Meeting of the Federal Open Market Committee

December 18, 1990

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 18, 1990, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Boehne
Mr. Boykin
Mr. Hoskins
Mr. Kelley
Mr. LaWare
Mr. Mullins
Ms. Seger
Mr. Stern

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

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

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

Messrs. J. Davis, R. Davis, Lang, Lindsey, Promisel, Rolnick, Rosenblum, Siegman, Simpson, and Stockton, Associate Economists

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

Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Ettin, Deputy Director, Division of Research and Statistics, 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. Beebe, T. Davis, Ms. Greene, Mr. Scheld, and Ms. Tschinkel, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Kansas City, New York, Chicago, and Atlanta, respectively

Mr. McTeer, Senior Vice President, Baltimore Branch

Messrs. Goodfriend and McNees, Vice Presidents, Federal Reserve Banks of Richmond and Boston, respectively

Messrs. Guentner and Thornton, Assistant Vice Presidents, Federal Reserve Banks of New York and St. Louis, respectively

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CHAIRMAN GREENSPAN. Would somebody like to move the minutes of the previous meeting?

VICE CHAIRMAN CORRIGAN. So move.

MR. SYRON. Second.

CHAIRMAN GREENSPAN. Without objection. Gretchen Greene.

MS. GREENE. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Are there any questions for Gretchen?

MR. FORRESTAL. Gretchen, do you think the market continues to anticipate further easing by the Fed? Is that the [unintelligible] of the market?

MS. GREENE. I think the body of opinion does expect that. The questions in the market's mind are: How much and how fast?

MR. HOSKINS. You mentioned that negotiations to ratify the swaps are finished. My question is: Given the size of our current foreign exchange holdings, why do we need to ratify those levels?

MS. GREENE. These are the swap arrangements that we have with other central banks, which have a term of one-year and are renewable every year. As a routine matter we renew them each year.

CHAIRMAN GREENSPAN. It was more than just Germany and Japan.

MR. TRUMAN. Yes, the action to renew them was endorsed by the Committee at the last meeting.

MS. SEGER. Gretchen, I've always wanted to know how much of the activity in the foreign exchange market involves corporate positioning as opposed to traders who work for money center banks. I know that many multinational corporations are having to get involved with foreign exchange more and more as a byproduct of their real work. Do you have any sense of how that proportion would fall out?

MS. GREENE. That's a very difficult question to answer, partly because we don't have very good statistics and partly because the concept is hard to define. When we last conducted the turnover survey, in 1989, we did ask banks to tell us what proportion of their total foreign exchange turnover was with customers. I've forgotten the number, but I believe it was somewhere between 5 and 10 percent. But that only goes so far, because it depends on every respondent identifying who was a customer and that would not necessarily be a corporate customer. Nonbank financial institutions could be customers also. The rest of the business that a bank does, although it's reported as interbank business, may be in support of the customer's business. For example, if I do a trade with a customer and then I wish to manage my position, that forces me to go into the interbank market to do a certain amount of transactions. I think the average

number of interbank transactions one might engage in to support one customer trade could be anywhere from 4 to 10.

MS. SEGER. What made me think of it was that I was talking to a friend of mine who is a corporate treasurer and he was saying that in their shop, which is a very major company, they now have at least one person in the treasurer's office 24 hours a day monitoring what is going on around the world not only because of general interest but also because of their foreign exchange situation. That's what made me think that maybe corporations as whole, particularly multinational ones, are more involved than they used to be, say, 10 or 15 years ago.

MS. GREENE. I think they are; the trend is definitely [up].

MS. SEGER. Thank you very much.

CHAIRMAN GREENSPAN. Further questions for Gretchen? If not, can we hear from the domestic Desk, Peter?.

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

CHAIRMAN GREENSPAN. Questions for Peter on either the Desk operations or the leeway request?

MS. SEGER. You mentioned the reserves that institutions would need for clearing purposes and that, obviously, the required reserves also have served that purpose to this point.

MR. STERNLIGHT. Yes.

MS. SEGER. Who actually will be determining that number? Is that a bank matter? It's not a monetary policy matter.

MR. STERNLIGHT. Well, the banks will make their individual decisions on this; it's a question of what levels they will feel comfortable with. We've spoken to some of the money center banks who have been reviewing where they will be with the reduction in reserve requirements. Several of them are considering establishing these required clearing balances because they say, for example, that the balances they would have to keep at the Fed would be coming down to a range that just doesn't give them enough of a margin of comfort for daily operations.

MS. SEGER. Well, I understand that. But I just wondered if the people within the Federal Reserve who are so concerned about the daylight overdraft issue are also going to get involved in setting the numbers or if it would be driven strictly by managerial [decisions].

VICE CHAIRMAN CORRIGAN. Reserve Banks--

MR. STERNLIGHT. Well, the comments I've heard have had to do more with just the avoidance of overnight overdrafts. Some of the studies by the Board's staff suggest that not very much impact is expected on the daylight overdraft side of it.

MR. KOHN. We expect some increase, but relatively small. It is very hard to gauge, given that banks presumably would re-orient and

re-configure their transactions to avoid those overdrafts if possible. In terms of required clearing balances, my understanding is that that is driven primarily by the commercial banks in an effort to avoid overnight overdrafts.

MR. BOEHNE. Will we need to use foreign currency as backing during this period?

MR. STERNLIGHT. It looks as though we will need to in early January; I think Don would know.

MR. KOHN. Our projections agree with Peter's.

MR. BOEHNE. Will there be some announcement of this or will it just happen mechanically?

MR. KOHN. The Chairman signed a letter--I asssume it went out last Friday or Monday--to the Hill notifying them and an S-letter notifying the [Reserve Banks]. Hopefully, there will not necessarily be a public announcement; it's up to them. An S-letter should be already out or will be going out to the Reserve Banks with the appropriate documentation to the Federal Reserve agents. That was supposed to go out at the same time, so it might have left yesterday.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Peter, you mentioned market expectations of what might happen next in terms of rates or even a discount rate move.

MR. STERNLIGHT. Yes.

MR. SYRON. You noted what the situation was and the range of expectations developing in the market. To what extent is that difference due to this year-end situation? In other words, people are saying that it may be a while before something happens; how much are they influenced by the year-end situation? Is it markedly different than if we were at the same place in the cycle--if it's possible to determine that--and this were July rather than December?

MR. STERNLIGHT. I think the reserve requirement move was seen as being helpful in [terms of] the year-end situation. With respect to a further easing of reserve pressures or a reduction in the funds rate, I think some have felt that the steps taken recently helped in reducing some of those year-end pressures. But to say that that is a factor may just be imparting my own speculation about what their thinking process might be; maybe they're looking forward to another move near term. As I say, there was a high expectation, particularly after the last employment report, that there would be another easing by year-end; but it tended to get set back a little by the producer price report last Friday.

MR. SYRON. Thank you.

MR. PARRY. I'm just wondering if the funds rate is going to come down without a change in the discount rate. How do you think the participants in the market would view that? Would that confuse them or would that be a non-event?

MR. STERNLIGHT. There has been some discussion about whether there are technical impediments to the funds rate coming down to the level of the discount rate or perhaps even below the discount rate. I think it would be feasible for that to occur--that the market would accept it. They would probably continue to look for the discount rate [cut] in due course, but they might think there were reasons--perhaps concerns over the dollar or whatever--that the Fed was holding off for a time on the discount rate.

MR. PARRY. Would it affect your operations at all?

MR. STERNLIGHT. It would take some careful implementation whichever way one goes on this. So, yes, it would have some effect; but I think it can be done either way.

MR. PARRY. Easier or more difficult?

MR. STERNLIGHT. I don't really have a strong point of view.

MR. BLACK. It would be easier in that you would not have to worry about what the level of borrowed reserves was as much as you did.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I have a question that relates to Bob Parry's question involving the relationship between the discount rate and the fed funds rate and also the very low level of borrowing. It seems to me that a big part of the so-called reluctance of banks to borrow could be explained by that. If you can get fed funds for about the same rate as the discount rate why go through the hassle at the discount window? [Unintelligible] your favorite desk a call. We probably will see borrowing go to zip, if we let the fed funds rate and the discount rate coincide.

CHAIRMAN GREENSPAN. Except for those who pay big premiums [over] the funds rate.

MS. SEGER. Yes, but I may know an atypical group that has made money--

MR. SYRON. Would this have been seen as a possible temporary change or do you think the market would interpret this as either a change in operating procedures as far as what we said about the borrowings or a ratification of a change that may or may not have occurred in operating procedures? If we were to go effectively to no difference [between the funds rate and] the discount rate or a penalty discount rate without saying anything about--

MR. STERNLIGHT. I'm not sure how they would interpret it; I think they might regard it as a temporary circumstance.

MR. KOHN. As I indicated in the Bluebook, I think that would produce a little uncertainty. I agree completely with Peter that from a technical perspective he could execute policy either way, particularly now that we pay a lot more attention to the funds rate and a lot less attention to borrowing than we used to. But I do think putting the funds rate under the discount rate would raise a question

in some minds as to whether we had gone to a penalty discount rate. And it also would raise questions because the newspapers have reported that there are preferences within the Fed not to do that. So, I think if they see that, they then would be waiting for a discount rate change. It would raise a bit of uncertainty but it's certainly completely doable from a technical perspective. It would perhaps lead to a small increase in federal funds rate volatility, but very small.

MR. KEEHN. Peter, I think maybe you have answered the question, but let me just go back over it again. On this year-end issue, I keep hearing that because of capital level constraints this year the year-end pressures are going to be particularly tough. Are you saying that was the case but [unintelligible] a bit?

MR. STERNLIGHT. Certainly, the concern is still there. It seemed to reach its peak about the end of November and came off. In the last couple of days we've seen some move back up but not with that near panicky feeling that seemed to be there in November. An awful lot of preparation was undertaken for year-end and in some cases we're hearing that institutions have prepared themselves to be able, within limits, to take on some credits at year-end where they think they will find good business opportunities to do some of that. So, at this point anyway, I'm not looking at it as a terrible looming problem, but it's certainly something that we're going to keep a very close watch on right up to the year-end.

MR. GUFFEY. Peter, I don't think I understand the Japanese [unintelligible] in the market that has pushed the rates up. Are [U.S. money markets] providing liquidity to offshore Japanese banks or are they only providing liquidity to the Japanese banks here in the United States?

MR. STERNLIGHT. Well, I think it has been provided mainly to the U.S. operations and then they may have done operations to move some of the funds. I can't say what might have happened after that step. But as to why there was this greater sense of demand--maybe Ted or Gretchen would want to comment too--there was some greater reluctance among U.S. banks to extend lines to Japanese banks to the same extent as before, because even though U.S. banks were being downgraded and were regarded with less favor, so were Japanese banks. There was less willingness to extend some of those lines and less willingness particularly to serve as intermediaries between, let's say, smaller U.S. banks that would have funds to provide and the ultimate Japanese bank as buyer. Whereas before a major U.S. bank might have been willing to sit there in the middle and take its 1/16th or 1/8th, they might say that it's not worth 1/16th or 1/8th to have this exposure to an entity that's coming under some question.

MR. HOSKINS. Peter, I think you alluded somewhat--maybe I misread you--to the idea that in your day-to-day operations it's a little more difficult to signal where we are, given the reserve requirement change. I'm wondering if we should view this as an opportunity to get a little more variability into the funds rate and to get back toward more of a reserve borrowing approach. Of course, that would require the discount rate to be moved if we were to choose to operate in that way. Is this an opportunity?

MR. STERNLIGHT. I don't really see it that way because I think what we have now just is a very low level of borrowing. And we don't really have a good substitute to put in the place of the focus on the funds rate. If anything, as we go through this transition period in the reserve requirements, I think we're going to have to lean even more on the funds rate. I really just don't see a good alternative to that.

MR. HOSKINS. Maybe we ought to signal explicitly then and tell the market what the funds rate [objective] is.

MR. STERNLIGHT. Well, it's coming darn close to that.

CHAIRMAN GREENSPAN. Further questions for Peter? If not, we need two motions. I'll first entertain the motion for ratifying the Desk operations since the last meeting.

MS. SEGER. So move.

CHAIRMAN GREENSPAN. Is there a second?

VICE CHAIRMAN CORRIGAN. Second.

CHAIRMAN GREENSPAN. Without objection. Secondly, would somebody like to move Peter's request for a leeway increase?

MS. SEGER. I'll move that also.

VICE CHAIRMAN CORRIGAN. Second.

CHAIRMAN GREENSPAN. Without objection. We'll now move on to the other regular staff reports. Messrs. Prell and Truman have the floor.

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

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

CHAIRMAN GREENSPAN. Comments?

MR. PARRY. Ted, I'd like to follow up a bit on your comments about net exports. The decline in GNP for the fourth quarter that the staff has in the Greenbook is about $32 - $33 billion and the improvement in net exports is about $30 billion. That improvement has to look highly unlikely, given the October number. You usually don't have reversals, though this could be something of an aberration.

