had a fair amount of moisture, yes. It's going to affect both yield and quality.

CHAIRMAN GREENSPAN. Does that spill over into Saskatchewan, do you know?

MR. STERN. I don't know. With regard to the national economy, the incoming data haven't affected my view of things from the last meeting. I think we do have continued strong growth in demand. In the second half, I see the economy probably growing a bit slower than it did in the first half, but I'm not expecting a lot of slowing based on what I can see going on here. As I hinted earlier, I'm uncertain what this means for inflation because the relationships between capacity and price or wage pressures don't seem to me to be as robust as they were in the early 1980s. In those circumstances, I tend to fall back on a few things that I think I do know having to do with what we might expect for labor force growth and for hours worked per employee. When I go through that kind of arithmetic in my head, I come to the conclusion that we will have to be lucky to avoid a building of inflationary pressures here if I'm right about the strength of demand.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. I noticed in the Greenbook projection a substantial decline in the rate of growth in domestic final sales relative to GDP, and I think that will come true. I have distributed a table[1] that I've based on something I've been playing with for a number years since I didn't know what was happening: It involves distinguishing NIPA personal income from the money that households actually have to spend. It's based on a fairly accurate theory that you can avoid taxes nowadays, but to do so you can't spend the money. [Laughter] To show the adjustment--I'm going down the chart, line by line--wages basically pass through to cash flow. Interest does, if you receive it, but most household interest-bearing assets are actually held in such things as 401Ks and never accrue in a cash form directly to the household. And so the adjustment here is that I take both taxable and tax-exempt interest, which obviously does flow through to the household, as a share of total NIPA interest.

CHAIRMAN GREENSPAN. What are you doing with imputed interest?

MR. LINDSEY. With imputed interest? Imputed interest is not cash flow.

CHAIRMAN GREENSPAN. No, I understand that, but it's in the NIPA.

MR. LINDSEY. But it is in the NIPA, that is correct--in proprietary income. The same thing would be true for dividends. It's a little challenging because a lot of what NIPA considers to be proprietary income actually may take the form of business-type consumption. And so what I do again is to take the share that the taxpayers actually report as the share of total NIPA-based proprietary income. With transfers, I'd like to thank the Research Division here. I learned a lot about medical transfer payments which turn out to be a substantial portion of transfers. I'm taking those out because if Medicare reimburses your doctor or if your insurance company reimburses your doctor, you really don't see the check, so that is taken out of transfers. The same thing is true with other labor income which is paid into pension plans or health plans.

CHAIRMAN GREENSPAN. There are also directors' fees in that line which should be in the cash flow.

MR. LINDSEY. It probably would feed through to cash flow and I'm willing to stipulate an adjustment several points to the right of the decimal point for that.

1. A copy of the table discussed by Mr. Lindsey is appended to this transcript.

MR. KELLEY. It disappears in the rounding.

MR. LINDSEY. Especially for Federal Reserve directors, which may not even show up as an asterisk!

CHAIRMAN GREENSPAN. Barely.

MR. LINDSEY. Rent and farm income--most of this number is actually income on owner-occupied houses. I always reassure Susan that we have a higher income than we thought because we live rent free in the house, and she just laughs at me because we can't spend the money and indeed I believe her when it comes to assessing our household cash flow. The other point on this is farm income. Farmers generally have no income. It's amazing that the industry still exists given how much they report on their tax returns. The government would regularly make money in a budgetary sense by making the farm sector tax exempt. But the easiest thing to do for this purpose, as far as I'm concerned, is just to zero it out. I take out social insurance contributions and personal taxes, and what's left is the difference between disposable personal income, on a NIPA basis, and disposable personal cash flow. You'll note that one is substantially below the other. I then compared that to personal consumption expenditures. And, indeed, looking at NIPA we might take a rather sanguine view of the household position because in fact during the last year, which was a very strong year for household employment, income actually grew faster than expenditures. But if you compare it to cash flow, and here I think it's important to take out the third-party medical payments that pay for part of medical personal consumption expenditures, the number to compare would be 205.2 in spending versus 155.1 in cash flow. And it suggests that in fact the increase in household spending was much more than the increase in the actual cash that they are seeing.

Now, households could do this for a long period of time. Where I see this as of concern is that it can't go on forever. The difference between cash flow and income, in fact, I think is consistent with the double-digit rates of growth we have been seeing in installment credit. The question is why are households doing this to themselves. I think the Michigan survey had good reasons for it. We created for other good reasons a great buying opportunity in the last year for houses and cars. The survey asked people why, for example, now is a good time to buy cars. Well, back in July of 1993, 38 percent said it was because prices are low, and that percentage has fallen to 28 percent, meaning prices are not seen as good today as they were a year ago. On the other hand, a year ago 7 percent of respondents said now is the time to beat price increases. That has doubled to 14 percent currently. Another reason to buy now was the expectation that interest rates would go up, and that number has similarly increased. So households a year ago or in the last year thought now is a good time to buy cars because prices were low and were going to go up, and interest rates were low and were going to go up. I don't consider that a good indicator for the future. The same thing was true with houses, but even stronger. The argument that prices are low for houses has fallen from 33 percent to 19 percent in a year. The expectation, on the other hand, that now is a good time to borrow in advance of rising interest rates has risen from 6 percent a year ago to 21 percent currently. For houses as well, consumers have been spending money they don't have because we have had a bargain basement sale for the last year. That is not going to continue no matter what we do today. Similarly, I think businesses have been having a good time in the last year. If you look at the difference between cash flow for businesses and plant and equipment expenditures, it's been running with cash flows substantially above plant and equipment expenditures since about 1992. At the same time, there have been record-setting net increases in nonfinancial equities and bonds outstanding.

All that put together suggests that there are a lot of expectations of inflation in the household sector; there is a substantial accumulation of cash, which presumably can feed inflation in the business sector. The question is whether or not it will come to pass. So I think we are in a very bad dilemma. I think nominal GDP is growing too fast; I think the mix is going to worsen; I think the consumer is going to spend less; and we are going to have less real growth. But at the same time, I believe we are going to see accelerating inflation and that means the good times are over and we have to stop celebrating and we have to make a tough decision.

CHAIRMAN GREENSPAN. First Vice President Conrad.

