

Meeting of the Federal Open Market Committee Meeting  
December 20, 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, December 20, 1994, at 9:00 a.m.

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

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

Messrs. Boehne, <sup>1</sup>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, Mishkin,  
Promisel, Siegman, Simpson, Sniderman,  
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

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1. Left before discussion of the economic situation.

Mr. Ettin, Deputy Director, Division of Research  
and Statistics, Board of Governors  
Mr. Madigan, Associate Director, Division of  
Monetary Affairs, Board of Governors  
Mr. Slifman, Associate Director, Division of  
Research and Statistics, Board of Governors  
Ms. Low, Open Market Secretariat Assistant,  
Division of Monetary Affairs, Board of  
Governors

Messrs. Davis, Lang, Rolnick, and Rosenblum, Senior  
Vice Presidents, Federal Reserve Banks of  
Kansas City, Philadelphia, Minneapolis, and  
Dallas respectively

Messrs. Gavin and McNeese, Vice Presidents, Federal  
Reserve Banks of St. Louis and Boston  
respectively

Mr. Kuttner, Assistant Vice President, Federal  
Reserve Bank of Chicago

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

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CHAIRMAN GREENSPAN. Would somebody like to move approval of the minutes for the meeting on November 15?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection. I recognize President Jordan for a motion.

MR. JORDAN. Thank you, Mr. Chairman. I'd like to nominate Mark Sniderman to be an associate economist of the FOMC.

CHAIRMAN GREENSPAN. Would somebody like to second the motion?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Unless I hear an objection, it's approved.

Peter Fisher has a number of interesting things to discuss this morning. Peter.

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

CHAIRMAN GREENSPAN. Questions for Peter? If not, shall we go on to Joan Lovett?

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

CHAIRMAN GREENSPAN. Questions for Joan? Governor Phillips.

MS. PHILLIPS. You mentioned that the markets were thinner at the year-end than they usually are. Would you expand on that?

MS. LOVETT. It has been a disappointing year for a lot of people in the financial markets. We have had some sense since Thanksgiving that many people are just hanging on in the hope of getting through December 31. If they have done well or have managed to do all right, they want to finish the year in that position. If they haven't done well, they don't want to add to their losses. As a result, there has been a general tendency for people to try to take cover. This gives us a hint as to why we have had abrupt moves when securities have come into the market in clumps, because people don't feel they necessarily have the wherewithal to take them on. If they do buy them, they have to re-route them right away or hedge them with something equivalent.

MS. PHILLIPS. Is this causing more discounting of the Orange County paper than you might ordinarily expect if they had been selling that paper at another time of year?

MS. LOVETT. I think that in the Orange County case there probably are several influences at work. It was helpful that people eventually were able to get a handle on just what the county has. In

the first day or so, people couldn't get any information from Orange County on almost anything, and I think that is what caused the biggest market backup. Since that time, the markets have come back in many cases to where they were prior to the break of the news or maybe just 5 or 10 basis points past that, even with some of the securities being liquidated. So I think the initial move occurred because of the lack of knowledge of exactly what was going on and what was going to happen. By the same token, markets are in an atmosphere where there is an FOMC meeting and people view interest rates as being on an upward trend. If you could have picked a time for Orange County to sell, maybe this would not have been the time you would have picked.

MS. PHILLIPS. Thank you.

CHAIRMAN GREENSPAN. Would somebody like to move to ratify the domestic transactions of the Desk since the last meeting?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection. Let's now move on to Messrs. Prell and Truman.

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

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

CHAIRMAN GREENSPAN. Questions for either gentleman?

MR. PARRY. Mike, you talked about the inflation forecast and indicated that you made, in effect, an intercept adjustment in the forecast to carry forward the favorable experience that we seem to have had in 1994. Would you talk further about why we have had that favorable experience and why it might continue? We may be seeing actual growth in excess of potential. As we get closer to capacity isn't there a risk that we will have seen a delay in the typical Phillips curve relationship? If it were to reassert itself in 1995, might inflation turn out to be a fair amount higher than you indicated in the forecast?

MR. PRELL. That is a risk I hinted at in my remarks about the late 1980s experience. I think the key here is to look back at why we projected the inflation that we did for 1994. In essence, we were concerned at the beginning of the year that the pattern of expectations we were seeing, the very buoyant attitudes and so on, and the rapid growth at the end of last year were going to give us a stronger price increase this year than would have been dictated by our analysis of where levels of resource utilization were. Looking back now, we see a pattern that seems reasonably consistent with our fundamental view of the Phillips curve picture. We did not get down to our point estimate of the NAIRU until this summer. Under the circumstances, some further deceleration was not implausible. We also think that perhaps we underestimated the cost effects in the medical care area. We have had tremendous deceleration of the cost of medical benefits, and this has helped to tamp down the rate of increase in compensation. I think that has been a surprise that was not built into our forecast and now appears possibly to have been a broad element that was helping to bring down the inflation rate this year. We don't see that contributing as much going forward. We think there

will still be some deceleration, but it will probably taper off to some degree.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Mike, there have been a couple of threads in the discussion about 1994: the Greenbooks in the past, this one, and your remarks now. On one side, we have had a lot more growth in output and employment this year than we--or anybody--had been anticipating and much larger increases in short-term interest rates than had been expected. In your remarks, you made reference to questions about the demand damping effects of higher rates. The other side is the greater underlying strength of the real economy. Which has been the larger contributing factor: that there is something else going on that has created more strength on the real side than we had anticipated or, as has been conjectured in the press, that monetary policy is less potent? To which of these would you subscribe?

MR. PRELL. I don't think one can rule out the possibility that the interest sensitivity of the economy in the short run may be less than it was. Certainly, we have felt all along that, without the disintermediation effects of Reg Q ceilings that we got decades ago, there wasn't going to be quite the abrupt swing toward restraint that previously accompanied increases in short-term market interest rates. But we are still learning. Financial markets continue to evolve. It is conceivable that the lag structure is different. I just don't think we have enough evidence to make a strong statement in that regard. Part of what has happened this year has been a surprise in the growth of European economies, in particular, that has helped to buttress export demand. On the domestic side, while we cited a risk repeatedly through the year that inventory investment could be stronger than we were anticipating because businesses might become concerned about the availability of supplies, as things turned out, that seemed to be a much more dynamic feature in the economy than we had anticipated. There is a cyclical dynamic to this. As inventory investment and exports proved strong, that raised aggregate demand and that in turn reinforced the desire for inventories. As we got more production and more income, that raised consumption. So this is a process that feeds on itself up to a point.

Going forward, it is critical, as I noted, that these levels of inventory investment are unsustainable. If the economy is going to get back to a growth rate of no more than the long-run potential rate, there has to be a drop-off at some point. The question is when that drop-off in inventory investment will occur. We are also banking on there being a significant lagged effect of the interest rate increases that have occurred. It is still early, as has been discussed repeatedly here. As estimated even in our current models, the lags are long enough so that we would only begin to get significant effects now and in the early part of next year. We are also building in further rate increases, which will have their effect more in the latter part of 1995 and into 1996, but we think these rate increases may reinforce the effects in the shorter run, too, through increases in adjustable rate mortgages and even adjustments in the stock market. If short rates rise as much as we have assumed, it will be more and more difficult for households to get enthusiastic about taking on what appear to be some risks in the stock and bond markets when they can get sizable real returns without risk in the short run.

MR. JORDAN. There are a couple of things that follow from your remarks in looking into the year ahead and contrasting it with 1994. When I started looking at your Greenbook forecasts for 1995 and 1996, on one side I welcomed the continued discipline that comes from the concern about inflation and the overriding desire to contain it to achieve our longer objectives. On the other side, though, I was reminded of the feeling that I have had in conversing with employees in Cleveland in the last couple of months; they keep telling me that the unusually warm weather that we have had in October, November, and December is not good because it means we are going to have an unusually cold January, February, and March. There is this vindictive weather god out there that catches up with us. What is it about the process you go through in putting together the forecast that says that favorable surprises in output and employment in one period must be matched with unfavorable developments in a subsequent period such that the level of output and employment always comes out approximately the same in any given forecast horizon?

MR. PRELL. In fact, we didn't quite get back to the unemployment level in our prior forecast. We took the kinder, gentler approach to some limited degree here so that by the end of the period, we are in essence back at our point estimate of the NAIRU as it currently stands rather than somewhat above that. This means in essence that we don't see any disinflationary pressure through 1996. We merely stabilize things. That is the design principle here. What we have attempted to do is give you a baseline forecast that holds activity to a path that at least doesn't let inflation get out of control and tries to tell you whether that is achievable and how. That exercise involves a great deal of uncertainty, but that is why the good news in terms of output and low unemployment that we have recently experienced gets offset by bad news of slow growth and increasing unemployment later in the forecast.

MR. JORDAN. Okay. I expected that answer. Let me follow up on it because it raises a big concern about our February meeting. Some time between now and that meeting, we have to submit projections to you whose so-called central tendencies are to be published in the Humphrey-Hawkins report. What I suspected to be the case and confirmed when I looked it up is that the numbers in the central tendency in February are almost the same, with only slight differences, as the prior December Greenbook projections. The central tendencies, which of course exclude the outliers, tend to be a little more optimistic than the Greenbook on output, a little lower on unemployment--0.1 percent or so--and a little better on inflation. But there is not much difference; essentially, the central tendencies are the numbers in the prior December's Greenbook. If that turns out to be what happens this time, I am concerned about what we are going to be announcing publicly. The Chairman has to go before Congressional committees two or three weeks after the February meeting and go public with these numbers. The markets expect this Committee to take some action in February to raise the funds rate again. Then the Chairman is going to be in the position of saying that what we expect to happen--actually I have never understood whether it is what we want to happen or what we predict is going to happen--is that output growth is going to drop under 2 percent, unemployment is going to rise, inflation is going to rise, and therefore we will jack up the funds rate.

MR. PRELL. I don't know if there is anything I can say! It certainly occurred to me that taking these numbers just as they are might provide a somewhat unappealing forecast in the Humphrey-Hawkins report. But this forecast is not so far from the consensus view among economists that a little degree of optimism, as you suggested, wouldn't put it in the ballpark. I don't want to prescribe what people should say here. What we have forecast clearly is a slight uptick in unemployment between now and the end of next year, a slight uptick in inflation, and growth that is only modestly below most people's assessment of the long-term trend. We are a little bit lower, I think, than the consensus forecast at this point for GDP growth. We are lower on the inflation rate than the consensus forecast. I admit that these are differences, but we think they are consistent.

MR. TRUMAN. If I could add just two points: One is--I'm not sure this is helpful--my impression that the Administration is going through much the same problem. If they think that the NAIRU is about what we have estimated it to be, they no longer are in a position to say growth will slow down to potential of 2-1/2 percent because in that case they will have built in a permanently higher inflation and lower unemployment rate. I'm not sure how they will square that circle. In terms of comparing the Committee's forecast with the Administration's forecast, there may be some leeway on that score. My second point comes back to your initial question on the effectiveness of monetary policy and whether it may be reduced. In today's world, of course, we tend to assume that one of the channels of monetary policy is through the exchange rate. That is why we have model results that suggest the overall effect may be the same as it was 15 or 20 years ago, but the channels have changed with the relaxation of Regulation Q. I don't know whether you want to call it an exogenous event, or a favorable event, or an unfavorable event, or something unrelated where there has been a breakdown in monetary policy. But, of course, with the dollar having gone down this year rather than going up, which would have been your ex ante assumption, you do have a difference that could either be attributed to a stronger than expected "economy" in some sense or a short circuiting of that channel in this particular instance.

CHAIRMAN GREENSPAN. Further questions?

MR. BLINDER. I'd like to ask a question of Mike that keys off of where he finished with Jerry Jordan. Yesterday in the briefing, Governor Yellen asked Mike a question about the difference in the forecasts attributable to the tightenings that are embedded in the Greenbook forecast but not yet acted upon by the FOMC. She cited some numbers generated by the staff model. Mike, you indicated that you didn't really accept those numbers. I'd like to know--it is germane to the question that was just asked--what would be the forecast at a constant funds rate or the difference in the forecast between a constant funds rate path and the funds rate path embedded in the staff forecast?

MR. PRELL. The model simulation we have done using a constant funds rate has only slightly more growth in 1995 and then appreciably greater growth in 1996.