MR. TRUMAN. Well, it could be. You may have noticed that last year we had a similar aberration in October, so I think there are some misplaced seasonal factors at work in these data. Obviously, if we had to go back and do the forecast given the data we have as of this morning, we might have a somewhat smaller swing. However, much of this swing is coming from the oil phenomenon and we have pretty good data going through the early part of December on that. I might note that the oil number that's on the table there is higher than we had projected both in quantity and value, but that is largely because we found some oil in the New York harbor that hadn't been included in previous months. If you strip that out, you have a sharp drop-off in

the quantity of oil, which will be stripped out in the GNP account, and a sharp drop-off in the volume of oil imports, which get valued at 1982 prices. So, that's going to have a big statistical impact in the current quarter.

VICE CHAIRMAN CORRIGAN. Let me add: the oil was in ships!

MR. PARRY. If the improvement were on the order of maybe half of what was forecast here, we could be talking about a decline of 1 or 2 percent more at an annual rate than the forecast.

MR. TRUMAN. Sure.

MR. PRELL. We have not had time to sort through these data in detail and to try to match them up against the various expenditure categories, but I think one needs to emphasize that GNP measures domestic production.

MR. PARRY. Right.

MR. PRELL. Indeed, as of last Wednesday when we went to press with the Greenbook, we didn't even have retail sales data, etc. We were depending to a considerable extent on the labor market data to get some sense of what the input was to domestic production and then we were trying to make some reasonable guesses, in effect, about productivity and so forth. But I think one should not leap to the conclusion that dollar-for-dollar any surprise in net exports would track through to GNP. We may find stronger expenditures on capital goods, for example, to match some imports or some other adjustment. There may be more luxury cars being imported, which will be part of our bulge in consumption in the fourth quarter. If that were the case, rather than coming out of inventories, that might have implications for the first quarter. So, I think it's a very complex process that one needs to go through with these data.

CHAIRMAN GREENSPAN. Well, can we assume that since the PCE for October is higher than originally estimated and imports are higher that we may be seeing nothing more than a higher level of imports of consumer goods?

MR. TRUMAN. Every category was actually up; there is no one particular thing to point to. Automobiles were up substantially and that may be the luxury car phenomenon. Other consumer goods also were up substantially, but capital goods were up too.

MR. PARRY. But you said PCE in October, right?

CHAIRMAN GREENSPAN. Yes. I'm sorry; I meant November.

MR. PRELL. [Unintelligible.]

CHAIRMAN GREENSPAN. Any further questions for the gentlemen? If not, I think we'll start around the table.

MR. BLACK. Mr. Chairman, these are obviously uncertain and difficult times not only for consumers and producers but also for forecasters. This looks a little different from anything we've ever had before. I think the staff's forecast is highly plausible, given

the assumptions on which it rests. But our hunch is that the projection for real GNP for the current quarter and the first half of 1991 will turn out to be on the high side even if the oil prices do come down from the relatively optimistic path that the staff has assumed. I have several reasons for saying this. One is the big revision the staff has made in net exports of goods and services by showing a pretty steep, near-term drop in imports which, of course, has the effect of raising both real GNP and net imports of goods and services compared to the November Greenbook forecast. We think the direction of this revision was clearly appropriate, given the weakness in domestic demand that's been evident in the recent data and also the census data mentioned in the Greenbook and again the figures that we've gotten on the merchandise trade balance for October--though a lot of that may wash out as Ted suggested. Despite all those things, the magnitude of the revision looks a little big to us. And the second reason is this persistent weakness in M2, which I don't think anybody really can explain satisfactorily. That continues to worry us a great deal. And finally, we've been impressed by the continued strong negative tone of most of the anecdotal information that we've been getting from all sorts of sources. One piece of information that struck me as particularly impressive came from the

who is in the plastics business and makes parts for manufacturers all over the country and sells them on a nationwide business. He called up specifically to tell us that the bottom had fallen completely out of his order book, which is something that he had not seen before.

CHAIRMAN GREENSPAN. That was as of when?

MR. BLACK. This had happened last month. Now, we feel somewhat more comfortable with the staff's inflation forecast than with the projections on output and employment. The staff has revised downward a little its projections for inflation for 1991 and 1992 from the last Greenbook, and that strikes us as appropriate. But as I said earlier, I really think the monetary restraint that we have put in place over the last several years as a whole may well produce greater long-term benefits on the inflation side than the staff has been projecting even if this recession turns out--as I hope it will--to be as mild as they are projecting.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Well, Mr. Chairman, about the best that we can say about the Dallas District is that it's pretty flat. This is what our statistical evidence is saying and it has been confirmed by our board of directors at our meeting last Thursday and by other anecdotal information that we've been getting lately. It is increasingly difficult to find a segment of our District economy that is doing well. Most of our contacts are mentioning either mild declines or slight gains. Manufacturing activity has been weak, particularly in electronics and defense-related industries. Construction activity has picked up slightly, but most of that pickup represents a completion of major petro-chemical projects begun about two years ago. Our retailers are telling us that the Christmas season has been slow, with merchandise not moving except at post-Christmas-type discounts. Overall, the outlook for the District economy is for little or no growth over the next few months.

With respect to the national picture, I certainly would not take issue with Mike's forecast, particularly since he added somewhere along the line that the risks are certainly on the down side.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, the economy in the Twelfth District continues to be slow overall, with mixed pockets of activity across the region. The California economy, which accounts for about two-thirds of the District's employment, has slowed along with the nation. If we look at employment, what has happened since August is that employment is actually down slightly and our year-over-year employment growth remains about 1/2 point above the national average. Not surprisingly, the slowdown has been most pronounced in trade, construction, and manufacturing, with year-over-year declines in construction and manufacturing that are not that different from the rest of the nation. In the near term we expect that the state will continue to move along with the national pattern. If you look at the remainder of the District, however, there are some rather interesting developments. There are some effects of the national slowdown, but the District's manufacturing employment outside of California is actually at the same level as a year earlier and construction and trade employment are up 4.3 and 3.6 percent, respectively. Residential real estate sales volumes are certainly down in California, Hawaii, and Washington but up in a fairly sizable way--believe it or not--in Arizona, Utah, Idaho, and Nevada. Home prices continue to rise except in Seattle and the coastal California areas, which, of course, do represent a very substantial part of the District. The agricultural outlook, which is very important to us because in some measures it is the single largest industry in the District, is quite bright. The USDA points to particularly strong production and export performance for the region's fruits, vegetables, and other specialty crops.

If I may turn very briefly to the national outlook: In the current quarter we see real GNP declining at a rate of about 4 to 5 percent, which is a bit stronger falloff than projected in the Greenbook. I must admit that I can't point to any particular quantifiable factor that would be causing that degree of weakness. It's obvious, for example, that the oil shock is not enough to produce that kind of a falloff. Our best guess is that we'll see a small rate of decline in the first quarter, similar to that in the Greenbook, followed by a pickup in the second half of the year much along the same lines as in the Greenbook, including improved exports. It does appear to us that the underlying inflation rate may have peaked and that with the unemployment rate on the rise we're likely to see some moderate progress in that area over the next year or so. Our projections for inflation, however, are somewhat higher than those in the Greenbook. Thank you.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Thank you, Mr. Chairman. I had thought until relatively recently that we were beginning to see some signs of a sort of second derivative in New England--a turnaround to some potential flattening. But I must say, given the beginning of a slowdown in the national economy, that that's probably not in the cards at this point. We have seen some real evidence in the region of markets working in an

entirely favorable sense in terms of better price performance and better asset levels [unintelligible] in wage levels. As far as the District itself goes--and I don't know what the implications of this are for the nation--retailing looks very, very soft. People are out; there is activity in the stores, but people are not buying. Promotions haven't been that effective, and retailers say they don't expect that people are going to be buying after the first of the year. This isn't a case of delaying purchases; it's a case of people just saying "I'm not going to buy very much more." I talked to some people yesterday at major department stores who indicated that it has been a very poor Christmas season thus far for their outlets, both locally and nationally. And consistent with that is what we see in credit card activity. We talked with some people at credit card unit and they said year-over-year the level of charges in New England is down 3 percent, compared to up slightly nationally. I don't know what the national implications of this are, but certainly in New England an important factor has been the loss of paper wealth in [declining values of] housing. We're beginning to do some work on this and very very crude estimates would indicate paper wealth reductions of $600 to $800 billion in the region's real estate. That is very significant on a personal income of about $290 billion in terms of any sort of consumer consumption factor. I think housing construction in the area still has to go down a ways. As I said, we have seen some real improvement in prices, with some spec housing having declined 40 to 50 percent in price and land prices also having declined in some areas.

MS. SEGER. That's an improvement: down 40 to 50 percent?

MR. SYRON. Well, it's an improvement because the price level was just so high that it wasn't consistent with any long-term viable economic gain.

VICE CHAIRMAN CORRIGAN. Because it stops being solvent on some of the prices? Is that what you're saying?

MR. SYRON. It just stops being solvent at those prices. I think that's an important point; I'm glad you mentioned that. Actually, until recently the transaction level had improved a bit, but land prices had very significant changes, again involving speculation in developed lots, finished lots. In some cases we know of, transaction prices were down 1/2 and in a few cases 3/4 from the original asking price. We're also seeing this in labor markets, where there has been a very dramatic improvement [in the availability of] marginal labor, if you will--for warehouse labor, McDonald's labor, and that kind of thing. The banking situation has been pretty bleak and obviously is going to continue to be so for a while; some bad news seems likely after the first of the year. As far as the credit crunch goes, I think we <u>have</u> seen indications that some of the larger banks are attempting to improve their earnings as they go out to increase their willingness to lend. At this stage, that really hasn't been translated very much into increased activity, given the concerns that are going on. Manufacturing is generally weak, with some exceptions. Some exports are doing fairly well as are some short-term defense-related items, particularly missiles ordnance that has to be replaced. Capital spending looks quite weak to us. In talking to some people--and one has to remember that 1981-1982 was a fairly benign period relatively in New England--we hear them comparing the current period

to 1974-1975, and they are saying that they are just going to wait a while before they do any spending and that survival is the most important thing. I think a good side of all of this is that it has brought an increased awareness of the excesses of the past. We hear from more and more people: "Let's just get this over with as quickly as possible and go on to something in the future."

I agree with Bob Parry in terms of the forecast; what we look at internally suggests that the fourth quarter could be a little weaker than the Greenbook [forecast]. As far as the national economy goes, I think we may well face somewhat of a bimodal potential outcome. I personally find the Greenbook a feasible forecast, albeit with somewhat of a change in conditions--some modest further easing. However, I am concerned about some of the imponderables [such as] consumer confidence. Historically, if you look at the data, these periods of oil price run ups and then improvement have been associated with a real bounceback in consumer confidence. This may be different because of the issue of diminishing war fears. I don't know that I think this will wash out, but the perceived decline in wealth nationwide that Gary mentioned, given what is going to happen to housing prices, may have an effect. On the exports side, there's some concern about whether foreign economies, particularly that of Japan, will be as strong as we might hope. And given what's happened to prices, I think housing nationally will be depressed for a while. So, even without a real problem in the financial sector, there are a number of factors that could tip us over to the other side--into the second of the two modes. I think all this argues for taking out some modest insurance on where we're going; I don't think in any sense that it means one should panic. I think we have made, or are in the process of making, substantial improvement on prices. And the issue is to keep that improvement but at the same time be vigilant so that this doesn't really tip over into something that none of us wants. Thank you.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, conditions in the Sixth District continue to weaken with the exception of the energy and chemical areas, which seem to be doing fairly well. Most of the industries in the District are experiencing deteriorating conditions. We did a recent survey of retailers about their Christmas season sales, and they say that spending is not only weak but has fallen below what had been very modest expectations to begin with. And as other people have mentioned, the retailers are not really looking for any comeback after the first of the year. The good news, to the extent that it is good, is that inventories at least are under tight control at this point, which is consistent with the discussion in the Greenbook. We don't have the base of export activity in the District that other parts of the country have and, therefore, manufacturing activity is not good and we won't get the effect of greater export activity. As a result of that, we've seen in recent weeks a stream of announcements of layoffs and plant closings. That includes the banking industry and that, incidentally, is getting front page headlines--not only the condition of the financial institutions but the layoffs associated with it. The business and financial contacts that I talked to in recent weeks are universally gloomy, and that includes our directors. Most of them, I would say, think that this contraction is going to be a deep and lengthy one--deeper and longer

than the standard forecasts. Worries about the banking system, as I said, get daily attention, and recent publicity about the FDIC is certainly aggravating peoples' concerns and not contributing to confidence in any great way. On the credit crunch, the most recent thing I heard was at a meeting I had with about 14 or 15 business people. The only thing they wanted to talk about was the lack of financing. They simply can't get financing even though they have had a long association with their bank, and that is a source of great concern to them.

While the situation in the Sixth District does not look at all good, our forecast for the nation is very similar to the Greenbook both with respect to GNP and inflation; and our assumption about the behavior of oil prices is very similar as well. Notwithstanding that, I do think that the risks are on the down side of the forecast and I'm very concerned about the stress in the financial system that could very well restrain a rebound in activity. I'm also concerned about the weakness in the monetary aggregates.