MR. CONRAD. Thank you. The pace of business expansion in the Seventh District, I think, is a bit more subdued than earlier this year, but we feel that considerable momentum remains when the supply shortage in the auto sector is taken into account. In looking at the auto picture, the July seasonally adjusted annual rate of sales was about 13.7 million units. That was down from May and June, but it was considerably above June 1993--by about 7 percent. That continued to reflect the strength in light truck sales and also, I think, benefited from a boost in imports. We agree with the assessment that the weak sales are largely due to supply shortages and not to a decline in overall demand. When we talk to the auto companies, their build plans will likely only stabilize the supply situation. Third-quarter production, which was planned at 2.7 million units, actually is beginning to seem a little out of reach based on what we see in terms of start-up delays. We think that, reasonably, production could be about 50 to 100 thousand units below that estimate. If sales do approach the 15 million unit annual rate, which analysts are forecasting, inventories will probably remain below the 55 days that exists now and could be more in line with a 40-day supply for some of the more popular models. On the price front as far as autos are concerned, the announced price increases from the Big Three are in the 1-1/2 to 3 percent range; that is about $250 to $500 per vehicle. But if you look at a weighted-average price with respect to the more popular models, 3 percent seems to be at the low end of the range and it may be a 3 to 4 percent range. If you look at that in combination with the reduction in incentives, which have been reduced by as much as 40 percent, price pressures have most assuredly increased in the motor vehicles area.

Not all segments appear to be as strong as autos. Reports from District retailers suggest that little has changed from the second quarter when growth slowed somewhat. In talking to our largest retailer, they looked at second-quarter sales as a small setback, but they expect what they saw as a boring, slow, middle-of-the-road upward trend to continue. We don't sense any concern about retail inventories at this point in time, but as has been mentioned by others, intense competition continues to hold down price increases in this sector. On the manufacturing front, steel shipments have slowed a little, and that mostly seems to be coming out of some of the plants in Michigan. In Chicago and northern Indiana production and shipments are holding up well. Shipments of major home appliances, which have been strong, are expected to post only a modest year-over-year gain for the second half, and that would represent a small decline from first-half shipments on a seasonally adjusted basis. Heavy truck production, after operating flat out for the last two years, is expected to decline by a modest amount in the third and fourth quarters. There are some slots or openings for truck production that could be accommodated in that quarter, although overall utilization of the stock continues to be high and rates paid by shippers continue to increase. The housing sector is pretty much as others have reported. We have seen a small uptick in multifamily construction. In the labor markets, unemployment rates around the District continued to trend downward during the second quarter and remain below the national average. A major temporary help firm reported paying higher wages to attract better qualified workers. Another firm suggested the same result, but also indicated that, because of competition, they were unable to pass on higher wages to their customers. On the ag side, District crop estimates for corn and soybeans confirm the prospects for a large harvest this fall. Corn yields are likely to be the second highest ever and soybeans will probably set a new record. This prospect has weighed heavily on corn and soybean prices.

As for the national outlook, our GDP forecast is a bit stronger than the Board staff has suggested. Employment remains strong. There appears to be little slack, and we view the risk as tilted to the up side as far as the national economic picture is concerned. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. We contacted some of the retail operations headquartered or having significant operations in the Fourth District and asked them about inventory situations. Basically, the pattern was that everything is okay. said they had only a very small rise in their national operation inventories and it was all intentional; they felt they entered the third quarter on plan. had a very large increase because they said they were operating too far below desired inventories, and they now feel that they are only slightly below. They entered the second quarter 11 percent below where they wanted to be, and after a very large buildup and good sales, their inventories are only slightly below where they want them to be. said that they wanted to have a big inventory buildup, but they didn't get as much as they wanted because sales growth turned out to be stronger than they had expected--in the double-digit range. had a more modest increase in inventories, about 4 percent, and feel that they are comfortable. So, we got no negative stories from the retail side on inventories. The steel sector is quite strong. They put through a 5 percent price increase at the beginning of July and it has held. They are now looking for a further 3 percent increase in the first quarter. They are operating basically with a 90-day delivery schedule and running at capacity. Nonresidential construction is picking up and that is helping to push up steel demand as well. Companies are saying that those construction managers that are able to compete in the dollar-based foreign market, mainly Latin

America and Asia, are getting significant increases in construction contract awards, and that is helping exports also, especially capital goods. Overall, capital goods and machine tools are quite good, both domestically and exports. Residential construction is characterized as having leveled off in most of the District, but at good levels of activity.

The bankers talk about big increases in C&I loans--double-digit increases. Some of that is inventory financing; some of it is business expansion; but they also report that consumer and mortgage lending has dropped sharply. Smaller banking companies increasingly talk about being loaned out, and the bigger banks are happy to hear the small banks say that. As Bob Forrestal reported for the Southeast, we had an advisory council meeting a couple weeks ago involving a variety of companies from all over the District and the same kind of stories was coming from all of them about the difficulty of hiring unskilled or semi-skilled workers. Companies that provide temporary workers said they have a lot of available positions that nobody applies for. On the other hand, upper-end positions--one company said that they were looking for a new chief financial officer, and they got 300 applicants. They also were looking for truck drivers and warehouse workers and got virtually no applicants; maybe the financial types ought to drive trucks. High-tech employment continues to be reported up, offset by healthcare employment which continues to decline in the major metropolitan areas.

Regarding the Greenbook and the Blue Chip forecast, the Blue Chip is higher for the next year, as it typically is, for nominal GDP, real GDP, inflation, and interest rates. All I can say is that I hope they are wrong on some parts of their forecasts and I hope the Greenbook is wrong. I am still troubled by the idea that increased employment or increased output causes inflation. I think if you went back a year ago and took most of the forecasts, whether it is the Greenbook or the Blue Chip or the Wall Street Journal forecast, and if they had forecast the job growth and output growth that we have had, they would have said we were going to have a lot more inflationary pressure than we have seen. This idea that we need to see a slowdown in the growth of output and jobs in order to avoid price increases--I am very skeptical of that.