MR. BLINDER. Right.

MR. PRELL. By the model's assessment, that would add several tenths to the inflation rate in 1996. So in that sense, the difference here is one of stable inflation at slightly over 3 percent versus an accelerating price picture with the inflation rate moving up into the mid-3 percent range by 1996. I don't have a basis for seriously questioning this outlook. I do think there is a risk in the near term that, if the economy behaves anything like what we are anticipating and if the fed funds rate were to remain at 5-1/2 percent, inflation expectations could mount in ways that wouldn't be anticipated in the structure of our model. It is manifest that the market is expecting as much tightening as we have built in, if not more. The recent response of the markets to the tightening action shows that they are rather sensitive to indications that we are going to resist inflationary tendencies. The common forecast is for inflation to move up. I'd say the consensus is about 3-1/2 percent, looking at the Blue Chip forecasts for 1995. I think there would be considerable worry--unless there are clear indications the economy has weakened in the next couple of months--if the Fed were not to move the rate up significantly.

MR. BLINDER. I wasn't pushing a constant-funds-rate policy; I was just asking what the effects of that policy were, particularly on the real growth rate and on the inflation rate. On a fourth-to-fourth quarter basis, your forecast has real GDP growth decelerating from 4.1 percent in 1994, to 1.9 percent in 1995, and then to 1.8 percent in 1996. If you accepted what was in the the staff model and you backed out the effects of the coming tightening, that 1.9 percent and 1.8 percent would change to 2.1 percent and 2.5 percent. Now, to my way of thinking about the marginal effect of new policy with respect to timing, wouldn't you expect the inflation effects to be zilch in 1995, pretty mild in 1996, and in fact mostly having an impact in 1997? I am talking about additional policy changes, not about the tightenings we have banked already.

MR. PRELL. I think inflation mounts because, in this alternative, we are running with an unemployment rate that remains below the NAIRU out through 1996 and presumably into 1997, so we are getting an accelerating picture.

MR. BLINDER. Sure. I'm only talking about the derivative.

MR. PRELL. But I think that in the near term, taking into account exchange rate and import price effects and so on, the model begins to get additional inflation creeping in within 1995 and building a bit. It is very gradual and probably undiscernibly different. That again goes back to the comment I made earlier. It could creep up on you, and sustaining the low unemployment rate, as happened in the late 1980s, eventually does build up to a significant pickup in inflation. That is what our forecast has been designed to avoid.

MR. BLINDER. I was not questioning any of that; you misinterpreted the question; it is only about the marginal effects of policy. If we have passed through the NAIRU, which seems reasonably likely, exactly what you said ought to be happening. But the marginal effect on inflation of policy tightening from today forward, to my way of thinking, ought not to be on this Greenbook page. That is really the question. Or do you agree with that?



MR. PRELL. I think it would show up certainly in the tenths column, but we are talking about a matter of a couple of tenths over the next year or year and a half.

MR. BLINDER. Okay.

MR. PRELL. It is not dramatic. I would caution that in thinking about the slowdown in the economy, one does not want to think of that as purely a straight interest rate effect. Some of it is the inevitable reversal of that cyclical dynamic in the inventory investment area that I talked about. Our inventory equations, just as other forecasting tools, don't work all that well, so it is not something I'd want to bank on the model to capture. This is a very important element in the timing of the deceleration as we see it.

CHAIRMAN GREENSPAN. This reminds me of a discussion I remember having at the CEA in 1973 when everyone was talking about the small inflationary effects that were on the horizon--0.2 or 0.3 percent. Our models are really gross simplifications of the real world. As I've indicated before, simulations on reduced-form structures, which without appropriate add-ons give us silly forecasts, should not be employed with a great degree of confidence at this stage. I think our capability of doing the type of simulation that you are discussing here is really marginal. We have to be careful about reading terribly much into it. Just remember, it is the same econometric structure in the model that engendered a significant slowing in the second half of 1994, which didn't occur. The difference is the add-ons and the underlying structure that we don't capture. I'm not saying it is not useful to discuss what the potential impacts and lags are; it is just that I hope that everyone retains a large dose of skepticism in applying these types of structures. President McTeer.

MR. MCTEER. Mike, how much additional fed funds increase is built into your forecast?

MR. PRELL. We have the funds rate moving up into the 6-1/2 or 7 percent area by early next spring.

CHAIRMAN GREENSPAN. Any further questions? Let's move on to the Committee discussion. Let me just say, incidentally, that I've noticed at the last couple of meetings that our discussions of economic conditions have spilled over into an awful lot of policy at this point. I request, if you can possibly do it, that you stay with an analysis of what you see and leave the policy prescription for the next segment, or we will be contaminating our agenda here in an inappropriate way.

MR. MCTEER. Mr. Chairman, it seems though that that would be easier to do if the Greenbook based its projections on where policy is currently. What we have here is a Greenbook that assumes a further tightening, the amount of which is unspecified. So that makes it very difficult for us to--

CHAIRMAN GREENSPAN. I think it was specified in the Bluebook.

MR. PRELL. It is specified and you should have heard through your research director what the specific numbers were. I apologize if there was a slip in communications.

MR. MCTEER. I must have missed it when I read the Greenbook, but just now you said a 6-1/2 to 7 percent funds rate. Surely, it was one or the other or 6-3/4. It seems sort of vague.

MR. PRELL. My point is that we think the tightening needs to be significant. I think a problem with specific numbers is that they imply a false sense of precision about what it will take. Yes, to enter something into an econometric model, we would write down 6-3/4 percent.

CHAIRMAN GREENSPAN. I acknowledge your issue but still request that, if you possibly can, you stay on this side of the fence. President Minehan.

MS. MINEHAN. Let me just kick off the regional overview. The First District continues to expand at a moderate pace. We have had a rate of job growth for the region as a whole that is behind the nation. Our unemployment numbers are about the same, and as usual there are all sorts of variations by state, with Massachusetts still leading the pack and Connecticut still bumping along. Consumer and business confidence in the region has risen sharply according to both recent data and an increasing amount of anecdotal information. On the other hand, while District bank lending has grown through the third quarter, the pace of its growth is well behind that of the nation as a whole. And if you compare the districts, the First District is lagging in all kinds of bank lending.

Job growth continues to be concentrated in services, especially business and health excluding hospitals. Manufacturing employment continues to lag, but the anecdotal reports from First District manufacturers are generally positive. Strength is fairly broad-based. However, there continues to be weakness in the defense area.

Most of our manufacturing and retail contacts report increases in input prices, though their comments often revolve around the same inputs, largely paper and wood products in our area. They are also starting to report increases or planned increases in selling prices. Larger organizations, both retail and manufacturing, seem to indicate that the downsizing is over. About half of our contacts report that they are going to be hiring in the new year. If they have price increases in mind, they probably will be putting them through about the beginning of the year. There are reports of wage increases in the range of 3 to 5 percent. I think, however, that the high side of this range probably reflects some desire in companies that have been through downsizing to reward those people who are remaining. I don't think that is necessarily reflective of a trend of continuing 5 percent wage increases.

Now trying to stay on the right side of this fence, with regard to the Greenbook, we were more optimistic generally speaking when the year began. We thought there was likely to be a lower full employment level, a little more potential for growth, and certainly no inflationary risk of any size. We saw balanced risks at that time.

As the year has gone by, we along with everybody else have been impressed by the degree to which the data are always stronger than we expect. I see that Boston is widely thought of as a dove on these matters, but even the most dovish of the people at the Boston Fed now believe that the risks are more on the up side.

Our own forecasts are now a bit more pessimistic than the Greenbook. We think 1995 will have more overshooting on the employment side and a greater risk of inflation than is embodied in the Greenbook. If this doesn't stray too far over the fence, we think that the tightening in the Greenbook is about the minimum that is needed. [Laughter]

CHAIRMAN GREENSPAN. That is like Babe Ruth bunting a home run. [Laughter]

MS. MINEHAN. You handed me a challenge.

CHAIRMAN GREENSPAN. Peter Fisher has an announcement that I thought we ought to interpose.

MR. TRUMAN. He's not here, but maybe I can make it. He can clarify the facts later, but let me just state that at about 9:30, the Mexicans did announce that they had moved their intervention band by 15 percent and will continue to crawl that band by four new centavos a day. So, they basically have moved the band by 15 percent. We don't have any market quotes--

MR. FISHER. [Re-entering the meeting] Actually, we do. The peso has traded at 3.83 to 3.86, down about 11 percent from yesterday; it has not approached the outer band at all. Screens in New York are not quoting the Mexican stock market, but talking to people in Mexico, the decision seems to have been taken well in Mexican markets. Even though the ADRs--Mexican stocks traded in New York--were down, reports indicate that Mexican stocks are trading up in Mexico. So, the market seems to be taking it well in Mexico so far, and the peso hasn't traded out to its limit.

CHAIRMAN GREENSPAN. If you are going to do 15 percent, you really want the market to do 10 to 12 percent on its own.

VICE CHAIRMAN MCDONOUGH. Sounds just about perfect.

CHAIRMAN GREENSPAN. Let's hope it doesn't happen again.

MR. BLINDER. The first 35 minutes.

MS. MINEHAN. Right. It's not over until it's over.

MR. BLINDER. I take the longer view, an hour or so!

VICE CHAIRMAN MCDONOUGH. You'd never be a good foreign exchange trader!

MR. BLINDER. No!

MR. TRUMAN. As Peter mentioned in his earlier report, one problem with their monetary policy is that they have an auction today

of their tesobonos and another auction tomorrow of their peso-denominated debt. Financial market reactions will depend on how they choose to play those auction results.

CHAIRMAN GREENSPAN. To get good results on that or at least not disastrous results would be very helpful. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. The Tenth District economy continues to grow at a healthy pace and gains remain spread across all states and all industries. Our bank directors are almost uniformly positive about current conditions and the near-term outlook for our region. One key example comes from the transportation industry, where reports show strained capacity resulting from very strong demand for shipments of coal, autos, building materials, and a variety of other products. In almost every part of the District, we continue to hear reports of shortages of labor, spanning both skilled and unskilled. Consistent with these reports, current data show nonfarm jobs in the District up almost 3 percent in October from a year earlier, about equal to the nation. Most states added jobs at rates close to the District average, but a couple--New Mexico for example--were substantially over the average.

Manufacturing continues to improve, with most of the strength in the durable goods industries. Our contacts in the District's key automobile assembly plants tell us that they are operating at capacity levels following the changeover to new models. Major expansions are under way in the District for plants producing computer chips and other computer equipment. Construction activity remains robust across the District. Most of the recent strength has been in public projects with some modest slowing in home building. The energy sector is at least stable over the past few weeks, but farm incomes are probably on the weaker side for us, especially in cattle and hog production. Bank credit continues to increase at most District banks, with strong loan growth offsetting some modest decline in securities.

At the national level, we are looking for growth in the last quarter to be as much as 5 percent. I look for that momentum to carry forward into next year. I also share the view that the economy is currently operating beyond long-term potential levels. Such measures as the unemployment rate and capacity utilization certainly suggest that and perhaps even an overheating economy. At the current policy stage and looking forward to next year, I think we do have continued inflationary pressures that confront us as we enter 1995. With that, to avoid going over the fence, I'll shut up.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, economic activity on balance in the Seventh District appears to be even stronger than at the time of our November meeting. Like the Greenbook, we have raised our estimate for real GDP growth for the fourth quarter, and I expect it to be in the 5 percent range. It also seems likely that rapid growth will persist into the first quarter of 1995, with some likelihood of growth in excess of 3 percent. With real GDP already slightly above potential output, this robust pace of real activity threatens to generate a noticeable increase in CPI inflation later in 1995, moving inflation above the Greenbook forecast. Indicators of consumer activity in the Seventh District remain quite robust. For most of the

District, the holiday sales season is running very strong, particularly for such durables as personal computers, electronics, appliances, and big screen televisions. Only sales of soft goods such as apparel have lagged.