Now, there are two other things that I would mention, which affect my outlook for policy. Because of the credit crunch and because of the situation at financial institutions we may not be getting the same effect from monetary policy that we ordinarily would; it may be damped. And that may call for a little more aggressive policy response at this particular time. I think it would be a very big mistake for us to deal with the financial problems of the banking industry by exercising greater forbearance; the way to deal with this situation as well as the economy generally is to have a more aggressive monetary policy. I guess I'll have a chance to say a little more about that later.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. There's not a lot of additional news to be said about the District economy; there hasn't been a lot of change. I will comment on a couple of things that have come up recently. In talking to some of the large firms in the Twin Cities, a good number of them had a very good 1990, particularly those that have some substantial foreign exposure or are major exporters. Despite that, they almost universally have a good deal of concern about 1991, particularly domestically, of course. One of the reactions that seems to be occurring is that they are stretching out their salary programs. That is, they're going to go ahead in January with the normal kind of salary programs that they've had in previous years but are telling employees that those increases will last for 15 to 18 months. That's something that I, at least, hadn't come across until recently, and I think it is clearly because of their concerns about the economy and business conditions in 1991. With regard to holiday sales in the District, I'm not hearing much in the way of euphoria nor terrible gloom. So, I assume that things are rather mediocre and that's about all that can be said about it.

With regard to the national economic outlook, I generally agree with the shape of the economic performance as expressed in the Greenbook, although I will admit that I'm less confident that the upturn is going to occur quite as quickly as envisioned in that document. There are a number of intangibles to worry about at this juncture, it seems to me. And I think, as Dick Syron suggested, the

major wild card is real estate values. I just feel instinctively that if those values continue to come down substantially and if that becomes more pervasive around the country than it has heretofore, that has to have a bigger effect on the economy.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Thank you, Mr. Chairman. While in a comparative sense economic activity in the District has been stronger than the national economy, as I have commented at past meetings, I think there has been a clear downward shift both in sentiment as well as in the underlying level of activity itself. Probably the greatest impact--and Mike can certainly comment on this--has been in the auto sector. We've finally reached the point where these fleet sales have moved through the system. And that had kept both production and sales at a higher level than we would have expected over the last several months. Given that, I think sales levels probably will be down and will be more reflective of underlying consumer demand. As a result, sales forecasts have been reduced. One manufacturer that I talked to has reduced its sales expectations for next year by about 1 million units --down to 13-1/2 million units. And even that is dependent on a pretty good improvement in the second half of the year. At this point the auto inventories are at pretty reasonable levels with days supply around the mid-80s, and that's certainly better than was the case last year. Nonetheless, production schedules for the first quarter of next year are down substantially. And the manufacturers say the risk is clearly on the down side--that they probably will be reduced even further as we get into the quarter. All of this is backing up into the suppliers to the auto industry; they've seen very significant cutbacks in their orders. So, the backup is beginning to be pretty pervasive both in Michigan and Indiana, which are heavy suppliers to the industry.

Another swing factor has been the level of construction activity. We also have finally been hit by this. Commercial contract awards have all but stopped. At this point we have quite a number of projects that are still [some distance from their] completion dates. So, we're going to have a lot of floor space coming on and, therefore, vacancy rates which already are beginning to climb certainly are going to be climbing even further. We're going to have some cash flow problems developing in some of the developer areas. For home starts, our numbers are perhaps not off as much as the national numbers, but currently we're seeing a downturn there as well. The volume of home sales this year is significantly lower than last year.

In the good news category, in the agricultural sector the production levels clearly were high, although the prices weren't quite as good as farmers would have liked. Farm incomes at the end of the year are really in very good shape and I think the farm sector is in pretty good balance. Many of the uncertainties that were bothering them before are behind us. Farm equipment sales next year are expected to be about level with this year. There are going to be some layoffs in that sector to bring inventories into line, but the farm outlook seems to be pretty good.

It is hard to get a fix on retail sales, particularly this early in the season. My hunch is that the Christmas season will come in better than a lot [unintelligible] would suggest. Clearly, the

pricing is bad. When I say that sales will be okay, I really mean that in a volume sense. I think pricing is going to be very tough and, therefore, the profit levels will be down. On the inflation front, excluding energy, I think the news is just okay. Competitive pressures out there are terribly heavy and, therefore, the pricing continues to be tough. The steel industry is a good example. They're going to ship 84 or 85 million tons this year, which comparably is a pretty good year, but the pricing is really rough. As a consequence, companies are shipping a lot of metal but are not making as much money doing that. And certainly on the labor front there are no current excessive upward pressures.

In a national context, our forecast is very consistent with the staff forecast, at least in broad contour, We have some interim quarterly differences, but I don't think that's particularly significant. In my mind, the major uncertainty here is the financial system. I can't remember a time when there has been a bigger buildup of pressures throughout the financial system. It's awfully difficult to measure the impact if something were to get loose on us here in a kind of [destabilizing] way. And when we get into the policy discussion, that would be a very important determinant, at least to my mind, of how we should conduct policy.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I would say that the sentiment is increasingly pessimistic or if it's not pessimistic, the level of concern is rising. Retailers are still hoping for a season-saving finish. They have a long weekend just before Christmas and there's still some hope; but there has been so much price discounting that even if sales do pick up, their profit margins are going to be poor. Manufacturing has been weakening longer in our District than it has in the nation, so it's at a very low level. But a number of manufacturers are building into their 1991 plans some pickup for the second half of next year. There is extreme pessimism in construction for obvious reasons. Bankers are worried to scared, depending on how close they are to retirement.

MR. HOSKINS. Some may retire sooner than they expected!

MR. BOEHNE. The District's unemployment rate, which had been below the nation's, has caught up with the nation's and I suspect will rise above it. And for the first time in a long time we now have areas in the District with unemployment rates of 7, 8, and even 9 percent. The state and local fiscal situation is very serious, particularly in Philadelphia, but it is not limited to Philadelphia. Now that the state elections are over, I think the state of Pennsylvania will have to face up to a large deficit. New Jersey, which has had huge tax increases, still has a deficit. And a number of municipalities that probably won't make The Wall Street Journal nonetheless are having very serious problems.

On the national economy: While the Greenbook forecast of a relatively mild, short-lived recession is plausible, my guess is that it's wrong and that we will have a longer lasting and a more serious recession. Even if one is optimistic about how the Middle East situation will come out and about oil prices, I doubt very much whether consumer spending will bounce back with the same amount of

vigor by spring as envisioned in the Greenbook. Consumers just feel chastened after a number of years of some fairly loose spending habits. And I think they're going to remain cautious. Even if the optimistic assumptions on oil and the Middle East are realized, we still are going to have high and probably rising unemployment. The consumer still has these high debt burdens, and delinquencies are rising. Also, the worries about bank safety, which are all over the talk shows and in the newspapers, just weigh on people and I think they are going to weigh on people even more. So, my guess is that we're going to see a fairly bearish consumer for longer than envisioned in the Greenbook.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Starting off with the District, in terms of the statistics we are still slowing. But even though manufacturing employment is going down, we're still getting modest employment growth overall. I'd say the employment picture generally in the District is somewhat stronger than in the nation. In terms of nonresidential construction, over the last year we're down about as much as the rest of the country. Housing has not been hit nearly as hard, but it is down. As far as anecdotal information goes, and I mentioned this on our recent telephone conference call, the sense I'm getting from directors and others--and it was reinforced in some further discussions last week--is that things have not gotten materially worse in the last 30 days. As far as holiday sales go, I think retailers in the District are expecting modest, or maybe somewhat larger, real declines in retail sales. But that generally was anticipated and I think inventory levels in general are in pretty good shape. One very bright spot is bank performance in the District. We have third-quarter numbers in now: Returns on assets are still about 1 percent; returns on equity are greater than 12 percent; and nonperforming loans are unchanged from the prior quarter and the prior year.

CHAIRMAN GREENSPAN. Can't you create some contamination? [Laughter.]

MR. MELZER. Probably the fourth quarter won't look as good; I'd expect some deterioration. But again, it's a much better picture than I think we see elsewhere. In terms of expansion of credit, that generally has been sluggish over the last year in the District.

On the national front, the one comment I would make is that we've had some concerns over the last couple of months--really since September, October, and November--about the slowdown in the monetary aggregates. I guess the way that one would conceptualize what is going on is that as demand for reserves has fallen our operating procedures of pegging the funds rate has really caused us to drag out reserves to maintain whatever the targeted funds rate was. I think there was evidence in, say, the early part of this 2-1/2 month period that we weren't really keeping pace with declines in other short-term market rates. I don't know to what extent we can rely on these spreads, but it's something that I think is worth looking at. The main point I wanted to make in this connection is that with the steps that were taken in November, we really have not only caught up with the declines in market rates but actually have moved the funds rate ahead of them. Just to cite a couple of examples: From the end of September to the end of October, the funds rate had only come down 9

basis points, whereas short rates had come down on the order of 20 to 30 basis points depending on what instrument we looked at; but for the period as whole, from the end of September through the middle of December roughly, the funds rate was down 100 basis points and these very short-term rates were down roughly 30 to 60 basis points. So, if one worried about our being out of position and not providing adequate reserve growth, to the extent that these interest rate spreads are some indicator we certainly have caught up with the market movement and gone beyond that. Perhaps that gives a somewhat more optimistic perspective in terms of what reserves and money might do down the road.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. In the Tenth District, in contrast to several other Districts, we still have growth--though to be sure it's rather modest. But we always had modest growth, I think, relative to the nation; this time we happen to be positive while the nation might be negative. A lot of this largely comes from a very good harvest. For virtually all of the crops grown within the Tenth District, the harvest is completed. The exception is the cotton crop down in southern Oklahoma, which is an outstanding crop apparently, and the prices are very high for cotton because of some reduced crops in other parts of the country. All in all, the agricultural sector is very healthy. Cattle and hog prices remain very strong. Wheat, corn, and other small grain prices have diminished because of the large world output in agricultural products. However, there is some hope--not euphoria--that with the export credits that have just recently been granted to the USSR that exports of agricultural products will pick up and will impact our part of the world.

On the energy side, there has been some modest pickup in exploration drilling. I'm not sure that that will last very long. For example, the rig count in the Tenth District went up modestly from 325 rigs to 336 rigs in the month just passed. But the employment pickup in the energy sector probably is related more to the reworking of old wells than it is to new drilling or exploration. That is, you can take a well that may be producing 6 to 10 or 12 barrels a day, rework it for $10,000, and increase that production to 18 or 20 barrels a day; it makes sense given the oil prices currently.

Retail sales within the District, as best as we have been able to determine, are essentially flat. I'm talking about the Christmas season, ex autos. Autos are very soft as they are around the country. I might just indicate, however, that the best anecdotal evidence about the agricultural sector [arose at] our branch board meetings: There was one report that new pickup trucks were actually being sold for cash, which is something that hasn't happened in 6 to 8 years in the Tenth District. As for retail sales being flat, the report that I received most recently about the Christmas season not being very strong [is partly related to] the very warm weather we have had. Retailers expect or at least hope that in the last seven days--and there is a cold front coming through the Midwest--those sales will pick up and that the Christmas or holiday season will indeed turn out better than most people expected, at least in our part of the country.

With regard to manufacturing, automobile assembly plants have been closed down periodically because of cutbacks by the manufacturers, and the extended holiday will continue well into the first of the year for all of the auto plants within our District. Construction is essentially flat, both commercial as well as residential. There is some hope, particularly in the state of Kansas; there is a very big highway project there as a result of this public works project. The value of the nonbuilding contracts in that state is well ahead of last year.

All in all, the Tenth District is doing fairly well. All the major cities that are metropolitan areas have unemployment rates well below the national rate. And there's fairly good optimism--at least based on comments of our board members, not only at the head office but at each of the branch boards.

With regard to the national outlook, we differ a bit in our view of that but the depth of the recession is not greatly different from peak to trough than what is projected in the Greenbook. We have had some concern, and our numbers would reflect it, that the recession will be a little longer by one quarter. In other words, rather than turning up in the second quarter of next year we would not expect to see that uptick until the third quarter; and then the latter two quarters of the year would be fairly close in the aggregate to what the Greenbook projects. With regard to prices, in the Tenth District we don't see any price pressures and we don't quarrel with the projections in the Greenbook.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. Mr. Chairman, as far as the national economy is concerned, I think Dick Syron made my point earlier. If I had to put a forecast on a piece of paper, I'd probably put down one that looks a lot like the one that Mike has put in the Greenbook. Having said that, and for all the reasons that have been cited earlier, I think the risks in the second quarter of 1991 and beyond are probably on the south side of that forecast. Indeed, in looking at Mike's forecast, if we had an economy behaving in growth terms like his forecast for the next seven quarters--while it may be cyclically less than we've seen in the past--I'd consider that terrific. Basically, he has 2-1/2 percent growth throughout the balance of 1991 and 1992.