When we look at the relationship between the narrower monetary aggregates and the opportunity costs--the Board staff occasionally gives us a chart on this using M1 and we can do the same thing with monetary base measures and so on--a year ago we were in a situation where the historical relationship was holding up very well. Looking ahead, we had four possibilities: the historical relationship that simply stopped functioning; a 25 percent drop in intermediate- and long-term interest rates--that didn't happen; the other two possibilities were a sharp acceleration in nominal GDP growth or a sharp drop in narrow money growth. We had actually a combination of those. The historical relation today still holds; there is simply nothing that has broken down. Now we have a very sharp deceleration in reserve growth, the monetary base, and M1, and with the kind of interest rate increases we already have had let alone any further increases, that leaves me with a feeling that we may be closer to our idea of neutral than some of the other comments that I'm hearing would imply. I think that the question of whether we have moved early and substantially isn't as easy to answer as one might think. I happen to think that the National Bureau's timing of July, 1990 as the cyclical peak was simply wrong, and that without the Gulf War, we might not even have had what qualifies in the usual sense as a contraction or recession. Much of the last three years, four years now, has been a period of, first, the Gulf War and then this restructuring phenomenon. Then coming off a level of 3 percent federal funds with the kind of inflation that we are experiencing, a 125 basis point increase is substantial in what in a different way of thinking is an early phase of the cycle.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. With respect to the real economy, I may be in a position similar to Jerry Jordan's. It does seem to me that we are moving into cycle maturity. In many ways, the economy's performance is about as good as it gets; the economy seems to be hitting on all fours. The growth in the last four quarters has been above potential. We have had upward revisions for the last two quarters, and this is despite an earthquake, blizzards, and now floods and fire. So we have had plenty of natural disasters. We are at low unemployment, perhaps at the NAIRU if it really exists. If it exists, we are there. With respect to inflation, the recent experience clearly has been good. If growth is close to potential, then it's feasible for us to stay within a 3 percent CPI.

I thought I might talk a little about the financial markets; they haven't been mentioned quite as much today. The markets have been buffeted significantly this year. The stock market, I'd have to say at this point, is showing a great deal of resilience. We clearly are off the January highs, but we are not in the state of fragility that we experienced earlier in the year. There has been significant portfolio adjustment, so I think that people are lined up on both sides of the market now. We are not seeing everybody lined up on one side of the market, which I think was the situation at the beginning of the year. The bond market has withstood considerable volatility, and I think one of the significant things there is that we haven't had any major accidents. I think that a number of the players have learned how to operate in some of these changed environments. Currency markets also have withstood significant volatility, although I'm not sure that all the players have learned as much as there might be to learn in the currency area. Banks are aggressively financing the expansion.

There are some signs that the expansion could continue for quite a while. In spite of the recent runups in inventories, we are still hearing that businesses went into this last quarter in a planned position, and many are talking about adding to inventories. We are seeing continued strength in business investment. The order books are showing considerable depth. We are finally getting enough confidence in the business sector to see significant additions to payroll. Even on the construction side, although we are seeing some slowdown in housing, nonresidential is taking up some of the slack. Earnings are holding up significantly and that, of course, is helping to keep the stock market fairly resilient. We may even start to see exports contribute a little more to GDP growth. On the household side, I do agree that expenditures are likely to level off somewhat. Even so, we are seeing credit use up, and with employment up, that is likely to keep consumption levels respectable or at least close to potential.

It seems to me that the risks at this point are on the up side. We could be understating the strength in the economy. I agree that there are still some downside risks and they certainly exist in some parts of the country, but they appear to be outweighted by the upside risks.

The pundits, kibitzers, and Fed watchers seem to suggest that the Fed really doesn't need to worry about inflation because it's mild--3 percent--and it's not increasing, although many of the forecasters are now at least starting to show some increase beyond 1994. But all that means is that the Fed is either at the curve or maybe ahead of the curve. There are, I think, some worrisome signs on the inflation front. We have heard a lot of stories around the table today about businesses now being able to pass on price increases. We have seen strong increases in the producer price index for intermediate materials for the last four quarters. The core CPI for the second quarter actually edged up to 3.1 percent, although the overall CPI has been flat thus far in 1994. So at best, we are stalled out on inflation and we are starting to see oil price increases work their way into the system. I continue to suggest that a 3 percent level of inflation, even if you make the adjustments for the errors in CPI measurement, still does constitute a form of tax and something that we should continue to be concerned about. I think that one of the reasons that we have been able to see inflation stall out at this point is productivity increases. This has been one of the major factors that has kept wage increases from infecting the CPI, but that depends on a continuation of this supposed new trajectory for productivity increases that we have seen in the 1990s. So, if the productivity increases are not continued, that will be another pressure that we will start to see on inflation. In sum, I think that the economy is doing quite well. We have a chance for this to be a continued expansion but it is putting pressure on inflation.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. I'd like to pick two nits with the Greenbook. One is a small nit, one is big as nits go, I guess. [Laughter] Still, I think it is a nit in the sense that the basic outlook of the Greenbook, subject to a qualification I'll come to, seems about right. The first, which really is a nit, has to do with inventories, especially retail inventories. I think there is a hazard--although I'm somewhat reassured by some of the comments I heard around the table, especially from Cleveland--that the retail part of this inventory buildup is potentially dangerous. Perhaps I overstated; this is a cause for concern not for panic. I don't think it's going to snap back up in any huge way, but let me just read you two phrases that capture what I mean. This one is from the Greenbook, page 4 and it says "there is no evidence of an inventory overhang at this time." This one is from the DRI report that came out about two days ago and it says: "the sharp inventory accumulation of all goods in the second quarter creates an inventory overhang." It's not so much an illustration that one organization knows a lot more than the other, although I guess if I had to put all my chips on one table, I'd bet with Mike Prell over Roger Brinner. It is meant to illustrate that reasonable people can look at these data and have different views. If you decompose the inventory buildup over the last three months, March to June, 60 percent or so is at the retail level on the Board's adjusted current cost basis, which happens to be the way the handout reached me two days ago; I could have computed this another way as well. The number was $42 billion at an annual rate compared to an average in the three previous quarters of $14 billion, and the $42 billion is the biggest number in a long time. When I see a number that big on quite weak sales growth--negative overall on retail sales over that period and 0.3 percent on average per month if you take out autos, which are a special case--and with the inventory/sales ratios creeping up not down, I'm a little less sanguine than the Greenbook about the amount of forward momentum in the very near term. Now, as I said, it's not a very big deal. I'm not talking about a qualitative change in outlook, only a quantitative change, but it is potentially in the negative direction.