The District's manufacturing sector continues strong after the summer supply disruptions in the automobile industry. Auto and light truck sales are running at about a 15-1/2 million unit annual rate in the fourth quarter. Although availability continues to constrain sales for some models, many of the problems should be resolved over the next six months, allowing domestic producers to continue to gain market share. Over the next six months, the Big Three automakers plan to boost light truck capacity at existing plants by about 800,000 units through a number of changes to production processes. Production schedules for the first half of 1995 are quite aggressive, up 4 percent in the first quarter from strong year-ago levels and up 5 to 6 percent in the second quarter. While this is a very upbeat assessment, some extremely tentative signs of moderation in automobile sales were reported to us just recently. Specifically, reports yesterday from two major automobile manufacturers revealed some softness in demand at the dealer level. Although retail sales remain strong, some dealers have pared back their orders from manufacturers, possibly as a result of declines in showroom traffic, unexpected increases in stocks, or higher interest rates. In response, one manufacturer has taken the unusual step of trimming its production plans and reducing overtime levels at several plants. Although it is too early to attach much weight to these reports, they may represent early tangible effects of this year's increases in short-term rates.

Heavy-duty truck sales were strong again in October, and it now looks as if sales for all of 1994 will set a new record high. Orders also remain brisk, with the backlog extending into next year's fourth quarter. The backlog is due at least in part to producers allowing customers to lock in current prices and avoid expected price increases next year if they are willing to accept later delivery. Significant strength is also evident in our District's steel, machine tool, and office furniture industries.

In the agricultural sector, the situation is more mixed. It appears that some slowing has occurred in sales of farm equipment, especially for large tractors and combines. Still, domestic manufacturing schedules are up strongly in November and apparently in December as well. Prices in livestock markets have been depressed by large meat supplies, particularly for hogs. On the other hand, crop markets have been supported recently by improving export prospects and by the heavy use of government price support programs, especially among farmers in District states. Upward price pressures are reported for food packaging costs, including very steep 25 to 30 percent increases in corrugated cardboard prices, with another increase expected in January, as well as increases in prices of tinplate and bottles used as beverage containers. In addition, the explosion of a major fertilizer plant in Iowa has added temporary pressures to tight supplies and sizable price increases already evident for fertilizer.

On the employment front, labor markets continue to firm. Auto-related employment is at its highest level since 1979, and overall manufacturing employment in the District is back to its 1989

level. In Michigan, the unemployment rate in November was the lowest since the end of 1969, and in Illinois, the rate was the lowest since the late 1970s. Moreover, surveys of employer hiring plans in the Midwest are the highest in at least 18 years. The tightening in District labor markets has been accompanied by more frequent reports of upward pressure on wages due to labor shortages.

Overall, Seventh District economic activity is consistent with the national economy. It has continued to grow at a rate that, if maintained, would lead to increasing inflationary pressures.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, the Twelfth District's economy is growing solidly. Outside of California, the pace of growth is moderating in some of the intermountain states, although Oregon's economy seems to be accelerating. Economic indicators for California show continued improvement, aside from the financial problems in Orange County.

The current estimate of the Orange County investment pool's losses is \$2 billion, but the ultimate loss probably is going to be slightly higher. That \$2 billion is equivalent to around 2-1/2 percent of Orange County's \$75 billion personal income or around .3 percent of total state income. However, the comparison with a single year's personal income overstates the economic impact of the financial losses, since a large proportion of the funds was earmarked for capital expenditures that are spread over several years. Since more than 97 percent of the funds in the pool were invested by government entities within Orange County, most of the economic effect will be felt in Orange County itself, which accounts for roughly 10 percent of California's economy. The county and other participating governments appear to have been largely successful so far in finding ways to meet immediate cash needs. There is still a great deal of uncertainty about how the effects will be distributed among the affected jurisdictions. However, it is clear that these local government entities will cut spending substantially. Orange County already has postponed some large capital projects and put a freeze on hiring and all nonessential spending. A number of other jurisdictions are making similar moves.

One of the immediate effects has been to raise the cost of borrowing for Orange County governments and for the State of California. As was discussed earlier, credit spreads rose on municipal securities all over the country after Orange County filed for bankruptcy. These spreads generally have fallen back to the levels that prevailed before the problems in Orange County became public. The exception seems to be the State of California. Credit spreads on state issues rose more than on most other tax-free bonds. Subsequently, spreads have come down only a little from their post-bankruptcy peaks, and they remain higher than they were before the bankruptcy. This might reflect market speculation that the state government, which already is financially weak, eventually will be asked to bear some of the cost. In this regard, I should point out that in contrast to California State bonds, the credit spreads for actively traded city and county issues within California look about like those for municipals in the rest of the country.

Exposure of Twelfth District banks to Orange County has been and continues to be minimal. Loans and direct holdings of Orange County debt by banks are small, and the same goes for exposures under letters of credit. However, a few banks face some indirect exposure through sponsorship of mutual funds with Orange County holdings. Sponsors of some affected mutual funds, notably the money market funds, bought the funds' holdings of Orange County debt to prevent their funds from realizing the full losses. In other words, they wanted to make sure they didn't "break the buck" on the money funds. In general, the market seems to have differentiated among various mutual funds according to the extent of their Orange County exposure. We also learned that one of the banks that has a tax-exempt money market fund, instead of buying the Orange County paper at par as was done by a few other banks, issued a letter of credit for the Orange County debt, which of course increased its price and reduced the problem.

I'd like to turn to the national economy now and hopefully I will remain on the right side of the fence as well, but I certainly don't want to be on top of the fence. [Laughter] The national economy continues to exhibit surprisingly strong growth in employment, output, and spending. Indeed, the evidence suggests that the current pace of real economic activity has not been diminished very much by the tighter stance of monetary policy this year, or at least that any policy effects have been more than offset by other factors. Simulations of our own structural model, which has a monetary policy response similar to models such as DRI's and Ray Fair's, suggest that the tightening so far this year has reduced the growth rate of GDP by about 1/2 percentage point in 1994. The tightening also is projected to reduce GDP growth by a full percentage point in 1995, and another 1/2 percentage point in 1996. Long bonds have moved up more quickly than they often do in response to a policy tightening; there were charts in Part II of the Greenbook that illustrated this. This early increase has probably accelerated the effects of policy, so a greater proportion of the effects of the monetary restraint than suggested above may already have been achieved. I might note parenthetically that this has a rather interesting implication for the MPS model where one-half of the effect is in the third year. That is very different from any other model. The more conventional models are showing a faster effect.

Even assuming that monetary policy tightens further, as in the Greenbook, our structural model sees a substantial risk that inflation in 1995 and 1996 will be somewhat above its current pace.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Thank you, Mr. Chairman. The economy in the Sixth District continues to expand, although the pace of the expansion has decelerated somewhat from the growth rates we saw earlier in the year. Consumer spending is holding up quite well. We had a rebound in retail sales right after the Thanksgiving holiday that has continued this month, and most retailers are now expecting that they will exceed last year's strong levels by as much as 6 to 8 percent. However, they are also reporting that their sales are dependent to a large extent on special promotions and discounts, and that obviously is cutting into their profit margins. Big ticket items are selling particularly well. Sales of apparel, which had been weak for some

time, are also seeing strong gains. We have had reports starting in November that automobile sales were slowing, and that has continued through the first half of December. Tourism remains a very bright spot in the District economy.

Manufacturing activity was relatively flat in the Sixth District last month, although most plants expect to see gains over the next six months. Producers of lumber and building materials are operating at or near capacity, but several of them have noted that shipments have begun to decelerate. The same pattern is showing up in home furnishings and equipment. In contrast, activity at producers of paper, pulp, and chemicals rose substantially, and demand for auto parts is also strong. Again, the outlook for capital spending was a little less favorable than a month ago.

Home sales in the District fell below strong year-ago levels in most areas, although realtors are reporting that they expect a rebound in sales in the spring. Multifamily real estate markets continue to improve and rental rates are rising. Commercial real estate is also doing relatively well throughout the region, although I find it interesting that some architects report that demand for their services is in decline; that could imply some softening of construction next year. With respect to loan demand, bankers say that it's mixed, with increased commercial real estate lending and declining mortgage lending. Automobile lending also declined along with sales.

Labor markets haven't changed very much in the District since last month. We continue to see labor shortages reported in certain areas. It's most pronounced in Tennessee and in Atlanta. In Atlanta, it's related partly to the Olympics and partly to retailers who are finding it very difficult to get people for the holiday sales period. Skilled construction workers are in strong demand everywhere, and wages in that industry are rising sharply.

As for prices, about 50 percent of manufacturers indicate that they are still being pressured by the rising costs of raw materials. They are noting difficulty again in passing these costs on to final goods.

I would just add with respect to Orange County that we haven't seen any fallout in our District from that episode.

Now your fence looms rather large in front of me as I turn to the national economy, but let me go at it this way if I may. We, too, were surprised by the rapid rate of growth in 1994 and by the relatively low inflationary response to that growth. As opposed to the last couple of meetings, we did not run forecasts with an assumption of tightening. We did it with constant federal funds this time. It's interesting that our GDP forecast through the fourth quarter of 1996 brings the rate of growth in real GDP down to about the 2.5, 2.6 percent level throughout that period without any tightening at all. The CPI through that period is higher, as you would expect, than the Board's forecast, but it remains at about a 3.2, 3.3 percent level throughout 1995 and 1996, with the unemployment rate somewhat below the Greenbook forecast. That raises the question in my mind--and I think I raised this last time--whether or not there is something different going on in the economy this time around that



would suggest that potential growth is higher and the NAIRU is lower. But I think the basic question is whether or not there can be greater growth in the economy with less inflation, thereby implying somewhat less tightening than is forecast in the Greenbook.

CHAIRMAN GREENSPAN. President Broadus.

MR. BROADDUS. Our directors and other business contacts continue to report generally robust activity in our region with just a couple of exceptions that I'll mention in a minute. I guess the most striking anecdotal information we have gotten lately has to do with labor market conditions, which as a number of other people have noted for their Districts appear to be tightening very noticeably throughout our region. At our last board meeting about 10 days ago, we had several reports of shortages in both retail help and construction workers. The shortage of construction labor is said to be pushing construction costs up in North Carolina. Also in November, West Virginia posted the biggest monthly increase in jobs ever in that state, and it was quite broadly based across the West Virginia economy.

Elsewhere, most of the information we have on holiday sales has been positive. Also on the positive side of the ledger, we see increasingly clear signs of a firming of conditions in commercial real estate markets in a number of local areas. Actual construction has not accelerated markedly yet, but commercial vacancy rates are declining, rents are beginning to increase in at least a few metropolitan areas, and there is talk about increases in other areas not too far down the road. Prime space has become increasingly hard to come by, especially large blocks of it.

Lest you think the only news we ever listen to in our Bank is good news, let me mention a couple of signs of possible moderation in activity in some sectors in our region. We do a monthly survey of manufacturing activity in the Fifth District, as a number of other Reserve Banks do in their respective Districts. Our November survey suggested fairly significant slowing in activity in that sector, which is very important in our District. This slowing is in some contrast to the published national data. Also, we see continuing signs of a flattening in residential real estate activity across the District. At their meeting a few days ago, our Charlotte directors said that buyer traffic for single-family homes had hit a wall in the month of November. We never know how much weight to give to that kind of anecdotal information, but it does seem a little at variance with some other things we have heard.

Finally, with respect to prices in the District, our latest monthly survey suggests that both manufacturers and retailers are now expecting somewhat sharper price increases over the next six months than they were just a few weeks ago.

Nationally, of course, the broad contour of the Greenbook forecast hasn't changed a great deal. The thing that struck me is that--there has been some comment about it already--in spite of the strong projected growth near term, the bulge in the CPI predicted for the first quarter of next year is noticeably less pronounced than it was in the November Greenbook. Inflation remains relatively steady over the whole two-year forecast horizon. I think Mike's comments

suggested fairly that projections key off of the recent favorable actual inflation data rather than the apparent strength in real economic activity and the strong job growth and low unemployment rate.

Let me just say that I don't envy the staff's task in developing this forecast. I think developing any kind of reasonable and credible forecast in this situation is exceedingly difficult and the forecast we have is certainly plausible. Still, I think we have to recognize that this projection can be described as relatively optimistic under the circumstances. There are considerable risks in the forecast at this point, greater perhaps than we have seen earlier. I think these risks are probably somewhat more balanced than they have been up to now, but there still are substantial upside risks. As we all know, the economy is clearly very strong; it's really roaring I think; but there are quite a few signs of weakness here and there. There is a lot of talk about passing intermediate-level price increases through to final prices at the beginning of the year. So I think there is certainly a possibility, more than marginal, that we could begin to see the economy overheat as we move into next year and see an inflation rate significantly higher than the rate the Greenbook is projecting. At the same time, I think the downside risk on the real side as we get out into late 1995 and early 1996 is greater now than it has been, especially given the further tightening of policy that may be needed to contain inflation going forward. Because of this--and I'm going to step on your fence if I may here just briefly, Mr. Chairman--while I think some additional restraint will almost certainly be required before this thing is over, I believe we need to be somewhat more cautious in applying it than was necessary earlier this year when we were further away from a cyclical peak and when we had a serious credibility problem.

