Meeting of the Federal Open Market Committee

February 5-6, 1991

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, February 5, 1991, at 2:30 p.m. and was continued on Wednesday, February 6, 1991, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Black
Mr. Forrestal
Mr. Keehn
Mr. Kelley
Mr. LaWare
Mr. Mullins
Mr. Parry
Ms. Seger

Messrs. Guffey, Hoskins, Melzer, and Syron, Alternate Members of the Federal Open Market Committee

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

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

Messrs. Beebe, Broaddus, R. Davis, Lindsey, Promisel, Scheld, Siegman, Simpson, Slifman, and Ms. Tschinkel, Associate Economists

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

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Mr. Stockton, Associate Director, Division of Research and Statistics, Board of Governors
Mr. Hooper, Assistant Director, Division of International Finance, Board of Governors
Mr. Rosine,[1] Senior Economist, Division of Research and Statistics, Board of Governors
Mr. Fisher,[1] Economist, Division of Monetary Affairs, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

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

Mr. McNees, Vice President, Federal Reserve Bank of Boston
Mr. Thornton, Assistant Vice President, Federal Reserve Bank of St. Louis
Ms. Krieger, Manager, Open Market Operations, Federal Reserve Bank of New York

1. Attended portion of meeting relating to the Committee's discussion of the economic outlook and its longer-run objectives for monetary and debt aggregates.

Transcript of Federal Open Market Committee Meeting of
February 5-6, 1991

February 5, 1991--Afternoon Session

CHAIRMAN GREENSPAN. Good afternoon, everyone. Welcome, Bob McTeer; it's nice to see you at the table. You're sitting between two formidable characters but I suspect you'll survive.

MR. SYRON. What do mean by that?

CHAIRMAN GREENSPAN. The first item on my agenda is not on the [meeting] agenda but it's something I'd like to bring up because I know a number of you felt quite uncomfortable about the need [for the Board] to take the action that we took on Friday and the way we had to take it. The action, in my judgment, had to be done and I think in retrospect it clearly was right. I thought waiting until this meeting [would have] put policy behind formidably, which I think we have to avoid. As we discussed at that time, we moved under the directive de jure, which was still targeting borrowing and not the funds rate. And, obviously, under those conditions, there's an immediate basis point-for-basis point passthrough with the discount rate. De facto, it's very hard to believe that that is what we're doing. As a consequence, I think we have to resolve this question in a manner that is consistent with the rules of this Committee. Unless somebody has an objection, I would suggest that we form a small committee--and I'm recommending Messrs. Kohn, Sternlight, Mattingly, and a Federal Reserve Bank economist of their choice--to prepare a paper on this issue and how it should be handled for inclusion on the agenda of our March 26th meeting. We have so much ambiguity on this particular issue that I think we have to get some clarification so that the Board, the Desk, and the Committee know where we are under all conditions on this issue. If anyone has anything to add to that, I'd appreciate [hearing] it. If not, I'd just like to go forward and officially appoint that committee to prepare a paper and put this issue on the agenda next time.

MR. HOSKINS. Just a clarification on the paper: The mandate is to look at the operating instruments as well as the relationship of the discount rate to the funds rate?

CHAIRMAN GREENSPAN. The mandate is basically to evaluate our procedures and give options on what the alternative actions are when the Federal Reserve Board chooses to move the discount rate.

We are into the formal meeting. Since at the moment we have no chairman, I will turn [the meeting] over to Governor Seger, who is our senior [Board] member, to obtain a chairman and vice chairman for us.

MS. SEGER. As Mr. Greenspan says--I shouldn't call him chairman at this point--we have to select a new chairman and vice chairman for this FOMC year. I would entertain a motion for chairman.

MR. ANGELL. Oh, you want them separately.

MS. SEGER. Yes.

MR. ANGELL. I move Mr. Greenspan be chairman.

MS. SEGER. Okay, thank you. May I have a second or some more nominations?

SPEAKER(?). Second.

MR. SYRON. Move the nominations closed.

MS. SEGER. All in favor?

SEVERAL. Aye, aye.

MS. SEGER. Thank you.

MR. KELLEY. You were just in time, Dick!

MS. SEGER. Right. Now we need a nomination for vice chairman, please.

MR. ANGELL. I move Mr. Corrigan.

MS. SEGER. All right. Any additional nominations?

MR. KELLEY. I'll second Mr. Corrigan.

MS. SEGER. Thank you. All in favor?

SEVERAL. Aye, aye.

MS. SEGER. Thank you. I guess we have our officers.

CHAIRMAN GREENSPAN. Congratulations, Mr. Vice Chairman.

VICE CHAIRMAN CORRIGAN. Condolences, Mr. Chairman.

CHAIRMAN GREENSPAN. We now have to elect staff officers and I ask the Secretary, technically the Deputy Secretary--he's just been promoted--to read them.

MR. BERNARD.
Secretary and Economist, Donald Kohn
Deputy Secretary, Normand Bernard
Assistant Secretaries: Joseph Coyne and Gary Gillum
General Counsel, Virgil Mattingly
Deputy General Counsel, Ernest Patrikis
Economists: Michael Prell and Edwin Truman
Associate Economists from the Board:
David Lindsey;
Larry Promisel;
Charles Siegman;
Thomas Simpson; and
Lawrence Slifman.

Associate Economists from the Federal Reserve Banks:
Alfred Broaddus, proposed by President Black;
Richard Davis, proposed by President Corrigan;
Karl Scheld, proposed by President Keehn;

Sheila Tschinkel, proposed by President Forrestal; and
Jack Beebe, proposed by President Parry.
That's the list, Mr. Chairman.

CHAIRMAN GREENSPAN. If there are no objections, I will consider the list to be approved. The next item on the agenda is to select a Federal Reserve Bank to execute transactions for the System Open Market Account, and we recommend the New York Bank unless I hear any objections. Without objection, I assume that is approved.

MS. SEGER. I was going to push Kansas City!

CHAIRMAN GREENSPAN. I knew you were! That's the reason [I made a prompt recommendation.] We need to select the Manager for Domestic Operations and the Manager for Foreign Operations, System Open Market Account. The incumbents, of course, are Messrs. Sternlight and Cross. Unless I hear objections, I will assume that we approve their carrying on for the next year. I assume you have reviewed the Authorization for Domestic Open Market Operations and again, without objection, I will assume that that is also approved. I'll now call on Mr. Cross for a series [of recommendations]. Mr. Cross.

MR. CROSS. Mr. Chairman, this is the warehousing agreement proposal?

CHAIRMAN GREENSPAN. Yes.

MR. CROSS. Mr. Truman circulated a memorandum on this matter to the Committee and I concurred in the memorandum. The Committee will recall that at its meeting last March it agreed to a proposal to increase the warehousing maximum by $5 billion, from $10 billion to $15 billion. This was made subject to a Treasury request. In the event, the additional amount of $5 billion was not needed during the year and was not used; there was no Treasury request to use it. Indeed, the Treasury has taken an initiative, with our aid and encouragement, to reduce the amount outstanding under the present warehousing agreement. As you know, the amount outstanding has been reduced in the past months from $9 billion, which is where it stood when the Committee approved the increase, to $4-1/2 billion. The Treasury in reversing these amounts and reducing the outstandings to $4-1/2 billion has always urged that a cushion of unused capacity be retained in case there is a requirement for it, even though [the need] has been going the other way. We have made the point that we don't think the warehousing facility should be in continuous use and we have been helping and encouraging them in bringing the amount down from $9 billion to $4-1/2 billion. Our view is that the correct approach at this point would be to drop the additional $5 billion that was added last year and to seek the renewal of the facility at the present time with the pre-existing maximum of $10 billion. And I so recommend, Mr. Chairman.

CHAIRMAN GREENSPAN. Questions for Mr. Cross?

MR. HOSKINS. I have a couple, Sam. One is: What happens if we don't renew it? Does it automatically expire or is this a process that the FOMC has set up to review this annually? If so, I guess the idea is that the Committee is endorsing this kind of activity.

MR. CROSS. Well, there have been warehousing arrangements with the Treasury going back to the early 1960s. I would have to seek legal guidance on what would happen if at the time when there were outstandings the Committee did not authorize their continuance.

MR. KOHN. I assume they would run off as they mature.

MR. CROSS. I assume so, yes. The next ones that fall due are in May and June. Well, I don't know what the legal position would be. If there were no warehouse facility, I don't know whether that would mean that the whole $4-1/2 billion would have to be ended at this moment or--

MR. MATTINGLY. They would go off according to the terms. Is there a term on them?

MR. KOHN. Yes.

MR. CROSS. There are terms on them.

MR. MATTINGLY. [Each] would roll off according to its terms; there would be no additional warehousing after the resolution.

MR. HOSKINS. So, if we endorse the recommendation of $10 billion, would that essentially mean that the FOMC endorses the activity of warehousing?

MR. CROSS. It means that the FOMC endorses the continuance of this facility up to a maximum of $10 billion, yes.

MR. KOHN. The FOMC has been authorizing the warehousing on an annual basis when it votes on this.

MR. GUFFEY. Sam, what's magic about $10 billion as opposed to $5 billion, for example?

MR. CROSS. Well, as I say, the Treasury has taken the initiative and has acted to bring down the amount outstanding quite substantially in this past period. They have always made the point very clearly that in doing so they urge and would expect that there would be a continuation of this [facility] so that if conditions should change--and they can change--it would be available to them quite promptly in order to continue further warehousing. At this point conditions are such that it certainly does not look like that's the way it's going; it's going the other way. We're in the process of reducing our foreign currency holdings.

MR. GUFFEY. A follow-up question: If we were to authorize $10 billion, then it's up to them? We don't trigger it but they do? They could do this anytime they want to and we have to take it?

MR. CROSS. If we authorize the $10 billion, then typically we act on their request in providing the warehousing. Now, obviously, this is not an adversarial relationship, as far as I'm concerned. It's something that we talk to them about, work with them on, and deal with them on a daily basis. It has always worked satisfactorily on that basis.

CHAIRMAN GREENSPAN. Charlie Siegman, do you have anything you'd like to add?

MR. SIEGMAN. No. I think the Treasury's need for some contingency or a cushion for reserve is appropriate, given the uncertainties. Otherwise, we'd have to review this on an emergency basis rather than--

MR. CROSS. Any action to change this does get reported. If we leave it at $10 billion, that's outstanding until we choose to act otherwise or we look at it again next year.

CHAIRMAN GREENSPAN. I think we're still in the mode of trying to reduce our holdings [of foreign currencies] and that will continue. We have communicated that periodically to the Treasury, and I think we are just going to bring down gradually what we all think is an excessive position in this respect. It will take a while, but I think we're moving in the right direction.

MR. CROSS. We've made clear to the Treasury many, many times that we don't visualize this as a facility that should be in continuous use. It's there when conditions are such that it's required and it should be drawn down, or reversed, at times when conditions warrant. That's the basis we've been working on and the basis on which it has been reduced to $4-1/2 billion in recent months.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Mr. Chairman, for two years I was rather uncomfortable with this position. I am not uncomfortable with this $10 billion request. I feel that the Treasury was rather generous in moving in this direction, [based on] the Federal Open Market Committee's objections. It seems to me that they gave heed to the size of the fund, which was one basis for the objections. The second area that I was objecting to as a matter of principle is no longer valid in that we did call to the attention of the Congress [issues] about the appropriations process. If the Congress feels comfortable with the arrangement, I'm certainly on board in this context.

CHAIRMAN GREENSPAN. Any further questions? Would somebody like to move approval of Sam's request?

VICE CHAIRMAN CORRIGAN. I'll move it.

CHAIRMAN GREENSPAN. Is there a second?

MR. SYRON. Second.

CHAIRMAN GREENSPAN. Without objection, it is approved. We have three additional foreign currency instruments, which have to be approved. Would somebody like to move them?

VICE CHAIRMAN CORRIGAN. I would move that.

CHAIRMAN GREENSPAN. Second?

MR. SYRON. Second.

CHAIRMAN GREENSPAN. Without objection. The next item on the agenda is the memorandum from Mr. Mattingly, which is dated January 25th, on the Committee's Rules Regarding the Availability of Information. I specifically requested that individuals on the Committee be contacted to see what the general response to that draft memorandum was. There were several who had problems with it. My view is that if there isn't [virtual] unanimity on an issue such as this, it would be inappropriate for us to [approve] it or move on it. And I would suggest that it just be dropped at this stage. Hopefully we'll get our issues in this area resolved in a somewhat better manner. Nonetheless, we have to have a vote on the technical part of that memorandum before publication. Would somebody like to move that?

MS. SEGER. I'll move it.

MR. SYRON. Second.

CHAIRMAN GREENSPAN. Is there a second? Is there any discussion? Without objections.

MR. KEEHN. Would it be appropriate to ask what the nature of the objections was?

MR. KELLEY. Yes, I'd be interested also.

CHAIRMAN GREENSPAN. Don, why don't you comment?

MR. KOHN. Several members of the Committee and other presidents questioned the need for it. Several expressed the view that, indeed, whoever was doing this leaking knew it was wrong, so why do we have to pass more rules? A couple members of the Committee were concerned that the language having to do with verbal or unwritten--as well as written--material was overly broad and might end up gagging their ability to discourse in public even in the normal course of business without [divulging] anything that could be used in that way. Let's see, those were two of the reasons. Really, it was: Why do we need this? It could be misinterpreted; it could be used against the Committee at some point. It seems unnecessary, so why go forward with it? That was, I think, the general nature of the objections. Norm, do you--

MR. BERNARD. Yes, in line with your comment, the observation was made that the rules already contained the prohibitions and the authority for the Chairman [on this matter], so there was really no need to be more specific and draw attention to this.

MR. SYRON. Mr. Chairman, I understand that it is your intent just to drop this now, but do you anticipate that this will be reexamined and revisited?

CHAIRMAN GREENSPAN. No, if there is concern in the Committee that in order to respond to a specific problem we are creating too [cumbersome] an instrument--which is what I infer, basically, from the comments--then I would recommend that we just drop it and live with the problem that we have and hope that it does not get worse. Maybe we'll be fortunate and it will disappear.

MR.SYRON. I hope I'm not being gratuitous, but my own concern is that I think the problem that we have, if it continues, is a problem that threatens the viability of how we approach both the discussion and formulation of policy. So, if the problem were to continue, I think we would have to do something.

CHAIRMAN GREENSPAN. Well, unless somebody can find a means that is acceptable to the Committee on a virtually unanimous basis, I think we will have to live with this until we find some alternative.

MR. KEEHN. I don't have a solution to that problem, but just to express my view: I thought a greater degree of specificity was appropriate, and given the problems that we've experienced, I understand that it could be contentious.

CHAIRMAN GREENSPAN. If the issue comes up again and it is creating significant difficulties for deliberations in this organization, then it will be appropriate to [revisit] it. But somebody has to have an idea that is [unintelligible] formality. Okay, do we have to a motion? [Secretary's note: The motion was made, seconded, and approved.]

Can we now have a motion to approve the minutes of the previous meeting for December 18?

VICE CHAIRMAN CORRIGAN. So moved.

MR. SYRON. Second.

CHAIRMAN GREENSPAN. Without objection. Sam Cross, would you now bring us up-to-date on your operations since December 18?

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

CHAIRMAN GREENSPAN. Questions for Sam?

MR. HOSKINS. I have a question on intervention activities with respect to the mark, since that's the only currency involved in the intervention we've been doing. I presume that is supposed to be a sterilized intervention. The question really is: If we're pegging a rate like the funds rate, how do we know we're sterilizing it?

MR. CROSS. I think it happens automatically, but I defer--

MR. KOHN. If we didn't sterilize it, the supply of reserves would be changed and the funds rate would be different. So, I think in order to peg the funds rate, we have to sterilize it. If I can see that the funds rate is being basically determined by supply and demand for reasons--

MR. HOSKINS. Yes, but you're sterilizing around the funds rate and not around total reserves.

MR. KOHN. Either way I think it's--

MR. HOSKINS. Total reserves is what we think drives money and we're trying to get money to grow. So, if one is worried about the slowness of monetary growth, one might worry about this practice.

MR. KOHN. If we didn't sterilize it, then it would show through presumably to total reserves, to interest rates, to borrowing, or whatever it is the Committee is targeting.

CHAIRMAN GREENSPAN. Other questions for Mr. Cross?

MR. KEEHN. Sam, what is your sense of the outlook for the dollar? You say that, given the interest rate differential and other things that are putting pressure on the dollar, [downward pressure] is there. But is a precipitous fall likely here or just this continued downward pressure?

MR. CROSS. Well, it's very hard to predict because one never knows when something is likely to set off concerns about confidence in the [exchange] rate of the dollar, which could lead to a precipitous fall and spread to other markets and all the problems that that entails, since we obviously still have a large deficit that we still have to finance and have to attract the funds to do it. There has been downward pressure on the dollar and, as I say, it's at an all time low in terms of the mark. As to the prospects over the more medium term, there are some facts that tend to provide more encouragement about it. For example, the dollar at these very low levels is considered by many people to be quite competitive; and if this present period can be managed, then maybe that [sentiment] will begin to be reflected more in the exchange markets.