My much bigger nit to pick came in the second paragraph of the first page of the Greenbook where it says "labor and capital resources currently appear to be quite fully employed." I would have preferred to say "not quite fully employed, though close," I picked the words carefully, "not quite fully employed, surely close." We are unfortunately at one of those points in time where even though we know we don't know these things with precision and cannot fine-tune the economy, we have to make a decision on that because we are very close to capacity; there is very little doubt about that. It matters, in this context, whether you are close on the down side or close on the up side, even though it is hard to tell the difference. The view in the Greenbook--"quite fully employed"--colors a lot of what comes next. It is reflected in particular in the NAIRU estimate, which in the Greenbook forecast is implicitly, on the new measure, 6.3 or 6.2 percent, something like that. You could subtract .2 percent for the change in measurement, which is the Board staff's current estimate of this very elusive number and a number that keeps on shrinking. You will remember the BLS thought it would be .6 percent back in January. I think reasonable people couldn't rule out zero at this point, but .2 percent seems a reasonable estimate right now based on what we know. If you take that .2 percent off, to convert to the old basis, which is not only the way I think but the way the econometric evidence speaks, that translates to an old basis NAIRU of 6.1 or 6.0 percent implicit in the Greenbook forecast. To me, that is at the high end of the reasonable range. I don't want to say it is an unreasonable estimate; it is a reasonable estimate but definitely at the high end. My reading of the evidence is that a better estimate of the NAIRU on the old basis would be something closer to 5.6, 5.7, 5.8 percent. I repeat again, these kinds of discrepancies only matter when you are really close to the NAIRU. A year and a half ago, it didn't much matter which of those numbers you thought was more accurate. I'd just like to say I don't think 6.3 percent unemployment should be the FOMC's aspiration level. I have a strong feeling that we ought to be shooting for a lower unemployment rate than that. We had a lower unemployment rate than that for the last three months, not incidentally. As I said, this colors what is in the Greenbook because, commensurately with that, the average growth rate over the next five quarters, that is the last quarter of this year and all of 1995, is between 2.1 and 2.2 percent in the Greenbook forecast--which, again, I would have thought is slower than we would really like to produce. It is not slow if you think we actually have had a small overshoot and we need to nudge the economy back down, because 2.1 or 2.2 percent is a nice small amount lower than, say, 2-1/2 percent which would nudge the economy down a little. My feeling is that that is not quite the appropriate policy given where I think the NAIRU is.

However, while in some sense this is a "fundamental" difference, I characterized it as a big nit.

The Greenbook forecast is not at all unreasonable given the staff assumptions about monetary policy from here to January, that is, another 100 basis points on the funds rate built into the forecast. I looked at what the econometric models, the Board's and others, say about what 100 basis points are good for, given the normal historic reaction of long rates to short rates. Now, as I think Mike mentioned, with the first 125 basis points we had much more than the normal reaction of long rates to short rates. I think all of us hope, and at least most of us believe, that we have a good chance in the next ratcheting up of short rates to get less than the normal reaction. But just taking the normal historical reaction, 100 basis points of further tightening on fed funds would, after about a year, knock .7 percent off of GDP, and after two years about 1-1/3 percent. So on growth rates, something in the range of .6 to .7 per year for the next two years would be taken out by that amount of tightening. If you add that back in to 2.1, you're playing with a number that looks like 2.7 or 2.8 percent on current policy, and that seems quite reasonable. So, I think the staff forecast is consistent with the policy that is built in, which I've already indicated I think produces growth that is too slow. I was going to say too slow for my taste, but I should say too slow for the economy's best interests. I think--and I'm taking this more from the Greenbook of six weeks ago, where if I remember it was quite explicit while it was more implicit in this Greenbook--that this comes from a very literal, for my taste too literal, interpretation of not wanting to let inflation accelerate. We don't want to let inflation accelerate. That doesn't necessarily mean we have to stand against a 10 or 20 basis point increase in inflation, especially given the unwinding of a variety of factors including the speed effect that Mike mentioned. If you look at the core CPI numbers in this Greenbook, it is 3.1 percent in 1993--this is fourth-to-fourth--3.1 percent in 1994, and 3.1 percent in 1995. It is a quite literal holding of the line exactly where we are, and the staff estimate is that it would take about 100 basis points more on the fed funds rate to do that. I don't think we have to interpret this quite as literally as all that, and this is a reason that I think we should be aspiring to a bit higher growth than is in the Greenbook. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. I think this has been a good session in getting most of the factors out on the table, and I'll try to be brief. First of all, I still have some question in my mind as to just how much danger we are in here as to inflation being in sort of a scary take-off zone. I think there are still some important factors that are holding it in check. I would particularly note that the forecast for unit labor costs is still very low. Even out through 1995 it never gets much above 2 percent, which should be a big deterrent. In that regard, even though my bullish forecast on productivity has got a little egg on its face from the most recent numbers, I'm still optimistic that productivity is going to continue to increase at a significant secular rate. Certainly, I think it's fair to say that we haven't seen much in the way of an increased thrust in compensation, construction probably being an exception to that. Secondly, foreign inflation and its influences continue to be low. Inflation is low in the countries that basically have high costs because they still have big production gaps that are apparently going to stay in place for the indefinite future. Those countries that have higher inflation tend to have very low cost structures in the first place, so they ought to be able to keep the pressure off prices. So I'm not sure how much imminent danger we really are in, that there is more than just a troughing or perhaps an upcreep in prospect. But for all of that having been said, it is clear that we are either at or very, very near capacity, however that is defined, and there is a lot of momentum present that shows every prospect of carrying us past that. As a consequence, it seems to me that the risks are clearly on the up side both for activity and inflation. I'm put to mind of an old saying of my mother's who used to like to say to her children, "a stitch in time saves nine."

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. Let me speak briefly about the economy in the Second District; it continued to expand over the past month, but we are seeing some weak spots, especially in the state of New York. Payroll employment declined at an annual rate of 1 percent in June in New York State and 2 percent in New York City. There were some rather large declines in manufacturing jobs in many areas throughout New York State. Continuing announcements by manufacturers of additional cuts suggest weakness in New York State manufacturing employment for some time to come. The latest announcements, each referring to worldwide staff, were a 10 percent cut at Bausch and Lomb and further paring at IBM and a major pharmaceutical company. Trading losses and dampened bond market activities spurred layoffs in fixed income departments at three major securities firms and additional cuts appear likely. Multiple mergers and acquisitions within the thrift industry also are taking their tolls on the job count. In contrast, New Jersey added another 10,000 jobs in June, and I'm not sure what the split is between Ed Boehne's District and mine, but that is an annualized gain of 2.9 percent. Manufacturing employment has been stable for the past three months, and small job gains accrued in most other sectors of the economy. So we now have an unemployment rate that has fallen to 6.4 percent in New Jersey, just above the national figure, an unemployment rate in New York State of 7.1 percent and in the City 8.8 percent. One of the things that I've been learning as I have been traveling around New York State is that there is a growing malaise in the business community, a belief that New York State is not a particularly good place to run a business. That has led to some of the moves to Connecticut and to New Jersey by the financial industry.