Speaking of credibility, I think the recent behavior of the bond rate suggests, to me at least, that we have acquired some of late. In my view, that is the most encouraging development we have seen in some time. The trick is going to be to maintain it going forward as we move into a situation where the risks are at least a little more balanced than they have been. I might just note once again if I may that precisely in this kind of situation, something like an inflation target might be helpful.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you. For the most part, the Ninth District economy remains very strong; much of it is operating at full employment or maybe even beyond. Two interesting pieces of information have become available since the last meeting. On the anecdotal side, I think there is some accumulating evidence that housing is slowing down, both sales and construction activity--that there has been some response to higher interest rates. I wouldn't say that the supporting information is overwhelming, but I think there has been enough of it to indicate some effect in our area. Secondly, we did have a meeting with a large number of Twin City business leaders several weeks ago, and I would say the general tenor of that meeting was that whatever we have here, we don't have equilibrium. What I mean is that most of their talk was about labor shortages across the board, from the skilled to the entry level jobs. That market hasn't cleared. It has not resulted yet in a lot of wage pressures, although people talk frequently about raising wages in one part of the pay

scale or another. But it sounded to me as if there is more to come, that we clearly have some disequilibrium. The same thing was true when they discussed what they were seeing in terms of crude and intermediate materials prices and availability. There obviously are pressures there. It sounded to me as if there is more to come and that ultimately that will put pressure on final goods prices. Now whether this results in simply a blip in inflation at the consumer level or something more sustained remains to be seen. But clearly there is a lot of pressure. If these people are representative, there is a lot of pressure coming.

With regard to the national outlook, I guess what I found the most surprising part of the Greenbook forecast, something that people have already commented on, was the inflation outlook. If I used the Greenbook type of framework, which as I understand it relies a lot on capacity pressures to drive inflation, and look at how the economy has performed and where we are in terms of the unemployment rate and capacity utilization and so forth, I think I would come out with a lot more inflation over the next several quarters than is there. My concern is that we could get an acceleration of inflation--the 1/4 point or so that the Greenbook seems to envision is just noise. That could happen or not happen depending on a lucky or unlucky break or two. My judgment would be that if we get an acceleration of inflation, we will not need a magnifying glass to discern it.

CHAIRMAN GREENSPAN. That is the point I was trying to make before, Gary. This business of a 1/2 percentage point increase in inflation at an annual rate as though that means anything--

MR. STERN. You can go from 0.2 to 0.3 of a point--

CHAIRMAN GREENSPAN. You can round the numbers to the nearest 5 percent!

MR. STERN. You can go from 0.2 to 0.3 percent per month and that gives you a percentage point right there. On a monthly basis, it doesn't look like very much.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. The economy in the Eleventh District continues to show the same healthy rate of growth that has been in place throughout 1994. We have been looking intensively for signs of slowing activity in response to tighter monetary policy. So far the only perceptible slowdown has been in single-family construction, which peaked in April, but this decline has been more than offset by strong activity in multifamily and nonresidential construction. There has been no slowing in the rate of expansion of the most interest-rate-sensitive sectors of our manufacturing industries--rubber, plastics, lumber, nonelectrical and electrical machinery, primary and fabricated metals, furniture, paper, stone, clay, glass, all of those. Defense-related and energy-related manufacturing are the only areas other than single-family construction that show signs of weakness. I continue to hear scattered reports of price and wage pressures, but the number of these reports seems to have dissipated since the last FOMC meeting. Nonetheless, capacity constraints are strong and possibly intensifying for electronics, petrochemicals, and paper products. Wage pressures are reported in the electronics,

telecommunications, fabricated metals, and trucking industries. Firms in the temporary help industry expect even greater difficulty recruiting skilled workers next year, which could put even more pressure on wages and prices. In spite of growing pressures on wages in several industries and rising materials prices in a number of others, we have seen little evidence of price rises on final goods and services, especially at the retail level. In fact, our Beigebook contacts in the retailing sector tell us that intensified competition in recent months has brought the average of their selling prices below those of a year ago.

As the Greenbook points out, we have all consistently underestimated the strength of the economy throughout this year. All the risks seem to be on the up side at this stage with respect to real growth as well as inflationary pressures. The improvement of job prospects, consumer confidence, and credit availability are propelling strong growth in the consumer sector. The need to add to capacity is putting upward pressure on investment spending. Stronger economies in Europe and Latin America will be increasing our export demand. There is nothing in the new fiscal policy proposals that would stifle these demand pressures. Quite the contrary, the anticipation of tax cuts will likely add to demand pressures, capacity constraints, and price and wage pressures in the coming months. Mr. Chairman, I'll defer the next sentence!

CHAIRMAN GREENSPAN. I don't know how successful this is.  
[Laughter] Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The Second District continued recent trends of a robust economy in New Jersey and a slowing expanding economy in New York State. Data for the most recently available month indicate that employment grew 2.7 percent in New Jersey and stagnated in New York. Consumer sales throughout the District in November grew quite moderately, but the data and the anecdotal evidence indicate a strong Christmas season in all parts of our District.

On the national level, I feel that there is great uncertainty about where the economy is going, or at least I am very uncertain. I do not believe that growth in the very strong fourth quarter, which could well be 4-1/2 to 5 percent or even more, is the real world but a happenstance of all possible positive elements coming together. If it is not too good to be true, at least it would seem too good to continue, and growth next year should slow down to a sustainable pace. Our Q4/Q4 GDP growth forecast for 1995 under current policy assumptions is 2.4 percent with the CPI at 3.3 percent and going up. We think that the cost pressures that have been discussed by many people probably are already baked in the cake.

The greatest uncertainty is to figure out where current monetary policy is and its effect on the economy. Is it tight and, if tight, in relation to what? We did some work on comparing the present policy stance at full employment, and we tried to find some previous periods when one could say the economy was more or less in the same macro performance position. We came up with April 1972, May 1978, and November 1987 as periods to be compared. Then we looked at various indicators of whether monetary policy is tight or not. If you look at the real fed funds rate, which we compared with the latest 12-month

CPI, it's now 2.6 percent, which is considerably tighter than in the 1970s and somewhat tighter than in 1987. The monetary aggregates, M1 and M2, are very much tighter than in all the previous comparison periods. The Treasury yield curve is flatter, which would indicate that the market feels that policy is better positioned than it was in those previous periods. Even the crude PPI, which has been rather troublesome lately, if you look over the 12-month trend it too indicates that price performance is better, and therefore one would think that monetary policy may well be tighter. I'm not sure that that tells us that current monetary policy is perfect. It doesn't tell me whether it's a little too tight or a little too loose or very much, except that it tells me that if I were to leap over what tiny bit of fence remains, that waiting might have something going for it. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Sounds like a leap to me. President Jordan.

MR. JORDAN. Thank you. With regard to Orange County-type developments, before that drove everything else off the newspapers, we were getting a number of similar reports in our area. Cuyahoga County lost \$150 million, which they say is equivalent to a new football stadium, so we have a team for sale. And it appears now that the state held \$900 million of stripped bonds that are deeply under water. So, we are going to see significant reductions in waste, fraud, abuse, and underemployed people on county and state payrolls! These people will be going to work, fortunately, because they are going to find a very good labor market.

I focused this time mostly on manufacturing. Manufacturing employment in our District is almost 50 percent above the national average; it's really the main part of the Fourth District economy. With only one exception, manufacturers said that the NAM president does not speak for them. Sometime people volunteered this to me; sometime I sought out their views. If there is a NAIRU in the Fourth Federal Reserve District, I would say it's a lot lower than it is assumed to be for the nation because our unemployment rates are 4 percent or less in most of our metropolitan areas. And yet I still don't sense any change in people's attitudes about what will happen to inflation in the future. People talk about very tight labor markets. I continue to hear the same stories about shortages of skilled and unskilled workers, yet it doesn't seem to be getting built into people's plans. They may be looking to that reservoir of previously discouraged workers that was supposed to have existed, or the disguised unemployed that we are supposed to have inherited from earlier periods, or the otherwise underemployed people out there. But if they exist, they live in other Districts and we are having to import them; we have reversed the population flows and are getting some in-migration. Our manufacturers talk about paying hiring bonuses and performance bonuses based on having had a very good year, but they are not building pay increases into their wage bases in order to attract or to retain workers. One of the states, Kentucky, recently suspended its program to attract businesses to the region because they simply view their labor market as so tight that going out and trying to steal companies from other regions of the country was not a very profitable thing to be engaged in. The person who told me this was very disappointed because he heads up that program and he was not sure what he was going to be doing.

I talked to the CEO of one of the giant companies that mainly supplies the motor vehicles industry, especially heavy trucks, and also produces other equipment. With regard to his capital expenditure plans for the longer run, whether for increasing capacity or making productivity-enhancing investments, I asked him what assumptions he made about future price increases. He said zero. He was very adamant in saying that it would be irresponsible for any industrial leader in America today to assume that they can plan on any price increases for their output. Instead, capital expenditure proposals are evaluated on the basis of their ability to achieve the productivity increases to match any cost increases in labor or other resources. I thought this was at least one bit of evidence that what we are trying to achieve--stability in the purchasing power of money--is beginning to take hold in the minds of our business people.

Another industrial leader from a very large company that supplies paints and other chemical products approached me saying that we must have an immediate and very substantial increase in the federal funds rate. And, of course, I was curious and asked him why he felt that way. Was he concerned about inflation? He said absolutely not, because he could not increase his prices. In fact, he said that he was trying to hold the line and resist pressure to reduce his prices because of increased competition. But his costs were killing him and the Fed needed to raise the funds rate in order to reduce those costs.

Small and large manufacturers in the District are doing very well in the export markets, especially exports to Mexico and Canada. District exports have posted strong increases in the last two or three years, and companies that had never engaged at all or significantly in these markets are now finding them very attractive and are doing quite well. I hear a lot of reports of plans to increase capacity in the next year or two as well as continuing emphasis on labor-saving investments.

Turning to the national economy, I can understand why people who believe that the growth that we have had in 1994 is the result of prior demand stimulus would feel that we ought to take that stimulus out before it spills over into excess demand and therefore rising prices. It is a legitimate point of view. It is not clear to me why we didn't recognize that excess demand earlier and therefore make a better forecast for 1994 if we knew that that was what was going on. Maybe hindsight provides the answer. But I still think that we ought to consider an alternative interpretation of what we have been experiencing this year and that is that it is the dividend for prior restraint. We should have expected that policy actions to reduce inflation and to build our credibility on the inflation rate would produce the type of output increases that we have had. Therefore, what has been going on this year is not the sort of thing that necessarily spills over into rising prices and higher inflation in the future.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. In the third quarter, nominal GDP was up 6.7 percent from a year earlier, the largest year-over-year rise in five years. More recently, nominal retail sales rose at a 15.1 percent annual rate from July to November, the fastest four-month pace since the spring of 1987. There are few signs yet that our monetary policy

actions have slowed the pace of spending. Since March, for example, business loan growth has accelerated to an 11.1 percent rate, after falling in 1993. Nevertheless, in my view monetary policy has shifted toward restraint. All monetary aggregates have shown relatively weak growth since spring. Inventory investment has been very strong this year. In my view rapid inventory accumulation has been desired and is likely to continue for a time. Despite rapid inventory accumulation so far this year, the inventory-to-sales ratio has remained near the lowest level since the early 1950s. According to a recent survey by our staff, attempts in the Eighth District to build inventory, especially of finished goods, have been unsuccessful simply because of continuing strong sales growth. One major motor vehicle manufacturer in the Eighth District reported that it held larger stocks than its two domestic competitors simply because, in contrast to its rivals, it had the capacity to keep production closer to the pace of sales. Even so, this firm has had difficulty in keeping its strongest selling models in stock. Such observations matched the concern with respect to the nation as a whole expressed in the National Association of Purchasing Managers surveys in October and November.