MR. SYRON. Sam, and Peter also: With respect to what you in the market hear, do you hear much more in the way of concern about overseas purchases of U.S. debt securities? How much has this been an issue and how much do people anticipate it becoming more of an issue? Or do they?

MR. CROSS. It is an ongoing saga. Every time we have a refunding the question arises: Will it this time be a party to which no one comes--a Stella Dallas party? But thus far, [unintelligible]. There continues to be foreign participation; it changes and at times has declined quite noticeably, but funds continue to come in. Peter, do you want [to comment]?

MR. STERNLIGHT. I don't think there's anything remarkably different about foreign participation. I'm hearing that there was good foreign participation in the three-year note that was just offered today. There is rather limited talk about what participation there might be in the longer maturities, but that's related more to the portfolio decisions of those foreign holders rather than about the particular [amount of] dollars at this point.

VICE CHAIRMAN CORRIGAN. What we are seeing though, Dick, is foreigners backing away a little from private securities of all kinds, including bank paper--certainly anything over 5 years. Even if it's from Morgan Guaranty, it cannot be sold overseas.

MR. SYRON. But this is a financial fragility risk question as well as a question about the dollar.

VICE CHAIRMAN CORRIGAN. Right, it's both.

MR. CROSS. Also, a lot of the activities in the foreign exchange markets reflects changes in hedge ratios. That [means that if] Japanese investors and these categories of large investors decide that they think the dollar's prospects are not good, they will change the hedge ratio without necessarily getting rid of the securities or anything like that. So, you can't detect this just by what is going on in the securities markets. There's an awful lot of hedging and dehedging and that is a very important factor.

MR. FORRESTAL. Sam, are these funds that are flowing in in connection with Desert Storm detectable in terms of coming through the foreign exchange markets? Are they continuing to cushion the--

MR. CROSS. They pay us in marks and yen and we feed them out in a manner that is like our normal customer business. In other words, we just try to make clear that this is not an action by us [so as not] to appear to be influencing the rate.

MR. FORRESTAL. So it's not affecting rates?

MR. CROSS. As far as we can tell, it has worked out quite well so far.

MR. BLACK. You haven't used the BIS on this have you, Sam? We have done this ourselves?

MR. CROSS. We have used the BIS for some portion of these sales of foreign currencies, so that we're not seen in the market to appear to be selling. Thus far, it seems to have worked out satisfactorily.

CHAIRMAN GREENSPAN. Anything further for Sam? If not, would somebody like to move approval of his transactions of yesterday?

SPEAKER(?). I move them.

CHAIRMAN GREENSPAN. Is there a second?

MS. SEGER. Second.

CHAIRMAN GREENSPAN. Without objection. Mr. Sternlight.

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

CHAIRMAN GREENSPAN. Thank you, sir. Questions for Peter? Tom.

MR. MELZER. Peter, I wanted to ask you about your thoughts on the instability of the funds rate. Do you view the instability as a problem, which seems to be what you've implied, in terms of markets knowing where we are and other interest rates not being affected? Maybe it isn't a big problem, but I'm sure there are other problems in terms of overnight financing and that sort of thing. So my first question is: Is the instability a problem? Secondly, do you think it will persist as some of these seasonal factors affecting reserve balances, cash, and so forth pass? In other words, are the reserve balances adequate to handle the clearings? And, finally, assuming they aren't, what do you think we can do about it?

MR. STERNLIGHT. I think it has been something of a problem. We've been somewhat lucky in that we've been able to communicate policy moves as well as we have without that process getting confused. So, I wouldn't say it was such a problem that it kept us from doing the essentials of the job, but it was something of a problem. As to whether it's a temporary or more lasting phenomenon, I think the severity should be ameliorated from what it has been as the players get used to the new factors and partly because we're just now coming through a reserve period where the need for maintaining balances at the Fed to satisfy reserve requirements is exceptionally low. It's a seasonal low point for balances at the Fed because cash is seasonally high and reserve requirements are seasonally low. Also, there has been a gradual build-up--rather modest so far, but ongoing--in these required clearing balances. More and more banks have looked at the possibility of [establishing] these required clearing balances to pay for Fed services and that has gone up about $500 or $600 million since mid-December. I know that's true of a number of large banks; and undoubtedly many small banks also are looking at it now. So, I expect to see something more there. But I don't know if that's going to be enough to erase the problem totally. I suspect there's going to be some lingering element of greater volatility looking ahead. As to what can be done about it, probably the best thing--if one could have a wish list on this--would be to be able to pay interest on required reserves. But that would take Congressional action. We've been considering, and some market people have suggested, the possibility of bigger reserve carryovers. I think that could be of a little help but rather limited; it takes more looking to decide just how much help it might be.

MR. KOHN. Bigger and longer, too.

MR. STERNLIGHT. Also, there has been a suggestion that the banks have more than one period in which to use excess that developed in a given period. The suggestion has been made to have the Desk enter the market later on the same day. I would see very little net gain from that just because we're physically limited in how late we can go in and still achieve delivery in the day. So much of the greater volatility has come after that point in the afternoon. But we really don't have much more information, let's say, at 1:00 p.m. than we have at 11:00 a.m. that would give us much gain from later entries.

MR. PARRY. Do these developments suggest that the level of reserves that banks are required to hold is very close to what they would hold if there were no required reserves?

MR. KOHN. Yes, it suggests that they're close to what they would hold for clearing purposes alone.

MR. PARRY. Isn't that sort of surprising? One would have thought that with a 12 percent requirement on transactions balances that would have [meant] much more [reserves] than a bank--

MR. KOHN. Transactions balances are a very small proportion of total deposits; they're less than 10 percent, or in that range.

MR. STERNLIGHT. And a great majority of banks, of course, are not bound at all. They have been meeting their needs fully with all cash anyway.

MR. KOHN. I think there is still a tax involved in this reserve requirement because if one were transacting with a private bank, one might hold these balances but at least receive compensating balance credits or earnings credit on them. They would serve double duty for you. We don't allow them to serve double duty, although that's part of what is going on. The banks are building up their clearing balances and those balances do serve double duty, but the required reserves [do not].

MR. PARRY. It is surprising that just that one change in reserve requirements, which didn't look like it was that much in terms of billions, just moved to the margin--

CHAIRMAN GREENSPAN. Do you have any idea what proportion of the balances are literally dedicated to paying or offsetting fees?

MR. STERNLIGHT. Well, required [clearing] balances are around $2.3--

MR. KOHN. $2.6 billion, I think.

CHAIRMAN GREENSPAN. $2.6 billion?

MR. KOHN. Right, but that's not included in our required reserves. We have about $16 billion of required reserves this week, which is the seasonal low, plus another $2.6 or $2.7 billion of required clearing balances.

CHAIRMAN GREENSPAN. So, it's still a small part?

MR. KOHN. Yes.

CHAIRMAN GREENSPAN. So, even if those were eliminated, that is not going to--

MR. KOHN. Well, I think that $2.6 or $2.7 billion will rise over time so that people feel more comfortable with the total level of their balances with the Federal Reserve.

VICE CHAIRMAN CORRIGAN. But the rate at which the balances now are turning over, whether they're required clearing balances or required reserves, has grown exponentially and is still growing. So, I don't find it surprising, Bob, that that last change had as big an impact as it had.

MR. PARRY(?). It's a fifty percent change.

VICE CHAIRMAN CORRIGAN. It's a very big percentage change. And if you look at the turnover as a proxy for transactions, it's still rising at a geometric rate.

MR. SYRON. Peter, with respect to the relationship between the RP rate and the funds rate: Have you had to alter your stopouts or other terms in an effort to get to a particular funds rate in this [intermeeting period]?

MR. STERNLIGHT. We have noticed, of course, the relationship of RP rates and the funds rate. We have done some looking into what might have brought about the relatively higher RP rate. Traditionally that has been a little under the funds rate. It may have something to do with just the volume of securities being financed; it may have something to do with name problems, in terms of some of the parties getting their financing. I wouldn't say it has been that much of a problem in trying to get to the funds rate that we want. We generally have an idea of the amount of repurchase agreements we want to do and we stop where we have to in order to get that amount done. But we'll also be conscious of where the stopout rate is and where it might fit in relation to what we are hearing from the market as to their expectation of the stopout. That might be a small factor in our decision about just how much to do on occasion, but I think it's a pretty small factor.

MR. SYRON. But there has been a meaningful change?

MR. STERNLIGHT. I don't think so.

VICE CHAIRMAN CORRIGAN. The other thing, too, that would make a difference that I don't think Peter touched on--but I guess Don will be discussing tomorrow--is the whole question of the use and administration of the discount window, particularly in terms of these end-of-day types of things.

MR. STERNLIGHT. Making for a very high funds rate at times [unintelligible] to come to the window. Yes, I should have mentioned that.

CHAIRMAN GREENSPAN. Bob Black.

MR. BLACK. Mr. Chairman, I have been on the [morning] call thus far this year and I think Peter handled this exceptionally well under very difficult conditions. But it necessitated his resolving these frequent doubts between the borrowed reserve target and the expected federal funds rate always, it seemed to me, on the side of the expected federal funds rate. And that's how he kept the market apprised of what we really were aiming at. Peter, I just wanted to ask you if you could remember a period when the relationship between the borrowed reserve level and the federal funds rate was quite as tenuous as it seems to have been [recently].

MR. STERNLIGHT. No extended period.

MR. BLACK. I hope there wasn't another because I know how you struggled with that.

CHAIRMAN GREENSPAN. Si Keehn.

MR. KEEHN. Peter, I agree with Bob's answer but as another operational alternative: What if you were in the market more frequently than once a day--frequently enough that you could deal with some of the volatility?

MR. STERNLIGHT. Well, as I say, we go in at that hour when we have our reserve numbers assembled. On rare occasions we've gone in earlier because we had to be sure of being able to do the job or because we wanted to register at an earlier hour some viewpoint as to conditions that were ongoing. So, there's a limitation at one end involving when we would have reserve information in our hands and that sets [the timing] at around 11:00 to 11:30 a.m. At the other end, if we're going to get delivery and have our operations effective that day, it can't be much later than 1:30 p.m. or so. So there's not an awful lot we could do under present institutional arrangements about the volatility that comes in mid and late afternoon and on into the early evening, which is when we get some of the greatest extremes of variability.

MR. BLACK. Si, one time during the week I was joking with members of the Board's staff [on the call], and Peter asked if we would mind stopping so he'd have time to get into the market. It looked like we were going to delay him unduly--which was unintentional by the way!

CHAIRMAN GREENSPAN. Lee Hoskins.

MR. HOSKINS. Well, this point has already been tortured by three other people, but the problem is not the market knowing where we want the funds rate; they know where that is. The problem is in the latter part of the day. What you said about having to have everything done by 1:30 p.m. sort of defuses my question; otherwise you could just stand ready to buy and sell at 6-1/4 percent as an alternative to what we're doing. That leads me to another question--really for you, Mr. Chairman. In this commission that you have just given to Don Kohn, are we going to consider alternative operating procedures? Was the mandate that broad?

CHAIRMAN GREENSPAN. No, we're restricting it to the very specific problem that was on the table. The other issue is so broad that the commission won't get back in time--

MR. PARRY. We need another commission.

MR. ANGELL. It would be pretty radical for us to be willing to say what it is we're really doing!

CHAIRMAN GREENSPAN. Bob McTeer.

MR. MCTEER. Peter said that authority to pay interest on required reserve balances might be helpful. Usually when that's discussed in the context of proposed legislation, it is coupled with authority for banks to pay interest on demand deposits. I just wondered: If you got both of those as a legislative package, would the second part of that help or offset the benefit of the first part?

MR. STERNLIGHT. I don't see a direct problem in terms of implications for open market operations. I think there are broader issues to consider, which the System certainly would want to think through in a legislative way.

MR. MCTEER. That would free up a lot of resources in the economy devoted to cash management and add a little efficiency I would think to the--

MR. KOHN. The last time the Board testified to the Congress on this, which was 5 or 6 or 7 years ago probably, we linked those two proposals partly because we were concerned about the politics of giving the banks money and enhancing their profits. We thought both of those were desirable for really very different reasons but [the proposed legislation] didn't go anywhere.

MR. BLACK. It wouldn't appear to be as much of a giveaway program now with the banks so troubled.

MR. KOHN. Yes, I think it probably would be welcomed.

MR. BLACK. If you could ever sell it, this is the time you could sell it.

VICE CHAIRMAN CORRIGAN. One thought on this volatility in the funds rate in a context in which it has been stipulated that there has not been an enormous problem in terms of policy transparency: I must say that I'm not sure I consider the volatility all bad. If nothing else, it may ultimately be consistent with a little more discipline and a little more order in the way borrowings are managed. As I said, I don't think it's necessarily the end of the world.

CHAIRMAN GREENSPAN. Is there any evidence that the failure to use the discount window is pressing everything on open market operations? Do you sense that?

MR. KOHN. Well, yes. I think that's part of what has been going on really for a couple of years now. I don't know that it's the shift of the borrowing function; the borrowing function has gotten down so close to the origin that it's hard to imagine further shifts. But I would guess, if anything, that in the last several months it has been worse.

CHAIRMAN GREENSPAN. If you do that in the context of lowering reserve requirements in general, it's double-hitting the System then.

MR. KOHN. Yes, the safety valve. I will talk about this tomorrow, but in some sense the safety valve of the discount window doesn't seem to be there and so we get these 90 percent funds rates that banks feel they have to bid before they come into the window. As Peter said, there has been a lot more use of the window, partly because they were just about forced--they had to [borrow] in order to avoid overnight overdrafts. I'm not sure that's so bad; it creates a little background in borrowing here.

CHAIRMAN GREENSPAN. Any further questions for Peter?

MS. SEGER. Can you open the [discount] window at night so they won't been seen going in? Would that help?

MR. BLACK. They already have been seen coming out.

MR. LAWARE. Let in the night air!

VICE CHAIRMAN CORRIGAN. There is this other point, too, that Bob McTeer raised and Si raised. Virgil, I forgot the nature of the authorization, but in the 1980 law I remember we stuck in a provision where there is the authority to pay interest on these--

MR. MELZER. Supplemental balances.

VICE CHAIRMAN CORRIGAN. --clearing balances or supplemental balances in a context in which the Board makes a determination of whether those supplemental balances are needed. I don't think it was just for monetary policy or even for clearing purposes.

MR. KOHN. No, I think it was for monetary policy purposes.

MR. MELZER. We had our lawyers look at that and their view was that we can't use that escape hatch right now. I think somebody else ought to check it out, but our view is that it can't be used.

MR. KOHN. I think the other point was that we can't reduce the reserve requirements--say, take them down to 8 percent and then put them back again and pay interest on the difference between 8 and 12 or 14 percent or something like that. There was some protection, I believe, in the [law].

MR. MULLINS. If we do see a legislative proposal for interest on required reserves, I'm afraid we'll have a [unintelligible] attached to the bank insurance fund. Peter, you mentioned the three-year auction. How did that go today?

MR. STERNLIGHT. Quite well. There was strong bidding. I just got a brief report on that and it came out about where we were expecting, at a 6.98 percent average.

MR. MULLINS. What about noncompetitive bids? Anything on that?

MR. STERNLIGHT. I did not hear.

CHAIRMAN GREENSPAN. Anything further for Peter? If not, would somebody move to ratify the actions taken since the December 18th meeting?

MS. SEGER. I'll move it.

CHAIRMAN GREENSPAN. Without objection. We now move to the chart show, with Messrs. Prell, Promisel, and Slifman.

MR. PRELL. Thank you, Mr. Chairman. We'll be utilizing the chart package that everyone should have. If you haven't found it, you may have another.

MESSRS. PRELL, PROMISEL, and SLIFMAN. [Statements--see Appendix.]

CHAIRMAN GREENSPAN. Questions for our colleagues?

MR. PARRY. First, I'd like to say that the presentation was very useful--particularly the last exercise, which was quite helpful. I'd like to press a bit more on this issue of the credit crunch. I think I understand how you characterized its impact but I wonder if you would do it somewhat differently. If you were to look at the causes of recession, such as higher oil prices, war, consumer confidence, or--as some outside this room might say--monetary policy, etc., where would you in an ordinal sense put the credit crunch? How would you characterize it--as small, as the top cause, or as the bottom one?

MR. PRELL. Well, I think the credit crunch was already at work prior to the downturn. As you know, we've discussed that over the course of the past year and we would characterize this in some nonquantitative way as a significant but not huge effect. If one could somehow embody this in GNP growth terms, it probably would be less than a percentage point--maybe much less than that.