Let me say a brief word on the local economy, in the New York metropolitan area particularly. Keeping in mind that in manufacturing terms that is nowhere near as important as it once was, the fact of the matter is that it still has something like 10 or 12 percent of the nation's population and in some industries such as real estate it's disproportionately more important than even population would indicate. For the metropolitan area as a whole, it is clear that the white collar recession is still deepening. Some of this is the prominent headlines that you see on cutbacks in financial firms. But it's not just that. Indeed, that white collar profile of the recessionary forces in the metropolitan area really is quite extraordinary in any kind of a historical perspective. We think the real estate situation still has a ways to go south. Again, the market measured in square footage terms is very, very large. You lose sight of the fact that lower Manhattan by itself has almost as much office space as the city

of Chicago. And when you look at the situation in the metropolitan area broadly defined, New York City itself probably is marginally okay in that vacancy rates are now in the area of 20 percent, which is high but not fatal. And there is not a whole lot of fresh new supply in the construction pipeline; there is some, but not tremendously large amounts. Rents, on the other hand, really have plummeted. If you look at prime midtown office space--I'm talking about large chunks of space, say, 200,000 to 400,000 square feet, not little pockets of space--space that perhaps as recently as a year ago but certainly 18 months ago could have commanded $50 to $55 a foot, today they are lucky to get $30. It really is an extremely large change in a very, very short period of time. As I said, the only saving grace is that there aren't that many truly large blocks of space even in the midtown market with the exception of three or four buildings that are being finished on 6th Avenue. The suburban real estate markets are worse than the New York City markets and that is true pretty much across the board, whether you're talking about Long Island, Jersey, Westchester, or parts of Connecticut. We don't have very good statistics in terms of how much space is sitting there. Most of these surveys, Coldwell Banker and the like, are pretty good for cities but not so good for suburban areas. Based on what developers are telling us and what our examiners see, we think the downside potential in the suburban community is still quite considerable.

Ed Boehne touched on this in the context of Philadelphia and Pennsylvania, but we have basically the same kinds of pressures on the state and local fiscal side with all the implications either for higher taxes and/or lower spending at the state and local level. The New York City situation isn't great at the moment; it doesn't look anything like the way it looked in the mid-1970s, but it's not good. And whether we're talking about Connecticut or parts of Long Island, there are large prospective deficits in state and local government budgets pretty much across the board. Leaving the metropolitan situation alone for a moment, the general psychology of the situation, as reflected in attitudes of CEOs of major multi-national companies, is that it's pretty lousy. Interestingly, in the face of Ted's comments earlier, I don't get the sense that the companies that are major exporters are quite as confident about the potential for volume growth in exports in 1991 as they were even three months ago. Now, they haven't said so, but it's not considered a [near certainty] as I think it was as recently as three months ago that they would continue to see volume growth in the area of 10 percent or 12 percent.

As far as the Christmas retail season goes, the sense I get from both the national retailers that are headquartered in New York and even from some of the small businessmen we talk to is that "It ain't good." It's very soft. The only exception is in the very high price end of the retail market in New York City, and that's coming from foreign buyers. I don't know how this gets into trade statistics and things like that--not that it's all that important in absolute dollars--but the very high end of the retail market in New York City is quite strong mainly because foreign buyers benefiting from the exchange rate look upon New York as a shopping haven at the moment.

On the credit crunch, there too I think we still have a ways to go. We will talk about this later, but one particular manifestation of that--the way it seems to be at least at the moment spilling through into the money supply--is becoming a greater concern

to me. The silver lining behind the cloud of the credit crunch is that there is now what I would describe as pervasive evidence of significant rebuilding of pricing and margins taking place pretty much across the board. Now, some of that has been facilitated by the withdrawal of the Japanese banks from not only the direct lending markets but the commitments and standby-type markets as well. But the evidence I think is now pervasive that we are seeing a significant rebuilding of pricing and margins; whether it can be sustained is another question. But I mention that because it is quite clear to me that there is some combination of margins and spreads and levels of interest rates that will snap the credit crunch and snap it in a constructive way. I'm not sure we're there yet, but we may be getting closer than we suspect, especially if this rebuilding of spreads and margins proves to be somewhat durable.

There are a lot of uncertainties. But the combination, as Gary and Dick and several others said earlier, of the real estate sector and the vulnerabilities as they impact on the financial sector are probably the biggest single source of uncertainty as I see it right now. I've said this before but let me emphasize it again: There is a natural tendency to focus commentary on financial concerns on the banking system; but as I see it those problems are every bit as acute in both cyclical and structural terms for the nonbank sectors of the financial system as they are for the banking system. Indeed, just yesterday we were looking at a broad cross section of data on the insurance industry, top to bottom. And I will tell you, that is pretty grim stuff, to put it mildly.

Just anecdotally on the real estate situation, I spent a morning last week with Bob Boykin and his Dallas directors and up until then I had been tending to convince myself that Texas had turned a corner. Maybe Houston has, but one of in the construction business was telling me that he thought there were 10 to 20 million square feet of newly constructed office space in the Dallas area that would be better off bulldozed. If you say $100 a square foot and take the midpoint of that estimate of 10 to 20 million, that's $1-1/2 billion worth of new construction with no place to go. So, again, of all the wild cards out there I think that real estate--as it reflects directly on the economy, along the lines of Gary's comments, but also as it reflects on these problems on the financial side--is the biggest single wild card.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. The District continues to perform better than the nation. Just as an example: For the year October-to-October, output in the state of Ohio was up 5 percent and in the nation it was up about 2 percent. The weakest link, as you might expect, is in autos right now. There is one exception: We have an announcement of a new auto plant in the Lexington area that is going to employ a number of people. The Lexington area is an abnormal situation; the unemployment rate there is 3.2 percent. But the unemployment rates around the District over the last three months average 5.5 percent in Ohio and 4.2 percent but rising in the Pittsburgh area. Economic activity is definitely weaker than it was last month but that weakness is not translated, at least by most participants that we surveyed, into a recession in the District. They're apprehensive that one will develop there; they believe one is under way in the nation. But when

we talk about a softening market, we talk about reducing overtime. And other than in autos and construction, we haven't had major layoffs in the District. So, it's still performing quite well. In fact, the capital goods side is still doing better than manufacturing overall, but not quite as well as it was before. It's a little more mixed now, but there are still some positive signs. Heavy trucks had their third best month of the year, in terms of new orders, in October. So there is still a little strength around the District in capital goods. Retail sales are flat, as everybody has indicated already.

In terms of the national outlook, I think we'd be pretty happy to see Mike's forecast come true. It has a declining inflation rate. We'd like to see a little more of that. I would simply like to focus on the fact that that's a relatively short recession he has forecast and that whatever is causing it--whether you believe it's oil or the credit crunch--neither is laid [at the foot of] monetary policy. And the kind of decision we're going to make later today really is going to have its impact at the time Mike has a snapback in the forecast in terms of real growth. So, that is something that we ought to think carefully about in terms of making our policy decision. In the longer term I guess Mike has 2.4 percent growth, which is close to our potential growth; but I would expect us to see in his footnotes a note that our potential may be somewhat less now. We have a lot of asset prices that are coming down. It seems to me that those represent some excesses that occurred in the past and that resources have to flow out of those areas. I don't think there's any way around that. We have some defense restructuring to do and obviously some restructuring in financial services. It seems to me that those things, along with the factors that Mike pointed out, argue that our potential growth probably will slow in the future. So, I don't have the sense that anything is falling apart on us at the moment. Several of you suggested a number of risks that are out there, and I think those are always there. What that points out to us is the size of the errors around the forecast--that we are very uncertain about those. And when we're uncertain about them I think we ought to proceed cautiously. If there is a reason to ease, it seems to me it has to do with the monetary aggregates. About the best we can do in terms of managing the economy is to keep inflation low and let the economy take care of itself. That means we've got to watch the aggregates.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. I think looking at the M2 growth is always a good place to start. It seems to me that there is clearly a very significant downtrend over a four-year period in the growth rate of the monetary aggregates. But so far there has not been what you would call a classical monetary shock; that is, the rate of growth actually has been brought down in a very gradual pattern. It is true that the rate of growth over 26 weeks is now getting close to a level at which I think anyone would be concerned if that were to continue to weaken on a 26-week basis. But I would just note that in 1987 and 1989 we had almost identical periods of weakness on a 26-week basis. Clearly, we ought not ignore what those monetary aggregates are saying. But I would note, as Tom Melzer did to a degree, that the yield curve doesn't really suggest that we have a monetary tightness phenomenon that's being driven by the central bank; that is, the slow [money] growth is not driving short-term rates above money market rates. We have just the opposite. The yield curve basically shows that there is

quite a bit of monetary liquidity out there. The foreign exchange market also I think shows considerable monetary easing; that is, the transmission mechanism of monetary policy for the United States is increasingly through the foreign exchange mechanism. Certainly we've had a considerable, 15 percent decline, of the dollar against the G-10 currencies. That is a factor for domestic stimulus. Commodity prices it seems to me are showing more money neutrality than they are monetary restraint. That is, you have some fall-back in commodity prices, but you don't have the rate of deflation in commodity prices that set in during the 1985-1986 era and that really became pervasive.

Of the factors that we have going for us, the two factors I'd like to mention that are difficult to judge are the phenomena of house prices and other real estate. Unfortunately, there's no futures market for housing. But I think we ought to begin thinking about housing and other real estate more as if they were a commodity, because clearly what has been happening here is really [similar] to what happened in the agricultural depression of the mid-1980s, which was a rather short, sharp depression in agriculture. What we see happening is that the forward price is not rising as fast as it was expected to have been rising before. Now, if someone has a 10-year horizon and expects house prices to rise at a 10 percent annual rate, that would mean a $100,000 house would be worth $269,000 in 10 years. But if all of a sudden you think it will rise not at 10 percent but at a 5 percent rate, then instead of $269,000 you're looking at $163,000 for the 10-year forward price. That means that the forward price has to come down about 37 to 40 percent. If the forward price comes down faster than long-term interest rates, then of course the present value is also going to fall. But that doesn't mean that housing inflation is gone; it just means an adjustment from a 10 percent housing inflation environment to a 5 percent housing inflation environment. What makes this so tricky is that houses have so much to do with household perceptions of wealth. Consequently, household saving behavior is certainly impacted. I think all of us understand that we're seeing a long-cycle event in regard to attitudes here.

The other area of uncertainty, it seems to me, relates to the fact that the U.S. economy is increasingly competitive in a global marketplace. The international competition just means that there will not be sustained profit margins in any industry such as there were in former times when there was less vigorous international competition. Now, the problem that concerns me here is the advent of failure and whether or not we might be falling into a turnaround in an expansion in an international economic order and we turn that into a protectionist world in which international trade stops growing. That event then, of course, could lead the world into a most precarious circumstance. In that regard I think we should be rather careful about policies that might cause the foreign exchange value of the dollar to weaken further, which in some sense can be a very strong motivating factor in regard to protectionism elsewhere. We have enough protectionist forces in the United States. And when we start seeing these protectionist forces hit the European Economic Community, as I think is entirely possible where the foreign exchange value of the dollar is right now, it means that we're going to crowd in there at a rate that they're not going to like--not just in agriculture but in other areas. So, that's an uncertainty that causes me to think more than once.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. Just so you'll know, I'm crying not because of the outlook but because I have a virus in my eye. Last night when I was reviewing the staff forecast one more time I was reminded of something in my childhood. Although it was a long time ago I do remember a few things from it! My mother always read to me every night and I had a strong preference for stories that had "they lived happily ever after" kinds of endings. I feel the same way about the forecast. I really do love the ones that are positive, optimistic, and happy. So, I have no problem [with the forecast]. And that's why I would remind you that at the beginning of the year, when we had the soft landing scenario which was marvelous because it accomplished all our goals with no pain, no strain, no sweat, that was terrific. But it sounded too good to be true and what I have discovered is that if things sound too good to be true there is often a problem. So while this forecast isn't [unintelligible] scenario, it still isn't a dismal forecast. I hope that what is in the Greenbook turns out to be right. But I'll just mention some of the questions I have about the numbers, even though, as I said, I hope that Mike's and his staff's assumptions are on target rather than mine.

First of all, I really sense that whatever it is we're in now--I call it a recession--it's going to be longer and more serious than the Greenbook suggests. One thing I'm more concerned about is consumption. As you know, I've been taking a more dismal view of the auto industry for some months now, and I think that some of my concerns are [now] rather evident to the public at large. And I don't see what is going to turn that around really quickly. Also, in the consumption arena I am concerned about the nature of the layoffs that we're seeing around the country; it's not just Joe on the line at the Rouge, the blue collar types I used to assume would be laid off. But that didn't have the same impact as when the sales vice president of some company who lives next door loses his job or a bank president loses his job or in some states bureaucrats are being laid off. That sends a different message and I think it's having a big impact even on the people who are still working.