In November, employment gains exceeded the robust average monthly increases from January to October and were more than twice as large as the average monthly rise in the civilian labor force. Eighth District unemployment fell to 4.7 percent in October, its lowest level since August 1974. That's a level at which we have been hovering for some time. On a comparably measured basis, the nation's unemployment rate has fallen to its March 1989 level, which in turn was the lowest since December 1973.

Notwithstanding this evidence of strength on the real side, the positive reaction of the bond and other financial markets in recent weeks is heartening. I hope this means that the markets now believe that the long-term inflation rate will not accelerate from its current level. Whether the nearly universal expectation that inflation over the near term, or the long term for that matter, will be 3 percent or more is acceptable is another question, as is whether we act today in terms of any short-term actions. I am not at all averse to strong cyclical real growth if the thrust of our policy is consistent with long-run price stability and we have credibility.

CHAIRMAN GREENSPAN. Unfortunately, President Boehne had to leave because of an emergency he had to attend to. I'd like to ask Rick Lang whether he could give us a brief survey of what is going on in the Third District.

MR. LANG. Thank you, Mr. Chairman. The Third District economy continues to expand but at a more moderate pace than in the nation as a whole. Employment levels in several areas of the District still have not reached their pre-recession levels. Manufacturing activity continues to be one of the strong points; its levels continue to be high, although not as high as in earlier months. Retailers are telling us that they are experiencing good holiday sales, especially sales of durable goods.

Housing activity around the District remains mixed, with only a few areas in the District showing signs of strength. There are some signs of increases in nonresidential building activity, although this is not translating into substantial gains in construction employment

at this point. Bank lending around the region is up but also not as strongly as in the nation as a whole. That is particularly true of business lending. Price pressures continue to be evident in the manufacturing sector, but they do not appear to be widespread around the region. Also, although we do not have evidence of strong pressures on wages in the region, we do hear of more cases of signing bonuses being given to workers in some sectors of the District economy. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Thanks very much. Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. I'll try and stay entirely on the right side of the fence by talking about fiscal policy! [Laughter] I have three observations to make: First, we are now getting the first indications of the effects of the 1993 tax law changes. I have presented scoring stories to this group before. I want to stress that what we have are very preliminary indications, but they are from both the macro aggregate level and from detailed micro data that were published in Statistics of Income.

According to our staff estimates, if you look at a liability model estimate of what taxpayers owed, in 1992 it was \$498 billion and in 1993 it was \$522 billion. We had a net gain of \$24 billion in liabilities.

CHAIRMAN GREENSPAN. That is for individuals?

MR. LINDSEY. Yes, I'm looking at the individuals' side here. Personal income rose 4.3 percent between 1992 and 1993.

CHAIRMAN GREENSPAN. What was it without transfer payments?

MR. LINDSEY. Slightly below that--4.1 percent. But there are offsetting factors. I could go on for too long, but you don't want me to.

CHAIRMAN GREENSPAN. I don't!

MR. LINDSEY. The general approach to estimating, given the adjustments the Chairman is talking about, would be to take per-tax-return personal income. The elasticity of receipts with respect to per-return personal income based on the index used for inflation is 1.0. The elasticity for real increases is about 1.5. The inflation index for 1993 was 2.8 percent. So we would expect, if nothing had changed in the law, about a 5 percent overall increase in nominal receipts or \$25 billion. We got \$24 billion, which doesn't leave any room for revenue from the tax increase. Looked at from an alternative point of view, the estimated revenue from the tax rate increase was \$15 billion. So, that would leave \$9 billion left over, or an increase of about 1.8 percent attributable to economic growth. So, we would have to assume that receipts grew at only about 40 percent of the rate of increase in nominal income, which is also implausible. The micro data tell a very similar story. These are early tax return estimates and every year the Statistics of Income publishes an early compilation. I would stress that the data are early. What I want to contrast is, for the same type of sample, the top 763,000 taxpayers which in 1992 were those making over \$200,000. Overall AGI for those taxpayers rose .4 percent versus 2-1/2 percent for other taxpayers.



But when you break down the composition of income you get a pattern that I think strikingly suggests an enormous behavioral response. For example, looking at Schedule C income, which is notoriously susceptible to changes in tax rates, people making under \$200,000 did not have a bad year; they gained about 3 percent, but the rich people did terribly. They had a decline of 43 percent in their reported business income. And while corporate profits for C Corporations did great in 1993, and partnership and S Corp profits for people making under \$200,000 rose 28 percent, those sorts of profits fell 25 percent for people who were affected by the tax rate increase. The third parameter that is probably most susceptible to tax rate behavioral responses is charitable giving. Where overall charitable giving rose about 3 percent, charitable giving by those making over \$200,000 rose 41 percent. If we add up the dollar changes here, a \$5.5 billion decline in business income, a \$14 billion decline in partnership income, and \$2.9 billion in extra charitable deductions, just looking at those three factors we get a shortfall from 1992 levels of \$22.3 billion that would have been taxed at an average rate of 38 percent. That would give us a shortfall of \$8.5 billion. In other words, more than half of the tax increase was offset by behavioral responses. I found it striking because both the micro and macro data point in the same direction.

I think that that type of evidence plus evidence that has accumulated over the last 15 years is going to lead to some modest changes, and I want to emphasize the word "modest," in the scoring process that Congress will use. But I do want to disagree--and I rarely do--with Bob McTeer's observation. I think that we should keep in mind a number of effects with regard to what is going to happen to fiscal policy. In my mind the short-term effects of fiscal policy will probably be contractionary. To explain why, first, I think the dynamic will be to produce a near-term balanced change in the overall scoring. There are two philosophical reasons why the new leadership in the House should do that. First, Newt is a political philosopher, and his basic strategy is to reverse the observation that all politics is local, which is Tip O'Neill's approach, where you buy off the taxpayers in your District by putting up a project and they don't care about the national effect, meaning the tax implications. The election was run on a reversal of that strategy. And so I think if you're placing yourself in Newt's shoes as a political strategist, you want both to pay off your constituents and punish the opposition. That requires both tax cuts and spending increases.

In addition, I think the lesson of the iron triangle is not lost, and there will be intentional efforts to try and weaken the long-term effects of the relationship between the bureaucracy, Hill staff, and the press by defunding it. So I think we will see that the timing of spending reductions will be much quicker than anyone anticipates. And they will be heavily oriented toward what in Washington we call "reductions in force" and the rest of the country calls "firings." They actually are not firings; they are buyouts. So, here is why I'd like to elaborate on why we should keep in mind that probably the net effect of what we are going to see is a fiscal contraction. With a buyout you give the departing employee a lump sum payment. That expands the government deficit. But the newly laid off employee does not run out and spend his buyout immediately; in fact, he's a little traumatized and will actually cut back on spending. So

there would be one example of where you'd get an increase in the budget deficit which would not feed back into higher aggregate demand.

Second, of those prospective tax increases, I think two in particular will happen. One is a child credit which actually will be dribbled out over the course of the entire fiscal year and may not even start until midyear. So you get \$10 a week in your paycheck. The timing of the median-dollar fiscal impetus will be much later than the timing of the offsetting dollar of spending cuts. The other tax cut, which is capital gains, I think has clear timing issues. More important, I think there are issues for the effect on the marginal propensity to consume that dollar, which I think is probably quite low. So, I believe the net fiscal impetus that is going to come from the budget changes on a timing basis is going to be quite negative for 1995 and 1996. Second, I think if we look at the marginal propensity to consume issues again, the effect on demand of any fiscal change is going to be rather small. We always taught that the balanced budget multiplier was around 1 in a very simplified model or more precisely that the effect of a spending cut is more dramatic than the effect of a tax change.

There is a third reason why that's going to affect the economy in a negative way, and that is that we are going to see I think an intensely regional distribution of the spending changes, mainly focused in the northern portions of the Fifth District! If you want any indication of that, go for a tour of some of the nicer sections of Upper Northwest section of Washington, and you will see "For Sale" signs just about everywhere, although I think there were local elections which may have affected that outcome as well as the national elections. As in the case of defense spending cutbacks, I think we are going to see a highly regionalized effect.

The third observation I'd have on the net impact is on the regulatory side. I think that compared to the fiscal actions the regulatory actions of the new Congress will be extremely dramatic. Here I think the right model to think about is what happens to GDP when you stop building a pyramid. I don't mean to imply that all of our regulations are pyramids, but some have cost-benefit relations which are not much better. When you stop building a pyramid, you lay off workers and you have a negative effect on GDP. Those workers will eventually find employment. Their real output will be higher, but those real output gains will not be seen for two or three years. I think we are going to see a major change in the regulatory apparatus, and particularly in the mandating of the private sector and state and local governments to spend money for federal regulatory purposes. The net result, I think, will also be contractionary on the economy, at least over the forecast horizon. Thank you.

CHAIRMAN GREENSPAN. Sounds like a 30-year bond rate of 5 percent! Governor Kelley.

MR. KELLEY. Mr. Chairman, in the spirit of "contain yourself to what you see," what I see is what I've heard all morning--a very strong economy where the risks are rather heavily skewed to the up side. Let me take just a minute to mention two other matters. The first, which has been alluded to a couple of times this morning, is that there may be more substance than many of us think to this whole notion that we have some kind of a new economy with a lower propensity

toward inflation. I am referring to this whole mix of arguments that we may have a lower NAIRU, a new level of competition, world markets with lots of capacity, much higher productivity, and probably less significant wage pressures than one might expect with this level of employment. I have had a lot of sympathy with that argument for a long time and spoke to it several times at our meetings during the spring. I don't much doubt that that has been present and is present in the mix of the economy right now. I think it probably is a significant reason why we have done as well as we have so far relative to the amount of growth and the amount of inflation that we have experienced. But I rather doubt that we can depend on that mix of considerations to carry us very much higher in the level of capacity utilization than we already are experiencing without having that mix of considerations exhaust themselves with higher inflationary pressures showing up.

The other thing I'd like to mention is that I am worried about and puzzled by the formation of consumer debt. I think there has to be a serious downside risk there, either short term or long term. Consumer debt is off the charts on the up side in relation to consumer income or net worth, and its growth should slow. There are precious few signs that it is slowing so far, but there is a short-term possibility that what we are seeing now is that the consumer is indeed shopping until he or she drops and that maybe the wallet will close after Christmas. Inventories could start to build up quickly. That is something to watch immediately after Christmas. If we don't get some slowing in the near future, then I would worry that that is going to imply some other types of problems further on down the line that could perhaps be even more serious. Thank you.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you. Our discussion has demonstrated the depth and the breadth and the resilience of the economy. These are terms that we usually use for market conditions, but we could certainly apply them to this expansion period. We are closing in now on four years of economic expansion. Growth in three of those years is now indicated to have been above potential in most parts of the country. It almost seems that Orange County is the only place that does not appear to be participating. A key question is similar to the one that Governor Kelley just posed; that is, when are we going to see stronger signs of a slowdown? So far we are hearing and seeing significant signs of momentum going into 1995. I do think that the monetary stimulus that extended from 1989 through the first part of 1994 is causing a good deal of the momentum, and I don't think we need to put too fine a point on it. Within that period we had 15 months of a 3 percent federal funds rate that certainly has had an influence. I do think that the so-called head winds died down sometime in 1993. People became more comfortable with their balance sheets, and the monetary policy ease started to show through significantly into the economic system. As other people have said, these restructuring head winds are now becoming tail winds. We are now reaping the benefits of the earlier balance sheet restructuring which is providing a lot of cash for both businesses and households to spend. Whereas we did have a credit crunch in the banking sector, now we are seeing significant willingness by banks to lend to both households and businesses. Both business investment and construction spending, which had been a drag

on the economy, are now starting to contribute significantly to the expansion.

Well, at some point it must stop. I think that forecasters have plenty of room to be humble as we end 1994. It is at least feasible that consumers could slam on the brakes early next year--when they balance their checkbooks when they really start to assess how much debt they have taken on. Maybe it will happen when they get the latest repricing of their ARMs or when the wealth effects start to hit as they get their year-end mutual fund statements. I think people are beginning to realize that the paycheck increases are not as great as they have seen in the past. We may not have the strong year-end bonuses in some areas that we have seen in past years. In short, I think that the party for consumers is going to be over, but it is not clear how far the current momentum is going to carry us forward from here.