MR. PARRY. Some rather to these other--

MR. PRELL. By our reckoning, the oil price shock--just the direct normal type of oil price change that we run through econometric models--would have had a larger effect as of the end of last year. We think during this recent period that [other factors had] a much larger effect than oil prices. Certainly at this point we ought to be seeing a turnaround in terms of the oil price effect and we'll be seeing what other things are in train. The even greater unknown in all of this is [what] psychological damage was done by the oil price change, which probably summoned up in people's minds recollections of a couple of earlier major shocks that were followed by recessions. I suspect that it created in many people's minds the specter of rising unemployment and so on. There also was the war aspect of the situation, which may not have been a very positive factor in people's thinking, though I must say historically--for example, in the Viet Nam war--it's not entirely clear that people become grossly negative in their expectations and their sentiment as there is an increase in military activity. But my sense is that that has not been a big plus for sentiment. And we had last fall this debacle over the budget. If we all think back to that period, we'll remember what an appalling spectacle that was; and it probably had at least in the short run a rather devastating effect on people's assessment of whether the government here in Washington really had a handle on economic affairs. I haven't seen any concrete evidence that this financial fragility and the failures of banks and so on stand out as factors in people's thinking; but I think it has to be a negative, too, for consumer sentiment. On top of all this, we've had fiscal restraint of a modest degree in train for a while. These things cumulate to a very considerable damping effect at least on economic growth. And with the oil price change and the war I think it put us into negative territory. That's my crude [analysis].

CHAIRMAN GREENSPAN. Bob Forrestal.

MR. FORRESTAL. Well, I too, would like to compliment the staff on a very good chart show. They're always good, but this one was particularly helpful.

CHAIRMAN GREENSPAN. It was really quite innovative, I think.

MR. FORRESTAL. Very innovative, yes. I might ask a question about the alternative export forecast: If that turned out to be the case, how much would that shave off your real GNP forecast? Would it be a substantial decline?

MR. PROMISEL. Well, at $15 billion, if you take the $9 billion out of net exports it is something on the order of--

MR. PRELL. It's something under 1/4 percent [on] real GNP. But, as Larry pointed out, that was on the assumption that you stick to a previously assumed monetary expansion path. If you wanted to offset that, you would raise money stock growth and let interest rates fall and you would have some offsets through exchange rates and effects on the interest-sensitive sectors of the economy. So, it would not be such a large shock and not at all difficult to offset through a moderate policy adjustment if you saw it coming.

CHAIRMAN GREENSPAN. Other questions? Bob.

MR. MCTEER. I guess the most striking thing about the real GNP forecast was the abrupt turnaround from the current quarter to the next quarter. I notice from your Chart 13 that over 1/3 of it is inventory investment and, since that happens again in the next quarter, I assume that's intended inventory investment rather than involuntary. What makes you think that inventory investment is going to be so strong in the next three quarters?

MR. SLIFMAN. First, it turns out that in the second quarter itself we still actually have some liquidation going on but the rate of liquidation is slower than in the first quarter, so in a GNP accounting sense it shows up as a positive number here. We do, however, start to get some accumulation beginning in the second half of the year. But the amounts of accumulation are very, very small in dollar terms. Again, it's because of these swings from rapid liquidation to slower liquidation to a small accumulation that in GNP terms that winds up adding to real GNP. That is really what I was trying to show on the preceding chart, Chart 12, where you can see that even during part of that projection period we still have GNP below final sales and then it rises just very gradually. We think it's a very modest amount of inventory accumulation that takes place; in fact, the inventory/sales ratio that's consistent with this actually falls for a while and then basically just flattens out at these historically low levels.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. Mike, several people have commented on the chart show, which really was first-rate, but let me just add to that. I thought the paper that you circulated on potential GNP, etc., was absolutely marvelous. I don't know what your practices are about publishing those kinds of things but I would hope it would be published. It's really an excellent piece of work.

MR. PRELL. Thank you. We haven't really thought about publication but we'll have to give it some thought.

VICE CHAIRMAN CORRIGAN. It really is, as I said, an absolutely first-rate piece of work.

CHAIRMAN GREENSPAN. Dick Syron.

MR. SYRON. Mike, just a question, going back to what Bob asked. Though it's not enormous, the swing in the impact of government [spending] in the second quarter is 0.3. How much of that is state and local and how much is federal? It may be reflecting what we see all the time but I'm becoming more and more bearish on the state and local [sector].

MR. SLIFMAN. Actually, it's a very small amount, as you can see. In terms of our forecast we see it basically all coming from state and local purchases. But they're very small; they're growing 0.3 percent, which is a very small number. The federal net real purchases are falling. What we really have in terms of the state and local sector is some construction going on but not very much.

MR. SYRON. But the 3/10ths might be just GNP?

MR. SLIFMAN. Right. And it turns out that that also happens to be the growth rate as well.

MR. SYRON. Okay.

MR. SLIFMAN. They happen to match up in that one instance.

MR. PRELL. Are you referring to the second quarter?

MR. SYRON. Yes.

MR. PRELL. Well, in the second quarter there's actually a little uptick in federal spending, but it's only 2-1/2 percent. But your point on state and local [spending] is well taken. In fact, we've lowered our projection of state and local real purchases in this forecast and we only have a 1/2 percent increase this year, which assumes probably some decline in construction spending--an area that really had been surprisingly strong through last year. We've been surprised on the up side fairly frequently over the past year or so that this apparent fiscal problem has not shown through on spending. Obviously, on some of it there's a lag. They sold bonds earlier and are going to go ahead with some of these infrastructure investments. But we expect that there will be some crunch there; obviously, a number of you are familiar with rather dire situations in your locales.

MR. SYRON. Thank you.

CHAIRMAN GREENSPAN. Bob Black.

MR. BLACK. I have a question to which probably everybody except me knows the answer on Chart 3.

MR. PRELL. That's promising; that's my kind of question!

MR. BLACK. This is shown as a percent of real federal purchases. What is the fiscal impetus there?

MR. PRELL. I'd be happy to send you a descriptive memo, but it's a measure we developed that unlike the high [employment] budget surplus--which you know is a measure of discretionary fiscal policy--basically rates various components of the budget according to their impact on aggregate demand as revealed by econometric relations. It strips out some of the trend elements and gets rid of some of the one-time sorts of financial effects that at times distort the high employment budget. For example, in the high employment budget currently those contributions from foreign countries would show up in the normal calculation as additional revenues and greater fiscal restraint. And it's somewhat counter to [logic] to think that if somebody else pays for it instead of having to pay for it ourselves that that's additional restraint on aggregate demand. So, this measure doesn't include that sort of thing. And we think it's probably a better way of capturing things. We've run this in terms of horse races against other measures of fiscal policy in determining GNP and this seems to work better.

MR. BLACK. Yes, I would be interested in seeing your memo. I'm sorry I was the only one who didn't understand.

MR. PRELL. I hesitate at times to use this because I know it's a more obscure measure, but I thought that under the circumstances--

MR. BLACK. I was just curious. I was trying to figure out what it could be and I couldn't come up with anything.

MR. MULLINS. It's a way to characterize a $300 billion budget [deficit] as fiscal restraint.

MR. PRELL. Clearly, there was a package of cuts in expenditures and hikes in revenues enacted last year and that's the basic process that's going on here.

CHAIRMAN GREENSPAN. Lee Hoskins.

MR. HOSKINS. I, too, want to compliment the staff on its professionalism and objectivity in presenting this very interesting report. I have one question with respect to the longer-term averages that you present here. A naive and uninitiated person--nobody at this table, of course--could read this as saying that with the baseline [policy] we will average 2-1/4 percent [real growth] for 5 years and if we have an easier monetary policy, a pro-inflation policy, we will average 2.6 percent. So, over long periods of time it looks like if we have a pro-inflation policy or rapid money growth, we'll have higher rates of real growth. And that simply doesn't seem to [happen] over the longer periods of time. I presume your answer is that 5 years isn't [a long] enough time period.

MR. PRELL. A different way to look at it is that there's an aggregate supply function out there and an aggregate demand function. If monetary policy keeps pushing the growth of aggregate demand out there faster than aggregate supply will support, we're going to end up with accelerating inflation. And that's the message that this is intended to convey. There will be a lot of dynamics over a period of time if we are right and you kept pressing against that. But that's, I think, the interpretation of this data. Obviously, there are significant uncertainties, and I think we underscored this in the report. Larry's reason for presenting the band on it was to suggest that on a statistical basis 2.6 percent is almost as good an estimate as 2.3 percent. Where the issue arises is if you take the more optimistic view, say, of the Administration and you're talking about 3 percent plus [real growth]. That begins to press pretty hard against our confidence intervals here; that's stretching it. But there are lots of assumptions made about the future in this and this is just our best guesstimate--as careful an analysis as we could do.

MR. HOSKINS. If you were to run your model with expectations of some degree of credibility or full credibility, would you expect to get the same results?

MR. PRELL. I don't think credibility would be--

MR. KOHN. Are you referencing the Bluebook?

MR. HOSKINS. Yes, the one that has the five-year average.

MR. KOHN. Right. It's our view, which we expressed in the Bluebook, that we could get either the [unintelligible]. However, if [the Federal Reserve] had some credibility, we think the tighter alternative would give you some combination of higher output and lower inflation than presented here. These simulations embodied entirely backward-looking expectations.

MR. HOSKINS. Built on the 2.3 and 2.6 percent projections for--

MR. KOHN. I think that's also noteworthy with respect to your observation about real GNP over this time. In some sense it helps that we've started above the assumed natural rate so that you can push the economy for a little while. It's a bit like Mike's alternative simulation. Inflation takes a while to begin picking up because we don't drop below the natural rate for a time. So, in some sense this was a favorable starting point for a more expansive policy. But you'll note that when we get out to 1995 finally, we do have lower growth in output; it's a little higher level of output and we do have a soaring inflation. At some point, presumably, the Fed would have to [rein that inflation] in.

MR. PRELL. And the same point is made simply in our Greenbook forecast: in essence that over the next seven quarters after this one the economy is growing at a rate clearly above our estimate. But it's an environment of decelerating prices because we're above the natural rate.

CHAIRMAN GREENSPAN. Any further questions? If not, why don't we take a coffee break and come back and do the tour de table.

[Coffee break]

CHAIRMAN GREENSPAN. Who would like to start the round table? Bob.

MR. PARRY. Thank you, Mr. Chairman. The Twelfth District economy continues to blend recessionary problems in California with robust growth in the rest of the region. The California economy continues to experience weakness similar to that of the rest of the nation, although some data indicate that conditions may be improving. Employment in January registered a 1.1 percent decline from a year earlier, with weakness reported in durable goods manufacturing, construction, and retail. Agriculture has suffered at least $1 billion in crop losses because of the freeze and it looks as though there could be significantly greater damage if the water cuts actually take effect as a result of the very serious drought. The remainder of the District states continue to report relatively strong growth. Outside California, employment in the past year has grown 3.3 percent. Individual state growth rates range from a low of 2.3 percent in Hawaii to 6 percent in Nevada. But Hawaii is a very interesting situation. They're not growing because they don't have a growing labor force; they have an unemployment rate of only 2.8 percent. Despite relatively sluggish retail sales, trade employment still has grown 3.2 percent in the rest of the District. And employment in services has grown a solid 5 percent.

I have two interesting vignettes about the effect of the war on the economy. who is a very large retailer with stores predominantly in the West but also on the East Coast. He said that they didn't have the best Christmas but that sales really started to pick up right after Christmas and then just went down the tank on the 16th of January. I called him last Friday and he said that sales have started to come back a bit, so apparently there must have been a very quick reaction, probably because people were watching their televisions.

VICE CHAIRMAN CORRIGAN. The CNN effect!

MR. PARRY. The other vignette is from He said that the Prime Minister of Japan made a speech about the inappropriateness of people vacationing if they are draft age males; it wouldn't look good to the rest of the world. And in the week after the speech there were 2,000 cancellations [by Japanese tourists] of reservations in Hawaii, each one of whom typically goes for 4 or 5 days and spends $500 per person as opposed to $125 spent by U.S. tourists. I just thought those stories were rather interesting.

If I can turn to the national outlook, we are expecting a short recession and a moderately strong recovery, assuming that the war in the Gulf is over by spring and oil prices remain low. Our forecast, as it turns out, is very similar to that of the Greenbook. And we do expect the inflation rate to come down to about 4 percent or a little lower both this year and next. However, I'd like to add that to prevent a subsequent rise in inflation, it seems that we're going to have to respond to the economic recovery by tightening policy in a timely fashion, which of course is assumed in the Greenbook forecast, just as we've recently eased policy to prevent a deep recession.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, starting with a comment about the national economy: Our forecast is considerably more modest than Mike's rosy scenario. But I am pleased that our forecast is comfortably included within the central tendency. We have a couple of particular differences: First, and this really relates to the Greenbook, we expect a pretty significant reduction in consumer durables in the second quarter rather than a very large pickup. That difference probably relates to the automotive sector, which seems to us to be very much on the optimistic side in the staff forecast. I'll make a comment or two about the automotive sector in just a moment. The second significant area of difference is on the export side. Our expectation for import growth is a bit more modest than the Board staff's, but the difference is more particularly on the export side; we just don't think that exports are likely to grow to quite the level that the Board staff shows in their forecast. And that really accounts for the differences in their forecast and ours.

Turning now to the District: As I have been reporting, the District really is doing quite well compared to other parts of the country but we are now catching up. Clearly, a shift is taking place; certainly, more and more within the recent couple of weeks, our region is taking on the aspects of a fairly classic manufacturing recession. So far it's mainly auto-related. The Middle East events have resulted in an almost total shift in attitudes with regard to the outlook in that sector. At this point it's very hard for automakers to keep any semblance of a normal production schedule. Normally, they set their production schedules pretty far in advance. But now they are meeting frequently--about weekly--and the tendency is to reduce production week-in and week-out. As a result of significantly reduced retail sales, dealer inventory is building up in terms of the number of days stock on hand. And, therefore, the dealers' attitudes are just terrible and dealer orders have been cut back substantially. [Their sales] are running at about 50 percent of last fall's levels, and last fall was pretty weak to start with, particularly if you take out the fleet aspect of that. So, the dealer orders from the manufacturers are very, very low. Employment levels and production schedules have been reduced substantially and at least one company that I talked to would expect that production this quarter will be down 11 percent from last year, which was not in itself a strong period. They would further expect that the risks are on the down side with respect to incoming orders, and it's entirely possible that their production in the first quarter will come in 24 percent below last year. As they add their production and the production for the other manufacturers together they would expect that this would have a negative impact on the first quarter GNP by about 1 percentage point. It's far too early to tell what is going to happen to auto production in the second quarter, but certainly it's going to be down compared to last year. And as you would expect, [the impact of] autos is now moving into the supplier community and the suppliers are seeing very, very sharp curtailments of purchases.

That's the bad news. There is some better news. The steel business--and I found this surprising--is quite good. The orders are continuing to come in at reasonably good levels and firms are operating currently at a level of about 83 percent of capacity. The current estimate for shipments this year is 81 million tons. That's down from 85 million tons last year but is still a pretty good year, at least as they see it now. And I think, encouragingly, they are exporting steel at pretty good levels even to Japan. I do think the steel industry is one where the competitive aspects have improved very substantially just in going through the last three or four years. Machine tool orders are surprisingly strong; some of that goes into the auto sector. There will be substantial retooling in the auto sector as they come up with some new models over the next year or two, so that has been strong. Agricultural equipment certainly is going to be down; they have cut production substantially in this quarter but not nearly as much as the auto sector. The production plans for the remainder of the year are expected to be down about 12 percent.

I end up with a comment--an anecdote really--on retail sales not unlike Bob Parry's. I talked with a guy who runs a specialty chain store that has operations all over the country. They had a good year last year and a good Christmas season. But as of January 15th there was just a complete shutdown of retail sales, unlike anything he had experienced in his life,. He mentioned one story about a conversation with one of their salesmen he had seen when he was in New England. The salesman had just completed the sale of a large couch to somebody. As they were completing the paperwork, the buyer was just filled with apologies that she was buying the couch. She made the point that she thought it was a bad time; she was embarrassed to be making a purchase at this particular time but the family desperately needed a couch to sit on and that's why they were doing it. He suggested this is symptomatic of the attitudes that people have; they are quite worked up about this [war in the Gulf]. And as a consequence, his retail stores are really quite void of people. He doesn't think this will be a continuing effect, but for now it has had a very significant impact on their sales.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Starting with the District, Mr. Chairman, conditions in the Sixth District remain weak, although it does seem that the earlier deterioration is ending. The unemployment rate is averaging higher than in the rest of the country and we think it's going to continue to be that way for some time. The export sector is doing fairly well, although we've noticed that we've lost exports from the Sixth District to the Soviet Union and the Persian Gulf in recent months. That reflects some agricultural products, particularly rice. And I was very surprised to find that we're losing the sale of carpets to Saudi Arabia. I didn't realize we were selling carpets there, but apparently it has been a big factor.

MS. SEGER. They put it on the desert to keep down the dust!

MR. FORRESTAL. Is that what it is?

MR. BLACK. They're not Persian carpets, are they?

MR. FORRESTAL. Obviously not. The energy sector seems to have softened somewhat after it became pretty clear that increased OPEC production and heavy inventories would keep prices down. And the District's [energy] producers are still seeing quite a heavy shortage of skilled workers, as we have talked about before. The rig count in Louisiana was down 9 percent from a year earlier and the offshore count was 7 percent lower. Even though the data we have continue to be uniformly negative, I would say, based on the contacts that I've had personally and that our staff has had, that there seems to be a little less pessimism about the situation, even with the war in the Persian Gulf. People are convinced, I think, that the steady deterioration has slowed up if not stopped. And bankers are seeing a bit more light in terms of the demand for funds. As a result of all this, we are looking for a somewhat better situation in the District, although in my view the recovery in the Southeast as well as in the nation is still pretty fragile.