Also, there is the deterioration in confidence. I'm from a state where confidence is usually negative because the state's economy is very cyclical, so I'm used to a lack of confidence and nervousness and all that. But I've never seen anything like what I'm seeing now. And I'm not confining my remarks to Michigan at all; it's widespread and is impacting ordinary individuals who just have this feeling that something isn't right. They don't necessarily know what it is that's wrong, but they just feel uncomfortable. I know that it's nice to assume that that's a fallout from Saddam Hussein and the higher gasoline prices and the worries over availability of oil, but my sense is that if all those things were taken care of [unintelligible] this afternoon and whatever it takes to solve this problem were done, this would not go away completely. Also, you don't hear much about it, but there is a real problem with the consumer debt load. I used to nag our researchers about looking at the consumer debt load and was told that the two sides of the balance sheet were okay--that the assets were building at the same time as the debt load was, so forget it. But it is a problem now, at least for a lot of individual consumers. And I think some of the delinquency and loan write-off data suggest that. In fact Sunday night I happened to have my TV on and one of the

PB evangelists came on and his wife was announcing that in January they're going to run some seminars for their parishioners to tell them how to get out of debt in 1991. Now, that says something to me: It has even become a moral issue!

Also, we are being hit by very much higher taxes in this country. I realize we've just seen a nickel a gallon increase on gasoline so far, but that budget deal has a lot more coming up. That may help the budget deficit, but I don't think it's going to be a positive for consumer behavior. And at various state levels, there are substantially higher tax hikes down the pike. We saw a lot of tax hikes in 1990 and I believe we're going to see still more in 1991 because so many states and cities and other localities do have budgetary problems. So, I just feel very concerned that the consumption side is going to be weaker than we're assuming.

Housing has gone down rapidly. We're now down again to where we were back in the 1981-82 recession--depression for my part of the world. That's where we are already. It seems to me that the so-called credit crunch has been especially tough in this arena; it has been centered on the home builder, not Mrs. Jones who needs to get a mortgage to buy a house. It's the financing for the person who wants to build the darn thing. Again, I hope I'm not being too negative but I just don't see what's out there that's going to turn that credit availability problem around really soon for those kinds of folks. If I'm right that that's a big constraint, then I don't know what's going to turn this around.

On exports, I would just repeat what Jerry said. In talking to people who actually export rather than to academic analysts, I think the opportunities for 1991 look a little less robust. And when I think about the shape of the economies of some of our major trading partners such as Canada, which is already in a serious recession, it makes me agree with the folks who are in the business. Also, I realize we're running a sort of war in the Middle East, but I think there are still some defense cuts coming through, which will have an impact on places like sunny California and have already had some effect in the Northeast. So, those are some of my concerns. And what I think is really unique this time, though--to borrow the term of my favorite peanut farmer--is this general malaise that seems to exist throughout the land. It's hitting individuals as consumers but also as businessmen and women. Personally, in my life time, I have never seen it that way.

On the financial fragility issue, there is this drumbeat--which unfortunately is coming out of Washington, D.C.--about the problems of the financial industry. If we could put a gag or a muzzle or something like that on some of these people so they would shut up, maybe this problem would be less severe. But we haven't, and the awareness of this is just becoming a big problem and in turn is tied into the so-called credit crunch. And as I already have mentioned a number of times, there is the special situation in real estate, the deflation in real estate values. Unless you go back to the 1930s, I don't think you will see anything like it. My good friend Wayne Angell in his comments used +5 and +10 percent figures; you'd get some exciting numbers if you used -15 percent. Thank you.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. I was most impressed with Lee Hoskins' report that in the middle of this environment they're building auto plants in Lexington, Kentucky, which shows you the resiliency of the American people. You didn't mention: Was it Toyota or Nissan? [Laughter.]

MR. HOSKINS. Toyota.

MR. MULLINS. Toyota. My view is generally in agreement with the staff's forecast. Producers seem to have cut back almost in advance of the cut in consumer spending, keeping inventories lean. And I think that puts the economy in pretty good shape for a rebound in the spring. It may be a bumpy landing rather than a soft landing. I'm not quite so sure that consumer confidence, Humpty Dumpty, can be reassembled as quickly as it is in the Greenbook. The pessimism is still rampant; I think Martha's correct on that. I got a call from a former student who is a partner in They just had a meeting of their national partners and the overwhelming view there was that we had entered a deep and long recession. That doesn't seem to be entirely consistent with the somewhat better than expected retail sales data and orders data, so there's still this gap. Perhaps it has just been a long time since people have seen a nationwide recession, so they don't remember what it feels like and it's pretty scary and they don't know how to get through it. Still, I think there is the potential for this rebound. The stock market thinks there is; it doesn't appear to be quite so pessimistic as the public. Indeed, if we have a resolution in the Gulf, if the bad news on financial institutions becomes old news, and if the banks start to go for the profit, I also believe there's a potential for consumer purchases that have been deferred. The autos that people are driving are reaching very old ages in terms of the average for autos. People still aren't going to buy in the current environment, but at some stage we might get a rebound. I think the real estate problems are more troubling and long-lasting in terms of the wealth impact of that reduction [in value]. I still speak from the perspective of a New England homeowner. We also have several sources of stimulus in place moving in our favor. The oil prices have started to come down and I hope they'll continue; the dollar is down; there is monetary ease--long interest rates, not just the short rates, have come down fairly substantially over the fall.

Financial fragility continues to be a concern. Publicity about it seems to be unending in virtually all areas. Jerry mentioned insurance companies; I would just mention one industry that has yet to hit the news but conceivably could and that is the mutual fund industry. If you look at junk bond mutual funds, high yield bond mutual funds, they've done an extraordinarily good job of managing through this collapse in the junk bond market. However, over the past several months a number of them have allowed their redemptions to run their cash reserves to precariously low levels. Given the illiquidity in the market, if one of them should have to suspend redemptions, very quickly I think all of them would be under pressure. They're a tiny part of the market. It's not significant from an overall point of view, but I think it would get publicity and perhaps have an impact on other mutual funds--bond funds, money market funds, and the like. I wouldn't suggest that monetary policy can do anything about that, although it would be nice to have liquidity and a lot of credit availability in that case. But I do think there is a potential for a

series of negative surprises in the finance area, which does not bode well for confidence.

More generally, though, the concern is: Who is going to finance this rebound? Where is the financing going to come from to fuel the rebound? If you look across the board, the non-RTC thrifts reported very large losses in the third quarter. Most of that was in the group that is targeted for RTC action. But even the good thrifts, it seems to me, about broke even. Insurance companies are under pressure due to asset quality, and they also have a great need next year to refinance a large volume of maturing GICs, guaranteed investment contracts. So they're going to be under some pressure; it's not clear they can expand lending. Finance companies have been taking up a lot of the slack and growing at a rapid pace. Business loans by finance companies started the year at about $250 billion and they're closing in on $300 billion. That compares with $600 to $700 billion in business loans at commercial banks, so it's still not too large. I wonder how long they can continue to grow and take up the slack at this pace. Commercial paper also took up some of the slack. Again, nonfinancial commercial paper is only about $150 billion, so presumably they can't take up all the slack. But commercial paper issuance, after growing rapidly in August, September, and October, collapsed in November presumably due to credit quality concerns as marginal credits decided to take down their back up lines from Japanese banks, which probably accounts for some of the fed funds anomalies in that period.

I think there's little evidence of a credit crunch for investment grade companies. You only have to look to the bond issuance in November, which was up very dramatically; but none of that involved below investment grade issues. One wonders who is going to finance the segment of the market that is below investment grade. Banks have been the traditional source. I thought that the bank credit supply conditions were likely to ease in January. The logic was that a lot of these banks want to show a good risk-based capital number on that year-end statement, and that is done by investing in mortgage-backed securities and governments, not loans. I thought that would tend to free up. And there is the point that Jerry mentioned: The fed funds rate has come down quite a bit without the prime changing. At some stage those competitive juices have to start flowing, and I thought it would happen pretty rapidly in the first part of the year. I'm a bit more pessimistic now for a number of reasons. First, I'm pessimistic in the sense of thinking that this credit supply [situation], including bank credit conditions, is likely to extend into the new year. There is a growing concern and publicity about the bank insurance fund. Now, it's accepted that there will be some sort of recapitalization paid for by the industry. I think there will be a period of uncertainty and banks may continue to hold back until they see how that issue is resolved in terms of how much they're going to have to pay and in what form they will have to pay. I also think the FDIC will start to resolve some of these institutions that it may have delayed until the new year. The Treasury report on banking reform when it comes out, probably in the first week of January, may well call for some fairly dramatic changes, which will result in a lot of debate in Congress. That again might be the type of thing a banker would look at and say: "I think maybe I'll hold tight for a bit instead of moving out aggressively." Obviously, we still can have some bad news in the fourth-quarter results on asset

writedowns at banks. And even an issue like mark-to-market for banks is going to be debated, I think, in the early part of next year. The proponents of mark-to-market will argue very loudly that banks are misrepresenting their assets and misleading investors. And those sorts of arguments are not the type that are likely to lead to increased confidence in the banking system. So, on balance, there may be some easing of the credit supply condition, but I don't think we're going to return to normalcy until a number of these issues--such as the bank insurance fund and having some of these problem institutions resolved and off the street--are resolved, probably later in the spring.

We can't control a lot of those issues. We can't take responsibility for junk bond funds. But we should have responsibility for money. I continue to be bothered by its anemic growth. We did have blips in M2 in August and September but the overall pattern continues to be one of slow growth. M2 growth was 3.2 percent in the second quarter of 1990, 3.1 percent in the third quarter of 1990, and I think we're projecting about 2 percent in the fourth quarter. This is no monetary shock, but it is a squeeze I would say. So, while the real economy seems to be feeling its way--however depressed people are--through this downturn in a manner which in my opinion has the potential to produce a rebound, I do think the slow growth in money and credit is not good news in this environment and does not augur well for achieving that rebound in the spring.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mr. Chairman, one of the advantages of waiting until almost the end is that you could just say "Me too" because everything has pretty much been said. But I can't resist the opportunity to make a comment or two about the Greenbook forecast. It seems to me that oil is the major wild card in that forecast. And I'm uncomfortable with the assumptions that either the situation is going to stabilize in the Middle East or get better, which would bring oil prices down and keep them down. That seems to be an important part of the recovery [forecast]. It might have been useful in this special case to have had an alternative forecast that might suggest what would happen if there were hostilities in the Middle East or if the Saudi production capacity had been damaged in some fashion which would create, for example, an oil price of $40 a barrel and keep it there for a while. I think that would significantly prolong the timing of the recovery. The other wild card, it seems to me, is the credit crunch, which I think except for the comments around the table has been dismissed rather casually. And yet we have in at least one part of the country a credit paralysis that is affecting the whole economy and shows no signs of reversal. And I think that serious impairment is spreading down the East coast. Bankers clearly are worried and scared and certainly are unwilling to lend in major parts of the country. And consumers are worried. And Messrs. Littan, Brumbaugh, and Seidman and the media are doing their best to raise that worry to the level of sheer terror. I think that terror relates to consumer attitudes toward banks and toward investment and spending and getting further in debt. And since we have such a consumer-driven economy, it's hard for me to see a rapid upturn until those consumer attitudes have changed. My best guess would be that those consumer attitudes will not change significantly until the Middle East situation is settled one way or another and until the banking situation is

perceived as being stabilized. I think those are the underlying concerns that are haunting consumers, and I don't think those attitudes are going to turn markedly more optimistic until those two factors have been addressed.

CHAIRMAN GREENSPAN. Finally, Governor Kelley.

MR. KELLEY. Well, Mr. Chairman, I guess I'm the last leaf on the bush and there's certainly very little left to be said about current conditions, as Governor LaWare just remarked. But I would like to try to resurrect a perspective that I first offered, probably a little prematurely, a year or so ago as to the underlying longer-term thrust of what's going on here. It seems to me that what we may be seeing is the first downturn in what may be a rather powerful and long-lived deflationary era--a sea change, if you will. I think there's considerable evidence underlying that. On a worldwide basis almost all commodities are abundant: food, materials, heaven knows in this country built space, and labor. Capital can seek out low cost labor and is mobile enough to get there and put production in place on a low-cost basis. It seems that monetary policy has been under tight control for some time; there's not too much of a problem in sight there. Hopefully, fiscal policy is turning around. Maybe the most important thing on an economy-wide basis in this country is that I think we've gone from an era of creating debt, which was inflationary, to servicing debt, which is deflationary. And if there's anything to all of this thesis, I think it can explain a lot of the financial problems and a lot of the real estate problems that we see. And it may be manifesting itself in this long decline that we're going through in corporate profits, where firms are being squeezed between the last of the upward thrust of cost pressures and the inability to pass that through in the form of prices. I don't think this is a done deal. There are a lot of things--monetary, economic, political, sociological--that could change this and abort it. But if this is true, it has implications for how we view everything. If this is true, we may have a stickier short-term situation--a little slower in. the near term to come out of the recession, but a far more positive longer-term outlook as time goes along and we do come out. The converse of that would be if we're in another episode of what we've seen before in the postwar era. If that turns out to be true, we could wind up with a quick, weak recovery and then fall back rather soon and be very disappointed. But if it becomes clear that this is a new era and a disinflationary one, I think the long-term perspective is really quite positive. But that does leave us with a near-term challenge: to facilitate the weaning of the economy off of the inflation kick that it has been on for so long and to avoid the potential for deflation and serious contraction that that could lead to. Thank you.