On the business side, I think that the tail winds actually may be a bit stronger because of the productivity kick that we are getting from re-engineering and technology investment. Eventually, monetary policy will start to bite harder as this pipeline effect works its way through the economy. We have been given breathing space with respect to final consumer price increases. We may have been saved by the bumper grain crop that we have seen this year. Energy prices backed off. We have had a mild autumn. Ironically, the labor market is giving us some mixed signals. There has been a lot of discussion around the table today about labor shortages, but also discussion of the fact that we are not seeing big pressures in wage markets. Jerry Jordan talked about some of the temporary measures that are being taken to try to deal with these labor shortages that do not affect the permanent wage structure. I think that despite the fact that we have a 5.6 percent unemployment rate, there is still some considerable unrest in the labor markets. People have jobs, but they don't necessarily have the jobs that they want or that they like. Except in some skilled areas there may be more flexibility in the labor market than we had thought. I believe there is a willingness now to move and change careers, and this willingness will be helpful in containing wage pressures as we move forward. And certainly on the benefits side, the health cost containment efforts have been helpful.

In sum, as we move into 1995 I, too, think we are going to get a slowdown, but the question is when and how much. On the fiscal side, I'm not as confident as Larry Lindsey in making predictions. It seems to me that everything is on the table in the Congress. In this contest of wills that we are about to see, I hope that the loser is not deficit reduction.

On the market side, the financial markets really have performed quite well given all of the shocks that we have experienced in 1994, but I think there is more yet to come. We have seen quite an orderly correction this year, but there may yet be some fallout. Joan Lovett and, of course, Bob Parry talked at length about Orange County. I don't think we have seen all of that play out. I don't think we have yet seen all of the implications of the Bankers Trust situation play out. When people get their year-end mark-to-market statements on their mutual funds, there may well be some surprises. I think many of the counties may still be trying to figure out exactly where they stand. So there may well be some shocks coming in 1995. The point of

that, of course, is that there is considerable uncertainty as we go into 1995.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mr. Chairman, if the staff projection for the fourth quarter is correct, we clearly have a more vibrant economy than most of us had expected and the surprise is the lack of inflation flares in the current figures. I am somewhat puzzled by the Greenbook projection for the first quarter of 1995. The abrupt GDP slowdown seems to me to be counterintuitive. With the very high level of capacity utilization and reduced slack in the labor markets, pressures are building for price increases and higher wage demands when contract negotiations begin next year. What I find puzzling is the widespread existence of sales at significant discounts on every kind of merchandise. Brooks Brothers has recently offered 40 percent off on top-of-the-line goods, and the newspapers and catalogs are bursting with ads for sales. Coming during the top selling season of the year, these sales would seem to support the idea that price increases are very difficult to make stick. To be sure, steel--operating at or about 95 percent of capacity--has negotiated contracts for 1995 deliveries at higher prices. And that pattern will probably spread in the near future to other industries that also are operating at high levels of capacity. The momentum certainly seems to be there for accelerating growth in the economy even though it is already burning along at a rate well above potential. And as the night follows the day, inflation is certain to be lurking. The height of the Greenspan Wall prevents me from completing my prepared remarks at this time. I will wait for the gate to open. [Laughter]

SPEAKER(?). The flood gate was it?

CHAIRMAN GREENSPAN. I've learned my lesson!

SPEAKER(?). A less-than-successful building project.

CHAIRMAN GREENSPAN. Yes, that is right!

MS. MINEHAN. That is really true.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. I think the wall was extremely successful. I'm not going to breach it. I'm also going to be very brief since, coming almost at the end, almost everything that I might have said--and its opposite--has already been said! [Laughter]

Let me take a few minutes to defend the conventionality of the Greenbook forecast against some of the objections that were raised. Although, as a small footnote, in thinking ahead about my Humphrey-Hawkins forecast in February, my inclination would have been to be a little higher on near-term growth--1995 growth--and maybe a little higher on inflation. But these are small differences. I want to defend the Greenbook both in the particulars, the kind of outlook that it is pushing--a rapid deceleration of growth and a small increase in inflation--and also on the basic methodology of being conventional. I think there is a lot to be said for, and very little on the other side, the staff of the central bank to be extremely

conventional in its methodology and not buy on to hypotheses that have very little empirical support, although 10 years later that might look like a good idea. Usually it doesn't, but it might. Speaking as a citizen and as a central banker, I'm glad to see the staff sticking to the tried and at least not falsified methods! [Laughter]

I agree with the Greenbook outlook that we probably have pushed a bit past the NAIRU. There is a probability distribution around this, of course, but the best guess is that the economy probably has pushed a little past the NAIRU, or noninflationary capacity. I also agree that it is quite reasonable to expect a very considerable deceleration of growth in 1995 under current policy and then a tiny bit more in 1996 if there is no further tightening. One of the reasons--Susan Phillips and several people have mentioned it--is something that is too easy to forget: the lagged effects of the stimulative monetary policy that only ended in February 1994, and only very slightly at that. It is even easier to forget the stimulative effect of the bond market rally that peaked in price, troughed in yield, only in October 1993. Everything we know about lags in interest rates says that those two things--the previous Fed stance and the bond market rally attributable to whatever you want to attribute it to--should be powering the economy in 1994. I think the main reason behind the standard forecasts' underestimates of 1994 was an unwillingness to believe in interest rate effects. It is the same kind of thing that is happening now; everyone is looking around and asking where it is, not believing, and then all of a sudden it is there. This has happened many, many times in the past, and I have no doubt that it will happen in the future. And it probably is happening right now. This is a second reason to expect a considerable deceleration. We first of all have the petering out of the previous expansionary effects of interest rates and, second, just the beginning of the early stages of the kicking in of the contractionary phase of monetary policy. As I think Mike indicated in answer to some question, you should just now be beginning to see the effects of the Fed's tightening in 1994. It is very hard at this point to see it in the tea leaves, but history suggests that it is right around the corner. So those are two fundamentals leading me to think we should have a sharp deceleration in 1995--the wearing off of the previous expansion and the kicking in of the tightening.

Finally, there is the inventory swing. I think the staff outlook--I was about to say it is exactly right, but nobody can get it exactly right. Nobody knows the timing of this, but it is an awfully good bet that between the fourth quarter of 1994 and the fourth quarter of 1995, the inventory swing alone will take something between 1/2 and a full percentage point off the growth rate. It would be quite surprising if that didn't happen. So all that points to a considerable slowdown in the economy even if there is no more tightening of monetary policy, and somewhat more if there is. That is as close to the fence as I'm going to come right now.

Let me just take two minutes on inflation. Many people are surprised, and several people have remarked around this table, about the modest rate of inflation given the rapid economic growth. I want to say two things about that. First, this is not quite as surprising as people seem to think. If we have overshot capacity, as Mike said, we have overshot very, very recently and by very, very modest amounts. And there are long lags. It would be surprising indeed if we already

saw a sharp increase in inflation from that. Simple evidence, which says the same thing in a different way, is that the conventional Phillips curves are fitting this episode extraordinarily well. They have very small residuals. So, if there is a new economy due to greater openness, a traumatized labor force, or whatever--all these things are possible--the evidence for that is really not in the data. And so I think the staff is wise to stay clear of it. That is, it would be imprudent for us as central bankers to presume we are in a new, substantially less inflationary world. On the other hand, the recent news is good: To the extent that the errors are coming in not quite zero, they are coming in favorably. And while we would be imprudent to jump hastily to a conclusion that we are in a new world, we would be foolish to ignore the evidence as it comes in. And the Greenbook doesn't ignore it. They have written down the inflation forecast a bit in reaction to the recent data. I think that is about the right way to deal with it.

Finally, a last remark about inflation and in defense of the staff: Standard econometric estimates would say that a 1 percent overshoot--1 percent as measured by the unemployment rate for an entire year--would add about 1/2 percent to the inflation rate. Now, it is correct that nobody should take these numbers as equivalent to the gravitational constant in physics--never mind Einsteinian amendments to that. We don't know these numbers nearly that well. On the other hand, there is no particular reason to think that it is too low rather than too high. It is the best guess, and even if you want to view that 0.5 percent effect as saying 0.5 plus or minus 2 percentage points, which I think would be very much an exaggeration of the errors, 0.5 is still as good a guess as you can make--except that, if anything, the incoming evidence seems to be pointing to a little less of an inflationary impact, not a little more, as I said a minute ago. So, the evidence is not overwhelming. But, if anything, it would shade you toward less of an inflationary acceleration, not more. So, there, I have defended you!

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. My opinion concerning the strength and likely future direction of the economy has changed just marginally since our last meeting. Certainly, the evidence has continued to accumulate that we have an economy with a very good head of steam. We see that in the employment report, a significant rise in the help wanted index, growing order backlogs, and frankly to my surprise in the Michigan indexes of car, appliance, and house buying intentions which all turned up after having fallen, in some cases substantially, in November. So I must admit I'm surprised to see so little evidence of a slowdown, although I continue to feel--as I stated last time--that we are seeing in part the lagged effects of a prolonged period of low interest rates, as Governor Blinder also noted.

There is certainly some risk that real growth will slow less in 1995 than the Greenbook forecast now assumes and that we could overshoot potential output in 1995 by more. Nevertheless, I'll just continue to emphasize, as others and I have in the past, that our previous actions have added a great deal of restraint to the pipeline. Since our last meeting real interest rates have risen considerably, and as Bill McDonough emphasized, real interest rates by various measures are not low by historical standards. We have seen, finally,

a decline in the stock market, which will bring wealth effects on consumer spending into play, and for once the dollar has been appreciating--which re-enforces direct interest rate effects and plays some moderating influence on the inflation forecast. In addition, of course, as Mike has emphasized, inventory accumulation is bound to slow and it seems possible to me that accelerator mechanisms can then kick in to slow the economy significantly.

So, I see a number of changes in the pipeline that I expect to work to cool off demand but with a very substantial lag. And frankly at this stage I remain uncertain as to just where the economy would be in 1996 with the 100 to 150 basis points increase that is assumed in the Greenbook. I share the concern of a number of private forecasters and of some of you that this degree of tightening in the near term could slow demand growth and that we could end up producing a boom/bust scenario. To avoid such an outcome, it seems to me that the funds rate would have to fall rather quickly, by more than the Greenbook assumes, once growth slows to trend, even with the economy below the NAIRU.

CHAIRMAN GREENSPAN. Thank you. Is coffee available?

MR. BERNARD. Yes.

CHAIRMAN GREENSPAN. Let's take our usual break.

[Coffee break]

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

CHAIRMAN GREENSPAN. Questions for Don? If not, why don't I start as usual? I'm impressed with the extent to which it is very difficult to find any negative factors in the current outlook. You can not find it in the order patterns, which are strong across the board. There are very few firms outside the defense-related area or long-term turkeys that are not doing exceptionally well. [Laughter] The Christmas selling season is, as always, difficult to read. The trouble with the Christmas selling season is that the constant dollar volume is really predetermined because retailers will sell what they have and the only thing that is indeterminate is the price. But that is quite relevant to how the system works when you get into the first quarter. Looking strictly at the data as they stand at this stage, it is very difficult to tell whether in this quarter the GDP growth rate is 3 percent or 7 percent. We are making forecasts about how the system is going to evolve. My own impression is that since it is extraordinarily unlikely that all of these positive events will continue without change for terribly long, one has to assume that this expansion will start to ease off at some point. The only thing that I think we have to be careful about is that the easing may be more delayed than we suspect. And until we begin to see the process of erosion in its early stages, we really have no basis for saying that the expansion is slowing down. We are looking at history; we are looking at relationships; but there are no significant demonstrable imbalances in the system that basically say things have to change. We are projecting that there will be a change, but that again is a projection. As of the moment in the labor markets, initial claims continue at quite low levels. The fairly strong pattern of C&I loans suggests that inventory accumulation is still moving at a reasonably



strong pace and that is bolstered by the orders pattern, which suggests that producers' durable goods are doing well. Remember, a goodly part of inventories is supported by the capital goods and construction markets even though we don't keep the data that way.

As best I can judge, profit margins are still on the firm side and even though profit forecasts are beginning to look more symmetrical rather than just continuously underestimated, the evidence on the profits side is still quite positive. Prices, as a lot of you have noted, are firming in the commercial real estate markets, although my suspicion is that the nationwide figures may still be eroding albeit at a much slower pace. I won't add much on homebuilding; it is a puzzle but I think that if it doesn't start to move down, then all of our historical relationships, all of our basic data, are lacking in predictive value. I don't believe what is going on in homebuilding, but we will find out eventually.