Looking at the national economy, our forecast is quite similar to the Greenbook forecast but it is weaker. We show a somewhat smaller decline in the present quarter but the rebound over the rest of the year is not quite as robust. One of the differences that we have--and this has been alluded to by someone else--is that we don't see as much of a contribution coming from the export sector. It seems to us that the improvements in net exports are not going to be quite as strong [as in the staff forecast]. As a result of this lower growth rate than the Greenbook, we obviously see a higher unemployment rate toward the end of 1991. But our estimate of inflation is somewhat better--in fact quite a bit better--than the Greenbook. We are anticipating inflation, measured by the CPI, of about 3 percent; looking at the chart, I think we're at the low end of the forecasts. These forecasts, of course--both the Greenbook, I assume, as well as ours--did not take into account the easing action of last Friday. So, if you look at those forecasts in that light, perhaps they represent a worst-case scenario. But I'm not convinced that that's the case. It seems to me that the recession could last somewhat longer and be a bit deeper than we're forecasting. Both our forecast and the Greenbook forecast seem to me to be quite reasonable. But I think the uncertainty surrounding the general economic situation and the situation of the Persian Gulf threatens any potential rebound in consumer confidence and consumer spending.

The deterioration of public confidence or the lack of confidence in the banking system also is going to be a major factor. The credit crunch perhaps is not getting any worse, but the announcements that keep coming forth from the press and on the talk shows about weak bank earnings and the potential FDIC losses and a deficit in the FDIC are really quite adversely affecting sentiment and raising considerable concern about the public costs of dealing with these problems. And the rise of bankruptcies may be working in the same direction. My point is that even though I believe the Greenbook forecast is a reasonable one, although a bit rosy, I think the risk is still very much on the down side.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. In the District, weakness is widespread. I suspect we have several more months of downturn, with the beginning of the recovery more a second-half phenomenon than a second-quarter one. Attitudes are really very, very cautious both among business people and individuals. And we see bank assets continuing to slide, with a couple of banks close to the edge. Real estate is probably several years away from recovery, especially on the commercial side.

In the nation, I think the staff forecast, while well thought out, is on the rosy side. We can't be very sure of any forecast at this point. I think we just need to keep an open mind and stay alert to incoming information. I'd rather err on the side of too much stimulus at this point rather than too little because I think the costs of misjudging and having a prolonged and deep recession are very [high]. Having said that, I think we have to be prepared to offset it with some tightening at some point. But we simply can't afford to have a prolonged, deep recession, given what is going on in the financial system.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Actually, Ed Boehne and others have said much of what I wanted to say. In terms of the situation in New England, unfortunately, I don't think one can characterize it any other way than as dismal, with pessimism on the edge of panic. At this point there really is no source of strength with the possible exception of Patriot missiles for which Raytheon is running three shifts a day, seven days a week. When people turn on CNN there is almost a perverse desire to see another one go up because it means more production!

MS. SEGER. How many people do they employ?

MR. SYRON. About 2,000 in that particular facility.

There is some export strength. As for employment, though we started at a substantially lower unemployment rate and a higher per capital income [unintelligible] the 1973-75 recession years, the decline in employment we're seeing in New England now is at a substantially faster rate than at any time in the postwar period. That also holds true for the change in growth in personal income. This is having the impact you'd expect. Retailing is extremely soft; we're seeing very widespread discounting of all merchandise. When we talk to retailers they say: "Once this inventory is gone we are not building any inventories. We're tired of doing this." Actually, that may be somewhat favorable in the longer term. We're seeing a change in the composition of the retail outlets, even in fairly affluent neighborhoods, more toward discount stores. Tonier places are closing and there are more vacancies. And we are seeing price improvements going along with this.

As you have all read, we have an extraordinary degree of financial nervousness. It's to the extent that on the talk shows every morning as you're driving in you can dial up and get the Tracy Report and for $20, which you can charge to your Mastercharge, you will be sent a list of safe Swiss banks where they say you should be sure that you have some of your money. We've shipped out close to $400 million in the last several weeks in emergency cash payments [because of] runs in Rhode Island. People are calling in to question the safety of the FDIC. There are some real concerns about our larger institutions. and some other mutual funds and insurance companies are raising questions with us about how they can be sure that they'll be protected if they have a fail in a repo transaction during the day and it goes into overnight or if they send in funds in anticipation of funds in an ACH transfer and an institution is closed. In fact they have come with proposals to have that stuff essentially swept off the bank's books onto our books overnight. The surprising thing is that the banks are so panicked about it that large institutions have come to us and asked if we can do this. I think the only way to look at the economy is that we have a long way [to come] back. A friend of mine just did a real estate forecast which is being hailed as greatly optimistic because he shows the beginning of some bottoming out and a snapback in 1995. Compared to a lot of other people's forecasts, actually it is relatively optimistic. The recovery there is going to be quite slow.

As far as the national economy goes, it seems to me that an awful lot has to do with what happens to confidence. Mike I think pulled everyone's line and appropriately so by saying "rosy scenario." I have been inclined, as have others, to accuse the forecast of being somewhat rosy. But in particular I think the simulations that Mike showed at the end are very useful in dealing with that. So much depends on confidence. No one knows how long the war is going to last. My own naive view of this was that if we had a sort of Nintendo war that was over in a week, there might be some great exuberance and people would feel like they should go out and spend. But even if this war goes on for several more weeks or a couple of months, I don't see it leading to a great bounceback in consumer confidence. As far as the oil price impact on confidence, relatively recently we've seen some improvement in oil prices. And I do have to admit that I bought the credit crunch story late in New England and now have to eat crow with a lot of people and admit that they were right. I think the chart you showed was very useful but we're not at the high point nationally in terms of where we'd be [with respect to] a credit crunch number. All those things weigh a little on the down side, so I'm inclined to think that the forecast may be slightly or a little more than slightly optimistic. But if that's the situation, as I say, I think the simulations or the scenarios that were shown at the end [of the chart show] are the way to go. Because of my own, perhaps biased, concerns about financial fragility, I'd be prepared to take out some insurance now with the notion that we would, as Ed said, make a commitment that we'd be willing to turn quickly if we're wrong and we don't need it.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Well, I was hoping I wouldn't follow Dick because I don't have any colorful adjectives to use to describe the District economy! I guess I would have to say it's mixed. The rural areas, because of the importance of agriculture, continue to do reasonably well. One exception is the areas where wood products are important. It took a little longer to hit them than I might have thought, but clearly because of the weakness in housing that sector has deteriorated. On the other hand, in the Twin Cities there is a lot of concern about many of the issues we've already touched on this afternoon. And while the objective measures of economic activity are still reasonably good, there are lots of signs of at least imminent softness in the economy.

With regard to the war, I haven't been able to judge what it has meant psychologically. There are a couple of objective things. Some of the large corporations have either eliminated or severely curtailed foreign travel as a consequence of the war. On the other hand, some of the firms that clearly have military business said their orders have just taken off. There is no question about that. The response has been large and very quick, and they, of course, are quite positive.

With regard to the national economy, like many others, I guess I'm not as confident as the staff about the recovery occurring quite as quickly and quite as robustly as the Greenbook suggests. It seems to me that even if this turns out to be a garden variety recession, it could well last into the spring and maybe even into the summer. In that regard, I thought the latest employment report was more or less consistent with that--suggesting that maybe this is a garden variety recession but that it has a way to go.

I can't resist commenting a bit on the credit crunch and the real estate situation. I think maybe we are exaggerating the effects of the credit crunch, at least in that area. In a sense we do have an inventory problem in the economy. It's not in manufacturing; it's in real estate. We simply have too many office buildings, too much retail space and, in many parts of the country, too much residential space. We know that prices are going to decline in that environment and they have. I don't happen to think that additional credit availability would help the situation at all. I can't think of any responsible way of addressing this problem. We're really paying for the excesses of the 1980s both in the real estate market and in financial institutions. We have to work our way through those. We have to let the market deal with this because the excess supply is apparent. As I say, I don't see any responsible way out of that.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. After only a couple of days on the job, I don't have a lot of firsthand knowledge of the economy in the Eleventh District except for the residential real estate market. I find myself buying into a rebounding market and selling into a market which is declining fairly rapidly. The Eleventh District, as I'm sure you are aware, ended 1990 out of sync with the rest of the country. It was either somewhat stronger or less weak, depending on what measure one looks at. Employment growth held up much better than it did in the national economy. In the fourth quarter there was employment growth not only in the government and private services sectors but even slight employment growth in the manufacturing sector and fairly substantial employment growth in nonresidential construction. Most of the growth occurred in the first two months of the fourth quarter and then the weakness started in December. Of the states in the Eleventh District, the strongest was New Mexico with total employment growing by 3.6 percent at an annual rate; in Texas and Louisiana growth was at annual rates of about 2.5 and 0.6 percent, respectively. Part of this had to do with the composition of the energy sector rather than primary oil or primary gas. Gas has been very weak and employment has been shrinking there. Oil drilling hasn't gone up very much in the Texas and New Mexico areas, but employment in that industry has grown somewhat as existing wells have been worked more intensively. Also, the additional profits and incomes that are resulting from the higher oil prices have added to the liquidity and spending power of the sector and have helped that part of the country do a bit better than the rest of the country.

As for the national economy, I believe I would be describing the Dallas research staff's view accurately in saying that they really have no quarrel with the pattern of the Greenbook forecast. They just believe that the expected rebound is not likely to be as sharp as the Greenbook has it.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. The overall pace of economic growth in the District appears to be slowing somewhat, due mostly to weakness in manufacturing and construction. Automobile manufacturing, for example, which we share with the St. Louis District, has weakened further. But the District aircraft manufacturers reported improvement in sales of business jet aircraft and as a result are showing a good deal of strength. Construction activity in the District remains weak overall but public works projects, such as a large public project in Kansas, continue to offset the weakness in both residential and nonresidential building activity. I might also say in reference to state and local spending that throughout several of our metropolitan areas there appears to be on the shelf--the bonds have been sold--infrastructure construction that will be commencing in 1991 and will hold up that sector somewhat. The oil price volatility and uncertainty about the outlook for oil prices is slowing activity in the District's oil patch. And sluggish export demand has led to weak prices in wheat, corn, and soybeans. On the other hand, the livestock prices continue to bolster farm income, and I would characterize the rural areas as being fairly optimistic.

There is one vignette I'll add to Bob's: In talking with a restauranteur who has stores across the United States in the mid to upper range of restaurants, they also found that [their business] virtually closed down on January 16th, 17th, and 18th. But by the first of February they were back at a level that they found encouraging. They attributed it largely to CNN and people sitting in front of the TV to determine what was happening in the Gulf war.

As to the Greenbook forecast, we also believe it to be rosy. That is, the pickup in the second quarter seems unlikely to us but we believe there will be the start of a pickup in the second half--probably in the mid to late part of the third quarter. We have growth about a percentage point below the growth projected in the Greenbook for the year 1991 but a percentage point above that projected in the Greenbook for 1992. So, averaging it out, the staff forecast does not look unreasonable to us; it is simply the timing and the contour of the recovery that we believe may be different than in the Greenbook. I would say that if the war continues beyond midyear, then all bets are off as far as we can tell. As I understand it, the best guess is that it should be over by mid-April.

CHAIRMAN GREENSPAN. The 18th!

MR. PRELL. In the a.m!

CHAIRMAN GREENSPAN. Saudi Arabian time.

MR. GUFFEY. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I think the staff has done a very thorough job in putting together their economic forecast but, like so many of the other speakers, I believe that it may be a bit on the optimistic side and that the risk of error with respect to real GNP is at least moderately tilted toward the down side. I think the staff is probably about right on its guess that the war may end in the spring but my fear is that it will be the late spring rather than the early spring. In any event, while the war is going on there are going to be a lot of continuing uncertainties and periodic setbacks and it's going to damp both business and consumer confidence as well as sentiment in the financial markets. Now, these negative impacts are going to be amplified, I think, by three big problems: the situation in the Northeast; the perceived fragility in the banking system; and the extreme weakness in commercial real estate in substantial parts of the country. So, we think there's a significant chance that the economy will recover later and probably less strongly than the staff is projecting. Our guess would be that the recovery might begin in the third quarter rather than in the second. And we expect only about 1 percent growth in real GNP on a fourth-quarter-to-fourth-quarter basis, which does not put us comfortably within the central tendency, as Si was, but labels us as an outlier in that the staff is predicting about 2 percent growth over this period. We also are an outlier on the inflation side because we're more optimistic about inflation under the assumption that we can avoid a long and destructive war in the Gulf. In addition to the effects of the declining oil prices on the CPI, we think that the underlying trend rate of inflation is going to begin to respond in '91 to the considerable deceleration that we've had in the growth of the aggregates over the last several years. I think it's quite possible that our core inflation rate for the CPI may be down to around 3-1/2 percent or lower by the end of the year.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. On the national scene, we're very close to the median; I'm not sure that has ever happened before but there's some statistical probability of that and I guess it occurred. In the short run, not surprisingly, our staff would view the major risk as being whether the assumption with respect to money growth, something in the 4 to 5 percent area, is realized. I guess I'm a little schizophrenic about that because I'm worried that it may be realized and then some. And in that context I think Mike's scenario 2 here is very instructive because we could have some considerable challenges ahead of us. We have to get through the one we're in right now but, as we've discussed in the past and as Bob Parry mentioned, I hope we will be ready to respond in the other direction when we need to.

CHAIRMAN GREENSPAN. That 8 percent funds rate is a quarterly average. What is the peak?

SPEAKER(?). [Unintelligible] percent.

MR. MELZER. In terms of our District, I don't have a lot to say. Our economy is stagnant, probably declining slightly. Perhaps with what is going on in autos and cancellation of the A-12, we'll have some further weakness showing up. Essentially, what has been going on is that manufacturing weakness, which is not as great as it is nationally, is being offset by strength in services--health services and business services, generally.

Just one last comment on the banking sector: I would say that when the year-end numbers come out, some weakness probably will show up; but our banks are still in relatively good shape. I was at our Memphis branch a couple of weeks ago and one of the bankers said "This kills me to do this, but I've got to tell you that I don't think additional stimulus from the Fed is really going to help. We're swimming in reserves; we don't know what to do with them. And the problem is that when we try to lay them off, eventually we get to the New York money center banks and we don't necessarily want to sell very much!" Another banker--these were both large bankers in that area--said that they have cut their fed funds selling by 70 percent in the last year. I took that to mean in terms of approved names on the list. So, that's a pretty dramatic shift.

MR. PRELL. Mr. Chairman, if I might just inject a point that perhaps we should have made in talking about that last simulation: According to our model, the additional M2 in 1991 would be about 2-1/2 percent. So, to give you some--

MR. MELZER. That's the incremental amount, Mike?

MR. PRELL. Yes, incremental M2 growth in 1991.

MR. MELZER. To bring it up to a total of what, Mike?

MR. KOHN. Seven percent.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. On the anecdotal side, the only thing I can say that is unambiguously good is that the weekend before last in Tampa, Florida, there were actually no signs of a recession. Quite to the contrary.

MR. KELLEY. Playing for the championship for the Second Federal Reserve District!

VICE CHAIRMAN CORRIGAN. That's right. But on a more serious note, the impression that I get from talking to businessmen and women and directors and others is that the statistics have basically caught up with their expectations, which had been distinctly sour for some time prior to the point when [the weakness] really showed through in the statistics. As I've said before, I do think that the real estate situation, at least in the greater New York metropolitan area--while not in the same category as it is in parts of New England--has not bottomed out. I think Gary's point is absolutely right: The excess inventory of real estate of all kinds is going to take a long time to work itself out. It's not just in the Northeast; I get the impression that this is pretty much a nationwide problem. Also, as several people have mentioned, one does get the impression that at least for a while in mid-January the so-called CNN effect was quite real in terms of retail operations and restaurants. They say it even showed through in the theaters in New York City. I have no independent evidence of that.

But notwithstanding all of that--and this is where we come to the great dilemma--if you go through the exercise of looking at the economy sector by sector, regardless of whether you rely on a formal econometric model or rules of thumb that you may have acquired over time, it's not that hard to see a short recession. Based on my own purely subjective instincts, having spent a lot of time going through that kind of analysis, if I had to make a guess I would probably say that the chances of an outcome that is somewhere around the center of the central tendency are probably 50/50. Indeed, I would think there's at least some chance that we could get as robust a recovery as Mike has in his forecast. But, of course, if we do get that, then we have an obvious problem of the second scenario on the last page of the chart show.