What I think is a somewhat greater concern, but I don't know enough about yet, is that in the tier of the State between Albany and Buffalo where there had been a rather successful transition from making carpets and clothing to rather more computerized activities like check clearing both by the Fed and by the major New York banks, one of the major attractions of that part of New York State was the quality of life. If you don't mind a lot of snow, it has kind of an idyllic climate, a beautiful countryside, and a very fine lifestyle. That has changed or is in the process of changing largely as a result of people doing what would appear to be good things, and that is putting correction facilities and prisons in that part of the state. However, the families of the prisoners and the kids in the correction units also move into the community and it has transferred something of an inner city to unlikely places like Rome, Utica, Rochester, and Syracuse. That is switching off the businessmen from thinking that this is a particularly friendly place to situate themselves in order to grow, and they don't have to go particularly far because they are seeing Pennsylvania, which isn't too far away, as having a somewhat friendlier environment. I think if there are two states in the country where you wouldn't wish to have a malaise, they would be California and New York, or at least those would be two of the three candidates with Texas probably. We are going to have to continue to watch what's happening in the State of New York because the trend is not a very happy one.

On the national level, our staff forecast is so close to the Greenbook that it is something of a rounding error even to talk about it. Our staff forecast is somewhat more benevolent on inflation in the second half of this year, but that appears to be more than anything else that the Greenbook is somewhat more concerned about increasing energy prices than we are. So, for example, next year we have real GDP growing at 2.1 percent and the Greenbook is exactly in the same place. The main difference is that we don't think it's going to take quite as much official action: We have the same macro results with a funds rate of 5-1/4 percent whereas the Greenbook, as you know, has a funds rate of 5-1/2 percent. We have the CPI at 2.9 percent and the Greenbook has it at 3.0 percent. In looking at these forecasts myself, I'm somewhat more optimistic than either the Greenbook or my own staff, and I think the difference largely is that I am really very strongly convinced that by historical reference this FOMC is well ahead of past experience in taking appropriate monetary policy actions. If we continue to do the right things, perhaps even including today, at some stage that is going to become more apparent to the practitioners in the economy, and I think that we have a pretty good shot at that. If that is true, although the numbers would not be great, the significance I think would be substantial. I think we could get somewhat better economic growth of the kind that Alan Blinder was talking about at a somewhat lower rate of inflation. I recognize that that would be a very happy outcome and one always has to try to abstract one's wishes from one's analysis, but I do think that there is a significant possibility that we could achieve that.

CHAIRMAN GREENSPAN. Thank you. Governor LaWare.

MR. LAWARE. Mr. Chairman, the learned comments of our colleagues have been so encompassing that they leave me with little additional wisdom to share with the Committee. My personal view is that the economy may be more robust than the Greenbook forecast would imply. I continue to believe that consumer uncertainties about job security and about what government is up to tend to be a damping influence and a counter to runaway growth. However, I think the current brisk rate of growth argues for some further braking from policy.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Two issues are of importance to me in assessing the current economic situation. First, how much momentum is there in the expansion and second how much slack is in the economy, how close is it to potential output? With respect to the issue of momentum, I find myself largely in agreement with the staff analysis presented in the Greenbook. Real growth is slowing, but I do think there remains enough momentum to keep aggregate demand growing at a rate somewhat in excess of the growth rate of potential output long enough to push the economy above potential in the absence of some further monetary restraint. My own estimate of the degree of momentum in demand has increased over the last few months. Most important in my thinking, the decline in the value of the dollar and upward revisions in estimates concerning the strength of foreign economies will be reducing the drag on demand that stems from net exports. In line with the staff forecast, I also expect the declining dollar to feed through to some mild upward pressure on import prices. Now that the economy is close to potential, higher import prices should create a bit more scope for American producers of import substitutes to raise their own prices. I don't want to overemphasize the impact of the dollar decline on aggregate demand and prices, but at the margin, especially in the context of an economy that is nearing potential, this seems like a source of momentum. And I see these international factors as offsetting to some extent the moderating influence of higher interest rates on housing and consumer durables spending. The strength of new orders for durable goods and the strong profit projections suggest continuing strength in investment, and the staff analysis convinces me that there are risks that the slowdown in demand could be insufficient, absent some further tightening to prevent overheating.

With respect to the issue of how close the economy is to potential, I confess uncertainty here. Nevertheless, on the basis of both econometric and anecdotal evidence, it seems to me that output has not yet passed potential, although we are approaching it. I don't yet see strong enough indications of tightness in labor markets, or enough signs of increasing wage pressure, or sufficient indication of a pickup in the growth of unit labor costs to conclude that we have ventured beyond potential. Capacity utilization is high by historical standards, but investment also is adding to capacity at a rapid rate. I see only scattered evidence of lengthening lags in filling orders. On balance, I'd say my sense is that the economy could stay where it is in terms of unemployment or even shave a few tenths more off the unemployment rate without risking significantly a pickup in inflation. This inclines me toward the feeling that there should be some tightening of policy to reduce momentum, but somewhat less than the Greenbook assumes. The Greenbook forecasts for real growth in 1995 are somewhat too low in my opinion to end up with an economy in 1995 that is operating near enough to potential.

CHAIRMAN GREENSPAN. Thank you. I assume coffee is there?

MR. BERNARD. Yes.

CHAIRMAN GREENSPAN. Let's recess for our usual coffee break.

[Coffee break]

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

CHAIRMAN GREENSPAN. Questions for Don?

MR. JORDAN. Don, I interpret the recommendations you make vis-a-vis the arguments that go with it as implying disagreement with the Greenbook. The reason I say that is because if you accept the Greenbook projections--the output and the inflation numbers through 1995--the objectives of the Committee and the logic that we are at or close to capacity and the NAIRU and that a 5-1/4 percent funds rate is neutral in the sense of maintaining the inflation rate let alone bringing it down, that would lead you to recommend 100 basis points today, and you don't do that.