I think the interesting question is why wages are not responding to what is a very rapidly tightening labor market. After speaking to some labor leaders and others who talk to their members and have a sense of this, I get the impression that long-term job insecurities are quite pervasive especially with respect to the portability of health insurance and pensions that make workers more cautious about changing jobs. The layoff rates are very low; the turnover rates are really quite low by American standards; and there is a tendency among workers just to stick with what they have. The effect of this, I suspect, is a major factor in holding wage increases to a very sluggish pace considering all the evidence we have been getting in recent months of labor market tightness. This is crucial because so long as that is the case and productivity is positive, unit costs are very well contained. Any endeavor to move final prices up in that environment induces competitors to come in and try to steal a firm's market share, which erodes the firm's pricing capability. So long as we have some evident flexibility in the system, then prices can not readily move. This doesn't necessarily mean that business firms have to run out of capacity; obviously, it just starts to get a little more costly or a little tight and we begin to get pressures. But it is not clear from the anecdotal data and the macro data that we have that these pressures are severe. I thought that the exercise that was done for the Greenbook Part II, which separated where the growth rates have been in manufacturing depending on which industries were at high operating rates, is tending to suggest that there is more flexibility in this system than our old conventional wisdom of capacity use would indicate. There obviously has to be a limit somewhere, and when we look back on this we may well find that we have a system that is a lot more flexible than we presupposed.

This is also true, I think, with respect to monetary policy. While it is certainly the case that we have what historically would have been a not insubstantial amount of a policy impact by this time, the simulations that the staff has done, including the fact that long-term interest rates moved up faster than the normal process would imply, suggest that we are probably some 25 percent into the cumulative effects of our policy tightening at this stage. That is not a small number, and we are now seeing very little effect as a consequence. On the contrary, what we are seeing is an easing of credit terms in the banking sector and the old notion that we used to have 30-40 years ago--that the central bank would tighten, short-term

interest rates would rise, bank credit would suddenly be crunched by Regulation Q or some other factor, financing would be undercut, and the economy would swoon--clearly is an historic relic and the disintermediation that we used to see is just not there. On the contrary, we are having difficulty getting banks to notice that interest rates are up. The interest rates on automobile installment paper are really lagging. Everybody is trying to protect market share, and this whole thing just doesn't seem to be coming together. But it will. It always does. And the question is essentially pretty much when.

I think it is really worth recognizing that there is something quite different about the timing of this recovery. Ordinarily, a recovery has a much higher rate of growth in the early stages and slows in the later stages. Probably what is happening here is that we really didn't have the classic movement to a cyclical recovery until well into the cycle, and we are probably now at effectively the earlier stages in a geriatric sense as distinct from the calendar. What this suggests is that we probably still have quite significant momentum in the system, and it is not clear just when it will ease off. I wonder to what extent we can attribute all of this to monetary policy and monetary policy lags. Surely, we can attribute some of it; there is no question that that is the case. But there is an internal dynamic in the economy that is wholly independent of the business cycle. I do think the issue that Jerry Jordan raised is an interesting one, and even though it is very difficult to prove statistically, it may well be that the fact that inflation is relatively low may--despite all the discussions we have had about the inadequacy of the evidence--be contributing to improved productivity. If that is the case, we will get some greater growth in potential. I hope that one of these days I will be able to use one of these statistics after the fact, and finally say I told you so [Laughter] without struggling. I must say I'm a little concerned about the continued ease in bank lending terms which I suspect is greater than the numbers show.

I seriously wonder what our monetary actions from here on will do to 1995 as well as to 1996. I think it is true, as a number of you have pointed out, that if we really look at the distributed lags--the average performance historically of monetary policy--it is very difficult to make the case that what we may do in the early months of 1995 will have significant effects in calendar 1995 in real terms. I would only caution that if we get an unexpected breakout on the up side in inflationary expectations, the distributed lag of monetary policy will bunch up very quickly. We have to be careful about that. I do think the argument that most of the impact is delayed is clearly a correct view, but I think we have to be careful about the probability--even though it is low--of significant aberrations that could have important negative effects.

All in all, if we decided that we needed to move the funds rate up at this meeting, which I don't support I must say, I doubt very much that that would have a negative effect on economic activity. I think the economy's momentum is still quite strong. I do worry, however, with or without the Orange County turmoil and the usual end-of-year problems, whether we would be taking undue risks in endeavoring to tighten in this environment. I think that the odds that we are going to have to move shortly after the first of the year,

no later than our next meeting, are quite high. However, it is conceivable that this expansion could fizzle out fairly quickly. I frankly don't expect that, but I think we can't disregard that possibility. Where I would come out at this stage is that I hope we will be comfortable staying where we are for a while. I believe, as Don Kohn pointed out, that we have time to make further adjustments if need be, but because of the possibility that we might find it necessary to move after the first of the year but before January 31, I think it would be preferable to have an asymmetric directive. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I support your conclusion that alternative B with an asymmetric directive is appropriate. As I remarked earlier, the degree of uncertainty about the effect of existing monetary policy suggests waiting. Also, the markets are very thin as Joan described earlier, and as Susan Phillips suggested we could have some remaining effect of governmental actions on Bankers Trust, which would create some uncertainty in markets. Therefore, I think that to make a move that is not absolutely necessary right at this time involves some degree of risk. It is difficult to quantify and would be better if we avoided it. Why asymmetric? We get enough data in the first half of the month--nonfarm payroll employment on the 6th of January, retail sales on the 13th, and industrial production on the 17th--

CHAIRMAN GREENSPAN. Industrial production we get much earlier.

VICE CHAIRMAN MCDONOUGH. We do?

CHAIRMAN GREENSPAN. Yes, it is a Federal Reserve number!

VICE CHAIRMAN MCDONOUGH. The world gets it later. In any case, I think what is important is not so much what we know but what is known outside. It might very well be the case that by the middle of the month, roughly, our strong views on price stability could be questioned. And, therefore, we should have the capability of moving. We can move in fact without an asymmetric directive, but I think that we are better off with the asymmetric directive toward tightening. Therefore, I believe that the combination of doing nothing today with an asymmetric directive toward tightening is the appropriate mix.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mr. Chairman, one argument against policy moves at this time is this skittishness of the markets on the heels of the Orange County mess. On the contrary, I think the markets have reacted to the "Lemon" County and the Bankers Trust situations with great poise and restraint. In my opinion, the markets may be more dismayed by a lack of further tightening now, particularly as they sense the increased level of economic activity, the shrinking labor market slack, high levels of capacity utilization, and consumer attitudes that don't foretell much slowing of consumption. In the past, there has been market speculation that we were behind the curve. The November action countered that impression, and I worry that ignoring the continued strength of economic activity even temporarily may reignite concerns about our determination. At the risk of dubbing the Fed as the Grinch who stole Christmas, it seems to me we need to snub

the brakes again without delay, and therefore I would prefer alternative C symmetric.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. I favor "B" asymmetric toward tightening. As I mentioned before, the response of the financial markets to our last move together with the slow growth of the aggregates convinces me that we can afford to do nothing now and observe the effects of our prior actions for a time. I must say, though, that I'm not at all convinced that we have fully met the current challenge especially if our goal, as I think it should be, is price stability. Therefore, I think it is important that we give serious consideration at the February meeting as to how we might convey our long-term intentions in this regard. The question that we had from Senator Riegle last July was indicative, I think, of the fact that perhaps on the outside there was some confusion as to exactly what we intended.

CHAIRMAN GREENSPAN. There has been some discussion that the new Congress would establish such a legislative goal.

MR. MELZER. Yes. With regard to that issue, perhaps one thing we ought to think about would be to provide some longer-run inflation forecasts, say beyond 1995 or 1996, because, as an initial step in considering legislation, I think one could say that monetary policy is going to have its principal long-term impact on inflation. Eventually, I would be inclined to establish long-run inflation or price level objectives as some other central banks have done. Now clearly this is going to require a lot of further work, and I'm encouraged by the fact that the staff is looking into that issue. I would hope that we might have something, at least to start on, that we could talk about at the February meeting.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. Thank you, Mr. Chairman. I agree that this is a good time for waiting. It was only 35 days ago that we raised the fed funds rate by what was essentially a record amount. The August interest rate increase was only three months before that, and by all historical standards ought not to be showing in the data as yet. That is to say, 125 of the 250 basis points of tightening that we have done up to now could not possibly be in the data at this point. I think if we were to move now it would imply some sense of alarm on our part, some sense of urgency that things were going badly wrong. And like you, I don't think things are going badly wrong. Things are looking pretty good. Even the next FOMC meeting comes just 11 weeks after the November 15 action, that is, less than a quarter. What is magic about a quarter? It is, of course, the magic number for a macro economist who tends to look at the economy every quarter. It is a shame there wasn't more spacing in there, but that is the way the FOMC calendar falls. So, I think you are almost surely right that it is wise to wait until the next FOMC meeting unless something fairly startling happens. In that regard, I would prefer a symmetric directive. I don't feel strongly enough about this to make a big deal of it, but I have a predisposition to wait until the next FOMC meeting for a number of reasons. I wasn't persuaded by Bill's argument that if these data that he mentioned come in strongly that we might not wish to wait what

basically amounts to only two more weeks. If the Greenbook forecast without the additional tightening is, say, 2.1 percent real growth in 1995, which we were discussing before, it is not so obvious that we ought to take action to push it down lower than that. As I said before, I suspect that the projection might be a little on the low side; that without more tightening growth in 1995 might be higher than that; and indeed that more tightening might be necessary. I for one have an open mind about future increases in short rates.

Finally, I won't repeat my thermostat speech of the last time, but I always keep in mind that the classic mistake of central banks in almost all times and almost all countries is to overstay either their tightening or their easing.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. As we all know, the Greenbook is assuming that the funds rate has to be pushed up another percentage point or perhaps even more to keep inflation from breaking out. Obviously, we can't know for sure at this stage whether that much tightening is going to be needed, and indeed as you suggested, Mr. Chairman, things may work out so that nothing more is needed. Still--

CHAIRMAN GREENSPAN. That is a very low probability.

MR. BROADDUS. I would think so, and I think it is certainly a very high probability that we are going to have to do something more. The question before us this morning is whether or not we need to do some of that tightening today or whether we can put it off a little longer. I think it is a very close call. My own preference at this meeting would be to move the funds rate up 1/4 percentage point to 5-3/4 percent. I realize the 1/4 point funds rate moves earlier in the year had adverse reactions, and at that time some argued that those moves were made under sensitive circumstances. However, the situation is very different now. We only recently made a very strong move, so I don't think that kind of reaction would be a problem at this stage of the game. I think the main argument for a relatively modest further move today is that it would reinforce and lock in the quite considerable credibility gains that the November tightening appears to have produced, as I believe John LaWare suggested. I think some reinforcement at this stage would be desirable given the very strong recent data on both employment and spending. At the same time, a 1/4 point move would be significantly more restrained than any of our last three moves, and it would indicate that we recognize the need for caution as we move closer to the cyclical peak. So, my preference would be for a 1/4 percent increase. I also would like to second Tom Melzer's comments about the need to consider some sort of inflation target, something to nail down our longer-term goals and objectives at the February meeting.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I would agree with those who say that we need to take some action at some point. I think that that should be now, not later. The best environment is to do it now while sensitive to market concerns. I happen to think Governor LaWare is correct. By delaying we would risk having to do more later and having more adverse effects, so I would prefer doing something now.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I think the main part of our problem right now is inflation psychology. It certainly reflects the lack of a nominal anchor. It suggests that it would be helpful to have a politically supported mandate to attain and maintain a stable value of the dollar. If somehow we could achieve the conditions of a true gold standard--without gold but the steady purchasing power of money in the minds of people--over time it would make some of these short-term things that we go through a lot easier to deal with. I also support Tom Melzer's suggestion about having a discussion but also having a long-term focus. That may sound like a minor change but one that may be important in a communications sense because our long-term forecasts are often taken as long-term inflation objectives. I still feel that the numbers we put together for the Humphrey-Hawkins process should not be people's predictions of what is going to happen with regard to inflation, but rather a reflection of what we intend to try and achieve by our monetary policy actions.