On the other hand, I would say that the chances of an outcome that is weaker than the central tendency--again this is not scientific --are probably about 15 percent or 20 percent. But unfortunately, I can't rule out the possibility of an outcome that is very significantly weaker, either. Now, I don't think that's the likely outcome but if you asked me whether we could have a long and really deep recession I think I'd have to say there's at least a 10, 15, or 20 percent possibility of that. Again, I don't think it's anywhere near the likely case, but I don't think one can rule it out. And the reasons it can't be ruled out in part get to the things that Gary was talking about: the overhangs of the excesses of the '80s. Some of Mike's charts on corporate cash flow positions and debt positions and things like that I don't think really capture how much of an overhang those things are. But on top of that I do think what we have is a recession that in the first instance is being driven by expectational factors, some of which are conditioned by those earlier excesses. But whatever the precise anatomy of the recession, the character of it, as I see it, is different enough that it is that much more difficult to judge how things will work their way through it, even in terms of this question of how much bang for the buck do we get from lower interest rates. I'm not sure. And because of some of these behavioral and expectational characteristics of current patterns of behavior it's very, very difficult to make that judgment.

On the credit crunch issue, again, I essentially agree with Gary's point. But I think there's also a little more to it than that. One really does get the impression--it's more than an impression because I have been told point blank even by the best banks in the Second District, and at least one or two of them are among the best banks in the country--that the banks simply are not doing things on the credit extension side anything like the way they used to, even to those who would have been considered good customers 8 or 9 or 10 months ago. And the rate of foreclosures as opposed to restructurings or stretchouts, especially in the real estate sector, is another symptom of that phenomenon. So, while I think it's fair to say that the credit crunch is exaggerated, especially in political circles, I think it's entirely fair to say, as Gary did, that it tends to reflect these excesses of the past. I still think it is a very important consideration in the current setting, especially as it bears on this all important question of confidence and expectations. That is one of the many reasons why I find that I can be so ambivalent about what I think is going to happen. I sit down with Dick Davis and his guys and they convince me in two hours that Mike Prell is right, or more or less right, and not to worry. Then I start thinking about it and I say: "I guess I am worried." And that's about where I am, Mr. Chairman.

CHAIRMAN GREENSPAN. Lee Hoskins.

MR. HOSKINS. The District's [economic] activity has softened since October but is still generally stronger than the nation's. The unemployment rate in Ohio is up about 1/2 point but employment is about the same; it hasn't changed much. In fact, if you look at [initial unemployment] claims, the peak seems to be in the first week of January at 44,000 and they declined gradually each week to around

24,000. The hardest hit, of course, are autos and auto-related industries; that has impacted steel companies, which are operating at about 70 percent. [Unintelligible] cited a recent survey by a bank of its customers and 85 percent of respondents said that in terms of new projects they have no trouble getting credit; in terms of operating monies, 91 percent said they have no problem. As for straight-out anecdotal information, the international airline with which I'm familiar, since my wife works for it, has offered a month off without pay to anyone who wants not to work. That's clearly associated with the war and lack of travel.

And you're probably all waiting for my stainless steel strip index, but I'm not going to give it to you because I've latched onto a new one: the Smuckers Index! I had a chance to talk with Paul Smucker, an elderly gentleman who has been through many business cycles and he told me that apple butter sales remain relatively soft and that's a good sign because during deep recessions apple butter sales soar. [Laughter] So, I'll be reporting to you on apple butter.

CHAIRMAN GREENSPAN. It sounds to me as though business is in a jam! [Laughter/hoots]

MR. HOSKINS. I'll make my comments on the national economy really short after that! As I look at it, I agree with the staff's view and also with what the Chairman has been saying. This is principally a situation where the downturn occurred as a result of the war and the consumer sentiment associated with that. With respect to problems in real estate, I think Gary Stern has it right: It's a long-term problem; there's no easy way out of it. And I don't think monetary policy can help either one of those situations. Now, I'm sitting here looking ahead at policy. There's a lag that we all know about, and we have a forecast that says the economy will be rebounding at about the time that the average lag says [current] policy is going to have an impact. So, I have some concerns about that, but I'll save those for Don Kohn. What I think we, from the point of view of a central bank, ought to be focusing on--[unintelligible] some of the concerns that people around the table have particularly from the areas that have been impacted hard--is what is happening to money. Perhaps some of you are interested in credit, but I would tend to focus on money. If we're going to worry about anything, I think we ought to worry about making sure that we don't permit a procyclical monetary policy at this point.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. My view of the economy is that the fourth quarter was not quite as bad as I expected; it looks like a contraction that is accounted for mostly by inventories, with much of it in the auto industry. The downturn still seems to be synchronized in the sense that inventories are in line with no serious imbalances, with the one exception of the commercial real estate inventories which are out of balance. But we have yet to see the imbalances. More recent data continue to have a sour cast to them, although the leading indicators were up in December; durable goods were also up but, of course, that [increase] was focused in certain areas. It bothers me a little that the purchasing managers index is still dropping and consumer confidence has yet to bottom out. Indeed, I agree with Jerry that the hard data are kind of catching up with the attitudes, and I wish the attitudes would stop moving for a while. I noticed this afternoon during the break that the 10-day auto sales reported this afternoon were at a 5.2 million annual rate whereas people were expecting a 6.3 million rate or something of that nature. When I look at corporate finance, it doesn't lead me to forecast a vigorous rebound either. I think the Greenbook mentions that 1990 was a year of record defaults; that's really probably just the overhang of the junk bond market. But 1990 was also a year of record downgradings in bond ratings and almost a record in dividend cuts--probably the greatest number of dividend cuts and eliminations since the late 1950s. And that just suggests that corporations, like banks and consumers, may be in for a period of retrenchment--a period in which they will rebuild their capital structures and bond ratings before they're ready for aggressive growth again. Against this doom and gloom of recession and financial fragility, the stock market continues to charge ahead and [the DOW] will approach 3,000 if it continues another few weeks at the current pace. Why is this happening? Perhaps the most common indices we look at are more weighted toward multinational companies and reflect the prospects in some of the--

CHAIRMAN GREENSPAN. But the stock prices of smaller companies have gone up even faster.

MR. MULLINS. [Yes], the difficulty is the smaller companies have gone up even faster. It is an interesting scenario when our staff says we will have downgradings this year. I assume from watching the screen that the downgradings are continuing at a pretty rapid pace, yet their stock prices are going up. Now, of course, that can happen in a period of uncertainty; when you're a highly leveraged company your bond prices can go down but your stock prices can go up. Still, I think it's hard to escape the conclusion that the stock markets see better times ahead. And while it is true that a lot of publicly traded companies do have access to the public debt markets and commercial paper markets, when you get down to the broad equity markets this is not true and that includes some of the growth companies. So, I would say that the long bond rate, which is now approaching 8 percent, confirms that the recession is here and inflation is under control; but the stock market tends to suggest that there's a light at the end of the tunnel. I don't know how much confidence one would want to put in the stock market as a forecaster, but the stock market has a rosy forecast. So, overall I see the economy still contracting at a slow pace. There's real uncertainty about the war. What will happen when the ground war starts? What will really happen to consumer confidence in that case? I tend to agree that the prospects are good for a rebound this summer. I also tend to agree with what a lot of people have said: that it's not likely to be quite as robust as [the staff] forecast. I think this--the war, the recession--has been a pretty sobering experience. People haven't experienced a recession in a long time. And with all the bad news about the financial system, it may take consumers and businesses a while to rebuild confidence.

As for the banking system, the credit crunch has been discussed pretty thoroughly here. I think some progress has been made in the [banking] industry. They made it through the end-of-year financing pressures and now not only has the fed funds rate come down but the other money rates--the CD rates and commercial paper rates--have come down pretty substantially, by [125] and 175 basis points.

This has really helped to open up the margins it seems to me; even bank stock prices have rebounded a little. And it has opened up a spread that might accelerate the process of financial healing in some of those institutions. We also have gotten through the fourth quarter and the results of another round of commercial real estate problems. The industry has absorbed another round of publicity about the bank insurance fund being broke; and also the public impact of the failure of Bank of New England is behind us. That was the most visible weak institution overhanging the market. Looking ahead, we may have another quarter or so of bad results to get through. And I'm afraid we will have a lot more publicity on the bank insurance fund that we'll have to put up with as well as a lot of publicity about the banking reform legislation, which will be accompanied by comments that the banking system is in trouble. I'm also concerned about the weak elements in the banking system and the need to get some of those weak components cleaned up rather than just waiting for them to fail into the bank insurance fund. I don't know exactly how to do that, but I think they could be a drag on the economy and on the psyche for a long time unless we can think of how to do that. So, overall on the banking system, I think we've had some progress, primarily in that the lower rates have helped the banking system; but there is a way to go in working through the bad news. I noticed noncompetitive bids in the three-year note auction were only $769 million, which is far below the $2 billion that people were expecting and the $2-1/2 billion that was the record. And what bothers me about the financial system is not only the direct impact on lending but also that the bad news about banks feeds directly into consumer confidence it seems to me. And then there's also the low probability but serious outcome of a crack in the financial system.

As others have mentioned, I think we have a good dose of stimulus in the pipeline: the reduction in the dollar--even as we speak, probably. Oil prices have come down without a real rebound in consumer confidence yet, as Dick noted, which would suggest that it's the war that is affecting confidence and not just the oil prices. And the fed funds target has come down 200 basis points since the summer; [rates on] long bonds are down probably about 100 basis points. Most of this has taken place without disrupting markets. I know there is a lot of uncertainty left relating to the war, and I still have concerns about the financial system; a lot of these concerns are captured in the money and credit data and I continue to think we should focus on money and credit, which are ultimately and appropriately our responsibility.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mr. Chairman, there are three things that puzzle me about the staff outlook for the economy as reflected in the Greenbook. First, the projection is based on far from firm and certain assumptions that there will be a quick and decisive end to the Gulf War and no substantial damage to Saudi productive capacity that would interrupt supplies. These assumptions underlie the further assumptions that oil prices will stabilize in the low $20s and consumer confidence will rebound promptly and decisively at war's end. No "what if" alternative, or worst case scenario is offered against which to make judgments pertinent to the proper course for monetary policy. Second, the degree of fragility in the economy is not really addressed. There is no quick end in sight for commercial real estate problems, and certain large segments of the banking industry are continuing to downsize and restrain loan growth. The current timidity of bank lenders is being compounded by depositor anxieties and deposit erosion to the perceived safer haven of government securities or money market funds. Third, it is not clear in my mind what role the banks are expected to play in the projected recovery. If fund flows are not to depository institutions but rather to Treasuries and to the money market funds, they won't be reflected in lending activity. In my view the economy is [experiencing] a paralysis of confidence which may not respond to the classic monetary policy moves to increase reserves and lower rates. Anxious consumers are loathe to spend or borrow. Businessmen are looking for clearer signs to invest, whether in inventories or plant. Governments plagued at the federal, state, and local level by unmanageable deficits are in a weak position to offer stimulus. And bankers, paranoid about overdiligent examiners, worried about capital levels, uncertain about the economy, and finding prospective borrowers weakened by recent economic trends, are refusing to lend. This spells out to me a recipe for economic stagnation. And I'm at a loss to understand how monetary policy can deal with it beyond sending signals that we hope the lookouts will see and interpret properly.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I would accept the staff's forecast or something close to it--maybe a bit less robust--as probably the most likely outcome. And, certainly, it's positive and desirable. But the concerns I have turn out to be ones that have run through this discussion over and over again. That is, I am struck in a way that I've never been struck since I've been here that the risk of war analysis is very, very heavily skewed on the side of caution. If we get a recession that is mild and ends soon and the rebound that follows it, that is going to present questions for monetary policy, without any doubt. But they will be happy kinds of questions, if you will, and they are going to be in a positive context. Again, that's probably the most likely scenario.

But I think the positive consequences that would flow from that result are not nearly as significant as their mirror image on the down side--the negative consequences that could flow if we get the opposite scenario. If the situation turns out to be much more severe, along the lines that Jerry described a few minutes ago, that could have some very nasty consequences that are much larger in scope than their positive counterparts on the other side. They're broader in scope as far as their impact on our society goes, and I think they are far longer-lasting in the effect they could bring. That has some likelihood, whatever it is, and it's certainly greater than zero--perhaps 15 percent. I don't know [the precise number], but there is certainly the statistical probability that we could get a much more severe result. If we do, and if we wind up with the seriously crippled banking system that John LaWare fears, for instance, it would be very difficult for that kind of a banking system to make it to the time when the economy was coming back around. I'm not sure where the financial contribution and support would come from if the banks have been crippled before that outcome started to take effect.

Obviously, the process of watching the banking system become crippled, if that should evolve, would have a severe impact on consumer and business confidence and would exacerbate the situation. We could have a very, very large deficit built up, which would have a very long tail as far as its consequences go: a much larger debt burden; the further fragility that would result from leveraging up the economy; and all those kinds of things that would follow from the leveraging up that we're all familiar with. I think it would foreclose--or at least for a very long time severely impinge upon--a variety of social and political options that we need to have available to us in this country as far as rebuilding our infrastructure goes, [ranging] from education needs to rebuilding bridges. It would have a very severe impact on business investment down the line and on various elements of our international position. And I would think that it would have to have severe inflation implications that really aren't necessary for us to have to undergo. Another point that I don't think is inconsiderable in the long-term scheme of things is that it would have a very severe impact on the possibility of constructive banking reform in the near future. We think that the time may have come for an effective reform movement. And if we got into a very severe recession right now, that would certainly doom the possibilities of the passage of a good package in the near term. So, we have a severe skewing that I haven't been conscious of in my thinking before, and I think it necessitates our looking at some things that sometimes we don't have to spend a lot of time on--a broader array of considerations and potential downside concerns as well as some very long-lived potential downside results that we would all hate to see ensue. All of which leaves me intrigued with the thought of investigating and considering further scenario 2 on the last exhibit.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. This event clearly is an event that doesn't happen very often. We really haven't seen [in a long time] such a switch in preference from wanting to be leveraged to wanting to have liquidity. We haven't seen such a period in which the creditors are not anxious to lend. This is a very significant event and it's an event that I don't think we've seen since the 1930s. This economy has a lot of factors that make for a very significant departure from the way we went through the events in the 1930s and the way we're going through them today. I agree with the staff's estimate in regard to the areas in which there are strengths. There are considerable strengths. And I tend to believe that of the factors on the export side particularly. It seems to me that this $20 billion per year payment from abroad--I don't care how you classify it--is really like an export of a military service. If you put that together with the other factors, our balance of payments certainly swings rather dramatically. But that swing in the balance of payments does mean that a saving rate move is going to go with it, and certainly the government sector is not going to be the source of that savings. And I doubt that the corporate sector is apt to add to that savings. So, I tend to think that there is somewhat less robust final demand in the consumer sector than I would expect. Frankly, if it occurs in the second quarter and it becomes evident that there are no more interest rate declines, then I would expect the foreign exchange value of the dollar to make a very significant turnaround. I would expect the foreign exchange value of the dollar to head back to the highs of 1989 in rapid order. That, of course, may then mean that later on we would get a slowdown on the export side. There is a significant downside risk that if monetary policy focuses on what I call a fairly weak economic scenario, monetary policy will not be neutral but in fact could be quite damaging to the spot [dollar] prospects. That is the most dangerous event that we're looking at here: to have the foreign exchange value of the dollar move into a decided destabilized position, which I think could cause the bond markets and the stock markets to reverse rather rapidly.

So, I'm looking at a scenario that I think is somewhat like [what was described by] some of the rest of you, but I tend to believe that monetary policy, if we're not careful, will make it worse rather than better. From June of 1989 we've decreased the fed funds rate by 365 basis points; that's a rather significant move. But it focuses upon the wrong rate in regard to what ails us. The right rate is the rate that the real estate market is facing, which is the long bond rate. And now for the first time in a long time we actually have long bond rates lower than they were a year [earlier]. And it seems to me that we are in a rather precarious [position] if we believe--and I guess I take this from Gary Stern and many others--that these corrections don't have to take place. If we believe that, I think we are mistaken. I think the correction with regard to household savings is underway and is going to take place and I think the use of monetary policy to deal with that has to be very, very carefully done so as not to make it worse rather than better. If we do not destabilize the situation, it seems to me that the rebound is going to occur. There are many factors [signaling] that. But if the dollar becomes progressively weaker, I don't think that will help us a bit on exports because in the mood of a war economy, with many countries in recession, that kind of environment could foster protectionist sentiment that could be very, very explosive.

So, even though I'm not quite as optimistic on the real side as the staff, I do agree with the staff's [assessment of the] sources of strength; I think they are there. And I'm comfortable with that, if we do not harm this situation. I would admit that I am rather bullish in that if the Federal Reserve policy doesn't destabilize the situation--and I'm going to sound a little silly perhaps when I say this--I would not be surprised if my forecast of the CPI at 3.2 percent [is wrong] for 1992. The reason my CPI is so high is because of what the foreign exchange value of the dollar put us through; and once the dollar begins to rebound I can see CPI inflation doing very, very well. And then [we could] get the correction that we need, which is mortgage rates in the 7 percent range in order to bring this about where we need it. You see, real interest rates cannot be homogenized at this point; there are real interest rates in every market. And the real interest rate for houses right now is pretty darn high. In a falling real estate market--when one does not expect house prices to rise, and even expects them to fall--real interest rates even after taxes may be extremely high. So, I think the key is getting long-term bond rates down; and that's a lot harder than getting short-term rates down.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I think most of my points have been made--12 times--but I will start off just by explaining an experience I had when I dug into my files to see what I had sent in this time last year for a forecast because I try to key off that when I do the next go-around. Last year I was the source of the low end of the range, in case any of you have forgotten. I had 1 percent real growth fourth quarter-to-fourth quarter, which was off the bottom of the chart. And what is making me nervous is that that turned out to be too high; as you know, it came in at about .3 percent. Anyway, having said that, I love Mike's forecast and I hope it is realized. Even though I'm leaving, I certainly hope that this is what materializes. But I must say that I'm a little skeptical that it will.