MR. KOHN. First of all, I think the function of the Bluebook is somewhat different from that of the Greenbook, at least I conceive it as such, and that is to take the alternatives that I think the Committee will be seriously considering and say what we think the short- to intermediate-term consequences of choosing those alternatives will be in financial markets and to a lesser extent in the economy and give the Committee pros and cons on each of the alternatives. The latter are then amplified in my briefing to give you some things to think about leading up to your decisions. It is true that one alternative might be to take the funds rate up 100 basis points right now. I didn't see that as a viable alternative. I'm not sure, given the uncertainties, that even the Greenbook would be in favor of something that large right away, surprising the markets by as much as that. But I can see your argument; it's like the argument of last February. If you think you have to go a percentage point and you're reasonably confident in that, the longer you take to do it, the more uncertainty there could be in the market and the less likely you might be to get your outcome. But it just didn't seem to us to be one of the alternatives that the Committee would be considering seriously.

CHAIRMAN GREENSPAN. Any other questions for Don? If not, let me get started. Let me just say first that after listening to the roundtable discussion and looking at the usual long sets of figures, what I come away with is that despite the longevity of this recovery, there really are few signs of aging. There are marginal evidences of imbalances, marginal evidences of pressures, but in general it still looks as though this recovery has a considerable set of momentums associated with it. First of all, profit margins are still rising and indeed, they are coming in above expectations. That is an extraordinarily rare characteristic for the latter stages of a business expansion. Inventory/sales ratios are low, especially if one strips out the trade markups to produce constant dollar factory values of inventory/sales ratios. Those ratios have been coming down very dramatically as the "just-in-time" processes have accumulated at a fairly substantial pace. I suspect that we finally hit bottom in the spring with "just-in-time." That is, the room for further declines in inventory/sales ratios has become very significantly limited and, as a consequence of that, the process of going to zero change means a boom in inventory investment.

Unquestionably an important concern here is whether we are looking only at the end of "just-in-time" or looking at inventory investment that is substantially unintended and that could back up as the DRI overhang analysis suggests. First of all, we do know that a substantial part of the inventory change, especially in the trade area, is imported goods. Internal estimates by Board staff indicate that imported goods accounted for roughly 1/3 of the inventory change in April and May. This obviously means that to the extent the added inventories came from imports, to the extent that there is any unintended inventory accumulation there, it is the imports and the foreign producers that get backed up, not domestic. Secondly, if there were a significant element of unintended inventory accumulation here, we really would expect to begin to see it in the new orders series. A goodly chunk of the inventory accumulation is clearly very directly intended inventory accumulation, because a lot of it is in capital goods areas where the order patterns have been very strong. But from anecdotal evidence on orders and the actual detailed Commerce Department data on orders, it is very difficult to make the case that there is any significant element of unintended inventory accumulation in these numbers. I think there is some evidence on the basis of inventory numbers that orders for furniture did back up a little, but it is really at the margin and very little evidence suggests that we have a particular problem there. We also are not seeing evidence in the inventory structure of any serious difficulty even on the other side. It's true that there has been slowing down in deliveries, but lead times on new orders have shown very little evidence of rising, especially in the production materials area. And so it is suggestive that we neither have an exceptionally tight inventory situation or a loose one. That seems consistent with a middle stage of the business cycle, one that is neither negative nor particularly positive.

I do think we are getting some slowdown in the rate of growth, but the crucial question is from where? We tend to look at the gross domestic product as the measure of what the economy is doing and there is some serious question in the last two or three quarters whether or not that is low-balling the rate of growth. As we discussed previously, looking at gross domestic income, which is conceptually equivalent and leaving aside the issue of very weak data for the second quarter, the growth in gross domestic income was several tenths above the growth in gross domestic product in the fourth quarter and the first quarter. Disaggregating the gross domestic product into the value of industrial production and "all other" and substituting the industrial production index for the value of industrial production as a conceptually equivalent measure of aggregate growth, again we get stronger growth than is in the GDP numbers. What this is indicating is that we have to be a little careful about these measurements. For example, I find utterly noncredible the probability that, in the real world, productivity declined in the second quarter. The reason I say this is that if you get an expansion in the economy, leaving aside its nature, and you get rising profit margins, you begin to wonder where the profit margin rise is coming from. It clearly is not through increases in prices. The question basically is how to reconcile this situation in which we get this huge increase in work hours and therefore in compensation of employees against a slowed GDP that suggests, other things equal, that margins are declining, not opening up. I am merely saying that I am a little suspicious of the GDP figures, although I grant that the underlying work hour figures themselves may be exaggerated in the second quarter. But it is very hard to reconcile the anecdotal evidence and the basic data with which we deal to believe those productivity data, and that is one more reason at least to wonder about some of the GDP figures.

In the current period, there is very little doubt that we are not getting a significant amount of deterioration. I think it is certainly the case for the interest-sensitive sectors--residential construction and to whatever extent we can say that weakness in motor vehicle sales is other than shortages. I think there was a very persuasive case put forward by Mike Prell's associates at a Board meeting the other day that a very large part of the decline in motor vehicle sales is the result of shortages and not a basic weakness in demand. Nonetheless, I think one must argue that there is a slowing down in that particular area, and it is being offset, probably not fully, by expansions in the capital goods markets, which I suspect may again be underestimated in the GDP sense in constant dollar terms because the communications equipment prices just do not look realistic, as a number of people are beginning to conclude. This suggests that real producers durable equipment is probably rising at a faster pace. It may also imply, I might say parenthetically, that the capacity measures may also be affected on the up side. However, I think we are getting clear evidence of improving world economic growth vis-a-vis our earlier views, which suggests that the export markets are moving and doubtless the exchange rate will have some impact there as well. The drag from nonresidential construction is clearly at an end. The indications that values of commercial real estate are beginning to stabilize and are beginning to move up in certain local areas are consistent with the beginning of a turn in office and other commercial construction. We are running through the backlogs of very major deterioration in the nonresidential building area, and I think that sector will cease to exert weakening pressures. Very currently, we are seeing initial claims for unemployment insurance that are quite low, and that suggests that the labor markets are doing rather well. Growth in employment seems quite significant. Not only are orders strong but there is impressive evidence that unfilled orders are accelerating on the up side both in current and constant dollars. A statistic we don't talk about very often, but it is not irrelevant because it is a leading indicator, is the extraordinary rise in net business formation, which BEA shows as a fairly sharp upswing--again something not consistent with a late stage of the business cycle. So it strikes me that, as Don Kohn puts it, with the reverse head winds coming in the bank credit data, loan data, and the like, it is beginning to get a little nervous-making, I must say. This stuff is really beginning to move.