CHAIRMAN GREENSPAN. Thank you. Why don't we adjourn for coffee and come back in 10 minutes.

[Coffee break]

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

CHAIRMAN GREENSPAN. Questions for Don?

MR. MELZER. Don, I noticed in the money projections in the Bluebook that there's a very dramatic difference when you get out to February and March between alternatives A and B, much more so than I think we normally see. Do you want to comment on that?

MR. KOHN. We tried to stick with about a normal difference. First, we have a different base here. We are meeting earlier in the month than usual. Ordinarily, we would have a December-to-March base and we'd be meeting around the end of December or early January. So partly, it's because we're meeting a couple of weeks earlier. Aside from that, we didn't do anything special to widen the difference. We used the usual assumed elasticities.

MR. MELZER. I just can't recall 2 and 3 percentage point differences in the growth rates between these various alternatives. It just struck me.

MR. KOHN. I think that's roughly in line with what we see as the elasticities after three or four months.

MR. MULLINS. What interest rate elasticities do we assume for money demand, roughly speaking?

MR. KOHN. I can give you some numbers on what if the funds rate changes by x basis points, that kind of thing.

MR. MULLINS. Yes.

MR. KOHN. A 50 basis point decrease in the funds rate--now this is a quarterly average, so it won't show up the way it would in the monthly numbers--gets you about 3/4 point for the year, but it's loaded into the first and particularly the second quarters. So 1/2 point on the funds rate will get you about .09 by the second and third quarters and then it tends to drop off after a while.

CHAIRMAN GREENSPAN. It's four times the quarterly rate.

MR. KOHN. Dave just handed me a note: the elasticity after, say, four or five months is about .08 or .09.

MR. MULLINS. And empirically that works very well. My impression was that the theoretical models had much lower elasticity.

MR. KOHN. Well, I think in this case a lot depends on how the offering rates adjust to the market interest rates. That adjustment drives this a lot; the elasticities are lower over time because the offering rates then adjust to the market rates. So over time--after a couple of years--you get some very low elasticities. But our assumption here is that the offering rates, while adjusting perhaps faster than we would have thought a couple years ago because the market rate is moving down and we presume the banks don't want [to attract deposits], would still adjust sluggishly.

MR. MULLINS. And in the past the model fit the data pretty well. When did it stop fitting the data pretty well?

MR. KOHN. About the second quarter of this year. Well, that's not quite a fair response. We've had large errors from

quarter-to-quarter and even for a couple of quarters in a row. But in terms of cumulative error, this year we're going to have the largest error we've had, even outside the sample period, by at least a half point.

MR. MULLINS. Okay.

MR. HOSKINS. Don, to your surprise, I'm not going to ask you where alternative C is today. I do have a question.

MS. SEGER. You must have been in the Christmas punch!

MR. HOSKINS. I started early, Martha. I do want to follow-up on a couple of questions that have already been raised. You have pretty rapid growth--accelerating growth--in January, February, and March. The quarter finishes at 7.6 percent. And I guess that's really what David was [raising]. To press on: What happens in the next quarter? Do you expect us to go back to a 6 percent growth rate or 5 percent or lower?

MR. KOHN. In terms of alternative A?

MR. HOSKINS. Yes, if we adopted alternative A.

MR. KOHN. In the 6 to 7 percent range, I think. It would still be an increment from where it would have been otherwise. So I guess what we would have would be more like 7 percent.

MR. HOSKINS. So, we'd have a pretty strong first half, at 6 percent or something like that? It seems to me we'd be giving up some of our gains--

MR. KOHN. I think you could have that kind of growth. I'll try to be a little clearer here. We are assuming that this upward shift in velocity continues--a downward shift in money demand--so we're sort of going off a base. If we had alternative A, say, that will give us about 125 or 150 basis points [since] this past summer. Before, we would have expected much more rapid growth by the second quarter of next year if it weren't for this shift. Our models, in fact, are projecting growth of around 6-1/2 percent in the first quarter; instead we have 2-3/4 percent growth. So, we have that down by an increment, but that's relative to the fourth quarter which is already coming down. So, we still get the trajectory going up. It just has a couple of percentage points shaved off what you would have expected before the second quarter.

MR. HOSKINS. But instead, under alternative A it will be about 6 percent money growth for the first half of the year, or somewhere in that range. You have 5 percent in the first quarter and 7 percent in the second.

CHAIRMAN GREENSPAN. We are a couple of weeks away and there is just no evidence that that has started yet. So, be careful with your forecast.

MR. HOSKINS. Well, we've been concerned about the model because, as you know, we put a lot of emphasis on M2. We did try running a different version with no trend variable in it. What we put

in was a thrift share as an explanatory variable and that did get rid of the drift in the model. It doesn't make money grow any faster, but it tries to get at the problem in a different way.

MR. KOHN. We're trying a number of experiments using yield curve variables and things along that line to try to capture substitutions in and out of M2. Our expectation was to try to supply the Committee before the February meeting--well before the February Committee meeting, we hope--with a memorandum summarizing the various experiments we've been running to help to explain this number. A pure model forecast with alternative B in it has a 5-3/4 percent growth in the first quarter and then 4-3/4 percent in the second quarter. [One-and-one-half percentage points of] the impetus [behind] that 5-3/4 percent is an interest rate effect; the interest rate decline we've had through the fourth quarter has its biggest effect in the first quarter in that model.

CHAIRMAN GREENSPAN. President Black, first.

MR. BLACK. Mr. Chairman, I was just looking at the P* model shown in Chart 9 and, as I read that, it provides me with a pretty good comfort level. Don, do you take much comfort in that?

MR. KOHN. The problem, President Black, is that it rests on an assumption about what the equilibrium velocity level is. And I think the discussion we just had--

MR. HOSKINS. Clarifies it.

MR. KOHN. Occasionally, we have some doubts about whether we will return to V* or not at that--

MR. BLACK. Well, in the long run it has been pretty darn stable.

CHAIRMAN GREENSPAN. We don't know anything that contradicts it.

MR. BLACK. That's right.

MR. KOHN. We're beginning to accumulate a few quarters that tend to move it away, but so far we certainly don't have any long-run evidence that it has moved away. If velocity were to return to its old pattern and if we were to get the same M2 growth--so that the Committee didn't compensate by having more M2 growth as velocity shifted back--then you'd get this pattern of prices.

MR. BOEHNE. If the discount rate were to go down by 1/2 point but the Committee only wanted the funds rate to go down 25 basis points, how difficult would it be to communicate that to the market, given the fact that we haven't done this much in the past and given the normal churning that goes on at year-end? It might take a while for this to occur and we may find ourselves in a situation of having to--. I guess the miscommunication risk is what I'm driving at.

MR. KOHN. Peter may want to answer this as well, but my thought was that you really have two instruments for that. One is the press release. If this were the decision of the Committee and the

Board separately arrived at [a decision to cut the discount rate] but somehow coordinated that, we could hint--without necessarily saying the funds rate will only drop by 1/4 point--that it's partly to catch up to previous decreases in market interest rates. That would be a very broad hint and we could play with that wording to give the best possible clue in the press release. And I think it would only take a couple of operations by Mr. Sternlight thereafter to make it clear. If they dropped the funds rate further than the Committee wanted it to, all we have to do is bring in some reserves in a pretty aggressive way. Now, I think you're right that the churning around year-end is a problem; and my view is that if we're going to do something, we probably ought to do it in the next couple of days to get it out there and done with and then pretty well even keel it through this potentially difficult period around year-end. But I don't see why it can't be done in the next few days.

MR. STERNLIGHT. I would agree that it can be conveyed. I think something about like that move is what a number of people in the market expect. That would also help in being able to convey [an intention] like that.

MR. BLACK. If we did this, you don't think it would provide an undue degree of surprise, do you?

MR. STERNLIGHT. No.

MR. BLACK. That's the way I read it.

MR. HOSKINS. And what if we didn't do anything? Would that be a surprise?

MR. STERNLIGHT. I think people are looking for some action but not necessarily immediately. If nothing were done going well into January, let's say, I think that would be an element of disappointment to the market.

CHAIRMAN GREENSPAN. Wayne, you were first.

MR. ANGELL. Yes, Don, I just wanted to comment. Of course, the problem that occurs by the Federal Open Market Committee moving away from the borrowing targeting is that we thereby take away the separation between the discount rate decision, which is the Board of Governors decision with the recommendations of the Reserve Bank boards as a factor. If the Federal Open Market Committee really were to choose a fed funds target precisely--if we said we want it to be 7 percent, say--then under those circumstances there is no monetary power left with the Board of Governors and Reserve Bank District boards as we'd normally see. As long as we maintain the charade of a borrowing targeting then that separation of function can still be there, it seems to me. That is, as long as we write the FOMC minutes based upon the charade of borrowing then the old practice can still be there.

MR. HOSKINS. Are you recommending that?

MR. ANGELL. Well, I don't want to get into a discussion about the discount rate. I can argue both sides of that.

VICE CHAIRMAN CORRIGAN. You'd have to! [Laughter.]

MR. ANGELL. But I do think in this discussion we ought to recognize that it might be desirable--that is, the Committee and the Board may wish to consider maintaining a policy that does not wipe out this distinction we've historically used. And I would not be for that kind of a change [unintelligible].

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Peter, you made the point that you thought the market might be expecting something like 1/2 point on the discount rate and 25 basis points initially on the funds rate. I find that overall approach fairly attractive. But I'd like to ask Gretchen: Is that generally in the neighborhood of what's expected in the exchange markets as well?

MS. GREENE. I think it's fair to say that in the exchange markets the distinction between the discount rate and the federal funds rate may not be quite as widely appreciated. The symbolic influence of the discount rate probably carries a greater weight in exchange markets than it does domestically simply because the exchange market looks at lots of central banks and the discount rate for so many central banks is an important policy instrument. So, it might take a little while for the exchange markets to come to the same interpretation as the domestic market of such an action.

MR. SYRON. Would there be some comfort, if I can use that term, to the exchange markets by what would be conveyed in the sort of press release that Don talked about?

MS. GREENE. They do look at the press release and, sure, anything that could be comforting in the press release would help.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Don, what do you think it would take to get the prime rate to come down?

MR. KOHN. I don't know. We had a grand debate when we were writing the Bluebook as to whether something like this would take the prime rate down. Most of us felt that come hell or high water banks probably wouldn't do it before the first of January. I do think that another easing and something as symbolic as the discount rate might pry a few people loose even before year-end. A further easing in my mind would raise the odds to a very, very high level that the prime rate will come down after year-end. The issue is whether they might reduce it sometime in the next two weeks. The discount rate change might do [the trick] by focusing some attention on it. But I think it almost certainly--he says hesitatingly!--would happen at some point after the first of the year. It would still leave an unusually wide spread between funding costs, assuming CD rates came down pari passu with the funds rate. So their margins would still be wide.

CHAIRMAN GREENSPAN. Roger.

MR. GUFFEY. As I remember your earlier comment, Peter, the year-end positioning has almost run its course, is that right?

MR. STERNLIGHT. I think the intensity of pressures reached a peak about the end of November and then subsided. We've seen some increase in rates again in the last couple of days but--as I see it anyway--without the same sense of stringency or near panic that seemed to be there in late November. I wouldn't want to say it has run its course. I think we could still be in for some pressures that you'd want to monitor and maybe deal with in some way.

MR. GUFFEY. Well, given that, my question is: How soon after the first of the year would you see that unwinding being completed? What I'm really driving at is whether to delay a discount rate action and a reduction of the funds rate until after the first of the year, which is two weeks, roughly, given the several days on which the market would [not] operate in any event because of the holidays.

MR. STERNLIGHT. Well, in terms of what the market looks for, I think one of the critical things will be the next employment report, which I believe comes out January 3rd or quite early in January. If that looks weak again and if they haven't seen some [easing] by then, they will look for it and be quite disappointed if they don't see it. Normally, you'd expect year-end pressures to unwind about a week after the turn of the year. We do have the added complication of the reserve requirement reduction and how banks respond to that and how we respond to their response.

MR. GUFFEY. I guess I was suggesting that since the activity has not been as intense this year as in past years it might unwind more quickly after the first of year--in a shorter period of time.

MR. STERNLIGHT. I don't have a particular sense of that.