I'll just mention a couple of things. One relates to the assumed bottoming out of housing or the investment in residential structures. I realize I'm biased because I just met with a couple hundred homebuilders last month, but I really think there is a problem there. I think the credit crunch is still present in that industry, particularly on the side of builder financing. The United States is a big country and housing markets are local; there are zillions of them. They are not all like Boston or Denver or Dallas. There really is a housing shortage, especially in low and moderate income housing. We can use some more structures. So, I hate to dismiss this as something that we don't need to be concerned about. And I don't believe that we've seen the bottom yet on this; I don't think it's going to bottom out in the second quarter because of this credit situation. Also, on the consumer side: I would love to see the consumer come roaring back into the stores. It used to be VE day or VJ day--I'm aging myself; I don't know what this would be--[VS] or something.

MR. SYRON. VI.

MS. SEGER. VI or VIQ. Anyhow, I would love to assume that [that will happen]. I have no idea when the war will end but, whenever it does, I just don't think that in and of itself is going to cure all the consumer confidence problems because I think part of the confidence problem involves the war but another big part involves this continuing flow of bad news about the financial system. It's like having cold water run down your back continually and a lot of people are reacting that way. That's part of it, but also consumers are still very overloaded with accumulated debts. I saw in one of the presentations the quality of consumer debt deteriorating, mortgage defaults growing, and that sort of thing. So, I just don't think consumers are in shape to run right out and go on a spending spree if they feel like it.

Finally, on the assumption that exports are really going to carry a big part of the load: again, I would like to assume that. I'm impressed with how we have gotten our exports turned around. But as I hear about the conditions in other countries, such as Canada, that are our major trading partners and I think about their problems, I just wonder how strong those markets are going to be and, therefore, whether our exporters--no matter how good they are and how good their products are--in fact can achieve these kinds of results. Anyway, this certainly would be my preferred outcome; there's no doubt about it. But I just have a feeling that the timing is somewhat too optimistic and that whenever the bottom does occur the rebound from that low point will be more gradual and less sharp.

CHAIRMAN GREENSPAN. Okay. Why don't we recess until tomorrow morning at 9:00 a.m. You may leave your papers here.

[Meeting recessed]

February 6, 1991--Morning Session

CHAIRMAN GREENSPAN. Mr. Kohn.

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

CHAIRMAN GREENSPAN. Thanks. We're open for discussion on this issue. Let's do questions first. Any questions? Dick Syron.

MR. SYRON. Don, I find myself in great sympathy with what you said. I have a technical question having to do with this issue of V2 and the credit crunch--not the New England credit crunch, but the national credit crunch. The chart we saw yesterday in the chart show indicated that, in terms of this particular measure of the credit crunch, we are not in a much different place than we usually are at this stage in the cycle. But part of your velocity forecast assigns some weight to the credit crunch, doesn't it? It may be consistent with the earlier data; that's what I'm trying to get a hint on.

MR. KOHN. My interpretation of the charts--and I think Mike had the same interpretation--was that something unusual did seem to be happening in the depository sector. It was hard to see it reflected--in his charts, anyhow--in total credit or total borrowing really. The flow of credit relative to GNP didn't look all that different from past recessions--although it was consistent with a recession, which we weren't anticipating at the beginning of the year.

MR. SYRON. But the smaller business borrowing would be mostly from banks.

MR. KOHN. Right. The banking depository credit was extraordinarily weak, and we think that's what is being reflected in M2. Now, part of the reason we have a velocity shift is because some part of that weakness in depository credit doesn't matter. As Mike pointed out, to the extent that it just reflects easily securitized consumer credit or mortgage credit that flows through different channels, the final borrowers--for example, households in this case--don't even know who is holding their credit. It doesn't matter to them whether it's a bank or someone else. But when it seems to cut a little further into small businesses, where information is important and where the cost of rechanneling the credit may be rather high, then [it does]. So, to the extent that it's easily rechanneled, we could get an increase in velocity because the banks wouldn't need to issue time deposits. GNP would be whatever it was anyhow and M2 would be weak relative to GNP. But to the extent that it cut into not so easily rechanneled credit, it would have an effect both on M2 and on GNP. That's why I say I think some of the weakness we saw in M2 was reflected in GNP over the year and some of it was this velocity shift. But the velocity shift persists. To the extent that it does persist, we don't need to worry about <u>that</u> amount of shortfall in M2 relative to GNP. And I think that is the part that's easily rechanneled in our depository institutions.

MR. KOHN. Further questions for Don? Governor Angell.

MR. ANGELL. Don, I really have a two-part question. I want to precede the question, though, by the comment that I thought this section in the Bluebook on page 8 and the following pages on long-run strategy was most helpful. I thought you put it in the context that is just right for decisionmaking. And I'm not trying to set you up for the question. You mention on page 10 in that paragraph about in the middle of the page--this is about strategy II--that "nominal interest rates, while higher than in the baseline in the first two years, thereafter move below those in the baseline as inflation comes down more." I didn't see those interest rates in the chart. Did I miss that somewhere?

MR. KOHN. That's because in the past we haven't shown those interest rates in here. In the baseline forecast, for example, we would have interest rates averaging about 5-3/4 percent by the end of 1995--just to give the end point.

MR. ANGELL. Okay.

MR. KOHN. We have a 5-3/4 percent funds rate in the baseline and about 5-1/8 percent in the slower M2 [growth scenario].

MR. ANGELL. Okay. Could you give me those numbers for 1993 also?

MR. KOHN. Sure. In the fourth quarter of '93 it's 6-1/2 percent, rounded, in the baseline and it's about the same actually [in the slower M2 growth scenario]. The fourth quarter of '93 is about where the crossover occurs.

MR. ANGELL. I presume these rates are short-term interest rates?

MR. KOHN. That is the funds rate.

MR. ANGELL. Now, Don, the tough question, which I've set you up for: Could you tell me about the pattern of long rates with those two scenarios? And to make it really tough, I'd like to know the pattern of long rates without credibility and the pattern with, you might say, enough extra effort to bring on credibility.

MR. KOHN. Governor Angell, I can give you the deviation from the baseline. I don't have the charts showing the actual rates in the baseline, but I can tell you for the corporate bond rate that by the end of 1995 it is lower in the tighter alternative than in the baseline by about 15 basis points.

MR. ANGELL. Yes, but what I really want to know about is the second half of '91. Would the long bond rate be higher or lower if you add credibility?

MR. KOHN. Certainly, without credibility it would be higher. The way this works is that in the slower growth scenario--in order to damp money growth even more than the staff forecast, given the momentum of GNP--you have to raise interest rates. You have higher nominal and real interest rates that damp spending gradually. That then feeds through to inflation. How fast it feeds through might depend on credibility effects; in the model there aren't any credibility effects. And then the [lower] inflation will bring down nominal rates, although you'd still have higher real rates, at least with a backward-looking expectations [model], and a higher unemployment rate at the end of this period under the tighter alternative, as you see from the table.

MR. ANGELL. So, in other words, you're saying that the first part of any tightening would give [rise to] expectations of further tightening, which alters the opportunity cost of holding bonds, and thereby bond prices would be somewhat lower than they otherwise would be until the improved inflation effect overcomes it?

MR. KOHN. Right.

MR. ANGELL. And that's where credibility would be so important?

MR. KOHN. Right. If there were credibility effects, obviously, that would feed through faster and bond [prices] would probably rise; but [the markets] have to believe us. In my mind, the credibility comes mostly from our actions rather than from our words. So, it would take a while for that credibility to build. But once it did, then I believe that bond yields certainly would come down faster than we've captured in here.

MR. ANGELL. Thank you.

CHAIRMAN GREENSPAN. Other questions for Don? If not, let me start off with general comments on this issue. I have been puzzled, as I think everyone has been, by the extent to which our equations forecasting M2 and the various interest rate assumptions became progressively worse through the fourth quarter and kept a fairly large gap in the first quarter. That's suggestive, obviously, of two possibilities: that there has been a shift in the function and that we're now on a different slope, or that it's going to snap back. And if it snaps back, that implies a dramatically different outcome than if the existing divergence continues. My impression of the difference is that it is really quite substantial. In short, at this stage we really do not have a feel for how this is going to come out--not in a way that would make us feel rather comfortable about it, I would suspect.

I conclude from this that we have very little basis on which to move from our preliminary position. I would say we pretty much have to make a fairly strong judgment in order to move one way or the other from alternative I, because I am fearful that if we choose either of the other two alternatives we probably would be setting ourselves up for things to go in the wrong direction. I think there is just as much of a probability that we soon will be engendering double-digit M2 as zero; if we could somehow hedge that until we get a much better fix on what is going on in the numbers, I must say I would do that. So, I prefer to stay basically with the preliminary ranges of alternative I. Dick Syron.

MR. SYRON. I fully support what you suggest. I think we're in a time when the course of the economy is uncertain, the course of world events is uncertain, and the course of the behavior of the aggregates vis-a-vis the economy is uncertain. And in the context of all of this, we are also in a period when everyone is watching what we do extraordinarily closely. It seems to me that it makes all the

sense in the world to be ...
would presume tha...
fairly ...

the throws of the agonies of the unemployment rate and reduced output, we have the potential to run [over on] the other side. And we're going to need the excuse to come back. And I think a 6 percent ceiling gives us the excuse to come back and raise interest rates quicker than the 6-1/2 percent ceiling.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I would maintain the ranges that you recommended.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I agree with the argument that stability is good and that there is great uncertainty. But I was just looking at Appendix B [in the Bluebook]--I realize this is ancient history but I do pay attention to the monetary aggregates and the targets we set--and I just thought I'd remind you about M2 growth, looking back: In 1988 we missed the midpoint on the low side; in 1989 we missed the midpoint on the low side; and last year we missed the midpoint on the low side. And to me, at some point anyway, there ought to be an effort to think about at least a modest catching up. I guess that is the main reason, along with the desire for some stability, that I would prefer to carry forward the targets that we had for last year rather than use the tentative ranges that were set last July for this year. I think we've been assuming our targets were half-way appropriate but we've been low-balling it right along. I remember a few years ago, when Beryl Sprinkel was at the CEA, he made some pass at that idea in one of the Economic Reports to the President. Anyhow, I just feel more comfortable not drawing a line at the end of each calendar year and acting as if January 1 isn't related to December 31. So, I would go with a mix, using alternative III for M2 and alternative I for M3. That would just carry last year's ranges forward, which is a nonexistent alternative.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Well, I want to repeat my skepticism abou-y, power of monetary policy to affect the economy, at least tempo or at this stage of the game and the preference I stated yesterd I giving signals that might jiggle the thing off dead center 6] believe it is stuck. On the other hand, I worry about a [es with signal. In spite of the fact that we have associated our ster concern about the aggregates, I worry about the effect ognal of growth in the aggregates, particularly M2, as a possiblgh time to lower interest rates at a point when we have not had eecent moves in see where the dollar is going to settle down after th circumstances, the discount rate and the funds rate. And under th although it may I think alternative I is the safest course of acti the growth of the raise some questions about whether our concern ab aggregates is genuine.

CHAIRMAN GREENSPAN. M2 still has not gotten back into the alternative I range yet.

-- LAWARE. Well, I know and understand that.

MR. KELLEY. Mr. Chairman, I support alternative I, as you suggest. I think we've been talking about two sets of effects that the ranges have: the signal effect and the guidance for actual policy. Looking back at Appendix B, I note that over a period of years actual experience does track along with our intent in the sense that both the ranges and actual growth have been coming down gradually--since 1983 in the case of M2. But in any one year [growth] varies substantially inside the range. So, actually, any of these three ranges would give us ample room to conduct policy as we might need to in order to accommodate the events over the course of the year. But in the case of the signal effect, I think we're rather locked in to alternative I. If we were to raise the ranges, it would send a bad sign to the market relative to our inflation [credibility]; if, on the other hand, we were to lower them, it would send a bad sign to the economy relative to our desire to help check this recession. Therefore, I feel comfortable with the actual policy guidance effect of any of the three, but the signal effect leads me to alternative I.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I think Wayne Angell has probably made my comments--rather well, as a matter of fact. It seems to me that there are only two real and important aspects to the range for M2--and that's the only aggregate I'd be concerned about. One is the midpoint, which gives us ample opportunity to achieve the staff's forecast for the year, and the other is the top of the range. The real test if we do get the bounceback [in the economy], which implies vigorous growth of M2, is going to be whether or not we have the courage to do what I think we should do fairly quickly. The second part of that is that we only have 5 months, or 6 months maybe, before we take a look at these ranges again. I think the message that would be received well by the markets is that we are indeed still concerned about inflation. All the rhetoric about the short recession I think plays well with the longer-term view that inflation is our major target.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. I support your proposal, Mr. Chairman, and your rationale. We have seen an extended period of low money growth rates, [with growth for 1990] the lowest shown in Appendix B [for any year since at least 1979], and also falling growth rates in recent years. I'm comfortable with the existing ranges. In the last 10 months M2 growth has been at the low end of its range; I don't think it's a good idea in the current environment to reduce the range. I think we would appear to be lowering the target so we'd have a greater chance of hitting it. I also think it's not a good idea to raise the range; we're unlikely to achieve it and it's not a good idea to reverse the trend of reducing the range gradually through time. And even the 2-1/2 percent low end of the current range is roughly consistent with the long-term real growth potential of the economy. I think this is an important decision, given the heightened public perception that we're interested in M2 and the aggregates in general. I think any decision other than alternative I risks confusion. We should focus on achieving actual money and credit growth within the ranges and leave the ranges pretty much alone.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Let me just comment first on the strategies that Don laid out. I strongly favor strategy II. Given our role as a central bank, I can't see associating myself with any other strategy. The only thing we can affect in the long run is inflation; that's the only one that really shows any progress. That does not lead me, however, to alternative II in terms of the ranges; I would support alternative I. As Bob Parry already acknowledged, there's already a reduction in the ranges implicit in the tentative ones, so in my mind that's consistent with strategy II. My own view is that a further reduction in the ranges, given the environment we're in right now, really wouldn't be seen as particularly credible. I don't think we would buy any credibility by ratcheting them down any further. What is credible and what we need to do in this environment is to make sure that we acknowledge that the one thing we affect in the long run is prices and that we're still committed to price stability. [I mean that] not in a saber rattling short-term context, but we have made so much progress over the last four years in bringing down the growth rate in money that, as I've said before, I think we have a tremendous opportunity here to make a permanent impact on inflation. And I want to make sure we don't lose sight of that. I'm sure we won't as a Committee, but in terms of what we're conveying to the public we need to convey that we have some short-term problems to work through now but we still have our eye on the right ball.

CHAIRMAN GREENSPAN. I think not moving the ranges up in the face of this recession gives that signal. It's cyclically adjusted!

MR. MELZER. What I'm suggesting is that we can't rely on that alone to convey the message.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Well, I'm pretty much in the same mode as Wayne and Roger and Tom. Our job is to reduce inflation over time. I think all of these ranges allow us to do that, as Mike Kelley pointed out. Midpoints are important and I would hate to have us think that if we do come out for your suggestion, we have to hit the midpoint because that's above where growth has been averaging. I think that was Wayne's point. So, I'm for strategy II, a tighter [M2], because that's the one that makes inflation disappear on this piece of paper in front of us. I'm not sure it will, in fact. But I'm not troubled by marching the ranges down slowly over time because there's a consistency in that that does lend itself to credibility. And we are moving down a notch. So, while I would prefer to be more aggressive, I can understand your arguments and would support them.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I support your proposal, Mr. Chairman, and I agree with Tom Melzer that we have an opportunity here really to make some progress on the core rate of inflation if we conduct our affairs [unintelligible].

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I would associate myself pretty much with Tom Melzer's statement. I could buy the economic case for alternative II, but I don't think I'd want to put you in a position of having to announce a reduction in the targets in the middle of a recession. So, I would support alternative I.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. We're sending a rather powerful signal these days with our short-run policy movements, and I think it's important that we not confuse that signal. I think staying where we are with alternative I is least likely to do that. We already have lowered the ranges one notch and by not going back [up] we send a signal that we haven't given up on inflation. To go to alternative II in the current environment of bringing interest rates down would send some mixed messages, which I don't think we want to send. In terms of operating room, I think all of these ranges give us operating room. And if we get a shift in the function, these ranges aren't going to be terribly relevant. So, I come down for alternative I on both counts: the signal effect and the operating room.

CHAIRMAN GREENSPAN. With the exception of Governor Seger, I assume that when the preferences for alternatives were being cited it was across the board, with no differentiation being made with respect to the ranges for M2, M3, and debt. If that's the case, it appears that we have a--

MS. SEGER. Oh, I can go with alternative I.