All in all, it is very difficult to get around the general notion that, even though there is some evidence of a slowdown in the rate of growth, it still appears to be coming in at a somewhat higher level than I suspect we are used to looking at, if all we are looking at is the gross domestic product figures themselves. Also, there is an underlying momentum here that suggests there are a couple of big legs left in this business cycle.

I think one has to conclude, as far as policy is concerned, that another upward notch in rates is clearly called for at some point. Therefore, the question we have to ask ourselves, which is not inconsistent with what Jerry Jordan was raising, is if we believe that, why not now? I think the question really gets to a notion of what we expect we will ultimately have to do. I frankly don't know whether or not the staff's estimate of a 100 basis point increase is the right number. I do know that there is a not insignificant probability that 50 basis points may be enough if we do it now. I don't know what the probability is but if somebody said, is it .1, I'd say it's a lot higher than that. Is the probability greater than 50 percent? I doubt it. I think it's a third, maybe 40 percent, but who knows. I do think that if we move 50 basis points now, the probability that we will not have to move before the end of the year probably is greater than 50 percent. One of the reasons I say that is that implicit in the 100 basis points that they have in the Greenbook is the fact that long-term rates are coming down and we are getting a new sort of dynamic in the system coming from residential construction. In that context, we need an upward adjustment of short-term rates because the shape of the yield function is beginning to move closer to normality. I'm not sure about where long-term rates are in that particular context. But I do know that as we look at the situation now, unlike where we were in the early stages of our tightening moves, where remember I was terribly concerned--maybe overly concerned but I doubt it--that if we did more than 25 basis points we were risking the stability of the system. With the May move, I think we clearly demonstrated that the bubble for all practical purposes had been defused, and that we needn't worry about larger increases at this stage. With the passage of time, I think the moving of securities from weaker hands to stronger hands has now made it far less likely that a 50 basis point move at this point would shake the markets in any significant way, if at all.

I'm a little concerned that 25 basis points would merely raise the issue of when the other shoe is going to drop. I am a little nervous about raising the rate more than 50 basis points because frankly I'm not sure we need it. If we don't need it, there is no point in doing it and it's an element of risk that I don't think we need to take. My own view--I'm being a little more detailed than I usually am so I hope people will excuse me in this respect--is that it's very important if we were to do 50 basis points, that we not give the impression that somehow we anticipate major accelerations and this is just the beginning of a long series of 50 basis point increases. If the markets believe that, then I think we have a very serious potential of creating a major negative market reaction. I think we have to be very careful to avoid giving that impression. The only realistic way we can avoid that is to issue some type of statement with any move that we make that implies that we are in the process of reassessing where we will go--in other words, our intention to hold for a while without tying our hands, which we cannot do.

After talking to my colleagues on the Board of Governors, I think there is a sentiment on the part of the Board to raise the discount rate 50 basis points in line with what a number of the Reserve Banks are requesting. I think implicit in that, in the view of the Board, is to request this Committee to allow all of the increase to pass through. Also, I might add, implicit in that general policy view is our adoption of symmetric instructions to the Desk. The more I think about that as a potential sort of policy package, the less I like all of the other alternatives. I started off at either no change and asymmetry or 50 basis points with symmetry on the grounds that 25 basis points struck me as risking the other shoe dropping syndrome. But I must say, the more I listened to this group and your comments on the elements involved and such things as the housing starts figures this morning--incidentally, Mike, the adjusted permits if we add back the nonpermit issuing areas are down only .8, not 1.7.

MR. PRELL. I just got these numbers at the break and I think the picture in the adjusted permits and the single-family starts is really one of rough stability in the past three months.

CHAIRMAN GREENSPAN. In other words, if we had a very weak residential construction area or a weak motor vehicles area, I would say we might want to pause and do nothing. But I think the evidence is increasingly convincing that we probably need to do 50 basis points. I must admit that I was going to start out more even-handed --on the one hand, on the other hand, if you will--but I convinced myself to steer away from that. [Laughter] So with those apologies, I open up the discussion. Bob.

MR. FORRESTAL. Mr. Chairman, I think your conclusion about this expansion having life in it is exactly right. I certainly agree that all the numbers and the anecdotal information that we have seen and heard this morning would indicate that the momentum is still there. As a matter of fact, in our forecast, we built in a 50 to 75 basis point rate increase and we produced a 1995 GDP of 2.6 percent, which I think is a desirable kind of deceleration in the economy to appropriate levels much nearer to potential. On the other side, if we look at what is happening with inflation, what is likely to happen, we have strong consumer demand, strong loan demand, and the economy is very close to capacity. We have higher oil prices that are likely to remain at current levels unless Iraq gets back into the picture, a weak dollar, and the beginnings of labor shortages. All of these developments, I think, make a very compelling case that we have to move. I think the sooner we move the better. I certainly support the notion of 50 basis points because, like you, I think 25 basis points really is not going to have the desired effect, and it's going to cause uncertainty in the markets. I also am pleased that the Board is considering a discount rate increase because I think the combined policy actions will have very desirable effects. So, I'm completely supportive of what you are suggesting.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I, too, agree with your policy recommendation. Given my comments earlier, I think that it is the appropriate action to take. I also agree that if we only did 25 basis points, it would create uncertainty rather than what I think we can accomplish with this move. So I agree.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. I'm also supportive of the package that you outlined. I just want to take two minutes to emphasize that it really is a package. If we are going to make this kind of policy credible, it has to be with a symmetric directive. It has to be with a statement that indicates as clearly as we can state within the limits of Fedspeak that our oars are out of the water. That does not mean that we have thrown the oars overboard; we still have the oars, [Laughter] but we have pulled them out of the water. I think that was implicit in what the Chairman said, and I think it is important. So I wanted to emphasize it. I think, as he did, that the choice comes down to zero or 50 basis points for the reasons that everybody has now indicated. The crucial thing for us, one of the reasons I eliminated 25 basis points, is that that is likely to engender the belief that we are starting up a staircase--not just another shoe to drop, but maybe Imelda Marcos' closet. [Laughter] By the same token if we move 50 basis points, it is crucial--that is why I come back to a statement--not to engender a belief that we are starting up a shorter staircase but one with risers of 50 basis points. Like the Chairman, I think there is at least a fighting chance that 50 basis points would be enough. So with such a strong statement, I not only support but support enthusiastically the suggestion of the Chairman. Without it, I would not.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I came in on the fence between "B" and "D." I never did like "C" for the reasons that you described. I'm not at all convinced that the 100 basis points is ultimately necessary. My staff is more convinced, I guess along with the Board's staff, than I am, and I think going 50 basis points now with the kind of package you are talking about reduces the probability that ultimately we will have to go the full 100 basis points. And so for that reason I support the 50 basis points.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. I enthusiastically support your proposal, Mr. Chairman--all the various elements of it.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I also enthusiastically support the complete package. As I indicated in my earlier go-around comments, I think the chances of inflation accelerating significantly next year and beyond are great if we do not move.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Alan, I came in favoring alternative D coupled with at least an increase of 50 basis points in the discount rate. So I, too, support what you have recommended. Just a couple of comments on how aggressively to move, though there seems to be support for your recommendation: I think that both to contain emerging inflationary pressures and to demonstrate our resolve with respect to price stability in the long run, we have to move aggressively now. I share your concerns about the potential of "the other shoe dropping" syndrome with respect to doing only 25 basis points. I think, as people have said earlier, temporizing now just makes our job tougher later. With respect to credibility, I think there is evidence in financial markets that we have a ways to go before we really do have credibility with respect to our longer-run inflation intentions.