CHAIRMAN GREENSPAN. Any further questions? If not, let me get started and be fairly brief because I think that we've covered a lot of ground this morning and put on the table most of the major issues. I think it's fairly clear at this stage that the type of economic phenomenon we're looking at is something without any parallel in the post-World War II period. This is in a sense a balance sheet suppression, the type we've all been mentioning. It's really quite interesting to see the process, which is essentially one in which values continue to be under significant pressure. For example, we're now beginning to see the weakening of residential real estate prices work its way into the CPI through the owners' equivalent rent numbers, which have finally flattened out. Earlier data suggested that these numbers moved in parallel; they went out of line a bit earlier this year, which is probably a statistical fluke. But it's fairly clear that we're beginning to see a disinflationary process going on, starting largely from the balance sheet structure of businesses as well as the financial system. And I think that's a major element that is feeding into the basic price structure. We are looking at it through the assets side and also as assets affect prices and prices affect wages, reversing the usual type of pattern. We're obviously also seeing a significant weakening in the retail markets as a consequence of a fairly dramatic decline in realized capital gains on the sale of existing residences, which started to be weak in the second quarter. And, although the data are very fragmentary, as we move into the fourth quarter the level of existing home sales has to be awfully low. I think a goodly part of the weakness in consumer markets is not only consumer psychology but also a reduction of

purchasing power--quite similar to what President Syron was talking about with respect to New England, only on a much broader basis. The psychology issue is obviously becoming really quite pronounced. While one can argue that a substantial part is balance sheet related and asset related, the coincidence of the decline with the Persian Gulf crisis clearly has to be a considerable part of that. But it's fairly apparent, irrespective of how one is looking at the pattern of economic activity as it works its way back between psychology and action, that we are seeing a seizing up of some forms of credit availability. And the intermediation that has been taken out of the system in large part because of the savings and loan shrinkage is not insubstantial at this stage. So, overall what is occurring, as a number of you have said and one can sense it, is that the fear [felt by] banks and the fear of getting involved in the intermediation process are really putting a big suppression on things. I would suspect the 2 percentage point difference that Don is getting between the growth of M2 and that in his model may in fact reflect something we don't measure--namely, the inclination of individuals to hold liquid deposits which in the previous calculations are all presumed to be risk free. The very substantial [volume of] noncompetitive tenders [in Treasury auctions] obviously in train this year is a mere suggestion of that particular phenomenon.

Having said all of that, we have severe recessionary pressures. But recessions always end. And while our basic requirement as far as policy is concerned is to make certain that we maintain adequate liquidity in the system, especially under conditions such as those we are now experiencing, we also obviously have to look at the other side of this. At some point we are going to come out of this and we want to make reasonably certain that when we do we're not looking at a degree of liquidity in the system that brings with it [higher] inflation rates and the next downturn much more quickly than is usual. So, I think that it's apparent that we have a fairly difficult next six months ahead. I don't think there's any particular short-term policy uncertainty. My judgment and what I hear as the general consensus around here, if I read it correctly, is that the money supply has become extraordinarily restricted and that we're looking at what is a very major credit contraction. The fact that the prime rate hasn't moved is an indication of the extent of that. And I think there is an inclination to ease up a bit further here. I'm becoming more convinced as the days go by that, while the optimum policy would be to somehow bring the funds rate down and [to generate] the associated credit with it until we get the economy in somewhat of a balanced growth position at which point [short-term rates] could stay down, the chances of being able to implement that are becoming increasingly small. It's just not credible that a central bank can't print money; and the more we try to print it, in figurative terms, the more likely it is that at some point we'll succeed beyond our wildest dreams. And while I would argue strongly that we have to get some downside policy cushion here, namely to make certain that we supply adequate credit into the system, I think we also have to be prepared for the fact that we may, and probably will, overdo it. At some point the equations will come out right and we are going to be required to start pulling back, probably earlier than we might be desirous of doing so. So, I would not at this particular stage leave out the possibility that we may overdo it, but I would not be overly concerned about that provided we are aware sufficiently in advance that that's what's happening. The difference between where the credit aggregates,

the money supply, the monetary base--all the various financial elements with which we interface--are at this moment and where inflationary concerns are I think is rather substantial. We have a long way to go, so I'm not particularly concerned about it. The bottom line that I come out with is: As I think we implied, the discount rate is on the table [for Board consideration] tomorrow. Should the Board decide to reduce the rate in line with the vast majority of the recommendations of the Reserve Banks, then it strikes me that perhaps the partial accommodation of a 1/2 point reduction in the discount rate with a 1/4 point in the funds rate, bringing it from 7-1/4 percent to 7 percent, probably is at this stage the most sensible policy option. If the Board chooses not to reduce the discount rate, I would still argue in favor of moving the funds rate another 1/4 of a point to 7 percent under appropriate open market policies. And I would further suggest that having done that, we should remain asymmetric toward ease. Comments?

MR. ANGELL. Mr. Chairman, I'm sympathetic to what you're saying, but I just want to be sure that we're maintaining as best we can the fine line. I wonder if you could accommodate that to mean that we would be voting here for alternative B symmetric toward ease, and then you as Chairman of the Committee would have some discretion over the intermeeting period, particularly as you sat with the Board of Governors in regard to the discount rate.

CHAIRMAN GREENSPAN. It could be done that way. What I'm actually recommending is that the FOMC act independently to move. But as I noted, it's a technical question.

MR. ANGELL. Here again, I'm thinking that the way policy runs and has run over the last several years is that at some period of time the Federal Open Market Committee has the balance of power. That is, during periods in which interest rates are increasing, ordinarily the fed funds rate moves up as pressures are put on the fed funds rate. In a sense the Reserve Bank directors and the Board of Governors have a standby policy. And even [when the rate is] on the way down that's also the case. Now, on the way up a point is reached where the distance between the fed funds rate and the discount rate gets so wide that no one is willing to allow that kind of a subsidy, so then the balance swings to the Reserve Bank directors and the Board of Governors. And until someone convinces me otherwise, I would favor maintaining that [balance]. And I would favor the FOMC saying at this point in time that the direction of interest rates downward now largely rests with the boards of directors of the Reserve Banks and with the Board of Governors. In a sense it's kind of a flip-flop. I think we ought to hear a debate on that question and see if there's a better way to do it.

CHAIRMAN GREENSPAN. Well, why don't we quickly put that on the table and let people comment. Bob Black first.

MR. BLACK. Mr. Chairman, you formulated exactly what I would have done. I just want to express the hope that the Board of Governors in its wisdom does what you suggested it might do tomorrow so that the net effect would be a 1/4 point change in the federal funds rate. If the Board does not act, then 1/4 point is all I would want to do at this point. I think a 1/2-point move would do things to the bond market and the foreign exchange market that we wouldn't like very

much. That would be seen as throwing in the towel [on inflation] at this point. So, I'm with you 100 percent on that.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. [Unintelligible], I guess mainly because the Greenbook is a bit more optimistic than I would be. I would like to make two points, though. It seems to me that the process that we've been going through in recent months does suggest that there is a high likelihood that we will overshoot at some point. I feel as though we have to have a view of the future that we have some confidence in. We realize that there are rather substantial lags in terms of when these policy changes will have an effect. And if we don't do that, and we react primarily to conditions as we see them appear in the statistics, I think that there is a high likelihood we will overshoot. Secondly, if that does occur and maybe even if it doesn't--and this is a point that you certainly alluded to--I think we need to be prepared to reverse our actions at some point rather promptly.

CHAIRMAN GREENSPAN. Do you have any views on Wayne Angell's comments?

MR. PARRY. I want to think about it.

MR. HOSKINS. I wanted to get a clarification from Governor Angell. Are you suggesting that we stay at 7-1/4 percent asymmetric toward ease and, not to prejudge what the Board will do, but suppose that it lowers the discount rate 50 basis points, that all of that will be passed through? Or is that just a signalling device?

MR. ANGELL. No, I was suggesting that with our asymmetry toward ease we delegate to the Chairman the decision as to whether or not the full 50 points show through or only 25 show through. I'm just trying to keep it technical so that the FOMC is only talking about the so-called pressure or [existing] pressure between the fed funds rate and the discount rate. But in the intermeeting period, given the uncertainty in the FOMC about what the Board will do, the Chairman would have the discretionary authority. And if the Board chose not to move the discount rate, the Chairman then could go ahead and immediately move the fed funds rate by 25 basis points. So, I'm not talking about any difference in outcome in terms of what the Chairman is suggesting; I'm just talking about the technical manner.

MR. SYRON. If the Board voted not to accept the recommendation of the majority of the Reserve Banks, what would be the expectation, if I can use that phrase, of what the Chairman would do?

MR. ANGELL. Well, I think the Chairman has made it clear that he would expect to move the fed funds rate.

MR. SYRON. 25 basis points now and maintain asymmetry toward ease?

MR. BLACK. Which might or might not be used.

MR. SYRON. Oh, yes.

MR. ANGELL. I'm not talking about any change in outcome from what the Chairman is proposing.

MR. HOSKINS. Let me finish off then. My preference would be not to change; I could live with asymmetric language. But I would agree with Governor Angell's proposal: that is, if the Board is going to change the discount rate, do it first and see what happens. Then we would have the opportunity, if the foreign exchange markets reacted badly to that, to sit for a while or to move forward. It seems to me to give you more degrees of freedom. But my overall preference--

CHAIRMAN GREENSPAN. We do have to have a press release with a discount rate action, which does bind our hands with respect to that issue.

MR. HOSKINS. No, I'm saying that [unintelligible] you've lowered the discount rate, say, 50 basis points, but you don't do anything with respect to the funds rate until that reaction--

CHAIRMAN GREENSPAN. But if you do that, the problem is that the normal market expectation would be a 50 basis point decline in the funds rate, which is more than I think we want to suggest. So, in the press release we're going to have to say something to the effect that the expectation is for it to show through only partially in the funds rate.

MR. ANGELL. Mr. Chairman, I think the FOMC ought to talk about the distance between the fed funds rate and the discount rate, and they ought to be advising us along with the boards of directors. And I think the Board of Governors should decide this question.

MR. LAWARE. I'm not clear on why you think they must move in lock step. There has been a disparate relationship as long as I can remember between the discount rate and the fed funds rate. We've been operating for two weeks at least at a 1/4 point [spread between the two rates]. We operated at 300 basis points for a while. Why would the assumption be that we would drop both by the same amount?

CHAIRMAN GREENSPAN. Because that's in fact what we've been doing.

MR. ANGELL. Any time we've moved the discount rate, except September 3 of 1987, we've moved the fed funds rate the same amount as the discount rate.

MR. LAWARE. Well, I don't know why we should feel our hands are tied because of that.

MR. BLACK. I think we could put out a news release if we decided this sort of thing.

CHAIRMAN GREENSPAN. Well, let me put it this way. Let's first get the policy down for which there seems to be very little difference. And then we'll worry about the means of implementation. It will not be viewed differently in the market but it will affect how the minutes read and how the implementation of the directive reads. It won't affect anything else, but let's make certain that we get some

agreement on what we're actually going to do and hold for a minute the question of how that is technically implemented. Bob Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, with respect to the policy issue I start from the proposition that we're in a contraction, that the contraction is going to continue, and that the risk of a more serious downturn is present. And the risk of that kind of a downturn is one that I would not like to take at this point. I think it's an undue downward risk, and I would prefer that policy be contracyclical at this point rather than procyclical. I think you put your finger on a very important aspect of this downturn: the psychology. And the psychology is universally bad. Although monetary policy can't cure all of the ills in the economy and certainly can't deal with the Middle East and so on, I do think it's the only thing at this point--unless there is a solution to the Middle East situation--that is really going to bolster the psychology. So, while we do have the risk of overdoing it, I would be prepared to run that risk at this point. My preference would be to move 50 basis points immediately; however, if you wanted to do it in two steps with an asymmetric directive, I wouldn't have a great problem with that. If you did 50 basis points immediately, I think that to some extent technically solves the discount rate problem because the funds rate would be below the discount rate and the market would be expecting some symmetry between the two. My preference in terms of policy and implementation would be to move 50 basis points [on the funds rate] and to drop the discount rate as well.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. First of all, I support precisely the recommendation that you put on the table. That is, I hope the Board will move the discount rate 1/2 point, with the Committee trying to settle the funds rate in around 7 percent--I have no question myself that Mr. Sternlight and his friends can engineer that even in the year-end environment--and maintain asymmetry in the directive. I know it's late, but let me just make a couple of quick comments in terms of the policy setting. I think Martha made a good point before when she spoke about the soft landing. Everyone knew that was going to be a difficult exercise. The economy now seems to have tipped into a recession. But I think it's important that we and others keep in mind that if indeed it is a recession, the causes of it seem to be [primarily] an autonomous shift in expectations growing in part out of excesses of the past, of which the credit crunch is a symptom, and in part from Saddam Hussein. Not to raise vestiges of the past, but in his Per Jacobsson lecture Paul Volcker made the point that if there is a recession, it's not going to be monetary policy's fault. And I think that's right. Moreover, if we can achieve an outcome like Mike's forecast, I don't think it's the end of the world by a long shot. In addition, we can say now what we couldn't say six months ago: that there's at least a strong [hint] or two that suggests that the inflation outcome could be better than we thought six short months ago. All in all, while no one likes a recession, I don't consider the outcome terrible by a long shot as long as we get something like Mike's forecast. And that's where I do worry a bit, if not a lot, about the money supply. No one is ever going to accuse me of being a monetarist, but as I see it the money supply, total reserves, and whatever, are all kind of in the red zone. And in those circumstances I think the policy you're suggesting is exactly right. Even with that

policy I'm by no means convinced that we are inevitably and irreversibly destined to overdo it. I think we can squeeze through.