CHAIRMAN GREENSPAN. No, I was just trying to get [that clarified]. What I'm saying is that alternative I generally seems to capture the center of this particular group, and I would ask the Secretary to take the role on that motion.

MR. KOHN. Do you want to read that portion, Norm?

CHAIRMAN GREENSPAN. Yes, you better read it.

MR. BERNARD. I'm reading from page 23 in the Bluebook or line 43 in the other handout, starting near the bottom of page 2: "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability, promote a resumption of sustainable growth in output, and contribute to an improved pattern of international transactions. In furtherance of these objectives, the Committee at this meeting established ranges for growth of M2 and M3 of 2-1/2 to 6-1/2 percent and 1 to 5 percent, respectively, for the period from the fourth quarter of 1990 to the fourth quarter of 1991. The monitoring range for growth of total domestic nonfinancial debt was set at 4-1/2 to 6-1/2 percent for the year"--

MR. KOHN. 8-1/2. Let's not swallow it back too much; it's 4-1/2 to 8-1/2 percent.

MR. BERNARD. --"4-1/2 to 8-1/2 for the year. With regard to M3, the Committee anticipated that the ongoing restructuring of thrift depository institutions would continue to depress its growth relative to spending and total credit. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Black	Yes
President Forrestal	No
President Keehn	Yes
Governor Kelley	Yes
Governor LaWare	Yes
Governor Mullins	Yes
President Parry	Yes
Governor Seger	Yes

CHAIRMAN GREENSPAN. We'll now move on to current monetary policy. Don Kohn.

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

CHAIRMAN GREENSPAN. Questions for Don?

MR. HOSKINS. Don, what does your model tell you for M2 for the first half, given the [policy] moves that have been made?

MR. KOHN. If we build in the error that seems to be in train for the first quarter--that is, if we put in the 4 percent and the 5 percent that we had for February and March--that would give us 2-1/2 percent for the first quarter. Now, the model has something like 6 percent for the second quarter but we wouldn't expect anything like that. We'd be looking probably at something more in the 4 to 5 percent area as a judgmental forecast. We're looking at a 1-3/4 percent approximate shortfall from the model for the year; we have a substantial part of that in the first quarter but not entirely. I don't have a projection for the first half that really goes with alternative B, but I would guess off the top of my head that it implies something like 5 percent, which would be about a 1-point shortfall from the model; the latter was saying 6 percent.

MR. HOSKINS. But our confidence in the model has fallen?

MR. KOHN. It never was very high.

CHAIRMAN GREENSPAN. Other questions for Don? If not, let me start off with my appraisal. First of all, to me the most fascinating aspect of the last several weeks is the stock market, which I think essentially is clueing in to the fact that the war will be either significantly contained or short. Now, I'm not sure it makes all that much difference. If, for example, we cauterize the major [enemy] forces around Kuwait and wait for their supply of food and water to run down, which could take months, and it appears as though their offensive capabilities in the area--scuds, aircraft, and so forth--are pretty much eliminated, I'm not sure it matters whether the war is over at that point or not. But I think the market essentially reads it that way. What is really important about the stock market is not so much whether it is forecasting correctly or not but that the very mood of the market itself has economic implications in the context of what I would call an add-factor economy in which most of our equations don't work and what really moves the forecast is how one fiddles with the add-factors. In that sort of environment, confidence is the problem, essentially. I would think at this particular stage that the news is possibly better than we feared, if I may put it that way. And while we've all taken pot shots at the Greenbook forecast, it is not a zero probability forecast by any means. [Laughter]

MR. PRELL. [Damning with] faint praise!

CHAIRMAN GREENSPAN. I'm willing to go at least 15 percent!

MR. PRELL. Can I get you to 60?

CHAIRMAN GREENSPAN. With all seriousness, I'm a little concerned that we may be looking at the January data with a longer-term view of what it all means than it may in fact mean, especially if one realizes that it [reflects] the climate going into the war or the uncertainty it raised. One thing I found fascinating yesterday was how many people around here are getting feedback around the country on the CNN effect. Usually we only hear it anecdotally in one place; we heard it virtually all around this table. I hope it doesn't get out; it's terrific for CNN business!

In any event, I do think that in the context of our success in bringing down money supply growth, we're beginning to see the benefits on the inflation side. That's one area where I actually don't quite agree with the Greenbook because I think the inflation forecast is too high. From what I can sense, looking at the internal price structure of a lot of companies and talking to a lot of people about market resistance [to higher prices], it may turn out to be doing better than we know. I think it's showing up very specifically in the obviously crucial wage area. I think this has given us room to lower the interest rate structure, which we have done, without engendering inflationary effects. And I think the way in which it has been done to date, with a rather slight lag probably, has been very helpful in preventing inflationary pressures from moving up over the longer run. Ideally, I would suspect that we would like to have the rate structure, to the extent that it is relevant, come down and just stabilize as we go into the expansion phase. But trying to ease into the equilibrium in that manner strikes me as really quite unrealistic. I have come to the conclusion that we may have to move it down further as insurance but be prepared to back right up when and if that becomes necessary. Unless we seriously believe that we have the capability of bringing rates down to a point, including where we are now, and then flattening them out at that point, we have to be [operating] under the presumption that we are going to move them down and then we are going to move them up. I think we have to be prepared to do both, but hopefully in a less volatile manner than has been the case for monetary policy in the past. I would say certainly that in recent years we've been able to do that and I hope we can continue.

What this leads me to, granted all of what we were discussing yesterday, is that it seems extremely unlikely that this economy will start to move up, or more importantly that the money supply will start to move up, at a pace that would induce us to be moving in a direction of tightening rather than easing prior to our next meeting. I can conceive of our easing further--not immediately, but certainly in response to additional events. I would conclude, therefore, that the appropriate policy at this stage would be "B" asymmetrical toward ease. Governor Angell.

MR. ANGELL. Mr. Chairman, I'm in agreement with everything you have said. I think you put it exactly right, so I'm not going to repeat any of that because I think you hit it right on the mark. I'd also like to say, Mr. Chairman, that I could detect in Don Kohn's statement not just a pure analysis, but I thought he also was leaning in exactly the same direction that you have indicated.

CHAIRMAN GREENSPAN. Are you suggesting that I influenced Don Kohn?

MR. ANGELL. Yes, I am; he's easily influenceable! In going with your outline, I would like to mention that the one thing I disagree with you on is that I think the probability of this scenario is more like 45 percent rather than 15 percent.

CHAIRMAN GREENSPAN. I said "at least"!

MR. ANGELL. Oh, at least 15 percent! I'm going to go to 45 percent even though I tend to think the recession is going to be a little longer and the recovery a little shallower. But the fact of the matter is that I think we do have ahead of us some more disheartening news on the first quarter. Not only do we have the CNN effect, which I think really is there--people have been watching TV more than shopping--but there's also the travel factor. I have been at the airport in Zurich and at Heathrow and JFK, and there just isn't anybody there. There is a real impact. Harrod's runs a beautiful store at Heathrow and they had about 30 sales people and I think 2 customers. So, it does seem to me that travel is going to be down sharply; that along with the CNN effect means that the first quarter will be down sharply. So, I think we do have some bad news ahead of us and we need to steel ourselves for that.

Now, if the staff is correct regarding the bounceback, one thing I do believe is that once the capital markets recognize that the U.S. economy is in a recovery phase, there'll be no more cuts--and possibly increases--in short-term interest rates. And I do believe the dollar could have a very sharp bounceback effect once we get past a period of stability. So, I did a little calculation. We have what --about $56 billion of deutschemarks? Is that close?

MR. CROSS. That's close.

MR. ANGELL. I was thinking that we may have a window of, say, 90 days to get rid of 2/3rds of that. If we want to get rid of 2/3rds of the deutschemarks we hold--I'm not counting the interest because so far this year the $50 million we've done is only 1/5th of the interest we've earned--we're going to have to sell quite a bit. I calculate $620 million per working day over the 90-day period.

CHAIRMAN GREENSPAN. That will get their attention!

MR. ANGELL. It really is a very substantial item, and I would suggest that the budget deficit for 1991 does not need to have a huge foreign currency exposure because we've marked the gains up in

1990 on a mark-to-market basis for our payments to the Treasury. So, Mr. Chairman, I appreciate very much that you have gotten done the $50 million and just would suggest that you carry on with more enthusiasm!

MR. SIEGMAN. Governor Angell, we have $33.9 billion in DM, in recent values.

MR. MELZER. He wants to go short!

MR. SIEGMAN. We did sell--

MR. ANGELL. Oh, I was looking at the totals.

CHAIRMAN GREENSPAN. Including Treasury holdings.

MR. ANGELL. I was including the Treasury too, but I thought the Treasury probably would want to do the same as we would.

MR. CROSS. Are you [using] DM or dollars?

MR. SIEGMAN. No, this is dollar values.

CHAIRMAN GREENSPAN. Bob Black.

MR. BLACK. Mr. Chairman, I would agree that alternative B is the best. We have just taken a fairly significant, strong, and dramatic policy action and any further move now would appear to me to be sending the signal that we had pushed the panic button. The staff may be right in saying that we won't have to ease further in this cycle; I certainly hope that that's true because it's in that area and the failure to tighten up promptly that we've usually made our mistakes. But in my own forecast I see it somewhat weaker than the staff does. So, I think it's possible that we may have to do a bit more [easing] before we start upward, though I hope not. But because of that possibility, I would go with your asymmetric directive tilted toward ease. Lest anyone think that a hawk has become a dove, I think I will be among those who will argue the strongest quite early for an increase in the federal funds rate, if the economy does turn around.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I support your recommendation of alternative B since it appears that the economy will be recovering at a satisfactory rate 6 to 9 months from now, especially in light of the policy moves that were taken recently. However, I do have a strong preference for a policy directive that is symmetrical. If new developments in the next several weeks suggest greater weakness, I believe there should be a full discussion of the implications of those developments for the outlook 6 to 9 months from now before policy is changed. It seems to me that that kind of discussion runs the greatest chance of avoiding the error of going too far in the direction of ease in response to weakness in the statistics that are conveying information about the performance of the economy in the recent past.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, we have done a lot over the past several months and the most recent action is just behind us; for that reason I would support your prescription. I do think, as I said yesterday, that the risk continues to be on the down side and that we may get some bad economic news over the next several weeks. And for that reason I would support also your prescription for an asymmetric directive. I'm glad you said what you did about our moving on the up side when that becomes necessary because I think it's important for us to remember that we're not on automatic pilot with monetary policy and that we have to adjust to conditions. I might say, going back to the asymmetric directive, that we have a long interval between this meeting and the next one and I think it's important to be able to move promptly if the information is negative. On the CNN effect, I might just say too that Jane Fonda is very happy with that!

CHAIRMAN GREENSPAN. Si Keehn.

MR. KEEHN. Mr. Chairman, I support your recommendation. It seems to me that we've done quite a bit and we ought to sit back and pause here. Having said that, I think the chances are that we are more likely to ease than to tighten before the next meeting and, therefore, I think the asymmetric language would be appropriate.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Mr. Chairman, I support your recommendation. I was particularly encouraged--and you have said it all the way along, so it should be no surprise--[by your] preparing this group for having to tighten if things start to grow. However, on the asymmetric language, I'm comfortable for different reasons. I hope we will be emphasizing slowness in money growth as the reason for moving rather than weakness in the economy. The errors in our ability to predict the economy one quarter out by anybody's forecast evaluation are really quite large. I think our best chance of getting to where we want to be in the long term is to continue progress on relatively steady money growth over time. So, I would hope that the asymmetric language would be exercised if we get bad news--that is, slower growth in money than we anticipate.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I certainly would support the suggestion you put on the table, but I would just elaborate a little on one or two aspects of policy beyond that. Everybody has put his or her own probabilities on outcomes of various forecasts and, as I said yesterday, my own sense of it is that there's at least a 50 percent chance that we'll get something along the lines of the central tendency of the Federal Open Market Committee members' forecasts. And we certainly can't rule out the kind of [outcome] that Mike talked about. But if we're going to get either of those--a modest recovery beginning sometime around midyear or even a fairly bouncy one as in Mike's forecast--it seems to me that either outcome is already baked in the cake in policy terms. There is enough there, if policy is working, to produce that result.

On the other hand, there is a 10, 15 percent chance--again, pick your number--of it being a lot weaker. Now, especially if it turns out to be a lot weaker, then we're looking at a very deep recession with all of the [attendant] financial problems. That, by the way, I think would blow the stock market right out of the water. Then we really would have a terrible situation not only in terms of what it implies for the economy and unemployment and all the rest, but in those circumstances I think policy would be judged universally as the culprit. Moreover, the risk of the whipsaw effect sometime out in the future, which is embodied in Mike's second scenario on the last page of yesterday's handout--even in the case of a steep recession--gets much greater under any scenario like that.

Now, I think the problem for policy and the appearances of policy is a bit further complicated by this credit crunch issue. There are two schools of thought about the credit crunch. One school of thought is that it's very real and that the Fed in particular isn't doing much about it. I don't happen to agree with that school of thought. Gary's analysis yesterday comes much closer to the mark as far as I'm concerned. But there is that other school of thought: that the Fed itself is overstating the credit crunch because that rather suits its purpose. And the argument that grows out of that essentially says that the weakness in money is really due to policy, not a credit crunch--that the credit crunch is a smokescreen and the Fed is hiding behind that smokescreen. Indeed, that argument goes one step further and says that the Fed is targeting the funds rate, that reserves are strictly demand determined, and that it's the policy process itself that is producing the weak growth in money supply and/or the credit crunch, or even worse for the Machiavellian types that the Fed is hiding behind the credit crunch. The reason I bring that up is again in the context of what happens--regardless of whether you think the risks are 10 percent or 20 percent--if it turns out that the economy goes down the tank. That leaves me in this quandary of desperately searching for what I like to think of as a low-cost insurance policy. To me, a low-cost insurance policy is something that either in substance or in form tries to defuse some of those arguments without bringing with it the necessary result that we go too far in underlying policy terms and set ourselves up in the kind of conundrum that Mike so graphically described yesterday. So, I ask: Is there a low-cost insurance policy? That is somewhat of a contradiction in terms, of course; there really cannot be.

While I don't think it's germane to the Committee's discussion this morning, I have this rather crazy idea that runs around in my head that might deserve consideration as a low-cost insurance policy. Essentially, what is running through my mind is going a good deal further than we have been thinking to date about trying to bring the discount window to bear in this process. The concept that rolls around in my head--and I understand it can be shot to pieces, but maybe Don and Mike and the staff could think about it a little anyway--is a 6-month period, for example, within which we would have a highly advertised program of more liberal discount window accommodation, including term discount window loans. The program would be structured to say that its purpose is to ensure liquidity to individual institutions to meet the needs of creditworthy borrowers. We might have more liberal collateral requirements, but we'd haircut the devil out of them so there would be no risk to the Federal Reserve. But the thought would be that people could have easier access and more generous collateral requirements--in terms of what is put up [as collateral], not in terms of how it is haircutted. It would have a market rate of some kind or other. The way I think about it is that if it's <u>used</u>, I don't see that it has to have any material impact on the broad thrust of policy, at least if one thinks of policy in terms of interest rates or exchange rates. I think we could engineer those effects out through Mr. Sternlight's operations. So, if it's used, fine; I don't think it has to compromise the basic thrust of policy. And there would be no risk to the Federal Reserve. On the other hand, if it's not used, I'm not sure that that's the end of the world either. Indeed, if it's not used, it seems to me that it goes at least a little in the direction of helping us to defuse the argument that our unwillingness to provide liquidity either through open market operations or otherwise is the cause of the credit crunch and all these other things that go with it.

Now, as I said, there really is at the end of the day, of course, no such thing as a low-cost insurance policy. This has smoke and mirrors to it. But I am worried about the danger that is inherent in an outcome in which [the economy] really goes south on us. I ask myself what other alternatives there are that do not involve the risk of compromising the basic thrust of monetary policy, and I look with Bill Taylor and others at some of the things they are talking about on the supervisory side. Now, the problem there is that the ones that might do something by their very nature are going to raise the specter of forbearance on the thrift situation and all the rest, and I think in a global setting relaxing capital standards or something like that would be crazy. On the other hand, the kinds of accounting things that are being talked about I don't think are going to do anything. As a matter of fact, I think they will be viewed transparently as not doing much at all. Again, maybe we don't need a low-cost insurance policy; but that, I think, is your judgment.

CHAIRMAN GREENSPAN. Well, no. On the contrary, that is not my judgment. I think we may need it; I'm not saying that we don't; we may and I think we should consider it. But it might be useful to continue on and get some comments on that issue at the luncheon, okay?