There is some good news about what seems to be a consensus around the table that the rates of change of output and employment this year are unsustainable. And as somebody said, unsustainable things have a habit of ending. The question is whether it will end as a result of a natural process in which whatever dynamics produced it in the first place start to diminish so we get a deceleration in the rate of change toward something that's more consistent with trend. Or is it something that we have to take conscious policy actions to force if it is not occurring naturally? I would resist the latter. To the extent that the anticipated slowing in the growth of activity is supposed to occur because of reductions in capital expenditures for productivity-enhancing or capacity-increasing purposes, it is not to be welcomed. It is implausible to me that investing less in capacity and productivity lessens the chance of inflation. In fact, quite the contrary; we should welcome having more people invest in capital expenditure programs for capacity or productivity. So if you're going to contemplate an action before the next meeting, with or without an asymmetric directive, with or without a telephone call, I hope that the numbers will be reviewed very carefully to determine whether what we are seeing is a result of still diminished head winds and the economy has a ways to go in a natural spontaneous process versus something that is read in the marketplace as a spillover of excess demand. And that is going to happen if it isn't carefully done. I wouldn't dissent against an asymmetric directive, but I would be very concerned if any action taken was interpreted in the marketplace as anti-growth for the sake of it.

MR. MELZER. Jerry, just to clarify, I favor your objective as well, but recognizing the practicalities of getting from where we are to that in a relatively short period of time and the possibility of a legislative mandate, I was suggesting that a long-term forecast may be an intermediate step we could take on our own right away. But I agree with you.

CHAIRMAN GREENSPAN. We inevitably are going to have to be discussing that because we are required to do projections of the monetary aggregates.

MR. KOHN. Just for 1996.

MR. MELZER. Yes, I'm looking even further out as a possibility.

MR. KOHN. 1995, excuse me.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I want to associate myself fully with Governor Blinder's views. My reasoning is similar. The first observation is that I think the November move was extremely successful. Our decision to go 75 basis points took off the market pressure in both the foreign exchange market and the bond market. I think had we moved 50 basis points, we would be moving another 50 basis points today. So in that sense we should be patting ourselves on the back for our last move. And as a result I don't think we should move right now.

I have four reasons for not preferring an asymmetric directive. The first has to do with data. Reporters often ask whether we are waiting for information from the Christmas season to decide what we are going to do. The right answer is that there is absolutely nothing that we are going to do at this meeting that could conceivably affect the Christmas season or vice versa. In fact, as our discussion about lags has indicated, what we are talking about is not even the first quarter; what we are talking about is late 1995 and early 1996 with regard to the effect of our actions. So, rather than looking at current activity we have to use our crystal balls, which admittedly are cloudy, and stare down the road. So, I'm not sure what information is going to come out in January to cause us to change our minds.

On the other hand, I do think that over the longer period we are going to have information that will be useful. We will have more information on where fiscal policy is headed and sooner than we usually do. In addition, we are going to have information on the consumer. I think the anecdotal evidence on the consumer situation, as Governor Kelley suggested, is that they appear to be tapped out. In fact, when you talk to bankers, they are now issuing credit cards to C and D class credits, and they are doing so profitably. I'm saving this for the next meeting, but when I look at the cash flow situation of households, the only private sector support for this spending in my mind is a buildup of consumer credit. I think the credit data bear that out. So, I would rather delay for information reasons--certainly not move in January, and I may even want to delay at our next meeting on January 31-February 1.

The other issues have to do with our tactics in the market. We have learned this year that moving at meetings gives us a much more efficient tradeoff measured by the short-term move compared to the long-term move. Generally, we have had flat or rallying markets on moves at meetings. We have been unsuccessful when we moved intermeeting, and I think that is another reason not to go asymmetric and not to move intermeeting.

Finally, and I think this reinforces President Melzer's point, we will have to consider our long-term intentions at our next meeting and we will be making not only a tactical move but a strategic move. And I think we should at the very least want to hold whatever tactical moves we have until we know where we are going to go

strategically. So for those reasons I concur with Mr. Blinder and urge symmetric "B."

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, in my view the economy has picked up more momentum since our last meeting, and the degree of tightness in labor and product markets has risen even further. Our analysis agrees with the Greenbook that further tightening is needed in order to prevent an increase in the inflation trend. Therefore, I would prefer a 50 basis point increase in the funds rate. Frankly, I don't see the problems of Orange County as a reason to hesitate in doing what is best at this point for the national economy. Financial futures markets expect a 50 basis point increase in the funds rate by early January. Thus, I doubt that a policy move at this time would cause much disruption. However, I can support your recommendation since I interpret your comments as indicating that a change in policy is quite likely by roughly the middle of January. If the tone of the economic data does not change, I am concerned that further delay beyond that point would lead to a deterioration of inflationary expectations.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, we believe that further tightening is almost inevitable because of the unexpectedly rapid pace of the expansion and the prospect of unsustainably robust growth continuing in the future. However, in light of the unusually large action at the November meeting, we recommend leaving the rate unchanged for the time being, with the expectation that economic developments in the coming weeks will confirm the need for an increase in the funds rate at the January meeting, if not before. So, I would agree with you on the asymmetric directive.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, I think that the case for not moving today is quite persuasive. We did move aggressively just a few weeks ago and I think we have moved aggressively throughout the year. The cumulative moves are really quite significant. We need to remember the lags in monetary policy and give some time for that to work through the pipeline. In fact, I am not convinced that any great further degree of tightening is necessary, but I have an open mind on that score. Also, as I tried to indicate before, I think there is now greater flexibility in the economy. At the risk of belaboring that point, I think there is a plausible argument that would suggest that the economy can support a greater degree of growth at the present time without incurring inflationary pressures. Obviously, this is more theory and argument than anything else, and as has been pointed out this morning there is really not very much empirical evidence. Some of the things that you cited with respect to the labor market I think are appropriate and relevant here, so the burden of proof obviously is on those who would suggest that this is a plausible theory, and I think there is a risk in using it in terms of policy deliberation. However, I do think it is important to keep this in mind as we go forward because if this is in fact the case we run a risk on the other side of seriously overdoing monetary policy actions. For the moment,



I would support your recommendation. I would prefer a symmetric directive, but I could support the asymmetric option as well.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, in appreciation for Governor Blinder not giving his thermostat speech I'll forego giving my inflationary teakettle speech! [Laughter] But I do think that given the momentum that we observe that it is overwhelmingly likely that we are going to need to go up at least some more; and it does seem to me that once one becomes convinced of that, then it is desirable to do it quite soon in the expectation that that is the best way to head off having to do too much. That said, I think it certainly would be a good idea to hold off until after the year-end pressures. At that point, we ought to take another very hard look at it. For today, I certainly support your "B" asymmetric approach.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I also would support "B" asymmetric. I think that we have more tightening to go, but I'm willing to wait until early next year. As a general matter, I agree with Governor Kelley-- if you are going to do it, earlier is better. But I think we have been given some breathing room with the favorable CPI numbers. It would be useful to let us get past the end of the year and the year-end marking-to-market. That allows the markets a chance to settle out. Ultimately, I think that more tightening is going to be necessary. With all of the market and monetary restructuring that has taken place, it is probably going to take larger swings in interest rates to achieve monetary goals. It is very difficult to generalize from past experience when the pipeline is going to kick in fully. I would like to see us give serious consideration to the longer-term inflation targeting approach that a number of people have spoken about; Tom Melzer started off the discussion of it today. But for today, I think "B" asymmetric will serve us well.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Mr. Chairman, I favor alternative B to hold the funds rate at 5-1/2 percent at this meeting, and I favor it for the reasons suggested in the Bluebook. I also concur with the sentiments expressed by Governors Blinder and Lindsey and President Forrestal. I think a wait-and-see strategy is reasonable, given the magnitude of previous tightening and particularly given our uncertainty about whether and how much the economy is likely to slow on its own and my own uncertainty about how much additional tightening is going to be needed. I would prefer a symmetric directive with a strong presumption that we would wait until the next meeting in order to act.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I agree with your proposal.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I'd favor "B" with a symmetric directive. I favor "B" because I do think we have applied some restraint and, given the lags, I think we ought to be patient and take some time to

see what effects, if any, they have. I favor a symmetric directive for several reasons. Part of it is my normal antipathy to, or discomfort with, asymmetric directives. But more fundamentally on this occasion, I have trouble imagining what evidence we will get in the next several weeks that is really going to help us address what I consider to be one of the key questions: What is the economy going to be like and what is the appropriate stance or policy actions that will influence things later in 1995 and into 1996? It just doesn't seem likely to me that we are going to learn anything in the next several weeks that is going to help us very much in addressing those questions. I may be wrong, but we can have a conference call if significant new information does materialize. Beyond that, the suggestion has been made, and I certainly agree with it, that there are a number of fundamental longer-run policy issues that the Committee should discuss and perhaps try to reach consensus on. I noted a number of them in my recent communication. [Secretary's note: A copy of Mr. Stern's letter to Chairman Greenspan, dated November 29, 1994, is appended.] And I think the one that is on the table already about longer-run inflation objectives is a good place to start.

CHAIRMAN GREENSPAN. Just to clarify: One of the events that is not irrelevant is how the markets respond to what's happening.

MR. STERN. Yes.

CHAIRMAN GREENSPAN. And I think that that is probably the most crucial "statistic" in a sense and really the only one that could make a material difference in this period. I agree it is very hard to find data with anything crucial. But I think that there is a very important issue here, namely that we not allow our erosion in our credibility that we have built up and which has kept the cap on long-term interest rates. I must tell you, it is too subtle an issue for any of us to predict. Let's get to President Minehan and then I have a few things I'd like to say about this issue.

MS. MINEHAN. I have been concerned for some time about the thermostat issue that Governor Blinder raised. We did quite a little work prior to this meeting to assure ourselves that at least as far as we could project, however deficient that projection might be, that the amount of tightening that is already in the pipeline is not sufficient. We came out pretty strongly, all of us in Boston, with the conclusion that it is not sufficient. So for us, it is not a question of "whether;" it is a question of "when." I would align myself with the people who think that if it is not a question of whether but a question of when, that sooner is better than later. In that area I would align myself with Governor LaWare's remarks. Don Kohn talked about the markets being fairly confident, but I think it is important to remember that what the market giveth the market can take away, too. And along the lines of what you said, Mr. Chairman, I too would be concerned that we might lose the credibility that has been hard won. I view the 75 basis points we did at the last meeting in two ways: as a 50 basis point make-up for actions that I think we should have taken earlier, and as 25 basis points into what we needed to do at that meeting. So, I don't really regard that move as being as strong as some other people do. All of that said, I'm very cognizant of the probability that people who are closer to the markets than we are in Boston have a view of the thin trading and whatever that is perhaps better taken than ours. So I'd be willing to go "B,"

but I'd feel fairly strongly that asymmetric should be the tone because I am concerned that we might see market movements, given the strength of the underlying economic data.

CHAIRMAN GREENSPAN. This is an interesting result we are getting. It is very clear that there is a heavy consensus for "B." However, there is a very sharp split on symmetric versus asymmetric unless we take the two members who have argued for an increase as being on the asymmetric side--but we don't usually do it that way. What I would like to do, though, is more pro forma and that is to suggest the following as probably an appropriate way to come at this. We are, as I think a number of us have discussed, in a crucial area as to how we should behave. Given the discussion that we have had around this table, I don't think it would be wise to move before the next meeting without a conference call to be certain that everyone has a say with respect to how they view what we are dealing with. I frankly don't know whether or not such a call will be appropriate; it may well be very clear during the period that it is not. But I don't think we ought to move in the intermeeting period without having had a Committee discussion. I would like to stay with the asymmetric directive with "B" because it captures, marginally as I read it, the view of the Committee. But it is pro forma and I would suggest that the difference frankly between symmetric and asymmetric, as far as action is concerned, probably is minuscule. So, I would like to put "B" asymmetric on the table for a vote.

MR. BERNARD. I am reading from page 14 of the Bluebook: "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might 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."

MR. LINDSEY. Somewhat and slightly? You said somewhat more and slightly less?

MR. BERNARD. I used somewhat with the "greater" restraint and slightly with the "lesser."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

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

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CHAIRMAN GREENSPAN. The next meeting is January 31st and February 1st, and luncheon is served.

END OF MEETING