Just quickly on the point that Governor Angell raised, which I think goes well beyond how we communicate this particular change: I think Governor Angell is raising a more difficult question of the whole matter of the relationships between the Board of Governors and the boards of directors on the one hand and the Open Market Committee on the other. I must say, Wayne, that looked at over a very long period of time on both sides of the interest rate cycle, I for one think that those relationships are about right. And I would be most reluctant to change them. I might add, at the risk of seeming to prod a bit, that if one does care about the [monetary policy] role of directors and the Board of Governors it seems to me it's a matter of logical extension that one should not be too crazy about a penalty discount rate.

MR. ANGELL. I understand that and as I suggested, Jerry, there's another side of that issue. In regard to that relationship I feel exactly as you do.

CHAIRMAN GREENSPAN. Well, it might not be a bad idea at some point to have a sort of a fleshing out of this [unintelligible] issue you're raising. President Melzer.

MR. MELZER. I can accept your recommendation on the funds rate, Alan. I think it's probably appropriate. I have a sense--as I expressed earlier and to use a phrase I heard elsewhere--that we're getting ahead of the curve a little. I think we have brought the funds rate down faster than market rates, and I presume that that is going to show through to the aggregates. But this is responsive to the concern of the slow growth. I agree with you that we're likely to overdo it. Unfortunately, I don't have the same confidence that we'll undo it. I say that simply because I sat here as recently as 1986 and 1987 as we looked at quarterly growth rates in M2 in excess of 10 percent and I have to tell you there are lot of asymmetric monetarists. That's Lee's phrase, but I think it's very true. There were many people not at all worried about that [M2 growth] at that time. I hope I'm wrong, but I'm not--

CHAIRMAN GREENSPAN. If P* is any sort of basic inference, we are significantly better positioned than we were then.

MR. MELZER. Oh, I understand what position we're in, and that's why--

CHAIRMAN GREENSPAN. We have a lot of room to make a mistake in here.

MR. MELZER. Yes.

MR. BLACK. Bob Parry and I are going to be on next year too [as voting members]!

MR. MELZER. In any case, I would like to try to avoid the overshooting not only for that reason but also because I think a volatile monetary policy has other consequences that flow from that. On the discount rate, if it were up to me I would let the 1/4 point

show through in open market operations tomorrow and I'd be inclined to cut the discount rate on Friday. And at that point I'd make it very clear that it's simply a technical adjustment to move the discount rate in line with other rates. I think the communication in this other scheme could get a little confusing. I think we could establish a 7 percent funds rate by Friday and then just have a technical adjustment [in the discount rate] and use the appropriate language for that. I'm not concerned about Wayne's concern here. We could be left in the same position if the Board decided not to move the rate on Wednesday and then we would have a situation where, with the authority we are proposing to delegate to the Chairman, we would still have the funds rate coming down close to or possibly below the discount rate. So, I'm not troubled with that. I'd go ahead with the open market operations.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, I would enthusiastically support your recommendation, which I think is absolutely the right thing to do given the current circumstances. Specifically, in terms of our decision here today, I would reduce the fed funds rate by 25 basis points, have asymmetric language, and hope that the discount rate would be reduced concurrently or shortly.

CHAIRMAN GREENSPAN. President Stern.

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

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. I would support your recommendation, Mr. Chairman. I would also hope that there is a discount rate cut. The only comment I would make is that I hope you would exercise considerable discretion in going any further in the intermeeting period unless something very unusual happens.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. I just wanted to finish the policy statement separate from the discount rate issue. I think we ought to have asymmetric language. I'd rather have the 25 basis point move in the hands of the Chairman at his discretion. We have made some significant moves in terms of interest rates in the recent past and we haven't seen those fully show through yet. Don's projections presumably could err on both sides, not just one side, and we may well get a faster growth rate of money. But even with the projection that we have, a 50 basis point move puts us at the top of our tentative target range for next year by June. And it seems to me that some patience is needed here and some careful watching of the aggregates. I'm not averse to moving if the aggregates pan out to be more than a 26-week fluke. But maybe we ought to see what's in that aggregate box before we move ahead.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Mr. Chairman, I like your suggestion exactly as it was put. I disagree with Lee in the sense that I think what the FOMC ought to do--I'm not a voting member--is vote to make a 25 basis

point cut with asymmetric language toward ease. It is true that this is not a policy-induced recession. I think that's a very important point. It is also our responsibility to take into consideration the world as it exists, and I think what you suggested does that without panic on the down side. I think it's very important that we now move ahead, but I must say I feel some of Tom Melzer's concerns about how quickly we'll adjust, being a confessed asymmetric monetarist. We may not react as quickly on the up side. It's important that the FOMC vote for what it thinks should be done, and I'm a little wary of getting into things that have too many conditions. This is a very difficult question. Besides the results of being on horseback here, there are too many things that are permutations and combinations--that if A happens we'll do this and if B happens we'll do that. We ought to say what we think should be done, and I think your suggestion did that.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I enthusiastically support a move toward ease, and tomorrow I will vote in favor of a discount rate cut because I think one of the reasons for the lack of confidence in business communities is the feeling that somehow or other a lot of people in Washington don't know what's going on. I think this would be a kind of discreet action. It wouldn't be so discreet that no one would know it, but it would be something that would fit on the front page of the newspapers and, therefore, would be communicated all over the country and not just to fed watchers. And that would help a great deal. I'm not a betting woman, but to answer Don Kohn's question: If this goes across the wire tomorrow at 9:30 a.m., we'll see the prime rate cut announcements starting about 9:42 a.m.

MR. SYRON. That's pretty precise!

SPEAKER(?). You want to bet?

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I support your recommendation, Mr. Chairman. I think the Federal Open Market Committee ought to vote for a 1/4 point reduction in the rate today with an asymmetrical directive, and I think you and your colleagues ought to do what you will tomorrow.

CHAIRMAN GREENSPAN. As long as it's the right thing! Governor LaWare.

MR. LAWARE. I support your recommendation, Mr. Chairman. The only thing I'd add is that I feel quite strongly that under the circumstances there is very little chance that this particular policy directive would lead us to overshoot the mark.

CHAIRMAN GREENSPAN. I regretfully suspect that you may be right. Governor Kelley.

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

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. I support the recommendation. I think we have allowed the fed funds rate to come down gradually this fall and more rapidly recently as market rates also have fallen more rapidly. We've yet to see the full impact on M2. Still, M2 seems to be decelerating a bit. And I think there's ample room to continue at least this marginal decline. It is true that I've only seen Don's forecast errors on one side, but there's always the possibility that it will turn around.

MR. KOHN. It has.

MR. MULLINS. So, I support the recommendation.

CHAIRMAN GREENSPAN. Roger, do you have any remarks?

MR. GUFFEY. I would support your recommendation, Mr. Chairman. I would go one step further, however, given the background that we have reduced the fed funds rate by roughly 3/4 of a percentage point in a six-week period starting with October 29 and that hasn't shown through yet. Another 1/4 point doesn't bother me, but if we continue I do have a concern about overshooting and I also have a concern about moving the fed funds rate to the level of the discount rate or making the discount rate a penalty rate. I would feel a lot more comfortable about your recommendation if indeed I was assured that the Board would act rather promptly to reduce the discount rate and that only half of it, 1/4 point, would show through.

CHAIRMAN GREENSPAN. I might just say technically--

MR. GUFFEY. I don't see standing on ceremonies, which I think Wayne Angell has brought forth in the distinction between the Board and the FOMC. Now is the time to set policy and I'd like to see it established here.

MR. ANGELL. Mr. Chairman, I would like to comment on the monetary policy question rather than the technical one that I spoke to earlier. My position is just about exactly identical with Tom Melzer's. We have quite a few more months of rather unpleasant news ahead of us. And if anyone is under the illusion that there are not going to be pressures to reduce the fed funds rate and the discount rate in January, and February, and March--. It seems to me that we have at least three more months of rather bad news because in spite of all the manifestations from looking at M2 I really believe that most of the members of the Committee are looking at the real economy. And there's always a lag in regard to the information on the real economy. That's why the Chairman was suggesting the problem in regard to our overshooting. Now, I hope that this time around, Tom, there will be the votes to make the rather dramatic move, which may have to be made if you look at the forward looking indicators--the money stock, commodity prices, and the yield curve. We could find ourselves in a position where we have to tighten before we have any real evidence that the economy has recovered. And I think that's going to be very difficult to do. So, Mr. Chairman, I can go along with this, but my decided preference is to go much slower than 75 basis points a quarter. And I mean 75 basis points a quarter. If we continue to do that, at some point we're going to find out what the Foreign Desk warned us about: the problem of the dollar. It's almost as if there's a willingness to walk us there and we're going to find that we're

going to be blindfolded; we're going to walk in the dark and sometime we're going to find it. And that frankly scares me. So, I'm very uncomfortable voting to do what we're doing. I do hope that the votes are going to be there when it is necessary and the time comes to tighten.

CHAIRMAN GREENSPAN. I think that's well said. This is not the tough vote; the tough vote is on the other side of this.

MR. BLACK. And it's on the other side where we've made our mistakes every time throughout our history practically.

CHAIRMAN GREENSPAN. Well, let us remember one thing that we can be pleased about and that is that we've cut off the top of this [inflation bulge] very early on. In terms of looking at the real M2, we have not been confronted with this big [unintelligible]. In other words, essentially we've stabilized the growth in money supply to an extent that we haven't seen in quite a long time. And hopefully we can continue doing that. We're not going to get it [unintelligible] but we have kept it within our target guidelines now for a surprisingly long period of time. And I just hope we have the capability of doing that in the future. But I think what Wayne Angell has said is something we'd better be at least careful about. [Unintelligible] run this. It's going to happen. If it turns out that the Greenbook forecast is right, that would be terrific. But as Mike said very early on, he thinks that the risks of that forecast are asymmetric toward a worse outcome. And I think we're all saying that that's what we're responding to, but it may not turn out that way. And we had better be prepared to--

VICE CHAIRMAN CORRIGAN. Well, the last time we really had the problem that Governor Angell was talking about wasn't in fact in 1987; it was in 1988. To use the soft landing analogy, Mike pointed out to us 15 months ago that we overshot the runway. And if you want to look for mea culpas, the mea culpas belong in 1988 and not 1987. And I think that's the last time--

MR. ANGELL. But, Jerry, my view is that in the last quarter of 1986 everything really took off and we really ignored all those events. Every money market watcher knew in March of 1987 what had happened and market interest rates soared and soared twice as much as what we did.

VICE CHAIRMAN CORRIGAN. And policy firmed and then firmed further through the summer of 1987 and the stock market crash took it down. And when we got into 1988 that is where the real problems were.

MR. ANGELL. Yes.

CHAIRMAN GREENSPAN. Are you saying we overdid it in 1988 on the up side?

VICE CHAIRMAN CORRIGAN. No, we didn't go down soon enough and far enough.

MR. HOSKINS. We didn't have a recession then; it's a lot tougher when there's a recession on.

SPEAKER(?). No, that's right.

CHAIRMAN GREENSPAN. Okay, can we put this directive to a vote?

MR. KOHN. Norm, I would put 4 percent and 1 percent in the two blanks at the end.

MR. ANGELL. On line 21--. I'm sorry, I may be ahead.

MR. BERNARD. We also distributed changes for lines 17-20 and 20-21 to take account of the new information on trade for October and the CPI for November, which we got this morning.

MR. ANGELL. I think lines 21-23 as proposed risk the mistake of our saying that the inflation is okay. Do I have the wrong one? It is dated December 18th. It says "Consumer prices continue to increase moderately." My view is that it would be better to say that consumer prices are rising moderately as compared to the rather strong rise that occurred in the first nine months of the year. I'm afraid this will be interpreted as meaning that we think consumer prices during 1990 have been okay.

MR. SYRON. Why don't we say consumer prices have improved somewhat.

CHAIRMAN GREENSPAN. The trouble, unfortunately, is that the ex-oil part also accelerated at some point, which gives some--. May I request that the Committee leave with the chair the solution to this problem?

MR. ANGELL. That's fine.

CHAIRMAN GREENSPAN. We have to get the right language.

MR. BERNARD. "In the implementation of policy for the immediate future, the Committee seeks to decrease slightly the existing degree of pressure on reserve positions, taking account of a possible change in the discount rate. Depending upon progress toward price stability, trends in economic activity, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, slightly greater reserve restraint might or somewhat lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with growth of M2 and M3 over the period from November through March at annual rates of about 4 and 1 percent, respectively."

CHAIRMAN GREENSPAN. Will you call the roll?

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Boehne	Yes
President Boykin	Yes

President Hoskins Against my instincts but given the collective weight of my colleagues and the promise that they'll do the right thing next year at the right time--Yes

MR. BOEHNE. Get it in writing.

VICE CHAIRMAN CORRIGAN. Some of us take that personally!

MR. BERNARD.

Governor Kelley	Yes
Governor LaWare	Yes
Governor Mullins	Yes
Governor Seger	Yes
President Stern	Yes

CHAIRMAN GREENSPAN. We'll now adjourn to luncheon. Our next meeting is February 5-6.

END OF MEETING