VICE CHAIRMAN CORRIGAN. Right.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Mr. Chairman, I support your recommendation with asymmetry. Many of the reasons have been given before; one is that there's a long interval before the next meeting. I think we may have to do something before the next meeting, and [it makes] sense to take out insurance on the fundamental policy side. I do agree very strongly with the comments that Wayne made--and it's reassuring that everyone has made them--on the importance of recognizing the scenarios that were shown. [I'm pleased] that we're willing to pay the premiums involved in this insurance policy if we do have to [ease] in the intermediate period rather than being tighter and I think we all should realize that there may be a difficult period coming out of this one. The only comment I would make is--and again this may be more appropriate for the [non-FOMC] lunch discussion--that we may well have to do something more on the discount rate before doing more on the funds rate because with a 6-1/4 percent funds rate and a 6 percent discount rate, given people's aversion to borrowing, effectively, we have a penalty discount rate right now. I think it's equally likely that the next move may well be a cut in the discount rate without a further change in the funds rate.

CHAIRMAN GREENSPAN. Without the funds rate showing through and with the spread opening up again?

MR. SYRON. That's right.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I support your recommendation with the asymmetry.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. I also support the proposal. I do think that we will have to get through another bout of unsettledness when we confront the possibility of a ground war, which could give us another CNN effect for a week or two--although it may be less popular because it may look less like a video game. I agree that there are risks on the down side and I think that's understandable, given the 6 to 9 months of very slow growth in money and credit we have had. I would think that we'd be facing a pretty tough period, although looking beyond that we have a good dose of stimulus in the pipeline already. But I still think, given the uncertainties, that it's wise to be asymmetric toward ease and watch events.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Mr. Chairman, when I read the Bluebook, I wrote in the margins "I like the interest rate implications of alternative A but that alternative puts us on too steep a growth path for money in the out years." So, I would recommend alternative B. And the asymmetric language toward ease sounds good to me, although I like Lee Hoskins caveat about that being focused largely on the growth of the aggregates.

I can just confirm the CNN effect. In anticipation of moving, we had our cable disconnected last week and I've been suffering withdrawal but I haven't gone to the mall yet!

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I agree with your recommendation and your comments surrounding it.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I certainly support alternative B. With regard to the question of the language: Looking to the future, if all we want to consider is asymmetric language toward ease, that certainly makes sense because I find it very hard to believe that between now and March we will get enough coincidence of events to suggest that we would want to raise the borrowings target and the funds rate. However, we have moved a lot recently, and I think we do have to consider the lags in all this. In light of that, I would have a preference for symmetric language just because I think we run the risk of not allowing the actions that we've taken to date to have an effect on both the aggregates and ultimately on the economy.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I support alternative B also. Let me just pick up on some things Jerry said. I was writing some notes here and when he started talking I thought he was going to say the same thing I am. But when you hear what I have to say, you'll realize that that was virtually impossible. Basically I agree with this focus on slow money versus weak current economic numbers. I think that's what we ought to focus on; that's what we have influence on. But I'm also sympathetic to the uncertainties with respect to the short-term behavior of money, particularly the broader aggregates. Don has talked about it--the restructuring that's going on in depository institutions and so forth. And I guess we also know that the base is distorted by currency flows overseas. So, if it were up to me, I would pay some attention to reserves. That's what we affect directly. And over the last year there has been virtually no growth in reserves. Now, I'm not being critical here, because I think we've tried to respond to that to some extent by bringing rates down; and we have recognized in this Committee the perils of funds rate targeting and we've been trying to respond to that. But we shouldn't sit around and be surprised that we're not getting any money growth if we're not providing any reserves.

CHAIRMAN GREENSPAN. But we are. Supposing reserve balances stretched across not only transaction balances but across the whole spectrum of various depository obligations. Required reserves under those conditions obviously would have been going up a great deal more. How would money in that environment have moved differently from the way it has?

MR. MELZER. I'm not sure. My only point is that I don't think we can expect money to grow if we don't provide the basic fuel that's necessary; we're demand driven.

CHAIRMAN GREENSPAN. What I'm trying to get at is that it is really an excess required reserves problem and we've locked our required reserves into an instrument that has become increasingly obsolete. I think you may raise the question on excess or free reserves or something like that, but I'm uncomfortable with total reserves as an issue.

MR. MELZER. Well, I'm not proposing a specific approach here. I'm just saying that I would pay some attention to what is going on there. We have some uncertainty about how the aggregates are behaving; that's what we can influence. And I think we should pay some attention to it.

CHAIRMAN GREENSPAN. That would be influencing by increasing reserves. I don't know any other way of doing it.

MR. MELZER. Yes.

CHAIRMAN GREENSPAN. What I'm trying to get at is this: Is there additional information here other than the money supply data themselves that you feel we ought to be targeting?

MR. MELZER. I guess what I'm suggesting, picking up on Jerry's point that we're vulnerable, is that where we're vulnerable is that somebody may look at it and say basically that by targeting the funds rate we haven't provided any reserves to permit an expansion in the aggregates. And my answer to that is not smoke and mirrors; our best defense against somebody taking a shot at us is trying to do the right thing. And I think we have been--

MR. ANGELL. But Tom, if we focused on reserves, don't you think that we could end up with a 2 percent fed funds rate rather easily? Are you willing to pay that price?

MR. MELZER. I'm not suggesting that we target reserves. I'm just saying that in this uncertain environment it could be helpful because if we're sitting here pegging the funds rate at the wrong level and we're shrinking the supply of reserves, we are not going to see the money growth that we are going to need. I think that could just be helpful to us in this process. I think you all know what I've advocated over time; I'm not one who would be inclined to go nuts on the easing side, but I think this could be helpful in the other direction as well. My main point is that our best insurance policy is just to assure ourselves that we are doing the right thing. And that's going to be the best defense. We are going to be vulnerable if the record shows on a continuing basis that we're still not providing adequate reserves. And I'd be the first one to say on the other side that it's a problem, too, if those [monetary growth] rates shoot up to double-digit rates over a sustained period of time, as they very likely could with what has already been done. Anyhow, I support the Chairman's proposal.

CHAIRMAN GREENSPAN. Bob Black, do you have a comment?

MR. BLACK. Yes. I was just going to say that I have a lot of sympathy for what Tom said. I think that reserve measures can be refined, though. There are several things that are reservable that are not part of M2. The whole [reserve structure] is set up with the idea of controlling M1 but we know ahead of time, because requirements against interbank deposits and government deposits are lagged, what volume of reserves we need for that. And we could put those in at the beginning of the period. Those against the M2 portion are not lagged quite as much. So anything we put out over and above that, which would be something of a refined measure of total reserves, would be available for supporting M2 and nothing else. I think we could get to something like that. Another thing I'd like to see us do is to try to make some estimates of the amount of currency that is going abroad because that [outflow means the] currency component is badly distorted and if we think that's part of our domestic money supply, we're being badly mislead. But I really think the rate of growth in the aggregates is demand-determined now, and I think as Tom does that it ought to be supply-determined to some degree and that's not easy because of the reserve structure we have. Also, I think financial innovation would create a number of instruments that would not be reservable; indeed, a lot of them in M2 are not reservable now. But I think we can get something better by moving in general in that direction. And I would support--

MR. MELZER. I forgot one other point I was going to make, which is that I think we can best defend ourselves by sticking to promising things we can control and we can affect. We cannot solve an intermediation problem in the economy, and I think that creates false expectations. But what we can do is make sure that we're providing adequate reserves to the System so that the financial intermediaries can do with those what they will.

VICE CHAIRMAN CORRIGAN. But no matter how you measure reserves or anything else, in the kind of situation we're in right now the only way that we can deal with this conundrum would be to run a policy, in effect deliberately, that is prepared to accept the risks of very large amounts of free reserves or excess reserves in the System. And by definition if there is something real to this so-called credit crunch, that approach to policy--no matter how you define the base or how you define reserves--carries with it the risks of a 2 percent federal funds rate.

MR. MELZER. Which, of course, we haven't seen.

VICE CHAIRMAN CORRIGAN. We haven't seen it because [of how] we're conducting policy. But the only fail-safe experiment--and that's what it would be--that would resolve that issue, no matter how you define the base and no matter how you measure reserves, would be the willingness of this Committee to run a policy that carries with it the risks of a 2 percent federal funds rate.

MR. MELZER. I'm not suggesting that we use it as an operating target.

VICE CHAIRMAN CORRIGAN. I know you're not.

MR. MELZER. I'm just saying that if it were up to me, in this environment where we're worried about getting the money growth path, I'd hate to be sitting here three months from now with a slope on that line of total reserves that was still totally flat as it has been over the last year.

VICE CHAIRMAN CORRIGAN. That's part of the reason why I made the suggestion about trying to get some reserves out through the discount window in a way in which Peter could do a pretty good job of protecting against--

SPEAKER(?). Sterilizing!

VICE CHAIRMAN CORRIGAN. Protecting against--well, sterilizing them!

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I support your recommendation for all the reasons that have been articulated here. I would like at an appropriate time, now or later, to suggest a change in the order of the priorities of our considerations in the operational paragraph. I don't know whether you'd like to pursue that now or do it as a separate item.

CHAIRMAN GREENSPAN. Let's do it separately. Governor Seger.

MS. SEGER. I support your view, Mr. Chairman, but I would say that the risk is definitely on the low side if for no other reason than the auto industry situation. As you know, it's responsible for the biggest chunk of the decline in the fourth quarter. Both auto sales and production in my judgment are going to be a disaster in this quarter and right now I can't think what is going to bring them off the floor in the next quarter. That is simply one reason. In addition, there is the confidence factor. I think that is partially related to CNN and the Gulf War but I think there's another big chunk coming just from this nervousness over the financial system. I wish that weren't the case but I think it is. Certainly, a lot of easing has been done. But in order to compensate for the credit crunch, which in my judgment is definitely out there, there will be a need to do still more to offset that. I think it would be good to look at Jerry's idea, too; it strikes me as sort of extraordinary to accommodate a special challenge of this nature, which I haven't seen since the 1930s. So, I would go with [alternative B], asymmetric toward ease.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Alternative B. I would prefer a symmetric directive, given the background of the easing that already has taken place and the closeness of the easing just last Friday. A symmetric directive does not imply that you do not have the flexibility to take a cut at easing between now and the next meeting on your own. And that is the insurance that I would feel comfortable with rather than the asymmetric directive.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. At the risk of getting in over my head prematurely, I want to raise a point in connection with Tom's concern about reserves and in connection with the comment about excess reserves and free reserves. I wonder if we might have some parallel now to the situation in the late 1930s when the Federal Reserve perceived [the existence of] a lot of excess reserves in the System and took action to raise reserve requirements to mop them up only to find later that the bankers didn't necessarily regard them as excess. They were excess in the legal sense, but not necessarily excess in their own minds in view of the uncertainties in the economy. I wonder if we might have a situation now where there's a difference between what bankers themselves perceive to be excess reserves and what are excess in a legal sense. If that's the case, then I think there may be some room to be concerned about the flatness of the reserve aggregates.

CHAIRMAN GREENSPAN. Well, that's the reason I raised that; because Peter has that problem every day as to what the demand for excess is and it doesn't mean it's going [unintelligible].

We're going to move now to the directive and vote on alternative B, with asymmetric language toward ease. But prior to doing that, Governor Kelley has the floor--with a proposal I would presume?

MR. KELLEY. Yes sir, if I may. As it appears in lines 72 and 73 of the operational paragraph we have stated for some time that our order of priority was "price stability" followed by "trends in economic activity." My suggestion is that, to the extent we'd like to be forthcoming in this document, it might be an appropriate time to reverse the order of those first two priorities. That would be consistent with the reasons for our recent actions and I think it would be consistent with the Committee discussion that I've heard here yesterday and today. We have an awful lot at stake in this economy and that is what we've been discussing. But I don't think that a reversal of that magnitude would in any way indicate a downgrading of our consideration of inflation. It's certainly going to continue to be vitally important to this Committee, and it shouldn't and won't be forgotten. But at this time I think, for the record, it would be a more accurate reflection of the reality of the Committee's concerns to reverse the order of those first two priorities.

MS. SEGER. Shouldn't we also move up monetary aggregates then, Mike?

MR. KELLEY. Well, I don't know where--

MS. SEGER. As I've sat and listened here today, that has received a lot of discussion.

MR. KELLEY. Somehow I'd like to have everything be first, but that's difficult. My suggestion would be simply to reverse the first two.

CHAIRMAN GREENSPAN. You'd like to comment?

MR. ANGELL. Mr. Chairman, I'm only going to talk about a question of the way that we conduct our business. I feel so strongly about this issue that, if we're going to do it, I'd really want to have a recorded vote on this.

CHAIRMAN GREENSPAN. On this?

MR. ANGELL. On this.

CHAIRMAN GREENSPAN. Indeed, that we will.

MR. ANGELL. Okay.

CHAIRMAN GREENSPAN. This is an important issue.

MR. ANGELL. Okay. In other words, a recorded vote on the amendment?

CHAIRMAN GREENSPAN. Yes.

MR. PARRY. So, what is your view?

MR. ANGELL. My view is that price stability needs to be there first and that it really does help the long bond market to get long rates down to have price stability as the first priority.

MR. LAWARE. I don't often argue with my colleague on my left, [Mr. Kelley], but it seems to me that price stability and the progress toward price stability is the thing that has enabled us to make the recent moves toward ease, or one of the things that has supported that. I wouldn't want to lose sight of that as a primary target. I'd be more comfortable leaving it where it is.

MR. PARRY. I would agree with Governors Angell and LaWare; in fact, I'm a little concerned that recent trends in economic activity may be a bad basis for current policy.

CHAIRMAN GREENSPAN. Bob Black.

MR. BLACK. I agree with what Governor Angell suggested. I'd also like to move monetary aggregates up [in the list]. I'd rather have them before trends in economic activity, but that's raising an issue I don't think you want to get into.

MR. BOEHNE. I think there are times when you don't want to kick sleeping dogs and this is probably one. I know that Governor Angell feels very strongly about this issue but, frankly, I would hope that we could resolve this informally one way or the other. We have a great deal of unanimity in the Committee now, and I think that's important given all the problems out there in the economy. I think to have a separate vote on word ordering is not in the best interests of the big issues that we face. I would urge that we--

CHAIRMAN GREENSPAN. We may not need it.

MR. BOEHNE. Well, I would hope so.

MR. KELLEY. It doesn't look like we do.

MR. HOSKINS. I probably don't need to comment.

MR. MULLINS. My preference also would be not to change the order and not to appear to be responding to the current economic conditions, but rather to respond with policy actions. And I would agree with [unintelligible].

MR. KEEHN. I agree with Mike's thought; but having said that, changing the order at this point I think would imply more than we want to. So, I'd be inclined to leave it as it is.

MR. FORRESTAL. I would feel the same way.

CHAIRMAN GREENSPAN. Mike, you probably want to withdraw it at this stage and resurrect it at a later time.

MR. KELLEY. Consider it withdrawn for lack of a second!

MR. BERNARD. "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. 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 December through March at annual rates of about 3-1/2--"

MR. KOHN. Can we say 3 to 4 percent, using round numbers, rather than 3-3/4 and 3-1/2 percent?

MR. BERNARD. So it would be "growth of both M2 and M3 over the period from December through March at annual rates of about 3 to 4 percent."

CHAIRMAN GREENSPAN. We're changing the 3-3/4 percent? Is that it?

MR. BERNARD. We seldom use quarters.

CHAIRMAN GREENSPAN. I'm thinking of 3-1/2 to 4 percent as more capturing what the Committee discussed because we're not going to get up to our range if we don't stipulate that kind of range.

MR. ANGELL. The reason is that the current lags keep us from getting up there within this period, but it does get us to the range later.

MR. KOHN. We have it projected up there by March.

CHAIRMAN GREENSPAN. But is 3-3/4 percent what you're projecting?

MR. KOHN. 3-3/4 percent for M3 and 3-1/2 percent for M2.

CHAIRMAN GREENSPAN. Let's make it 3-1/2 to 4 percent; I think that may capture the point.

MS. SEGER. May I just ask one question? Has there ever been a directive put out that just went one way? In other words, do we really think that in the next six weeks or so greater reserve restraint might be pursued?

CHAIRMAN GREENSPAN. Yes.

MS. SEGER. I'm just asking if that is true; that's all I'm saying.

CHAIRMAN GREENSPAN. It's conceivable, in the spirit of President Boehne's remarks.

MS. SEGER. This isn't a criticism. I'm just asking if that has ever been done.

CHAIRMAN GREENSPAN. No, I know that.

MR. BERNARD. Governor Seger, this is ancient history, but going back to the late 1960s the directive was quite different in form but in essence at times it was one way.

MS. SEGER. Thank you.

MR. KOHN. We're going to write 3-1/2 to 4 percent in there?

MR. BERNARD. For both M2 and M3, 3-1/2 to 4 percent.

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Black	Yes
President Forrestal	Yes
President Keehn	Yes
Governor Kelley	Yes
Governor LaWare	Yes
Governor Mullins	Yes
President Parry	Yes
Governor Seger	Yes

CHAIRMAN GREENSPAN. If anyone would like to change their [Humphrey-Hawkins] projections, I think Mike would like to have the changes by close of business Monday.

MR. PRELL. Monday is fine.

MR. BOEHNE. Your testimony is when?

CHAIRMAN GREENSPAN. [February] 20th and 21st, I believe. The next meeting is March 26th.

END OF MEETING