With respect to the statement, the only concern I would raise and hope you take into account in drafting it is to make sure you incorporate what you said about not tying our hands. We really can't know today what could transpire, and we have to have flexibility to evaluate incoming data and move further if necessary. If financial markets really concluded that we basically were "out to lunch" for the rest of the year, we could set in motion speculative forces that actually accelerate the need to move again. So it's got to be done carefully; I trust your judgment on how to do that, but it is tricky.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. There is not much I can add to what I think has been a shared sense that there is some risk right now, mostly on the up side, and that we need to deal with that risk. We agree further tightening is necessary. We would go with the 50 basis points; we would follow it up with a discount rate increase. We are getting into the area of nuances here. I think our belief on the nuance side is a little closer to Governor Blinder's than perhaps to President Melzer's, that whatever the nuances are in this statement, they ought to be in the form of sort of wait and see if anything more is necessary--

CHAIRMAN GREENSPAN. Let me read a suggestion that hopefully captures what is involved here so that nobody is blindsided on this. The potential statement would read: "The Federal Reserve will continue to monitor economic and financial developments to gauge the appropriate stance of policy. But these actions are expected to be sufficient at least for a time to meet the objective of sustained noninflationary growth." That is as good a crafting as I think can be done to capture what it is we are trying to do and yet not tie our hands, because tying our hands would be a terrible mistake, and I don't think it's credible in any event.

MS. MINEHAN. I would fully agree with that and I would be in favor of that wording.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I support your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I also support the package. If we were to delay, I think it would be a roll of the dice, because I don't think there would be any new information that would be coming in over the near term that would make a difference. The economy is moving fast enough that I think we are in "drive," not "neutral," right now. There is a chance that a 50 basis point move could sideline us for a while and it may in fact be enough. I don't think we know. I think that your wording does capture that. There is a possibility of being sidelined, that our next move may be next spring and may even be an easing move. I just don't think we know.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I support your proposal, Mr. Chairman.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I certainly support the recommendation and, as several people have already commented, I think the statement and any other discussion that occurs in the next weeks are very important. The facts of the matter are that we don't know what is going to come down the road, and if and when we may have to move next. I think we ought to make that clear to the markets, and I believe the statement does a pretty good job of that--that this is not a permanent position.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. I support your proposal, Mr. Chairman, for all of the reasons that have been expressed.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I support the package very fully. This may well be all we have to do in the adjustment of policy that began the fourth of February. We may have to tighten some more next year, but we have seen that the effect of monetary policy since February 4th, because of the steepness of the yield curve, has been somewhat greater than it was in previous periods. If that continues, we could very well get into next year and decide, as Governor Phillips has just suggested, that the next policy move should be an easing of policy. I think a very forthright statement, like the one that you have read to us, is most important. A nuance that I feel about it is that it is an indication of self confidence on your part and the Committee's that such a statement be made. A self-confident Federal Reserve that is seen as doing its job well gains the kind of credibility that makes people think when the next move is appropriate we will take it, whether that is up or down.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I support the package.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Mr. Chairman, I support your proposal and believe there is a good chance that a 50 basis point increase in the funds rate now will be sufficient in the absence of significant news. And I like the proposed statement that you read.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I support your proposal.

CHAIRMAN GREENSPAN. First Vice President Conrad.

MR. CONRAD. We would support the recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I just had a comment on the language; I don't know if this is the right time to make it. Have you gotten everybody's view? I shouldn't come back in unless you've gotten everyone.

CHAIRMAN GREENSPAN. Yes, I think so.

MR. MELZER. I think the "at least for a time" does it in terms of the flexibility, Alan. If I heard it right, you said "consistent at least for a time with the Committee's goals of"--what was that--noninflationary?

CHAIRMAN GREENSPAN. "Noninflationary growth."

MR. MELZER. "Noninflationary growth?"

CHAIRMAN GREENSPAN. "Sustained noninflationary growth."

MR. MELZER. The only question I have is whether it is possible that somebody could then conclude that the roughly 3 percent inflation we are seeing now is consistent in the mind of the Committee with zero inflation?

CHAIRMAN GREENSPAN. I would think not. Noninflationary to me means noninflationary; 3 percent is not noninflationary.

MR. MELZER. Okay.

CHAIRMAN GREENSPAN. We are talking about objectives, we are not talking--

MR. MELZER. I understand.

CHAIRMAN GREENSPAN. Okay, read the directive.

MR. BERNARD. With the discount rate phrase?

CHAIRMAN GREENSPAN. Yes.

MR. BERNARD. I'm reading from page 14 in the Bluebook: "In the implementation of policy for the immediate future, the Committee seeks to increase somewhat the existing degree of pressure on reserve positions, taking account of a possible increase in the discount rate. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, 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 modest growth in M2 and M3 over coming months."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

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

CHAIRMAN GREENSPAN. Thank you very much and our next meeting is--

MR. BERNARD. The 27th.

CHAIRMAN GREENSPAN. September 27th.

MR. KOHN. I think, Mr Chairman, we would plan on releasing the statement around 2:15 p.m. as we have been doing.

CHAIRMAN GREENSPAN. Yes, but we first need a Board meeting.

MR. KOHN. Yes, after the Board meeting.

CHAIRMAN GREENSPAN. May I suggest that the Board members join me in the other room?

END OF MEETING